



# Budget Commentary\* • Singapore • 17 February 2006

## The Listening Budget

It has been suggested in certain quarters that drafting up Budget wishlists is a futile exercise, although one that causes only slight inconvenience, involving, as it does, little more than dusting down last year's and changing the date.

However, wishlist cynics will have been stopped in their tracks by this year's Budget Speech, delivered by Finance Minister Lee Hsien Loong on 17 February 2006. They will be faced with the prospect of a clean sheet of paper for next year's attempt and the daunting task of guessing what could possibly be left to fix on the fiscal front.

Changes in the area of wealth management and intellectual property were in direct response to industry suggestions, and the Maritime incentives a reaction to new and exciting ideas from abroad. Measures taken to help the country's low income workers largely involved acceptance of recommendations by the Ministerial Committee set up for that purpose. The rest, as is customary now, was a tidying up exercise, but one that somehow seemed more focussed, due mainly to a more consultative approach on the Government's part.

It was no surprise however that corporate tax rates stayed where they were: they are already among the lowest in the world; and personal tax rates needed to settle in behind them.

In all it was a listening Budget. Not all got handouts, agreed. And nobody will suggest that all the measures got all the way. But it was a Budget that must surely have been well-received, if for no reason other than its sheer responsiveness.

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Singapore

17 February 2006

## Contents

<b>No changes to tax rates</b>	<b>4</b>
<b>Enhancing Singapore's status as a Global Financial Centre</b>	<b>4</b>
Giving the wealth management industry a boost	4
Designated Unit Trusts	4
Qualifying domestic trusts	4
Qualifying foreign trusts	4
Onshoring offshore income	5
<b>Promoting capital markets and treasury activities</b>	<b>5</b>
Real Estate Investment Trusts	5
Qualifying Debt Securities	5
Finance and Treasury Centres	6
Over-the-counter derivatives clearing facilities	6
Islamic finance	6
Tax exemption for captive insurance companies	8
<b>Supporting Singapore's dynamic shipping and logistics industries</b>	<b>8</b>
Maritime Finance incentive	8
Approved International Shipping incentive	8
Global Trader Programme	9
<b>Measures to promote a knowledge-based economy</b>	<b>9</b>
Research & development activities funding	9
Intellectual property rights	9
Research & development cost-sharing payments	9
Creators of industrial designs and digital media	10
Issues for further consideration	10
<b>Other corporate tax changes</b>	<b>10</b>
Foreign-sourced income exemption	10
Approved holding companies	10
Transfer pricing guidelines	10
Share-based compensation payments	11
Industrial building allowances	11
Limited Liability Partnerships	11
<b>Goods and Services Tax</b>	<b>11</b>
Zero-rating of tools	12
Zero-GST warehouses	12
General insurance	12
Real Estate Investment Trusts	12
Islamic finance	12
Other matters – in retrospect	13
<b>Shortening the record-keeping period</b>	<b>13</b>
<b>2005 in retrospect</b>	<b>13</b>
Tax cases	13
Income tax implications from the adoption of Financial Reporting Standard 39	14
Advance ruling system	14
2005 in snapshot	15
<b>PricewaterhouseCoopers thought leadership</b>	<b>19</b>
Promoting research & development and intellectual property management in Singapore	20
The need for transfer pricing regulations in Singapore	21
A lighter look at the dark side	23
Where is GST heading?	24
<b>Appendices</b>	<b>26</b>
A. Comparison of Asia-Pacific effective tax rates on repatriated corporate profits	26
B. Comparison of Asia-Pacific individual tax liabilities	27
C. Resident individual tax rates	28





## No changes to tax rates

The reduced personal tax rates for the year of assessment 2007 had already been announced by the Finance Minister last year and there are no surprise changes to that.

On the corporate tax front, and as mentioned by the Finance Minister, Singapore's headline corporate tax rate of 20% is already among the lowest in the region. Our effective tax rates are even lower, taking into account the partial exemption scheme, as well as various incentives on offer. Hence, there is really no need to reduce the corporate tax rate further, which is something we had expected.

Propelled by a recent spate of lively debates on the survival of estate duty, the Ministry of Finance is reviewing the estate duty concept, and expects to reach a conclusion by the next Budget. For now, there are no changes.

## Enhancing Singapore's status as a Global Financial Centre

### Giving the wealth management industry a boost

#### Designated Unit Trusts (DUTs)

The DUT scheme, which was introduced in 1995, has been instrumental in developing Singapore's investment funds market from virtually nothing to the thriving \$1 trillion industry it is today.

The basic concept is that certain specified income and gains are not taxed at the trust level; and in essence, only Singapore companies are taxed on any distributions.

One area of contention was the basic qualification for the status. After a deal of controversy over the original criteria, a circular issued by the Monetary Authority of Singapore (MAS) in November 2003 specified that the trust has to be "a collective investment scheme constituted under section 286 of the Securities and Futures Act (SFA)", and had to be "opened to the public for subscription" in order to qualify as a DUT.

However, through developments in the market and a desire for a limitation on the volume of issue documentation and procedures, schemes targeting "sophisticated" investors began to evolve. Such schemes were given life under section 305 of the SFA, not section 286, and thus did not qualify for DUT status, despite technically being "opened to the public for subscription".

The changes announced appear to regulate this anomaly, and as a result enhance the flexibility of the investment fund market as well as its product offerings, by allowing section 305 schemes to now qualify for the status.

#### Qualifying domestic trusts

Currently, individuals resident in Singapore are exempt from tax in respect of foreign-sourced income and virtually all forms of Singapore-sourced investment income. However, where such income is received by the trustee of a Singapore trust, the Inland Revenue Authority of Singapore's (IRAS) view is that the income is effectively converted to taxable income on its way through. Given that the income would have been exempt in the absence of the trust arrangement, a new qualifying domestic trust concept has been introduced in order to regulate the anomaly.

To qualify, the settlor of the trust must be an individual, and the beneficiaries either individuals or charities. While it is not clear that the IRAS view of the current treatment is correct, this new move at least removes the uncertainty, and represents another step in tidying up tax issues facing the wealth management industry.

#### Qualifying foreign trusts

Currently, foreign trusts are protected from Singapore tax if their funds are administered – which effectively means managed – by a trustee company in Singapore. A trust will only qualify for this protection however, where neither the settlor nor beneficiaries are citizens of or resident in Singapore, or they are foreign companies as defined in the legislation.

A "trustee company" is one that is either licensed as a trust company under the Trust Companies Act, or is the Singapore branch of a company incorporated outside Singapore which provides services as a trustee or custodian.

The additional benefit of this status is that the trustee company in Singapore can qualify to be taxed at only 10% on fee income earned from the trust in relation to the administration and management services provided.

The enhancements announced in the Budget Speech propose three things. The first is to expand the scope of the qualification criteria by including a wider range of qualifying settlors and beneficiaries, although details of just who are not available. The second is to extend the protection of the fund to situations where it is administered by a company that is exempt from the requirement to hold a trust business licence, under the Trust Companies Act. The third enhancement is to extend the 10% concessionary rate to the fee income of such exempted entities, subject to certain qualifying criteria.

These changes effectively put the trust industry on a par with the fund management industry and represent a further step in the process of creating a dynamic wealth management environment in Singapore.

### Onshoring offshore income

Currently, foreign funds that meet certain criteria are protected from Singapore tax even if the discretionary management of the funds is carried out in Singapore. To qualify as a foreign investor under these rules, the fund must neither be tax resident in Singapore nor have more than 20% of its share capital (where it is a company) owned by Singapore residents or citizens, either directly or indirectly. This is known as the 80:20 rule.

A typical fund structure thus has to involve a fund that is set up and maintained outside of Singapore. This is clearly less than ideal since it puts a drag on an otherwise irresistible move to Singapore by ancillary services supporting the fund management industry, such as processing, custodian services, legal, accounting and audit.

In order to reduce the drag, the Finance Minister has, in response to industry lobbying proposed that the protection for funds be extended to funds which are set up in Singapore as companies. Unfortunately, the inference is that the 80:20 rule will remain, as there is still a need for the company to be "substantially owned by foreigners". This last piece is disappointing as it still means that an arbitrary rule exists, compliance with which is outside the control of existing shareholders or managers, and could be broken one day, met the next.

It is not clear as a result, whether this will encourage the funds to come onshore where the issue will be much more open to scrutiny and control.

### Promoting capital markets and treasury activities

#### Real Estate Investment Trusts (REITs)

With the growing popularity of REITs as an asset class, Singapore has stepped up the pace in the race to be the leading real estate financial hub in Asia (outside Japan).

The Budget proposal expands the scope of tax exemption for REITs to include foreign-sourced interest and distributions by foreign trusts paid out of income or gains related to the ownership of foreign properties, subject to the REITs satisfying certain qualifying conditions. This is in recognition of the fact that REITs may hold property-related assets that yield income in a form other than dividends, e.g. property-backed securities that generate interest income. At the same time, the broadening of the scope of exemption relating to foreign properties is timely, given the inherent

limitations and size of the domestic market and the booming economy in many parts of Asia including China and India. The latest measure will seek to put Singapore on a par with Hong Kong in terms of attractiveness of the fiscal regime for listing REITs with foreign properties.

Unfortunately, the operation of section 13(12) of the Income Tax Act (ITA) in the context of the new concession remains a Ministerial discretion. As yet, the qualifying conditions have not been announced. Consistent with the case now for dividend income exemption under this sub-section (for REITs holding foreign properties in a multi-tier Special Purpose Company (SPC) structure), it may be that foreign tax needs to have been paid in relation to the underlying income before a similar tax exemption is available. Finally, it remains to be seen if Singapore will, at some point in time, consider granting certainty for REITs on the treatment of gains on the disposal of real properties or property-related assets by legislating the circumstances under which such gains are considered capital (and hence not taxable) in nature.

### Qualifying Debt Securities (QDS)

The QDS scheme is a familiar tax incentive in the local debt capital markets, having been around since 1998. Over the years, various enhancements have been made to extend the validity of the scheme and increase its attractiveness to issuers wanting to tap into Singapore's debt capital market.

In the 2004 Budget, the QDS scheme was extended to cover discount income in relation to debt securities with tenures of 1 year or less. This left a gap in the market since it effectively meant that discount on debt securities with maturities of greater than 1 year did not fall under the QDS regime, even though the debt issues themselves qualified under the definition of a QDS. This year, the Finance Minister proposed that the QDS regime be extended to cover discount on debt securities with a tenure of more than 1 year. This enhancement will be available to long-term discounted debt securities issued from 17 February 2006 to 31 December 2008, being the statutory expiry date of the QDS scheme.

From an economic perspective, a discount is equivalent to interest and since there is no restriction placed on interest derived on long-term debt from qualifying under the QDS scheme, it was rather puzzling why the 2004 Budget did not go all the way to extend the QDS coverage to discount from debt instruments of all tenures. The resulting "inconvenience" to debt arrangers who have had to structure debt issues to avoid this pitfall, and the inflexibility caused in the pricing of debt instruments, have led to major lobbying efforts to the Government to extend the coverage of the QDS scheme to long-term discounted debt.

While this is a useful step, consideration should also be given by the Government to extending the lifespan of the QDS regime beyond the current 31 December 2008, in order that its latest enhancement to the QDS incentive will achieve the desired effect of encouraging the development of Singapore's debt capital market.

### Finance and Treasury Centres (FTCs)

Companies enjoying the FTC incentive were handed out more goodies by the Finance Minister this year. Last year, FTCs welcomed the inclusion of Singapore dollar denominated transactions within the definition of qualifying treasury services and trading activities, as well as the ability to include local related companies as approved network companies. This had the effect of enhancing the scope of incentivised activities and services they could offer.

In this year's Budget, the Finance Minister announced an extension of the FTC incentive to cover the arrangement of, and transactions in, derivatives, subject to a restriction on counter-parties. While details of the enhancement are yet to be announced, we believe that the changes could be targeted at two areas.

Firstly, the scope of the qualifying derivative products covered under the FTC incentive could be expanded to include financial derivatives such as total return swaps, credit default swaps or interest rate options, caps and collars traded over-the-counter. This would provide the impetus for an FTC to engage in a wider variety of instruments for its treasury management, hedging or trading needs.

Secondly, the FTC scope could be extended to cover treasury centres arranging derivatives transactions between their associated companies. Currently, the incentive only provides the concessionary tax rate where the FTC arranges interest rate and currency swap transactions between network companies or with specified parties such as banks and non-residents. Also, the FTC could only engage in derivatives transactions with specified counter-parties but not with its network companies. The extension of the incentive to include derivative transactions with network companies and with other FTCs in Singapore will boost the effectiveness of treasury operations in Singapore.

### Over-the-counter (OTC) derivatives clearing facilities

A new incentive will be introduced to promote OTC derivatives clearing activities. Approved clearing members of a Singapore OTC derivatives clearing facility will be given a 5% concessionary tax rate for a period of 5 years. The qualifying period for the incentive is from 17 February 2006 to 16 February 2011.

This new tax incentive is targeted at enhancing Singapore's position as a major oil-trading, ship-broking and financial hub and ties in with recent moves by the Government to expand Singapore's financial markets and pursue strategies to develop the financial infrastructure supporting international trading. The presence of well-established clearing facilities will encourage more global players to enter Singapore's OTC derivatives markets to trade products. The incentive should attract market participants in the development of a clearing facility for OTC derivatives such as energy derivatives and forward freight agreements, which is a key linchpin in this strategy.

### Islamic finance

"Islamic finance" has been the new buzzword in the financial services sector in recent times. This is not surprising given that demand for products complying with the *Shari'ah* (teachings of Islam) principles is growing at a tremendous rate, with the global asset size for Islamic finance estimated at between US\$200 billion and US\$400 billion, with an annual growth rate of 15%.

The Government has recognised the need for tax law changes in order not to impede the growth of this area of financial services. In the last Budget, measures were introduced to remove the double imposition of stamp duty for Islamic transactions which involve real estate, and to align the tax treatment of payouts from Islamic bonds with that of conventional financial instruments for the purposes of the QDS incentive.

This year, the Finance Minister has taken another step to harmonise the tax treatment of 4 *Shari'ah*-compliant financial products with that of their conventional counterparts. Specific tax rules will be prescribed for products structured under the Islamic concepts of *Murabaha*, *Mudarabah*, *Ijara wa-igtina* and *Sukuk* so that these products would be as attractive to investors as conventional financing contracts. A summary of the proposed tax changes in relation to the 4 Islamic concepts is provided in the table.

Generally, the Government will introduce tax rules to re-characterise the profits derived or payouts made on the Islamic products as essentially, interest income or interest expenses. This would then make it easy to apply the current tax rules on the Islamic transaction, e.g. granting QDS treatment to a *Sukuk* issue. While the rationale for the policy changes is understandable, further consideration should be given to ensuring that the prescriptive tax rules do not give rise to further tax complications. For instance, where a profit on a *Murabaha* transaction involving trading stocks is paid

by a Singapore buyer to an overseas Islamic bank, the re-characterisation to interest income would raise the question as to whether the Singapore buyer should be withholding tax on the profit of the overseas Islamic bank. Under current tax rules, such a purchase and sale of trading stocks does not fall within Singapore's withholding tax regime. This could change dramatically when the re-characterisation rules are introduced. The potential interaction of the proposed re-characterisation rules with Singapore's double tax agreements should also be thought through.

Table: Summary of the proposed tax changes in relation to the 4 Islamic concepts

	Basic structure	Proposed tax treatment
<i>Murabaha</i> concept	This is typically used in trade financing arrangements and involves the Islamic financial institution purchasing goods from a supplier and then on-selling those goods to its customer at an agreed mark-up. The customer may pay for the goods immediately or (more usually) at a later point in time. Therefore, the difference between the purchase cost to the Islamic financier and the sale price to its client will form its profit from the transaction.	Income tax – any gains or profits accrued and any expenses incurred, in lieu of interest, will be regarded as interest.  Goods and Services Tax (GST) – if the loan is used for the purchase of non-residential property, any mark-up on the selling price by the bank to the buyer will be exempt from GST and the bank will be allowed to claim GST on the purchase of the non-residential property from the vendor in full. (See further comments in “GST”.)
<i>Mudarabah</i> concept	This is similar to a fund management structure. It involves a contract between the beneficial owner of funds, who wishes to invest his funds in a profitable way and a managing trustee who has the skills to use the funds in an agreed manner for defined purposes. The managing trustee (the <i>mudharib</i> ) is to utilise the funds in the agreed manner and then return to the investor (the <i>rabb al-mal</i> ) the principal and the agreed share of the profit.	Income tax – any profits payable to a customer, in lieu of interest, by a qualifying financial institution will be regarded as interest.
<i>Ijara wa-igtina</i> concept	This is a variation of the Islamic leasing contract which involves structuring the hiring of an asset such that, at the end of the financing period, the customer purchases the leased asset. This may be an arrangement whereby the customer makes payments into an Islamic investment which will eventually lead to the customer taking over the asset from the financing institution. Profits (if any) accumulating in the investment account will be for the benefit of the customer.	Income tax – any gains or profits accrued and any expenses incurred, in lieu of interest, will be regarded as interest.  GST - if the loan is used for the purchase of non-residential property, any mark-up on the selling price by the bank to the buyer will be exempt from GST and the bank will be allowed to claim GST on the purchase of the non-residential property from the vendor in full. (See further comments in “GST”.)
<i>Sukuk</i> concept	Generally, <i>Sukuk</i> refers to an Islamic investment certificate typically backed by the cashflows of an asset.	Stamp duty – stamp duty on instruments related to the transfer of immovable properties that is in excess of that chargeable in the case of an equivalent conventional bond issue, may be remitted, subject to conditions.

## Tax exemption for captive insurance companies

Captive insurers are essentially insurance companies set up to underwrite the risks of their related companies. Captive insurance is a form of self-insurance involving the insurance of risks internally within a group of companies.

While the use of captive structures may generate tax benefits to a group of companies, their use is typically part of an overall risk management programme.

Currently, captive insurance companies in Singapore are eligible for a 10% concessionary tax rate on income arising from their offshore business and certain offshore income used to support this offshore business. Unfortunately, a 10% tax rate is not attractive when rated against other key captive locations in the world such as Bermuda, Guernsey, British Virgin Islands, Vermont, Cayman Islands, etc., that do not levy tax on captive businesses.

The proposed tax exemption for captive insurers is a positive step in the right direction. It will no doubt enhance Singapore as a captive location. In the near term, we are likely to see increased interest from Australian-based multinational companies (MNCs) in setting up captives in Singapore. In the longer term, we may yet see Singapore develop into the captive location of choice for MNCs in Asia.

The proposed tax exemption is structured as an incentive that is available for 10 years upon approval. We look forward to more details on the qualifying criteria for the incentive (likely to be minimal) and whether (and if so, how) existing captives could qualify for the incentive.

## Supporting Singapore's dynamic shipping and logistics industries

### Maritime Finance incentive (MFI)

A new financial concept in Singapore, the shipping fund has been made popular more recently in Korea and Germany, primarily due to the favourable tax regimes in these countries and the potentially higher investment returns. It is likely that future shipping funds launched in Singapore will be modelled on the Korean and German predecessors.

The MFI is the result of the collective effort of the Maritime and Port Authority (MPA) of Singapore and the MAS in promoting Singapore as the premier maritime and financial hub.

Under the MFI scheme, it is proposed that:

### **(a) Qualifying income of the ship investment vehicle (SIV) (which can be a ship leasing company, a shipping fund or a shipping trust) will be exempt from tax.**

It remains to be seen what will be included in the qualifying income. As the shipping fund may be structured in a variety of ways, it is critical for the definition of qualifying income to be broad enough to cover all possible structures. For instance, it is common for a special purpose vehicle (SPV) to be set up to hold each individual ship. However, it is not clear if the SPV would be regarded as an SIV since it is not the main investment vehicle. The definition of the qualifying income should therefore be broad enough to cover also income received by the SPV – particularly if it is to be a Singapore entity.

It is also not clear whether the qualifying income would include gains arising from the sale of ships. It is important that rules be laid down for this as it could have a significant impact on overall returns of the funds.

### **(b) The qualifying fee income of the ship investment manager (which can be a fund manager company or a trustee manager) will be taxed at a concessionary 10% tax rate.**

Under current law, the income of the manager would not qualify for a reduced tax rate, even if he were classified as a "fund manager" since the SIV would be in Singapore, thus it would not be a foreign investor. In addition, ships are not designated investments for the purpose of the incentive. It is somewhat disappointing to see, however, that this fee income was not given exemption under the Pioneer Service incentive. This would have put the whole concept on a par with the venture capital fund incentive and given added significance to the package overall.

However, for the proposed MFI to be successful as a competitive force against the more mature markets of Korea and Germany, there are a number of issues which subsequent clarifications should address. Nevertheless, given that the income of the SIV is tax exempt, this is probably already better than the German tonnage tax system, where some tax would still be incurred. It is certainly one step closer towards establishing Singapore as a shipping finance hub.

### Approved International Shipping (AIS) incentive

Given the Government's determination in maintaining Singapore's status as a global shipping hub, particularly in the face of unprecedented competition from Malaysia, Hong Kong and more recently Dubai, it

was not surprising that Budget 2006 included some more sweeteners for the shipping industry.

Currently, the AIS scheme, which confers exemption for shipping profits in tranches of up to 10 years, allows only one renewal of the status. This makes a maximum incentive period of only 20 years.

The Government has decided that, with effect from 2007, qualifying shipping companies may apply for a third AIS incentive period of 10 years. As a result, the maximum period of the AIS incentive is now increased from 20 years to 30 years. For AIS enterprises whose incentive period is nearing the pre-existing maximum tenure, this move may provide a compelling reason for them to continue to use Singapore as a base. It may also encourage them to expand their business operations from this base.

## Global Trader Programme (GTP)

Currently, trading companies awarded the GTP tax incentive will pay a concessionary tax rate of either 5% or 10% on their qualifying income.

In the course of their trading, GTP traders often engage in derivative transactions to hedge their physical trades. To qualify for the concessionary tax rate on their derivative trades, the GTP traders have to show that the paper trades are in connection with, and incidental to the physical trades. However, it may be difficult to prove this nexus given the complex trading environment of today's markets. This problem may be exacerbated where GTP traders engage in both qualifying and non-qualifying transactions.

The Finance Minister's proposal to treat paper trades as qualifying under the GTP scheme without the need to demonstrate the connection to an actual physical trade would greatly relieve the compliance and documentation requirements of the GTP traders.

However, it is not clear whether this relaxation will cover all derivative trades of GTP traders, including those which can be linked directly to a non-qualifying transaction.

## Measures to promote a knowledge-based economy

The Finance Minister announced a number of reform measures designed to enhance Singapore's already attractive fiscal environment for research and development (R&D) and knowledge-based activities.

## Research & development activities funding

Determined to make Singapore an R&D hub of global stature, the Finance Minister has announced the establishment of an R&D fund, into which \$5 billion will be injected over the next 5 years. This, coupled with the funds allocated for the Ministry of Trade and Industry's Science & Technology Plan 2010 and the Ministry of Education's academic research plans, takes the Government's entire outlay on R&D to \$13.55 billion over the next 5 years. The goal is to boost the proportion of R&D expenditure to Gross Domestic Product from 2.3% in 2004 to 3% by 2010, with significant contributions also expected from the private sector.

## Intellectual property rights (IPRs)

Currently, under section 19B of the ITA, capital expenditure incurred to acquire specified IPRs can be amortised for tax purposes on a straight-line basis over 5 years. However, there is a requirement for the acquirer to secure both legal and economic ownership of the IPRs.

Recognising the importance of economic ownership of IPRs, the Finance Minister has proposed extending writing-down allowances (WDAs) for IPRs where economic, but not legal, ownership is transferred. However, specific approval will be required for this benefit. This is a deviation from the otherwise automatic basis for claiming WDA for IPRs under section 19B of the ITA. Typically, economic, but not legal, ownership would be transferred when, for example, territory rights are carved out of the principal IPRs.

This concession should encourage MNCs to transfer the economic ownership of their valuable IPRs to a Singapore entity, without losing control over legal ownership.

## Research & development cost-sharing payments

Section 19C of the ITA presently allows amortisation for expenditure incurred under an approved R&D cost-sharing agreement over 5 years (or over a shorter period as may be approved).

As a measure to encourage R&D collaboration, the Finance Minister has proposed an acceleration of the writing-down period to one year.

Interestingly, approval will still be required for claiming the accelerated WDA.

## Creators of industrial designs and digital media

Currently, royalties earned by individual knowledge creators such as inventors, authors and proprietors of approved inventions / innovations are taxed at the lower of 10% of gross receipts or net royalty income.

It is proposed that the above concession be extended to royalties earned by individuals engaged in creating industrial designs, as well as interactive and digital media. In effect, at least 90% of such gross receipts will qualify for tax exemption.

## Issues for further consideration

While the above tax reform measures are welcomed, the Government may wish to consider other tax reforms in order to boost R&D and intellectual property management activities in Singapore. See “Promoting R&D and IP Management in Singapore” later in this Commentary, highlighting some of these additional issues.

## Other corporate tax changes

### Foreign-sourced income exemption (FSIE)

The FSIE was introduced in 2003 as a means of reducing the administrative burden of the foreign tax credit system it replaces, and encouraging the tax-free repatriation of funds to Singapore.

Unfortunately, the system has created more issues than it has solved and has not been generally well-received. There are a number of areas where the exemption may not be available. One area of concern is access to information which proves that the exemption criteria have been met. Another is proving, particularly, in the case of service fee income, that it was sourced outside Singapore.

It is not clear what, precisely, the Finance Minister had in mind when he announced changes for companies who have “found themselves to be unable to meet the qualifying rules for this tax exemption”. However, it may involve some of the situations described above, among others. The concession proposed by the Finance Minister is to grant exemption for foreign income that is disqualified from the FSIE regime if it is remitted under specific scenarios or circumstances. This does little to inspire confidence that this simplified system is going to get any simpler.

Details are to be released by the IRAS in due course.

## Approved holding companies

One of the features which detracts significantly from Singapore establishing herself as the regional capital for holding companies is the uncertainty over the treatment of gains on the disposal of subsidiaries and other investments.

In an attempt to bring certainty to this equation, and allow MNCs to establish their holding base here with confidence, the Finance Minister proposed that gains on the disposal of shares in companies held by approved holding companies will be exempt from tax provided the shares are 50% or more owned, and have been held for more than 18 months.

This raises a few questions. It is not clear what is meant by an approved holding company and whether it means simply approved for this purpose or for some other purposes (such as one of the headquarters incentives). It is also not clear whether shares held for less than 18 months would automatically be taxable. However it is to be presumed (or hoped) not.

The move does not necessarily answer all prayers, yet it is a step in the right direction and one that demonstrates the Government’s willingness to listen to market feedback. The scheme will be administered by the Economic Development Board, from whom details can be obtained in due course.

## Transfer pricing guidelines

Although in spirit, the IRAS adopts the Organisation for Economic Co-operation and Development’s approach to transfer pricing, there is currently little in the way of statutory or extra-statutory guidance as to how these guidelines are applied in practice. See “The Need for Transfer Pricing Regulations in Singapore” later in this Commentary.

Although guidelines are yet to be released, the IRAS has been assigned the task of providing taxpayers with guidance on applying arm’s length principles by the Finance Minister. Perhaps the most interesting statement in the Budget Speech was that they must also provide taxpayers “assistance in resolving disputes with foreign tax authorities on transfer pricing issues”. Given that, because of Singapore’s relatively low tax rates, there is likely to be transfer pricing into Singapore rather than out, the statement seems to suggest the IRAS is prepared to go in to bat against more aggressive tax authorities in an attempt to defend their revenue base.

It is hard to see how the guidelines can be that complex, although details will be announced shortly by the IRAS.

## Share-based compensation payments

Currently, the IRAS' view is that traditional grants of share options, and their subsequent exercise by employees, do not represent an actual cost or outgoing to the company. Accordingly, tax deductions are not available for any expenses charged to the income statement. This is particularly aggravating under new accounting rules which require options to be valued and expensed, and fails to recognise the symmetry that there should be between taxation of the individual, and the provider of the benefit.

Under changes announced in the Budget Speech, tax deductions will now be granted to companies where they have effectively gone into the market and purchased their own shares (known as treasury shares) to be awarded to the employees under the scheme. Presumably because this does represent an outgoing to the company (albeit not generally one that is charged to the income statement), it is felt justified to allow a deduction. Before changes to the Companies Act which came into effect in January 2006, this course of action was not permissible locally.

It is not clear whether this new treatment will encourage companies to use a treasury share approach as the preferred method of implementation, but it is worth considering if it means the difference between a deduction and not. It is also not clear whether the costs recharged by a parent company to the employing company where the parent issues the shares would also be covered if there was no actual cost at the parent company level.

## Industrial building allowances (IBAs)

IBAs are intended to generate industrial activities by permitting a taxpayer to charge against the income from his trade or business, capital expenditure incurred over a period of time on the construction of an industrial building or structure as defined in section 18(1) of the ITA.

The following changes, effective for purchases on or after 1 January 2006 have been proposed by the Finance Minister:

**(a) To allow initial allowances and annual allowances to purchasers of new buildings with a leasehold interest of less than 25 years.**

This change brings flexibility and removes the distinction between properties of different tenure.

**(b) Eligibility of annual allowances to be based on current use of building as a qualifying industrial building.**

No annual allowances are presently allowed if the building was previously not used as an industrial

building, whereas if it was previously used as an industrial building, annual allowances are available. This is not logical since it should only be relevant what the current use of the building is. The new change addresses this imbalance.

**(c) To compute annual allowances and initial allowances on purchased buildings (both new and used) based on the purchase price, without reference to the cost of construction.**

Under the current system, the IBA amount claimable by a taxpayer acquiring an industrial building is the lower of the original cost of construction or the net purchase price. The Budget proposal dispenses with this restriction and now allows the new owner to claim by reference to what he paid for the building, even if this is more than the original construction cost. It is not clear however what the annual allowance rate will be in this case, although if the intention is to bring the regime in line with that applying to plant and machinery, then it will be 3% until such time as the cost expires.

**(d) To remove the 50-year restriction on annual allowance claims.**

Currently, no annual allowances can be claimed after the end of the 50th year from the date of first use of the building. However, if the aim of the changes is to align the treatment of industrial buildings with that of plant and machinery, then the removal of the 50-year limit is in conformity with that objective.

## Limited Liability Partnerships (LLPs)

Since LLPs were introduced in early 2005, more than 1,000 LLPs have been formed. Currently, it is unclear whether LLPs qualify for tax incentives as they are look-through entities. However, as the intention is to award tax incentives by reference to whether the business brings in new activities or creates new value for Singapore, the Finance Minister has announced that tax incentives will be awarded to partnerships on a scheme-by-scheme basis, and broader-based implementation will be considered after further study.

## Goods and Services Tax (GST)

It looks like the GST has come of age with various references and a surprising variety of GST changes which featured in virtually all the growth sectors that were mentioned in the Budget Speech.

Below is a summary of some of the changes that were announced by the Finance Minister.

## Zero-rating of tools

It is quite common for a contract manufacturer to design a tooling (mould) that enables the bulk production of components for an overseas customer. Currently, the GST legislation requires the supply of the tooling to be standard-rated at the rate of 5% where the tooling is not exported. This would put contract manufacturers at a competitive disadvantage if they had to absorb the GST that the overseas customer would not want to pay.

To put contract manufacturers on a competitive footing, the Finance Minister announced that the supply of tools used in the manufacture of goods for export will be zero-rated. This will take effect from 1 April 2006.

## Zero-GST warehouses

Under the Zero-GST Warehouse scheme, which came into effect on 1 January 2006, qualifying companies are able to import goods into a zero-GST warehouse free of GST. Similarly, GST is suspended when the goods are transferred from one zero-GST warehouse to another. GST is only payable when the goods are removed from the zero-GST warehouse to the local market.

To strengthen Singapore's status as a regional logistics and distribution hub, there will be an automatic approval from 1 July 2006 for the suspension of GST for goods that are removed from a zero-GST warehouse by all persons registered under the Major Exporter Scheme or the Approved Third Party Logistics Company (3PL) scheme.

## General insurance

Premiums paid in respect of a general (non-life) insurance contract are generally subject to GST, while the indemnity payments are not (although there is existing legislation that could subject the indemnity payment to GST in the hands of a taxable person).

To reduce business costs, the Finance Minister announced that general insurers can claim GST based on the tax fraction (5/105) of the cash indemnity paid to non-GST registered policyholders under contracts that are subject to GST. Further, the insurers can claim GST on expenses incurred on policyholders' passenger cars (e.g. workshop repairs) which would be welcomed by insurers with a large motor car insurance business as they are currently unable to claim input tax for such expenses. However, insurers will have to wait until 1 January 2007 for the changes to take effect.

The above changes will no doubt reduce the costs of general insurers, particularly for those insurers who write significant personal lines businesses. One challenge the insurers will face is in the identification of

"non-GST registered policyholders". These will typically be individuals taking up policies for personal risks (e.g. motor, personal accident, travel, fire, household) as opposed to business risks. Having an effective start date of 1 January 2007 will give insurers time to plan for this information.

What does this mean to you? Well, the next time you renew your general insurance policy, you may be asked if you are GST-registered. And who knows, with luck, insurance rates may come down in 2007!

## Real Estate Investment Trusts

As part of the tax measures to develop Singapore as a choice listing location for REITs, the Finance Minister announced that GST incurred on the setting up of SPVs and on the acquisition and holding of overseas non-residential properties by the SPV will now be recoverable.

While the measure sounds sensible, it may have limited benefits if the expenses to structure and set up the SPV are mainly offshore expenses on which GST is not applicable. Also, the change is only effective for GST incurred for a 4-year period from 17 February 2006 to 17 February 2010. It is not clear as to why it is necessary to have a 4-year restriction on input tax claims. This is unusual under a GST system.

## Islamic finance

GST is not forgotten in the Government's attempt to align the tax treatment of Islamic financing contracts with the treatment of conventional financing arrangements.

In addition to the income tax changes which are discussed elsewhere in our Commentary, the Finance Minister announced that for a loan used for the purchase of non-residential property under a *Murabaha* or an *Ijara wa-igtina* contract, any mark-up on the selling price of the non-residential property will be exempt from GST (akin to the GST exempt treatment of interest income). Further, the bank will be allowed to claim full GST on the purchase of the non-residential property from the vendor. Subject to further details, the latter change will presumably mean that the GST is not subject to the input tax restriction that is normally applied to banks. Under such arrangements, the bank will purchase the property and then on-sell at a mark-up, with deferred payment terms, thus replicating a repayment mortgage arrangement. The ability to reclaim in full presumably again replicates a conventional transaction under which the bank would not purchase the property - and thus not incur any GST costs.

## Other matters – in retrospect

While most businesses look out for tax changes in the annual Budget Speech, it is important for businesses to be aware of “off-Budget” changes that may be announced through amending legislation during the year or through circulars issued by the IRAS. As can be seen from the table highlighting the various tax changes under “2005 in snapshot”, the past year also saw various legislative changes and circulars issued by the IRAS in relation to GST.

While most of these relate to refinements of the GST law and IRAS interpretations, one interesting legislative change now makes a customer (debtor) repay his input tax if he fails to pay the vendor the full consideration, or any part thereof within 12 months from the date of supply or due date of payment, whichever is later. Failure to do so is tantamount to an under-declaration of tax which is subject to penalties. This could be a good reason for you (and us) to remind your (and our) debtors to pay their bills on time!

## Shortening the record-keeping period

To lighten the burden on businesses, the Finance Minister announced that the record-keeping period in 17 statutes will generally be reduced to five years. The statutes affected include the ITA, the Companies Act, the LLPs Act, the GST Act, the Customs Act and the Charities Act. Full details of the 17 statutes can be found in Annex C of the Budget Statement. It is expected that in the case of the ITA and the GST Act, there will have to be a corresponding reduction in the timeframe for raising assessments. The move would be an interesting precursor to the implementation of a self-assessment system on the income tax side, however.

## 2005 in retrospect

### Tax cases

2005 saw some interesting tax cases, in particular three cases that focussed on the deductibility of interest and borrowing costs. It was perhaps expected that the High Court in *T Ltd v Comptroller of Income Tax (CIT)* would find that interest costs incurred by a property letting business prior to the granting of a temporary occupation permit (TOP) were not deductible. This is because the Court determined they were incurred prior to the commencement of business.

The Court's comments of wider impact were those dealing with the link between interest deductibility and the purpose of the loan. The Court's view was that

interest should be deductible even if the purpose of the loan was to fund the acquisition of a capital asset, provided the asset was used to generate income that was chargeable to tax.

It is not unreasonable that interest costs should be deductible where the purpose of the borrowing is to acquire fixed assets for use in a business, particularly as there is a specific section of the ITA that provides a deduction for interest. However, from the judgement in *IA v CIT*, it does appear that deductions in such cases do not extend to other funding costs. The High Court allowed the taxpayer deductions for borrowing costs, guarantee fees and early payment penalties. The judgement drew heavily from the fact that the purpose of the original syndicated loan was to acquire or construct trading stock, being the land and building of the taxpayer who was a property developer, and was therefore revenue in nature.

*IA v CIT* is an interesting case as it looks to the purpose of the borrowing rather than associating the borrowing costs and guarantee fees with the raising of the debt itself and therefore potentially tainting them as being capital in nature. This favourable outcome does have potential for downside, for example costs such as discount on facilities used to acquire fixed assets may not be deductible following the Court's line of reasoning.

The issue of interest allocation was covered in the case of *JD Ltd v CIT*. IRAS has long held the view that the ITA requires passive income to be looked at on a source-by-source basis to determine available deductions. The Court ruled that where an investment does not produce income, the interest on funds used to acquire it would not be deductible and there was no basis for deducting interest against another source of income. IRAS does allow some concessions in this area but the case confirms the problems facing taxpayers in obtaining full deductions for interest if they acquire passive assets.

Other cases that were of general interest included *ITBR Case (Appeal No. 8 of 2003)* which confirmed that the functional test is critical in determining the availability of capital allowances on fixtures in buildings. It also confirmed that the function of each individual asset must be considered rather than the fixtures as a whole. In *IB v CIT*, the Board ruled that profits arising out of a transaction which is not an activity in the ordinary course of a trade or business is still taxable under section 10(1)(g) of the ITA if the taxpayer entered into the transaction with the intention or purpose of making a profit from that transaction. This judgement does little to ease the uncertainty over whether a gain on the sale of investments is capital or revenue in nature.

Finally, in the case of *KE v CIT*, one of the conclusions reached by the Board was that income assessed under

section 10(1)(a) of the ITA is gross income rather than gross profits. Not an unexpected conclusion. However, the case does show the inadequacies of the ITA in dealing with trading stock and appears to demonstrate that the Courts can allow IRAS practices to override the strict wording of the law.

## Income tax implications from the adoption of Financial Reporting Standard (FRS) 39

FRS 39 imposes significant changes in the accounting treatment of financial instruments. On 30 December 2005, IRAS published a circular laying out its response to the tax problems posed by the introduction of FRS 39.

The current tax treatment of financial assets and liabilities was well-established. Only realised gains or losses on the disposal of financial assets were subject to tax or allowed as a deduction and then only where such gains or losses were on revenue account. There are concessions for writing down assets to the lower of cost and market value and for banks and other entities in the finance industry allowing them to follow the accounting treatment for financial derivatives in certain circumstances. Interest on financial liabilities is deductible based on the contract rate.

FRS 39 significantly changes the recognition and measurement of financial instruments in an entity's financial statements. FRS 39 accounting makes it difficult for entities to identify the tax adjustments that would be required to comply with the current tax treatment. The circular is therefore quite pragmatic in its approach to the problem. It largely allows taxpayers to follow the accounting treatment for income statement gains and losses on financial assets that are held on revenue account and most financial liabilities. There will be some adjustments for items such as non-interest bearing and non-arm's length loans but mostly it is good news, for example, a tax deduction will be allowed if there is an impairment of financial assets held on revenue account. The tax rules will also follow the accounting rules for hedging instruments where the underlying asset or liability is on revenue account.

There are problems with the circular, not the least of which is that it is prescribing tax rules that do not exist in the tax legislation. Other problems lie in the determination of assets held on capital account and liabilities that are deemed to constitute accretions to capital. Assets will only be held on capital account where a claim has been made to and agreed by the CIT. It is not yet clear how the clearance process will work in practice and it may be burdensome for taxpayers. There is also no clear guidance on what liabilities will be deemed to constitute accretions to capital and it will be an administrative burden to

recalculate interest on such liabilities to the contract rate of interest as required for tax purposes. There is also no clarity on how the capital/revenue distinction for FRS 39 purposes will interact with other tax positions such as the taxation of foreign exchange gains and losses or the forgiveness of debts.

It is good to see some transitional relief as well as the availability to elect to stay with the current system and opt in to the FRS 39 system in a future year. As noted above there will be a significant administrative burden in reworking FRS 39 data to satisfy the current tax requirements.

## Advance ruling system

In 2006, IRAS introduced an advance ruling system for taxpayers. We have moved from the previous somewhat ad-hoc system to a fully legislated advance ruling system that should provide greater clarity for taxpayers. An advance ruling is an interpretation of how tax law applies to a specific transaction undertaken by a specific taxpayer. A ruling is binding on the IRAS to apply the tax law as set out in the ruling. However, it only applies to the particular arrangement outlined in the ruling so care must be taken to ensure the actual transaction mirrors the facts provided to them.

An advance ruling is binding and not subject to appeal. However, the taxpayer can choose to ignore the ruling when preparing his tax return. The ruling is then likely to be reviewed in the course of assessment of the return. It is uncertain as to the weight the Courts will give to rulings if any appeals are on the specific issues that were covered.

Taxpayers will have to carefully consider whether they are comfortable with the rulings process. It is largely untested, the IRAS charges fees for reviewing ruling applications (including the recovery of any third party costs they incur, such as the use of external counsel) and adverse binding rulings cannot be appealed.

## 2005 in snapshot

As usual, 2005 saw various legislative changes being introduced and circulars being issued by the Inland Revenue Authority of Singapore (IRAS) and other administering agencies, with most of them being changes introduced in the 2005 Budget. Set out below are some of the highlights.

<b>January</b>	Section 10E Companies	The IRAS releases a circular detailing an administrative concession where non-owners of immovable properties that carry on a business of letting such properties are excluded from the ambit of Section 10E.
	Shipping Incentives	The Minister for Transport announces that from the year of assessment (YA) 2006, foreign exchange and derivative gains of Singapore-flagged ships and Approved International Shipping (AIS) Enterprises will automatically be treated as shipping-related hedging gains, which qualify for tax exemption.
	Goods and Services Tax (GST)	The IRAS issues a circular clarifying the interpretation and application of the phrases "directly in connection with" and "directly benefit" for the purpose of zero-rating the supply of international services.
<b>February</b>	Global Trader Programme (GTP)	The GTP incentive is enhanced to include physical or derivative trades denominated in Singapore dollars.
	Shipping Incentives	The AIS incentive is extended to include ship-leasing companies approved by the Maritime and Port Authority on or after 18 February 2005.
	Tax Incentives for Flagship Concept Projects and Approved Tourism Events	The Singapore Tourism Board releases an overview of the following incentives: <ol style="list-style-type: none"> <li>1. investment allowances for capital expenditure on approved flagship concept projects; and</li> <li>2. concessionary tax rate of 10% for income derived from organising or staging approved tourism events.</li> </ol>
	Real Estate Investment Trusts (REITs)	The Monetary Authority of Singapore (MAS) issues a circular with details on: <ol style="list-style-type: none"> <li>1. the lifting of certain conditions for granting tax transparency treatment;</li> <li>2. a stamp duty remission on instruments relating to the sale of immovable properties by individuals and companies into public listed / to-be-listed REITs; and</li> <li>3. a concessionary withholding tax rate of 10% on distributions made by such REITs to foreign non-individual investors.</li> </ol>
	Deductions for Donations	Double tax deduction for donations is extended to donations that carry naming rights. In addition, the scope of the computer donation scheme is expanded.
	Tax Relief for Contributions to the Central Provident Fund (CPF)	The CPF tax relief cap allowable to self-employed individuals is increased to 17 months of the CPF monthly salary ceiling prevailing for the year, with effect from YA 2006.
	Supplementary Retirement Scheme	The relevant income base for computing the contribution cap is revised to 17 months of the prevailing CPF monthly salary ceiling with effect from 1 January 2005. This is regardless of the source of income.
	GST	The Bonded Warehouse Scheme is liberalised by removing the requirement for at least 80% of the imported goods stored in the bonded warehouse to be destined for re-export.
	Amendment to Tax Legislation	The Stamp Duties (Amendment) Act 2005 is gazetted.

<b>March</b>	Start-up Fund Managers Incentive	The MAS issues a circular providing details of a new incentive which grants new fund managers a 12-month period to build up the foreign ownership of their funds under management to the 80% level to allow the funds to qualify for exemption, and their own income for 10% concessionary tax rate.
	Islamic Finance	The MAS publishes details of tax concessions for Islamic financing arrangements, namely the extension of the tax incentives under the Qualifying Debt Securities (QDS) scheme to include Islamic debt securities, and the extension of the tax exemption for Singapore-sourced investment income for individuals to include amounts payable from Islamic debt securities.
	Finance and Treasury Centre (FTC) Incentive	The MAS issues a circular detailing enhancements to the FTC incentive, including: <ol style="list-style-type: none"> <li>1. the extension of fees for approved qualifying activities and withholding tax exemption to include fees denominated in Singapore dollars; and</li> <li>2. allowing Singapore-based associated companies of the FTC to qualify as approved network companies.</li> </ol>
	GST	The IRAS issues a GST guide for charities and non-profit organisations.
	Stamp Duties	The IRAS issues a circular with details of the following stamp duty reliefs announced in the 2005 Budget: <ol style="list-style-type: none"> <li>1. the refund of stamp duty in excess of \$50 for all sale and purchase arrangements relating to immovable property rescinded on or after 18 February 2005; and</li> <li>2. the extension of stamp duty relief on documents relating to the transfer of immovable property and shares under certain circumstances to the transfer of financial institutions' mortgages with their customers.</li> </ol>
<b>April</b>	Securities Lending or Repurchase Activities Incentive	The MAS issues a circular detailing enhancements to the Securities Lending or Repurchase Activities Incentive, which is extended to companies registered with the MAS and to all securities other than unlisted Singapore shares, with effect from 18 February 2005.
<b>May</b>	Approved Commodity Derivatives Trading Incentive	The MAS issues a circular detailing enhancements to the existing scheme. Income derived from qualifying transactions in exchange-traded commodity derivatives now qualify for the 5% concessionary tax rate. The definition of commodity derivatives is also expanded to include income from forward freight agreements.
	Double Tax Agreements (DTAs)	Singapore signs DTAs with Israel (ratified in December) and the Slovak Republic.
<b>June</b>	Limited Liability Partnerships (LLPs)	The IRAS issues a supplementary circular to clarify the income tax treatment for LLPs in respect of unabsorbed capital allowances, industrial building allowances, losses and donations, the partial disposal of property, and the appointment of a manager.
	Advance Rulings	The IRAS issues a circular detailing the new Advance Ruling System which took effect from 1 January 2006.
	Carry-back Relief System	The IRAS releases details of the loss carry-back system.
	Approved Special Purpose Vehicle (ASPV)	The MAS issues a circular detailing the conditions under which the income of an ASPV engaged in asset securitisation transactions can be exempt from tax. It also deals with withholding tax exemption on payments made for over-the-counter financial derivatives connected to a securitisation transaction.
	GST	The IRAS issues a revised circular which includes additional conditions to be fulfilled in order to qualify for the administrative concession to disregard the secondment of staff among companies within a corporate group.
	DTAs	A protocol amending the existing DTA with India is signed following the signing of the Singapore-India Comprehensive Economic Co-operation Agreement.

<b>July</b>	Offshore Insurance Business	The MAS removes the requirement for insurance companies to apply for offshore insurance business tax concessions within 3 months of the commencement of writing offshore insurance business.
	Non-resident Banks	The IRAS grants an administrative concession to non-resident banks operating in Singapore making loans to a foreign borrower under "borrower bears tax" terms, allowing the banks to dispense with the requirement to regross the interest income on which foreign withholding tax is paid and apply the capping rules.
	Per Diem Allowances and Benefits-in-kind (BIK)	The IRAS releases an update on the tax treatment of per diem allowances and a list of acceptable per diem rates on a country-by-country basis. It also announces the addition of three new tax concessions for BIK, namely: <ul style="list-style-type: none"> <li>• non-basic medical care benefits</li> <li>• overtime transport allowance and reimbursement</li> <li>• overtime meal allowance and reimbursement</li> </ul>
	DTAs	The protocol signed with India in June is ratified.
<b>August</b>	DTAs	Singapore signs a third protocol with New Zealand.
	GST	The IRAS issues GST guides for: <ul style="list-style-type: none"> <li>• property developers</li> <li>• property owners and property holding companies</li> <li>• real estate agencies</li> </ul>
<b>September</b>	Shipping Incentives	The withholding tax exemption for interest payable by an AIS Enterprise on approved loans is extended to include front-end and commitment fees.
	Income Tax Administration	The IRAS publishes a detailed list of additional information and documents that should be submitted together with tax computations to expedite finalisation.
	GST	The IRAS issues updated GST guides for: <ul style="list-style-type: none"> <li>• Transfer of Business as a Going Concern</li> <li>• Exports</li> </ul>
<b>October</b>	GST	A list of particulars and information to be furnished to the Comptroller where a person has made a supply of goods of a taxable person other than by way of a sale, is gazetted.
<b>November</b>	Amendment to Tax Legislation	The Income Tax (Amendment) Act 2005 is gazetted.
	Stamp Duties	The Stamp Duties (Qualifying Islamic Financing Arrangements) (Remission) Rules 2005 are gazetted. These provide for the removal of the double imposition of stamp duty on instruments relating to Islamic-structured real estate mortgage financing.
<b>December</b>	Financial Instruments	The IRAS issues a circular detailing the income tax implications arising from the adoption of Financial Reporting Standard 39 – Financial Instruments: Recognition and Measurement.
	Estate Duty	The Estate Duty (Remission for Deaths in Quick Succession) Order 2005 provides for partial/full remission of estate duty on the passing of property or an interest therein where the second death takes place within two months of the first.
	Amendments to Tax Legislation	The Goods and Services Tax (Amendment) Act 2005 and Stamp Duties (Amendment No. 2) Act 2005 are gazetted.
	DTAs	Singapore signs a new DTA with the Republic of the Fiji Islands, and ratifies the DTA signed with Israel in May.

For more details, visit our Singapore tax website at [www.pwc.com/sg/tax](http://www.pwc.com/sg/tax) , or call your usual PricewaterhouseCoopers Services Pte Ltd contact. A list of useful links is also provided below:

<b>MOF</b>	<a href="http://app.mof.gov.sg">http://app.mof.gov.sg</a>
<b>IRAS</b>	<a href="http://www.iras.gov.sg">http://www.iras.gov.sg</a>
<b>EDB</b>	<a href="http://www.sedb.com">http://www.sedb.com</a>
<b>IE Singapore</b>	<a href="http://www.iesingapore.gov.sg">http://www.iesingapore.gov.sg</a>
<b>MAS</b>	<a href="http://www.mas.gov.sg">http://www.mas.gov.sg</a>
<b>MPA</b>	<a href="http://www.mpa.gov.sg">http://www.mpa.gov.sg</a>
<b>MOM</b>	<a href="http://www.mom.gov.sg">http://www.mom.gov.sg</a>
<b>STB</b>	<a href="http://www.stb.com.sg">http://www.stb.com.sg</a>



## PricewaterhouseCoopers thought leadership

A first in our annual Budget Commentary, we share with you a collection of PwC's thought leadership articles on current tax issues and our wishes for this year's Budget.

Authored by our tax partners and managers, these articles were published in The Business Times in the lead up to the Singapore Budget 2006.



By Abhijit Ghosh (above)  
and Shyam Srinivasan

## Promoting R&D and IP Management in Singapore

Globalisation, increased market competition and rapid technological advancement have pushed Intellectual Property (IP) [resulting from Research & Development (R&D) activities] onto Boardroom agendas today. Increasingly, IP has become a core asset and a key driver of competitive advantage for businesses across the world.

R&D activities are generally conducted by companies where they have the commercial capability to perform such activities. In the absence of a natural capability for conducting R&D in a particular location, a favourable tax regime can play an important role in attracting inventors and investors to conduct R&D and IP management activities.

Singapore already has an attractive tax regime for R&D and IP management activities, consisting of a variety of tax deductions, incentives and grants. To further boost R&D and IP management activities in Singapore, it may be worthwhile considering the following tax reform proposals, which consist of new measures as well as modifications to existing provisions.

### Proposals

- As a starting point to stimulate R&D spending in Singapore, an automatic deduction of say 125% for qualifying R&D expenditure should be considered. An additional automatic deduction of say 25% may be provided for substantial R&D spending above a specific threshold in a particular year.
- It may also be beneficial to introduce an R&D tax credit scheme. Under this scheme, a tax loss company could surrender its tax losses for a cash refund calculated, for example, as a defined percentage of the actual expenses incurred on qualifying R&D activities. Effectively, the credit will act as a subsidy for further R&D activities of these companies. The scheme would be particularly useful where group relief is not available and would encourage research-intensive start-up companies, especially during the initial years of their operations.
- Currently, under Section 19B of the Singapore Income Tax Act (SITA), capital expenditure incurred to acquire specified IP rights can be amortised for tax purposes on a straight-line basis over 5 years. One of the key requirements is that both legal and economic ownership of the IP must be acquired. This requirement appears to belie current commercial practice. Multinational companies may not transfer legal ownership of their valuable IP to a Singapore group entity, but they may be keen to provide long-term territorial rights to exploit such IP (i.e. economic ownership). If a lump sum is paid to acquire such

long-term territorial rights, there is a risk of such expenditure being treated as capital in nature and yet not qualifying for tax amortisation under Section 19B. So, the rules could perhaps be modified to allow for amortisation claims even when only economic ownership of IP is acquired.

- Further, it is suggested that the 31 October 2008 end date for obtaining 5-year writing-down allowances be extended indefinitely, in order to support continued IP migration to Singapore on a long-term basis.
- Presently, under Section 19C of the SITA, expenditure incurred under an approved R&D cost-sharing agreement may be amortised on a straight-line basis over 5 years or less. However, when a participant to a cost-sharing agreement wishes to sell, assign or otherwise dispose of any right, technology or know-how developed under the agreement (or receives any amount from another party for allowing them to become a party to the agreement), the entire amount received is taxed as if it is a revenue gain. This provision attempts to tax capital receipts (being the excess of the amount received over the cost-sharing expenditure) which should not otherwise be taxed in Singapore. Hence, it may be appropriate to modify this provision.
- The current R&D and IP management hub scheme grants a tax exemption for foreign-sourced royalties and interest, provided that this income is reinvested in R&D activities (and certain other conditions are met). However, the efficacy of this scheme is debatable, given the practical difficulties associated with the scheme. For example, companies do not necessarily want the restriction of ploughing back the foreign royalties and interest income into R&D activities. Further, there is lack of clarity on whether royalties from licensees in non-treaty countries will be treated as foreign-sourced royalties and thus qualify for tax exemption. A significant overhaul of this scheme or alternatively, the possibility of providing an outright exemption for all royalties received in Singapore from overseas parties, should be explored.
- Lastly, it may be useful to consider whether Singapore withholding tax on all royalties payable to non-residents should be abolished. The objective would be to remove one of the barriers for migration of cutting-edge, existing technologies to Singapore.

Singapore has built a strong foundation for becoming a global centre for R&D activities and an IP management hub. Tax reform is an important factor which can catalyse the progress towards a knowledge-based economy. In this regard, some of the aforesaid proposals could be considered for further enhancing Singapore's already attractive fiscal environment for R&D and IP management activities.

### About PricewaterhouseCoopers Tax

PricewaterhouseCoopers Tax practice is among the largest in Singapore. With more than 250 tax professionals and directors, we help individuals, businesses, both public and private organisations, with tax strategy, planning and compliance. From financial services, treasury, fund management, mergers and acquisitions, intellectual property, international tax planning (inbound and outbound) and Goods and Services Tax (GST) to transfer pricing, our tax professionals will provide you with the ideal tax solution.

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By Nicole Fung (above) and  
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## The need for transfer pricing regulations in Singapore

Companies are now being managed along global or regional lines, not national ones. Many have global brands, global R&D and regional profit centres. A recently concluded study indicates that as much as 60% of international trade takes place within multinational companies (MNCs) themselves.

With the globalisation of trade and commerce over the last decade, MNCs have set up their operations in various parts of the world and consequently are exposed to tax in multiple jurisdictions. On account of this, transfer pricing issues are becoming increasingly important in this globalised world. There is a growing uneasiness amongst governments that the benefits of a globalising world may mean that they have a looser hold on companies who will, and do, shift their employees, know-how and capital; and it is becoming harder to say quite where the global firm's profits are generated.

Owing to the nature of their relationship, entities within the MNC group are in a position to change their profits and decrease the group's global tax costs. At times, this results in a shifting of tax base from one jurisdiction to another.

To combat such strategies, and to protect their revenue and tax bases, Revenue authorities usually incorporate transfer pricing regulations in their respective tax laws.

Transfer pricing methodologies are used to determine whether international transactions between related parties (cross border transaction amongst MNC group entities) are priced in accordance with the arm's length principle (i.e. at rates at which third parties would transact). Such transfer pricing regulations place checks on MNC group entities to ensure they have priced their transactions appropriately, and to ensure that there is no leakage of tax to another jurisdiction on account of pricing strategies adopted by those MNC members.

In the context to the Asia-Pacific region, Singapore has one of the most competitive tax rates. A comparison of the corporate tax rates within the region is shown in the table.

Country	Tax rate	Country	Tax rate
Australia	30%	Japan	42%
China	33%	Korea	27.5%
Hong Kong	17.5%	Malaysia	28%
India	33.66%	Philippines	35%
Indonesia	30%	Singapore	20%

Apart from competitive tax rates, Singapore also provides a plethora of tax incentives under its domestic tax law. Based on the above, it would seem that Singapore would be a preferred destination for MNCs to divert their activities and consequentially, their profits.

Unfortunately, this is not always true.

One of the reasons for this could be due to the absence of a detailed transfer pricing legislation in Singapore tax law.

Most of Singapore's trading partners have detailed transfer pricing legislation in their tax law. Further, some of these countries impose relatively high penalties for non-compliance with transfer pricing laws (refer to the summary in the table below).

Country / Transfer pricing law	Penalties
<b>Australia</b> Detailed transfer pricing regulations	Between 0%-50%
<b>China</b> Detailed transfer pricing regulations	No specific transfer pricing penalties
<b>France</b> Detailed transfer pricing regulations	Ranging from 40% to 80%
<b>Germany</b> Detailed transfer pricing regulations	5% to 10% surcharge on income adjustments
<b>India</b> Detailed transfer pricing regulations	<ul style="list-style-type: none"> <li>• 100% to 300% of incremental tax in case of adjustment</li> <li>• Documentation penalty of 2% on transactional value</li> </ul>
<b>Japan</b> Detailed transfer pricing regulations	No specific transfer pricing penalties
<b>Malaysia</b> IRB released Transfer Pricing Guidelines on July 8, 2003	100% to 300% of tax undercharged
<b>Netherlands</b> Detailed transfer pricing regulations	0% to 100% of the additional tax
<b>South Korea</b> Detailed transfer pricing regulations	10%-30% penalty for underreported taxable income
<b>Switzerland</b> No specific transfer pricing regulations	No specific transfer pricing penalties
<b>UK</b> Detailed transfer pricing regulations – incorporated from OECD guidelines - regulations cover thin cap as well as transactions within UK	100% of additional tax on filing of incorrect return
<b>USA</b> Detailed transfer pricing regulations	20% to 40% penalty for underpayment of taxes

In comparison to its trading partners, Singapore does not have a specific transfer pricing regime in place. The Singapore tax law introduces transfer pricing only in a very limited manner.

The income tax provisions in Singapore, as they presently stand, do not provide for any specific requirement for taxpayers to analyse their transfer pricing arrangements and to substantiate the reasonableness of such arrangements. Further, presently Singapore-based entities do not need to maintain documentation to justify / prove that their pricing arrangements meet the arm's length standard. Also, no specific transfer pricing related penalties have been prescribed.

As against this, Singapore's trading partners have detailed transfer pricing regulations in place, along with specific penalties for non-compliance with transfer pricing laws.

As a consequence, in cross-border, inter-group transactions involving Singapore entities, MNC groups, in order to comply with transfer pricing requirements in their home jurisdictions and to mitigate the risk of related penalties, tend to err on the side of caution and inject greater income into their respective countries. At times such practices may lead to dilution of Singapore's tax base.

The introduction of a formal set of transfer pricing regulations within the Singapore tax law would be an advantage to both tax legislators and tax payers.

From a tax legislator's perspective, considering the fact that Singapore is a hub for the Asia-Pacific region and that a large part of trade into the region is routed through Singapore, it becomes imperative to ensure that Singapore gets its due share of the revenues emanating from such trade. Transfer pricing regulations seem to be a good tool for ensuring this.

Transfer pricing regulations would also be useful to major investors into Singapore as this would ensure that the profits belonging to Singapore operations would be defended against aggressive tax regimes. These investors would also appreciate platforms like Advance Pricing Arrangements where they can discuss their pricing arrangements on potential transactions with the tax authorities and get upfront rulings on such matters. This would ensure a degree of certainty as regards their pricing arrangements and protect the taxpayers from tax adjustments subsequent to the consummation of the transaction.

All in all, transfer pricing regulations would be a positive development for investors as it would provide certainty on pricing arrangements and would provide avenues for getting upfront clearances on pricing of significant transactions, and for the Singapore tax authorities, as it would be a useful tool for monitoring adequacy of profits being transferred to the Government coffers.

#### About PricewaterhouseCoopers Tax

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By David Sandison (above) and David Richardson

## A lighter look at the dark side

David Sandison and David Richardson of PwC try to take a humorous look at the pension scene in Singapore – and find it's no laughing matter.

It is good to have a sense of humour. Without it, some of the stark realities of life could not be faced. Add a touch of procrastination, and you have all the ingredients necessary for a long and happy life until the day the grim reaper makes his sombre call.

However, reaching that happy day may not be all that amusing, if you have not ensured a secure financial base to pay for that vague and uncharted piece of your life - retirement. Here are some interesting statistics that will make your hair fall out if it has not already.

Did you know that in the last 15 years, life expectancy in Singapore has grown from 71 for males and 76 for females, to 77 for males and 81 for females? Not only that, if you actually make it to 62, then you can now expect to reach 82, even as a mere male of the species. Fifteen years from now, if you hit the 62 spot, you will be able to count on another 30 years of champagne and caviar, once you have hung up your boots. What is in the kitty at retirement will have to stretch for a long, long time if you are planning on retiring at 60.

Things have changed and are continuing to change at a vigorous pace. "But I'll be OK," you say, "my children will look after me." Think again. Are your expected 1.2 children (at the current birth rate) going to be able to support you, your wife and the ever increasing population of grandparents?

Imagine the scene. Colin (age 25), supporter and protector of the family, earning \$4,000 a month as a young executive (\$110 a day after a bit of tax and CPF) comes home after a long day at work. "Hi, mum, dad, grandma, granddad, grandpa, granny, auntie, I'm home!" (as if they wouldn't know). With that lot on his hands, how do you think he is going to save for his retirement, let alone enjoy his own life? You don't need to be on NASA's payroll to work out that the CPF (which he has spent on his HDB) isn't going to do it for him. And he probably won't get much mileage out of his (by then) 0.8 children – who will possibly be more inclined to work overseas and forget about him.

To put the issue more in context, let's take a look at the minimum sum in the CPF. Although specific data is not available, a reasonable estimate of the average minimum sum in the CPF is around \$70,000. This is currently sufficient to buy you an annuity of around \$400 per month, or \$13 a day. Integrated Resort here we come! (You can afford to go every 8 days – unless your wife wants to come too, or you need to eat, have medical costs to meet, or conservancy charges to pay.) "Yes, but I have my home", you say. Well, have you ever tried eating a sofa?

What is the message here? The message is that things are in a

serious state, and with current demographic trends, they are only going to get worse. Something major needs to be done in order to ensure that people do have enough money to enjoy (or at least survive) their retirement years, which are almost now as long as one's working life. What is needed is for more to go into the pot, rather than messing around with the little that is in it.

See how can this be achieved? Well, the answer is not easy and it will require discipline – which quite frankly, most people do not have. As an illustration, ask yourself whether you see the tax savings on CPF or SRS contributions as allowing you to save more – or just enjoy bigger take-home now. (Go on, be honest.)

Part of the answer however, is already available, but it requires a buy-in from employers. That is the Approved Scheme under Section 5 of the Income Tax Act. Such schemes allow tax deductible (employer only) contributions, a tax free rolling-up of income, and taxable payouts (with tax managed by spreading) on retirement. Such schemes supplement and complement the CPF; or in the case of foreign employees, allow for a tax efficient pension in the first place. (How can we attract foreign talent for the long term if there is no security?)

What is in it for employers is an arrangement which can enhance employee loyalty – much more so than share options can, and one which, apart from administrative costs, need cost no more in terms of remuneration. Quite simply, bonuses (or part of them) can be diverted into the fund; and administrative costs can be minimised through pooled schemes.

What is in it for the employee is discipline and a tangible enhancement to retired life. Colin can now get on and build his own future. What is in it for Singapore is continued attraction for fund management and the creation of a pool of funds looking for investment.

So if they are so good, why are section 5 schemes languishing in a state of disuse? The answer probably lies in the dominance of the CPF over the last 20 years and the introduction of tax on the pension payout after 1993. However with rapidly dwindling CPF contribution limits, another means of disciplined savings needs to fill the space.

True, as currently configured, the section 5 scheme is in need of an overhaul. Employees cannot currently contribute, and that needs to change. To help encourage new schemes, double deductions could be given to employers for initial contributions. The crowning achievement would be to exempt the pension, as was the case before 1993.

But nobody is going to say that the section 5 scheme will answer all prayers. It will mean sacrifice, and there is still plenty of scope for improvement to the conditions. But it is time to get serious, and get serious now. It is time to make sure the retirement dream does not become a nightmare.

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This article was contributed to The Business Times and first published on 15 February 2006.



By Koh Soo How

## Where is GST heading?

GST generally has such a low profile that it is always a surprise when it does make headlines. This, in my view, is somewhat unfortunate. It may be the low rate of tax in Singapore that makes it easy to ignore but businesses should take this apparently simple tax much more seriously.

Just how important is the taxation on consumption? Around 140 countries now have a valued-added tax (VAT) or GST system and it is almost certain that this number will increase, as tax authorities around the world migrate the overall tax burden from direct taxes to the less visible indirect taxes. Indirect taxes may even go so far as replacing direct taxes as the most dominant source of taxes globally as tax systems move away from a system of taxing labour and investment to a taxation of consumption.

Coupled with the fact that VAT/GST is becoming an increasingly important source of tax revenue for governments across the globe, PricewaterhouseCoopers (PwC) recently launched a new publication entitled "QuoVATis" examining how indirect taxes are evolving globally and the impact this has for businesses around the world.

### GST in the city state

We all know that the rate of GST in Singapore is one of the lowest in the world (see table on the next page) and the system is one of the simplest. So why is it that the amount of GST errors that IRAS find during audits so high? In 2004, the amount of GST collected was about a third of the income tax collection. Yet, the total tax and penalties collected from GST errors detected was more than that for Income Tax.

If you look at the numbers, you will see that the revenue collected from GST has grown in recent years from less than 20% of the income tax collected to over 30%. This is a trend that is set to continue both here and in the rest of the world. If cutting corporate taxes has contributed to Singapore earning the title of the world's second-freest economy according to a recent study of economic freedom by The Heritage Foundation, one has to ask from where the government is likely to replace the loss of revenue from corporate tax?

### Nuts & bolts of GST

In theory, GST is neutral to business. As countries compete for investments globally, there is a natural drive to reduce direct taxes on businesses. As governments still need revenue, GST becomes critical. In India, where they only introduced VAT last year, there are already reports that revenues are up.

There are arguments that GST is a regressive tax, i.e. it taxes the poor at the same rate as the rich. However many countries have put in place measures to mitigate this, for example by having low or zero tax rates for basic necessities. By reducing direct taxes, you put more money in people's pockets and give them the choice as to how they spend it. One of the groups against introducing VAT in the United States argue that it would become a money making machine. In other words, they fear that it would be far too easy for the government to raise more and more tax without the people noticing.

In a GST system, the tax is designed to be borne by the consumer, but it is not practical to collect tax directly from him. The tax is collected at each stage from importation, through manufacture to retail sale. Registered taxpayers collect the GST from their customers on each sale, calculating the amount due by applying the tax rate to the price charged for the goods or services sold. In turn, they are also customers of other taxpayers and the tax they are charged can be offset against the tax they have collected.

### Impact on businesses

GST is a tax that is charged on virtually every single transaction that a business is involved in, every sale and every purchase. For a comparison with direct taxes, consider the trading account of a business. The direct tax is calculated on the smallest number shown after deducting purchases from sales. However, the indirect tax (GST) applies to both the two largest numbers i.e. sales and purchases. As a consequence, the tax throughput on the total sum of a business' transactions can be huge.

The very reasons that make GST such an efficient tax for revenue authorities and governments are the reasons that make it almost certain that business will make mistakes. How big those mistakes become is down to how well the business understands the tax and has planned ahead.

Put simply, every transaction a business undertakes has the potential to get the GST wrong. This is made worse by the fact that for most transactions, the GST is automated. This means that if it is wrong once, it will be wrong every time. So not only are there many more chances to get it wrong, there is also a multiplier effect.

Hence, businesses need to be proactive in considering indirect taxes at an early stage of planning with a robust global indirect tax strategy aligned to the overall business strategy. The amounts at stake, and hence the risks, are high and proactive management is essential.

### In the region and beyond

If we look a little wider beyond Singapore and consider the region as a whole, it becomes obvious why indirect taxes must be high on the list of priorities for any business. With the spread of globalisation, companies now see the world as their marketplace. If you trade in a country, you will be affected by its indirect tax system.

Virtually every country in the region, if not the world, has an indirect tax system. India recently introduced a VAT in 2005 and Malaysia is planning one for 2007. While Hong Kong is still studying the introduction of a GST, it is only a matter of time before they will need to introduce it. China has recognised that their current turnover taxes system does not work so well in the modern world and are experimenting with a revised VAT system. There is talk of Japan contemplating a revamp of its consumption tax system to a VAT/GST type system.

If you compare Asia-Pacific with the EU which has had VAT systems for years, there are many similarities but also some major differences. In the EU, all countries have a VAT system based on a common legislative framework. There are no barriers to the free movement of goods and services from country to country i.e. there is a single market. In this region, most countries have a VAT or GST. However, there is no common system and there certainly isn't the free movement of goods and services across borders. Despite

ASEAN working to reduce or remove trade barriers and the promotion of free trade agreements, the differences in VAT/GST systems are expected to remain.

The apparent similarity of the GST systems in the region is one of the greatest challenges facing businesses. It is all too easy to fall into the trap of thinking that if you understand your own system, you will know how GST works elsewhere. It is also noticeable that the penalty regimes around the region tend to be punitive and so very expensive.

The need for clear thought and planning for GST is only just becoming understood in the region. In other parts of the world, where the tax is more mature, it is very common to find indirect tax specialists embedded in the business.

However, it is not only businesses that need to learn. GST has been described as “an adolescent tax, just as big as mature taxes, but with much still to learn”.

Indirect tax specialists have a key role to play in ensuring we achieve a balanced model as the tax matures and grows. They need to work with industry and government tax policy makers to achieve the “win-win” model of sustainable global profit and total risk management for businesses and the certainty of revenue flows and continued economic growth for tax authorities and governments in an efficient and equitable way.

Country	GST/VAT rate
Denmark	25%
France	19.6%
UK	17.5%
China	17%
Germany	16%
India, New Zealand	12.5%
Australia, Philippines, Indonesia, Korea	10%
Switzerland	7.6%
Thailand	7%
Japan	5%
Singapore	5%

#### About PricewaterhouseCoopers GST Practice

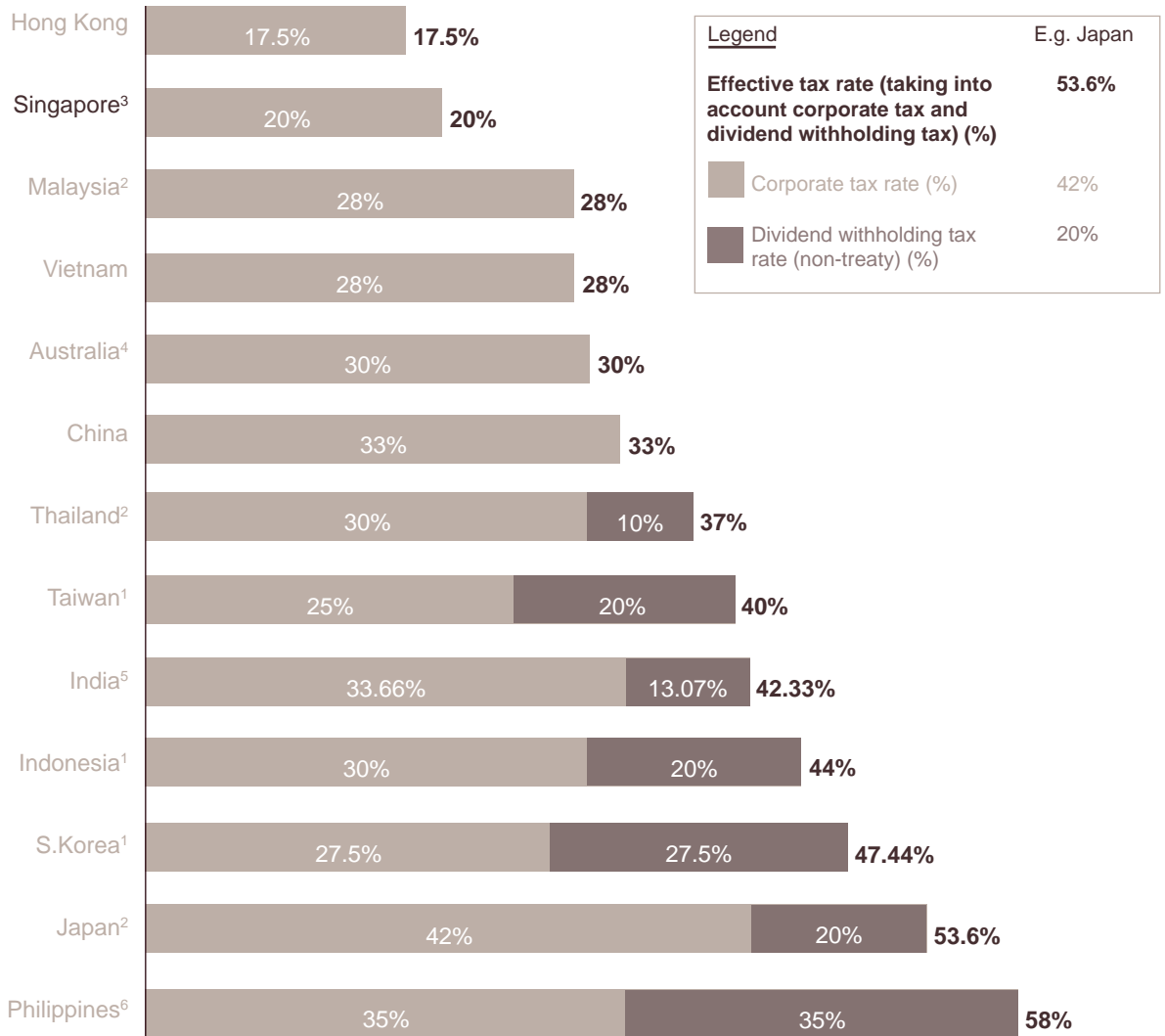
Adopting a business-focussed approach, PricewaterhouseCoopers GST team provides local and international consultancy services to SMEs and multinational corporations. The team can help in:

- identifying areas to improve GST efficiency
- avoiding reporting pitfalls
- providing in-house training
- performing GST health-checks
- managing GST audits

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## Comparison of Asia-Pacific effective tax rates on repatriated corporate profits (for income year 2006)



Note: Certain rates above are approximate effective rates which include local/resident surtax or surcharge (e.g. China, India & S.Korea), and additional income-related taxes such as provincial, inhabitants, enterprise or municipal tax and undistributed income tax (e.g. Japan).

<sup>1</sup>Lower rates of tax apply to income below certain levels.

<sup>2</sup>Lower rate of tax apply to small and medium-sized enterprises.

<sup>3</sup>Partial exemption of up to \$52,500 applies to the first \$100,000 of chargeable income.

<sup>4</sup>Fully-franked dividends paid to non-residents are not subject to dividend withholding tax, but to the extent that a dividend paid to a non-resident is unfranked, withholding tax at the rate of 30% will generally apply.

<sup>5</sup>India does not impose dividend withholding tax. This is a dividend distribution tax on the dividends declared, distributed or paid by the company. Such dividend is exempt from tax in the hands of the recipient shareholders.

<sup>6</sup>Dividends paid to a non-resident corporation are subject to a lower rate of 15% if the country in which the corporation is domiciled either does not impose income tax on such dividends or allows tax deemed paid credit of 20%. In addition, a 10% improperly accumulated earnings tax is imposed on the improperly accumulated earnings of a corporation which allows its earnings or profits to accumulate beyond its reasonable needs.

## Appendix B

### Comparison of Asia-Pacific individual tax liabilities (a married man with two dependent children for income year 2005)

	Total Remuneration US\$75,000		Total Remuneration US\$100,000		Total Remuneration US\$200,000	
	Tax Liability US\$	Effective Tax Rate %	Tax Liability US\$	Effective Tax Rate %	Tax Liability US\$	Effective Tax Rate %
Singapore	4,930	7	8,555	9	26,295	13
Australia <sup>1</sup>	22,134	30	34,377	34	82,877	41
China	15,800	21	23,613	24	64,846	32
Hong Kong	6,103	8	11,103	11	31,103	16
India	23,972	32	32,387	32	66,047	33
Indonesia	21,782	29	30,404	30	64,893	32
Japan	6,224	8	12,286	12	49,630	25
Malaysia	15,628	21	22,628	23	50,628	25
Philippines	22,851	30	30,851	31	62,851	31
S.Korea	10,401	14	17,272	17	53,847	27
Taiwan	9,485	13	16,910	17	53,916	27
Thailand	17,280	23	24,769	25	61,469	31
Vietnam	18,041	24	28,041	28	68,041	34

**Notes:** Deductions for Social Security are not taken into account unless the contributions are compulsory by law. Standard deductions are taken into account.

<sup>1</sup>Based on new tax rates for year ending 30 June 2006.

## Appendix C

### Resident individual tax rates for years of assessment 2006 and 2007

	Chargeable Income	Year of assessment 2006		Year of assessment 2007	
		Rate %	Tax \$	Rate %	Tax \$
	\$				
On the first	20,000	0.00	0.00	0.00	0.00
On the next	10,000	3.75	375.00	3.50	350.00
On the first	30,000		375.00		350.00
On the next	10,000	5.75	575.00	5.50	550.00
On the first	40,000		950.00		900.00
On the next	40,000	8.75	3,500.00	8.50	3,400.00
On the first	80,000		4,450.00		4,300.00
On the next	80,000	14.50	11,600.00	14.00	11,200.00
On the first	160,000		16,050.00		15,500.00
On the next	160,000	18.00	28,800.00	17.00	27,200.00
On the first	320,000		44,850.00		42,700.00
On income above	320,000	21.00		20.00	

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