

Amendments to the Income Tax Act

Introduction

The Income Tax (Amendment) Bill 2017 (the Bill) was read for the second time and passed in Parliament in October 2017.

Besides the tax changes announced in the 2017 Budget Statement, this year's Bill contains a number of other proposals which arose from the on-going review of Singapore's income tax system. These include, most notably, various proposed measures to strengthen the transfer pricing (TP) regime such as the introduction of a mandatory transfer pricing documentation (TPD) requirement. The Bill also includes a specific tax framework for companies which re-domicile into Singapore, and prescribes the tax treatment of certain items arising from the adoption of Financial Reporting Standard 109 – Financial Instruments (FRS 109) and Financial Reporting Standard 115 – Revenue from Contracts with Customers (FRS 115).

Transfer pricing

Current legislative framework

The arm's length principle is enacted in section 34D of the Income Tax Act (ITA).

Since 2006, the Inland Revenue Authority of Singapore (IRAS) has issued guidelines on the interpretation and application of the arm's length principle in Singapore ("TP Guidelines"). The guidelines have been updated in 2015, 2016 and 2017 and are generally consistent with the internationally accepted principles set out in the Organisation of Economic Co-operation and Development (OECD) Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators.

Changes under the Income Tax (Amendment) Bill 2017

The Bill introduces a number of key changes to Singapore's TP landscape. In summary, the key changes are:

- Preparation of contemporaneous TPD from YA 2019 (when a certain threshold is met)
- Penalties for not preparing contemporaneous TPD have been increased to SGD 10,000
- A 5% surcharge on the amount of TP adjustments which is automatically applicable unless waived by the IRAS
- Codification of the substance over form approach, where the IRAS is empowered to re-characterise transactions in certain cases

Mandatory transfer pricing documentation

The Bill introduces requirements for maintaining mandatory contemporaneous TPD for businesses with turnover exceeding \$10 million with effect from the Year of Assessment (YA) 2019 (i.e. financial year ending 2018).

The Bill provides that detailed rules will be published separately to set out exceptions to the TPD requirement. It is expected that the various exceptions currently provided in the TP Guidelines will be contained in these rules, so as to address concerns with compliance cost.

A point to note here is that on literal reading of the proposed section 34F, it seems that once a taxpayer has crossed the threshold for preparing contemporaneous TPD in one year, it may be required to do so for subsequent

years. We understand that the IRAS would be clarifying this point in the near future; from a compliance cost and tax risk perspective, it does not appear to be the intent to continue with the TPD requirement if the taxpayer's business has very much scaled down over time.

The penalty for not complying with such TPD requirements has increased from current \$1,000 for not keeping proper business records to \$10,000 for non-compliance. This signifies the IRAS's intent to enforce its TPD requirements.

Powers to enforce the arm's length principle

The current section 34D has been completely rewritten and sets out the IRAS's powers to enforce the arm's length principle. In particular, it provides for two scenarios where the identification of arm's length conditions need to be reconsidered, namely:

- Where the unrelated parties would have entered into substantially different commercial or financial relations from the actual intercompany arrangement;
- Where unrelated parties would, in comparable circumstances, not have entered into any commercial or financial relations.

In these situations, the identification of the arm's length conditions needs to be carried out as if the parties were unrelated. The Bill further gives the IRAS power to disregard the form of the transaction where the substance of the transaction is inconsistent with the form.

This addition closely mirrors the recent amendments to the TP Guidelines, where the IRAS included additional wording on substance over form considerations in assessing profit attribution. As an example, the current TP Guidelines as updated on 12 January 2017 provides examples on how the IRAS will look at functional substance. Please refer to our [Tax Bulletin on the 4th edition TP Guidelines for more details](#).

By legislating these requirements, Singapore reiterates its commitment to observe the recommendations in the OECD Base Erosion and Profit Shifting (BEPS) project on aligning profit recognition with the location of value creation.

Deemed remittance on TP adjustments

The Bill further provides that any adjustment made by the IRAS will be treated as accruing in or derived from Singapore or received in Singapore from outside Singapore, as the case may be.

Singapore taxes locally sourced income as it arises and foreign sourced income upon its receipt in Singapore. The Ministry of Finance (MOF) has since clarified that for the IRAS to impose tax on any TP adjustments to foreign sourced income, some part of the income must first be received in Singapore. As such, the TP adjustment mechanism will be consistent with the scope of the charging provisions in the ITA.

Introduction of a surcharge for non-compliance

A 5% surcharge will imposed on any transfer pricing adjustment made by the IRAS from YA 2019. In other words, if arm's length conditions are not met – then IRAS can make TP adjustments by increasing income, reducing or disallowing deductions or reducing losses.

In all three cases, the IRAS could apply the 5% surcharge on the amounts adjusted, although he may, for a good cause, remit in whole or in part, the surcharge. These surcharges are due within one month to the IRAS from the date of notification from the IRAS. Hence, even where taxpayers may be in a scenario where there are no additional taxes to be paid (e.g. where there are losses), taxpayers would still face a cash outlay with these surcharges.

It should be recognised that the arm's length outcome could be expressed in a range of results. There is therefore some uncertainty over how this provision will be applied in practice as transfer pricing is not an exact science. Guidance from the IRAS (e.g. case examples) would be extremely helpful for taxpayers to appreciate these considerations more completely. By way of contrast, the approach adopted by other countries provides that penalties are imposed only when taxpayers do not have adequate documentation to support their filing position (e.g. in the absence of a reasonably arguable position in Australia). The onus on businesses to support their TP policy is thus more pronounced in Singapore for surcharge mitigation purposes.

Other amendments

The Bill also provides for the lifting the statutory time limit of four years for the IRAS to raise additional assessments for cases under the Mutual Agreement Procedures (MAP) process¹ so that the outcome of the MAP agreed with the relevant foreign competent authority can be given full effect.

It also denies any claim for error or mistake under section 93A of the ITA arising from related party transactions in the absence of contemporaneous and adequate TPD.

What does this mean for you?

The penalties for not preparing comprehensive TPD have significantly increased. For taxpayers who have been preparing TPD based on the TP Guidelines, the proposed requirements should be practically manageable. However, those which have not done so should begin to prepare TPD to support their filing position, particularly given the increased financial penalties.

The Bill provides the IRAS with wide powers to enforce the arm's length standard. With the legislation of substance over form principles as well as new penalties/surcharges, taxpayers will need to monitor the alignment of their tax and TP models with their operating models. In particular, as business cycles shorten and business changes take place more frequently, tax directors will need to look at these developments a lot more closely.

Introduction of a tax framework for inward re-domiciliation

The Companies (Amendment) Act 2017 introduced an inward re-domiciliation regime in Singapore.² In the light of this, the Bill proposes a new tax framework for companies which re-domicile into Singapore.

For a company which qualifies to apply the tax framework, it specifies the tax treatment of certain items of expenditure incurred, or assets acquired, before registration date, including:

- Bad debts and impairment losses for debts
- Impairment losses from financial assets
- Impairment losses on assets
- Expenses
- Trading stocks
- Treatment of the following expenditure in the year of commencement of business in Singapore - costs for protecting intellectual property, research and development expenditure, renovation or refurbishment expenditure, qualifying design expenditure and pre-commencement expenditure
- Capital allowances for assets
- Writing down allowances for intellectual property

The Bill further specifies that the tax exemption scheme for start-ups will not be available to re-domiciled companies. The reason cited by the MOF in response to public feedback calling for the scheme to be extended to re-domiciled companies

¹ Section 74 of the ITA

² The effective date for the re-domiciliation provisions has not been announced.

is that allowing such companies to qualify for the scheme would not be in line with the scheme's policy objective, which is to support entrepreneurship in Singapore and help local start-up companies grow.

The Bill also provides for re-domiciled companies to be given tax credit for exit taxes imposed by their originating jurisdiction on unrealised profits if those profits are also taxed in Singapore. Unlike the current foreign tax credit scheme, this credit is subject to an approval process and certain conditions. It is unclear under what circumstances or conditions it will be given or denied, and if approval may be sought (e.g. by way of an advance ruling) before the company redomiciles.

Introduction of Financial Reporting Standard 109 tax treatment

FRS 109, which will apply to entities for financial periods beginning on or after 1 January 2018, replaces the existing Financial Reporting Standard 39 – Financial Instruments: Recognition & Measurement.

The proposed FRS 109 tax treatment largely aligns the tax treatment of financial instruments with the accounting treatment. A few key observations are summarised below:

Gains and losses on transactions undertaken to hedge capital risk will be disregarded. This broadly mirrors the equivalent provision in section 34A and the position in common law. However, it has now been held in Singapore courts that deductions under section 14(1)(a) may be allowed even when they are capital in nature. As such, there will be mismatch in characterisation if the gains and losses arose from hedging instruments not covered under section 14(1)(a).

The proposed legislation sets out the tax treatment of an expected credit loss arising from a loan that is transferred by a bank or qualifying finance company to another person, where the transfer is not pursuant to a qualifying amalgamation and where the a deduction was previously allowed to the transferor. Where both the transferor and transferee are in the business of money lending, the deduction previously allowed to the transferor is treated as having been allowed to the transferee; otherwise, the provision is treated as a trading receipt of the transferor. As banks and qualifying finance companies are in the business of money lending, any loss on loan transfer should be deductible. As such, it is unclear why it is necessary to deem any deductible loss previously claimed as taxable income of the transferor if the book value (i.e. net of credit loss) of the loan transferred was the actual sum realised, i.e., when a loss was indeed incurred by the transferor.

It should be noted that taxpayers, unlike in the case of FRS 39, are not given a choice under the law to opt out of the FRS109 tax treatment. MOF has advised that there will not be a choice to opt out so that the tax system is kept simple to reduce compliance cost. While it is appreciated that there is merit in simplicity, this represents a departure from established tax principles, where realisation is a fundamental tenet of the concept of income. Entities that are required to adopt FRS 109 in the preparation of their accounts will not have the option of adopting the realisation basis of taxation.

The IRAS has however indicated that it is prepared to allow an additional three-month instalment to ease the transition for taxpayers on pre-FRS 39 tax treatment who have additional tax payable as a result of the move to FRS 109 tax treatment. The additional instalment will be given upon request by taxpayers, and applications for longer instalment periods will be considered on a case-by-case basis.

Provide for adjustments to the amount of statutory or exempt income arising from the adoption of FRS 115

FRS 115 – Revenue from Contracts with Customers will be effective for annual periods beginning on or after 1 January 2018. It supersedes the following existing accounting standards:

- FRS 11 – Construction Contracts
- FRS 18 – Revenue
- INT FRS 113 – Customer Loyalty Programmes
- INT FRS 115 – Agreements for the Construction of Real Estate
- INT FRS 118 – Transfers of Assets from Customers
- INT FRS 31 – Revenue: Barter Transactions involving Advertising Services

The Bill proposes introducing a new section 34I to allow adjustments to be made to the amount of statutory or exempt income of a person for the year of assessment corresponding to the basis period in which FRS 115 is first applied. Where the application of FRS 115 results in a higher or lower statutory income (or exempt income) for the basis period prior to the first basis period in which FRS 115 is adopted, the excess income or deduction, as the case may be, must be adjusted against the person's total income for the first year of assessment in which FRS 115 is adopted. In the event that the person's income is subject to different tax treatments (e.g. statutory tax rate and exempt), the amount to be adjusted against the respective income streams should be determined in accordance with the statutory formulae.

By way of example, with the adoption of FRS 115, if a company is required to record an increase in revenue by adjusting the retained earnings and the increase is solely due to the contracts qualifying for pioneer incentive. In accordance with the proposed section 34I(3)(b), it is then required to allocate the difference against the respective income streams using the formula prescribed. This would result in additional taxes on the amount allocated to the normal tax category notwithstanding that the increase solely relates to pioneer trade and hence would have qualified for tax exemption absent the application of FRS 115.

While the proposal will ease the administrative burden of having to revise the prior years' tax computations, it may not be equitable for some taxpayers when the adoption of FRS 115 only result in changes in exempt income or income subject to concessionary tax rates.

While it is heartening that the MOF has indicated that the IRAS may allow taxpayers who are facing financial hardship as a result of this change to pay by instalment on a case-by-case basis, the absence in the proposed legislation of a provision allowing taxpayers to approach IRAS on a case-by-case basis to agree on the tax treatment of revenue for cases will inevitably lead to inequitable tax outcomes for certain taxpayers..

Conclusion

Those who have been following Singapore tax developments will note that legislation for the much-anticipated Intellectual Property Development Incentive has not been included in the Bill. Given that this is a new and hitherto untested scheme, it is to be hoped that the legislation will be released for consultation before it is read in Parliament.

Unlike in the past, the Bill contains a raft of non-Budget related measures. In many ways, they reflect updates to cater for developments in international tax and changes to financial accounting standards in the local context.

Conscious that these changes will increase compliance costs, the government has proposed certain measures to minimise some costs (e.g. safe harbour for TPD, greater alignment with accounting standards). Nonetheless, businesses will need to familiarise themselves of these impending changes as they will affect the way they go about meeting their tax obligations in an increasingly inter-connected world.

Lastly, even though the Bill provides an indication of the legislative changes that will be introduced, they are still subject to change and is not yet law.



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