Update to the taxation of gains on disposal of foreign assets

January 2024

In brief

Changes to Singapore's tax regime for foreign-sourced income, first proposed in June 2023 (refer to our earlier Tax Bulletin), came into effect on 1 January 2024.

A new section 10L of the Income Tax Act 1947 (the Act) imposes tax on gains from the disposal of foreign assets taking place on or after 1 January 2024 when they are received in Singapore by an entity of a relevant group (unless certain exclusions apply). On 8 December 2023, the Inland Revenue Authority of Singapore (IRAS) published its e-Tax Guide "Income Tax: Tax Treatment of Gains or Losses from the Sale of Foreign Assets" (the e-Tax Guide) to further clarify the scope of this new taxing provision, the economic substance requirements for exclusion from this tax, and certain administrative requirements including an avenue for businesses to obtain an advance ruling on the adequacy of their economic substance.

Section 10L was introduced in response to updates to the EU Code of Conduct Group guidance. Hong Kong and Malaysia have likewise revised their foreign-sourced income taxation regimes to exclude gains from the disposal of foreign assets where economic substance requirements are not met.

In detail

Changes from the draft legislation

The Income Tax (Amendment) Act 2023, published on 30 October 2023, provides for the introduction of the new section 10L with effect from 1 January 2024.

The draft Income Tax (Amendment) Bill 2023 (the draft Bill), including the then-proposed section 10L, was earlier published by the Ministry of Finance (MOF) for public consultation. The MOF subsequently published a summary of the feedback received and its responses to those comments. Certain suggestions were accepted and have been included in the final legislation. In addition, the IRAS has sought to address certain concerns raised during the public consultation in its e-Tax Guide. These are discussed below.

Changes to the draft section 10L of the Act include:

Ascertainment of gains and losses chargeable to tax

- Deductible expenses – In addition to expenditure incurred to acquire, create or improve the foreign asset and that to sell or dispose of the asset, deductible interest cost as well as expenditure incurred to protect or preserve the value of the foreign asset may be deducted in determining the taxable gain, if they have not been deducted against any other income.

- Losses – Losses incurred on the disposal of foreign assets (which would have been brought to tax if they were gains) may be set-off against gains from the disposal of foreign assets that are subject to tax. Unutilised foreign-sourced disposal losses may be carried forward for set-off against future gains.

Economic substance requirements

- The requirement in the draft Bill for non-pure equity holding entities (non-PEHEs) to carry on a trade, business or profession in Singapore has been removed, thus allowing investment holding entities with the requisite economic substance to be excluded from the operation of this new provision.

Gains from disposal of intellectual property rights

- Gains from the disposal of certain intellectual property rights (IPRs), the income from which is taxed at a concessionary rate of tax under section 43X of the Act may be excluded from the operation of section 10L. A modified nexus approach is used to determine the extent to which such gains will not be taxable when received in Singapore.

- Except for the above, there is no carve-out for gains on sale or disposal of all other IPRs from section 10L (if the gains are received in Singapore).

Foreign tax credit

- Double taxation relief or unilateral tax credit (as the case may be) will be available for foreign tax paid in respect of gains taxed under section 10L of the Act. Resident taxpayers may also elect for foreign tax credit pooling, subject to conditions.

IRAS e-Tax Guide

The e-Tax Guide provides details on the administration of section 10L including its intended scope, the economic substance requirements for exclusion from this tax, and certain administrative requirements.

Scope of section 10L

Foreign entities with no presence in Singapore

A foreign entity which is part of a relevant group could, potentially, be subject to tax on its gains from the disposal of its foreign assets if such gains are received in Singapore. This is because foreign entities are not excluded from the scope of section 10L of the Act.

Section 10(25) of the Act (that provides for when foreign income is considered received in Singapore) is likewise broadly scoped. In practice, the IRAS has clarified that section 10(25) will not apply to foreign businesses that are not operating in or from Singapore – these businesses may remit their foreign income to Singapore without being taxed on the income.

The IRAS has taken a similar approach by clarifying in its e-Tax Guide that the new section 10L will not apply to foreign entities (i.e., not incorporated, registered or established in Singapore) that are not operating in or from Singapore and gives the same example (as for section 10(25) of the Act) of a foreign entity that only makes use of the banking facilities in Singapore and has no operations in

Singapore. This clarification and its consistency with the application of section 10(25) of the Act is welcome.

Entities enjoying specified tax incentives

Gains derived by prescribed financial institutions and entities enjoying certain tax incentives are excluded from the scope of section 10L of the Act. However, this exclusion only applies to the extent that the disposal of the foreign asset is "part of or incidental to the incentivised business". The e-Tax Guide clarifies that the determination of whether the disposal is part of the incentivised business should take place at the time of disposal. Practically, this could give rise to (at least) two issues.

Firstly, the question of whether income from (and by extension, gains on disposal of) foreign assets is incidental to an incentivised business is sometimes an item of contention between taxpayers and the IRAS. The problem may be exacerbated if there is a significant time lapse between the time of disposal and receipt of the gains in Singapore as supporting documentation may be difficult to locate when the IRAS challenges the tax position taken. To address this, businesses contemplating foreign asset disposals may consider obtaining upfront certainty from the IRAS to agree that any gains on disposal of its foreign asset and any income derived therefrom is covered by the incentive.

Secondly, while we expect that most incentivised entities would have sufficient economic substance in Singapore to be excluded from the scope of section 10L of the Act, this must be determined with reference to the basis period in which the disposal took place (and not when the gains are received). Therefore, businesses should maintain the necessary documentation to demonstrate economic substance in the relevant year.

<u>Economic substance</u>

The determination of whether an entity has met the economic substance requirement in Singapore is made with reference to the basis period in which the sale or disposal of the asset occurs, and the test will be applied at the entity level, although exceptions are made for special purpose vehicles, where the economic substance test may be applied at the holding company level (subject to conditions).

In its response to the public feedback on the draft Bill, the MOF acknowledged requests for bright-line tests (such as prescribing minimum thresholds) for establishing economic substance requirements but explained that it would not be possible due to the diversity of businesses and their modes of operation. Instead, the IRAS has provided various examples of how the economic substance test will be applied, including the factors to be considered where economic activities are outsourced, as in the case of a real estate investment trust (REIT), a private trust and a registered business trust.

The IRAS will also provide an avenue for businesses to seek advance ruling on the adequacy of their economic substance in anticipation of a sale or disposal of foreign assets taking place within one year from the date of application. The IRAS has termed these "ESR AR applications" and rulings issued under this framework may be valid for up to five years of assessment, i.e. they apply to the sale or disposal which is the subject of the advance ruling as well as any subsequent disposals which take place within the advance ruling validity period. This is provided that the relevant facts and representations made by the entity remain unchanged and there is no change in the tax laws or the IRAS' interpretation of them.

<u>Losses</u>

Losses incurred on the disposal of foreign assets (which would have been brought to tax if they were gains) may be set-off against gains from the disposal of foreign assets that are subject to tax. Unutilised foreign-sourced disposal losses may be carried forward for set-off against future gains.

Annex E of the e-Tax Guide illustrates the utilisation of such losses including an interesting scenario where the entity is able to meet the economic substance requirements in certain years but not others. Coincidentally, losses are incurred in years when the entity is able to meet the economic substance requirements and gains are derived in years when the entity is unable to meet those requirements resulting in the gains being subject to tax under section 10L of the Act when received in Singapore, but the losses cannot be set off against the gains as they would not have been taxable had they been gains. This example suggests that the economic substance of any entity within the scope of section 10L of the Act could come under the IRAS's scrutiny even for loss-making years.

Administrative requirements

In the light of the potentially extensive tracking requirements, the IRAS has stipulated in the e-Tax Guide that businesses will be required to provide certain information in their tax computations when submitting their annual income tax returns, mainly to facilitate tracking of unremitted gains, utilisation of losses and allowable expenses, and information relating to their economic substance in Singapore.

The e-Tax Guide also lists records and supporting documents that entities are required to maintain, but which need not be submitted with the tax return.

Funds and asset management industry

Fund entities that enjoy tax incentives today are already required to meet certain economic commitments as part of their respective incentive awards. Given the potential implications of section 10L to the funds industry, we expect that further guidance from the authorities should be forthcoming.

Key takeaway

With section 10L, businesses can no longer rely on non-taxation of capital gains nor the statutory safe harbour under section 13W for sale or disposal of foreign assets (where the gains are received in Singapore). Although we expect that businesses with economic substance should not be materially affected, they should monitor their own circumstances so as to ensure compliance with the economic substance requirements or to avoid inadvertent remittance of foreign sourced gains into Singapore. Hence, businesses owning foreign assets need to assess if future disposals of such assets (including in the case of a group restructuring) could fall within the scope of section 10L of the Act, including the situs of these assets, whether there is remittance of gains to Singapore, the adequacy of economic substance requirements and the viability of seeking an advance ruling from the IRAS.

The avenue for businesses to obtain an advance ruling on the economic substance requirement is welcome, but it is hoped that in due course, further guidance (such as safe harbour thresholds) will be issued to provide greater certainty for businesses.

Table 1: Comparison of Singapore's section 10L to Hong Kong's foreign-sourced income exemption regime as it applies to foreign-sourced disposal gains

	Singapore		Hong Kong		
	Gains on disposal of foreign assets (except IPR)	Gains from disposal of qualifying IPR	Gains from the sale of property (excluding equity interests and IPR)[1]	Gains from the sale of equity interests	Gains from the disposal of IPR
Economic substance requirement	✓		✓	✓	
Participation requirement				✓	
Nexus requirement		✓			✓

Note: Specific exceptions, e.g. financial institutions and entities enjoying the following tax concessions, are not included in this table:

- Aircraft Leasing Scheme
- Development and Expansion Incentive
- Finance and Treasury Centre Incentive
- Financial Sector Incentive
- Global Trader Programme
- Insurance Business Development Incentive
- Maritime Sector Incentive
- Pioneer Certificate Incentive

Table 2: Comparison of economic substance requirements between Singapore and Hong Kong

	Singapore	Hong Kong
(A) PEHEs		
Definition	An entity: • whose function is to hold shares or equity interests; and • derives only (i) dividends or similar payments from shares or equity interests, (ii) gains from sale or disposal of shares or equity interests; and (iii) income incidental to its activities of holding shares or equity interests.	An MNE entity[2] which only: • holds equity interests in other entities; and • earns dividends, disposal gains; and income incidental to the acquisition, holding or sale of such equity interests.
Economic substance requirements	The entity is required to: • submit to a public authority on a regular basis any return, statement or account required under the written law under which it is incorporated or registered; • have its operations managed and performed in Singapore, whether by its employee or other persons	The MNE entity is required to: • satisfy every applicable registration and filing requirement under the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32), the Limited Partnerships Ordinance (Cap. 37), the Business Registration Ordinance (Cap.

[1] Excludes gains derived by an entity that is a trader, where the gains are derived from, or incidental to, the entity's business as a trader.

[2] Under the Hong Kong FSIE regime, MNE entity refers to person that is, or acts for, an MNE group or an entity included in an MNE group. An entity is defined as a legal person (other than a natural person) or an arrangement that prepares separate financial accounts, such as a partnership and a trust. A MNE group refers to a group that includes at least one entity or permanent establishment that is not located or established in the jurisdiction of the ultimate parent entity of the group.

	where the activities performed by such other persons for the entity are subject to its direct and effective control; and • have adequate human resources and premises in Singapore to carry out its operations.	310); and the Companies Ordinance (Cap. 622); and • have adequate human resources and premises for carrying out the specified economic activities[3] in Hong Kong.
(B) Non-PEHEs		
Definition	An entity/ MNE entity that is not a PEHE	

Economic substance requirements	The entity is required to:
	• have its operations managed and performed in Singapore, whether by its employee or other persons where the activities performed by such other persons for the entity are subject to the direct and effective control of the entity; and
	• have adequate economic substance in Singapore.
	• Factors considered are:
	  • the number of full-time employees of the entity (or other persons managing or performing the entity's operations) in Singapore
	  • the qualifications and experience of such employees or other persons
	  • the amount of business expenditure incurred by the entity in respect of its operations in Singapore
	  • whether the key business decisions of the entity are made by persons in Singapore.
		The MNE entity is required to:
		• employ adequate number of employees with necessary qualifications to carry out the specified economic activities[4] in Hong Kong; and
		• incur adequate amount of operating expenditure for carrying out the specified economic activities in Hong Kong.

[3] Specified economic activities for a PEHE in Hong Kong is the holding and managing of its equity participants in other entities.

[4] Specified economic activities for non-PEHE in Hong Kong is the making of necessary strategic decisions in respect of any assets the entity acquires, holds or disposes of; and managing and bearing principal risks in respect of such assets.

Contact us

If you would like to discuss any of the issues raised, please get in touch with your usual PwC contact or any of the individuals listed below.

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