



## Singapore Business Tax developments

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#### **Income Tax Treatment arising from the adoption of Financial Reporting Standard (FRS) 116—Leases or Singapore FRS (International) (SFRS (I)) 16—Leases**

On 8 October 2018, the Inland Revenue Authority of Singapore (IRAS) has issued an e-Tax Guide on the "Tax Treatment Arising from Adoption of Financial Reporting Standard 116 (FRS 116) or Singapore Financial Reporting Standard (International) 16—Leases".

FRS 116 applies to entities with effect from annual reporting periods beginning on or after 1 January 2019 (i.e., YA 2020, or YA 2021 for entities with non-December year ends). Earlier application is permitted for entities that apply FRS 115 *Revenue from Contracts with Customers* at or before the date of initial application of FRS 116.

FRS 116 will supersede the following accounting standards when it becomes effective:

- (a) FRS 17—Leases;
- (b) INT FRS 104—Determining whether an arrangement contains a lease;
- (c) INT FRS 15—Operating leases—Incentives; and
- (d) INT FRS 27—Evaluating the substance of transactions involving the legal form of a lease.

## Current accounting and tax treatment under FRS 17

We begin with a brief discussion of the current accounting and tax treatment under FRS 17 as an aid in understanding the changes brought about by the adoption of FRS 116.

For good order, section numbers are quoted with reference to the Singapore Income Tax Act.

Broadly, FRS 17 requires lessors and lessees to account for leases as a finance lease (FL) if the lease transfers substantially all the risks and rewards incidental to ownership of an asset. An operating lease (OL) is a lease other than a FL. Of note is that FRS 17 does not require the lessee under an OL to record the leased asset and associated liabilities of future lease payments in its balance sheet.

The tax treatment of receipts and payments under a lease hinges on the characterisation of the lease. This is prescribed under Section 10D and Regulations made thereunder.

Briefly, for tax purposes, a FL is defined (in Section 10D) as a lease of any machinery or plant (including any arrangement or agreement in connection with the lease) which has the effect of transferring substantially the obsolescence, risks or rewards incidental to ownership of such machinery or plant to the lessee. FLs are further categorised into "FL treated as a sale<sup>1</sup>" and those that are not treated as a sale for tax purposes. An OL is any lease other than one that is treated as a FL.

The tax treatment of receipts and payments accounted for under FRS 17 (the "existing tax treatment") is summarised as follows:

<b>Classification of leases for tax purposes</b>	<b>Lessor<sup>2</sup></b>	<b>Lessee</b>
OL	Lease income is subject to tax when the lease income accrues to the lessor under the lease agreement. <sup>3</sup>  Capital allowance is given to the lessor on the leased asset if it qualifies as a machinery or plant.	Tax deduction is allowed on the contractual lease payments incurred.  No capital allowance allowed on the leased asset.
FL not treated as a sale	Lease income (i.e., interest and	Tax deduction is allowed on lease

	<p>principal repayment) received by the lessor is subject to tax.</p> <p>Capital allowance<sup>4</sup> is given to the lessor on the leased asset if it qualifies as a machinery or plant.</p>	<p>payments incurred (i.e., interest and principal repayment).</p> <p>No capital allowance allowed on leased asset.</p>
FL treated as a sale	<p>Interest income is subject to tax on an accrual basis. Principal repayment is not taxable.</p> <p>No capital allowance allowed on leased asset.</p>	<p>Tax deduction is allowed on interest expense on an incurred basis. Principal repayment is not deductible.</p> <p>Capital allowance allowed on leased asset if it qualifies as a machinery or plant and lessee carries on a trade or business.</p>

<sup>1</sup> A FL is treated as a sale if a FL satisfies any of the conditions listed under paragraphs (a) to (e) of Regulation 4(1) of Income Tax (Income from Finance Leases) Regulations.

<sup>2</sup> It is assumed that a lessor referred to in the e-Tax Guide is carrying on a trade or business in leasing.

<sup>3</sup> As an administrative concession, lessor can elect to be taxed on income from an OL using the effective rent method, subject to conditions. The effective rent includes the amortisation of lease expenses; any non-deductible lease expenses should be adjusted upfront (i.e. at the inception of the lease).

<sup>4</sup> Allowed to be set-off against income from finance leasing only. A set-off against other income and transfer under group relief system is allowed only upon cessation of the finance leasing activities that give rise to the capital allowances.

## Accounting for leases under FRS 116

Under FRS 116, lessors and lessees will account for leases differently.

Whilst the accounting treatment for lessors remains largely unchanged (i.e., lessors will continue to classify leases as an OL or FL), lessees will no longer classify their leases as an OL or FL. Instead, a lessee is required to recognise a right-of-use (ROU) asset representing its rights to use the underlying leased asset and a corresponding lease liability representing its obligation to make lease payments.

The ROU asset and lease liability gives rise to amortisation expenses and interest expenses respectively over the tenure of the lease.

### Tax treatment of leases under FRS 116

The existing tax treatment of leases continues to apply to leases accounted for under FRS 116.

<b>For lessors</b>	<p>The existing tax treatment for lessors will be retained.</p> <p>The impact of FRS 116 on lessors is not expected to be significant given that lessor accounting remains substantially unchanged.</p>
<b>For lessees</b>	<p>The existing tax treatment for lessees will be retained, notwithstanding the significant changes made to lessee accounting. Broadly:</p> <ul style="list-style-type: none"><li>• The characterisation of leases as a FL or OL continues to be the starting point in determining the tax treatment of payments under a lease.</li><li>• The characterisation remains governed by Section 10D. The IRAS has indicated that lessees could refer to examples and indicators provided in paragraphs 63 and 64 of the FRS 116 accounting standard to determine whether a lease arrangement should generally be classified as a FL.</li><li>• A significant impact arising from the retention of the existing tax treatment of leases is that tax deduction is granted on contractual lease payments incurred under an OL and a FL not treated as a sale, instead of amortisation and interest expenses. Once FRS 116 is effective, taxpayers with OLs (say of office equipment) which are accounted for as ROU assets will be required to make tax adjustments throughout the tenure of the lease.</li><li>• Tax deduction is granted on interest expenses arising from a FL treated as a sale on an incurred basis. The quantum of deductible interest expenses is determined based on the interest rate implicit in the lease. If that rate cannot be readily determined, the lessee shall use the lessee's incremental borrowing rate. Amortisation expenses are not deductible and tax adjustments are required. Principal repayments should qualify for capital allowance if the asset is qualifying plant or machinery and used in the trade or business.</li></ul>

## Tax treatment for subleases

The e-tax guide provides several examples to illustrate the tax treatment of subleases.

Broadly, a sublease is a transaction for which an underlying asset is re-leased by a lessee (also referred to as an intermediate lessor, or "IL") to a third party, and the lease between the head lessor and IL (head lease) continues to remain in effect.

In a sublease arrangement, the IL will be deriving income from the sublease and making payments to the head lessor.

A summary of the accounting and tax treatment are as follows:

Accounting treatment	Tax treatment
<p>An IL shall classify the sublease as a FL or OL in the following manner:</p> <p>(a) If the IL has elected to treat the head lease as a short-term lease, the sublease shall be classified as an OL.</p> <p>(b) Otherwise, the sublease shall be classified <b>by reference to the ROU asset</b> arising from the head lease resulting in an OL or a FL, as the case may be.</p>	<p>The classification of the sublease for the IL (as head lease lessee) is to be <b>determined by reference to the underlying asset</b> instead of the ROU asset. This is to align with the existing tax treatment applied for the purpose of classifying leases for tax purposes.</p>

To elaborate the above, the e-Tax Guide provides the following example:

*"If the useful life of an asset is 20 years and is leased by the IL for 8 years and is immediately subleased out for 8 years, the sublease will be classified as a FL under the accounting treatment, as determined by reference to the ROU asset (i.e. 8/8 years). However, for tax purposes, such a lease will be treated as an OL as the lease term is not for the major part of the economic life of the underlying asset (i.e. 8/20 years)."*

In the above example, as the sublease is regarded as an OL, the IL will be taxed on the lease income.

Practical difficulties may arise for the IL in determining the useful life of the underlying assets as such information may not be readily available. This could have a potential impact in how the IL will classify a sublease arrangement.

## Withholding tax obligations

Under FRS 116, withholding tax obligations would be determined based on the legal characterisation of the payments rather than the accounting classification of the expenses in the profit and loss statement.

Broadly:

<b>Classification of lease arrangement for tax purposes</b>	<b>Withholding tax obligations</b>
FL treated as a sale	Lessee has to treat the interest portion of the lease payment as a payment falling within the ambit of section 12(6)
OL and FL not treated as a sale	Lessee has to treat the entire lease payment for the use of any movable property as a payment falling within the ambit of section 12(7)

## Total asset method used in determining deductible interest expenses

Briefly, the total asset method (TAM) is used to determine the quantum of deductible interest expenses in instances where funds from interest-bearing debt cannot be specifically identified to the acquisition of income producing assets.

The adoption of FRS 116 will result in most leases being accounted for on the lessee's balance sheet as ROU assets. This raises the issue of whether ROU assets should, for purposes of the TAM:

- i) Be included in the total asset base; and
- ii) If so, be regarded as income producing assets.

The IRAS has stated that, in applying the TAM to common interest expenses, the total asset base should exclude:

- (a) Assets financed by the specific interest bearing loans;
- (b) ROU assets treated as a sale agreement; and
- (c) ROU assets where contractual lease payments incurred have been allowed as deduction for tax purposes.

## GST treatment

The GST treatment for leases remains unchanged with the adoption of FRS 116. For GST purposes, a lease is treated as:

- (a) A supply of goods if the possession of the goods is transferred under an agreement which expressly contemplates that the property (i.e., ownership or title) will pass at some time in the future. For example, goods sold under a hire purchase agreement; or
- (b) A supply of services if only the possession of the goods is transferred, without any provision for possible future transfer of ownership of the goods.

### Deloitte Singapore's comments

IRAS' e-tax guide on FRS 116 confirms the authorities' position that the tax treatment of leases under FRS 116 *will not be aligned* with the accounting treatment. This position was first mooted by the IRAS in a public consultation paper issued a year earlier on 8 August 2017.

The impact of adopting FRS 116 may be analysed from the perspective of *tax costs* and *compliance burden*.

In relation to the former, given that the existing tax treatment continues to apply to leases accounted for under FRS 116, no material adverse *cash* tax impact should arise from the adoption of the new accounting standard. Similarly, no material transitional adjustments are anticipated as the existing tax treatment for both lessor and lessee are retained.

For the latter, we anticipate increased compliance burden for lessees since the tax treatment of leases for lessees is not aligned with accounting. Specifically:

- Lessees would not be required to distinguish between an OL or a FL for accounting purposes although the requirement to do so remain for tax purposes. Consequently, the classification of leases may not be subject to review during an audit of the financial statements. In view that the classification of leases includes elements of subjectivity, businesses may have to incur additional cost to obtain technical guidance, particularly in situations where lease terms are complex.
- The significant changes to lessee accounting and the prevalence of operating leases in businesses should result in a sizeable number of taxpayers having to make tax adjustments as the quantum of deductions under an OL is ascertained based on contractual lease payments incurred. The timing difference between accounting and tax-deductible expenses may also give rise to deferred tax adjustments.

The following clarifications in the e-tax guide are also noteworthy:

- Currently, payments liable to be made to a person who is not a resident in Singapore (excluding any permanent establishment in Singapore) for the charter (including time charter) of any

ship under any agreement or arrangement on or after 17 February 2012 is exempted from tax under section 13(1)(oa). Waiver of withholding tax obligation is also granted to such payments made to non-Singapore residents on or after 17 February 2012 under section 45A(2D). The IRAS is of the view that the aforementioned income tax and withholding tax exemptions do not apply to payments made under a FL not treated as a sale for any ship leasing arrangement. In particular, payments under a FL not treated as a sale are deemed to be derived from Singapore under section 12(7)(d)<sup>5</sup> and withholding tax is *prima facie* applicable if such payments are made to non-Singapore residents.

We note that the ambit of section 12(7)(d) encompasses amounts regarded as "rent or other payments... for the use of any movable property". *Ipsa facto* payments under a FL not treated as a sale are regarded as payments for the use of movable property and it is not clear why such payments would be excluded from the withholding tax exemption that applies to "payments... for the charter of any ship under any agreement or arrangement".

Separately, prior to 17 February 2012, a withholding tax rate of 2% (which may be reduced by an applicable tax treaty) was applicable to bareboat, voyage and time charter fee payments to non-residents. The e-Tax Guide is silent on whether payments made pursuant to a FL not treated as a sale are regarded as 'bareboat, voyage or time charter fees' and consequently there is uncertainty over whether the 2% withholding tax rate would apply to such payments. If not, a 15% withholding tax rate strictly applies and this may add to business costs given that in most situations withholding tax on charter payments are typically borne by the lessee.

<sup>5</sup> A new section 12(7AA) has been introduced under the Income Tax (Amendment) Bill 2018.

- In relation to TAM, the IRAS holds the view that for ROU assets where contractual lease payments incurred qualify for tax deduction (i.e., an OL for tax purposes) should be excluded from the total asset base. This is similar to the current tax treatment where operating leases, being off-balance sheet financing items, are not included for TAM purposes.
- Under FRS 116 where the lessee is required to recognise the leased goods as his assets under the single lessee accounting model, if the lease agreement does not contemplate the transfer of property to the lessee, for GST purposes, there is no supply made by the lessee when the lessee returns the goods without any consideration to the lessor at the end of the lease term. It is extremely important for the lessor to correctly determine whether a particular lease is a supply of goods or services for GST purposes as different place of supply and time of supply rules apply.



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