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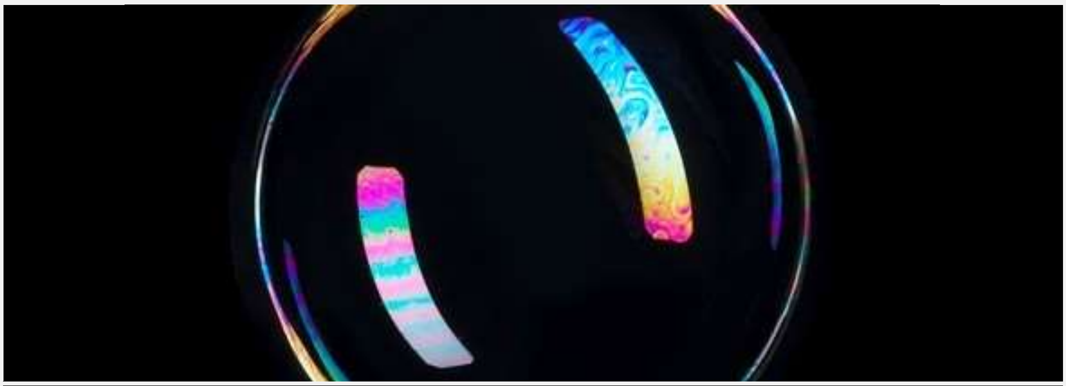

Singapore Business Tax Alert
New e-Tax Guide on Total Asset Method for Interest Adjustment

Greetings from your tax team at Deloitte Singapore. This newsletter is your reference for practical information on relevant business tax issues.

Update: New e-Tax Guide on Total Asset Method for Interest Adjustment

The Inland Revenue Authority of Singapore (IRAS) has issued an e-Tax Guide on Total Asset Method (TAM) for Interest Adjustment on 16 December 2016. The guide sets out the application of the TAM in attributing common interest expense to income producing and non-income producing assets.

There are a fair number of past Singapore tax court cases addressing the tax deductibility of interest expenses, highlighting both the importance of this matter to taxpayers as well as the complexities surrounding this subject. As the e-Tax Guide draws on guiding principles from a few of these cases, we first lay out the relevant case laws underpinning deduction of interest expenses under the Income Tax Act.

IA v Comptroller of Income Tax [2007] MSTC 7,521	Amongst others, *IA* sets out guiding principles for determining when interest is deductible under s 14(1) and s 14(1)(a). Briefly, only interest incurred on funds used to acquire revenue

	assets are deductible under s 14(1). In other instances (such as where funds were used to acquire capital assets, or funds were not earmarked for a specific purpose and is thus considered as accretion to the capital of the taxpayer), interest must satisfy conditions laid out in s 14(1)(a) to rank for tax deduction. It is appropriate to note that TAM applies only to interest deductible under s 14(1)(a).
Andermatt Investments Pte Ltd v. Comptroller of Income Tax [1995] SGCA 63	*Andermatt* sets out the principle that for interest to be deductible under s 14(1)(a), there must be a **direct link** between the money borrowed and the income produced. The High Court, in an earlier judgement, held that: "The expression "the income" in s 14(1)(a) of the Act referred to **the income from a specific source for a specific period** and not total income from all sources for that period. It refers to income from that source for that period in acquiring which such capital has been employed…"
JD v Comptroller of Income Tax [2006] SGCA 52	*JD* concerns the deduction of interest expenses against dividend income [which were assessed to tax under s 10(1)(d)] from a basket of share investments, some of which yielded dividends whilst others did not. The interest expenses arose from a common pool of interest-bearing funds and were not directly identifiable against dividend-yielding investments and non-dividend yielding investments. As such, the deductibility of such interest expenses were governed by s 14(1)(a). Amongst others, the Court: (i) Held that the source of dividend income stems from the particular share counter that yielded the revenue* (i.e. one counter, one source) (ii) Affirmed the principles laid down in *Andermatt*, in that there must be a **direct link** between money borrowed and the income produced (iii) Held that the phrase "where the Comptroller is ***satisfied*** that such sum is payable…" confers a

		degree of administrative discretion on the Comptroller to administer s 14(1)(a) (iv) Due to the findings in (i), regarded the use of the Total Asset Method (termed Total Assets Formula in *JD*) to determine the quantum of deductible interest expenses as a "logical mathematical method and not some arbitrary or unreasonable measure" and may be used in situations where there is no direct link between money borrowed and the income produced.

**This position in law is modified by the administrative concession granted by the IRAS on "Group" treatment of <u>taxable</u> dividends.*

Turning to the salient points of the e-Tax Guide:

1. The IRAS has stressed that, as a strict position of law, only interest from funds utilised to acquire income-producing assets qualify for deduction under section 14(1)(a). Taxpayers who are unable to prove or track the utilisation of their interest-bearing funds to the acquisition of income-producing assets are unable to claim tax deduction on interest expenses arising from those funds.

2. Notwithstanding this position in law, the IRAS has exercised its administrative discretion in instances where taxpayers are unable to establish the precise utilisation of their interest-bearing funds. Interest expenses arising from these funds termed "common interest expenses" would be denied tax deduction to the extent that they are attributable to non-income producing assets. The attribution of interest expenses to non-income producing assets is performed using the TAM formula, which is expressed in the following manner:

$$\frac{\text{Cost of non-income producing assets as at balance sheet date}}{\text{Cost of total assets as at balance sheet date}} \times \text{Common interest expenses}$$

3. The TAM formula rests on a key assumption that common interest expenses are used to finance the acquisition of <u>all</u> assets of the Company. The IRAS has stressed that the TAM is a simple formula which uses the cost of assets as a proxy for the utilisation of funds. This being the case, taxpayers that utilise the TAM method are generally not allowed to make adjustments to the formula, such as excluding from the

formula the cost of non-income producing assets which existed before the taxpayer had obtained the interest-bearing funds.

4. With the above in mind, the deductibility of interest expenses may be broadly summarised as follows:

<table>
<tr><th>Examples</th><th>Deductibility</th><th>Remarks</th></tr>
<tr><td>Interest expense incurred on interest-bearing loans taken up to finance revenue assets or specific income-producing assets</td><td>Deductible against income arising from those assets</td><td rowspan="2">To <u>exclude</u> assets specifically funded by such interest-bearing funds from the denominator (cost of total assets) of the TAM formula</td></tr>
<tr><td>Interest expense incurred on interest-bearing loans taken up to finance specific non-income-producing assets</td><td>Not deductible. Also, no option to regard interest expenses from such loans as common interest expenses in order for part of the interest expenses to be deductible via TAM</td></tr>
<tr><td>Common interest expense incurred on interest-bearing loans</td><td>Apportionment of interest expense via TAM to income-producing assets is required to determine amount of deductible interest expenses.</td><td>All assets (except those specifically funded by interest-bearing funds) are to be included in the denominator of the TAM formula. Also:
the cost of non-income producing assets which existed before the Company had obtained the borrowed funds <u>should be included</u> in the TAM formula
the cost of assets financed by non-interest bearing funds <u>should be</u></td></tr>
</table>

		included in TAM formula

5. Issues/points to consider:

a. Under the previous full imputation system for dividends, interest expense incurred on loans used to finance share investments that generate dividend income are deductible. Following the shift to the current one-tier system, the TAM must continue to be used to attribute common interest expense against tax-exempt dividends (even though there will not be any tax benefit). TAM is also to be applied, where applicable, towards other tax-exempt investment income.

b. Taxpayers who are on the FRS 39 tax treatment are to use the value of the assets as reported on the balance sheet (as at the year-end balance sheet date) without adjustment for impairment or valuation surplus / deficit.

c. However, such taxpayers may elect to use historical costs for the purposes of applying the TAM. Such an election requires the taxpayer to track and keep proper records of the historical cost of all assets separately.

d. In order for taxpayers to claim that an asset is funded by a specific interest-bearing loan, the taxpayer must be able to identify and track how the interest-bearing loans are applied. This is a practical issue; where the use of the funds are stipulated in the loan agreement, this should ordinarily satisfy the IRAS. In other instances, such as where the loan is structured as say a medium term note without a specific purpose, there may be practical difficulties in substantiating the use of funds from each tranche or drawdown. Amongst others, the provision of bank statements showing the flow of funds (dates and amounts) may be helpful to demonstrate the linkage between a loan amount and its subsequent usage.

e. The e-tax guide sets out formally what has been the IRAS' practice in the past, and highlights the IRAS' focus in this area. A key message from the IRAS is that relatively little adjustments are allowed to the TAM formula since it is a 'proxy' formula and is designed to be simple to apply. As such, taxpayers should exercise care when structuring their interest-bearing borrowings. This includes considering when assets are acquired or disposed since only year-end balances are taken into account by the TAM. The application of Singapore's interest deduction rules is arguably complex and taxpayers with interest-bearing borrowings should seek advice and determine how the said guidelines would affect their tax positions going forward.

Contacts

For more information on any of these issues, or any other Business Tax matters, please contact **Low Hwee Chua**, or your usual Business Tax Services contact in Deloitte.

Business Tax Services		
Name	**Contact Number**	**Email**
Low Hwee Chua Singapore Leader	+65 6216 3290	hwlow@deloitte.com
Ajit Prabhu Mergers & Acquisitions Tax Leader	+65 6530 5522	aprabhu@deloitte.com
Daniel Ho Partner	+65 6216 3189	danho@deloitte.com
Lee Tiong Heng R&D and Government Incentives Leader	+65 6216 3262	thlee@deloitte.com
Liew Li Mei Partner	+65 6216 3232	liliew@deloitte.com
Linda Foo Partner	+65 6530 5562	lfoo@deloitte.com
Michael Velten Financial Services Tax Leader	+65 6531 5039	mvelten@deloitte.com
Ong Siok Peng Partner	+65 6216 3257	spong@deloitte.com
Rohan Solapurkar Partner	+65 6531 5027	rohans@deloitte.com
See Jee Chang Partner	+65 6216 3181	jcsee@deloitte.com
Shantini Ramachandra Deloitte Private Tax Leader	+65 6800 2295	sramachandra@deloitte.com
Steve Towers International Tax Leader	+65 6216 3227	stowers@deloitte.com
Wong Chee Ming Partner	+65 6530 5595	cwong@deloitte.com

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