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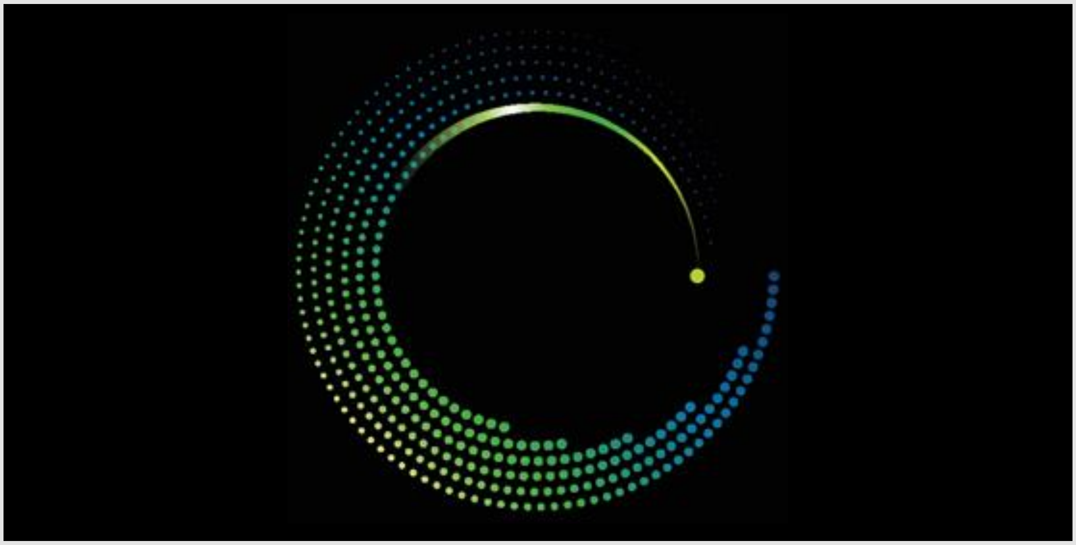

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IRAS updates on tax treatment on appropriation of trading stock for non-trade or capital purposes and conversion of non-trade or capital assets to trading stock

On 5 April 2022, Inland Revenue Authority of Singapore (IRAS) published an e-Tax Guide on the tax treatment on the appropriation of trading stock for non-trade or capital purposes and conversion of non-trade or capital assets to trading stock (e-Tax Guide).

Background

It is helpful to start with a definition of the terms 'appropriation' and 'conversion' as it applies to trading stock.

An appropriation occurs when trading stock of a person's trade or business is permanently set aside for use other than for sale or disposal in the ordinary course of the person's trade or business. On the other hand, a conversion occurs when a non-trade or capital asset is converted, whether wholly or partly, to trading stock.

The following are examples of appropriation of trading stock for non-trade or capital purposes and conversion of non-trade or capital assets to trading stock:

- a trader of computers may decide to use a computer from its trading stock for its daily operations (i.e., as fixed asset of the trade);

- a business may donate its trading stock for charitable purpose;
- a property developer may decide to keep the balance of unsold property units for long-term investment to derive rental income; or
- a hotel owner may redevelop the hotel into residential properties for sale.

Trading stock appropriated for non-trade or capital purposes

When trading stock is appropriated for non-trade or capital purposes, gains or losses are recognised for income tax purposes as the trading stock is treated as sold on the date of appropriation, notwithstanding that there is no change in the ownership of the trading stock in question.

Section 10J provides that, with effect from 16 November 2021, an amount equal to the open market value (OMV) of the trading stock as at the date of appropriation is treated as income for the Year of Assessment (YA) relating to the basis period in which the trading stock was appropriated.

The net profit (or loss) resulting from the appropriation of trading stock is taxable (or deductible). Expenses incurred in connection with that appropriation are deductible under section 14 of the Income Tax Act (ITA), subject to section 15 of the ITA.

For donation of trading stock that qualifies for enhanced tax deduction under section 37(3) of the ITA, the cost of acquiring, making, or constructing the trading stock will be treated as income, instead of its OMV as at the date of appropriation.

Capital allowances under section 19 or 19A of the ITA will be allowed on the qualifying plant or machinery that was converted from trading stock. The capital expenditure is treated as incurred on the date of appropriation of the trading stock and capital allowance is allowed based on the OMV of the trading stock as at the date of appropriation.

Non-trade or capital asset converted to trading stock

Where a non-trade or capital asset is converted to trading stock, the gain or loss upon the conversion relating to the change in the value of the non-trade or capital asset up to the date of conversion is capital in nature and is not taxable or deductible.

Section 32A provides that, with effect from 16 November 2021, the OMV of the non-trade or capital asset as at the date of conversion is treated as the cost of the trading stock for the purposes of computing the gains or profits arising from the subsequent sale or disposal of such trading stock.

The amount of profit or loss on sale is computed based on the following formula:

Profit or loss on sale of trading stock	=	Actual sale price	-	OMV of the non-trade/capital asset on the date on which it is converted to trading stock	-	Cost of any additional work done

Where the non-trade or capital asset converted to trading stock is a qualifying plant or machinery for which capital allowance has been claimed, a balancing adjustment must be made. The balancing adjustment [i.e., balancing allowances (BA) or balancing charges (BC)] is computed based on the difference between the tax written down value (TWDV) of the plant or machinery and its OMV as at the date of conversion. A BC is taxable while a BA is deductible. The BC, if applicable, is capped at the amount of capital allowances previously granted in respect of that non-trade/capital asset.

Filing requirement and timing of tax adjustment

A person is required to give notice of any appropriation of trading stock for non-trade or capital purposes, or conversion of non-trade or capital asset to trading stock, to the Comptroller of Income Tax (CIT) at the time of filing the tax return for the basis period in which the appropriation or conversion took place. The prescribed reporting form (AC Reporting Form) can be found in Annex C of the e-Tax Guide.

In the case where the income on the appropriation has not been assessed to tax in that YA relating to the basis period in which the appropriation took place, such income is treated as the person's income for the YA in which the CIT discovers sufficient facts to reasonably conclude that such appropriation has taken place.

Section 95 may apply if the taxpayer had filed an incorrect tax return by omitting information relating to the appropriation of trading stock for non-trade or capital purposes, which resulted in lower tax charged.

More details can be found on IRAS' website

Deloitte Singapore's view

The characterisation of an asset as either trading stock or capital primary rests on the intention of the taxpayer at the time when the asset was acquired. Was the asset acquired with an intent to trade in it, or was it acquired as part of the profit-making apparatus? However, intentions may change subsequent to the initial purchase and the enactment of Sections 10J and 32A codifies what is arguably the prevailing practice of the CIT when the taxpayer has a change of intention with regard to an asset.

According to the e-Tax Guide, the CIT would determine the intention of the taxpayers based on the facts and circumstances. Although intention is subjective, determining whether an appropriation or conversion has taken place is objective because it is based on observable facts.

As a result, it is critical to explicitly document the intention, and the e-Tax Guide provides examples of relevant documents and information to support an appropriation or conversion. When trading stock is appropriated for non-trade or capital purposes, the CIT will consider changes in accounting classification, board of directors' resolutions, investment return/cashflow analysis, and other unequivocal evidence that provides a reasonable inference that the appropriation is permanent. When a non-trade or capital asset is converted to trading stock, the CIT considers whether the period of contemplation has passed and there is a committed plan of action on a specific date (e.g., the date of contractor appointment or the date of payment of development charge to redevelop an immovable property for sale, etc).

While the examples of relevant documents and information in the e-Tax Guide are not exhaustive, they are certainly helpful in providing taxpayers with insights into what the CIT expects to prove intention and assess whether appropriation or conversion has taken place. Being able to explicitly document the intention will be beneficial; for example, property developers converting trading stock into investment assets when the market is bad, etc.

According to the FAQ, determining whether an appropriation or conversion has taken place appears to require a collective assessment of all relevant facts and circumstances, i.e., no single factor or indicator is conclusive. Furthermore, the taxpayer bears the burden of proof, i.e., taxpayers must keep contemporaneous documents to prove that trading stock has been appropriated to non-trading asset (and vice versa), and these documents must be made available to CIT upon request.

Separately, where the CIT discovers that appreciated trading stock has been appropriated for capital purposes in a particular assessment year and tax was not assessed on the income in that year, that income is deemed to arise in the year of discovery by the CIT. This protective provision ensures that assessments raised by the CIT for appropriated trading stock should be raised ‘in time’, otherwise the CIT may be statutorily time-barred from raising assessments if the change in intention happened a few years back.

At this juncture, it is not clear if the CIT would infer that trading stock retained by the taxpayer for long periods of time have been appropriated for capital purposes. In our view this should not be the case as an appropriation requires clear intent on the part of the taxpayer. Nevertheless, on grounds of prudence taxpayers may wish to retain requisite documentation to support its contention that the asset(s) in question continue to be held as trading stock. It should also be noted that the retention period of such documentation may exceed normal requirements, which is currently five years from the first day of the relevant assessment year pursuant to Section 67(1) of the ITA.

Contact

Should you have any comments or questions arising from this newsletter, please contact either the listed contacts below, or any member of the **Singapore Tax & Legal team**.

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