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Tax Alert

ISSUE 14 | **FEBRUARY 2017**

Income Tax: Total asset method for interest adjustment

Introduction

The Inland Revenue Authority of Singapore released an e-Tax Guide on 16 December 2016 which provided clarifications on the application of the Total Asset Method (TAM) of attributing common interest expenses (including borrowing costs akin to interest) to income producing and non-income producing assets. It sets out the rationale of the using the TAM, the underlying assumptions and how TAM should be applied.

Taxpayers who use the TAM should align their methodology from the date of this e-Tax Guide.

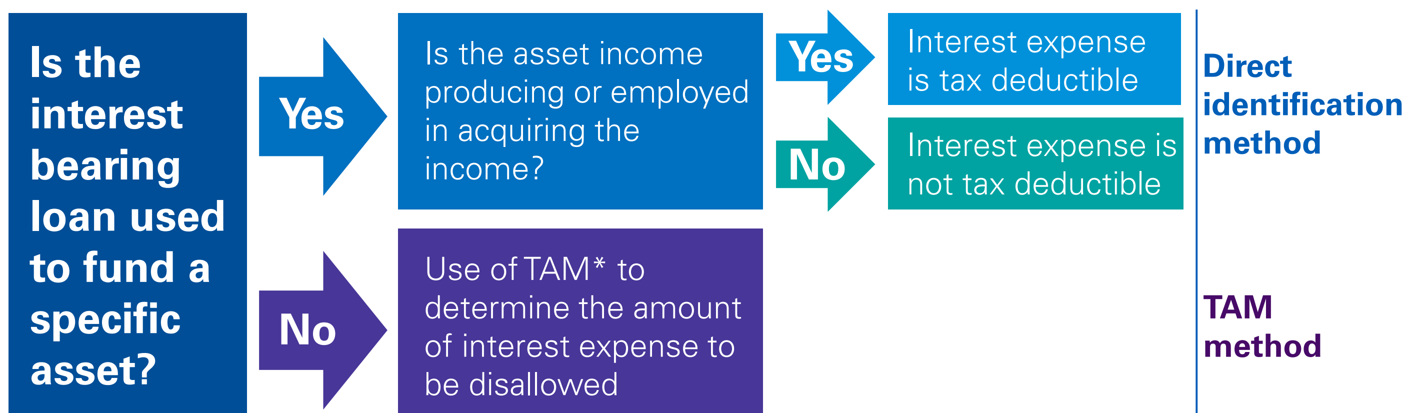
Background

Under Section 14(1)(a) of the Singapore Income Tax Act, for an interest expense to be tax deductible, the Comptroller of Income Tax (the Comptroller) has to be satisfied that such interest is payable on capital employed in acquiring the income; failing which the interest expense is not deductible. In other words, there must be a direct link between the interest expenses incurred on the use of loans and the income earned.

Generally, an interest bearing loan could be taken up by the company to fund a specific asset or the interest bearing loan could be co-mingled with the company’s other funds. Where the interest bearing loan is co-mingled with other funds, and direct identification and tracking of interest bearing loan to the income-producing asset cannot be established, the common interest expense incurred on the loan would not be tax deductible under Section 14(1)(a).

Use of TAM as a proxy

As an administrative practice, the Comptroller has been allowing the use of the TAM as a proxy method to ascertain the amount of common interest expense attributable to non-income producing assets to be disallowed. The income tax treatment for the interest expense incurred on an interest bearing loan is summarised below:



*** The formula used in the TAM is as follows:**

Amount of interest expense to be disallowed =

$$\frac{\text{Cost of non-income producing assets as at Balance Sheet date}}{\text{Cost of total assets as at Balance Sheet date}} \times \text{Common interest expense}$$

Underlying assumptions

The underlying assumption of the TAM is that all (specific and common) interest expenses incurred on borrowed funds are used to finance the total cost of assets of a company (i.e. the denominator) as at the relevant financial year end. To the extent that the cost of assets is not financed by specific interest bearing loans, the common interest expense is attributable to the cost of these assets that are income producing and non-income producing in a proportionate manner.

Key clarifications:

Once the TAM is used, the company has to include the cost of all assets as at the financial year end, other than the amount financed by specific interest bearing loans, in the denominator of the formula, even if:

i. there are non-income producing assets which existed before the company takes the interest bearing loan; or

ii. there are cost of assets which are financed by non-interest bearing funds.

It is also clarified that when the specific interest bearing loan is fully repaid, the cost of asset financed by the loan should be included in the denominator of the TAM in subsequent years of assessment.

Administrative procedure

Taxpayers are required to maintain sufficient documentations to support their interest restriction computations and to submit them as and when requested by the Comptroller.

Other clarifications

Also covered in the e-Tax Guide are:

- The Comptroller would allow variation in the application of TAM accepted by the Comptroller in past years of assessment until the relevant assets/ loans are disposed/ repaid.

- For taxpayers who remain on pre-FRS 39 tax treatment, historical costs of assets are used for the purpose of TAM. For taxpayers who are on FRS 39 tax treatment, the value of the assets used is the value reported on the balance sheet without any adjustment. However, they can elect to use the historical costs of assets by making an election in writing upon submission of tax returns. At any time after the election, taxpayers can make an irrevocable option to use the value of the assets shown in the balance sheet under the FRS 39 valuation.

- TAM may be used to ascertain the amount of interest expenses to be disallowed in cases where loans to related parties in Singapore are made or to ascertain the amount of qualifying borrowing costs (akin to interest) attributable to non-income producing assets which are not tax deductible.

- Interest expenses incurred on bank loan for payment of dividends to shareholders are not tax deductible as it is a non-trade transaction.

Our views

Absent a distinct and direct identification method, TAM is a simple formula commonly adopted by taxpayers as a proxy for the interest expense incurred on the borrowing that was used for non-income generating activities. The application of the TAM reduces compliance costs. However, due to the inherent assumptions underlying the TAM formula, it may not consistently produce a fair result.

In view of the above, it is pertinent that businesses consider the tax deductibility of interest expenses before obtaining an interest bearing loan. Business should also take the opportunity to review its current debt financing structure to optimise its interest deduction claim. Areas to consider include:-

1) Should the business fund the acquisition of an asset through specific and identifiable borrowings or through payment out of co-mingled pool of funds?

2) What documentations should the business maintain to support the tax deductibility of the interest expenses?

3) Which entity (i.e. investment holding parent or operating entity) should be the borrowing entity within the Group?

4) Should the parent company inject funds into subsidiary company via equity or interest bearing loan?

Other related issues – Cross-border financing

Where a local entity incurs interest expense or borrowing costs in extending a loan to a related party overseas, additional issues such as foreign withholding tax implications on the interest income and transfer pricing implications on the basis of charge would need to be considered. There is also a need to consider the tax deductibility of the interest expenses for the overseas entity in the foreign jurisdiction and the applicability of the foreign tax credit in respect of the foreign withholding tax suffered on the interest remitted.

Hence, in deciding on the debt financing structure for group entities especially those involving foreign entities, a review should be conducted for overall tax efficiencies.

How we can help

As a committed tax advisor to our clients, we welcome any opportunity to discuss the relevance of the above matters to your business.

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