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Tax alert

Taxation of gains from sale of foreign assets received in Singapore by businesses without economic substance

On 3 October 2023, the Singapore Parliament passed legislative amendments introducing a new Section 10L to the Singapore Income Tax Act 1947 (SITA). This new provision will tax gains from the sale or disposal of foreign assets on or after 1 January 2024 that are received in Singapore by businesses without adequate economic substance in Singapore. This applies even if the gains are capital in nature or tax-exempt, e.g., under Section 13W of the SITA, unless they meet certain exceptions.

The Inland Revenue Authority of Singapore (IRAS) had also recently published the much-anticipated e-Tax Guide on *Tax Treatment of Gains or Losses from the Sale of Foreign Assets* on 8 December 2023 to provide further guidance on the application of Section 10L (the e-Tax Guide).

This change marks a significant departure from the long-standing Singapore tax treatment of not taxing gains on disposal of assets as long as they are capital gains (whereby capital gains are not taxed in Singapore).

The rationale behind this amendment is to align the tax treatment of gains from the sale of foreign assets to the EU Code of Conduct Group guidance, which aims to address international tax avoidance risks. This change is also in line with Singapore's focus on anchoring substantive economic activities in Singapore.

This tax alert is an update of a previous tax alert published on 30 August 2023 covering the proposed Section 10L. In this alert, we provide a summary of the salient changes, our observations and the key issues that businesses should consider when evaluating the potential implications to their operations.

Building a better working world

Under the new Section 10L, gains from the sale or disposal of foreign assets on or after 1 January 2024 that are received in Singapore by an entity of a relevant group will be treated as income chargeable to tax under Section 10(1)(g) of the SITA, unless exceptions apply. Section 10L applies even if the gains are capital in nature or tax exempt (e.g., under Section 13W of the SITA).

Where the sale or disposal occurs prior to 1 January 2024, the gains received in Singapore on or after 1 January 2024 by a relevant entity would not be caught under the scope of Section 10L.

Scope of Section 10L

Foreign assets

Foreign assets refer to movable or immovable properties situated outside Singapore. Section 10L(15) sets out specific rules on where these properties are situated, and include (amongst others):

- Immovable property and tangible movable property are situated where the property is physically located.
- Intellectual property right (IPR), or any licence or other right in respect of any IPR, is situated where the owner of the IPR, licence or right is resident.
- Intangible movable property is situated where the ownership rights in respect of the property are primarily enforceable.
- Secured or unsecured debt (other than a judgment debt or securities) is situated where the creditor is resident.
- Shares or securities (including any right or interest in such shares or securities) issued by a company are situated where the company is incorporated.
- Registered shares, equity interests or securities are situated where the shares, equity interests or securities are registered.

Received in Singapore

Section 10L(9) sets out when gains from the sale or disposal of foreign assets are regarded as received in Singapore. Gains are received in Singapore when they are:

- Remitted to, transmitted or brought into Singapore.
- Applied in or towards satisfaction of any debt incurred in respect of a trade or business carried on in Singapore.
- Applied to purchase any movable property that is brought into Singapore.

These rules are similar to the existing remittance rules under Section 10(25) of the SITA.

In addition, in the IRAS' e-Tax Guide, it is indicated that in cases where the gain received in Singapore is less than the historical cost of the foreign asset, the IRAS is prepared to treat the amount received in Singapore as capital funds and not disposal gains. This is provided that the entity can furnish an account of the funds from foreign-sourced capital sources before the date of repatriation showing that after the repatriation, the funds remaining outside Singapore is no less than the amount of gain from disposal of the foreign asset that has yet to be received in Singapore. This treatment is similar to the IRAS' position for foreign-sourced income in general.

Entity of a relevant group

Section 10L applies to an entity that is a member of a relevant group. An entity is defined as a legal person (not being an individual), a partnership, or a trust.

An entity is treated as a member of a group if the entity's financial results are included in the consolidated financial statements of the parent entity of the group, or are excluded from such consolidated financial statements solely on size or materiality grounds or on grounds that the entity is held for sale.

A group is a relevant group if the entities of the group are not all incorporated or established in Singapore, or if any entity in the group has a place of business (such as a branch or a permanent establishment) in more than one jurisdiction.

Tax treatment of disposal gains from foreign assets (not being foreign IPRs)

Under Section 10L(8), Section 10L will not apply to gains from the sale or disposal of a foreign asset (not being a foreign IPR) when it is:

- Carried out as part of, or incidental to, the business activities of a financial institution.
- Carried out as part of, or incidental to, the business activities or operations of an entity whose income is exempt from tax, or is taxed at a concessionary tax rate, under certain specific tax incentives schemes in Singapore.
- Carried out by an excluded entity (i.e., entity that meets certain economic substance requirement - refer to table below).

Economic substance requirement

Pure equity-holding entity (PEHE)*	▶ Submits to a public authority the required return, statement or account on a regular basis ▶ Operations of the entity are managed and performed in Singapore (whether by its employees or by other persons where the activities performed by other persons are subject to the direct and effective control of the entity) ▶ Has adequate human resources and premises in Singapore to carry out the operations of the entity
Non-PEHE	▶ Operations of the entity are managed and performed in Singapore (whether by its employees or by other persons where the activities performed by other persons are subject to the direct and effective control of the entity). ▶ Has adequate economic substance in Singapore taking into account: ▶ Number of full-time employees (or other persons managing or performing the entity's operations) in Singapore ▶ Qualifications and experience of the employees or other persons ▶ 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

* Refers to 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 on the sale or disposal of shares or equity interests, or (iii) income incidental to its activities of holding shares or equity interests.

In the IRAS' e-Tax Guide, it was explained that the economic substance requirement will be determined based on an analysis of the entity's core income generating activities in Singapore and be commensurate with the business model and scale of operations. The economic substance requirement has to be met in the year of disposal of the foreign asset rather than in the year the gains are received in Singapore, for the gains to be excluded from the scope of Section 10L.

The economic substance requirement will typically be assessed at the entity level. There are certain exceptions whereby the requirement is applied at the holding company level on behalf of its special purpose vehicles.

Where economic activities are outsourced, such outsourcing arrangements can still satisfy the economic substance requirement if the following conditions are satisfied:

a. The economic activities are carried out by the outsourced entity in Singapore.
b. The outsourcing entity has a direct and effective control over the outsourced activities carried out by the outsourcing entity on its behalf.
c. The outsourced entity must set aside dedicated resources (e.g., manhours) to provide the outsourced services.

If the outsourced entity is a related party, it is expected that the outsourced entity should charge the outsourcing entity an arm's length service fee, subject to transfer pricing rules where applicable.

The IRAS has also clarified that if an entity that holds shares or equity interests in other entities also derives interest income from shareholder loans, such interest income would not be considered as income incidental to its activities of holding shares or equity interests in other entities, and therefore the entity would not be able to fall under the definition of a PEHE. Instead, it would have to assess if it can meet the economic substance requirement for non-PEHEs.

Businesses may submit advance ruling applications to seek upfront certainty on the adequacy of economic substance when a proposed sale or disposal of foreign assets is expected to take place within a year from the date of the application. The advance ruling, if issued, is valid for up to five years of assessment (YA)s, including the YA in which the proposed sale or disposal of foreign assets is expected to take place. The IRAS may decline to make a ruling under certain circumstance (which are the existing circumstances as stated under the general advance ruling application rules). The IRAS has published further information on administrative procedures relating to advance ruling for Section 10L on its website.

Tax treatment of disposal gains from foreign IPRs

Section 10L provides for a different tax treatment of gains from the sale or disposal of foreign IPRs compared to other classes of foreign assets.

Under Section 10L(6), Section 10L will not apply to a prescribed percentage of disposal gains relating to qualifying foreign IPRs as defined in Section 43X[1] of the SITA. The prescribed percentage is arrived at based on the modified nexus approach, which seeks to establish a direct nexus between the income benefiting from the IP regime and the extent to which the taxpayer has undertaken the underlying research and development that generated the IP asset.

[1] Refers to the concessionary tax rate for intellectual property income under the IDI

For non-qualifying foreign IPRs, the full amount of the gains from the sale or disposal of the IPRs will be subject to tax when such gains are received in Singapore, regardless of whether the entity has adequate economic substance in Singapore.

Given that the exclusion from Section 10L for disposal gains from foreign IPRs is available only for businesses benefitting from the IP Development Incentive (IDI), the application of the above exclusion appears to be fairly limited. This means that disposal gains of non-qualifying foreign IPRs received by businesses will likely be subject to tax under Section 10L when received in Singapore, even if the business is currently incentivised under a non-IP incentive (such as the Development and Expansion Incentive), or if it has economic substance in Singapore.

Ascertaining the gains chargeable to tax

In arriving at the amount of disposal gains chargeable to tax under Section 10L, the following items are allowed as a deduction:

a. Expenditure to acquire, create, or improve the foreign asset, or to protect or preserve the value of the foreign asset, or to sell or dispose of the foreign asset. This includes expenses incurred to finance the acquisition, creation and improvement of the foreign asset.

b. Any loss incurred by the entity from the sale or disposal of any other foreign asset, where had it been a gain, such gain would have been within the scope of Section 10L.

The balance of losses not set off against the current year gains subject to tax under Section 10L may be carried forward and used to set off against foreign-sourced disposal gains that are chargeable to tax under Section 10L in a future YA. Unlike the utilisation of normal tax losses where certain tests (such as the substantial shareholdings test) need to be met before the losses can be used to set off future income, there is currently no such test for losses under Section 10L. However, such losses cannot be carried back to set off against prior year Section 10L gains that were remitted and brought to tax in the prior year.

Section 10L(10) also provides that if the sale or disposal of the foreign asset was at a price lower than the open market price (OMP) of the foreign asset, the IRAS may treat the following amount as the amount of gains received in Singapore:

$$A + B - C$$

Where:

- A refers to the amount of gains actually received in Singapore
- B refers to the OMP of the foreign asset
- C refers to the actual price for the sale or disposal of the foreign asset

The IRAS has clarified that the difference between the OMP and the actual price of the foreign asset (i.e., B – C) will not be taxed if there is no amount of gain received in Singapore. The difference will be taxed in the year when there is an amount of gain received in Singapore.

Foreign tax credit

Singapore tax residents may claim foreign tax credits on gains chargeable to tax under Section 10L that are received in Singapore, to the extent that foreign taxes were imposed on such gains before the gains were received in Singapore. Such foreign tax credit may be claimed within four years after the year of remittance.

Administrative requirements

Businesses that recognise gains from the disposal of foreign assets are required to provide certain information in their tax computations when submitting their annual income tax returns, such as:

- Unremitted gains or unutilised losses brought forward and carried forward
- Gains or losses in the current YA and the amount received or utilised in Singapore during the financial year
- Tracking of allowable expenses
- Information on economic substance in Singapore (e.g., number of employees, amount of operating expenditure and information on outsourcing arrangements.)

Businesses are required to retain all records reasonably required by the Comptroller to ascertain the amount of net gains from disposal of foreign assets chargeable to tax, such as documents supporting the sales proceeds, historical costs, foreign tax paid, payroll reflecting the number of full-time employees, etc. for submission to the IRAS upon request.

Conclusion

While the introduction of Section 10L marks a significant departure from the long-standing Singapore tax treatment of not taxing gains on disposal of assets as long as they are capital gains (whereby capital gains are not taxed in Singapore), Section 10L should not undermine Singapore's quasi-territorial taxation regime where foreign-sourced income is only taxable in Singapore when received in Singapore.

Businesses, in particular, investment holding entities in Singapore that have low or no economic substance and businesses that expect to sell or dispose of foreign IPRs would need to consider the impact of Section 10L.

The IRAS' e-Tax Guide has provided clarification on certain aspects of the economic substance requirement. However, there remains some level of uncertainty as the economic substance requirement is dependent on the specific facts and circumstances of each entity. Businesses may consider if advance ruling should be sought to obtain certainty on the adequacy of economic substance when a proposed sale or disposal of foreign assets is expected to occur.

If you would like to know more about the issues discussed or EY services, please contact one of the following or your usual EY contact:

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