FRS 109 Tax Treatment

Understanding the Intricacies in Applying FRS 109 Tax Treatments

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"Financial Reporting Standard (FRS) 109 Financial Instruments, which replaces FRS 39 Financial Instruments: Recognition and Measurement, applies to all institutions reporting under FRS for annual periods beginning on or after 1 January 2018. Assuming that an entity has a 31 December financial year-end and has not opted for early adoption of FRS 109, Year of Assessment (YA) 2019 will be the initial YA that FRS 109 tax treatment would apply.

"The move to FRS 109 represents a shift from a more rule-based accounting approach used in FRS 39 towards a more principle-based accounting approach. The new accounting standard introduces principles-based requirements for classification and measurement of financial assets," highlighted by Accredited Tax Advisor (Income Tax) Chai Wai Fook, Tax Partner, and Accredited Tax Practitioner (Income Tax) Toh Shuhui, Director, Ernst & Young Solutions LLP, at a recent *Tax Excellence Decoded* session by the Singapore Institute of Accredited Tax Professionals (SIATP).

Under FRS 39, financial assets were classified into the fair value through profit or loss (FVTPL), held-to-maturity, available-for-sale and loans and receivables categories. This changed under FRS 109 as these categories made way for the amortised cost (AC), fair value through other comprehensive income (FVOCI) and FVTPL categories. Financial assets are now classified on the basis of the business model within which they are held and their contractual cash flow characteristics.

In respect of impairment requirement, it has moved from the incurred loss model under FRS 39 to the expected loss model under FRS 109. It is no longer necessary for a loss event to have occurred before impairment losses are recognised. Instead, an entity must now assess whether the credit risk on a financial instrument has increased significantly since the initial recognition and if so, recognise a loss allowance for "Expected Credit Losses" (ECL) equal to either a 12-month ECL or lifetime ECL.

Taxpayers that are required to comply with FRS 109 for accounting purposes must follow the FRS 109 tax treatment, with no option to opt-out. Taxpayers that do not need to comply with FRS 109 for accounting purpose will not be required to comply with FRS 109 tax treatment unless the taxpayer specifically elects to adopt the FRS 109 tax treatment.

New Section 34AA of the ITA

The tax framework for FRS 109 is found in Section 34AA of the Income Tax Act (ITA).

Similar to FRS 39 tax treatment, FRS 109 tax treatment is generally aligned with the accounting treatment. There are however exceptions to the default FRS 109 tax treatment as provided in the provisions of Section 34AA such as any profit, loss or expense that is capital in nature. The Inland Revenue Authority of Singapore (IRAS) has also issued an e-Tax guide on "Income Tax Treatment Arising from Adoption of FRS 109 – Financial Instruments" on 22 November 2017, after seeking feedback from the public previously on its proposed positions on the income tax implications arising from the adoption of FRS 109. The e-Tax guide provides guidance to entities that are required to comply with FRS 109 and incorporates some of the feedback received.

Accredited Tax Advisor (Income Tax) Chai Wai Fook, Partner, and Accredited Tax Practitioner (Income Tax) Toh Shuhui, Director, Ernst & Young Solutions LLP, explained the underlying principles and key concepts in applying the FRS 109 tax treatments.

Itemised Listing of Financial Assets on Capital and Revenue Account

Under FRS 39 tax treatment, taxpayers are required to submit to the Comptroller of Income Tax (CIT) a list of financial assets on capital account for CIT's determination (whether the assets are indeed on capital account).

Similarly for FRS 109 tax treatment, taxpayers are encouraged to submit an itemised listing of all debt instruments (measured at FVTPL, FVOCI or AC) and equity instruments measured at FVTPL held as financial assets on capital account annually, together with their income tax returns. Taxpayers should also submit an itemised listing of all equity instruments measured at FVOCI (on both revenue and capital account) together with their income tax returns in the YA of the basis period in which the asset is derecognised. Submission of such itemised lists serves as a form of contemporaneous documentation on taxpayers' intention at the point of tax return filing.

Adjustment of Financial Instrument Classification

If at any one time there is information showing that a financial instrument (whether an asset or a liability) ought to be classified as on revenue account instead of capital account, or vice versa, all the tax adjustments relating to the gains and losses of that financial instrument will be treated as income or deduction in the YA of the basis period in which discovery occurs. Any such amendments, however must be made by the CIT within a time limit of four years following the YA in which the financial instrument is disposed of. The converse can be applied by taxpayers as well.

Tax Treatment

In determining whether a tax adjustment is required on a gain or loss, the first consideration is whether the financial asset or liability is on revenue or capital account. Generally, tax adjustments are required for financial instruments on capital account as the gains are non-taxable and the losses are non-deductible.

For financial instruments on revenue account, gains are generally taxable and losses are deductible (with the exception for impairment loss on non-credit-impaired financial instruments) and as such, no further tax adjustments are required. The timing (of when tax is levied or deduction is allowed) is dependent on the classification of the financial instrument, and in general occurs when the gain or loss is recognised in the Profit and Loss (P&L).

The same concept applies to financial liabilities. If a financial liability on revenue account is measured as FVTPL, the gains or losses (other than that attributable to changes in credit risk recognised in OCI), whether realised or not, will be taxed or allowed a deduction as they are recognised in the P&L.

IMPAIRMENT LOSSES

Under the FRS 109 tax treatment, only impairment losses recognised in the P&L in respect of credit-impaired financial instruments on revenue account will be allowed for tax deduction and any reversal amount subsequently recognised in the P&L will be taxable.

Participants sought out Accredited Tax Advisor (Income Tax) Chai Wai Fook, Tax Partner at Ernst & Young Solutions LLP, with questions on FRS 109 tax treatment.

Transition to FRS 109

TRANSITION FROM FRS 39 TAX TREATMENT

On transition from FRS 39 to FRS 109, taxpayers are required to reclassify its financial assets and liabilities, and remeasure the carrying amount of such financial assets and liabilities. Any difference between the remeasured carrying amount at the Date of Initial Application (DIA) of FRS 109 and the previous carrying amount (which represents the unrealised gain or loss) is recognised in the opening retained earnings or equity at DIA.

In addition, taxpayers are also required to determine the difference between the ending impairment allowance (in accordance to FRS 39) and the opening loss allowance at DIA (in accordance to FRS 109) and recognise such impairment loss or reversal in the opening retained earnings at DIA.

For taxpayers moving from FRS 39 tax treatment to FRS 109 tax treatment, such transitional accounting adjustment recognised in the opening retained earnings at DIA may be subject to tax or allowed as a deduction in the YA of the basis period in which FRS 109 is first applied.

TRANSITION FROM PRE-FRS 39 TAX TREATMENT

Transitional tax adjustments from pre-FRS 39 tax treatment to FRS 109 tax treatment seek to ensure all taxable or deductible cumulative gains or losses at DIA are valued as if there was no opt-out of FRS 39 tax treatment previously, and make adjustments to cumulative gains or losses (including applicable impairment losses) on financial instruments that are on revenue account.

Unlike transitional tax adjustments from FRS 39 tax treatment, transitional tax adjustments from pre-FRS 39 to FRS 109 are calculated using prescribed formulae on an instrument-by-instrument basis. Such transitional tax adjustments are then brought to tax or allowed a deduction in the transition YA.

CONCLUSION

As taxpayers move into FRS 109, it is important to identify and consider the tax impact of their transitional tax adjustments early. This is to minimise possible cash flow crunch from the additional tax payable arising from the transitional tax adjustments in the YA of the basis period in which FRS 109 is first applied.

Taxpayers should also familiarise themselves with the FRS 109 tax treatment to ensure that they comply with the requirements under Section 34AA and the IRAS' e-guide. As a good practice, taxpayers should consider maintaining any other contemporaneous documentation that would support their claim on whether the financial instruments are held on revenue or capital account, in addition to the itemised listing of financial instruments on revenue and capital account submitted to the CIT.

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