FRS 115: Tax Treatment

Understanding The Implications

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Financial Reporting Standard (FRS) 115: Revenue from Contracts with Customers will apply to all entities reporting under FRS for annual periods beginning on or after 1 January 2018. Unless an entity opts for early adoption of FRS 115, year of assessment (YA) 2019 (for entities with December financial year-ends) or YA 2020 (for entities with non-December financial year-ends) will be the initial YA that FRS 115 tax treatment would apply.

Shedding light on the new standard at a recent *Tax Excellence Decoded* session organised by the Singapore Institute of Accredited Tax Professionals (SIATP), Partners from KPMG in Singapore, Chan Yen San and Accredited Tax Advisor (Income Tax) Pauline Koh, summarised the accounting changes under FRS 115 and highlighted the underlying principles and implications of FRS 115 from a tax perspective respectively.

Accounting Overview

Under FRS 115, an entity has to recognise revenue depicting the transfer of promised goods or services to customers in an amount reflective of the consideration to which the entity expects to be entitled in exchange for those goods or services, by applying the following five-step model for revenue recognition:

Step 1: Identify the contract(s) with a customer;
Step 2: Identify the performance obligations in the contract;
Step 3: Determine the transaction price;
Step 4: Allocate the transaction price to the performance obligations in the contract,; and
Step 5: Recognise revenue when (or as) the entity satisfies a performance obligation.

Among the numerous changes from current requirements, FRS 115 provides specific criteria to determine when a performance obligation is satisfied over time, as well as specific guidance on identifying performance obligations in a contract. Significant financing components are also recognised for contracts with either upfront payments or deferred payments, with some exceptions.

The robust Q&A session led by Pauline Koh (in black) and Chan Yen San engaged participants and clued them in on the tax treatment of FRS 115.

As the accounting profit serves as the starting point for the computation of tax liabilities, the accounting changes arising from FRS 115 will be relevant for tax purposes. There is currently no option for taxpayers to opt out of FRS 115 tax treatment.

On 12 January 2018, the Inland Revenue Authority of Singapore (IRAS) published an e-Tax guide on "Income Tax Treatment Arising from Adoption of FRS 115 – Revenue from Contracts with Customers", to provide guidance on the tax treatment for entities adopting FRS 115.

Under the FRS 115 tax treatment, the accounting revenue as determined in accordance with FRS 115 will generally be accepted as the revenue for tax purposes to minimise complexities in tax rules and compliance burden for taxpayers. This means that the FRS 115 tax treatment will, in most cases, align with the accounting treatment, unless specific tax treatment has been established through case law or is provided under the law, or where the accounting treatment deviates significantly from tax principles (in the case of contracts with significant financing components).

EXCEPTIONS TO FRS 115 TAX TREATMENT

i) Specific tax treatment established through case law

An example where the tax treatment will deviate from FRS 115 tax treatment would be in the case of property developers. Under the existing tax treatment for property developers (which is in line with *MPD Pte Ltd v Comptroller of Income Tax* [1998] MSTC 5249), profits are recognised for tax purposes when a property development project is substantially completed (or when the Temporary Occupation Permit is granted), regardless of the revenue recognition method adopted for accounting purposes. As the existing tax treatment is established through case law, it will prevail over the FRS 115 tax treatment.

ii) Specific tax treatment provided under the law

Section 10F of the Income Tax Act (ITA) on the "Ascertainment of income from certain public-private partnership arrangements" specifically provides that where a contract is entered into under a public-private partnership arrangement and is (or contains) a finance lease, subject to conditions, the part of the lease payment under that finance lease that is attributable to repayment of principal is not taxable. In such cases where the tax treatment is specifically provided for by the law (as in the case of Section 10F), the specific tax treatment will prevail regardless of how revenue is recognised for accounting purposes.

iii) Accounting treatment deviates significantly from tax principles (in the case of contracts with significant financing components)

Under FRS 115, subject to certain exceptions, an entity is required to adjust the promised amount of consideration for the effects of the time value of money, if the timing of payments as agreed to by the parties to a contract provides a significant benefit of financing the transfer of the goods or services either to the customer or to the entity.

While the effect of financing (interest income or expense) is required to be presented for accounting purposes, such interest income or expense is but notional adjustments made due to the accounting requirements and must be disregarded for tax purposes. In the case of contracts with significant financing components, entities are required to make tax adjustments to their tax computations to adjust for notional interest income or expense (reflected in their Profit and Loss Statements). In addition, as the amount of revenue recognised for accounting purposes would differ from the contractual amount due to the significant financing component, tax adjustment has to be made to bring the contractual revenue to tax when the revenue is recognised. The information relating to these adjustments from significant financing components have to be clearly disclosed in the tax computations.

It is therefore good practice for entities to ensure that significant financing component of long-term contracts (with upfront payment or deferred payment) are separately identified and tracked for tax purposes.

It should be noted that notional interest expenses are not within the scope of Sections 12(6) and 45(1) of the ITA, as they are neither incurred for tax purposes nor is there any actual interest payment made to a non-resident. Hence, withholding tax is not applicable on such notional interest expenses.

Ms Chan (in white) and Ms Koh sharing their tax and accounting insights of FRS 115 with illustrations of possible scenarios businesses may face.

Transition to FRS 115

TRANSITIONAL TAX ADJUSTMENTS

When an entity adopts FRS 115, it has to apply FRS 115 either retrospectively to each prior reporting period, or retrospectively with the cumulative effect of initially applying FRS 115 recognised at the date of initial application. This will in turn result in an over-recognition or under-recognition of income attributable to prior YAs in the initial YA.[1] Regardless of the transition method adopted for accounting purposes, any upward transitional adjustments arising from the adoption of FRS 115 that are revenue in nature would be assessed to tax, and any downward transitional adjustments would be deducted against exempt income or allowed a tax deduction (as the case may be) in the initial YA.

Specifically, upward transitional adjustments which are revenue in nature (including both trade and non-trade income) will be assessed to tax at the same tax rate applicable to trade income being taxed in the initial YA. An entity will be taxed at the applicable normal tax rate in the year of change if it is not enjoying any incentive on its trade income, and will be taxed at the applicable concessionary tax rate in the year of change if it is enjoying incentive on its trade income. Where the entity is enjoying multiple incentives on its trade income, the upward transitional adjustments will be apportioned to the different applicable tax rates in the year of change based on the respective revenue of that year from the different trade.

It should be noted that the applicable tax rates are based on the tax rates in the year of change, notwithstanding that such transitional adjustments may pertain to a prior YA in which the entity was enjoying incentives. As an example, if an upward transitional adjustment pertains to under-recognition in a YA where the entity was enjoying incentives (and assuming that the entity no longer enjoys any incentives in the year of change), then the upward transitional adjustment would be assessed to tax at the applicable normal tax rate.

In respect of non-trade foreign income, the transitional tax adjustments will apply only to amounts that are remitted or deemed remitted to Singapore. Separately, it should also be noted that entities facing cashflow issues due to the additional tax payable arising from upward transitional adjustments may apply to IRAS for instalment plans on a case-by-case basis.

As entities transition into FRS 115, it is beneficial to perform an early evaluation to obtain a clear understanding of the potential tax impact of FRS 115, particularly on transitional tax adjustments in the initial YA. This would allow entities to address these tax implications early and ease the implementation process. Entities should also consider whether their accounting systems need to be enhanced to allow proper and accurate extraction of financial data to effect the necessary tax adjustments.

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[1] The initial YA refers to the YA relating to the basis period in which the FRS 115 is adopted for the first time.

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