KPMG

# Tax alert

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# IRAS new e-Tax Guide on taxation of gains from sale of foreign assets

The Inland Revenue Authority of Singapore (IRAS) has published an e-Tax Guide on Tax Treatment of Gains or Losses from the Sale of Foreign Assets (the Guide) on 8 December 2023. The Guide explains the income tax treatment of gains or losses from the sale or disposal of any movable or immovable property situated (or deemed to be situated) outside Singapore (collectively "foreign assets").

To recap, in our previous tax alert issue 12, we provided details on the scope of the proposed section 10L (introduced in the draft Income Tax Amendment Bill 2023 released on 6 June 2023) to tax the gains on sale of foreign assets occurring on and after 1 January 2024 and our insights. Section 10L has since been legislated in the Income Tax Act 1947 (ITA) via the Income Tax (Amendment) Act 2023 that was enacted on 30 October 2023.

In this tax alert, we highlight the main points in the Guide and provide our views.

## Tax treatment of foreign-sourced gains from disposal of "foreign assets" from 1 January 2024

Disposal gains received in Singapore by an entity[1] of a relevant group from the sale or disposal of a foreign asset[2] (such gains being deemed as foreign-sourced gains), will be treated as income chargeable to tax under section 10(1)(g) of the ITA under the following circumstances:

a) the gains are received in Singapore from outside Singapore by a covered entity; and
b) the gains are derived by an entity without adequate economic substance in Singapore; or
c) the gains are from the disposal of foreign Intellectual Property Rights (IPRs).

## Covered entities

Only entities of relevant groups will be within the scope of section 10L of the ITA. A group is a relevant group if:

a) the entities of the group are not all incorporated, registered or established in Singapore; or
b) any entity of the group has a place of business outside Singapore.

**The following table provides some examples of the types of entities or groups that will fall within or outside the scope of section 10L.**

| Entities/groups within the scope of section 10L | Entities/groups outside the scope of section 10L |
|---|---|
| • A group comprising two Singapore entities (a Singapore company and its Singapore subsidiary) and the Singapore company has an overseas branch. | • A single entity (Singapore company) which has an overseas branch (as both are considered one legal entity). |
| • An entity of a group has a place of business (a branch or a permanent establishment) in a foreign jurisdiction. | • A group with only Singapore entities and operates only in Singapore. |
| | • Foreign entities that are not operating in or from Singapore. |

[1] Entity refers to
a) any non-individual legal person (including a limited liability partnership);
b) a general partnership or limited partnership; or
c) a trust.

[2] Section 10L(15) of the ITA prescribes rules on the locality for a list of properties (including immovable properties, shares, ship and aircraft, intellectual property rights, etc.), which determines whether such properties are "foreign assets" and hence whether the associated disposal gains are foreign-sourced for section 10L purposes. This list is re-produced in Annex A of the Guide.

Section 10L will also not apply to any sale or disposal of foreign assets (not being IPRs) by:

a) prescribed financial institutions where the sale or disposal is carried out as part of their businesses;
b) entities under certain tax incentive schemes where the sale or disposal is carried out as part of, or incidental to, activities that qualify for exemption or concessionary tax rates under those schemes; or
c) entities that are able to meet the economic substance requirement in Singapore in the basis period in which the sale or disposal occurred.

### Economic substance requirement (ESR)

The table sets out the conditions to be satisfied by a covered entity to meet the ESR:

| | Pure equity-holding entity (PEHE) | Non-pure equity-holding entity (Non-PEHE) |
|---|---|---|
| **Definition** | • Primary function is to hold shares or equity interests in any other entity; and<br>• Has no income other than dividends, gains on disposal of shares or equity interests, or income incidental to the holding of shares or equity interests. | • Entity that is not a pure equity-holding entity. |
| **Broad statutory conditions to satisfy ESR test** | a) The entity complies with statutory filing obligations;<br>b) The entity's operations are managed and performed in Singapore (whether by its employees, or outsourced to persons that are subject to the direct and effective control of the entity); and<br>c) The entity has adequate human resources and premises in Singapore to carry out the operations. | a) The entity's operations are managed and performed in Singapore (whether by its employees, or outsourced to persons that are subject to the direct and effective control of the entity);<br>b) The entity has adequate economic substance in Singapore, with the following considerations:<br>i. the number of full-time employees or other persons managing the entity's operations in Singapore;<br>ii. qualifications and experience of such employees or other persons;<br>iii. business expenditure incurred in respect of its Singapore operations; and<br>iv. whether the key business decisions of the entity are made by persons in Singapore. |

Consistent with its more limited functions, a PEHE is subject to a lower bar for meeting the ESR relative to a non-PEHE. It has been clarified in the Guide that a PEHE would be regarded as meeting the "adequate premises" criterion if any of the following conditions are met:

- it has an office in Singapore for the use of its employee(s);
- it shares a premise with an associated entity for the use of its employee(s); or
- the outsourced service provider performing the PEHE's core income generating activity has an office in Singapore.

The Guide also provides a few examples to illustrate the application of the ESR to PEHE and non-PEHE. Notably, based on Example 1 for PEHE (paragraph 8.4 of the Guide), a PEHE (with no employees of its own) may be treated as having satisfied the ESR if:

i. its director in Singapore (excluding nominee director) manages the investments (e.g., monitoring, and making strategic decisions on investment/divestment); and
ii. the director ensures that the PEHE complies with its statutory filing obligations.

It has also been clarified in the Guide that the assessment of the ESR for non-PEHEs (i.e., "operations...managed and performed in Singapore") will be based on examples of industry-specific "core income-generating activities" as provided in Annex B of the Guide. These examples are extracted from Annex D of the Harmful Tax Practices 2017 Progress Report on Preferential Regimes.

### Outsourcing Rules: Outsourcing of economic activities

The Guide provides guidance on outsourcing of economic activities ("Outsourcing Rules") which could ease the administration of ESR in arrangements where economic activities are outsourced to third party service providers.

Where an entity outsources some or all of its activities to other persons (e.g., third party service providers or group entities), the outsourcing arrangement will be regarded to satisfy the ESR, subject to meeting the conditions below:

a) the economic activities (i.e., core income-generating activities) are to be carried out by the outsourced entity (e.g., service provider) in Singapore;
b) the outsourcing entity has exercised adequate monitoring and control of the economic activities carried out by the outsourced entity; and
c) the outsourced entity must set aside dedicated resources (e.g., manhours) to provide the outsourced services.

It has been clarified that for purposes of the "dedicated resources" criterion in condition (c) above, it is possible for the outsourced entity (i.e., service provider) to provide services to more than one entity (client), so long as the resources employed are commensurate with the complexity and level of services provided to the other entities/clients. For the purpose of this criterion, the IRAS would also generally expect that the outsourced entity charge an arm's length fee for the activities performed, subject to transfer pricing rules (where the outsourced entity and outsourcing entity are related parties).

The Guide also provides specific examples to illustrate the application of the Outsourcing Rules on outsourcing of economic activities for a:

i. Singapore listed real estate investment trust;
ii. private trust; and
iii. registered business trust.

ESR conditions are considered met for such outsourcing arrangements if:

- the core income generating activity is carried out by its respective REIT manager, trustee and trustee-manager (collectively "Outsourced Party") in Singapore;
- the trust deed sets out the following:
  - The functions and responsibilities of the Outsourced Party;
  - Provision for the termination of the services of the Outsourced Party;
- the Outsourced Party has set aside dedicated resources to perform its functions and responsibilities per the trust deed; and
- the Outsourced Party charges an arm's length fee for its services.

*Our view on the Outsourcing Rules*

The application of the statutory ESR (especially in the case of non-PEHEs) is largely a factual enquiry, which invariably entails an element of subjectivity and thus potential uncertainty, depending on the facts of each case. The introduction of the Outsourcing Rules in the Guide is thus most welcome, as such rules may help streamline the application of the ESR for outsourcing arrangements. That said, we are of the view that the "dedicated resources" criterion under the Outsourcing Rules may still potentially give rise to uncertainty; while it has been clarified that an outsourced entity may provide services to more than one outsourcing entity, this is subject to the requirement that resources employed in providing services to the tested outsourcing entity/client are commensurate with the complexity and level of services provided to other entities/clients, which is ultimately a question of fact – and thus inevitably gives rise to some degree of uncertainty.

On a practical level, there is also the question of how might the outsourcing entity/client (who is in most cases unrelated to the outsourced entity/service provider), be able to obtain information on the number of entities/clients served by the service provider, let alone demonstrate to the IRAS' satisfaction that resources expended by the service provider in respect of the tested entities are commensurate with the complexity and nature of services rendered to other entities/clients. In view of such practical considerations and with a view to enhancing tax certainty, it is our suggestion that the IRAS use arm's length remuneration (which is already a requirement for the "dedicated resources" criterion) as the sole proxy for the level of services (and thus economic activities) performed in Singapore.

### Testing of ESR for special purpose vehicles (SPVs) at holding company level

The Guide provides rules which allow the ESR test for special purpose vehicles (SPVs), which are typically set up to ring-fence the risk of investments, to be applied at the level of the holding company level.

The ESR for an SPV can be tested at the level of its immediate or intermediate holding entity (as the case may be) that is not also an SPV, or at the level of the ultimate holding entity (if the lower tier holding entit(ies) is also SPV(s)). This is subject to the relevant tested holding entity (i.e., immediate, intermediate, or ultimate holding entity) –

- having effective control (for accounting purposes based on FRS 110, or equivalent) over the SPV;
- deriving economic benefits from activities carried out by the SPV; and
- defining the core investment strategies that the SPV implements.

This is a practical and welcome measure, as it recognises that SPVs – which in most cases have no headcount or do not incur much expenditure, may face difficulties in meeting the ESR on their own. Allowing the ESR to be tested at the holding entity level (subject to the above conditions) also duly recognises the commercial reality that SPVs are set up to advance the objective of their holding entity, which is also likely where the economic substance resides.

### Gains from the sale or disposal of foreign Intellectual Property Rights (IPRs)

The tax treatment of gains from the sale or disposal of foreign IPRs is different from that of other foreign assets and is briefly summarised in the table below:

| Qualifying foreign IPRs | Non-qualifying foreign IPRs |
|---|---|
| • Governed by section 43X<br>• Modified nexus approach is used to determine the extent of gains that will not be taxable when received in Singapore<br><br>Modified Nexus Ratio (MNR)=<br>$\frac{QE \times 130\%}{QE + NE}$<br><br>– QE= Qualifying Research and Development expenditure incurred on the qualifying IPR<br>– NE= Non-qualifying expenditure incurred on the qualifying IPR<br><br>• Gains subject to tax=<br>Total gains – gains not subject to tax (disposal gains of qualifying IPR x MNR) | • Full amount of gains is taxable when such gains are received in Singapore, regardless of economic substance in Singapore |

Owners of such IPRs are to keep record of gains/losses of foreign IPRs not subject to tax under the Modified Nexus Approach.

It is notable that the treatment of foreign IPRs is different from that of other foreign assets; in particular the fact that the full amount of the gain from non-qualifying IPRs will be subject to tax when the gain is received in Singapore, irrespective of whether the selling entity has reasonable economic substance in Singapore.

The FAQ section of the Guide does however provide a helpful clarification. Specifically, it covers the scenario where a Singapore resident is the economic owner of the IPR, but where the legal owner is a non-Singapore resident. Where the Singapore resident sells its economic ownership of the IPR in these circumstances, such gains would be considered Singapore sourced and therefore not within the scope of section 10L. Given that many MNCs operate with IP structures under which legal and economic ownership is separated – an example of this would be the many Singapore regional HQs which hold economic rights to IP for the Asia Pacific region, with the legal owner situated in an HQ location outside Singapore – this is a welcome clarification.

### Foreign tax credit

Foreign tax credit may be claimed within four years after the year of remittance if the foreign-sourced disposal gains received in Singapore have been taxed in the foreign jurisdiction before the gains are received in Singapore.

While it was generally expected that double taxation relief would be available, given that disposals of foreign shares (in particular) are often subject to tax in other jurisdictions, this is a helpful clarification for taxpayers and alleviates concerns regarding potential double taxation of gains.

### Administrative Requirements

To ensure that entities keep track of the gains/losses from disposal of foreign assets and accurately report their taxes when such gains are received or losses are utilised in Singapore, the IRAS has provided a list of information required to be included in the tax computations when submitting their annual income tax returns. Besides tracking the gains/losses and the related expenses, the required information includes information on economic substance in Singapore as well as gains/losses of foreign IPRs not subject to tax.

### Advance Ruling on Adequacy of Economic Substance

For certainty, a taxpayer can also seek advance ruling on the adequacy of economic substance when a proposed sale or disposal of foreign assets is expected to occur, provided that the proposed sale or disposal is envisaged to take place within one year from the date of application. Such ruling if issued may be valid for up to five YAs, including the YA relating to the basis period in which the proposed sale or disposal of foreign assets is envisaged to take place.

## Key takeaways

For MNEs headquartered in or outside Singapore using Singapore as a platform to invest into overseas jurisdictions, the additional guidance relating to Outsourcing Rules and testing of ESR for SPVs at the holding entity's level (as discussed earlier) – offers much needed clarification which to some extent streamlines the administration of the ESR test.

In our previous tax alert issue 12, we highlighted that investment holding entities which carry out lending activities (e.g., provision of shareholder's loans to investee/subsidiaries) may face difficulties in meeting ESR where they are regarded as non-PEHE, given that such investment holding entities would in most cases have minimal operations. Such holding entities (subject to conditions for SPVs; see page 4 above) may now be able to have the ESR tested at the level of their parent/holding company – which is generally where the substance resides and hence more likely to meet the ESR.

For Singapore-managed funds that are covered entities[3], it would be necessary to consider the application of the ESR to the relevant entities making the disposal of foreign assets. Based on the Outsourcing Rules prescribed in the Guide, it is possible that many Singapore-managed funds – whose core income generating activities i.e., investment management-related functions are outsourced to the Singapore fund managers, may already be able to satisfy the prescribed outsourcing rules to be considered as having met the ESR. That said, as we have noted earlier, the "dedicated resources" criterion under the Outsourcing Rules may potentially create uncertainties and practical compliance difficulties for tested entities operating under an outsourcing model (including Singapore managed funds). We thus proposed above (see page 3) that the arm's length remuneration paid to outsourced entities be used as a proxy to satisfy the "dedicated resources" criterion for ease of administration.

In addition, given that Singapore-managed funds that are approved under the Singapore Resident Fund Scheme or Enhanced-tier Fund Scheme are already required to satisfy substantive economic conditions (which are indicative of the presence of real economic activities in Singapore), it is also hoped that the IRAS or relevant authorities would soon (given that section 10L comes into operation effective 1 January 2024) introduce safe harbour rules to deem qualifying funds to have satisfied the ESR.

Overall, the Guide provides useful clarifications on certain key aspects of section 10L, including industry-specific examples of what constitute the "core income generating activities" that must be carried out in Singapore for non-PEHEs operating across various industries. While this should provide taxpayers with some direction when applying section 10L to their specific circumstances, when it comes to substance, precisely how much is "enough" is still left open to interpretation.

The advance ruling mechanism provides an avenue for taxpayers to obtain certainty on the tax treatment of foreign asset sales, however, before embarking on such applications it is important that taxpayers first review the substance of their activities to give themselves the best chance of a positive outcome. The fact that the substance test only needs to be met in the year of disposal (as clarified in the FAQs) should give taxpayers that are not intending to dispose of foreign assets in the near-term additional time to address any substance concerns. Having said that, section 10L looks like it is here to stay and both existing and contemplated Singapore asset-holding structures need to be reviewed through a section 10L lens to ensure the associated risks are appropriately managed.

## How we can help

If you have concerns regarding the potential impact of section 10L to your business, our sector specialists would be delighted to discuss with you further and help you to navigate the new rules.

[3] For Singapore-managed investment funds, such funds may not be covered entity for section 10L purpose in the first instance – generally where, by virtue of generally acceptable accounting principles, the fund entities qualify as investment entities and hence are not required to consolidate the overseas investees under their control, and/or are otherwise not themselves required to be consolidated by their controlling shareholders in Singapore or outside Singapore.

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