Tax Alert

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Cutting through the complexity of the FRS 109 tax treatment

On 22 November 2017, the Inland Revenue Authority of Singapore (IRAS) issued an e-Tax Guide on "Income Tax Treatment Arising from Adoption of FRS 109 – Financial Instruments (FRS 109 e-Tax Guide)". The technical contents contained therein demonstrated a significant level of complexity in which the taxpayer is required to grapple with before one can assess the impact of the FRS 109 tax treatment on his or her business.

Therefore, in this tax alert, we seek to help the reader cut through the complexity by highlighting the key differences between the FRS 39 tax treatment and the FRS 109 tax treatment. With this comparison as the backdrop, taxpayers can engage in further and deeper discussions with tax advisors and other stakeholders on this topic.

Differences between the FRS 39 and the FRS 109 tax treatments driven by differences between the respective accounting treatments

Key differences between the FRS 39 and FRS 109 accounting treatments	Key differences between the FRS 39 and FRS 109 tax treatments
There is a classification known as "Available-for-sale (AFS)" under FRS 39. The AFS classification no longer exists under FRS 109.	The FRS 39 tax treatment catered for AFS financial assets is no longer relevant after the taxpayer transits to FRS 109.
There is a classification known as "Fair Value through Other Comprehensive Income (FVOCI)" under the FRS 109. This is a new classification which previously did not exist under the FRS 39.	The FRS 109 tax treatment for FVOCI financial assets is new as such financial assets previously did not exist under FRS 39.
In respect to the impairment requirement, unlike the FRS 39 incurred loss model, it is no longer necessary for impairment losses to be recognised in the P&L only when there is objective evidence of impairment due to a loss of events under the FRS 109 . Instead, under the FRS 109, an entity has to assess whether the credit risk on a financial instrument has increased significantly since the initial recognition and recognise a loss allowance for "Expected Credit Losses" (ECL), which represents a 12-month ECL or lifetime ECL (for credit-impaired financial asset or non-credit-impaired financial asset).	Unlike the FRS 39 tax treatment, not all impairment losses recognised under the FRS 109 are deductible. Under the FRS 109 tax treatment, only impairment losses recognised in the P&L with respect to credit-impaired financial instruments that are on revenue account are allowable as deduction. It is therefore critical for taxpayers to identify accurately impairment losses with respect to credit-impaired financial instruments on revenue account and justify the deduction claim moving forward.

Already opted out of the FRS 39 tax treatment? There is no option to opt out of FRS 109 tax treatment.

The FRS 109 tax treatment will be the only tax treatment once taxpayers adopt the FRS 109 for accounting purposes. Unlike the FRS 39 tax treatment, there will be **no option** to opt out of the FRS 109 tax treatment.

As a result, in respect to those tax payers with significant amounts of accumulated unrealised revenue gains (especially in cases where taxpayers are transiting from pre-FRS 39 tax treatment to FRS 109 tax treatment), these gains will be brought to tax at the point of adoption of the FRS 109.

Transition to FRS 109 – be ready for transitional tax implications

When the FRS 109 was first applied for accounting purposes at the date of initial application of the FRS 109 (DIA), a taxpayer would have to reclassify its financial assets and financial liabilities, and remeasure their carrying amounts.

When the unrealised gain or loss and the impairment loss or gain (arising from the re-classification and re-measurement exercise) recognised at DIA, are recognised in other components of equity at DIA, there will be no tax adjustment required. However, when they are recognised in the opening retained earnings at DIA, they may, under certain circumstances, be subjected to tax or allowed as a deduction (in the YA of the basis period in which FRS 109 is first applied). For impairment gain or loss, only impairment losses with respect to credit-impaired financial assets on revenue accounts will be allowed as a deduction.

Plan and act early

Following up from the above, we would like to highlight some key action points for these two groups of taxpayers below:

a. Taxpayers currently on pre-FRS 39 tax treatment

Taxpayers who are currently on the pre-FRS 39 tax treatment would need to pay extra attention. Given that there will be no option to opt out of the FRS 109 tax treatment, taxpayers currently on pre-FRS 39 tax treatment sitting on significant amounts of accumulated unrealised revenue gains would be taxed on the gains when they adopt the FRS 109.

Taxpayers need to estimate the amount of such a one-time transitional tax bill in advance, assess the adequacy of their cash flow for settlement of the tax bill and get ready sufficient cash. Where additional instalments are required from the IRAS to settle the tax payable, it is prudent to apply early to the IRAS.

b. Banks and finance companies

As part of the transitional adjustments moving into the FRS 109, banks and finance companies are also required to apply the impairment methodology (i.e. the ECL method), as well as any additional impairment amounts required by MAS on prudence grounds.

While it is clear that any future annual FRS 109 impairment losses on non-credit-impaired loans and debt securities recognised in the P&L of banks and finance companies will be allowed as a deduction (for a prescribed period) subjected to the rules under Section 14I of the Income Tax Act, the tax treatment of the transitional adjustments in the hands of such taxpayers arising from non-credit impaired financial assets on revenue account is uncertain.

Banks and finance companies should therefore assess in advance the scale of these transitional adjustments in their hands and consult their tax advisors early.

How we can help

The FRS 109 tax treatment and its associated implications are complicated. As a committed tax advisor to our clients, we set the stage through highlighting the above issues and we welcome any opportunity to engage you in a deeper discussion on the relevance of the above named matters with regards to your business.

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