Tax Alert

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Income Tax Implications Arising from the Adoption of FRS 115 Revenue from Contracts with Customers

In this issue of Tax Alert, we bring to you the income tax implications which may arise with the introduction of the accounting standard FRS 115 *Revenue from Contracts with Customers*.

For Singapore income tax purposes, an income is subject to tax if it is sourced in Singapore (i.e. it is derived from or accrued in Singapore), or if foreign-sourced income is received or deemed to be received in Singapore, unless specifically exempted under the Singapore Income Tax Act.

For Singapore-sourced income, tax principles provide that an income would be subject to tax based on the "entitlement to income" principle. From the Inland Revenue Authority of Singapore (IRAS)'s perspective, the alignment of tax treatment to FRS 115 may represent a shift away from the "entitlement to income" principle as revenue is now recognised when the entity has performed its obligations even if it might not be entitled to the income yet.

An expense is tax deductible when it is wholly and exclusively incurred in the production of income. It is considered incurred only when the liability to pay the expense has crystallised in law and in quantum. However, with the adoption of FRS 115, IRAS is of the view that there could be situations where estimated expenses are recognised to match estimated revenue that is recognised upfront.

To aid in making a decision on whether or not tax rules should be amended to align with the FRS 115 accounting treatments, IRAS issued a public consultation paper in October 2015. The table below summarises the proposed tax treatments set out in the consultation paper, our assessment on the potential implications, and the comments we furnished to IRAS.

	Revenue	Potential implications and KPMG's input to IRAS
1	Align tax treatment with FRS 115 accounting treatment unless otherwise stated.	**Potential implication:** • Some companies may face a great impact to cash flow due to huge upfront recognition of revenue, e.g. Telecommunication companies that recognise handset revenue upfront may end up with a mismatch between reported revenue (which is taxable upfront) and the amount collected from customers. **KPMG's input to IRAS:** • Measures to mitigate the cash flow impact (such as instalment plan) should be introduced for such companies.
2	Where specific tax treatment has been established through case law or provided under the law[1], the specific tax treatment will be applicable.	**Potential implication:** • As specific tax treatments established through case laws are voluminous and hard to access from the public domain, it would be impracticable for taxpayers to know which case laws supersede the FRS 115 accounting treatment. Hence, they may unknowingly align their companies' tax treatment with FRS 115 accounting treatment even though a specific tax treatment based on an established case law should be applicable instead. **KPMG's input to IRAS:** • Circumstances should be prescribed where specific tax treatment established through case law is applicable.

[1] For example, Section 10F of the Income Tax Act on the ascertainment of income from certain public-private partnership arrangements.

	Revenue	Potential implications and KPMG's input to IRAS
3	Where the accounting treatment deviates significantly from tax principles, tax adjustments have to be made. For example, for contracts with significant financing components, full amount of revenue has to be taxed in the year it is earned. However, interest income/expenses arising from the existence of significant financing components will not be taxable/tax deductible as they are notional.	**Potential implication:** • Additional compliance and administrative burden on taxpayers to track revenue received from customers as well as interest income/expenses arising from the existence of significant financing components for tax adjustment purposes. **KPMG's input to IRAS:** • Not applicable since suggested tax treatment is in line with existing tax principles, where interest income/expenses arising from significant financing components are notional.
4	Property developers shall continue to adopt the existing tax treatment i.e. profits are taxed when the Temporary Occupation Permit is granted.	**Potential implication:** • No potential implications since property developers are already making tax adjustments for profits to be taxed only when Temporary Occupation Permit (TOP) is granted. **KPMG's input to IRAS:** • Not applicable since there is no potential implication.
5	Construction companies – IRAS will continue to accept the percentage of completion method which is in line with the existing FRS 11.	**Potential implication:** • IRAS is silent on the tax treatment in cases where construction companies are required to recognise revenue from contracts based on the "competed method" under FRS 115. **KPMG's input to IRAS:** • Since IRAS generally accepts the accounting treatment under FRS 11 for construction companies prior to the application of FRS 115, IRAS should similarly accept the revenue as determined in accordance with FRS 115 (either over time or at a point in time) for tax purposes.
	Expenses	
6	Estimated expenses recognised based on accounting matching principle would only be tax deductible if they have been incurred by the entity.	**Potential implication:** • There may be a mismatch of income and expenses for tax purposes. This will create cash flow issues for companies who pay more tax upfront on estimated revenue but are unable to claim a deduction on the estimated expenses. **KPMG's input to IRAS:** • To address the cash flow issues and to minimise compliance burden, a tax deduction should be allowed on the estimated expenses recognised, to the extent that they can be directly attributed to the estimated revenue/revenue recognised.
	Transitional tax adjustments	
7	Regardless of the transition method adopted for accounting purposes, income/loss arising from transitional adjustments will be subject to tax at the same tax rate that applies to the company's trade income derived in the Year of Assessment relating to the year in which FRS 115 is first adopted.	**Potential implication:** • Some companies may face great cash flow impact due to huge transitional adjustments in the year of change resulting from upfront recognition of revenue arising from unexpired contracts that were signed up before the year of change e.g. Telecommunication companies making transitional adjustments to recognise handset revenue for all unexpired contracts that were signed up before the year of change will end up with a mismatch between reported transitional adjustments in the year of change (which is taxable upfront) and the amount collected from customers. • For companies enjoying a concessionary tax rate under a tax incentive in prior years, their tax liability may be unduly increased if the tax incentive has expired in the year in which FRS 115 is first adopted. **KPMG's input to IRAS:** • For income/ loss arising from transitional adjustments, allow companies to apply the concessionary tax rate/ tax exemption which was previously applied prior to the adoption of FRS 115.

Other issues not addressed in IRAS' consultation paper

- Incremental costs of obtaining a contract with a customer/costs to fulfil a contract.

  Incremental costs of obtaining a contract with customers and costs to fulfil a contract are recognised as assets in accordance with FRS 115. Such assets would be amortised on a systematic basis or impaired when applicable. There is no specific guidance on the tax treatments for such costs in IRAS' consultation paper.

  Under existing tax deduction principles, the costs recognised as assets are generally tax deductible when incurred and the subsequent amortisation or impairment would not be allowed for tax deduction.

  If IRAS allows estimated expenses to be deductible against estimated revenue (as proposed in item 6 of the table above), it remains to be seen whether the IRAS will also align the tax treatment of these incremental costs and costs to fulfil a contract with the accounting principle under FRS 115, i.e. a deduction is only allowed when the costs are amortised/impaired through the income statement.

We hope IRAS would carefully consider each and every comment solicited through the public consultation exercise, and that the tax treatments to be introduced would not unduly burden affected companies both from a financial and tax compliance perspective. We will provide you with updates when IRAS releases further details.

Meanwhile, we would advise you to gain full insights and understanding of the potential tax impacts of FRS 115 on your company, and thereafter to think ahead about how to manage/address the foreseeable tax issues. If you have significant foreign subsidiaries in jurisdictions which are also adopting FRS 115 equivalent (i.e. IFRS 15 Revenue from Contracts with Customers or its equivalent), you should also consider the relevant local tax implications. Further, if the timing of revenue and cost recognition for accounting is not aligned with tax, companies may need to consider the impact on deferred tax accounting.

For a start, in redesigning/modifying your company's accounting system to adopt the new accounting treatments under FRS 115, there should also be considerations on how your system may be modified to allow proper and accurate information extraction to effect the necessary tax adjustments and for the purpose of computing current and deferred tax provision.

To find out more about the IRAS' proposed tax treatments, please refer to the **IRAS' consultation paper** on Income Tax Implications Arising from the Adoption of FRS 115.

How we can help

As a committed tax advisor to our clients, we welcome any opportunity to discuss the relevance of the above matters to your business.

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