KPMG

Tax alert

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Updates on total asset method for interest adjustment

The Inland Revenue Authority of Singapore (IRAS) has updated its e-Tax Guide on the total asset method for interest adjustment (the Guide). The Guide, which was first published on 16 December 2016, sets out the rationale for using the total asset method (TAM) of attributing common interest expenses (including borrowing costs akin to interest) to income producing and non-income producing assets, the underlying assumptions and how the TAM should be applied.

In a previous tax alert, we provided details of IRAS' clarification on the application of TAM and our views on areas businesses should consider when reviewing their debt financing structure to optimise their interest deduction claims in Singapore.

In this tax alert, we summarise the recent updates to the Guide and provide our insights.

Background

Under Section 14(1)(a) of the Singapore Income Tax Act 1947, for an interest expense to be tax-deductible, the Comptroller of Income Tax (CIT) has to be satisfied that such interest is payable on capital employed in acquiring the income, failing which the interest expense will not be tax-deductible. In other words, there must be a direct link between the use of the loans and income earned.

In the situation where the taxpayer is unable to directly identify and track the use of an interest-bearing loan[1] to specific assets financed by the loan, and not all the assets are incoming producing, the CIT has been exercising its administrative discretion to use the TAM as a proxy method to determine the amount of common interest expense attributable to non-income producing assets to be disallowed.

Updates and clarifications

In the updates to the Guide on 28 February 2023, the CIT clarified that if a taxpayer cannot identify and track the use of the interest-bearing loan to any specific assets, and not all the assets of the taxpayer are income producing, the TAM would be the **default method** for attributing common interest expense to the assets of the taxpayer. Where variation of the TAM was accepted by the CIT for the past years of assessment (YsA), the agreed variation will continue to apply until the relevant assets are disposed of or the relevant loans are repaid. Thereafter, the TAM will be the **default method** to be applied.

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[1] These refer to any form of financing, for example, bank overdrafts, loans, bonds and notes where interest is charged.

Besides the abovementioned, other clarifications in respect of the TAM formula to be applied are summarised in the table below.

Description	Clarification
Specific interest expense (interest expense arising from loans or borrowings undertaken to fund specific assets)	Includes: • Interest expense arising from right-of-use (ROU) assets treated as sale agreements for tax purposes for which a lessee is eligible to claim deduction on interest expense against the income produced from the ROU assets (including assets under hire purchase arrangements) • Foreign exchange differences arising from interest expense incurred in relation to the above
Common interest expense (interest expense incurred on loans other than those arising from loans undertaken to fund specific assets)	Excludes: • Non-deductible interest expense (e.g. interest expense incurred on loans undertaken to finance the payment of dividends) • Interest expense on an ROU asset regarded as an operating lease or a finance lease not treated as a sale agreement for tax purposes as the lessee is allowed a tax deduction on the contractual lease payments[2] Includes: • Foreign exchange differences arising from interest expense incurred (except in relation to the above excluded items)
Valuation of assets	For assets covered under FRS 109 (financial assets[3]): • By default, value reported on balance sheet For assets not covered under FRS 109 (non-financial assets[4]): • Historical costs
Total assets (denominator of TAM formula)	Includes: • All current and non-current assets as reflected in the balance sheet Excludes: • Cost of assets financed by specific interest-bearing loans (including assets under hire purchase arrangements), ROU assets treated as sale agreements for tax purposes and ROU assets where contractual lease payments incurred have been allowed as a tax deduction

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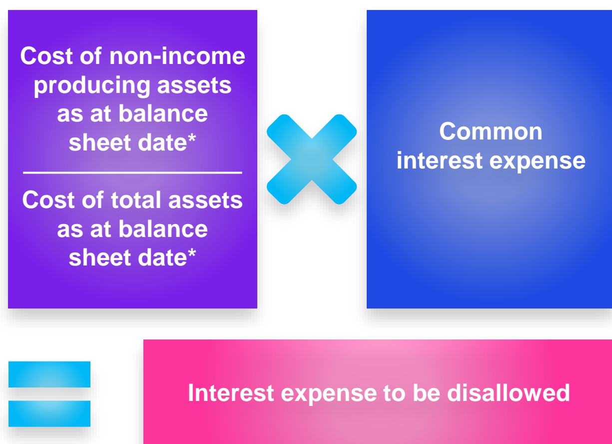
[2] More details in the IRAS e-Tax Guide "Tax Treatment Arising from Adoption of Financial Reporting Standard 116 or Singapore Financial Reporting Standard (International) 16 – Leases".

[3] Can elect to use historical costs of the assets by making an election at the time of submission of Income Tax Returns, subject to the tracking of historical costs of all the assets separately and keeping of proper records on the cost of the assets. The election, once made, would have to be consistently applied. The taxpayer can still opt to use the value of the financial assets shown in the balance sheet under the FRS 109 valuation at any time after the election. However, this option to use the value of the financial assets shown in the balance sheet, once exercised, is irrevocable. Taxpayers on pre-FRS 39 tax treatment or on the FRS 39 tax treatment but have elected to use historical costs of assets, may continue to do so when they transit to the FRS 109 tax treatment, provided that they continue to track the historical costs of all the assets separately and keep proper records on the costs. The taxpayers may at any time exercise an irrevocable option to use the value of the financial assets shown in the balance sheet under the FRS 109 valuation.

[4] Examples: investment property, investment in associate/subsidiary/joint venture, property, plant and equipment, goodwill and other intangible assets.

Our views

Default method
The Guide specifically states that the default method to be applied to attribute common interest expenses to assets, where interest expense restriction is applicable, will be the TAM as described in paragraph 5 of the Guide:



** the relevant financial year end*

Notwithstanding the above, where the taxpayer can substantiate that a particular interest-bearing loan has been taken to fund a specific asset and that asset is income producing, the interest expense incurred on such a loan can be deductible against the income produced by the asset. This is known as the direct identification method and should continue to be applied as the priority to the extent possible. Any interest expense and cost of asset so identified should be excluded from the TAM.

Formula for TAM
Under the TAM, the cost of an asset financed by a non-specific/common interest-bearing loan should continue to be included in the "cost of total assets" in the denominator in subsequent YsA even if such loan has been fully repaid. In the case of an asset financed by a specific interest-bearing loan, the cost of such asset should be included in the “cost of total assets” in the denominator in subsequent YsA after the loan has been fully repaid.

Downside of TAM
While the TAM is a simple formula that seeks to reduce compliance costs for taxpayers, it seems to have oversimplified the interest restriction calculation, as the continued inclusion of the following in the TAM formula may result in taxpayers being unfairly penalised:

i. the cost of non-income producing assets financed by a specific interest-bearing loan which has been fully repaid;
ii. the cost of non-income producing assets which existed before an interest-bearing loan was undertaken by the company, and
iii. the cost of non-income producing assets financed by non-interest-bearing funds.

Upside of TAM
On the other hand, the inclusion of the following would be beneficial for taxpayers as this would increase the “cost of total assets”, resulting in a smaller proportion of common interest expense to be disallowed:

i. the cost of income-producing assets financed by a specific interest-bearing loan which has been fully repaid; and
ii. the cost of income-producing assets financed by non-interest-bearing funds.

In our view, making the TAM approach the default method for attributing common interest expense to assets seems to indicate the IRAS’ preference to avoid any ambiguity in the TAM application and potential lengthy discussions with taxpayers. In other words, moving forward, taxpayers do not appear to be allowed to present their case for a more accurate approach in determining the amount of tax-deductible common interest expense.

Considerations for interest-bearing loan undertaken to finance payments for ROU assets
The IRAS has clarified that:

i. the interest expense arising from ROU asset treated as sale agreement for tax purposes (including assets under hire purchase arrangements) are included as specific interest expense; and
ii. the notional interest expense arising under FRS 116 on an ROU asset regarded as (1) an operating lease or (2) a finance lease not treated as a sale agreement for tax purposes, are excluded from the common interest expense.

It was also clarified in the Guide that cost relating to these ROU assets is excluded from the total cost of assets in the denominator of the TAM formula. However, the Guide does not seem to have considered the situation where interest expense is incurred on an interest-bearing loan taken up to fund the recurring payments for the ROU asset (which is an actual interest expense incurred, unlike the notional interest expense arising under FRS 116).

Where a taxpayer treats the corresponding interest expense (from the loan taken up to fund the recurring payment for the ROU asset) as a common interest expense, such interest expense should not fall within the excluded interest expense highlighted in (ii) above as the interest expense described in (ii) seems to be dealing only with the notional interest expense arising from accounting purposes under FRS 116, as a result of the delayed payments for the ROU asset.

Hence, the inclusion of the interest expense arising from a non-specific/common interest-bearing loan used to finance the payments for the ROU asset, and the continued exclusion of the cost of such ROU asset from the "cost of total assets" in the denominator of the TAM formula, would put the taxpayer in a disadvantageous position as a larger proportion of common interest expense would be disallowed for the taxpayer.

It is worth highlighting that the essence of the TAM is to allow taxpayers to avail of an administrative concession, allowing them to claim the portion of common interest expense which is attributable to income-producing assets. Therefore, the exclusion of the cost of ROU asset from the "cost of total assets" when the payments for such ROU asset is funded by a non-specific/common interest-bearing loan seems to go against the principles shaping the TAM formula.

For purposes of annual tax return filings

Do note that the taxpayer will have to present its interest restriction calculation in its tax computations. While the supporting documents need not be submitted as part of the annual tax return filings, the taxpayer should maintain sufficient documentations for submission to the IRAS when requested. Otherwise, the IRAS may make adjustments to disallow the interest expense and/or penalties may be imposed for any incorrect claim. Since the taxpayer is required to maintain sufficient documentations, it is then interesting that, moving forward, the IRAS does not appear to allow the taxpayer to exclude from the TAM certain assets which the taxpayer may be able to substantiate were financed by non-interest-bearing funds, or where the assets existed before the interest-bearing loan were undertaken by the taxpayer, among other scenarios.

Moving forward

All taxpayers, especially those which have previously adopted a modified TAM approach that was accepted by the IRAS in the prior YsA, would have to re-evaluate its debt financing structure in view that a modified TAM approach may no longer be accepted by the IRAS once the relevant assets are disposed of, or when the relevant loans are repaid. It is therefore pertinent that businesses start considering the impact of the current position seemingly adopted by the IRAS to identify potential additional taxes payable arising from the change in formula for TAM to be adopted in subsequent YsA.

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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