Tax alert

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To Opt or not to opt – that is the Question for Banks

In this Tax Alert, we discuss the recent option granted by the Inland Revenue Authority of Singapore (the IRAS) to Singapore licensed banks (the Banks) for a Special Input Tax Recovery Method (the Special Method)[1] for Goods and Services Tax (GST) with effect from 1 April 2025. If this option is not taken up, the Banks will remain claiming input tax based on the current Fixed Input Tax Recovery Rate[2] (the FITR) by default. Hence, the pressing need for the Banks to consider carefully of this option for it is irreversible.

Background of FITR

Before we discuss the considerations that the Banks should factor in when deciding whether to opt for the Special Method or remain with the FITR, it may be worthwhile to revisit how the FITR was initiated.

Going back 31 years to 9 February 1993, when the White Paper for the introduction of GST was released, followed by the subsequent release of the GST Bill, there were written representations by businesses and individuals to the Select Committee (the Committee). Amongst them was the Association of Banks in Singapore where several concerns were raised[3]. One concern highlighted the Banks' inability to recover the bulk of the input tax and thus had to absorb the irrecoverable input tax as their business cost on account of the substantial exempt financial services they provide[4]. Another concern was the tax cascading effect on businesses in the event the Banks were to "pass on the costs to customers (to an amount of less than 3%[5] in an attempt to recover some of the costs), there will be wide-ranging adverse effects because all economic sectors in Singapore are users of financial services. This will increase the business costs in Singapore" [6].

The Committee acknowledged that "where exempt supplies are provided to a taxable business, this can lead to a tax cascade". Put simply, the GST cost that cannot be fully claimed by a partially exempt business is passed on to the GST-registered business which uses the financial services. The financial services cost (with irrecoverable GST embedded) would enter into the cost of the GST-registered business before arriving at the selling price. When GST is charged on the sale of goods or provision of services, this leads to GST on GST, which is the tax cascade issue.

To address the tax cascade concern, the Committee recommended allowing businesses to recover input tax on exempt supplies made to other taxable businesses. This is enshrined in regulation 30(2) of the GST (General) Regulations. The Committee further added that "under this method, the Comptroller can work out with the businesses concerned a simple input tax apportionment formula based on the proportion of the institution's business with other taxable business.

1 E-Tax Guide entitled "GST – Special input tax recovery method for Banks" published on 6 March 2024
2 For digital banks, the IRAS will allow them to adopt the FITR on a case-by-case basis. For banks that obtain banking license from 1 April 2025, they must seek the Comptroller's agreement on the input tax recovery method they wish to adopt.
3 Report of the Select Committee on the GST Bill [Bill no. 14/93]
4 Input tax incurred for the making of exempt supplies is typically not claimable
5 The applicable GST rate when it was first introduced on 1 April 1994
6 Paper No. 40 – Report of the Select Committee on the GST Bill

Such a system will be simple for both the financial institutions and Comptroller to administer" [7]. This recommendation presented the FITR, a single rate that applies to the Banks based on the type of license each Bank is awarded and reviewed annually[8] by the Comptroller of GST (the Comptroller). This has proven beneficial for the Banks, with a rate of 74% for a Full Bank for the past several years since 1 April 2021[9] and 94% for a Wholesale and Merchant Bank for many years till 31 March 2025[10]. This rate has been accepted by most Banks.

Special Input Tax Method for Imported Services

With the introduction of reverse charge on 1 January 2020, several Banks approached the IRAS to request for a special input tax formula which was built upon the standard formula of input tax claim and the IRAS has agreed to the following formula for claiming input tax on imported services:

- Input tax[11] directly attributable to the making of taxable supplies – claimable in full;
- Input tax directly attributable to the making of exempt supplies – not claimable at all;
- Input tax that is not directly attributable to taxable or exempt supplies (residual input tax) – claim based on the FITR.

We understand that a handful of Banks have been granted this method for the claiming of input tax on imported services. The FITR continues to be used for claiming input tax on local purchases. The IRAS has stated that this is only an interim solution and the Banks are required to decide to adopt either the Special Method or continue using the FITR come 1 April 2025.

What are the considerations

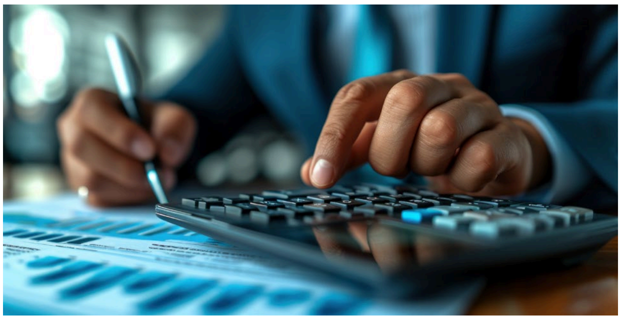
If the FITR were to remain at 74% for Full Banks and 94% for Wholesale and Merchant Banks after 1 April 2025, in our view, there should be less impetus for the Banks to consider the Special Method. After all, this has been the methodology since the introduction of GST 30 years ago which all the Banks are familiar with.

It is simple - no tracking of zero-rated supplies, exempt supplies as well as exempt supplies made to taxable and non-taxable customers. GST return reporting is reduced to only 4 figures - standard-rated supplies, output tax and input tax and the value of taxable purchases which is re-grossed from the value of input tax (i.e. no tracking required). No longer period adjustment is necessary since it is a fixed rate for each tax year. Business cost is undeniably contained. Consequently, it is understandable that most Banks responded to the IRAS's survey last year with the request for the retention of FITR as the default.

The pertinent question would be what the FITR will be come 1 April 2025, which is noticeably missing in the e-Tax Guide on the Special Method, unlike the Consultation Paper where indicative rates were shared. If the FITR falls below the current rate, this begs the question of how far the drop had to go before the option to the Special Method makes business sense as it affords an avenue to achieve a higher input tax recovery.

Briefly, the Special Method builds on the standard formula, as follows:

- Input tax directly attributable to taxable supplies – claimable in full;
- Input tax directly attributable to exempt supplies – not claimable at all;
- Input tax that is not directly attributable to taxable or exempt supplies (residual input tax) – claim based on the ratio of value of taxable supplies and exempt supplies to a GST-registered person and total value of all supplies or any other proxies approved by the Comptroller.



This formula requires the values of taxable supplies, comprising standard-rated and zero-rated supplies, and exempt supplies. Zero-rated supplies include exempt supplies of services that qualify as international services such as provision of loans to persons belonging outside Singapore. For residual input tax claim, exempt supplies made to GST-registered persons would be treated as if these are taxable supplies. Thus, tracking of this figure is required. In addition, a longer period adjustment to even out any spike of a single category of supplies in the tax year is required. Turning to business expenses, the Banks would now need to allocate these expenses into the above-mentioned three categories.

[7] Paragraph 37 of the Committee's views on the main issue raised in the Report of the Select Committee on the GST Bill
[8] 1 April to 31 March of the following year
[9] To remain 74% till 31 March 2025 as released on 15 April 2024
[10] Released on 15 April 2024
[11] This refers to input tax on business expenses incurred for the furtherance of business that are not disallowed
under regulations 26 and 27 of the GST (General) Regulations

It is interesting to note that input tax directly attributable to the making of exempt supplies is totally denied without regard if the exempt supplies are made to GST-registered businesses. To this end, to contain the business costs, the Bank could pass on the irrecoverable GST to the GST-registered clients. To illustrate, the Bank incurs legal fees and recovers the legal fee from the Singapore GST-registered business which applies for a loan. Since the Bank is unable to claim the input tax, this would be passed on to the GST-registered business. This is precisely the tax cascading that the Committee was concerned with and thus such denial of input tax runs contrary to the Committee's recommendation. This is a point worth raising to the IRAS to address the tax cascade issue. Besides, the Special Method should be "simple" in the spirit of the Committee's recommendation and thus the use of proxy in place of tracking of figures should not be too complicated but one that is readily available.

Some Banks have conducted a preliminary review of the amount of input tax claimable if the Special Method were adopted. This review is based on the available statistics and various assumptions, such as the number of the business sectors it operates in and proxies used to apportion the residual input tax. Conducting this review is advisable as it prepares the Banks for a fall-back position of opting for the Special Method when the FITR drops too low to warrant a review for this option. Additionally, this could be expected by the overseas head office or the senior management if the Banks choose to remain with the FITR. This is particularly so for Banks where the head office is in a country with similar Special Method for the input tax claims, because the FITR is rather unique in the global indirect tax landscape.

For Banks whose revenue primarily stems from taxable supplies, such as those in wealth management businesses where fee-based income constitutes a significant proportion of revenue, and if the majority of expenses are directly attributable to these identifiable taxable supplies, such Banks could potentially claim more input tax using the Special Method. Even if they engage in treasury activities, as long as the counterparties belong outside Singapore or are Singapore GST-registered businesses, the residual input tax formula would work in the Banks' favour.

Needless to say, the Banks would need to consider the compliance cost in tracking the value of supplies and the allocation of business expenses. Since standard-rated supplies are currently tracked, it could assess if the value of zero-rated supplies, i.e. taxable supply of services to clients belonging outside Singapore could be tracked without incurring too much system costs. If value of exempt supplies is not possible or too costly to track, the Banks could consider adopting a proxy. Allocation of expenses would be a one-time exercise since they are largely recurring.

Next Steps

The last date to apply to the Comptroller for the Special Method is drawing near – 30 June 2024, if you wish to adopt the Special Method from 1 April 2025. If this deadline is too soon and you are not yet ready, you may defer a year or two, or until you are in a better position to assess the costs and benefits associated with this Special Method, as the decision is irreversible.

If you are determined to stick with the FITR regardless of the rate, due to a lack of resources to collate the necessary data, you may consider conducting a high-level assessment of the cost of transitioning to the Special Method and the resulting benefits to justify the decision. While the IRAS has not yet indicated the FITR for 1 April 2025, it is prudent for the Banks to be prepared and be aware of the floor that FITR may drop to before considering the Special Method.

How we can help

If you have concerns navigating the Special Method or have performed a preliminary review but are unsure about the appropriateness of the adopted proxies, allocation of business expenses into the various categories, or the categorisation of revenue in accordance with the GST legislation/IRAS guidelines, please do not hesitate to contact us. Such a review is not just beneficial but essential, especially in light of rising business costs and evolving tax rules.

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