

IRAS CIRCULAR

**INCOME TAX IMPLICATIONS ARISING FROM
THE ADOPTION OF FRS 39
– FINANCIAL INSTRUMENTS: RECOGNITION &
MEASUREMENT**



**INLAND REVENUE
AUTHORITY
OF SINGAPORE**

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IRAS CIRCULAR

INTRODUCTION

1. With effect from 1st January 2005, companies with annual periods beginning on or after 1st January 2005 have to comply with Financial Reporting Standard 39 – Financial Instruments: Recognition and Measurement (hereinafter referred to as “FRS 39”) for accounting purposes. This circular explains the changes to the treatment of financial assets and liabilities for income tax purposes arising from the adoption of FRS 39¹ for accounting purposes.

CURRENT TAX TREATMENT OF FINANCIAL ASSETS AND LIABILITIES

2. Presently, for income tax purposes, only **realised** gains or losses arising from the disposal of financial assets are subject to tax or allowed as a deduction if the taxpayer derives such gains or incurs such losses on **revenue** account. As an exception, where the financial assets on revenue account are carried at the lower of cost and market value, and a provision for diminution in value has been made in the accounts, the provision may be allowed as a deduction for income tax purposes while any write-back up to the cost brought to tax.

3. For a taxpayer whose gains or losses are derived on **capital** account, the gains or losses are not taxable or allowed as a deduction. The provision for diminution in value is also not allowed as a deduction.

4. For banks and certain other entities that engage frequently in financial derivatives for both hedging and trading purposes, we have, since 1996, granted an administrative concession to accept the accounting treatment for financial derivatives on the condition that they follow certain accounting treatment².

5. For taxpayers with financial liabilities, such as loans taken or bonds issued, the interest expense³ incurred on such liabilities is allowed as a deduction by virtue of section 14(1)(a) of the Income Tax Act (hereinafter referred to as “ITA”) when the conditions in that section are met. In the case of financial liabilities that do not constitute accretion to capital, any premium or discount incurred is taxed or allowed as a deduction.

¹ The version of FRS 39 referred to in this Circular is the fourth version issued in August 2005. It can be downloaded from the website of the Council on Corporate Disclosure and Governance (“CCDG”) - www.ccdg.gov.sg

² (a) For financial derivatives for trading, they are accounted on a marked-to-market basis and the resultant profit/losses are recognised immediately and taken to the profit and loss account.

(b) For financial derivatives used for hedging purposes, they must be clearly identified at the outset and the gains or losses realised must be amortised over the life of the underlying hedged transactions and matched with the gains/losses or income/expenditure of the latter transactions, in all cases where there is a mismatch in the timing of the closing out of the two types of transactions. The bank will maintain clear rules on how this matching is done.

³ This is based on the rate of interest in the contract.

CHANGES IN INCOME TAX TREATMENT

6. With the adoption of the FRS 39 for accounting purposes, companies will now have to reflect their financial assets and liabilities at market values in their financial statements. A brief overview of the FRS 39 accounting treatment is provided in Annex 1. To minimise tax adjustments, the income tax treatment of financial assets and liabilities has been changed so as to be closer generally to the accounting treatment (this new tax treatment is hereinafter referred to as the “FRS 39 tax treatment”).

(A) FINANCIAL ASSETS

Financial assets on revenue account

7. For the financial assets on revenue account, the income tax treatment will be aligned with that of the accounting treatment under FRS 39. This would mean that -

- (a) for the assets classified as fair value through profit or loss, all gains or losses recognised in profit or loss (hereinafter referred to as the “profit and loss account”) will be taxed or allowed as a deduction even though they are unrealised;
- (b) for the assets classified as available-for-sale, all gains or losses which are recognised in balance sheet (as a separate item in the equity) will not be taxed or allowed as a deduction. At the time of derecognition⁴, the cumulative gains or losses recognised in equity that are transferred to the profit and loss account will be taxed or allowed as a deduction. For these assets, impairment losses (please also refer to paragraph 11), reversal amount of impairment losses⁵ and foreign exchange gains or losses that are recognised in the profit and loss account will be taxed or allowed as a deduction;
- (c) for the assets classified as held-to-maturity and loans, the “interest income” based on the amount shown in the accounts, which is calculated using the effective interest method⁶ under FRS 39, will be taxed.

Arising from this alignment with the accounting treatment, taxpayers need not make any adjustment for income tax purposes.

Financial assets on capital account

8. In the event that the taxpayer claims that the financial assets are on capital account, it should submit a list of these assets to the Comptroller of Income Tax

⁴ Generally, this refers to the time when the assets are disposed of.

⁵ There is an exception for equity securities. The reversal amount of impairment losses for equity securities are recognised in the balance sheet and only transferred to the profit and loss account when they are derecognised.

⁶ Please refer to footnote 13 for an explanation of the effective interest method.

(hereinafter referred to as the “CIT”) for his determination whether they are indeed assets on capital account. Where the CIT has agreed that they are assets on capital account, the gains or losses will not be taxed or allowed as a deduction. This treatment will continue until such time that circumstances have changed and the taxpayer requests for a review to treat the assets as being on revenue account, in which case, the change of tax treatment will be prospective. However, the CIT reserves the right to tax the gains that have been agreed to be on capital account if at the time of realisation, there is evidence to show that the gains are revenue gains.

9. For assets on capital accounts (except for debt securities and negotiable certificates of deposit where the tax treatment is provided in paragraph 10 below), gains or losses reflected in the profit and loss account, such as those arising from fair valuing of the items or impairment losses, are to be adjusted since they are neither taxable nor deductible for income tax purposes.

10. For debt securities and negotiable certificates of deposit that are on capital account, the interest income reflected in the profit and loss account under FRS 39 will be adjusted to that based on the coupon/contractual rate⁷ and that based on the provisions of section 10(12) of the ITA respectively.

Impairment of financial assets on revenue account

11. Under FRS 39, impairment losses are incurred under certain circumstances described in the Standard⁸. General and specific provisions for bad and doubtful debts would no longer be made. For income tax purposes, impairment losses incurred on financial assets on revenue account will be allowed as a deduction and any reversal amount will be taxed.

Special rules for impairment of financial assets on revenue account for banks and finance companies in certain circumstances

12. Under the Monetary Authority of Singapore (hereinafter referred to as the “MAS”)’s Notice 612⁹ “Credit Files, Grading and Provisioning”, any bank, merchant bank or finance company which does not have a robust loss estimation process or sufficient quality historical loan loss data and are unable to provide for collective impairment under FRS 39 are required to continue to maintain a level of collective impairment provisions that is not less than 1% of the gross loans and receivables after deducting any individual impairment provisions that have been made. As a concession, subject to the conditions stipulated in section 14I of the ITA, the amount determined under the provisions of section 14I will be deducted for income tax purposes for a period of 5 years from the first year of assessment (hereinafter referred to as the “YA”) that such bank, merchant bank or finance company is required to comply with FRS 39 for accounting purposes. Such banks, merchant banks and finance companies are expected to be able to comply with the requirements of FRS 39 for provision of impairment losses by the end of the fifth year.

⁷ This is because the interest income arrived at based on FRS 39 rule is based on effective interest method that includes the transaction cost, discount and premium.

⁸ Paragraphs 58 to 62 of FRS 39

⁹ MAS Notice 1005 for merchant banks and MAS Notice 811 for finance companies

13. For any annual period where the banks, merchant banks and finance companies are able to provide for impairment losses under FRS 39, the entire impairment amount for financial assets on revenue account computed under FRS 39 will be allowed. Should there be any additional collective impairment amount required under MAS Notice 612 on prudence grounds, it will also be allowed as a deduction.

14. Any reversal amount of the impairment losses previously allowed is taxable and no indexation¹⁰ of the reversal amount of impairment losses is required, including any write-back of specific provision for doubtful debts made prior to FRS 39 tax treatment.

(B) INTEREST-FREE & NON-ARM'S LENGTH LOANS

Interest-free loans

15. For any interest-free loan, the “discount” of the loan recognised in the profit and loss account will not be allowed as a deduction and the “interest income” recorded in the profit and loss account will not be taxed because these are merely book entries. This treatment is only applicable to genuine cases of interest-free loans where there is no payment for these book entries. Hence, tax adjustments will be required to disregard these items.

Non-arm's length loans

16. Under FRS 39, taxpayers are required to measure these loans at amortised cost using the effective interest method. This means that at initial recognition of the loan, there will also be a “discount” of the loan recognised in the profit and loss account. In addition, apart from the interest received based on the contractual rate of say 2% when the market interest rate is say 5%, there will also be “income” recognised over the life of the loan which adds up to the “discount” written off to the profit and loss account at the initial recognition.

17. Notwithstanding the accounting treatment, only interest income based on the contractual rate will be taxed. Hence, tax adjustments will be required to achieve this outcome.

(C) FINANCIAL LIABILITIES

18. For the financial liabilities, the income tax treatment will also be aligned with that of the accounting treatment under FRS 39. This would mean that -

¹⁰ Indexation is the adjustment to compensate for the reduction of tax rate between the time the deduction for doubtful debts was allowed to the time the same amount is brought back to tax.

- (a) for liabilities at fair value through profit or loss, all gains or losses will be taxed or allowed as a deduction even though they are unrealised;
- (b) for liabilities measured at amortised cost using the effective interest method, the interest expense computed under FRS 39 will be allowed as a deduction, except for any borrowing that constitutes accretion to capital. In such a case, adjustment is required and only interest expense incurred based on the contractual rate is allowed under section 14(1)(a) of the ITA.

(D) HEDGING INSTRUMENTS

19. For hedging instruments where the underlying asset or liability is on revenue account (e.g. trade receivables), unrealised gains will be taxed and unrealised losses will be allowed as a deduction. However, for hedging instruments where the underlying asset or liability is on capital account, unrealised gains or losses will not be taxed or allowed as a deduction.

(E) TRANSITIONAL RULES

20. Under FRS 39, at the beginning of the financial year in which the Standard is initially applied, the entity is required to identify those financial assets and liabilities that shall be measured at fair value and those that shall be measured at amortised cost, based on the criteria in FRS 39. It will then have to remeasure these items at fair value or amortised cost as the case may be. Any difference between the remeasured amount and the previous carrying amount, excluding available-for-sale assets, is recognised as an adjustment to the balance of retained earnings at the beginning of the financial year in which the Standard is initially applied (hereinafter referred to as the “opening balance of retained earnings”). For available-for-sale assets, the difference between the remeasured amount and the previous carrying amount together with subsequent cumulative changes in fair value is recognised in a separate component of equity until subsequent derecognition or impairment, when the entity transfers the cumulative gain or loss to the profit and loss account.

21. For financial assets and liabilities that are on revenue account, the adjustments recognised in the opening balance of retained earnings will be taxed or allowed as a deduction in the first YA that the FRS 39 tax treatment is applicable after the taxpayer is required to adopt FRS 39 for accounting purposes¹¹. For the available-for-sale assets, as the gains or losses are recognised in equity, they will not be taxed or allowed as a deduction in the said first YA.

22. As a concession, a 5-year instalment plan will be granted for the additional tax payable arising from the transitional tax adjustments for the first YA in which the FRS 39 tax treatment is applicable. To enjoy this concession, the taxpayer has to

¹¹ The transitional adjustments for income tax purposes also include the difference between the book value of the financial assets or liabilities (i.e. the previous carrying amount) and the amount recognised for income tax purposes as at the last day of the basis period of the year of assessment just before the adoption of FRS 39 tax treatment. Examples are trade receivables, bond premium/discount, upfront fees and deferred income.

move to FRS 39 tax treatment no later than the 5th YA after it has first adopted the FRS 39 for accounting purposes.

OPTION TO REMAIN IN PRE-FRS 39 TAX TREATMENT

23. The FRS 39 tax treatment described in the preceding paragraphs will be the default tax treatment for all taxpayers that adopt FRS 39 for accounting purposes. However, a taxpayer can **elect in writing, at the time of submitting the tax return in the first YA it adopts FRS 39 for accounting purposes** to remain on the current tax treatment described in paragraphs 2 to 5 (hereinafter referred to as “pre-FRS 39 tax treatment”), with the option of moving to the FRS 39 tax treatment at any time thereafter¹². Such a move to the FRS 39 tax treatment is irrevocable once it is exercised. A taxpayer that moves to the FRS 39 tax treatment at any time after the 5th YA from the YA that it has first adopted FRS 39 for accounting purposes **will not** be granted the 5-year instalment plan for the additional tax arising from the transitional tax adjustments.

Conditions for taxpayers that opt to remain in pre-FRS 39 tax treatment

24. Taxpayers that opt to remain in the pre-FRS 39 tax treatment are required to comply with the following two conditions:

- a) Furnish details showing how the tax adjustments are arrived at;
- b) Maintain relevant documents to support the tax adjustments made. This would mean that the period of storage of such records may exceed the statutory record-keeping period if the financial assets are not disposed of within this period.

25. If any taxpayer fails to comply with the above conditions, it will be required to move to the FRS 39 tax treatment from the YA in which the failure to comply with the conditions arises. Once the FRS 39 tax treatment is applied in any YA due to this failure, the taxpayer will not be allowed to revert to the pre-FRS 39 tax treatment even if it is able to comply with the two conditions subsequently.

TAXPAYERS NOT REQUIRED TO COMPLY WITH FRS 39

26. For taxpayers that do not need to comply with FRS 39 for accounting purposes or companies that are temporarily exempt by Accounting & Corporate Regulatory Authority (“ACRA”) from complying with FRS 39 for accounting purposes, the pre-FRS 39 tax treatment continues to apply to them.

27. A summary of FRS 39 tax treatment is in Annex 2.

¹² Such taxpayers have to determine the transitional adjustments as at the first day of the annual period in which the FRS 39 tax treatment is first applied.

ENQUIRIES

28. For general enquiries or clarification on this Circular, please call 1800-3568622.

Inland Revenue Authority of Singapore

Classification of financial instruments

1. All financial assets should be classified under the following four categories:
 - (a) Financial assets at fair value through profit or loss;
 - Held for trading;
 - Designated as at fair value through profit or loss;
 - (b) Available-for sale assets;
 - (c) Held-to-maturity assets;
 - (d) Loan and receivables.

2. All financial liabilities should be classified under one of the following two categories:
 - (a) Financial liabilities at fair value through profit or loss;
 - Held for trading;
 - Designated as fair value through profit or loss;
 - (b) Others, which will be measured at amortised cost.

Valuation of financial instruments

3. All the financial instruments should be measured at fair value¹³, except for:
 - (a) loans and receivables, and held-to-maturity investments which should be measured at amortised cost using effective interest method¹⁴ ;
 - (b) investment in equity instrument which do not have a quoted market price in an active market and whose fair value cannot be reliably measured and derivatives that are linked to and must be settled by delivery of such unquoted equity instruments, which shall be measured at cost¹⁵ .

¹³ Fair value is defined in terms of a price agreed by a willing buyer and seller in an arm's length transaction. Where there is no active market, valuation techniques will be used. Factors influencing the fair value of a financial instrument includes:

- time value of money
- credit risk
- foreign currency exchange prices
- commodity prices
- equity prices
- volatility
- prepayment risk and surrender risk
- servicing costs for a financial instrument

¹⁴ The effective interest method is a method of calculating the amortised cost of a financial asset or a financial liability and of allocating the interest income or interest expense over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash payments of receipts through the expected life of the financial instruments. The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate, transaction costs and all other premiums or discounts. [Extracted from paragraph 9 of FRS 39].

¹⁵ See paragraph 46 of FRS 39

Gains or losses

4. The changes in the value of financial assets and liabilities at each year-end will be dealt with under each category of the assets or liabilities¹⁶.

- (a) For financial assets and liabilities classified as at fair value through profit or loss (category 1), the unrealised gains or losses are recognised in the profit and loss account.
- (b) For available-for-sale financial assets (category 2), the unrealised gains and losses are recognised directly in equity, through the statement of changes in equity, except for impairment losses and foreign exchange gains or losses which are recognised in the profit and loss account, until the financial asset is derecognised, at which time the cumulative gain or loss previously recognised in equity shall be recognised in the profit and loss account.
- (c) For financial assets (i.e. held-to-maturity assets, loans and receivables (categories 3 and 4)) and financial liabilities carried at amortised cost, a gain or loss is recognised in the profit and loss account when the financial asset or financial liability is derecognised or impaired, or through the amortisation process. The changes in the amortised cost calculated using the effective interest method are recognised either as “interest income”¹⁷ or “interest expense” in the profit and loss account.

¹⁶ See paragraphs 55 and 56 of FRS 39

¹⁷ This is an accounting concept on interest income. It includes the interest based on the coupon/contractual rate, amortised discount/premium and transaction cost of the debt instrument/loan.

Summary of FRS 39 Tax Treatment

No	FRS 39 Accounting Treatment of Assets/Liabilities	FRS 39 Tax Treatment
	1. Financial Assets - Subsequent measurement of (a) Financial assets classified as “held for trading” & “designated at fair value through profit or loss (hereinafter referred to as “P&L”) (b) Financial assets classified as “available-for-sale” (c) Financial assets classified as “held-to-maturity” (d) Financial assets classified as “loans & receivables”	
1a	Fair value changes at each year-end for financial instruments classified as “held for trading” or “designated at fair value” are recognised in P&L	For assets on revenue account, to adopt the accounting treatment and tax/allow the unrealized gains/losses. For assets classified as “held-for-trading”, the presumption is that the assets are on revenue account.
1b	Fair value changes at each year-end for “available-for-sale” assets are recognised in B/S (equity)	For assets on revenue account, to adopt the accounting treatment where the unrealised gains/losses are recognized in the B/S. For assets on revenue account, to allow/tax the impairment losses/reversal amount of the impairment losses. However, for <u>equity securities</u> , the reversal amount of impairment losses is taxed only until they are disposed of.
1c 1d	“Held-to-maturity” assets, loans and receivables to be measured at amortised cost using the effective interest method. The amortized amount, transaction cost and discount/premium (using effective interest method) are reflected as “interest” in the P&L at each year-end	For assets on revenue account, to adopt the accounting treatment, i.e. to tax the interest income calculated using effective interest method. For assets on capital account, to tax interest income based on contractual rate. Tax adjustments will be required.

No	FRS 39 Accounting Treatment of Assets/Liabilities	FRS 39 Tax Treatment
2. Impairment of assets a. For general taxpayers b. For banks and finance companies in certain circumstances		
2a	Impairment losses in respect of assets (such as loans and receivables), other than assets classified as fair valued through P&L	For assets on revenue account, to adopt the accounting treatment, i.e. to allow a deduction for impairment losses and to tax the reversal amount of impairment losses with no indexation required
2b	<p>For banks and finance companies that are unable to comply with the requirement of FRS 39 in the provision of collective impairment losses in respect of assets on revenue account and are required to provide for it under MAS Notice 612.</p> <p>After the 5-year period, the banks and finance companies are expected to comply with the impairment requirement under FRS 39. MAS may require further provision despite full compliance with FRS 39 on prudence grounds.</p>	<p>To allow the provision for collective impairment losses under MAS Notice 612 for a period of 5 years from the first year the taxpayer adopts FRS 39 for accounting purposes.</p> <p>To allow any further provision required under MAS Notice 612 in addition to FRS 39 impairment losses.</p>
3. Interest-free loans and Non-arm's length loans		
3.	Loans are measured at amortised cost using the effective interest method and "interest income" is recognised in P&L.	For interest-free loans, to disregard the "interest income" and "discount" as they are merely book entries (provided no payment is involved).

No	FRS 39 Accounting Treatment of Assets/Liabilities	FRS 39 Tax Treatment
		For non-arm's length loans, interest income will be taxed and interest expense will be allowed based on the contractual rate.
4. Financial liabilities - Subsequent measurement of (a) Financial Liabilities classified at "fair value through P&L" (b) Financial liabilities at amortised cost		
4a	Unrealised gains/losses from the fair valuing of the liability recognised in P&L	<p>To adopt the accounting treatment and tax/allow the unrealised gains/losses.</p> <p>For liabilities classified as "held-for-trading", the presumption is that the liabilities do not constitute accretion to capital.</p>
4b	The amortized amount, transaction cost and discount/premium (using effective interest method) are reflected as "interest" in the P&L at each year-end	<p>If the borrowing constitutes accretion to capital, only interest expense based on contractual rate is allowed.</p> <p>If the borrowing does not constitute accretion to capital, to adopt accounting treatment of allowing the interest expense based on effective interest method.</p>
5. Hedging		
5.	Unrealised gains or losses of derivatives that are used for hedging activities written off to P&L unless the derivatives meet the conditions for hedge accounting.	<p>To tax/allow the unrealised gains/losses if the underlying assets or liabilities are on revenue account (e.g. trade receivables).</p> <p>Not to tax/allow the unrealised gains/losses if the underlying assets or liabilities are on capital account. Tax adjustment is</p>

No	FRS 39 Accounting Treatment of Assets/Liabilities	FRS 39 Tax Treatment
		thus required.
6. Transitional Rules		
6	<p>Unrealised gains/losses arising from transitional adjustments</p> <ul style="list-style-type: none"> - remeasure assets and liabilities at fair value or at amortised cost according to the classification and any difference between the remeasured amount and the previous carrying amount is recognised as an adjustment of the balance of retained earnings at the beginning of the financial year in which FRS 39 is initially applied. - for “available-for-sale” assets, any difference between the remeasured amount and the previous carrying amount, together with all subsequent cumulative changes in fair value is recognised in a separate component of equity until subsequent derecognition or impairment, where the cumulative gain or loss is transferred to P&L 	<p>To adopt the accounting treatment and tax/allow amounts recognised in the opening retained earnings. In addition, the transitional adjustments for income tax purposes include the difference between the book value of the financial assets or liabilities (i.e. the previous carrying amount) and the amount recognised for income tax purposes as at the last day of the basis period of the year of assessment just before the adoption of FRS 39 tax treatment. Examples are trade receivables, bond premium/discount, upfront fees and deferred income.</p> <p>By default, taxpayers are presumed to align the tax treatment with the FRS 39 accounting treatment, unless they opt out. They will be granted a 5-year instalment plan for additional tax arising from the transitional adjustments.</p> <p>A taxpayer can elect to stay on the pre-FRS 39 tax treatment at the time it submits the tax return in the first YA it has adopted FRS 39 for accounting purposes. It has the option of moving on to the FRS 39 tax treatment irrevocably at a later date. A concession of 5-year instalment plan granted if option to move on to FRS 39 tax treatment is exercised no later than the 5th YA after the taxpayer has first adopted FRS 39 for accounting purposes.</p>

No	FRS 39 Accounting Treatment of Assets/Liabilities	FRS 39 Tax Treatment
7. Taxpayer not required to comply with FRS 39		
7	Tax treatment of financial assets and liabilities for taxpayers that are not required ¹⁸ to comply with FRS 39 for accounting purposes	To allow pre-FRS 39 tax treatment.

¹⁸ Such as sole-proprietors or partners of a partnership, or those that are temporarily exempted by ACRA from complying.