IRAS Consultation

Income Tax Implications Arising from the Adoption of Financial Reporting Standard 115 – Revenue from Contracts with Customers

INLAND REVENUE
AUTHORITY
OF SINGAPORE

Published by
Inland Revenue Authority of Singapore

Published on 12 October 2015

Table of Contents

Public Consultation on Income Tax Implications Arising from the Adoption of Financial Reporting Standard 115 – Revenue from Contracts with Customers

1 Invitation to comment

1.1 IRAS has examined the income tax implications that would arise from entities adopting the new Financial Reporting Standard on *Revenue from Contracts with Customers* ("FRS 115").

1.2 This consultation paper sets out the guidance on IRAS' proposed positions on the income tax implications arising from the adoption of FRS 115.

1.3 We seek your comments on the guidance, particularly on the following:

a) We have provided guidance under paragraphs 6 to 8 on IRAS' proposed positions on the income tax implications arising from the adoption of FRS 115.
   - Are there tax implications relating to FRS 115 that have not been addressed in the paper? If so, please indicate those implications (including examples where possible) and your recommendation.

b) Paragraph 8 of the consultation paper sets out the transitional tax rules relating to the adoption of FRS 115.
   - Are the transitional rules sufficient to address the tax impact arising from the adoption of FRS115?
   - What other transitional tax rules would be necessary?
   - What other challenges do you anticipate in regard to the tax adjustments that an entity would have to make as a result of the transitional rules?

c) For entities that may experience cash flow issues arising from the upfront recognition of revenue as required under FRS 115, we assess that the impact on cash flow is likely to be in the year of transition and would even out in the steady state.
   - Do you agree with this assessment? If otherwise, please elaborate the extent to which the upfront recognition of revenue might impact you?

2 Submission

2.1 To facilitate our review of your comments, please use examples to illustrate your basis and rationale where possible. Please also indicate the specific section of the consultation paper to which your comments relate. Your response should preferably not be more than four pages long.

2.2 We reserve the right to make public all or parts of any written submission made in response to this consultation paper and to disclose the identity of the contributor. We may also contact the contributor if we need further clarification on any comments provided. All comments received will be considered.

2.3 The closing date to submit your comments is 11 November 2015. Your submission should include your name, the organisation you work for or represent, your email address and telephone number. Please address your submission to:

Comptroller of Income Tax
Inland Revenue Authority of Singapore
Tax Policy & Ruling Branch
55 Newton Road
Singapore 307987

Or Email to: public_consultation@iras.gov.sg

3 Aim

3.1 This consultation paper provides guidance on IRAS' proposed positions on the income tax implications arising from the adoption of FRS 115 – Revenue from Contracts with Customers.

3.2 It will be relevant to you if you are a business entity that has contracts with customers within the scope of FRS 115[1].

4 At a glance

4.1 The Accounting Standards Council issued FRS 115 – Revenue from Contracts with Customers on 19 November 2014. FRS 115 applies to contracts which an entity has with its customers. It applies to entities with effect from annual periods beginning on or after 1 January 2018[2]. Earlier application is permitted.

4.2 For tax purposes, the accounting changes arising from FRS 115 are relevant because:

a) financial statements are relied on for tax purposes (i.e. accounting figures serve as the starting point for the computation of tax liabilities); and
b) the impact would be pervasive given that revenue recognition is a fundamental step in the preparation of financial statements, and applicable to all businesses across all industries.

4.3 IRAS has examined the income tax implications arising from the adoption of the FRS 115 and takes the following proposed positions:

a) To accept the accounting revenue as determined in accordance with FRS 115 as the revenue figure for tax purposes except where specific tax treatment has been established through case law or provided under the law and where accounting treatment deviates significantly from tax principles;
b) To require tax adjustments for the significant financing components recognised as interest income/expenses; and
c) To treat the profit/loss arising from transitional adjustments as income/loss subject to tax under section 10(1)(a) of the Income Tax Act ("ITA") in the Year of Assessment ("YA") relating to the year in which FRS 115 is first adopted where the income is derived from a trade, business, profession or vocation.

---

[1] FRS 115 shall be applied to all contracts with customers, except the following:

a) Lease contracts within the scope of FRS 17 *Leases*;
b) Insurance contracts within the scope of FRS 104 *Insurance Contracts*;
c) Financial instruments and other contractual rights or obligations within the scope of FRS 110 *Consolidated Financial Statements*, FRS 111 *Joint Arrangements*, FRS 27 *Separate Financial Statements*, FRS 28 *Investments in Associates and Joint Ventures* and FRS 39 *Financial Instruments, Recognition and Measurement*; and
d) Non-monetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers.

[2] The mandatory effective date for FRS 115 has been deferred for one year to 1 January 2018.

PART I – Fundamentals and principles of FRS 115

5 Background

5.1 FRS 115 establishes principles for reporting useful information to users of financial statements about the nature, amount, timing and uncertainty of revenue and cash flows arising from an entity's contracts with customers. It applies to entities with effect from annual periods beginning on or after 1 January 2018. Earlier application is permitted.

5.2 The core principle of FRS 115 is that an entity is required to recognise revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.

5.3 In this respect, in determining the amount of revenue to be recognised, an entity should apply the following steps:

- Step 1: Identify the contract(s) with a customer;
- Step 2: Identify the performance obligations in the contract;
- Step 3: Determine the transaction price;
- Step 4: Allocate the transaction price to the performance obligations in the contract; and
- Step 5: Recognise revenue when (or as) the entity satisfies a performance obligation.

5.4 For more details on FRS 115, please refer to the Financial Reporting Standard - *FRS 115: Revenue from Contracts with Customers*. This is available on the Accounting Standards Council website on www.asc.gov.sg.

PART II – IRAS' proposed positions on income tax implications arising from the adoption of FRS 115

6 Acceptance of accounting revenue as determined in accordance with FRS 115 as revenue figure for tax purposes

6.1 The recognition of revenue under FRS 115 is based on the satisfaction of performance obligations by the entity. This means that revenue should be recognised by the entity when it has performed the necessary performance obligations.

6.2 It is recognised that the timing of revenue recognition under FRS 115 would differ from existing accounting practices under certain circumstances. These differences are detailed in the table below.

S/N	Circumstances	Existing practices	Requirements in FRS 115	Impact
1	Where the sales contract includes incidental obligations and sales incentives	Some entities may not separately recognise revenue for the transfer to the customer of goods or services that are considered to be sales incentives or otherwise incidental or ancillary to the other promised goods or services in the contract.	Entities are required to assess whether such incidental obligations and sales incentives are goods or services that are distinct. If so, the entity has to recognise revenue when (or as) each distinct good or service is transferred to the customer, even if the transfer is effected within the same transaction.	Revenue from bundling contracts or contracts which provide warranties may be recognised later.
2	Where there is no observable evidence of the stand-alone selling prices of each of the goods or services promised in the contract	An entity may be precluded from recognising revenue on the transfer of a good or service to a customer if there is no observable evidence of the stand-alone selling prices of each of the goods or services promised in the contract.	An entity is required to allocate the transaction price on the basis of estimated stand-alone selling prices of those goods or services.	Estimates of revenue are required; Revenue may be recognised earlier.

S/N	Circumstances	Existing practices	Requirements in FRS 115	Impact
3	Where revenue may be recognised at a point in time or over time	Lack of clear and comprehensive guidance on whether an entity should recognise revenue at a point in time or over time.	An entity will be able to recognise revenue over time only if the criteria specified in FRS 115 are met. Otherwise, the entity will recognise revenue at a point in time when the customer obtains control of the promised good.	Timing of revenue recognition may change for affected entities.

6.3 Tax principles provide for income to be subject to tax when it is accrued to the entity. In other words, income is subject to tax based on an "entitlement to income" principle. To the extent that under FRS 115, revenue is recognised when the entity has performed its obligations even though it might not be entitled to the income yet, the adoption of FRS 115 for tax purpose might represent a shift away from the "entitlement to income" principle. For instance, in a case where the contract does not provide for any milestone payments, the entity may be required to recognise the revenue attributable to the work it has done even if it is not able to request for payment from the customer yet. Accepting such revenue amount for tax purposes means that the income could be subject to tax earlier, as compared to under the current rules.

6.4 Nevertheless, in most cases, an entity generally would be entitled to its income once the service is performed/goods are transferred. On this basis, FRS 115 is unlikely to have a major tax impact on revenue recognition for most businesses.

6.5 It is also observed that FRS 115 requires more judgment and results in more subjectivity with the stipulation of the use of estimates in various circumstances. One example would be where the consideration from the customer is variable. Under FRS 115, entities are required to estimate the revenue using either the "expected value" or the "most likely amount", depending on which amount better predicts the amount of consideration to which the entity will be entitled.

6.6 Notwithstanding, IRAS' assessment is that for most cases, the difference in the amount of revenue recognised arising from adopting FRS 115 is a mere timing difference and the entire amount of revenue from a contract would eventually be subject to tax. As such, to avoid creating unnecessary complexities in tax rules and to minimize compliance burden on entities, IRAS will accept the revenue as determined in accordance with FRS 115 as the revenue figure for tax purposes.

7 Exceptions to accepting the accounting revenue as determined in accordance with FRS 115 as the revenue figure for tax purposes

7.1 There are exceptions whereby the general tax treatment in paragraph 6.6 will not apply and IRAS will **not** accept the accounting revenue as determined in accordance with FRS 115 as the revenue for tax purposes. These exceptions are:

a) where specific tax treatment has been established through case law or provided under the law[3]; and

b) in exceptional circumstances where the accounting treatment deviates significantly from tax principles, for example, contracts with significant financing components which is further elaborated in paragraphs 7.4 – 7.7.

7.2 Property developers and construction companies

The profits of a property developer are recognised for tax purposes when a property development project is substantially completed, that is when the Temporary Occupation Permit is granted[4]. This is regardless of the revenue recognition method adopted for accounting purposes under current accounting standards. With the adoption of FRS 115, the existing tax treatment for property developers will be retained[5]. For construction companies, IRAS generally accepts the accounting treatment under FRS 11 *Construction Contracts* which requires the use of the percentage of completion method when the outcome of a construction contract can be estimated reliably. As the application of revenue recognition criteria under FRS 115 should similarly result in the recognition of revenue over time for construction companies, IRAS assesses that there is unlikely to be a significant change in the way such companies recognise revenue.

7.3 Estimated expenses

Under FRS 115, there could be situations where revenue may be recognised upfront based on estimates. In these situations, some entities may request for the deduction of "estimated expenses" against their FRS 115 estimated revenue (i.e. based on the accounting matching principle). However, notwithstanding the accounting treatment, if such "estimated expenses" are expenses that have not been incurred by the entity, tax principles should prevail and a tax deduction would **not** be allowed for such expenses.

[3] For example, Section 10F of the ITA on the ascertainment of income from certain public-private partnership arrangements.

[4] MPD Pte Ltd v Comptroller of Income Tax (1998) MSTC 5,249

[5] For more details of the income tax treatment for property developers, please refer to the IRAS e-Tax Guide "Income Tax: Taxation of Property Developers" published on 6 March 2013.

7.4 Tax adjustments for significant financing components recognised as interest income/expenses

Under the existing practice, if a customer pays for goods or services in advance or in arrears, some entities may not consider the effect of any financing component in the contract when determining the amount of revenue to be recognised. However, FRS 115 requires an entity to consider the effect of any significant financing component in the determination of the transaction price. This is particularly relevant to long term contracts in which payment by the customer and performance by the entity occur at significantly different times.

7.5 To elaborate, under the requirements of FRS 115, an entity is required to present the effect of financing (interest revenue or interest expense) separately from the revenue from contracts with customers under certain circumstances. For example, where a customer makes an upfront payment for a product that would be delivered two years later, the entity would be required to recognise an interest expense during the two years from contract inception until the transfer of the product and a higher quantum of sales revenue at the end of two years (i.e. the revenue recognised upon the transfer of the product) in their accounts. Conversely, where a customer makes a deferred payment for a product already delivered, the entity will recognise a lower quantum of revenue upfront (i.e. upon delivery of the product) and an interest income during the two years from contract inception until the receipt of the cash payment.

7.6 As this is a significant departure from the "entitlement to income" principle, where contracts with significant financing components are concerned, IRAS will **not** accept, for tax purposes, the revenue figures as recognised in the accounts. This means an entity accounting for contracts with significant financing component will have to make the necessary tax adjustments to bring the full amount of revenue (i.e. the full payment from customer) to be taxed as income in the year it is earned, and to disclose the information relating to those adjustments in its tax computation. In addition, for tracking purposes, the entity will be required to record interest income/expenses arising from the existence of significant financing component separately from other interest income/expenses. Such interest income/expenses will not be taxable/deductible for tax purposes.

7.7 Annex A provides examples on the relevant journal entries in the entity's accounts and the necessary tax adjustments that the entity should make when preparing its tax computation.

8 Transitional tax adjustments

8.1 FRS 115 is effective for annual periods beginning on or after 1 January 2018. If an entity applies FRS 115 earlier, it has to disclose the fact and apply FRS 115 retrospectively with transitional reliefs.

8.2 According to FRS 115, an entity shall apply FRS 115 using one of the following two methods:

a) retrospectively to each prior reporting period presented in accordance with FRS 8 *Accounting Policies, Changes in Accounting Estimates and Errors;* or

b) retrospectively with the cumulative effect of initially applying the Standard recognised at the date of initial application (i.e. the start of the reporting period in which an entity first applies the Standard).

8.3 To minimise tracking difficulties and compliance burden of entities, regardless of the method adopted for accounting purposes, IRAS will treat the profit/loss arising from transitional adjustments as income/loss subject to tax under section 10(1)(a) of the ITA in the YA relating to the year in which FRS 115 is first adopted where the income is derived from a trade, business, profession or vocation. Such income/loss will be subject to tax at the same tax rate(s) that apply to the trade income derived during the basis period for that YA. This is notwithstanding that the adjustments may pertain to a prior year in which the entity was enjoying incentives.

8.4 To elaborate, the tax rates that would apply for each instance in the relevant YA will be:

Where the entity is	Applicable tax rate
Not enjoying any tax exemption or concessionary tax rate on its trade income	Taxed at the applicable normal tax rate (“NTR”) in the year of change
Enjoying concessionary tax rate (“CTR”) or tax exemption on its trade income	Taxed at the applicable CTR or exempt from tax in the year of change
Enjoying multiple CTR, tax exemption and/or NTR on its trade income	Apportionment to the different applicable tax rates in the year of change based on the respective revenue from the different trades

8.5 Examples of the relevant tax adjustments that an entity may need to make in its tax computation can be found in Annex B. Entities are required to furnish details showing how the tax adjustments are arrived at and maintain relevant documents to support the tax adjustments made.

Annex A – Tax treatment for entities with revenue arising from contracts with significant financing components

Example 1: Where an **advance payment** is received by the entity (i.e. the taxpayer)

- Contract to sell Product X, with upfront cash receipts of $50,000
- Delivery in 2 years
- Taxpayer's incremental borrowing rate is 5%

Applicable journal entries (in taxpayer's books):

Dr Cash $50,000
Cr Contract liability $50,000
[Recognition of contract liability upon cash receipt]

During the 2 years from contract inception until the transfer of Product X:
Dr **Interest expense $5,125** [$50,000 x (1.05^2-1)]
Cr Contract liability $5,125
[Recognition of interest expense on upfront payment]

Tax adjustment:
Not incurred (i.e. no legal obligation to pay) by taxpayer and therefore, not deductible

Dr Contract liability $55,125
Cr **Revenue $55,125**
[Recognition of revenue for the transfer of Product X at end of 2 years]

Tax adjustment:
Revenue accrued to the taxpayer (i.e. the amount the taxpayer is entitled) should be $50,000 and therefore, only $50,000 should be subject to tax

Example 2: Where a **deferred payment** is received by the entity (i.e. the taxpayer)

- Contract to sell Product Y, with deferred cash payment of $50,000 2 years later
- Upfront delivery of Product Y
- Entity's incremental borrowing rate is 5%

Applicable journal entries (in taxpayer's books):

Dr Receivable $45,351
Cr **Revenue $45,351**
[Recognition of revenue and contract receivable upon delivery of Product Y]

Tax adjustment:
Revenue accrued to the taxpayer (i.e. the amount the taxpayer is entitled) is $50,000 and therefore, full $50,000 should be subject to tax

During the 2 years from contract inception until the receipt of cash payment:
Dr Receivable $4,649 [$45,351 x (1.05^2-1)]
Cr **Interest income $4,649**
[Recognition of interest income]

Tax adjustment:
An accounting construct and should not be taxable. Otherwise will lead to double taxation.

Dr Cash $50,000
Cr Receivable $50,000
[Recognition of cash receipt at the end of 2 years]

Annex B –Transitional tax adjustments assessed in the Year of Assessment relating to the year of change

Example 1: Over-recognition of profits in prior years

- Applying FRS 115, assume retained earnings is to be reduced by $2,000 in the year of change and that this amount will be subsequently recognised as revenue in Year 1.

Retained earnings	**Profit & Loss**	
Adjustments in Year 0	Revenue recognised in Year 0	Revenue recognised in Year 1
-$2,000	$0	$2,000

Year 0 = Year of change

Tax adjustments to be made:

- Reduction in income of $2,000 allowed in the YA relating to the year of change
- Subsequently, the income of $2,000 will be taxed in Year 1 when it is recognised.

Example 2: Under-recognition of profits in prior years

- Applying FRS 115, assume additional income of $2,000 from prior years recognised in year of change and there is no revenue to be recognised subsequently.

Retained earnings	**Profit & Loss**	
Adjustments in Year 0	Revenue recognised in Year 0	Revenue recognised in Year 1
+$2,000	$0	$0

Year 0 = Year of change

Tax adjustments to be made:

- $2,000 subject to tax in the YA relating to the year of change