Exemption of Foreign Income – Benefit from it

The tax regime of Singapore has traditionally been on a territorial basis - i.e. only income derived in Singapore, or income derived overseas but received in Singapore, is subject to tax.

With increasing globalisation, Singapore has finally provided for tax exemption of specified foreign-sourced income remitted to Singapore on or after 1 June 2003. The exemption puts Singapore on par with Malaysia, which granted 100% foreign-income exemption as far back as 1995. Hong Kong, on the other hand, has never taxed foreign sourced income.

This progressive approach enhances Singapore's position as an attractive business hub and boosts our service exports.

What should a Singapore company look for when it acquires or starts new businesses overseas? In particular, how can a tax efficient structure which maximises post-tax cash flows be achieved?

FOREIGN INCOME EXEMPTION

There are 3 types of foreign-sourced income remitted to Singapore that is exempted from tax – dividends, branch profits and service income received by Singapore resident companies.

For the purpose of the tax exemption, a dividend is considered foreign-sourced if it is paid by a company that is not tax resident in Singapore.

A foreign branch refers to a business operation of a company registered as a branch in a foreign jurisdiction. O*nly* foreign branch profits arising from a trade or business carried on by a foreign branch will qualify for the tax exemption. Non-trade or non-business income such as interest income or royalty income will be excluded.

Service income refers to professional, technical, consultancy or other services provided by a person in the course of its trade, profession or business. Service income is treated as foreign-sourced if the service is provided through a fixed place of operation in the foreign jurisdiction.

CONDITIONS FOR EXEMPTION OF FOREIGN-SOURCED INCOME

To qualify for foreign-income exemption, 2 main conditions have to be met:

1. The foreign income must be received from a jurisdiction with a headline tax rate of at least 15%. The headline tax rate refers to the highest corporate tax rate of the foreign jurisdiction. It need not be the actual tax imposed on the specified foreign income.
2. The foreign income must have been subjected to taxation in that jurisdiction i.e. income tax must have been paid or is payable in that jurisdiction

POTENTIAL PITFALLS

On the surface, these 2 conditions appear reasonable and not too daunting. However, many investment structures may have been designed to meet foreign tax objectives in the country of operation and may fail one or both conditions.

1. DOUBLE TAXATION

When investing overseas, it is not uncommon for companies to set up special purpose vehicles (SPVs) as intermediate holding companies. SPVs are used in joint venture situations, or simply to facilitate future divestment or listing.

Intermediate holding companies may also be used to segregate different core businesses or investments in certain regions or countries. For example, investments into various countries in Asia are often structured through an intermediate Asian holding company.

Careful planning is necessary when deciding whether to use intermediate holding companies, especially if the income from these investments will likely be repatriated to Singapore in future.

The use of SPVs in tax havens such as British Virgin Islands and Cayman Islands may cause the underlying income to fail either one or both conditions for Singapore tax exemption as these countries typically do not impose any

income tax on virtually all categories of income.

Where no tax is paid or payable at SPV or intermediate holding company level, the dividends remitted from that intermediate holding company will be taxed at the current corporate tax rate of 20% if received in Singapore. This comes with no relief for the foreign tax paid by the subsidiaries, associated companies or investments held by the intermediate company because the tax paid by lower tier subsidiaries/investments are effectively disregarded.

With proper planning, it is possible to avoid Singapore taxation by retaining non-exempt foreign income offshore and use it to, say, fund offshore investments. In addition, the persons who are managing such non-qualifying unremitted foreign income must be familiar with the deemed receipt rules.

2. FOREIGN TAX INCENTIVES

Given the prevalence of tax incentives in many Asian countries, many investee companies are enjoying tax incentives and, subsequently, are not paying any foreign income tax. Will they then satisfy the 'subject to tax' condition?

The Inland Revenue Authority of Singapore (IRAS) regards the 'subject to tax' condition as being met if the tax incentive is granted for carrying out substantive business activities in the investee country.

3. TRANSFER OF FUNDS

Another perhaps more obscure condition for the foreign-income exemption is that the monies must not have been invested in or moved to another foreign jurisdiction before being remitted to Singapore. This may trip up the unwary.

Many group companies practice 'cash pooling' where excess funds of the group are channeled through designated central bank accounts for lending to entities within the group which requires funding. If the foreign income is remitted directly from the foreign jurisdiction to the central bank account (say, in Hong Kong) without first being remitted to Singapore, the corresponding income will fail the foreign-income exemption.

In general, the rule of thumb is to remit the qualifying foreign income to Singapore first, before channeling the funds out again to an overseas bank account. There may be bank charges for such fund transfers to Singapore but the costs are well worth it if the amounts are large.

4. RESIDENCY

One must remember that the foreign-income exemption applies only to Singapore residents. The residency of a Singapore company is taken to be the place where the management and control of the company is exercised. The IRAS usually looks to the place where the board of directors meets to decide on strategic issues as an important factor in determining the management and control of the company.

The tax residency of a Singapore branch will follow that of its foreign head office and will almost inevitably be treated as a non-resident for Singapore tax purposes. Therefore, the Singapore branch that earns foreign-sourced service income will not benefit from tax exemption.

5. SERVICE INCOME

For companies which derive service income, there is an additional condition to satisfy – the service must be rendered in the course of a person's trade, business or profession, through a fixed place of operation in a foreign jurisdiction.

What is meant by 'a fixed place of operation'? Merely leasing an office will not qualify if the activities performed are auxiliary or preparatory in nature, such as collecting information for the Singapore company or providing information regarding the Singapore company's expertise.

The IRAS has clarified that the term 'fixed place of operation' refers to a place of management, an office, or a certain amount of floor space through which the person or his employees perform the activities that produce the profits of his trade, business or profession. This place must have a degree of permanence and should be regularly used by the person to carry on his trade, business or profession.

For instance, a Singapore engineering company secures a one-month service contract in Indonesia. Under the contract terms, the Singapore company is required to send two engineers to be based in the customer's factory in Indonesia to install the

machines and provide training to employees. If this is a one-off contract, the one-month presence at the customer's factory in Indonesia would not satisfy the 'degree of permanence' aspect of the exemption criteria.

If, as a result of the contract, the Singapore company leases an office in Indonesia, regularly sends a team of engineers to provide engineering services to various customers in Indonesia and pays tax in Indonesia, the income from that Indonesia office should qualify for tax exemption when it is remitted to Singapore.

If the level and period of activities in that country exceeds certain thresholds, it may be justifiable for the Singapore company to register a branch or subsidiary in that foreign country. If so, the nature of the income will change from foreign-sourced service income to either branch profits or dividends from subsidiaries.

Viewed from this perspective, IRAS' current definition of 'a fixed place of operation' may be somewhat restrictive.

6. EXEMPTION VS FOREIGN TAX CREDIT
Consider the following example:

ABC Pte Ltd has tax losses of $1 million in Singapore. However, its profit from an architectural contract in Thailand amounts to $2.4 million. After paying Thai income tax at 37.5%, the net cash that can be remitted to Singapore is $1.5 million.

Foreign Tax Credit Regime (Pre-June 1, 2003)

Under this regime, the remitted foreign income of $1.5 million must be set off against the company's tax losses of $1 million. This reduces or eliminates the tax losses that might otherwise be available for offset against future taxable income in Singapore.

The only way to avoid the offset of part or all of the company's tax losses is to retain the high taxed foreign income outside Singapore until the Singapore tax losses are fully utilized.

Foreign Income Exemption Regime
With the introduction of the foreign income exemption, as long as the conditions for exemption are satisfied, the Thai income will be exempt from tax in Singapore. With the exemption, there will not be any offset of the foreign income which is tax exempt against the Singapore tax losses.

Accordingly, the tax losses of $1 million are preserved and are available for offset against future taxable income.

It follows that there will be no adverse Singapore tax implications if high taxed foreign income is remitted to Singapore, regardless of whether the Singapore company is in a taxable or tax loss position.

In summary, the foreign income exemption regime is an improvement over the former foreign tax credit system. It is encouraging to note that the government is regularly reviewing and improving our tax regime to facilitate the nation's globalization drive.

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