Tax Considerations for an Initial Public Offering

by Accredited Tax Advisor (Income Tax & GST) Mr Lee Tiong Heng, Tax Partner, Deloitte & Touche LLP

When restructuring in preparing for an initial public offering (IPO), businesses need to be mindful of the tax impacts on their underlying investments in countries like China and India. This was one of the key points raised at the seminar organised by the Institute of Certified Public Accountants of Singapore in collaboration with various thought leaders from Deloitte & Touche LLP.

Attended by over 100 accounting professionals and business leaders, the half-day seminar at M Hotel, covered a range of topics to help small and medium-sized enterprises (SMEs) or those considering an IPO in planning their tax strategies. The Singapore Institute of Accredited Tax Professionals was also present to support the event in line with its objective of promoting tax excellence.

Broadly, businesses will need to decide on equity or debt financing, perform tax due diligence, review its group structure and consider the tax implications arising from the proposed group structure.

Raising Funds the Debt or Equity Way

While an IPO may be the aspiration of many entrepreneurs and business owners, a thorough analysis on the best way for a business to raise capital should be done to determine if debt or equity (and perhaps via an IPO) financing is more appropriate. Factors to consider would include the business model, the accounting, legal and most definitely, the tax implications to raise funds via debt or equity.

Companies should note that when choosing to finance their business through debt, typically in the form of loans or bonds, interest expense on the issuance of debt securities will be incurred. Such interest expenses will only be deductible if the funds raised are used to finance income-producing assets.

Equity financing takes the form of money obtained from investors in exchange for an ownership share in the business. In equity financing, incidental costs (such as legal and professional fees) are not tax deductible. In addition, whilst interest expense in debt financing can be tax deductible, dividend payments resulting from equity financing are not.

Companies should also note that interest payments to non-Singapore tax residents in connection with any loans or indebtedness are subject to a final withholding tax at 15%. Companies can however consider applying for tax incentives which grant withholding tax exemption on interest payments (e.g. Approved Foreign Loan Incentive for purchase of productive equipment). Alternatively, businesses can consider to structure its loans with countries whereby the tax treaties provide for the withholding tax on interest to be reduced or exempted.

Singapore – Location. Location. Location.

It is a usual practice for companies to reorganise its group structure to achieve tax efficiency before embarking on the journey to go public. To this end, Singapore is an ideal location for many businesses to base its holding company as there is no tax on capital gains, no thin capitalisation or Controlled Foreign Corporation (CFC) rules and availability of a wide range of tax incentives schemes like the Development and Expansion Incentive, Headquarters Award and Global Trader Programme.

Moreover, with a prevailing corporate tax rate of 17% and a partial exemption scheme on the first S$300,000 of normal chargeable income, Singapore's effective corporate tax rate is considered relatively low.

Singapore also has a wide tax treaty network with close to 70 countries and these generally provide for reduced withholding tax rates for dividends, interest and other payments.

Tax Tardiness... Not!
It is imperative that even before embarking on the IPO journey, businesses should ensure that their tax matters are in order so as not to face any tax liabilities that may affect the company's repute or stock performance after its IPO launch. Subject to meeting the qualifying conditions, businesses can utilise the voluntary disclosure programme that the Inland Revenue Authority of Singapore (IRAS) has in place where no penalty will be imposed if businesses voluntarily disclose any non-compliance within a one-year time frame. A reduced penalty of 5% is imposed for voluntary disclosure after a one-year period.

Tax Efficient Group Restructuring
Besides finalising the location, businesses also need to review its group structure.

A typical efficient group structure is illustrated in the diagram below where a company holds various companies with separate activities and operations. This ensures that commercial and operational risks are ring-fenced and it also facilitates future expansion plans. Moreover, such a structure is considered efficient for future dividend distribution and shares disposition from a tax perspective.

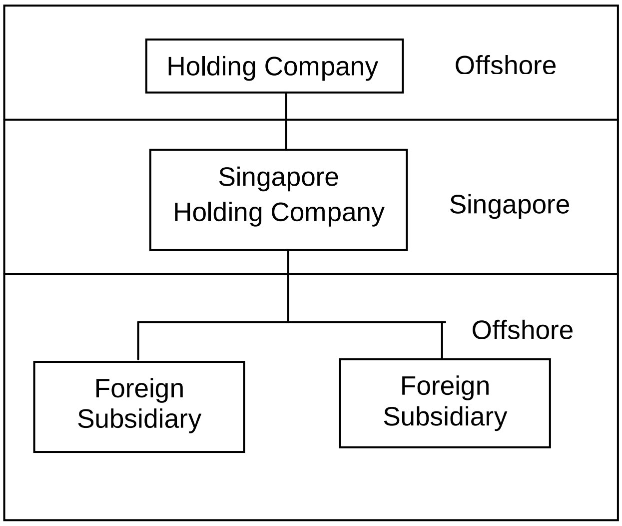


Diagram 1. A typical efficient group structure comprises a holding company with various subsidiaries consisting of separate activities and operations.

Dividend Flows
Companies can set up subsidiaries in countries whereby the tax treaties provide for the dividends paid to a non-resident to be tax exempted or subject to a reduced withholding tax rate.

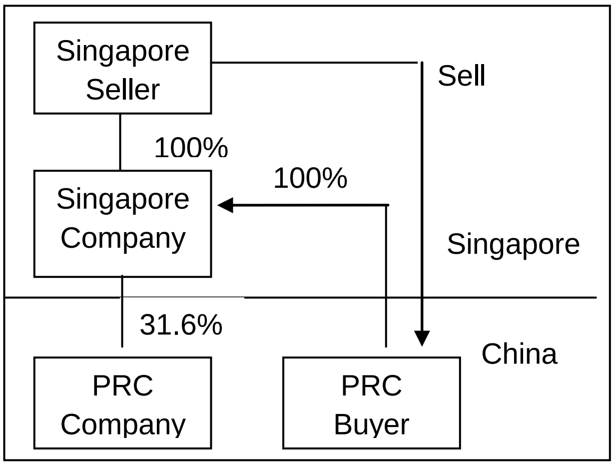
Dividends received by the Singapore holding company can qualify for tax exemption under Section 13(8) of the Singapore Income Tax Act if the company meets certain qualifying conditions. In addition, one-tier exempt dividends made by the Singapore holding company are also exempted from tax in the hands of the shareholders.

Efficient Exits
Business owners need to note that at point of exit, gains derived from the disposal of equity investments will not be subjected to tax if the divesting company holds a minimum shareholding of 20% in the company whose shares are being disposed, and this minimum 20% shareholding is maintained for at least a period of 24 months prior to the disposal.

When the above conditions are not fulfilled, the tax treatment of the gains arising from share disposals will continue to be determined based on the facts and circumstances of the case.

When disposing its investments, companies should take note of the taxation on indirect transfer of shares. The Chongqing and Vodafone cases serve as good examples on the tax implications arising from indirect transfer of shares.

Chongqing case



In May 2008, the Chongqing tax authority considered the capital gains derived by the Singapore Seller from the transfer of Singapore Company's equity to the PRC Buyer to be essentially a transfer of the Singapore Company's 31.6% equity interest in the PRC Company, and they were, therefore, regarded as PRC-sourced income. Consequently, a 10% withholding tax was imposed by the Chongqing tax authority on the capital gain on the Singapore seller.

Vodafone case

The Indian tax authorities issued a notice to Vodafone for failing to withhold tax on the acquisition of shares of a non-resident Hutchison Group entity outside India. The Indian tax authorities viewed that the "controlling interest" in Hutchison Essar Ltd, an Indian company held indirectly by Hutchison Group, was effectively transferred even though the shares transferred belonged to a non-resident entity and the share transfer had taken place outside India.

Nonetheless, the Supreme Court held that the Indian tax authorities did not have territorial jurisdiction to tax the offshore transaction, and therefore, Vodafone was not liable to withhold Indian taxes. However, subsequent to the decision made by the Supreme Court, the Indian government had sought to introduce several retrospective amendments to make transactions such as the Vodafone purchase liable to Indian tax.

Gearing up for IPO - Asset Transfer vs Share Transfer

After a proposed structure has been decided for IPO, businesses will need to decide whether to transit from the current structure to the proposed structure via asset transfer or share transfer. Some of the pros and cons of an asset transfer and share transfer are summarised in the table below:

	Asset Transfer	Share Transfer
General	▪ Higher stamp duty costs when transfer of immovable properties in Singapore is involved. ▪ From a commercial risk standpoint, asset deal allows better insulation against contingent and potential (onerous) liabilities of business transferred.	▪ Generally less complicated and entails a shorter process as compared to an asset deal. ▪ Greater commercial risk as all assets and liabilities are transferred.
Capital allowances/ Writing-down allowances	▪ Potential to obtain step-up on tax cost base of assets acquired. ▪ Goodwill not tax deductible. Where possible, purchase consideration to be allocated to assets qualifying for tax deductions/ allowances.	▪ Not applicable.
Unutilised tax losses and	▪ Not available for transfer. Forfeited upon transfer of business.	▪ Available for carry forward, subject to shareholding test

capital allowances		and/or business tests.
Group relief system for transfer of tax losses	▪ Not applicable	▪ May no longer be available if share deal results in a foreign-incorporated or an unincorporated body in the ownership chain. Their shareholding will not be considered in determining direct or indirect shareholdings.
Deductibility of interest and prescribed borrowing costs to finance the asset/ share deal	▪ Generally deductible to acquirer on loan specifically used to finance acquisition of income-producing assets.	▪ Only deductible against dividend income received from the share investment. No deduction value if dividend is tax exempt in Singapore.

As SMEs grow, IPO is an enticing option for many. However, as can be seen, a myriad of considerations with direct and indirect implications have to be carefully reviewed. Businesses need to be prudent and should seek professional advice on this significant milestone of the business.

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Tiong Heng has more than 16 years of tax experience serving local, multinational and listed companies in Singapore including four years with the Inland Revenue Authority of Singapore (IRAS). Tiong Heng is regularly involved in tax consultancy and planning services in mergers and acquisitions, corporate restructuring, cross-border transactions, tax ruling requests, taxation negotiation with the IRAS and Singapore tax incentive application from the Singapore government authorities. He is a fellow member of the Certified Public Accountants of Singapore and is an Accredited Tax Advisor (Income Tax & GST).

This technical event commentary is written by SIATP's Tax Manager, Ms Lee Shin Huay. An Accredited Tax Practitioner (Income Tax), Shin Huay has over six years of experience in corporate and individual tax. Previously from Deloitte & Touche LLP, she now leads various initiatives of Singapore's first dedicated professional body for tax specialists to enhance Singapore's position as a centre of tax excellence.