

A new ball game for Tax?

FRS 115 Revenue from Contracts with Customers

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Although the word “income” is not defined in the Singapore Income Tax Act (“ITA”), the profits and gains of an entity are to be computed in a manner that is consistent with the ordinary principles of commercial accounting and in conformity with the rules of the ITA¹. In this regard, accounting information contained in the financial statements of a taxpayer generally serve as the starting point for the computation of his tax liabilities.

However, accounting principles may not be conclusive for the purposes of computing the gains and profits of a taxpayer for tax reporting because of the different objectives of accounting and tax. Accounting is concerned with, amongst others, providing financial information about an entity that is useful to investors and creditors in making economic decisions in relation to the entity². Tax, on the other hand, is a creature of statute and is prescribed by the Government to meet various fiscal requirements.

In dealing with conflicts between the two, the Singapore Courts have affirmed the primacy of tax laws over accounting principles³. Divergences between the former and the latter should prima facie result in tax adjustments being made, unless statutory provisions or administrative concessions are enacted or granted to align tax with accounting recognition. One such alignment is the promulgation of Section 34A of the Income Tax Act (“ITA”), which bridges the gulf between fair value accounting for financial instruments introduced by Financial Reporting Standard (“FRS”) 39 and the cardinal tax principle that neither profit nor loss may be anticipated.

On this note, a significant change in accounting standards that may be of utmost interest to most entities and users of financial statements, and one that could once again result in profits or losses being anticipated for tax purposes, is looming on the horizon: the introduction of FRS 115 “Revenue from Contracts with Customers”.

Revenue recognition under FRS 115

The Accounting Standards Council of Singapore issued FRS 115 on 19 November 2014. The new accounting standard applies for annual periods beginning on or after 1 January 2017 but earlier application is permitted.

FRS 115 introduces a single, comprehensive control-based revenue recognition model for all contracts with customers (other than financial instruments, insurance or lease contracts, which fall

¹ Pok Soy Yoong et al, *The Law and Practice of Singapore Income Tax* (Second Edition), Volume 1, p535.

² *The Conceptual Framework for Financial Reporting*, 2011. Accounting Standards Council Singapore. Available from: <<http://www.asc.gov.sg/2014Volume>> [1 April 2015].

³ *Pinetree Resort Pte Ltd v. Comptroller of Income Tax* [2000] SGCA 48 and the more recent case of *ABD Pte Ltd v Comptroller of Income Tax* [2010] 3 SLR

under the scope of other standards) and harmonises revenue reporting across entities and industries. The core principle of the new model is that an entity shall 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 services⁴.

Broadly, determining when the transfer of a good or service occurs under the new standard is based on when the customer obtains control of that good or service, which can happen either over time or at a point in time. For the simplest transactions where consideration is exchanged for goods or services instantaneously, the accounting recognition of revenue in such instances should be aligned with tax principles. However, as transactions become more complex, applying the core principle invariably requires more judgement⁵ and may give rise to variances between recognition of revenue for accounting purposes and accrual of income for tax purposes.

Income accrual for tax purposes

For Singapore income tax purposes, the phrase “accruing in or derived⁶ from” in Section 10 of the ITA sets the point in time when income sourced in Singapore is to be recognised for taxation purposes (note that income sourced outside Singapore is to be taxed only when it is received or deemed received in Singapore). In this regard, “accrue” means “to which any person has become entitled⁷”. A taxpayer is “entitled” to income when he has done all that is required of him to earn the income and whether he has done all that is required of him depends on the particular trade he is engaged in⁸.

At first glance, FRS 115’s revenue recognition principle, which is to recognise revenue only when performance obligations are satisfied, appears broadly aligned with the meaning of ‘entitled’ for tax purposes. As always, the devil is in the details. The following are some tax issues that may arise from the adoption of the new accounting standard: -

- There could be instances where the point of revenue recognition by an entity under FRS 115 differs from the time when its customers are legally obligated to pay for the goods or services. It is unclear when an entity would be regarded as being ‘entitled’ to the income in such a scenario.
- Currently, other than the above case law principles, there is a lack of comprehensive guidance on when an entity becomes entitled to the income arising from long-term contracts, such as construction contracts, for tax purposes. In practice, the existing accounting revenue recognition basis (e.g. revenue recognition based on percentage of completion or milestones achieved) is often used as a starting point in the tax computation, with appropriate tax adjustments on a case-by-case basis. FRS 115 introduces new concepts, such as the unbundling of separate performance obligations, measurement of variable consideration, and methods of allocating consideration, which may impact the current measurement and timing of revenue for long-term contracts. These will further complicate the reconciliation to the income reporting for tax purposes.
- Following from the above, revenue recognised under FRS 115 could potentially include amounts that are not yet certain. For example, a variable consideration (say additional \$1M if project is completed 1 month earlier), may have to be estimated as part of revenue to be recognised over time resulting in an earlier recognition of the variable revenue. If that revenue is taxed, it seems only appropriate that expenses matched to such revenue for accounting purposes should also be allowed tax deduction. Where such expenses are also anticipated or provided for, it is uncertain

⁴ FRS 115, Paragraph 2

⁵ *Revenue recognition: At last, a common universal language for top line reporting*, July 2014. Accounting Standards Council Singapore. Available from <http://www.asc.gov.sg/Portals/0/attachments/Consultations/2014/Revenue_Article.pdf> [1 April 2015]

⁶ The meaning of ‘derive’ has been held to be synonymous with ‘accrue’ in *Commissioners of Taxation v. Kirk* [1900] A.C. 588

⁷ *Pinetree Resort Pte Ltd v. Comptroller of Income Tax* [2000] SGCA 48

⁸ *ABD Pte Ltd v Comptroller of Income Tax* [2010] 3 SLR

whether such the claim for tax deduction will be accepted by the Inland Revenue Authority of Singapore (“IRAS”).

- FRS 115 requires entities to assess whether incidental obligations or sales incentives arising from a transaction can be regarded as goods or services that are distinct. If so, the entity has to recognise revenue when each distinct good or service is transferred to the customer. This contrasts with the current practice where revenue may not be separately recognised for incidental obligations or sales incentives. For example, a car manufacturer that bundles a maintenance services package along with the sale of a car may now have to recognise part of the revenue relating to the maintenance services at a later date. Other taxpayers, such as telecommunication companies, may find themselves recognising higher revenue upfront as they would have to allocate revenue to various components of their bundled mobile phone contract, such as the handset (upfront) and the ongoing telecommunication services (over time). This creates a deviation from the normal tax principles, as arguably the telecommunications service provider is only entitled to its revenue upon the provision of telecommunication services over time and as such revenue is invoiced, as opposed to the point in time when the free handset is given to customers. While some may argue that this is only a timing difference or cash flow issue, the accelerated recognition of revenue (if tax is aligned with the accounting recognition) may in some cases result in additional tax burden for the taxpayer if the taxpayer suffers losses in the later years, due to the fact that trade losses can only be carried back for one year and subject to a cap of \$100,000.
- FRS 115 also requires entities to consider the effects of any significant financing components in the determination of the transaction price and the effects of the financing (interest expense or interest revenue) would have to be presented separately from the revenue figure. The financing component would be recognised periodically while the remaining revenue figure will be reduced / increased accordingly. Presently, it is unclear whether such interest income would be taxed as a separate source income or as part of trade income.

Conclusion

Where the tax and accounting revenue recognition principles are not aligned, this may result in additional compliance costs for taxpayers to identify and track the appropriate tax adjustments, and in the worst case scenario result in a separate income and expenses account to be maintained for tax purposes.

On the other hand, for taxpayers whose revenue would be accelerated under FRS 115, they may face additional cash flow or tax burden as mentioned above if the tax treatment is aligned with accounting recognition.

An “opt-out” regime similar to the FRS 39 tax treatment under Section 34A of the ITA may need to be implemented for such taxpayers should the revenue recognition basis under FRS 115 be adopted for tax purposes, to save on compliance costs. In determining whether to align tax with accounting treatment or otherwise, the relevant authorities will no doubt be balancing the twin priorities of maintaining a simple tax system whilst protecting Singapore’s revenue base.

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