2-2015

Foreign Source Income Tax Exemption and Pooling System: Which works Better? (Part 2 of 3)

Clement Kai Guan TAN
Nanyang Technological University

Teng Aun KHOO
Singapore Management University, takhoo@smu.edu.sg

DON'S COLUMN

FOREIGN-SOURCED INCOME TAX EXEMPTION AND POOLING SYSTEM

Which Works Better? (Part 2 of 3)

BY
CLEMENT TAN KAI GUAN
AND KHOO TENG AUN

This is the second of a three-part series. In Article 1, published in ***IS Chartered Accountant***, January 2015, we had concluded that it would be more tax beneficial to claim the foreign tax credit under the pooling system (PS) than under the source-by-source and country-by-country system (SCS) provided that the foreign tax paid (FTP) is:

- Greater than the Singapore tax payable (STP) for one type of foreign income, and
- Less than the STP for another type of foreign income.

In Article 1, the foreign dividend income received in Singapore by a resident company was treated as tax exempt under the foreign-sourced income tax exemption (FSIE) regime. Besides the foreign dividend income, foreign branch profit and foreign-sourced service income when received in Singapore by a resident person (not being an individual)[1] will also qualify for tax exemption under the FSIE regime. Tax exemption granted under the FSIE regime is subject to the following conditions:

a) Headline tax rate of the foreign country from which the income is received is at least 15% at the time the foreign income is received in Singapore;
b) Foreign income had been subjected to tax in the foreign country from which they were received (the rate at which the foreign income was taxed need not be the same as the headline tax rate), and
c) Comptroller is satisfied that the tax exemption of the foreign income would be beneficial to the person resident in Singapore.

A situation may arise where a specified foreign income[2] meets qualifying conditions (a) and (b) for exemption under the FSIE regime and also the conditions qualifying for the foreign tax credit under the PS. At first glance, tax exemption on the specified foreign income under the FSIE regime may seem to be the preferred choice as any increase in total chargeable income, if the specified foreign income is not tax exempt, is likely to lead to an increase in tax payable.

The purpose of this article is to address whether it is always better to claim tax exemption on the specified foreign income under the FSIE regime in the context of the PS.

ILLUSTRATION

Company A derives a local trade income of $3,000,000 and receives in Singapore the following elected gross incomes[3]:

- Foreign interest income of $10,000 (FTP @ 8%),
- Foreign royalty income of $2 million (FTP @ 5%), and
- Gross foreign dividend income of $5 million which qualifies for tax exemption under the FSIE regime, and also for foreign tax credit under the PS.

Table 1 shows the tax treatment of the foreign dividend income under the following three scenarios:

- Column A: Foreign dividend income is tax exempt under the FSIE regime;
- Column B1: Foreign dividend income is subject to Singapore tax and suffers a foreign tax rate of 10%;
- Column B2: Foreign dividend income is subject to Singapore tax and suffers a foreign tax rate of 30%.

1 In this article, our focus is on a resident company.

2 Specified foreign income refers to foreign sourced dividend income, foreign sourced branch profit and foreign sourced service income.

3 Elected income means any item of foreign income for which a resident person qualifies to claim the foreign tax credit under the PS.

PHOTO SHUTTERSTOCK

Table 1 Tax computation for Company A receiving foreign income

		PS		
		FDI tax exempt under the FSIE	FDI subject to Singapore tax and FTC claimed in respect of the FDI	
		A	B1	B2
Foreign tax rate on Dividend income		-	10%	30%
		$	$	$
Local trade income		3,000,000	3,000,000	3,000,000
Foreign income:				
Interest income (FTP @ 8%, that is, $800)		10,000	10,000	10,000
Royalty income (FTP @ 5%, that is, $100,000)		2,000,000	2,000,000	2,000,000
FDI (exempt under the FSIE regime)		0		
FDI (FTP @ 10%, that is, $500,000)			5,000,000	
FDI (FTP @ 30%, that is, $1,500,000)				5,000,000
Net chargeable Income before Partial tax exemption	X	5,010,000	10,010,000	10,010,000
Less: Partial tax exemption		152,500	152,500	152,500
Normal chargeable income after Partial tax exemption		4,857,500	9,857,500	9,857,500
Tax payable before FTC (@ 17%)	Y	825,775	1,675,775	1,675,775
Less: FTC - lower of pooled FTP of $100,800, that is, ($800 + $100,000) and pooled STP of $331,299[4]		100,800		
Less: FTC - lower of pooled FTP of $600,800, that is, ($800 + $100,000 + $500,000) and pooled STP of $1,173,545[5]			600,800	
Less: FTC - lower of pooled FTP $1,600,800 , that is, ($800 + $100,000 + $1,500,000) and pooled STP of $1,173,545[5]				1,173,545
Net tax payable after FTC		724,975	1,074,975	502,230
Less: Net tax payable (without FDI)			724,975	724,975
Increase/(Decrease) in net tax payable due to the inclusion of FDI			350,000	(222,745)
Excess of pooled FTP over pooled STP disregarded		0[6]	0[7]	427,255[8]
Excess of pooled STP over pooled FTP		230,499	572,745	0
Singapore effective tax rate	Y/X	16.48253%	16.74101%	

FI: Foreign income
FTC: Foreign tax credit

ANALYSIS OF TABLE 1

1) By including the foreign dividend income of $5 million as a taxable income (in scenarios B1 and B2, the overall tax payable before foreign tax credit will increase by $850,000[9] as compared to scenario A.

2) Consequently, the amount of pooled foreign tax credit granted under the PS will increase by $500,000[10] in scenario B1, and $1,072,745[11] in scenario B2.

3) Depending on the extent of the increase in (1) and (2), the net tax payable *after* the pooled foreign tax credit may increase or decrease. In scenario B1, it will increase by $350,000 ($850,000 - $500,000), but in scenario B2, it will decrease by $222,745 ($850,000 - $1,072,745).

4) Claiming exemption on the foreign dividend income under the FSIE regime in scenario A is more tax beneficial than subjecting it to tax

[4] ($10,000 + $2,000,000) x Singapore effective tax rate of 16.48253%

[5] ($10,000 + $2,000,000 + $5,000,000) x Singapore effective tax rate of 16.74101%

[6] FTP of $100,800 less FTC granted of $100,800

[7] FTP of $600,800 less FTC granted of $600,800

[8] FTP of $1,600,800 less FTC granted of $1,173,545

[9] $1,675,775 less $825,775

[10] $600,800 less $100,800

[11] $1,173,545 less $100,800

[12] Alternatively, $5,000,000 x Marginal Rate of 17% = $850,000

[13] ($10,000 + $2,000,000) x Singapore effective tax rate of 16.74101% less pooled FTP of $100,800

in scenario B1. Although there is an excess of the STP over the FTP in respect of the foreign interest and royalty incomes, the inclusion of the foreign dividend income does not give rise to an excess of FTP over STP that Company A can utilise under the PS.

In scenario B2, the inclusion of the foreign dividend income gives rise to an excess of FTP over STP that Company A can utilise under the PS to further increase the amount of pooled foreign tax credit granted. Overall, by not claiming tax exemption on the foreign dividend income under the FSIE regime, Company A can enjoy further tax savings of $222,745. This is explained as follows:

	Inclusion of foreign dividend income of $5,000,000 results in an		
(a)	**Increase in tax payable before FTC**		**$850,000[9, 12]**
(b)	**Increase in FTC granted of $837,051, being the lower of STP of $837,051 (that is, foreign dividend income of $5,000,000 x 16.74101%) and FTP of $1,500,000 thus giving rise to an excess of FTP over STP of $662,949**		**$837,051**
	Additional tax payable [(a) - (b)]		**$12,949**
(c)	**Excess of FTP over STP ($662,929) in respect of the foreign dividend income, which can be utilised to offset against the excess of pooled STP over pooled FTP in (d) below.**	**$662,929**	
	In respect of the total foreign interest income and royalty income of $2,010,000		
(d)	**the excess of the pooled STP over the pooled FTP**	**$235,694[13]**	
	Additional FTC granted as a result of including the foreign dividend income - lower of (c) and (d)		**($235,694)**
	Additional tax savings		**$222,745**

CONCLUSION

Generally, if a specified foreign income which qualifies for tax exemption under the FSIE regime also meets the conditions qualifying for the foreign tax credit under the PS, tax exemption under the FSIE regime is usually beneficial unless

1) Prior to the inclusion of the specified foreign income, there is already an excess of pooled STP over the pooled FTP, and
2) FTP in respect of the specified foreign income is greater than its STP.

The idea here is to be able to utilise the excess in (2) to offset against the excess in (1). This effectively means an overall higher amount of pooled foreign tax credit granted in the end.

However, with the inclusion of taxable foreign dividend income, overall tax payable before foreign tax credit also increases.

At this point, one has to compare the extent of the increase in the overall tax payable before foreign tax credit with the extent of the increase in the overall amount of pooled foreign tax credit granted after the inclusion of the foreign dividend income. This is when one needs to test out the "beneficial tax exemption" condition under the FSIE regime by comparing the two different sets of tax computations, that is, tax exemption versus non-tax exemption.

In our illustration, we conclude that it is more tax beneficial for Company A to claim tax exemption under the FSIE regime in respect of its foreign dividend income under scenario B1, when the foreign tax rate is 10%. However, under scenario B2, Company A is better off by not claiming tax exemption when the foreign tax rate on the foreign dividend income is 30% as there are additional tax savings of $222,745.

In this article, the entire amount of foreign dividend income is treated as either being tax exempt under the FSIE regime or taxable under the PS. In our next article, we will extend our analysis in scenario B2 further by varying the portion of foreign dividend income that is treated as tax exempt under the FSIE regime and the remaining portion as taxable under the PS. In doing so, we will determine if Company A is able to further optimise its tax position. ISCA

Clement Tan Kai Guan is Associate Professor of Accounting, Nanyang Business School, Nanyang Technological University, and Khoo Teng Aun is Associate Professor of Accounting, Singapore Management University.