Section 10L – Taxation of Gains From Sale of Foreign Assets

Overview

On 6 June 2023, a new section 10L was introduced in the draft Income Tax (Amendment) Bill 2023 (**Section 10L**), in respect of which the Ministry of Finance (**MOF**) invited the public to provide feedback. The MOF has provided its response to key feedback and incorporated the proposed legislative changes into the Income Tax (Amendment) Bill 2023 (**Bill**) which was introduced in Parliament on 18 September 2023. The Bill was read for a second time and passed without amendments on 3 October 2023. Section 10L, which treats as income chargeable to tax any gains from the sale or disposal of foreign assets by an entity of a relevant group if the gains are received in Singapore, will apply to gains arising from sales or disposals occurring on or after 1 January 2024.

We summarise in this update our views on Section 10L.

Background to Section 10L

Section 10L was introduced to align the treatment of gains from the sale of foreign assets to the European Union (**EU**) Code of Conduct Group (**COCG**) guidance, which aims to address international tax avoidance risks. We note that the work done by the COCG in this regard is also generally aligned with the publications issued by the Organisation for Economic Co-operation and Development (**OECD**) for the Inclusive Framework on Base Erosion And Profit Shifting (**BEPS**) project under Action 5 (Harmful tax practices), which seeks to realign taxation of profits with the substantial activities that generate them, especially in the context of preferential tax regimes. This is to prevent taxpayers from deriving benefits from a regime while engaging in operations that are purely tax-driven and involve no substantial activities.

Following the COCG Report No. 14674/22 published on 24 November 2022 (**2022 Report**), the COCG updated certain aspects of their guidance on foreign source income exemption (**FSIE**) regimes, notably on tax treatment of capital gains. According to the guidance on FSIE regimes, the main problem intended to be addressed is situations of double-non-taxation. This is because FSIE regimes that are broad enough to exclude from taxation passive income (including capital gains) without any conditions is harmful, and can result in ring-fencing and lack of substance.

The updated guidance in the 2022 Report further recommended that jurisdictions that exclude from taxation certain types of passive income (including capital gains) should: (a) implement adequate substance requirements in line with the EU's Code of Conduct (Business Taxation); (b) have robust anti-abuse rules in place; and (c) remove any administrative discretion in determining the income to be excluded from taxation.

In this regard, Singapore was asked to make a commitment by 30 June 2023 to amend its FSIE regime in line with the FSIE guidance by 30 June 2024, to take effect from 1 July 2024, and this is likely to have led to the introduction of Section 10L.

Key Points on Section 10L

Section 10L treats as income chargeable to tax any gains from the sale or disposal of foreign assets by an entity of a relevant group if the gains are received in Singapore. An entity is a member of a group if its assets, liabilities, income, expenses and cash flow: (a) are included in the consolidated financial statements of the parent entity of the group; or (b) are excluded from the consolidated financial statements of the parent entity of the group solely on size or materiality grounds or on the grounds that the entity is held for sale. A "relevant group" is one which has entities established in more than one jurisdiction or if any entity of the group has a place of business in more than one jurisdiction. This means that an entity that only has business operations in Singapore will not be subject to Section 10L. It was also clarified during the second reading of the Bill that foreign tax credits continue to be available based on current rules and that Section 10L will not cover foreign entities that have no operations in Singapore other than the use of banking facilities in Singapore.

The Bill has also clarified Section 10L exclusions. Section 10L will not apply to gains from the sale or disposal of a foreign asset (except for intellectual property rights) carried out as part of, or incidental to:

(a) The business activities of prescribed financial institutions (i.e., licensed banks, licensed merchant banks, licensed finance companies, licensed or regulated insurers, and holders of a capital markets services licence); or

(b) The business activities or operations of an entity, being activities or operations from which the entity derives income that is exempt or subject to a concessionary rate of tax under certain tax incentive schemes.

Section 10L will also not apply if the sale or disposal of the foreign asset is carried out by entities that are excluded entities, which are divided into pure equity-holding entities (**PEHEs**) and entities that are not PEHEs (**Non-PEHEs**).

Both PEHEs and Non-PEHEs must have their operations managed and performed in Singapore (whether by its own employees or by other persons under the control of the entity) to be regarded as an excluded entity.

A PEHE is regarded as an excluded entity if it: (a) submits any return, statement or account which needs to be submitted to a public authority regularly; and (b) has adequate human resources and premises in Singapore to carry out the operations of the PEHE.

A Non-PEHE is regarded as an excluded entity if the entity has adequate economic substance in Singapore, taking into account considerations such as:

(a) The number of full-time employees of the Non-PEHE (or other persons managing or performing the Non-PEHE's operations in Singapore);

(b) The qualifications and experience of such employees or other persons;

(c) The amount of business expenditure incurred by the Non-PEHE in respect of its operations in Singapore; and

(d) Whether the key business decisions of the Non-PEHE are made by persons in Singapore.

In this regard, the MOF has indicated that it will not be prescribing in legislation bright-line tests to establish whether the aforementioned economic substance requirements are met. That said, it has stated that the Inland Revenue Authority of Singapore (**IRAS**) will provide further guidance on this, including examples for certain sectors, through an e-Tax Guide to be published by the end of 2023. This was reiterated during the second reading of the Bill.

Although neither the MOF nor the IRAS has released official guidance, it is clear from the MOF's statements that it is taking reference from the publications issued by the OECD BEPS project under Action 5, as well as the COCG guidance (which also makes reference to the OECD BEPS project). In this regard, we would like to reiterate that the main mischief targeted by the OECD BEPS project under Action 5 and by the COCG is to realign taxation of profits with the substantial activities that generate them, especially in the context of preferential tax regimes.

We expect that the IRAS' e-Tax Guide will take reference from the guidance set out in the BEPS Action 5 Progress Reports, which similarly does not provide any bright-line tests, but instead provides general guidelines on the core income-generating activities for different types of preferential regimes, which in turn are used to determine the level of substance required. In particular, we would like to highlight holding company regimes and fund management regimes, which are highly relevant in Singapore's context:

(a) **Holding company regimes**

A distinction is drawn between PEHEs and Non-PEHEs. The OECD has indicated that there are different policy considerations in respect of PEHEs in that preferential regimes for PEHEs primarily focus on alleviating economic double taxation. They therefore may not require much substance in order to exercise their main activity of holding and managing equity participations. The key considerations instead lie in issues of transparency and the inability to identify the beneficial owner of the income generated by the PEHE.

For Non-PEHEs which earn different types of income (e.g., interest, rents, and royalties), the core income-generating activities would be those associated with the income that the Non-PEHE earns, and the analysis would depend on the specific regime that the Non-PEHE falls under. In addition, the requirement for a Non-PEHE to carry on a trade, business, or profession in Singapore has been removed, given that investment holding entities may not meet this requirement as they are passive holding entities.

(b) **Fund management regimes**

What is notable under Section 10L is that funds which enjoy tax exemption under the tax incentives set out in sections 13D, 13O or 13U of the Income Tax Act 1947 are not specifically excluded from the application of Section 10L. It therefore appears that whether such an entity can be excluded from the application of Section 10L will depend on whether it can be regarded as an excluded entity on the basis that it has operations managed and performed in Singapore. The factors that may be relevant for the purposes of determining whether there are such operations could include the

resources required to carry out the core income-generating activities by the relevant fund's manager such as taking decisions on the holding and selling of investments, calculating risks and reserves, taking decisions on currency or interest fluctuations and hedging positions, and preparing relevant regulatory or other reports for government authorities and investors. Presumably, funds which rely on the services of licensed third-party fund managers should be regarded as having met these substance requirements.

In this regard, we note that the Monetary Authority of Singapore has been strengthening the substance requirements for family offices structures applying for the incentives under sections 13O and 13U. We expect the IRAS' guidance with respect to family offices enjoying the sections 13O or 13U tax incentives to adopt a similar approach.

Concluding Remarks

The e-Tax Guide to be published by the IRAS by the end of 2023 will provide further clarity on how the substance requirements apply. In addition, it was announced during the second reading of the Bill that the IRAS will continue to refine its guidance based on feedback and consultation with industry partners. Taxpayers should therefore continue to take note of developments on Section 10L.

If you would like information and/or assistance on the above or any other area of law, you may wish to contact the Partner at WongPartnership whom you normally work with or any of the following Partners:

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