IRAS' AUDIT ON FAMILY-OWNED/MANAGED COMPANIES

1. Overview of the Family-Owned/Managed Companies

Family-owned/managed companies are companies owned and / or managed by individuals related as a family, for example, spouse, parents, children and siblings. The family may own a majority of shareholding and be in active control of the company; that is, share ownership becomes an instrument of control. On the other hand, a family may own a majority of the shares in the company, but exert only passive control. In other cases, the family exercises effective control even though it owns only a minority of the shareholding in the company.

2. Characteristics of Family-Owned/Managed Companies

IRAS estimates about one-third of the companies in its tax base are family-owned/managed companies. These companies are mainly from the following industries:

(a) Wholesale Trade;

(b) Retail Trade;

(c) Travel Agencies/Tour Operators;

(d) Wholesale and Retail Trade of Motor Vehicles;

(e) Specialized Construction Activities;

(f) Warehousing.

Some family-owned/managed companies, which tend to be small to medium in size, may not have put enough resources and attention on maintaining proper accounting records and meeting their tax obligations, since the business owners are related.

3. IRAS Compliance Review

IRAS conducts regular compliance reviews on taxpayers' Income Tax Returns. In 2007, we carried out audits on 649 family-owned/managed companies. In 2010, IRAS conducted audits on another 150 family-owned/managed companies. In our letters issued to these companies, we highlighted the common mistakes made by family owned / managed companies in tax reporting and advised them to conduct a self-review of their accounts and tax computations before IRAS commenced its audits. These companies also have to complete questionnaires on their business operations, record-keeping practices and accounting systems.

To encourage companies which have made mistakes to come forward with revised tax computations voluntarily, such cases will be considered under the IRAS Voluntary Disclosure Programme, if the qualifying conditions are satisfied.

4. Audit Outcomes

For the 649 audits conducted in 2007, 296 (45.6%) family-owned/managed companies were found to have errors in their tax returns.

For the subsequent 150 audits conducted in 2010, 55 (37%) family-owned/managed companies were found to have made mistakes in their tax reporting. As at March 2012, nearly $2.6 million of private motor vehicles expenses were wrongly claimed by the companies audited by IRAS. We have also uncovered more than $1.2 million being remuneration paid to directors that did not commensurate with actual services performed. Other wrongful claims of expenses discovered amounted to more than $7.4 million.

In total, the taxes recovered by IRAS from the audits conducted on family-owned/managed companies were approximately $16.5 million. After careful consideration of the circumstances surrounding each case and the level of co-operation, penalties amounting to $3 million were imposed on the companies.

5. IRAS's Audit Observations and Common Mistakes made by Taxpayers

We observed that the small family-owned/managed companies generally tend to pay insufficient attention to maintaining proper controls and accounting records resulting in their non-compliance with tax rules.

Family-owned/managed companies are encouraged to use this checklist as a guide to help them avoid making common mistakes on their claims for tax-deductible expenses.

We highlight below the common mistakes observed by the IRAS auditors in their audits of the family-owned/managed companies:

(a) Claiming of non-deductible expenses
(b) Claiming of remuneration not commensurate with actual services performed
(c) Claiming of private and domestic expenses
(d) Incorrect claim for interest expenses attributable to non-income producing assets
(e) Over-claim of CPF contributions
(f) Over-claim of medical expenses
(g) Omission in Form IR8A
(h) Understatement of income
(i) Overstatement of purchases and other expenses
(j) Excessive charging of consultancy fees, management fees, royalties, etc
(k) Property trading gains claimed to be capital gains.

(a) Claiming of deduction of non-deductible expenses

Under Section 15(1)(k) of the Income Tax Act 1947, claims of private motor vehicle expenses (i.e. S- plated cars) are not deductible even if they are incurred in the course of business. In the course of our audit, it was found that taxpayers often made wrongful claims of private motor vehicle expenses including petrol, insurance, repair and maintenance, parking and ERP charges etc.

(b) Claiming of remuneration not commensurate with actual services performed

Many of the family-owned companies were managed by the family members. It was found out that the remuneration paid to the directors' family members such as their children, did not commensurate with the actual services performed.

Taxpayers should only claim remuneration that is reasonable having regard to the services performed by the family members as compared to an independent employee with the same qualifications and experience performing the same services.

Amount of remuneration paid to the company directors' parents, spouses, children and siblings who are not working in the company or whose remuneration did not commensurate with the actual services performed would not be deductible for tax purposes.

(c) Claiming of private and domestic expenses

IRAS observed that many family-owned/managed companies do not draw clear distinction between business and private expenses. To expedite their tax reporting, some companies assumed that the private portion would not be significant and claimed the whole amount as deductible expenses.

Expenses not incurred for the business such as private expenses on entertainment, membership subscription, personal insurance and travelling expenses, will be disallowed for income tax purposes.

For expenses to be tax deductible, the expenses must be wholly and exclusively incurred in the production of income. In other words, these expenses must be expended solely for business purposes only and must not include any non-business element. Companies should maintain proper records to segregate private expenses of its shareholders / directors / employees from business expenses and exclude such private and domestic expenses from their claims in tax returns.

(d) Incorrect claim for interest expenses attributable to non-income producing assets

Interest expenses relating to non-income producing assets are not deductible for income tax purposes. As such, companies should make interest adjustments in their tax computations if there are any interest expenses applicable to non-income producing assets.

Examples of non-income producing assets are:

- Vacant properties acquired for long-term investment,
- Investments in shares/securities which have not yielded any dividends,
- Interest-free loan or amount owing by non-trade/sundry debtors,
- Interest-free loan or amount owing by related companies (non-trade)/shareholders.

Interest adjustments are normally made using the total asset method. This method is based on the principle that total funds are used to finance all assets, including both income-producing and non-income producing assets.

Under the total asset method, interest adjustment (disallowable interest expense) =

$$\frac{\text{Cost of non-income producing assets}}{\text{Cost of total assets}} \times \text{Interest expenses}$$

(e) Over-claim of CPF contributions

Another mistake found was claiming of excess CPF contributions by companies. Such voluntary CPF contributions are not tax deductible under the law.

(f) Over-claim of medical expenses

In general, tax deduction for medical expenses is capped at 1% of the total remuneration incurred in the basis period. Total remuneration refers to employees' salaries, allowances and bonuses, directors' remuneration (excluding directors' fees) and allowable CPF contributions.

For companies that implemented either Portable Medical Benefits Scheme (PMBS) or Transferable Medical Insurance Scheme (TMIS) and met the qualifying conditions, tax deduction for medical expenses is capped at 2% of the total remuneration incurred in the basis period.

IRAS observed that some family-owned companies did not apply the capping or have computed the capping wrongly. Such wrongful claims are not allowable for income tax purposes even if they were incurred in the course of business.

(g) Omission in Form IR8A

In the course of our audit, we discovered errors such as commission (wrongly classified as handling charges in the accounts) paid to directors were not declared in the directors' Form IR8A. Companies should include such payments in the Form IR8A issued to the directors for their tax reporting.

(h) Understatement of income

Some taxpayers made arithmetical errors when totaling up their income. Some failed to take into account all the invoices issued for goods sold or services rendered, resulting in their failure to report the full amount of income for income tax purposes.

(i) Overstatement of purchases and other expenses

Many taxpayers were found not to have kept sufficient source documents and records to substantiate their claims on purchases and expenses. In some cases, the purchases of goods and other expense items were inflated due to double-counting. Some expenses were even estimated without any valid basis.

(j) Excessive charging of consultancy fees, management fees, royalties etc.

There were cases where family-owned companies made excessive claim of consultancy fees, management fees, royalties, etc paid to related companies. Such transactions usually lack economic substance since the receiving companies do not carry out substantive business activities to earn the income. There are occasions where the recipients' accounts merely showed statutory expenses and the level of assessable income reported was just enough to set off against the amount of income exempt under the partial/full tax exemption schemes. Such companies usually have common directors and the companies share the same business address and tax agent.

(k) Property trading gains claimed to be capital gains

Our audits also revealed instances of company directors engaging in property trading under the company's name. Although it was claimed that the property was purchased for investment purpose, the company's short holding period of the property, lack of financial ability to hold the property for long term and its active effort to seek buyers indicated the intention to trade. Trading gains from the sale of properties are taxable.

Companies should review the original intention for purchasing the properties and the circumstances leading to the sale of properties to determine whether such gains/losses from the sale of these properties are taxable/deductible.

6. Keeping Proper Records

Good record keeping practice is an important part of a business operation. With good record-keeping, companies are unlikely to make common mistakes described above. It also helps companies achieve better internal controls and serve as an essential source of information to detect business losses, internal fraud and theft. Proper record-keeping helps companies to reduce their costs and efforts on collating information when preparing for tax and other reporting obligations.

Businesses are expected to put in place a record keeping system to ensure that all tax declarations are duly supported with the required documents. Penalties may be imposed on companies failing to keep and retain proper records.

For more information on the records that companies should keep and how long they should be kept, companies are encouraged to refer to Record Keeping Essentials for Businesses.

7. Voluntary Disclosures of Errors

IRAS will continue to conduct regular compliance reviews on various industries as part of our efforts to enhance voluntary compliance by companies. Companies are encouraged to maintain proper records and submit accurate and complete tax returns.

Under Section 95 of the Income Tax Act 1947, any person who negligently or without reasonable excuse makes an incorrect Income Tax Return may be liable to a penalty as high as two times the amount of tax undercharged. Severe cases of omissions or errors may be subject to court prosecution.

Taxpayers are encouraged to voluntarily disclose errors made in their past Income Tax returns. Under the IRAS Voluntary Disclosure Programme, IRAS will waive the penalty for voluntary disclosures of omissions or errors which meet the qualifying conditions and are made within the 'grace period' of 1 year beginning from the statutory filing date of 30 November. For voluntary disclosures made after the 'grace period', IRAS will impose a reduced penalty rate of 5% per annum.