IRAS' AUDITS ON FAMILY-OWNED/MANAGED COMPANIES

1. Overview and Characteristics 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. These include:

- Families that own a majority shareholding, whether they have active or passive control of the company; and
- Families that only own a minority shareholding in the company but are able to exercise effective control.

Based on IRAS' observation, family-owned/managed companies are generally weaker in maintaining accounting records and some may face difficulties in meeting their tax obligations due to unfamiliarity with the tax laws.

As the owner/employees are related, the distinction between private and business expenses are sometimes not clearly drawn, and hence family-owned/managed companies have a higher tendency to make incorrect claims for private expenses.

2. IRAS' Compliance Reviews and Audit Outcomes

IRAS conducts regular compliance reviews specifically on the income tax returns of family-owned/managed companies. As at 2022, 816 audits have been conducted on family-owned/managed companies and 44% of the companies were found to have errors in their tax returns. This resulted in total tax recovery of approximately $16.7 million. After careful consideration of the circumstances surrounding each case and the level of co-operation from the companies, penalties amounting to over $3 million in total were imposed on the companies for the errors in their tax returns.

In the most recent review concluded in 2022, questionnaires were issued to the companies for them to provide information on their business operations, record-keeping practices and accounting system. We also highlighted the common mistakes made by family owned / managed companies in tax reporting and advised the companies to conduct a self-review of their accounts and tax computations before we commenced our audits. This was to encourage companies which had made mistakes to come forward with revised tax computations voluntarily.

Under IRAS' Voluntary Disclosure Programme, we 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', we will impose a reduced penalty rate of 5% per annum.

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

We highlight below the common mistakes observed in our audits of the family-owned/managed companies. Taxpayers are encouraged to use this checklist as a guide to help them avoid making such mistakes in their tax returns.

(a) Capital expenditure and non-deductible expenses

Tax deductions on capital expenditures are disallowed under Section 15(1)(c) of the Income Tax Act 1947 (ITA). Such capital expenditures include expenses incurred to issue shares or for dividend distribution, purchase of fixed assets, as well as depreciation expenses in the financial statements. Some family-owned businesses omitted to make tax adjustments for such non-deductible expenses in their tax computations.

(b) Private motor vehicle expenses

Private motor vehicle expenses (i.e. S- plated cars) are not deductible even if they are incurred in the course of business under Section 15(1)(k) of the ITA. We found that taxpayers often made wrongful claims of private motor vehicle expenses including petrol, insurance, repair and maintenance, parking and ERP charges etc.

(c) Capital allowances and enhanced allowances/deductions under the various government schemes administered by IRAS on non-qualifying assets / expenditure

Capital allowances are allowed on capital expenditure incurred on machinery or plant for the purpose of the company's trade, profession or business under Section 19/19A of the ITA. However, we found that some family-owned companies were not familiar with what was considered machinery or plant for the purpose of capital allowances, and tried to claim capital allowances on renovation expenses such as floor tiles, sanitary fittings, false ceiling, etc. Such expenditures do not qualify for capital allowance under Section 19/19A, and are claimable under Section 14N of the ITA instead, subject to qualifying conditions.

For enhanced allowances / deductions under various government schemes administered by IRAS, we found that that some family-owned companies were not fully aware of the conditions of the various schemes. In this regard, they made claims on expenditures that did not qualify under the schemes or expenditure that were in excess of what was allowed under the scheme.

(d) Keyman insurance

Some family-owned companies made incorrect tax deduction claims for life insurance policies taken up for directors as collateral for trade facilities provided by a bank. The banks were the beneficiaries of these life insurance policies. Such insurance premiums do not qualify for tax deduction as keyman insurance, as the policies do not meet the qualifying conditions provided in the e-Tax Guide "Deductibility of 'Keyman' Insurance Premiums".

(e) Private and domestic expenses

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, are 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 and must not include any non-business elements. 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.

(f) Remuneration paid to directors and family members that did not commensurate with actual services rendered

Many family-owned companies were managed by family members and we found that the remuneration paid to the directors as well as their family members such as their children, did not commensurate with the actual services performed.

Companies should claim deductions on remuneration paid to directors/family members that commensurate with the actual services rendered to the company. Relevant considerations include the services performed by the directors/family members, as well as the level of remuneration that would be paid to an independent employee with the same qualifications and experience performing the same services.

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

(g) 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 as provided in the e-Tax Guide "Income Tax Total Asset Method for Interest Adjustment". 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)

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

(h) 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.

(i) Over-claim of medical expenses

In general, tax deductions for medical expenses are 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 meet the qualifying conditions, tax deductions for medical expenses are capped at 2% of the total remuneration incurred in the basis period.

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

(j) Omission in Form IR8A

We observed errors such as payments (e.g. commission) made to directors that 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.

(k) 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.

(l) 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.

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

Some family-owned companies made excessive claims of consultancy fees, management fees, royalties, etc. paid to related companies. Such transactions usually lacked economic substance since the receiving companies did not carry out substantive business activities to earn the income. There were 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.

(n) 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 purposes, 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 the gains/losses from the sale of these properties are taxable/deductible. In addition, companies should maintain contemporaneous documentation (e.g. minutes of Board meeting, Directors' resolution, feasibility studies and loan agreement) to support their claims for purchasing properties for investment purposes.

(o) Continued claim for expenses even though business has ceased

There were instances that companies continued to claim deductions on expenses even after they had ceased business and became dormant. Such expenses are not deductible as they were not incurred in the production of income.

4. Keeping Proper Records

Good record keeping practices are an important part of business operations. With good record-keeping practices, companies are unlikely to make the common mistakes described above. Companies will also be able to achieve better internal controls and be better able to detect business losses, internal fraud and theft. Proper record-keeping also helps companies reduce their costs and efforts in 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 that fail 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" available in IRAS website.

5. Consequences of filing of incorrect returns

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 ITA, 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.