IRAS' AUDIT ON BUDGET HOTELS

1. Overview of the Budget Hotel Industry

The tourism industry has seen an upward trend of visitor arrivals in recent years. The rapid pace of globalisation together with the expansion of low-cost carriers in Asia, as well as Singapore's robust medical infrastructure, have contributed to the tourism industry.

The hotel industry in Singapore is also seeing new opportunities. There are now a total of 292 hotels[1] compared to 226 hotels at end 2006.[2] More family/locally-owned budget hotels[3] have opened in Chinatown, Little India, Geylang, East Coast, Joo Chiat, Bencoolen and Balestier, catering to budget travellers. Conglomerates in Singapore are also looking towards developing budget hotels in Singapore and the region. It is estimated that about 50% of registered hotels in Singapore[4] belong to the budget hotel category.

2. Regulatory Environment

Hotels in Singapore are regulated under the Hotels Act (Chapter 127) ("HA"). The HA is administered by the Hotel Licensing Board ("HLB"). To operate a hotel, a person has to apply to HLB under the HA for the following:

- a certificate of registration to use the premises as a hotel; and
- a hotel-keeper's licence to enable the person to keep or manage the hotel

To ensure that the premises are used for legal and proper hotel operations, the HA requires the registered hotels to comply with various standards and regulations including the following:

- exclusion of prostitutes, catamites and bad characters;
- proper maintenance of guests' particulars;
- proper maintenance of hygiene (in terms of room size, number of occupants, light and ventilation, sanitary arrangements, etc.)

There is also a Singapore Tourism (Cess Collection) Act ("STCCA") for collection of cess which is reduced to 0% since 01.07.07. The STCCA's classification of registered hotels as gazetted and non-gazetted is still in place, namely:

- gazatted hotel => charge on room-nights only, predominantly in prime/commercial/tourist locations, within the STCCA scope

[1] Obtained from Hotel Licensing Board website (of the number of registered hotels)
[2] Extracted from Annual Report on Tourism Statistics 2009
[3] Also termed as "economy tier" hotels in the Annual Report on Tourism Statistics 2009 to include hotels in the budget segment and are generally located in outlying areas.
[4] Extracted from Annual Report on Tourism Statistics 2009

- non-gazetted hotel => hourly/daily charge basis, generally in outlying areas, outside the STCCA scope

The Annual Report on Tourism Statistics also has the following classification by number of hotel rooms:

- small hotels => hotels with 200 rooms or less
- medium hotels => hotels with 201 - 400 rooms
- large hotels => hotels with 401 – 600 rooms
- very large hotels => hotels with 600 rooms

Budget hotels are usually categorized as small hotels under the HA and non-gazetted hotels under STCCA.

3. Operation models

Budget hotels generally operate as sole-proprietorships, partnerships and companies, with some being family owned and/or managed. Other than the big players which run hotels as part of the hotel chain, many of them have small scale operations of less than 100 rooms and a work force of 10 to 20 employees. Besides the provision of daily accommodation services, most of these hotels provide rooms on an hourly occupancy basis. Almost all of them provide basic amenities to their patrons while some of them charge for selling food, beverage and miscellaneous comfort items such as toiletries. Banquet function room and services, restaurants and room services are not common features in these hotels.

These hotels often operate on a cash basis. The room management and accounting systems are usually not fully computerised. In fact, some of them operate only manual systems for room management, sales takings and expenses recording.

4. IRAS audit review

IRAS conducts regular compliance reviews on taxpayers' Income Tax returns. IRAS audited 35 such budget hotels which provide daily and hourly accommodation services. On-site visits were made by IRAS' auditors to all the selected hotels. Some of the visits were unannounced while the rest were pre-arranged with taxpayers. Information and documentation on the hotels' business operations, record keeping practices and accounting systems were gathered during the visits to facilitate the IRAS auditors in ascertaining the accuracy of the taxpayers' Income Tax reporting.

Nearly $10 million of sales takings from room rentals and other incidental income sources were under-declared by the budget hotel operators audited by IRAS. Our auditors also uncovered wrongful claims of expenses amounting to $2 million. In total, the taxes recovered by IRAS were approximately $1.7 million. After careful consideration of the circumstances surrounding each case, penalties amounting close to $1.7 million were imposed on these hotel operators as they had failed, without reasonable excuse or through negligence, to furnish correct Income Tax Returns to IRAS.

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

We observed that the budget hotels audited generally tend to have poor internal controls and record keeping practices that resulted in their non-compliance with tax rules. Weaker internal controls and record keeping practices were found in those hotels which were family owned and/or managed. However, since the completion of our audits, we note that the hotels audited have made improvements to their internal controls and record keeping practices in order to facilitate their compliance with Income Tax reporting.

Below are the common mistakes observed by the IRAS auditors in their audits of the budget hotels:

(a) Understatement of hotel room rentals
(b) Omission of other incidental sources of income
(c) Depositing cash takings net of purchases or into personal accounts
(d) Claiming of private expenses
(e) Claiming of expenses without maintaining sufficient supporting documents
(f) Claiming of expenses which are capital in nature

(a) Understatement of hotel room rentals

Most of the budget hotels audited by IRAS did not maintain proper records of their sales takings. Some hotels kept their daily records of revenue in loose sheets which could not be reconciled completely to the monthly totals. Others kept incomplete details of revenue generated from daily room occupancy, such as period of stay of each patron and the room rate. There were also some budget hotels which charged hourly rates and accepted cash payments only. Due to the short turnaround time, these hotels failed to issue receipts and that caused them to make errors when tabulating sales.

These poor record keeping and accounting practices resulted in the taxpayers' failure to report the full amount of income from room rentals accurately for Income Tax purposes.

(b) Omission of other incidental sources of income

Some budget hotels provided and charged for light refreshments and basic amenities such as toiletries to their patrons without reporting the sales as income. There were also hotels which operated in-house restaurants but failed to include sales generated from the restaurants in their Income Tax reporting.

Taxpayers should issue serially numbered invoices in respect of all goods sold or services rendered and account for all the invoices issued when preparing their accounts.

(c) Depositing cash takings net of purchases or into personal accounts

Many of the budget hotels audited by IRAS operated on a cash basis. Sales receipts and purchases were mainly in cash. Typically, the hotels deposited their sales takings net of cash purchases and other business expenses such as salaries, into their personal bank accounts. For the hotels which did not issue sales invoices nor maintain proper recording of sales, the practice of not banking cash receipts intact into the business bank accounts resulted in their under-reporting of actual sales revenue.

There were also some hotels whose business takings were deposited into the personal bank accounts of the directors instead of business bank accounts, resulting in their omission and non-reporting of sales revenue.

Taxpayers are encouraged to ensure that sales receipts generated from the business are deposited intact into the business bank accounts in order to facilitate their sales reporting for Income Tax purposes.

(d) Claiming of private expenses

Another common mistake made by budget hotels is making wrongful claims of private expenses incurred by the directors for themselves and/or their family members who did not work for the business. In one case audited by IRAS, a taxpayer claimed periodic lump sum service fees paid to different persons. On greater scrutiny by the IRAS auditor, it was found that some parts of the payments pertained to the director's private car. These expenses are specifically disallowed under the law. Further examination also showed that non-deductible private expenses incurred by the same director were charged to the company's travelling, entertainment and insurance accounts. These included premiums paid for the director's personal accident policy and petrol costs in respect of the director's private car.

IRAS has observed that private claims of entertainment and travelling expenses are prevalent in the budget hotel industry. For outgoings and expenses to be tax deductible, they must be wholly and exclusively incurred in the production of income. That means, they must be expended solely for business purposes only and must not include any non-business element.

(e) Claiming of expenses without maintaining sufficient supporting documents

Very often, claims were made by budget hotels without sufficient records and supporting invoices. During our audit of the industry, we have observed cases where lump sum payments were made to directors without any payment vouchers or records pertaining to the nature of the payments. We have also noted cases where budget hotels made estimated claims on wages paid to daily-rated casual workers for their cleaning services as they did not maintain records or payment receipts. As a result, the IRAS auditors were unable to ascertain the existence and validity of the transactions in order to allow the claims. Other common areas where such unsubstantiated claims were found during our audits were the staff training and welfare expenses, salaries and professional fees.

Taxpayers should keep proper documentation and records to substantiate their purchases and expenses. They should also ensure that such claims are with economic substance and justified on a commercial basis. More information on good record keeping standards can be found in the IRAS e-Tax Guides*:

- Record Keeping Guide for GST-registered Businesses; and
- Record Keeping Guide for Non GST registered Businesses.

* Please refer to Related Items under Keeping proper records and time limit to raise assessments.

(f) Claiming of expenses which are capital in nature

Some budget hotels included professional fees relating to the purchase and construction of hotel as deductible claims. Rectification and development expenses incurred on labour, materials and new painting works to renovate the hotels' interiors were also claimed As these expenses relate to additions to the hotels' profit-making capital structure the expenses were generally considered to be capital in nature. Hence, they were disallowed for deduction by the IRAS auditors.

However, taxpayers can make capital allowance claims on capital expenditure incurred on qualifying plant and machinery under Section 19 / 19A of the Income Tax Act 1947. Further, to reduce business costs, tax deduction will also be granted on all qualifying Renovation and Refurbishment costs incurred from 16 February 2008 under Section 14Q of the Income Tax Act 1947.

Taxpayers should review and maintain a proper breakdown of their capital expenses so that the appropriate capital allowance / deduction claims can be made on the qualifying expenses.

6. Voluntary Disclosures of Errors

IRAS will continue to conduct regular compliance reviews on various industries as part of our efforts to enhance voluntary compliance of our taxpayers.

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. Serious 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 any first time 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.