KPMG

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Basis of Assessment for Service Companies

Recently, the Inland Revenue of Singapore (IRAS) did a review of the basis of assessment for service companies. IRAS clarified that its administrative practice to allow adoption of the cost plus mark up (CM) basis is strictly for service companies providing routine support services as listed in *Annex C of IRAS e-Tax Guide on Transfer Pricing Guidelines, 4th Edition.*

In this issue, we provide details on IRAS clarification and how service companies will be affected.

Normal trading company basis of assessment

The basis of assessment for a service company is the Normal Trading Company basis (NTC basis), like all other companies. Its chargeable income is ascertained after detailed examination of its accounts and making the following tax adjustments in accordance with the provisions of the Income Tax Act:

- deducting non-taxable income;
- adding back disallowable expense;
- claiming enhanced deduction under the Productivity and Innovation Credit (PIC) scheme; and
- deducting capital allowances, losses and donations.

IRAS administrative practice – CM basis

As an administrative practice, IRAS is prepared to allow adoption of the CM basis for service companies on the premise that the affairs of such companies are simple, in that they do not undertake risks nor own significant assets (including intellectual property rights), and their expenditure are typically operating expenses of revenue nature.

Under the CM basis, chargeable income is computed based on 5% mark-up on total expenditure[1], without any further adjustments or claims such as:

- double or further tax deductions;
- PIC enhanced deductions and PIC cash payout;
- capital allowances, losses and donations;
- deductions under the Business and IPC Partnership scheme; and
- foreign tax credit.

[1] Total expenditure is defined to mean the total costs as reflected in the profit and loss accounts and as determined according to the Singapore Financial Reporting Standards.

IRAS clarification on the CM basis

In the recent IRAS-SIATP dialogue held on 23 March 2017, IRAS informed that it has carried out a review and note that the CM basis has not been consistently applied. The CM basis has been applied on a wider scope of services (e.g. providing consultancy and professional services to professional services to promote and develop retail network), and not confined to companies providing routine support services only. There have also been disputes on the total expenditure, as well as disputes on claims of donations, double tax deductions, capital allowances, foreign tax credits, PIC deductions and PIC cash payout.

IRAS has made the following clarification:

- The CM basis is strictly for service companies providing certain routine support services (as listed in *Annex C of IRAS e-Tax Guide on Transfer Pricing Guidelines, 4th Edition*) to only related parties; and

- Where the CM basis is adopted, the chargeable income is computed based on 5% mark-up on total expenditure, without any further adjustments.

Consequently, companies that fall outside the scope of the CM basis and have adopted the CM basis will have to transit to the NTC basis of assessment with effect from Year of Assessment (YA) 2019. Service companies on CM basis which are seeking to make tax adjustments and tax claims should also transit to the NTC basis of assessment as the CM basis is no longer relevant.

IRAS will release further details by September 2017.

Our comments

Newly incorporated service companies must examine its scope of services to be rendered carefully to ascertain if they qualify for the CM basis of assessment, and if so, whether it is beneficial to adopt since this would mean foregoing claims for double or further tax deductions, PIC enhanced deductions and PIC cash payout etc.

Service companies providing routine support services (as listed in *Annex C of IRAS e-Tax Guide on Transfer Pricing Guidelines, 4th Edition*) and adopting the CM basis are not affected. However, they should monitor their scope of services to ensure that they continue to qualify for the CM basis. Should the scope of services change anytime from the basis period relating to YA 2019 onwards to include any service not listed in *Annex C of IRAS e-Tax Guide on Transfer Pricing Guidelines, 4th Edition*, they will have to transit to the NTC basis of assessment.

Existing service companies that do not qualify for the CM basis (i.e. those companies that provide services other than the routine support services as listed in *Annex C of IRAS e-Tax Guide on Transfer Pricing Guidelines, 4th Edition*) will have to transit to the NTC basis of assessment with effect from YA 2019. This is likewise for existing service companies on CM basis seeking to make tax adjustments and tax claims.

Companies transiting into the NTC basis of assessment need to look out for the applicable transitional rules that IRAS are releasing and prepare for the transition. In our view, the transition rules are likely to require determination of the past "should have been" tax positions (prior to YA 2019), which include the following non exhaustive items:

i. Manner in which capital allowances (CA) should have been claimed on qualifying assets acquired;
ii. Remaining balance of Section 14Q deduction on qualifying renovation and refurbishment costs incurred;
iii. Breakdown or movement of provision balances and what should be the applicable tax treatment going forward; and
iv. Unutilised donations (if any) to be utilised in the future.

Once the transitional rules are released by the IRAS, affected companies should start to prepare for the transition immediately. This is likely to involve tracing back past records and reworking the tax impacts to determine balances for YA 2019 as a consequence of the change in the basis of assessment.

In this regard, it is more crucial for affected companies with accounting year-end in early part of the year. These companies would have commenced their financial year ending in 2018 (i.e. basis period for YA 2019) and need to be ready to transit into the NTC basis quickly, to be on time for their tax provisioning exercise, as well as for the filing of their Estimated Chargeable Income (which deadline is within 3 months from their accounting year-end).

Lastly, for service companies providing services not listed in *Annex C of IRAS e-Tax Guide on Transfer Pricing Guidelines, 4th Edition* and have simply applied the cost plus 5% mark-up on non-routine support services, they would need to consider whether a higher mark-up should be applied for the services and prepare detailed transfer pricing analysis to support the mark-up. We will keep you updated when IRAS releases further details.

How we can help

As a committed tax advisor to our clients, we welcome any opportunity to discuss the relevance of the above matters to your business. We are also able to help address your transfer pricing issues by:

- conducting a transfer pricing review to assess the company's exposure and recommend the appropriate risk mitigation strategies;
- recommending appropriate arm's length transfer prices to value transactions for both documentation and planning purpose;
- defending against tax authorities' audits of transfer pricing;
- preparing transfer pricing documentation etc.

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