Basis of assessment for service companies

PwC Singapore Tax Bulletin

29 August 2017

The Inland Revenue Authority of Singapore (IRAS) allows service companies providing services to related parties to compute their chargeable income based on 5% mark-up on total expenditure, without any further tax adjustments, as an administrative concession. The IRAS has recently proposed that, with effect from the Year of Assessment (YA) 2019, only service companies that meet specified conditions will be allowed to continue applying this basis of computation. In this bulletin, we provide details of the IRAS's conditions and discuss the impact of this impending change. Multinational groups which have service companies that may be affected should start to take into consideration transitional matters (such as the additional information requirement) as they prepare their YA 2017 returns.

Cost-plus mark-up basis of assessment

It is common to have a company within a group of companies to provide support services to the members of the group. The concept of a service company developed with the entry of oil service companies providing administrative and technical support for oil exploration and drilling operations in the region. As Singapore develops into a major headquarters and regional services location for multinationals, service companies continue to play an important role.

Traditionally, a service company was one that provided routine administrative and support services to related entities. It was essentially a cost centre rather than a profit-making entity. Hence, it was not uncommon for such a company to be reimbursed for its expenses without any mark-up. As it was difficult (in the past) to determine an arm's length charge for such services, the IRAS was prepared to accept a deemed profit of 5% on the cost of the services provided.

In order to ease the administrative and compliance burden of such service companies, and as they do not also have significant non-deductible expenditure and fixed assets, the IRAS has accepted a simple cost-plus mark-up basis of assessment (CM basis) for computing taxable income as an administrative concession.

Under the CM basis, chargeable income is computed as a 5% mark-up on total expenditure, without any further tax adjustments, such as claims for further tax deduction (e.g. enhanced deduction and/or cash payout under the Productivity and Innovation Credit (PIC) Scheme), capital allowances and foreign tax credit.

Over the years, as multinationals expand their presence in Singapore and the region, some service companies may have taken on additional roles and functions beyond the routine support services that they were set up to perform. Nonetheless, the IRAS has continued to allow them to apply the CM basis.

Now, the IRAS is seeking to rationalise the application of this basis of assessment.

The IRAS has clarified that the CM basis will continue to be available as an administrative concession, to service companies on the premise that they fall within the following scenarios:

- The routine support services fall within Annex C of the IRAS e-Tax Guide entitled "Transfer Pricing Guidelines";
- The service provider does not offer the same routine support services to an unrelated party; and
- All costs, including direct, indirect and operating costs relating to the routine support services performed, are taken into account in computing the 5% mark-up.

The IRAS has clarified that the CM basis is strictly for service companies providing the specified routine support services to related parties. With effect from YA 2019, the IRAS will require companies which do not meet the above conditions to prepare their tax computations on a normal trading company (NT) basis.

Normal trading basis

Under the NT basis, the company's chargeable income will be ascertained in accordance with the provisions of the Income Tax Act. The company will need to make tax adjustments such as the following:

- Excluding items that are not taxable e.g. foreign income not received in Singapore, gains from sale of fixed assets, etc.
- Adding back non-deductible expenses
- Claiming double and further deductions for qualifying expenditure
- Claiming capital allowances and donations
- Setting off brought forward loss, capital allowances and donations

Action needed

Multinational groups which have service companies which prepare and file their tax returns on the CM basis should start to review the scope of services being provided by those entities to ensure that they will continue to qualify to apply this basis. In the event that they do not, and a change to the NT basis is required, the company should start reviewing the necessary past years' records as certain brought forward balances will need to be ascertained for the YA 2019 tax computation.

On the other hand, although a company which has to switch to the NT basis will have to deal with a more complex tax computation, depending on its financial profile, it may not necessarily be a worse outcome. For example, if the company has substantial qualifying fixed assets, it may be able to defer its tax expense (albeit service companies typically do not carry much fixed assets, and the deferral will only for a few years) by accelerating its capital allowance claims. In addition, such companies will now be able to benefit from double or further deductions if they incur the relevant qualifying expenses (e.g. research and development expenses, donations, etc.).

Transitional adjustments: If the company has ascertained that it will have to adopt the NT basis, it should start to identify and collate the information required in anticipation of the change for the YA 2019 tax filing. The manner in which the transition from the CM basis to the NT basis will be carried out has yet to be agreed with IRAS; but it is likely to entail some tracking of past years' records to determine certain brought forward balances for the YA 2019 tax computation.

Although the details have not yet been released, some examples of possible items which are likely to be affected include:

- Fixed assets - The company will need to determine the tax written down value of existing qualifying assets to bring into its YA 2019 tax computation in order to start claiming capital allowances
- Renovation and refurbishment costs – Likewise, the YA 2019 opening balance of section 14Q deduction available on qualifying renovation and refurbishment costs incurred will need to be ascertained.
- Provisions - The company will need to re-examine its provision balances, including provisions made in the past and subsequent movements to ascertain the tax treatment of these provisions in the future.
- Timing differences - The tax treatment of expenses for which there is a timing difference between tax deduction and accounting recognition (e.g. stock-based compensation) will also need to be addressed in the year of transition.

- Identifying tax adjustments - Accounting records may need to be upgraded/reviewed to provide more transactional details so that tax adjustments (e.g. private car expenses, capital items, exchange differences) can be made.
- Further deductions - The company should also consider its business plans and the availability of possible tax concessions, e.g. double deductions for expenses incurred for internationalisation of its business.
- Related party transactions - The company would need to assess the transfer pricing implications of related party dealings including the basis of charge, documentation and reporting requirements.

Further observations

The CM basis serves as safe harbour for intercompany services. Safe harbours in themselves are not unusual – they are practised in a number of countries as they offer the benefit of reducing taxpayers' administrative burden and providing much-desired certainty in tax compliance. The rationalisation of the CM basis would mean more detailed analysis of income and expenditure items is required for companies which need to switch to the NT basis of preparing tax computations. While there is some increase in complexity with tax compliance, with its attendant additional cost of data collation, there could also be benefits that these companies may enjoy under the NT basis, e.g. further deductions for certain expenses. Early review of business plans and accounting systems will help to ensure a smooth transition and also position the company to benefit from the availability of the various deduction schemes.

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