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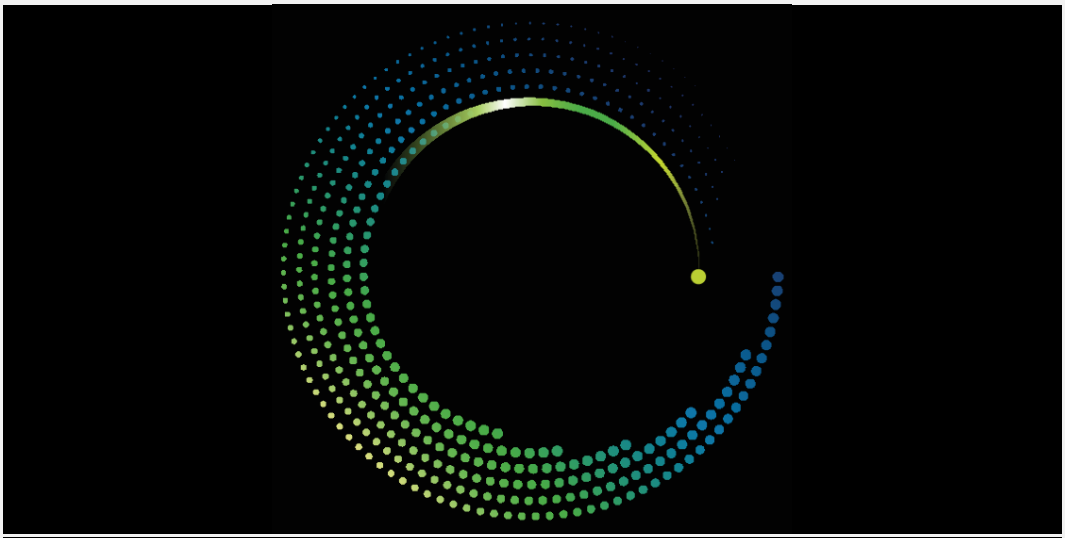

Tax Bytes

IRAS releases updated Transfer Pricing Guidelines

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Greetings from your Tax & Legal team at Deloitte Singapore. We hope that you and your loved ones are staying safe and healthy despite these challenging times. As we navigate ourselves through this trying period, we are committed to giving you the support you need.

We are pleased to share the following with you:

Inland Revenue Authority of Singapore (IRAS) releases updated Transfer Pricing Guidelines (TPG)

On 10 August 2021, IRAS published the sixth edition of the Singapore TPG. The key updates in this edition focused on the following areas:

- Specific additional guidance on related party financial transactions and cost contribution arrangements;
- Expanded guidance on "benefits tests" for related party services, safe-harbour profit mark-up on low value-adding services, and use of certain profit level indicators;
- Supplementary clarifications on the Transfer Pricing documentation rules, and imposition of adjustments and surcharges; and
- Further explanations on the approach to Transfer Pricing audits, dispute prevention and resolution, and arbitration process.

Key highlights

Specific guidance and clarifications in the updated TPG are compulsory, largely "compliance" in nature, and may have a significant impact on taxpayers with intercompany transactions.

Related party financial transactions

The updates to the guidelines provide an extensive discussion requiring taxpayers to adhere to the arm's length principle in conducting related party financial transactions such as loans, cash pooling, hedging, financial guarantees, and captive insurance.

As with any related party transactions, it is critical to accurately delineate the actual financial transactions and conduct a thorough functional analysis. The guidance clarifies that the functional analysis should consider the applicability of the guidance on related party services and cash pooling. In some instances, a taxpayer's activities in raising and providing funds to other members of the same group may be more for managing the liquidity, coordinating, and administering a cash pooling arrangement for the group, etc. Depending on the facts and circumstances of each case, the arm's length remuneration for such activities may be determined according to those guidelines instead of the guidance on pricing related party loans.

When applying the three-step approach for the Transfer Pricing analysis of a related party financial transaction (i.e., conducting comparability analysis, identifying the most appropriate Transfer Pricing method and tested party, and determining the arm's length results), the updated Transfer Pricing guidelines direct taxpayers to take guidance from Chapter X of the Organisation for Economic Co-operation and Development (OECD) TPG. Before determining whether the rate of interest for a related party loan is an arm's length rate, it is important to determine whether the purported loan between the related parties should be regarded as a loan for tax purposes or as some other kind of payment, in particular a contribution to equity capital, using the three-step approach.

The IRAS highlighted certain economically relevant characteristics (such as presence or absence of fixed repayment date, obligation to pay interest, ability of the borrower to obtain loans from unrelated lending institutions, right of the lender to enforce payment of principal and interest, level of seniority of the purported loan, etc.), which should be analysed and may serve as useful indicators in determining whether a purported loan should be considered as loan. Taxpayers can refer to Chapter X of the OECD TPG and the IRAS' e-Tax guide on Income Tax Treatment of Hybrid Instruments for further guidance, particularly on the factors that are generally used to determine if a hybrid instrument is a debt or equity instrument for tax purposes.

Once it has been established that a purported related party loan or part of it is to be regarded as a loan, the next step is to apply the arm's length principle to that loan. In analysing its economically relevant characteristics, both the lender and borrower's perspectives should be taken into account. The IRAS does not regard interest-free related party loans as arm's length transactions, unless taxpayers have reliable evidence that independent parties under comparable circumstances would similarly provide loans without charging any interest.

When using the Comparable Uncontrolled Price (CUP) method, the arm's length interest rate for a related party loan can be benchmarked against publicly available data (i.e., external CUP) and on any potentially available internal CUP, provided all economically relevant conditions are sufficiently similar. It can also be based on the return of realistic alternative transactions with comparable economic characteristics (e.g., bond issuances, loans that are uncontrolled transactions, deposits, convertible debentures, commercial papers, etc.) and adjustments may be made to strengthen comparability.

Besides the CUP method, the guidance refer to Chapter X of the OECD TPG for other approaches to price intra-group loans. Where other approaches are deemed more appropriate, taxpayers can apply them if the Transfer Pricing documentation justifying the approach adopted is prepared and maintained. The IRAS specifically points out that generally bank opinions are not regarded as evidence of arm's length terms and conditions as they do not reflect actual transactions or actual offer to lend.

In instances where a lender advances a related party loan but does not assume risks relating to that loan, it will be entitled to no more than a risk-free return. A risk-free return may be determined by referencing highly rated government issued securities, interbank rates, interest rate swap rates, or repurchase agreements of highly rated government issued securities. Where there are multiple comparable reference securities, the reference for the risk-free return would be the security with the lowest rate of return.

The creditworthiness of the borrower is one of the main factors to consider in determining an interest rate. Where the borrower has a publicly available credit rating published by an independent credit rating agency, that rating may be informative for the arm's length analysis of the related party loan. Otherwise, taxpayers can apply quantitative and qualitative analyses of the individual characteristics of the borrower using publicly available financial tools or independent credit rating agencies' methodologies to determine the credit rating of the borrower.

The effect of passive association (i.e., implicit support) on the borrower's credit rating solely by virtue of group affiliation, resulting in payment of a lower interest rate, would not require any compensation to be made by the borrower to the group, nor any comparability adjustment. However, reduction of interest rate as a result of a formal or explicit guarantee from a related party is considered as a direct benefit to the borrower and requires payment of arm's length guarantee fee to the related party guarantor. Whilst evaluating the impact of implicit support, the guidelines indicate that taxpayers can refer to guidance provided by credit rating agencies in ascertaining linkages and their effect on borrower's credit rating.

The guidelines also clarify that every related party loan needs to be evaluated individually as each related party loan could be different (i.e., their terms and conditions may differ). However, to reduce compliance burden, taxpayers having multiple related party loans may choose to determine the arm's length interest rate on aggregate basis for loan transactions which have similar characteristics.

Taxpayers are required to prepare Transfer Pricing documentation to substantiate that the pricing for their related party financial transactions is arm's length, unless they are within the documentation exemption thresholds. Taxpayers that are not required to prepare Transfer Pricing documentation may wish to do so to better manage the Transfer Pricing risk relating to their related party financial transactions.

Cost contribution arrangements

In place of multiple intra-group arrangements, members of a group may enter into a cost contribution arrangement (CCA) to share the development of intangibles or tangible assets, or to obtain services from each other.

The guidance refers to the definition of CCA and largely follows the principles set out in the OECD TPG. There are commonly two types of CCAs—a "development CCA" is one that is established for joint development, production, or the obtaining of intangibles or tangible assets whilst a "services CCA" is an arrangement established for obtaining services.

For the conditions of a CCA to satisfy the arm's length principle, all the participants must mutually benefit from it, and share the upside and downside consequences of risks associated with achieving the anticipated outcomes. The value of the participants' contributions must be consistent with what independent parties would have agreed to contribute under comparable circumstances given their proportionate share of the total anticipated benefits, and each participant's share of the actual overall contributions must be proportionate to its share of the overall expected benefits to be received under the CCA. Detailed steps on the application of the arm's length principle to a CCA are provided in the guidelines.

When related parties enter into a CCA, separate arm's length balancing payments may be necessary for pre-existing contributions. Similarly, a change in the participation of a CCA may trigger a reassessment of the proportionate shares of participants' contributions and expected benefits. Upon terminating a CCA, the arm's length principle requires the participants to retain their interest in the results of the CCA activity, if any. This is consistent with their share of contributions to the CCA throughout the term of their participation, taking into account any balancing payments actually made or received.

Any balancing payment arising from an adjustment to a participant's contribution would be treated as an addition to the contribution of the payor and as a reduction in the contribution of the payee. Transfer Pricing adjustment may be made by a foreign tax authority when it assesses that the value of a participant's proportionate contributions to a CCA or its proportionate expected benefits from a CCA have been incorrectly determined. Such adjustment may bring about balancing payment between the participants resulting in either a reduction or an increase in a taxpayer's claim for deduction for its proportionate contributions made under the CCA.

Taxpayers are required to prepare and maintain Transfer Pricing documentation to properly document all the relevant facts and circumstances relating to their CCAs—the guidelines provide a list of information to be included. Examples are also provided to illustrate the application of the guidance on CCA. The guidelines also note that for the purpose of applying the arm's length principle, a CCA has the same meaning as a cost-sharing agreement (CSA), where a deduction for certain research and development (R&D) expenditure is allowed under the Income Tax Act. As such, the guidance is equally applicable to a CSA.

Benefits tests on related party services

In using the "benefits test" to examine the provision of related party services, the updated TPG provide additional explanations on the treatment of costs relating to shareholder and duplicative activities.

Shareholder activities (e.g., meetings of shareholders, issuing of shares of parent company, listing on stock exchange, complying with reporting requirement of parent company, auditing of other group member's accounts in the interest of the parent company, etc.) are not considered to be related party services since these activities are not expected to benefit the group entities, and are performed by the holding company because of its ownership interest. It should not be charged to group members as well (as they would not be willing to pay for them if they were independent parties). Accordingly, costs associated with such activities should only be borne and allocated at shareholder level. Where these activities are carried out by a group member, they should be recharged by and remunerated at arm's length by the holding company.

In cases where a group member may merely duplicate a service that another group member is performing for itself or receiving from a third party, there is no commercial or practical necessity for such duplicative activities and no service is considered provided. However, whilst generally this is the case, there could be situations where duplication of service is necessary (for example, seeking expert opinion from different parties to facilitate business decision making or performing regulatory control functions locally and on consolidated basis at group level). Any consideration of possible duplication of services needs to determine the nature, reasons, differences, and other features of each of the activities.

Profit mark-up on low value-adding services

The IRAS has expanded the types of activities where a 5% cost mark-up may be used. In addition to the existing list of routine support services (i.e., Annex C of the Singapore TPG), taxpayers may consider applying the 5% profit mark-up under the OECD simplified approach for low value-adding intra-group services when the routine support services meet the definition of low value-adding intra-group services; the routine support services are not specifically excluded; the tax authority of the counterparty has adopted the OECD simplified approach; 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 profit mark-up.

When taxpayers apply the OECD simplified approach upon meeting the required conditions, the 5% profit mark-up for the routine support services is considered to be in accordance with the arm's length principle. It may however be noted that unlike exemption from preparation of Transfer Pricing documentation currently available for routine support services listed in Annex C of the Singapore TPG, if taxpayers apply the OECD simplified approach, they are not exempted from documentation. In such a case, taxpayers are to provide the information and required documentation.

If a taxpayer is of the view that the group services it provides constitute routine support services based on its own facts and circumstances, it may request for a confirmation from the IRAS. It is also noted that the IRAS has included "Management reporting—compiling data for management purposes" as an additional service under the list of routine support services in Annex C of the Singapore TPG.

Use of Berry ratio and value-added cost mark up as profit level indicators

In addition to the usual profit level indicators (PLI) that may be used in applying the Transaction Net Margin Method (TNMM), the guidelines, which already previously recognised the use of Berry ratio (i.e., the ratio of gross profit to operating expenses), further adds the use of value-added cost mark-up as a PLI.

The latest guidelines note that both Berry ratio and value-added cost mark-up rely on the presumption that the value of the functions performed is proportional to the operating expenses (and not to sales) and are similar PLIs; hence, the consideration for the use of either PLI will be the same. It also reiterates caution with the use of these PLIs, particularly where the taxpayer's costs of goods sold are a key driver of its profitability and the taxpayer can influence those costs. In such cases, both PLIs are considered unsuitable.

Clarifications on the documentation rules

A new section clarifying the Transfer Pricing documentation requirements have been added through a list of frequently asked questions. The main clarifications include the following:

- Date of completion of the documentation is required to substantiate, whether it has been prepared on a contemporaneous basis.
- In preparing the organisational holding structure, the Singapore business needs to be linked to other entities within the worldwide structure. For complex structures, use of an abbreviated chart with location and ownership linkages to related parties with which the Singapore entity has transacted during the year should suffice.
- Instead of a generic description of the business, the entity-level information should give an overview of the legal and business structure, business model and strategy, the industry and economic conditions, and how the business fits and contributes into the overall value chain.
- The description of the transactions between the taxpayer and its related parties should provide the details, value, term of contractual agreements of each transaction along with the identity, location, and relationship. This should be accompanied with the functions performed, risks assumed (including decision making capabilities), and assets used by each counterparty.
- The Transfer Pricing analysis should include the reasons and basis for the Transfer Pricing method and PLI used, the tested party/transaction, the comparable set with their financials, and any comparable adjustments.
- Arm's length price and computations should be provided and any useful documentation of the events that affected the business performance significantly may be included.
- Transfer Pricing documentation prepared for other tax authorities that follows the IRAS' requirements and contains information relevant to the business operations in Singapore, supplemented with information required by the IRAS at the group and entity levels, may be used.

Imposition of adjustments and surcharges

The updated TPG provide additional clarifications on the application of upward adjustments and when penalties and surcharges will be imposed:

- Taxpayers may voluntarily make upward adjustments for past financial years on their related party transactions, but such self-initiated retrospective upward adjustments are similarly subject to a surcharge of 5%, regardless of whether there is tax payable on the adjustments.
- Certain Transfer Pricing adjustments are not subject to the surcharge of 5% percent including year-end adjustments meeting specified conditions, compensating adjustments in accordance with an Advance Pricing Arrangement (APA) agreement and the outcome of a Mutual Agreement Procedure (MAP), and adjustment made to implement an arbitration decision.

Whilst Transfer Pricing adjustments are subject to a surcharge of 5% percent, the IRAS may, for a good cause, remit the surcharge wholly or in part if the taxpayer has been cooperative; has provided the responses and required documentation within the timeline set by the IRAS; has maintained proper Transfer Pricing documentation; and has good compliance record of prompt submission of tax returns and payment of tax by the due dates for the current and immediate two preceding year of assessments.

To encourage voluntary disclosure of non-arm's length related party transactions, a full remission of the surcharge on self-initiated retrospective upward adjustments will be granted if they are made within two years from the tax return filing due date, on condition that the taxpayer has not received the IRAS' query or notification on the commencement of a Transfer Pricing audit and has been cooperative with good compliance records. Otherwise, a partial remission may be granted beyond the two-year period.

On the other hand, the IRAS will not allow any retrospective downward adjustments unless the adjustments are due to an error or mistake within the statute of limitation of four years from the end of the relevant year of assessment where the error/mistake was made under section 93A(1) of the Income Tax Act, and supported by contemporaneous Transfer Pricing documentation.

Transfer Pricing audits and controversy

In this latest TPG, the IRAS has removed the word "consultation" and now formally refers to it as an "audit" process, where the IRAS examines taxpayers' compliance through reviewing their tax assessments or conducting audit on their Transfer Pricing practices. The IRAS also emphasises that where arm's length principle is not complied with, it will consider making Transfer Pricing adjustments to increase their profits and impose a 5% percent surcharge.

To prevent potential disputes, the IRAS encourages APA application from taxpayers. However, it clarifies that it will not accept an APA application where the proposed transaction is not carried out for *bona fide* commercial reasons or involves a scheme that, as one of its main purposes, has the avoidance or reduction of tax. The IRAS also notes that it will not accept a taxpayer's request for an APA on a related party transaction when it is under on-going audit. The taxpayer may consider applying for the APA after the IRAS has completed its audit.

The IRAS may also reject an APA or MAP application in certain circumstances, such as the taxpayer has inadequate Transfer Pricing documentation or it does not comply with the arm's length principle. If the APA or MAP application is rejected, the IRAS will explain the reasons to the taxpayer and the taxpayer may seek alternative remedies under the relevant domestic tax law or other options to manage its Transfer Pricing risks.

The IRAS clarifies that where there are no significant changes to the facts and circumstances of the related party transaction over the years, it is of the view that the same Transfer Pricing method should be applied consistently. To consider an APA request where a different method is used for a prior period not covered under the proposed APA, the IRAS will seek to understand the reasons for the different Transfer Pricing method for the APA.

Should double taxation arise due to adjustments from the IRAS' audit, the taxpayer can seek legal remedies under the domestic tax law or request for the MAP under the relevant Avoidance of Double Taxation Agreement (DTA) to resolve the double taxation. When the outcome of an MAP requires the IRAS to reduce the Transfer Pricing adjustment it made previously and if the IRAS had previously imposed a surcharge on the adjustment, the IRAS will withdraw the surcharge relating to the amount of adjustment discharged.

Where the IRAS and relevant foreign tax authority are unable to resolve the Transfer Pricing dispute under a MAP within a certain period of time (generally between two and three years), the taxpayer may request to resolve the dispute through "arbitration" if the relevant DTA provides for such recourse.

Under the arbitration provisions in the relevant DTA, the taxpayer may request in writing for any unresolved issues to be submitted to an arbitration panel. The decision made by the arbitration panel based on the proposals or information provided by the IRAS and relevant foreign competent authority is binding on both competent authorities. Arbitration offers certainty to taxpayers and may help to resolve cross-border disputes in a more timely manner.

Deloitte Singapore views

The new updates recognise the need for specific additional guidance on areas that taxpayers consider relatively important in the context of related party dealings, particularly on the Transfer Pricing aspects of financial transactions and intangibles/services through cost contribution arrangements. As with the previous editions, the principles and approaches being followed by the IRAS are largely aligned with the OECD TPG.

On the determination of the arm's length interest on loans, the IRAS has now made it clear that as part of the Transfer Pricing analysis, a transaction purporting to be a related party loan needs to be examined and delineated accurately as indeed a loan—this would be particularly relevant to transactions/instruments that are either hybrid in nature or those that are not "plain vanilla" debts. There has, however, been no specific exceptions mentioned for entities that are in the business of lending and borrowing or treasury centres, which seems to suggest that all purported related party loan transactions should first be analysed and determined to be a loan. Thereafter, the arm's length interest should be charged on the loan amount.

The guidelines also address various commonly encountered issues in relation to financial transactions and services, including recognising that certain of such financing transactions as actually provision of services. It also offers clarifications on the appropriate reward of a risk-free return for lender that does not assume risks and that implicit support on borrower's credit rating requires no payment or comparability adjustment. It further reiterates that generally bank opinions are not regarded as evidence of arm's length terms and conditions as they do not reflect actual transactions. These clarificatory points are useful practical insights on the IRAS' positions and approaches, and are consistent with the OECD TPG.

One issue that might warrant closer attention is the treatment of financial guarantees. Until the issuance of this latest guidelines, the treatment of financial guarantee had not been specified, and in practice, this has not been a major area of review during IRAS' Transfer Pricing review or audits. Many taxpayers have also opted simply not to charge any guarantee fees. In light of the updated TPG, it may be necessary to re-evaluate the current basis and consider potential changes.

The guidelines on CCAs (which equally apply to CSAs) are extensive and largely aligned with the OECD TPG with examples to assist taxpayers with applying the principles to their specific facts and circumstances. As with other related party transactions, the IRAS emphasises the need to apply the arm's length principle and for taxpayers to prepare and maintain Transfer Pricing documentation for their specific arrangements.

Certain minor updates to the guidelines also offer practical assistance to taxpayers, particularly in helping them comply with the arm's length principle and the documentation regime. The recognition of the safe-harbour profit mark-up on low value-adding services based on the OECD simplified approach is helpful as it potentially expands and includes additional services (that meet the definition of low value-adding services) under the safe harbour mark-up of 5% regime, thereby reducing compliance costs and ensuring that taxpayers focus on more complex transactions.

In addition, the expanded guidance on benefits tests for related party services and use of certain profit level indicators offer additional insights to assist taxpayers for their specific facts and circumstances. Similarly, the supplementary clarifications on the documentation rules through a frequently-asked-questions format is helpful for taxpayers to ensure targeted efforts and costs on their compliance exercises. For example, it confirms that Transfer Pricing documentation prepared for other tax authorities with supplementary information meeting all the IRAS' requirements may be used by a taxpayer.

As with the previous updates to the Singapore TPG, the updates convey a clear message of more stringent compliance expected by the IRAS, and the actions that the IRAS may take to enforce such compliance. The updated guidelines lay out situations that the IRAS would make upward adjustments and the imposition of the 5% surcharge, and the conditions for partial or full waiver of such surcharge.

The IRAS encourages taxpayers to be cooperative and strive for a good compliance record as well as initiate voluntary disclosure of non-arm's length related party transactions with the possibility of a full or partial remission of the surcharge on such voluntarily disclosed adjustments. The IRAS also makes it clear that it will allow retrospective downward adjustments only in cases of error or mistake and not on other grounds such as adjustments due to an outcome of an overseas tax audit (which should be resolved via the MAP process), and supported by contemporaneous Transfer Pricing documentation.

A marked change in tone and description is the use of the word "audit" (this will no longer be referred to as "consultation"), which affirms Transfer Pricing audits as the main avenue through which the IRAS will examine taxpayers'

Transfer Pricing compliance, and the expectation that the process will be more formal and thorough compared to the “consultation” process previously. The IRAS also emphasises that where it assesses that there has been non-compliance, it will make Transfer Pricing adjustments for non-arm’s length transactions to increase a taxpayer’s profits and impose the 5% percent surcharge.

At the same time, the updated guidelines also reiterate the benefits of the APA process for taxpayers wanting certainty and the MAP process for taxpayers who will have suffered double taxation. In addition, it also highlights the availability of an additional recourse for taxpayer to resolve TP disputes through “arbitration”, where applicable.

Overall, the updates align the latest version of the Singapore TPG closer to prevailing OECD guidance, and continue the trend of messaging the expectation and requirement for more stringent Transfer Pricing compliance, as well as the continued support that taxpayers will find in the IRAS when they seek certainty under an APA.

As such, the release of the updated guidance presents a great opportunity for taxpayers to revisit their existing Transfer Pricing policies and documentation to ensure that they are fit-for-purpose and compliant to the latest requirements, as well as to identify and address any potential areas of Transfer Pricing compliance risk.

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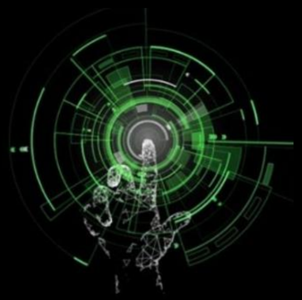

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