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Client Alert

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Singapore: Guidance on and clarification of the transfer pricing rules

IRAS has recently released the Transfer Pricing Guidelines (Sixth Edition) to replace the previous guidelines released in February 2018. We detail some of the key changes below.

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In brief

The Inland Revenue Authority of Singapore (IRAS) updated its transfer pricing (TP) guidelines on 10 August 2021, with the release of the IRAS e-Tax Guide: Transfer Pricing Guidelines (Sixth Edition) ("**Revised TPG**"). In line with Singapore's approach to be aligned with international standards, the changes are generally consistent with the OECD's "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations" published on 10 July 2017 ("**OECD Transfer Pricing Guidelines**"). IRAS has provided additional guidance and clarification with respect to TP documentation (TPD) compliance, surcharges on TP adjustments, advanced pricing arrangements (APA) and mutual agreement procedure (MAP) requests.

In this alert, we discuss the Revised TPG and consider its impact on taxpayers.

Key takeaways

- Moving forward, there will be a greater focus from IRAS in requiring robust TP analysis and TPD that fulfils Singapore TPD requirements. Taxpayers should consider whether the newly introduced administrative concessions could reduce their compliance burden. Taxpayers should also review their existing TPD, as well as their plans to prepare TP analysis and TPD going forward in light of the changes.
- Additional guidance on cost contribution arrangements (CCAs) and financial transactions are provided.
- IRAS would consider remitting the 5% surcharge applied on TP adjustments in certain circumstances. The surcharges are likely to have significant financial impact, and getting a remission is particularly important for multinational enterprise (MNE) groups with subsidiaries in Singapore where the surcharge is not creditable in the jurisdiction of the holding company. Taxpayers should ensure proper TPD is maintained, as well as consider the benefits of providing prompt voluntary disclosures where TP issues have been identified.
- Taxpayers should thoroughly review transactions relating to APA requests to ensure that there are bona fide commercial reasons for the transactions, and that these do not have the main objective of reducing or avoiding tax. Taxpayers will have to explain and justify any changes to TP methodology where there are no significant changes to the facts and circumstances.
- IRAS raises the availability of arbitration under certain Avoidance of Double Taxation Agreements (DTAs) to resolve TP disputes that cannot be settled under a MAP within a certain period, subject to certain conditions being met.
- Where TP adjustments are made by foreign tax authorities, IRAS will not allow an additional tax deduction claim and will not allow the refund of taxes previously withheld in the absence of a MAP application.

In more detail

We discuss the updates to the Revised TPG below, as well as outline our recommendations to taxpayers.

A. Berry ratio and value-added cost markup

Taxpayers should carefully consider the use of the Berry ratio and value-added cost markup as appropriate profit level indicators (PLI) for the transactional net margin method (TNMM). Additional guidance has been provided on the use of these PLI, potentially signaling increased scrutiny from IRAS over their use in the TNMM.

Specifically, the Berry ratio presumes that the value of functions performed is proportionate to operating expenses and not sales, but is an unreliable financial indicator where the taxpayer's cost of goods sold is a key driver of profitability and the taxpayer has the ability to influence the cost of goods sold. Similarly, a value-added cost markup (i.e., the ratio of operating profit to operating expense) presumes that the value of the functions performed is proportionate to the operating expenses and not sales.

B. TPD requirements

IRAS has emphasized that taxpayers need to satisfy existing TPD requirements. That being said, to reduce the TPD compliance burden, taxpayers may take advantage of the following administrative concessions:

- In preparing the TPD, where the organizational structure is complex, the taxpayer may present an abbreviated structure showing the location and ownership linkages of all related parties that transact with the taxpayer, instead of the entire worldwide group structure.
- TPD prepared for other tax authorities can form part of the TPD for Singapore TPD purposes where it fulfils the requirements under the Singapore Income Tax (Transfer Pricing Documentation) Rules 2018 ("**TPD Rules**"), with supplemental information to bridge any gaps in the information provided.

C. Surcharges

Where IRAS makes a TP adjustment, this is subject to a 5% surcharge. The surcharge will apply regardless of whether the adjustment results in additional tax payable, and is payable within one month of receiving a written notice from the Comptroller of Income Tax, regardless of any objection or appeal.

However, surcharges will not apply to the following adjustments:

- Year-end adjustments at year-end closing of accounts when certain conditions are met
- Compensating adjustments to arrive at the agreed arm’s length price under an APA
- Corresponding adjustments to eliminate double taxation under a MAP agreed by IRAS, the taxpayer and the foreign tax authority
- Adjustment made to implement an arbitration decision

IRAS may consider remitting the surcharge, in whole or in part, where the taxpayer has been cooperative during the TP audit or review, and has a good compliance record. In particular, this would require all the following conditions to be met:

- The taxpayer has been cooperative and has provided the information and documentation requested within the timelines set by IRAS.
- The taxpayer has maintained proper TPD.
- The taxpayer has promptly submitted tax returns and paid taxes due for the current year of assessment and the immediate two preceding years of assessment.

Although self-initiated retrospective adjustments are also subject to a surcharge of 5%, a full remission will be granted to upward tax adjustments, provided certain conditions are met upon disclosure of the upward adjustments to IRAS. These conditions include: (i) making adjustments within two years of the tax return filing due date; (ii) not receiving an IRAS query on the transactions for the relevant year of assessment or not receiving a notification from IRAS on the commencement of an audit or investigation; and (iii) showing cooperation and a good compliance record (see preceding paragraph). However, even if the upward tax adjustments are applied more than two years after the tax return filing due date, a partial remission may still be granted, provided that the other conditions are met.

D. MAPs and APAs

If provided for under the relevant DTAs, taxpayers may request arbitration under the MAP where IRAS and the relevant foreign tax authority are unable to resolve the dispute within the agreed or stipulated time. An arbitration panel will then make a decision that is binding on both competent authorities. Singapore opted for the arbitration provisions to be included in its DTAs when it signed the OECD's Multilateral Convention to Implement Tax Treaty-Related Measures to Prevent Base Erosion and Profit Shifting. If a DTA partner similarly adopts the same arbitration provision, an arbitration mechanism should be available to a taxpayer qualified to invoke the relevant DTA.

IRAS has clarified that it will not accept an application for an APA where the proposed transaction meets one of the following conditions:

- Is under audit or investigation in prior years
- Is not carried out for bona fide commercial reasons
- Involves a scheme which has, as one of its main purposes, the avoidance or reduction of tax

IRAS may also reject MAP or APA applications where the taxpayer has insufficient TPD or does not comply with the arm's length principle.

When applying for an APA, IRAS expects taxpayers to apply the same TP methodology per the prior years where there are no significant changes to the facts and circumstances, unless taxpayers can explain and justify the change in methodology.

E. Intra-group related party services

Under the current administrative concession, taxpayers may apply a 5% markup for specified routine support services.

Moving forward, in addition to the specified routine support services, taxpayers may now apply a 5% markup for low value-adding intra-group services under the OECD simplified approach. This is subject to all the following conditions being met:

- The intra-group services meet the definition of low value-adding intra-group services of the OECD simplified approach, and are not specifically excluded.
- The tax authority of the other related party similarly adopts the OECD simplified approach.
- The service provider does not offer the same intra-group services to an unrelated party.
- All costs, including direct, indirect and operating costs relating to the intra-group services performed, are taken into account in computing the 5% mark-up.

Do note that the exemption under the TPD Rules to prepare TPD for specified routine support services does not cover the low value-adding intra-group services under the OECD simplified approach. In other words, taxpayers are still required to prepare TPD for these intra-group services, and IRAS has stated that the documentation of such services should be consistent with the requirements under the OECD Transfer Pricing Guidelines.

Besides for the specified routine support services and the low value-adding intra-group services discussed above, taxpayers should also note the additional guidance regarding the application of the "benefits test." This may indicate that moving forward, IRAS will place additional emphasis on the application of the benefits test in determining the provision of related party services.

F. Cost contribution arrangements

IRAS has introduced a new section for CCAs, with the guidance equally applicable to cost-sharing agreements (CSA) as defined under the Income Tax Act (ITA). This section is generally consistent with Chapter VIII of the OECD Transfer Pricing Guidelines covering CCAs.

IRAS has set out a four-step process for the application of the arm's length principle to a CCA:

- Step 1: Determine the participants in the CCA. The participants should have an assigned interest or right, which the participant has a reasonable expectation of benefiting from and can exploit.
- Step 2: Determine the participant's share of expected benefits from the CCA. Expected benefits (such as additional income or cost savings) should also include those to be realized in future periods, and should be allocated using a relevant allocation key.

- Step 3: Determine the arm's length value of each participants' contribution to the CCA. The contributions should generally be valued on an arm's length basis, though contributions may be valued at cost where: (i) the results are the same or insignificantly different; or (ii) where independent parties in comparable arrangements measure contributions at cost.
- Step 4: Determine the allocation of CCA contributions to each participant according to its share of expected benefits. Where there is a difference between the proportion of contributions and overall expected benefit, a balancing payment should either be made or imputed.

When a new participant enters the CCA, an existing participant leaves the CCA or the CCA is terminated, taxpayers should consider if payments or compensation is required. For example, payments may be necessary: (i) as consideration for acquiring or disposing of interest in the results of the CCA; or (ii) if upon termination of the CCA, the interest of one participant is transferred to another participant.

The tax treatment of contributions or balancing payments will depend on the underlying activity and the provisions in the ITA (such as Sections 14D and 14DA which cover R&D CSAs). Where a taxpayer's tax deduction claim increases as a result of TP adjustment made by foreign tax authorities to the value of the contributions or the expected benefits, IRAS will not allow the additional deduction claim in the absence of a MAP application (on the contrary, a decreasing claim for deduction may be made without a MAP application). Similarly, where a foreign tax authority makes a TP adjustment resulting in a lower CCA contribution payment that is subject to withholding tax, IRAS will not allow the refund of taxes previously withheld in the absence of both: (i) a MAP application; and (ii) an actual (rather than notional) reduction in the taxpayer's liability to make the payment under CCA. However, taxpayers should account for additional withholding tax should they have actual liability to make additional payments under the CCA.

Taxpayers should ensure all the relevant facts and circumstances relating to the CCAs are documented when preparing TPD, including details of all the following:

- Participants in the CCA
- Details of other parties that are not participants but involved in the CCA activity or benefit from the results of the CCA activity
- Objective, nature, scope and terms and conditions of the CCA.
- Description of the features of the CCA and explanation of their consistency with the key features required of a CCA
- Functional analysis of each participant in the CCA
- Application of the arm's length principle
- Details of payments between the participants, including balancing payments, buy-in payments and buy-out payments
- Changes to the terms and conditions of the CCA and the consequences of such changes

G. Financial transactions

The guidance on financial transactions (which was previously limited to related party loan transactions) has been expanded. The expansion/change is generally consistent with Chapter X of the OECD Transfer Pricing Guidelines, and requests taxpayers to take guidance from Chapter X of the OECD Transfer Pricing Guidelines on cash pooling, hedging, financial guarantees and captive insurance.

With respected to related party loans, the following additional guidance will apply:

- Taxpayers should first determine whether a purported loan should be regarded as a loan for tax purposes, or whether it should be regarded as other kinds of payment (e.g., a contribution to equity capital). Useful indicators include the presence of a fixed repayment date, the obligation to pay interest, the ability to obtain loans from third parties and service these loans, the rights to enforce payment of principal/interest, and seniority/subordination.
- Both the lender and borrower's perspectives should be considered when analyzing loans. For example, the lender may consider other options realistically available for the use of its funds, and the borrower will seek the most cost-effective source of funding.
- IRAS does not regard interest-free related party loans as arm's length transactions, unless evidence of third parties advancing interest-free loans in comparable circumstances can be provided.

- Taxpayers should perform an analysis of risk assumption and its effect on the arm's length return each related party is entitled to. For example, where a parent company exercises control over the risks of a related party loan advanced from one subsidiary to another, and has the financial capacity to assume such risks, the lender should only be entitled to a risk-free return under the arm's length standard, and the remaining interest (over the risk-free return) should be allocated to the parent company. In such a scenario, IRAS has stated that:
    - In the absence of an APA or MAP, it is unlikely that IRAS will reduce the lender's income to the risk-free return where the lender is a Singapore taxpayer and the parent company resides outside Singapore.
    - Where the parent company resides in Singapore and both the borrower and lender reside outside Singapore, IRAS may increase the parent company's interest income to account for the remaining interest (over the risk-free return) where the interest income is trade income to the parent company.
- A risk-free return may be determined by reference to highly rated government securities, interbank rates, interest rate swap rates or repurchase agreements of highly rated government securities. Such reference rates should account for currency, issue date and maturity. Where there are multiple reference rates, IRAS expects the lowest rate of return to be selected.
- The comparable uncontrolled price method is preferred in determining the arm's length price for related party loan transactions, given the widespread availability of data and information on transactions between independent borrowers and lenders (e.g., bonds, loans, deposits, convertible debentures, commercial paper). However, other TP methods may be utilized if more appropriate, with examples of such alternatives being provided in Chapter X of the OECD Transfer Pricing Guidelines.
- Where the credit rating of the borrower is not publicly available, taxpayers may apply quantitative and qualitative analyses using publicly available financial tools or credit rating methodologies from independent credit rating agencies. Such analyses should take into account group membership to account for implicit support that may be received through group affiliation. The taxpayer may apply the group credit rating (typically the rating of the ultimate parent entity) to the borrowing entity where the credit rating cannot be reliably determined. Where independent lenders will accept such group credit rating, the group credit rating is the most reliable indicator.

H. Recommendations to taxpayers

We recommend taxpayers review their existing TP analyses and TPD, as well as their plans to prepare TP analysis and TPD going forward, keeping in mind the following:

- While the updates are consistent with the OECD Transfer Pricing Guidelines, the expansion of the guidance may signal a more stringent approach in IRAS' application of the arm's length principle and a greater focus from IRAS in requiring robust TP analysis, in particular with respect to CCAs and financial transactions.
- The additional guidance and clarification on TPD may indicate an increased scrutiny from IRAS in ensuring that taxpayers comply with the requirements under the TPD Rules.
- To ease taxpayers' compliance burden, IRAS has allowed taxpayers to prepare abbreviated organizational structures, use TPD prepared for other tax authorities, and elect to apply the OECD simplified approach for low value-adding intra-group services. When preparing TPD, taxpayers should consider whether these administrative concessions could help alleviate the time and effort required to satisfy the TPD Rules.

Given that the 5% surcharge will be imposed on the amount of TP adjustment rather than the additional amount of tax payable, and may not be creditable (and therefore ineligible as a foreign tax credit) in the headquarters jurisdiction of the taxpayer, the financial impact of the surcharge may be significant. To seek and qualify for remission on the surcharges, it is crucial that taxpayers ensure that proper TPD is maintained, and where TP issues have been identified, taxpayers should consider providing prompt voluntary disclosures to IRAS.

We would also expect more scrutiny from IRAS on APA applications. Before submitting an APA application, taxpayers should ensure that: (i) the transaction has a bona fide commercial reason; and (ii) does not have as the main purpose tax avoidance or reduction. Further, IRAS will likely want further explanation where there is a change in TP methodology, but no significant changes in facts and circumstances. Taxpayers should thoroughly review the purpose of their APA, and carefully consider the necessity of the APA request, and how this should be communicated to IRAS.

Taxpayers should consider invoking the arbitration provisions in the relevant DTA where the competent authorities cannot resolve a TP dispute under a MAP within a certain period. This would greatly increase the effectiveness of the MAP program and encourage the use of MAPs to resolve cross-border TP issues involving Singapore. Do note that where TP adjustments are made by foreign tax authorities, IRAS will not allow an additional tax deduction claim and will not allow the refund of taxes previously withheld in the absence of a MAP application.

For more information, and to discuss what this Revised TPG means for you, please get in touch with your Baker McKenzie TP or tax contact. Our Singapore TP team can assist with developing TP analyses or TPD to comply with the updated guidance, develop approaches and strategies with respect to disputes or disclosures to minimize surcharges on TP adjustments, and provide support through the MAP or APA processes.

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