Tax Alert

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New release of transfer pricing guidelines (sixth edition)

In August, the sixth edition of the Inland Revenue Authority of Singapore's (IRAS) e-Tax Guide on Transfer Pricing Guidelines (TP Guidelines) was released. This KPMG Tax Alert focuses on the key changes and how taxpayers in Singapore might be affected.

Transfer pricing audits and methods

- TP Audit – The term "TP Consultation" was replaced with the term "TP Audit".
- Transfer pricing method – It was emphasised that the appropriateness of the transfer pricing method would be a priority during transfer pricing audits, highlighting that most significant transfer pricing disputes arise from disagreements in this area.
- Mark-up on value-added costs – The TP Guidelines clarify that the application of this profit ratio would be subject to the same considerations that apply for the Berry ratio, in particular whether the value of the function correlates with the operating expenses.

The impact of these changes may at first glance seem limited, but they are likely to indicate a paradigm shift. While taxpayers were given the benefit of the doubt in certain situations in the past, there may be more robust enforcement and stronger positions taken by the IRAS going forward. This is likely to include all relevant areas of transfer pricing, including but not limited to the timeliness, quality and comprehensiveness of TP documentation, the existence of intercompany agreements, and the commercial necessity to engage in related-party transactions.

Given that transfer pricing regulations have been in place for 15 years in Singapore, there is a clear expectation that taxpayers have familiarised themselves with this topic and are aware of their obligations.

Services transactions

For related-party services, which remain a contentious area in transfer pricing, certain additions/clarifications were made:

- Benefit test – Regarding the "benefit test", a prior condition that the benefits must be "sufficiently direct and substantial" was removed, though it would remain advantageous if that was the case.
- Duplication of services – With respect to the "duplication of service" (i.e. receipt of the "same" service from different sources), a deduction would be allowed under certain, albeit exceptional circumstances.
- Simplified Organisation for Economic Co-operation and Development (OECD) approach – Under the new TP Guidelines, the IRAS allows the application of a mark-up of 5 percent under the OECD's simplified approach for low value-adding services under certain conditions and provided that the OECD's approach is also accepted in the counterparty jurisdiction. In the past, Singapore taxpayers were only able to apply the 5 percent mark-up concession where all the services in question meet the IRAS' definition of "routine services".

The above changes could potentially provide some relief to taxpayers, though their significance in practice remains to be seen.

APA/MAP

- Acceptance of Advance Pricing Arrangement (APA) applications – It was clarified that APA applications would not be accepted for taxpayers currently under audit or investigation (including ongoing TP consultation) by the IRAS for past financial years. As such, taxpayers who are considering an APA should ensure that they initiate and submit their application promptly.
- Arbitration under Mutual Agreement Procedure (MAP) – In order to make the MAP process more efficient for taxpayers and create certainty of double taxation relief, the IRAS has opted for mandatory arbitration under the Multilateral Instrument (MLI) protocols to amend its double tax treaties. If the other tax authority has chosen the same option under its double taxation agreement with Singapore, taxpayers have the option to involve an arbitration panel of independent experts if the IRAS and the other tax authority are unable to resolve the issue within a specified time frame.

In summary, APAs and MAPs remain a viable option for taxpayers in certain situations partially because any upward adjustments made under these programmes would not be subject to the surcharge of 5 percent.

Application of surcharge

Further information was provided on which scenarios the surcharge of 5 percent on gross transfer pricing adjustments would apply and the circumstances where the IRAS may consider a partial or full remission of the surcharge.

- Remission – A full remission of the surcharge may be granted to taxpayers who make self-initiated retrospective upward transfer pricing adjustments within 2 years from the filing due date of the respective tax return, provided that the taxpayer has not received any notification from the IRAS on the commencement of an audit or investigation.
- Good compliance record – The above concession would only be eligible to taxpayers who have shown cooperative and responsive behaviour, maintained contemporaneous TP documentation and good tax compliance records.

The introduction of the remission of surcharge reflects the IRAS' recognition of taxpayers who take their transfer pricing obligations seriously, and proactively review and manage their transfer prices. From a practical standpoint, taxpayers should be mindful that requests for extensions to respond to the IRAS' queries can impact their compliance record.

Expanded guidance for financial transactions

The following guidelines were introduced, in addition to broadening the scope of the TP Guidelines beyond loans to other types of financial transactions (including cash pooling, hedging, financial guarantees and captive insurance):

- Debt vs. equity characterisation – Taxpayers need to determine first whether a purported loan should be considered a loan for tax purposes or some other kind of payment (e.g. an equity contribution). The analysis should consider factors commonly applied to differentiate between debt and equity in the context of financial hybrid instruments.
- Interest free loans – The TP Guidelines emphasise that interest-free related-party loans are not considered arm's-length transactions unless reliable evidence can be provided that this represents a commercial arrangement which would have been agreed upon between independent parties, which can be challenging in practice.
- Two-sided approach – The analysis performed should take into consideration the perspective of the lender and the borrower. This could lead to challenges, especially where there is a significant interest rate differential between the jurisdictions of the transacting parties.
- Relevance of quotations – The TP Guidelines formalise the IRAS' long-standing position that quotes from banks are not regarded as evidence of arm's-length terms since they do not reflect actual transactions.
- Implicit support – It was acknowledged that, under certain circumstances, the potential effects of a borrower being part of a multinational group on its credit rating (commonly known as "implicit support") should be considered, although in general an analysis based on the standalone credit rating of the borrower is preferable. In cases where the borrowing entity is strategically important for the group as a whole, implicit support would likely be more relevant.
- Risk-free return – Where a company extending a loan does not exercise control over the risks related to the loan and does not have the financial capacity to assume those risks, it would not be entitled to more than a risk-free return, taking into account its cost of funding.
- Re-financing – Many taxpayers tend to either obtain a loan to repay an existing loan or extend the tenure of an existing loan. Both will be treated as a new loan, which would require the establishment of the arm's-length terms and interest rate anew.

In summary, most of the changes underscore the IRAS' emphasis on analysing transactions more holistically (including why the arrangement was structured in a particular way) before evaluating its pricing. As such, the taxpayer will be required to explain the commercial reasoning for the transaction, including whether a certain level of debt for a borrowing entity is sustainable.

Cost contribution arrangements (CCA)

A new chapter regarding transfer pricing considerations for CCAs was added which may reflect the IRAS' expectation to see more CCAs in Singapore going forward given Singapore's status as a research and development (R&D) hub. It broadly aligns with the CCA guidance issued in the OECD TP Guidelines and covers both the economic principles as well as its formal aspects.

- Purpose – It was acknowledged that CCAs can be useful in situations where different entities pool resources for R&D activities or to avoid a web of bilateral service charges.
- Sharing of benefits – The fundamental principle of a CCA is that all parties jointly contribute to the CCA and mutually benefit from its outcome on a pro-rata basis to their contribution. There is a detailed 4-step process to identify and calculate the contributions and benefits received.
- Importance of agreements – A key requirement sometimes overlooked is that a CCA is an ex-ante contractual arrangement, which clearly defines its participants and their envisaged contributions.

While the technical details disclosed by the IRAS is in line with the OECD, taxpayers should be aware that the IRAS in practice diligently scrutinises whether all the conditions for a CCA are fulfilled (in substance and in form). Taxpayers who take the position that their related-party transaction falls under the umbrella of a CCA should therefore re-look into the various conditions and ensure they can provide the respective evidence to the IRAS.

KPMG's observations

The TP Guidelines contain some substantive changes and introduction of new concepts that are impacted by the IRAS' transfer pricing audit experience, its interactions with other tax authorities, as well as recent international developments and Singapore's involvement therein.

Overall, the importance of having contemporaneous transfer pricing documentation in place was highlighted in the TP Guidelines, including details on certain key areas that require thorough analysis, such as disclosure of decision-making capabilities in the group regarding risks assumed and risk control functions.

Given the IRAS' emphasis on timeliness, taxpayers should critically assess whether they not only have the resources but also the process in place to actively manage their transfer pricing matters on a day-to-day basis. A key focus area would be the capability to extract, process and interpret real-time financial information to evaluate the need for transfer pricing adjustments. As such, taxpayers should consider whether they need to transform their tax and finance function and, where appropriate, deploy the use of technology to derive greater insights and value.

From a technical perspective, taxpayers should review their intercompany funding arrangements considering the revised TP Guidelines, especially where interest-free loans have been extended to foreign affiliates.

How we can help

As a committed tax adviser to our clients, KPMG welcomes any opportunity to discuss the relevance of the above matters to your business.

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