

SINGAPORE TRANSFER PRICING UPDATE (10TH AUGUST 2021): IRAS PUBLISHES THE SIXTH EDITION OF THE TRANSFER PRICING GUIDELINES

Since its first edition published in 2006, the Inland Revenue Authority of Singapore (“IRAS”) has periodically revised its transfer pricing (“TP”) guidelines to keep up with the ever-changing TP landscape and international tax developments.

On 10th August 2021, IRAS issued the sixth edition of its TP guidelines (“**Sixth Edition TPG**”), updating and replacing the previous version released in early 2018.

Overall, the amendments made under the Sixth Edition TPG enhanced certainty and clarity for Singapore taxpayers as they addressed various important aspects not explicitly covered in previous editions.

In this regard, we summarise below the key changes that will likely have direct and practical implications:

1. Additional guidance on TP surcharges

Section 9 of the Sixth Edition TPG now provides more detailed clarification on the application of TP surcharges.

a. Conditions for remission of 5% TP surcharge

Under Section 34E(5) of the Singapore Income Tax Act (“SITA”), the Comptroller has the power to remit wholly or in part any surcharge on transfer pricing adjustments for any good cause. Section 9 of the Sixth Edition TPG now sets out the conditions for IRAS to consider a remission / waiver of the 5% surcharge. While a remission remains at the full discretion of IRAS, this is a welcomed addition which provides more clarity to taxpayers on how the merits of each case are and will be evaluated.

Briefly, a partial or full remission of the surcharge will only be considered where the taxpayer has (i) a good compliance track record (i.e., filing tax returns and paying taxes on time); (ii) proper contemporaneous TP documentation; and (iii) a cooperative attitude during TP audits. (Conditions (i), (ii) and (iii) are collectively referred to as “**Remission Conditions**”)

b. Voluntary / retrospective TP adjustments

Section 9 of the Sixth Edition TPG also introduces new guidance on taxpayers’ voluntary/self-initiated retrospective upward TP adjustments. Based on the additional language included in the Sixth Edition TPG, a TP surcharge will apply not only to TP adjustments made by IRAS, but also to self-initiated retrospective upward adjustments made by taxpayers that were executed after the close of a particular financial year.

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In this regard, to encourage voluntary disclosure of non-arm's length arrangements in prior years, IRAS will consider a full or partial remission of the surcharge, where the relevant conditions are met. Where (i) the adjustment is booked within two years of the tax filing deadline; (ii) there has been no query, notification of audit or investigation from IRAS for the relevant year of assessment ("YA"); and (iii) the taxpayer meets the Remission Conditions (as stated under Section 9 of the Sixth Edition TPG), a full remission will be granted. Where only conditions (ii) and (iii) are met, a partial remission may be considered.

This may have an impact on taxpayers who are planning to perform any self-initiated upward adjustments while implementing TP policies, or making additional adjustments due to unforeseeable economic conditions (e.g. COVID-19).

2. Guidance on cost contribution agreements ("CCA")

The Sixth Edition TPG introduces an entirely new Section 17 which covers a wide range of topics surrounding the CCA. This is an important clarification on attributes that are relevant to Section 14D (expenditure on R&D) and 14DA deductions (enhanced deduction for qualifying expenditure on R&D) under SITA. IRAS also clarified that cost sharing agreements (CSA) and CCA has the same meaning for the purposes of applying the arm's length principle.

Briefly, the details under this section include:

- » A four-steps approach to apply the arm's length principle to CCA;
- » The arm's length requirements surrounding entry, withdrawal and termination of CCA;
- » Illustration of tax treatment for CCA payments (with reference to Section 14D / 14DA e-Tax guide);
- » Specific TP documentation requirements on CCA; and
- » Appendix A to illustrate application of the arm's length approach to CCA.

3. Arbitration

The Sixth Edition TPG also introduces the concept of arbitration as a potential route for resolving double taxation issues when MAP discussions hit a stalemate. This reflects the latest international developments surrounding the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting ("MLI").

For context, Singapore opted for the arbitration provisions to be included in Singapore DTAs (Avoidance of Double Taxation Agreement) during the signing of MLI. The arbitration provisions will apply if Singapore's DTA partners similarly adopt the same arbitration provisions of the MLI. Arbitration provisions may also be included in the Singapore DTAs through bilateral discussion with DTA partners.

4. Rejection of APA applications on transactions without bona fide commercial reasons

IRAS will not accept an APA application involving transactions entered into by related parties without bona fide commercial reasons or involves a scheme with avoidance or reduction of tax as one of its main purposes.

A new FAQ also clarifies that IRAS will not accept an APA application while the transaction is still under audit / investigation by IRAS, as well as IRAS's general expectation that a consistent TP method should be applied across all covered years of an APA.

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5. Intra-group service transactions

The Sixth Edition TPG also provides more description on what constitutes "shareholder activities". As a starting point, shareholder activities are generally not considered related party services and therefore, do not justify any remuneration for such services. That said, the Sixth Edition TPG distinguishes general shareholder activities and shareholder activities carried out by a group member on behalf of a holding company, with the latter being regarded as the provision of a service that warrants compensation by the holding company.

Additionally, specific reference is also made to Chapter VII of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("OECD TPG") on Special Considerations for Intra-Group Services. The Sixth Edition TPG adopts the OECD's simplified approach for low value-adding intra-group services, which forms some of the conditions for applying a 5% mark up for low value-adding intra-group services.

6. Financial transactions

Section 15 of the Sixth Edition TPG has significantly broaden its guidance on financial transactions, specifically including financial transactions such as cash pooling, hedging, financial guarantees and captive insurance in addition to loans. The Sixth Edition TPG made direct reference to Chapter X of the OECD TPG on Financial Transaction. Moving forward, taxpayers will be able to leverage from the wealth of technical guidance contained in Chapter X and adopt the OECD's analysis framework to a Singapore context.

There are also other substantial amendments and additions which include:

- » Clarification on IRAS's position that zero interest rate intercompany loans are not arm's length, unless there is evidence that third parties under comparable circumstances would provide interest free loan;
- » Distinguishing whether a purported loan should be regarded as a loan or other kind of payment (e.g., contribution to equity capital);
- » Clarification on situations where a financial transaction may be analysed under the service transaction category's methodologies;
- » More detailed guidance on the evaluation and determination of credit ratings;
- » New illustrations on re-financing of existing intercompany loans (guidance on the base reference date of different tranches of loan renewal); and
- » New illustrations on situations where the entity providing the funds may not be the entity that exercises control over the actual credit risks (relevance of risk-free returns in such cases).

7. Additional consideration on Berry ratio and Value-Added Cost Mark-up

In 2015 (under the Second Edition of the TPG), IRAS first introduced prescriptive conditions where Berry ratio (i.e., gross profit to operating expenses) could be used as an alternative financial indicator to compare profitability of a taxpayer against that of an independent third party. It has since been a controversial profit level indicator ("PLI") where taxpayers tend to have a wide range of different technical interpretations.

The Sixth Edition TPG clarifies that Berry ratio relies on a presumption that the value of "functions performed" (activities carried out by the taxpayer) is proportional to operating expenses but not sales. Further, it also clarifies that Berry ratio becomes an unreliable financial indicator where the taxpayer's costs of goods sold is a key driver of its profitability and the taxpayer has ability to influence those costs.

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IRAS also draws the same presumption for another commonly applied PLI i.e., the value-added cost mark-up (“VACM”), where the same considerations will apply for determining whether VACM is a suitable financial indicator to be used.

This will likely have practical implications for taxpayers who relied on these PLIs for their TP documentation or TP policies. Where taxpayers apply a Berry ratio or VACM analysis, more careful consideration must be made in rejecting sales based PLIs (e.g., operating margin) and in defining and determining the cost base (i.e., if COGS were included) to ensure selection of the most appropriate financial indicator.

8. Contents of TP documentation

In the form of a FAQ under Appendix B of the Sixth Edition TPG, IRAS shed some light on its expectation on the level of disclosure required in the TP documentation. These include:

- » Date of completion: The TP documentation must be dated to substantiate that it was prepared contemporaneously (penalty and surcharges, validity of periodic TP adjustments, applicability of MAP/APA will be affected).
- » Level of detail in factual sections: IRAS emphasized that generic description of the taxpayer’s business is insufficient. It will also be relevant for taxpayers to describe (i) reasons for entering into the related party transaction; and (ii) contributions to the value chain by the respective related parties.
- » Special factor analysis: Considerations could be made on documenting the events that affected business performance significantly, especially when the taxpayer is making a loss, or suffered a lower profit margin.

9. Other Changes

There are also other subtle changes that are interesting to note such as changing the name of TPC (TP consultation) process to TPA (TP audit), which may signal IRAS’s shift from a “consultative” approach (to encourage and facilitate implementation of the arm’s length principle, since the TP consultation program was launched many years back in 2008 in the form of a standalone e-tax guide) to a more “investigative” approach moving forward.

This is not surprising given that the TP guidelines and legislations have been in place for several years now. Consequently, taxpayers should also review their TP documentation and policies critically to ensure defensibility in the event of queries or audits.

The Sixth Edition TPG also includes a list of references to other e-tax guides which are relevant to TP:

- » Transfer Pricing Guidelines (Special Topic) – Commodity Marketing and Trading Activities
- » GST: Transfer Pricing Adjustments
- » Transfer Pricing Guidelines (Special Topic) – Centralisation of activities in Singapore.

Conclusion

The amendments in the Sixth Edition TPG enhance the technical sophistication of the guidance to various TP topics. Direct references to the OECD TPG also demonstrate Singapore’s commitment towards applying the arm’s length principle in line with international practices.

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As OECD's BEPS 2.0 Project marches forward, we will expect more complicated and challenging issues in the years to come and these technical grounding will help pave the way for the application of the arm's length principle.

In every sense, the Sixth Edition TPG provides a timely update and much needed guidance for taxpayers to navigate their TP matters.

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