The Arm's Length Principle in Singaporean Transfer Pricing

Associate Professor Mr Lee Fook Hong

Transfer pricing refers to the determination of prices at which goods and services are transacted between related parties particularly with regard to cross-border transactions. For transactions between independent unrelated parties, market force will decide the commercial pricing of the goods and services transacted. However if transactions involve related parties, the lack of independence in commercial and financial relations can lead to the setting of prices that may be different from independent commercial prices. This may result in distortion of profits and the tax liabilities of each of the related entities.

With the increasing move towards globalization and international trading, more organizations especially multinational corporations (MNCs) are now engaged in cross-border transactions. Goods from the production division of one company may be sold to the marketing division of another related company overseas within the same group with the choice of transfer pricing affecting the division of the total profit among the various companies within the same group. This has led to the imposition of transfer pricing regulations as governments seek to stem the flow of taxation revenue overseas, making the issue one of great importance for MNCs.

Where the related companies are located in different tax jurisdictions with different tax rates, the potential distortion in profits and tax liabilities of each company may give rise to a greater concern as there are incentives to plan more profits for related companies operating in jurisdictions of low tax rate while little profits or no profits are allocated to companies operating in countries with high tax rates. So the overall tax liability of the whole group of companies is reduced to a minimum.

Singapore does not have formal transfer pricing rules in its income tax legislation. The arm's length principle is deemed to apply as a matter of fundamental tax treatment. Singapore adopts and adheres to the OECD principles. For effective tax planning in relation to transfer pricing transactions, taxpayers should follow the OECD Transfer Pricing Guidelines closely in evaluating their compliance with the arm's length principle.

Although Singapore tax legislation does not contain specific provisions stipulating the use of the arm's length principle for related party transactions, various sections of the Singapore Income Tax Act (SITA) imply or refer to the concepts or the use of the arm's length principle. In addition, the arm's length principle is also found in all of the Singapore's comprehensive Double Taxation Agreements (DTAs). Hence, the adoption by the Inland Revenue Authority of Singapore (IRAS) of the arm's length principle for related party transactions is enshrined in the SITA and Singapore's double tax treaties.

The arm's length principle is the internationally endorsed standard for transfer pricing transactions between related parties. The arm's length price is the price at which two unrelated parties agree to a transaction. However this is most often an issue in the case of companies with cross border operations where international subsidiaries trade with one another. When related parties adopt a transfer price which adheres to the arm's length principle, they would reflect comparability in the pricing that independent commercial entities in similar situations would transact. Therefore theoretically there will be no distortion of profits and tax liabilities.

The Transfer Pricing Guidelines released by Singapore's tax authority (IRAS) will help taxpayers in applying the arm's length principle and the preparation and maintenance of documentation to demonstrate compliance with the arm's length principle.

IRAS endorses the use of the arm's length principle for several reasons. Firstly, Singapore believes that the market forces of supply and demand is an important factor for

consideration in allocating resources and rewarding good efforts. IRAS agrees with what is cited in the OECD Transfer Pricing Guidelines i.e. that the application of the arm's length principle treats related and independent entity transactions equally for tax purposes and hence avoids the creation of tax advantages or disadvantages that would otherwise distort the relative competitive position of either entity. Secondly, the arm's length principle is adopted by most tax jurisdictions. By so adopting and complying with this internationally accepted principle, taxpayers and tax authorities will have a common basis to deal with related party transactions. This would reduce the incidence of tax adjustments and avoid transfer pricing disputes and double taxation.

The application of the arm's length principle is however not straight forward or without difficulties. For instance, certain business structures are so complicated that no similar arrangement can be identified between independent parties. This will render the comparison difficult for applying the arm's length principle. Another difficulty is the obtaining of relevant data and information which may not be available or which may be confidential in nature and cannot be disclosed without revealing business secrets. Because of such difficulties in mind, IRAS has provided guidance on the application of the arm's length principle.

While there is no legislation specifically dedicated to transfer pricing in Singapore, two sections in the SITA are relevant to transfer pricing and these can be used by IRAS to adjust transfer prices. Firstly, Section 33 of SITA allows IRAS to disregard or vary an arrangement if its purpose, whether directly or indirectly, is to alter the incidence of tax payable; or reduce or avoid any tax liability imposed or would have been imposed. However Section 33 will not apply if the arrangement was carried out for bona fide commercial reasons and did not have, as one of its main purposes, the avoidance or reduction of tax.

In addition to the Section 33, Section 53(2A) of SITA allows IRAS to assess a non-resident person and charge any tax due to a resident person if the transactions between a resident person and a non-resident person, are arranged so that the business done by the resident person, owing to the close connection between the two and to the substantial control exercised by the non-resident person over the resident person, the course of business is so arranged that the resident person derives no profits or less than the ordinary or normal profits .

IRAS recommends that taxpayers adopt the following 3-step approach to apply the arm's length principle in their related party's transactions. The recommended steps are, however, not mandatory or prescriptive.

I) Conduct a comparability analysis

The arm's length principle is based on a comparison of prices and margins obtained by related parties with those obtained by unrelated parties engaged in similartransactions. For such price comparisons to be meaningful, the relevant characteristics of the situations compared to each other should be substantially similar.

There are factors affecting comparability. A comparability analysis should examine the comparability of the transactions with regard to the characteristics of goods or services. The specific characteristics of goods and services may affect the pricing significantly. For instance, a product with better quality would fetch higher selling price. Therefore, characteristics of goods and services must be assessed carefully to identify their difference. Similarities in actual characteristics of the goods and services are most critical when one needs to compare prices of related party transactions against independent ones.

Other than the characteristics of goods and services, the functions performed and risk borne and assets employed by the businesses are also important considerations that may affect a comparability analysis. Therefore, a comparability analysis must include a comparison of the economically significant functions performed, risks assessed and assets employed by the related party with those performed by the independent party. The functions that should be included in the comparison include design, development, research, manufacturing, distribution marketing and financing. The analysis should also take into account of assets used such as factories/plants, machineries and other valuable intangibles. An appraisal of the risk(s) undertaken is also important in determining arm's length prices. The possible risks that should be considered in the functional analysis should include market risks, risks in cost of production, foreign exchange and interest rates.

Prices may vary across different markets even for transactions involving the same goods and services. In order to make meaningful comparisons of prices and margins between entities, the market and economic conditions in which the entities operate or where the transactions are undertaken should be comparable. Government policies and regulations may have anan impact on prices and margins. Business strategies should also be examined in determining comparability for transfer pricing purposes. An entity may embark on a business strategy of temporarily charging a lower price for its products compared to similar products in the market to expand its existing foothold or penetrates into new segments of the market.

II) Choosing the appropriate Transfer Pricing method and tested party

Over the years there have been a number of methods developed in the international arena for evaluating transfer prices/margins against a bench mark based on the prices/margins adopted in similar but independent transactions. The OECD Transfer Pricing Guidelines recommend the following five methods:

1) The Comparable Uncontrolled Price (CUP) method

The CUP method compares the price at which a controlled transaction is conducted to the prices at which a comparable uncontrolled transaction is conducted. This makes it easier to conceptually determine the arm's length price by using the sale price between the two unrelated corporations. However, the fact that virtually any minor change in the circumstances of trade may have a significant effect on the price, makes it exceedingly difficult to find transactions that are sufficiently comparable.

By comparing the price of the transactions, the CUP method employs the most direct assessment of whether the arm's length principle is complied with. In practice, CUP method is usually most suitable for evaluatingmost suitable for evaluating transactions involving products with similar characteristics and undertaken in similar market conditions. Notwithstanding that, the CUP method requires a high level of comparability to produce reliable results.

2) Resale Price (RP) method

The RP method is found by working backward from transactions taking place at the next stage in the supply chain. It is determined by subtracting an appropriate gross markup from the sale price to an unrelated party with the appropriate gross margin being determined by examining the conditions under which the goods and services are sold. This method is applied where a product purchased from a related party is resold to an independent party. The resale price to the independent party is reduced by a comparable gross margin to arrive at the arm's length price of the products transferred between the related parties. Under arm's length conditions, the resale price margin should allow the reseller to recover the cost of sales as well as a reasonable profit margin based on the function performed.

3) Cost Plus (CP) method

The CP method is generally used for the trade of finished goods. It is determined by adding an appropriate markup to the costs incurred by the selling party in manufacturing/purchasing the goods or services provided, with an appropriate comparable markup being used on the profits of other companies. This method is useful where semi-furnished goods are sold between related parties or where the related party transactions involve the provision of services.

4) Profit Split (PS) method

The PS method is applied when the businesses involved in the examined transactions are too integrated to allow for separate evaluation and so the ultimate profit derived from the transactions is split based on the level of contributions of each of the participants in the project.

The PS method basically involves two steps. First it identifies the profit to be split. This may be the total profit arising from the project. The second step involves splitting the profit by reference to the relative contributions of the parties in the transactions. These contributions are assessed based on the functions performed, assets employed and risks assumed by each party.

5) Transactional Net Margin method (TNMM)

The TNMM is a method that requires a thorough examination of the company in question in order to determine the net profit margin relative to an appropriate base of costs to be realized through the examined transactions. TNMM is essentially a unified version of RP and CP method. This means that this method requires a level of comparability similar to that required for the application of the two traditional transaction methods. The primary difference between the TNMM and RP/CP methods is that TNMM focuses on net margin instead of gross margin.

III) Determining the Arm's Length Results

After the appropriate transfer pricing method has been chosen, the method is applied on the data of independent party transactions to arrive at the arm's length result. Knowing that it is generally difficult to arrive at a specific price or margin that is the arm's length price or margin, IRAS is prepared to accept transfer pricing analysis using a range of prices or margins to determine an arm's length price so long as the comparables are reliable. With the arm's length results determined, taxpayers would be able to adopt the result for their transfer pricing practices.

Singapore taxpayers however should also regularly monitor their business activities for structural changes in the location of group functions, assets employed and risks assumed to ensure that their transfer pricing practices are always aligned with the changes in their businesses.

Transfer pricing documentation

Singapore Transfer Price Guidelines are consistent with the approaches recommended in the OECD Transfer Price Guidelines although IRAS does not impose a formal requirement to prepare transfer price documentation. However, IRAS expects taxpayers to exert reasonable effort to undertake a sound transfer pricing analysis to ascertain the arm's length pricing as well as to demonstrate that such analysis has been performed. The keeping of records to demonstrate that such efforts have been undertaken to conform to the arm's length principle is known as "documentation". Taxpayers who violate the record keeping requirements under Sections 65, 65A and 65B of the SITA would not in anyway be precluded from enforcing these provisions.

The main objective of preparing and maintaining documentation is to place the taxpayers in a position where it can readily demonstrate that it has exerted reasonable efforts to ensure that its transfer prices are consistent with the arm's length principle. Adequate documentation will facilitate reviews by tax authorities on a taxpayers' transfer pricing analysis and help resolve any arguments that may arise.

In their attempt to cut costs, taxpayers may choose not to keep their transfer pricing documentation up to date. IRAS is conscious that keeping adequate documentation may result in compliance and administrative costs for taxpayers. IRAS therefore adopts the following principles with regard to documentation:-

- Taxpayers are only required to prepare or obtain documents necessary to allow a reasonable assessment of whether they have complied with the arm's length principle. Taxpayers should evaluate the complexity of the related party transactions as well as the costs of compliance arising from documentation.

- Unlike other tax jurisdictions, IRAS does not impose a penalty specifically for lack or insufficiency of documentation. In the absence of provisions for penalties, taxpayers must bear in mind the relevant provisions of the SITA in relation to record keeping and try to keep proper and adequate documentation. With the proper and adequate documentation, taxpayers will have proof to show that the arm's length principle has been complied with.This will put the taxpayers in a better position to defend their transfer pricing analysis and avoid unnecessary disputes with and adjustments by the tax authorities.

The documentation required depends on the specific facts and circumstances of each case. The taxpayers who have the most intimate knowledge of their businesses are therefore in the best position to explain their approaches to transfer pricing. Although it may not be possible to specify a comprehensive list of documentation requirements for all the taxpayers, generally taxpayers involved in related party transactions should at least prepare "cost and risk" transfer pricing documentation with all relevant information to demonstrate that they have assessed and considered their transfer pricing risk profile.

Details on the information that should be documented include the following:-

- Detailed information of the group showing the organization structure, location and ownership linkage, nature of business activities and functions performed by each party in the group.

- Detailed information on each related party in Singapore, the entity's business models, its functions, risks and assets employed.

- Details on transactions between related parties and their contractual terms of transactions, segmental financial accounts and information in regard to the transactions

- Transfer pricing analysis comprising choice of the tested party and reasons substantially the choice as well as details on comparables, and comparability analysis. The analysis should also include the transfer pricing method chosen and reasons to support the method adopted. The determination of the arm's length price/margin with detailed computation and explanation must also be included.

Although transfer pricing documentation may include sufficient information, nevertheless in certain circumstances of Singapore's transfer pricing perspective, taxpayers should always bear in mind the consideration of whether such transfer pricing documentation is sufficient from the perspective of its foreign associates as different countries have different transfer pricing requirements.

Availability of Mutual Agreement Procedures (MAPs) and Advance Pricing Assignment (APAs)

Singapore currently has a network of more than 50 comprehensive double taxation agreements (DTAs) in force. All the DTAs provide for the Mutual Agreement Procedures to resolve instances of double taxation. Where a tax authority makes adjustments to the transfer prices of the transaction between the related parties, double taxation will arise. Taxpayers in such cases may apply to the competent authorities to invoke MAP in order to eliminate double taxation. All related parties involved should notify the relevant competent authorities in their respective jurisdictions of their intention to invoke the MAP within the time limit specified in the relevant DTA. Failure to notify the competent authorities within the applicable time limit may result in the tax authorities' rejection of MAP request and the double taxation suffered may not be relieved.

An APA determines in advance an appropriate set of criteria to ascertain the transfer prices of specified party transactions over a specified period of time. It is an

agreement between the taxpayer and the competent tax authority that a future transaction will be conducted at the agreed-upon price which is recognized as the arm's length price.

There are two types of APAs namely unilateral and multilateral APAs. A unilateral APA is an agreement between a taxpayer and IRAS while a multilateral APA involves agreement between Singapore and one or more of its tax treaty partners. A Unilateral APA is simpler to implement but may not be recognized by a third foreign tax authority and taxpayer may run the risk of being assessed should the foreign tax authority does not agree with the method of computing the arm's length price. A Multilateral APA also provides such coverage although their implementation requires a more lengthy application process including consultation between and the agreement of all competent tax authorities involved.

There is no mandatory requirement for taxpayers to seek an APA. However, in recognition of commercial needs, IRAS is making APA facilities available to taxpayers who are involved in cross-border related party transactions.

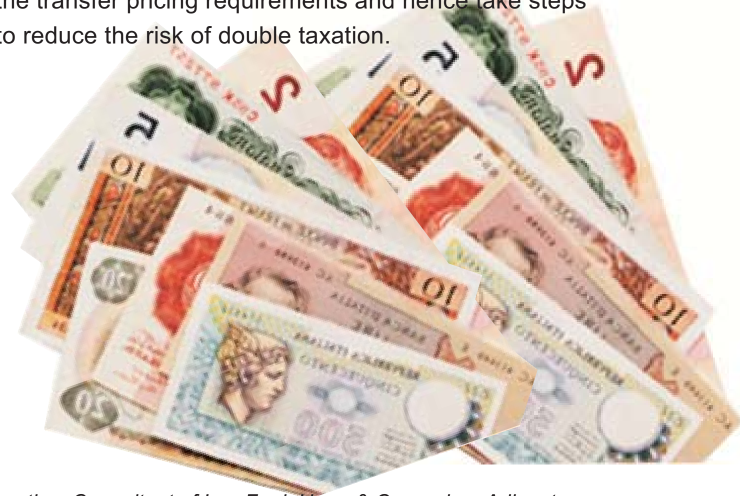
As outlined in the Transfer Pricing Guidelines, the taxpayers' cooperation with IRAS is said to be critical to the success of the APA and MAP process. Full co-operation would include accurate responses or clarification to the queries raised by the competent authorities and furnishing of good quality analysis of the issues.

APA is regarded as binding on the tax authority and on the taxpayer. When implemented in accordance with the stated conditions, tax authorities would suspend audits and would not impose penalties with respect to the transactions involved. Hence, taxpayers should enter into APAs in good faith with the aim of obtaining certainty in complying with arm's length principle.

Concluding remarks

The release of the Transfer Pricing Guidelines is timely. This shows that IRAS is now focusing more attention on issues of the transfer pricing in Singapore. The Transfer Pricing Guidelines will go a long way to clarify IRAS expectation of Singapore taxpayers in relation to their cross-border related party transactions. The guidelines give guidance to taxpayers on to how to comply with the arm's length principle. It also gives recommended preparation and maintenance of documentation to demonstrate compliance with arm's length principle. Besides, the guidelines also set out procedures for applying for the MAP and APA facilities in order to avoid double taxation. This will be very useful as there have been increasing cross border transactions in the Asia Pacific region, and more and more multinational companies are searching for more efficient way to compete in the global trading environment.

Hopefully with the release of Transfer Pricing Guidelines, taxpayers may now have better understanding regarding the transfer pricing requirements and hence take steps to reduce the risk of double taxation.



Author's Profile

Associate Professor Lee Fook Hong *PhD FCIS FAIA MCIArb*

Formerly an Adjunct Professor at Nanyang University, Singapore. Presently a Consultant of Lee Fook Hong & Co. and an Adjunct Professor at SIM University (UNI-SIM).

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- Life is pleasant. Death is peaceful. It's the transition that's troublesome.
- Help a man when he is in trouble and he will remember you when he is in trouble again.
- Complex problems have simple, easy to understand wrong answers.
- Whoever said money can't buy happiness, didn't know where to shop.
- Alcohol doesn't solve any problems, but then again, neither does milk.
- Most people are only alive because it is illegal to shoot them.