Transfer Pricing Guidelines

Comparing OECD and IRAS

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KEY TAKEAWAYS

- IRAS' Transfer Pricing Guideline (TPG) focuses more on comparability; OECD's TPG focuses more on delineation and allocation of risks.
- Fundamental principles in IRAS' and OECD's TPGs are largely aligned.
- Both share the common objective that transfer pricing between related parties must follow the arm's length principle.

As a member of the Organisation for Economic Co-operation and Development (OECD)/G20 Inclusive Framework for Implementing Measures against Base Erosion and Profit Shifting (BEPS), Singapore supports the key principle underlying the BEPS Project, namely that profits should be taxed where the real economic activities generating the profits are performed and where value is created. Singapore also adheres to the internationally agreed arm's length principle.

The fundamental principles articulated in OECD's and the Inland Revenue Authority of Singapore (IRAS)', Transfer Pricing Guidelines (TPGs) are similar even though their approaches may vary. While the latter focuses on comparability, the former places emphasis on the delineation and allocation of risks to parties that control the risks and have the financial capacity to bear the risk. These differences provided the setting for an enlightening webinar organised by the Singapore Chartered Tax Professionals, where Adriana Calderon, Director, Transfer Pricing Solutions Asia, compared and contrasted the latest TPGs.

COMPARISON OF IRAS' AND OECD'S TP GUIDELINES

Applying The Arm's Length Principle

At the heart of transfer pricing (TP) is the arm's length principle. The goal of a TP study is to apply the arm's length principle to ensure that the pricing of transactions between related parties reflects independent pricing. Contemporaneous TP documentation is prepared and kept as evidence.

While both Singapore and OECD support the arm's length principle, different approaches have been laid out in their respective TPGs to apply the arm's length principle on related party transactions.

OECD

Based on OECD's TPG, a contractual allocation of risk (and associated expected return) will be respected only if each party that is contractually allocated a risk is considered, through the accurate delineation analysis, to control its allocated risk, and to have the financial capacity to bear the risk.

The accurate delineation of a transaction is about assessing how the actual behaviour of the parties to a transaction compares to the terms of the written contract. To do this, OECD recommends a five-step process which involves the review of:

- Contractual terms of the transaction;
- Functions performed, assets used, and risk assumed;
- Characteristics of property or service;
- Economic circumstances of the parties and of the market; and
- Business strategies pursued by the parties.

In addition, OECD also proposes the following six-step process to effectuate the analysis of risk:

Step 1: Identify economically significant risks with specificity;

Step 2: Determine how specific, economically significant risks are contractually assumed;

Step 3: Perform functional analysis to determine the parties that assume and manage the risks;

Step 4: Interpret the information from Steps 1 to 3 and determine whether the contractual assumption of risk is consistent with the conduct of the associated enterprises and other facts of the case;

Step 5: Allocate the risk to the enterprise exercising control and have the financial capability to assume the risk; and

Step 6: Price the transaction, taking into account the consequences of risk allocation.

IRAS

Unlike OECD's more elaborate approach, IRAS recommends that companies adopt the following three-step approach to apply the arm's length principle in their related party transactions:

Step 1: Conduct comparability analysis;

Step 2: Identify the most appropriate TP method and tested party; and

Step 3: Determine the arm's length results.

Despite having only three steps, IRAS' approach is actually a lot more similar to OECD's approach than one may realise.

The comparability analysis under IRAS' approach, for example, requires identifying the commercial or financial relations between the related parties, and the conditions and economically relevant circumstances attached to those relations, in order that the transaction between the related parties is accurately delineated. It also requires comparing the conditions and the economically relevant circumstances of the related party transaction as accurately delineated with the conditions and the economically relevant circumstances of comparable transactions between independent parties. These economically relevant circumstances are referred to in OECD's five-step process used to delineate a transaction.

Upon completion of the comparability analysis, companies should then identify the most appropriate TP method and tested party for the arm's length analysis. Once identified, the selected TP method is applied on the data of comparable independent party transactions to arrive at the arm's length result.

KEY OBSERVATIONS

OECD and IRAS have laid out different approaches in applying the arm's length principle on related party transactions, with OECD being notably more explicit in articulating the control and financial capacity requirement in the allocation of risk.

However, there are also similarities between the two approaches. Importantly, OECD and IRAS share the same objective, that is, to ensure the transfer price between related parties is similar to that between two independent parties in accordance with the arm's length principle.

TP Methods

Both the OECD's and IRAS' TPGs endorse the use of the following five TP methods:

TRADITIONAL TRANSACTION METHODS

i. Comparable Uncontrolled Price (CUP) Method
ii. Resale Price Method
iii. Cost-Plus Method

TRANSACTIONAL PROFIT METHODS

iv. Transactional Net Margin Method (TNMM)
v. Transactional Profit Split Method

OECD recommends that companies find the most appropriate TP method for each case based on the strengths and weaknesses of each method in view of the nature of the specific transaction, as well as the availability of reliable information needed to apply the selected method.

Traditional transaction methods are generally regarded by OECD as the most direct means of establishing whether conditions in the commercial and financial relations between associated enterprises are at arm's length. Where they can be applied in an equally reliable manner, OECD generally prefers traditional transaction methods to transactional profit methods.

IRAS' stance on TP methods is fairly consistent to that of the OECD's. Depending on the specific scenario and facts, the method that produces the most reliable results, taking into account the quality of available data and the degree of accuracy of adjustments, should be applied. As traditional transaction methods provide for a more direct comparison with independent party transactions, IRAS would generally prefer traditional transaction methods to transactional profit methods.

TP Documentation Requirements

OECD

OECD recommends a three-tiered structure consisting of:

i. a master file containing standardised information relevant for all multinational enterprise (MNE) group members;

ii. a local file referring specifically to material transactions of the local taxpayer; and

iii. a Country-by-Country (CbC) Report containing certain information relating to the global allocation of the MNE group's income and taxes paid together with certain indicators of the location of economic activity within the MNE group.

SINGAPORE

In Singapore, companies are required to prepare TP documentation under Section 34F of the Income Tax Act if their gross revenue derived from their trade or business for the basis period exceeds S$10 million, or if they were required to prepare TP documentation in the previous basis period, unless exemption applies.

Singapore-headquartered MNEs are also required to prepare and file a CbC Report to IRAS if they meet all of the following conditions:

i. The ultimate parent entity of the MNE group is tax resident in Singapore;

ii. Consolidated group revenue for the MNE group in the preceding financial year is at least S$1,125 million; and

iii. The MNE group has subsidiaries or operations in at least one foreign jurisdiction.

KEY OBSERVATIONS

Instead of having a separate master file and local file, Singapore's TP documentation consists of information both at the group level (to provide a good overview of the group's businesses that is relevant to the business operations in Singapore) and the entity level (to provide details of the Singapore taxpayer's business and its related party transactions).

For the CbC reporting requirement, only the ultimate parent entity of a Singapore MNE group is required to file the CbC Report in Singapore. A Singapore constituent entity of a foreign MNE group is not required to notify IRAS of the foreign reporting entity that will be filing a CbC Report in the foreign jurisdiction.

Intangibles

To determine whether an entity has economic ownership of an intangible asset, OECD introduced the concept of "DEMPE" functions.

Essentially, DEMPE is designed to allocate the returns to the entities within the MNE group for the functions performed, assets used and risks assumed in the development, enhancement, maintenance, protection and exploitation of intangibles.

Intra-Group Services

There are mainly two key issues in the analysis of TP for intra-group services – whether the intra-group services have in fact been provided, and if so, what the intra-group charge for such services should be in accordance with the arm's length principle.

Both OECD and IRAS recommend the use of the "benefits test" to determine whether intra-group services have been rendered. To be considered an intra-group service, an activity should be one which an independent enterprise would have been willing to pay or perform for itself. In practice, this is a major dispute area as different tax authorities have different interpretations as to whether certain activities would qualify as intra-group services.

After establishing that intra-group services have been rendered, the appropriate charge for the service should be determined based on the arm's length principle. When performing the comparability analysis for intra-group services, it is important to consider both from the perspective of the service provider and the perspective of the recipient.

Financial Transactions

One of the key issues regarding related party financial transactions is whether a purported loan should be regarded as a loan (instead of a contribution to equity capital). In accurately delineating an advance of funds, economically relevant characteristics (such as the presence or absence of a fixed repayment date; the obligation to pay interest; the right to enforce payment of principal and interest, and the ability of the recipient of the funds to obtain loans from unrelated lending institutions) may be useful indicators.

Overall, the fundamental principles articulated in OECD's and IRAS' TPGs are largely aligned, and any differences are mostly administrative or procedural in nature. Where Singapore taxpayers require more guidance on a specific TP area that is not explicitly covered in IRAS' TPG, it would be useful to also refer to OECD's TPG.

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