Technical Group Discussion

Navigating the Transfer Pricing Battlefield

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Transfer pricing (TP) refers to the determination of prices at which goods, services and intangible properties are transacted between related parties within a Multinational Enterprise (MNE). In this aspect, Singapore, similar to most of the countries globally, follows the Arm's Length Principle (ALP) that is documented in the Organisation for Economic Co-operation (OECD) Model Tax Convention.

Participants listened attentively as Mr Alan Ross shared insights on navigating through the complexities of Transfer Pricing.

The ALP basically requires a transaction with a related party to be made, under comparable conditions and circumstances, on the same terms as a transaction with an independent party or between two independent parties. Singapore released its TP Guidelines in February 2006 and these guidelines are similar to the guidance provided in the OECD Transfer Pricing Guidelines for Multinational Corporations and Tax Administrations (Guidelines) on the applicability of the ALP.

As part of the Singapore Institute of Accredited Tax Professionals (SIATP)'s continual efforts in promoting tax excellence, a technical discussion on TP complexities and practical approaches that companies could adopt to manage their TP policies was organised and facilitated by Alan Ross, Head of Tax, and Falgun Thakkar, Senior Manager, at PwC Singapore.

A Must...A Global TP Policy
In managing this complex global issue, MNEs should have an appropriate TP Policy for its intra-group transactions and such policy should be consistent and aligned with the business model of the entity. In other words, the TP Policy cannot be determined by an entity in isolation from the business realities of the entity.

A good starting point in planning the TP Policy is to have clearly-defined contracts between the various group entities that reflect the allocation of risks and responsibilities among these entities. However, the contract must be adhered to in reality such that the actual conduct of the related parties mirrors what is stated in the contract.

Key Components in TP Documentation
Besides having a clear and workable contract, a global TP policy is usually effective only if there is also appropriate TP documentation. “Best practice” documentation typically covers four inter-related areas – industry analysis, an overview of the company concerned, an analysis of the company’s functions, assets and risks in relation to the transaction in question and an economic analysis (that is, proving that the intra-group transactions meet the ALP). While these may seem simple, documenting these can be a challenge in reality.

Industry Analysis
Information such as the market size, key industry trends, competition, industry outlook, profit cycles and value drivers should be included. These set the foundation for the other aspects of the TP documentation.

Determining an industry’s value driver may be a challenge. For example, new mobile devices appear every six months, and the components within these are updated accordingly. The semi-conductor industry which produces the chips in these components needs to keep up. One could thus argue that the value driver in this industry would be their research and development (R&D) capability rather than any other functions.

Determining the industry’s value driver is important as this can then be correlated and compared with the MNE’s own value drivers. The value drivers help in determining the appropriate allocation of profits within the MNE such that the entity owning the functions, assets and risks relating to the value drivers would generally get the higher returns.

Company Overview
Besides an industry analysis, an overview of the company comprising the following information, *inter alia*, is important:

- Organisational chart;
- Financial statements;
- Business strategy and value drivers and TP policy etc.

Functional Analysis
Companies should document their functional profile which includes the functions, assets and risks of the companies relating to the transaction in question. This is quite important as it helps in determining the functional characterisation of various entities involved in the transaction.

Economic Analysis
The next step would be to determine the most appropriate TP methodology to prove the arm’s length nature of the inter-company transaction in question.

There are various methods under the OECD Guidelines (that is, comparable uncontrolled price method, cost plus method, resale price method, profit split method, transactional net margin method (TNMM)) which are used to prove the arm's length nature of the inter-company transaction. The most common method that is used at present is the TNMM.

Under the TNMM, the next step would be to determine the "tested party". This refers to the least complex party in the transaction; it has the least amount of risk associated with it or has no intangibles or unique assets. The profitability can then be easily determined and compared with other similar entities in the industry for benchmarking purposes. The benchmarking would typically result in a range of comparable prices/margins that would form the arm's length range.

Putting it altogether, these four areas, can enable MNE to explain the arm's length nature of their inter-company transaction should they be queried by the tax authorities.

Best Practice Documentation

In conclusion, best practice documentation in substantiating the TP for intra-group transactions starts with clearly defined legal agreements, supplemented by TP documentation at the local and headquarters level. It is important to document key business decisions and commercial rationale relevant to the transaction in question.

In addition to the above, if the MNE has undergone a business restructuring, it should also document the implementation of such business restructuring in the context (which has also resulted in tax efficiencies due to movement of functions, assets and risks) in accordance with the OECD Guidelines Chapter IX. The documentation should record and reflect the commercial rationale for the business restructuring and other TP= related factors.

Overarching everything, the pricing model should be aligned and consistent with the business model. In order to prove that the restructured business model is appropriately implemented, MNEs need to document what it was before and after "restructuring" and whether the business model implemented after the "restructuring" is similar to what was planned.

Challenges Ahead

While there are ways to manage TP risks, such as using dispute resolution avenues available under domestic laws and various tax treaties including the Mutual Agreement Procedures and Advance Pricing Arrangements, various developments in TP will ensure that it continues to be on the radar of many C-suites.

It is also interesting to note that following this seminar, there have been developments relating to TP. OECD has come up with two important developments that could potentially have an impact on the way MNCs prepare TP documentation.

The first development relates to the issuance of comprehensive action plan (CAP) by OECD on the base erosion and profit shifting (BEPS) matter. Part of CAP comprises the OECD plans to develop documentation rules that will require MNEs to provide all relevant governments with information regarding global allocation of income, economic activity, and taxes, according to a common template. The OECD published its White Paper on Transfer Pricing Documentation as part of the ongoing workstream on transfer pricing simplification and following the inclusion of the matter in CAP. This paper is open for public consultation till 1 October 2013. However, this affirms that TP should continue to be on the radar of many C-Suites.

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About SIATP's Technical Discussions

SIATP's technical discussions have continually been very well received by accredited tax professionals. Unlike the run-of-mill Continuing Professional Educational courses which typically cover tax fundamentals, SIATP's interactive technical discussions are designed to cover tax issues that do not have clear-cut solutions or situations that may have different interpretations. Over time, these discussions contribute in boosting the overall tax standards in Singapore.

About Mr Alan Ross

Mr Alan Ross
SIATP Board Member
PricewaterhouseCoopers Singapore (PwC)
Accredited Tax Advisor (Income Tax)
T: +65 6236 7578
E: alan.ross@sg.pwc.com

With over 30 years of experience, Alan is Head of Tax, Singapore as well as the Asia Pacific Value Chain Transformation Tax Leader at PwC. Prior to his transfer to Singapore in January 2011, Alan was partner in charge of PwC Canada's Global Structuring practice where he was responsible for the firm's services across International Tax, Transfer Pricing, Mergers and Acquisitions and Indirect Tax.

A seasoned international tax advisor with extensive experience in both consultancy and industry, Alan has first-hand experience of the many transfer pricing and practical issues associated with a multinationals.

About Mr Falgun D Thakkar

Mr Falgun D Thakkar, Senior Manager
PricewaterhouseCoopers Singapore (PwC)
Accredited Tax Practitioner (Income Tax)
T: +65 6236 7254
E: falgun.d.thakkar@sg.pwc.com

Falgun is a key member of the Tax Controversy and Dispute Resolution team within PwC and has been involved in advising and assisting multinational companies with cross border Mutual Agreement Procedures and Advance Pricing Arrangements.

With more than nine years of experience in Transfer Pricing, Falgun possesses extensive experience in advising multinational companies with their transfer pricing documentation requirements, planning and defending their transfer pricing arrangements as well as optimising the effective tax rate with value chain transformation.

This technical event commentary is written by SIATP's Senior Manager, Joanna Wong.