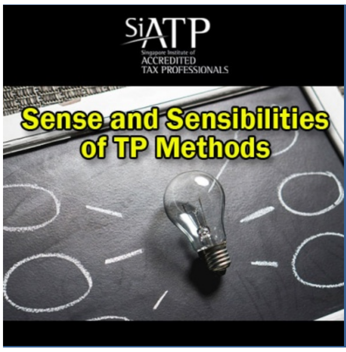

Sense and Sensibilities of TP Methods

Comprehend the various transfer pricing methods and their application

28 August 2017, Monday

Facilitated by:
Ms Adriana Calderon

As tax authorities around the world continue to focus on transfer pricing (TP), companies must stand ready to defend their TP positions to avoid potential adjustments or penalties arising from TP audits. Maintaining adequate contemporaneous TP documentation is often the key.

Transfer Pricing Documentation

In Singapore, the Income Tax (Amendment) Bill 2017 introduced a new Section 34F to legislate the requirement for applicable Singapore taxpayers to maintain contemporaneous TP documentation starting from Year of Assessment 2019.

A typical TP document comprises the company and industry analyses, the functional analysis and characterisation of entities, and the economic and benchmarking analyses. The selection of an appropriate TP method, which is the focus of this article, is the precursor to reliable economic and benchmarking analyses.

Overview of Transfer Pricing Methods

The Organisation for Economic Co-operation and Development (OECD) suggests that the most appropriate TP method should be applied when selecting a method to test any particular transaction. Likewise in Singapore, the Inland Revenue Authority of Singapore (IRAS)'s TP Guidelines clarifies that it does not have a specific preference for any one TP method. Instead, 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 selected.

In selecting the most appropriate TP method, it is essential to consider the strengths and weaknesses of each method, the nature of the transaction (such as distribution, services, manufacturing, intercompany loans or royalties), the availability of reliable data, and the degree of comparability between the transactions.

"To apply any particular method, the key is the reliability and quality of data," shared Adriana Calderon, Director, Transfer Pricing Solutions Asia, during a *Tax Excellence Decoded* (TED) session organised by the Singapore Institute of Accredited Tax Professionals (SIATP). "There must be reliable and comparable data to support the methodology."

Adriana Calderon, Director, Transfer Pricing Solutions Asia, shared an overview of the various TP methods and the key considerations when applying them.

Arm's Length Methodologies

There are generally five internationally accepted TP methods. They can be categorised into the traditional transaction methods and the transactional profit methods.

The traditional transaction methods, which comprise the comparable uncontrolled price (CUP) method, the resale price (RP) method and the cost plus (CP) method, compare the price or margins of related party transactions with the prices or margins of transactions between independent parties. The transactional profit methods, comprising the profit split (PS) method and the transactional net margin method (TNMM), compare the profit arising from related party transactions with the profit generated in transactions between independent parties.

While the traditional transaction methods are generally more precise than transactional profit methods, they may not always be practicable due to the insufficiency of reliable data, uniqueness of product or service, or complexity of the business situation.

Where the traditional transaction methods or the transactional profit methods are equally reliable, the traditional transaction methods are generally preferred.

Comparable Uncontrolled Price Method

The CUP method compares the price for properties or services transferred in a related party transaction to the price charged for properties or services in an independent party transaction in comparable circumstances. There are two ways of applying the CUP method – the internal CUP, which is a transaction between the tested party and an independent party, and the external CUP, which is a transaction between two independent parties.

Adriana Calderon, Director, Transfer Pricing Solutions Asia, also discussed the application of TP methods for services, distribution and intercompany loans through various case studies.

The CUP method is the most direct and reliable way to determine the arm's length price. However, it requires a high level of comparability for it to be reliable, such that there must be a high degree of similarity between the product (in terms of product type, specifications, ingredients or components), contract terms (for example, volume discounts), as well as the economic and market conditions. Where material differences that could affect the price exist, reasonably accurate adjustments must be made for the CUP method to remain relevant.

The CUP method is commonly applied in intercompany loans, as well as transactions involving intellectual property and royalties.

Resale Price Method

The RP method seeks to establish the price at which a product purchased from a related party is resold to a third party. Essentially, it seeks to value the function performed by the reseller of the product and establish the margin. The RP to the independent party is reduced by a comparable gross margin (or the RP margin) to arrive at the arm's length price of the product transferred between the related parties.

The RP margin should allow the reseller to not only recover its selling and operating costs, but to also earn a reasonable profit based on its functions performed, assets used and risks assumed (FAR).

The RP method is most appropriately applied in circumstances where the reseller or distributor adds little value (for example, performing marketing and sales related activities instead of complicated processing), or where the resale of product is realised in a short period of time after acquisition. Available data of comparable companies at the gross margin level also determines whether the RP method may be reliably used. The main limitation of this method is the reliability of the classification between the cost of goods sold and operating expenses when using external data.

Cost Plus Method

The CP method seeks to value the functions performed by the supplier of the properties or services. Essentially, it requires the estimation of an arm's length consideration by adding an appropriate profit mark-up to the costs of the supplier of goods or services (cost base).

The profit mark-up is ideally determined by reference to a profit mark-up earned by the same supplier in a comparable dealing with an independent party (internal CP). It can also be based on the mark-up applied in transactions between independent parties (external CP).

In applying the CP method, direct and indirect costs of producing a good or providing a service are used to compute the cost base. Operating expenses (such as marketing expenses) are not included in the cost base.

The CP method is common in low-risk routine-like activities such as manufacturing transactions. It is particularly applicable in cases of semi-finished goods sold between related parties and in the provision of services.

Profit Split Method

The PS method is based on the concept of splitting the combined profits of a transaction between related parties in a similar way as how independent parties would under comparable circumstances, and is the only method that tests both sides of a transaction (that is, a two-sided method).

One distinct advantage of the PS method is that it provides the means to allocate profit to the entities involved for all their respective routine and non-routine contributions in the absence of market or comparables data to apply other methods. It is especially useful when either one or both parties to a transaction have developed unique and valuable intangible property that contributes to the total profitability of a transaction, or when controlled transactions cannot be separately analysed due to a high level of integration.

Adriana Calderon, Director, Transfer Pricing Solutions Asia, also shared insights on how to determine and apply the most appropriate method rule.

There are two approaches in applying the PS method, either by contribution analysis or residual analysis. In a contribution analysis, the combined profits earned are divided based on the parties' relative contributions (or the relative value of functions performed) to earning that profit. This is determined by conducting a functional analysis.

Unlike the contribution analysis, the residual analysis divides the combined profits earned in two stages. Each party would first identify and allocate an arm's length return to their respective routine contributions (for example, manufacturing and distribution) by carrying out a benchmarking exercise using comparable data. Any residual profit remaining would then be allocated between the parties based on their relative unique contributions (for example, the ownership of intangibles).

Transactional Net Margin Method

The TNMM compares the net profit earned by a taxpayer from a related party transaction with the net profit earned by independent parties in a comparable transaction. The TNMM requires the selection of a net profit ratio, also known as profit level indicator.

The key with the TNMM is to choose an appropriate profit level indicator, depending on the facts and circumstances of the transaction. Some examples of profit level indicators are operating margin, net cost plus, return on operating assets and berry ratio.

Similar to the RP and CP methods, the TNMM is typically applied to only one of the parties involved in the transaction. This similarity means that the TNMM requires a level of functional comparability in relation to the tested party and the comparable entities (although to a lesser extent).

As each TP method has its strengths and weaknesses, it is important for companies to justify their selection of the appropriate method given the specific facts and circumstances. Once an appropriate method is selected, it is recommended that the method remains unchanged (unless there are substantial business changes which may warrant a review) as frequent changes in the TP method may trigger tax audits.

Whichever TP method the company chooses, contemporaneous TP documentation must be maintained to demonstrate that the arm's length principle is complied with at all times.

Please click here to rate this article.

Facilitator

Ms Adriana Calderon
Director
Transfer Pricing Solutions Asia

This technical event commentary is written by Felix Wong, Head of Tax, and Angelina Tan, Technical Specialist, SIATP. This article is based on SIATP's Tax Excellence Decoded session facilitated by Adriana Calderon, Director, Transfer Pricing Solutions Asia.

For more tax insights, please visit www.siatp.org.sg.