Don’t Trip Over Transfer Pricing Risks

Understanding The Key Risk Areas In Transfer Pricing

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The transfer pricing (TP) landscape has evolved significantly in the last decade. Multinational enterprises (MNEs) have the unenviable task of ensuring that the TP compliance requirements in each of their countries of operations are met. The evolving TP landscape, coupled with the enhanced transparency and active exchange of information between tax authorities, further add to companies’ challenges in managing their TP risks. Until the dust is settled, companies must remain vigilant and keep updated on the latest developments to minimise their TP risks.

TP Compliance

Broadly, there are mainly three sets of TP compliance requirements that MNEs should pay attention to – tax return forms, Country by Country (CbC) reporting and TP documentation. Tax return forms are used by tax authorities to gather basic information on related party transactions; CbC reporting provides information about the global business, and TP documentation (which comprises master file, local file, and any other local documentation requirements) demonstrates that such related party transactions are conducted at arm’s length.

“It is vital for companies to ensure that information disclosed in their tax return forms and TP documentation in each country is consistent,” highlighted Adriana Calderon, Director, Transfer Pricing Solutions Asia, at the recent *Tax Excellence Decoded* (TED) session organised by the Singapore Institute of Accredited Tax Professionals (SIATP). “Instead of handling each compliance requirement in silos, companies should consider managing their TP compliance requirement as a group to reduce the risk of contradictory disclosures.”

Managing Common Driver of TP Risks

Risk of Mismatch between Profit and Value Contribution

One controversial TP area that tax authorities often focus on is whether the profit attribution reflects the value contribution and characterisation of each company. It is thus critical to understand the functions, assets and risks to determine the remuneration for each company. Ultimately, an MNE group must be able to demonstrate that profits are taxed where value is created and that there is matching between substance and form.

To address tax authorities’ concern, a robust functional analysis (describing the economically-significant functions undertaken, risks assumed and assets used by related parties that entered into a transaction) should be performed to provide evidential support that the MNE’s profits are being taxed at where the value is created.

The key to a high-quality functional analysis is to have a good understanding of the business operations. To gain a more complete picture of where value is created within the MNE group, it is often advisable in practice to expand the information-gathering process beyond in-house tax and finance personnel, and reach out to key operations personnel (such as the general managers or key appointment holders of the various business units).

RISK OF UNSUPPORTED TRANSACTION PRICE

Another contentious area relates to the pricing of related party transactions. In cross-border transactions, it may be challenging to arrive at a transfer price which can satisfy both tax authorities, particularly if the two tax authorities have very different views on the appropriate TP method to determine a price.

In the absence of contemporaneous TP documentation, tax authorities would often make TP adjustments to companies' transfer prices to collect what, in their view, is the appropriate amount of tax. The risk of TP adjustments can often be reduced by performing a thorough benchmarking analysis, which uses comparable data to validate that the price of the transaction was carried out at arm's length, prior to the submission of tax returns.

A common misconception in TP benchmarking analysis is that external comparables are always the only available data to apply a TP method. However, when available, internal comparables may be more suitable as they are likely to comply with the comparability criteria required to test the price of the transaction under review. Typically, companies will start by examining if there are any existing internal arrangements where similar products or services are sold to both related and unrelated parties.

High-Risk Transactions

SERVICES TRANSACTIONS

Intra-group services transactions are one of the most challenged types of transactions in the region. It is noted that in practice, taxpayers tend to focus on determining an appropriate mark-up, but often neglect other relevant factors for services transactions, such as the "benefits test".

The "benefits test" is used to determine whether the activities performed confer a benefit to the recipient. Essentially, it boils down to whether an independent party in a similar situation would be willing to pay for such activities, and whether the benefits are identifiable and capable of being valued. If the "benefits test" is not properly addressed, tax authorities may challenge the service transaction by contending that a service has not been provided and accordingly disregard the entire service charge.

In addition to determining an appropriate mark-up using proper benchmarking analysis and addressing the "benefits test", taxpayers should also prepare an analysis of the cost base and include it in their TP documentation.

Separately, it should be noted that loss-making service companies are generally frowned upon by tax authorities, as service companies should (in theory) impute a profit on their costs. In this regard, when an intra-group transaction involves a recurrent loss-making service company, it is essential that valid explanations are provided to justify the losses and demonstrate that they are not related to the related party transactions.

Adriana Calderon, Director, Transfer Pricing Solutions Asia, shared her insights on key risk areas in transfer pricing.

INTANGIBLE TRANSACTIONS

For intangible transactions, mere legal ownership and funding of the development of an intellectual property (IP) do not establish any entitlement to the returns derived from the IP. It is recognised that multiple companies within an MNE, not just the legal owner of the IP, may have been involved in the key value functions in connection with the IP.

Practical tips in managing TP were shared through examples and various scenarios.

To be entitled to all profits from the IP, a company must perform all the key activities also known as the DEMPE functions (Development, Enhancement, Maintenance, Protection and Exploitation) and have the capacity to control the related risks. Ultimately, the profits generated from the IP should be proportionally attributed to the various companies that performed the DEMPE functions (in line with their respective contribution to the value of the IP).

It should be noted that each of the five DEMPE functions may have different degrees of contribution to the value of the IP. MNEs should thus assess the level of contribution of the different functions to the value before dividing the profits among the MNE entities.

Singapore TP Compliance Framework

TP DOCUMENTATION REQUIREMENT IN SINGAPORE

Turning our attention back to Singapore, the new Section 34F of the Income Tax Act codifies the requirement for the mandatory preparation of TP documentation from Year of Assessment (YA) 2019. Specifically, it introduces the conditions under which certain taxpayers are required to prepare TP documentation. It also introduces some exemptions to ease compliance burden. Existing TP rules before the enactment of Section 34F will continue to apply to TP documentation prepared for YA 2018 and before.

Under the new section, taxpayers are required to prepare TP documentation if the gross revenue derived from its trade or business for the basis period exceeds S$10 million, or if the taxpayer is required to prepare TP documentation for the previous basis period. In other words, preparation of TP documentation for the current basis period will be required if it was required for the last basis period. This is to ensure that taxpayers will continue to prepare TP documentation if their gross revenue temporarily drops below S$10 million.

The new section also includes two main exemptions – TP documentation is no longer required when the taxpayer's gross revenue is below S$10 million for the current basis period and the immediate two preceding basis periods, or if it is one of the special transactions specifically exempted under the Income Tax (Transfer Pricing Documentation) Rules 2018. Examples of the specified transactions qualifying for exemption from TP documentation include related party domestic transactions subject to the same tax rate, related party domestic loan where the lender is not in the business of borrowing and lending money, related party loans on which the indicative margin published by the Inland Revenue Authority of Singapore (IRAS) is applied, routine support services on which 5% cost mark-up is applied, related part transactions covered by an Advanced Pricing Agreement (APA), and related party transactions not exceeding certain thresholds.

RELATED PARTY TRANSACTION REPORTING

With effect from YA 2018, companies must submit a new "Form for Reporting of Related Party Transactions" (RPT Form) together with their Form C if the value of related party transactions in their audited accounts for the financial year exceeds S$15 million. The RPT Form will provide IRAS with greater visibility on companies' TP position and serves as a risk assessment tool for IRAS when selecting taxpayers for a risk review.

It will thus be wise for companies falling under such high-risk areas to take this opportunity to review their existing TP positions and ensure sufficient TP documentation is in place before filing their first RPT Forms this YA.

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