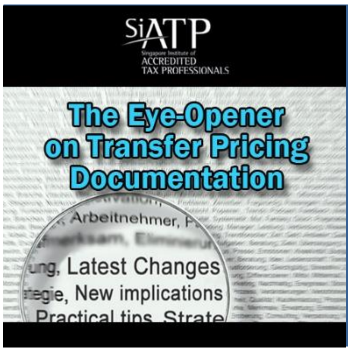

Getting Your TP Documentation Right

Practical Tips for Implementation

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In recent years, more and more countries around the world are introducing Transfer Pricing (TP) documentation requirements to their domestic legislation. Likewise in Singapore, the Income Tax (Transfer Pricing Documentation) Rules 2018 (TP Documentation Rules) were gazetted in February 2018, codifying the country's TP documentation requirements into the Income Tax Act (ITA).

"While TP documentation is now mandatory in Singapore, companies should not prepare it solely for compliance purposes," shared Adriana Calderon, Director, Transfer Pricing Solutions Asia, at a recent Tax Excellence Decoded (TED) session organised by the Singapore Institute of Accredited Tax Professionals

"TP planning is key to successfully defending a TP position. Accordingly, companies should recognise the importance of contemporaneous TP documentation, particularly in the event of a TP dispute or audit, as it provides evidential support that a taxpayer's related party transactions are in line with the arm's length principle and commercial realities. More importantly, the TP documentation exercise can be taken as an opportunity for companies to review their organisational structures and related party transactions, so as to ensure the alignment of substance and form."

There is a common misconception that the arm's length principle does not apply if a company is not required to prepare TP documentation. It should be noted that the arm's length principle applies to all companies that have entered into related party transactions, regardless of whether they are required to prepare TP documentation.

TP Documentation Requirements in Singapore

From Year of Assessment (YA) 2019 (financial year 2018), companies must prepare TP documentation under Section 34F of the ITA if the 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 exempted under the TP Documentation Rules. For example, one exemption stipulates that TP documentation is not required for a specific transaction if its total value does not exceed the stated threshold.

To illustrate, Company A, which derived gross revenue of S$12 million and service fee of S$0.5 million, is exempted from preparing TP documentation on the service transaction. This is on the basis that the service fee is within the S$1 million exemption threshold for the category "provision of services from related parties". Company A is still obliged to comply with the arm's length principle under Section 34D of the ITA.

The Inland Revenue Authority of Singapore (IRAS) recognises that the type of transactions and details of the transactions may not change significantly from year to year. Accordingly, companies are allowed to rely on previous TP documentation to support their transfer price for up to two basis periods if they comply with the specific requirements as prescribed in the IRAS' e-Tax guide on "TP Guidelines".

Companies with cross-border related party transactions should note that while a transaction may not trigger TP documentation requirement in Singapore, the same transaction may yet create a TP documentation requirement in the counterparty's home country, and hence should be examined based on the other country's TP rules.

Structure of TP Documentation

In Singapore, TP documentation generally covers group-level information, entity-level information, industry analysis, overview of the international related party transactions, functional analysis and characterisation of entities, selection of TP methods, and application of the TP methodology. The requirements for group-level and entity-level information are largely similar to the OECD's master file and local file requirements respectively. An overview of each core section is provided below.

1) GROUP-LEVEL INFORMATION

This section provides an overview of the group's businesses relevant to the Singapore company for the financial year. Specifically, a description of the group's business (such as the group's products and services and key competitors), the group's intangible assets that are used in and applied to the Singapore company, the group's financial activities and financial position, and key changes that took place within the group (such as important business restructuring, acquisition or divestitures), should be provided. In addition, Advanced Pricing Agreements that are relevant to the Singapore company should also be included.

2) ENTITY-LEVEL INFORMATION

The entity-level information provides details of the Singapore company's business and the transactions with its related parties. It includes providing a description of the role of the Singapore company within the group (for example, whether the Singapore company is an entrepreneur or a limited risk entity), the management structure showing the reporting lines, the organisational structure showing the number of employees, the products and services provided, and the financial performances of the Singapore company.

It is to be noted that companies that are consistently loss-making are generally considered to be high-risk entities by tax authorities. As such, it is vital for loss-making companies to explain and justify their losses for the financial period (for example, the losses may be due to market downturn affecting the entire industry).

Adriana Calderon, Director, Transfer Pricing Solutions Asia, shared her extensive experiences on transfer pricing documentation.

3) INDUSTRY ANALYSIS

The industry analysis provides an overview of the company's business model and the macro economic factors influencing the model, such as the characterisation of the market (whether mature, high-growth or contracting), competitors, regulatory issues, and industry trends.

It is to be noted that companies should take into context how the company is impacted when preparing the industry analysis, and avoid providing too much information that is irrelevant to the purpose of the TP documentation (for example, providing extensive industry analysis with irrelevant worldwide information or business segments).

4) OVERVIEW OF INTERNATIONAL RELATED PARTY TRANSACTIONS

This section provides an overview of the international related party transactions entered into by the company during the financial year (for example, purchases of goods, technical services and intercompany loans) and explains the way in which each price is determined and implemented.

Intercompany contracts would generally provide the basic information in describing the transactions. Companies can then couple these with a narrative of the commercial drivers of the transactions and substance. Ideally, these figures should reconcile with those reported in the "Form for Reporting of Related Party Transactions" (RPT Form) submitted to the IRAS.

Ms Calderon dispelled doubts with her wealth of knowledge on the subject.

5) FUNCTIONAL ANALYSIS AND CHARACTERISATION OF ENTITIES

The functional analysis describes the taxpayer business model that focuses on the functions, assets and risks. It identifies the economically significant functions undertaken, risks assumed and assets used by related parties that entered into a transaction, and provide evidential support that profits are being taxed at where the value is created. Accordingly, each related party that participated in the transaction is characterised (whether it is a marketing agent, limited risk distributor, etc). The functional analysis is one of the fundamental pillars of the TP documentation as it is the key to supporting the substance of a transaction.

6) SELECTION OF TP METHODS

This section documents the selection of the most appropriate TP method for the transaction, which is based on an analysis of the strengths and weaknesses of each of the five TP methods (comparable uncontrolled price method, resale price method, cost plus method, profit split method and transactional net margin method), the nature of the transaction, the availability of reliable data, and the degree of comparability between the transactions.

7) APPLICATION OF THE TP METHODOLOGY (INCLUDING ECONOMIC AND BENCHMARKING ANALYSIS)

The economic analysis, including the benchmarking analysis, provides an analysis and understanding of the price used in the transaction. It includes the choice of comparable data, the compatibility analysis, the financial analysis and calculation of the arm's length range (whether full range or interquartile range). In practice, it is generally advisable to ensure the transfer price falls within the interquartile range and is as close as possible to the median. Deviations from the median should be explained.

PROVIDING CLEAR CONCLUSIONS AND ADEQUATE EXPLANATIONS WHILE MINIMISING IRRELEVANT INFORMATION

When preparing TP documentation, it is vital to provide clear conclusions and adequate explanations. Taxpayers should also recognise that less is often more for TP documentation – a "to-the point" approach is generally preferred. Extensive documentation with no clear conclusions on key issues should be avoided.

For example, the characterisation of the related parties and the test parties should be clearly defined after conducting a functional analysis; the reasons for choosing a particular TP method and the reasons for selecting a particular set of comparable companies should be well explained and justified. On the other hand, irrelevant information (such as detailed description of a business line that is not related to the Singapore company) should be minimised.

ADDRESSING THE ISSUE OF LACK OF SUBSTANCE

Companies need to recognise that TP documentation cannot resolve the issue of lack of substance, as substance cannot be created with TP documentation. To address tax authorities' concern that there may be a mismatch between profit and value contribution, a robust functional analysis should be performed to ensure that profits are being taxed at where the value is created, and that there is matching between substance and form. It is important to understand that substance and arm's length pricing are the two key pillars of any TP analysis. Particularly, the lack of substance is the biggest TP risk for companies, one that is difficult to minimise and manage even if the taxpayer prepares TP documentation.

MANAGING OTHER TP RISKS

In the absence of TP documentation, tax authorities may make TP adjustments to companies' transfer prices to collect what they deem as the appropriate amount of tax. This risk can often be mitigated by performing a benchmarking analysis (which uses comparable data to validate that the price of the transaction was carried out at arm's length) prior to the filing of the income tax return.

When carrying out a benchmarking analysis, companies should note that local comparables are generally preferred by tax authorities over regional comparables. As such, it is advisable to use local comparables unless the company can demonstrate that no suitable local comparables can be found.

With increased transparency and sharing of information by tax authorities, the heightened scrutiny on TP is here to stay. As the new TP documentation requirements kick in this coming YA, companies that have not been preparing contemporaneous TP documentation for their related party transactions will need to act now.

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