

Financial Services Transfer Pricing Developments in Singapore

The Inland Revenue Authority of Singapore (IRAS) have recently issued a circular on transfer pricing consultation, setting out how they intend to review taxpayers' compliance with the arm's length standard. They have also provided additional guidance on advance pricing arrangements. These developments, together with their participation at a regional transfer pricing conference and the release of a draft circular on loans and services, represent a step-up by the IRAS in ensuring that taxpayers observe internationally accepted transfer pricing principles when conducting business with related parties.

Introduction

The past few months have seen a flurry of activities in the transfer pricing scene in Singapore. It began on 30 July 2008, when the IRAS issued a circular entitled *Transfer Pricing Consultation*, which sets out how they intend to conduct reviews of taxpayers' related party transactions. This was quickly followed by the first batch of questionnaires being sent to select taxpayers, requesting details of such transactions.

On 20 October 2008, the IRAS issued another circular, *Supplementary Administrative Guidance on Advance Pricing Arrangements*. Very broadly, the circular builds on the guidance provided in an earlier circular on the procedures for seeking advance pricing agreements (APA) and spells out certain important time limits which taxpayers should observe.

This circular was followed, on the next day, with the release of a public consultation paper on related party loans and services. The paper sets out the IRAS' views on the application of the arm's length principle to these two types of related party transactions commonly undertaken by taxpayers, on which feedback from the public is sought.

Between issuing these circulars, the IRAS participated at the regional transfer pricing conference organised by the Tax Academy of Singapore on 17 October 2008, sharing their views on transfer pricing with practitioners from the region and representatives from the Organisation for Economic Cooperation and Development (OECD) and the Australian Taxation Office.

This bulletin provides a high level commentary on these recent developments, and considers their impact on the financial services sector in Singapore. Details of the circulars can be found on the IRAS' website (www.iras.gov.sg).

Transfer pricing consultation

It should not come as a surprise to taxpayers that the IRAS should start to conduct transfer pricing reviews. It is after all two years since the Singapore transfer pricing guidelines were issued. In line with this expectation, the overall objective of the consultation is for the IRAS to assess the level of taxpayers' compliance with those guidelines.

The process begins with the IRAS sending a questionnaire to select taxpayers who have significant volume of related party transactions, requesting information on the types and values of these transactions as well as the extent of documentation maintained to support the transfer prices adopted. The IRAS will consider if a transfer pricing review ought to be undertaken on the basis of, among other things, the taxpayer's response. The review itself entails a visit to the taxpayer's premises, whereupon detailed information about the company's operations and its related party transactions will need to be made available to the IRAS.

The IRAS have not stated any quantitative criteria on what they meant by significant related party transactions. Some years ago there was a requirement for taxpayers to provide certain information on related party transactions in their tax returns. The basis of disclosure then was whether their sales/purchases with related parties exceeded 25% of total sales / purchases. The IRAS

have not said whether they are applying this criterion. We expect that taxpayers will be selected based on the quantum of related party transactions, their profit and loss profile and the responses to queries raised by the IRAS in the normal course of an assessment.

Although it has been spelled out as a consultative process, the review contains an element of field audit, through which the IRAS may make adjustment should they consider it appropriate. Therefore, taxpayers should keep sufficient documentation to demonstrate that their transactions with related parties are conducted at arm's length, so as to mitigate the risk of an audit and the IRAS making adjustments.

Additional guidance on APA

Drawing from their experience in dealing with APA applications, the IRAS have issued additional guidance for taxpayers seeking to enter into unilateral, bilateral or multi-lateral APA. The circular sets out various important timelines to observe during pre-filing, the formal APA submission and review, and when (and the period for which) roll-back may apply to bilateral or multi-lateral APA. The IRAS will not accept roll-back for unilateral APA, since the matter will be dealt as part of the assessment process. They have also spelled out the circumstances under which they will discontinue an APA discussion; for example, when the taxpayer does not keep to reasonable timelines for providing information or when complete information is not given.

Related party loans and services

The draft circular on related party loans and services provides much needed guidance for taxpayers, given that these transactions are commonly undertaken among related parties. It reiterates the need to comply with the arm's length standard, but provides certain safe harbour and transitional provisions to assist taxpayers' with implementation.

It should be noted that in relation to lending, the guidance covers both loans transactions as well as inter-company credit balances arising from normal trading activities. There are, however, certain exclusions that should be welcomed by taxpayers: the IRAS will not insist on the charging of arm's length interest for loans between two Singapore companies

and where the lender is not in the business of providing finance. Further, taxpayers who have extended cross border loans on an interest free basis are given a two-year period (starting from 1 January 2009) to restructure the loans to reflect commercial, arm's length conditions.

The draft circular spells out certain comparability features relevant to loan pricing, including the purpose of the loan, its duration and currency, availability of security, market conditions etc, as one would normally expect for such arrangements. However, it does not touch on other areas typically related to intra-group financing, e.g. guarantees or whether the amount of debt is at arm's length (although the latter might well be a thin capitalisation issue). It remains to be seen whether further guidance on these areas will be given in the future.

In practice, the IRAS have been disallowing deduction for interest expenses incurred by a person, to the extent they are referable to the giving of interest free loans. They consider this approach to be a proxy to the application of the arm's length principle, and have stated that they will continue with this approach during the transitional period. It should, however, be noted that interest deduction and the application of the arm's length principle are strictly not mutually exclusive under current law, as the former is governed by separate statutory provision and case law.

In relation to services, the draft circular provides examples of routine services and hence when it is appropriate to adopt a cost plus 5% mark-up basis of remuneration. Consistent with the approach adopted by some foreign tax authorities, it provides a list of activities for which such a basis may be applied, and formalises the current practice of the IRAS in this area. This approach essentially exempts taxpayers from having to conduct a formal study to prove the level of mark-up for the provision of a broad range of support services, although it should be noted that the safe harbour will not be available if the taxpayer provides similar services to third parties. Further, taxpayers are not precluded from adopting a different mark-up if they are able to support the charge based on a benchmarking study. Finally it has been clarified that no mark-up is required on pass-through costs.

The draft also covers cost pooling in relation to the provision of services (but not development of intangibles). The approach is broadly in line with the principles articulated by the OECD, in that the participants' share of the overall costs should be proportionate to their respective expected benefits. Again, certain safe harbour provisions are introduced: payments charged to participants in such an arrangement may be made without a mark-up if the services are considered routine in nature and are not supplied to third parties, the provision of such services is not the taxpayer's principal activity (it will not be regarded as such if the costs of providing them do not exceed 15% of the total expenses of the service provider), and there is documentation to prove the intent to share costs.

Impact on financial services sector

These developments will have significant impact on financial institutions. In particular, they emphasise the need for proper documentation to support related party transactions, as it forms a critical element of an audit defence (or in preventing an audit). It is also vital in an APA discussion as having such documentation provides the basis for supporting the IRAS' negotiations with their counterparts and facilitates the meeting of timelines by the taxpayers.

A few initial observations could be made on the draft circular for loans and services. Naturally, financial institutions will not be able to rely on the safe harbours provisions for related party transactions, as their principal activity comprises the provision of finance. Being in this business, they are expected to adopt arm's length pricing for lending to related parties. It is important for financial institutions to document the basis of pricing these transactions, to demonstrate that they are concluded on terms comparable to those transacted with third parties (or explain any material difference in circumstances, e.g. in case of quasi-equity capital injection). Finance and treasury centres engaging in leading and lagging as part of their liquidity management mandate should also be aware that the circular may apply.

Given that many financial institutions in Singapore act as a regional hub, the guidance given for services is particularly relevant. Although the draft proposes the adoption of safe harbour for routine services,

it merely removes the need to perform a detailed benchmarking to support the mark-up to be adopted for Singapore taxation. There remains a need for them to be able to properly allocate expenses to the beneficiaries of the services, both for the provision of services and in cost pooling arrangements. In that regard, financial institutions will need to demonstrate the relationship between the costs incurred (whether by direct identification or adoption of reasonable allocation keys) and the benefits enjoyed by the service recipients, in order for the latter to justify a deduction to their tax authorities. Financial institutions should also consider foreign withholding tax and value added tax considerations when introducing a profit mark-up on recharges.

Further, where a Singapore based taxpayer is being charged for services at a profit mark-up of more than 5%, it would appear difficult to justify applying the safe harbour when it provides similar services to related parties. The IRAS will likely insist on the higher mark-up for the services supplied from Singapore, since they have stated that the arm's length mark-up should be applied where available.

Conclusion

It can be seen from the above that the IRAS are seeking to ensure that Singapore taxpayers adhere to internationally accepted transfer pricing norms in their related party dealings, without introducing draconian rules that needlessly escalate tax compliance cost. No doubt, this is reflective of the need for Singapore to balance the objectives of protecting its revenue base and honouring its tax treaty obligations, with that of ensuring that its attractiveness as a financial centre is not being eroded by an uncompetitive tax regime.

Certain aspects of these transfer pricing guidelines will need to be clarified. Having said that, the package of guidance released to date, comprising the IRAS' position on the arm's length principle, the availability of APA as a dispute resolution mechanism and the safe harbour provisions for loans and services transactions contained in the draft circular, should in many ways help Singapore to achieve these goals.

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