IN A NUTSHELL

1. The arm's length principle is applied by performing the comparability analysis. There are five factors to consider in making the comparison – (1) the contractual terms; (2) the characteristics of the property transferred or services provided; (3) the functions performed by each of the parties to the transaction, taking into account assets used and risks assumed, the circumstances surrounding the transaction, and industry practices; (4) the economic circumstances of the parties and of the market; and (5) the business strategies of the parties.
2. The three steps of comparability analysis in the *IRAS TP Guidelines* is actually based on an earlier articulation (*OECD TP Guidelines 1995*) of the expanded nine-step OECD guidance (*OECD TP Guidelines 2010*) on comparability analysis and IRAS permits the nine-step approach to be used.
3. In essence, the comparability steps are
   - First seek to understand the broad economic circumstances surrounding the transaction before going into detail and understanding the controlled transaction itself by accurately delineating the transaction and performing a functional analysis;
   - After understanding the economic circumstances and the related party transaction in detail, the next step is to look for internal comparables and if there are no or insufficient internal comparables, look for external comparables.
   - Next, based on the type of transaction and the availability of comparables, determine the most appropriate transfer pricing method based on the strength and weakness of each method. In applying the TP method, the potential comparables found in the earlier step are screened to eliminate those that are not reliable and for the remaining ones, comparability adjustments may be made to improve their reliability as comparables.
   - The final list of comparables then produces the arm's length range by using a method of central tendency (median, interquartile range, etc). Any point within this range is regarded as arm's length under OECD and IRAS guidelines.
4. Practical observations
   - Transfer pricing analysis can be quite technical and this is why companies with tax teams still outsource the comparability analysis to advisors, especially the benchmarking search (see discussion in Chapter 5) in external databases for comparables. The outcome of the analysis is required to be documented in the TP documentation, especially the Entity level file (see discussion in 7-900) to show that the taxpayer has applied the arm's length principle.
   - Transfer pricing rules and the way they are applied may differ across jurisdictions, therefore, what is arm's length in Singapore would still need to be separately analysed to see if it complies with the rules in another country.

¶4-100 What to Compare

The *IRAS TP Guidelines*[1] adopts the OECD Transfer Pricing Guidelines' framework[2] of five economically relevant characteristics or comparability factors in considering whether a controlled transaction is comparable to an uncontrolled transaction. These are:

1. The contractual terms of the transaction;
2. The characteristics of the property transferred or services provided;
3. The functions performed by each of the parties to the transaction, taking into account assets used and risks assumed, including how those functions relate to the wider generation of value by the multinational enterprise ("MNE") group to which the parties belong, the circumstances surrounding the transaction, and industry practices;
4. The economic circumstances of the parties and of the market in which the parties operate; and
5. The business strategies pursued by the parties.

¶4-200 How to Compare

IRAS recommends that taxpayers adopt the following three-step approach to apply the arm's length principle in their related party transactions[3]:

Step 1 – Conduct comparability analysis

Step 2 – Identify the most appropriate transfer pricing method and tested party

Step 3 – Determine the arm's length results

This recommended three-step approach is neither mandatory nor prescriptive. A taxpayer can modify the recommended approach or adopt an alternative approach if its individual circumstances require such modifications to better arrive at the arm's length result[4].

The current *OECD TP Guidelines* (Chapter III) describes the same comparability analysis process in nine steps.

The intuition to the nine steps illustrated in the diagram below is that it goes from the macro to the micro (transactional):

First, seek a broad understanding of the economic factors and the conditions of the controlled related party transaction.

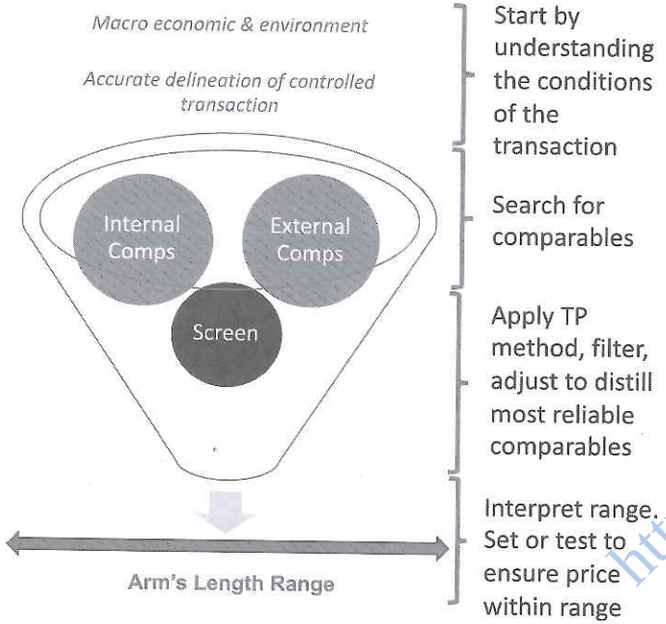
[1] Para 5.18 *IRAS TP Guidelines*. Note para 5.18 lists the first four factors and business strategies is separately discussed in 5.33, 5.39 and 5.46 of the *IRAS TP Guidelines*.
[2] Para 1.36 *OECD TP Guidelines*.
[3] Para 5.12 *IRAS TP Guidelines*.
[4] Para 5.14 *IRAS TP Guidelines*.

Second, having understood the controlled transaction in its entirety, including the functions, assets and risks of both parties, search for potential comparable data (internal and external comparables).

Third, select and apply the most appropriate method to the potential comparable data, filter/screen and adjust so as to narrow down to only reliable comparable data;

Finally, construct and interpret the arm's length range. Either set the price or test whether the price or margin is arm's length.

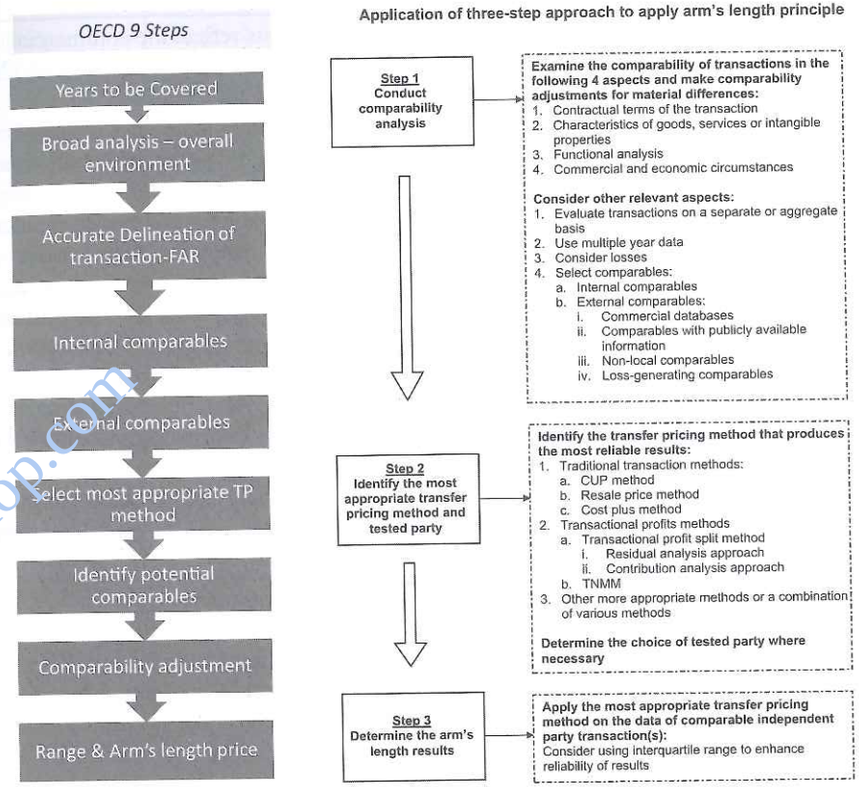
Intuition of the 9 Steps: Getting to Reliable Comparables



The 9 steps goes from macro (big picture business environment) to micro (transactional); From a broad search for data to filtering and adjusting to narrow down to only reliable comparable data

There is generally no practical difference between the three steps in the IRAS' three steps and the OECD's nine steps. The *IRAS TP Guideline*'s three steps is in essence the OECD's articulation of the comparability steps in its 1995 Edition of the *OECD TP Guidelines*, upon which the first edition of the *IRAS TP Guidelines 2006* was based. The *IRAS TP Guidelines* has since been updated in successive editions to keep pace with the OECD developments, including incorporating the concept of "accurately delineating the transaction" and risk analysis in the fifth edition but the three steps have been retained.

Equivalence between OECD's 9-steps vs IRAS' 3 steps



¶4-300 How the Five Comparability Factors Work

UNDERLYING CONCEPT

An independent enterprise will compare a potential transaction to all options that are realistically available to it. This means, for example, that an enterprise will be unlikely to accept a price offered if it knows that other customers are willing to pay more for an extra feature in its product or service. In assessing its options, the independent enterprise will take into account the economically relevant factors and differences produced by the comparability analysis using the five factors. Another way of looking at it is that had the two related parties been independent, each would want to bargain for every economically relevant factor or difference to be reflected in the price.

Factor	*Explanation*[5]
Contractual Terms of the Transaction	The terms of the intercompany agreements reflect the commercial or financial relations between the parties. These agreements provide the starting point for delineating the transaction between them and how the responsibilities, risks, and anticipated outcomes arising from their interaction were intended to be borne by each party at the time of entering into the contract. The contractual terms may be in the form of Master services or sales agreements or Master lending agreements which sets the terms for entire categories of transactions or it may take the form of specific transactional level intercompany agreements or even communications between the parties other than a written contract such as invoices. The latest OECD and IRAS guidance emphasize the need to examine the conduct of the parties beyond the written contracts as the contracts alone may not provide all the information necessary to perform a transfer pricing analysis or reflect the "true bargain" between the parties. Taken together, the analysis of economically relevant characteristics in all five categories provides evidence of the actual conduct of the associated persons.
Characteristics of the property transferred or services provided	Similarity in product characteristics is more relevant when comparing prices than profit margins between controlled and uncontrolled transactions. The traditional methods particularly Comparable Uncontrolled Method, are more sensitive to difference in product or service characteristics between controlled and uncontrolled transactions. The differences that are relevant are those with an economic impact and influence on the reliability of the comparables. For example, the delivery of machinery two weeks later may not affect the price but the delivery of traded commodities two weeks later can mean a different price altogether. Other relevant characteristics: (a) tangible property: the physical features, quality and the volume of supply of property; (b) provision of services: the nature and extent of services; and (c) intangible property: the form of transaction (eg licensing or sale), type of property (eg patent, trademark or know how), the duration and degree of protection; and the anticipated benefits from the use of property.

[5] Adapted from www.hasil.gov.my/bt_goindex.php?bt_kump=5&bt_skum=20&bt_posi=1&bt_unit=1&bt_sequ=4&bt_lgv=2.

Factor	*Explanation*
Functions performed by each of the parties in the transaction, taking into account assets used and risks assumed, including how those functions relate to the wider generation of value by the MNE group, the circumstances surrounding the transaction, and industry practices	The price or compensation between two independent persons will reflect the economically significant/value creating functions performed, the value of the assets used/contributed and risks assumed by each party in the transaction. Such functional analysis using the FAR (functions, assets and risks) framework enable the accurate delineation of the controlled transaction and determination of the comparability between controlled and uncontrolled transactions or entities. The analysis focuses on what the parties actually do, the capabilities they provide and the value they create, with a special emphasis on the allocation of risks (see 4-430 below). The structure and organization of the industry and how they influence the context in which the MNE and the comparable independent entities operate need to be examined. The value chain of the MNE and how value is generated by the group as a whole, the interdependencies of the functions performed by the associated persons with the rest of the group, and the contribution that the associated entities to value creation need to be understood and documented.
Economic circumstances of the parties and of the market in which the parties operate	Arm's length prices vary across different economic circumstances. Factors that may affect the price or margin of a transaction include: (a) the geographic location and size of the market; (b) the extent of competition in the markets; (c) government regulations such as licensing, price controls and national insurance; (d) the level of supply and demand in the market as a whole and in particular regions; (e) customer purchasing power; (f) cost of production including the costs of land, labour and capital, and transport costs; (g) the level of the market (eg retail or wholesale); (h) the date and time of transactions; (i) the availability of substitute goods and services; and (j) the extent of government intervention, eg whether goods compared are price controlled.

Factor	*Explanation*
Business strategies pursued by the parties	Business strategies adopted by an enterprise influences the price charged for a product. In a comparability analysis, it is necessary to evaluate whether an independent person in the same circumstances as that of a controlled person would have adopted similar strategies and if so, what rewards would have been expected. Business strategies that are relevant in determining comparability include innovation and new product development, degree of diversification, risk aversion, assessment of political changes, duration of arrangements, market penetration schemes, distribution channel selection, market level and location.

¶4-400 The Comparability Steps Explained

In the next few sections, the workings of the three steps in the *IRAS TP Guidelines* will be explained using the more detailed OECD 9 steps framework[6] since they are broadly equivalent.

	OECD TP Guidelines (Chapter III)	*IRAS TP Guidelines*
Identify the years to be examined	Step 1	Step 1: Conduct comparability analysis
Broad-based analysis of the taxpayer's circumstances	Step 2	
Accurate delineation of the transaction	Step 3	
Search for possible sources of comparable information	Step 4	
	Step 5	
Select the most appropriate transfer pricing method	Step 6	Step 2: Identify the most appropriate transfer pricing method and tested party
Screen & identify potential reliable comparables	Step 7	Step 3: Determine the arm's length result
Comparability adjustments to improve reliability	Step 8	
Interpretation	Step 9	

[6] Adapted from: Platform for Collaboration in Tax, "*A Toolkit for Addressing Difficulties in Accessing Comparables Data for Transfer Pricing Analyses*" (24 Jan. 2017).

¶4-410 Broad-Based Analysis of the Taxpayer's Circumstances

This step involves undertaking a broad-based analysis of the taxpayer's circumstances and may include an analysis of the industry, competition, economic and regulatory factors, and other elements that may affect the taxpayer and its environment.

It is common to refer to

- the annual report;
- industry reports, consultant/analyst reports and publications on industry, region or country trends, product cycles, supply and demand, pricing and other information;
- identifying competitors in the same industry; and
- compare competitors' activities and financial data with those of the taxpayer

¶4-420 Accurate Delineation of the Transaction

After gathering background and contextual information, the next step is to perform a detailed functional analysis with an emphasis on accurately delineating the controlled transaction.

The accurate delineation of the actual transaction between the related parties aims to find the "real deal" between the parties and requires establishing the economically relevant characteristics of the transaction. Such characteristics consist of the conditions of the transaction and the circumstances in which the transaction takes place[7] considering the five economically relevant characteristics or comparability factors described above.

Here the OECD guidance emphasizes verifying contractual terms by reference to the conduct of the parties. While a transfer pricing analysis will typically start from the related party contracts, where the substance and the form of a transaction are misaligned or inconsistent, the substance will take priority to the extent the two are misaligned. To the extent that related party contracts do not fully delineate the transaction, or they conflict with the actual conduct of the parties, the latter will prevail.

Example – Conduct that Differs from Contract[8]

Where there are material differences between the contractual terms and the actual conduct of the related parties, the actual transaction should be determined from the actual conduct.

Parent Co in Country P has a distribution agreement with its subsidiary, Sub Co, in Country S. Under the distribution agreement, Sub Co is to distribute Parent Co's

[7] Para 5.18 *IRAS TP Guidelines*.
[8] Para 5.24 *IRAS TP Guidelines*.

products and to conduct marketing activities in Country S. Based on an analysis of the other economically relevant characteristics it was determined that:

- All marketing activities are undertaken by Parent Co, ie full responsibility lies with Parent Co.
- Sub Co does not have the capability to perform marketing activities.
- Sub Co merely distributes the products without performing any marketing activities or incurring any costs relating to such activities.

Based on the actual conduct of Parent Co and Sub Co, it can be concluded that the written agreement does not reflect the actual conduct of the parties. Thus, the identification of the actual transaction between Parent Co and Sub Co should not be based solely on the written agreement but should be determined from their actual conduct.

Functional Analysis on Functions Performed, Assets Used and Risks Assumed ("FAR")

An important element of a comparability analysis is the functional analysis, which is the foundation of a transfer pricing analysis, providing information to identify all important features of a controlled transaction, including critical functions, key assets utilised and the assumption of economically significant risks (commonly referred to as functions, assets and risks or "FAR"). See example of FAR questions in 4-450 below.

¶4-430 Enhanced Risk Analysis

Following BEPS, the *OECD TP Guidelines* was revised to emphasize the assumption of risks to be a crucial part of the functional analysis and the process of delineating a transaction[9]. The key point is that assumption of greater risks carries the expectation of greater profits. Any contractual assumption of risk must be borne out by the conduct of the parties and in the substance of the transaction.

As set out in the *OECD Transfer Pricing Guidelines* (at paragraph 1.60) a detailed analysis of risks is performed with the following steps:

1. Identification of specific, economically significant risks;
2. Determination of how the specific, economically significant risks have been contractually assumed;
3. Gather information on the conduct of the parties, ie how the associated enterprises that are parties to the transaction operate in relation to assumption and management of the specific, economically significant risks, and, in particular, which enterprise or

[9] Para 1.71 of the *OECD TP Guidelines*, which defines risk as the effect of uncertainty on the objectives of the business.

enterprises perform control functions and risk mitigation functions; encounter upside or downside consequences of risk outcomes (eg greater or lower than anticipated revenues or costs); and have the financial capacity to assume the risk;

4. Interpretation of Steps 1–3
   (i) The determination of whether the contractual assumption of risk is consistent with the conduct of the associated enterprises (ie whether the associated enterprises follow the contractual terms);
   (ii) The determination of whether the party assuming the risk [as determined in 4(i)] exercises control over the risk and has the financial capacity to assume the risk based on the information gathered in Step 3. If so, this party is regarded as assuming the risk and Step 5 need not be considered;
5. If the party assuming risk does not control the risk or does not have the financial capacity to assume the risk, allocate the risk to the party that does control it and has the financial capacity to assume it; and
6. Pricing the transaction, taking into account the outcomes of the risk allocation.

Step 1 **Identifying Economically Significant Risks With Specificity**	Economically significant risks are assessed in terms of likelihood and size of the potential profits or losses arising from the risk Non-exhaustive list of risks: • Strategic / marketplace risk • Infrastructure / operational risk • Financial risk • Transactional risks • Hazard risks Determining the economic significance of risk and how risk may affect the pricing of a transaction between associated enterprises is part of the broader functional analysis of how value is created by the MNE group, the activities that allow the MNE group to sustain profits, and the economically relevant characteristics of the transaction.
Step 2 **Contractual Assumption of Risk**	Starting point for transfer pricing analysis is the contractual terms as intended by the parties[10]. Where there is no written contractual agreement between the related parties, all aspects of the arrangement would need to be deduced from available evidence of the actual conduct of the parties. This includes the functions that are actually performed, the assets that are actually used or contributed and the risks actually assumed by the parties[11].

[10] Para 5.20 *IRAS TP Guidelines*.
[11] Para 5.25 *IRAS TP Guidelines*.

	Identify implicit and explicit assumptions of risks in intragroup contracts Contractual assumption of risks as an *ex ante* agreement to bear some or all of the potential costs associated with the *ex post* materialization outcomes of risk in return for some or all of the potential benefit associated with the *ex post* materialization of positive outcomes.
Step 3 **Functional Analysis in Relation to Risk**	It aims at identifying which enterprises: i. control the risks ii. assumes the risks iii. have the financial capacity to assume the risk Control over and management of risk[12] is evidenced by: • capability to make decisions to take on, lay off, or decline a risk-bearing opportunity, together with the actual performance of that decision-making function; • capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision-making function; and • capability to take measures that affect risk outcomes, together with the actual performance of such risk mitigation Risk assumption means: • Bearing the upside and downside financial (and other) consequences of the materialization of the risk Financial capacity to assume the risk is manifested by: • Access to funding to take on the risk or to lay off the risk, to pay for risk mitigation functions and to bear the consequences of the risk. See further discussion below*
Step 4 **Determination of Whether The Assumption of Risks Is Consistent With the Parties' Conduct**	• Analysing whether the associated enterprises follow the contractual terms (their actual conduct is the best evidence in relation to the assumption of risk) • Analysing whether the party assuming the risk, exercises control over the risk (understood as both capability and actual performance) and has the financial capacity to assume risk

[12] Footnote 6 to *IRAS TP Guidelines*, citing *OECD Transfer Pricing Guidelines* (ie revisions to Section D of Chapter I in the Actions 8-10: 2015 Final Reports on Aligning Transfer Pricing Outcomes with Value Creation).

Step 5 **Allocation of Risk**	• Allocation of risk to the enterprise exercising control and having the financial capacity to assume the risk (when the enterprise assuming the risk (based on steps 1–4) does not exercise control over risk or does not have the financial capacity to assume the risk) • In case of multiple associated enterprises both controlling risks and having financial capacity to assume the risk, allocation of risk to the one exercising the most control • An assessment of the commercial rationality may be necessary in exceptional circumstances (eg where no enterprise possesses both control and financial capacity) **Non-recognition** (see discussion in 3-300 above): *OECD TP Guidelines*[13] and Section 34D(1C) of the ITA allows, in specific circumstances, for a transaction to be disregarded. The effect of disregarding a transaction is that the taxable profit of the enterprise involved is adjusted to what it would have been if the transaction had not occurred at all, or, if appropriate, adjusted to what it would have been if the transaction had been structured in a commercially rational manner. However, every effort should be made to determine pricing for the actual transaction as accurately delineated under the arm's length principle.
Step 6 **Pricing The Transaction, Taking Into Account The Outcomes of the Risk Allocation**	After accurately delineating the transaction above, including allocating the assumption of risks, the pricing of the actual transaction should take into account the financial and other consequences of risk assumption and the remuneration for risk management. A taxpayer who assumes a risk is entitled to the upside benefits and incurs the downside costs. A taxpayer who assumes and mitigates the risk will be entitled to a greater remuneration than a taxpayer who only assumes or only mitigates the risk and does not do both.[14]

Details on How to Analyse Control and Financial Capacity to Bear Risk

To assume a risk for transfer pricing purposes, the taxpayer needs to control the risk and have the financial capacity to assume the risk[15].

1. Financial Capacity to Bear Risk[16]
   – The capacity to "access to funding to take on the risk or to lay off the risk, to pay for the risk mitigation functions and to bear the consequences of the risk if the risk materialises".

[13] Para 1.122 *OECD TP Guidelines*.
[14] Para 5.35(b) *IRAS TP Guidelines*.
[15] Para 5.35(c) *IRAS TP Guidelines*.
[16] Para 1.64; 9.29 *OECD TP Guidelines*.

2. How is this Capacity Assessed?
   - On the basis of "the available assets and the options realistically available to access additional liquidity, if needed, to cover the costs anticipated to arise should the risk materialises. This assessment should be made on the basis that the party assuming the risk is operating as an unrelated party in the same circumstances as the associated enterprise, as accurately delineated under the principles of this section".

Example of the Reasoning Process[17]

If taxpayer claims that it assumes credit risk when customers default on payments, it would need to demonstrate that it has:
- The financial capacity to assume the risk (such as availability of credit lines from banks),
- The capability and authority to decide to take on, lay off or decline the risk (such as whether or not to sell the product to the customer or whether or not to sell on credit to customer), and
- The capability and authority to decide whether and how to respond to the risk (such as taking legal action to recover the debt).

A Taxpayer may outsource its day-to-day mitigation activities, such as credit risk analysis. However, it has to demonstrate that it has the capability to determine the objective of outsourcing the credit risk analysis, who it wants to hire to perform the credit risk analysis, etc.

If taxpayer claims that it assumes inventory obsolescence risk, it would need to demonstrate that it has:
- The financial capacity to assume the risk,
- The capability and authority to decide to take on, lay off or decline the risk (such as whether or not to sell a slow moving product), and
- The capability and authority to decide whether and how to respond to the risk (such as conducting marketing campaign to boost ailing sales or employing a diversification strategy).

¶4-440 Wholistic, Two-Sided Consideration of Functions, Assets and Risks ('FAR')

The emphasis on risk notwithstanding, all five economically relevant characteristics, such as those relating to the property or services transferred and the economic circumstances of the parties and of the market in which the parties operate should also be considered in terms of their possible impact on the reliability of potential comparables.

[17] Adapted from para 5.35 *IRAS TP Guidelines*.

For example, if the transfer pricing analysis shows that the transaction is for the sale of a product or services which have a truly global market, the geographic location of potential comparables may not be a significant factor to be taken into account. Conversely, if a related party loan is between parties in developing countries and the potential comparables involve borrowers from advanced economies, an adjustment for the increased sovereign risk may be appropriate.

The functional analysis must be performed for both parties to the transactions even for the one-sided transfer pricing methods – Resale Price, Cost Plus and Transactional Net Margin, without which it will not be possible to fully understand, accurately delineate the transaction and pick the tested party (see discussion in 4-400).

Functional Analysis (FAR) Points to Where Value Is Added and Which Party Deserves Compensation or A Share of Profits

In essence, the level of return derived by a taxpayer should be directly correlated to the FAR[18] contribution to value creation. For instance, a party performing key revenue generating functions such as sales or engineering services should get a higher compensation than another party reforming a routine support service; a party selling a product with warranty (ie taking on product defects risk) should earn a higher return compared to another party selling the same product without the warranty. Likewise, a party contributing a valuable asset such as a reputable brand trademark that enables the product to sell at a premium should be compensated at arm's length for the value created by this additional asset in enhancing the product.

¶4-450 Example of Functional Analysis Questions

The following example is adapted from U.S. IRS Exhibit 4.61.3–4 (05-01-2006)[19]

Transfer Pricing Functional Analysis Questionnaire

For guidance in performing a functional analysis of a business this questionnaire sets out a list of generic questions that might be used to gain an understanding of the various functions, risks, and intangibles. The list is not intended to be exhaustive and should be tailored to suit the needs of the specific business entity being reviewed. Note that the portion on risk analysis has to follow the enhanced 6 Steps OECD Risk Analysis guidance (see 4-430 above) that has also been adopted in the *IRAS TP Guidelines*.

[18] Para 5.36 *IRAS TP Guidelines*.
[19] Source: IRS (2006), available at www.irs.gov/irm/part4/irm_04-061-003.html#d0e2784.

ANALYSIS OF FUNCTIONS

I. Manufacturing

A. Materials Purchasing

1. What materials or partly finished goods are purchased?
2. From whom are purchases made?
3. Are any purchases made from related companies?
4. Where and how are raw materials purchases?
5. Who performs the purchasing function?
6. Who plans purchasing schedules?
7. Who negotiates purchasing arrangements?
8. Who approves the vendor as being of acceptable quality?
9. Do purchasing decisions require head office approval?
10. What are the other approvals required? Who makes these approvals?
11. Are any purchases made on consignment?
12. What are your major risks?

B. Inventory

1. Where is inventory held?
2. Who controls the levels of inventory?
3. How are inventory levels controlled?
4. Is there a computer system?
5. Are any purchases made on consignment?
6. How many days of inventory are on hand?
7. Has there ever been a case, for whatever reason, where you were stuck with excess inventory?
8. Who bears the cost of obsolete inventory?
9. What are your major risks?

C. Production Equipment

1. Who determines the purchasing budget?
2. Who negotiates purchasing?
3. Who maintains the plant?
4. Who has expenditure authority for capital equipment?
5. Who writes specifications for the plant?

6. From whom is production equipment purchased?
7. Are any purchases made from related companies?
8. Do you have discretion over the equipment used?
9. Can you modify the equipment?
10. What decisions require head office approval?
11. What are the approvals required?

D. Production Scheduling

1. Who is responsible for production scheduling decisions?
2. What factors enter the decisions?
3. When are the decisions made?
4. Is a computer system used?
5. What decisions require head office approval?
6. What are the approvals required?
7. What are your major risks?
8. Does your distributor buy everything you manufacture?

E. Manufacturing and Process Engineering

1. What products are produced?
2. Who designed the products and who owns the technology?
3. What is the manufacturing process?
4. Who developed the original process?
5. Have any improvements been made locally?
6. Is it possible to compare productivity between the subsidiaries in the group?
7. Have you ever utilised a third party to produce your products?

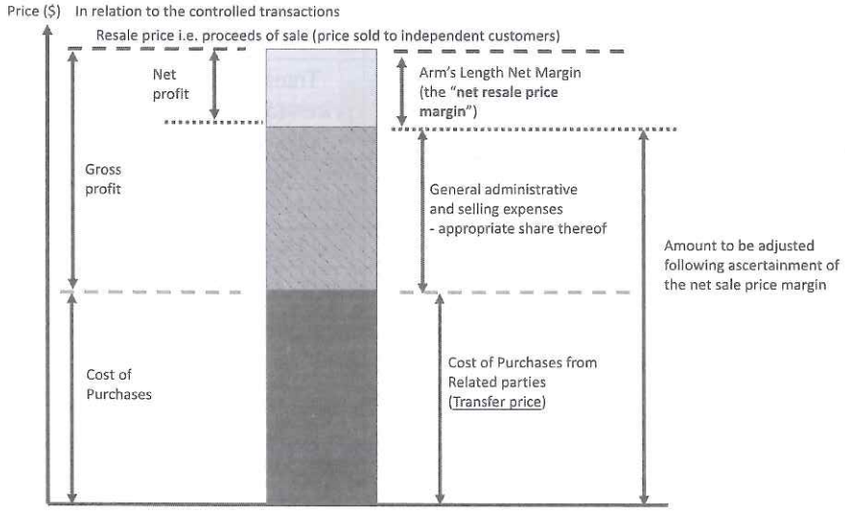
F. Package and Labelling

1. What packaging and labelling is done?
2. Where is it done?
3. Who makes the decisions in relation to packaging and labelling?
4. Have you complete autonomy to make such decisions?

G. Quality Control

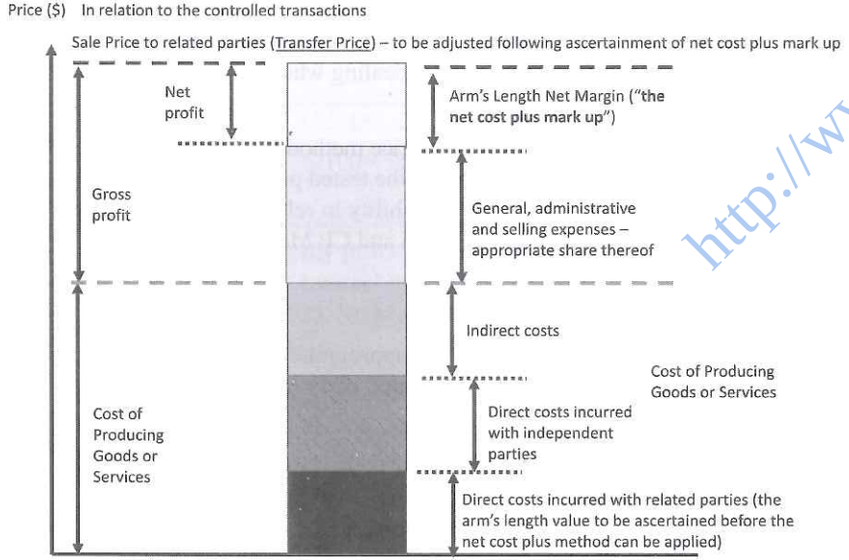
1. What form does quality control take?
2. Who sets finished product quality standards and procedures?

Transactional Net Margin Method (Net Resale Price Basis)



Adapted from ATO TR 97/20

Transactional Net Margin Method (Net Cost Plus Basis)



Adapted from ATO TR 97/20

When is TNMM Appropriate?

TNMM is frequently used if there is insufficient reliable data or where the traditional transaction methods (CUP, Resale price and Cost plus) are not able to handle commercial complexities and complicated FARs.

Strengths

Prices are likely to be affected by differences in products, and gross margins are likely to be affected by differences in functions, but net profit indicators are less adversely affected by such differences[46].

Net profit indicators are more tolerant to differences in accounting standards

Weakness

A transactional net margin method is unlikely to be reliable if each party to a transaction makes valuable, unique contributions[47].

Net margin as the basis for comparison can be influenced by many factors that either do not have an effect, or have a less substantial or direct effect, on price or gross margins. Examples of such factors include the efficiency of plant and machinery used, management and personnel capabilities, competitive position, etc[48]. Unless reliable and accurate adjustments can be made to account for these differences, the TNMM may not produce reliable measures of the arm's length net margins[49]. Say comparable company A is poorly managed, while the tested party may have been run very well. Would it be reliable then to draw conclusions relevant to the transfer prices of the tested party from the fact that the tested party made a 10% operating margin but the company which is said to meet the comparability criteria made an operating margin of 6%?

How to Apply TNMM

Comparisons at the net profit level can be made on a single transaction or in relation to some aggregation of dealings between related parties.

First, select the tested party, ie the party with the least complicated FAR.

[46] Para 2.69 *OECD TP Guidelines*.
[47] Para 2.59 *OECD TP Guidelines*. Where each party makes unique and valuable contributions, consider profit split method below.
[48] Para 5.94 *IRAS TP Guidelines*.
[49] Para 5.95 *ibid*.

Next examine the net margin relative to an appropriate base (eg costs, sales, assets) that is attained by the tested party from a related party transaction to that of comparable independent parties. This ratio of net profit and the appropriate base is commonly known as the net profit indicator or profit level indicator[50].

Select the most appropriate net profit indicator or profit level indicator by considering[51]:

(a) Strengths and weaknesses of the various possible indicators;

(b) Nature of the transaction and the appropriateness of the indicator applied to the transaction;

(c) Availability of reliable information needed to apply the TNMM and compute the indicator; and

(d) Degree of comparability between the related and independent party transactions, and the accuracy with which comparability adjustments can be made to eliminate differences.

Examples[52]

Net profit/ Profit level indicator	Numerator	Denominator
Operating profit margin	Operating profit	Sales
Full cost mark-up/Return on Total Cost	Operating profit	Total costs including all direct, indirect and operating costs
Value-added cost mark-up	Operating profit	Operating costs
Return on asset	Operating profit	Operating assets (normally only tangible assets)
Return on Capital Employed	Operating profit	Capital employed which is usually computed as the total assets minus cash and investments
Berry Ratio	Gross profit	Operating expenses

In determining the numerator and denominator, note that[53]:

(a) Only those items that are directly or indirectly related to the transaction in question, and are of an operating nature should be taken into account; and

[50] Para 5.91 *ibid.*
[51] Para 5.96 *ibid.*
[52] Para 5.97 *IRAS TP Guidelines.*
[53] Para 5.98 *ibid.*

(b) Items that are not similar to the independent party transaction being compared should be excluded.

In practice, this means if the tested entity engages in a variety of different controlled transactions, segmentation of financials need to be performed to apply the profit level indicator only to profits that are attributable to particular controlled transactions should be included. Financial items that are not trade related, taxes, extraordinary items and other non-operational items should not be included in the numerator. For other items, the decision whether to include such items in the numerator depends on the relevance – for instance, if personnel costs are key-value drives, then include stock incentive and pension costs; for asset-intensive industries where assets are key value-drivers, include depreciation.

TNMM Example 1

Company X is a Singapore subsidiary of HQ Co, located overseas. HQ Co. manufactures computers, which it sells to X and other associated distributors in different countries. The computers distributed by X bear company HQ Co's trademark. X also provides technical support to all its customers.

Sales	100,000
Cost of Goods sold	90,000*
Gross Profit	10,000
Operating Expenses	15,000
Net Loss	(5,000)
Margin (Net Loss)	-5%

Assume that there are significant product differences that cannot be reliably adjusted, thus CUP method is not appropriate; and the resale price method is not used as no comparable measurement of gross margin can be found due to differences in accounting practices amongst independent distributors.

The TNMM is adopted on the basis of net profit return to sales. External benchmarks show that the net profit margin to sales (commonly referred to as "Operating Margin") earned in a comparable transaction by an independent party is 6%.

Adjustments on X will be as follows:

Net profit of X = 100,000 x 6% = 6,000

Adjusted cost of goods sold = 100,000 – 15,000 – 6,000 = 79,000*

TNMM Example 2

MNE Group operates a captive shared services centre in the Philippines, Company P that provides routine HR and accounts payable support for subsidiaries across ASEAN. Company P provides HR and accounts payable support for a full year of approximately 2,000 hours of service to related party X. P's total costs of providing 2,000 hours of service is S$250,000.

Assume there are comparable independent providers of comparable HR and accounts payable services such a Company I

Company I's P&L shows the following

Revenue	900,000
-Labour cost	450,000
- Rent	200,000
- SG&A	150,000
Total costs	800,000
Profit	100,000

Net Cost Plus Margin = Operating profit (100,000)/Total costs (800,000) = 12.5%

Next, use the Net Cost Plus Margin of 12.5% to calculate the arm's length transfer price. Arm's length charge for services = Total cost of providing services + Net Cost Plus Margin = S$250,000*(1+12.5%) = S$281,250

COMMENTARY

The choice of appropriate profit level indicator can be a point of contention upon audit. An example is where a taxpayer applies a net cost plus margin to a small local distribution/ marketing subsidiary supporting the head-office in sales. A tax authority may assert that the arm's length returns should be higher using Operating Margin as the more appropriate Profit Level indicator, based on local comparables.

Berry Ratio

The Berry Ratio profit level indicator is the ratio of gross profit to operating expenses. IRAS' position is that the Berry Ratio should be used with caution and in limited cases

because it is sensitive to how costs are classified, whether as operating expenses or not. Such limited cases are when[54]:

(a) The taxpayer acts as an intermediary purchasing goods from related parties and on-selling them to other related parties;

(b) The taxpayer does not perform any value-added functions other than distribution relating to the products distributed. An example of such value-added functions is manufacturing;

(c) The value of the functions performed by the taxpayer is not affected by the value of products distributed, eg accounting and billing functions;

(d) There is a direct link between operating expenses and gross profits; and

(e) The taxpayer does not employ any intangibles in the particular transaction.

Example

Profit and loss	*Independent intermediaries*	*A related manufacturer*	*B related distributor*
Sales (1)	600	Transfer price?	800
COGS (2)	510	30	Transfer price?
Gross profit (3)=(1)-(2)	90	?	?
Operating Expenses (4)	75	5	15
Operating profit (3)-(4)	15	?	?
Berry Ratio (3)/(4)	90/75= 120%		

Profit and loss	*Independent intermediaries*	*A related manufacturer*	*B related distributor*
Sales (1)	600	Transfer price=722	800
COGS (2)	510	30	Transfer price= 800-78=722
Gross profit (3)=(1)-(2)	90	?	65*120%=78
Operating Expenses (4)	75	5	65
Operating profit (3)-(4)	15	?	13
Berry Ratio (3)/(4)	90/75= 120%	→	120%

[54] Para 5.100 *IRAS TP Guidelines.*

assess if, on the facts, the PSM is the most appropriate method and split profits in a similar way as to how independent parties would under comparable circumstances.

Weakness

The profit allocation criteria can be subjective or mechanistic unless a reliable internal or external comparable can be found. Where there are no reliable comparables, tax authorities have a large leeway to challenge the profit splitting factor(s) used, the valuation of the contribution of each party (particularly where intangibles are involved) and the proportion computed for each party and re-allocate a large amount of profits to an associated enterprise engaging in a particular transaction.

In cross-border transactions, it may be difficult for the taxpayer and tax administrators to access information from all parties and differences in accounting practices and currencies make it hard to measure combined revenue and costs for all the associated enterprises participating to the tested transaction.

The IRAS considers the PSM as appropriate where[58]:

(a) The parties' contributions to the transactions and their interaction are highly inter-related and integrated. A high degree of integration means that the way in which one party to the transaction performs functions, uses assets and assumes risks is interlinked with, and cannot be reliably evaluated in isolation from the way in which another party to the transaction performs functions, uses assets and assumes risks. If the contribution of at least one party to the transaction can be reliably evaluated by reference to other transfer pricing methods, the use of transactional profit split method would not be appropriate;

(b) The parties make unique and valuable contributions to the transaction. Contributions are "unique and valuable" where they are not comparable to contributions made by independent parties in comparable circumstances, and they represent a key source of actual or potential economic benefits in the business operations.

(c) The existence of unique intangible assets makes it difficult to find reliable comparables.

(d) Each party shares the assumption of one or more of the economically significant risks in relation to that transaction or the parties assume the economically significant risks separately but those risks are so closely inter-related or correlated that the playing out of the risks of each party cannot reliably be evaluated separately.

Examples of the above include the set-up of a partnership, joint research and development undertaken to develop and exploit intangible assets such as brands and pharmaceuticals or joint ventures to pursue projects such as producing a movie.

[58] Para 5.80 *IRAS TP Guidelines*.

Finally, it is worth nothing that once the PSM is chosen, it applies equally to losses as to profits[59]. This is an important consideration when profits are expected to be volatile over the years and certainly need to be modelled and thought through before taxpayers apply for an advanced pricing agreement covering several years on the basis of a profit split method. From an operational and practical perspective, it is much easier to split profits than it is to allocate losses.

How to Apply it

The IRAS explicitly recommends that taxpayers use the Residual analysis approach over the Contribution Analysis approach for the following reasons[60]:

(a) The relative value of the contribution of each party is often more difficult to quantify when one attempts to divide the total profit directly; and

(b) The use of comparable data to allocate part of the total profit in the first stage of the residual analysis approach will generally improve the reliability of the transactional profit split method.

As a first step, the profit to be split needs to be identified. This generally refers to the operating profit, although occasionally, it may be appropriate to carry out a split of the gross profit and then deduct the expenses incurred by or attributable to each relevant party[61].

EXAMPLE – RESIDUAL PROFIT SPLIT[62]

The success of an electronics product is linked to the innovative technological design both of its electronic processes and of its major component. That component is designed and manufactured by Company A; is transferred to related Company B which designs and manufactures the rest of the product; and is distributed by related company C. Information exists to verify by means of a resale price method that the distribution functions, assets and risks of Company C are being appropriately rewarded by the transfer price of the finished product sold from B to C.

The most appropriate method to price the component transferred from A to B may be a CUP, if a sufficiently similar comparable could be found. However, since the component transferred from A to B reflects the innovative technological advance enjoyed by A in this market, which is found to be a unique and valuable contribution by A. Assume it proves impossible (after the appropriate functional and comparability analyses have been carried

[59] Para 2.115 of the *OECD TP Guidelines* explicitly states that "References to "profits" in this section should generally be taken as applying equally to losses".
[60] Para 5.87 *IRAS TP Guidelines*.
[61] Para 5.82 *IRAS TP Guidelines*.
[62] Adapted from Example 11 of *OECD TP Guidelines*.

out) to find a reliable CUP to estimate the correct price that A could command at arm's length for its product.

Calculating a return on A's manufacturing costs could however provide an estimate of the profit element which would reward A's manufacturing functions, ignoring the profit element attributable to the unique and valuable intangible used therein. A similar calculation could be performed on B's manufacturing costs, to give an estimate of B's profit derived from its manufacturing functions, ignoring the profit element attributable to its unique and valuable intangible. Since B's selling price to C is known and is accepted as an arm's length price, the amount of the residual profit accrued by A and B together from the exploitation of their respective unique and valuable intangibles can be determined. At this stage, the proportion of this residual profit properly attributable to each enterprise remains undetermined.

The residual profit may be split based on an analysis of the facts and circumstances that might indicate how the additional reward would have been allocated at arm's length. The R&D activity of each company is directed towards technological design relating to the same class of item, and it is established for the purposes of this example that the relative amounts of R&D expenditure reliably measure the relative value of the companies' contributions. This means that each company's unique and valuable contribution may reliably be measured by their relative expenditure on research and development, so that, if A's R&D expenditure is 15 and B's 10, giving a combined R&D expenditure of 25, the residual could be split 15/25 for A and 10/25 for B.

Preliminary: Identify Profit Pool to Be Split

Profit and loss	*A*	*B*
Sales (1)	50	100
Purchases (2a)	10	50
Manufacturing cost(2b)	15*	20*
Gross profit (3)=(1)-(2a+2b)	25	30
R&D Expenses (4a)	15	10
Other Operating (4b) Expenses	10	10
Net Profit (3)-(4a+4b)	0	10

Step 1: Separately identify and remunerate routine functions (eg manufacturing of A and B), leaving the residual profit

Assume that there are third-party comparable manufacturers without unique and valuable intangibles earn a return on manufacturing costs (excluding purchases) of 10% (ratio of net profit to the direct and indirect costs of manufacturing) in both countries where A and

B operate. A's manufacturing costs are 15*, and so the return on costs would attribute to A's manufacturing a routine profit of 1.5. B's equivalent costs are 20*, and so the return on costs would attribute to B manufacturing routine profit of 2.0. The residual profit is therefore 6.5, arrived at by deducting from the relevant net profit of 10 the combined manufacturing profit of 3.5.

Step 2: Allocate the residual profit based on appropriate profit splitting factors (eg R&D expenditure)

The initial allocation of profit (1.5 to A and 2.0 to B) rewards the manufacturing functions of A and B, but does not recognise the value of their respective unique and valuable contributions that have resulted in a technologically advanced product.

Since in this case it is determined that the relative share of total R&D costs incurred by A and B in relation to the product is a reliable proxy for the value of their respective unique and valuable contributions, the residual can be split between A and B on that basis.

The residual is 6.5 which may be allocated 15/25 to A and 10/25 to B, resulting in a share of 3.9 and 2.6 respectively, as below:

A's share 6.5 x 15/25 = 3.9

B's share 6.5 x 10/25 = 2.6

Step 3: Recompute the P&L for tax purposes after allocations

A's net profits would thus become 1.5 + 3.9 = 5.4.

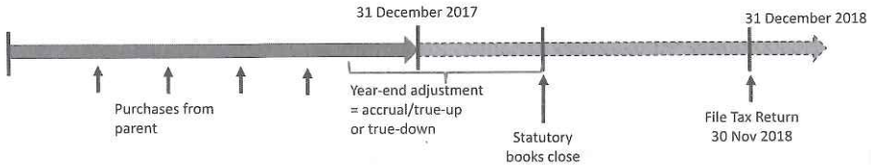
B's net profits would thus become 2.0 + 2.6 = 4.6.

Profit and loss	*A*	*B*
Sales (1)	50+adjusted profit share = 55.4	100
Purchases (2a)	10	55.4
Manufacturing cost(2b)	15	20
Gross profit (3)=(1)-(2a+2b)	30.4	24.6
R&D Expenses (4a)	15	10
Other Operating (4b) Expenses	10	10
Adjusted Net Profit (3)-(4a+4b)	5.4	4.6

Note: All such TP adjustment calculations will need to be retained as supporting documents for audit.

Example

Taxpayer S purchases of goods from parent for distribution at various points in time across FY 2017. The transfer pricing analyses and TP documentation for FY 2017 state that the arm's length remuneration is an operating margin (ie operating profit over sales) of between 3% and 5% for its distribution function.



	Scenario 1	Adjusted	Scenario 2	Adjusted
Sales to 3rd party clients (A)	25,000,000	25,000,000	25,000,000	25,000,000
Less: Purchase from Parent	17,000,000	17,000,000 + 250,000	18,000,000	18,000,000 - 250,000
Gross Profit	8,000,000	7,750,000	7,000,000	7,250,000
Less: Operating expenses	6,500,000	6,500,000	6,500,000	6,500,000
Actual Operating profit (B)	1,500,000	1,250,000	500,000	750,000
Operating margin(B/A)	6%	5%	2%	3%
Arm's length range	Above range	Within range	Below range	Within range
Taxable profits		⬇ Must meet conditions		⬆ Even if conditions not met

¶11-300 Compensating Adjustments

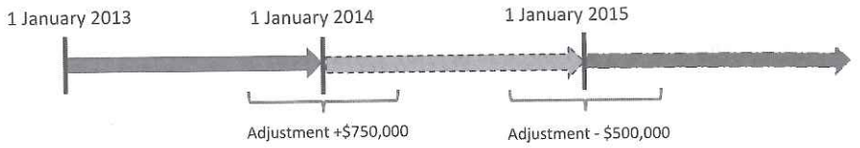
Compensating adjustment are adjustments that taxpayers are required by IRAS make to ensure that the arm's length result for tax purposes is reported as agreed in an advance pricing arrangement with IRAS, even though they differ from actual results[6].

Example

Taxpayer S purchases goods from an offshore parent for distribution from 2009 - 2017

Assuming S enters into APA with IRAS covering 2010-2015 wherein the arm's length remuneration is agreed to be an operating margin (ie operating profit over sales) of 5% for its distribution function.

[6] Para 11.11–11.13 *IRAS TP Guidelines*



	2013	Adjusted	2014	Adjusted
Sales to 3rd party clients (A)	25,000,000	25,000,000	25,000,000	25,000,000
Less: Purchase from Parent	16,500,000	16,500,000 + 750,000	17,750,000	17,750,000 - 500,000
Gross Profit	8,500,000	7,750,000	7,250,000	7,750,000
Less: Operating expenses	6,500,000	6,500,000	6,500,000	6,500,000
Actual Operating profit (B)	2,000,000	1,250,000	750,000	1,250,000
Operating margin(B/A)	8%	5%	3%	5%
Arm's length range	Above range	As agreed in APA	Below range	As agreed in APA
Taxable profits		⬇		⬆

COMMENTARY

Year end or pre-close adjustments are common place in transfer pricing operations. These are commonly referred to as "true-ups" or "true-downs". As a matter of statutory accounting work cycle, such adjustments should be made prior to the close of the statutory financial books in the following year. If such adjustments are late and miss the book closing, they can lead to significant problems if they are made in the accounts of the following year. Large adjustments at year end or pre-close can also lead to problematic large swings in the Profit and Loss statements. A common way to avoid this is to make periodic adjustments monthly or quarterly with a smaller true-up at year end (See further discussion in 18-400 on operational transfer pricing).

Self-initiated Retrospective Adjustments

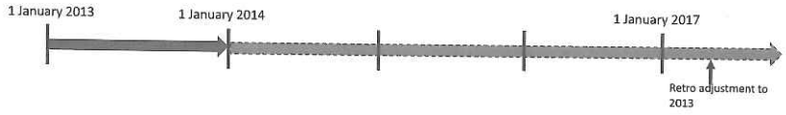
Taxpayers may review their past transfer prices relating to the transactions with their related parties due to subsequent change in circumstances and decide to make retrospective upward or downward adjustments for past financial years to arrive at what, in the taxpayers' opinion, would be the arm's length prices. These adjustments are referred to as self-initiated retrospective adjustments[7].

[7] Para 11.15 *ibid.*

IRAS will not allow any retrospective downward adjustments in the absence of contemporaneous TP documentation supporting the adjustments. However, IRAS is not precluded from bringing any retrospective upward adjustments to tax if doing so would be in accordance with arm's length price[8].

Example

Taxpayer S purchases services from a Group shared services center (X) in 2013 for SG$1m. In 2017, taxpayer retrospectively self-adjusts the costs of services for 2013.



	2013	Scenario 1: upward in 2017	Scenario 2: downward in 2017	Scenario 3: downward in 2017
Sales to 3rd party clients (A)	25,000,000	25,000,000	25,000,000	25,000,000
Cost of Goods sold	17,250,000	17,250,000	17,250,000	17,250,000
Gross Profit	7,750,000	7,750,000	7,750,000	7,750,000
Less cost of services from X	1,000,000	1,000,000 -100,000	1,000,000 +100,000	1,000,000 +200,000
Less Other Operating expenses	5,500,000	5,500,000	5,500,000	5,500,000
Actual Operating profit (B)	1,250,000	1,350,000	1,150,000	1,050,000
Operating margin(B/A)	5%	5.4%	4.6%	4.2%
Arm's length range	Within range		Within range	Below range
Taxable profits		⬆ Upward adjustment OK	⬇ Ok if supported by contemporaneous doc	⬇ Not permitted, not supported by change in contemporaneous doc

Scenario 1

In 2017, taxpayer makes a self-initiated retrospective adjustment for 2013, reducing by $100,000 the cost of X's services to factor in a lower uplift percentage or lower cost base

- to comply with group global transfer pricing policy which X or Taxpayer had failed to consider; or
- following revisions in transfer pricing analysis

There is an increase in taxable income for the Taxpayer. Permitted.

[8] Para 11.17 – 11.18 *ibid.*

Scenario 2

In 2017, X applied a higher uplift % or factored in additional costs of SG$100,000 for the services rendered in 2013

- to comply with a tribunal or court ruling in country X
- to comply with a unilateral, bilateral APA or MAP (to which IRAS is not a party)

covering 2013, where it was ruled or agreed that for 2013, the arm's length price for those types of services should be SG$1.1m instead of SG$1m (eg due to higher cost base or mark-up).

Taxpayer makes a self-initiated retrospective adjustment for 2013, increasing cost of X's services by SG$100,000 correspondingly. The resulting operating margin is 4.6%.

Paragraph 11.27 of the *IRAS TP Guidelines* states that IRAS will not allow any retrospective downward adjustments in the absence of contemporaneous TP documentation supporting the adjustments. Further, Paragraph 11.21 of the *IRAS TP Guidelines* require the taxpayer to inform IRAS before performing any corresponding adjustments.

If Taxpayer has 2013 contemporaneous TP documentation stating an Operating margin range of 4.5% to 5.5%. Permitted.

If Taxpayer does not have 2013 contemporaneous TP documentation, even if X's benchmarking from the trial, APA or MAP indicates that 4.6% is within an arm's length range in country X, the self-initiated retroactive adjustment may not be permitted by IRAS.

Scenario 3

Same as 2 above except that the adjustment is SG$200,000 which brings the operating margin of 4.2% below the arm's length range as stated in Taxpayer's 2013 contemporaneous TP documentation. Not permitted. Again this is so even if the determination for X from the trial, APA or MAP indicates that 4.2% is within an arm's length range in country X.

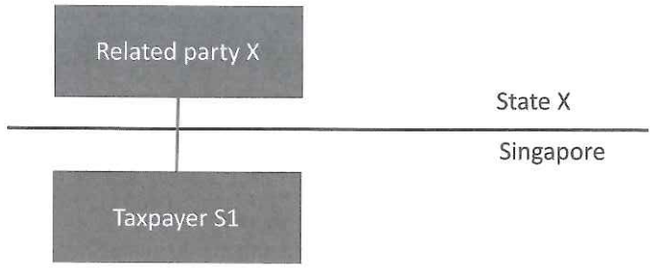
¶11-400 Corresponding Adjustments

When two related parties transact with each other, revenue for one party (eg provider for service or seller of goods) means cost for the other (eg cost of service received or cost of goods sold) and vice-versa. If the transfer price for one party is adjusted and the corresponding item of account for the counterparty is not, double taxation results. This is when the same profits are taxed twice as a result of a tax authority's transfer pricing audit and application of arm's length price[9].

To eliminate the double taxation, IRAS may agree to reduce the profits of the taxpayer by a downward adjustment to the taxpayer's profits to match the initial adjustment, known as corresponding adjustment[10].

[9] Para 11.19 *ibid.*
[10] Para 11.20 *ibid.*

Example – Cross-Border Corresponding Adjustment



X sells goods with S1 at $100
Revenue of X = $100
X's cost = $50
X's profit = $50
TP adjustment, arm's length price = $120
X's revenue = $100+$20
X's cost = $50
X's revised profit = $70

S1 sells the goods to third parties at $150
Revenue of S1 = $150
Cost of Goods sold = $100
S1's profit = $50
Corresponding adjustment under Article 9(2)*
Revenue of S1 = $150
Revised Cost of Goods sold = $100 + *$20
S1's revised profit = $30

Total Tax base prior to TP adjustment = $50 + $50 =$100
Change in Tax base due to TP adjustment = $70 + $50 = $100 (result: double taxation of $20)
Tax base after corresponding adjustment = $70 + $30 = $100 (result: double taxation eliminated)

In the cross-border context, corresponding adjustment, if agreed to by the Competent Authorities of both countries under MAP to eliminate double taxation generally falls under Article 9(2) of the Associated Enterprise Article of the relevant DTA[11]. The commentary to Article 9(2) makes clear that the State from which a corresponding adjustment is requested should comply with the request only if that State "considers that the figure of adjusted profits correctly reflects what the profits would have been if the transactions had been at arm's length". This means that in competent authority proceedings the State that has proposed the primary adjustment bears the burden of demonstrating to the other State that the adjustment "is justified both in principle and as regards the amount".

In general, IRAS will only consider making corresponding adjustments when:

(a) There is a DTA between Singapore and the jurisdiction making the TP adjustment;and

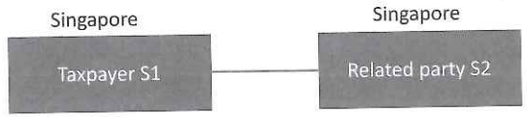
(b) Taxpayers have applied for MAP and is accepted by IRAS and the foreign Competent Authority.

[11] Note that the OECD BEPS Action 14 recommends that the presence of Article 9(2) in a DTA should not be a precondition before MAP and corresponding adjustment is available.

COMMENTARY

There is no mention of Corresponding Adjustment in the domestic context in the *IRAS TP Guidelines*. However, it is unlikely IRAS will make such adjustments as it negates the effect of a transfer pricing adjustment as illustrated below.

Example – Domestic Corresponding Adjustment



S1 sells goods with S2 at $100
Revenue of S1 = $100
S1's cost = $50
S1's profit = $50
TP adjustment, arm's length price = $120
S1's revenue = $100+$20
S1's cost = $50
S1's revised profit = $70

S2 sells the goods to third parties at $150
Revenue of S2 = $150
Cost of Goods sold = $100
S2's profit = $50
Corresponding adjustment*
Revenue of S2 = $150
Revised Cost of Goods sold = $100 + *$20
S2's revised profit = $30

Total Tax base prior to TP adjustment = $50 + $50 =$100
Change in Tax base due to TP adjustment = $70 + $50 = $100
Tax base after corresponding adjustment = $70 + $30 = $100
Result: Corresponding adjustment will negate the effect of the initial TP adjustment on S1

¶11-410 Do Not Self-Initiate Corresponding Adjustment, Proceed Through IRAS

IRAS requires taxpayers who suffer double taxation arising from transfer pricing adjustments by a foreign tax authority not to make corresponding adjustment in their tax returns or tax computations on their own accord without informing IRAS[12].

Instead, Taxpayers may seek relief from double taxation through the mutual agreement procedure if it is available under Singapore's DTA with that foreign country. IRAS will only consider making corresponding adjustments to eliminate double taxation when[13]:

(a) There is a DTA between Singapore and the foreign jurisdiction of the tax authority that made the transfer pricing adjustments; and

(b) Taxpayers have applied for the MAP provided in that DTA and such application is accepted by IRAS and the foreign tax authority.

[12] Para 11.21 *ibid.*
[13] Para 11.23 *ibid.*

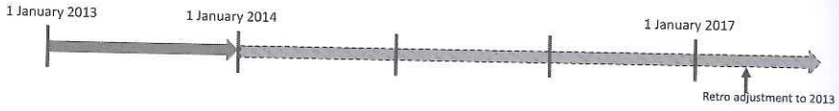
IRAS will affect the corresponding adjustments to eliminate double taxation if the outcome of the MAP is accepted by IRAS, the foreign tax authority and the taxpayers[14].

Example

Taxpayer purchases services from a Group shared services centre (X) in 2013 for $1m. Taxpayer has 2013 contemporaneous TP documentation stating an Operating margin range of 4.5% to 5.5%.

In 2017, the authorities in country X adjusts X's price of services by an additional SG$200,000.

Scenario 3, taxpayer suffers double taxation – the additional SG$200,000 is taxed in country X with no matching deduction for taxpayer in Singapore.



Taxpayer should not on their own accord make any corresponding adjustment in their tax returns or tax computations without informing IRAS[15].

	2013	Scenario 3: downward in 2017	Scenario 4: downward in 2017
Sales to 3rd party clients (A)	25,000,000	25,000,000	25,000,000
Cost of Goods sold	17,250,000	17,250,000	17,250,000
Gross Profit	7,750,000	7,750,000	7,750,000
Less cost of services from X	1,000,000	1,000,000 +200,000	1,000,000 +150,000
Less Other Operating expenses	5,500,000	5,500,000	5,500,000
Actual Operating profit (B)	1,250,000	1,050,000	1,100,000
Operating margin(B/A)	5%	4.2%	4.4%
Arm's length range	Within range	Below range	Below original range
Taxable profits		Not permitted, not supported by range in contemporaneous doc	Made pursuant to MAP agreed to by X, IRAS and taxpayer. Ok.

[14] Para 11.24 *ibid.*
[15] Para 11.21 *IRAS TP Guidelines.*

Scenario 4: Taxpayers seeks relief from double taxation through the mutual agreement procedure ("MAP") provided in the DTA between Singapore and country X. IRAS will accept the corresponding adjustments to eliminate double taxation if the outcome of the MAP (in this case SG$150,000 instead of the original SG$200,000) is accepted by IRAS, country X's tax authority and the taxpayers (Paragraph 11.24)

COMMENTARY

The underlying rationale running throughout the general prohibition against self-initiated adjustment which is also common in other jurisdictions, is that each country is sovereign and makes and enforces its own transfer pricing rules. Even if countries profess to follow the OECD arm's length principle, they will not as a matter of policy automatically give up the right to apply their arm's length rules or right to tax. In cross-border dealings, no authority would willingly accept the determination of another authority or a deal struck between the taxpayer and another authority unless it is at the negotiating table.

¶11-500 Correcting an Error or Mistake in Transfer Pricing

This concept of needing contemporaneous documentation to support a retrospective adjustment is codified in Section 93A(1A) of ITA, introduced in 2017 which mandates that any claim for error or mistake for transfer pricing must be supported by TP documentation that satisfies Section 34F of the ITA.

Section 93A(1B) of ITA further states that Section 93A(1A) applies whether or not taxpayer is required to prepare TP documentation under Section 34F of the ITA.

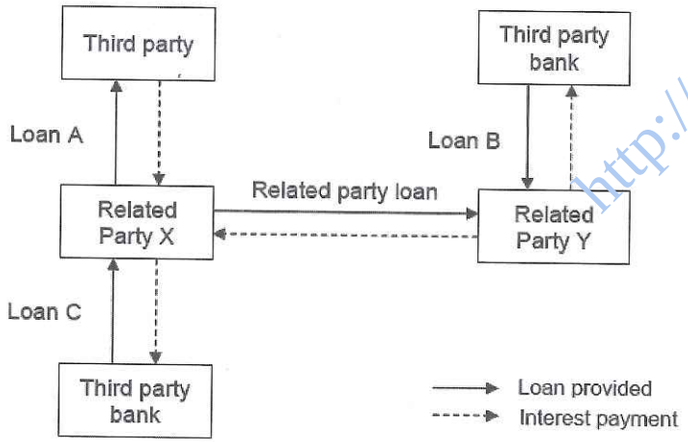
COMMENTARY

There must be contemporaneous TP documenting supporting the assertion of error or mistake. Change in the opinion of the taxpayer in regard to transfer pricing analysis or benchmarking is unlikely to be reason enough to justify a retrospective change in the TP policy.

¶14-300 Specific Guidance on Comparability Analysis

Paragraphs 13.11 to 13.26 of the *IRAS TP Guidelines* provides specific guidance on the application of the three-step approach in paragraph 5.12 to determine the arm's length interest charges for related party loans. These include:

1. Comparability factors to consider[3]:
   (a) Nature and purpose of the loan;
   (b) Market conditions at the time the loan is granted;
   (c) Principal amount, duration and terms of the loan;
   (d) Currency in which the loan is denominated;
   (e) Exchange risks borne by the lender or borrower;
   (f) Security offered by the borrower;
   (g) Guarantees involved in the loan;
   (h) Ranking of the loan (senior or subordinated); and
   (i) Credit standing of the borrower.
2. Specifying the CUP method as the preferred method. Taxpayers must maintain documentation to justify if a method other than CUP is applied.[4]
3. Interestingly, the guidance suggests that in applying the CUP method, certain internal comparables are more reliable than others.



[3] Para 13.13 *ibid.*
[4] Para 13.14–13.15 *ibid.*

In the diagram in Paragraph 13.16(a) above, assuming X is not in the business of borrowing and lending, where there is a

Singapore Lender (Party X) and Foreign Borrower (Party Y)[5]

- Loan A is the preferred internal CUP as X should charge Y the same interest rate that it charges a third party.
- Loan B, if Loan A is not available, is the next internal CUP that X can use as X should charge Y the same interest rate that a third party charges Y.
- Loan C if both Loan A and Loan B are not available and the moneys borrowed by X are on-lent to Y, ie X should charge Y the same interest rate that a third party charges X.

Singapore Borrower (Party Y) and Foreign Lender (Party X)[6]

- Loan B is the preferred internal CUP as Y should pay X interest at the same interest rate that it pays a third party.
- Loan A, if Loan B is not available, is the next internal CUP that Y can use as Y should pay X interest at the same interest rate that X charges a third party.
- Loan C if both Loan A and Loan B are not available and the moneys borrowed by X are on-lent to Y, ie Y should pay X interest at the same interest rate that a third party charges X.

COMMENTARY

A common question in practice is whether taxpayers can point to bank quotes from third party banks as comparables to defend the rate that is charged in lieu of performing a full transfer pricing analysis. MNEs often have close relationships with one or a panel of banks and are able to readily obtain quotations on terms that matches those of their related party loans. For example, taxpayer S intends to lend US$20m to an offshore related party B a loan for 2 years. B obtains 3 quotations from third-party banks P, Q and R at 4.8%, 5.0% and 5.2% for loan facilities on the same currency, tenure and other terms as it will lend to B. Can S then argue that 5.0% or even 4.8% at the lowest end is a comparable uncontrolled price with which to set the related party interest rate? Bank quotes have been known to be rejected in other countries on the basis that it does not represent a "genuine" price as it not a binding transaction and potentially influenced by the close relationship between MNEs and their bankers. There is no guidance nor case decision on this in Singapore. At the time of writing, the OECD appears to disapprove of relying on bank quotes in its Public Discussion Draft on BEPS ACTIONS 8–10, Financial Transactions, issued on 3 July 2018.

[5] Para 13.16(b) *ibid.*
[6] Para 13.16(c) *ibid.*

However, a practical consideration is that if IRAS does not accept B's bank quotes and none of the safe-harbours apply to this loan, the taxpayer may not have the information to fulfil the Entity level documentation requirements in the absence of a proper transfer pricing analysis.

You should not confuse the above examples of internal CUP with pass through financing. In such cases, instead of third parties lending to or borrowing from Parties X and Y, loans A, B or C are related party loans. Such transactions are not internal comparables and cannot be used. For example, in the last scenario, if X the foreign lender had borrowed not from a foreign bank but from Z, another related party, then the interest charged by Z to X is not an internal comparable with which X can then charge Y, the Singapore borrower. Further, the monies flowing through from Z to X to Y without X retaining any margin could in certain situations fall afoul of anti-avoidance rules against conduit financing.

After method selection and application, in determining the arm's length result, Paragraphs 13.17 to 13.19 suggest that the arm's length interest rate is usually made up of a base reference rate and a credit spread or margin to compensate the lender for bearing credit risk of the borrower[7]. The base reference rate is usually a publicly available rate.

Examples of base reference rates for floating rate loans are[8]:

SG$ Singapore Inter Bank Offered Rate ("SIBOR")

US$ London Inter Bank Offered Rate ("LIBOR")

Eurozone Interbank Offered Rate ("EURIBOR")

Examples of base reference rates for fixed rate loans[9] are:

SG$/US$ swap rate

Singapore Government Securities ("SGS") yield

¶14-310 Where There Are CUPs

Comparability adjustments of two kinds can be made to eliminate the differences to improve comparability:

(i) Selecting the most appropriate base reference rate based on the currency and tenor of the loan[10]; and

(ii) Adjusting the margin to reflect differences in credit risk profiles between the tested borrower and the comparable borrower[11].

[7] Credit risk is risk of a borrower not being able to repay the loan.
[8] Para 13.35 *ibid.*
[9] Para 13.34 *ibid.*
[10] Para 13.20–13.21 *ibid.*
[11] Para 13.22 *ibid.*

Examples

The tested borrower's related party floating rate loan is denominated in US$ based on US Treasury and bond market rates and has a tenure of 12 months.
The internal CUP has a base reference rate of 3-month SG$ SIBOR.
Assuming all other factors are comparable.
The comparability adjustment to the internal CUP will be to substitute the SG$ SIBOR with the 12-month US$ LIBOR to adjust for the differences in currency.
The tested borrower's related party loan is denominated in British pounds and calculated as 1-month LIBOR plus 300 bps. The tested borrower is rated Aa3 by Moody's.
The external CUP involves a borrower rated at Aa1 borrowing at the rate of LIBOR plus X bps. The market spread or difference in interest rates between Aa3 and Aa1debt instruments is 150bps during the same period.
Assuming all other factors are comparable.
The comparability adjustment to the CUP will be to add 150bps as an additional margin to LIBOR plus X bps to eliminate the effect of the difference in credit risks between the tested and comparable borrowers.

¶14-320 Where There Are No Appropriate CUPs

Paragraph 13.23 of the *IRAS TP Guidelines* suggests determining arm's length interest rate by identifying a suitable base reference rate and then adding to it a margin derived from the estimated credit rating of the borrower. This suggest that IRAS is willing to accept the credit rating Yield approach in the GE Capital case (see discussion 20-100).

Implicit Support

In this regard, a complicating consideration is whether and if so, to what extent should an MNE group or parent's credit rating influence that of the credit rating of a member of that group. Another angle to look at the issue is whether the parent will implicitly support the subsidiary in the event it defaults even if there is no explicit written guarantee.

To illustrate, Top Notch private limited is a Singapore incorporated member of Top Notch MNE group listed in the UK. Top Notch's parent entity Top Notch plc has a rating of AA according to S&P. Top Notch Singapore is a 100% held subsidiary of Top Notch plc. Top Notch Singapore had commenced business in a rented office two years ago and now has twenty staff including the ASEAN general manager executing plans to rapidly expand the sales of Top Notch products across ASEAN and has no other assets. Top Notch Singapore on a "stand-alone" entity without considering the affiliation to Top Notch group would unlikely have a AA credit rating as a company with no track record nor staff. On a "stand alone" basis, assume it has a credit rating of BBB+.

However, Top Notch Singapore carries on business under the "Top Notch" brand, is 100% held directly by Top Notch plc, conducts Top Notch's main line of business and is crucial in executing the ASEAN strategy, therefore, it is unlikely that Top Notch plc will let Top Notch Singapore fail or default on any loan because of the reputational and business impact. As a result, the "market", ie independent lenders such as financial institutions, may be willing to lend Top Notch Singapore taking into account the high probability of such "implict" support. The practical result is instead of charging Top Notch Singapore high interest rates pegged to BBB+ rated borrowers, banks may be willing to extend loans at much lower interest rates close to the AA rating of Top Notch parent or group.

Paragraph 13.24 states that "IRAS prefers evaluating the credit rating of the borrower on a standalone basis. However, IRAS may accept a credit rating of the borrower based on the overall group credit rating if it can be substantiated that an independent lender will similarly accept such group credit rating". At the time of writing, the OECD appears to acknowledge the need to factor in implicit or parental support at least for important members of the MNE group in its Public Discussion Draft on BEPS ACTIONS 8–10, Financial Transactions, issued on 3 July 2018.

COMMENTARY

The guidance merely states "the credit rating of the borrower can be estimated using commercial credit scoring software provided by credit rating agencies based on information available at the time the related party loans are obtained". In practice, unless the taxpayer is a financial institution or has a capable treasury, it is likely that the taxpayer will lack the expertise or tools to perform such analysis and document it in a way that is verifiable upon audit and will have to seek external help.

¶14-400 Multiple Loans – Aggregated Analysis

The arm's length principle is fundamentally a transaction level analysis. Each party loan can be different, therefore, taxpayers should technically determine the arm's length interest rate for each loan individually. However, to ease compliance burden, IRAS permits taxpayers with multiple related party loans to determine the arm's length interest rate for comparable loans on an aggregate basis using the comparability factors listed in Paragraph 13.13 as a guide.

COMMENTARY

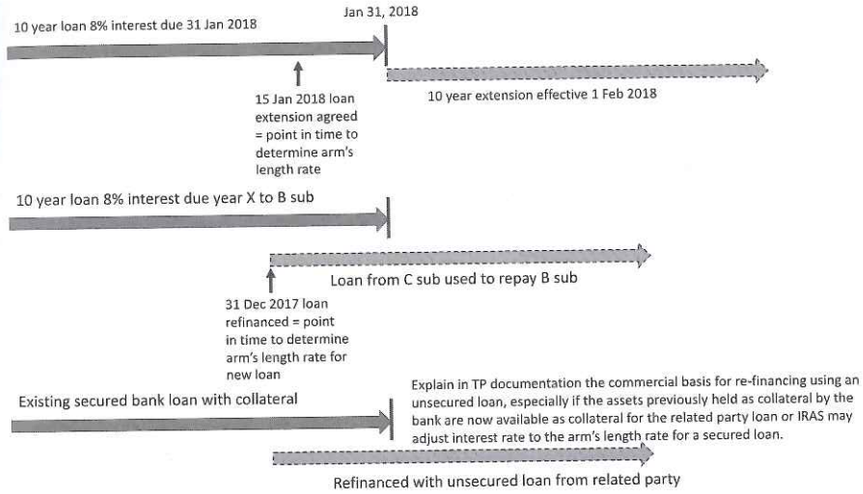
Although there are no further details, the above is a very useful clarification by IRAS. Generally, non-financial services MNEs lack the expertise and resources

(eg Bloomberg subscriptions) to price, much less perform comparability adjustment for each loan. Therefore, in setting related party lending policies, it is more practicable administratively to bucket loans in aggregate into several categories, rather than do individual loan pricing. The categories justified with aggregate analyses may take the form of different currencies, tenure, geographies or other characteristics. For example, all Euro denominated short term related party loans are grouped in the same bucket and apply the same transfer pricing approach in calculating the interest rate. Another example could be that entities in countries above investment grade sovereign ratings are put in a different bucket from entities in countries with poorer than investment grade sovereign ratings, with additional interest margin added to borrowers from the latter bucket to reflect the higher risks.

¶14-500 Refinancing and Extensions Considered as New Loan

Refinancing occurs when a taxpayer obtains a loan from a related party to repay an existing loan. IRAS considers refinancings and extension of the tenure of an existing related party loan as new loans[12]. Taxpayers need to re-establish the arm's length terms and interest rate and prepare TP documentation accordingly.

Examples - Refinancing and Loan Extensions[13]



[12] Para 13.27 *ibid.*
[13] Para 13.27 *IRAS TP Guideline.*

COMMENTARY

A commonly encountered situation in practice is where loans and deposits involving a member of an MNE group and a Group treasury centre intended to be short term in nature gets rolled over or extended automatically. This is a potential source of dispute where taxpayers may apply a short term interest rate whereas the tax auditor may assume that the loan is of a longer tenure, thus deserving of a higher rate of interest. The uncertainty is compounded where there are multiple withdrawals, partial pay downs, fluctuation in balances during a period in question. One way to avoid such ambiguity would be to execute loan or deposit agreements specifying the terms and documenting anew any change in balances or terms when a renewal, roll-over or refinancing takes place.

¶14-600 Consequences of Failure to Apply Arm's Length Interest Rates[14]

1. IRAS will disregard any interest expense in excess of the arm's length amount, notwithstanding that tax may have been withheld on the full interest payment to the foreign related party.
2. IRAS may not support the taxpayers in MAP discussions to resolve any double taxation arising from any transfer pricing adjustments made by IRAS or foreign tax authorities in relation to the interest charges.

¶14-700 Domestic Interest Expense Limitation

For domestic loans between two Singapore taxpayers and the lender is not in the business of borrowing and lending funds, IRAS will limit the interest expense claimed on such a loan if it is provided interest-free or at interest rates that are not supported by transfer pricing analysis.

Example

- Taxpayer A provided a loan to Taxpayer B SG$100,000
- Interest charged by Taxpayer A in 2014 SG$100
- Interest expense incurred by Taxpayer A in providing the loan in 2014 SG$1,000
- Taxpayer A's interest expense claim of SG$1,000 is limited to SG$100

COMMENTARY

An interesting question may arise as to whether the above rule allows Taxpayer A to charge zero interest, so long as it does not claim any interest expense or is prepared to accept

[14] Para 13.10 *IRAS TP Guidelines*.

that its interest expense claim is zero? This is a practical question as related enterprises especially in closely held family owned groups may hesitate to charge each other any interest, since all monies "belong to a single owner" even if they are in separate legal entities.

It is unlikely that IRAS had intended the above to be permitting zero interest rate domestic loans, ignoring the arm's length principle. Paragraph 13.9 of the *IRAS TP Guidelines* explains that the interest restriction whilst not conform to the arm's length principle, serves as a close proxy and is intended to "facilitate taxpayers' efforts in complying with the arm's length principle for related party loans while keeping compliance cost low".

¶14-800 Indicative Margin Safe-Harbour

IRAS has introduced an indicative margin which taxpayers can apply on each related party loan not exceeding SG$15 million.

Scope: Applies to related party loan not exceeding SG$15 million obtained or provided during each calendar year period. It applies to both domestic and cross-border loans.

The indicative margin is updated at the beginning of each calendar year and published by IRAS on its website[15]

1 January 2017 to 31 December 2017	+ 250 bps (2.50%)
1 January 2018 to 31 December 2018	+ 175 bps (1.75%)

The threshold of SG$15 million is based on the loan committed, at the prevailing exchange rate at the time the loans are obtained or provided and not the loan utilised.

Example

Taxpayer S obtained a loan facility of US$ 12 million from a related party B and utilises only US$8 million. At the time of the grant of the loan, the US dollar to Singapore dollar exchange rate was US$1:S$1.4. The loan facility is equivalent to SG$16.8 million exceeding the S$15m threshold. Taxpayer cannot apply the indicative margin notwithstanding that the amount utilised or intended to be utilised is US$ 8 million (S$ 11.2 million) which is less than SG$15 million[16].

[15] www.iras.gov.sg/irashome/Businesses/Companies/Working-out-Corporate-Income-Taxes/Specific-topics/Transfer-Pricing/Other-Issues/.

[16] Sect 13.31 *ibid.*

IN A NUTSHELL

1. There are a number of models MNEs use to manage transfer pricing risks. This spans the entire spectrum ranging from complete outsourcing to advisors to full-capability in-house teams who only use advisors for disputes or benchmarking. In recent years, the optimal TP set-up has been trending toward centralized management driven by the need for global reporting, documentation, consistency and the drive towards automation of processes and cost efficiency.
2. The optimal set-up to manage transfer pricing risk also depends on the size of the business, the business model adopted, the geographical footprint and the stage of development of the transfer pricing function. The judicious use of external advisors can bring benefits in four aspect – adding capability, capacity, consistency and facilitating change.
3. But what remains unchanging and important across all MNEs is the need for buy-in from the key stakeholders and close collaboration between transfer pricing, tax and the finance and accounting functions.
4. Generally, effective in-house transfer pricing functions exhibit both consistency in approach/strategy and investment across the years. Good transfer pricing practices take time to put in place and cultivating employees who possess institutional knowledge of the organisation takes years to develop but the benefits are hard to quantify and are realized only in later years upon audit. A good transfer pricing function requires individuals and teams with a good mix of skills with clearly defined roles and responsibilities, supported by management buy-in to effectively collaborate with finance, accounting, treasury, legal and IT.
5. Once the compliance requirements are met, processes and controls bedded down, MNEs can take transfer pricing to a strategic level by incorporating transfer pricing considerations into their tax structuring and business models. In the post-BEPS world, any such planning needs to be based on sound business rationale and substance, including having the locations where profits are recognized align with where value is created.

¶19-100 How To Organize Your Transfer Pricing Function?

The transfer pricing set-up of an MNE that is optimal for a company depends on the industry, geographical exposure and stage of development of the company. There is a strong tendency towards centralization with the advent of the OECD BEPS Action 13 three-tiers of documentation as the Country-by-Country and the Master files need to be coordinated and prepared centrally.

¶19-110 Companies With An Initial Offshore Footprint

Companies in the initial stages of their foray overseas may see marketing offices being set up or their first offshore manufacturing facilities. If the types and volume of cross-border

intercompany transactions are not significant, there is unlikely the justification to build dedicated in-house transfer pricing capability. Here the guidance of advisors is generally sought as transfer pricing is likely managed by finance (CFO, controller) or tax managers who are generalists and handle an array of other tax matters. Transfer pricing is characterised by meeting the minimum compliance requirements, especially documentation of each country and limited resources are focused on key related party transactions or certain high-risk countries.

¶19-120 Companies With A Mid-Sized Footprint In Several Offshore Jurisdictions

As the business expands into more countries, the tax function may start having country or regional tax managers covering the key jurisdictions or regions. The tax function may also be organized into substreams of specialization such as indirect tax and transfer pricing. At this stage, it is possible that the MNE may hire one transfer pricing specialist or a small team at the corporate centre. This is so as to prepare and implement globally coherent transfer pricing policies and perform the value chain analysis needed to draft the Masterfile documentation. The central transfer pricing specialist or team will likely serve as an advisor to the geography or business line tax managers and focus on central group cost recharges of management fees, treasury operations and centrally held intangibles such as brands and other intellectual property.

¶19-130 Large Global MNEs

Transfer pricing can become a "vertical" in a large MNE, alongside other specialist functions such as indirect tax and mergers and acquisitions. The necessity of CbC reporting will further drive centralization alongside the need for value chain analysis in the Masterfile. The central team also set the transfer pricing strategy and framework for the MNE and design most of the globally consistent policies. They can be supported by regional transfer pricing leaders who may cut across business (eg in an oil & gas company, a transfer transfer pricing specialist covers all the downstream activities of the business) or geography lines (eg Europe, Asia, Latam). At the country end, large countries may have large enough intercompany flows and issues to justify one or two transfer pricing specialists whereas most countries will have tax or finance managers who are not transfer pricing specialists work with advisors or the regional or global team to manage transfer pricing risks.

Finally, a large MNE with many tens or a hundred countries to cover can choose to either outsource the TP documentation compliance to an advisor or build Shared Services Centre teams in low cost locations such as India, Philippines or Eastern Europe to support the headquarter transfer pricing team in such tasks. Such Shared Services Center teams perform a number of routine functions such as preparing documentation, supporting transfer pricing analysis by extracting data, running computations, generating reports as well as managing repetitive financial calculations plus allocations and archiving data.

¶19-200 Getting Value-Added Assistance from Advisors

Generally, advisors add value in four key aspects. These can be loosely termed as the 4 "C"s which are as follows: Capability, Capacity, Consistency and being a Change agent.

a. Capability

The best external advisors are up-to-date with the rapidly developing OECD/BEPS technical guidance and local law and regulations. They are experienced in handling local, regional or municipal audits and authorities. The latter is particularly valuable in countries with new transfer pricing regimes where the local rules may not be clear or the administration of those rules in audit may be uncertain. In emerging Asia, knowledge of local practices, appeals procedures and personalities can be critical in managing dispute resolution and reaching a successful settlement with the relevant authorities. For bilateral APA and MAPs, there is almost always advisors involved and occasionally more than one set of advisors, one in each country.

Another key capability is performing technical comparability analysis, especially the economic benchmarking analysis and having access to databases for external CUPs. Small tax functions may not have the budget to hire transfer pricing specialists who are able to perform functional interviews and do benchmarking analysis. It does not make sense for an MNE to subscribe to databases such as Bureou van Dijk, ThomsonReuters and RoyaltyStat to perform benchmarking when an external advisor can do it cheaper (for instance, database prices are tied to number of searches), faster and more efficiently (having performed many searches). Furthermore, transfer pricing analysis can involve complex valuation techniques especially in hard to value areas such as intangibles.

Finally, a skilled advisor can bring comparative knowledge of industry best practices and use his experience in having encountered many different scenarios to give strategic advice or transactional structuring advice.

b. Capacity

Transfer pricing work can be periodic or 'lumpy'. External advisor(s) can bring short-term or project-based capacity to bolster or relief an internal tax team. Examples of such engagements can range from having the advisor team perform a transfer pricing planning study including functional interviews, industry write-ups and economic analysis to outsourcing entire processes such as coordinating global documentation across the MNE's footprint. Advisors can be brought in to support major corporate restructurings, mergers and acquisitions or significant audits.

c. Consistency

Some MNEs find using a single firm as a global preferred advisor has the advantage of better coordination across geographies to achieve consistency of transfer pricing advice, instead of having to brief and coordinate two or more different sets of advisors

across each country. There is also the convenience of having a single engagement partner coordinate across the country advisor teams. Advisor standards can differ greatly across Asia and a firm steer from the main engagement partner can quickly resolve local service quality issues. The advent of the BEPS Action 13 three-tier documentation places a premium on consistency, especially in aligning the local documentation to the value chain described in the Masterfile. A single advisor coordinating documentation can ensure that transfer pricing planning studies are consistently documented across the country-by-country, master file and local files. Consistency can only increase in importance as the world moves towards increasing transparency and automatic exchange of TP documentation.

d. Change Agent

There are often challenges in implementing transfer pricing where the tax or finance team tasked with implementation run into conflicting interests (for instance where transfer pricing require other teams to change long standing procedures or IT infrastructure) or where effecting process change can be painful. Here, an external advisor often brings invaluable objective advice that enables the CFO, Tax director or transfer pricing leader article the transfer pricing risks, engage and secure buy-in from senior management and stakeholders. The expertise and knowledge of comparative industry best practices can help the in-house team to find practicable solutions.

¶19-300 Outsourcing and Automation

There are advisors who tout the benefits of wholesale outsourcing of the transfer pricing function, citing immediate head-count reduction and cost savings, and the other advantages described above. One strong argument in recent times is the drive towards greater efficiency by automating processes or via the harnessing of technology. The huge expense of IT projects and limited expertise of in-house tax teams makes it impracticable to self-develop tools to automate tax and transfer pricing compliance and reporting functions. Here, the large advisory firms have the resources to develop and offer tools ranging from documentation solutions that produce templated Master and local file documentation integrated with database searches to ERP enhancements that eliminate manual processes and provide sophisticated data analytics tools and dashboard views.

Caveat

Notwithstanding the above advantages of using external advisors, there are certain elements of transfer pricing implementation where in-house capability may be difficult to replace:

a. Pragmatic policy setting

– Typically, advisors do not implement policies. They do not have the same depth of understanding of the business models, product specifications and most importantly, a holistic appreciation of the organizational needs and constraints that an in-house

person would have. Successful policy setting and implementation is an 'art of the feasible'. It depends on a multitude of factors such as stakeholder objectives, the availability of data, selecting a method that the accounting system and processes can handle (see discussion in 18-400 on operational transfer pricing) and that the country managers can comprehend and agree to.

b. Knowledge of finance infrastructure and relationships

- Maintaining a transfer pricing infrastructure requires good relationships with finance teams and the ability to influence as well as work through the tax and finance channels. It is not possible for a small tax or transfer pricing team to introduce controls to police the proper implementation. The ongoing checks, assurances and resolution of issues require the ongoing support of finance colleagues. An effective in-house transfer pricing person or function has the big advantage over external advisors of being able to build such relationships and retain the institutional knowledge for future audits.

¶19-400 The TP Journey – Evolution of Transfer Pricing Capability

The in-house transfer pricing function can be developed beyond mere compliance to making sure there are proper governance and controls and even taking it to a strategic level.

Here is an example of such a journey:

¶19-410 Where Do I Begin? – Get the Basics Right

If you have responsibility of setting up transfer pricing and there is none previously in the company, a starting point would be to undertake a review across the MNE group to identify and understand the key intercompany transactions. Map out and quantify key related party transactions, whether there are internal comparables and identify risk factors such as services provided without charge and entities with continual losses (see risk indicators above). Draw up transfer pricing policies to cover the major intercompany transactions and implement them.

Read up on individual countries' documentation requirements, including whether they follow OECD Master and Local file formats, exemption thresholds and penalties. Engage internal stakeholders (especially finance who has the data) and consider engaging an advisor to help set up a complete basic documentation framework that meets the minimum requirements in all the footprint countries. The objective at this early stage should be to put in place adequate transfer pricing policy and documentation to avoid penalty.

Next, introduce transfer pricing policies and intercompany agreements across the group to cover these key related party transactions. Work with local tax and finance teams to establish clear roles and responsibilities to ensure that the policies are implemented in the financial books.

¶19-420 Intermediate – Consolidating Your In-house Transfer Pricing

Having covered key risk areas with TP analysis and documentation in the first stage, consider hiring dedicated transfer pricing specialists in-house to improve the quality and consistency of policies and documentation. Ensure that intercompany agreements are in place and all transfer pricing supporting documentation are properly archived

Enhance Controls: Consider instituting a group wider transfer pricing governance framework and controls process such as regular review of transfer pricing accruals and update of TP documentation especially upon setting up of new entities or changes in businesses. Some MNEs form multi-stakeholder TP governance committees that meet periodically to ensure that implementation issues are addressed and resolved.

Invest in Education: raise transfer pricing awareness throughout tax, finance and business so that transfer pricing is embedded into tax and other functions and transfer pricing risks is proactively identified and managed prior to transactions or business changes.

Consider Offshoring and a build-up of Shared Services Center teams in lower costs jurisdictions to rationalize advisor spends and migrate manual computational or documentation functions to cheaper offshore locations.

¶19-430 Advanced – Realizing the Greater Benefits of Transfer Pricing

The most sophisticated transfer pricing functions collaborate closely with the rest of tax and finance to harness the planning and strategic aspect such as optimizing the supply chain using principal and limited risks entities models, resolving disputes using MAP and getting certainty via APAs. It is also good practice to analyse the tax/transfer pricing profile presented by the CbCR and Masterfile, alongside the profitability by business lines, geographies and entities to identify transfer pricing stress points and anticipate disputes.

- A strategic and a long-term view to transfer pricing can take the form of an APA strategy where MNEs start by anchoring core related party transactions though bilateral or multilateral APAs with key countries such as the US, the UK, Germany and Japan. They then extend such principles to the rest of the MNEs' geographic locations by either negotiating APAs with the other countries or citing the core APA in support of adopting the same transfer price in the local file documentation.
- Process efficiency improvements can be taken to a higher level with automation of manual processes, tools to enhance documentation, invoicing, accruals and other ERP processes.
- Transfer pricing can be integrated into the overall enterprise or tax risk management framework with dedicated control manuals and procedures in place as well as establishing escalation channels. In this regard, the broader finance control function or even internal audit may be enlisted to ensure transfer pricing is properly implemented across the organisation.

– Safeguarding Reputation: As transfer pricing and tax avoidance have hit the headlines (witness the EU state aid cases, the Australia senate hearings and press reports of foreign MNEs being audited), the most advanced taxpayers have prepared their senior executives, particularly those in countries to handle sudden audit raids or unsolicited press queries and incorporated transfer pricing considerations in managing their sustainable taxpayer reports that may accompany the annual report.

¶19-500 Key Factors to Effective In-house Transfer Pricing

Whichever the stage of development the in-house transfer pricing function is in, several important factors stand out in effective in-house transfer pricing teams.

Firstly, a good transfer pricing function requires individuals and teams with a good mix of skills who all have clearly defined roles and responsibilities. The primary competency required of an in-house transfer pricing specialist would be the ability to effectively communicate and influence other people who work within the organisation. This would include teams who do not directly report to him/her as well as the ability to be effective across different cultures. A good team would also be cross-functional (or it may be two teams with one in the tax department and another, an intercompany accounting function in the finance department). It should include transfer pricing professionals who know how to conduct functional interviews, project manage advisors and draft documentation as well as finance trained staff who know the statutory accounting as well as ERP systems and have the relevant links and relationships to be able to source data from group and local level finance colleagues to compute and effect transfer pricing entries and maintain control measures. A balanced team could include both veterans who know the organisation, business and products well and get things done, combined with lateral hires who may bring with them the latest transfer pricing technical knowledge and fresh ideas from elsewhere. From the top, such a team must be supported by management so that there is buy-in and willingness of other functions finance, accounting, Treasury, legal and IT to collaborate.

More broadly, there is consistency in approach/strategy and investment across the years. Good transfer pricing practices (design, implementing and embedding transfer pricing) and institutional knowledge of the organization takes time to develop. The benefits are hard to quantify and are realized only in later years upon audit. The budget cycle and investment horizon of publicly listed MNEs tend to be short term. It is tempting, as a number of MNEs have done during economic or cyclical downturns, to either reduce advisor budgets (by for instance, forgoing regular refresh of transfer pricing analysis) or even make transfer pricing teams redundant only to suffer the consequences later as the loss of institutional knowledge and out-dated policies hinder audit defense years later. In a post-BEPS world, it is not prudent to measure the worth of the function by how aggressive transfer pricing can be used in planning and reducing the MNE's effective tax rate. Consequently, the benefits of good transfer pricing can be hard to quantify. The paradox is that the more effective the transfer pricing, the fewer the audits or the less severe the audit adjustments. This may give the wrong indication that transfer pricing resources can be cut. At a time of increasing

transfer pricing scrutiny and fast evolving, complex rules, the wise CFO or Chief Tax Officer will do well to maintain a steady level of funding and investment to keep their transfer pricing risk well managed.

¶19-600 Strategic Tax Planning

Once the compliance requirements are met, process and controls bedded down, MNEs can take transfer pricing to a strategic level by incorporating transfer pricing into their tax planning and business models.

In the years running up to BEPS, such strategic tax planning with transfer pricing typically involve business restructuring such as

(a) the conversion of full-fledged distributors into limited-risk distributors or commissionaires;

(b) conversion of full-fledged manufacturers into contract-manufacturers; and

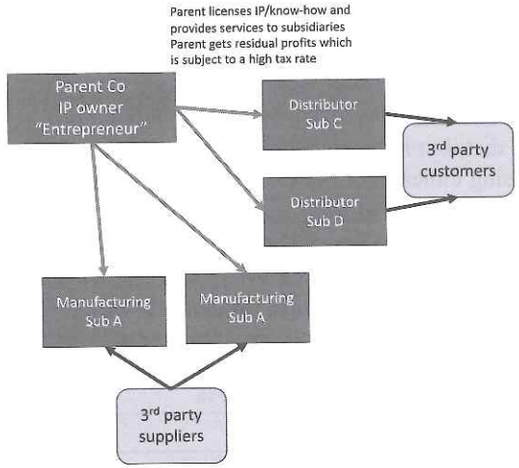
(c) restructuring of the supply chain and holding locations of intangible property.

The result can take the form of a "centralised entrepreneur/principal" supply chain model.

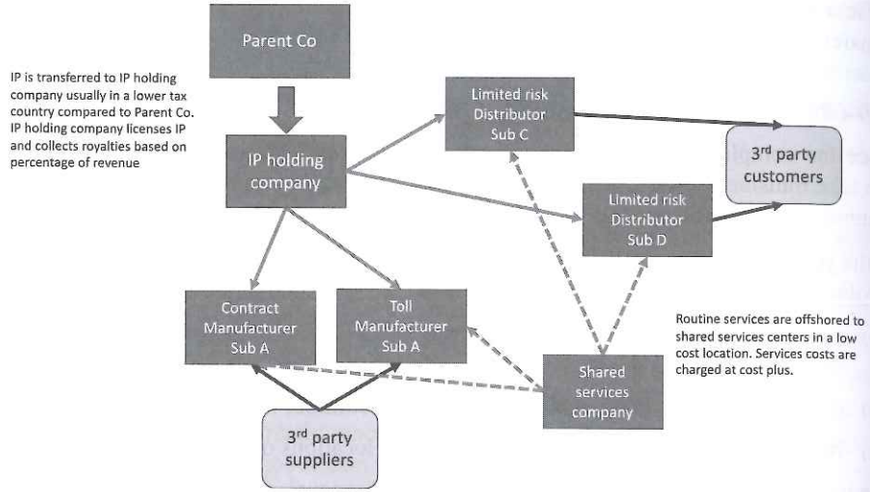
The core elements are:

- A "central entrepreneur/principal" company usually located in a low tax country;
- An "IP owner" company, which in many, which is often also the "central entrepreneur/principal" entity, again in a low tax country;
- One or more subsidiaries that are "Contract or toll manufacturers" or "Commissionaire or limited risk distributors"

Before Value/Supply Chain Restructuring



After Restructuring



The restructuring of the value/supply chain into these "centralised entrepreneur/principal" model can led to significant tax savings and consequently, lower effective tax rate for the MNE group.

EXAMPLE

Company A in Country A with tax rates of 30% and Company B in Country B with tax rates of 15% are related parties. Assume Company A manufactures goods at a cost of SG$10m and Company B distributes the goods in Country B at SG$12m. The operating margin (ignoring costs for now) is 20%.

Prior to Restructuring:

A is the full fletched manufacturer

B is limited risk distributor

As a limited risk distributor under transfer pricing, B earns 1.5% distribution margin at arm's length using either the Resale Pirce method or TNMM. Therefore, EBIT for B is SG$150,000

A as the entrepreneur, gets the Residual profit of SG$1.85m

Taxable profit	*Tax Rate*	*Tax Due*
A at $1.85m	30%	555,000
B at $150,000	15%	22,500
Total Tax paid by Group		577,500

Post Restructuring:

A becomes a limited risk contract manufacturer. This involves moving out functions and especially assets and risks from A. For example, if A holds intangibles, it is transferred to B and B undertakes to reimburse A for inventory and other risk.

B post restructuring owns intangibles and assumes significant risk, is therefore, no longer a limited risk but a full fletched distributor

As a limited risk contract manufacturer, A earns a 3% cost plus margin at arm's length using TNMM analysis. EBIT of A at 3% margin is SG$300,000

B as the full-fledged distributor and IP owner gets the residual profit of SG$1.7m

Taxable profit	*Tax Rate*	*Tax Due*
A at SG$300,000	30%	90,000
B at SG$1.7m	15%	255,000
Total Tax paid by Group		345,000

The end result is that the Group saves SG$232,500 of taxes by this restructuring. Such restructurings used to be easily implemented as the transfer of intangible assets and risks can be done without disrupting business operations.

In recent years, governments have put in place countermeasures that limit the effectiveness of such tax planning including exit toll charges for migration of businesses and assets and general or specific anti-avoidance rules. The BEPS project has further reduced the effectiveness of such planning with the DEMPE concept, requiring that the returns to intangibles be directed/allocated to where the key people's functions are performed (see discussion in 15-400). Corporate restructurings are required to be disclosed in the TP Documentation. Hence, the business rationale and robust transfer pricing analysis need to be performed and documented in anticipation of close scrutiny of such restructurings. In conclusion, in the post-BEPS world, sustainable planning needs to be based on sound business rationale and substance including having the locations where profits are recognized align with where value is created.

amounts expressed in this manner, CAHPL faced no exposure to currency risk. CFC faced currency risk (borrowed in US$, lent in AU$) and did not hedge currency risk but received a large forex gain upon repayment, ie difference between US$3.75bn and US$2.5bn.

For Australian tax purposes, CAHPL claimed a deduction for the interest paid to CFC over the term of the loan. The dividends received by CAHPL from CFC were exempt from tax under participation exemption. So far as CFC is concerned, the ATO issued a Private Ruling in 2003 to CFC declaring that the interest it received from CAHPL was not liable to Australian interest withholding tax which is normally 10% but is subject to a number of specific domestic law and tax treaty exemptions.

It was indicated that CFC was not taxable in the US on the interest income. As a result of the interest differential, CFC generated profits and it paid dividends to CAHPL, which were exempt from tax in Australia. CAHPL in turn paid dividends to its shareholder.

DEAL ECONOMICS

CAHPL reduced its Australian income by the interest outflow but recovered most of the funds as dividends. Tax effect is that income which might have been taxed in the hands of CAHPL at the corporate rate of 30% leaves and returns to Australia tax-free. The higher the interest rate on the loan from Chevron Funding Corp, the greater the arbitrage which was not subject to tax in either the US or Australia. The arbitrage also lowered the overall funding cost to the Chevron Australia Holding group.

ATO Challenge in 2010

Invoking Australia's transfer pricing laws, the Australia Taxation Office ("ATO") denied CAHPL a deduction for more than 50% of the interest claimed over the life of the Facility and applied a 25% penalty on the basis that CAHPL entered into the facility for the purpose of obtaining a tax benefit in connection with a transfer pricing scheme (approximately AUD$340m in total).

Key Points at the Trial

The court rejected the taxpayer's appeal against the assessment on the basis that the taxpayer had failed to satisfy its onus of proving that the assessment was excessive.

- Judge accepted Chevron Executive's testimony:
  - The higher the amount borrowed and the interest rate paid by CAHPL, the higher the cash benefit to CAHPL because there was no tax leakage in the US and the corresponding dividend from CFC to CAHPL would be tax free to CAHPL, and that borrowing on the terms in fact adopted was not sustainable for CAHPL without the dividend flows, and accordingly, the terms adopted would be unsustainable between independent parties as there would be no dividend between them (testimony from banking expert).
  - The effect of CAHPL not granting security, not giving covenants and no parent guarantee for CAHPL's borrowing all combined to push up the interest rate.
- A total of 19 expert witnesses who included commercial lenders, bank regulator, an ex-OECD official, a US tax expert and experts in oil & gas provided 45 reports but Judge gave "no weight to the opinions of transfer pricing economists where those opinions appear not to be founded in the statutory language which the Court must apply".

Transfer Pricing Issues

1. **Appropriate Approach to determining the interest rate - Credit rating vs commercial lender approach**
   - ATO: First determine the credit rating of CAHPL and the loan itself and then benchmark an arm's length interest rate or credit spread based on market rates for similarly rated comparable debt arrangements.
   - Judge: correct approach to determining the borrower's creditworthiness is from the perspective of a **commercial lender** and not by reference to how an external credit ratings agency would rate the borrower. As part of their internal credit risk analysis, there was evidence which the Court accepted that relevant lending institutions do not necessarily follow the same approach as credit ratings agencies and do not rely on credit agency ratings in deciding whether and at what price to lend.
   - Court found that banks would give more weight than rating agencies to parental support and rating agencies would be careful in upgrading from non-investment grade (S&P BB+ and below) to investment grade (S&P BBB- and above)
2. **Implicit support – how to treat the influence of parental affiliation on the creditworthiness of the borrower and therefore the interest rate, in absence of explicit guarantee**
   - ATO argued: Parental affiliation can have a material impact on and significantly improve the creditworthiness of the borrower. It is "a feature of the market to take account of any affiliation the borrower has" and fundamental to the interpretation & application of the ALP.
   - CAHPL argued: Concept has no application, as the statutory test was to determine the appropriateness of the pricing based on a hypothetical transaction between two separate and independent entities and that therefore the borrower could not have any parental affiliation.
   - Per Robertson J: Cannot ignore affiliation between a hypothesised party to a transaction and other members of that party's group of companies.

Acknowledged that while implicit support may be relevant when assessing a borrower's credit rating, its existence and value is a matter of fact. He accepted Chevron's argument that in the absence of a legally binding parental guarantee, implicit credit support had very little, if any, impact on pricing by a commercial lender in the real world.

- Compare with GE Capital where 100bps explicit guarantee fee for Canadian subsidiary issuing commercial paper & unsecured debentures in Canada) – consistent in recognizing implicit support but applied credit rating approach

3. **Ability to Recharacterise the related party transaction**
   - Robertson J found that if that property had been acquired under an agreement between independent parties dealing at arm's length with each other, the borrower would have given security and operational and financial covenants and the interest rate, as a consequence, would have been lower.
   - CAHPL argued: any such approach was recharacterisation or reconstruction not permitted under *OECD TP Guidelines* and the reconstruction power in the more recent Subdivision 815-B, in support of its proposition that it was impermissible to rewrite the terms of the loan. Court should keep the terms as they were and just determine the interest rate.
   - Per Robertson J: Such re-writing of the terms of the Credit Facility Agreement does not amount to impermissible recharacterisation. Forcused on interpreting the statute ("consideration" in Division 13, "conditions" in Subdivision 815-A) rather than OECD TP language against not "recharacterising" or not "rewriting".
4. **Are Standards of Comparability for Benchmarking Interest Rates Too Stringent?**
   - Robertson J: Rejected 4 loan agreements from the ATO expert and 5 loan agreements put forward by Chevron expert, reasoning that:
     - the amount of the loans was significantly different to that under review;
     - there was security provided whereas there was none in the CAHPL loan;
     - there were no financial covenants in the CAHPL loan;
     - there was doubt as to whether the CAHPL loan should be benchmarked against senior debt or subordinated debt;
     - the loans were of different tenors; and/or
     - the borrower companies were either in different industries (not E&P, even if they were in the energy industry), or experiencing financial difficulties, or not operating in the Australian market, or were parents rather than subsidiaries.
   - Robertson J: Since there was no CUPs, Chevron had not "shown that the consideration in the Credit Facility Agreement was the arm's length consideration or less than the arm's length consideration nor proved that the amended assessments were excessive".

Relevance for Singapore

The *IRAS TP Guidelines* has described the approach to comparability analysis in a related party loan situation in Section 13 of *IRAS TP Guidelines*. Nevertheless, because this is a Commonwealth case and Singapore has no TP case precedents, it is of persuasive authority in Singapore court, though the case applied Australian laws which though fundamentally based on the arm's length principle, contain certain differences particularly in the area of the scope and ability to recharacterise a transaction.

Some takeaways from *Chevron*

- In examining related party lending transactions, a court is not limited to just adjusting the interest rate to an arm's length one but can look more broadly at arm's length terms, though the Australia transfer pricing rules addressed by the case is interpreted more broadly than the Singapore rules;
- Any CUP search should be carried out using the financial data of the borrower that is or would have been available to an independent lender at the time of negotiation of the tested transaction;
- In order to identify CUPs, the credit risk of the borrower should be assessed in the same/similar way as would be carried out by independent lenders at the time of the making of the loan, though as noted above, the practical aspects of this expectation have not been clarified by the judge;
- Credit agency ratings should not always be relied upon for assessing the credit quality of the borrower, although the rating methodology used by the rating agencies may be similar to that which would be applied by an independent lender;
- Whether or not implicit support of a parent exists is a matter of fact and so may be taken into consideration – the court found that Chevron's parent would have given a guarantee though there was no explicit one on the facts, but in practice such implicit support is likely to have little if any impact in the real world – whether there is any benefit would appear to be a question of fact;
- Loan agreements between related parties should be drafted with the terms that would appear at that time in the real world, as if between an independent borrower and an independent lender (eg with clarity on subordination, appropriate financial covenants, security and so on). Without this, it would be very difficult in practice to benchmark the interest rate, given the high standards of comparability that would be expected.

These series of questions are designed to tease out the key concepts and can be readily used in any course assessment.

¶21-100 Question 1 – Supply Chain and Segmental View of TP

NiHaoMei ("NHM") is the ultimate holding company of a Malaysia based multinational group that develops, manufactures and distributes branded consumer packaged goods. NHM was incorporated in 1981 and sells its Asian-customized products in 23 Asian and a few Western countries, primarily through supermarkets, wholesale outlets, department stores, pharmacies, and via the internet through e-commerce retailers. In 2013, the group held 30% of the world's leading consumer brands across five Strategic Business Units ("SBU"); employed over 23,800 people worldwide; and had global net sales totalling US$10 billion.

Strategic Biz Unit	*2013 Net Sales (US$)*	*2013 Earnings Before Interest and Tax as a % of Net Sales*	*2013 Net Profit before tax as a % of Total Assets*
Beauty	2,000,000,000	15%	5%
Grooming	1,000,000,000	10%	3%
Health Care & Medicines	1,500,000,000	-5%	-7%
Fabric & Home Care	2,000,000,000	5%	5%
Baby & Family Care	3,000,000,000	8%	10%

Research and development activities account for 20% of net sales on an annual basis. All raw and packaging materials are purchased from unrelated parties and all sales are to unrelated parties. The group owns all the patents and licenses covering product formulation and manufacturing processes. All the products carry a valuable trademark, which is critical to the overall marketing and branding of the products and in part, the group's success can be attributed to the existence and continued protection of these trademarks, patents and licenses. Collectively the group spends 10% of net sales annually on marketing and advertising. The group has centralised regional purchasing and distribution centres, regional contract manufacturing plants, and a global service and finance centre.

What are the main elements of the group's supply chain?

The main elements in the supply chain includes procurement of raw material and packaging, manufacturing (could be fully-fledge but definitely includes some contract manufacturing), logistics, R&D, intellectual property protection, services (financial, IT, management, accounting), marketing, wholesale distribution and other logistical support, retail.

What are the potential related party transactions?

- Services: central purchasing and distribution; global service (IT support, management)
- Financing: intercompany financing, which could include loans, guarantees, hedging
- Contract Manufacturing
- Intangibles: providing use of trademarks and patents (know-how) licensing, sharing or transfer through sale; marketing – development of global marketing strategy; protection of group IP; undertaking R&D on behalf of the group

What could explain the variation between the profitability of the different Strategic Business Units?

The Margins of the SBU could vary due to a range of:

- the nature of materials and processes used to manufacture the products
- the capital intensity of the businesses
- differences in selling, general and administrative expenses as a percentage of net sales
- a specific SBU incurring start-up or market penetration costs
- being hit by a down turn in that particular segment
- market forces (extra competition, increases in labour, raw materials, transport)
- any government or legislative controls/changes (could include environmental, tax, health)
- level of financing and interest rates
- level of R&D and marketing spend
- advances in technology, eg medical sector could be impacted but innovation
- fads and trends, eg in the beauty sector
- poor management or other internal anomalies
- tax planning and profit shifting

¶21-200 Question 2 – Advance Pricing Arrangements

You are a junior member of the tax team in an advisory firm. A multinational drug and medical company, headquartered in Country A, has been operating through subsidiaries in Countries B, C, and D for the last 20 years. Recently, all companies have been subjected to tax authority audits, which has been a costly and time-consuming exercise. To avoid future problems, it has been suggested to the directors of the board that consideration be given to entering into an Advance Pricing Agreement (APA) with all four tax authorities and all the relevant entities, so that they can set and forget the prices for the next twenty years in line with their strategic plan.

They seek your bosses' advice as a highly regarded transfer pricing expert but your boss is on holiday speeding 30 miles per hour down the black ski slopes of Whistler and is not contactable. In a panic, you have no choice but to dust off your notes from textbooks so many moons ago and try to draft a reply addressing the following questions for your bosses' review.

- **What exactly is an APA, and is it consistent with their understanding as set out above?**

  An APA is an arrangement between IRAS and the taxpayer or the relevant foreign competent authority to agree in advance an appropriate set of criteria to ascertain the transfer pricing for a taxpayer's related party transactions for a specific period of time. An APA can be unilateral, bilateral or multilateral and in essence the agreement reached between the taxpayer and the authorities give clear directions as to the way in which prices can be set between related parties so as not to need a transfer pricing audit. An APA is based on certain critical assumptions which if varied could void the APA. The main issue with the understanding of the clients is that an APA that could extend to 20 years would be most unlikely. Further, a quadrilateral APA, whilst possible, poses the challenge of coordinating the meetings and positions and coming to an agreement that satisfies all four authorities. There is also a significant risk of delay. In practice, it is more common to see a series of unilateral and bilateral APAs.

- **How long do APAs last?**

  Most commonly APA regimes provide for 5 years forward but they can be shorter for example three years and possibly longer at not more than seven years taking into account roll-back years. They are unlikely to be shorter than three years because they are expensive and time-consuming to negotiate and would not be worth the effort if it was for a shorter period. It is unlikely to be as long as 20 years as the environment in which the APA operates becomes less and less predictable as time goes by and revenue authorities will wish to revisit the issues that go to the pricing that is applicable between related parties.

- **Can APAs embrace all the parties identified above?**

  First Company A and its subsidiaries must be resident in and have access to the tax treaties in their respective countries. Next, the question is whether countries A, B, C and D all recognise (including having the appropriate Double Tax agreements with Article 25) and accept the operation of the APAs. It is possible that one or more of these countries would not be willing to enter into such arrangements but they are becoming more commonplace and most developed and many developing countries would accept the need for the utility of such an agreement.

- **What are the advantages and risks involved in seeking an APA?**

  Some considerations before applying for the APA include:

  - Securing an APA can be very time consuming especially where many countries are involved.
  - Securing an APA can be very expensive requiring detailed analysis usually provided by a substantial accounting firm to support the pricing which the parties are arguing for in the context of the APA.
  - Securing an APA can involve disclosure of certain sensitive information to revenue authorities in a number of different jurisdictions and this can inadvertently expose the group to further tax investigations particularly relating to prior years before the operation of the APA begins.

- **How long is it likely to take to seek an APA, and is it costly?**

  An APA is a time-consuming and costly exercise. The time to negotiate such an agreement from beginning to end is almost certain to be at least one year and more likely three years of negotiation, drafting, amending and finalisation. Costs are hard to predict but it will draw upon a lot of internal resources and advisor costs can run to as much as $US500,000 or more for complex transactions.

- **Provide a list of content or headings that will appear in an APA agreement.**

Refer to Annex B3 of *IRAS TP Guidelines*

1. Covered entities - This refers to the related parties to the covered transaction.
2. Covered transactions: This refers to the transactions on which an arm's length remuneration is to be agreed.
3. Covered Period: This refers to the Fiscal Years to be covered in the APA. Note that this need not be calendar years. For example, India has years starting 1 April to 31 March the following year.
4. Transfer pricing method: This is the agreed method on which the arm's length remuneration is to be determined.
5. Arm's length remuneration: This is the agreed arm's length remuneration for the covered transaction.
6. Compensating Adjustment Rules: The rules set out the basis of determining the compensating adjustments.

7. Critical assumptions: No material changes throughout the covered period to the:
   - economic environment in which the covered entities operate.
   - functions performed, risk assumed and assets employed by the covered entities with respect to the covered transaction.
   - accounting methods and business operations of the covered entities with respect to the covered transaction.
8. Annual Compliance report: The covered entities are to submit the annual compliance report, including computations, to demonstrate compliance with APA terms by the filing due date of covered entities' income tax returns.
   - **If, three years after an APA becomes operative, the number of Country B employees is halved and a new subsidiary is established in Country E, will the APA continue to remain valid and effective?**

This will depend on whether the number of employees that are involved in each country participating in the APA was a critical or material assumption made under the assumption is part of the APA. If it was, such a substantial change could be critical and material and would at the very least require full disclosure to Country B authorities and all the other three countries as well as it may have a material impact on the acceptable pricing from the perspective of all four countries.

The new subsidiary in Country E may not be an issue as subsidiary E and Country E is not a party to the APA unless there are changes to the functions, assets and risks of the covered entities A, B, C and D or their margins impacted.

¶21-300 Question 3 – Functional Analysis

GERMAN MARQUE WITH CHINESE INGENUITY

XiFeng and Deutsche Maschinell Gefertigt ("DMG") are two car companies with Chinese and German parent companies respectively. DMG is a London Stock Exchange listed company active in the design, manufacturing and distribution of cars in Germany and around the world. XiFeng is a State owned car maker owned by the ChengDu state government. In this industry it is important to be able to constantly renew the product line and propose new Auto designs for sale each season. One competitive advantage of DMG is precision engineering techniques or the ability to come up with a new snazzy model every eighteen months, so that customers will be interested in their cars. They also have companion concept stores where strong customer loyalty is built for repeat custom. XiFeng does not have its own design department and generally produces "copies" of foreign cars under production license.

Since 2007, the DMG has sold its products in China under a limited risk collaboration with XiFeng. XiFeng purchases the cars from the DMG and sells them using glitzy marketing campaigns in twenty concept stores across in China following the DMG branding philosophy. The agreement between DMG and XiFeng requires that every eighteen months, DMG will buy back any inventory that remains unsold by the XiFeng and that the latter will replenish its offerings from the new car models put out by DMG.

In 2009, DMG acquired 35% of the shares in the XiFeng to form a joint venture with the ChengDu government. The limited risk distribution agreement remains unchanged.

In 2010, confident of the success enjoyed thus far, XiFeng then created a new subsidiary in Germany, XiFeng Deutchland to distribute XiFeng made cars in Germany to German auto-dealers who will then undertake after sales service in Germany. These cars are made in XiFeng's factories in China using some modern technology patented by DMG and licensed to XiFeng for at a rate of 3% of annual revenues generated from exploiting the technology.

In 2013, the 35% that DMG owned in XiFeng was then increased to 51%. Again the limited risk distribution agreement remaining unchanged. However, the licensing agreement was scrapped and instead DMG allowed XiFeng to use all its patents free of charge since it is now part of the global DMG corporate 'family'. Further, DMG moved some R&D activities and assembly lines to China to derive significant location savings, as the manufacturing and labour costs are significantly lower in China than in Germany. The cars made by the assembly lines in China are then distributed by both DMG and XiFeng Deutschland in Germany. To support this expansion of activities, DMG extends a working capital loan of US$100million to XiFeng at LIBOR plus 18% interest rate. DMG further charges XiFeng head-office management charges for finance, marketing and other central costs since XiFeng is now consolidated into the DMG group and receives the standard finance, HR and other support from DMG headoffice.

In 2014, DMG considered negotiating a bilateral Advanced Pricing Agreement between China and Germany to gain certainty over the related party transactions between DMG and XiFeng.

Formulate a functional analysis of the three entities of the group at the end of 2013, on the basis of information available above.

(a) Manufacturing

DMG - DMG has its own production lines in Germany and it moves some assembly lines from Germany to China in 2013 in view of the significantly lower manufacturing and labour costs in China compared to Germany.

XiFeng - XiFeng undertakes manufacturing activities in China.

XiFeng Deutchland does not undertake any manufacturing activities.

Other possible aspects of functional analysis

- Procurement – which entity performs purchasing of materials and parts for the production process
- Inventory – which entity controls the level of inventory, where is the inventory held
- Production Equipment – which entity maintains the plant, authorises the purchase or disposal of capital equipment and specifies what plant equipment is needed
- Production Scheduling – who is responsible for the production schedule decisions
- Quality Control and testing – who sets finished products quality standards and provides the technical know-how to do quality control and related tests.

(b) Research and Development

DMG - carries out R&D activities in order to develop new car model every 18th months, using its precision engineering techniques and patented modern technology. In 2013, DMG moved some R&D activities and assembly lines to China to derive significant location savings. The cars made by the assembly lines in China are then distributed by both DMG and XiFeng Deutchland in Germany.

XiFeng –XiFeng does not undertake significant R&D activities as it does not have its own design department, and generally it produces "copies" of foreign cars. In 2010, following the incorporation of its subsidiary, XiFeng Deutchland in Germany, XiFeng uses DMG's patented technology and know-how in its production process, and pays to DMG licence fees of 3% on annual revenue generated from exploiting DMG patented technology. Subsequently in 2013, DMG shareholding was increased from 35% to 51%, and the licensing agreement was scrapped and DMG allowed

XiFent to use all its patents free of charge since XiFeng become part of the global DMG corporate group.

XiFeng Deutchland does not undertake any R&D activities.

Other possible aspects of functional analysis

- What R&D activities are carried out by DMG, DMG's China R&D Centre and XiFeng on their own?
- Do DMG and XiFeng commission third parties to carry out R&D on their behalf?
- What intangible assets do DMG, DMG's China R&D Centre and XiFeng own or have the right to use?
- Who controls and direct the R&D and who bears the risks of failure of R&D efforts?
- Apart from allowing XiFeng to use DMG's patented technology and know-how in XiFeng's production process, does DMG render services to XiFeng such as technical assistance and training of XiFeng's employees?

(c) Marketing, Sales & Distribution

DMG – DMG's marketing strategy includes developing its own branding philosophy for the German and overseas markets, as well as its own marketing campaigns for execution by its distributors. DMG is selling its cars in China through its distributor, XiFeng under a limited risk distribution ("LRD") agreement, where XiFeng purchases the cars from DMG and sells them in China using marketing campaigns that aligned to DMG branding philosophy. Pursuant to the LRD agreement, every 18th month DMG will buy back any inventory that remains unsold by XiFeng and that the latter will replenish its offerings from new car models put out by DMG

XiFeng – More information is needed to properly analyse the marketing, sales and distribution activities carried out leading to the sales of XiFeng's cars. From 2010 onwards, XiFeng Deutchland distributes XiFeng's cars in Germany through the German auto-car dealers who perform after-sales service in Germany. In addition, XiFeng operates as the limited risk distributor since 2007, who is responsible for selling DMG's cars in China using marketing campaigns that aligned to DMG branding philosophy.

XiFeng Deutchland – Consider whether XiFeng Deutchland is involved in any strategic marketing, sales and distribution decisions or rely on parent company, XiFeng for direction. Essentially XiFeng Deutchland is a commission agent that acts as a distribution agent for the parent company, XiFeng for the sales of cars in Germany.

Other possible aspects of functional analysis

- Marketing, Sales & Distribution Strategies – which entity make strategic marketing, sales and distribution decisions, whether third-party distributors are used (which