Transfer Pricing for Singapore-based Headquarters

TP Methods, Documentation and Disputes

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Transfer pricing (TP) has been a mainstay in the international tax scene ever since it was catapulted into the limelight by the Organisation for Economic Co-operation and Development (OECD)'s Base Erosion and Profit Shifting (BEPS) project back in 2013. As the OECD presses on with its two-pillar solution under the new BEPS 2.0 initiative, TP is set to dominate the international tax agenda for years to come.

Earlier this year, the Inland Revenue Authority of Singapore (IRAS) published a specific guidance for multinational enterprise (MNE) groups with centralised activities in Singapore, and subsequently updated its TP guidelines. At a webinar organised by the Singapore Chartered Tax Professionals, Adriana Calderon, Director, Transfer Pricing Solutions Asia, zoomed in on the key TP issues that Singapore-based headquarters (HQs) should take note of.

Role of HQ

According to IRAS' e-Tax guide, HQ is defined as a "centralised office location(s) where an MNE group's management and key staff operate and oversee business activities". Functions of an HQ may include centralised key decision-making, management and coordination, building customer insights, developing product and service strategies for local markets, as well as achieving economies of scale and cost efficiencies.

While the term "HQ" is commonly used for tax, corporate planning, corporate communications and TP purposes, IRAS has expressed that the said label should not dictate the TP analysis. Instead, emphasis should be placed on assessing the actual functions, assets, and risk profiles of the HQ to determine the appropriate transfer price for centralised activities.

In practice, the function profile of an HQ may range anywhere from a service provider to an entrepreneur, depending on the nature of the activities it conducts, taking into account assets used and risks assumed.

On one end of the spectrum is a service provider providing routine centralised services that are generally administrative and executory in nature. On the other end is an entrepreneur that performs significant functions to organise and operate the business, makes key business decisions, and controls and assumes significant entrepreneurial risk and has the financial capacity to assume risk.

Functional Analysis

An HQ's contribution to value is defined by the nature of the activities it conducts, the assets used and the risks assumed, for which the HQ should be appropriately compensated for the benefits it confers to the MNE group.

Functions performed by HQs

HQs generally conduct a wide spectrum of activities that are centralised. The HQ may perform the activities on its own account and acts as a principal, or on behalf of another entity and acts as a service provider. Broadly, these can be categorised into four functional profiles:

i) Principal in distribution, manufacturing or research and development (R&D) arrangements;
ii) Activities relating to core business processes;
iii) Activities relating to administrative, technical, financial, commercial, management, coordination, and control functions;
iv) Shareholder activities.

It should be noted that shareholder activities (such as the preparation of the consolidated financial statements of the group) do not benefit the group entities. As such, HQs should not charge a service fee in respect of these activities.

Assets utilised by HQs

Depending on the functions performed by and the role of the HQs, different assets may be employed to run their operations.

For example, an HQ acting as a principal may own the relevant intellectual property (or license patents and other technologies from the group's intellectual property owners) to execute its responsibilities, while an HQ acting as a principal in a manufacturing arrangement may own raw materials, packaging materials and finished goods.

Risks assumed by HQs

There are many different risks that can be encountered by HQs, such as market risks, commercial risks and supply chain risks.

Where the HQ acts as a principal, it would typically assume all or some of the key business risks. The HQ must have the financial capacity to assume the risks, as well as the capability to make key business decisions and conduct activities relating to core business processes. In contrast, an HQ providing only routine centralised services would generally be limited to the operational risks of providing the services.

Appropriate TP Method

The functions performed, assets utilised and risks assumed by the HQ define its contributions to the value chain of the MNE group; this in turn determine the arm's length remuneration that it should earn.

To price the actual related party transaction, one of the five TP methods as set out in the TP Guidelines, any other more appropriate method, or even a combination of methods may be used. Common industry practices and the availability of reliable independent comparables should be considered when selecting the most appropriate method to price HQ activities.

Generally, an HQ assuming economically significant risks and is characterised as an entrepreneur should receive the residual profit in accordance with the selected TP method, and be entitled to the upside benefits and incur the downside costs. On the other hand, an HQ that is characterised as a service provider would generally receive a fixed return based on the level of value add of its service.

TP Documentation & Exemptions

Maintaining a set of robust and contemporaneous TP documentation is key to minimise TP exposure. HQs are subject to the same thresholds for preparation of mandatory TP documentation in Singapore as outlined in the TP Guidelines, that is, if the gross revenue from their trade or business for the basis period exceeds S$10 million, or if they were required to prepare TP documentation for a previous basis period.

Exemption from TP documentation may apply if the HQ's gross revenue is below S$10 million for the current basis period and the immediate two preceding basis periods (even if related party thresholds are exceeded), or if it is one of the transactions specifically exempted under the TP Documentation Rules.

TYPE AND CONTENT OF TP DOCUMENTATION

A Singapore-based HQ is required to prepare TP documentation at the group level and entity level, both of which are largely similar to the OECD's master file and local file requirements respectively.

Where the Singapore-based HQ is the ultimate parent entity of the MNE group and has group revenue exceeding S$1.125 billion, it is also required to file a country-by-country report.

Frequency of Review

It is a best practice for HQs to review and refresh their TP documentation annually to ensure that information contained in the TP documentation remain accurate, and that the transfer price supported by the TP documentation is still at arm's length.

In Singapore, to reduce compliance burden, taxpayers are allowed to use TP documentation prepared previously to support the transfer price in the basis period concerned if that past TP documentation is a qualifying past TP documentation.

In the basis period where such qualifying past TP documentation is used, taxpayers need to prepare a simplified review and declaration that qualifying past TP documentation has been prepared together with a copy of the qualifying past TP documentation.

TP Audit-Ready

In the event of audit or review by tax authorities, common documents and information requested during audit or reviews typically include contracts, contemporaneous TP documentation, invoices, organisational charts, job descriptions, basis for the price in the transactions, and support on calculation of the price.

As the open years for which a TP audit are generally between five and seven years, HQs should ensure that they retain these documents and information to stay audit-ready.

Common TP Disputes

TP ADJUSTMENTS

An HQ may make year-end adjustments as its actual results differ from the arm's length prices determined in its TP study before or during its year-end closing. In Singapore, IRAS would generally accept the year-end (downward) adjustments if the TP analyses and contemporaneous TP documentation are in place, the year-end adjustments are made symmetrically in the accounts of the affected related parties, and the adjustments are made before the HQ files its tax returns.

An HQ may also make self-initiated retrospective adjustments due to subsequent changes in circumstances (for example, to comply with a group global TP policy which has not been taken into account previously or to reflect revisions in TP analyses). It is understood that IRAS will not allow any retrospective downward adjustments unless such adjustments are due to an error or mistake under Section 93A(1A) of the Income Tax Act and supported by contemporaneous TP documentation.

ISSUES ARISING FROM COVID-19

Many businesses suffered losses due to the COVID-19 pandemic. From a TP perspective, the question then is who in the MNE group should bear the negative impact arising from COVID-19. While the full impact is yet to be seen, it would not be unlikely to see some tax authorities trying to dispute MNE groups' loss allocation, and accordingly, subject them to TP adjustments and double taxation.

One possible flashpoint is the business volatility caused by COVID-19 which results in wide fluctuations of profits and losses. While IRAS has allowed taxpayers to apply term testing for YAs 2021 and 2022 (such that related party transactions can be tested over a multiple-year period to reduce volatile TP results due to COVID-19), the same may not be allowed in other jurisdictions. This may then lead to potential disputes in the other jurisdictions.

Against the challenging international backdrop, the TP environment is no doubt tougher than ever and will only get more intense going forward. It is therefore crucial for MNE groups and Singapore HQs to actively manage their growing TP risks by reviewing their existing TP processes and practices, as well as evaluating the adequacy of their TP documentation.

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