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Singapore Transfer Pricing developments

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Greetings from your Tax & Legal team at Deloitte Singapore. We hope that you and your loved ones are staying safe and healthy despite these challenging times. As we navigate ourselves through this trying period, we are committed to giving you the support you need.

We are pleased to share the following with you.

Inland Revenue Authority of Singapore (IRAS) releases additional clarifications for taxpayers affected by COVID-19

On 7 September 2020, the IRAS released on their website an initial guidance for taxpayers dealing with the impact of COVID-19 on their transfer pricing (TP) arrangements. The clarifications provided by the IRAS in September 2020 cover the following areas:

- TP documentation and substantiation of arm's length outcomes for taxpayers impacted by COVID-19.
- Concession to apply term-testing for Year of Assessment (YA) 2021 without pre-approval from IRAS.
- Procedural clarifications on Advance Pricing Agreements (APA).

It was anticipated that the IRAS would provide further update once the Organisation for Economic Co-Operation and Development (OECD) Working Party No. 6 releases its COVID-19 TP guidance ("OECD Guidance").

On 18 December 2020, the OECD provided its policy recommendations to address challenges in applying TP rules in the years affected by the COVID-19 situation.

In response to the OECD Guidance, the IRAS updated its guidance on 29 January 2021 with the following updates:

- Additional clarifications and information in TP documentation to justify the impact of COVID-19 on the industry and business in general.

- Treatment of government assistance such as Job Support Scheme (JSS) for TP purposes.
- Clarification on whether Limited Risk Distributors (LRDs) can incur losses in FY 2020.
- Clarification on inclusion of loss-making comparables in benchmarking studies.

In addition to the above, the IRAS has also extended the term-testing concession for taxpayers by one additional year to YA 2022 (FY 2021).

Please click on the link below for more information.

More information

Key highlights

The latest IRAS guidance continues to be in the form of an interactive question and answer format. In the latest update, the IRAS provided additional insights on how to treat government assistance, losses for LRDs and the inclusion of loss-making comparables in benchmarking analyses.

The IRAS also extended the term-testing concession for taxpayers to cover YA 2022 (in addition to YA 2021).

The following sections discuss the additional clarifications issued by the IRAS in detail:

- **Additional clarifications and information in TP documentation to justify the impact of COVID-19 on taxpayer's industry and business in general**

  In the earlier version of the COVID-19 TP Guidance, the IRAS provided certain parameters to help taxpayers prepare robust TP documentation and evidence to justify their TP outcomes during the COVID-19 period. In this updated guidance, in line with the OECD Guidance on comparability analysis during periods affected by COVID-19, the IRAS has issued the following additional clarifications and information requirements:

  1. In order to document the impact of COVID-19 on the taxpayer's business and the industry, the IRAS has clarified that the following reference points may be used:

     a. Macroeconomic information like country specific Gross Domestic Product (GDP) data or industry indicators from central banks, government agencies, industry or trade associations to the extent useful in understanding the context of the related party transaction.

     b. Statistical methods such as regression analysis or variance analysis that may be used to predict the extent to which a certain variable will vary with reference to other variables under certain specific conditions (e.g., the response of corporate profits in certain industries to GDP movements).

  2. A comparison of any changes to the contractual arrangements between the taxpayers and their related parties, vis-à-vis independent parties in light of COVID-19.

  3. The IRAS has further clarified that the following data points may be analysed in-depth to quantify and justify the negative impact of COVID-19 on the taxpayer's business:

     a. An analysis of how sales volumes have changed during COVID-19, including whether the change is due to the use of other sales channels, and specifically compared to sales generated in pre-COVID-19 years.

     b. An analysis of the change in the company's capacity utilisation, taking into account its related party transactions and/or transactions with independent parties.

c. Specific information related to incremental or exceptional costs borne by parties to the related party transaction (either with related or unrelated parties) or by the group as a whole.

4. The IRAS has also clarified that the receipt of any COVID-19 specific government assistance should also be taken into account, in the comparability analysis. The accounting treatment of such assistance has to be also be appropriately considered when undertaking the TP analysis.

5. Additionally, the IRAS also expects taxpayers to document details of any government intervention measures, for example, temporary cessation of business due to COVID-19 that affect their transfer prices with related parties.

- **Treatment of benefits received from government assistance (e.g., JSS payouts) for TP purposes**

The IRAS recognises that benefits from government assistance may be economically relevant and potentially have TP implications, whether the assistance is provided to a member of a group directly or made available to independent parties within the market where a group operates. The IRAS is also appreciative of the fact that the benefit of government assistance could potentially affect arrangements and pricing between independent parties and their customers in a particular market. Accordingly, it becomes critical to examine the impact of such benefits on the taxpayer's related party arrangements as well as on independent parties as part of a TP analysis.

In line with the OECD Guidance, the IRAS has also categorically explained that as a general rule, an independent party acting in a commercially rational manner would retain the benefits from government assistance, unless it is specifically stated in the government assistance that the benefit has to be passed on or shared with another party. The objective of providing government assistance and wage support benefits (such as the JSS) to taxpayers is to help them retain their local employees during this period of economic uncertainty. Accordingly, government interventions should be treated as 'conditions of market' in the particular country. Taxpayers are **not** expected to pass on the benefits from government assistance to their related parties through transfer pricing. However, an exception may apply if there is reliable evidence showing that third parties would have done so under comparable circumstances.

In order to help taxpayers understand the exception, the IRAS has provided the following key commentary as regards the parameters to be considered before determining whether the benefits received by the taxpayer can be treated as operating in nature:

1. The receipt of government assistance may be part of the economic circumstances of the parties and a feature of the market in which they operate.

2. The potential effect of receipt of government assistance on the pricing of related party transactions will depend on 'economically relevant characteristics' of the transaction. This will require an accurate 'delineation' of the transaction and comparability analysis.

3. It would be 'contrary' to the arm's length principle to assume that mere receipt of government assistance would affect the pricing of delineated related party

transactions without performing a thorough comparability analysis (using independent comparable data and perspective of both parties to the transaction).

4. The provision of government assistance to a related party should ‘not alter the allocation of risk’ in a related party transaction for TP purposes. However, it may reduce the quantitative negative impact of a risk.

The IRAS has also illustrated how the guidance will apply to LRDs who have received JSS from the Singapore government. Applying the above principles in a situation where the Singapore LRD is involved in sale of products to related parties, the IRAS has re-emphasised that it is important to consider how ‘independent’ parties in the market treat such government assistance. As a starting point, comparable transactions between independent parties would need to be examined to determine if the effect of JSS was passed on to the customers, for example, in terms of a lower price.

The IRAS has also clarified, using a numerical example, that in the absence of reliable information on whether the comparables would have passed on the benefits of JSS to its customers, taxpayers can take the view that the comparables would have retained the benefits from the government assistance. Subsequently, the taxpayers will have to treat JSS income as being non-operating in nature i.e., the cost base of the taxpayer should not be reduced by the JSS payouts for the purpose of computing the TP outcome.

- **Clarification on whether LRDs can incur losses in FY 2020 (YA 2021)**

The IRAS has clarified that the acceptance of losses for LRDs as arm’s length outcome is subject to the facts and circumstances of each case. The analysis of allocation of risks and decision-making controls within the group is critical to allocate profits or losses between group companies and the LRDs.

The IRAS has explained that a significant decline in demand due to COVID-19 can result in significant operating losses for the group. Depending on local economic conditions, it is possible that Singapore LRDs will also be exposed to such market risk. As such, as long as reliable evidence can be provided that independent distributors undertaking a comparable transaction would have similarly incurred losses under comparable circumstances, the Singapore LRDs may incur operating losses emanating from materialisation of the market risk, provided it is clearly delineated that the LRD assumes certain market risks and those risks indeed “played out” due to COVID-19.

Conversely, if the LRD does not bear inventory risk, any loss arising from the materialisation of inventory risk should not be borne by the LRDs.

Further, if the TP analysis shows that the LRD is not subject to market risk, inventory risk or any other specific risk, then the LRD should not bear the corresponding losses associated with playing out of these risks.

- **Inclusion of loss-making comparables in the bechmarking study**

The IRAS has clarified that in order to undertake an enhanced and reliable comparability analysis, it prefers taxpayers to use multiple year data as opposed to single-year data. At present, the impact of COVID-19 on businesses can only be seen in the years 2020 and beyond. However, it is practically challenging to obtain such contemporaneous and reliable information readily in the public domain.

The IRAS is of the view (consistent with Section 5 of the TP Guidelines issued on 23 February 2018) that excluding the following comparables would eliminate persistently loss-making independent parties for reasons other than COVID-19 i.e., entities that suffered losses for sustained periods before the COVID-19 pandemic:

1. Comparables with weighted average loss for the tested period; or

2. Comparable which incurred losses for more than half of the tested period.

Hence, as a general principle, comparables that suffer losses in the COVID-19 period, but have not suffered persistent losses in the past years can be included in the comparability analysis and benchmarking study. The IRAS will review this guidance once additional reliable financial information for the years impacted by COVID-19 becomes available.

- **Additional concession to apply term-testing for YA 2022, in addition to YA 2021**

  The IRAS also extended the application of term-testing for an additional year to include YA 2022. The conditions for the application of term-testing for YAs 2021 and 2022 remain unchanged.

  Term testing is highlighted as a one-off event in the TP documentation for YAs 2021 and/or 2022, and in line with the earlier clarification, term-testing for YA 2022 may generally be applied over a period of three years.

Deloitte Singapore's views

The updated clarifications issued by the IRAS are largely consistent with the principles prescribed in the OECD Guidance, and the additional flexibility and alternatives to conducting a comparability analysis/TP analysis provided under the IRAS and OECD Guidance would be helpful to all businesses affected by COVID-19.

The clarifications issued by the IRAS certainly provided a helpful direction to taxpayers, in terms of acceptable approaches and information that can help enhance comparability analysis, and documenting the impact of COVID-19 on a taxpayer's profit outcome.

Aligning with the OECD Guidance, the IRAS' tone also affirms that it is open to explanations from taxpayers in relation to COVID-19 impact as long as they are documented and properly reference to information or evidence available in the public domain. The extension of term-testing to YA 2022 is welcomed, as it is apparent that the earlier concession applicable for YA 2021 is only appropriate for taxpayers with a December accounting year end. For example, for a taxpayer with a March year end, COVID-19 is expected to have a major impact on its business in YA 2022 (1 April 2020 to 31 March 2021), instead of YA 2021. As term-testing is relatively easy to apply, this would provide a useful alternative for Singapore taxpayers to substantiate their TP outcome for YA 2022.

The clarification provided by IRAS on three specific issues, namely, the possibility of LRD bearing losses, the inclusion of loss making comparables and the treatment of government assistance is useful, as these represent some of the top concerns on the minds of many taxpayers. There had been concerns that tax authorities might take an ideological position of these issues.

Though strict conditions still need to be met before a taxpayer can rely on the IRAS clarification (not an unqualified application of the IRAS clarification on these issues), the IRAS' position is nonetheless assuring as it demonstrates that IRAS is at least prepared to take a fact-based approach on these issues, based on the taxpayer's actual, commercial situation, while maintaining a principled position.

Companies in such situations can consider exploring how they may rely on the IRAS clarifications on these three issues, particularly how information or appropriate evidence could be identified and collated, to substantiate the reliance.

The clarification on government assistance provided detailed insights into the parameters and comparability requirements that taxpayers need to consider in connection with the TP treatment of such assistance.

However, the clarification does read as the IRAS being inclined (unless robust contrary evidence is provided) to exclude these items from the calculation of the profit level of the tested party, as seen in the following excerpt:

"Generally, IRAS is of the view that an independent party acting in a commercially rational manner would retain the benefits from government assistance, unless it is specifically stated in the government assistance that the benefit has to be passed on or shared with another party. In this regard, your company is not expected to pass on the benefits from government assistance to your related parties through transfer pricing. An exception may apply if there is reliable evidence showing that third parties would have done so under comparable circumstances."

The IRAS goes on to acknowledge that it may be difficult to find 'detailed information' on whether independent parties would pass on these benefits, and suggested that if so, the Singapore taxpayer (the tested party) 'can take the view' that these independent parties would retain the benefits i.e., the Singapore taxpayer (the tested party) should likewise retain the benefits and hence exclude such items from the calculation of its profit level for TP purposes.

The financial impact of government assistance, particularly the JSS, has been significant for many businesses, and its impact is especially pronounced in the calculation of profit level indicators (PLI) for TP purposes. For instance, in a typical situation, a company may have experienced substantial decline in sales (revenue) during the period impacted by COVID-19. However, because of JSS and other government assistance, its operating profit may not have declined by the same extent (or in some businesses, stayed the same as pre-COVID-19 levels). However, in a typical application of Transactional Net Margin Method with OM (operating profit/revenue) as the PLI, the OM % would show a significant increase.

With the IRAS position on this matter now clarified, we would urge companies to conduct an early assessment of how the IRAS position would impact their PLI calculation, and take timely action. One obvious risk is that foreign tax authorities (in jurisdictions where the related parties are located in) may hold a different view and given the substantial impact such assistance may have on the PLI calculation, a potential gap may arise in how IRAS and these authorities calculate and determine the 'true' profitability.

Hence, in order to mitigate such risks, companies should have a clear and timely view of how their PLI is impacted, and address such risks appropriately, which may include an in-depth analysis into the impact of these items, identifying appropriate comparables and making suitable comparability adjustments or references, or perhaps even consider some TP adjustments before the closing of FY 2020.

In conclusion, along with the OECD Guidance, the guidance from IRAS provides useful alternatives and approaches (to the ‘traditional’ or ‘conventional’ approaches to TP analysis) to help both taxpayers and IRAS get to a better assessment of taxpayers’ financial situation and outcome due to COVID-19. For FY 2020, taxpayers are strongly encouraged to assess and revisit their TP arrangements in light of these developments and consider if certain proactive actions need to be taken in preparation for the closing for FY 2020, and/or in the preparation of transfer pricing documentation for FY 2020.

Contacts

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