

## **SUMMARY OF RESPONSES – PUBLIC CONSULTATION ON DRAFT IRAS SUPPLEMENTARY CIRCULAR: “TRANSFER PRICING GUIDELINES FOR RELATED PARTY LOANS AND RELATED PARTY SERVICES”**

A public consultation exercise was held between 21 October 2008 and 20 November 2008 to obtain public feedback on a draft IRAS supplementary circular entitled “Transfer Pricing Guidelines for Related Party Loans and Related Party Services” (hereinafter referred to as “draft supplementary circular”).

2 Following IRAS’ issuance of Transfer Pricing Guidelines for Singapore taxpayers on 23 February 2006, IRAS has received a number of queries concerning the application of the guidelines to related party loans and related party services. The draft supplementary circular seeks to address these queries and provide guidance and clarifications on the application of the Transfer Pricing Guidelines to related party loans and services.

### **Response to the Public Consultation Exercise**

3 IRAS received comments from 11 respondents on the draft supplementary circular during the public consultation period. IRAS wishes to thank all respondents for their comments.

4 Some of the comments received concern transfer pricing issues not specific to related party loans and related party services. As the comments received fall outside the scope and intent of the draft supplementary circular, they have not been addressed in this response.

### **Summary of Comments**

5 IRAS has considered carefully all the comments received.

6 Based on these comments, IRAS has further fine-tuned the draft supplementary circular and also included additional clarifications arising from certain issues raised by respondents. These changes do not alter the draft supplementary circular in a material manner.

7 The supplementary circular has been finalised and issued by IRAS on 23 February 2009.

8 The comments and IRAS’ responses are summarised below.

## **TRANSFER PRICING GUIDELINES FOR RELATED PARTY LOANS**

### **DEFINITION OF LOAN**

(i) Paragraph 2.1.1 of the draft supplementary circular states that a loan includes credit facilities or intercompany credit balances arising from the normal course of sales and provision of services which are left uncollected over a substantial period beyond which a third party trade creditor would typically allow.

Respondents had requested that IRAS establish a definition for “substantial period” for this purpose, i.e. to specify the length of time a related party trade debt which remains unpaid could constitute a loan where arm’s length interest requirement may apply. One respondent also commented that many businesses do not charge interest on unpaid third party debts whatever the period outstanding. Another respondent was of the view that the factors listed in paragraph 2.2.2 might not be applicable in the case of trade debts, and that IRAS’s suggestion to use the SIBOR, LIBOR or other similar rate might not be suitable for determining the interest rate to be charged on trade debts. Clarification was also sought on whether non-trade receivables on current account owing by overseas related parties may be treated as a loan requiring an arm’s length interest to be charged and whether netting of non-trade receivables and non-trade payables may be allowed.

**IRAS’ Response:** IRAS considers that a loan arises when there is money lent in one form or another, irrespective of how the loan is given effect. As such, a loan can arise from trade debts or any other unpaid debts or sums due from related entity, if these debts or sums owed were left uncollected over a substantial period of time. What constitutes a substantial period of time for this purpose would, more often than not, have to be determined by reference to the specific facts and circumstances in each case. For example, the terms of repayment of a debt often depend, among other factors, on the type of debt involved and also the industry in which a taxpayer operates in. Even though third party sales may not necessarily exist to be used as a reference, as some comments suggested, taxpayers should examine the credit terms common to the industry in which they operate to assist in the determination of when independent enterprises might impose interest charges on unpaid balances. IRAS would also like to clarify that where taxpayers consider the factors listed in paragraph 2.2.2 or the suggestion to use the rates stated in paragraph 2.2.4 inappropriate in their circumstances, they are not precluded from determining the appropriate arm’s length interest rate based on their own analysis and documentation. Taxpayers know best their business operations and the business environment in which they operate. They should also be in the best position to make such an assessment and determination.

## RELATED DOMESTIC LOAN

### Definition

(ii) Paragraph 2.1.2 of the draft supplementary circular states that a related domestic loan arises when a domestic entity lends to, or borrows from, a related domestic entity. Clarifications were sought on the definition of the term “domestic entity”. It was suggested by some respondents that the term be defined based on the entity’s country of incorporation or by the entity’s country of residence. Other respondents suggested that a “domestic entity” should be defined to mean “an individual resident in Singapore, a company incorporated or is a tax resident in Singapore, a body of persons, a trust or a partnership or any other non-corporate entity or organization constituted in Singapore and a Singapore branch of a foreign company”.

**IRAS’ Response:** For the purposes of the draft supplementary circular on related party loans, a domestic entity means any business entity that is incorporated or

registered in Singapore and is carrying on a business in Singapore. For greater clarity, the definition of “domestic entity” has been incorporated into the supplementary circular released on 23 February 2009.

### **Application of Arm’s Length Principle**

(iii) Paragraph 2.1.8 provides for the continuation of the current practice of making interest adjustments on lenders who make loans to related entities which are interest-free or otherwise at interest rates not supported by transfer pricing analysis, as a proxy to the application of the arm’s length principle. IRAS does not regard this practice as a perfect proxy to the application of the arm’s length principle to related party loans. Nonetheless, IRAS was prepared, based on previous feedback received, to continue with the practice under certain circumstances so as to facilitate domestic taxpayers’ efforts at complying with the arm’s length standard. This will be applicable to related domestic loans and only if the lender is also not in the business of borrowing and lending funds. A clarification was sought by one respondent on the definition of the phrase “in the business of borrowing and lending funds”. Another respondent raised a query on whether such practice would be in violation of the non-discrimination provision contained in Singapore’s tax treaties.

**IRAS’ Response:** Generally, an entity whose principal activity (or one of its principal activities) is that of borrowing and lending funds would be considered to be in the business of borrowing and lending funds (e.g. banks or other financial institutions, finance and treasury centres). However, to determine whether an entity is in the business of borrowing and lending funds, further analysis would often have to be carried out based on the facts of each case. For this reason, it will not be possible, or appropriate in the first instance, to list exhaustively the types of entities covered by this definition.

On whether the practice may violate the non-discrimination provisions of Singapore’s tax treaties, IRAS is of the view that this will not be the case. The application of interest adjustment as a proxy to application of the arm’s length principle applies to related domestic loans, provided the lender is also not in the business of borrowing and lending funds. A related domestic loan arises when a domestic entity lends to, or borrows from, another related domestic entity. Where interest adjustment applies, the distinguishing factor for determining what constitutes a domestic entity is not its nationality (i.e. place of incorporation). Any entity which carries on a business in Singapore and is therefore required to register its business in Singapore is also considered a domestic entity even if it is not incorporated in Singapore. Furthermore, a domestic entity lending to or borrowing from a related domestic entity is clearly not in the same circumstances as a domestic entity lending to or borrowing from a related foreign entity, both in law and in fact.

## **RELATED CROSS-BORDER LOAN**

### **Grandfathering of Existing Cross-Border Loan**

(iv) Some respondents expressed concern that existing cross-border loans should be “grandfathered” under the current system (i.e., making interest adjustments on lenders instead of requiring that an arm’s length interest rate be charged), or suggested alternatively that the two-year transition period should be extended to

accommodate those loans with terms that extend beyond the two-year transition period provided in the draft supplementary circular.

**IRAS' Response:** IRAS is of the view that the arm's length principle is the correct and most appropriate standard for determining the rate of interest in related party loans. Related parties should not find it too onerous to restructure loans between themselves to appropriately reflect arm's length conditions. Nonetheless, to facilitate taxpayers' efforts at complying with the arm's length standard, IRAS is prepared to allow a two-year transition period from 1 January 2009 for related parties to restructure cross-border loans. With this administrative concession, taxpayers will only be required to fully comply with the arm's length principle for all cross-border loan arrangements from 1 January 2011.

### Foreign Source Income

(v) Some respondents also highlighted that in the case of cross-border loans, any interest receivable by the Singapore lender would probably be foreign source income since the borrower is outside Singapore. As such, the interest income would be subject to tax in Singapore only if the interest is remitted or deemed remitted to Singapore. That being the case, should the Singapore lender decide not to charge any interest or charges interest at below arm's length rate, the current provisions in the Singapore Income Tax Act do not allow the deeming of such interest income to be Singapore-sourced income or the deeming of the income to be remitted to Singapore.

**IRAS' Response:** Whether interest income constitutes domestic or foreign source income is a question to be determined by reference to the specific facts of a case. Interest income derived by a taxpayer who is carrying on a business of lending money in Singapore would constitute Singapore source income. Accordingly, such interest income would be taxed in Singapore whether the income is remitted or not. Where the interest income constitutes foreign source income, it is recognized that the current legislation may not fully support deeming the remittance of the arm's length interest income to Singapore. IRAS will closely monitor this situation, and may consider taking appropriate steps to address any concern that arises. In this regard, where IRAS determines that the arm's length principle is not adhered to in a related party loan arrangement, IRAS may not be prepared to enter into mutual agreement discussion should a treaty partner make any adjustment on, including any secondary adjustment which may cause withholding tax to become payable by, the borrower in respect of the loan. This is because the Singapore lender's objection to the tax adjustment(s) made by the foreign tax authority on the borrower is not justifiable in the absence of a transfer pricing study reflecting what the arm's length interest rate should be. In the absence of an arm's length interest charge on a loan which is supported by appropriate documentation, IRAS will also not be prepared to consider any claim of relief made by taxpayer for any foreign tax paid.

### Foreign Lender

(vi) Clarifications were sought on whether the requirement to charge interest at arm's length rates on cross-border loans is applicable where the lender is not a Singapore entity. In other words, whether the requirement applies where the Singapore entity borrows from an overseas related party and that party decides not to levy any

interest on the outstanding loan. If the arm's length requirement is applicable, and in the case where the cross-border loans are not made at arm's length, clarification was sought on whether the imputed interest payment to a lender outside Singapore would be subject to withholding tax and whether a deduction would be allowed to the Singapore borrower on the deemed interest payment to the overseas related party.

**IRAS' Response:** IRAS believes that the arm's length principle should be adhered to for all related party loans, including all cross-border loans given by or received by a Singapore entity. In the case of a cross-border loan received by a Singapore entity, it is recognized that the current legislation may not fully support the deeming of payment of an arm's length interest charge on the loan to the related overseas lender. No deduction is allowable to the Singapore borrower unless it incurs interest expenditure in the production of income. IRAS will closely monitor this situation, and may consider taking appropriate steps to address any concern that arises.

Similarly, in this regard, where IRAS determines that the arm's length principle is not adhered to in a related party loan arrangement, IRAS may not allow any interest cost subsequently on-charged by the overseas related lender as a result of any income adjustment made on the lender by a foreign tax jurisdiction. This is because any such subsequent request made by the Singapore borrower for tax deduction under these circumstances would, more often than not, be regarded as one made without a valid basis. IRAS may also not be prepared to enter into mutual agreement discussion should a treaty partner make such adjustment on the lender in respect of the loan. This is because the objection to the tax adjustment made by the foreign tax authority is not justifiable in the absence of a transfer pricing study.

#### **DETERMINATION OF ARM'S LENGTH INTEREST**

(vii) Some respondents sought clarification on whether a transfer pricing study conducted to satisfy the requirements of a foreign tax authority would be acceptable by IRAS. Otherwise, two sets of studies would have to be made. A number of respondents had requested that IRAS allow publicly available interest rates to be used as proxies rather than as references. In other words, the suggestion was that IRAS should establish a "safe harbour" rate of interest.

**IRAS' Response:** A transfer pricing study is conducted to determine the arm's length price for related party transactions, including related party loans. When conducting a transfer pricing study on a related party loan arrangement aimed at satisfying the requirements of either IRAS or a foreign tax authority, the arm's length interest charge on the loan in question has to be determined based on the interest charge that would be agreed between independent entities. That being the case, the arm's length interest charge established is unlikely to differ significantly regardless of whether the transfer pricing study is made to satisfy the requirement of IRAS or a foreign tax authority. Accordingly, IRAS is likely to accept the transfer pricing study conducted to satisfy the requirement of a foreign tax authority if, upon careful examination by IRAS, the established interest charge is found to be reflective of an arm's length interest charge.

## TRANSFER PRICING GUIDELINES FOR RELATED PARTY SERVICES

### DIRECT VS. INDIRECT CHARGING

(viii) Some respondents sought further guidance on the use of indirect charging methods, including the components of the cost base under an indirect charge method. For example, clarification was sought on whether notional costs such as employee equity compensation under FRS 102 should be included in the cost base when determining the arm's length fee. One respondent also enquired whether IRAS would accept the use of one unique allocation key for all the routine support services listed in Annex A of the draft supplementary circular.

**IRAS' Response:** Guidance on the components of the cost base under a cost plus method for transfer pricing purposes may be found in paragraphs 3.2.5.1(c)(iv) and 3.2.5.1(c)(v) of the IRAS circular on Transfer Pricing Guidelines ("the main circular") issued on 23 February 2006. Respondents may wish to refer to the main circular which suggests that the cost base should be computed in accordance with accounting principles that are generally accepted in Singapore if the tested party is an enterprise in Singapore. On the use of one unique allocation key, it is open to the taxpayer to substantiate that it is appropriate to do so for the services under consideration.

### ASCERTAINING THE ARM'S LENGTH FEE

#### Transfer Pricing Methodology

(ix) Some respondents were concerned that taxpayers may draw the inference from the draft supplementary circular that the cost-plus method is favoured by IRAS as the appropriate transfer pricing methodology to adopt for related party services, compared to other methods such as the transactional net margin method, which one respondent pointed out was not specifically discussed in the draft supplementary circular and hence may be inferred as being less acceptable by IRAS.

**IRAS' Response:** IRAS does not have a specific preference for any transfer pricing method adopted as long as the method adopted produces the most reliable results taking into account the quality of available data in determining the arm's length fee. The acceptance of a 5% mark-up on cost for routine services merely provides an alternative to carrying out a detailed transfer pricing analysis by taxpayers. Taxpayers may provide IRAS with a detailed transfer pricing analysis to support the charging for services using different transfer pricing methodologies or at mark-ups other than 5%, wherever relevant.

### ROUTINE SERVICES

#### De-minimis Concept

(x) One respondent proposed the removal of the requirement under paragraph 3.3.10 which states that the routine support service should not also be provided to an unrelated party. It was felt that this requirement may be too stringent. Instead, a de-minimis concept is proposed, which the respondent felt could also serve as an alternative quantitative test to supplement the list of routine support services in

Annex A of the draft supplementary circular.

**IRAS' Response:** IRAS has considered the proposal to provide for a de-minimis threshold but determined that this may not be appropriate. This is because where a service is also provided to an unrelated party, this may indicate that the service could constitute part, if not the whole, of the service provider's profit-earning operations. In this respect, IRAS agrees with another respondent who has commented that services similar to those listed in Annex A (which may ordinarily constitute services of lower business risk and lower added value in typical related party service arrangements) may actually be considered high value-add services in certain sectors or industries and as a result, may not be eligible for the 5% safe harbour mark-up. Hence, where a service is also provided to unrelated parties, IRAS is of the view that such service should no longer qualify as a routine service for purposes of applying the 5% mark-up. In such a case, it may also be appropriate to consider whether the service fee charged to an unrelated party may be used as the comparable uncontrolled price to determine the arm's length fee. The same rationale applies to the inclusion of this condition in paragraph 3.3.16(a) of the draft supplementary circular.

#### Identifying Routine Services

(xi) Some respondents commented that it might be useful to insert a general definition of routine support services based on their main characteristics, with the list of routine support services in Annex A kept as a non-exhaustive list of examples of routine support services. There were also comments on procedure for updating the list.

**IRAS' Response:** Paragraph 3.3.9 of the draft supplementary circular describes the nature of routine support services. This should provide the general principles to guide taxpayers in their determination of whether a service could be considered as a routine support service. Paragraph 3.3.12 of the draft supplementary circular also clarifies that the list of services in Annex A may be updated in future. IRAS will review and update the list in Annex A from time to time. Taxpayers may also write in to IRAS at anytime to request IRAS to consider modifying, deleting or expanding on the list. IRAS will consider such requests when updating the list.

#### Identifying Non-Routine Services

(xii) A respondent sought further guidance on the identification of non-routine services. The respondent asked, for instance, whether specialised services that are provided infrequently and which are not associated to routine services could be considered as non-routine services. Another respondent also suggested that IRAS indicates the types of services that might require a mark-up greater than 5%.

**IRAS' Response:** Taxpayers who provide services to related parties should demonstrate that their pricing of the services meets the arm's length standard with the support of appropriate transfer pricing analysis in all cases. However, IRAS recognizes that such a requirement, if applied across-the-board, could unduly increase the compliance burden on taxpayers. IRAS is therefore prepared to accept the 5% mark-up commonly adopted for certain routine support activities as a reasonable arm's length charge for routine support services. IRAS has provided a

list of routine support services for this purpose to facilitate compliance. Services which are not included in this list will not be considered routine support services.

#### List of Services in Annex A

(xiii) Some respondents proposed additional services to be included in the list of routine support services in Annex A. However, there were also respondents who pointed out that some of the routine support services listed in Annex A may be non-routine in nature. Examples cited are purchasing, computer support, database administration and public relations.

**IRAS' Response:** IRAS has reviewed all proposals received for clarification, addition or removal from the list of routine support services in Annex A. In reviewing the proposals, IRAS has considered whether the descriptions of the service activities used in Annex A may be further fine-tuned or clarified to better reflect the scope of routine services to be covered and the routine nature of such services. The list of routine support services in Annex A of the draft supplementary circular has been updated accordingly.

#### 5% Mark-up

(xiv) Respondents also provided comments on IRAS' acceptance of a 5% mark-up for providers of routine services. Whilst welcoming the ease of application and reduction of compliance burden through the introduction of a standard mark-up of 5%, one respondent proposed that a range of margins be used instead, especially if the overseas related party is operating in a country which applies a different mark-up requirement for similar routine services. Another respondent commented that a 5% mark-up seemed relatively low, and was concerned it might cause difficulties for a foreign company to justify a higher mark-up on routine services charged to Singapore related parties. There was also the question of whether the 5% safe harbour mark-up is applicable for both inbound and outbound provision of related party routine services.

**IRAS' Response:** IRAS recognises that different countries could have adopted different levels of mark-up on costs under their respective safe-harbour provisions. These mark-ups may be lower or higher than 5%. IRAS is prepared to accept a 5% mark-up on the basis that this has been a practice commonly adopted by related party service providers in Singapore as remuneration for providing routine support services. IRAS considers that a 5% mark-up may be accepted as a reasonable arm's length charge for such services, whether inbound or outbound. However, paragraph 3.3.13 clarifies that taxpayers are not precluded from adopting a mark-up other than 5%, if the outcome adheres to the arm's length principle.

#### Deemed Mark-up

(xv) One respondent sought clarification on whether a deemed service fee income computed based on a 5% mark-up on costs is acceptable in situations where the service provider of routine support services chooses not to charge service fees to its related parties.

**IRAS' Response:** IRAS will bring to tax a deemed mark-up on costs in cases where the service provider of routine support services chooses not to charge service fees to

its related parties. IRAS however will not allow deduction to the related party recipients of such routine support services unless they incur the related expenditure in the production of their income.

## **SERVICES PROVIDED ON A COST POOLING BASIS**

### **15% Threshold**

(xvi) One respondent sought clarification on the application of the 15% threshold under paragraph 3.3.16(b) of the draft supplementary circular. Specifically, the clarification relates to whether the threshold is applied on a legal entity basis, whether there is any restriction on what may be included as total expenses, and IRAS' treatment if the 15% threshold is not met in a particular year because actual expenses fall short of projected expenses.

**IRAS' Response:** The 15% threshold is applied on an entity-basis, and total expenses are those reflected in the financial accounts for the relevant financial year. As such, IRAS would take reference from actual expenses, and not projected expenses, in determining both the costs of providing the services as well as total expenses. However, IRAS recognizes that there may be practical difficulties in applying the 15% threshold using actual expenses. Therefore, IRAS is prepared to accept the use of projected expenses if there is a reasonable basis upon which the projected expenses have been derived and the expenses are reviewed at the end of each year to determine whether the 15% threshold criterion has been met. If it is determined upon review that the 15% threshold has not been met when it was previously projected to have been the case, then any additional tax payable on the 5% mark-up (or other appropriate mark-up) for routine support services provided should be accounted for accordingly.

### **Annex A**

(xvii) One of the conditions for a service provided in a cost pooling arrangement to be charged to related parties with no element of mark-up is that the service being provided is one listed in Annex A of the draft supplementary circular (paragraph 3.3.16(c)). Respondents suggested that this condition in paragraph 3.3.16(c) should either be removed or expanded in scope to include all routine services, some of which are specified in Annex A.

**IRAS' Response:** Although IRAS is prepared to accept no mark-up on costs for services provided on a cost pooling basis, the intention is to restrict the services to those listed in Annex A of the draft supplementary circular. IRAS is, however, prepared to review taxpayers' requests for additional routine support services to be included in Annex A.

### **Costs to be Borne**

(xviii) One of the respondents requested for the relaxation of the criterion that each party's share of the costs must be borne "in the form of cash or other monetary contributions", citing as reason the fact that certain parties to the arrangement may contribute their services in lieu of cash or other monetary contributions.

**IRAS' Response:** The provision for cost pooling arrangements is a concession

granted in recognition that group companies may find it beneficial to pool resources together in acquiring certain commonly used services within the group. IRAS notes the feedback and will monitor the situation and review the need to further broaden this criterion.

### **Documentation Requirements**

(xix) Some respondents sought more guidance on what would be considered as adequate documentation to support the basis of cost allocation as being at arm's length under a cost pooling arrangement. In particular, clarifications were sought on:

- (i) Whether documentation requirements under a cost pooling arrangement would be more onerous compared to other arrangements,
- (ii) Whether a signed written agreement is necessary to show that the parties intended to pool resources together to share costs prior to the provision of the service, and if so, what elements should be contained in the agreement. Whether an intercompany service agreement with a preamble that the parties intended to pool the resources together to share costs would suffice, and
- (iii) Whether it is sufficient, in proving the expected benefits of the cost pooling arrangement, to merely state the reasons for the cost pooling arrangement in the contract between related parties, for example the lower administrative costs for the corporate group.

**IRAS' Response:** Given the varied circumstances under which related parties may enter into a cost pooling arrangement, IRAS considers it appropriate not to prescribe specific documentation requirements for such an arrangement. While the intention is not to impose onerous documentation requirements on a taxpayer, IRAS nonetheless expects that there should be written documentation for such an arrangement, which should also be properly endorsed by the related parties involved, to support the intent of the parties to enter into the arrangement prior to the effective date of the cost pooling arrangement. The expected benefits of the cost pooling arrangement for the recipients of the service should also be stated clearly in each arrangement.

### **Approval Requirements**

(xx) One respondent sought clarification on whether the requirement for sufficient documentation showing that the parties intended to pool resources together to share costs prior to the provision of the service, means that prior approval from IRAS is required for each cost pooling arrangement.

**IRAS' Response:** The requirement for documentation to prove that the related parties had intended to enter into a cost pooling arrangement prior to the provision of the service is to ensure that the related parties do not apply the cost pooling treatment on a retrospective basis. There is no need to obtain prior approval from IRAS for each cost pooling arrangement. Taxpayers are required to provide the documentation for their cost pooling arrangements upon request by IRAS.

## **STRICT PASS-THROUGH COSTS**

### **Legal and Contractual Liability**

(xxi) Some respondents asked for further guidance on what is meant by "legal or

contractual liabilities". One respondent sought clarification on whether legal liability refers to the nature of the service (i.e. where the service enables the related party to fulfil a legal obligation), or to the fact that the legal obligation to pay for the service lies with the related party.

**IRAS' Response:** Legal or contractual liability refers to the fact that there is legal or contractual liability to pay for the services provided by the third-party service provider.

### **Scope**

(xxii) Some respondents proposed a relaxation of the considerations stated in paragraphs 3.3.18 to 3.3.19 of the draft supplementary circular, before the cost of a service may be allowed strict pass-through treatment. Some respondents proposed that strict pass-through costs should be allowed as long as the group service provider or another corporate group member is the contractual party in the master agreement with third-party service providers, a related party benefited from the service provided by the third-party service provider, and the cost of providing the service can be identified and where possible, directly charged or otherwise allocated on a reasonable basis to the related party.

**IRAS' Response:** Strict pass-through costs, where IRAS is prepared to accept no mark-up on costs for services, are intended to apply only for specific situations where it is clear that the legal and contractual liability for the services falls on the related party benefiting or expected to benefit from the service. IRAS would like to point out, however, that in the case of strict pass-through costs, the related party services concerned are not confined to only routine support services.