

**PUBLIC**  
**CONSULTATION**  
**PAPER**

**IRAS**  
**SUPPLEMENTARY**  
**CIRCULAR**  
**(DRAFT)**

**TRANSFER PRICING GUIDELINES**  
**FOR**  
**RELATED PARTY LOANS AND**  
**RELATED PARTY SERVICES**



INLAND REVENUE  
AUTHORITY  
OF SINGAPORE

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## FOR PUBLIC CONSULTATION

IRAS issued a circular setting out the Transfer Pricing Guidelines for Singapore taxpayers on 23<sup>rd</sup> February 2006. It has since received a number of queries concerning the application of the guidelines to related party loans and related party services.

This draft supplementary circular provides guidance and clarifications on the application of the arm's length principle as set out in the Transfer Pricing Guidelines to related party loans and related party services. Specifically, this supplementary circular addresses the following queries received:

- (i) whether interest free loans or interest-bearing loans not supported by transfer pricing analysis are acceptable;
- (ii) whether the application of a 5% mark-up on costs can be accepted for services rendered to related parties; and
- (iii) whether payments for services purchased from another service provider can be passed through to related parties at no mark-up.

Before this supplementary circular is finalized, we would like to have your feedback on the clarifications provided therein. Please provide your comments via email to: [international\\_tax@iras.gov.sg](mailto:international_tax@iras.gov.sg) by 20 November 2008. In your email, please include your name and contact number so that we could seek further clarifications from you where necessary.

Thank you.

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## SECTION 1 INTRODUCTION

- 1.1 IRAS issued a circular setting out the Transfer Pricing Guidelines for Singapore taxpayers on 23<sup>rd</sup> February 2006 (hereinafter referred to as the “main circular”). The main circular provides guidance on the application of the arm’s length principle and related matters. This supplementary circular provides further guidance and clarification on the application of the arm’s length principle to related party loans and related party services.
- 1.2 The arm’s length principle is the internationally accepted standard for transfer pricing between related parties. IRAS believes the arm’s length principle is the most appropriate standard to determine the transfer prices for related party transactions. IRAS abides by this principle. This should strictly apply to all related party transactions. Nonetheless, IRAS recognizes that a mechanical application of the arm’s length principle could give rise to difficulties and concerns for businesses. In some cases, the conduct of a comprehensive analysis for the purpose of demonstrating compliance with the arm’s length principle might not be practical. IRAS is therefore prepared to consider allowing for practical alternatives to assist taxpayers in complying with the arm’s length principle.
- 1.3 Taxpayers are responsible for managing their own tax exposures, including the risks of transfer pricing adjustment for cross-border related party transactions. Globalization has caused the level of cross-border related party transactions to dramatically increase over the years and along with it, the increased focus by most tax authorities on such transactions to ensure their tax bases are not inappropriately eroded. Transfer pricing adjustments made by a tax authority for cross-border related party transactions might result in double taxation for taxpayers. It is therefore in the best interest of taxpayers with related party transactions to minimise the incidence of double taxation by ensuring that they establish arm’s length transfer pricing policies and maintain adequate documentation to demonstrate compliance with these policies.

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## SECTION 2 TRANSFER PRICING GUIDELINES FOR RELATED PARTY LOANS

### 2.1 Application of the Arm's Length Principle to Related Party Loans

2.1.1 A loan arises when there is money lent in one form or another, irrespective of whether the loan is effected through a written agreement or instrument. It 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.

2.1.2 A related party loan can arise in the following situations:

- (a) a domestic entity lends to, or borrows from, a related domestic entity (hereinafter referred to as "related domestic loan");
- (b) a domestic entity lends to or borrows from a related foreign entity (hereinafter referred to as "related cross-border loan").

2.1.3 In adhering to the arm's length principle, an entity that makes a loan to, or otherwise becomes a creditor of, another related entity should charge the related entity for the use of funds at a rate that reflects an arm's length rate of interest.

2.1.4 The arm's length rate of interest is the rate of interest which should have been charged, at the time the indebtedness arose, between independent parties under similar circumstances. In other words, the arm's length rate of interest is the interest rate that the lender of the funds would charge to provide funds to borrowers that are independent of the lender.

2.1.5 In the case of a related domestic loan, it is currently common practice for entities to extend/receive interest-free loans or interest bearing-loans at rates that are not supported by transfer pricing analysis to/from other related entities. At present, entities making such loans have not been strictly required to adopt the typical methodology of charging an arm's length rate of interest. Instead, IRAS would restrict the amount of any interest expense claimed by the lender on such loans, where applicable. Such a practice does not ordinarily conform to the arm's length principle. Nonetheless, it serves as a close proxy to the arm's length principle in many cases of domestic inter-company loans.

2.1.6 Taxpayers have expressed concern that a requirement to apply arm's length methodology to all related party loans would result in complications for them and increased compliance cost. They have requested IRAS to consider continuing with the current practice of restricting the interest expense claimed as a proxy to the arm's length principle.

2.1.7 It remains IRAS' view that the arm's length principle is the correct and most appropriate standard for determining the rate of interest in related party loans. While interest adjustment applied at the lending entity level may serve as a

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proxy to the arm's length principle under certain circumstances, it is not a perfect proxy and may only address concerns of revenue leakage partially under certain other circumstances for domestic tax purposes vis-à-vis a case where arm's length methodology is applied. For example, the limitation on tax deduction is of minimal impact if the lending entity does not incur interest expense.

2.1.8 Nonetheless, taking account of taxpayers' feedback and other considerations, IRAS is prepared to facilitate domestic taxpayers' efforts at complying with the arm's length standard by continuing the current practice of making interest adjustment on lenders who make loans to related entities which are interest-free or otherwise at interest rates not supported by transfer pricing analysis. This practice will only apply to related domestic loans and where the lender concerned is also not in the business of borrowing and lending funds.

2.1.9 In the case of related cross-border loans, taxpayers should adopt the arm's length methodology for these related party loans. Nevertheless, IRAS recognises that some domestic lenders may have extended loans to foreign related entities, which are interest-free or otherwise at interest rates not supported by transfer pricing analysis. These domestic lenders may need time to restructure the loans to reflect commercial conditions and obtain an arm's length rate of interest. Consequently, IRAS is prepared to continue applying interest adjustment to them on such loans for a transition period of two years starting from 1 January 2009. After this two-year transition period i.e. from 1 January 2011 onwards, IRAS would require all cross-border loan arrangements to reflect arm's length conditions.

2.1.10 Observing the arm's length standard is part of Singapore's tax treaty obligations. The arm's length principle is also the internationally adopted standard. The adoption and compliance with this principle will reduce the incidence of transfer pricing adjustments, improve the resolution of transfer pricing disputes and hence reduce the potential for double taxation to arise for related party loans. As a corollary, taxpayers who choose to extend interest-free cross-border loans or interest-bearing cross-border loans not supported by transfer pricing analysis to related parties should recognise that when such loans are subject to transfer pricing audits/adjustments, there may be higher risk of unresolved disagreement over the adjustments and hence double taxation.

## **2.2 Guidance on the Determination of the Arm's Length Interest**

2.2.1 Section 3 of the main circular provides a framework to guide the application of the arm's length principle. Taxpayers could rely on this framework and the 3-step approach in particular when analysing and determining the arm's length interest for related party loans.

2.2.2 When conducting a comparability analysis, all the relevant facts and circumstances relating to the loan must be considered. These factors include:

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- (i) the nature and purpose of the loan;
- (ii) The market conditions at the time the loan is granted;
- (iii) the principal amount, duration and terms of the loan;
- (iv) the currency in which the loan is denominated;
- (v) the exchange risks borne by the lender or borrower;
- (vi) the security offered by the borrower;
- (vii) the guarantees involved in the loan;
- (viii) the credit standing of the borrower;
- (ix) the interest rate prevailing at the situs of the lender or borrower for comparable loans between unrelated parties.

2.2.3 The comparable uncontrolled price ("CUP") method is the preferred method for determining the arm's length pricing for related party loans, not only because of its conceptual superiority compared to the other methods, but also because it is often found to be the most suitable method for loan transactions. However, if circumstances render another method to be more appropriate, taxpayers could rely on that method, and maintain documentation to justify why that method is more suitable.

2.2.4 As practical guidance for the arm's length analysis, IRAS suggests that taxpayers rely on a suitable reference rate, such as the Singapore Inter Bank Offered Rate ("SIBOR"), the London Inter Bank Offered Rate ("LIBOR"), prime rates offered by banks or specific rates quoted by banks for similar loans. Adjustments could then be made to the reference rate, based on the outcome of the comparability analysis undertaken, to arrive at the appropriate arm's length rate or range of rates.

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## **SECTION 3 TRANSFER PRICING GUIDELINES FOR RELATED PARTY SERVICES**

### **3.1 Application of the Arm's Length Principle to Related Party Services**

3.1.1 Related party services, also commonly known as intra-group services, generally refer to activities that are performed for one or more related parties within a group of companies/businesses. It is common that related parties within a group would arrange for a broad array of services to be furnished by one or more members of the group. Such services may include administrative, technical, financial, commercial, management, coordination and control functions.

3.1.2 This supplementary circular provides guidance on the circumstances under which IRAS considers the provision of related party services has arisen and the application of the arm's length principle to such services. Whilst the guidance provided in this section has general application to all transactions involving related party services, the guidance provided in paragraphs 3.3.9 to 3.3.13, and 3.3.16 below will have application on a prospective basis.

### **3.2 When is a Service Provided – Key Considerations**

3.2.1 In determining whether a service has been provided to a related party, one has to look at all surrounding facts and circumstances. It is not possible to establish a set of strict criteria to determine if an activity amounts to a service provided. However, there are generally accepted considerations to determine whether services have been provided.

3.2.2 A service is considered to have been provided when activities are performed for another party who receives, or reasonably expects to receive, benefit from such activities. When there is a reasonable expectation or intention for benefit to be conferred or received, a provision of service is considered to have taken place even if the expected benefit does not eventually materialise.

3.2.3 A benefit must have economic or commercial value such that an independent party would expect to pay to receive it or be paid for supplying it. The benefit must be identifiable and capable of being valued, and hence must be sufficiently direct and substantial. If the benefit to be derived from an activity is not what an independent party in comparable circumstances would be willing to pay for or to carry out for itself, then no service is considered to have been provided.

3.2.4 It is common for a parent company or a designated entity within a group of companies to undertake activities that benefit the group as a whole. Examples of such centrally performed activities include administrative, financial and personnel functions. Where such activities are those which an independent party would be willing to pay for or perform for itself, they constitute related party services.

3.2.5 Generally, when an identified need of a related party or a group of related parties is met by the performance of activities by another related party, a service is considered to have been provided since an independent party would have

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either engaged the services of a third party or performed the activities itself to fulfil the need. Consequently, where the performance of an activity confers a benefit to a related party who has no need for such activity, no service is deemed provided. Hence, where the benefit is too remote, there is no service provided.

## **3.3 Determination of the Arm's Length Fee**

3.3.1 Where a related party service has indeed been provided, it is then necessary to determine the appropriate arm's length charge for the service provided.

### Direct vs. Indirect Charging

3.3.2 In charging for provision of services, a service provider could adopt a direct charge method or an indirect charge method.

3.3.3 The direct charge method involves identifying clearly the actual work done, the cost expended for providing the services and the basis of charging. This method facilitates review and examination by tax authorities. Therefore, wherever possible, taxpayers should adopt the direct charge method in charging for related party services. This method is appropriate for specific services (such as conducting a market survey for a particular new product developed by a related party) rendered to related parties, where the beneficiary of the services and the costs incurred for performance of the services are usually clearly identifiable.

3.3.4 Indirect charge methods entail the use of an appropriate apportionment basis/allocation keys to charge/bill for the service provided, such as gross sales, income or receipts, loans and deposits, staff numbers, floor area and asset size, etc. IRAS recognises that it may not be practical for taxpayers to adopt the direct charge method for all related party services. For instance, it may not be possible for a taxpayer, which provides accounting services for all members belonging to the same group to identify the benefits received by, or the service performed specifically for individual recipients. In such a case, an indirect charge method will have to be used to approximate the charges.

3.3.5 The main consideration for using an indirect charge method is the appropriateness of the apportionment basis or allocation key. This, in turn, is dependent on the nature and the usage of the service. Generally, the most appropriate allocation key is one which most accurately reflects the share of benefits received or is expected to be received by the beneficiaries. While the choice of an appropriate allocation key is largely a question of judgement, taxpayers are expected to demonstrate that due consideration and analysis have been undertaken in arriving at the choice of the allocation key. IRAS will be prepared to accept the allocation key adopted by the taxpayer as long as it is reasonable, founded on sound accounting principles and has been consistently applied year to year throughout the group.

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## Ascertaining the Arm's Length Fee

- 3.3.6 After determining which charging method is appropriate, the next step is to ascertain an arm's length fee for the services provided. The remuneration for related party services should be in accordance with the arm's length principle. The arm's length principle requires a related party transaction to be viewed as having been made under comparable circumstances as a transaction with an independent party.
- 3.3.7 When performing the comparability analysis for related party services, it may be useful to undertake the analysis from the perspective of both the service provider and the recipient i.e. how much the provider would charge an independent party, taking into account its cost and how much the recipient is willing to pay for the service, considering what it would have otherwise paid to independent parties for similar services under similar circumstances.
- 3.3.8 As highlighted in the main circular, taxpayers should be guided by important considerations like the nature of the transaction, the availability and quality of data when deciding on the appropriate transfer pricing method. This is directly applicable to related party services. Notwithstanding this, it is observed that the CUP and Cost-Plus methods are often the most appropriate choices for determining the arm's length fee for related party services.

## Routine Services

- 3.3.9 It is a common practice among parent companies or group service companies to charge a 5% mark-up on costs incurred for providing certain routine support services which, for business convenience and efficiency reasons, are centralized within the parent company or a group service company. Examples of such services include accounting, payroll and certain other management or administrative functions. In practice, related companies may also, based on their own business considerations, provide intra-group services to one another where the nature of services is beyond routine services.
- 3.3.10 The issue of whether a 5% cost mark-up conforms to the arm's length principle will depend on the exact nature of service provided, actual or reasonably expected benefits to the recipient of the service, and a detailed analysis of what an independent party would have been willing to pay for a similar service under similar circumstances. Performing a proper transfer pricing comparability analysis for every type of service would greatly increase the administrative and compliance burdens for the taxpayer and increase the administrative costs of IRAS to evaluate them. To facilitate taxpayers' compliance with the arm's length standard while maintaining a high level of adherence to the arm's length principle, and based on industry norms, IRAS is prepared to accept the current 5% mark-up adopted for certain routine support activities as a reasonable arm's length charge for such services, provided that these routine support activities that the service provider offers to its related party are not also provided to an unrelated party.

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- 3.3.11 In charging the routine support service at a 5% mark-up, it is necessary to take into account all the costs which are directly or indirectly related to the services performed. Examples of direct costs are materials consumed and labour expended directly to render the services. Indirect costs, on the other hand, would include overheads, depreciation and telecommunication expenses incurred by the department providing the services.
- 3.3.12 [Annex A](#) provides a list of routine support services that are commonly provided on an intra-group basis across many industries, and which do not generally have a significant arm's length mark-up. The list is not intended to be exhaustive. Where taxpayers are of the view that certain intra-group services currently being provided have the nature of routine support services but are not included in this list, IRAS is prepared to consider adding such services in the list based on further review.
- 3.3.13 IRAS' acceptance of a 5% mark-up for providers of routine services accords an alternative to the undertaking of detailed transfer pricing analysis by these service providers. However, if these service providers have performed a detailed transfer pricing analysis that supports the charging for services at different mark-ups than 5%, such mark-ups should be adopted. Once the arm's length mark-up has been adopted, it should be applied consistently year-after-year throughout the group until there are material changes to the circumstances or services provided. To determine the arm's length fees, these service providers are encouraged to adopt the 3-step approach discussed in the main circular.

## Services Provided on a Cost Pooling Basis

- 3.3.14 There may be exceptional occasions where it is mutually beneficial for members of a corporate group to enter into a cost- pooling contract among them to share in the costs of routine support services for the common use of the group due to a common need. This allows them to pool resources together in order to acquire services which are not principal activities of the group and are not intended to be profitable exploits, but nevertheless may be required for the effective functioning of the group. This supplementary circular does not address cost contribution arrangements commonly referred to in the OECD transfer pricing guidelines (Chapter VIII), which are often entered into for the specific purpose of developing intangible assets. It addresses specifically the intra-group sharing or "pooling" of costs incurred for the provision of services by a related party within the group.
- 3.3.15 As the concept of mutual benefit is fundamental to cost pooling, a party to the cost pooling contract must have a reasonable expectation of benefiting or actually benefits from the services in respect of which costs are being shared. In addition, contributions of related parties to the costs of providing the service must be made in proportion to the nature and extent of expected benefits that each party receives and for purposes of this section, each party's share of the costs must be borne in the form of cash or other monetary contributions. No payment other than the allocation of costs should be made for the provision of services. To satisfy the arm's length principle, each participant's share of the

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costs must be consistent with that which an independent party would have agreed to under comparable circumstances given the benefit it would have reasonably expected to derive from the services being provided.

3.3.16 Payments charged to a related party for its proportionate share of the cost of services as described above may be allowed on a prospective basis with no element of mark-up, provided that the following conditions are fulfilled:

- (a) the service that the service provider offers to its related parties is not also provided to an unrelated party;
- (b) the provision of the service to the related parties is not the principal activity for which the service provider is set up to undertake. Whether the provision of a particular service constitutes the principal activity undertaken by the service provider for a financial year will depend on the specific facts and circumstances of each case. For this purpose, if the cost of provision of the service does not exceed 15% of the total expenses of the service provider as reflected in its accounts for the financial year concerned, such service will not be treated as the principal activity of the service provider for the particular financial year. All costs associated with services provided under the various cost pooling arrangements of each service provider will be aggregated for purposes of applying the 15% threshold set out above;
- (c) the service being provided is one listed in [Annex A](#) of this circular; and
- (d) there is sufficient documentation showing that the parties intended to pool resources together to share costs prior to the provision of the service.

3.3.17 Taxpayers should maintain adequate documentation to support the basis of the allocation of costs as being at arm's length, and reflective of the sharing of expected benefits arising from the provision of services. In order to minimize the risk of double taxation, such documentation should include a description of the type of services provided, why a specific method of allocating costs was selected, what was contributed by the related party, what benefit is anticipated and the details of the calculations used.

### Strict Pass-through Costs

3.3.18 A group service provider may occasionally arrange and pay for, on behalf of its related parties, services from third-party service providers, whether independent or related. In the case of payments made to third-party or related party service providers which have already charged an arm's length mark-up for their services, it may be appropriate for the group service provider to pass on such costs without a further mark-up, provided that the group service provider is merely the paying agent and does not itself act to enhance the value of such services. For example, a group service provider may incur expenses on behalf of its related party to pay for the costs of engaging a third-party firm to provide various corporate secretarial services for its related party. If such costs can be

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identified as legal or contractual liabilities of the related party itself, hence proving that the group service provider is merely a paying agent, these costs may be passed on to the related party without a further mark-up.

- 3.3.19      However, the group service provider should ensure an appropriate arm's length mark-up on its own aggregate costs of providing services, reflective of the nature of such services and extent of value-add generated for group entities benefiting from such services. The aggregate costs should include its own costs incurred, if any, in facilitating the purchase of services from third party or related party service providers. Hence, in the example given above, if the group service provider had used its own resources e.g., to arrange, select and liaise for the provision of the corporate secretarial services by the third-party firm, the cost of its own resources should be charged to its related parties at an arm's length mark-up.
- 3.3.20      [Annex B](#) contains a flowchart summarizing the proposed treatment for various categories of related party services highlighted in this supplementary circular.

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## **SECTION 4 DOCUMENTATION**

- 4.1      The main circular highlights the importance of documentation. This is also true for transactions pertaining to related party loans and services covered in this supplementary circular. Taxpayers should refer to the main circular for guidance on appropriate documentation.

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## **SECTION 5 ENQUIRIES**

- 5.1 If you wish to seek clarification on this supplementary circular or discuss your transfer pricing issues with IRAS, please direct your request to:

International Tax Branch  
Tax Policy and International Tax Division  
Inland Revenue Authority of Singapore  
55 Newton Road, Revenue House  
Singapore 307987

Fax: 65 6351 2131  
Email: [international\\_tax@iras.gov.sg](mailto:international_tax@iras.gov.sg)

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## Annex A

### **Routine Support Services Commonly Provided on an Intra-Group Basis**

#### **Accounting and Auditing**

Maintenance of accounting records, preparation of financial statements based on such records, and ensuring authenticity and reliability of accounting records, etc., including performance of operational and financial internal audits.

#### **Accounts Receivable and Accounts Payable**

Collation and verification of data on accounts receivable and accounts payable for the purposes of financial reporting, aging, billing, soliciting payments from customers, payment to vendors and procurement, etc.

#### **Budgeting**

Compilation of data for purposes of preparing budget estimates, reports, etc.

#### **Computer Support**

Provision of technical services and trouble-shooting support in relation to usage of computer hardware and software, etc.

#### **Database Administration**

General maintenance of computer databases including data storage, but excluding analytic services performed on stored data.

#### **Employee Benefits**

Administration of employee compensation and benefit plans e.g., healthcare, life insurance, dental, employee incentive compensation, profit sharing, etc., and co-ordination with external parties such as hospitals, insurers, etc. to implement such benefit plans.

#### **General Administrative**

Performance of clerical and administrative functions such as data entry, photocopying/scanning of materials, scheduling appointments, word processing, maintenance of file registry, etc.

#### **Legal Services**

Provision of general legal services by in-house legal counsel.

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## **Payroll**

Compilation and verification of employees' time worked and claims for reimbursable expenses to compute the salaries, commissions and reimbursements due to employees. It includes the preparation of pay cheques and arrangement for the crediting of such payments into employees' bank accounts.

## **Public Relations**

Handling of internal and external communications relating to corporate policies.

## **Purchasing**

Procurement of goods and services based on organizational requirements and standards.

## **Staffing and Recruiting**

Management of staffing requirements, performance issues and staff welfare in the organization or group and the implementation of recruitment plans such as publicizing open positions and screening of candidates, etc.

## **Tax**

Preparation of various tax returns, computations, reclaim forms and responses to queries for submission to tax authorities and the processing of tax payments, etc.

## **Training and Employee Development**

Management and implementation of training and development programs for employees.

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## Flowchart for Related Party Services

