IRAS CIRCULAR

TRANSFER PRICING GUIDELINES

INLAND REVENUE
AUTHORITY
OF SINGAPORE

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PREFACE

This circular gives guidance to Singapore taxpayers on applying the arm's length principle and the recommended preparation and maintenance of documentation to demonstrate compliance with the arm's length principle.

This circular also sets out the procedures for applying for the Mutual Agreement Procedure ("MAP") and Advance Pricing Arrangement ("APA") facilities in order to avoid or eliminate double taxation.

The guidance on arm's length principle and documentation requirements are applicable to all transactions, both local and cross-border, between a Singapore taxpayer and its related parties. However, the MAP and bilateral/multilateral APA facilities to eliminate or avoid double taxation are only available where the non-Singapore related parties concerned are residents of jurisdictions with which Singapore has concluded comprehensive Agreements for the Avoidance of Double Taxation ("DTAs").

IRAS hopes that, through this guidance, taxpayers can better understand the conditions for arm's length pricing and hence take steps to reduce the risk of double taxation.

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SECTION 1 INTRODUCTION

1.1 This circular provides guidance in applying and adhering to the arm's length principle for transactions carried out between related parties.

1.2 Transfer pricing refers to the determination of prices at which goods, services and intangible properties are transacted between related parties. When unrelated parties deal with each other, independent market forces shape the commercial pricing of goods, services and intangibles transacted between them. However, in transactions involving related parties, the lack of independence in their commercial and financial relations can potentially lead to the setting of prices that deviate from independent commercial prices. Consequently, this results in the distortion of profits as well as in the tax liabilities of each related entity. Where the related parties are located in different tax jurisdictions, the potential distortion in profits and tax liabilities of each related entity assumes a greater concern, as the difference in the taxation level in the different tax jurisdictions may lead to one or more such entities not paying the fair share of tax in one or more jurisdictions, with the related entities enjoying a tax advantage as a group.

1.3 The arm's length principle is the internationally endorsed standard for transfer pricing between related parties. When transfer prices of related parties adhere to this principle, they reflect comparability to the pricing that independent commercial entities in similar situations would transact at and hence, there will be no distortion in the profits and tax liabilities. IRAS abides by this arm's length principle and believes that this is the most appropriate standard to determine transfer prices of related parties.

1.4 Increasingly, tax authorities worldwide are stepping up their audit efforts to verify that transfer pricing of cross-border related party transactions comply with the arm's length principle. Where related party transactions are found not to have complied with the arm's length principle and where the profits and tax liabilities of the related parties in their jurisdictions have been reduced, adjustments to the profits and tax liabilities would be made. Such unilateral adjustments increase the total taxable profits arising from the related party transactions and hence result in double taxation. If a DTA exists between the jurisdictions where the related parties are located, a taxpayer may have recourse to the MAP, where the competent authorities of the tax jurisdictions may, through eventually agreeing on and recognising the arm's length transfer pricing, eliminate double taxation.

1.5 As tax authorities increase their transfer pricing audit efforts, taxpayers are equally concerned with ensuring that transfer prices with related parties within its group fulfil the arm's length principle. As their level of cross-border related party transactions increases over the years, taxpayers are also concerned about the potential increase in adverse effects of double taxation if the arm's length principle is not complied with. Hence, taxpayers have highlighted the need for certainty in applying the arm's length principle as well as the available recourse to eliminate double taxation if they should suffer double taxation as a result of transfer pricing audits.

1.6 Hence, this circular addresses taxpayers' concerns by providing practical guidance on applying the arm's length principle as well as the recommended documentation requirements. Information on applying for MAP and APA are also detailed in this circular, as these are critical facilities to help taxpayers avoid or eliminate double taxation that may arise from transfer pricing adjustments. It is hoped that by adhering to the principles and guidance in this circular, Singapore taxpayers that transact with related parties would be able to reduce the risk of transfer pricing adjustments and double taxation.

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SECTION 2 SCOPE

2.1 The guidance on the application of the arm's length principle (Section 3) and documentation requirements (Section 4) as provided in this circular apply to all related party transactions of goods, services and intangible properties. The guidance on Mutual Agreement Procedures and bilateral/multilateral Advance Pricing Arrangements discussed in Section 5 and Section 6 respectively are only applicable to related party transactions involving at least one party resident in Singapore or a jurisdiction with which Singapore has a comprehensive DTA.

2.2 A 'related party', in relation to any entity, means any other entity who, directly or indirectly, controls that entity, or is controlled, directly or indirectly, by that entity, or where both entities, directly or indirectly, are under the common control of a common entity. Hence, related parties include associated enterprises and separately taxable entities of an enterprise, such as permanent establishments of the enterprise.

2.3 This circular is only applicable where at least 1 related party is subject to tax in Singapore.

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SECTION 3 THE ARM'S LENGTH PRINCIPLE

3.1 Key Concepts & Guiding Principles

3.1.1 IRAS endorses the arm's length principle as the standard to guide transfer pricing. The arm's length principle is the internationally accepted standard adopted by many Member countries of the Organisation for Economic Co-operation and Development ("OECD") and non-Member countries.

3.1.2 The arm's length principle is stated in paragraph 1 of Article 9 (Associated Enterprises) of the OECD Model Tax Convention on Income and on Capital as follows:

"Where…conditions are made or imposed between…two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly."

3.1.3 Paragraph 2 of Article 7 (Business Profits) of the OECD Model Tax Convention on Income and on Capital specifies that, when attributing the profits to a permanent establishment, the permanent establishment should be considered as *'a distinct and separate enterprise engaged in the same or similar activities and under the same or similar conditions'*. This corresponds with the application of the arm's length principle specified in paragraph 1 of Article 9 (Associated Enterprises) of the OECD Model Tax Convention on Income and on Capital.

3.1.4 The arm's length principle requires the transaction with a related party to be made under comparable conditions and circumstances as a transaction with an independent party. It is founded on the premise that where market forces drive the terms and conditions agreed in an independent party transaction, the pricing of the transaction would reflect the true economic value of the contributions made by each entity in that transaction. Essentially, this means that if two related parties derive profits at levels above or below the comparable market level solely by reason of the special relationship between them, the profits will be deemed as non-arm's length. In such a case, tax authorities that adopt the arm's length principle can make the necessary adjustments to the taxable profits of the related parties in their jurisdictions so as to reflect the true value that would otherwise be derived on an arm's length basis.

3.1.5 Although Singapore's tax legislation does not contain a specific provision stipulating the use of the arm's length principle for related party transactions, various provisions of the Singapore Income Tax Act (such as Sections 32 and 53[1]) imply or refer to the concept or use of the arm's length principle. In addition, this principle is found in all of Singapore's comprehensive DTAs (typically in Article 7 (Business Profits) and Article 9 (Associated Enterprises)). Hence, IRAS' adoption of the arm's length principle for related party transactions is supported

[1] All quoted sections of the Singapore Income Tax Act in this Circular refer to those under the Income Tax Act (Chapter 134), Revised Edition 2004.

by the Income Tax Act. It is also required as part of Singapore's treaty obligations.

3.1.6 IRAS endorses the use of the arm's length principle for 2 main reasons:

(i) Singapore believes that the market forces of supply and demand are the best way to allocate resources and reward effort. IRAS agrees with what is cited in the OECD transfer pricing guidelines[2], that the application of the arm's length principle treats related and independent entity transactions equally for tax purposes and hence avoids the creation of tax advantages or disadvantages that would otherwise distort the relative competitive positions of either type of entity.

(ii) The arm's length principle is adopted by most tax jurisdictions. By adopting and complying with this internationally accepted principle, taxpayers and tax authorities will have a common basis to deal with related party transactions. This should reduce the incidence of transfer pricing adjustments and improves the resolution of transfer pricing disputes. As a result, the potential for double taxation will be reduced.

3.1.7 IRAS recognises that the application of the arm's length principle is not without difficulties. For instance, certain business structures and arrangements are complicated and unique, and hence may rarely be encountered between independent parties. The lack of comparable conditions established between independent parties makes it difficult to apply the arm's length principle. In addition, establishing the arm's length principle will sometimes require substantial analysis of large volumes of data and information. Some information may not even be readily available or may be of a confidential nature that cannot be disclosed without revealing business secrets. It may also be costly for taxpayers to perform such comprehensive analyses in applying the arm's length principle and prepare sufficient documentation to demonstrate compliance with the arm's length principle.

3.1.8 Therefore, IRAS stands by the following guiding principles with respect to the application of the arm's length principle:

(i) First and foremost, IRAS recognises that transfer pricing is not an exact science. Establishing and demonstrating compliance with the arm's length principle require the exercise of judgement. Hence, IRAS recommends that taxpayers adopt a pragmatic approach to ascertaining arm's length pricing for related party transactions. In this regard, taxpayers will not be expected to adhere rigidly to a defined set of rules in order to establish the arm's length price. Likewise, this circular is not intended to prescribe inflexible rules that must be followed in all circumstances. Rather, it is meant to provide useful guidance to aid the determination of and demonstration of arm's length pricing. Where circumstances warrant, taxpayers may depart from or complement the approaches suggested in this circular, provided that doing so aids in the determination of the arm's length pricing to be achieved in those circumstances.

[2] Paragraph 1.7 of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.

(ii) Taxpayers know their businesses and circumstances best. Such intimate knowledge of the commercial circumstances that their businesses operate in and the economic relationships between various related entities put taxpayers in the best position to perform a robust and comprehensive transfer pricing analysis to determine the arm's length price.

(iii) With the advantage of knowing their businesses and circumstances best, taxpayers should exert reasonable efforts to undertake a sound transfer pricing analysis to ascertain the arm's length price as well as demonstrate that such analysis has been performed. When reasonable efforts have been exercised to ensure that the arm's length principle is complied with, the transfer prices determined would be considered, *prima facie*, as arm's length.

(iv) IRAS welcomes taxpayers to discuss their concerns and difficulties in the application of the arm's length principle. IRAS believes that such consultations and cooperation between taxpayers and IRAS is a mutually beneficial and pragmatic way to assist taxpayers in complying with the arm's length principle.

3.1.9 The following paragraphs of this section which provide guidance on the application of the arm's length principle should be read with the above guiding principles in mind.

3.2 Guidance on Applying the Arm's Length Principle

3.2.1 The application of arm's length principle would, first and foremost, involve the identification of comparable situation(s) or transaction(s) undertaken by independent parties against which the related party transaction or margin is to be benchmarked. This step is commonly known as "comparability analysis". It entails an analysis of the similarities and differences in the conditions and characteristics that are found in the related party transaction with those in an independent party transaction. Once the impact of these similarities or differences have on the transfer price have been determined, the arm's length price/margin (or a range) can then be established using an appropriate transfer pricing method.

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

Step 1 – Conduct a comparability analysis

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

Step 3 – Determine the arm's length results

3.2.3 Further details and procedures of each of the steps are described in the ensuing paragraphs. It bears repeating at this point that transfer pricing analysis will always require an element of judgement. The recommended steps are neither mandatory nor prescriptive. Ultimately, the key objective in any transfer pricing analysis is to present a logical and persuasive basis to demonstrate that transfer prices set between related parties conform to the arm's length principle. A

taxpayer can modify the recommended approach or adopt an alternative approach, where that taxpayer's individual circumstances require such modifications to better arrive at the arm's length result.

3.2.4 **Step 1: Comparability Analysis**

3.2.4.1 The Concept of Comparability

The arm's length principle is based on a comparison of the prices or margins adopted or obtained by related parties with those adopted or obtained by independent parties engaged in similar transactions. For such price or margin comparisons to be meaningful, all economically relevant characteristics of the situations being compared should be sufficiently similar so that:

(i) none of the differences (if any) between the situations being compared can materially affect the price or margin being compared, or

(ii) reasonably accurate adjustments can be made to eliminate the effect of any such differences.

3.2.4.2 Factors Affecting Comparability

A comparability analysis should examine the comparability of the transactions in 3 aspects:

(a) Characteristics of Goods, Services or Intangible Properties

(i) The specific characteristics of goods, services or intangible properties play a significant part in determining their values in the open market. For instance, a product with better quality and more features would, *ceteris paribus*, fetch a higher selling price. Such product or service differentiation affects the price or value of the product or service. Hence, the nature and features of the goods, intangible properties or services transacted between related parties and those between independent parties must be examined carefully. The similarities and differences (which would influence the value of the goods, services or intangible properties) should be identified.

(ii) Paragraph 1.19 of the OECD Transfer Pricing Guidelines provides useful suggestions on the characteristics to be examined. They include (but are not limited to):

- in the case of transfer of goods: the physical features, the quality and reliability, and the availability and volume of supply of the goods;

- in the case of provision of services: the nature and extent of the services; and

- in the case of intangible property: the form of transaction, the type of intangible, the duration and degree of protection, and the anticipated benefits from the use of the property.

(iii) Similarities in the actual characteristics of the product, intangible or service, are most critical when one needs to compare prices of related party transactions against independent ones, such as when the Comparable Uncontrolled Pricing ("CUP") method is adopted as the transfer pricing method. On the other hand, comparisons of profit margins (used in methods other than CUP) may be less sensitive to the features and characteristics of the product or service in question, as the margins generally correlate more significantly with the functions performed, risks borne and assets used by the entity.

(b) <u>Analysis of Functions, Risks and Assets</u>

(i) Economic theory purports that the level of return derived by an entity should be directly correlated to the functions performed, the assets used and risks assumed. For instance, an entity selling a product with warranty should earn a higher return compared to another entity selling the same product without the provision of warranty. The difference in margin is due to the additional function performed and risk borne by the first entity. Likewise, a product with a reputable branding is expected to fetch a higher return compared to that of a similar product without the branding, due to the additional asset (in this case, trademark) employed in enhancing the value of the product.

(ii) Hence, a crucial step in comparability analysis must entail a comparison of the economically significant functions performed, risks assumed and assets employed by the related party with those by the independent party (which has been selected as the party against which the related party's margin or transactions are to be benchmarked). This is typically known as conducting a "functional analysis".

(iii) The functions that should be compared include (but are not limited to) design, research and development, manufacturing, distribution, sales, marketing, logistics, advertising, financing, etc.

(iv) It is also relevant and useful, when identifying and comparing the functions performed, to consider the assets that are employed or to be employed. This analysis should consider the type of assets used, such as plant and equipment, valuable intangibles, etc. and the nature of the assets used, e.g., the age, market value, location, availability of intellectual property protections, etc.

(v) An appraisal of risks is also important in determining arm's length prices/margins. The possible risks assumed that should be considered in the functional analysis include market risks, risks of change in cost, price or stock, risks relating to the success or failure of R&D, financial risks such as changes in the foreign exchange and interest rates, credit risks, etc.

(vi) In practice, one cannot be expected to compare all functions, risks and assets employed. Hence, it must be emphasised that only functions, risk and assets that are economically significant in

determining the value of transactions or margins of entities should be identified and compared.

(c) Commercial and Economic Circumstances

(i) Prices may vary across different markets even for transactions involving the same property or services. In order to make meaningful comparisons of prices or margins between entities/transactions, the markets and economic conditions in which the entities operate or where the transactions are undertaken should be comparable. A number of the economic circumstances that may be relevant in determining market comparability are identified in paragraph 1.30 of the OECD Transfer Pricing Guidelines. These include the availability of substitute goods or services, geographic location, the market size, the extent of competition in the markets, consumer purchasing power, the level of the market at which the enterprises operate (e.g., wholesale or retail), etc.

(ii) Government policies and regulations (such as price controls, national insurance, etc.) may have an impact on prices and margins. Hence, the effects of these regulations should also be examined as part of the examination for comparability of the market and economic conditions.

(iii) Business strategies should also be examined in determining comparability for transfer pricing purposes. Business strategies would take into account many aspects of an enterprise, such as innovation and new product development, degree of diversification, risk aversion, assessment of political changes and other factors bearing upon the daily conduct of business.

(iv) An entity may embark on business strategies of temporarily charging a lower price for its product compared to similar products in the market or incurring higher expenses in the short run (hence resulting in lower profit levels). Such strategies are commonly used for market penetration and market share expansion or defence. The key issue with respect to business strategies that temporarily reduce profits in anticipation of higher long-term profit is whether the adoption and outcome of such strategies produce an arm's length result. Hence, a claim that such strategies have been adopted ought to be demonstrated with evidence that that an independent party would have been prepared to sacrifice profitability for a similar period under similar economic circumstances and competitive conditions, so that a higher long-term profit can be realized.

3.2.4.3 Desired Outcome of Step 1

The ultimate aim of the comparability analysis is a comprehensive assessment and identification of the areas and extent of significant similarities and differences (such as product characteristics, functions performed, etc.) between the transactions/entities in question and those to be benchmarked against. Where adjustments could be made for material differences identified, the method or computation of making such adjustments should be developed.

Such thorough understanding of the level of comparability is necessary in deciding the choice of transfer pricing method and tested party (discussed in Step 2 below).

3.2.5 **Step 2: Choosing the Appropriate Transfer Pricing Method and Tested Party**

A number of methods have been developed in the international arena for evaluating a taxpayer's transfer prices/margins against a benchmark based on the prices/margins adopted in similar, independent transactions/entities. The OECD Transfer Pricing Guidelines recommend 5 such methods and classify them into 2 categories – Traditional Transaction Methods and Transactional Profit Methods.

3.2.5.1 Traditional Transaction Methods

The 3 Traditional Transaction Methods which will be elaborated below are:

- The comparable uncontrolled price ("CUP") method;
- The resale price method; and
- The cost plus method.

(a) Comparable Uncontrolled Price (CUP) Method

(i) The CUP method compares the price charged for properties or services transferred in a related party transaction to the price charged for properties or services transferred in an independent transaction in comparable circumstances. Any difference in the two prices may suggest that the related parties are not dealing on an arm's length basis, and that the price in the related party transaction may need to be substituted with the price in the independent transaction.

(ii) By comparing the price or value of the transactions, the CUP method employs the most direct assessment of whether the arm's length principle is complied with. As it is the most direct method, it should, in theory, be preferred to the other methods.

(iii) However, the direct comparison in the CUP method also means that it is reliable only if there is a high level of comparability between the transaction in question and the independent transaction, or where reasonably accurate adjustments can be made to eliminate the effects of the material differences. This is because the price or value of a property or service is very sensitive to differing characteristics, functions performed and market conditions etc.

(iv) In practice, the CUP method is usually most suitable for evaluating transactions involving products with very similar characteristics (in terms of type, physical features, quality and quantity transacted, etc) and undertaken in similar market or economic conditions, such as widely traded commodities. In such cases, where there is little room for product differentiation, the similarities in the characteristics of product and market or economic conditions are much more significant

than the comparability of functions performed, risks assumed and assets used by the entities.

(v) In summary, where it is possible to locate comparable independent party transactions, the CUP method should be adopted as it provides the most direct evidence of an arm's length price. However, taxpayers must bear in mind that the CUP method requires a relatively high level of comparability to produce reliable results. Hence, if reasonably accurate adjustments for differences in comparability cannot be made, it is necessary to select a less direct method instead.

(vi) IRAS encourages taxpayers to look out for both internal and external comparable transactions and then identify the most suitable ones to be used in their transfer pricing analyses. An example of the use of:

- the "external CUP" is given in Annex A; and

- the "internal CUP" is given in Annex B.

(b) Resale Price Method

(i) The resale price method is applied where a product that has been purchased from a related party is resold to an independent party. Essentially, it seeks to value the functions performed by the "reseller" of a product.

(ii) In this method, the resale price to the independent party is reduced by a comparable gross margin (the "resale price margin") to arrive at the arm's length price of the product transferred between the related parties. Under arm's length conditions, the resale price margin should allow the reseller to recover its selling and operating costs, and earn a reasonable profit based on the functions performed, assets used and risks assumed. The comparable resale price margin may be determined by reference to either:

- the resale price margin that the same reseller earns on items purchased and sold in comparable independent party transactions (internal comparable), or

- the resale price margin derived by an another reseller in comparable independent party transactions (external comparable).

(iii) As gross profit margins represent the gross compensation (after cost of sales) for specific functions performed, assets used and risks assumed, product differences are less critical than under the CUP method. Therefore, where the related and independent party transactions are comparable in all aspects except for the product itself, the resale price method might produce a more reliable measure of arm's length conditions than the CUP method. Nonetheless, it can be expected that the more comparable the products, the more likely it is that the resale price method will produce better results.

(iv) Where there are material differences that affect the resale price margin earned in the related and independent party transactions, adjustments should be made to eliminate the effects of those differences.

(v) The resale price method is most appropriate in a situation where the reseller adds relatively little value to the properties. The greater the value-added to the properties by the reseller, for example, through complicated processing or assembly with other products, the more difficult it is to use the resale price method to arrive at the arm's length price. This is especially so in a situation where the reseller contributes significantly to the creation or maintenance of intangible property, such as trademarks or trade names, in its activities.

(vi) Example on Resale Price Method – Please see Annex C.

(c) Cost Plus Method

(i) The cost plus method focuses on the gross mark-up obtained by a supplier who transfers property or provides services to a related purchaser. Essentially, the method attempts to value the functions performed by the supplier of the property or services. The cost plus method is most useful where semi-finished goods are sold between related parties or where the related party transaction involves the provision of services.

(ii) In this method, a comparable gross mark-up is added to the costs incurred by the supplier of goods or services in the related party transaction to arrive at the arm's length price of that transaction. The comparable gross mark-up may be determined by reference to either:

- the cost plus mark-up that the same supplier earns in comparable independent party transactions (internal comparable), or

- the cost plus mark-up that would have been earned in comparable transactions by an independent parties (external comparable).

(iii) As in the resale price method, fewer adjustments may be necessary to account for product differences under the cost plus method than the CUP method, and it may be appropriate to focus on other factors of comparability (such as the functions performed and economic circumstances). Where the related party and independent party transactions are not comparable in all aspects and the differences have a material effect on the price or margin, taxpayers are expected to make adjustments to eliminate the effects of these differences.

(iv) One key issue in applying the cost plus method is the comparability of the cost base in the related party and independent party transactions. Generally, costs could be broadly classified into 3 broad groups:

- direct costs, such as the cost of raw materials;

- indirect costs, such as depreciation, repair and maintenance which may be allocated among several products; and

- operating expenses, such as supervisory, marketing, general and administrative expenses.

(v) For the purpose of the cost plus method, direct and indirect costs of production are normally used to compute the cost base. If the tested party is an enterprise in Singapore, the cost base should be computed in accordance with the accounting principles that are generally accepted in Singapore. Where the comparable party adopts a definition of cost base or a method to compute cost that is different from that of the tested party, the cost base of the comparable party should be adjusted accordingly.

(vi) Example of Cost Plus Method – Please see Annex D.

3.2.5.2 Transactional Profit Methods

Transactional profit methods compare the profit arising from related party transactions with that generated from transactions between independent parties. The two transactional profit methods that are endorsed by the OECD Transfer Pricing Guidelines are the profit split method and the transactional net margin method ("TNMM").

(a) Profit Split Method

(i) The profit split method is particularly useful where transactions are so highly inter-related that they cannot be evaluated separately, or where the existence of unique intangible assets makes it difficult to find exact comparables.

(ii) The profit split method involves two steps. The first step identifies the profit to be split. This may be the total profit arising from the arrangements, or a residual amount that cannot be easily assigned to one party or the other. Such a residual amount is typically associated with the use of high value and unique intangibles. Generally, the profit to be split is the operating profit, although occasionally, it may be appropriate to carry out a split of the gross profit and then deduct the expenses incurred by or attributable to each relevant party. The second step involves splitting the profit by reference to the relative contributions of the parties in the transaction. These contributions are identified by taking into account the functions performed, the assets used and the risks assumed by each party, and valuing them as far as possible by reference to independent market data.

(iii) The common approaches to applying the second step are the residual analysis approach and the contribution analysis approach, as explained below:

Residual Analysis Approach

The residual analysis approach splits the total profit from the transaction in 2 stages. In the first stage, each party is allocated a basic return determined using comparable data for the readily identifiable functions (manufacturing, distribution, service provision, etc). The returns to these functions will usually not account for the return that would be generated by any unique and valuable assets possessed by the parties. In the second stage, the remaining profit (which is attributable to such unique assets) is allocated between the parties based on the relative contributions of the parties to the creation of such assets, taking into consideration how independent parties would have divided such residual profits in similar circumstances.

Contribution Analysis Approach

Under this approach, the total profit earned by the parties from a related party transaction is divided based on the parties' relative contribution to that profit. This differs from the residual analysis approach in that basic returns are not allocated to each of the parties to the transaction before the profit split is made.

(iv) Example on Profit Split Method (Residual Analysis Approach) – Please see Annex E.

(v) In IRAS' view, the relative value of the contribution of each party is often more difficult to quantify when one attempts to divide the total profit directly. The use of comparable data to allocate part of the total profit in the first stage of the residual analysis approach will generally improve the reliability of the profit split method. Therefore, in cases where the profit split method is appropriate, IRAS recommends that the residual analysis approach be used by taxpayers.

(b) Transactional Net Margin Method (TNMM)

(i) The TNMM compares the net profit margins attained by an entity from a related party transaction to those attained by comparable independent entities, relative to some appropriate base such as costs, sales, or assets.

(ii) Being a transactional profit method that is typically applied to only one of the parties involved in the transaction, the TNMM is closely aligned to the resale price and cost plus methods. This similarity means that this method requires a level of comparability similar to that required for the application of the two traditional transaction methods.

(iii) The primary difference between the TNMM and the resale price or cost plus method is that the former focuses on the net margin instead of the gross margin of a transaction. One of the weaknesses of using net margin as the basis for comparison is that it can be influenced by many factors that either do not have an effect, or have a less

substantial or direct effect, on price or gross margins. Examples of such factors include the efficiency of plant and machinery used, management and personnel capabilities, competitive position, etc. Unless reliable and accurate adjustments can be made to account for these differences, the TNMM may not produce reliable measures of the arm's length net margins.

(iv) Example on TNMM – Please see Annex F.

3.2.5.3 Which is the "Best" Method?

In theory, the traditional transaction methods provide for a more direct comparison with independent party transactions and hence would be superior to the transactional profit methods. In practice however, the reliability of the results produced by any method would be crucially affected by the availability and quality of data as well as the accuracy with which adjustments[3] to achieve comparability can be made. Hence, IRAS does not have a specific preference for any one method. Instead, the method that produces the most reliable results, taking into account the quality of available data and the degree of accuracy of adjustments, should be chosen.

Hence, in Singapore's context, a taxpayer can select any one of the 5 methods, or even a modified version of a method listed above to comply with the arm's length principle, as long as the taxpayer maintains and is prepared to provide sufficient documentation to demonstrate that its transfer prices are established in accordance with the arm's length principle.

3.2.5.4 Choice of Tested Party

Other than the profit split method, the use of the other transfer pricing methods would require a decision on which party to apply the transfer pricing analysis. This party is known as the tested party.

For pragmatic reasons, IRAS recommends that the party with the smaller scope of functions and less complex operations be used as the tested party. This is because it would be easier to find more comparable data. In addition, the choice of such a party as the tested party would likely result in the need for fewer adjustments and hence, greater accuracy in the adjustments made.

3.2.5.5 Desired Outcome of Step 2

At the end of Step 2, the method and tested party that produce the most reliable results should be identified for the arm's length analysis.

[3] As a rule of thumb, the method that requires the least adjustments will produce the most reliable measure of the arm's length price.

3.2.6 Step 3: Determining the Arm's Length Results

Once the appropriate transfer pricing method has been identified, the method is applied on the data of independent party transactions to arrive at the arm's length result.

3.2.6.1 Use of an Arm's Length Range

As transfer pricing is not an exact science, it is generally difficult to arrive at a specific price or margin that is the arm's length price or margin. More likely, the transfer pricing analysis would lead to a range of prices or margins. IRAS is prepared to accept the use of ranges, such as an interquartile range, to determine an arm's length range provided that the comparables are reliable.

3.2.6.2 Desired Outcome of Step 3

Upon the completion of Step 3, the arm's length results would be determined. These results should then be used to guide or justify taxpayers' transfer pricing practices.

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SECTION 4 DOCUMENTATION

4.1 Paragraph 3.1.8(iii) stated that taxpayers should exert reasonable efforts to undertake a sound transfer pricing analysis to ascertain the arm's length pricing as well as to demonstrate that such analysis has been performed. The keeping of records to demonstrate that such efforts have been undertaken to conform to the arm's length principle is known as "documentation".

4.2 This section describes the key principles and provides guidance on the types of documentation that taxpayers should keep to demonstrate that reasonable efforts have been taken to comply with the arm's length principle.

4.3 Key Concepts & Guiding Principles

4.3.1 The main objective of preparing and maintaining documentation is to place the taxpayer in a position where it can readily demonstrate that it has exerted reasonable efforts to ensure that its transfer prices are consistent with the arm's length principle. Therefore, adequate documentation will facilitate reviews by tax authorities on taxpayer's transfer pricing analyses and hence assist in resolving any transfer pricing issues that may arise.

4.3.2 Adequate documentation is characterised by both the sufficiency of the details kept to demonstrate compliance with the arm's length principle, as well as the timely manner in which the details are prepared.

4.3.3 IRAS is conscious that keeping adequate documentation may result in compliance and administrative costs for taxpayers. IRAS adopts the following principles with regard to documentation:

(a) Taxpayers are only required to prepare or obtain documents necessary to allow a reasonable assessment of whether they have complied with the arm's length principle.

Hence, on how extensive documentation should be, taxpayer's decision should be based on a balance between the need to show that the arm's length principle is complied with and the additional administrative costs. In this regard, taxpayers should evaluate the substantiality and complexity of the related party transactions as well as the costs of compliance arising from documentation.

Taxpayers are not expected to go to such lengths that the compliance costs arising from the preparation of documentation are disproportionate to the amount of tax revenue at risk, or to the complexity of the transactions. Conversely, scant documentation kept for complex and significant related party transactions may pose a risk of the transfer pricing being reviewed and challenged on whether it complies with the arm's length principle.

(b) Unlike many other tax jurisdictions, Singapore currently does not impose a penalty specifically for the lack or insufficiency of documentation. Taxpayers would not be penalised solely on the basis that the documentation is not sufficient or timely. However, if the taxpayer violates

the record keeping requirements under Sections 65, 65A and 65B of the Singapore Income Tax Act, IRAS would not in any way be precluded from enforcing these relevant provisions.

(c) Notwithstanding that there is no specific penalty (see above point in (b)), there are good reasons for taxpayer to keep adequate documentation.

Firstly, it is a generally accepted international principle that by keeping adequate documentation, the taxpayer has further discharged its burden of proof to show that it has complied with the arm's length principle. This would put the taxpayer in a better stead to defend its transfer pricing analysis and prevent transfer pricing adjustments arising from tax examinations by tax authorities.

Secondly, in considering taxpayers' application for MAP, IRAS would assess the quality of taxpayers' documentation. Taxpayers who have not prepared adequate documentation may find their application for MAP rejected or that the transfer pricing issue would be much more difficult to resolve.

(d) IRAS does not require documentation to be submitted when the tax returns are filed. The documentation should be kept by the taxpayers and submitted to IRAS only when requested to do so.

For administrative ease, taxpayers may wish to consider aligning the retention period for documentation with the record keeping requirement specified in Section 67 of the Singapore Income Tax Act (SITA)[4]. However, it is prudent for a taxpayer to maintain the documentation for as long as there is a possibility of being subject to transfer pricing examinations or if the taxpayer is involved in a MAP.

The mode of document storage is subject to taxpayers' discretion i.e. taxpayers may choose to store relevant documents as unprocessed originals, books or in electronic media. Taxpayers should find the most cost effective way to keep these records.

4.4 Guidance for Documentation

4.4.1 As a general guide, Annex G lists the types of information (not exhaustive) that may be helpful in substantiating that the taxpayer's transfer pricing analyses are in accordance with the arm's length principle and that the taxpayer has made reasonable efforts to determine arm's length transfer prices, margins or allocations.

4.4.2 However, the documentation required depends on the specific facts and circumstances of each case. It is not possible to specify a comprehensive list of documentation requirements that meet the needs of all taxpayers. Since taxpayers have the most intimate knowledge of their businesses and hence are in the best position to explain their approach to transfer pricing, taxpayers

[4] In Budget 2006, Prime Minister and Minister for Finance has decided to reduce the statutory record keeping requirements under the Singapore Income Tax Act to 5 years from the relevant year of assessment.

should include all other relevant information (even though not suggested in Annex G) in their documentation.

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SECTION 5 MUTUAL AGREEMENT PROCEDURES

5.1 Singapore currently has a network of at least 50 comprehensive DTAs in force[5]. All these DTAs provide for the Mutual Agreement Procedure ("MAP") to resolve instances of double taxation. In transactions between related parties located in 2 tax jurisdictions, where a tax authority makes adjustments to the transfer prices of the transactions between the related parties, double taxation would arise unless the tax authority of the other jurisdiction makes the corresponding adjustments to the income of the party located in its jurisdiction. In such a case, taxpayers may apply to the competent authorities (of the jurisdiction of which they are residents) to invoke the MAP, in order to eliminate the double taxation that arises from the transfer pricing adjustments made.

5.2 This section explains IRAS' position on the MAP process as well as provides guidance on how taxpayers may apply for the MAP with respect to transfer pricing adjustments.

5.3 Key Concepts & Guiding Principles

5.3.1 The MAP aims to provide an amicable way by which competent authorities may eliminate double taxation. In a MAP, the competent authorities will endeavour to come to agreement on the appropriate transfer pricing adjustments to relieve double taxation.

5.3.2 As Singapore's competent authority, IRAS seeks to eliminate double taxation that may be encountered by taxpayers. While IRAS would apply its best efforts in eliminating double taxation, such an outcome is possible only if there is concurrence by all competent authorities involved in the process. There may be instances where no agreement can be reached amongst competent authorities. In such cases, taxpayers would have to seek other remedies (e.g. legal remedies through the courts).

5.3.3 The MAP is an additional avenue available to taxpayers to resolve double taxation. Therefore, taxpayers will not be deprived of the other remedies that are available under domestic laws of the jurisdiction where the adjustments are made. However, if the matter is adjudicated in the courts of that jurisdiction while the MAP process is still on-going, taxpayers should inform the competent authorities, who would consult each other and come to a common agreement on whether the MAP process should cease. Similarly, the taxpayer is not obliged to accept the outcome agreed between the authorities. Taxpayers may withdraw the application, terminate the process or reject the agreed outcome. In such a case, taxpayers may seek alternative recourse to eliminate double taxation.

5.3.4 In the interest of achieving a fair agreement efficiently, taxpayers should cooperate fully with the competent authorities. Full cooperation would include swift and accurate responses or clarifications to the queries raised by the competent authorities and providing access to good quality documentation (see Section 4 "Documentation"), etc. Inadequate cooperation by the taxpayers may

[5] Details of Singapore's tax treaties are available at: http://www.iras.gov.sg/ESVPortal/tax_resources/treaties/index.asp

result in unresolved double taxation due to the inability to reach an agreement or the competent authorities' rejection of taxpayer's application for MAP.

5.3.5 IRAS will generally accept a taxpayer's request for MAP if:

(a) taxpayer has complied with the time limit specified in the applicable DTA for presenting the MAP request (see paragraph 5.4.1.1 for more details); and

(b) double taxation is almost certain i.e. double taxation should not be just a possibility, such as the mere occurrence of audit or examinations; and

(c) taxpayer is willing and able to render full cooperation throughout the process. In this aspect, IRAS will, amongst other things, evaluate taxpayer's quality of documentation based on the principles and guidance set out under the Section 4 "Documentation".

5.3.6 The complexity of issues involved in each specific MAP case will determine the time needed to resolve the case. IRAS undertakes to make its best efforts to achieve timely resolution of MAP cases and would regularly update taxpayers on the progress of their requests and indicate the expected timeframe for completion (see paragraphs 5.4.2.1 and 5.4.5.1 for more details).

5.4 Guidance on Making a MAP Request

5.4.1 Notification of Intention to Make MAP Request

5.4.1.1 If a taxpayer has been subject to transfer pricing adjustments with respect to its transactions with another related party, all related parties involved should notify the relevant competent authorities of their respective jurisdictions (i.e. in which they are tax residents) of the intention to activate the MAP. Under Singapore's treaties, taxpayers must present the request to the competent authorities within the time limit specified in the MAP Article of the relevant DTA. Failure to notify the competent authorities within the applicable time limit may result in the competent authorities' rejection of the MAP request, which can lead to the taxpayer suffering double taxation.

5.4.1.2 For the Singapore resident taxpayer, the notification to IRAS should be made in writing and should describe briefly the circumstances and provide basic information concerning the cause of double taxation.

5.4.1.3 If a foreign tax authority has made the transfer pricing adjustments, the Singapore resident taxpayer should not, under any circumstances, unilaterally make claims for corresponding adjustments or deductions in its current income tax returns, or file amending income tax returns. Instead, the taxpayer should inform IRAS of the double taxation and that it wishes to seek competent authority's assistance to resolve the issue.

5.4.2 **Preliminary Meetings**

5.4.2.1 IRAS undertakes to meet with the taxpayer within 4 weeks after the receipt of the notification for the latter to explain the circumstances leading to the transfer pricing adjustments, as well as for an update on the actions taken by taxpayer's related parties and the competent authorities in the other jurisdictions. At these meetings, IRAS will evaluate the taxpayer's situation and grounds for making the request as well as the quality and adequacy of taxpayer's documentation. If IRAS decides to accede to the taxpayer's request, guidance will be given on the information to be provided in the formal submission as well as the next course of action.

5.4.3 **Formal Submission of Request**

5.4.3.1 Unless IRAS or the other relevant competent authorities do not agree to taxpayer's MAP request, taxpayer should proceed to furnish a formal submission.

5.4.3.2 If taxpayer has prepared good quality documentation (based on the principles and guidance described under the Section 4 "Documentation"), the submission should comprise primarily the documentation that taxpayer has prepared and supplemented with any additional information the taxpayer thinks is necessary for IRAS to review and take up the request.

5.4.3.3 If taxpayer has not done proper documentation but IRAS has nonetheless accepted the MAP request after considering taxpayer's circumstances, the submission should still contain all the details based on the guidance described in Annex G (under Section 4 "Documentation"), any other additional information that the taxpayer considers to be relevant to enable IRAS to process and review the case, as well as all specific information requested by IRAS.

5.4.4 **Review and Resolution of Double Taxation**

5.4.4.1 On receipt of the formal submission, IRAS will commence the process of resolving the transfer pricing issues with the competent authorities of the other jurisdictions. This may include further discussions with taxpayers, requesting for more information, consultation and negotiation with the foreign competent authorities etc.

5.4.4.2 The negotiation of a case under MAP between the competent authorities is a government-to-government process. Hence, taxpayers do not, as a general rule, participate in or attend as observers at the negotiations or consultations between the competent authorities but they may be called upon to give clarification. However, as the taxpayers concerned are also stakeholders in this process, IRAS will regularly update them on the outcome of the competent authority consultations and the expected time frame to complete their cases.

5.4.5 **Post-Agreement Meeting and Implementation of Agreement**

5.4.5.1 When agreement is reached between the competent authorities, IRAS will meet with the taxpayer within 4 weeks of reaching agreement to discuss the details and implementation of the agreement.

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SECTION 6 ADVANCE PRICING ARRANGEMENTS

6.1 An Advance Pricing Arrangement ("APA") determines in advance, an appropriate set of criteria to ascertain the transfer prices of specified related parties transactions over a specified period of time. The provisions under the MAP Article of Singapore's tax treaties and the Singapore Income Tax Act enable the Singapore competent authority to accede to requests from taxpayers for APAs and to enter into such arrangements.

6.2 A bilateral or multilateral APA involves agreement between Singapore and one or more of its tax treaty partners. A unilateral APA only involves the taxpayer and IRAS.

6.3 A unilateral APA may not achieve the same level of certainty for taxpayers as in a bilateral/multilateral APA, since the other competent authorities or tax authorities may dispute the unilateral APA given that it is reached in the absence of their agreement. Notwithstanding, a taxpayer is free to choose between requesting for a unilateral or bilateral/multilateral APA.

6.4 The following paragraphs elaborate IRAS' positions on the bilateral/multilateral APA process as well as provide guidance on the application of such APA process[6].

6.5 Key Concepts & Guiding Principles

6.5.1 There is no mandatory requirement for taxpayers to seek an APA. However, in recognition of commercial needs, IRAS is making available the APA facility to taxpayers who are engaged in cross-border related party transactions.

6.5.2 An APA provides several advantages to taxpayers. Firstly, the APA prescribes guidance on the determination of acceptable transfer prices between related parties. It therefore offers certainty and minimises risks to the taxpayers. Secondly, an APA provides a more efficient and effective way of resolving complex transfer pricing issues, since it operates on the basis of cooperation between the taxpayers and the relevant competent authorities to reach agreement in advance. Thirdly, having an APA avoids lengthy and adversarial transfer pricing examinations as well as the possible imposition of penalties.

6.5.3 However, APAs may be time consuming and costly for taxpayers. This is because the prospective nature of an APA can mean that suitable data may be unavailable for analysis purposes, there is greater potential for disagreement between competent authorities, etc. Hence, taxpayers should evaluate their own situations and weigh the pros and cons before making a request for APA. If taxpayers choose not to enter into an APA and the transaction is subsequently subject to transfer pricing adjustments, the taxpayers may rely on the MAP or other remedies available in domestic laws to eliminate double taxation.

[6] The following paragraphs will generally still be applicable for unilateral APA requests, except that the references and procedures concerning foreign tax authorities would not be relevant.

6.5.4 As with the MAP, taxpayers' cooperation is critical to the success of the APA process. Full cooperation would include both swift and accurate responses or clarifications to the queries raised by the competent authorities and providing good quality analysis of the issues etc.

6.5.5 In most tax jurisdictions, an APA is regarded as binding on the tax authority and on the taxpayer, subject to any qualifications stated in the APA. In addition, once an APA has been obtained and taxpayers implement the APA according to the stated conditions, the tax authorities would suspend audits and penalties with respect to the transactions involved. Hence, taxpayers should enter into APAs in good faith, with the aim of obtaining certainty that their transfer prices have fulfilled the arm's length principle.

6.5.6 The APA process is a facility available to taxpayers to avoid potential double taxation. If taxpayer's request for APA is rejected or the competent authorities fail to reach agreement, taxpayers may still have recourse to the MAP or the other remedies that are available under domestic laws, should the taxpayer be subsequently subject to transfer pricing adjustments. Also, taxpayer is not obliged to accept the outcome agreed between the authorities. Taxpayers may withdraw the application, terminate the process or reject the agreed outcome. In such a case, taxpayers may seek alternative recourse to eliminate double taxation.

6.5.7 Generally, IRAS would accept an APA request if there is a genuine motive to obtain certainty for the avoidance of double taxation and the request relates to specific current or future transactions that are not hypothetical. However, the other foreign authorities involved must also agree with the request. The acceptability of an APA request is ultimately at the competent authorities' discretion. Should IRAS decline an APA request, it would offer taxpayer a full explanation of the grounds for declining the request.

6.5.8 With regard to the appropriate period that an APA should cover, IRAS is of the view that this should be addressed pragmatically, based on commercial realities. The APA should only cover periods where the critical assumptions and commercial factors that have significant impact on the validity of the APA are expected to remain unchanged. This basis should also be used to guide decisions on the suitability of applying the terms of the APA to prior years (commonly known as "roll-back" of the APA). Based on experience, most APA requests cover 3-5 prospective years, in addition to its application to 1-2 prior years.

6.5.9 IRAS appreciates that the usefulness of an APA to a taxpayer may be diminished if a timely agreement cannot be reached. In this regard, IRAS will do its best to expedite the APA process and reach agreement with the foreign tax authorities as soon as possible. However, the actual duration of the process would depend on the complexity of the issues involved in each case, and the response time of the foreign tax authorities. IRAS will update taxpayers on the progress of their requests and indicate the expected timeframe for completion on a regular basis.

6.6 Guidance on Making an APA Request

6.6.1 Pre-filing Meetings

6.6.1.1 The first step to an APA application is to arrange for pre-filing meetings with IRAS. At these meetings, taxpayers should present the salient information such as the company's business model and industry information, transactions to be covered, the period of the APA etc. If IRAS is willing to accept the case for APA, the taxpayer will be advised on the necessary follow-up actions (such as the content of the application to be submitted etc.) and what is expected of the APA process (e.g. the expected timeframe for completion etc.).

6.6.1.2 For bilateral and multilateral APAs, taxpayers should undertake similar meetings with the relevant foreign tax authorities and seek their agreement for an APA as well as their specific requirements with respect to the APA process. It would be helpful if taxpayers share such information from their meetings with the foreign tax authorities with IRAS.

6.6.2 Formal APA Submission

6.6.2.1 Unless IRAS or the relevant foreign authorities do not agree to the APA request, taxpayers should proceed to submit the formal APA application, which should include the following key components:

- General information concerning the taxpayer such as the nature of its business and its industry environment, worldwide organisational structure, etc;
- Details and explanation of the proposed transfer pricing methodology and analysis;
- All information and analyses needed to produce the arm's length results for the related party transactions;
- The set of critical assumptions under which the proposed transfer pricing methodology and analysis will operate;
- Period covered by the APA, including whether the APA would be rolled back to prior years;
- Any other information that IRAS or the other tax authorities have requested for.

6.6.2.2 In considering the details to be submitted, taxpayers may also find it useful to refer to the guidance described in Annex G (under Section 4 "Documentation").

6.6.3 **Review and Negotiate APA**

6.6.3.1 Upon receiving the formal submission, IRAS will commence the process of seeking an APA with the relevant foreign authorities.

6.6.3.2 This may include meetings with taxpayers to seek clarifications, obtaining more information, conducting site visits, consultations and negotiations with the relevant foreign competent authorities, etc.

6.6.3.3 As with the MAP, the negotiation of a bilateral or multilateral APA is a government-to-government process. Hence, taxpayers do not, as a general rule, participate in or attend as observers at the negotiations or consultations between the competent authorities but taxpayers may be called upon to provide clarification. However, as the taxpayers concerned are also stakeholders in this process, IRAS would regularly update them on the outcome of the competent authority consultations and the expected time frame to complete their cases.

6.6.4 **Post-Agreement Meeting and Implementation of APA**

6.6.4.1 When an agreement is reached, IRAS will meet with the taxpayer within 4 weeks of reaching agreement to discuss the details and implementation of the agreement. IRAS will also discuss with the taxpayer on the APA compliance and monitoring requirements.

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SECTION 7 ENQUIRIES

7.1 If you wish to seek clarification on this 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

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Annex A Example on the CUP Method (Using External CUP)

SingCo, a Singapore enterprise, sells a commodity product to its overseas subsidiary, Company A, which is located in country A. This commodity product is widely and competitively traded in country A and the price of the commodity at any point in time is easily available. In this case, the market price would be the CUP to determine if the transfer price between SingCo and Company A is at arm's length.

The market price adopted in the above example is commonly termed as "external CUP". Many taxpayers tend to rely on such external data in their attempts to locate comparable indepedent transactions. In practice, many tax administrations have found internal comparable transactions (commonly termed as "internal CUP") to be also useful and reliable in establishing the arm's length price. An internal comparable may arise where the taxpayer or another member of the group buys or sells the particular product, in similar quantities and under similar terms to independent parties in similar markets. Please see example in Annex B.

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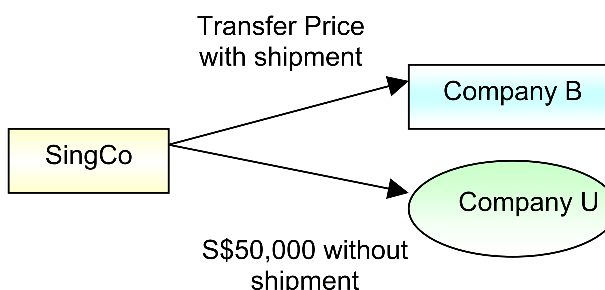
Annex B Example on the CUP Method (Using Internal CUP)

SingCo, a Singapore enterprise, sells only one type of computer disk drive. The disk drives are sold to 2 entities: SingCo's overseas subsidiary, Company B and a local unrelated company, Company U. Under the agreement between SingCo and Company B, SingCo will ship the hard disks to Country B where Company B is located on a CIF basis. On the other hand, Company U takes possession of the hard disks at SingCo's factory.



Assuming that the volume of SingCo's disk drive sales to both parties are similar in any one particular period, the CUP for the disk drives sold to Company B could be computed as follows:

Price of disk drives sold to Company U (per container of goods)	S$50,000
Add : Adjustment for insurance and freight	S$ 400
Transfer price (per container of goods) based on CUP	S$50,400
	========

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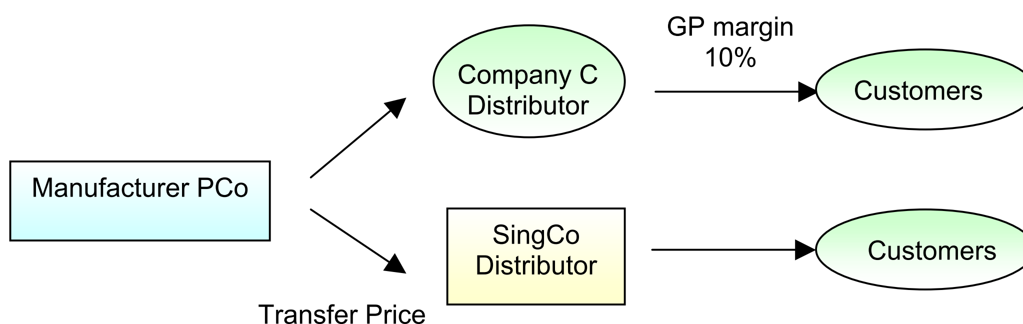
Annex C Example on the Resale Price Method

SingCo distributes laptop computers in Singapore for its overseas parent company, PCo. Company C, a Singapore company unrelated to PCo, has also been appointed by PCo to distribute desktop computers for it in Singapore. In this example, it is assumed that the laptop and desktop markets are similar in Singapore. The main difference between the two distributorship agreements is that SingCo performs promotional and marketing functions for PCo whereas Company C does not.



The gross profit margin of Company C from the resale of desktops to consumers was found to be 10%.

The arm's length price for the related party transaction is computed as follows:

SingCo's sales of laptop to unrelated parties	S$ 3,500
Less: Arm's length resale price margin based on Company C's transactions (10% x 3,500)	S$ 350
	S$3,150
Less: Adjustment for marketing costs	S$80
Transfer price (based on resale price method)	S$3,070
	=======

The above example is based on an internal comparable i.e. PCo's transactions with Company C (an independent party) is used to benchmark the transactions with SingCo (a related party). The same analysis could be undertaken using external comparables i.e. benchmarking the related party transactions between PCo and SingCo against comparable transactions between an independent manufacturer and distributor.

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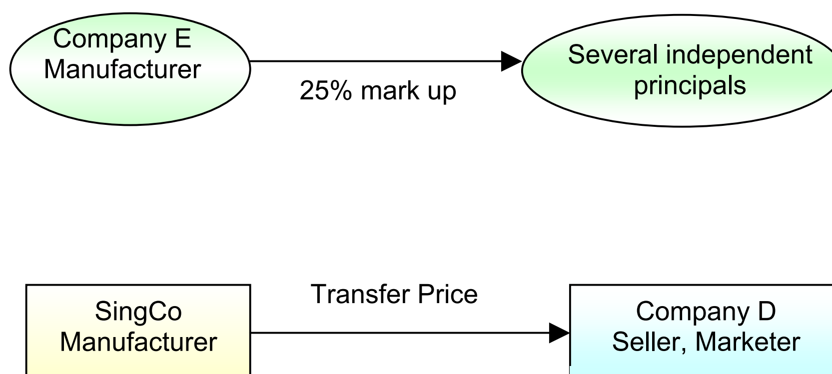
Annex D Example on the Cost Plus Method

SingCo is a domestic manufacturer of a specialized drug for its overseas associated company, Company D. The MNE group to which SingCo and Company D both belong is the inventor of the drug and the only producer in the world.

Under the agreement, Company D provides all the know-how used in the manufacturing of the drug and undertakes to acquire a fixed output from SingCo every month. Payment is to be made based on the costs incurred by SingCo, along with a mark-up to reflect a profit element for SingCo. Based on SingCo's financial statements, the cost incurred to manufacture one unit of the drug is S$70.

SingCo essentially performs the role of a contract manufacturer. An unrelated Singapore manufacturing company in the pharmaceutical industry that manufactures a different drug, Company E, has been identified as a potential comparable company. Company E charges an average mark-up of 25% for providing similar contract manufacturing services to several other independent companies.



The transfer price for the related party transaction is computed as follows:

Direct and indirect cost incurred by SingCo to manufacture one unit of drug	S$70.00
Arm's length mark up (25% x 70.00)	S$17.50
Transfer price (based on the cost plus method)	S$87.50 =======

The above example is based on an external comparable i.e. SingCo's transactions with Company D (a related party) are benchmarked against the transactions between Company E and independent parties. The same analysis could be undertaken using internal comparables e.g. benchmarking the related party transactions between SingCo and Company D against comparable transactions between SingCo and an independent party.

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Annex E Example on the Profit Split Method (Residual Analysis Approach)

SingCo is a Singapore manufacturing and sales company for telecommunication products. It developed an original microprocessor and holds the patent for the manufacturing technology. Company F, an overseas subsidiary of SingCo, develops and manufactures mobile equipment using the new microprocessor as well as technology developed by itself. Company F is the only manufacturer licensed by SingCo to use the new microprocessor. SingCo purchases all of the mobile equipment manufactured by Company F and sells them to third parties.

Both companies contribute to the success of the mobile equipment through their design of the microprocessor and the equipment. As the nature of the products are very advanced and unique, the group is unable to locate any comparable with similar intangible assets. Therefore, neither the traditional methods nor the TNMM are appropriate in this case.

Nevertheless, the group is able to obtain reliable data on handphone contract manufacturers and equipment wholesalers without unique intangible property in the telecommunication industry. The manufacturers earn a mark-up of 10% while the wholesalers derive a 25% margin on sales.

SingCo's and Company F's respective share of profit is determined in 2 steps using the profit split method (residual analysis approach).

- Step 1 – Determining the basic return

The simplified accounts of SingCo and Company F are shown below:

	Company F (S$)	SingCo (S$)
Sales	100	125
Cost of Goods Sold	(60)	(100)
Gross Margin	40	25
Sales, General & Admin	(5)	(15)
Operating Margin	35	10

The total operating profit for the group is S$45.

Company F

Cost of goods sold	S$60
Cost mark-up of contract manufacturer (10% x 60)	6
Transfer price based on comparables (without intangibles)	S$66
	====

SingCo

Sales to third party customers	S$125
Resale margin of wholesalers comparables (without intangibles)	25%
Resale margin (or gross margin)	S$31.25
	========

Computation of basic return based on comparables (without intangibles)

	Company F (S$)	SingCo (S$)
Sales	66	
Cost of Goods Sold	(60)	
Gross Margin	6	31.25
Sales, General & Admin	(5)	(15)
Routine operating margin	1	16.25

The total operating margin of the group is S$17.25.

- Step 2: Dividing the residual profit

The residual profit of the group is = S$45 – S$17.25 = S$27.75

On further study of the two companies, two particular expense items, R&D expenses and marketing expenses, are identified as the key intangibles critical to the success of the mobile equipment. The R&D expenses and marketing expenses incurred by each company are:

SingCo S$12 (80%)
Company F S$3 (20%)

Assuming that the R&D and marketing expenses are equally significant in contributing to the residual profits, based on the proportionate expenses incurred:

SingCo's share of residual profit (80% x 27.75) S$22.20
=======
Company F's share of residual profit (20% x 27.75) S$ 5.55
=======

Therefore, the adjusted operating profit of
SingCo is = S$22.22 + S$16.25 = S$38.45, and
Company F is = S$5.55 + S$1 = S$6.55.

The adjusted tax accounts are as follows:

	Company F (S$)	SingCo (S$)
Sales	71.55	125
Cost of Goods Sold	(60)	(71.55)
Gross Margin	11.55	53.45
Sales, General & Admin	(5)	(15)
Operating Margin	6.55	38.45

Hence, the transfer price determined using the profit split method (residual analysis approach) should be $71.55.

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Annex F Example on the Transactional Net Margin Method (TNMM)

SingCo is a Singapore manufacturer of dishwashers. All SingCo's dishwashers are sold to an overseas associated enterprise, Company G, and bears Company G's brand. Company G, a household electrical appliances brand name, sells only dishwashers manufactured by SingCo.

The CUP method is not applied in this case because no reliable adjustments can be made to account for differences with similar products in the market. After the appropriate functional analysis, SingCo was able to identify a Singapore manufacturer of home electrical appliances, Company H, as a suitable comparable company. However, Company H performs warranty functions for its independent wholesalers, whereas SingCo does not. Company H realizes a net mark up (i.e. operating margin) of 10%.

As the costs pertaining to the warranty functions cannot be separately identified in Company H's accounts and no reliable adjustments can be made to account for the difference in the functions, it may be more reliable to examine the net margins in this case. The transfer price for SingCo's sale of dishwashers to Company G is computed using the TNMM as follows:

SingCo's cost of goods sold	S$5,000
SingCo's operating expenses	S$1,500
Total costs	S$6,500
Add: Net mark up (10% x 6,500)	S$650
Transfer price based on TNMM	S$7,150
	=======

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Annex G Guidance on Documentation Requirements

Details on what should be documented includes the following:

(a) General Information on the Group

(i) Details on worldwide organisational structure, showing the location and ownership linkages amongst all related parties;

(ii) Information on the group's line of business, industry dynamics, market, regulatory and economic conditions in which the group operate;

(iii) The group's business models and strategies (past, present and future);

(iv) Brief information on the principal business activities and functions of each party in the group;

(v) Brief information on the business relationships (services provided, goods sold, intangible use, etc.) amongst all related parties; and

(vi) Consolidated financial statements of the group.

(b) Information on each Related Party in Singapore ("Singapore Entity")

(i) General information such as company registration number, address, etc.;

(ii) Detailed information on the entity's line of business, industry dynamics, market, regulatory and economic conditions in which the entity operate;

(iii) Detailed information on the entity's business models and strategies (past, present and future);

(iv) Detailed information on the entity's functions, risks and assets employed; and

(v) Financial statements including detailed profit & loss statements.

(c) Details on Transactions between Singapore Entity and all Related Parties

(i) Detailed information on all transactions with related parties;

(ii) Contracts or agreements (if any) to show the terms of the transactions; and

(iii) Segmented financial accounts with respect to the transactions, including explanations on the assumptions (if any) used to derive the segmented information.

(d) Transfer Pricing Analysis

(i) The choice of the tested party and reasons supporting the choice;

(ii) Details on comparables and the screening criteria for choosing the comparables;

(iii) Comparability analysis of the related party transactions and the comparables;

(iv) Details of (and reasons for) the adjustments deemed necessary to be made to achieve comparability;

(v) The transfer pricing method chosen and substantiate why the method is most appropriate;

(vi) The determination of the arm’s length price/margin, showing the detailed computation and explanation of any assumption made; and

(vii) If an arm’s length range is determined, furnish details/reasons to support the determination and use of the range.

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