IRAS' TRANSFER PRICING GUIDANCE ON CENTRALISED ACTIVITIES IN MNE GROUPS

APRIL 2021

On 19 March 2021, Inland Revenue Authority of Singapore ("IRAS") published its second special topic transfer pricing guidance on the topic of centralised activities of MNE Groups in Singapore ("Guidelines"). The Guidelines focus on the large number of headquarters ("HQs") located in Singapore but clarifies that the transfer pricing guidance provided would apply to other entities involved in centralized activities as well.

The Guidelines are structured similar to the first special topic transfer pricing guidance on commodity marketing and trading activities, broadly covering the following key aspects:

- Objective of centralisation of activities within MNE Groups
- Choice of Singapore as a preferred HQ location
- Functional analysis of centralised activities and characterisation of HQ functions
- Suitable transfer pricing methodology for different roles performed by HQs
- Transfer pricing documentation requirements (specific to centralized activities performed by HQs)

This article summarises the key takeaways of the Guidelines.

Headquarters in Singapore

Singapore is a popular choice as a HQ location, especially for MNE Groups with a core focus on the Asia market. The various attributes of Singapore which make it a preferred location for setting up HQs include:

- One of the most competitive world economies, a global financial center which is highly rated for ease of doing business
- Strategic geographical location in Asia with established travel routes to emerging markets in the continent
- Sophisticated ecosystem of global and regional supply chains with access to logistics providers and professional consultancy firms
- Strong talent base and established legal and digital infrastructure in a geo-politically stable environment
- Robust enforcement of intellectual property rights and cyber-security

A combination of these business and economic factors strengthen Singapore's position as a highly popular HQ location for MNE Groups.

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TRANSFER PRICING ANALYSIS

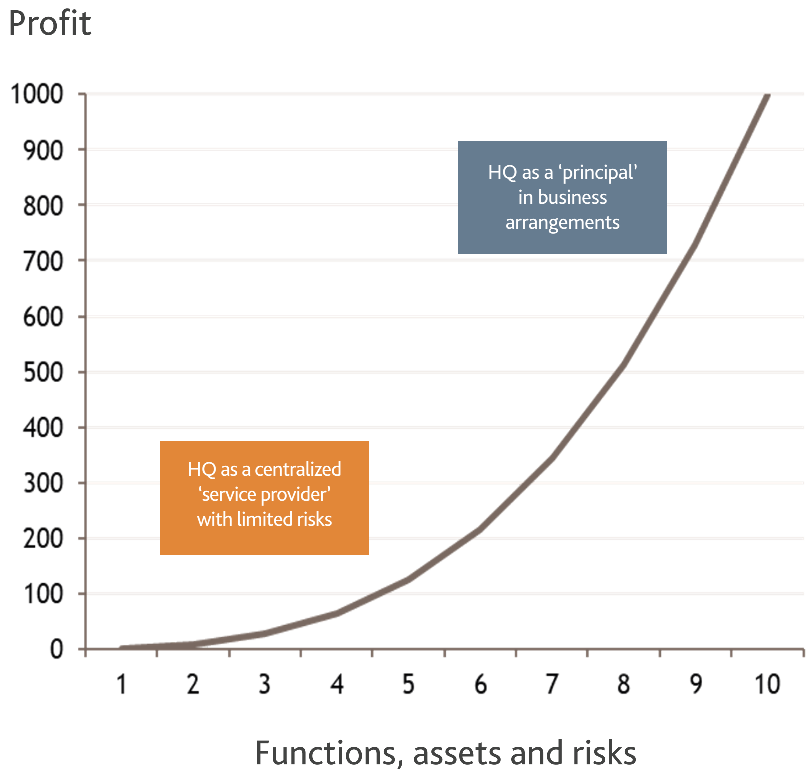
HQ is typically a term used for a centralised location where an MNE group's management and key staff operate and oversee business activities. Often, centralised activities are provided out of a HQ which benefit other members of the MNE Group. The Guidelines clarify that there are different functional profiles of HQs which in turn define their contribution to value. It is important to understand the business of the Group and accurately delineate the actual related party transaction in order to determine the intensity of activities undertaken by the HQ, and the arm's length transfer price. Due consideration must be given to the following steps:

1. Delineate the actual related party transaction of the HQ
2. Understand the nature of activities performed by the HQ and the assets used, which contribute to the value generated by the MNE Group as a whole
3. Assess the risks assumed by the HQ in performing its functions and whether the HQ controls the risk and has the financial capacity to assume the risk

BDO insight:

While the above steps are a norm in any transfer pricing analysis, the IRAS has stressed the importance of this exercise and in particular the consideration of how value creation takes place within the MNE Group, and the economic significance of the functions undertaken by the HQ in terms of value to the respective parties. Where HQ services might have been typically remunerated on a routine cost-plus basis, the IRAS does expect a different/ larger margin if the HQ acts as a principal assuming greater risks and decision making, to improve business outcomes of the MNE group.

The functional profile of the HQ has to be considered on its own facts and circumstances, with attention to the type of industry. The remuneration of the HQ should always be commensurate with its functions, assets and risks profile.



CHARACTERISATION OF HQs

The Guidelines discuss four possible categories of activities undertaken by HQs and the functional and risk characterizations along with guidance on the suitable transfer pricing methodology for each category, as summarized below.

Categories	Principal in distribution, manufacturing or research and development arrangements	Activities relating to core business processes	Activities relating to administrative, technical, financial, commercial, management, coordination and control functions	Shareholder activities
Functions	As a principal, HQ undertakes a decision making role in the arrangement and has qualified personnel for the role. The HQ also has collective oversight and can improve business outcomes.	The HQ provides services to other Group entities relating to the core business processes, including procurement, sales, trading, technical backend operations, etc.	The HQ provides centralized services to other Group entities in relation to common business processes which are administrative in nature and support the core business operations of the MNE Group.	If the HQ is the parent entity or regional holding company in the MNE Group, it may perform certain activities in its capacity as a shareholder. These functions do not benefit the Group entities.
Risk profile	As a principal, the HQ bears majority of the business risk arising from its activities and also has the capability to make decisions on the risk management and mitigation strategies.	The risk profile of the HQ involved in activities relating to core business processes is dependent upon the scope of its functions. If the HQ is making decisions to control the risks, it could be said to be bearing the relevant risks, while if the HQ is providing only guidance to Group entities on core business processes, the corresponding risks are usually borne by the Group entities.	The risk profile of the HQ involved in providing services in relation to administrative, technical, financial, commercial, management, coordination and control functions is usually limited to the operational risks of providing these services.	
Suitable transfer pricing methodology	The comparable uncontrolled price ("CUP") method is appropriate if a comparable transaction can be found and can be adjusted for, which is less common. Otherwise, since the HQ is the entity with the more complex functional profile, the related party would generally be the tested party. The cost plus method, resale price method and transactional net margin method ("TNMM") are options to test the related party's activities, depending upon the nature of the transaction.	The CUP method is appropriate if there are comparable services provided to third parties, or comparable services provided between independent parties, and can be adjusted for, which is less common. Otherwise, where the HQ shares in the risks and rewards of the core business processes, the profit spit method may be appropriate (residual profit is the HQ is the entrepreneur). In other cases, the cost plus or TNMM would be appropriate where the HQs contributions are measureable and driven by its costs.		Since the HQ is performing activities as a shareholder which independent parties would not pay for, it cannot charge a service fee in respect of these activities to Group entities.

CASE STUDY

To elaborate on these transfer pricing concepts, the Guidelines provide a case study which we summarize below (SG Co is the Singapore regional HQ):

Functional analysis:

- SG Co licenses the legal trademark to sell products in the Asia-Pacific region and the technology for manufacturing the finished goods from the Global HQ and pays the latter a royalty fee.
- SG Co carries out the entrepreneurial functions related to these products for the Asia-Pacific region.

Suitable transfer pricing methodology

The royalty rate for use of trademarks and manufacturing know-how could be set using the CUP method if possible, using comparable agreements for the use of similar intangibles.

Alternatively, a profit split or residual profit split method for determining the license fees is also a possible method, depending upon the relative functions, assets and risks assumed by Global HQ and SG Co.

Functional analysis:

- SG Co procures raw materials and packaging for related party contract manufacturers to produce the finished goods. SG Co is responsible for ensuring that the items are procured at the right price point, quality and terms of sale and there is continuity in supply.
- SG Co also ensures that the licensed-in technology is correctly used by the contract manufacturers in the production of finished goods. SG Co also works with the contract manufacturers to plan production and delivery for the finished goods in the respective markets.

Suitable transfer pricing methodology

Since the two related transactions of sale of raw material and packaging, and the sale of finished goods between the SG Co and the regional group manufacturers under the contract manufacturing agreement are closely inter-twined, they can be examined together.

The regional group manufacturers will be the functionally simpler entities and hence are selected as the tested parties. The TNMM method is commonly used and the contract manufacturers would usually be rewarded with a mark-up on total costs, based on margins earned by similar independent manufacturers.

The residual profits or losses, if any, emanating from the sale of products will be attributable to the SG Co.

CASE STUDY

Functional analysis:

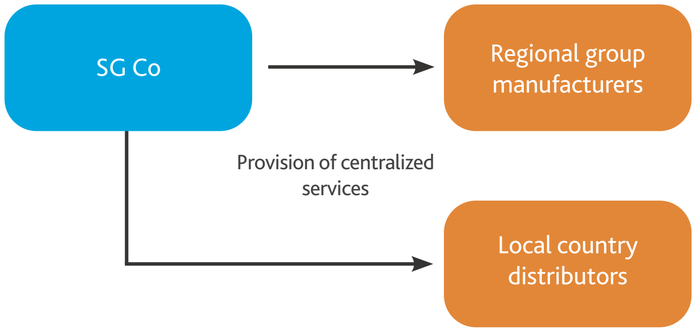
- SG Co is responsible for projecting and planning the demand for finished goods within the region.
- SG Co purchases the finished goods from the contract manufacturer, assumes title to the goods and is responsible for storage and delivery of the finished goods. It sells the finished goods to the local country distributors.
- SG Co also works with the related party distributors to ensure implementation of the group marketing strategy and is the principal to the local country distributors.

Suitable transfer pricing methodology

Relative to the SG Co, the local country distributors are the simpler entities with the less complex functional profiles and hence are selected as the tested parties.

Since SG Co is the principal in control of the distribution function, the TNMM is used to determine the margins for the local country distributors. For the role of local country distributors in driving the local market sales, the distributors would usually be rewarded with a profit level indicator using the operating margin.

The residual profits or losses, if any, will be attributable to the SG Co.



Functional analysis:

- SG Co provides other centralised services to related parties, including legal, human resource and talent management, finance and tax services.

Suitable transfer pricing methodology

SG Co can charge its related parties based on the TNMM, computing the service fee as the costs incurred in providing the service, plus an appropriate mark-up earned by similar independent service providers. The administrative practices for routine services covered in Annex C of the Singapore TP Guidelines (5th Edition) can also be used where applicable.

TRANSFER PRICING DOCUMENTATION REQUIREMENTS

HQs are subject to the same thresholds for preparation of mandatory transfer pricing documentation as other taxpayers.

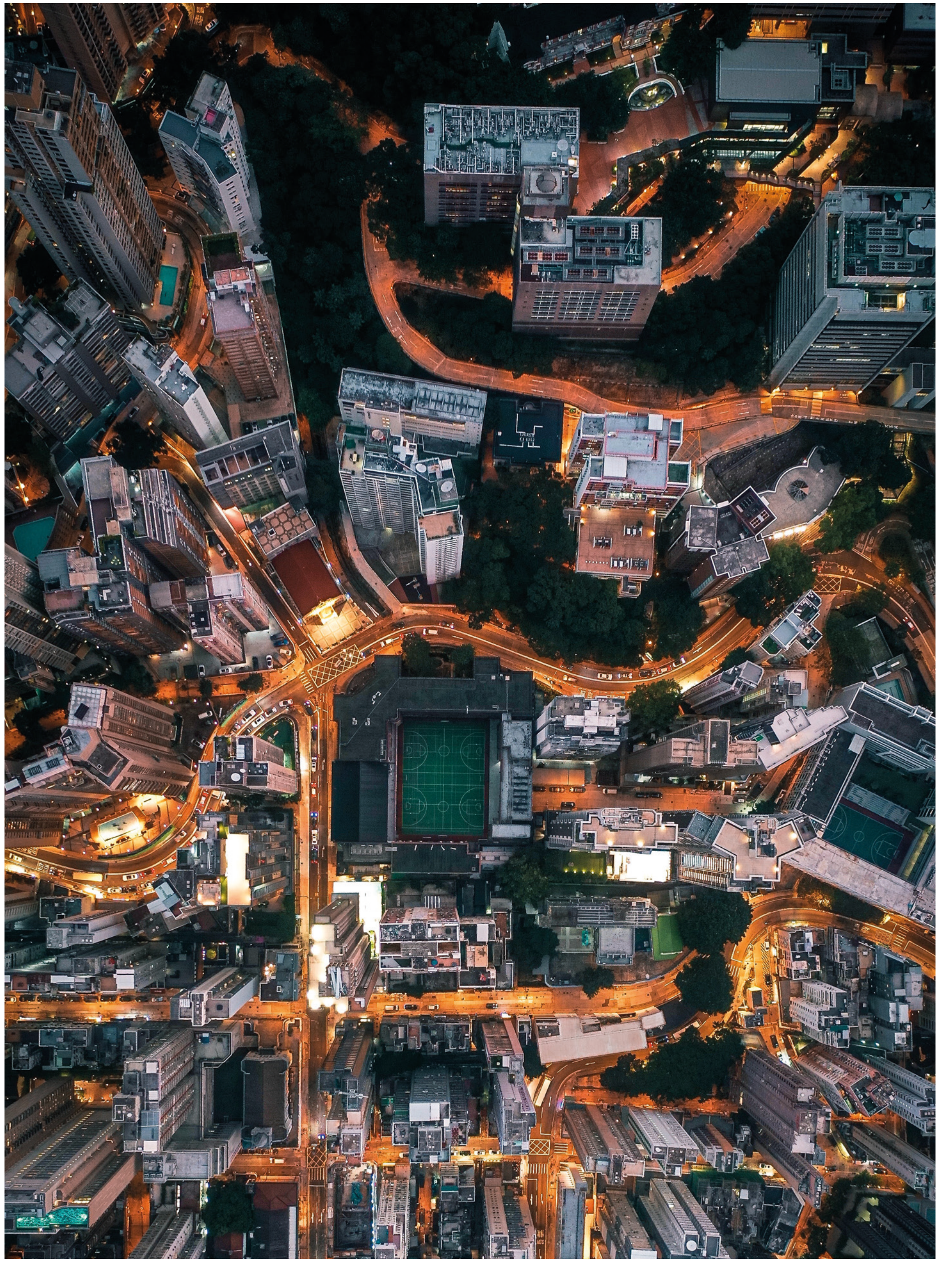
The IRAS has emphasised on the inclusion of the below information in the transfer pricing documentation:

- Business strategies and economic circumstances
- Value generation by the MNE Group and the contribution of the activities performed by the HQ (through their decision making highly qualified personnel) and the related parties to such value creation
- Robust functional analysis, with specific focus on risk assumption and risk control & management
- Inclusion of reliable evidences on how the HQ manages and controls the risks
- Description of the price-setting and price-testing policy/approach
- Benefits test where services are provided/received

BDO insight:

The IRAS has reinforced the emphasis on "substance over form", requiring taxpayers to produce evidence, such as actual examples on risk materialisation, beyond what is contractually formalised between related parties. The onus is placed on HQs to support their assumption and management of risks, and their contribution to value creation.

The IRAS encourages taxpayers to have explanations of transfer pricing arrangements on hand, even if they are exempted from preparing full blown transfer pricing documentation under Section 34F of the Singapore Income Tax Act. This is particularly relevant for arrangements between the HQ and other members of the MNE Group, where comparable activities/arrangements do not exist in a third party setting.



KEY TAKEAWAYS

The popularity of Singapore as a HQ location means that there are many global corporations with global/regional HQs in Singapore undertaking centralised activities. The Guidelines are welcome as it clarifies the IRAS' expectation for various transfer pricing arrangements between these HQs and their overseas related parties. The Guidelines also help these HQs explain the rationale of setting up in Singapore as a HQ location and this could help establish substance for MNE Groups in Singapore.

Taxpayers should note that the IRAS has been very active in recent years, enforcing and clarifying the Singapore transfer pricing legislation and contemporaneous documentation requirements introduced since financial year ("FY") 2018. It is crucial that HQs, or any other entities providing centralised services ensure that transfer pricing policies are defensible and meet with the requirements of the Guidelines. There should also be processes established to monitor the transfer prices systematically on a regular basis. These transfer pricing arrangements are not expected to be static, and should be updated for technological and other business changes which change the value add of the entities involved.

HQs can also expect increased IRAS audit activity in the area of HQ and centralised services, especially focusing on Singapore HQs or service providers who are loss-making or not being appropriately compensated for the activities undertaken. Whilst the IRAS remains pragmatic and takes care not to over burden taxpayers with excessive compliance requirements, taxpayers should appreciate that the transfer pricing enforcement landscape has shifted and become more aggressive. Being proactive to review cross-border transfer pricing arrangements is the first step to assessing and managing your transfer pricing risks.

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