KPMG

Tax alert

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The Danger of Neglecting Your Domestic Related-Party Transactions

Have you (or anyone in your organisation) ever said/thought some variation of the following?

We only focus on our cross border related-party transactions.

Domestic related-party transactions are exempt from TP, so I don't have to think too hard about them.

Left pocket, right pocket, it's not going to matter.

No loss to the government, IRAS won't care.

The level of the Inland Revenue Authority of Singapore (IRAS) scrutiny on related-party transactions (RPTs) is at an all-time high due to developments in Singapore and internationally. Many taxpayers tend to focus their planning and compliance efforts on their cross-border RPTs, and rarely devote the same level of attention or resources for domestic RPTs. This is true for both Singapore based groups, as well as multinational enterprises (MNE) with multiple Singapore companies. It is common for such groups to engage in domestic RPTs such as the sharing of common resources, provision of intra-group services and providing loans to other group members. Where there is no differential in the tax rate, IRAS exempts taxpayers from having to prepare TPD for such domestic RPTs which results in taxpayers adopting a more relaxed approach for these RPTs.

In this tax alert, we take a closer look at the law and how the misconceptions on domestic RPTs creates challenges for Singapore taxpayers, and the transfer pricing adjustments and penalties that have been imposed in these situations.

Overview of the Law

Section 34D of the Singapore Income Tax Act (ITA) requires all RPTs to be conducted at arm's length. Importantly, Section 34D does not make any distinctions between cross-border versus domestic RPTs.

While Section 34F of the ITA (i.e. the requirement for taxpayers to prepare adequate and contemporaneous transfer pricing documentation (TPD)), provides exemption for some domestic RPTs meeting the requisite conditions, it does not exempt taxpayers from the application of Section 34D. This means that Singapore taxpayers will have to stand ready to defend their transfer pricing policies on domestic RPTs. In recent times, we have observed a notable increase in the challenges by IRAS with respect to taxpayers' domestic RPTs.

A Cautionary Case Where IRAS Focused on Domestic RPTs

A Singapore based group of companies was challenged by IRAS for the non-charging of management services fees from its group headquarters to various subsidiaries. The taxpayer held the opinion that the charging of management fees within the Singapore entities was not required because:

- the taxpayer was employing group relief which allowed for 'loss items' of one company to be deducted from the assessable income of the other company of the same group, hence, management felt that this negated the need to charge for the services provided by the headquarters;
- some subsidiaries were non-income producing or were in losses, therefore management was of the opinion that there was no need to charge as they did not have the ability to pay;
- the misconception that the exemption from having to prepare TPD for domestic RPTs was essentially an exemption from charging an arm's-length fee; and
- the taxpayer regarded intercompany charging as an unnecessary administrative burden since not doing so would create no loss of tax revenue for IRAS.

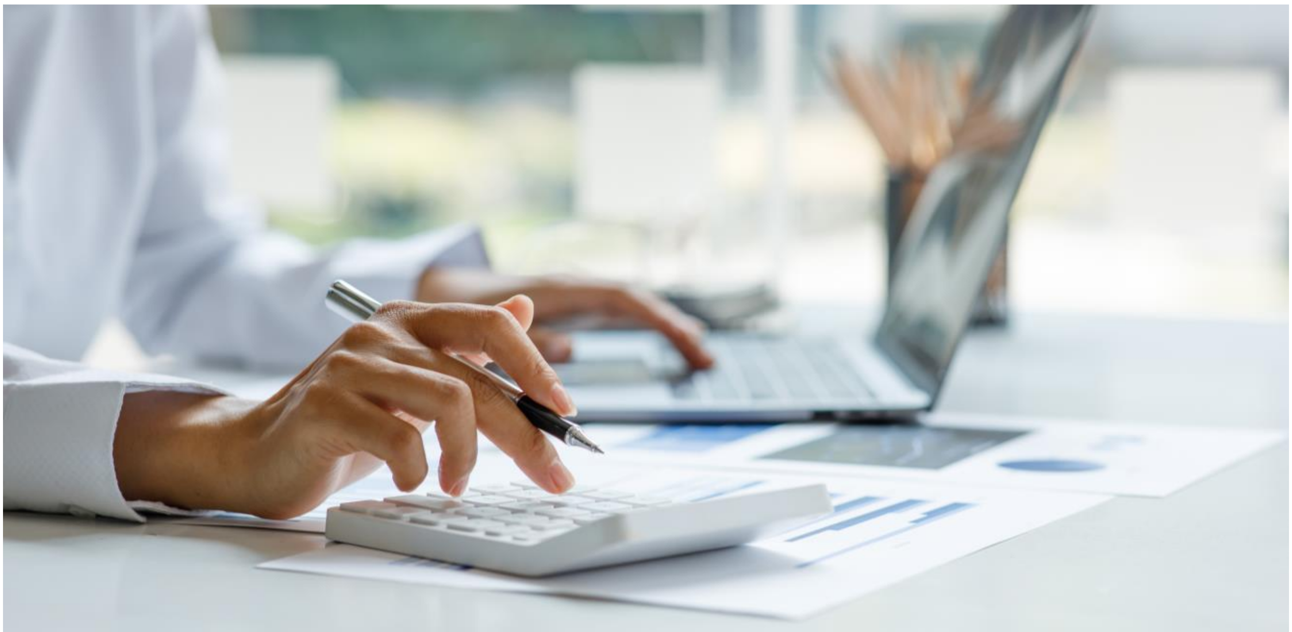
In this case (and several others with similar fact patterns), IRAS deemed additional income for the services provided by headquarters (which were not charged out). This resulted in additional taxes to be paid by the headquarters, plus the imposition of the 5 percent transfer pricing surcharge on the adjustment amount. On the other hand, IRAS did not allow for the other Singapore related parties (i.e. the service recipients) to claim for the corresponding deduction as the amount was not incurred, resulting in economic double taxation in Singapore. If this was a cross-border transaction, the taxpayer may have been able to initiate a Mutual Agreement Procedure, however there is no equivalent recourse for domestic transactions. The end result was a substantial tax adjustment made to the service provider over all the open years, a corresponding surcharge, and ultimately double taxation cost for the client. A hefty consequence for a transaction with seemingly low risk.

In addition to the above, in recent transfer pricing audits, there has also been increased focus on the determination of the cost based applied by the Singapore service provider. It is important to note that in situations where recharges are being made for services, that the correct cost base is utilised. IRAS has been challenging taxpayers for not including the appropriate costs in the calculation of the cost base. It is not uncommon for taxpayers to only include direct costs (such as salaries) and exclude indirect costs and notional costs. The position of IRAS is that the cost base should be fully loaded, and the inclusion of costs does not depend on whether costs are "incurred" and that such costs would include notional costs. A common area of dispute seen in recent years has been in relation to share-based compensation. Hence, it is critical to study the underlying nature of the expenses as IRAS queries in this area can be very detailed and complex.

Special Considerations - Latest Developments in Relation to Domestic Loans

Interest-free loans, or loans at a below-market interest rate, are very common among related entities within an MNE. Such loans are extended for various reasons including structuring considerations for future divestment, managing the financial and tax leakage arising from funding arrangements, or for administrative ease.

In the latest edition of the Singapore Transfer Pricing Guidelines (7th edition) released by IRAS on 14 June 2024, the use of interest restriction as a proxy to the arm's-length principle for domestic loans will be discontinued starting from 1 January 2025. IRAS requires that for domestic loans entered into from 1 January 2025, taxpayers should either apply the IRAS indicative margin (where applicable) or an arm's-length interest rate.



As before, IRAS does not regard interest-free related party loans as arm's-length transactions, unless taxpayers have reliable evidence that independent parties under comparable circumstances would similarly provide loans without charging any interest.

Hence, taxpayers may need to revisit existing domestic loans or plan carefully for new domestic loans post 1 Jan 2025, especially if they are interest free.

Note that there has been no change with respect to IRAS position on related party loans where the borrower is in the business of borrowing/lending, in which case the interest restriction as proxy approach would not be available.

Key Takeaways

While IRAS exemptions provide some relief to taxpayers with domestic RPTs from a compliance/administrative perspective, it is important to not trip up on the following.

- An exemption from TPD requirements is not an exemption from having to apply an arm's-length pricing for domestic RPTs. Hence, taxpayers should at minimum, maintain a basic level of TP analyses to support their domestic RPTs.
- When challenged by IRAS, domestic RPTs are subject to the same penalties and surcharges, without any corresponding relief from the view of the counterparty. Our recent observations are that the level of scrutiny on domestic transactions is as stringent as cross border RPTs i.e. don't expect IRAS to "go easy" on domestic RPTs.
- Tax authorities typically expect consistency, so taxpayers should adopt a consistent approach for both domestic and cross border RPTs, where applicable.
- Planning is critical to consider any impact for current domestic intercompany loan arrangements, as well as to put together a framework for new intercompany loans which are expected to be implemented on/after 1 January 2025.

How we can help

As a committed tax advisor to our clients, we welcome any opportunity to discuss the relevance of the above matters to your business.

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About our tax alerts

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