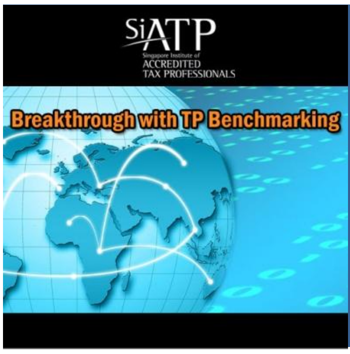

TED: Breakthrough with TP Benchmarking

All about Benchmarking Analysis

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Facilitated by:
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Ten years ago, transfer pricing (TP) was still a relatively unfamiliar subject to many businesses. Fast forward to today and it has been pushed into the spotlight.

TP is widely recognised by C-suites to have a significant impact on business profitability, income tax paid, shareholder value and the overall risk management framework.

Getting it wrong can potentially lead to huge tax bills or even negative exposure to the global media. It is therefore crucial for businesses, especially in this era of tax transparency, to ensure that their related party transactions are defendable in front of tax authorities. Central to it all is benchmarking analysis.

TP Documentation

To minimise the risk of TP adjustments by tax authorities, companies must be able to satisfy the tax authorities that their related party transactions are indeed conducted at arm's length[1]. Often, the best defence for taxpayers in times of TP disputes is a well thought-out TP policy supported by contemporaneous TP documentation.

Applying the principles set out in the OECD's and IRAS' approaches, TP documentation should include the following in practice:

- an introduction of the purpose, scope, regulatory environment and how the legislation applies;
- company and industry analyses;
- overview of international related party transactions and commercial and financial relations;
- functional analysis and characterisation of entities;
- selection of TP methods; and
- application of the TP methodology (including benchmarking analysis and determination of arm's length result).

The company and industry analyses provide the big picture on the company's business model and the macro economic factors influencing the model. After the overview is set out, the functional analysis and characterisation of entities are performed to identify each party's role in the transaction (taking into account the functions performed, assets used and risks assumed) and to provide justification that the amount earned by each party commensurates with its respective contribution.

The benchmarking analysis involves the use of economic data to support the company's transfer prices. This is achieved by comparing a tested transaction with transactions entered between third parties in same or similar circumstances. Essentially, the benchmarking analysis is performed to validate, using comparable data that the price of the transaction was indeed carried out at arm's length.

[1] The arm's length principle is the international standard to guide TP. It requires the transaction with a related party to be made under comparable conditions and circumstances as a transaction with an independent party.

"Benchmarking analysis is the backbone of TP documentation," explained Adriana Calderon, Director, Transfer Pricing Solutions Asia, in a recent *Tax Excellence Decoded* (TED) event organised by the Singapore Institute of Accredited Tax Professionals. "It uses economic data to support the taxpayer's prices agreed with related parties."

Indeed, a well-conducted benchmarking analysis is the backbone of TP documentation. It can provide strong support for the company in justifying that its transfer price has been determined as per the arm's length principle and based on commercial drivers, and hence mitigate the risk of undesired TP adjustments by tax authorities. The question then is: How should companies conduct their benchmarking analysis?

Benchmarking Analysis

There are four steps to a high-quality benchmarking analysis.

1. Determine the TP Methods

Generally, related party transactions are characterised based on their nature. Common characterisations from a TP perspective include the following groups: (1) distribution transactions, (2) services transactions, (3) manufacturing transactions, (4) Intercompany loans, and (5) Transactions involving royalties.

The appropriate TP method should be selected based on the characterisation of the related party transaction and the entities (as determined by the functional analysis). There are five commonly- accepted TP methods:

(i) Comparable Uncontrolled Price (CUP)
The CUP method is a TP method that compares the price for properties or services transferred in a related party transaction to the price charged for properties or services transferred in an independent party transaction in comparable circumstances;

(ii) Cost Plus
The Cost Plus method focuses on the gross markup obtained by a supplier for property transferred or services provided to a related purchaser. Essentially, it values the functions performed by the supplier of the property or services;

(ii) Resale Price
The Resale Price method is applied when a product that has been purchased from a related party is resold to an independent party. Essentially, it values the functions performed by the "reseller" of a product;

(iii) Profit Split
The Profit Split method is based on the concept of splitting the combined profits of a transaction between related parties in a similar way as how independent parties would under comparable circumstances;

(v) Transactional Net Margin Method (TNMM)
The TNMM is a TP method that compares the net profit relative to an appropriate base (for example, costs, sales, assets) that is attained by a taxpayer from a related party transaction to that of comparable independent parties.

Once the appropriate TP method is decided, the next step is to assess the data to use in the comparability analysis.

2. Assess the Data to Use

Comparable data may be internal or external. Internal comparables are transactions carried out by the tested party with unrelated companies in comparable circumstances to the tested transaction, while external comparables involve transactions between unrelated and independent companies, one of which is comparable to the tested party.

Typically, companies will start by examining if there are any existing internal arrangements where similar products or services are sold to both related and unrelated parties. In the absence of internal comparables, the company will have to perform benchmarking searches using databases for external comparables.

3. Consider Comparability Factors

More often than not, comparable data are not identical to the existing transaction. If so, how would companies know whether the comparable data used are indeed relevant to the tested transaction?

It is important for companies to ensure that none of the differences (if any) between the transactions compared may materially affect the price or margin being compared, and that reasonably accurate adjustments can be made to eliminate the effect of such differences.

When identifying and comparing economically relevant characteristics of the transaction, companies should consider all of the following five comparability factors:

- characterisation of the property or service;
- functions performed by the parties (taking into account the assets used and risks assumed);
- contractual terms of the transaction;
- business strategies employed by each party; and
- economic circumstances affecting each party

4. Select an Appropriate Database

There is a myriad of TP databases available in the market, each of which may have its own strengths – some may contain more information on certain types of transactions, others may be better for certain geographical locations. In this regard, companies should ensure to use an appropriate database taking into consideration the nature of the tested transaction.

Adriana Calderon, Director, Transfer Pricing Solutions Asia, shared her vast professional experiences on TP benchmarking.

Performing a Search for External Comparables Using a Database

Navigating unfamiliar databases in search of appropriate external comparables can be daunting for the uninitiated. To conduct an effective search, it is essential for the company to have a clear idea of the tested transaction and the tested party at the start. By definition, the tested party is the one where a TP method can be applied in the most reliable manner, and most reliable comparables can be found. In practice, the tested party is typically the less complex entity (and not the entrepreneur).

After the company is clear on the tested transaction and tested party, it may then set its search strategy, taking into account comparability factors. To avoid manually looking through hundreds of irrelevant sets of data, bulk rejections criteria should be considered (for example, companies with incomplete financial data for the last three years may be excluded).

It is good practice to review the data in two stages. The company can first scan through the general information of the companies to create a shortlist of potential comparable companies. This can be followed by a more detailed review of the shortlisted comparables where annual reports and company websites are thoroughly examined.

Adriana Calderon, Director, Transfer Pricing Solutions Asia, answering participants' queries on transfer pricing during the session.

Once the company has selected the appropriate comparables, it may proceed to carry out a financial analysis to calculate the appropriate arm's length range. In practice, it is generally advisable to ensure the transfer price falls within the interquartile range of the arm's length range and is as close as possible to the median.

The final and most important (yet oft-neglected) step when performing a search, is to document the entire search process for record-keeping purposes. Without proper documentation of the search process, tax authorities may not understand the rationale behind the company's search and as such the company's transfer price may not be accepted.

Other Notable Areas

Most countries do not accept loss makers as comparables. In Singapore, the IRAS views persistently loss-making independent parties to be less reliable comparables than profit-making independent parties. Taxpayers are expected to exclude independent parties as comparables if they have a weighted average loss for the tested period or incurred loss for more than half of the tested period.

It cannot be emphasised enough that TP documentation must reflect the reality of the company's business and transactions. A simple interview with an employee, a public announcement by the company or even a generic review of publicly-available information can provide vital information about the company and alert tax authorities that the company's TP documentation is not reflective of its business. TP documentation that does not reflect business reality is of no value to the company in defending its TP position.

TP benchmarking is both a science and an art. While there are certain methodologies guiding the benchmarking process, judgements have to be exercised at certain points to arrive at a reasonable conclusion. One thing though is for sure, the tax authorities are focusing on this space. If your company is making significant related party transactions but you have not started thinking about TP, now is the time to do so.

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This technical event commentary is written by Felix Wong, Head of Tax, SIATP. This article is based on SIATP's Tax Excellence Decoded session facilitated by Adriana Calderon, Director, Transfer Pricing Solutions Asia.

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