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TRANSFER PRICING NEWS

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INTRODUCTION

Transfer pricing is increasingly influencing significant changes in tax legislation around the world. This 24th issue of BDO's Transfer Pricing Newsletter focuses on recent developments in the field of transfer pricing in Argentina, Australia, Germany, Italy, Korea and Singapore. As you can read, major changes in legislation will be made in the coming period, with interesting developments in various countries around the world.

We are very pleased to bring you this issue of BDO's Transfer Pricing News, which we were able to produce in close co-operation with our colleagues from the above-mentioned countries. We trust that you will find it useful and informative. If you would like more information on any of the items featured, or would like to discuss their implications for your business, please contact the person named under the item(s). The material discussed in this newsletter is intended to provide general information only, and should not be acted upon without first obtaining professional advice tailored to your particular needs.

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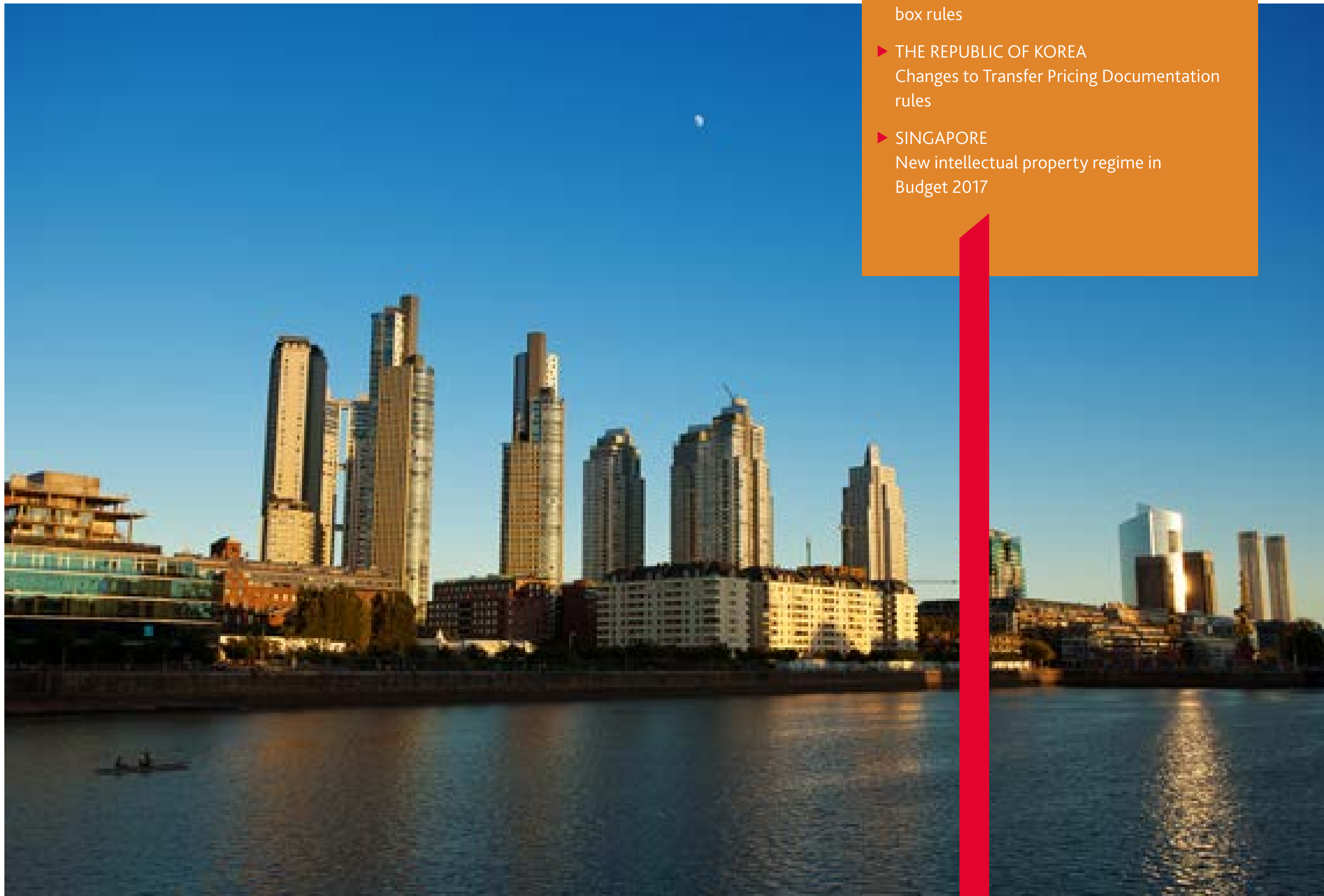

ARGENTINA

NEWS ON TRANSFER PRICING DOCUMENTATION IN ARGENTINA AND SOUTH AMERICA

The rules on transfer pricing are increasingly influencing significant changes in tax legislation around the world. In this context there are some recent developments as well as some forthcoming rules in the field of transfer pricing in some South American countries. This is a result of the impact of the Base Erosion and Profit Shifting (BEPS) project led by the Organisation for Economic Cooperation and Development (OECD). This article provides more information on this issue, especially on Action Plan 13 in relation to Transfer Pricing Documentation: the Master File, the Local File and the Country-by-Country Reporting.

BEPS progress in North and South America

Firstly, it is important to mention that 44 countries (responsible for around 90% of global Gross Domestic Product (GDP)) have participated in the BEPS project and have agreed the proposals. The participants included the following American jurisdictions: Argentina, Brazil, Canada, Colombia, Chile, Mexico and the United States of America. It is very likely that new regulations will be issued soon by the countries that have not yet done so.

It is also important to bear in mind that meetings took place between some of the countries in Colombia in February 2014 and Peru in February 2015 to discuss the BEPS implications, including the particular challenges faced when dealing with BEPS issues and implementing the new standards coming out of the BEPS action plan, both in terms of incorporating them into their legal systems and in the practical implementation by tax administrations.

South America overview

In general terms almost all the countries of the region have transfer pricing rules. Most of the jurisdictions apply similar criteria to the OECD guidelines, with some local adjustments. The different rules have been implemented in the region since 2000, firstly in Mexico and Argentina. It is clear that levels of maturity in terms of transfer pricing application and dispute resolution vary between countries. It is very common to find an obligation to carry out transfer pricing studies and transfer pricing returns (i.e. the same approach as Local Files) to be submitted to or handed over upon request to the tax authorities on an annual basis. There are specific fines for non-compliance on transfer pricing matters.

Some jurisdictions have already introduced the new documentation requirements including the Master File, Local File and Country-by-Country Reporting in their local regulations. This is the case in Brazil, Chile, Colombia, Mexico, Peru and Uruguay, which have introduced the legislation in line with OECD recommendations. More detailed guidelines are expected to be issued in these jurisdictions in order to obtain a good degree of compliance.

Developments in Argentina

Some local rules were issued in 2014 and 2015 in line with the action plan:

i. General Resolution 3572: registry of related parties local and foreign;
ii. General Resolution 3576: low tax jurisdiction vs. cooperative countries for transparency; and
iii. General Resolution 3577: triangulation of goods and specific mention of BEPS in the notes.

However, the rules in relation to Action Plan 13 are still not part of the local rules, due to a change of governments and tax administration officers that modified the order of priorities. It is expected that the tax authorities will issue new regulations in order to be in line with Action Plan 13, so regulatory changes are expected in the short term following the OECD guidelines (i.e. regarding timing, exemption for small and medium-sized enterprises, filing, place, language, template, fines, etc.).

Conclusion

Finally, it is important to highlight that during the OECD meeting in Kyoto, Argentina amongst other countries signed the Multilateral Competent Authority Agreement for the Automatic Exchange of Country-by-Country Reporting. Currently the total number of signatories amount to 57 countries, including the following jurisdictions from the region: Argentina, Bermuda, Brazil, Chile, Costa Rica, Curacao, Mexico and Uruguay.

It is advisable to follow closely all these matters in South America and worldwide to keep up to date and to identify carefully any new obligation related to Transfer Pricing Documentation.

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AUSTRALIA

CROSS-BORDER RELATED PARTY FINANCING ARRANGEMENTS ARE FIRMLY WITHIN THE ATO'S SIGHTS

Impact of Chevron case

In April 2017, the Full Federal Court ruled against Chevron Australia Holdings Pty Ltd (Chevron Australia) in favour of the Australian Taxation Office (ATO), on appeal. The case was heard in relation to the transfer prices on intragroup financing between the overseas related party and the recipient of funds, Chevron Australia. This was the longest-running transfer pricing legal case in Australia, and the ATO win is significant in the Australian, and possibly global, transfer pricing landscape. Given the significance of the win, this is definitely not the last ATO intragroup financing challenge we will see.

New ATO guidance

Possibly encouraged by the Chevron Australia decision, on 16 May 2017 the ATO issued a draft Practical Compliance Guidance PCG 2017/D4 (PCG) outlining the risk assessment framework for cross-border related party financing arrangements. This guidance has been anticipated for some time but is clearly timed to be released shortly after the Chevron decision, while the issues surrounding the related party debt are in the media spotlight.

The guidance follows the similar traffic light risk rating approach to the widely discussed marketing hubs paper issued by the ATO this year. In an attempt to produce a 'one size fits all' guidance, the ATO overlooks the complexity and multitude of possible arrangements when dealing with related party debt and the PCG may result in some puzzling outcomes on application. However, the PCG is a welcome tool and needs to be taken for what it is – an insight the ATO provides to taxpayers on how it will assess risk under financing arrangements and what to expect from the ATO based on these outcomes.

While risk assessment using the PCG is not compulsory for the majority of taxpayers, multinationals are well advised to use the guidance not only to assess the risk but to plan mitigation strategies, if necessary.

The PCG's potential effect on taxpayers

By issuing the PCG, the ATO will be seeking to influence behaviours amongst taxpayers in relation to high versus lower risk financing arrangements, thereby arguably encouraging taxpayers to restructure their funding operations to minimise audit and review risks.

The draft PCG deals with taxation issues associated with cross-border related party financing arrangements and is effective from 1 July 2017. It provides no guidance on how taxpayers can comply with the arm's length principle, which underpins the transfer pricing legislation. Instead, it is a risk assessment tool that uses a structured – albeit complex – checklist approach that allows taxpayers to self-assess their risk.

The PCG follows a traffic light risk rating approach allowing taxpayers to derive a risk rating, ranging from 'Green zone' (i.e. safe from the ATO review apart from exceptional circumstances) to 'Red zone', (i.e. likely to be subject to immediate ATO review or audit).

The framework is not straightforward and concentrates on a number of factors including:

- Terms of the debt (i.e. subordinated or senior, collateral, currency, exotic features, etc.);
- Interest cover and leverage ratios, compared to that of global group;
- Interest rate on the loan as compared to various third party debt either within the global group or held by the taxpayer;
- Headline tax rate of the lender;
- A number of other factors.

It should also be noted that there is a lack of consistency on how the ATO risk assesses inbound versus outbound loans, raising a concern that loans following the same policy will be assigned different risk ratings depending on whether they are inbound or outbound. This of course raises a question on the international response to such a risk assessment tool and also highlights the one-sided nature of the PCG.

Following the self-assessment of risk, taxpayers will be able to place themselves in a certain risk zone and get an insight as to what attention to expect from the ATO.

Zone	Risk Framework	What to expect?
White	-	Arrangements already reviewed and concluded by the ATO or a Court
Green	Low	ATO may verify all calculations and risk assessments
Blue	Low to Moderate	ATO will actively monitor financing arrangements with Alternative Dispute Resolution (ADR) as a viable option to resolve differences
Yellow	Moderate	ATO will work with taxpayers to understand and resolve differences with ADR as a viable option to resolve differences
Amber	High	ATO review is likely to commence as a matter of priority, with ADR as a viable option to resolve differences
Red	Very High	ATO likely to commence reviewing activities (including audit), through use of formal powers, with no access to the APA program and limited ability to resolve through settlement and ADR

In an attempt to produce a one-stop shop guidance, the PCG overlooks the complexity and multitude of possible arrangements and, in some cases, will result in puzzling outcomes on its application. There are numerous taxpayers with loans from independent financiers that are likely to fall outside of the 'Green zone' for commercial reasons alone, highlighting the lack of commercial focus of the PCG. As such, although the PCG's impact will be far-reaching, affecting all types of taxpayers and industries, it should be treated as a risk assessment tool rather than a conclusive answer to transfer pricing questions. Just because a taxpayer's risk rating is ranked above green does not mean the transfer pricing position is wrong or unsupportable. However, the ATO expects taxpayers who fall into the high risk zone to start discussions on how to manage the resulting risk.

Self-assessment using this guidance is not compulsory for the majority of taxpayers. However, any business notified by the ATO to complete the Reportable Tax Position Schedule will have to self-assess the risk rating of related party financing arrangements. The ATO will allow taxpayers an 18 months grandfathering period in which to self-assess and amend related party debt (both existing and newly created) to fall into the 'Green zone', with zero penalties.

It would be unreasonable to expect all taxpayers to structure their arrangements to fall within the 'Green zone', as that may be uncommercial not only in the context of the affairs of the Australian taxpayers but also in the context of the whole multinational group. The PCG itself also acknowledges that falling into the higher risk zone does not automatically mean that the arrangement is not arm's length.

As outlined above, the PCG is a draft document and there is a consultation period with comments due by 30 June 2017.

Key actions for the Australian taxpayers

1. We recommend that all taxpayers with related party debt assess their arrangements against the ATO framework and, depending on the outcome, revisit their financing arrangements;
2. Both the Chevron decision and PCG show the importance of properly analysing, documenting and evidencing intragroup financing arrangements, having regard to commerciality and ensuring that the arrangements do not substantially deviate from Group policies. Taxpayers should consider and explore all options that would be realistically available to the borrower in a hypothetical arm's length scenario, to ensure that the arrangement entered into is commercially viable and supportable;
3. Consider various risk mitigation strategies, such as restructuring, preparing solid documentation of the arrangements, or agreeing a Private Ruling or Advance Pricing Agreement with the ATO.

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GERMANY

CONTEMPLATED AMENDMENTS TO THE GERMAN DECREE ON TRANSFER PRICING DOCUMENTATION

In the final report on Action 13 of the BEPS project, the OECD recommends a three-fold documentation of intercompany transfer prices, consisting of Master File, Local File and Country-by-Country Report (OECD (2015), Transfer Pricing Documentation and Country-by-Country Reporting, Action 13-2015 Final Report). Section 90 paragraph 3 German General Tax Code ('*Abgabenordnung*' – AO) has already been amended accordingly.

Consequently the Decree on the form, content and extent of documentation ('*Gewinnabgrenzungsaufzeichnungsverordnung*' – GaufzV) should be amended accordingly. On 21 February 2017 the German Ministry of Finance (BMF) published a discussion draft (GAufzV-E). It can be appreciated that in drafting the appendix to section 5 GaufzV-E the BMF largely followed the OECD's recommendations regarding the Master File (cf. Elbert/Wellmann/Münch IStR 2014, page 800). The main changes in the regulations regarding form, content and extent of the Local File (country-specific, company-related documentation) contained in the GAufzV-E in comparison with the GaufzV are highlighted below.

More transparency on weighting

In the future, the weight a taxpayer attributed to the functions performed, risks assumed and key assets used in a transaction will be made more transparent. The required quantitative traceability (Section 1 paragraph 3 sentence 4 GaufzV-E) is key in cases where a profit split is applied on the basis of a weighted functional analysis or a value chain analysis. However, this may be expected to happen in exceptional cases only. As a rule, such weighting is not required (for example, in order to determine appropriate margins in distribution cases). In this regard the explanations provided along with the GaufzV-E correctly refers to the transactional profit split method. However, the wording of the GaufzV-E is too wide and there is a reason for concern that tax auditors will demand a corresponding analysis also in cases when it is unnecessary. In this respect, a clarification would be appreciated.

Naming of decision-makers

Section 4 paragraph 1 no. 3v(b) GaufzV-E provides that the names of the persons who make the crucial decisions on business relations are required. The regulation seems to target inter alia the determination of who controls the development, enhancement, maintenance, protection and exploitation (DEMPE) functions in connection with intangible assets. These functions have a significant influence on the allocation of intangible assets for transfer pricing purposes. Unintentional explanations for this carry a considerable risk.

Providing available information

According to section 4 paragraph 1 no. 4 (a) and (b) GaufzV-E, information available at the point in time transfer prices were determined has to be provided. If both the arm's length setting and the arm's length testing approach are approved by tax authorities, it is not necessary to provide such information.

Providing data used for benchmarking

Section 4 paragraph 3 GAufzV-E requires provision of extensive data and access to databases that were used for benchmarking. This requirement is far too excessive, potentially requiring the entire search process to be documented and comprehensible to tax authorities. However, it is disproportionate to oblige taxpayers to provide unrestricted access to expensive databases to tax authorities. This is particularly the case if one takes into consideration that timely tax audits are more wishful thinking than reality. It may even be impossible for taxpayers to fulfil, as benchmark studies are regularly performed by consultants and from a legal point of view the taxpayer has no access to the databases used. In accordance with the license agreement with the database provider the consultant is not allowed to pass on the data to third parties (here, the tax auditor). Moreover, German tax authorities themselves have access to databases, e.g. BvD's ORBIS database, which is regularly used by taxpayers. This raises the question of whether such provision is necessary in the GaufzV-E at all.

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ITALY

AMENDMENTS TO TRANSFER PRICING AND PATENT BOX RULES

In brief

Italy has amended its transfer pricing and patent box rules to follow OECD approach. Law Decree no. 50 (the Decree), containing urgent tax provisions and development measures, was approved by the Italian Council of Ministers on 11 April 2017. The publication of the Decree in the Italian Official Gazette on 24 April 2017 fully implemented its provisions with immediate effect. The Decree was converted into an ad hoc Law by the Italian Parliament on 21 July 2017.

Among the corporate taxation measures, it should be noted that within the Italian transfer pricing regulations, the 'normal value' concept has been replaced by the 'arm's length principle', and two new measures have been introduced to obtain the corresponding adjustment in Italy. With regard to the patent box regime, another important step to comply with BEPS recommendations was achieved, determining that trademarks are no longer included in the list of intellectual property (IP) qualifying under the regime.

In detail

On 24 April 2017, the Decree was published in the Italian Official Gazette. With regard to transfer pricing rules, it amends paragraph 7 of Article 110 of the Presidential Decree no. 917 of 22 December 1986 and introduces the new article 31-quarter of the Presidential Decree no. 600 of 29 September 1973. In addition, for the patent box regime, it modifies Article 1 of Stability Law no. 190 of 23 December 2014.

Transfer pricing amendments

In the Italian tax legislation, transfer pricing provisions are contained under paragraph 7 of Article 110 of Presidential Decree no. 917 of 22 December 1986. Reference must also be made to Circular letter of the Ministry of Finance of 22 September 1980 no. 32/9/2267.

In principle, items of income arising from intercompany transactions carried out by Italian companies with foreign related parties are evaluated on the basis of the 'normal value' of the goods sold, services rendered and goods and services received. Under the Italian tax law, the 'normal value' is defined as the average price or consideration paid for goods and services of the same or similar kind, under free market conditions and at the same stage of distribution, at the time and place in which the goods are purchased and the services rendered.

The 'normal value' concept was similar to the OECD arm's-length principle, although not precisely the same and potentially open to various interpretations. The Decree amends Article 110, paragraph 7, replacing the definition of 'normal value' with the 'arm's length' principle, as provided by Article 9 of OECD Model Tax Convention, in order to conform thoroughly with the Italian transfer pricing rules as per OECD guidelines. The Ministry of Finance is expected to issue a decree on the application of the new rules based on international best practice and reflecting recent OECD developments.

The Decree also introduces new article 31-quarter of the Presidential Decree no. 600 of 29 September 1973, aimed at extending the range of possibilities available to Italian taxpayers to mitigate double taxation arising from transfer pricing adjustments.

Before the Decree, obtaining the corresponding adjustments was possible only through the mutual agreement procedure (MAP), including the EU Arbitration Convention. In particular, MAPs can be enabled as provided under Article 25 of OECD Model Tax Convention (this Article has been transposed in most of the bilateral agreements against double taxation, signed by Italy), or under EU Arbitration Convention 90/436/EEC, ratified by the Italian Government with Law no. 99 of 22 March 1993.

Now it is also possible to obtain a corresponding adjustment in two further circumstances:

- Upon conclusion of tax audits, carried out within international cooperation activities, whose outcomes are shared by participating States; or
- Through a specific application filed by an Italian taxpayer where a final adjustment has been made based on the arm's-length principle in a country which has a double tax treaty with Italy that allows an acceptable level of information exchange.

The Italian Revenue Agency is expected to issue specific regulations setting out terms and conditions and the way in which this procedure will operate.

Therefore, taking into consideration an intercompany transaction entered into between an Italian company and its non-resident associated company, if the profits of the foreign company are revised upwards for transfer pricing adjustment, the increased profit will be liable to tax on the amount on which the Italian company has already been taxed.

In order to achieve a consistent allocation of profits between the two jurisdictions, the Italian Revenue Agency will make an appropriate corresponding downward adjustment to the profits of the Italian company if a final adjustment has been made based on the arm's-length principle. It is noted that the Italian Revenue Agency will perform a corresponding adjustment only if it considers that the primary adjustment applied to the profits of the non-resident associated company reflects how much the profits would have been if the intercompany transaction had been at arm's length and if the non-resident associated company resides in a country which has a double tax treaty with Italy that allows an acceptable level of information exchange.

It should also be noted that the Italian tax legislator's purposes behind the introduction of Article 31-quarter are to decrease inquiry times and the number of MAPs, with subsequent improvements in the efficiency of the administrative activities of the Italian Tax Authority.

Exclusion of trademarks from the patent box regime

The patent box regime was introduced in the Italian tax legislation by the Budget Law for 2015, on 23 December 2014, and was subsequently amended by Budget Law no. 208 on 28 December 2015.

The regime grants an exemption from corporate income tax and local tax on income derived from the exploitation of qualifying intangible assets. The exemption, provided for Italian resident companies and Italian branches of non-resident companies, amounted to 30% for 2015 and 40% for 2016, while for the current fiscal year onwards it amounts to 50%.

The regime can apply to taxpayers who perform research and development (R&D) activities and is characterised by a five year lock-in period. All income derived from the licensing or the direct exploitation of qualifying IP is covered by the regime. In the case of direct exploitation, an advance ruling is specifically required to determine the relevant income attributable to the qualifying IP, whereas, in the case of indirect exploitation, it is optional for taxpayers.

The Italian patent box rules have been modified by the Decree, which excludes trademarks from the definition of intellectual property that could potentially benefit from the patent box regime in Italy, and establishes that options concerning trademarks already exercised in 2014 and 2015 will be in force until 30 June 2021, without the possibility of renewing them. The exclusion will apply to:

- Taxpayers with a calendar fiscal year, to fiscal years for which the application for the patent box regime was made after 31 December 2016; and
- Taxpayers that do not have a calendar fiscal year, starting from the third fiscal year subsequent to the one ongoing as of 31 December 2014, for which the application for the patent box regime was made after 31 December 2016.

The purpose of the Italian Government in implementing this amendment is to align the Italian patent box regime with the recommendations of Action 5 of the BEPS project 'Countering harmful tax practices more effectively, taking into account transparency and substance'. This Action provides that under the nexus approach (i.e. with the aim of calculating the amount of income arising from IP by comparing qualifying expenditure with overall expenditure) marketing-related IP assets can never qualify for tax benefits under an IP regime.

Therefore, trademarks are excluded from the patent box regime, because they are not supported by an outstanding research and development activity.

An inter-ministerial decree is expected to provide specific guidelines to adapt the patent box regulation to the new amendment and to regulate the voluntary exchange of information regarding the options concerning trademarks.

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THE REPUBLIC OF KOREA

CHANGES TO TRANSFER PRICING DOCUMENTATION RULES

Korean tax authority adopts BEPS Action 13

The Korean tax authority (National Tax Service – NTS) formally incorporated BEPS Action 13 into Article 11 of the Law for the Coordination of International Tax Affairs (LCITA) at the 2015 and 2016 year end, so that taxpayers who meet certain criteria/thresholds must submit a Master file (MF), Local file (LF), and a Country-by-Country Report (CbCR).

Domestic corporations or permanent establishments of foreign corporations that meet both of the following conditions are required to submit a LF and MF:

1. Annual sales exceed KRW 100 billion.
2. Annual transactions with foreign special related parties exceed KRW 50 billion.

Domestic ultimate parent companies whose consolidated sales in the previous year exceed KRW 1 trillion are required to submit a (CbCR). A domestic subsidiary or a domestic branch of a multi-national enterprise (MNE) is required to submit a CbCR if:

i. The MNE's ultimate parent company is not obliged to prepare and submit a CbCR, or the ultimate parent company is located in a country/jurisdiction that is not a signatory country to the Multilateral Competent Authority Agreement (MCAA); or

ii. Where the 'Appointment of Submission Obligation for CbC' form is not submitted within 6 months after the end of the business year.

A MF and LF must be submitted within 12 months of the last day of the relevant business year of relevant taxpayers. A CbCR must be submitted within 12 months of the last day of the relevant business year of ultimate parent company.

The penalty for failure to submit or false submission of a MF, LF or CbCR is KRW 10 million for each file.

TP documentation rules under the Law for the Coordination of International Tax Affairs (LCITA)

Some TP related documents are required to be submitted when an income tax return is filed, while other TP related documents are required to be submitted upon NTS request.

1. TP documents required to be submitted for tax return filing

Each taxpayer engaged in international transactions with a foreign related party must submit a 'Statement of International Transactions' to the NTS. This Statement must contain information such as transaction volumes and types of goods, services, funds, other, etc. for each foreign related party.

In the case of payment guarantee transactions, a 'Statement of Payment Guarantee Transactions' must be submitted separately. The penalty for failure to submit/false submission of documents is KRW 10 million.

An 'Abbreviated Income Statement' must be submitted along with a 'Statement of International Transactions'. However, the submission obligation is exempted where:

i. The total amount of transactions of goods for each foreign related party does not exceed KRW 1 billion and the total amount of transactions of services does not exceed KRW 200 million.

ii. A 'Statement of Overseas Subsidiaries' and a 'Statement of Financial Statements of Overseas Subsidiaries' are submitted.

A resident taxpayer engaged an international transaction with a foreign related party must report a method for determining arm's length price (ALP) to the NTS. However, this will not apply in any of the following cases:

iii. Where the total amount of transactions of goods does not exceed KRW 5 billion and the total amount of transactions of services does not exceed KRW 1 billion.

iv. Where the total amount of transactions of goods for each foreign related party does not exceed KRW 1 billion and the total amount of transactions of services does not exceed KRW 200 million.

Where a resident makes a Cost Sharing Agreement (CSA) with a foreign related party, the taxpayer must report the allotted arm's length cost, participants, scope of the intangible assets, expected benefits, etc. to the NTS.

Where an actual transaction price differs from the arm's length price computed by applying the method of computing the ALP, a resident may file a return on the tax base and tax amount adjusted by deeming the ALP to be a transaction price, and apply for a rectification thereof along with a written report on transaction price adjustment in a 'Rectification of Transaction Price' form.

2. TP documents required to be submitted upon request from Korean tax authority

The NTS may request taxpayers to submit documents containing information such as methods of computing transfer pricing, which taxpayers must submit within 60 days after such a request.

The scope of materials which tax authorities may demand a taxpayer to submit includes any of the following documents:

1. Various relevant contract documents concerning the transfer or purchase of assets;
2. Price list of products;
3. Statement of manufacturing costs;
4. Specification of transactions by item, distinguishing between the related parties and unrelated parties;
5. Documents corresponding to subparagraphs 1 to 4, in the case of offers of services or other transactions;
6. Organisational chart of a corporation and a table of division of office duties;
7. Data for determining international transaction prices;
8. Internal guidelines for pricing among the related parties;
9. Accounting standards and methods relating to the relevant transactions;
10. Details of business activities of the parties involved in the relevant transactions;
11. Current status of mutual investments with the specially-related parties;
12. Forms or items omitted when submitting corporate tax and income tax returns;
13. Materials from which it is possible to understand the details of a transaction in connection with a service transaction under Article 6-2, as specified by Ordinance of the Ministry of Strategy and Finance;
14. Other materials specified by Ordinance of the Ministry of Strategy and Finance, including an agreement on cost allotment in connection with the tax adjustment by the allotted arm's length cost under Article 6-2 of the Act;
15. Other data necessary for computing proper prices.

Penalties for failure to submit documents 1 to 15 above are KRW 30 million - KRW 70 million depending on the documents.

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SINGAPORE

NEW INTELLECTUAL PROPERTY REGIME IN BUDGET 2017

Singapore's Finance Minister unveiled the Budget 2017 on 20 February 2017. One of the key themes of the Budget is to prepare Singapore businesses for the future economy and help enterprises digitalise, innovate and scale up globally. To encourage innovation and the use of intellectual property (IP) arising from a taxpayer's research and development (R&D) activities, the Budget has introduced a new incentive for IP income – the IP Development Incentive (IDI).

With the introduction of the IDI, the IP income which is currently incentivised under Pioneer-Services/Headquarters Incentive and the Development and Expansion Incentive-Services/Headquarters Incentive will be removed for new incentive awards approved on or after 1 July 2017 and covered under the new IDI. Existing incentive recipients will continue to have such income incentivised under the existing awards until 30 June 2021.

While the tax rate under these incentives could be lowered to 0%, 5% or 10% (from the headline tax rate of 17%), it is unclear at this stage at what rate the IP income will be incentivised under the IDI, but it is not expected to deviate too much.

Singapore's commitment to OECD-BEPS project and impact on IDI

With Singapore joining the inclusive framework of the Organisation for Economic Co-operation and Development's (OECD) Base Erosion Profit Shifting (BEPS) project, it has committed to implement four minimum standards of the 15 point action plan, one of which is Action 5 – Countering harmful tax practices. Action 5 specifically requires substantial activity for any preferential regime, which is to align taxation with substance by ensuring that taxable profits can no longer be artificially shifted away from the countries where value is created. In the context of an IP regime, the preferential treatment will be available only to IP income where the taxpayers in fact undertake R&D activities in-country (known as a 'modified nexus approach').

It is proposed that the IDI will incorporate the BEPS-compliant modified nexus approach which makes the granting of benefits conditional on the extent of R&D activities of taxpayers receiving the benefits. In other words, only income that arises from IP where the actual R&D activity is undertaken by the taxpayer itself will be eligible.

The modified nexus approach uses expenditure as a proxy for substantial activities. To counter harmful tax practices, the nexus approach defines 'qualifying expenditure' in such a way that it effectively prevents mere capital contributions or expenditure for substantial R&D activity by parties other than the taxpayer from qualifying the resulting income for benefits under an IP regime.

Furthermore, the nexus approach applies a proportionate analysis to the calculation of IP income eligible for tax incentives. The proportion of income that may benefit from an IP regime is the same proportion as that between qualifying expenditure and overall expenditure. In other words, the nexus approach allows a regime to provide for a preferential rate on IP-related income to the extent that it was generated by qualifying expenditure.

The nexus ratio used to calculate IP income eligible for tax incentive is therefore summarised by the OECD as:

$$\frac{a + b}{a + b + c + d}$$

- 'a' Represents R&D expenditures incurred by the taxpayer itself;
- 'b' Represents expenditure for unrelated party outsourcing;
- 'c' Represents acquisition costs of IP;
- 'd' Represents expenditure for related party outsourcing.

The expenditure covered in 'a' and 'b' is referred to as 'qualifying expenditure' whereas the sum of all expenditure within the denominator refers to 'overall expenditure'. Expenditure for unsuccessful R&D will typically not be included in the nexus ratio.

As noted from the above formula, R&D expenditure for related party outsourcing will be excluded, which means that IP income arising from R&D outsourced to related parties will be excluded from this incentive, whereas activities undertaken by unrelated parties (whether or not they were within the jurisdiction) will qualify.

IP eligible for IDI

At this juncture, it is unclear what types of IP will qualify for the IDI. It would be useful if the IP covered within the new regime is kept broad compared to the OECD report on Action 5, given that Singapore's economy is service-based rather than manufacturing-based. The IP covered within Action 5 report is:

i. Patents defined broadly;
ii. Copyrighted software; and
iii. IP assets that are non-obvious, useful and novel but are substantially similar to the IP assets in the first two categories.

The IDI will be administered by the Singapore Economic Development Board (EDB) and will take effect on or after 1 July 2017. As with the other incentives in Singapore, IDI is also expected to be on an approval basis. Further details of the new IP regime are awaited from the EDB.

The way forward

The IDI's objective is to boost R&D and innovation activities in Singapore by retaining and attracting technology-driven businesses to Singapore. The introduction of IDI is proof of Singapore's commitment to align taxation with value creation.

Going forward, taxpayers who wish to apply for an IDI should be mindful that the overall compliance costs will increase as taxpayers will now have to track and trace expenditures, IP assets and IP income, since the nexus approach depends on there being a nexus between expenditure and income. In addition, IDI may not apply to any and all IP, which means that taxpayers should review whether their IP is covered before proceeding with the application process.

Overall, the introduction of IDI is a welcome encouragement for innovation in Singapore, and further affirms Singapore's commitment to global best practices on preferential tax treatment for IP income.

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CURRENCY COMPARISON TABLE

The table below shows comparative exchange rates against the euro and the US dollar for the currencies mentioned in this issue, as at 24 July 2017.

Currency unit	Value in euros (EUR)	Value in US dollars (USD)
Korean Won (KRW)	0.00073	0.00085

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