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Singapore updates guidance on indicative margin for intercompany loans for risk-free rate loans

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Introduction

The Inland Revenue Authority of Singapore ("IRAS") has provided the safe harbor margin, referred to in the Singapore Transfer Pricing Guidelines as the administrative margin, for the pricing of intercompany loans provided/ received by Singapore taxpayers, annually since 1 January 2017. The primary objective of the indicative margin is to facilitate compliance with the arm's length principle and maintain a high level of adherence to the arm's length principle. The safe harbor margin also helps minimize the compliance burden faced by taxpayers in analyzing and benchmarking each intercompany loan entered into by the taxpayer as each related party loan can be different.

How it works

The indicative margin is applied in the following manner:

- Taxpayers can choose to apply the indicative margin to each related party loan that does not exceed S$15 million at the time the loan is obtained or provided.
- The threshold is based on the loan committed and not the loan utilised.
- The indicative margin is applicable to both Singapore-dollar denominated and foreign currency denominated related party loans (based on the prevailing exchange rate).
- The indicative margins have historically been applied to floating rate loans, where the margin is applied on the prevailing Singapore Interbank Offered Rate ("SIBOR"), for Singapore dollar loans and the London Interbank Offered Rate ("LIBOR"), for foreign currency loans.
- For fixed rate related party loans, the IRAS suggests that taxpayers can apply an appropriate swap rate as the base reference rate.

It should be noted that the adoption of the indicative margin is not mandatory. Taxpayers may adopt a margin that is different from the indicative margin provided that this is consistent with the arm's length principle.

IBOR to ARR Transition

As readers may be aware, the financial markets have undergone a major overhaul with the base reference rates (i.e., IBOR) being replaced by Alternative Reference Rates (ARRs). On 31 December 2021, all GBP, EUR, CHF, JPY, and 1-week & 2-month USD LIBOR tenors were terminated. The remaining USD LIBOR tenors will cease on 30 June 2023.

These changes in the global financial markets will also impact Singapore, whereby the Monetary Authority of Singapore ("MAS") will discontinue the Singapore Overnight Rate ("SOR") which relies on the USD LIBOR, after 30 June 2023. Similarly, the SIBOR will be discontinued by 31 December 2024.

To support a smooth transition away from SOR and SIBOR, the Association of Banks in Singapore and the Singapore Foreign Exchange Market Committee have identified the Singapore Overnight Rate Average ("SORA") to replace SOR and SIBOR as the key interest rate benchmark for use in Singapore Dollar financial instruments.

Updated guidance from IRAS for transfer pricing

To reflect the changes in the financial markets, the IRAS has provided indicative margins based on the Risk-Free Rates ("RFRs") as base reference rates. The table below provides the rates for both 2022 and 2023.

Related party loan not exceeding S$15 million obtained or provided during the period	Indicative margin
1 Jan 2022 to 31 Dec 2022	+ 180 bps (1.80%)
1 Jan 2023 to 31 Dec 2023	+ 230 bps (2.30%)

IRAS has also advised taxpayers to convert any legacy IBOR loans to ARR loans before the IBORs are decommissioned. Specifically, IRAS has noted that in converting such legacy IBOR loans, it is not as simple as applying the new indicative margins to the ARR rate as the manner in which the IBOR was calculated is substantially different to the way in which the ARR is determined. Hence, it is necessary to apply the guidance issued by the relevant governing bodies for the relevant IBOR/RFR pairs to adjust for credit and risk factors.

Transfer Pricing considerations

As taxpayers begin reviewing and modifying their external financial arrangements to a world without LIBOR, they should also consider the potential impact of this change on their intercompany financial arrangements.

Specifically, taxpayers need to ensure that the rates being applied on the ARRs are consistent with the arm's length principle. Traditionally, this has been carried out through benchmarking analyses where comparable transactions are identified from databases. However, to find comparable transactions that use an ARR interest rate may be quite a challenge since currently most comparable data in public databases is provided on a historical basis, which means the majority of data available are still in LIBOR.[1] Thus, a more in-depth analysis, for example by using credit default swaps or economic modelling to obtain more relevant results may need to be carried out.

Furthermore, other than the IRAS' guidance on indicative margin, there is limited guidance from either the OECD or the UN or any other tax authority on how to calculate the arm's length spread/ margin that is to be applied to the ARR. The necessary amendments to the intra-group financial agreement include the establishment of a contractual term of interest rates, setting a spread adjustment, and adjusting the notice of payment. Considering the difference in loan terms in ARR, which only has overnight terms and does not have credit risk, to determine the interest rate need to calculate the compounding interest rate from the ARR over a certain period. In addition to determining the ARR with different maturities, economic differences between the IBOR and the ARR must be considered. For example, related to credit risk spread, market participants are not expected to give up on the spread between IBOR and an ARR. Therefore, an additional credit adjustment spread should be added to the term ARR.

[1] At the time of writing, we understand that only about 10% of transactions in the RoyaltyRange database are based on overnight rates.

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Companies will also need to ensure that the changes are supported by contractual clauses in both new and existing agreements. To the extent LIBOR is referenced in existing agreements, appropriate fallback language should be included. However, companies should, where possible, avoid making changes that are so substantive that tax authorities could argue that a new loan has been issued, rather than an existing loan having been changed.

Due to the lack of guidance, additional transfer pricing analyses might be required to substantiate the arm's-length nature of intercompany transactions affected by the LIBOR transition (such as loans). Organizations should consider whether they should do any of the following:

- Update loan analyses to account for changes in interest rate and/or market conditions.
- Update the credit analyses to incorporate new RFR and spread adjustment.
- Document economic analyses to substantiate the arm's-length nature of the RFR and its equivalence to LIBOR.
- Perform comparability adjustments to benchmarks to account for the differences between LIBOR and the RFR (for example, secured versus unsecured).

It should be noted that the application of the arm's-length principle depends on determining the conditions that an independent enterprise would have agreed to in comparable transactions under comparable conditions. Correspondingly, it is critical to identify the comparability analysis, which includes contractual terms, functional analysis, characteristics, economic conditions and business strategies. In particular, functional analysis to determine the contractual risk assumptions, the lender's and borrower's perspectives would typically be considered. The assumed risk simultaneously will have an impact on the determination of the interest rate.

Finally, from a transfer pricing perspective, related parties should transact with one another in the same way as unrelated parties would under similar facts and circumstances. Therefore, it is useful to also look at relevant industry practices.

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