



TRANSFER PRICING FLASH

20th MAY 2020

Let's take a stroll back to year 2018 ...

At the National Tax Conference ["NTC"] 2018 held on 16th and 17th July 2018, a council member of Chartered Tax Institute of Malaysia ["CTIM"] pointed out that with the Revised Audit Framework in 2018, response time granted to taxpayers by the Inland Revenue Board ["IRB"] had been reduced from 21 to 14 days while audit settlement was reduced from 4 to 3 months. The council member queried if all tax cases should be penalised.

We would like to recapitulate these few points that Dr Nik Abdullah Sani Nik Mohamed, former Director of Multinational Tax Branch of Lembaga Hasil Dalam Negeri ["LHDN"], had stressed, in response to the query by the council member of CTIM, the following points:-

- i. The need for audit investigation, desk and field audits had increased over the past 5 years.
We do not foresee a declining trend in this!
- ii. The timeframes were decreased to encourage taxpayers to come forward and discuss matters.
The IRB has become more approachable and would like to be seen as "taxpayers-friendly".
- iii. He added that it was the IRB's intention to make compliance easy and non-compliance hard.
The IRB will be easy-going with those who comply with the law but will come on hard to those who defy.
- iv. Compliance was the new tax planning. More efforts were being made to assist the taxpayer with compliance, rather than hunting them down and penalising them.
Complying with the law is the way to go.
- v. As transfer pricing ["TP"] had been in the spotlight, the IRB's dedicated audit / investigation teams were dealing with increasingly complicated TP issues, resulting in the development of more sophisticated, aggressive approaches as they gain exposure and experience.
Will your organization be a potential TP audit target?

Then, at the NTC 2019, the Chief Executive Officer of LHDN, Dato' Sri Sabin Samitah announced that the IRB had been given an original target of RM147 billion to collect for year 2019. He said, "developing countries like Malaysia should collect at least 20% of GDP to be able to provide services for its people. That's why the target increases every year".

In short, the IRB will never collect enough, and it pays for us to be tax compliant.

The Current Scenario

The IRB has become more aggressive in conducting TP audits involving transactions with offshore entities. If the tax authority decides that the terms of a transaction or series of transactions do not meet the arm's length principle, a reassessment may be made which may significantly affect the tax positions of the taxpayers involved.

We have gained some insight into the *first TP case law in Malaysia* as well as the *main changes in the Transfer Pricing Audit Framework 2019 [“TPAF 2019”]* in the previous publications of *Transfer Pricing Flash*. In this publication, we wish to share with you some of the indicators that will trigger a TP audit by the IRB and the action plan your organisation should take.

1. Significant Controlled or Related Party Transactions

As prescribed in the TPAF 2019, TP audit will be prioritised by the IRB on taxpayers with significant amount of controlled transactions with related parties, especially offshore entities. Information on controlled or related party transactions are easily accessible by the IRB via the annual tax returns (Part F). Calculation of materiality can be gauged simply by dividing the amount of controlled transactions by the total amount of sales revenue, cost of sales, or the operating expenditure as disclosed in the annual return. As there is no written definition of “significant” in the Income Tax (Transfer Pricing) Rules 2012 nor the Malaysian Transfer Pricing Guidelines 2012, further revised in 2017 [“MTPG”], it is subject to the IRB's interpretation.

However, one may rely on the monetary threshold stipulated in the MTPG as a guide that where the amount of controlled transactions exceed the threshold requirement to prepare a full TP documentation, it may be material enough to warrant a TP audit. The thresholds are as follows:-

- a. A business with gross income exceeding RM25 million, and the total amount of related party transactions exceeding RM15 million. The related party transactions include but not limited to sales, purchases, management services, rental, royalty, etc.; **or**
- b. Principal financial assistance exceeds RM50 million. Financial assistance includes loans, interest bearing trade credits, advance or debt and the provision of any security or guarantee.

2. Profit Anomaly

Sudden plunge in profits, persistent losses over a period of years and fluctuations of results that are contrary to market trends are seen as “red flags”. If a taxpayer suffers losses or records erratic results for several years and the annual tax return of the taxpayer reflects significant amounts of related party transactions or a series of different related party transactions, there is clearly a high TP risk exposure on the taxpayer.

In the event of consistent losses or low profitability, the taxpayer should examine if the loss or low profits arise purely from industry or transfer pricing factors. Commercial reasons such as shortage in supply of raw materials, shifts in demand from buyers, fluctuating commodity prices, imposition of a new policy by the government, and other factors affecting the market / industry should be supported by valid documentary evidence. Verbal claims by taxpayer without appropriate supporting documents stand a weak chance in audit defence.

3. Intragroup Service Transactions

In the recent years, there has been an increasing scrutiny by the IRB on intragroup service transactions as they are considered base eroding payments. In general, the intragroup service transactions include, but not limited to, management services, administrative services, technical and support services, procurement services, marketing and distribution services and other commercial services. The following are the common issues arising from these transactions:-

- Justification of benefits arising from services rendered to service recipients,
- Proof of receipt of services,
- The basis of charge,
- Determination of cost base in computing the service fee, and
- Allocation basis used in charging the service recipients.

As the burden of proof lies with the taxpayers, failure to provide the necessary supporting documents will warrant a non-tax deduction or price adjustment for the intragroup service payments and an imposition of penalties by the IRB accordingly. In contrast, for service providers, the IRB will make an upward adjustment on the service income if the mark-up rate is considered non-arm's length.

Other "red flag" indicators to the IRB include:-

- Other payments which deplete the tax base (base eroding payments), such as large-volume sales at a big discount, licensing fee and royalties, interest-free loan and introduction of new intra-group payments;
- Large or complex one-time transactions – the transactions that have the potential to impact the TP arrangement between group members in future years, such as business restructuring;
- Tax attributes of related non-resident entities – material cross-border transactions with related entities in low tax jurisdictions or related entities which enjoy preferential tax treatment.

How many years does the IRB cover for TP audit?

Unlike corporate tax audit with statute of limitations of 5 years, TP audit could cover up to 7 preceding years of assessment. As we are now in calendar year 2020, the years open to tax adjustment from the TP audit is from year of assessment 2013 onwards. However, in the event of fraud, wilful default or negligence, the 7 years of statute limitation would not apply as provided for under Section 91(3) of the Income Tax Act 1967.

How does the IRB determine the TP risk level of taxpayers?

The IRB usually relies on more than one factor to identify the level of TP risks of the taxpayers. It is reasonable to deduce that the more indicators of risk factors present in the case being examined, the higher the level of TP risk and therefore, the greater the chance of getting an uninvited visit by the IRB.

Facing the Reality

*There's an age-old riddle –
What goes up but never comes down?*

*Tax audit!
Tax collection!!*

With the increasing collaboration amongst tax authorities across borders and intensified TP audit activities by the IRB, business organisations are now subject to higher TP risk and scrutiny.

Taxpayers must face the possibility that the IRB could review and challenge their offshore structures and/or controlled transactions. Tax authorities worldwide select transactions subject to audit based on a risk analysis. Therefore, in order to efficiently reduce any potential TP risk, taxpayers should seek to evaluate their tax position and consider obtaining a high-level review of their structure, transactions and TP policies to confirm that their controlled transactions clearly adhere to the arm's length standard.

Protecting Your Organisation's Tax Position

At Moore Advent Malaysia, we connect and collaborate with you to take care of your needs. We are a network of firms in 110 countries with more than 30,000 people who are committed to delivering quality in assurance, advisory and tax services.

Our TP consultants could assist to conduct a TP risk assessment exercise to evaluate the potential TP risks present in your organisation. Through the TP risk assessment, your organisation together with our consultants would be in a better position to evaluate and develop plans to mitigate such TP risks through legitimate planning or enhanced compliance with the TP legislations.

Find out more about our TP team and services and tell us what concerns you by visiting us at www.moore.com.my.

As you are cautious to protect yourself and your family from the COVID-19 pandemic, let's strive to protect your organisation's TP position from the unnecessary audit by the tax authority. It pays to be tax compliant.

Stay Safe, Stay Compliant

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