TRANSFER PRICING FLASH

29th APRIL 2020

DID YOU KNOW?

Brian Herbert, an American author, once said

“The capacity to learn is a gift; the ability to learn is a skill; the willingness to learn is a choice”

If we are in a situation looking for things to do to occupy our time during this Movement Control Order [“MCO”] period, then we have capacity to learn;

If we are currently reading this article, we clearly have ability to learn;

Now, the will to learn is a choice we have to make for ourselves and set our minds to do.

But first and foremost, we must be aware that we need to learn.

We, Moore Advent Malaysia, is aware that the journey to learn is MOORE fun if we learn together. Therefore, we wish to enlighten you or refresh your memory by sharing with you a few updates during this period of MCO.

DID YOU KNOW?

Malaysia was one of the few countries in Asia to issue the Transfer Pricing guidelines when our first Malaysian Transfer Pricing Guidelines [“MTPG”] were introduced in year 2003. After a decade, we have finally had a case concluded at the Special Commissioners of Income Tax Malaysia [“SCIT”] in year 2013 arising from transfer pricing audit conducted by the Inland Revenue Board [“IRB”]: **MM Sdn Bhd vs LHDN**.

In this case, the IRB made adjustments on the taxpayer’s (i.e. MM Sdn Bhd’s) commission income, disallowed payments for business process improvement [“BPI”] Services and Regional Services, and disallowed electronic data processing charges. The SCIT ruled in favour of the taxpayer.

The taxpayer was incorporated on 25th September 1974 and is principally engaged as a shipping agent for APMM. APMM, through a wholly owned subsidiary, owned 70% of the taxpayer. APMM entered into contracts with customers and the taxpayer was appointed by APMM to manage the customers. The taxpayer received commission payment from APMM, which was treated as the taxpayer’s income and taxed as business income.

There were several issues raised in this case. We share with you in this article the two issues relating to the transfer pricing [“TP”] adjustments made by the IRB, in a few salient points below:-

1. Reduction in Commission Rate

- There was a drop in the commission paid by APMM to the taxpayer between the years 2002 and 2005. The rationale for the reduction was that APMM acquired the container business of another entity and a new IT system had been under development. APMM decided to cease charging the IT development costs where agents like the taxpayer would have less cost to incur. Therefore, the commission rate was reduced proportionately to the agent's cost reduction. The IRB adjusted the commission rate received in year of assessment ["YA"] 2002 to YA 2005 by the taxpayer from APMM.

- The taxpayer defended that the reduced commission rate was consistent with the reduction of its functions performed, risks assumed and assets employed ["FAR"]. Despite the lower rate, the taxpayer yielded higher net operating margins compared to the earlier years with higher commission rates.

- Without examining the changes in the taxpayer's FAR, the IRB opined that the taxpayer's FAR remained the same before and after year 2002, hence the commission rates should not be reduced.

- The IRB has also requested for a TP documentation to be submitted by the taxpayer which at that time was not within the ambit of the Income Tax Act 1967 ["the ITA 1967"]. The taxpayer acted in good faith; prepared and submitted the TP documentation. Two benchmarking studies were conducted; one using Pan-Asian and the other using local independent comparables. The latter was submitted later after the IRB expressed that it did not accept the Pan-Asian study despite the taxpayer's reasons for preparing so. Nevertheless, the taxpayer's margins exceeded the inter-quartile range of results of both comparable sets. However, the IRB rejected the local benchmarking study submitted.

- The IRB did not provide reasons to support its conclusion that the reduction of commission rate by the taxpayer has resulted in the transaction being non arm's length. Neither did the IRB provide reasons for not accepting the TP documentation and the local benchmarking study. It invoked Section 140(1) of the ITA 1967 for the TP adjustment (**Note:** Section 140A of the ITA 1967 which governs the TP legislation was not enacted at that time of the TP audit). However, in issuing the notice of additional assessments, the IRB failed to provide particulars of the adjustment.

2. BPI Services and Regional Services ["Intragroup Services"]

- The IRB has alleged that the BPI services and regional services were never provided to the taxpayer and consequently disregarded the charge for both the services by making TP adjustments. However, the IRB did not provide reason for its allegation that no services were actually rendered.

- The taxpayer provided explanations for the services acquired and the supporting documents to the IRB. It further substantiated that it had indeed benefitted from the receipt of the services by demonstrating that its turnover and profit margins have risen significantly during the years where the services were rendered. In addition, the taxpayer has shown there was no duplication of services as it did not employ any personnel or external party to perform the same functions.

- The IRB argued that during the audit process the taxpayer did not present sufficient supporting documents as requested and contended that the taxpayer was negligent when in fact the taxpayer had co-operated fully. However, the IRB has failed to discharge its burden of proof to establish that the taxpayer was negligent. The IRB invoked Section 140(1) of the ITA 1967 for the TP adjustment without specifying the sub-paragraph of the said Section; i.e. not giving the taxpayer its basis for invoking Section 140(1) of the ITA 1967.

We summarise the key takeaways from the MM's case above:-

1. **The legal basis for TP adjustments and the mandatory TP documentation**

   The legal basis for invoking Section 140(1) of the ITA 1967 (which is a general anti avoidance provision) by the IRB in making the TP adjustment by increasing the commission rate received by the taxpayer was raised in this case. We need to acknowledge the fact that the TP audit was conducted before the introduction of Section 140A of the ITA 1967 which is a dedicated TP provision in the ITA 1967. The outcome of this case could have been different if the TP audit were conducted today with the existence of Section 140A of the ITA 1967 and the mandatory TP documentation requirement in the TP Rules 2012.

   TP documentations are essential for taxpayers to document their business operations including business strategies, FAR, factors that affect the company's business, etc. The details are provided for in the MTPG. A proper TP documentation and other supporting documents/evidences would clearly assist in the defense of a TP audit.

2. **Burden of Proof on Taxpayer for Services Rendered/Receipt**

   Before considering the basis of charge for intragroup services, the taxpayers are often challenged by the IRB on:-

   i. What are the services acquired;
   ii. Whether the services have indeed been rendered by the service provider; and
   iii. How do the services benefit the service recipient.

   The taxpayers are usually obliged to furnish various supporting documents which can be burdensome. Failure to do so may lead to disallowance of the payment for the services for tax deduction.

The above case has shed light on some practical issues encountered by taxpayers during an audit and serves as a reminder that preparation of a TP documentation is crucial to defend that the pricing of the related party transactions is in accordance with the arm's length principle. Having a well-supported TP documentation in advance before the IRB knocks on your door is truly time-saving and advantageous.

Now that you've learned about the MM's case, the willingness to comply with the TP Rules is a choice you must make.

Stay Safe, Stay Compliant.

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