



Crowe Perspectives

27 August 2020

Are you ready for a Transfer Pricing Audit?

By Foo Meng Huei, Executive Director of Transfer Pricing

Are you ready for a Transfer Pricing Audit

On 14 August 2020, the Bank Negara Malaysia released a report on the dismaying contraction of GDP of -17.1% for the Second Quarter of 2020 ("2Q20"). In the previous quarter (1Q20), the GDP growth was 0.7%. For the whole year of 2020, the GDP growth is forecasted at between -3.5% and -5.5%. Certainly, the on-going COVID-19 pandemic and the resultant Government's Movement Control Order ("MCO") have made a big dent in Malaysia's economy.



Against this backdrop, the Malaysian Inland Revenue Board ("IRB"), which had suspended its audit activities during the MCO period, have wasted no time in resuming its tax audit activities soon after the lifting of the MCO in early May 2020. Given that the IRB has a tax collection target of RM155 billion for year 2020, it is not surprising to see more intensified audit activities in the coming months. The biggest challenge to the IRB is to race against time to find tax revenue through uncovering errors in the tax returns during these tax audit exercises.



Increased focus on transfer pricing audits

For groups of companies, transfer pricing is a key area of focus for the IRB's audit as there is a high tendency in "mis-pricing" related party transactions due to complication of the subject matter. In this regard, companies involving in related party transactions (or technically known as "controlled transactions") are obligated to observe the transfer pricing provisions under Section 140A of the Income Tax Act 1967. Section 140A places the onus on the taxpayers to prove to the IRB that their controlled transactions have been conducted in accordance with the arm's length principle. Failure of which, the IRB is empowered to make transfer pricing adjustments it deems fit on the controlled transactions in the spirit of arm's length principle. Under the arm's length principle, the transactions between companies within a group are expected to be transacted as if they are dealing with independent parties.

Defending Transfer Pricing Position

In many instances, taxpayers were not able to defend their transfer pricing positions when subjected to close scrutiny by the IRB as they have under-estimated the amount of documents required to be supplied to the IRB during a transfer pricing audit.



As in other tax audits, prior preparation is key in avoiding any unforeseen issues during an official tax audit. An early preparation in anticipation of a transfer pricing audit will help taxpayers to alleviate the stress level of all concerned when the company is selected for a tax audit.

To take precautions one step further, one should adopt a positive mindset with the objective of managing a transfer pricing audit successfully and with the desired favourable outcomes.

Whilst taxpayers may have already gained a sense of familiarity with the compliance requirements under the Malaysian Transfer Pricing Guidelines ("MTPG"), many may not be aware of the transfer pricing audit process, let alone how to effectively manage the audit exercise.

Key Factors Affecting Transfer Pricing Audit Outcome

There are many factors affecting the outcome of a transfer pricing audit. We outline below three key factors that companies should take note in order to be adequately ready for a transfer pricing audit:

a) Is your company keeping sufficient documentary evidence as prescribed by the IRB?

An essential part of compliance with any tax legislation is the existence of proper records on the part of the taxpayer during a tax audit. Paragraph 11.1 of Chapter XI of the MTPG notes that:

“.....taxpayers are required to keep sufficient records for a period of seven years from the end of the year to which income from the business relates.”

The MTPG has outlined a list of documentation to be maintained by the taxpayers for the controlled transactions undertaken between related parties, including those controlled transactions pertaining to Intragroup Services, transfer of Intangible Properties, Intragroup Financial Assistance and Cost Contribution Arrangements. To justify the commerciality of controlled transactions, contemporaneous Transfer Pricing Documentation (“TPD”) should be in place to incorporate, among others, extensive information regarding the controlled transactions, pricing policies, functional analysis of the related parties, transfer pricing methodologies, economic analysis, market information, comparability analysis, terms of contracts, financial analysis, etc.

In a TP audit, a good set of TPD serves as persuasive evidence to support the arm’s length nature of the controlled transactions and hence is able to enhance the defensibility of the TP position of the company.

Unfortunately, some taxpayers do not keep adequate documentation regarding transfer pricing arrangements made within the organization.



Key Factors Affecting Transfer Pricing Audit Outcomes

b) Is the business conducted in accordance with the contractual arrangements in the TPD?

The contractual arrangements between related parties should always be supported by the actual conduct of the parties. For some taxpayers, contracts and conduct were aligned initially but deviated over time as business arrangements had inevitably evolved due to various reasons. These changes have not been updated in the TPD to reflect the actual conduct of the transactions.

Paragraph 11.3.2 of Chapter XI of the MTPG states that:

“

In cases, such as, where the facts presented by the taxpayer in the transfer pricing documentation are different from the actual conduct of the taxpayer, the information provided will be considered as incorrect information and be subjected to the penalty under paragraph 113(2)(b) of the Act.

”

During a TP audit, the IRB often scrutinizes whether the taxpayers in a controlled transaction have conducted the transaction in a manner which is in accordance with the terms set out in the TPD. Where inconsistency arises, the “substance” argument shall prevail over any “form” of written documents in the final assessment by the IRB. This will possibly result in additional tax assessment and penalties on the taxpayers.

For instance, Company A received management services from its related company which are supported by a service agreement. During a TP audit, it was found that the services provided to Company A were substantially narrower in scope. In such case, the IRB would have no hesitation in denying the management fee expense as a tax deduction on grounds of substance over form, leading to additional tax and penalties for Company A.



To mitigate the potential tax risk in future tax audits, taxpayers are advised to review their intercompany arrangements against the TPD to ensure that the actual conduct is aligned with the contractual arrangements. If required, the contracts and documents should be updated to reflect any changes in the actual conduct between the parties.

Key Factors Affecting Transfer Pricing Audit Outcomes

c) How timely is the company in preparing the TPD?

Paragraph 11.1.2. to Chapter XI of the MTPG states that:

“For transfer pricing purposes, a taxpayer who has entered into a transaction with an associated person in the basis year for a year of assessment is required to not only maintain the above records, but also prepare and keep contemporaneous documentations. **”**

It is crucial that the TPD is contemporaneous. This means that the TPD must be developed at the time of entering into the controlled transaction, and updated for changes prior to yearly submission of tax returns. In particular, the financial data and suitability of the comparables (comparable data) should be reviewed and updated yearly in order to apply the arm's length principle reliably. As a concession, the MTPG prescribes that a company should perform a fresh search of the comparables through a benchmarking study at least once every 3 years, on condition that all other factors remain unchanged.



Key Factors Affecting Transfer Pricing Audit Outcomes

c) How timely are you in preparing the TPD? (cont'd)

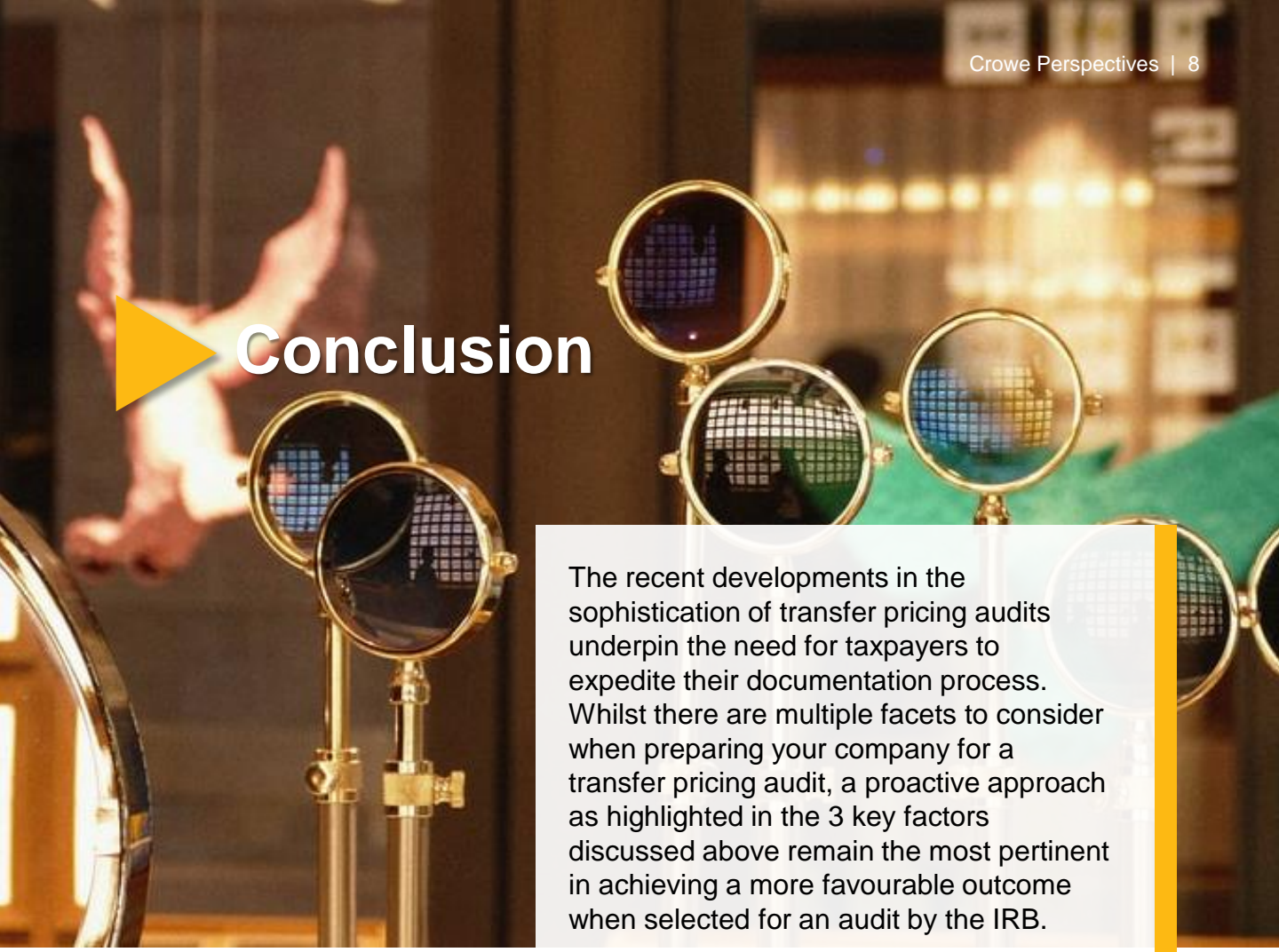
Once a company is selected for a TP audit by the IRB, the TPD must be submitted within 30 days from the date of the IRB's written request. There is a clear advantage in terms of cost saving for timely submission of TPD, as seen from the penalty regime in the IRB's Transfer Pricing Audit Framework issued on 15 December 2019, which is reproduced in the following table:

No.	Situation	Penalty Rate
		Audit Case on TP Issues
1.	Taxpayer did not prepare TPD	50%
2.	Taxpayer prepared TPD but did not fully comply with the MTPG; or Taxpayer failed to submit the documentation within 30 days from the written request.	30%
3.	Taxpayer prepared comprehensive and quality TPD according to the MTPG AND submitted the documentation within 30 days from the written request.	0%

As an illustration, Company B has updated its TPD based on the IRB's requirements and submitted the TPD to the IRB within 30 days from the date of written request from the IRB. On completion of the TP audit, the IRB made a TP adjustment resulting in additional tax payable of RM2,000,000 for the years of assessment 2017 to 2019. Where the TPD is of acceptable quality, it is possible that Company B will not suffer any penalty as the TPD has been submitted in a timely manner to the IRB. In contrast, where the TPD was only submitted after the stipulated deadline of 30 days, Company B will have to suffer a hefty penalty of RM600,000 (30% x RM2,000,000). The late submission of TPD is usually an indication that the TPD has not been prepared or updated in a timely fashion.



Conclusion



The recent developments in the sophistication of transfer pricing audits underpin the need for taxpayers to expedite their documentation process. Whilst there are multiple facets to consider when preparing your company for a transfer pricing audit, a proactive approach as highlighted in the 3 key factors discussed above remain the most pertinent in achieving a more favourable outcome when selected for an audit by the IRB.

In this data driven age, a reactive approach alone is guaranteed to leave tax risks unmitigated. Certainly, procrastination is not a strategy. If you have doubts on the capability of your team, it is worthwhile to consider outsourcing the preparation of the TPD to external tax consultants. By doing so, you are able to ease the burden of your team whilst also leverage on the expertise and experience of transfer pricing experts.



Foo Meng Huei
Executive Director

Getting ready for a Transfer Pricing Audit?

Get in touch with us today.



Contact us

Crowe KL Tax Sdn Bhd
Level 15, Tower C
Megan Avenue 2
12, Jalan Yap Kwan Seng
50450 Kuala Lumpur
Malaysia

Foo Meng Huei
Executive Director, Transfer Pricing
menghuei.foo@crowe.my
+603 2788 9898, Ext 2501

About us

About Crowe Malaysia

Crowe Malaysia is the 5th largest accounting firm in Malaysia and an independent member of Crowe Global. The firm in Malaysia has 13 offices, employs over 1,300 staff, serves mid-to-large companies that are privately-owned, publicly-listed and multinational entities, and is registered with the Audit Oversight Board in Malaysia and the Public Company Accounting Oversight Board in the US.

About Crowe Global

Ranked 8th largest accounting network in the world, Crowe Global has over 250 independent accounting and advisory firms in 146 countries. For almost 100 years, Crowe has made smart decisions for multinational clients working across borders. Our leaders work with governments, regulatory bodies and industry groups to shape the future of the profession worldwide. Their exceptional knowledge of business, local laws and customs provide lasting value to clients undertaking international projects.

www.crowe.my