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Transfer Pricing Focus: Increased Challenges In Characterization Of Controlled Transactions

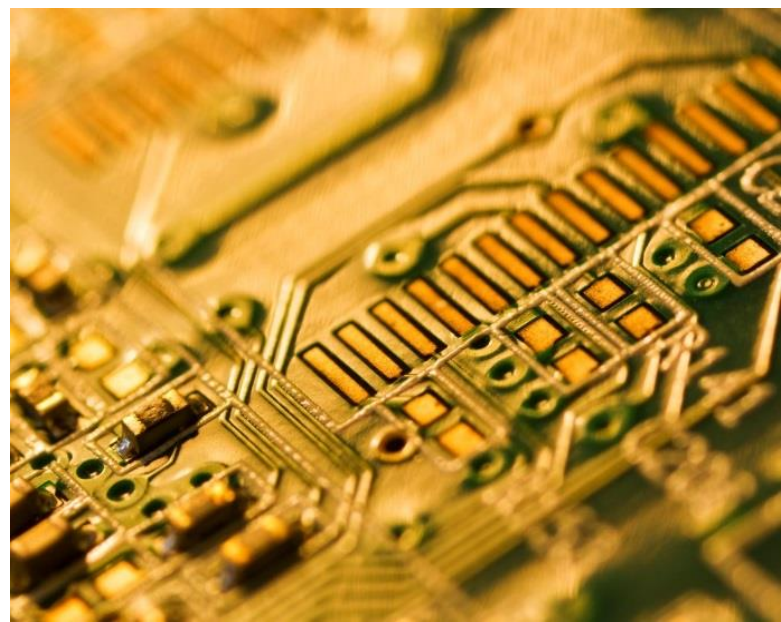
Transfer Pricing Compliance – IRB's New Focus?

- The Special Voluntary Disclosure Programme (SVDP) was launched by the Government since 2 November 2018 to increase tax revenue. With the 30 September 2019 deadline having passed, questions have been raised by the business community on the future plans of the IRBM: *Would the IRBM step up the enforcement through increased tax audits or tax investigations?* The answer could be found from the following statement:

“ After 30 September 2019, the team of investigators would start “risk analyses” and **would begin to hunt those who had owed the government in income taxes.** ”

*Dato' Sri Sabin bin Samitah, CEO of Inland Revenue Board
13 August 2019, Free Malaysia Today*

- One can tell from the above that it is almost certain that tax enforcement activities will be intensified, especially on taxpayers who have not participated in the SVDP. In a tax audit or tax investigation, many tax issues can be targeted by the IRBM that eventually may lead to additional tax payable by the taxpayers.
- For domestic and multinational groups of companies, transfer pricing issues will be the attention of the IRBM. The challenges of these companies evolve around justifying their transfer prices on related party transactions and meeting the **arm's length standard**.



Why Characterization is important in Transfer Pricing?

- A transfer pricing documentation (TP Doc) is required to be prepared to support the transfer pricing position in a related party transaction and it entails detailed analysis regarding the nature of the controlled transactions, taking into consideration the functions performed, assets employed and risks assumed by the respective parties in a controlled transaction.
- This characterization analysis of the controlled transaction entered into by the parties who are related to each other, known as associated persons, shall lend support to the arm's length returns earned by the respective entities.
- The IRBM may not always agree with the characterization concluded by the taxpayers. According to Rule 8 of the ***Income Tax (Transfer Pricing) Rules 2012***, the IRBM has the power to **re-characterize a transaction** where the economic substance differs from its form; or where the arrangement differs from those that would have been adopted by independent persons behaving in a commercially rationale manner.



- **Common pitfalls:** The failure to characterize transactions appropriately may lead to disagreement by the IRBM resulting in **re-characterization** of the transaction.
- To understand the issues on proper characterization of transactions, we set out below the different levels of characterization in the context of (a) manufacturing model, (b) distribution model and (c) services provision model.

Characterization for Manufacturers

Summary of different characterization of Manufacturers

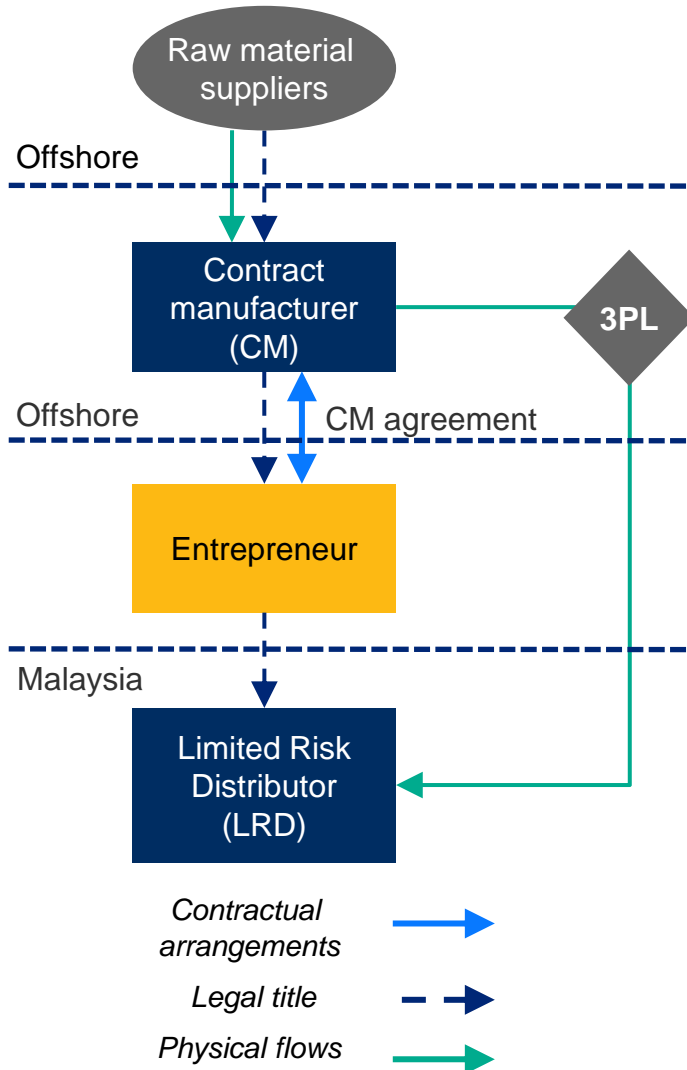
	Full-Fledged Manufacturer	Contract Manufacturer	Toll Manufacturer
Key Functions			
Production arrangement	Produce for its own sales	Produce for the principal	Produce for the principal
Intellectual Property (“IP”)	Owens the IP	Does not own IP	Does not own IP
Inventories	Owens	Owens	Does not own
Sales and Marketing	Yes	No	No
Logistics and Distribution	Yes	No	No
Key Activities			
Level of involvement	Full responsibility at every stage i.e. IP development, sales, production, after sales, logistics, etc.	Limited exposure to market volatility. Concentrate on manufacturing function	Only acts as a service provider without ownership of inventory



The above characterization for manufacturers are arranged in the order from manufacturer that bears the highest functional profile to the lowest functional profile

Supply Chain Structure Illustration

Contract Manufacturer (CM) Arrangement



❖ Facts

- CM and Entrepreneur enter into a long-term sales contract, pursuant to which Principal agrees to purchase finished goods (“FG”) from CM for an agreed price.
- CM is related to Entrepreneur.
- Entrepreneur owns the patent for the manufacture of the FG and the trademark which is placed on the FG.
- Entrepreneur agrees to provide a royalty-free license of the patent and trademark to CM.
- After completion of the manufacturing process, the FG are stored by CM for several days, and are then exported pursuant to Entrepreneur’s instructions to LRD.
- Title in the FG passes to Principal upon loading at dock.
- Principal engages third party logistics (3PL) to transport the FG from the CM’s plant to LRD premises.

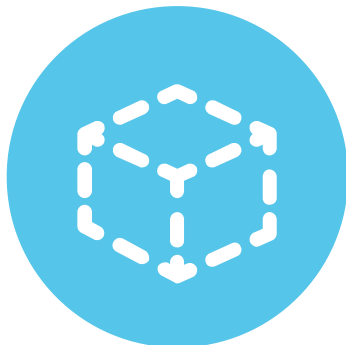
❖ BEPS Actions 8-10: Transfer pricing issues

- Need to address the issue relating to contractual allocation of risk to ensure such allocation is in line with the reality.
- Shall be exposed to challenges in the selection of comparable companies with similar functional and risk profile.

Characterization for Distributors

Summary of different characterization of Distributors

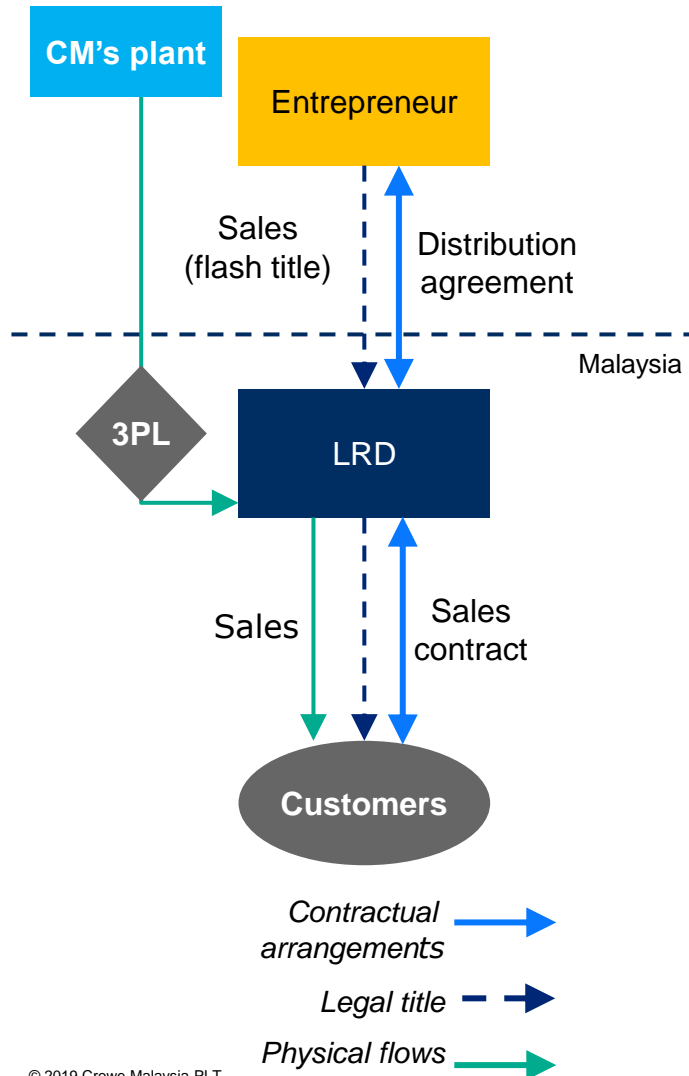
	Full-Fledged Distributor	Limited Risk Distributor	Commission Agent
Key Functions			
Marketing	Yes	Minimal	Minimal
Sales	Yes	Yes	Yes
After sales services	Yes	Yes	No
Inventory Management	Yes	Minimal	No
Key Activities			
Level of involvement	Fully responsible in all aspects of business i.e. IP development, marketing strategy development, inventory management, etc.	Limited scope of role of in-country team, with principal entity taking key risks	Receive commissions for finding clients. No involvement in inventory management.



The above characterization for distributors are arranged in the order from distributor that bears the highest functional profile to the lowest functional profile

Supply Chain Structure Illustration

Limited Risk Distributor (LRD)



❖ Facts

- Entrepreneur engages third party logistics (3PL) to transport the FG from the CM's plant to LRD premises.
- Principal sells FG to LRD where title of the FG passes to LRD immediately outside Malaysia's border point.
- LRD is related to Entrepreneur.
- Entrepreneur agrees to provide a royalty-free license of the trademark to LRD, permitting LRD to use the trademark to advertise and promote the FG in Malaysia.
- FG are stored at 3PL's warehouse in Malaysia. Entrepreneur sells FG to LRD. Title in the FG passes to LRD on delivery to LRD or as LRD directs.

❖ BEPS Actions 8-10: Transfer pricing issues

- Need to address issues relating to contractual allocation of risk.
- Challenges in selection of comparable companies with similar functional and risk profile.
- Where it involves intangibles, further analysis is required to address the issues on DEMPE (development, enhancement, maintenance, protection and exploitation).

Characterization for Service Provider

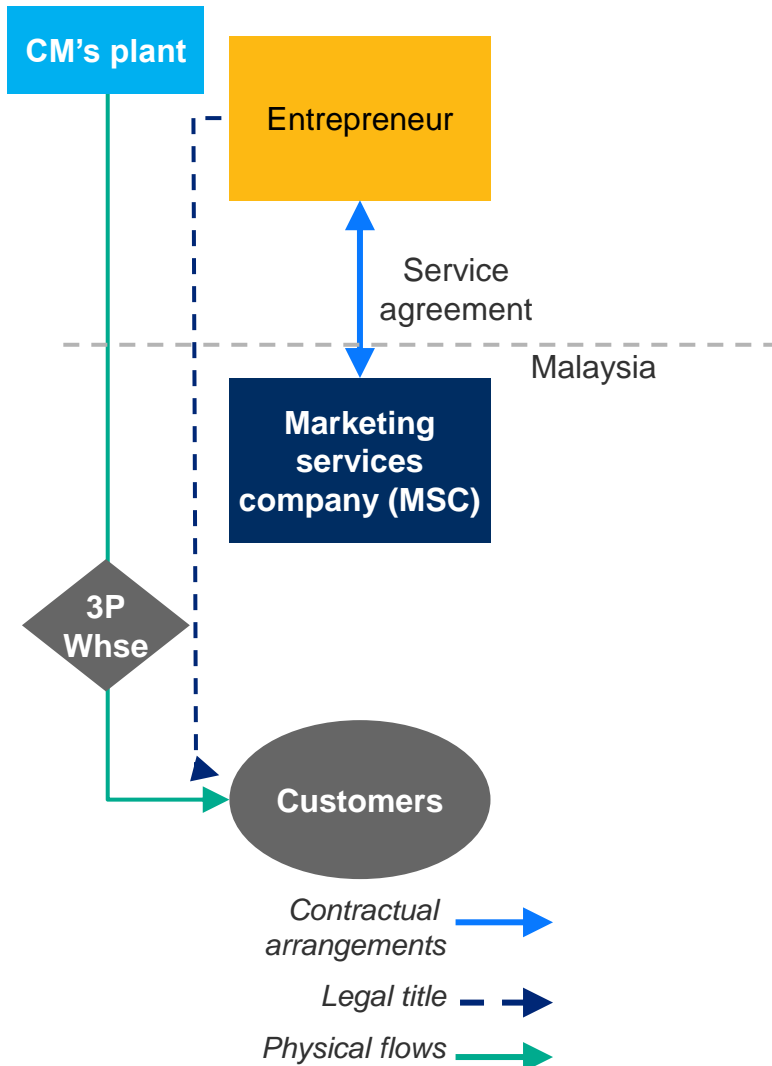
- *Service provider vs Service recipient*

	Service Provider	Service Recipient
Key Functions		
Provision of services (financial management, marketing, logistics, etc.,)	Yes	No
Intellectual Property (“IP”)	Does not own unique IP	May own IP required for its business
Key Activities		
Level of involvement	Employing qualified staff to deliver services. The services are normally supporting functions for the service recipient entities who are involved in the business frontline.	Usually an operating entity or business front liner. Outsource to other entities to provide supporting functions instead of performing such functions in-house.



Supply Chain Structure Illustration

Marketing services



❖ Facts

- Entrepreneur engages 3PWhse to transport FG from the CM's plant to customer premises.
- Entrepreneur sells FG to Customers where title in the FG passes to Customers outside the source country border point.
- Under the services contract with MSC, Entrepreneur agrees to appoint MSC as the sole marketing services company in source country. MSC is provided a royalty-free license of the trademark to advertise and promote the FG in Malaysia.
- FG are imported into Malaysia. Title in the FG passes to Customers on delivery.
- MSC is related to Entrepreneur.

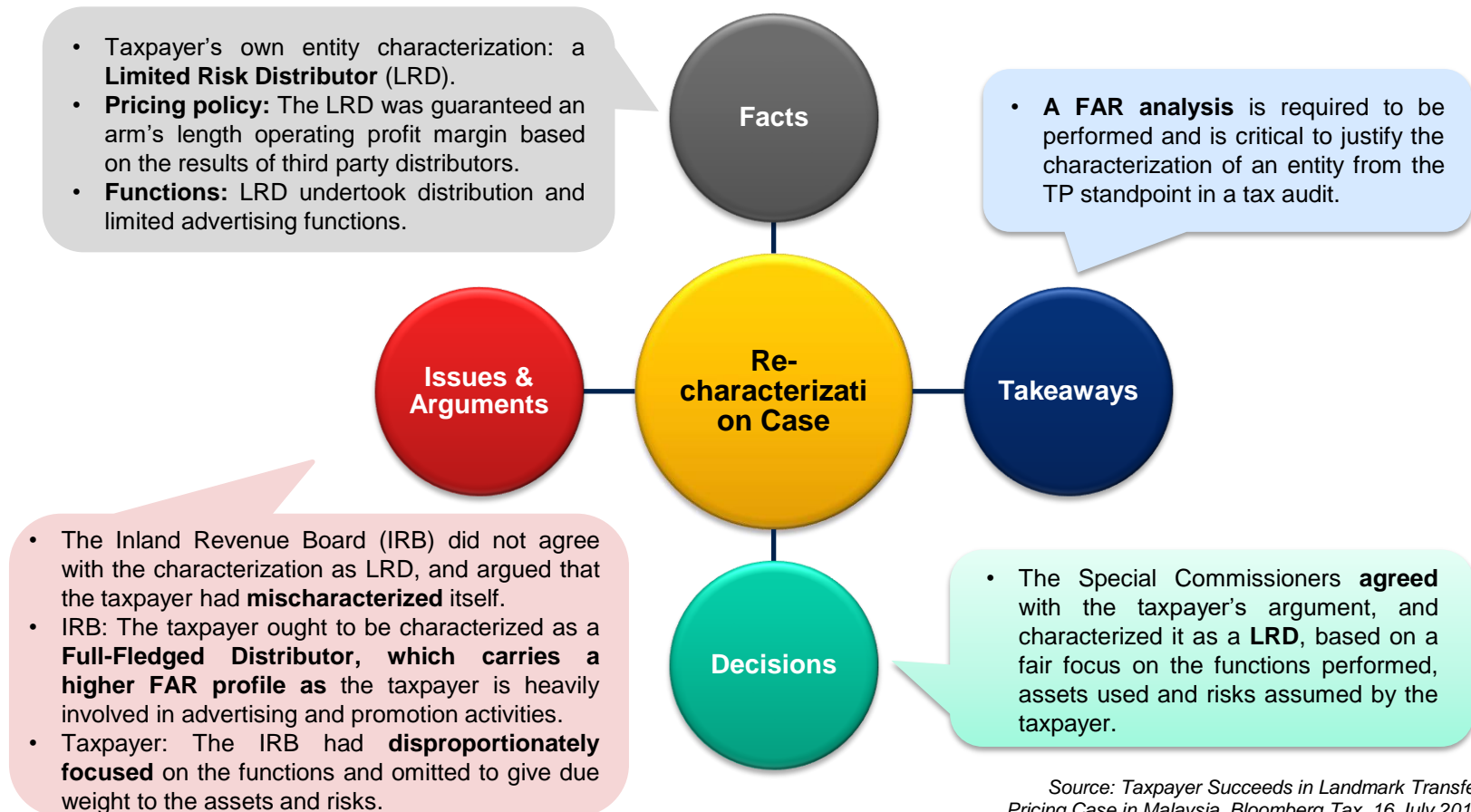
❖ BEPS Actions 8-10: Transfer pricing issues

- Where it involves intangibles, analysis of DEMPE functions with regard to marketing intangibles is required.
- Low value added service provider model.

Special Commissioners of Income Tax's case:

TP Issue - Entity Characterization For A Distributor

SCIT's case: Characterization has been increasingly scrutinized by the IRB in tax audits, thus the ability to distinguish between different characterization and its impact on the pricing of controlled transactions is critical for a company to defend a position and to resolve disputes arising during an audit, as highlighted in the case below.



Source: Taxpayer Succeeds in Landmark Transfer Pricing Case in Malaysia, Bloomberg Tax, 16 July 2019



Challenges in characterization in a post-BEPS world

In the post-BEPS era, i.e. Base Erosion and Profit Shifting Action Plan, with BEPS Actions 8 to 10 seeking to strengthen TP rules, taxpayers need to act mindfully so that their transfer pricing position could withstand the close scrutiny by tax authorities. This includes addressing the issue of characterization of transactions more diligently by identifying the economical significant functions performed, assets employed and risks assumed by each party in a controlled transaction.

The list is not exhaustive but, potential challenges would include but are not limited to “contractual allocation of risk” and “cash box entity” insofar as transfer pricing characterization is concerned.

❖ **Contractual allocation of risk:**

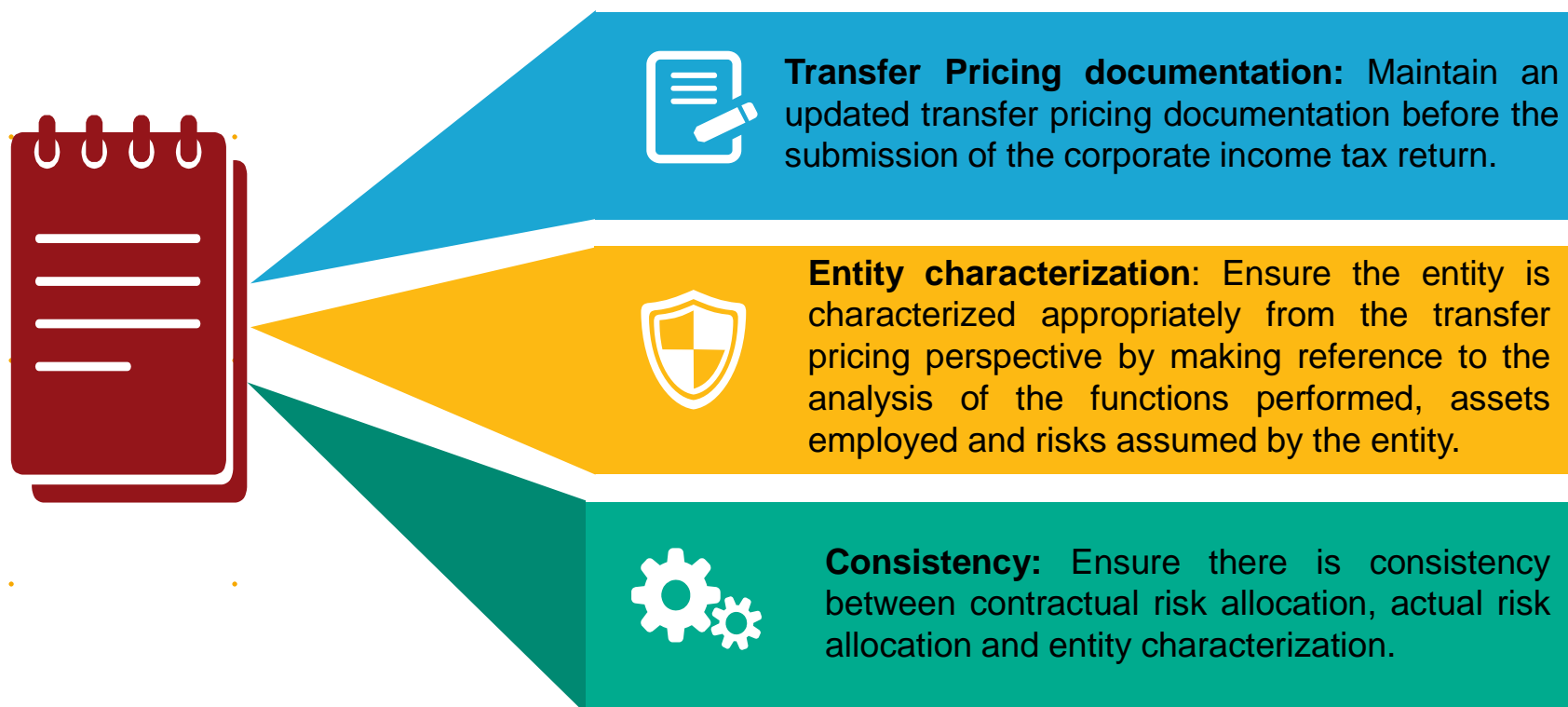
- Contractual agreements between related parties provide the starting point for allocating risks amongst parties.
- It is no longer enough to defend the characterization purely from the contractual arrangements between the parties.
- Essentially, entity characterization would very much depend on whether the contractual arrangements are supported by **actual** functions, value creation as well as the parties making the important business decisions.

❖ **Cash box entity:**

- Cash box entity is a capital rich entity with no or very low functionality.
- Cash box entity will likely be characterized as a fund provider and will generate no more than a risk-free return, assuring that no premium returns will be allocated to cash boxes without relevant substance.

What can the taxpayer do to reduce TP risks?

Check Point: To avoid unwanted shocks to the day-to-day business operations, the taxpayers may wish to assess their readiness on their TP issues through ensuring the following are put in place:





Thank You

Please feel free to contact us if you need assistance or further information:

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