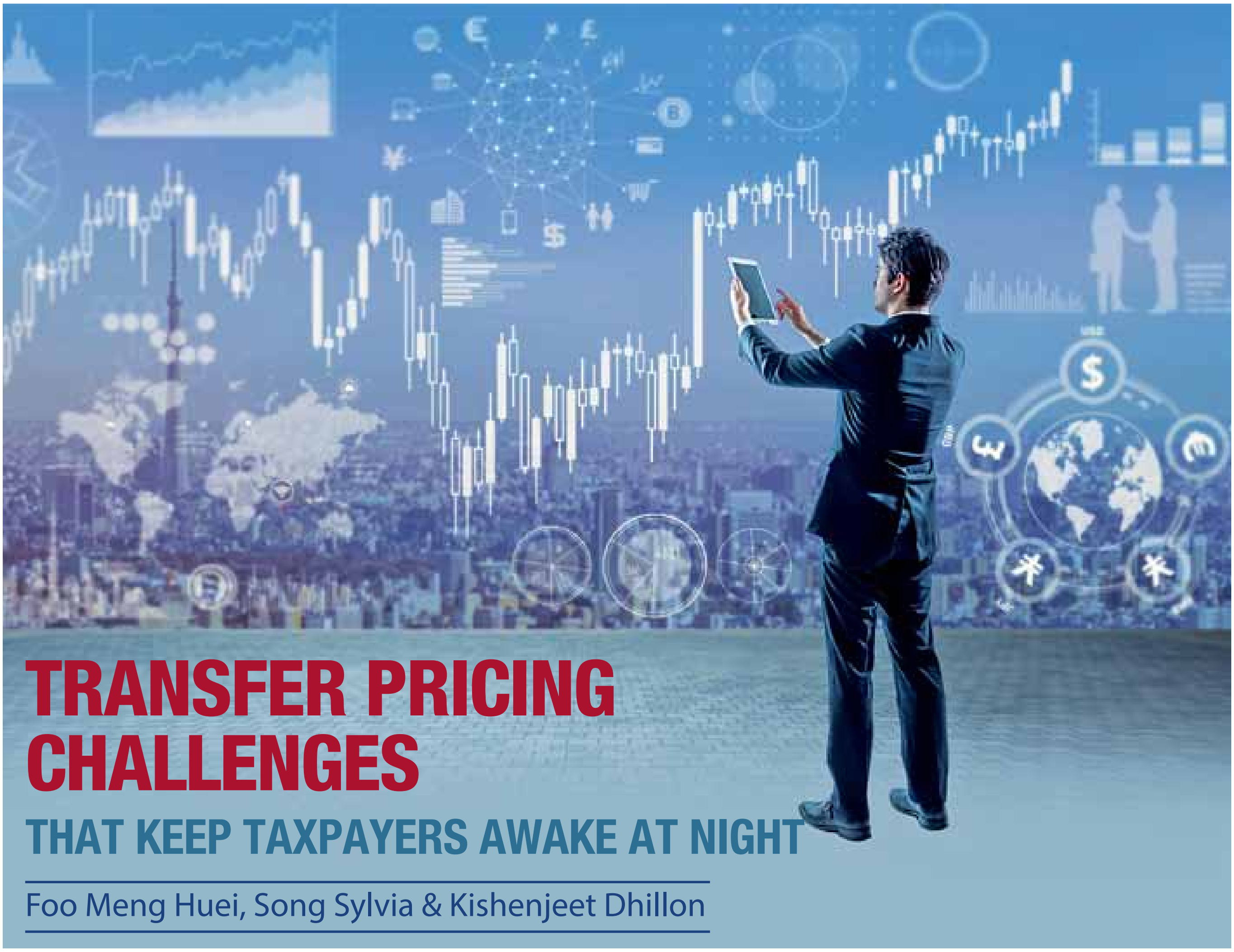

TRANSFER PRICING CHALLENGES

THAT KEEP TAXPAYERS AWAKE AT NIGHT

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According to a recent survey by the Harvard Business School of 600 CEOs on what keeps them awake at night during this global pandemic, the results found that:

> *"....almost every aspect of doing business must be completely rethought for both short-term survival and long-term success."*[1]

Whilst multinational corporations (MNCs) are pre-occupied with enormous business challenges to keep their companies alive, one key agenda is to review and reassess their cross border transactions between companies within the same MNC group. This is when transfer pricing becomes an unavoidable issue as any price movements between members within the MNCs will inevitably be under the close watch by the relevant tax authorities.

Going back in history, in Malaysia, tax collections from transfer pricing audits have increased significantly over the years. From RM155.9 million in 2014, the amount has increased almost four fold to RM582.6 million in 2018, within a span of five years.

The table below depicts the tax revenue

Year	Additional Tax (RM)	Penalty (RM)	Total Amount (RM)
2014	117,487,828	38,455,479	155,943,307
2015	103,462,733	21,407,454	124,870,186
2016	194,405,673	46,034,914	240,440,586
2017	477,775,200	186,481,024	681,939,667
2018	432,867,821	149,694,311	582,562,134

collected from transfer pricing audits by the Inland Revenue Board of Malaysia's ("IRBM") Multinational Tax Department between 2014 and 2018[2]:

The drastic rise in tax collections can be largely attributed to increased global trade and also reflects the intensified level of transfer pricing centric audits carried out by the IRBM. One can be quite certain that the transfer pricing challenges that lie ahead will not be less impactful when compared with historical trends.

There are many reasons for the transfer pricing adjustments and these may vary from minor malpractices by the taxpayers to insufficient documentation or differences in the interpretation of highly complicated technical issues. Whilst no statistics have been released on the nature of the issues uncovered in the transfer pricing audits, the more prominent transfer pricing challenges that are likely to keep taxpayers awake at night in the short and long-term will revolve around the following issues:

1. Provision of intra-group services

Under intra-group services arrangements, transfer pricing issues can be challenged from both the service provider and the service recipient perspectives. Essentially, intra-group services involve the provision of services by a related party to another related party. Such a transaction typically involves items such as shared services functions, management services, consulting services, IT support services, etc.

One of the main areas of focus in the IRBM's transfer pricing audits on intra-group services is whether the services meet the benefits test from the service recipient's standpoint. Where the IRBM is not convinced that the service recipient has economically benefited from the services received in its assessment, the IRBM would have no hesitation in denying tax deductions on the service fees paid to a related company. Some of the indicators that the services fail to meet the benefits test are as follows:

- The services are duplicative in nature as the service recipient already has an in-house team to perform the function.
- The scope of services is not clearly defined due to the absence of a formal agreement between the parties.
- There is no arm's length negotiation on the amount of service fees payable by the service recipient as the service recipient company accepted the charges by virtue of its relationship with the service provider without evaluating the need for such services.
- The payment of service fees resulted in continuous losses suffered by the service recipient and no other explanation is offered for the loss making position.

On the flip side of the coin, service providers who did not appear to adhere to the arm's length principle may often be exposed to additional tax. The following practices are not likely to be viewed favourably by the IRBM:

- Providing free-of-charge services to service recipients.
- Adopting the cost sharing or cost reimbursement approach to recover the costs of services provided to service recipients without adding any profit element to the cost, instead of employing the commonly acceptable cost plus method.
- Non-standardised pricing policies for different service recipients within the Group for similar services provided.

It is not rocket science in setting the arm's length pricing policies for the provision of intra-group services. Rather, the real challenge lies with the proper execution of such pricing policies within the organisation so as not to step on transfer pricing minefields.

2. Intangible properties

Intangibles refer to trade intangibles (e.g. patents, know-how, product design, software, etc.) or marketing intangibles (e.g. trademarks, marketing strategies, customer lists, distribution channels, government contracts, etc.). Given the extensive time and investment required to develop these intangibles, the legal or economic owner

of such intangible properties should be entitled to compensation in exchange for its transfer or usage. From a transfer pricing perspective, the same would be expected if the transaction had occurred between related parties.

A dispute can occur with the IRBM if there is a lack of documentation or analyses on the part of the taxpayer to substantiate payments for these intangibles. For example, a foreign holding company may provide access to "know-how" to a Malaysian subsidiary to enable the manufacturing of a new product. In exchange, the overseas holding company may charge a royalty based on a percentage of sales made by the Malaysian subsidiary. To complicate the matter, the Malaysian subsidiary may have also contributed to the research and development of the manufacturing "know-how". In such a scenario, the areas that are frequently challenged by the IRBM include the economic substance of the royalty payments and the quantum of payments for the use of the intangibles.

Unfortunately, the issues surrounding intangible properties are rather complex and require the parties to conduct extensive analyses to support their transfer pricing positions. This is especially so in light of the introduction of the DEMPE[3] analysis under BEPS Action 8 to 10[4], which has since been incorporated into the OECD's Transfer Pricing Guidelines issued in 2017. Similarly, the Malaysian Transfer Pricing Guidelines require the parties to carefully evaluate the relative value of contributions by entities to the DEMPE to ensure all affected entities in the group are appropriately compensated on an arm's length basis.[5] As a DEMPE analysis is relatively new from a Malaysian standpoint, everyone is still in the dark until the first test case is scrutinised by the IRBM and challenged in Court. It will be interesting to know to what extent the DEMPE analysis is able to play a crucial role in persuading the tax authorities.

3. Intra-group financing

The year 2020 has been a year filled with economic challenges amid the COVID-19 crisis. Stock prices hit rock bottom around the world in March 2020 and interest rates fell to historically low levels since then. The Bank Negara Malaysia cut its Overnight Policy Rate (OPR) four times in January, March, May and July 2020 with the latest revision at 1.75% in July 2020[6] to accelerate economic recovery.

Taxpayers need to be aware that intra-group financing transactions are under the IRBM's transfer pricing radar. Any financial assistance between members of a group will need to observe the arm's length principle. In arriving at the arm's length interest, the IRBM will look into the terms of the arrangement, including but not limited to, credit rating of the borrower, purpose of the financial assistance, quantum and tenure, currency denomination, collateral or security, cost of funds, prevailing market interest rate, etc., to determine the applied arm's length interest rate.

In an intra-group financing arrangement, the IRBM may scrutinise from either the lender or the borrower's standpoints. The focus on the lender company is whether the lender had undercharged interest to the borrower entity. In particular, an interest-free arrangement is considered not at arm's length and has high transfer pricing risks especially from the lender's perspective. On the contrary, the issue related to

[1] *Harvey Mackay, What keeps 600 CEOs awake at night during this global pandemic, 2020 (https://www.bizjournals.com/bizjournals/how-to/growth-strategies/2020/05/what-keeps-600-ceos-awake-at-night-during- pandemic.html)*

[2] *IRBM, Nuarrual Hilal Md Dahlan, Abu Tariq Jamaluddin and Rohana Abdul Rahman, Taxation Transfer Pricing Law incMalaysia: Salient Legal Issues, 2020 (https://www.researchgate.net/publication/341312717)*

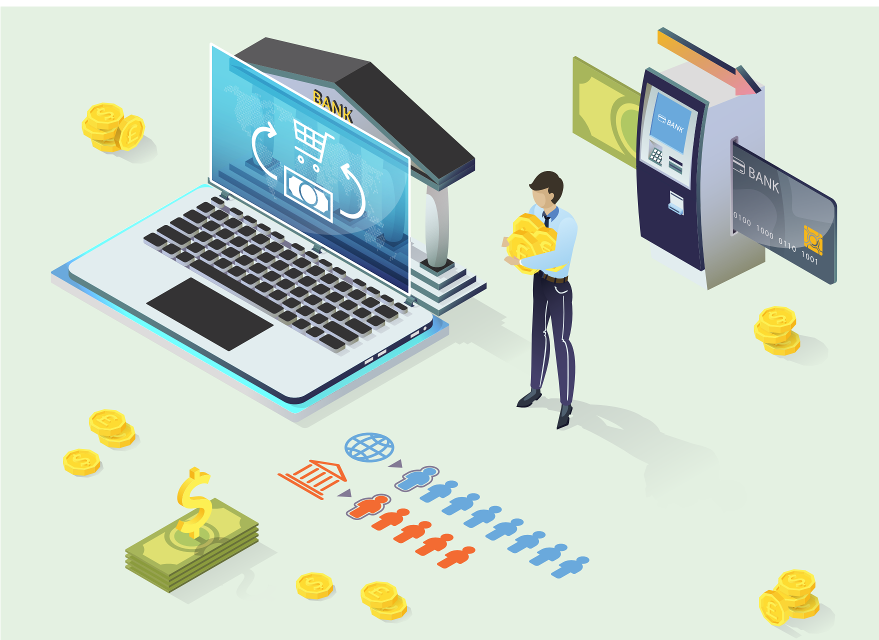
[3] *DEMPE is an abbreviation for Development, Enhancement, Maintenance, Protection, and Exploitation of the intangible*

[4] *OECD/G20 Base Erosion and Profit Shifting Project, Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10: 2015 Final Reports*

[5] *IRBM, Chapter VIII – Intangibles, Transfer Pricing Guidelines (Revised in 2017)*

[6] *Bank Negara Malaysia (https://www.bnm.gov.my/index.php?ch=mone&pg=mone_opr_stmt)*

the borrower company is whether the interest payments are excessive from the arm's length perspective. This is one of the red flags that prompts deeper scrutiny by the IRBM during transfer pricing audits. Any irregular practice not in accordance with the arm's length principle may render the lender or the borrower entities liable to additional taxes.



On this note, the IRBM is empowered to make transfer pricing adjustments according to Rule 13(1) of the *Income Tax (Transfer Pricing) Rules 2012* i.e. the power to make any adjustment to reflect the arm's length price or interest for the transaction by substituting or imputing the price or interest, as the case may be. The additional tax from transfer pricing adjustments on intragroup financing transactions can be staggering for larger sized inter-company balances that had accumulated over many years.

4. Re-characterisation of Transactions

The IRBM has and will continue to exercise its power to disregard and re-characterise business transactions, on the basis that the original transactions had existed without commercial merits. The onus is then passed on to the taxpayers to prove otherwise.

In *Shell People Services Asia Sdn Bhd (SPSA) v Ketua Pengarah Hasil Dalam Negeri, November 2019, High Court, Case No BA 25-68-08/20197*, what was originally a cost contribution arrangement was not acceptable by the IRBM. The IRBM had relabeled the same to be a provision of services arrangement where it imposed tax on the deemed profit margin by prescribing a cost plus model. As a result, SPSA suffered additional tax and penalties of RM15.6 million. Whilst the case is pending further deliberation by the Courts, this case shows that the IRBM can resolve to exercise their power to re-characterise certain inter-company transactions. The power to re-characterise a transaction is wide enough to revert the business model adopted by a taxpayer to some other model the IRBM deems fit.

Other possible scenarios that may be subject to the IRBM's re-characterisation are as follows:

- From a limited risk operator to a full fledge operator (e.g. a limited risk distributor that assumes a functional profile beyond the routine function).
- A transaction with an intermediary entity in a country that lacks economic substance (e.g. the use of a shell company in a tax friendly country as a distributor or use of a company in a tax haven to own an intellectual property, without the corresponding economic and commercial substance).
- Transactions that differ from those which would have been adopted by independent parties behaving in a commercially rational manner (e.g. a software licensing contract for entitlement to intellectual property rights without any consideration).

A re-characterisation made by the IRBM during a transfer pricing audit is poised to be damaging to the taxpayer's financial position as seen from the SPSA case.

Similar cases involving revenue authorities in other parts of the world exercising their powers to re-characterise transactions or reconstruct businesses have gained much attention recently. In two of the more high profile cases, the Federal Courts in Australia and Canada had been decided in favour of the taxpayers as the revenue authorities had not demonstrated sufficient evidence to overturn the commercial substance in *Glencore Investment Pty Ltd v Commissioner of Taxation of the Commonwealth of Australia, September 2019, Federal Court of Australia, Case No FCA 1432 (Glencore)* and *Her Majesty The Queen v Cameco Corporation, June 2020, Federal Court of Appeal, Case No 2020 FCA 112) (Cameco).*

Despite these outcomes that favour

taxpayers, MNCs have no reason to let down their guard as revenue authorities shall continue to find pain points and weaknesses in the transfer pricing systems of the MNCs.

5. Limited risk entity structure

From a technical standpoint, limited risk entities are entities that undertake limited functions and are guaranteed a routine profit. Traditionally, the IRBM will be expecting these entities to be profitable regardless of the economic cycle, be it good times or bad. The more common types are limited risk distributors, contract manufacturers and limited risk service providers.

How would the guaranteed profit stance stand in a situation such as that during the COVID-19 pandemic? In 2020, nearly all short-term macroeconomic indicators were down. According to the Ministry of Finance, Malaysia's economic outlook in 2020 remains weak. Sectors such as services (-3.7%), manufacturing (-3.0%), construction (-18.7%), mining (-7.8%) and agriculture (-1.2%) have all witnessed negative growth, and the country's Gross Domestic Product (GDP) is set to decline by -4.5% in 2020 (2019: 4.3%)[8]. As value chains are being adversely affected globally due to the impact of the pandemic, these limited risk operators in Malaysia may incur losses as they would have to share a portion of the overall financial losses suffered by the group. This presents an enormous challenge to limited risk entities from the documentation perspective.

In its efforts to ease concerns, the IRBM has responded to the situation and commented in public forums that they recognise that the present economic crisis is unprecedented and that they will seek to adopt a more pragmatic approach in such cases. At this juncture, there is lack of formal guidance from the IRBM on how MNCs should prepare themselves to justify their loss making positions. At the minimum, limited risk entities may consider documenting the following qualitative and quantitative analyses, by detailing the impacts for the "pre", "during" and "post" COVID-19 periods, in their transfer pricing documentation:

- Losses suffered by the entire supply chain within the Group.
- Reduction in sales volume vis-à-vis normal sales.
- Effect on disruption in distribution channels affecting the supply and delivery of raw materials and finished goods.
- Extraordinary expenses due to COVID-19, such as retrenchment costs, costs of adhering to the new pandemic related standard operating procedures, etc. Bad debts written off due to non-payment by customers.
- Additional financing costs incurred on new funds raised to ease cash flow constraints.

In the absence of persuasive reasons, loss making limited risk entities may stand a high risk of transfer pricing adjustments being imposed despite the unfavourable external economic environment.

Conclusion

The Malaysian government had proposed new amendments in the Income Tax Act 1967 (ITA) relating to transfer pricing in the Finance Bill 2020, including a new fine of between RM20,000 to RM100,000 on companies that fail to furnish transfer pricing documentation upon request by the IRBM, and a new surcharge of up to 5% on transfer pricing adjustments. These provisions are expected to take effect on 1 January 2021.

Together with other technical and practical challenges taxpayers are already facing, the transfer pricing landscape for year 2021 and onwards will undergo another makeover as MNCs enter into an era of heftier penalties being imposed for non-compliance with transfer pricing provisions under Section 140A of the ITA.

For taxpayers who are kept awake at night due to some of the transfer pricing challenges mentioned in this article, it is timely to revisit this subject matter internally. The transfer pricing challenges can be mitigated through being more vigilant on potential transfer pricing threats and making concerted efforts to comply with the transfer pricing rules. MNCs should act proactively now in finding out the root cause of their transfer pricing issues, and act to calibrate their transfer pricing documentation to meet the expectations of the IRBM as well as withstand their potential scrutiny in the future.

Disclaimer: This article does not seek to address all transfer pricing issues. The views expressed here are the writers' personal views.

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[7] *IRBM List of Recent Tax Cases (http://www.hasil.gov.my/bt_goindex.php?bt_kump=5&bt_skum=5&bt_posi=3&bt_unit=7000&bt_sequ=10) (https://tpcases.com/malaysia-vs-shell-services-asia-sdn-bhd-november-2019-high-court-case-no-ba-25-68-08-2019)*

[8] *Macroeconomic Outlook, Economic Outlook 2021, Ministry of Finance, Malaysia (https://www.treasury.gov.my/pdf/economy/2021/Chapter3.pdf)*

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