CTIM COMMENTS ON INCOME TAX (TRANSFER PRICING) RULES 2012

Prepared by the Transfer Pricing Task Force Group
(hereinafter referred to as "the Group").

The Group is pleased to provide comments on the Income Tax (Transfer Pricing) Rules 2012 [P.U. (A) 132/20121] (hereinafter referred to as "TP Rules" or "the Rules").

General comments

1. Retrospective application of the Rules

The effective date for laws or any guidelines/public rulings should commence from the date on or after such announcements, legislation or amendments to the legislation are made and announced to the public. Ideally, it should be prospective instead of retrospective. This is because retrospective treatment will cause hardship and it is unfair to taxpayers when a penalty is imposed during a tax audit on those tax returns which were submitted before the Rules was issued and the law was not clear at that point of time. The TP Rules are not in place when the law was deemed to have come into operation on 1 January 2009. Hence, the Group would suggest that the Rules be effective prospectively from the actual date on which they are gazetted rather than 1 January 2009.

Should the IRB decides to retain its decision, the Group would like to suggest a transitional period be given so that taxpayers can familiarise with the TP Rules (such as the manner of operation of the law, the documentation requirements etc.) since the TP Rules are new to most taxpayers and hence would face difficulties in complying with the Rules. Consideration should be given to taxpayers to counter balance the retrospective effect as some of the taxpayers are not fully aware of the requirement at that period of time. Therefore, taxpayers should not be unduly penalised for non-compliance during this transition period. We would propose a transition period until 1 January 2013.

2. Legality of the Rules

The Group is of the view that there are some contradictions with the domestic tax rules in the TP Rules. The Income Tax Act, 1967 ("ITA") should take precedent and hence anything that are in the Rules should be in line with the ITA. It is not appropriate to introduce concepts that are beyond the legislation.

In respect of re-characterization of transactions under Rule 8, the Group is of the view that TP Rules should provide guidance to the taxpayers on the application of Section 140A of the ITA rather than to introduce an anti-avoidance legislation within the Rules. The anti avoidance legislation should not be part of the Rules as it has been adequately dealt with under Section 140 of the ITA. Wordings in Rule 8 provide wide powers to the Director General to disregard transactions. Hence, Rule 8 seems to be *ultra vires* since there is already an existing anti avoidance provision in the ITA.

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Specific comments of the TP Rules

INCOME TAX ACT 1967

INCOME TAX (TRANSFER PRICING) RULES 2012

Interpretation

3. In these Rules—

"controlled transaction" means the transaction referred to in subsections 140A(2) and (5) of the Act;

"property" includes any goods, movable or immovable **thing**, or intangible property and beneficially owned property;

"service" includes any rights, benefits, privileges or facilities that are, or to be, provided, granted or conferred under an arrangement for or in relation to any work and assistance including financial assistance.

Comment:
The word "thing" in Rule 3 is unclear and requires further clarification.

Contemporaneous transfer pricing documentation

4. (1) A person who enters into a controlled transaction shall prepare a contemporaneous transfer pricing documentation.

(2) The contemporaneous transfer pricing documentation shall include records and documents that provide a description of the following matters:

(a) organizational structure, including an organization chart covering, persons involved in a controlled transaction;
(b) nature of the business or industry and market conditions;
(c) the controlled transaction;
(d) strategies, assumptions and information regarding factors that influenced the setting of any pricing policies;
(e) comparability, functional and risk analysis;
(f) selection of the transfer pricing method;
(g) application of the transfer pricing method;
(h) documents that provide the foundation for or otherwise support or were referred to in developing the transfer pricing analysis;
(i) index to documents; and
(j) any other information, data or document considered relevant by the person to determine an arm's length price.

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Comments:

(i) The Group would like to seek clarification on Rule 4(2)(d) and 4(2)(h). The Group feels that the definition is too broad and thus, examples should be given to provide greater clarity to taxpayers. The IRB should provide further guidance to taxpayers to ensure that taxpayers are aware of the specific nature of documents and information that need to be maintained.

(3) For the purpose of this rule—

"contemporaneous transfer pricing documentation" means transfer pricing documentation which is brought into existence—

(a) when a person is **developing** or **implementing** any controlled transaction; and

(b) where in a basis period for a year of assessment the controlled transaction is reviewed and there are **material** changes, the documentation shall be updated prior to the due date for furnishing a **return** for that basis period for that year of assessment.

Comments:

(i) In relation to the contemporaneous requirement, based on definition, it would appear that taxpayers who are already engaged in related party transactions would not be able to satisfy the contemporaneous requirement in respect of such transactions. The IRB should consider giving a waiver or at least a transitional period to allow taxpayers sufficient time to meet this contemporaneous requirement to counter balance the retrospective effect.

(ii) There can be a huge time gap between *developing* a controlled transaction and *implementing* a controlled transaction. The IRB should clarify which point in time is preferred.

(iii) The meaning of "material" in Rule 4(3)(b) is unclear. Hence, the Group would like to seek further clarification on the definition of "material" used in Rule 4(3)(b).

(iv) The word "return" needs to be clarified. It is presumed that "return" in this Rule refers to the company's income tax return. We would request that the IRB confirm our assumption.

Methods to determine arm's length price

5. (1) A person shall apply the traditional transactional method to determine the arm's length price of a controlled transaction.

(2) Where the traditional transactional method cannot be reliably applied or cannot be applied at all, the person shall then apply the transactional profit method.

Comments:

(i) The Group is of the view that the TP Rules does not reflect the revised OECD Guidelines (OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations)

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issued on 22 July 2010 which prescribe the application of the "best method" rule. The IRB should adopt the current basis as per the OECD.

(ii) Taxpayers should be given the flexibility to choose the most appropriate transfer pricing methodology in view that they are in the best position to determine the appropriate method based on their own circumstances whilst the IRB has the right to review the methodology adopted.

(iii) To be consistent with the latest OECD Guidelines, the Group suggests that any references to the notion that traditional methods are preferred over profit based methods be removed. It is sufficient to state that all methods are recognised transfer pricing methodologies under the TP Rules and that selection should be based on the "best method" approach.

(3) Where both the traditional transactional method and transactional profit method cannot be applied at all, the Director General may allow the application of **other** methods which provides the highest degree of comparability between the transactions.

(4) For the purpose of this rule—

"traditional transactional method" means the comparable uncontrolled price method or the resale price method or the cost plus method;

"transactional profit method" means the profit split method or the transactional net margin method

Comments:
With reference to Rule 5(3), the Group would like to seek clarification on what are "other methods" that is available other than methods described in this Rule.

Comparability of transactions

6. (1) For the purpose of rule 5, an uncontrolled transaction shall be used as a comparable in determining an arm's length price of a controlled transaction

(2) An uncontrolled transaction may be used as a comparable if-

(a) the comparability factors of such uncontrolled transaction and the controlled transaction are sufficiently similar; or

(b) none of the differences in respect of the comparability factors between such uncontrolled transaction and the controlled transaction, or between persons entering into any of those transactions, are likely to materially affect the price or cost charged or paid or the profit arising from those transactions in the open market; or

(c) reasonably accurate **adjustments** can be made to eliminate the material effects of such differences referred to in paragraph (b).

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Comments:
With reference to Rule 6(2)(c), the Group would like to seek clarification on what type of adjustments are acceptable to the IRB. In practice, during transfer pricing audits, the IRB normally rejects any form of adjustments made, such as working capital adjustments although this adjustment is recognised by the OECD.

(3) The comparability factors referred to in subrule (1) include-

(a) the characteristics of the property or services;

(b) the functions performed, assets employed and the risk assumed by the respective persons in the transactions;

(c) the contractual terms;

(d) economic circumstances; and

(e) business strategies of the persons in the transactions.

(4) For the purpose of determining the arm's length **price**, the results of the controlled transaction shall be compared with the results of an uncontrolled transaction for the same basis year for a year of assessment.

Comments:
(i) In practice, the Transactional Net Margin Method ("TNMM") is most often used during transfer pricing audits to evaluate the arm's length nature of the related party transactions. When applying the TNMM method, the results of the controlled transaction is compared against the inter-quartile range ("IQR"). The Group would like to seek clarification whether in cases where the result falls within the IQR, the IRB would be satisfied that it is arm's length or it is only arm's length if the result is above the median of the range. It should be noted that transfer pricing is not an exact science and therefore we always deal with a range of results to evaluate arm's length.

(ii) Further, recognition should be given that current year data may not always be available to test the current year result of the taxpayer. As such, the Group urges the IRB to recognise this limitation and avoid the use of "hindsight" when the data eventually becomes available.

(5) The Director General **may** allow for the basis period for a year of assessment the application of data from other years prior to or after that basis period if complete and accurate data are available to prove the effect of the life cycles or the business cycles of the products or services in the industry of the person in the controlled transaction.

Comment:
Based on the wordings of Rule 6(5), the Director General 'may' allow taxpayers to use data from other years to prove the effect of life cycles or business cycles. The Group is of the opinion that the

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word "may" prejudices the taxpayer's rights. This contradicts the IRB's client charter where the IRB has committed to provide a fair and just service for all transactions of the taxpayers.

Re-characterization of transactions

8. (1) The Director General may disregard any structure adopted by a person in entering into a controlled transaction if-

(a) the economic substance of that transaction differs from its form; or

(b) notwithstanding that the form and substance of that transaction are the same, the arrangements made in relation to the transaction, viewed in totality, differ from those which would have been adopted by independent persons behaving in a commercially rational manner and the actual structure impedes the Director General from determining an appropriate transfer price.

(2) Where the Director General disregards any structure adopted by a person in entering into a controlled transaction under subrule (1), the Director General shall make adjustment to the structure of that transaction as he thinks fit to reflect the structure that would have been adopted by an independent person dealing at arm's length having regards to the economic and commercial reality.

Comments:

(i) The Group is of the view that Rule 8(1)(b) should not be part of the Rules. The objective of Rules is to provide guidance to the taxpayers on the application of Section 140A of the ITA rather than to serve as an anti-avoidance legislation. Anti-avoidance matters are adequately dealt with under Section 140A of the ITA as mentioned in the General Comments above.

(ii) Further, if the form and substance of a transaction are the same, then it should be commercially acceptable and respected. Going beyond that would give the IRB vast powers to re-characterise any arrangement and thus create great uncertainties. It also does not recognise the uniqueness of business arrangements that certain multinational companies may be engaged in. This rule may also unduly reduce our competitiveness in attracting foreign investors.

Intra-group services

9. (1) A person in a controlled transaction shall apply the methods in accordance with rule 5 to determine the arm's length transfer price for intra-group services and in applying any of the methods he shall-

(a) demonstrate that the intra-group services have been rendered and the provision of such services has conferred an economic benefit or commercial value to his business; and

(b) demonstrate that the charge for intra-group services is justified.

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Comments:

(i) In practice, voluminous information is required to demonstrate services rendered and benefits conferred, but the IRB is often not satisfied or convinced. Hence, the Group suggests that the IRB provide specific guidance to taxpayers to specify the extent of data required to demonstrate that the activity confers a benefit of economic or commercial value to the taxpayer receiving such services as well as the level of documentation regarded as sufficient by the IRB.

(ii) Further, it is envisaged that there would be practical difficulties in complying with this requirement since the economic benefit or commercial value may not be not immediately evidenced. A reduction in cost or increase in revenue or profit may not necessarily be the indicators to show that intra-group services have conferred an economic benefit or commercial value. At times, services are often rendered to preserve the taxpayer's commercial position or market share and in such cases, there is no direct measure of the economic benefit or commercial value. The IRB should provide further clarification on how to comply with this Rule.

Intangible property

11. (1) Where in a controlled transaction an intangible property is sold or licensed out-

(a) the owner or ~~licensee~~ licensor shall charge an arm's length price; and
(b) the value of that property to the purchaser or licensor shall be the benefit that the intangible property is expected to generate.

Comment:

With reference to Rule 11, the Group would like to seek clarification on how intangible property is valued.

(2) For the purpose of subrule (1), the arm's length price for such sale or license shall be determined by applying the comparable uncontrolled price method, or in the case where the property is highly valuable or unique, the residual profit split method shall be applied.

(3) Notwithstanding subrule (2), the Director General may allow the application of other methods if the method provides the highest degree of comparability between transactions.

(4) Where the legal ownership of the intangible property does not vest with the person that has developed that property, such person shall receive an arm's length consideration for the development of such property.

Comment:

The Group would like to seek clarification on the criteria to determine legal and economic ownership of the intangible property. How does the IRB determine which person is the economic owner and when a person should be entitled to receive an arm's length consideration?

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(5) Where a person who is not the owner of the trademark or trade name undertakes marketing activities and bears marketing costs of such trademark or trade name in **excess** of those of a comparable independent person, he shall be entitled to an arm's length consideration for undertaking such activities from the owner of the trademark or trade name.

(6) In this rule, a person shall be deemed to be an owner of an intangible property and is entitled to any income attributable to that property if the expenses and risks associated with the development of the intangible property are borne by that person.

(7) For the purpose of this rule-

"intangible property includes patent, invention, formula, process, design, model, plan, trade secret, know-how or marketing intangible;

"marketing intangible" includes an intangible that is concerned with marketing activities, which aids in the commercial exploitation of the property or has an important promotional value for the property concerned.

Comments:

(i) Under Rule 11(5), the Group would like to seek clarification on what constitutes "excess" marketing activities or marketing cost. If compared to an independent person, the marketing costs is greater by 5%, is this regarded as "excess"? What if only 1%?

Due to the lack of publicly available information for benchmarking, it may not be possible to determine the level of marketing activities or costs of comparable distributors. Therefore, it is not possible to determine whether excess marketing activities are carried out or excess marketing costs are incurred. The Group would welcome if the IRB has any statistics to share with taxpayers to assist in the determination of excess marketing activities / costs.

(ii) Logically, it should be recognised that not all marketing activities would entitle a distributor to earn additional profits. There may be some 'expectations' of additional profits if the distributors are involved in marketing activities. There needs to be guidance on what types of marketing activities would constitute building trade name or trademark (i.e. marketing intangible) vis a vis promoting sales. Often, marketing expenses relate to "point-of-sales" activities that are incurred to increase sales, not creating marketing intangibles. As such, for clarity and certainty, it is suggested that "marketing activities / costs" be confined to those activities that are considered to create or enhance brand name or trademark.

Interest on financial assistance

12 (1) Any person in a controlled transaction who provides or receives financial assistance, directly or indirectly, to or from another person with or without consideration shall determine the arm's length interest rate for such assistance.

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(2) For the purpose of this rule-

"financial assistance" **includes** loan, interest bearing trade credit, advance or debt and the provision of any security or guarantee;

"interest" **includes** finance charge, discount, premium or other consideration relating to controlled transaction.

Comments:

(i) The definition of "financial assistance" and "interest" in Rule 12(2) are unclear. From the wordings above, it would appear that the definition of "financial assistance" and "interest" can include other items in addition to those specified. Hence, the Group would like to seek clarification on what are the other examples that falls under the definition of "financial assistance" and "interest".

(ii) Further, the Group would like to seek clarification on whether Islamic financing arrangements are excluded from the scope of the Rules.

Adjustment by Director General

13 (1) Notwithstanding any other provision of these Rules, where the Director General has reason to believe that any price including the rate of interest imposed or would have been imposed in a controlled transaction is not at arm's length, the Director General may make an adjustment to reflect the arm's length price or interest rate for that transaction by substituting or imputing the price or interest, as the case may be.

(2) Any adjustment under these Rules in respect of an assessment made on one of the persons in a controlled transaction may be reflected by an offsetting adjustment on the assessment of the other person in that transaction upon request by that other person.

Comment:

Penalty should not be imposed if the transactions are carried out between 2 local companies that do not result in any loss of tax revenue to the Government. Transfer pricing adjustments should not be made where it is solely to impose penalties.

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