

CTIM COMMENTS ON TRANSFER PRICING GUIDELINES 2012

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

The Group is pleased to provide comments on the Transfer Pricing Guidelines 2012 (hereinafter referred to as “TP Guidelines” or “the Guidelines”).

General comments

1. Thresholds

The objective of the thresholds introduced in the Guidelines is to ease the compliance costs burden of certain classes of taxpayers. However, companies who fall under the thresholds mentioned in the Guidelines would still be required to justify that their transactions with associated persons are arm’s length. Thus, they still need to prepare contemporaneous transfer pricing documentation. Under such circumstances, the objective of easing the compliance costs burden of these taxpayers may not necessarily be achieved. It may be more effective to exempt such companies from the need to prepare transfer pricing documentation.

Thresholds of taxpayers can change from year to year. The Guidelines is said to be applied to taxpayers with a gross income exceeding RM25 million *and* the total amount of related party transactions exceeding RM15 million. The Group would like to clarify the following:

- Whether the Guidelines are binding on the Director General;
- Definition of “gross income”;
- How the threshold of RM25 million *and* total related party transactions exceeding RM15 million is interpreted. The Group would like to enquire on whether there is a difference in the application of the Guidelines in the scenarios below:
 - i. Taxpayer with a gross income of RM20 million and total related party transactions of RM20 million;
 - ii. Taxpayer with a gross income of RM2 billion and total related party transactions of RM20 million;

The Group would like to clarify on whether the thresholds are applied based on the quantum of the related party transaction or on the materiality of the related party transaction. In scenario (ii), although the quantum of related party transaction is RM20 million, the impact on its total gross income is only 1% (RM20 million / RM2 billion). Would the Guidelines apply to this scenario?

2. Tax adjustments between persons who are both assessable and chargeable to tax in Malaysia

The Group would like to seek confirmation that no transfer pricing adjustment would be made on a transaction between two related taxpayers who are both assessable and chargeable to tax in Malaysia and consequently, no penalties would also be imposed. This is because the transaction would not result in any tax loss to the Inland Revenue Board (“IRB”).

3. Definition of “control” and “associated”

The Group would also like to seek clarification on the definition of “associated” persons in the TP Guidelines. Based on the Guidelines, the definition of an “associated” person under paragraph 5.2 seems to be wider than what is provided for under s140A of the Income Tax Act 1967 (“the Act”). Under s140A, the transactions that are covered shall be transactions between –

- (a) Persons one of whom has control over the other;
- (b) Individuals who are relatives of each other; or
- (c) Persons both of whom are controlled by some other person.

In this regard, s140A only applies to these transactions where there is an element of control. However, the definition or meaning of “associated” company for purposes of the Guidelines is where one company directly or indirectly participates in the management, control or capital of the other or both companies. Therefore, the Group feels that this definition is much wider than the one in s140A. We would like to seek IRB clarification on whether the Guidelines in fact prescribe a wider application of the transfer pricing rules.

Specific comments of the TP Guidelines

INCOME TAX ACT 1967 TRANSFER PRICING GUIDELINES 2012

4. Tested party

The determination of a controlled transaction leads to the determination of the tested party. As a general rule, the tested party is the one to which a transfer pricing method can be applied in the most reliable manner and for which the most reliable comparables can be found. In the Malaysian scenario, the IRBM gives priority to the availability of sufficient and verifiable information on both tested party and comparables. As such, IRBM does not accept foreign tested parties where information is neither sufficient nor verifiable.

Comment:

- (i) The Group is of the opinion that the principles prescribed by the OECD Transfer Pricing Guidelines whereby the tested party is selected based on the least complicated entity and where the transfer pricing method can be most reliably applied should be adopted. Based on past experiences with the IRB, it appears that the IRB does not accept foreign related parties as tested parties.
- (ii) The Group would like to clarify in what circumstance would information be considered as sufficient and verifiable. For example, if audited financial statements of the foreign tested party can be provided, is this sufficient?

5. Comparability analysis

- 8.1 A comparability analysis is a pre-requisite in the application of all transfer pricing methods that conform to the arm's length principle. This involves comparing conditions in a controlled transaction with those in an uncontrolled transaction.
- 8.2 A controlled transaction in a comparability analysis is the transaction that has been identified as the transaction where pricing may not be arm's length. An uncontrolled transaction may be:
 - (i) a transaction between the tested party and an independent party conducted under terms and circumstances similar to the controlled transaction (internal comparable); or
 - (ii) a transaction between two independent parties under similar terms and circumstances (external comparable).
- 8.3 An uncontrolled transaction is deemed comparable if the following five factors of comparability of that transaction with that of a controlled transaction are sufficiently similar:
 - (i) Characteristics of the property or services;
 - (ii) Functions performed, assets employed and risks assumed by the respective persons;

- (iii) Contractual terms;
- (iv) Economic circumstances; and
- (v) Business strategies.

8.4 In order to be deemed comparable, the following conditions must be met where there are differences between an uncontrolled transaction and a controlled transaction:

- (i) none of the differences between the transactions being compared or between the enterprises undertaking those transactions could materially affect the margins in an open market; or
- (ii) reasonably accurate adjustments can be made to eliminate the material effects of such differences.

Comments:

- (i) **The Group would like to highlight that publicly available information is very limited, and that the quality of such publicly available information is usually not good enough to perform an in depth comparability analyses. Given the limitations, the IRB should take recognition of this fact and adopt a more flexible approach when determining comparability. The Group would enquire as to what extent the IRB would expect the conditions for comparability to be analysed. At the same time, the Group would also like to seek the IRB's confirmation that any analyses on comparability must be based on objective and publicly available information, not information which are privileged only to the IRB (for example, if the information was obtained by the IRB using the provision under s81)**

6. Multiple year data

- 13.1 The purpose of analyzing multiple year data is to identify whether the outcome of a particular year is influenced by abnormal factors. However, the use of multiple year data does not imply the use of multiple year average.
- 13.2 In order to obtain a complete understanding of the facts and circumstances surrounding a controlled transaction, it is useful to examine data from both the years after the year under examination and prior years. The use of data from past years will show whether a taxpayer's reported loss on a transaction is part of a history of losses on similar transactions, a result of a particular economic condition in a prior year that caused an increase in cost in the subsequent year, or a reflection of the fact that a product is at the end of its life cycle.

Comments:

The Guidelines did not provide further guidance for situations where abnormal factors have been identified. Would such situations then warrant the use of multiple year average?

7. Arm's length range

- 14.1 An arm's length range refers to a range of figures that are acceptable in establishing the arm's length nature of a controlled transaction. The range is derived from applying the same transfer pricing method to multiple comparable data. It is established that transfer pricing is not an exact science, and that the application of the most appropriate transfer pricing methodology may produce a range of results. The facts and circumstances of a case are therefore important in determining a range, or the point in a range, that is the most reliable estimate of an arm's length price or allocation.
- 14.2 The arm's length range should be constructed using only comparable uncontrolled transactions that have, or have been adjusted to, a high level of reliability in comparison to the controlled transactions. A **substantial deviation among points** or between the data in the range (e.g. upper quartile and lower quartile) may indicate that comparables used are not reliable, and that material differences exist in terms of FAR which warrant comparability adjustments. In such cases, the reliability of comparable data must be carefully assessed, and adjustments made for the material differences in comparability analysis and the methodology should be reviewed.

Comments:

The Group would like to seek clarification from the IRB on what would tantamount to “substantial deviation among points” as mentioned above.

- 14.3 If every effort has been made to exclude data that have a lesser degree of comparability, but some comparability defects remain and cannot be adjusted, it may be appropriate to make transfer pricing adjustments to a value that best reflects the facts and circumstances of transactions between associated persons. This value may be derived from utilising **statistical tools** depending on the specific characteristic of the data set.

Comments:

The Group would like to request for examples of the statistical tools mentioned above.

8. Cost Contribution Arrangement (“CCA”)

- 21.3.2 Consideration for the entry, withdrawal and termination of a CCA should be dealt with at arm's length, as follows:
- (a) Where a participant's contribution is not consistent with its expected share of benefits from the CCA, a balancing payment may be required between the participants to adjust their respective contributions;
 - (b) Where a participant transfers its pre-existing rights of a prior CCA to a new participant, the exiting participant must be compensated based upon an arm's length value for the transferred interest (buy-in payment). The amount of the buy-in payment shall be determined based on the price an independent party would have paid for the rights obtained by the new participant, taking into account the proportionate share of the overall expected benefit to be received from the CCA;

- (c) Where a participant disposes off part or all of its interest, he should be compensated with an arm's length payment (buy-out payment).

Comments:

With reference to Paragraph 21.3.2, the Group would like to seek request for working examples in relation to balancing payment, buy-in payment and buy-out payment.

9. Profit Mark-up

- 20.7.1 It is vital to consider whether mark-up on a cost base is justifiable since in an uncontrolled transaction an independent person would normally seek to earn a profit from providing services, rather than merely charging them out at cost. Therefore, it is necessary to understand the nature of activity, the significance of the activity to the group, the relative efficiency of the service supplier and any advantage that the activity creates for the group.
- 20.7.2 The nature of service and the expected value to a recipient influence the arm's length price of the service provider. Specialised services, such as engineering services in the oil and gas industry, warrant a higher mark-up than general services such as repair and maintenance.
- 20.7.3 When applying the cost-plus method to an associated enterprise which assumes the role of an agent or intermediary to obtain services from independent enterprises on behalf of its group members, it must be ensured that the arm's length return is limited to rewarding the agency/intermediary function only. It is not appropriate to charge a service fee based on mark-up on cost of the services obtained from independent enterprises.
- 20.7.4 If a tested party is the service recipient in Malaysia, a mark-up by an overseas affiliate service provider which has fulfilled an arm's length test in that service provider's country of residence need not automatically be deemed arm's length in Malaysia. A benefit test from the perspective of the service recipient must still be demonstrated.

Comments:

The Group would like to request that the IRB introduces safe harbour mark-ups in relation to intra-group services. For example, where a mark-up of 5% is applied in relation to the provision of routine and administrative services, the arm's length nature of this 5% rate would not need to be supported by a separate benchmarking analysis. This will help to achieve the objective of reducing compliance costs burden of taxpayers.

10. Transfer pricing documentation

25.1 Contemporaneous Transfer Pricing Documentation

- (a) A documentation is deemed "contemporaneous" if it is prepared:
- (i) at the point when the taxpayer is developing or implementing any arrangement or transfer pricing policy with its associated person; and

- (ii) if there are material changes, when reviewing these arrangements prior to, or at the time of, preparing the relevant tax return of his income for the basis year for a year of assessment.
- (b) In preparing the documentation, the arm's length transfer price must be determined before pricing is established based upon the most current reliable data that is reasonably available at the time of determination. However, taxpayers should review the price based on data available at the end of the relevant year of assessment and update the documentation accordingly.

Comments:

Referring to paragraph 25.1(b) above, the Group would like to seek clarification on how this would be applied. In the situation where a taxpayer sets its transfer pricing policies based on information that is available at the beginning of its financial year and subsequently updates the data at the end of the financial year, if the result of the analysis at the end of the financial year is significantly different from the analysis at the beginning of the year, would the taxpayer be required to implement a retrospective change to adjust the result for the whole financial year? If so, the Group feels that this will increase compliance cost burden of the taxpayers. Instead, any change should only be implemented for the next financial year.

11. Penalty

- 26.1 Tax adjustments as a result of a transfer pricing audit are subject to penalty under subsection 113(2) with the following penalty rates applicable:

1	No Contemporaneous Transfer Pricing Documentation.	35%
2	Transfer Pricing Documentation prepared not according to requirements in the Guidelines.	25%

- 26.2 Taxpayers who do not fall under the scope of paragraph 3, and have not prepared a contemporaneous Transfer Pricing Documentation, may be subjected to 25% penalty on adjustments due to transactions not conducted at arm's length.
- 26.3 The rate of penalty shall be increased by 20% as compared to the last penalty rate imposed for the previous offence but limited to a sum not exceeding 100% of the amount of tax undercharged, where –
- (a) the taxpayer obstructs or interferes with a transfer pricing audit; or
 - (b) the taxpayer fails to comply with the arm's length principle after previous transfer pricing audits.

Comments:

The Guidelines does not provide for a situation where a taxpayer has prepared a transfer pricing documentation that is fully compliant to the requirements set under the Guidelines. In the event of a tax adjustment, the Group is of the view that there should be no penalties imposed.