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Taxpayer Succeeds in Landmark Transfer Pricing Appeal

Introduction

Recently, Wong & Partners successfully represented a Taxpayer before the Special Commissioners of Income Tax ("**SCIT**"). The issues litigated before the SCIT concern many long-standing and key areas of transfer pricing dispute between taxpayers and the Malaysian Inland Revenue Board ("**IRB**"), and the conclusions of the hearing could have significant implications regarding the conduct of transfer pricing audits in Malaysia.

The IRB has increased its focus on transfer pricing related issues in recent years, which has resulted in a significant number of transfer pricing-focused audits. The IRB often takes an aggressive position in these audits, which creates challenges for taxpayers in supporting their transfer pricing policies. Given there has been few transfer pricing cases litigated in Malaysia, this is a relatively untested area of law, which in turn has allowed the IRB to push the boundaries on the interpretation of the law, resulting in occasions where the IRB has deviated from commonly understood transfer pricing principles in audit situations. This has caused confusion and has resulted in there being a greater degree of challenge in resolving transfer pricing audits in Malaysia.

Background Facts

The Taxpayer is a Malaysian subsidiary of a multinational company dealing in fast moving consumer goods. The Taxpayer was appointed to act as a limited risk distributor for a related party entity ("**Related Company**") to oversee the distribution of its products in Malaysia. It was agreed that the Related Company will set the prices of the goods sold to the Taxpayer in a manner which guarantees a margin that adheres to arm's length principles. The margin was based on providing the Taxpayer with a Return on Sales ("**RoS**") based on the results of comparable third party distributors.

Following a transfer pricing audit, the IRB decided to invoke its powers under the Income Tax Act 1967 to adjust the transactions between the Taxpayer and the Related Company, contrary to a detailed transfer pricing analysis prepared by the Taxpayer and represented in transfer pricing documentation. The IRB concluded that the Taxpayer had mischaracterised itself in the functional analysis, and was not a limited risk distributor and should therefore be entitled to a higher compensation.

The IRB also selected five of its own comparable companies, after rejecting those put forward of the Taxpayer, and insisted that transfer pricing adjustments were to be made to the median of the results of the comparable companies, instead of assessing whether the actual results of the tested party were within any point of the arm's length or the interquartile range.

We summarise below the key transfer pricing arguments which were pivotal to the Taxpayer's success.

The Key Transfer Pricing Arguments

1. Use of Interquartile Range being the Correct Approach

A fundamental challenge in this case was the Taxpayer's challenge against the IRB's long standing practice of making transfer pricing adjustments to the median of the arm's length range of the results of the comparable transactions/companies.

The Taxpayer's challenge was on the basis that the Organisation for Economic Co-operation and Development ("**OECD**") has provided guidance that an arm's length range is actually a range that is acceptable for establishing whether the conditions of a controlled transaction are at arm's length. The IRB argued that under the Income Tax Act 1967, it is entitled to adjust to the median, even when the actual results pertaining the to prices charged fall within the interquartile range of the comparable transactions/companies.

2. Recharacterisation based on FAR Analysis and Adjustments

The Taxpayer argued that the IRB disproportionately focused its analysis of the arm's length characterisation of the entities that are counterparties to the transaction on the functions of the Taxpayer, and omitted to provide the due weight to the assets owned and risks assumed. Based on widely accepted transfer pricing principles and methodology, a proper 'functional analysis' must consider the Functions, Assets and Risks ("**FAR**") of the counterparties, and arrive at a conclusion of the characterisation based on what parties at arm's length would conclude and what in turn best supports the application of the best transfer pricing method. The Taxpayer argued that the FAR analysis performed by the IRB failed to do so, and was therefore defective. In addition, the Taxpayer argued that the methodology employed by the IRB in characterising the Taxpayer was based on an incorrect understanding of the Malaysian Transfer Pricing Guidelines and guidelines issued by the OECD.

The IRB in turn argued that it was entitled to draw conclusions on the Taxpayer's functions based on the distribution agreements entered into by the Taxpayer, and that it was not bound to apportion the necessary weight to the assets owned and risks assumed by the Taxpayer in the course of characterising the Taxpayer in relation to the distribution transaction. In addition, the IRB argued that certain functions (namely the advertising and promotional activities) carried out by the Taxpayer demonstrates that the Taxpayer ought to be characterised as a full-fledged distributor.

3. Selection of Comparables

The Taxpayer argued that the IRB had chosen its comparables based on the advertising and promotional level of expenses and selected comparables with similar level of expenses. This approach is not in line with widely accepted transfer pricing principles and methodology in conducting a reasonable and robust economic and comparability analysis to substantiate the arm's length nature of the actual comparables and the transfer prices that they imply are arm's length.

In addition, the Taxpayer contended that the IRB failed to disclose the actual data of the five comparables it had chosen to justify the said adjustments to the results of the taxpayer. Further, the Taxpayer even

attempted to make 'working capital' adjustments to the IRB's own comparables to allow for a fairer and more accurate comparison, which the IRB rejected. This effectively meant that no justification was provided to reject the Taxpayer's comparables or to support the arm's length nature of the IRB's comparables.

The IRB argued that there was no need for it to prepare a comprehensive transfer pricing analysis under law, and that its "work analysis" based on its field audit visit is sufficient justification for the adjustment. Further, it contended that the proposed working capital adjustments involves "complex algebra", and that "…complex algebra is generally not worth the trouble as the resulting adjustments may not be reliable." However, comparability adjustments are broadly accepted under OECD transfer pricing principles and detailed guidance exists in the OECD guidelines on how to apply them reasonably.

4. **Deductibility of Transfer Pricing Adjustments**

It is generally accepted that for distribution arrangements between related parties, the agreement(s) will contain mechanisms to ensure the margin (RoS) is maintained at a pre-agreed level, and adjustments have to be made on a periodical basis to ensure that the prices are appropriately maintained at arm's length levels, relative to comparable third parties.

In this case, the adjustments as stipulated in the Distribution Agreement between the related parties were done by way of grants payments to be made from the Taxpayer to the Related Party in the event that the Taxpayer's profit levels were above the target arm's length margin. These payments in turn were taken as deductions under Section 33 of the Income Tax Act 1967. Conversely, when the profit levels fell below the target arm's length margin, the Taxpayer was compensated by way of the grant mechanism and the compensation was subject to tax. These adjustments are commonly known as "true-up / true-down" adjustments.

The IRB disallowed the deductions on the basis that they were not wholly and exclusively incurred for the production of income. The Taxpayer in turn argued that the true-up/true-down adjustments had no other purpose of existence other than for the purposes of generating the income by ensuring that the margins are maintained at the target arm's length level. Furthermore, the receipt and payments were only made and received for the sole purpose of complying with the terms of the Distribution Agreement.

<u>The SCIT's Decision</u>

On 25 January 2019, the SCIT rendered its decision stating that it agreed with the Taxpayer's arguments and allowed the appeal in full.

<u>Conclusion and Comments</u>

The SCIT's decision is important as it successfully challenged some long standing practices by the IRB which have long troubled taxpayers, namely the inordinate focus on functions in the FAR analysis, the insistence on adjusting to the median, and the frequent failure by the IRB to undertake proper transfer pricing analysis on taxpayers before raising transfer pricing adjustments.

This decision is a much welcomed one, providing clarity and affirmation of the commonly understood transfer pricing principles. The decision is also a timely

reminder on the importance of the preparation of defensible transfer pricing documentation that can withstand scrutiny in the event that an audit or subsequent litigation is unavoidable.

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