LHAG Insights

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Landmark Decision on Transfer Pricing: Section 140A Income Tax Act 1967 and Income Tax (Transfer Pricing) Rules 2012

S v Ketua Pengarah Hasil Dalam Negeri

In a landmark decision yesterday, the Special Commissioners of Income Tax (**SCIT**) discharged an income tax assessment raised by the Inland Revenue Board (**IRB**) pursuant to transfer pricing (**TP**) adjustments made under s 140A of the Income Tax Act 1967 (**ITA**) and the Income Tax (Transfer Pricing) Rules 2012 (**TP Rules**). The courts have previously examined the IRB's general power to disregard transactions, including TP transactions, under s 140 of the ITA. However, this is the first decision addressing s 140A of the ITA and the TP Rules, which were promulgated to specifically deal with TP. The decision will provide welcome guidance on key principles in TP adjustments and the IRB's powers under s 140A of the ITA and the TP Rules.

The taxpayer was successfully represented by Dato' Nitin Nadkarni, Jason Tan Jia Xin and Chris Toh Pei Roo from Lee Hishammuddin Allen & Gledhill's Tax, SST & Customs Practice.

Brief background

The taxpayer is a Malaysian manufacturing company which is part of a large multinational group. It sells its finished products primarily to related parties outside Malaysia.

The taxpayer prepared and submitted its TP documentation based on the Comparable Uncontrolled Pricing (**CUP**) method. The IRB rejected the CUP method and directed the taxpayer to prepare a benchmarking analysis using the Transactional Net Margin Method (**TNMM**).

Despite maintaining its position that CUP was the most suitable method for assessing whether there had been any TP, the taxpayer complied with the IRB's direction. After an exchange of

correspondence, a final list of six comparable companies — three proposed by the taxpayer and three by the IRB — was agreed as acceptable for the purposes of the benchmarking analysis. The taxpayer's results fell within the interquartile range of the comparable companies for all four years under audit, and above the median in three out of the four years.

Nevertheless, the IRB proceeded to make TP adjustments on the taxpayer and issued an assessment for additional taxes. The IRB relied on s 140A of the ITA and Rule 13 of the TP Rules to adjust the taxpayer's results to the median for the one year (out of the four years in question) in which its profits fell below the median profitability of the comparable companies. The IRB rejected the taxpayer's contention that TP principles, as encapsulated in the Organisation for Economic Co-operation and Development TP Guidelines (**OECD Guidelines**),[1] stipulate that no adjustment is needed where the taxpayer's results already fell within the arm's length interquartile range.

Key arguments before SCIT

Dissatisfied with the assessment, the taxpayer appealed to the SCIT, where the following arguments were raised.

1. *No basis for adjustments to be made to the median where the taxpayer's results already fall within the interquartile range*

   The taxpayer argued that the IRB had itself selected TNMM as the most appropriate TP method, and accepted the final list of six comparable companies used. The taxpayer's results fell within the full range of results. The IRB had then narrowed the range by applying the interquartile range, which the taxpayer still fell within.

   In such a case, the OECD Guidelines stipulate that no adjustment should be made.[2] The use of the interquartile range to determine arm's length pricing has also been recognised in the TP practice of other developed jurisdictions including Singapore, the UK and the US, as well as the courts' decisions in France, Spain and Italy.

2. *Alleged comparability defects do not justify adjustment to median*

   During the hearing and in legal submissions, the IRB argued that the six comparable companies suffered from comparability defects which justified an adjustment to be made to the median.[3]

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1 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (July 2010)
2 OECD Guidelines, para 3.60
3 The IRB relied on paragraph 3.57 of the OECD Guidelines

The taxpayer argued that even where comparability defects exist, the OECD Guidelines only recognises the use of statistical tools that take account of central tendency such as the interquartile range to narrow the range, and not the use of the median. The interquartile range would still result in a narrowed range, whereas the median is only a single point in the range.

3. *Comparability adjustments should be demonstrated and documented for transparency*

   Under the OECD Guidelines if comparability adjustments are to be made, they should demonstrably improve the results of the benchmarking analysis. The IRB cannot simply select the median as the appropriate benchmark, without any mathematical or other justification. Any justification should be properly documented for transparency.[4]

4. *Contemporaneous evidence is to be preferred*

   The taxpayer further argued that the IRB had accepted the six comparables used at the material time. The IRB's belated allegation that there were numerous comparability defects was an afterthought. The contemporaneous documentary evidence was preferable to oral testimony at trial, which raised new matters not documented at the time of the audit and assessment.

5. *IRB's powers under s 140A of the ITA*

   The IRB argued that s 140A of the ITA and Rule 13 of the TP Rules give it wide power to make adjustments to the taxpayer's deemed profits to any point, i.e. not just the median but even to a higher point in the upper quartile range. The IRB also argued that the OECD Guidelines had no force of law, but merely provided moral suasion.

   The taxpayer accepted that the IRB is empowered to make TP adjustments under s 140A of the ITA and the TP Rules. However, like any government department, the IRB's powers are not unfettered, and its exercise of discretion is always subject to review by the court. Since the ITA and the TP Rules do not provide guidance on TP principles and the operation of TP methods such as TNMM, guidelines such as the OECD Guidelines are relevant for guidance.

Key takeaways from the SCIT's decision

On 4 February 2021, the SCIT unanimously decided in favour of the taxpayer and allowed the taxpayer's appeal in full, including

[4] OECD Guidelines, para 3.54

discharging the penalty imposed by the IRB. The SCIT's decision should be lauded for recognising the importance of uniformity in transnational tax matters. Importantly, this decision recognises:

(a) The prominence of the OECD Guidelines in TP matters

While the IRB's powers and the taxpayers' obligations are broadly set out in s 140A of the ITA and the TP Rules, guidelines remain important. Domestically, the IRB has issued its Transfer Pricing Guidelines 2012.[5] However, the internationally recognised OECD Guidelines[6] remain the "gold standard" for guidance in TP matters in Malaysia.

(b) That the IRB does not have unfettered discretion to make TP adjustments under s 140A of the ITA and the TP Rules

Since the ITA and the TP Rules do not provide guidance on TP principles and the operation of TP methods such as TNMM, guidelines such as the OECD Guidelines are relevant and cannot be ignored by the IRB.

(c) The importance of proper TP documentation and responses to audit correspondences

This decision further underlines the importance of proper written representations and replies to the IRB in any tax audit, with the benefit of timely input and advice from tax professionals. The courts tend to be suspicious of belated reasons given only at the hearing, whether by taxpayers or the authorities. In TP matters, failure to furnish contemporaneous TP documentation is now an offence under the newly enacted s 113B of the ITA.

Malaysia ranks among the top trading nations in the world and is dependent on attracting significant foreign investment if it is to progress economically. Multinational corporations (MNCs), for whom TP issues are of great importance, are greatly influenced by tax matters when making investment decisions. This decision demonstrates, once again, that Malaysian courts will act fairly and follow international "best practices" in dealing with complex transnational tax issues.

The full grounds of judgment from the SCIT are eagerly anticipated, to provide the necessary clarity and welcome guidance in TP adjustments and the IRB's powers under s 140A of the ITA and the TP Rules.

This is believed to be one of the first cases where judgment has been delivered by the SCIT in a matter heard, at least partly, virtually. The SCIT is to be commended for its commitment to expedite and conclude matters, despite the implementation of the

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5 Accessed at:http://phl.hasil.gov.my/pdf/pdfam/MalaysianTransferPricingGuidelines2012.pdf

6 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (July 2010) (now 2017)

latest Movement Control Order. The SCIT's willingness to embrace the use of technology in delivering justice accords with the spirit of the Practice Direction 1/2021 by the Chief Justice.[7]

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If you have any queries pertaining to tax assessments which have been raised by the IRB, please contact the author or his team partners, **Dato' Nitin Nadkarni** and **Jason Tan Jia Xin**, at **tax@lh-ag.com**

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[7] Arahan Amalan Ketua Hakim Negara Bilangan 1 Tahun 2021 — Pengendalian Prosiding Kes Sivil Melalui Teknologi Komunikasi Jarak Jauh bagi Mahkamah di Seluruh Malaysia