

# Transfer Pricing e-Alert

1 AUGUST 2019

## IRB's Arbitrary Determination Of Profit Level Indicator

In the recent transfer pricing case of *TEMSB v KPHDN*, the issue concerned the different determination of the profit level indicator (**PLI**) adopted by the taxpayer and the Director General of Inland Revenue (**DGIR**). The PLI was used to determine the arm's length price of controlled transactions between the taxpayer and its foreign holding company.

The DGIR invoked Section 140(1) of the Income Tax Act 1967 (**ITA**) and performed transfer pricing adjustments on the taxpayer. Additional tax assessments and penalty were raised, which resulted in the taxpayer appealing to the Special Commissioners of Income Tax (**SCIT**).

Senior partner Datuk D P Naban and partner S Saravana Kumar represented the taxpayer, and successfully resolved the dispute via a settlement agreement recorded before the SCIT. The settlement agreement is binding on both the DGIR and the taxpayer.

### Brief Facts

The taxpayer is a multinational corporation with a foreign holding company and manufactures gold bonding wires mainly used in the production of semiconductors. Gold ingots, the key raw material used, are sourced from the taxpayer's holding company. The holding company procures the gold bars, which are then sent to another intra-group related company to be processed into gold ingots and subsequently to the taxpayer for the manufacturing of gold bonding wires.

The payments made by the taxpayer to the holding company are in respect of the following transactions, which are invoiced to the taxpayer separately:

- Gold price of the pure gold bars sourced from the general market.
- Service fees for the procurement of the gold bars from third party suppliers.

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- Processing costs for converting the gold bars into gold ingots and the refining of gold ingots.

## DGIR's Assessments

The DGIR conducted a transfer pricing audit and performed tax adjustments on the taxpayer. The determination of the arm's length price by the DGIR was as follows:

<b>Transfer pricing method</b>	Transactional Net Margin Method (TNMM)
<b>Comparable companies</b>	The DGIR raised no issue with the comparable companies selected by the taxpayer.
<b>Profit level indicator</b>	Operating Profit Margin ( <b>OPM</b> ), whereby the operating profits are compared with the sales made by the business.
<b>Arm's length range</b>	Transfer pricing adjustment was made based on the median quartile range of the comparable companies.

The DGIR contended that OPM is the more suitable PLI, based on the following reasons:

- OPM is appropriate in situations where there are purchases from a related company and sales to independent customers. The taxpayer's sales are to third uncontrolled parties.
- The comparison to comparable companies is based on the manufacturing function only in view of the difficulty in obtaining comparable companies that produce the same product (bonding wire) as that of the taxpayer.
- The presence of pass-through costs in the form of gold ingots which are based on market price is disputable from the separation of costs from sales price aspect. This is because the taxpayer's manufacturing processes had converted the raw material (gold ingots) to finished goods (gold wire). Hence, the benchmarking can be conducted without the need to separate the cost from the sales price.

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## Taxpayer's Contention

The taxpayer appealed on the premise that the suitable PLI to be used is Return on Assets (**ROA**), based on the following factors:

- The manufacturing business of the taxpayer is asset-intensive, where these assets have a high correlation to profitability. According to the OECD Transfer Pricing Guidelines, the ROA is the appropriate base in cases where assets (rather than costs or sales) are better indicators of the value added by the tested party, for instance, in certain manufacturing and capital-intensive financial activities.
- Meanwhile, OPM is more suitable for distributors with a sales-driven business operation. Here, OPM cannot be used due to the presence of pass-through costs which are based on market price. The key raw material used for the taxpayer's gold bonding wire (gold ingots) makes up the pass-through costs which constitute approximately 95% of the selling price to the taxpayer's customers. In the case of OPM, the denominator of either total costs or sales would include a substantial amount of the pass-through costs. As such, the taxpayer's unique cost structure would have substantial differences from that of comparable companies selected.
- From a legal perspective, the DGIR had no legal basis to invoke Section 140(1) of the ITA and perform transfer pricing adjustments on the taxpayer, which resulted in the impugned tax assessments being raised against the taxpayer.
- The transfer pricing assessments were raised by the DGIR in 2015 for years of assessment (**YA**) 2006, 2008, 2010 and 2011. The assessments raised for YAs 2006 and 2008 were time barred when they were raised in 2015. Under Section 91(3) of the ITA, the assessments are to be raised within five years from the relevant YA, unless it appears to the DGIR that the taxpayer has been negligent or has committed any form of fraud or wilful default.

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- In raising the time-barred assessments, the DGIR had not raised any evidence to support its allegation that the taxpayer had been negligent or had committed any form of fraud or wilful default.
- In invoking Section 140(1), the DGIR had failed to identify the relevant sub-paragraph of the provision which the Inland Revenue Board (**IRB**) was relying on to justify the adjustments made.
- With regard to Section 140(5) of the ITA, the DGIR merely attached its revised tax computation and there was no breakdown or further detail of the transfer pricing adjustments.
- The basis of the IRB applying median adjustment was contested. There was no need to make any adjustment since the taxpayer falls within the inter-quartile range of the benchmarking analysis.

The strength of the evidence and the legal arguments advanced by the taxpayer persuaded the DGIR to re-evaluate its stand.

### Conclusion

Recent trends suggest an increase in transfer pricing audits by the DGIR. Thus, it is important that inter-related company transactions, including the determination of pricing policy, are well documented. In light of the different methodologies available in determining the arm's length price of a transaction, it would be prudent for taxpayers to seek professional advice to ensure that their transactions are at arm's length and that their pricing determination is properly documented.

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The *TEMSB* case illustrates that the DGIR's powers under the ITA are sometimes invoked without conforming to the stipulated requirements. It is well established that the exercise of the DGIR's statutory power cannot be arbitrary and the DGIR does not enjoy unfettered discretion. Our courts subscribe to the principle that the exercise of statutory power must not only comply with the express words of the relevant statute, but also with certain implied legal requirements.

In this regard, in addition to consulting their tax agent, taxpayers are advised to seek proper legal consultation when a transfer pricing audit is being conducted. This is to ensure that the appropriate legal strategy can be developed at an early stage in order to preserve the taxpayer's legal rights.

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