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Transfer Pricing e-Alert

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Transfer Pricing Considerations For Intra-Company Management Services

Section 140A of the Income Tax Act 1967 (**ITA**), which came into operation on 1.1.2009, requires a person to determine and apply the arm's length price for an acquisition or supply of property or services between associated persons. It also empowers the Director General of Inland Revenue (**DGIR**) to substitute the price of a transaction to reflect its arm's length price if there is reason to believe that the price is lower or higher than what might be expected if the parties to the transaction were independent persons dealing at arm's length.

In the *GW Sdn Bhd* tax appeal, the DGIR conducted a tax audit on the taxpayer between 2009 and 2010, during which the taxpayer's intra-company management services for the period 2002 to 2006 were scrutinised. As Section 140A was not applicable to this period, the DGIR invoked Section 140(6) of the ITA instead and disallowed the deduction claimed by the taxpayer for the management fee paid to its holding company. Among others, the DGIR contended that the transaction was not at arm's length and that the services received by the taxpayer were shareholder supervision activities rather than stewardship activities.

Our tax partners, Datuk D P Naban and S Saravana Kumar, successfully represented GW Sdn Bhd, and negotiated an out-of-court settlement with the DGIR.

Brief Facts

The taxpayer is in the business of manufacturing various types of aluminium foil base and film-base related packaging. It had three shareholders: a public listed company (W Bhd, which held the substantial portion of the shares), an individual and a government-linked company. W Bhd provided these management services to the taxpayer:

- Senior management support
- Training
- Finance support

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- Internal operational audit
- Tax, company secretarial and corporate services
- Human resource
- Office support.

The management fee for these services was fixed at 1% of the taxpayer's monthly net turnover. The taxpayer deducted the management fee as its business expenditure under Section 33(1) of the ITA for the years of assessment 2004, 2005 and 2006.

The other separate issue in this case was the taxpayer's reinvestment allowance claim for the expansion, modernisation and automation of its manufacturing business, for which the taxpayer incurred substantial capital expenditure on its factory, plant and machinery. The DGIR had originally disallowed the reinvestment allowance on the basis that the capital expenditure had been incurred on non-production aspects of the manufacturing business. However, on the first day of the hearing before the Special Commissioners of Income Tax (**SCIT**), the DGIR conceded and the taxpayer's reinvestment allowance claim was allowed in full.

DGIR's Assessments

The DGIR disallowed the deduction of management fee, alleging that:

- The fee was not at arm's length;
- There was duplicity of services, in that those management services could be provided by the taxpayer's existing employees;
- The management services were shareholder supervision activities by W Bhd to protect its investment in the taxpayer;
- The management services were to comply with the reporting requirements of the listed holding company.

GW's Appeal

At the SCIT hearing, the strength of the taxpayer's oral and documentary evidence led to the eventual settlement of the appeal, resulting in the DGIR allowing most of the management

fee as a deductible expense. The taxpayer's position was as follows:

- Prior to 1.1.2009, there was no transfer pricing legislation in Malaysia as Section 140A only came into force on that date. The DGIR could not apply Section 140(6) as a substitute to Section 140A(1) and invoke transfer pricing principles based on its Transfer Pricing Guidelines 2003 (**TPG**). Not only does the TPG have no force of law, but the scope of Section 140(6) also does not cover transfer pricing adjustment. This is because if Section 140(6) were wide enough to cover transfer pricing, it begs the question of why must then Parliament enact Section 140A as Parliament does not act in vain.

- Tendered as evidence all the past and present agreements with W Bhd to establish the terms and types of management services received. The terms of the agreements were at arm's length, and were deliberated at the taxpayer's board meeting which the minority shareholders had attended as well.

- Produced the list of employees together with the employees' qualifications, remuneration package and job description to establish that it does not have the resources and expertise to provide the management services received from W Bhd. As such, there was no duplicity of services.

- Submitted a letter from a key minority shareholder who was a prominent investor and independent of W Bhd. The minority shareholder explained that he would not have agreed to the taxpayer paying the management fee if such management services had not been necessary in the course of the taxpayer's business and the price paid was commensurate with the extensive management services rendered by W Bhd.

- It is not open to the DGIR to dictate as to how a taxpayer should conduct its business.

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- W Bhd's witness was able to explain that the nature of management services provided consisted of common business management services and not shareholder activities that were meant to supervise the taxpayer's performance.

- Had the taxpayer employed its own employees to render the management services provided by W Bhd, it would have cost them more than the management fee paid to W Bhd.

Conclusion

A global settlement was successfully negotiated on behalf of the taxpayer, in which the DGIR agreed to allow a substantial part of the management fees incurred in the years of assessment under tax audit and the subsequent years as the taxpayer wanted to bring closure to the matter.

This appeal highlights yet again that Section 140(6) cannot be invoked by the DGIR to perform transfer pricing adjustments. Additionally, the strength of the evidence led by the taxpayer at the SCIT hearing led the DGIR to re-evaluate its stand.

It is important that intra-company services are well documented and characterised to ensure that the payee is able to demonstrate the nature of services and benefits received. The basis of the cost allocation must be appropriate rate, whereby questions such as whether the mark-up should be imposed on a pass-through or third-party cost basis must be examined. Additionally, the documentation must contain the following:

- Description of the intra-company services provided and received;
- Identity of the service recipient and provider;
- Business rationale for the provision and receipt of such services;
- Description of the benefits of each category of services;
- Calculation of the management fee, including the calculation of the cost base, the relevant allocation key and the mark-up applied;
- Confirmation that shareholder activity costs and duplicate costs are excluded.

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Finally, businesses must take note that the revenue authorities in developed economies are reviewing low value intra-company services as part of the OECD's Action Plan on Base Erosion and Profit Shifting. The revisions to Chapter VII of the OECD Transfer Pricing Guidelines on intra-group services aim to achieve a balance between appropriate charges for low value-adding services and head office expenses as well as protecting the tax base of the country where the payer is located. It is a matter of time before the DGIR does the same here.

If you have any queries on strengthening intra-company services from a legal perspective, including the drafting of agreements, please contact **Datuk D P Naban** or **S Saravana Kumar** at **tax@lh-ag.com**

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