

Transfer Pricing e-Alert

4 JULY 2019

Arbitrary Transfer Pricing Assessments Successfully Set Aside

OSB v Ketua Pengarah Hasil Dalam Negeri

In a landmark ruling, the Special Commissioners of Income Tax (**SCIT**) unanimously allowed a tax appeal against transfer pricing tax assessments raised by the Director General of Inland Revenue (**DGIR**). The assessments were raised consequent to a transfer pricing audit.

Our Tax, SST & Customs lawyers, led by senior partner Datuk D P Naban together with partner S Saravana Kumar, and senior associate Jason Tan Jia Xin, successfully represented OSB.

Brief Facts

OSB is a Malaysian importer and distributor of health-related equipment and accessories. OI is a Singaporean company that develops the health products and equipment distributed by OSB in Malaysia. It is also the majority shareholder of OSB. OSB is the Malaysian franchisee of OI by virtue of a franchise agreement executed between the parties.

In 2011, the DGIR made transfer pricing adjustments on the following transactions of OSB with OI for the years of assessment (YAs) 2004, 2005, 2007 and 2008, on the basis that these had not been at arm's length:

- Purchase price paid by OSB for the health products and equipment;
- Advertising and promotional expenses incurred by OSB;
- Royalty paid by OSB to OI;
- Management fees paid by OSB to OI;
- Value of stock returns by OSB to OI in respect of excessive and/or defective stocks.

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Among other things, OSB sought to demonstrate how the purchase price and royalty paid were at least the same as, or lower than, those paid by other third-party franchisees to OI. Royalty and management fees were, in fact, waived for two particular YAs. OSB also presented two different transfer pricing reports prepared by independent tax consultants to substantiate its position that the transactions had been well within arm's length.

Notwithstanding the above, the DGIR proceeded to raise transfer pricing tax assessments with penalty. Aggrieved by the DGIR's decision, OSB filed its tax appeal to the SCIT.

DGIR's Arguments

The DGIR submitted that:

- The burden of proof lies with OSB to prove that the assessments were excessive or erroneous.
- The time-barred assessments were justified as OSB was negligent.
- The DGIR had not disregarded OSB's transactions, but had merely varied them by making adjustments to OSB's net profit to counteract the effect of such transactions on the basis that the transactions had not been at arm's length.
- The DGIR is not required to identify the applicable limb of Section 140(1) of the ITA.
- The DGIR is not required to give the particulars of adjustment together with the assessments.
- The transfer pricing adjustments made had been in accordance with the OECD Transfer Pricing Guidelines and the DGIR's Transfer Pricing Guidelines.
- OSB's transactions had not been at arm's length.
- The penalty imposed was proper, lawful and fully justified.

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OSB's Rebuttal

During the hearing, OSB presented evidence to substantiate the arm's length nature of its transactions with OI and to establish that:

- There is no basis for time-barred assessments as the DGIR has failed to establish negligence, fraud or wilful default on the part of OSB. Among other things:
 - i. OSB had taken professional advice from a reputable firm of tax consultants.
 - ii. OSB had provided all documents requested by the DGIR.
 - iii. OSB had made full and frank disclosure of its tax treatment and filed its tax return within the statutorily prescribed time period.
 - iv. The DGIR had given no reasons to justify the basis for the time-barred assessments.
 - v. There was no attempt by OSB to evade or avoid tax.
- The DGIR had failed to fulfil the requirements of Section 140(5) of the ITA where particulars of the adjustment were to be provided together with the assessments.
- The DGIR has failed to identify the applicable limb of Section 140(1) despite this being a mandatory requirement for invoking the said provision.
- The DGIR has disregarded the OECD Transfer Pricing Guidelines and its own Transfer Pricing Guidelines by applying the Transactional Net Margin Method (**TNMM**) despite the availability and applicability of the Comparable Uncontrolled Price (**CUP**) method.
- There was no rebuttal to the independent transfer pricing reports commissioned by OSB from two independent and reputable tax consultants.

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SCIT's Decision

In their oral grounds, the SCIT found merits in OSB's argument for the following reasons:

- Upon reviewing the evidence presented by both parties at trial and their respective written and oral submissions, the SCIT were of the view that the DGIR had failed to establish how the transactions had not been at arm's length.
- The DGIR failed to comply with Section 140 requirements by failing to identify the applicable sub-provision of Section 140(1) and by failing to provide particulars of the adjustment as stipulated by Section 140(5).
- The DGIR had failed to demonstrate why the TNMM should be used as opposed to the CUP method. OSB's usage of the CUP method was also based on professional advice from independent tax agents.
- There was no evidence of negligence on the part of OSB and thus, the time-barred assessments raised by the DGIR were not justifiable.

Conclusion

This case, to a large extent, demonstrates the transfer pricing dispute trends in Malaysia, which can be summarised as follows:

- The DGIR prefers local comparables, although domestic law does not include such restriction.
- The DGIR prefers examining the average results of the benchmarking analysis, rather than the lower inter-quartile range results.
- Almost all transfer pricing adjustments attract penalties.
- Transfer pricing documentation is requested and provided to the DGIR when the transfer pricing audit starts.

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- In most cases, the DGIR ignores loss-making comparables and arbitrarily only selects profit-making comparables for its benchmarking analysis.
- Transfer pricing assessing officers selectively apply the OECD transfer pricing policies and there is a lack of understanding that transfer pricing is not an exact science.
- There is a failure to appreciate legal and business intricacies.
- Transfer pricing assessing officers do not provide any rebuttal transfer pricing reports or benchmarking analysis. Any benchmarking analysis provided is based on the arbitrary selection of comparables furnished by the taxpayer.
- The DGIR refuses to apply the weighted average method in examining the benchmarking analysis.
- There is a special focus on management fees, advertisement expenses and commissions paid to non-resident companies.

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Our courts have generally managed to balance the rights and interests of both taxpayers and the government. While every taxpayer, whether an individual or a company, must ensure that tax due is duly settled, the courts have also held that it is well established that the exercise of the DGIR's statutory power cannot be arbitrary. It is encouraging that the 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.

If you have any queries pertaining to transfer pricing disputes, please contact **Datuk D P Naban** or **S Saravana Kumar** at tax@lh-ag.com

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