# LHAG Insights

## Special Alert!

Tax, Customs & Trade

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**Income Tax (Transfer Pricing) Rules 2023 – For Better or For Worse?**

On 29 May 2023, the Income Tax (Transfer Pricing) Rules 2023 ("**TPR23**") was gazetted. TPR23 takes effect from the year of assessment ("**YA**") 2023[1] and replaces its decade-old predecessor, the Income Tax (Transfer Pricing) Rules ("**TPR12**").

TPR23 seeks to introduce various changes to transfer pricing ("**TP**") practices in Malaysia. At first blush, not all of them may be welcome. We examine some of these changes below, vis-à-vis the previous position under TPR12.

**1) <u>Narrowing of "Arm's Length Range" to the 37.5th to 62.5th Percentile</u>**

Under TPR12, there was no definition for the arm's length range. Guided by the OECD Guidelines,[2] the Malaysian courts in various landmark TP cases had recognised the interquartile range ("**IQR**") (the 25th to 75th percentile) as the arm's length range.[3] With the promulgation of Rule 13(5) TPR 2023, the arm's length range has now been defined as the 37.5th to 62.5th percentile.

This new and reduced "*arm's length range*" represents a marked departure from international standards and practice. In line with the OECD Guidelines, the IQR is recognised and accepted globally as a determinant of arm's length pricing, including in Singapore, the United

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[1] TPR23, Rule 1(2).

[2] Organization for Economic Cooperation and Development ("**OECD**") Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("**OECD Guidelines**").

[3] See amongst others, ***SEO Sdn Bhd v Ketua Pengarah Hasil Dalam Negeri (KPHDN)*** **(2021) MSTC 10-129** (SCIT); ***KPHDN v Sandakan Edible Oils Sdn Bhd*** **[2023] 1 LNS 616** (HC); ***KPHDN v Procter & Gamble (Malaysia) Sdn Bhd*** **(2022) MSTC 30-523** (HC); ***CFE Ltd v KPHDN*** **(2022) MSTC 10-152** (SCIT).

Kingdom, and the United States.[4] Only a handful of countries have adopted a narrower arm's length range, and even then, these are still wider than Malaysia's:

| | |
|---|---|
| **India[5] and Maldives[6]** | 35th to 65th percentile |
| **Vietnam[7]** | 35th to 75th percentile |

The decision to further narrow the arm's length range is therefore a curious one.

**2) Director General of Inland Revenue's ("DGIR('s)") Power to Make Adjustments even when Price is Within the Arm's Length Range**

Under the OECD Guidelines:

(a) No adjustments are to be made where the taxpayer's result is within the arm's length range. Even where adjustments are to be made (when a taxpayer's result is outside the arm's length range), any points within the arm's length range could be acceptable; and

(b) Further, even where there are comparability defects, the OECD Guidelines do not mandate the use of median for the determinant of arm's length price. Instead, the OECD Guidelines recognise that the appropriate measure of central tendency includes the median, mean, weighted averages, or other measures, depending on the specific characteristics of the data set.

These principles were recognised by the High Court in ***Sandakan Edible Oils***. In particular, the High Court paid heed to the OECD Guidelines' reminder that:

> *"…transfer pricing is not an exact science, there will also be many occasions when the application of the most appropriate method or methods produces a range of figures all of which are relatively equally reliable".*

The High Court further held that median is an "arbitrary measure", noting that:

(a) The median point artificially assumes that a company is engaging in TP if it does not perform in the top 50% of its competitors every single year; and

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[4] According to the OECD TP Country Profiles, other countries that recognise the use of IQR as a determinant of arm's length price include Belgium, Bulgaria, China, Colombia, Costa Rica, Croatia, Czech Republic, Denmark, Dominican Republic, Egypt, Estonia, Finland, France, Georgia, Germany, Hungary, Indonesia, Ireland, Kenya, Liberia, Luxembourg, Malta, Mexico, Nigeria, Norway, Panama, Romania, Russia, Saudi Arabia, Seychelles, Singapore, Slovak Republic, South Africa, Switzerland, Turkey and the United Kingdom.

[5] India's OECD TP Country Profiles <https://www.oecd.org/tax/transfer-pricing/transfer-pricing-country-profile-india.pdf>

[6] Maldives' OECD TP Country Profiles <https://www.oecd.org/ctp/transfer-pricing/transfer-pricing-country-profile-maldives.pdf>

[7] Paragraph 9 of Decree 132/2020/ND-CP prescribing tax administration for enterprises having related-party transactions <https://ketoansaovang.com.vn/m/en/laws/162/decree-132-2020-nd-cp-prescribing-tax-administration-for-enterprises-having-relatedparty-transactions.html>

(b) A range rather than a single point should be used to determine arm's length price where there is a pattern of fluctuating profits between companies, as one would reasonably expect.

Rule 13(2) and Rule 13(3) TPR23 has now specifically empowered the DGIR to adjust the price of a controlled transaction to the median or up to the 62.5th percentile, even if the price falls within the arm's length range. This can be done when:

(a) The uncontrolled transaction has a lesser degree of comparability; or

(b) There are comparability defects that cannot be quantified, identified, or adjusted.

These provisions appear to be a direct response to recent judicial trend in which the IQR has been applied and the median rejected. Regrettably, they also appear to move Malaysia even further away from internationally accepted TP practices.

Another aspect of the High Court's decision in ***Sandakan Edible Oils*** however remains pertinent: comparability defects cannot be merely alleged but must be documented and identified. One can only hope that notwithstanding the seemingly wider powers under Rules 13(2) and 13(3) TPR23, the DGIR will exercise discretion and do so only in appropriate circumstances. Adjustments made to the median may still be challenged even if they are purported to be made under TPR23, and it could be demonstrated that the allegations of comparability defects are unsupported.

**3) Removal of Offsetting Adjustment & Imposition of Surcharge**

Under TPR12, taxpayers were previously allowed to request for the offsetting of adjustments against the assessment of the other party.[8]

TPR23 has removed this provision. Instead, consistent with the enactment of Section 140A(3C) into the ITA,[9] Rule 13(4) TPR23 now empowers the DGIR to impose a surcharge of up to 5% of the increased income or reduced deduction or loss,[10] where adjustments are made.

The removal of the offsetting adjustment provision raises concerns regarding potential double taxation, particularly in cases of domestic controlled transactions, where an adjustment is made to the assessment of the taxpayer, but no corresponding relief is given to the counterparty's assessment.

**4) Removal of Default TP Method**

Under TPR12, the traditional transactional method is recognised as the default TP method. It is only when the traditional transactional method is deemed unreliable that the taxpayer can apply the transactional profit method.[11] If both methods are inappropriate, the taxpayer may then

[8] TPR12, Rule 13(2).
[9] Section 140A(3C) of the Income Tax Act 1967 takes effect from 1 January 2021.
[10] Income Tax Act 1967, Section 140A(3C).
[11] TPR12, Rules 6(1), 6(2) and 6(3).

choose any other method that provides the highest degree of comparability.

Under TPR 23:

(a) There is no longer a default TP method.[12] Taxpayers now have the option, subject to the DGIR's discretion, to apply any method that provides the highest degree of comparability;

(b) Further, taxpayers must now:[13]

i. Explain and justify the method selected. Where the transactional profit method is used, the taxpayer must also justify the use of the profit level indicator[14] selected; and

ii. Ensure that the method selection is based on accurately delineated facts and circumstances, including the economically relevant characteristics[15] of the controlled transaction;[16]

(c) The DGIR is also empowered to review the selected method for determining the arm's length price based on the justification provided in accordance with Rule 6(2) TPR23.[17] If the DGIR determines that the selected method is not the most appropriate method, the DGIR has the discretion to replace it.[18]

## 5) Delineation of Controlled Transactions & Selection of Comparables

In using an uncontrolled transaction as a comparable in a controlled transaction, a taxpayer must now first accurately delineate the controlled transaction by identifying the commercial or financial relations between

[12] With the revision to Rule 6(1) TPR23.
[13] TPR23, Rule 6(2).
[14] "Profit level indicator" has been defined under the revised Rule 6(4) TPR23 as "a measure of a person's profitability that is used to compare a controlled transaction with a comparable uncontrolled transaction".
[15] The TPR23 has substituted the phrase of "comparability factors" (previously used under TPR12) with "economically relevant characteristics". Pursuant to the revised Rule 7(4), TPR23 has updated the "economically relevant characteristics" to be taken into account when delineating the controlled transactions and determination of comparable. Notably, Rule 7(4)(b) TPR further elaborated on the characteristic of functions performed by each associated persons, taking into account the assets employed and risk assumed. It is now an express requirement to consider the impact of the functions on the wider generation of value, the surrounding circumstances of the transactions and the industry practices (Rule 7(4)(b)(i) TPR23) as well as the actual and contractual risks, its economic significance and impact on pricing (Rule 7(4)(b)(ii) TPR23). Further, with the revised Rule 7(4)(d) TPR23, in addition to economic circumstances, the market condition is also now an economic relevant circumstance.
[16] TPR23, Rule 6(2)(b).
[17] TPR23, Rule 6(3)(a).
[18] TPR23, Rule 6(3)(b).

associated persons based on economically relevant characteristics.[19] This appears consistent with the OECD Guidelines.[20]

Further, Rule 7(5) TPR23 has been revised to disallow the use of complete and accurate data from years after the basis period to demonstrate the impact of the life or business cycles of the property or services in relation to the controlled transaction. The DGIR will only allow the use of data from the year under examination and prior years, provided that:

(a) The data can increase the reliability of the comparability analysis;[21] and

(b) The life or business cycles of the property or services will not be impacted by the commercial or financial relations between the associated persons.[22]

According to the revised Rule7(6) TPR23 (previously Rule 7(4) TPR12), data from the year under examination and prior years can only be utilised for assisting in the selection of uncontrolled transaction as comparables, and not for the use of multiple year averages.

This appears consistent with the DGIR's position stated during its Dialog Session with CTIM Technical Committee on TP,[23] where it clarified that multiple year data can be used for "*analysing the case and taxpayer information or performance over a period of time*". Moreover, the qualitative and quantitative basis and criteria for the selection of all comparables must be included in the contemporaneous TP documentation in accordance with Schedule 2 TPR23.

**6) Preparation of Contemporaneous TP Documentation**

Under TPR12, TP documentation is considered contemporaneous if it is created during the development or implementation of the controlled transaction.[24] Additionally, if there were material changes during a basis period for a YA, the documentation must be updated before the due date for filing a return for that period.

The key changes made by TPR23 are:

(a) TP documentation would now be regarded as "contemporaneous" if it is created before the due date for filing a return in the basis period for the YA in which the controlled

[19] TPR23, Rule7(2).
[20] Chapter I, Section D.1 of the OECD Guidelines <https://read.oecd-ilibrary.org/taxation/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-2022_0e655865-en#page257>
[21] TPR23, Rule 7(5)(a).
[22] TPR23, Rule 7(5)(a).
[23] Part C, paragraph 5 of the Dialog Session with CTIM Technical Committee on Transfer Pricing (TC-TP) relating to the Transfer Pricing Guidelines (Updated Version) – Chapter II and Chapter XI <https://phl.hasil.gov.my/pdf/pdfam/FAQ_as_at_01112018.pdf>
[24] TPR12, Rule 4(3).

transaction takes place.[25] Data from the years after that basis period will no longer be allowed to be applied as a comparable;[26]

(b) The completion date of the contemporaneous TP documentation must now be stated in the document;[27]

(c) TPR23 now provides more specific and detailed guidance on information, data, or documents ("**Information**") that the contemporaneous TP documentation must include.[28] Amongst others:

i. Schedule 2 specifies the necessary business information;

ii. Schedule 3 addresses Information pertaining to Cost Contribution Arrangements; and

iii. Only Information that has been "*used... to determine an arm's length price*" (previously, Information that was merely "*considered relevant*").[29] If any Information is inapplicable, this must now be indicated by the taxpayer;[30]

(d) New legal requirements for the preparation and furnishing of TP documentation have been introduced. Taxpayers are now obliged to:[31]

i. Use the most current reliable and reasonably available Information to prepare the contemporaneous TP documentation and determine the arm's length price;[32]

ii. Keep and retain the Information used in a manner that is readily ascertainable and accessible by the DGIR;[33] and

iii. Furnish the contemporaneous TP documentation to the DGIR within 14 days upon being notified to do so.[34]

It must be noted that pursuant to Section 113B of the Income Tax Act 1967 ("**ITA**"), a failure to furnish contemporaneous TP documentation constitutes an offence punishable by a fine of between RM20,000 to RM100,000, imprisonment of up to 6 months, or both.

It remains to be seen how the DGIR would balance the requirements for use of "*reasonably available*" Information for the preparation of TP documentation with its penchant for finding supposed "*comparability defects*". For instance, a taxpayer entering into a controlled transaction in a YA and preparing TP documentation for the same would have

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[25] TPR23, Rule 4(1).
[26] Rule 7(5) TPR12 previously allowed for the use of data from the years after the basis period as a comparable. This has now been removed in Rule 7(5) TPR23.
[27] TPR23, Rule 4(2)(e).
[28] TPR23, Rule 4(2).
[29] TPR23, Rule 4(2).
[30] TPR23, Rule 4(5).
[31] TPR23, Rule 5.
[32] TPR23, Rule 5(1).
[33] TPR23, Rule 5(2).
[34] TPR23, Rule 5(3).

limited information regarding its comparable (effectively, its competitors) for the same YAs. To what extent can the DGIR rely on such limitations as a "*comparability defect*" that had not been "*quantified, identified, or adjusted*" to justify adjustments to the median pursuant to the new Rule 13 TPR23?

**7) <u>Information Required for TP Documentation for Multinational Enterprise ("MNE") Group</u>**

TPR23 has also introduced several provisions that govern TP practices for MNE Groups. Firstly, pursuant to Rule 4(4) TPR23, MNE Group is now defined as:

(a) A "*collection of enterprises related through ownership or control*";

(b) That is either "*required to prepare consolidated financial statements for financial reporting purposes under the applicable accounting principles" or "would be so required if equity interest in any of its enterprises were traded on public securities exchange*".

This definition includes "*two or more enterprises for which the tax residence is in different jurisdictions, or an enterprise that is resident in Malaysia and is subject to tax with respect to the business carried out through a permanent establishment in another jurisdiction*", or vice versa.

With TPR23, Schedule 1 has also been introduced to specify the information required for the contemporaneous TP documentation of MNE Group. The documentation requirement specified in Schedule 1 is only available in a Master File, which is typically compiled at the enterprise level by the parent company. Further, it only applies to MNE Group that is subject to the Country-by-Country Reporting requirements i.e., MNE Group that has a consolidated group revenue of €750 million.[35] As such, this additional documentation requirement may pose challenges in terms of compliance as the documentation may not be readily available to the MNE Group members.

**8) <u>Expansion of Definition for Intangible Property & Income Attributable to Intangible Property</u>**

Under TPR12:

(a) "*Intangible property*" was merely defined as including "*patent, invention, formula, process, design, model, plan, trade secret, know-how or marketing intangible*"[36]; and

(b) "*Marketing intangibles*" were described as those which "*aids in the commercial exploitation of the property or has an important promotional value for the property concerned*".

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[35] Paragraphs 8 and 9 of Action 13: Guidance on the Implementation of Transfer Pricing Documentation and Country-by-Country Reporting by OECD <https://www.oecd.org/ctp/beps-action-13-guidance-implementation-tp-documentation-cbc-reporting.pdf>

[36] TPR12, Rule 11(7).

TPR23 has expanded these definitions:

(a) In addition to the examples given in TPR12, Rule 11(7) TPR23 now defines "*intangible property*" as "*an asset which is neither a physical asset nor a financial asset, but such asset is capable of being owned or controlled for use in commercial purposes, whose use or transfer would be compensated had it occurred in a transaction between independent persons in comparable circumstances*";

(b) TPR23 also extended the definition of "*marketing intangibles*" to specifically include "*trademarks, trade names, customer lists, customer relationships and proprietary market and customer data that is used or aids in marketing and selling property or services to customers*".

It must be noted that these newly specified intangible property is not typically included in financial statements. Taxpayers must now consider what "*asset which is neither a physical asset nor a financial asset*" would have to be taken into account in determining the arm's length price.

Further, it appears that the emphasis of the TPR23 for intangible property is now on contributions performed and risks assumed rather than mere ownership:

(a) Previously, Rule11(6) TPR12 contained a deeming provision; a person will be deemed an owner of an intangible property and will be entitled to the income attributable to the property so long as he has borne the expenses and risks related to the development of the property;

(b) Pursuant to Rule 11(4) TPR23, regardless of legal ownership, a person will be entitled to an arm's length consideration for their contributions to the value of the intangible property through the functions performed or risks assumed in its development, enhancement, maintenance, protection, or exploitation.

Similarly, Rule 11(6) TPR23 now provides that if a person does not perform any functions or control the functions or risks as mentioned above, they will not be entitled to the income attributable to the intangible property, even if they are the owner of such property.

These new developments appear to be consistent with the OECD Guidelines.[37]

**Concluding Thoughts**

Charitable observers may view TPR23 as a laudable attempt to balance between the competing considerations of aligning Malaysia with

[37]Chapter VI, Section B, Paragraph 6.32 of the OECD Guidelines <https://read.oecd-ilibrary.org/taxation/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-2022_0e655865-en#page257>

international TP practices, such as the OECD Guidelines, whilst simultaneously allowing them to maintain long-cherished (and contested) policies (such as the use of the median in TP adjustments).

Others may question the wisdom of prescribing what appears to be a globally unprecedented and narrowed "*arm's length range*", together with the use of the median to determine arm's length pricing. One cannot but help recall the KLHC's observation of the median as a poor determinant and "*arbitrary measure*" of arm's length pricing.

Malaysia has been vocal about its ambitions to attract foreign investment, and confident of its prospects based on good governance[38] and clear economic policies.[39] One cannot but wonder to what extent such ambitions and policies have been factored into the drafting and implementation of TPR23. Multinational corporations with significant volume of transactions with associated overseas entities would no doubt ponder upon the significance of TPR23 and its impact on their business practices.

Of one thing one can be certain: TP disputes will continue to be heavily contested.

A thorough comparison between the TPR23 and TPR12 can be viewed here.

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The taxpayer in Sandakan Edible Oils was successfully represented at both the SCIT and the KLHC by Dato' Nitin Nadkarni, Jason Tan Jia Xin and Chris Toh Pei Roo from Lee Hishammuddin Allen & Gledhill's Tax, Customs & Trade Practice.

If you have any queries pertaining to the KLHC's decision in ***Sandakan Edible Oils***, the 2023 TP Rules, or transfer pricing matters generally, please contact the authors or their team partners, Jason Tan Jia Xin , Ivy Ling Yieng Ping or consultant, Dato' Nitin Nadkarni at tax@lh-ag.com.



[38] https://www.malaymail.com/news/malaysia/2023/05/14/pm-anwar-unity-govts-good-governance-attracts-foreign-investors-boosts-revenue/69242

[39] https://www.thestar.com.my/news/nation/2023/05/22/pm-foreign-investors-attracted-by-malaysias-clear-economic-policies

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