



TRANSFER PRICING FLASH

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The Arm's Length Range – It's Finally Defined!

Since the onset of transfer pricing ["TP"] audits in the country, the Inland Revenue Board ["IRB"] has always adopted the practice of making TP adjustments using the median value of the range of comparables' results. For the past 2 years, we have seen several domestic cases (such as Procter & Gamble Sdn Bhd and Sandakan Edible Oils Sdn Bhd) where taxpayers have successfully challenged this long-standing practice of the IRB.

Following the issues disputed in these cases which have ruled in favour of the taxpayers, we now have the revised Income Tax (Transfer Pricing) Rules 2023 ["TP Rules 2023"] providing more explanation and certainty in the application of arm's length principle as compared to the Income Tax (Transfer Pricing) Rules 2012.

When and how TP adjustments be made?

We are all familiar that during TP audits, when the IRB is assessing the profitability of taxpayers in cases where the profit ratios are used in their benchmarking analysis, the IRB would not make TP adjustments where the taxpayers' results are above the median of the comparables' range of results. The said adjustments would only be made where the taxpayers' results for the year under audit fall short of the median.

This IRB's practice has been one of the issues of dispute in courts as it is not in line with the key principles outlined in the OECD Transfer Pricing Guidelines which clarifies that the application of the most appropriate method or methods in TP may produce a range of equally reliable figures where these differences in figures that comprise the range may be caused by approximation of the conditions that would have been established between independent enterprises. It is reasonable to deduce that any price or margin agreed between related parties within the minimum to the maximum value of the range of results would comply with the arm's length principle provided all the comparable transactions examined have relatively equal degree of comparability with the controlled transactions under review.

The IRB has finally decided what is considered arm's length, as seen from the TP Rules 2023.... And it is no surprise that TP adjustment would still be made if the taxpayer's results do not fall within the arm's length range. Taxpayers can now breathe the air of relief that their results would not be subject to TP adjustments if they fit within the arm's length range. *However, the Director General ["DG"] has the power to adjust the transfer price where the uncontrolled transactions have lesser degree of comparability compared to the controlled transactions or where any of the comparability defects cannot be quantified, identified or adjusted.* In such a situation, the DG may adjust the price of the controlled transaction to the median or any point above the median within the arm's length range. Any TP adjustments made by the IRB will attract a surcharge under the Section 140A(3C) of the Income Tax Act 1967, of not more than 5%, regardless of whether the TP adjustments would give rise to any additional tax liability.

These TP Rules 2023 are effective year of assessment 2023 onwards.

What is considered to be “the arm’s length range”?

The arm’s length range to be adopted by the IRB is quite different from the current practice. The arm’s length range is defined in the TP Rules 2023 to mean a range of figures or a single figure falling between the value of 37.5 percentile to 62.5 percentile of the data set.

This is a narrower range compared to the interquartile range widely used in benchmarking studies prepared by TP practitioners which takes the figures from the value of 25 to 75 percentile. As such, the derivation of the arm’s length range will take effect for controlled transactions under TP analysis for financial year 2023 onwards.

What else can the IRB do?

In addition to the above, the DG can replace the TP method selected by the taxpayer if he has reason to believe that the method is not the most appropriate method to determine the arm’s length price. This includes the choice of profit level indicator used in the TP documentation.

This simply means that a TP method used in determining an arm’s length price of a foreign related party with whom the taxpayer transacts may not necessarily be the most appropriate TP method for local TP purposes. The facts and circumstances of the controlled transactions of the taxpayer must be examined from local TP perspective.

It should be known by now that lots of effort and time must be invested in preparing a defense-ready TP documentation. A benchmarking study backed by carefully thought through and researched comparability analysis will withstand the challenge of the IRB during audits.

Stay tuned to our next TP Flash for more details of the TP Rules 2023.

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