



TRANSFER PRICING FLASH

17th September 2021

SEO Sdn Bhd v Ketua Pengarah Hasil Dalam Negeri [“KPHDN”]

As transfer pricing [“TP”] has increasingly become the focus for the Malaysian Inland Revenue Board [“IRB”] in recent years, the spike in TP audits is an expected trend. As more taxpayers are being challenged in audit situations, the disputes between the taxpayers and IRB have heightened leading to more litigations on TP issues taken up before the Malaysian courts.

In February 2021, another TP litigation case was concluded at the Special Commissioners of Income Tax Malaysia [“SCIT”]. The case is **SEO Sdn Bhd v KPHDN**. In this case, the IRB raised additional assessment after making an adjustment to the taxpayer’s (or “SEO”) margin according to the median value of the interquartile range of comparables’ results. SEO appealed before the SCIT and the SCIT ruled in favour of SEO.

SEO is a refining company principally involved in selling cooking oil and related products. Its products were sold to related and independent parties outside Malaysia. The IRB conducted a TP audit on SEO in March 2015 for year of assessment [“YA”] 2010 to YA 2013. During these years under audit, SEO recorded fluctuating profits. The IRB requested SEO for supporting documents to prove that the sales to its related parties were transacted at arm’s length. SEO had earlier appointed a consultant to prepare a transfer pricing documentation [“TP doc”] for financial year [“FY”] 2012. The consultant subsequently submitted the FY 2012 TP doc adopting the external Comparable Uncontrolled Price [“CUP”] method to justify that the sales by SEO to its related parties were in line with the arm’s length principle.

The IRB disagreed with the CUP method and provided its reasons for rejecting the use of CUP in its letter to SEO. However, SEO did not respond to the said letter nor did it oppose the reasons given by the IRB for rejecting the use of CUP during Court hearings. Following the IRB’s request, SEO subsequently provided a benchmarking analysis for the years under audit using the Transactional Net Margin Method [“TNMM”]. Finally, both the IRB and SEO settled with six (6) comparable companies in oil refining. After removing outliers, the range of benchmark results was from a minimum to maximum value. This benchmark results were also presented at the Court. The IRB adjusted SEO’s taxable profits for one year out of the 4 years under audit where its margin fell below the median of the range of results. Despite that the margin was within the interquartile range, the IRB adjusted SEO’s margin up to median value. The TP adjustment made by the IRB resulted in additional tax including penalty imposed on SEO.

The primary issues in this case were:-

- i. In making TP adjustment pursuant to Section 140A of the Income Tax Act 1967 ["ITA"], whether the Director General of Inland Revenue ["DGIR"] is required under the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations issued by Organisation for Economic Co-operation and Development ["OECD"], hereinafter referred to as OECD TP Guidelines or the Malaysian Transfer Pricing Guidelines 2012 ["MTPG"] to adjust the taxpayer's profits to median in cases where the margin is within the interquartile range;
- ii. Whether the DGIR correctly invoked Section 140A of the ITA to issue additional assessment for YA 2010; and
- iii. Whether there was any legal or factual basis for DGIR to impose penalty under Section 113(2) of the ITA.

The IRB has relied on the median value of the range of results for TP adjustment since the onset of conducting TP audits more than a decade ago. In this case, the SCIT's decisions favouring the taxpayer against the use of median for TP adjustment, can be summarised as below:-

- The DGIR has discretionary power to make an arm's length price adjustment under Section 140A of the ITA. The Income Tax (Transfer Pricing) Rules 2012 ["TP Rules"], Rule 13(1) provides that when the DGIR has reason to believe that the price charged in a controlled transaction is not an arm's length price, the DGIR has the discretion whether or not to make an adjustment to reflect the arm's length price by substituting or charging the price. Hence, making adjustment to indicate the arm's length price is not a mandatory requirement.
- Although the DGIR has accepted the use of the final 6 comparable companies, it had highlighted that there were still comparability defects. The Court had the opinion that the DGIR ought to have allowed other methods that would provide highest degree of comparability as per TP Rules, Rule 5(3).
- The DGIR has failed to support the decision to use the median point. The reasons given were existence of comparability defects and failure to meet the requirements under TP Rules, Rule 6(3). The reasons were inconsistent with the action taken, who agreed to use the 6 comparables when there were comparability defects.

The important message we wish to convey from the SEO's case above:-

- The facts and circumstance of this case set a precedence for application of a range of value, instead of a single value, as a reasonable approximation of the arm's length results. However, despite the judgement of this case favouring the taxpayer, it is not surprising that the IRB will continue its practice to adopt the median value to make TP adjustment. However, this case does give some assurance to taxpayers that their results below the median value do not necessarily point to TP as the root cause provided their results are within the arm's length range.
- The onus is on taxpayers to prove that its related party transactions are conducted in accordance with the arm's length principle. SEO placed itself in a favourable position before the court by complying with the TP legislation and preparing in advance a TP doc which is the primary document to justify that its related party transactions are in compliance with the said principle.
- The benchmarking analysis in a TP doc is often subject to the IRB's scrutiny. It is common practice in TP audits that the comparable companies are often being challenged and disputed by the IRB that leads to rejection of some, if not all, comparables in the analysis. Thus, producing a different range of results as compared to the original set presented in the TP doc.

After the introduction of the new penalty provisions which are effective 1st January 2021, it is more critical now for taxpayers to comply with the TP legal requirements. A robust TP analysis, as opposed to a “plain vanilla” analysis, will warrant the taxpayers a better chance to withstand the challenge of the IRB from audit through to litigation stage.

Strive to protect your organisation's TP position by being tax compliant. Please feel free to contact us at tax@moore.com.my.

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