

20 APRIL 2022

Transfer Pricing Adjustments: Applicability Of Section 140 Of The ITA

Contact Persons:

Datuk D P Naban
Senior Partner
Tax, SST & Customs Practice
☎ +603 6209 5405
✉ naban@rdslawpartners.com

S Saravana Kumar
Partner
Tax, SST & Customs Practice
☎ +603 6209 5404
✉ sara@rdslawpartners.com

Section 140(1) of the Income Tax Act 1967 (ITA) provides vast powers to the Inland Revenue Board (IRB) to counter-act any tax avoidance scheme by disregarding or varying certain transactions and making appropriate adjustments.

In the recent case of *OMSB v KPHDN*, the Special Commissioner of Income Tax (SCIT) has set aside the transfer pricing tax assessment raised by the IRB on the premise that Section 140(1) does not empower the IRB to perform transfer pricing assessment.

Recently, the IRB withdrew its appeal at the High Court and the decision of the SCIT was affirmed. The taxpayer was successfully represented by the firm's Senior Partner, Datuk D.P. Naban and the firm's Tax, SST & Customs Partner, S. Saravana Kumar.

Brief Facts

The taxpayer's principal business is the importation and distribution of health-related equipment and accessories manufactured by a Singaporean company known as OI Pte Ltd. As a full-fledged risk bearing distributor, the taxpayer undertakes decision making functions relating to the location of retail outlets and sale counters as well as advertising and promotional (A&P) activities to drive the sales and market growth of the products in Malaysia.

In 2009, the IRB conducted a transfer pricing audit on the taxpayer and raised the following issues:

- 4 out of 7 of the comparable companies proposed by the taxpayer in its benchmarking were not acceptable for the IRB.
- The A&P expenses allocated by the taxpayer were excessive and the expenses incurred by the taxpayer (i.e. purchase price, A&P expenses, royalty and management fee) were not at arm's length.

**REIMAGINING
TAX
SOLUTIONS**

- The Transactional Net Margin Method (TNMM) should be used instead of the Resale Price Method.

During the audit, the taxpayer provided a detailed explanation of its transfer pricing methodology and submitted two transfer pricing reports prepared by two different independent tax agents to support its comparability analysis that the related party transactions were at arm's length.

Notwithstanding the explanations given, the IRB ignored the same and arbitrarily made transfer pricing adjustments. The IRB raised tax assessments with penalty for the years of assessment 2004 to 2008. The IRB merely attached a one page tax computation of the transfer pricing adjustment to the final audit letter. This letter did not provide any breakdown or further details of the transfer pricing adjustments made. Being aggrieved by the IRB's arbitrary decision, the taxpayer appealed to the SCIT.

The IRB's Submission

The DGIR alleged that the taxpayer had failed to prove that the transactions entered by the taxpayer were in accordance with the arm's length principle. The crux of the IRB's submission is summarised as follows:

- (a) The burden of proof is on the taxpayer to show that the tax assessments were wrong and not on the IRB to prove otherwise.
- (b) The taxpayer had been negligent due to its failure to furnish evidence to support that payment made for the management fee for the YA 2004 was at arm's length.
- (c) The IRB may make such adjustments as it thinks fit to counteract the whole or part of any direct or indirect effect of the transaction.
- (d) There is no requirement for the IRB to identify the sub-limb of Section 140(1) of the ITA or for the IRB to provide the particulars of adjustment together with the tax assessments pursuant to Section 140(5) of the ITA.
- (e) The IRB had correctly made the transfer pricing adjustments in accordance with the OECD Transfer Pricing Guidelines and its own Transfer Pricing

OUR EXPERTISE:

Income Tax

- Tax Litigation & Appeal
- Judicial Review
- Dispute Resolution Proceedings
- Tax Audit & Investigation
- Tax Advisory & Restructuring (Legal)
- Employment Tax
- Transfer Pricing
- Tax Avoidance & Evasion
- Civil Recovery Proceedings
- Criminal Tax Investigation

Sales & Service Tax

- SST Litigation & Appeal
- SST Audit & Investigation
- SST Advisory (Legal)

Customs Duty, Excise Duty, Safeguard Duty & Anti-Dumping Duty

Trade Facilitation & Incentives

Real Property Gains Tax

Stamp Duty

Anti-Profitteering

GST Disputes

Guidelines 2003 on the allegation that some transactions undertaken by the taxpayer were not conducted at arm's length.

- (g) The penalties imposed upon the taxpayer after considering all facts and circumstances of the case were justified.

The Taxpayer's Submission

The taxpayer's position was that the IRB had erroneously made the transfer pricing adjustments and had failed to comply with Section 140(1) of the ITA. The crux of the taxpayer's submission is summarised as follows:

- (a) The IRB had failed to prove that the taxpayer was negligent in managing its transfer pricing treatment. The delay in issuing the time-barred assessment was entirely the DGIR's own doing and not because the taxpayer was negligent.
- (b) In making the transfer pricing adjustments, the IRB had failed to provide any reason to believe why the IRB had alleged that the transactions were not at arm's length.
- (c) Additionally, the IRB failed to provide a rebuttal report to the 2 detailed transfer pricing reports submitted by the taxpayer.
- (d) The IRB failed to provide the particulars of adjustment together with the tax assessments, which was a mandatory duty imposed on the IRB under Section 140(5).
- (e) The taxpayer relied on cases like *Port Dickson Power Bhd v KPHDN* [2012] MSTC 30-045, *MM Sdn Bhd v KPHDN* [2013] MSTC 10-046 and *KPHDN v Rainforest Heights Sdn Bhd* [2019] 1 LNS 513 to support its contention that the failure of IRB to identify the sub-limb of Section 140(1) to rely on would render the assessments raised to be fatal.
- (f) The IRB had erroneously made the transfer pricing adjustments by violating the OECD Transfer Pricing Guidelines and its own Transfer Pricing Guidelines. In addition to this, the IRB had completely disregarded the

OUR EXPERTISE:

Income Tax

- Tax Litigation & Appeal
- Judicial Review
- Dispute Resolution Proceedings
- Tax Audit & Investigation
- Tax Advisory & Restructuring (Legal)
- Employment Tax
- Transfer Pricing
- Tax Avoidance & Evasion
- Civil Recovery Proceedings
- Criminal Tax Investigation

Sales & Service Tax

- SST Litigation & Appeal
- SST Audit & Investigation
- SST Advisory (Legal)

Customs Duty, Excise Duty, Safeguard Duty & Anti-Dumping Duty

Trade Facilitation & Incentives

Real Property Gains Tax

Stamp Duty

Anti-Profitteering

GST Disputes

comparability test analysis done by two different independent tax agents and went ahead to apply TNMM without providing any reasons for doing so.

- (g) The taxpayer's transactions were perfectly made at arm's length. The burden was on the IRB to establish that the taxpayer's purchases or expenses were not at arm's length.
- (h) The IRB had failed to realise that both purchase price and royalty paid by the taxpayer to OI were lower or the same as other franchisees or distributors. Hence, the transaction was at arm's length. Further, the management fee payable by the taxpayer had been waived by Singapore related party for the YAs 2007 and 2009.
- (i) The IRB had also failed to realise that bulk expenses were allocated for A&P as the taxpayer needed to prepare A&P materials in 3 main languages i.e. English, Bahasa Malaysia and Mandarin when compared to the other franchisees in the region. The size of the taxpayer's market penetration for healthy lifestyle products in Malaysia is larger compared to other franchisees as well.

OUR EXPERTISE:

Income Tax

- Tax Litigation & Appeal
- Judicial Review
- Dispute Resolution Proceedings
- Tax Audit & Investigation
- Tax Advisory & Restructuring (Legal)
- Employment Tax
- Transfer Pricing
- Tax Avoidance & Evasion
- Civil Recovery Proceedings
- Criminal Tax Investigation

Sales & Service Tax

- SST Litigation & Appeal
- SST Audit & Investigation
- SST Advisory (Legal)

Customs Duty, Excise Duty, Safeguard Duty & Anti-Dumping Duty

Trade Facilitation & Incentives

Real Property Gains Tax

Stamp Duty

Anti-Profitteering

GST Disputes

The SCIT's Decision

The SCIT found merits in the taxpayer's submission and allowed the taxpayer's appeal for the following reasons:

- (a) The IRB had failed to identify and establish the applicable sub-limb of Section 140(1) of the ITA in varying and/or disregarding the transactions of the taxpayer.
- (b) The IRB had failed to provide particulars of the adjustment together with the tax assessments.
- (c) The IRB had no basis to demand for the TNMM method to be used to determine whether the transactions entered into by the taxpayer were at arm's length.
- (d) The IRB had failed to establish negligence in raising time-barred assessments pursuant to Section 91(3) of the ITA.

Contact Persons:

Datuk D P Naban
Senior Partner
Tax, SST & Customs Practice
☎ +603 6209 5405
✉ naban@rdslawpartners.com

S Saravana Kumar
Partner
Tax, SST & Customs Practice
☎ +603 6209 5404
✉ sara@rdslawpartners.com



About Us

We are a full-service commercial law firm with a head office in Kuala Lumpur and a branch office in Penang. Our key areas of practice are as follows:-

- Appellate Advocacy
- Banking & Finance (Conventional and Islamic)
- Capital Markets (Debt and Equity)
- Civil & Commercial Disputes
- Competition Law
- Construction & Arbitration
- Corporate Fraud
- Corporate & Commercial
- Personal Data Protection
- Employment & Industrial Relations
- Energy, Infrastructure & Projects
- Construction & Arbitration
- Fintech
- Government & Regulatory Compliance
- Intellectual Property
- Medical Negligence
- Mergers & Acquisitions
- Real Estate Transactions
- Shipping & Maritime
- Tax, SST & Customs
- Tax Incentives
- Trade Facilitation

Conclusion

This landmark ruling serves as a reminder to the public authorities that Section 140(1) of the ITA is not to be applied arbitrarily as:

- The IRB is duty bound to establish to which sub-limb of Section 140(1) of the ITA the transaction falls within.
- Section 140(5) of the ITA makes it clear that in making any adjustment and raising an assessment, the IRB must issue particulars of the adjustment together with the notice of assessment. Failure to do so will result in the assessments being declared null and void.
- Section 140(6) of the ITA is a deeming provision. It must be read together with Section 140(1) on the premise that they form an integral portion of the operation of the other. The burden of proof will only shift to the taxpayer when the IRB is able to show the existence of facts that entitled the IRB to invoke Section 140(6).
- In rejecting the taxpayer's proposed transfer pricing methodology, the IRB has a duty to conduct a proper comparability test analysis on its own and provide a valid justification to the taxpayer. A mere one-page tax computation showed that the IRB had no good reasons to substantiate its ground.

Authored by Felicia Wong Sie Ying, a pupil with the firm's Tax, SST & Customs practice.

**REIMAGINING
TAX
SOLUTIONS**