15 FEBRUARY 2022

SEO Sdn Bhd v KPHDN – A Recent Transfer Pricing Ruling

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Recently in *SEO Sdn Bhd v Ketua Pengarah Hasil Dalam Negeri*, the Special Commissioner of Income Tax (SCIT) allowed the taxpayer's appeal in setting aside the transfer pricing assessment raised by the Director General Inland Revenue's (DGIR). This alert highlights the key points of this appeal.

Background

The taxpayer was incorporated in Malaysia and was a refining company selling cooking oil and related products to parties outside Malaysia (controlled transactions). In 2015, the DGIR conducted a transfer pricing audit on the taxpayer. The taxpayer provided a benchmark analysis for the year of assessment (YA) 2010 by comparing with other refining companies in Malaysia to compare its transaction against transactions of other comparable entities in the same field.

The taxpayer suggested 4 companies while the DGIR suggested 9 companies but 3 of the companies proposed by the DGIR was rejected by the taxpayer and the DGIR had agreed to this. In addition, both parties had agreed to use the transactional net margin method (TNMM) to determine the transfer price.

Subsequently, the DGIR adjusted the taxpayer's price margin to 1.23% of median point as an arm's length transaction by applying Section 140A(3) of the Income Tax Act 1967 (ITA) and Rule 13(1) of Income Tax (Transfer Pricing) Rules 2012 (the 2012 Rules). This adjustment by the DGIR resulted in an additional taxes being imposed on the taxpayer (the DGIR's Decision). Being aggrieved by the DGIR's Decision, the taxpayer appealed to the SCIT.

The main issues considered by the SCIT were:

a) Whether it is mandatory for the DGIR under the Organisation for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines and

the Inland Revenue Board (IRB) Transfer Pricing Guidelines 2003 or 2012 to adjust the taxpayer's profits to the median in cases where the margins were in the interquartile range?

b) Whether Section 140A of the Act was correctly invoked by the DGIR in issuing the tax assessment?

The Taxpayer's Contentions

The taxpayer submitted the following:

- The DGIR had employed an automated methodology in deciding that the taxpayer had made pricing adjustment in the year with the lowest profitability compared to its comparables. In doing so, the taxpayer had achieved the profit margin exceeding the median point. The DGIR failed to take into account that the profits fluctuated year to year due to various factors including business decisions and other economic considerations. The fact that the taxpayer's profit was below the median in one of the four years did not imply that the taxpayer was engaged in pricing adjustment.

- For the YAs 2011, 2012 and 2013, by achieving the profit margin above the median point, the taxpayer was one of the top three companies with the highest profit margins compared to its competitors.

- By using the median point adjustment to establish the taxpayer's arm length price, the DGIR had erroneously applied an arbitrary measure.

- When determining the arm's length price, the DGIR should use a range instead of a single point.

The DGIR's Contentions

The DGIR submitted the following:

- The burden of proof to prove that the transaction is at arm's length is on the taxpayer. The DGIR was given the power under Section 140A(3) to substitute the price of the transactions entered into because the taxpayer had

failed to prove that the sale and purchase price of palm oil products in respect of transactions entered between related entities was at an arm's length as required by Section 140A(2).

- The 2012 Rules read together with Section 140A(1) were the applicable provisions in determining the arm's length price.

- Since the DGIR agreed that the taxpayer would prepare the benchmark analysis under TNMM, the 4 comparable companies could not be used under Rule 6(a) of the 2012 Rules because the comparative factors were not sufficiently similar to that of the taxpayer or the differences in comparative factors would affect the price, profit or precise adjustment to eliminate material comparative factors.

- According to the DGIR, the taxpayer submitted an incorrect statement since the profits from the controlled transactions between the taxpayer and the relevant entities which were not made accordingly were not disclosed. The DGIR claimed that they had reason to believe as required by Rule 13(1) of the 2012 Rules, that the price charged in the controlled transaction was not at arm's length price.

The SCIT's Decision

The SCIT allowed the taxpayer's appeal and held that the DGIR had erroneously raised the transfer pricing assessments. The SCIT's reasons are summarised below:

- The SCIT relied on the decision in *Re Ex Parte Application For Leave To Apply For Judicial Review by Shell People Services Asia Sdn Bhd Judgment* [Judicial Review Application NO: BA-25-68-08/2019] where it was argued that Section 140 and Section 140A of the ITA only confer discretionary powers and do not impose any mandatory statutory duty on the DGIR. If DGIR exercises a discretionary power under Section 140 or Section 140A, then there are certain conditions to be fulfilled. For instance, the DGIR must establish that he has reason to believe in making the tax adjustments against the

taxpayer. The DGIR has the discretion whether or not to make an adjustment by substituting or adjusting the price. However, the DGIR could not exercise this discretion arbitrarily.

- There was no evidence produced by the DGIR to support its decision in using the median point to determine the arm's length price. The DGIR failed to demonstrate that the adjustment to the median point was in line with or at the arm's length price or that the decision to adjust the price to the median was supported by any legal provisions or guidelines.

- The SCIT also relied on the Australian case of *Macmine Pty Ltd v FCT* (1979) 9 ATR 38, where it was held that the taxpayer had proved that there were no facts to back up the tax authority's decision to use the median point in a transfer pricing adjustment to ensure an arm's length pricing. As a result, the tax authority's decision to levy an additional assessment against the taxpayer was excessive and erroneous.

- Furthermore, the SCIT urged the DGIR to make a decision on a good basis based on the decision in *Stokes & Holding (Construction) Pty Ltd v FCT* (1973) 129 CLR 617, 3 AT 621 where the function of the administrative bodies is to form a bona fide opinion premised on proper grounds. In the present matter, the adjustment made by the DGIR was in contradiction with the powers provided under Section 140A and Rule 13(1) of the 2012 Rules.

Conclusion

This SCIT decision establishes that the DGIR does not have the authority to substitute the arm's length price arbitrarily. It is vital to note this case serves as a reminder to public authorities that the functions of administrative bodies, such as the DGIR, are to provide a bona fide opinion for the public and must be supported by proper evidence.

Further, this ruling is an apt reminder that the DGIR cannot insist to use the median point in determining the arm's length transfer price. This is especially so when paragraphs 3.57 and 3.62 of the OECD Guidelines clearly illustrate this position.

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Another interesting point is the observation made by the SCIT with regards to the question of burden of proof. The SCIT quoted the following paragraph from the *Macmine Pty Ltd* case with approval:

> "*The question in tax appeals is never whether the Commissioner has established, by proof, the particular state of facts upon which he relies in support of his assessment, it is, rather, whether the taxpayer has established the non-existence of the state of facts and, hence, the excessive of the assessment*"

The above clearly illustrates that if a taxpayer is able to demonstrate that there is the non-existence of the state of facts to support the DGIR's decision, then the taxpayer had discharged its burden to establish that the DGIR's decision was erroneous.

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