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## Documentation For Intra-group Service Arrangements – *Preparation For Transfer Pricing Audits*

### 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

Intra-Group Service Arrangements (IGSAs) are common amongst multinational corporations (MNCs) in order to, amongst others, reduce cost, increase efficiency and concentration of resources and expertise. However, IGSAs have a related cousin, known as Cost Contribution Arrangements (CCAs). CCAs and IGSAs bear several similarities in terms of substance, however the taxation rules applicable on the two differ. It is therefore prudent to understand the difference between these arrangements in order to correctly characterise them, because these arrangements would attract differing tax implications under Malaysian tax law.

### The Difference Between A CCA And IGSA

CCAs are contractual agreements where enterprises share the costs and risks of developing, producing or obtaining assets, services or rights, from which each enterprise or participant to the CCA will expect to benefit from. Parties' contributions under the CCA will reflect the proportion of benefit they expect to receive and will have a right to exploit ownership interests obtained from assets developed or receive services resulting from the activity of the CCA in accordance to the nature and extent pre-determined by the CCA.

IGSAs are where costs for services provided by one or more members of a multinational group for the benefit of other members within the group are initially borne by the parent company or one or more members of the group and are eventually recovered from the other members. A common example of IGSAs relates to contract manufacturing wherein a MNC will centralise the manufacturing and production facilities for the group of companies as purchasers.

A prominent difference between a CCA and IGSA is the absence of mutual expectation of benefits in CCAs. For

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IGSAs, a profit mark-up is usually charged to ensure that service providers earn an arm's length profit margin. However, costs in a CCA are shared without the need to impose an arm's length profit mark-up.

### The Difference In Tax Treatment

It is important to note that the distinction between CCAs and IGSAs are vague and may not be easily determinable. However, the rules regulating IGSAs are more stringent than CCA in that the taxpayer would have to prove, amongst others, that the intra-group services have been rendered and conferred an economic benefit or commercial value to the business and that the transaction was at arm's length.

The test for CCA is slightly different in that the taxpayer. The main consideration is that at the time of entering into a CCA, parties would agree that their contribution would be reflective of the anticipated benefits that they would derive. There exist a mutual and proportionate expectation between the resources diverted into the CCA and the results the taxpayer intends to benefit from. Furthermore, all parties should agree to share the consequences of risks associated with the CCA.

The Malaysian Transfer Pricing Rules (TP Rules) is stricter towards IGSA and seen in paragraph 9(2) of the TP Rules wherein a IGSA shall be disregarded in certain circumstances:

*“Any charge made by a person in a controlled transaction in respect of the intra-group services shall be disregarded if it involves –*

*(a) Shareholder or custodial activities;*

*(b) Duplicative services;*

*(c) Services that provide incidental benefits or passive association benefits; or*

*(d) On-call services.”*

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### The Test For IGSA

To be considered as an intra-group service for the purposes of determining an arm's length price, the service must satisfy the benefits test, i.e. whether the service recipient receives benefits that are of economic or commercial value, determined by any enhanced returns or decreased costs and the test of whether an independent enterprise in comparable circumstances is willing to pay for the services or perform such services in-house. The OECD Transfer Pricing Guidelines 2010 (OECD TP Guidelines), which the Malaysian Transfer Pricing Guidelines 2012 (Malaysian TP Guidelines) largely mirrors after, lists several services such as centralised services, debt-factoring activities, manufacturing or assembly operations and research as intra-group services.

In order to satisfy the "benefits test", the taxpayer would need to show that in a comparable circumstance, an independent entity would be willing to pay for the services or that the independent entity would perform the activity in-house. However, no IGSA should be a duplication of services for which the taxpayer has already incurred expenses. The OECD TP Guidelines identified several exceptions to the rule such as reorganisation or seeking a second opinion to reduce the risk of a wrong business decision.

Both the OECD TP Guidelines and the Malaysia TP Guidelines do not recognise the provision of incidental benefits in line with rendering intragroup services. A common example is that no service is considered to be rendered by the sole fact that an enterprise's credit rating has improved due to affiliation. However, intra-group services may be considered to be rendered where there was a concerted effort to improve the reputation and public relations of the enterprise.

In order to determine the arm's length price for IGSA's, it is important to note that a service provider would seek to earn a profit rather than providing the services at cost. Some of the considerations that an enterprise would need to consider are economic alternatives, a comparison of functions and expected benefits and reasons for not using third party services.

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### Preparation Of Supporting Documents

It is important that supporting documents or transfer pricing documents is vital in addressing the main issues with IGSAs in order to reduce any subsequent dispute with the revenue officers. The main areas to address are:

- To prove a service has been provided.
- It is not a service disallowed by the ITA.
- It is not a duplicated service.
- It is not a service for which the taxpayer only derives incidental benefits from.
- To determine the appropriate arm's length markup / price for the services provided.

It is important that taxpayers focus on the importance of addressing the "benefits test" or may face allegations by the revenue officers on the premise that no service has been rendered and hence having such expenses incurred being disregarded in its entirety. Therefore, the IGSAs should state in specific terms the purpose of the IGSAs, the nature of the services and how it contributes towards the taxpayer's business or economic outlook and whether an independent party would be willing to pay for such services. In *M/S. Philips India Limited v ACIT*, Circle - 12(2), Kolkata I.T.A No. 2489/Kol/2017, the Indian Income Tax Appellate Tribunal (ITAT) considered that service agreements provide how and when these services are to be requisitioned, costs are to be included in the charge for the services and contains a clause indicating the expected benefits and linking the charges to corresponding benefits.

It is important to maintain records of any correspondences such as emails, monthly calls, meeting minutes, formal requests, invoices and evidence of travel (if any). Other documents may also include reports, work plans and corporate strategies. In *Dresser Rand India Pvt. Ltd. v. ACIT* [2011] 141 TTJ 385 (Mum), the ITAT found documentary evidence such as copies of reports, emails and guidance to be demonstrative that the taxpayer had received services from

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the related party. Interestingly, the ITAT commented that tax authorities ought not to interfere whether with the commercial wisdom of the taxpayer in conducting his business and it is wholly irrelevant whether the taxpayer had benefitted or not. The question to be asked is whether an independent party would have paid for the services in the similar situation.

A common supporting document that revenue officers may ask for during tax audits is a description of the job descriptions of the employees of the service provider and the corresponding benefit that the receiving entity receives. The purpose is to ensure that there are no duplication of services and that the receiving entity had in fact benefitted from the services provided. The taxpayer should be able to produce documents evidencing the impact of the intragroup service to the overall performance of the taxpayer and how it assists in producing an advantage and improve the taxpayer's operations. In *Knorr- Bremse India Pvt. Ltd., Haryana v. ACIT, Faridabad*, ITAT- ITA 4023/DEL/2015, the lack of documentary evidence to prove the nature of the activities and benefits to the taxpayer was one of the reasons where the ITAT found in favour of the tax authorities. However, on appeal, the High Court remitted the matter back to the tribunal as the reasons for the ITAT in finding that the taxpayer ought to have shown an increase in profit from receiving the service to be flawed.

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Most IGSAs are expected to earn a return, the revenue officers will insist that the service provider will earn a profit on the costs associated with the provision of the service, commonly known as a mark-up. Taxpayers must then identify the expected return comparable companies would earn in providing the comparable service and carry out a benchmarking analysis to identify the suitable mark-up. The mark-up imposed would have to be reflective of the nature of services provided and risks assumed by the said service provider.

One of the common misconceptions is over-emphasis on the mark-up that taxpayers often miss out on identifying the accurate cost base and the "benefits test". In this vein, the taxpayer must identify the appropriate cost base that corresponds with the service provided vide the IGSAs. The cost base analysis should include computation of all the costs included and the use of allocation keys to allocate the costs

amongst the related entities such as the number of employees, revenue etc, if any. Differences in the cost base from the use of different indirect expenses may cause the service charge to not be at arm's length even if the markup is deemed to be within the arm's length range. In *Gemplus India Private Limited. v. ACIT* (ITA No.352/Bang/2009), there must be sufficient evidence to prove that the service charged by the service provider must be commensurate with then nature, quality and volume of services provided.

The Malaysian TP Guidelines had further shed light on the documentations taxpayers are expected to prepare. Amongst the supporting documents that taxpayers should take heed of are:

- The IGSA must contain the details of group of companies, periodic rates, invoice dates, time for payment of invoices and late payment consequence.
- Documentation indicating the recipient entity has absorb a proportionate share of the costs of administration and management.
- Documentation of each of the functions, such as marketing, legal or technical functions, as the case may be.
- The determination of the cost base such as the nature of the cost included in cost base, methods of allocation and basis of allocation of indirect cost in the cost base.

### Recent Developments

In *SPSASB v Ketua Pengarah Hasil Dalam Negeri* (unreported case), the Inland Revenue Board (IRB) invoked Section 140A of the Income Tax Act 1967 (ITA) to recharacterise a CCA into a IGSA. The IRB then imposed a "deemed profit mark-up" on the taxpayer and raised notices of assessment along with penalties. The High Court had disallowed the taxpayer's application for judicial review. However, on appeal, the Court of Appeal granted leave to the taxpayer to commence judicial review.

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☎ +603 6209 5405  
✉ naban@rdslawpartners.com

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



## Conclusion

The Finance Act 2020 had introduced stricter transfer pricing rules and more pertinently, made it a criminal offence where a taxpayer fails to comply with transfer pricing documentation. This newly introduced legislation would see any person who defaults in furnishing contemporaneous transfer pricing documentation to be liable to a fine of not less than RM20,000 and not more than RM100,000, or to imprisonment for a term not exceeding six months or to both.

There is also an increasing scrutiny on intra-group services in line with the Base Erosion Profit-Shifting (BEPS) risks/guidelines whereby emphasis is placed on the substance over form in controlled transactions. Amongst the recent developments to combat tax challenges in a digitalised economy are the introduction a global minimum corporate tax rate and with a two-pillar plan.

It is pertinent to note that paragraph 13 Schedule 5 of the ITA provides that the burden of proof that an assessment is erroneous is on the taxpayer. Therefore, the importance of proper document management is of utmost importance in defending a position so taken. In light of the aggressive stance taken by IRB, the need to maintain proper contemporaneous documents are vital and cannot be overlooked.

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Authored by Sophia Choy, an associate with the firm Tax, SST & Custom Department.

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