29 JUNE 2021

Transfer Pricing: Insights On Pass-Through Costs

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

In Malaysia, the Income Tax Act 1967 and the Income Tax (Transfer Pricing) Rules 2012 make no reference to the treatment of pass-through costs, nor does the law define the meaning of pass-through costs. Nonetheless, the Inland Revenue Board's Transfer Pricing Guidelines 2012 and the Organisation for Economic Co-operation and Development Transfer Pricing Guidelines (OECD Transfer Pricing Guidelines) provide some explanations on the treatment of pass-through costs.

Presently, there are no reported Malaysian cases on the concept of pass-through costs. As such, reference is made to other jurisdictions for some guidance on this matter. There are notable cases from India which discuss the concept of pass-through costs based on the OECD Transfer Pricing Guidelines.

This alert examines the definition and the treatment of pass-through costs from a transfer pricing perspective.

What Are Pass-Through Costs?

Pass-through costs are external costs incurred by a taxpayer on behalf of a related party or in some instances, on behalf of a third-party customer in relation to the taxpayer's business. In this regard, it is useful to examine the Indian cases of *Dy. Commissioner of Income-tax v M/s. Cheil Communications India Pvt. Ltd.* (2010) 29 CCH 0853 DelTrib and *John Matthey India Private Limited v Deputy Commissioner of Income Tax* (2015) 94 CCH 0067 DelHC which have elaborately described the concept of pass-through costs.

In *Cheil Communications*, the taxpayer was a subsidiary of Cheil Communications Inc (Cheil Korea) and the taxpayer company acts as an agent for Cheil Korea in undertaking advertising services for its customers. There were payments made to third-party advertising agency which were made on behalf of the customers. These payments were ultimately reimbursed by the customers. The Indian Income

REIMAGINING TAX SOLUTIONS

Tax Appellate Tribunal found that the payments were pass-through costs and did not represent value-added functions undertaken by the taxpayer. The taxpayer was merely an intermediary between the ultimate customers and the third-party service providers. The tribunal commented that:

> *"The assessee simply acts as an intermediary between the ultimate customer and the third-party vendor in order to facilitate placement of the advertisement. The payment made by the assessee to vendors is recovered from the respective customers or associate enterprises. In the event customer fails to pay any such amount to the advertisement agency, the bad debt risk is borne by the third-party vendor and not by the advertising agency i.e. the assessee".*

It can be observed that the taxpayer plays the role of an intermediary and facilitates the provision of the services by third-party vendor. Further, in this regard, there are no risk borne by the taxpayer in relation to the transaction as all risks are borne by the third-party vendor. Therefore, the expenses incurred pertaining to said transaction are considered "pass-through" costs.

Meanwhile, in *Johnson Matthey*, it pertains to Johnson Matthey India Private Limited, a taxpayer who was engaged in the manufacturing and sale of automobile exhaust catalysts. The taxpayer entered into an arrangement with Maruti Udyog Limited (MUL) where the taxpayer would sell the finished products to vendors pursuant to the instructions given by MUL. In this regard, the taxpayer notably bears no risk pertaining to the sale of the products. The price of the product sold on behalf of MUL was passed to the customers and did not affect the profits of the taxpayer. The High Court held that the cost incurred for the transaction between the taxpayer and MUL should be treated as pass-through costs with no mark-up.

At this juncture, it can be observed that expenses incurred in a transaction are considered pass-through costs when the following attributes are present:

- The taxpayer does not bear risk in relation to the expenses incurred.

- The taxpayer does not add value to the services or products provided by third-party service providers or vendors. In this regard, the taxpayer merely functions as an intermediary or an agent.

Therefore, it is pertinent for taxpayer to be able to produce documentary evidence in proving that the pass-through costs are risk-free in nature and that the taxpayer do not provide value-add to the third-party services and/or products.

The Treatment Of Pass-Through Costs

Generally, low value intra-group services must receive a "mark-up" rate to reflect the market value of the services. However, this does not apply to pass-through costs. Since pass-through costs are incurred in relation to transactions that are already within arm's length, the pass-through costs should not be adjusted with a "mark-up" rate. This position is clearly illustrated in the Inland Revenue Board's Transfer Pricing Guidelines 2012, where paragraph 20.7.3 of the guidelines describes the treatment of pass-through costs as the following:

> *"When applying the cost-plus method to an associated enterprise which assumes the role of an agent or intermediary to obtain services from independent enterprises on behalf of its group members, it must be ensured that the arm's length return is limited to rewarding the agency/intermediary function only. It is not appropriate to charge a service fee based on mark-up on cost of the services obtained from independent enterprises."*

Meanwhile, paragraph 7.34 of the OECD Transfer Pricing Guidelines 2017 narrates the operations and treatment of pass-through costs (paragraph 7.36 describes the same in the OECD Transfer Pricing Guidelines 2010) which reads as follow:

> *"... In such a case, it may not be appropriate to determine arm's length pricing as a mark-up on*

> *the cost of the services but rather on the costs of the agency function itself. For example, an associated enterprise may incur the costs of renting advertising space on behalf of group members, costs that the group members would have incurred directly had they been independent. In such a case, it may well be appropriate to pass on these costs to the group recipients without a mark-up, and to apply a mark-up only to the costs incurred by the intermediary in performing its agency function."*

At this juncture, it is evident that the transfer pricing guidelines 2012 draw a stark distinction between the costs incurred in the performance of agency function and the pass-through costs of the services provided by third parties. The former should receive a mark-up in accordance with the arm's length principle whereas the latter, being pass-through costs, should not receive any mark-up. This position was also confirmed in *Cheil Communications*.

Commentary

Various countries have acknowledged the concept of pass-through costs and applied the treatment of pass-through costs in accordance with the OECD Transfer Pricing Guidelines. These countries include, but are not limited to, Australia, Hong Kong, India, New Zealand, Switzerland, United Kingdom, United States and others.

Even though there are no reported Malaysia cases on pass-through costs pertaining to transfer pricing matters, the case of *Maersk Malaysia Sdn Bhd v Ketua Pengarah Hasil Dalam Negeri* is instructive as the courts need to give due regards to the OECD Transfer Pricing Guidelines in relation to transfer pricing matters.

Therefore, it is likely that our courts would adopt the approach provided in the OECD Transfer Pricing Guidelines, following the footsteps of our neighbouring jurisdictions. Further, paragraph 20.7.3 of the guidelines is also reflective of the approach provided in the OECD Transfer Pricing Guidelines. Hence, the laws with regards to pass-through costs are clear

and the courts should have due regards to the existing guidelines in relation to the treatment of pass-through costs.

Authored by Chan Hwa Sheng, a pupil with the firm's Tax, SST & Customs practice.

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

REIMAGINING TAX SOLUTIONS