Malaysia introduces Income Tax (Transfer Pricing) Rules 2012

Earlier this month, the Minister of Finance made public the Income Tax (Transfer Pricing) Rules 2012 and the Income Tax (Advance Pricing Arrangement) Rules 2012. Both these rules are deemed to come into operation with retroactive effect from 1 January 2009. The gazetting of these rules further highlights the fact that the Internal Revenue Board is increasingly focused on transfer pricing matters.

This article deals with the implications of the Income Tax (Transfer Pricing) Rules 2012 on taxpayers operating in Malaysia. Before analyzing the Rules and their implications, it is important to understand how transfer pricing has grown in importance in Malaysia.

Growth of transfer pricing regulations in Malaysia

Malaysia first introduced transfer pricing to Malaysian taxpayers in 2003, by issuing the transfer pricing guidelines (the "2003 Transfer Pricing Guidelines"). The Malaysian transfer pricing guidelines were largely based on the Organisation for Economic Cooperation and Development transfer pricing guidelines, issued in 1995. The legal basis of the Malaysian transfer pricing guidelines was subsection 140(1) of the Income Tax Act, 1967 which concerned itself with the general anti-avoidance legislation.

In order words, the Internal Revenue Board (IRB) relied on the general anti-avoidance legislation in order to disregards any transaction between related parties which were not conducted on an arm's length basis. In relying on the anti-avoidance provisions in the Income Tax Act, it should be noted that the burden of proof of evasion or anti-avoidance is discharged by the tax authority and not by the taxpayer. Through the introduction of the transfer pricing guidelines, the IRB began focusing on transfer pricing related matters with transfer pricing audits being conducted on a regular basis.

However, since the burden of proof needs to be discharged by the tax authority and not the tax payer, the IRB's prowess in assessing transfer pricing related matters was weak. Thus, in 2009, the IRB introduced a new provision, Section 140A, to specifically address the transfer pricing, focusing on the supply of property or service. This act essentially shifted the burden of proof on transfer pricing matters to the taxpayers. Furthermore, in 2009, the IRB also introduced the possibility of entering into unilateral / bilateral advance pricing arrangements ("APAs") with taxpayers.

In addition, the new Section 140A also saw the introduction of thin capitalisation rules in Malaysia, whereby a deduction for interest will be denied in respect of interest payments made to associated companies in respect of 'financial assistance', subject to certain criteria and conditions.

In 2011, the IRB introduced the consultation process, whereby questionnaires were sent out to select tax payers to request for additional information on related party transactions entered into by the taxpayer. Transactions included were not merely restricted to the supply of property or services, but it also included questions on inter-company loan transactions. This was an interesting development as the 2003 Malaysian Transfer Pricing Guidelines did not explicitly define what was meant by the "supply of property and services". Rather the 2003 Guidelines explicitly detailed how tangible and intangible property as well as services should be analysed from a transfer pricing perspective.

Furthermore, the taxpayer filling out this questionnaire will have to disclose the functional characterisation of its operations (e.g., as a distributor, service provider, manufacturer, etc.), and whether it has prepared transfer pricing documentation.

Given the growing focus on transfer pricing matters, it is not surprising that the IRB has gazetted the transfer pricing rules and has brought transfer pricing into law from 1 January 2009. These rules provide additional insights on the IRB's approach to transfer pricing.

Insights provided by the Income Tax (Transfer Pricing) Rules 2012

There are several observations that can be made arising from the income tax (transfer pricing) rules.

a. Related party transactions covered by the Rules

The Income Tax (Transfer Pricing) Rules 2012 are explicit on the nature of related party transactions that are covered under these Rules. These Rules are all encompassing in the sense that they include tangible and intangible transactions, services and inter-company financing transactions, i.e., transactions where an arm's length interest rate is required. Guidance is also provided on cost contribution arrangements which was absent in the 2003 Transfer Pricing Guidelines.

The universe of related party transactions that comes under the purview of the IRB has therefore been expanded through the introduction of these Rules.

b. Need for contemporaneous documentation

The Income Tax (Transfer Pricing) Rules 2012 explicitly notes that a person who enters into a controlled / related party transaction shall prepare contemporaneous transfer pricing documentation. This refers to documentation that is brought into existence when a person is developing or implementing any controlled transaction. In addition, where the controlled transaction is reviewed and there are material changes, the (contemporaneous) documentation (previously prepared) shall be updated prior to the due date for furnishing a return for that basis period for that year of assessment.

In other words, the IRB is explicitly requiring that taxpayers maintain contemporaneous documentation to support that their related party transactions meet the arm's length standard on an annual basis.

c. Guidance on transfer pricing methods

The Income Tax (Transfer Pricing) Rules 2012 continues to maintain the hierarchy of methods, of sorts. It notes in Section 5(1) that a person shall apply the traditional transactional method to determine the arm's length price of a controlled transaction. In the event that a traditional transactional method cannot be reliably applied, it may be possible to apply the transactional profit method.

This is particularly interesting, given that the OCED in its latest revisions to the transfer pricing guidelines has noted that the selection of a transfer pricing method always aims at finding the most appropriate method for a particular case. In other words, it has moved away from a hierarchy of methods which stipulates that the traditional transaction methods are preferred to the transactional profits method and that the comparable uncontrolled price (CUP) method is the best method.[1]

There remains room for application when preparing Malaysian transfer pricing analysis, as other methods not classified as traditional transaction methods or transactional profit methods can also be applied

d. Economic analysis

The Income Tax (Transfer Pricing Rules) 2012 explicitly notes that the results of the controlled or related party transaction shall be compared with the results of an uncontrolled transaction for the same basis year for a year of assessment. This suggests that all economic analysis will need to be conducted on an annual basis where the current year tested party's data is compared with the current year's comparable data.

It is a well known fact that the databases that are typically used to conduct transfer pricing analyses typically need 6 – 9 month before current year data are made available. Given this delay, there is likely to be a timing difference when the economic analysis is carried out. A literal reading of the Rules suggests that during the course of the year, taxpayers will compare the current year tested party data to prior year comparable company data. Subsequently, a financial data updating has to be carried out to obtain the most recent financial data for the comparable companies. As a result of this two stage approach, margins / mark-ups may change. This makes it very difficult for taxpayers to submit their returns with sufficient confidence that their related party transactions will continue to meet the arm's length standard, once the comparable data of the comparable companies are available.

e. Aggregation of transactions

The Income Tax (Transfer Pricing) Rules 2012 also explicitly requires taxpayers to determine the arm's length price for each controlled transaction in accordance with the Rules. In other words, the IRB has adopted a highly transactional approach to test the related party transactions. It is not likely that a whole of entity approach will work in Malaysia, particularly if the transactions are varied. Furthermore, no thresholds are allowed, which suggests that each and every controlled transaction has to be supported by relevant transfer pricing analyses.

Concluding Remarks

The Rules are welcome in the sense that they provide much needed clarity to taxpayers operating from or to Malaysia, engaging in related party transactions. The clarity provided by these Rules may only seem onerous to taxpayers as they only server to increase the compliance burden for Malaysian tax payers. It is interesting that these Rules remain silent on the penalty regime associated with transfer

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1 Having said this, the OECD Guidelines goes on to argue that if both a traditional transaction method and a transactional profit method are applicable, then the traditional transaction method is preferred to the transactional profit method.

pricing adjustments. In the absence of such guidance, one may expect that the general corporate tax penalties would also apply to transfer pricing related matters.

Subsequent to the introduction of these Rules, we strongly advice Malaysian taxpayers to prepare relevant transfer pricing analyses and documentation on a contemporaneous basis, with effect from 2009.