Tax Audit of Transfer Pricing

Increasing concern for intra-group services in this area.

Companies can expect more intense tax audit focus in the area of intra-group services, leading to more transfer pricing disputes in this area in the years to come.

This is hardly surprising given the current trend of multinational companies towards restructuring and centralising services in certain service companies to achieve efficiency and release other group companies to concentrate on their core competencies.

Group companies are increasingly being charged relatively significant management fees for services such as accounting, finance, legal, tax, treasury, human resources, information technology, corporate services, business development, research and development, procurement services, etc.

Intra-group services are typically viewed as low-hanging fruit by tax authorities due to the fact that documentation on services is typically not as robust as that relating to tangible goods. The absence or inadequate documentation is often a recipe for financial disaster.

This article examines the key areas of controversy surrounding intra-group services and action points for taxpayers.

THE RULES

The Income Tax (Transfer Pricing) Rules 2012 were issued in Malaysia in May 2012. The Rules provide taxpayers with guidance on the application of the arm's length standard under Section 140A of the Income Tax Act 1967, and the type of documentation that taxpayers are expected to maintain for transfer pricing purposes.

A key development under the Rules is the requirement that taxpayers prepare contemporaneous transfer pricing documentation.

This is defined to mean documentation, which is prepared when a taxpayer develops or implements a related party transaction.

In addition, where there are material changes in the transfer pricing policy, such contemporaneous transfer pricing documentation shall be updated prior to furnishing the tax return for that year of assessment. Further guidance on the application of the law under Section 140A and the Rules have been provided via the release of the Transfer Pricing Guidelines 2012 (TP Guidelines) in July 2012 which supercede the 2003 Transfer Pricing Guidelines.

The Rules are, by and large, based on the OECD Transfer Pricing Guidelines. For intra-group services, a two-part test needs to be satisfied:

- the service must have been rendered (ie, the benefit test); and
- if so, the charge must be at arm's length (having regard to the mark-up applied and the allocation keys used).

THE BENEFIT TEST

An intra-group service is considered to have been provided or rendered if the service provides an economic or commercial benefit to the recipient to enhance its commercial interests. An activity is considered to have conferred a benefit if an uncontrolled company in circumstances comparable to those of the recipient would:

- be willing to pay an independent party to perform the same or similar activity; or
- otherwise have performed the activity in-house for itself.

This test, known as the benefit test, is critical to determine whether an unrelated party would pay for an intra-group service, and therefore, whether the service provider can justify a charge for the provision of the intra-group service under the arm's length principle. The Rules provide that a benefit is of economic or commercial value if it:

- enhances the recipient's return or profitability by improving its production efficiencies; or
- results in cost savings or a decrease in the recipient's operating expenses for example by decreasing production time.

PRICING OF INTRA-GROUP SERVICES

The second stage of the test is to determine an appropriate arm's length transfer price for that service.

This involves selecting the most appropriate transfer pricing method and application thereof as well as the selection of an appropriate allocation methodology.

Local country practices are important when it comes to selecting the tested party and the search for comparable companies.

The revenue authorities in Malaysia have a strong preference for the use of local comparables.

The Rules provide that if the tested party is the service recipient in Malaysia, the fact that the mark-up by an overseas affiliate service provider has fulfilled the arm's length test in the service provider's country of residence need not automatically be deemed arm's length in Malaysia. A benefit test from the perspective of the service provider must still be demonstrated.

KEY AREAS OF CONTROVERSY

Some common issues raised during an audit are as follows:

Factual questions such as whether the taxpayer has in fact received the services – extensive documentation is often sought by tax authorities to justify that the services have been rendered. These include:

- A copy of the management service agreement;
- Detailed information on the nature of the services received to establish that the services rendered are not duplicative, shareholder activities or incidental in nature;
- Organisation chart of the service provider and the recipient to establish that there is no duplication of services;
- Details of the cost-benefit analysis undertaken at the time that the inter-company agreement was entered into which shows the expected benefits to the service recipient;
- Copies of time sheets, emails, memos, meeting minutes, teleconferences or visits by overseas personnel as evidence of the provision of services;
- Invoices from the service provider, showing details of services provided and the basis of charge; and
- justification that the charge is at arm's length.

The service recipient may be required to satisfy the tax authorities that the charge is justified relative to the benefits received by the service recipient. This may be particularly challenging for a taxpayer who has previously performed the services in-house for itself but is now required under a group directive to pay management fees for centralised services at a rate far in excess of its previous costs.

Another area of scrutiny is the basis of determination of the service charge, ie, whether it is a direct charge or an indirect charge and if it is an indirect charge, the cost allocation methodology used to apportion the charge.

Many companies allocate intra-group services based on turnover, which is a convenient and easy measure to apply, but often not defensible as it is not reflective of the benefit received by the service recipient.

Other issues are those, which surround the justification of the transfer pricing methodology with the Comparable Uncontrolled Price (CUP) being the preferred methodology and the mark-up that is applied to the cost base.

ACTION POINTS FOR TAXPAYERS

Taxpayers should be aware of the risk of not taking a more pro-active approach to managing transfer pricing risks arising from the lack of adequate documentation on intra-group services. This would include the following:

- Developing robust transfer pricing documentation in accordance with the Rules and TP Guidelines;
- Ensuring that supporting documentation (eg, agreements, emails, meeting memos, calculations, etc) is maintained to support the charge from the service provider; and
- Ensuring that the allocation methods used are commensurate with the benefits received by the service recipients.

Transfer pricing for intra-group services is an area that is increasingly being scrutinised by tax authorities. There is a need for taxpayers to address this area of risk to ensure that appropriate documentation is in place to defend the inter-company charges.

Documentation should include a detailed description of the nature of the services, establish that there is a need for these services and that the service recipient derives a benefit therefrom and that an arm's length price has been applied. mb

TAXPAYERS SHOULD BE AWARE OF THE RISK OF NOT TAKING A MORE PRO-ACTIVE APPROACH TO MANAGING TRANSFER PRICING RISKS ARISING FROM THE LACK OF ADEQUATE DOCUMENTATION ON INTRA-GROUP SERVICES.

Bernice Tan is an Executive Director of TAXAND MALAYSIA Sdn Bhd, which is part of the TAXAND Global Organisation, the first global organisation of independent tax advisers with a presence in nearly 50 countries. She can be contacted at bt@taxand.com.my. The views expressed here are the personal views of the writer.