e-tax news

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Non-compliance with Transfer Pricing Rules – a hefty price to pay?

Following the tabling of the Finance Bill 2020, the proposed insertion of new provisions relating to transfer pricing ("TP") as outlined below grants significantly greater authority to the Inland Revenue Board ("IRB") and reemphasises the importance of TP compliance, with effect from 1 January 2021:

i. Penalty for failure to furnish contemporaneous transfer pricing documentation ("TPD")

Presently, there is no specific provision in the Income Tax Act, 1967 ("ITA") penalising taxpayers for failure to furnish contemporaneous TPD. A new provision in relation to the penalty for failure to furnish contemporaneous TPD has been inserted into the ITA as follows:

Provisions	Proposed penalty
Section 113B(1) - On conviction	✓ Fine of RM20,000 to RM100,000 or imprisonment not more than 6 months or both; and ✓ Taxpayer to furnish TPD within 30 days or any period instructed by the Court.
Section 113B(4) - No prosecution	✓ Penalty of RM20,000 to RM100,000

Under the current practice, preparation of contemporaneous TPD is required for taxpayers who enter into controlled transactions but the TPD need not to be submitted along with the tax return. However, disclosure of related party transactions and declaration of contemporaneous TPD in the tax return are required since Year of Assessment ("YA") 2014.

Effective from 1 January 2021, on conviction, a fine of RM20,000 to RM100,000 and / or an imprisonment term of up to 6 months may be imposed on a taxpayer who fails to furnish contemporaneous TPD upon requested by the IRB (typically within 30 days per Transfer Pricing Audit Framework 2019). If no prosecution, penalty of RM20,000 to RM100,000 may be imposed by the IRB instead.

With the introduction of the above provision, even though no TP adjustment was made by IRB during a TP audit, penalty would still be imposed as the contemporaneous TPD is not furnished within the stipulated timeline. We understand that similar penalty regime has been implemented in our neighbouring countries such as Singapore, China and India.

Based on our interpretation of the proposed provision, this penalty may apply to the prior years' TPD so long the request to furnish contemporaneous TPD is made by the IRB after 1 January 2021. However, further clarifications from the IRB is required on whether this penalty will be imposed separately for each year of non-compliance. It is now clearly evident that TPD is an essential and mandatory document and taxpayers must ensure the readiness of TPD for all open YAs (i.e. the last 7 YAs) in order to mitigate any risk of hefty penalty.

ii. Power to disregard structure in controlled transactions

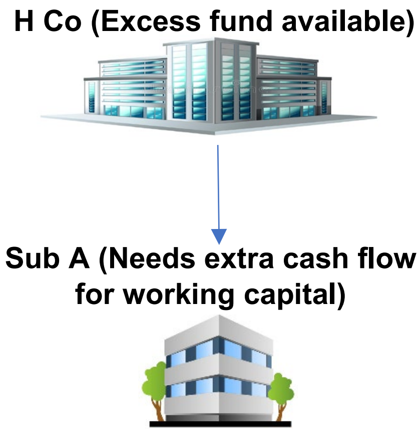
Presently, the provision in relation to power of the Director General of IRB ("DG") to disregard and make adjustment to any structure adopted by a person for TP purposes can be found under Income Tax (Transfer Pricing) Rules 2012. This provision has been incorporated into the principal tax legislation under a new Section 140A(3A) and (3B) of the ITA effective from 1 January 2021. This provision reinforces DG's power to disregard any structure of a controlled transaction if:

a. The economic substance of the transaction differs from its form; or
b. The form and substance of the transaction are the same but the transaction is a commercially irrational arrangement which would not have been adopted by independent parties.

How does the above affect a company with controlled transactions?

Let us explore a practical example on the potential implication of the new provision:

Example 1



Intercompany loan

- Loan amount: RM500,000
- Interest rate per year: 5%
- Principal repayment terms not stated

Prior to TP audit

	RM
Gross loss	(10,000)
Less: Interest expense	(25,000)
Loss for the year	(35,000)
Chargeable income	NIL

Post TP audit (Adjustment made by IRB)

	RM
Gross loss	(10,000)
Add: Interest expense*	25,000
Chargeable income	15,000
Additional tax payable @ 24%	3,600
TP surcharge (5% on TP adjustment) [See Section (iii) below]	1,250

* Under the new provision, the IRB may exercise its power to disregard and recharacterise the intercompany loan as a capital injection from H Co into Sub A instead of as a loan and to disallow the interest deduction taken by Sub A, on the basis that:

a. Financial institutions in the market (e.g. banks) will not grant a loan to a company without the loan period and principal repayment terms clearly stated in the loan agreement; and
b. Sub A is unlikely to be able to get a loan from any financial institution in the market due to its financially weak position.

With this amendment, it becomes even more important for businesses to maintain a contemporaneous TPD to support the "arm's length structure" along with the "arm's length price" of all commercial arrangements with associated enterprise in order to mitigate the risk of recharacterisation.

iii. Imposition of surcharge on transfer pricing adjustment

Presently, a penalty of up to 50% is only imposed on TP adjustments which result in additional tax payable during a tax audit. In another word, if a TP adjustment does not result in any additional tax payable, penalty will not be imposed.

It is now proposed that with effect from 1 January 2021, a surcharge of up to 5% on total TP adjustments will be imposed by the IRB on all tax audit and investigation cases irrespective of whether the TP adjustments result in any additional tax payable. We understand that a similar surcharge mechanism is currently being practiced by our neighbouring country, Singapore.

The imposition of surcharge will definitely affect a lot of companies that enter into controlled transactions, especially those entities which are not in a taxable position, i.e. have unabsorbed allowances or losses carried forward to set off the additional tax payable due to TP adjustments. The introduction of this surcharge strongly signals a reinforced focus by the IRB on TP compliance and it is expected that there will be a significant increase in TP audits going forward.

PKF's Comments:

With the introduction of the above provisions in the ITA, this has sent a very clear and strong message to all taxpayers that full compliance with TP is mandatory and inevitable. IRB expects taxpayers engaging in controlled transaction to have their contemporaneous TPD up-to-date for each YA, readily available by tax filing due date and is submitted to the IRB upon request.

In addition, taxpayers should review their existing intercompany transactions not only to ensure the pricing is at arm's length but also to ensure such transactions are economically and commercially justifiable.

HOW WE CAN HELP?

If you wish to assess the TP risk within your group in light of the above amendments proposed in Budget 2021, we can offer a complimentary assessment as below:

- Perform a free high level TP risk assessment on the Group
- Discuss with you our preliminary findings

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