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Advance Pricing Arrangements

Latest developments in transfer pricing.

EARLIER this year, the Inland Revenue Board (IRB) concluded Malaysia's first unilateral Advance Pricing Arrangement (APA). The OECD defines an APA[1] as 'an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (eg, method, comparables and appropriate adjustments thereto, critical assumptions as to future events) for the determination of the transfer pricing for those transactions over a fixed period of time.'

Transfer pricing refers to the price of a transaction between associated companies or between companies within the same group. The altering of this transfer price will influence the allocation of profits between buyer and seller firms. A high transfer price results in the profits shifting to the seller whilst a low transfer price shifts profits to the buyer. How multinational corporations (MNCs) fix pricing for transactions between associated companies in the group operating in different countries have given rise to significant tax disputes with tax authorities.

An APA is, therefore, a useful tool, which enables MNCs to avoid tax disputes and costly litigation. Essentially, an APA allows associated companies in two or more countries to agree in advance the price of a future transaction with the tax authorities in those countries. In Malaysia, the future years (ie, covered period) can be between three and five years.

Many countries encourage either bilateral or multilateral APAs[2] (ie, an arrangement in which two or more countries concur). The reason for this is because bilateral or multilateral APAs reduce the risk of double taxation for the taxpayers and provide a fairer result for the tax authorities involved.

In a unilateral APA, only the taxpayer and one tax authority is involved. Whilst it is generally easier to conclude a unilateral APA given that it involves fewer parties, it does not protect the taxpayer from the incidence of double taxation, since the other tax authority affected by the transactions covered under the APA may view that the methodology applied is not appropriate in determining the arm's length price.

As an APA is about a set of future transactions, it requires certain 'crystal ball gazing' skills as it involves predictions about the future. The reliability of the predictions depends on the critical assumptions on which they are based. The IRB tends to focus on certainty in tax revenue collection and they expect projections of absolute future profits. This would generally be difficult for taxpayers to accept since business risks tend to make absolute predictions difficult. The use of profit ranges coupled with appropriate critical assumptions can enhance the reliability of predictions.

A taxpayer planning to make an APA submission should be

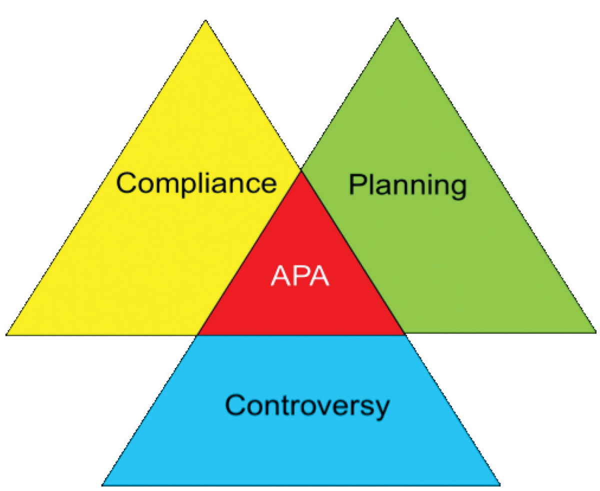
prepared to submit a comprehensive set of documents to the IRB. These would include:

- Transfer pricing documentation with respect to the covered transactions;
- Group & shareholding structure;
- Inter-company agreements; and
- Other relevant supporting documents.

Once the documents are submitted, a pre-filing meeting with the IRB would take place. Having reviewed the taxpayer's submission, the tax authority will then decide if the APA application can be considered. If so, the taxpayer would be allowed to participate in the process of obtaining the APA by presenting the case, negotiating with the tax authority, providing necessary information and finally reaching an agreement on the transfer pricing issues.

As long as the taxpayer follows the terms of the APA, the tax authority should not be making any transfer pricing adjustments with respect to the covered transactions in the APA period. The APA may also be applied to the preceding years. This is useful for MNCs who may not wish to devote unnecessary resources dealing with tax audits for those years. Ensuring future compliance with the transfer pricing regulations would also be simpler.

It is common to have terms in the APA to provide for revision or cancellation of the agreement for future years should the business of the taxpayer change significantly, or when uncontrolled economic circumstances change (eg, sudden increases in oil prices, significant fluctuations in the foreign exchange rates, etc).



APAs: An effective tool for tax compliance, planning & controversy management

Following the conclusion of the APA, the tax authorities would wish to monitor compliance with the APA. In Malaysia, the IRB requires the taxpayer to submit a compliance report within seven months of the close of its financial year. The taxpayer is also required to submit the audited financial statements and demonstrate whether there are any material changes to the covered transactions, which differ from the principles stated in the APA, and that critical assumptions remain relevant.

The tax authorities will often not subject a taxpayer to regular transfer pricing audits during the APA term. Usually, the compliance monitoring process is merely a means to verify the initial data and representations made. This, thus, avoids the time and resources involved in dealing with a full transfer pricing audit. As shown below, an APA can be a useful tool to resolve potential disputes.

As the APA process involves sharing substantial information about the taxpayer, the concern over the possible misuse of information by the tax authority is a real one. The OECD in this respect discourages tax authorities from using information collected through the APA process as a reason to conduct a closer scrutiny on the taxpayer should APA negotiations fail.

The application for an APA can be expensive and time consuming. Clearly, not all taxpayers would be able to afford it. Generally, it is the large corporations with complex transfer pricing issues which would be interested in APAs.

In summary, the IRB's APA programme has been a welcomed introduction for MNCs operating in Malaysia. In addition to providing certainty on transfer pricing issues, it is an important dispute resolution tool. Bilateral and multilateral APAs are particularly useful for avoiding double taxation given the participation by all the relevant countries. With an APA, cost savings with respect to transfer pricing compliance are also envisaged. It is these key factors that make the APA programme so appealing. With the continued enhancement of experience by the tax administration, it is hoped that Malaysia will continue to develop an effective and successful APA programme. mb

**Taxand was named the Asian Transfer Pricing Firm at the International Tax Review's 'Asia Tax Awards 2010'.*

[1] OECD or the Organisation for Economic Co-operation and Development Transfer Pricing Guidelines 2010, paragraph 4.123
[2] OECD Transfer Pricing Guidelines 2010 paragraph 4.130

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The views expressed here are the writer's own.