

# Navigating a Transfer Pricing Audit

**T**ransfer pricing is an art and not a science. Whilst easy enough to define, the concepts involved in transfer pricing are complex and often difficult to understand and implement.

Many taxpayers fail to realise that the preparation of transfer pricing documentation does not guarantee that the tax authority in Malaysia (or in any other country for that matter) will not challenge the transfer price and that the final price is often the result of negotiations between the company and the tax authority.

With that in mind, how then does one prepare for a transfer pricing audit? Broadly, preparation should begin prior to an audit and not upon receiving an audit notification letter from the Inland Revenue Board of Malaysia.

The three stages in preparing for a transfer pricing audit can broadly be categorised into pre-audit, audit and post audit.

## PRE-AUDIT

The pre-audit stage should involve

undertaking an internal risk assessment exercise. This should ideally be a yearly exercise and involves identifying all material inter-company transactions as well as liaising with the transfer pricing advisor to gain an understanding of the areas likely to be targeted by the tax authorities.

Taxpayers should also seek to understand whether there are industry and other areas of contention how such issues have been resolved in other cases that have gone before the tax authorities.

This risk assessment exercise should ideally align with the risk assessment tool used by the Inland Revenue Board of Malaysia (IRB) in selecting taxpayers for audit.

Since 2011 selected taxpayers have been required to complete a risk assessment form (the Form MNE/JCK), the responses of which will determine selection for further audit scrutiny.

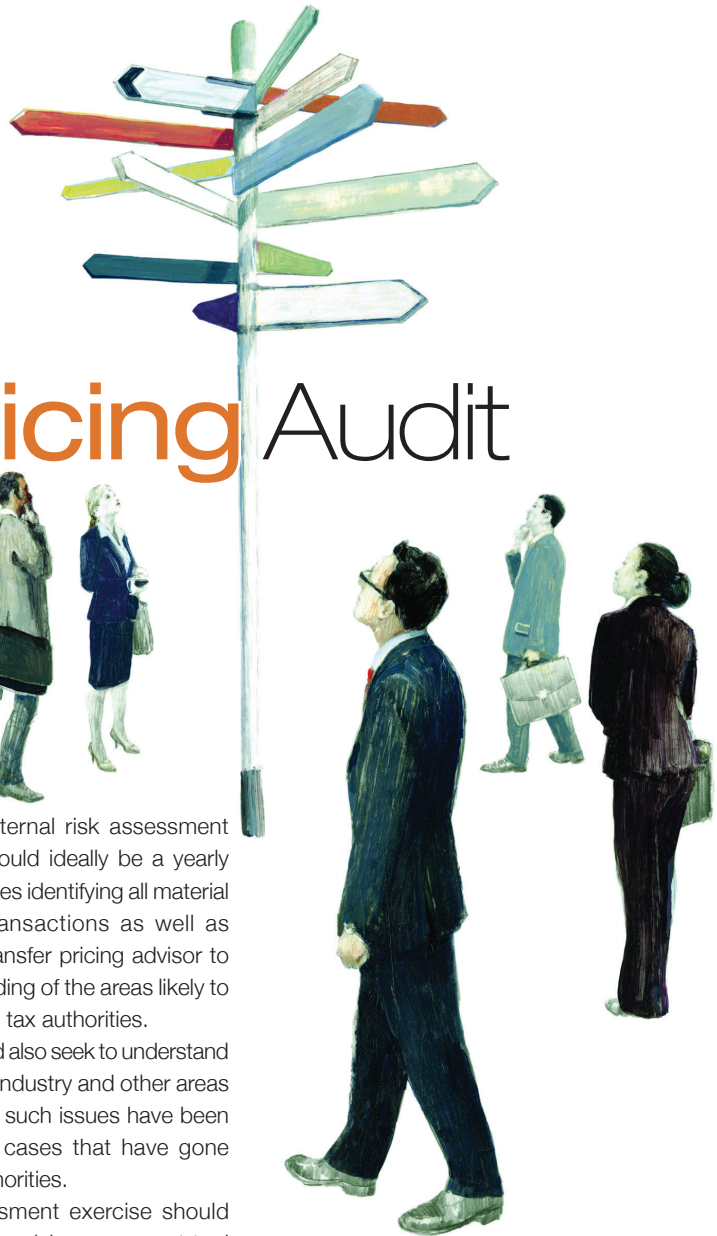
A taxpayer's transfer pricing risk is assessed from the perspective of quantum and transaction risk. A quantum risk relates to the value of tax at risk i.e. a transaction is considered high risk if the value of the transaction is such that an incorrect transfer price can lead to a significant understatement of taxable profits.

A transaction risk involves the consideration of factors such as the nature of the transaction and the complexity thereof.

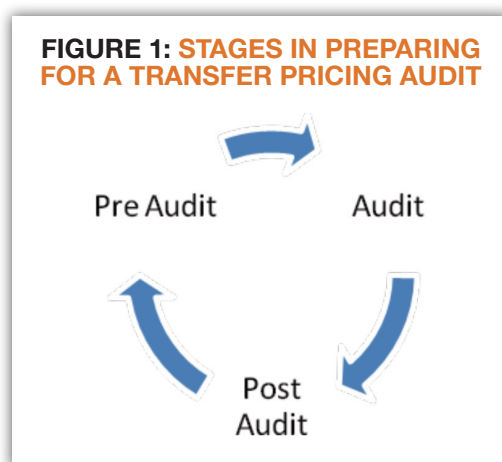
Additionally, taxpayers who have no or low quality transfer pricing documentation would generally fall into the high audit risk category while those who have contemporaneous documentation would fall into the lower risk category.

Arising from the internal risk review exercise, transfer pricing documentation should be prepared in compliance with transfer pricing rules and regulations of the country.

Where there is existing documentation, this documentation should be reviewed to ensure that the facts therein are accurate and that the economic analysis is in order.



**FIGURE 1: STAGES IN PREPARING FOR A TRANSFER PRICING AUDIT**



## AUDIT

Understanding the mechanics of the transfer pricing audit would enable taxpayers to effectively manage the process.

The Transfer Pricing Audit Framework which is effective 1 April 2013 provides guidance to taxpayers in Malaysia on the process involved in an audit. The taxpayer would be issued with a formal letter informing it of the IRB's intention to conduct a field audit. The notice period is at least 14 days.

A field audit is generally held at the taxpayer's premises and is carried out to enable the IRB to gain a better understanding of the taxpayer's business.

At the start of the audit, taxpayers will typically be required to give the tax authority an overview of the business in terms of its shareholding structure, organisational structure, business and global operations, management structure and functions, inter-company transactions, etc.

A factory tour would also typically be requested.

In managing the audit, the taxpayer should have in place the following:

- A direct contact person, usually a finance personnel, with whom the IRB auditors can speak to for questions and who can then supply the information required by the auditors as well as see to their other needs;
- Specific individuals from different key areas of the organisation should also be identified to prepare them for any subsequent audit queries. These individuals chosen should be the ones most knowledgeable about a specific function (e.g. research & development, production, accounting and finance, etc) within the organisation. As a functional analysis would usually be carried out by the tax auditors to obtain a better understanding of the business, it is important for the taxpayer to brief these individuals on how an interview is typically conducted and the issues that are likely to be raised in interviews by the IRB auditors;
- A room should be assigned to the IRB auditors for use during the entire audit period with adequate facilities;
- Ensure that all requests for information/

clarifications by the IRB auditors are in writing as this would ensure that all information requests are duly responded to. All responses to the tax authorities should be thorough but should be limited to the issue at hand as superfluous information may lead to additional questions which may prolong the audit.

- All information should be provided in a timely manner and the audit team should be informed as soon as possible if the taxpayer is unable to meet a deadline.
- Some of the documentations that the tax authorities would typically review during an audit include the following:
  - Primary accounting records e.g. source documents such as the accounting and record keeping systems and supporting documents and agreements tied to the taxpayer's business operations. Taxpayers will be required to produce supporting documentation (e.g. general ledgers, management accounts, invoices, etc) covering the years to be audited (typically this is between 1 to 3 years);



- Records of transactions with associated enterprises e.g. contract manufacturing agreements, management service agreements, loan agreements, royalty agreements, etc;
- Transfer pricing documentation; and
- Year-end transfer pricing adjustments.

## POST AUDIT

The post audit process involves the issuance of audit findings by the audit officer. From there, the taxpayer will be invited to meet with the tax authorities to discuss issues and work towards the closure of the case.

Based on the feedback and findings by the IRB auditors, the taxpayer should

re-evaluate the audit strategy with the the transfer pricing advisor. The focus at this stage should be on identifying negotiable and non-negotiable issues.

Non-negotiable issues are issues that the taxpayer would be willing to challenge by virtue of the fact that the issues have far reaching tax consequences for the taxpayer and possibly the Group.

Negotiable issues are those on which the taxpayer may be willing to concede so as to achieve closure of the case. For example, in Malaysia although the transfer pricing audit to carried out by a specialist team, it is possible that non-transfer pricing issues are picked up as well during the audit.

In such circumstances, a taxpayer may be willing to concede on the reclassification of some expenses from deductible to non-deductible.

Arising therefrom, if there are still unresolved transfer pricing issues, the taxpayer would need to weigh the options available in dealing with the transfer pricing controversy which include:

- Seeking a negotiated settlement;
- Competent authority relief (through the Mutual Agreement Procedure provision of the relevant double tax agreement); or
- Litigation.

Upon settlement of the audit, the taxpayer should work with the transfer pricing advisor to evaluate whether there is a need to review the transfer pricing set-up or to use APA's (where available) to reduce any potential future disputes.

Taxpayers in Malaysia with significant inter-company transactions can expect to undergo a transfer pricing audit at least once in every five years.

Whilst undoubtedly a time consuming and at times stressful process, this can best be managed by preparing well in advance via high quality documentation, establishing a clear chain of command in dealing with an audit and working closely with the transfer pricing advisor in evaluating the options open to the company in the event of a dispute. **mb**

BERNICE TAN, AN EXECUTIVE DIRECTOR OF TAXAND MALAYSIA SDN BHD CONTRIBUTED TO THIS ARTICLE. THE VIEWS EXPRESSED HERE DO NOT NECESSARILY REPRESENT THOSE OF THE FIRM. READERS SHOULD SEEK SPECIFIC PROFESSIONAL ADVICE BEFORE ACTING ON THE VIEWS. BERNICE CAN BE CONTACTED AT BT@TAXAND.COM.MY.