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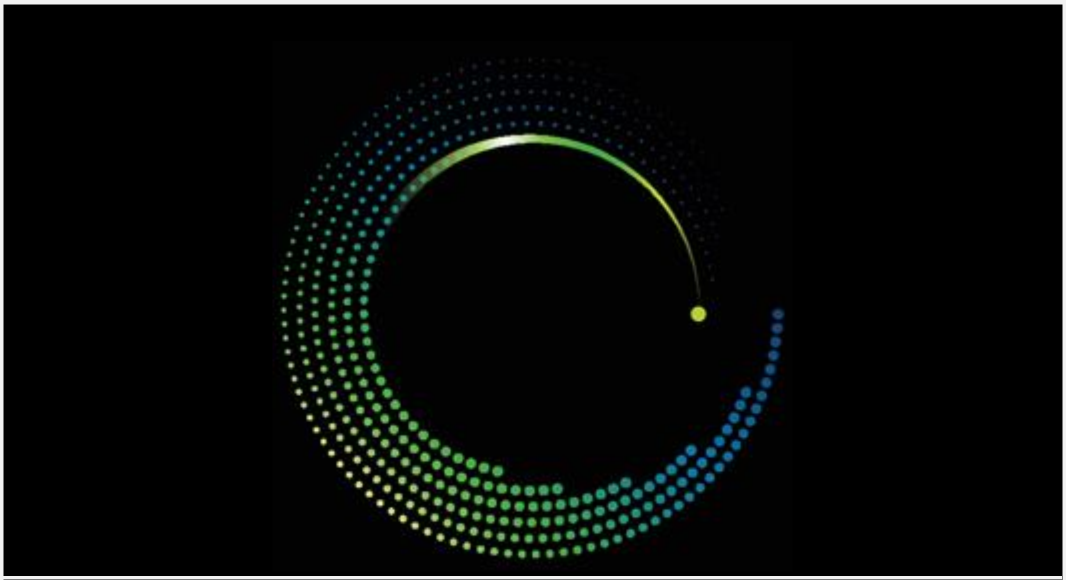

Tax Espresso – Special Alert

YA 2022 Income Tax Return – Significant additional disclosure expected on transfer pricing (Item F8)

The Inland Revenue Board of Malaysia ("IRB") has released the updated YA 2022 Form C -SampleRF_C2022_2.pdf (hasil.gov.my) which requires significant additional Transfer Pricing ("TP") disclosures (as per Item F8). The updated Form would apply to returns of taxpayers with financial years ending on or after 1 Jan 2022.

What are the additional disclosure requirements in Form C?

Entity characterisation

The taxpayer is required to provide entity characterisation pertaining to their business activities viz. manufacturing or distribution or service activities. The precise entity characterisation is critical, and it would need to be determined based on TP Functions, Assets and Risks (“FAR”) analysis. Hence, this additional disclosure would pose a challenge for taxpayers that do not prepare TP documentation report or those that just prepare the minimum TP documentation report without FAR analysis.

TP characterisation has strong interplay with impending Pillar One implementation as well as risk-reward assessment in audit.

Business restructuring

Business restructuring is one of the key red flag indicators for the IRB in selecting a TP audit case, especially for business restructuring resulting in reduction of profitability of the taxpayer. The IRB has also intensified its scrutiny on business restructuring performed immediately after the expiry of tax incentives or due to the impact of the pandemic. Not every business change is a *business restructuring*. This needs to be answered by applying transfer pricing definition of business restructuring, most notably in the OECD TP Guidelines. While the updated Form has laid out specific instances of business restructuring, there is a catch-all *“Others”* option.

Research and Development (“R&D”) activity

The IRB conducts a thorough scrutiny of R&D activities undertaken by the taxpayer and the transfer pricing compensation for the same, if any. Historical audit trends indicate emphasis by the IRB on taxpayer activities that contribute towards development and/or enhancement of manufacturing intangibles, including certain product/process improvements that are shared among related parties. Similarly, taxpayers enjoying incentives are sometimes required to undertake R&D activities as a condition to enjoy the exemption.

Routine cost plus compensation for the taxpayer undertaking R&D activities may not be appropriate in all cases, as explained in the Malaysia TP Guidelines. Accurate TP delineation of these R&D arrangements would necessarily precede correct disclosure in the YA 2022 return with respect to the declaration required on R&D, which in turn has interplay with other TP disclosures in the updated Form, e.g. business restructuring, ownership of intangibles, participation in cost contribution arrangements, etc.

Ownership of trade/ brand name/ Intellectual Property (“IP”)

The ownership criteria under transfer pricing are not restricted to only legal ownership but extends to economic ownership, which is generally determined based on the development, enhancement, maintenance, protection, and exploitation (‘DEMPE’) analysis of intangibles. Accordingly, even an excessive advertisement, and marketing and promotion activities by the local taxpayer may be viewed by the IRB as brand enhancement, leading to expectation of compensation for such economic ownership.

Other disclosures

Cash pooling, permanent establishment ('PE'), dividend declaration/payment, cost contribution arrangements, etc. are some of the other disclosures incorporated in the updated Form C. Regarding PE, the taxpayer needs to carefully evaluate if any of its activities trigger PE for a foreign entity, as this may have an impact on the disclosure required in the updated Form, unless the IRB provides clarification otherwise.

What are the consequences of incorrect disclosure in Form C?

In case the taxpayer gives any incorrect information in Form C for matters affecting the tax liability of a taxpayer or any other person, then penalty could be imposed on the taxpayer (up to 200% of tax undercharged under specific circumstances). The IRB may also allege that the taxpayer has disclosed incorrect information/false particulars in the tax return, and consequently the statute of limitations may not apply due to willful default/negligence. Any incorrect disclosures could also have consequential implications, such as increase in the probability of selection for audit, protracted dispute, impact on existing APA or those being negotiated, MAP negotiations, etc.

Separate from the above, effective for tax audits commenced on or after 1 January 2021, there is a new penalty under Section 113B (failure to submit contemporaneous TP documentation within 14 days upon request) and a surcharge under new subsection 140A(3C) (up to 5% of transfer pricing adjustment).

With the recent emphasis by the IRB on tax corporate governance framework and cooperative compliance, there is significant onus on the directors and other stakeholders to give due attention to TP. The additional TP disclosures in Form C effective YA 2022 should serve as a reminder of the enhanced compliance standards.

The way forward for taxpayers

The proposed additional TP disclosures in Form C appear similar to Form MNE, which was circulated by the IRB to selected taxpayers in the past, to conduct risk assessment for audit initiation. Their inclusion in Form C, widens the net and the information provided by taxpayers would aid in risk-based audit selection moving forward. Accordingly, it is critical that these particulars are accurate and aligned with the contents of the annual TP documentation report.

Get in touch

Please contact our TP partners and directors if you would like to have a discussion on the above.

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