TRANSFER PRICING AND TAX MALFEASANCE: PERSPECTIVES FROM THE MALAYSIAN INLAND REVENUE BOARD

SAW SOO FANG

UNIVERSITI SAINS MALAYSIA

2023

TRANSFER PRICING AND TAX MALFEASANCE: PERSPECTIVES FROM THE MALAYSIAN INLAND REVENUE BOARD

by

SAW SOO FANG

Thesis submitted in fulfilment of the requirements for the degree of Doctor of Philosophy

December 2023

ACKNOWLEDGEMENT

Many people deserve thanks and appreciation on the completion of the thesis. First and foremost, I would like to express my heartfelt appreciation to all my supervisors, Dr. Phua Lian Kee, Dr Zubir Bin Azhar and Ms Lim Tan Chin for their engagement, guidance, patience, direction for the research, motivation, constructive criticisms and comments, fruitful suggestions, invaluable advice and continuous support and assistance in completing this dissertation. I owe my deepest gratitude to them because without their guidance it would be impossible for me to finish this dissertation. I would like to acknowledge the YAB. Datuk Sabin Bin Samitah, CEO of the Inland Revenue Board of Malaysia (IRBM) for giving me the opportunity to embark on this journey by allowing me to obtain IRBM data from Data Analysis Centre located in IRBM Cyberjaya. Special thanks to Dr. Rasyidah Binti Che Rosli, Principal Assistant Director, Tax Operation Department of IRBM. Without her assistant, I would be not able to obtain relevant data for my dissertation. Her team lead by Encik Mohd Azizul Bin Jali has been support at their best as and when requested. Besides, great appreciation also given to the Puan Hairaneey Binti Mhd, Pengarah of Multinational Audit Luaran and her team station in Bangi. Puan Hairaneey has provided and share unlimited useful tax audit experience encountered by her and her team specifically on Transfer Pricing Division. She is knowledgeable and her team also did provide archival data listing for myself to complete the said dissertation on time. Thank you to Encik Muhamad Yusof Z Rusli. As for legal team division in IRBM, Cyberjaya, thank you to Encik Abu Tariq Jamaluddin, Director of Legal Department and also Encik Muzairi on data and legal case decided in SCIT of IRBM. From bottom of my heart, I would like to express my special thank you to my family for their understanding and continuous support, encouragement, patient, and constant dedication throughout my journey. Last but not least, I would like to express my special thank you to the former Associate Professor at University of Malaya Dr Choong Kwai Fatt. He constantly provides me guidance in my journey in completing this dissertation. Without his patient, guidance on know-how in completing this dissertation including valuable material sending to me on time.

TABLE OF CONTENTS

LIST OF TABLES

LIST OF FIGURES

Page

LIST OF ABBREVIATIONS

AEOI	Automatic Exchange of Information
AMLTFA	Anti-Money Laundering and Financial Terrorism Act
ASEAN	Association of Southeast Asian Nations
ATO	Australia Taxation Office
AUD	Australian Dollars
BEPS	Base Erosion and Profit Shifting
BNM	(Bank Negara Malaysia) Central Bank of Malaysia
CAP	Consumer Association Penang
CCRS	Certificate on the Common Reporting Standard
CMS	Case Management System
CUP	Comparable Uncontrollable Price
CTR	Cash Transaction Report
DGIR	Director General of Inland Revenue Board of Malaysia
FDI	Foreign Direct Investment
FIE	Financial Intelligent and Enforcement
FIU	Financial Intelligent Unit
GDP	Gross Development Product
HMRC	Her Majesty’s Revenue and Customs
MCO	Movement Control Order
MNE	Multinational Enterprise
MTD	Multinational Tax Department
MTPG	Malaysian Transfer Pricing Guidelines
ITP	International Transfer Pricing
ICA	Inter Company Agreements
ICT	Information and Communication Technology
IIPR	International Investment Position Report
IMF	International Monetary Fund
IRBM	Inland Revenue Board of Malaysia
IRS	Inland Revenue Service
ITA	Income Tax Act
LEAs	Law Enforcement Agencies

OECD	Organisation for Economics Co-operation and Development
PNG	Papua New Guinea
PE	Permanent Establishment
PU	[Pemberitahu Undangan] translated as Public Ruling
PwC	PricewaterhouseCoopers
RCI	Royal Commission of Inquiry
RM	Ringgit Malaysia
RPTs	Related Party Transaction (s)
SCIT	Special Commissioner of Income Tax
STR	Suspicious Transaction Report
TNMM	Transitional Net Margin Method
TP	Transfer Pricing
UK	United Kingdom
UNCTAD	United Nations Conference on Trade And Development
US	United States
USD	US Dollar

LIST OF APPENDICES

HARGA PINDAHAN DAN PENYELEWENGAN CUKAI: PERSPEKTIF DARIPADA LEMBAGA HASIL DALAM NEGERI MALAYSIA

ABSTRAK

Penyelewengan cukai yang berkaitan dengan manipulasi harga pindahan adalah masalah yang meluas dalam kalangan Perusahaan Multinasional (MNE). Oleh itu, matlamat untuk memerangi amalan penyelewengan cukai untuk memaksimumkan kutipan cukai telah menjadi agenda penting dalam kalangan pihak berkuasa cukai. Objektif kajian adalah: pertama, untuk memahami isu-isu berkenaan langkah-langkah yang diambil oleh LHDNM untuk mengesan bidang penyelewengan cukai dalam kalangan MNE Malaysia semasa menetapkan harga pindahan. Kedua, untuk menentukan tindakan yang diambil oleh LHDNM untuk mengatasi penyelewengan cukai oleh MNE dan akhir sekali, untuk menyiasat sebab di sebalik keperluan untuk melaksanakan undang-undang atau peraturan atau aktiviti untuk menghalang berlakunya penyelewengan cukai pada masa hadapan. Data arkib yang diekstrak daripada pangkalan data LHDNM digunakan untuk menganalisis profil MNE yang terlibat dalam kes penyelewengan cukai di Malaysia dan diikuti dengan temu bual elit. Temu bual elit telah dijalankan dari Mac 2019 hingga April 2020 dengan seramai 12 orang yang ditemuduga terdiri daripada pengawai LHDNM serta pengamal cukai. Keputusan mendedahlkan isu-isu berkenaan langkah-langkah yang diambil oleh LHDNM untuk mengenal pasti bidang salah laku cukai dalam kalangan MNE Malaysia. Isu-isu tersebut tersebut merangkumi julat penunjuk keuntungan yang diluluskan oleh LHDNM untuk penetapan harga, urus niaga antara syarikat yang digunakan untuk menetapkan harga pindahan, perselisihan pendapat mengenai penanda aras yang digunakan untuk menetapkan harga pindahan dan langkah cukai

lain yang LHDNM ambil untuk memerangi salah laku cukai MNE. Kuasa yang diberikan kepada Ketua Pengarah Cukai Pendapatan (KPHDN) di bawah Seksyen 140A Akta Cukai Pendapatan (ACP) 1967 bersama-sama dengan pelaksanaan strategi penalti cukai “bayar dulu, cakap kemudian” telah memainkan peranan penting dalam meningkatkan sikap pematuhan cukai MNE. Seksyen 140A ACP 1967 telah membolehkan LHDNM berjaya meningkatkan kutipan hasil cukai negara. Penemuan juga mendedahkan peningkatan dalam permintaan rayuan kes cukai yang diselesaikan melalui mekanisme rayuan iaitu Borang Q yang bertujuan mendapatkan semakan kehakiman di mahkamah rayuan iaitu Pesuruhjaya Khas Cukai Pendapatan (SCIT) atau Mahkamah Tinggi. Teori Heuristik Kewajaran digunakan untuk menerangkan sebab, kesan dan dinamik dalam membuat keputusan kehakiman. Ini adalah untuk mematuhi objektif kajian penyelidikan iaitu untuk memahami isu berkenaan langkah-langkah yang diambil oleh LHDNM untuk mengesan bidang penyelewengan cukai dalam kalangan MNE Malaysia dalam penetapan harga pindahan mereka. Ia juga meliputi bidang sama ada pembayar cukai yang disiasat diberi peluang untuk menyuarakan kebimbangan mereka dan/atau untuk memberikan maklum balas yang sewajarnya kepada pihak berkuasa cukai apabila sesuai serta sebab di sebalik keperluan pelaksanaan undang-undang atau peraturan demi menghalang berlakunya penyelewengan cukai pada masa depan untuk memerangi pengelakan cukai.

TRANSFER PRICING AND TAX MALFEASANCE: PERSPECTIVES FROM THE MALAYSIAN INLAND REVENUE BOARD

ABSTRACT

Tax malfeasance associated with manipulation of transfer pricing is a pervasive problem among Multinational Enterprises (MNE). As such, the aim to combat tax malfeasance practices to maximise tax collection has become a vital agenda among tax authorities. The objectives of the study are: first, to understand the issues with measures taken by IRBM to detect the areas of tax malfeasance among Malaysian MNEs when setting up transfer pricing. Second, to determine the courses of action taken by IRBM to overcome tax malfeasance by MNEs and lastly, to investigate the reason behind the need for an implementation of law or regulations or activities to deter future occurrences of tax malfeasance. Archival data extracted from IRBM databases was used to analyse the profile of MNEs that were involved in tax malfeasance cases in Malaysia and followed by elite interviews. Elite interviews were conducted from March 2019 until April 2020 with a total of 12 interviewees comprises of interviewees from IRBM as well as tax practitioners. The results showed issues with measures that the IRBM took to identify areas of tax misconduct among Malaysian MNEs. The issues encompass the range of profit indicators IRBM would allow for pricing, including intercompany transactions used to set up transfer pricing, disagreements over benchmarking used to set up transfer pricing, and other tax measures IRBM took to combat MNE tax misconduct. The power granted to Director General of Income Tax (DGIR) under Section 140A of Income Tax Act (ITA) 1967 together with the implementation of tax penalty strategy of "pay first, talk later" have played a vital role in improving MNEs' tax compliance attitudes. Under Section 140A

of ITA 1967, it has enabled IRBM to successfully increase the country's tax revenue collection. The findings also reveal an increase in demand of appealing resolved tax cases through appeal mechanism i.e. Form Q with the intention to seek a judicial review at appeals court i.e. Special Commissioner of Income Tax (SCIT) or High Court. Fairness Heuristic Theory is applied to explain the causes, effects and dynamics of judicial decision making. This is to adhere to the research study objective that is to understand the issues with measure taken by IRBM to detect the area of tax malfeasance among Malaysian MNEs in setting of their transfer pricing. It also covered the areas whether the taxpayer under investigation is given an opportunity to voice their concern and / or to provide appropriate feedback to tax authority whenever appropriate as well as the reason behind the need for the implementation of law or rules or regulations to deter future occurrences of tax malfeasance in combating tax evasion.

CHAPTER 1

INTRODUCTION

1.1 Introduction

Globalization is one of the noteworthy features of modern-day businesses. To maintain a competitive and sustainable upper hand in the globalized village, companies have embarked on expansion and diversification endeavors that have taken their activities across borders, which resulted in the emergence and growth of multinational enterprises (MNEs). MNE refers to a multinational corporation that owns and controls the production of goods or services in at least one country other than its home country (Bartlett & Beamish, 2010; Buckley & Casson, 2015).

MNEs are important players on the global platform. Beebeejaun (2019) stated that MNEs and their associated enterprises were approximated to account for a tenth of the global Gross Domestic Product (GDP) and their sales were estimated at half of the world's GDP. Their growth was argued to be faster than the average growth of the world economy's GDP. 60% of trade by MNEs is contended to be transactions that occur within group setups. The prices of these transactions are always a subject of controversy because they cannot be verified in many instances, and are mostly not at arm's length (the price that would be agreed upon if such transactions are conducted between independent businesses under the same or comparable circumstances). Bhat (2009) commented that this issue is the greatest irony of free market economies, whereby a substantial proportion of world trade is not governed by prices set by the market.

With the globalization of the trade, most MNEs established different entities at various locations, with specific activities (for example, procurement, distribution, and research and development) concentrated in specific centers that serve the entire group, while production and assembly activities may be located elsewhere. In an increasingly integrated global economy, it made economic sense for MNEs to operate in various places to take advantage of locational benefits. Production costs, infrastructure, tax incentives or tax systems, skilled labor supply, business environment, information technology networks, and other factors have all influenced the placement and migration of MNE manufacturing and assembly plants (Kyove et al., 2021). This trend of increasing internationalization brings new challenges to scholars who endeavor to identify business strategies of MNEs, especially those who are concerned with how MNEs implement their strategies to achieve and sustain a competitive advantage (Madhok & Liu, 2006).

Meanwhile, intercompany or related party transactions (RPTs) undertaken and completed utilizing transfer pricing methods have become the norm for MNEs in their attempts to penetrate global markets, and manage the increasing expansion of their international commerce. RPTs are the transfer of resources, services or obligations between entity and a related party (Fooladi & Farhadi, 2019). Related party refers to a deal or arrangement made between two parties who are joined by a pre-existing business relationship or having common interest. The provision of the definition of RPT has been spelled under Subsection 2(4) of Income Tax Act 1967, and Section 7 of Company Act 2016 respectively.

From the perspective of tax authorities, a significant area of concern is the impact of RPT on tax revenue collection from the related party transactions, which are conducted and settled using an internal transfer pricing approach. Analytical results showed that more than two-third of all international business trades are carried on within related parties (PwC, 2017; World Bank, 2011). By referring to the World Investment Report 2018 of United Nations Conference on Trade and Development

(UNCTAD), Malaysia is recognized as one of the largest foreign direct investment (FDI) recipients, with an average volume of USD9.0 billion since 2010. Practically, as a result of the high volume of RPTs, transfer pricing has become the most critical global tax issue in contemporary business environment (Captain & Brown, 2014).

RPTs often involve cross-border, and between divisions in different tax jurisdiction countries. With the advent of MNEs and their growth, transfer pricing become even more complicated. When setting an international transfer price, multinational companies usually focus on a single objective, that is, tax minimization. Adeniyi and Imade (2018) posit that multinational corporations take advantage of the different tax rates charged in different jurisdictions to minimize the group's total tax liability. Ways of doing this include the use of transfer pricing to reduce the profits of subsidiaries in high-tax countries, and increase the profits of its subsidiaries in low-tax countries. The study also noted that by changing the transfer prices, firms can redistribute the pre-tax profit between the subsidiaries, but maintain the figure of the total pre-tax profit. If more pre-tax profit is earned in low-tax countries, and less profit is earned in high-tax countries, the total payable tax can be reduced.

Previous empirical studies on international transfer pricing issues have provided evidence that the MNEs tend to use the international transfer pricing for shifting the group's income (Dawson, 1999; Grubert & Mutti, 1991; Grubert & Slemrod, 1998; Hines & Rice, 1994; Hoffman, 2001; Olibe & Rezaee, 2008; Oyelere & Emmanuel, 1998). For governments across the globe, tax revenue is the most important source of revenue. Total collectable revenue is an essential item for the governments to ensure that the pre-planned development expenditure can be funded accordingly. Thus, most governments are under pressure to combat revenue leakage, and under declaration of taxable revenue caused by tax non-compliance or mis-pricing activities such as intercompany transfer transactions.

1.2 Transfer Pricing

1.2.1 Concepts and Approaches in Transfer Pricing

Transfer pricing is the process of estimating the prices of products and services that are transacted between related MNEs that are located in various tax jurisdictions (Li, 2005; Li & Paisey, 2007). The transactions between related parties are held on conditions that the independent parties engaged in the same or comparable transaction at arm's length and finding the price to be reasonable (Holtzman & Nagel, 2014). This refers to a circumstance whereby an independent person or party engages in a business transaction with full information, without being influenced by others. To put it another way, arm's length pricing is the price that would be agreed upon if such transactions are conducted between independent businesses under the same or comparable circumstances. This is illustrated through Figure 1.1.

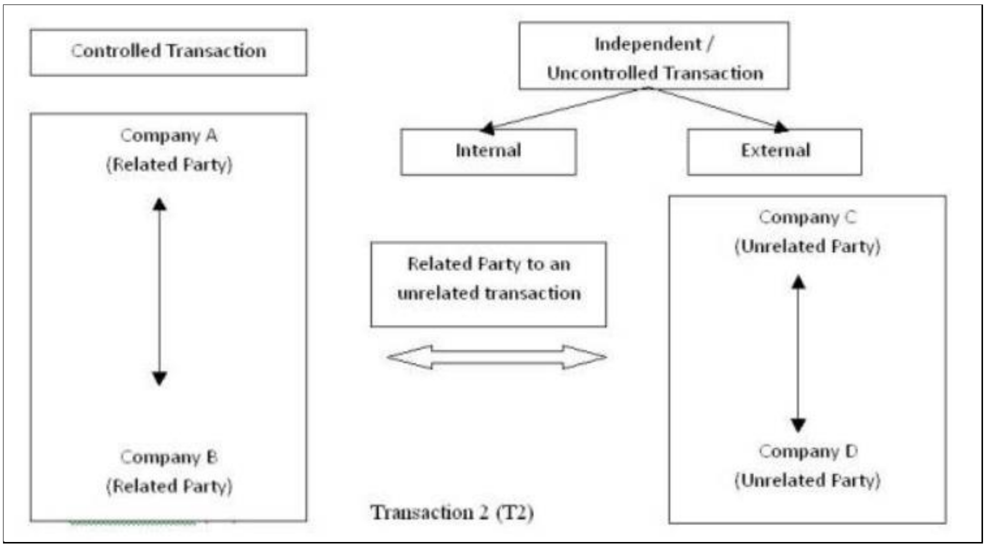

Figure 1.1 Illustration of Transfer Pricing Approach

From Figure 1.1, controlled transaction refers to a transaction that takes place between the associated enterprises or related entities/parties. Uncontrolled transaction is a transaction that takes place between independent enterprises or unrelated entities/parties as illustrated as Company A, Company B, and Company C. The price adopted by Company A and Company B, so called related party's price must have insignificant differences, as if the transaction is performed with an independent party or unrelated party (in this case, Company C), giving the fact that all conditions or circumstances are similar and comparable.

As per Chapter III of Malaysia Transfer Pricing Guidelines 2012 (Malaysia Transfer Pricing Guideline [MTPG], 2012), Comparable Uncontrolled Price (CUP) method is the most direct way of ascertaining an arm's length price. It compares the price charged for a property or services transferred in a controlled transaction to the price charged for a property or services transferred in a comparable uncontrolled transaction, in comparable circumstances. A difference between the two prices may be an indication that the conditions of the commercial and financial relations of the associated persons are not at arm's length, and that the price in the uncontrolled transaction may need to substitute for the price in the controlled transaction.

This method is only ideal if comparable products are available or if reasonably accurate adjustments can be made to eliminate material product differences. Other methods will have to be considered if material product differences cannot be adjusted to provide a reliable measure of an arm's length price.

Transfer pricing has the effect of reallocating profits between related parties of the group. The core objective is to minimize the total tax liability in the group and maximize tax saving. In other words, market forces dictate the transaction of prices of goods and services for unrelated parties, but have no influence on the transaction prices of the related parties. The basic goal of a transfer pricing plan is to maximize a subsidiary's total profit, while allowing the parent firm to pay less tax.

MNE's transfer pricing strategy establishes how revenues are split among the various units of the organization that operate in several countries. The success of an MNE's transfer pricing strategy is determined by the amount of taxes an MNE pays, to which tax administration the taxes go to, and how profit is allocated among the different units of the company operating in different tax jurisdictions. The uneven distribution of profits, which are decided by the related parties, result in less tax liabilities for the respective entities.

OECD reported that MNEs has the discretion of structuring their business models and determining their desired internal trading terms, which enables them to relocate their global profit to their affiliate members who operate in low tax countries, without affecting the equivalent economic activities, assets, risks, or functions (OECD, 2012). Thus, transfer pricing laws are essential in order to provide a guidance for the adjustments of profit allocation and the distribution of functions, assets, and risks among MNEs is performed within an acceptable range.

The major goals of the transfer pricing approach, according to regulatory agencies, are: (i) to represent the genuine profit inside a jurisdiction, that is, profit is not understated by manipulating sales price or loss, and not overstated by inflating the expenses; (ii) to prevent tax evasion; and (iii) to protect national tax collection so that they can collect the tax based on a fair share of the tax revenue.

According to MTPG (2012), a market price is determined by two independent actors acting on their own self-interest. The basic self-interest assumption may be affected if the agents are not autonomous. The arm’s length notion suggests that a transfer price is acceptable if all the transactions between the related parties are handled at arm's length pricing. However, this is difficult to achieve in practice because of the presence of the different hierarchy inside the related companies and difficult to find similar comparable when conducting business transactions.

1.2.2 Foreign Direct Investment (FDI) and Transfer Pricing in Malaysia

In Malaysia, tax revenue accounted for over 73.9 percent of the total domestic revenue in 2017, or 12 percent of Malaysia's Gross Domestic Product (GDP) (Malaysian Bureau of Statistics, 2017). In Malaysia, direct tax revenue increased by 15 percent to RM133.5 billion in 2018, owing to improved corporate profitability and a higher crude oil price of US$70 per barrel. Former Finance Minister of Malaysia, Mr. Lim Guan Eng, announced at a press conference that the total authorized FDI of Malaysia surged by 73.4 percent in the first quarter of 2019, that is, from RM16.9 billion to RM29.3 billion (The Star, 2020), as a consequence of notable approvals granted to Micron Technology and Jabil Circuit to operate their business in the state of Penang. He elaborated further that the rise was underpinned by a 127% increase in investment in the manufacturing sector, which resulted in a surge in FDI from RM8.9 billion to RM20.2 billion in 2018. Out of the RM20.2 billion in approved manufacturing FDI, RM11.5 billion came from the United States, RM4.4 billion from China, and RM2.2 billion from Singapore.

Figure 1.2 presents a summary of the FDI in Malaysia from the first quarter of 2018 to the second quarter of 2020. In 2020, Malaysia remained an appealing investment destination, despite the adverse conditions. Malaysia was able to attract FDI because of its stable political situation, the presence of free trade zones, and the availability of suitable labor (The Star, 2020).

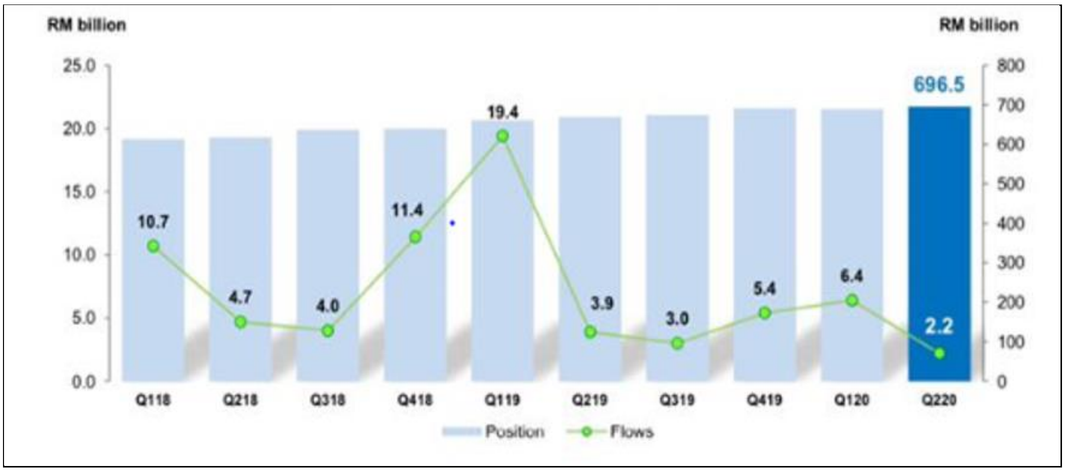

Figure 1.2 Foreign Direct Investment in Malaysia from Q1 2018 to Q2 2020

The Malaysian government aims to promote the country as a gateway of the ASEAN market. Hence, a variety of incentives was offered to foreign businesses, such as pioneer status and investment tax reductions. Table 1.1 summarizes the key investing nations and the major invested industries as of Q3 2020 (World Investment Report 2020, United Nations Conference on Trade and Development [UNCTAD)]).

Table 1.1 Foreign Direct Investment by Country and Industry 2020

Main investing Countries	Q3, 2020 (in %)	Main Invested Sectors	Q3, 2020 (in %)
Singapore	21.7	Manufacturing	38.6
Hong Kong	12.5	Financing and insurance	24.2
Japan	10.8	Mining and quarrying	6.1
Netherlands	8.7		

Source: UNCTAD, World Investment Report 2020

In addition, South Korean-based semiconductor giant, Simmtech Holdings Inc., has chosen Batu Kawan, Penang as the strategic location to build its first in the region printed circuit board (PCB) and packaging substrate factory, with an initial investment of RM508 million and a second phase investment of RM221.6 million (Bernama, 2016). This indicated that Malaysia, especially the Penang State, continues to stay as the prime choice for investors.

Tax is a significant source of income to a country. However, Malaysia is unprotected from its parallel risks, such as income shifting or tax fraud among the MNEs. The Global Financial Integrity Report (2015) disclosed that the outflow of illegal investment in Malaysia for the period 2013 to 2014 was USD418.542 billion, which included funds gained via tax evasion, organized crime, corruption, and other criminal acts. In 2015, the Panama Papers revealed that 2,300 Malaysia individuals and entities were hiding money in offshore tax havens.

On the impact of capital outflows to tax havens, International Monetary Fund (IMF) warned that financial flows seeking secrecy or fleeing corporate taxes tend to exacerbate the finance curse. It creates more inequality, increase the vulnerability to crises, and causes unquantifiable political damage. In addition, when financial capital flows from poorer countries to the rich-world tax havens, it results in the migration of labor (New Strait Times, 2023).

President of the Consumers Association of Penang (CAP), Mr. Mohideen Abdul Kader commented in New Strait Times (2023) that there is a need for a system to identify, contain, and reduce transfer mispricing by companies, which artificially inflated the costs of products, and deflates the profits through intra-company transactions. He further added that investigation should also include Malaysian individuals and companies named in the 2015 Panama Papers, and the 2016 Paradise Papers.

In 2022, CAP had called on the government to set up a Royal Commission of Inquiry (RCI) to investigate the outflow of financial assets from Malaysia to secret accounts in tax havens, which adversely impacted the country’s economy. CAP

President asserted that the setting up of RCI by agencies alone is not enough to address the issue. RCI should also identify the weaknesses in Malaysian laws and legal institutions in order to curb the outflow of illicit money, and make recommendations to strengthen the legal-institutional framework (New Strait Times, 2023).

Malaysia, regrettably, is one of the top five nations in the world for the flow of illicit money, resulting in an annual loss of USD48 billion (Kar & Spanjers, 2015). In 2015, it was estimated that RM125.1 trillion had been looted and stored in offshore tax havens, resulting in MNEs paying extremely little taxes or having tax-free access to those funds (Alleurope, 2015). In 2021, European Union placed Malaysia on its “grey list” of non-cooperative jurisdictions for tax purposes after revelations of the Pandora Papers.

The above scenario has alerted Malaysian tax authorities and the government to look into the present situation, and to identify the threat it may impose on Malaysia, such as losing tax revenue, and take appropriate measures to combat these challenges.

1.3 Problem Statement

The number of transfer pricing audits has increased considerably in recent years, owing mostly to the setting up of the Multinational Tax Department by the Inland Revenue Board of Malaysia (IRBM).

IRBM presented an analysis on Transfer Pricing Audit on July 2018, during its annual tax event at the National Tax Conference, which is summarized in Table 1.2. The data demonstrate that there was an upsurge in the number and intensity of transfer pricing audit over the past five years, that is, from 183 cases in 2013 to 265 cases in 2017. The increase was approximately 45% in 2017, as compared to 2013. Meanwhile, the total understatement tax collected, together with tax penalties, also increased by 400%, that is, from RM166.0 million in 2013 to RM681.94 million in 2017.

Table 1.2 Transfer Pricing Audit for 2013 to 2017

Year	Cases Resolved	Tax & Penalties (RM'million)
2017	265	681.94
2016	256	240.44
2015	250	124.87
2014	168	155.94
2013	183	166.00

Source: Multinational Tax Department, Inland Revenue Board of Malaysia, 2018

Table 1.3 also demonstrates the component amount of tax imposed from the transfer pricing audit for the years 2004 to 2018. The total amount of payable tax originating from transfer pricing audits for the 2018 amounted to RM582.6 million. In addition, it indicates that the total additional tax collected prior to 2013 was below RM100 million per annum, while the amount of tax collected after 2013 exceeded RM100 million. Furthermore, the amount of payable tax had doubled, that is, RM477 million in 2017 from RM194 million in 2016.

Table 1.3 Amounts of Payable Tax Arising from Transfer Pricing Audit from 2004 – 2018

Year	Additional Tax (RM)	Penalty (RM)	Total Amount (RM)
2004	24,579,529	2,432,370	27,011,899
2005	47,216,212	28,070,656	72,286,868
2006	73,385,623	18,600,308	91,985,931
2007	59,903,353	11,436,656	71,340,009
2008	40,191,247	6,921,183	47,112,430
2009	26,270,487	7,469,424	33,739,911
2010	90,137,793	27,853,992	55,096,075
2011	40,278,097	6,726,005	47,004,102
2012	90,137,793	27,853,992	117,991,785
2013	123,199,748	42,800,629	166,000,377
2014	117,487,828	38,455,479	155,943,307
2015	103,462,733	21,407,454	124,870,186
2016	194,405,673	46,034,914	240,440,586
2017	477,775,200	186,481,024	681,939,667
2018	432,867,821	149,694,311	582,562,134

Source: Multinational Tax Department, Inland Revenue Board of Malaysia, 2018

As at June 2018, based on the statistical result shared by the Senior Revenue Counsel of IRBM, the total number of appeal cases (746 cases) brought to the Special Commissioner of Income Tax (SCIT) remained unresolved. However, new cases that appealed to SCIT for the year 2018 itself were 174, together with the accumulated cases, the total number was 920 cases. The incremental cases constituted approximately 23% of all the cases. The above statistic had not taken into consideration the number of cases to be audited at the branch level. The same situation was experienced by the High Court, the Court of Appeals, and the Federal Court. The tremendous increase in the number of resolved tax cases concluded at IRBM branch level and appealing for judicial review has alarmed the tax authority that immediate attention is required to address the issues now. Table 1.4 depicts the number of appealed cases received by appeal courts as at June 2018.

Table 1.4 Resolved Tax Cases and Appeal for Juridical Review as at June 2018

Items	Special Commission of Income Tax	High Court	Court of Appeal	Federal Court
Balance b/f	746	58	19	3
Cases Received	174	26	15	3
Sub Total	920	84	34	6
Cases settled	90	29	11	1
Total	830	55	23	5

Source: Multinational Tax Department, Inland Revenue Board of Malaysia, 2018

With the rising number of tax malfeasance issues and audit disputes cases detected as observed from the statistical data shown in Table 1.2 to Table 1.4, it is essential to explore the issues with measures undertaken by IRBM to detect the areas of tax malfeasance among Malaysian MNEs when setting up of transfer pricing, and its move towards strengthening the legal-institutional framework to eliminate tax avoidance and tax evasion.

The sharp increase in tax collections can be attributed to the growing worldwide trade, but it also reflects the IRBM's heightened focus on transfer pricing audits. Based on the investigation results shared by the director of the Multinational Tax Department, the most common tax disputes and tax adjustments imposed by IRBM was due to the inappropriateness of arm’s length benchmarking adopted by

MNEs on inter-company transactions or transactions transacted below the median of arm's length range. There could be a variety of causes for the adjustment of transfer pricing, ranging from simple mistakes made by the taxpayers to a lack of paperwork or differing interpretations of the highly complex technical issues.

Transfer price is, without a doubt, a complicated topic fraught with hazards. “Is our tax authorities able to track this type of transfer and smell out any irregularities?” was the most often asked question by the taxpayers. When the fair prices of these commodities and services are easily determinable, IRBM can identify and “clamp down” on these behaviors; however, if there is no market to compare the products and/or services, the undesirable practices are more difficult to detect. As a result, IRBM mandates that a commercial transaction between related parties resemble a real transaction involving unconnected parties. That is, the affiliates should provide the same price that an unconnected buyer would pay. Hence, the "arm's length concept" is meant to combat tax avoidance.

However, the arm’s length adjustment is hard to evaluate, and the findings are not scientific. When the transactions in question are of fundamental products and services, the Arm’s Length Principle can be a simple baseline for IRBM. This means that other market participants have ready access to the market values of those transactions, making it simple to verify whether related party transactions are compliant to the arm’s length principle. The terminology of arm’s length principle is explained in detail under Section 2.3.6 of Chapter 2. MNEs may also face difficulties in acquire sufficient amount of knowledge in aspect of comparability due to limited quantity of data available in public domain, that is called, an incomplete world of information, or inexact comparable. If there is inadequate transactional data or untainted financial data to analyze the transaction while determining the arm's length price in the case under review, IRBM may modify the pricing.

Hence, a strengthened system is needed to reduce transfer mispricing by companies. At the same time, tax authorities should impose more stringent documentation requirements. The government should work with other nations to put in place an automatic exchange of financial information across borders, such as public disclosure of the ultimate beneficiaries of companies, country-by-country reporting for MNEs, and unitary tax with formula apportionment to prevent tax avoidance or outflow of profits to secret account in tax haven country.

IRBM has the responsibility to research on circumstances that lead to tax malfeasance, and to enhance their enforcement procedures. IRBM also have to find a solution to combat the perfect and complex tax strategies designed by MNEs to evade tax. Tax policies on how to increase the rate of tax compliance among MNEs is also crucial. Hence, IRBM plays an important role in promoting tax compliance of MNEs, and preventing tax malfeasance.

1.4 Research Objectives and Research Questions

This research is designed to understand the practical issues or problems encountered by IRBM during audit investigation. It also includes examining the measures IRBM can adopt in order to close the gap or discrepancies found when accepting and upholding the current laws and practices. In addition, this study also investigates on the challenges affecting the implementation of transfer pricing in Malaysia, which eventually impact on the tax revenue collected by IRBM, and the effort taken by IRBM to increase tax compliance awareness among MNEs.

Specifically, this study aims to attain the following objectives:

i. To understand the issues with measures taken by IRBM to detect the areas of tax malfeasance among Malaysian MNEs when setting up the transfer pricing.

ii. To determine the courses of action taken by IRBM to overcome tax malfeasance by MNEs, and

iii. To investigate the reasons behind the need for an implementation of law or regulations or activities to deter future occurrences of tax malfeasance.

With the above objectives, this study lay the research questions as below:

i. What are the issues with measures taken by IRBM to detect areas that give rise to tax malfeasance among MNEs in Malaysia?

ii. How does IRBM overcome tax malfeasance activities by MNEs in Malaysia?

iii. Why the need for an implementation of law or regulations or activities to deter future occurrences of tax malfeasance?

1.5 Research Approach and Scope

To answer the above research questions, the researcher attended the 2018 Annual National Tax Conference to obtain the latest updates on key statistics shared by IRBM. The information gathered from the conference was reviewed to determine the scope of the study and to develop the research objectives. Based on the patterns or trends observed from the statistics presented by IRBM, archival audited tax data from year 2013 to year 2017 were identified as the scope of the study. Following that, an initial request letter to obtain relevant data from IRBM was sent to the Director General of IRBM (also as the gatekeeper of IRBM), YAB Dato Sri Sabin on 25 March 2019. Upon obtaining an approval, a second letter was addressed to the Tax Operations

Department on 4 September 2019, specifically to discuss on the data extraction process. A face-to-face discussion was held in the premise of IRBM Cyberjaya, with consent signed for IRBM, in order to keep all archival data received in "Private and Confidential" under Section 138 of Income Tax Act 1965. After the said preliminary visit to IRBM Cyberjaya, the data requested was obtained through electronic mail, and through informal conversation channel, such as tele-conversations.

At the initial stage of data collection, data on audited resolved cases were extracted from IRBM Case Management System (CMS) for investigation. The study observed and reviewed the cases in order to find out the common ground that prompted IRBM to detect the under-reported tax using the adjustment of transfer pricing by Malaysian MNEs.

Subsequently, the second and third research objectives were formulated, with data collected from semi-structured interviews, which is the second stage data collection. Individuals who play a key and substantial role in establishing the tax policy were interviewed with semi-structured questionnaire. This procedure extracted the voices or suggestions of IRBM that are crucial in curbing transfer pricing malfeasance activities of Malaysian MNEs. The purpose of performing a qualitative study through elite interview is to gauge the practical unstructured issues that emerged in the activities of IRBM. The elite persons targeted include tax operations officers, policy makers, and tax compliance officers, who are mainly individuals involved in the enforcement of tax improvement of IRBM. In particular, this study arranged and performed face to face interviews with 12 elite individuals, (Mikecz, 2012), who have adequate knowledge on the following:

(i) Officers from Tax Operations, Multinational Tax Department of IRBM located in Bangi, which includes the director of the Multinational Tax branch, and the senior superior of the division that specializes in manufacturing cases, and

(ii) Officers from the Legal Division of IRBM located in Cyberjaya, which includes key personnel from the Tax Litigation Division, Tax Analysis Division, and Tax Disputes Division.

(iii) Tax practitioners who involved in transfer pricing submission and appeal cases.

Data collection was conducted between September 2019 to March 2020, which covered a period of approximately seven months. The identity of the interviewees would be protected due to the sensitivity of the information being provided. In addition, the collection of data from these interview sessions were kept at the highest confidential level in accordance to the Private and Confidential agreement that we signed between the researcher and the interviewees

1.6 Significance of the Study

Based on the Fairness Heuristic theory, this study attempts to identify the approaches adopted by IRBM when carrying out their activities of penalizing and preventing tax avoidance among MNEs of Malaysian manufacturing sector. It seeks to explain how and why people use fairness judgement in the ways described in theories, such as distributive, interactional, and procedural justice judgments, as well as the implications for human relationships in personal, legal, political, and other contexts. From the theoretical perspective, this study attempts to offer a different view on the understanding of the practices of the MNEs and the tax authorities.

This research utilizes the audited data collected from the Tax Compliance Division of IRBM's Transfer Pricing Department involving transfer pricing cases between the years 2013 to year 2017. From the practical perspective, the findings from the study would be beneficial for the MNEs that are creating their transfer pricing policy and documentation requirements for the first time. In addition, companies that are altering their transfer pricing policies to comply with the Malaysian Transfer Pricing Rules 2012, can benefit from the findings from this research as well.

The results may provide insights for MNEs to understand the differences of arm's length transfer pricing and arm's length benchmarking standards in real-world business circumstances. It also provides them with a basis for explaining or clarifying with the authorities in IRBM pertaining to the pricing policy adopted in their business or delegated by their head quarter in the absence of a perfect information situation.

1.7 Organization of the Thesis

This thesis comprises of five chapters. Chapter 1 offers an overview of the research background, the problem statement, the research objectives and the research questions, the approach and the scope of the present study, as well as the significance of the study.

Chapter 2 examines the literature review of international transfer pricing practices in relation to transfer pricing development in Malaysia. The Fairness Heuristic theory is used as the underlying theory of the current study, which helps to explain the basis of judgment for understanding the issues with measures taken by IRBM to detect the area of tax malfeasance among Malaysian MNEs in setting up of transfer pricing.

Chapter 3 elaborates on the research assumptions, paradigm and methodology that shaped the research design of this study. It begins with a discussion on the philosophical assumptions that lay the foundation of research approaches. This is followed by justifications on the usage of the interpretative approach in this study. Lastly, the data collection process is then explained.

Chapter 4 presents the findings and discussions. The profile of the MNEs and the findings are reviewed, in order to provide insight from the perspective of IRBM with regards to issues and measures taken by IRBM to deter the areas that give rise to tax malfeasance among Malaysian MNEs in the setting up of transfer pricing and also the re-decided tax decision ruled by appeal courts, that is, SCIT and High Court through Form Q submission process. Apart from that, reviews also covered the exercise of the power granted to IRBM based on Section 140A, Clause 3A and 3B of ITA 1967.

Lastly, this chapter ends with the discussion on the need for an implementation of law, rules or regulations to deter future occurrences of tax malfeasance by IRBM. The research findings are then put forward in order to provide suggestions or insights to MNEs to increase the quality of tax filing, as well as to improve compliance knowledge on transfer pricing, especially on aspects such as the preparation of contemporaneous transfer pricing documentation required by IRBM.

Chapter 5 summarizes the research findings. It also discusses the contributions of the study, the implications of the study as well as the suggestions for future research.

CHAPTER 2

LITERATURE REVIEW

2.1 Introduction

This chapter reviews concepts and literature related to international transfer pricing, tax malfeasance, and its compliance issues. Section 2.2 discusses the background of tax malfeasance, while Section 2.3 focuses on the development of taxation issues related to MNEs use of transfer pricing and government’s effort in combating transfer mispricing in Malaysia. The section that follows presents literature reviews on tax malfeasance. Finally, Section 2.5 concludes the chapter with the supporting theory.

2.1.1 International Transfer Pricing (ITP)

In general, ITP is the pricing process used for transferring goods and services among related companies that are located in different jurisdictions (Borkowski, 1997b; Chan & Chow, 1998; Oyelere et al., 1999). The goal of a transfer pricing strategy is to reduce MNEs' overall group tax payments, by taking advantages of tax differences of the various tax jurisdictions or involving a tax haven nation (Davies et al., 2018; Habu & Seidel, 2016; Hines & Rice, 1994; Tørsløv & Zucman, 2020). However, because of the direct effects of profit and revenue on host and home countries, the transfer pricing system for cross-border transfers between foreign associates and the parent company have created significant administrative and tax issues (Bartelsman & Beetsma, 2003; Li, 2005).

There are some definitions for transfer pricing. Li and Paisey (2007) defined it as “the process and determination of pricing of goods and services moved between connected entities of an MNE across different tax countries”.

According to Paragraph 3.1 of Transfer Pricing Guidelines (MTPG) 2012 issued by IRBM, transfer pricing is seen as "transactions between affiliated firms within an MNE, where one party is liable to Malaysian tax and the other related party is situated in foreign country". Transfer pricing also covers business affairs among permanent establishment (PE), head office and other related branches. Transfer pricing audit may include transactions between two related parties within Malaysia; for example, transactions between companies that are benefiting from an incentive or tax holiday as well as companies that are experiencing tax losses.

Ho (2019), alternatively, defined transfer pricing as inter-company price agreements on the transfer of products, services, and intangibles such as royalty, license fees, copyright, and patents. By enforcing the arm's length transaction, transfer pricing regulations and guidelines ensure that these transactions are priced fairly.

2.1.2 International Transfer Pricing (ITP): Organizational and Tax Management Perspective

ITP is the pricing process of goods, services, and intangibles moved between linked enterprises in a multinational company across several tax jurisdictions. As a result, each jurisdiction pays the assigned internal price determined by the internal parties. Sometimes, the parent corporation may exert managerial or administrative fees on specific services rendered to its subsidiaries. As company income tax rates differ from one country to another, the parent company may impose significant discretion in determining transfer pricing in order to take advantage of tax, as shown in Figure 2.1.

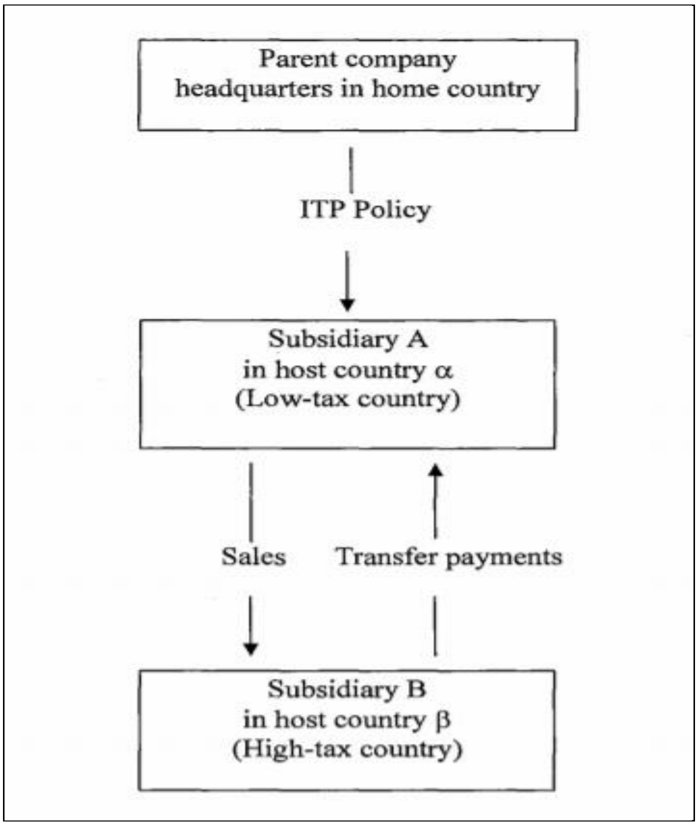

Figure 2.1 The Model of Simplified International Transfer Pricing
Source: Li, 2005, p. 40

The ITP model in Figure 2.1 illustrates that the parent firm in the home country owns two subsidiaries, Subsidiary A and B, both of which are based in the respective host countries of α and β. Subsidiary A sells its goods to Subsidiary B. The corporation tax rate for the host country of Subsidiary A (α) is 20%, whereas the corporation tax rate for the host country of Subsidiary B (β) is 33%. As a result, Subsidiary A can generate an intermediate product for Subsidiary B, and Subsidiary B processes the intermediate goods into a final product to be sold in its local open market. With this action, the parent firm establishes an ITP policy in a specific currency.

To further illustrate the ITP issue, assuming all other attributes are equal or remain unchanged, the parent firm would execute its power to instruct its low-tax Subsidiary A to sell the intermediate products to its related high-tax Subsidiary B at an exorbitant price, that is, a price that normally exceeds the mark of the market selling price, while neglecting the tax laws in the home country. Through this way, profit would be indirectly transferred from Subsidiary B to Subsidiary A; the higher the selling price, the more profit will be transferred to Subsidiary A. Given the lower tax rate in Subsidiary A's home country, tax paid by Subsidiary A will be less. In other words, parent firm would want to keep low profit in Subsidiary B in order to pay less tax. In case of losses in Subsidiary B, the profits of Subsidiary A (low tax jurisdiction) will be able to cover the losses in Subsidiary B (high tax jurisdiction). The net consequence is that the MNE can manipulate its total tax payments by moving profits to a country with a lower tax jurisdiction.

With the assistance of technology, it is easier for MNEs to structure and decide where to report their earned income or to relocate their earned profit to offshore and tax haven countries, via legal or illegal ways to minimize tax payments (Bucovetsky & Haufler, 2008; Johannesen, 2010; Marceau, 2010; Slemrod & Wilson, 2009; Stöwhase, 2005). As a consequence of the complicatedness of ITP, tax revenue authorities around the world lost their fair share of revenue. To mitigate tax loss, tax authorities strengthen their tax enforcement techniques in order to meet the challenges of collecting a fair share of taxes and protecting their tax bases (Brauner, 2008; Halperin & Srinidhi, 1991; Martini, 2015; Sansing, 1999; Shunko et al., 2014).

2.2 Tax Malfeasance

2.2.1 Definition of Tax Malfeasance

Tax malfeasance is a serious breach of corporate social responsibility as it puts a country's revenue base at risk. The Australia Taxation Officer (ATO) defines it as any debt activity or tax omission that deviates from the requirements of tax compliance (Kirchler & Wearing, 2006). Kasipillai and Jabbar (2006) characterized tax evasion as