IRBM

TRANSFER PRICING GUIDELINES

An updated version of Transfer Pricing Guidelines 2012 with effect from 15 July 2017

(*including latest amendments on para 11.2.3 and para 11.3.5 as of 2 February 2021*)

TRANSFER PRICING GUIDELINES
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CHAPTER I (TPGL 2012)
PRELIMINARY

1.1 INTRODUCTION

Transfer pricing generally refers to intercompany pricing arrangements for the transfer of goods, services and intangibles between associated persons. Ideally, the transfer price should not differ from the prevailing market price which would be reflected in a transaction between independent persons. However, business transactions between associated persons may not always reflect the dynamics of market forces. These Transfer Pricing Guidelines (hereinafter referred to as the Guidelines) are largely based on the governing standard for transfer pricing which is the arm's length principle as set out under the Organization for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines. Although some parts of the Guidelines have been adopted directly from the OECD Transfer Pricing Guidelines, there may be areas which differ to ensure adherence to the Income Tax Act 1967 (the Act) and Inland Revenue Board of Malaysia (IRBM) procedures as well as domestic circumstances. In this regard, the Guidelines may be reviewed from time to time. Notwithstanding the aforementioned, the arm’s length principle remains as the guiding principle throughout the Guidelines. Examples shown in the Guidelines are for illustrative purposes only. Thus, in dealing with actual cases, the facts and circumstances of each case must be examined before deciding on the applicability of any of the methods described in the Guidelines.

1.2 OBJECTIVE

1.2.1 The purpose of the Transfer Pricing Guidelines is to replace the IRBM Transfer Pricing Guidelines issued on 2 July 2003, in line with the introduction of transfer pricing legislation in 2009 under section 140A of the Act, and the Income Tax (Transfer Pricing) Rules 2012 (hereinafter referred to as the Rules).

1.2.2 The Guidelines are concerned with the application of the law on controlled transactions. They provide guidance for persons involved in transfer pricing arrangements to operate in accordance with the methods and manner as provided in the Rules, as well as comply with administrative requirements of the IRBM on the types of records and documentations to maintain.

1.3 SCOPE

1.3.1 The Guidelines are applicable on controlled transactions for the acquisition or supply of property or services between associated persons, where at least one person is assessable or chargeable to tax in Malaysia. To ease compliance burden persons referred to do not include individuals not carrying on a business, further-

(a) for a person carrying on a business, the Guidelines apply wholly to a business with gross income exceeding RM25 million, and the total amount of related party transactions exceeding RM15 million.

(b) where a person provides financial assistance, the guidelines on financial assistance are only applicable if that financial assistance exceeds RM50 million. The Guidelines do not apply to transactions involving financial institutions.

1.3.2 Any person which falls outside the scope of 1.3.1 may opt to fully apply all relevant guidance as well as fulfil all Transfer Pricing Documentation requirements in the Guidelines; or alternatively may opt to comply with Transfer Pricing Documentation requirements under paragraph 11.2.4 (a), (c) and (d). In this regard, the person is allowed to apply any method other than the five methods described in the Guidelines provided it results in, or best approximates, arm's length outcomes.

1.3.3 Notwithstanding the aforementioned paragraphs the Guidelines need not apply to transactions between persons who are both assessable and chargeable to tax in Malaysia and where it can be proven that any adjustments made under the Guidelines will not alter the total tax payable or suffered by both persons. Please also refer to paragraph 11.2.2.

1.3.4 The Guidelines are also applicable by analogy, in relation to transactions between a permanent establishment (PE) and its head office or other related branches. For the purpose of the Guidelines, the PE will be treated as a (hypothetically) distinct and separate enterprise from its head office or other related branches. Paragraph 1.3.1 does not apply to this category of taxpayers.

1.4 RELEVANT PROVISIONS

1.4.1 Section 140 of the Income Tax Act 1967 (ITA) empowers the Director General of Inland Revenue (DGIR) to disregard certain transactions which are believed to have the direct or indirect effect of altering the incidence of tax, and make adjustments as he thinks fit, to counter-act the effects of such transactions. Thus, Section 140 allows the DGIR to disregard transactions believed not to be at arm’s length and make the necessary adjustments to revise or impose tax liability on the persons concerned. Under subsection 140(6), the said non arm’s length dealings include transactions between persons one of whom has control over the other and between persons both of whom are controlled by some other person.

1.4.2 With effect from 1.1.2009, section 140A was introduced to specifically address transfer pricing issues. The section requires taxpayers to determine and apply the arm’s length price on controlled transactions. This section further allows the DGIR to make an adjustment to reflect the arm’s length price, or interest rate, for that transaction by substituting or imputing the price or interest, as the case may be; and to disallow considerations for controlled financial assistance which are deemed excessive in respect of a person’s fixed capital.

1.4.3 Paragraph 154(1)(ed), also introduced with effect 1.1.2009, empowers the Minister of Finance to provide for the scope and procedure relating to the implementation and facilitation of section 140A by way of the Income Tax (Transfer Pricing) Rules 2012.

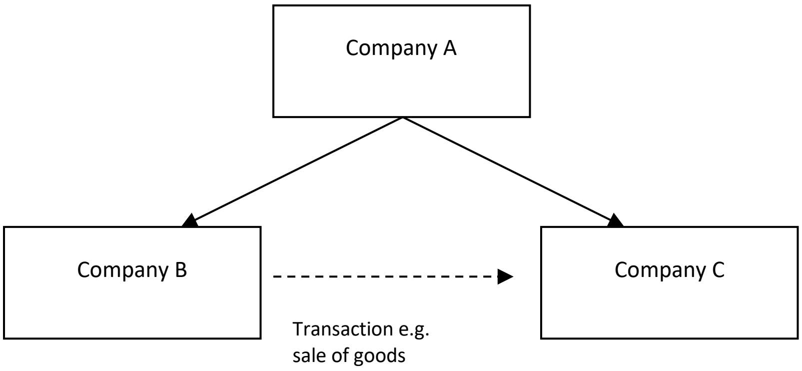
1.5 MEANING OF CONTROL AND ASSOCIATED

1.5.1 Section 139 of the ITA refers to "control" as both direct and indirect control. The interpretation of related companies or companies in the same group (referred to in the context of holding and subsidiary companies) is provided for under subsection 2(4) of the same Act.

1.5.2 Under the Guidelines, two companies are associated companies with respect to each other if one of the companies participates directly or indirectly in the management, control or capital of the other company; or the same persons participate directly or indirectly in the management, control or capital of both companies.

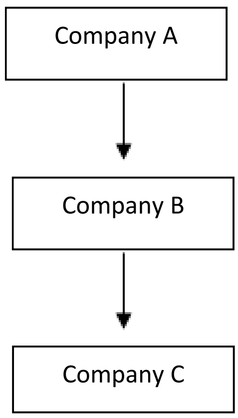
Examples of control and associated persons:

Example 1



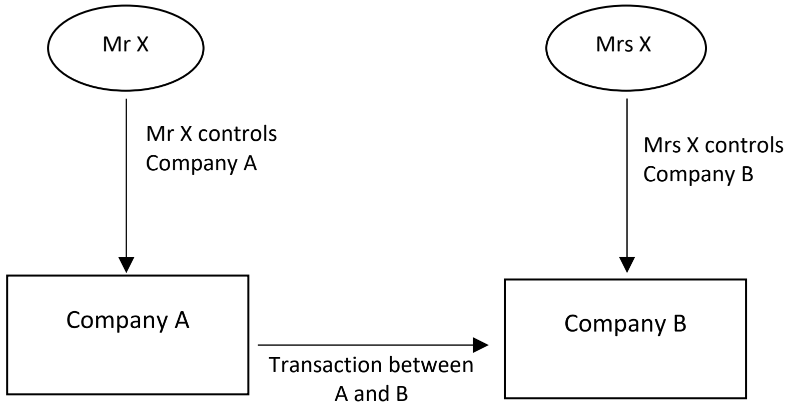
In this example, Company A controls Company B and Company C through share ownership. As Company A controls both Company B and Company C, Companies B and C are associated enterprises. Therefore, transfer pricing laws apply to transactions between the two.

Example 2



Company A controls Company B, which in turn controls Company C. Company A thus indirectly controls Company C, transfer pricing laws thus apply to transactions between them.

Example 3



The Act provides that transactions between Company A and Company B are deemed controlled transactions due to the relationship between Mr X and Mrs X.

CHAPTER II (UPDATED 15/07/2017)
THE ARM'S LENGTH PRINCIPLE

2.1 MEANING OF ARM'S LENGTH PRINCIPLE

2.1.1 The arm's length approach, which is internationally accepted as the preferred basis for determining the transfer price of a transaction between associated persons, will be the basis adopted by IRBM. This is consistent with the objective of minimizing the possibility for double taxation. According to the arm's length principle, a transfer price is acceptable if all transactions between associated parties are conducted at arm's length price. Arm's length price is the price which would have been determined if such transactions were made between independent entities under the same or similar circumstances.

2.1.2 The arm's length principle is stated in paragraph 1 of Article 9 of the OECD Model Tax Convention as:

"*Where . . . conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly*."

2.1.3 When associated persons enter into a transaction, the element of control which one party has over the other may exist. Under this circumstance, bargaining power rarely comes into play. Unlike independent companies, multinational corporation group or multinational enterprises (hereinafter referred to as an "MNE Group") usually operate based on its own set of conditions which normally do not reflect the market forces. While independent enterprises are concerned with maximising individual profits, by aiming for the lowest costs and highest returns, an MNE Group is concerned with overall group profits which may result in unequal distribution of profits within the group.

2.1.4 An example to illustrate the difference between controlled and uncontrolled transactions is as follows:

Company A purchases raw material to make furniture. Under an arm's length transaction, Company A would make the best effort to obtain its raw material at the lowest price possible in order to minimise its costs and maximise its profits. This will entail extensive bargaining between Company A and its suppliers.

However, in a controlled transaction, there usually exist elements of control that dictate the price and manner in which raw material is to be purchased. The likelihood of bargaining for the best price is minimal, and Company A may be expected to accept the price as dictated by its controlling entity. It is not impossible to witness prolonged losses in cases like Company A that has little say in the price it is willing to pay for raw material.

2.1.5 In essence, the application of the arm's length principle:

(a) treats associated persons as not dealing at arm's length and as if they operate as separate entities rather than as inseparable parts of a single unified business; and

(b) is generally based on a comparison of:

(i) prices, margins, division of profits or other indicators of controlled transactions; with

(ii) prices, margins, division of profits or other indicators of uncontrolled transactions.

2.2 GUIDANCE IN APPLYING THE ARM'S LENGTH PRINCIPLE

2.2.1 The application of the arm's length principle will mainly focus on achieving the transfer pricing outcomes that is in line with value creation by:

(a) ensuring that inappropriate returns will not accrue to an entity solely because it has contractually assumed risks or has provided capital, but align returns with value creation; and

(b) identifying circumstances in which transactions can be re-characterised.

2.2.2 The taxpayer need to ensure that:

(a) actual business transactions undertaken by them are identified, and transfer pricing is not based on contractual arrangements that do not reflect economic reality;

(b) contractual allocations of risk are respected only when they are supported by actual decision-making;

(c) capital without functionality will generate no more than a risk-free return, assuring that no premium returns will be allocated to cash boxes without relevant substance; and

(d) Their transaction has commercial rationality and IRBM may disregard transactions when the exceptional circumstances of commercial irrationality apply.

2.2.3 The application of the arm's length principle is based on a comparison of the conditions in a controlled transaction with the conditions that would have been made had the parties been independent and undertaking a comparable transaction under comparable circumstances (comparability analysis). There are two key aspects in such an analysis:

(a) to identify the commercial or financial relations between the associated persons and the conditions and economically relevant circumstances attaching to those relations, in order for the controlled transaction to be accurately delineated; and

(b) to compare the conditions and the economically relevant circumstances of the controlled transaction as accurately delineated with the conditions and the economically relevant circumstances of comparable transactions between independent persons.

2.2.4 **Identifying the commercial and financial relations**

The typical process of identifying the commercial or financial relations between the associated persons and the conditions and economically relevant circumstances attaching to those relations requires:

(a) a broad-based understanding of the industry sector (e.g. mining, pharmaceutical, luxury goods) in which the associated persons operates and the factors affecting the performance of any business operating in that sector. The understanding is derived from an overview of that particular MNE Group which outlines how they respond to the factors affecting performance in the sector, including its business strategies, markets, products, its supply chain, the key functions performed, material assets used, and important risks assumed. This information shall be provided by the taxpayer in support of the taxpayer's analysis of its transfer pricing and provides useful context regarding the commercial or financial relations between members of the MNE Group.

(b) identification of how each MNE operates within the group, analysis of each MNE's activities (e.g. a production company, a sales company) and identification of its commercial or financial relations expressed in transactions between them. The accurate delineation of the actual transactions between the associated persons requires analysis of the **economically relevant characteristics** of the transaction.

2.2.5 **Economically Relevant Characteristics/ Comparability Factors**

The economically relevant characteristics or comparability factors that need to be identified in the commercial or financial relations between the associated persons in order to accurately delineate the actual transaction can be broadly categorised as follows:

(a) the contractual terms of the transaction;

(b) the functions performed by each of the associated persons to the transaction, taking into account assets used and risks assumed, including how those functions relate to the wider generation of value by the group to which the persons belong (such as an MNE Group), the circumstances surrounding the transaction, and industry practices;

(c) the characteristics of property transferred or services provided;

(d) the economic circumstances of the associated persons and of the market in which the associated persons operate; and

(e) the business strategies pursued by the associated persons.

2.2.6 Options realistically available

Independent persons when evaluating the terms of a potential transaction will compare the transaction to the other options realistically available and they will only enter into the transaction if they see no alternative that is clearly more attractive. In other words, independent persons would only enter into a transaction if it is not expected to make them worse off than their next best option.

Independent persons would generally take into account any economically relevant differences between the options realistically available to them (such as differences in the level of risk) when valuing those options. Therefore, identifying the economically relevant characteristics of the transaction is essential in accurately delineating the controlled transaction and in revealing the range of characteristics taken into account by the parties to the transaction in reaching the conclusion that the transaction adopted offers a clearly more attractive opportunity to meet commercial objectives than alternative options realistically available.

2.2.7 Identification of comparable transactions

As part of the exercise of establishing an arm's length price, it is important to decide the level at which transactions are compared. The level of transaction is determined based on what is being used to compare, that is:

(a) a single transaction (e.g. the sale price and terms of sale of a particular product);

(b) a bundle of transactions;

(c) results at gross margin level;

(d) results at net margin level; or

(e) results by reference to some other measures, such as return on capital, ratio of costs to gross margin, etc.

The most appropriate comparable should be selected in adherence to the five economically relevant characteristics/ comparability factors as discussed in paragraphs 2.4.

2.2.8 Tested Party

The determination of a controlled transaction leads to the determination of the tested party. As a general rule, the tested party is the one to which a transfer pricing method can be applied in the most reliable manner and for which the most reliable comparables can be found. In the Malaysian scenario, the IRBM gives priority to the availability of sufficient and verifiable information on both tested party and comparables. As such, IRBM does not accept foreign tested parties where information is neither sufficient nor verifiable.

2.2.9 Selection and application of Transfer Pricing Methodologies (TPM)

The Rules have prescribed for specific methods to be used in arriving at the arm's length price as discussed in Chapter III of the Guidelines. In determining the arm's length price, a taxpayer will have to apply the most appropriate method based on the facts and circumstances of each particular transaction.

2.2.10 Profit Level Indicator (PLI)

In applying the TPM, due consideration must also be given to the choice of PLI which measures the relationship between profits and sales, costs incurred or assets employed. The use of an appropriate PLI ensures greater accuracy in determining the arm's length price of a controlled transaction. PLI is presented in the form of a ratio i.e. financial ratios or return on capital employed. Just as in the selection of transfer pricing methods, the choice of an appropriate PLI depends on several factors, including:

(a) characterization of the business;

(b) availability of reliable comparable data; and

(c) the extent to which the PLI is likely to produce a reliable measure of arm's length profit.

Some of the more commonly used PLI include:

(a) return on costs: cost plus margin and net cost plus margin;

(b) return on sales: gross margin and operating margin; and

(c) return on capital employed: return on operating assets.

Berry ratios is another form of PLI. It is define as ratio of gross profit to operating expense. In order for a Berry ratio to be appropriate to test the remuneration of a controlled transaction (*e.g.* consisting in the distribution of products), it is necessary that:

(i) The value of the functions performed in the controlled transaction (taking account of assets used and risks assumed) is proportional to the operating expenses,

(ii) The value of the functions performed in the controlled transaction (taking account of assets used and risks assumed) is not materially affected by the value of the products distributed, *i.e.* it is not proportional to sales, and

(iii) The taxpayer does not perform, in the controlled transactions, any other function such as marketing function or manufacturing function or any functions which add value to the products that should be remunerated using another method or financial indicator.

Berry ratios is only useful in an intermediary activities where a taxpayer purchases goods from an associated person and on-sells them to other associated person. In such cases, the resale price method may not be applicable as the sales is a controlled transaction, and a cost plus method might not be applicable either where the cost of goods sold consists of controlled purchases, however, operating expenses are reasonably independent from transfer pricing formulation. Unless, the operating expenses are affected by controlled transaction costs such as head office charges, rental fees or royalties paid to an associated person then the use of a Berry ratio may not be appropriate.

2.3 COMPARABILITY ANALYSIS

2.3.1 A comparability analysis is a pre-requisite in the application of all transfer pricing methods that conform to the arm's length principle. This involves comparing conditions in a controlled transaction with those in an uncontrolled transaction.

2.3.2 A controlled transaction in a comparability analysis is the transaction that has been identified as the transaction where pricing may not be at arm's length. An uncontrolled transaction may be:

(a) a transaction between the tested party and an independent party conducted under terms and circumstances similar to the controlled transaction (internal comparable); or

(b) a transaction between two independent parties under similar terms and circumstances (external comparable).

2.3.3 An uncontrolled transaction is deemed comparable if the economically relevant characteristics or comparability factors identified in the commercial or financial relations (as mentioned in paragraph 2.2.5) of that transaction with that of a controlled transaction are sufficiently similar.

2.3.4 Where there are differences between an uncontrolled transaction and a controlled transaction, the following conditions must be met in order to be deemed comparable:

(a) none of the differences between the transactions being compared or between the enterprises undertaking those transactions could materially affect the price or cost charged or paid or the profits arising from those transactions in an open market; or

(b) reasonably accurate adjustments can be made to eliminate the material effects of such differences.

2.4 FACTORS DETERMINING COMPARABILITY

2.4.1 Contractual terms of the transaction

A transaction is the consequence or expression of the commercial or financial relations between the parties. Where a transaction has been formalised by the associated persons through written contractual agreements, those agreements provide the starting point for delineating the transaction between them and how the responsibilities, risks, and anticipated outcomes arising from their interaction were intended to be divided at the time of entering into the contract.

The terms of a transaction may also be found in communications between the parties other than a written contract. The written contracts alone are unlikely to provide all the information necessary to perform a transfer pricing analysis. As such, further information will be required by taking into consideration evidence of the commercial or financial relations provided by the economically relevant characteristics in the other four categories (see paragraph 2.2.5). Taken together, the analysis of economically relevant characteristics in all five categories provides evidence of the actual conduct of the associated persons. The following example illustrates the concept of clarifying and supplementing the written contractual terms based on the identification of the actual commercial or financial relations.

Example 1

Company P is the parent company of an MNE Group situated in Country P. Company S, situated in Country S, is a wholly-owned subsidiary of Company P and acts as an agent for Company P's branded products in Country S market. The agency contract between Company P and Company S is silent about any marketing and advertising activities in Country S that the parties should perform. Analysis of other economically relevant characteristics and in particular the functions performed, determines that Company S launched an intensive media campaign in Country S in order to develop brand awareness. This campaign represents a significant investment for Company S.

From the example above, the characteristics of the transaction that are economically relevant are inconsistent with the written contract between the associated persons. Therefore, the actual transaction that should be delineated for purposes of the transfer pricing analysis is as per the conduct of the parties.

In transactions between independent parties, the divergence of interests between the parties ensures that contractual terms concluded reflect the interests of both parties and will ordinarily seek to hold each other to the terms of the contract. The contractual terms will be ignored or modified if it is not in the interests of both parties. However, the same divergence of interests may not exist in the case of associated persons, or any such divergences may be managed in ways facilitated by the control relationship and not solely or mainly through contractual agreements.

Therefore, it is important to examine whether the arrangements reflected in the actual conduct of the parties substantially conform to the terms of any written contract, or whether the associated persons' actual conduct indicates that the contractual terms have not been followed, or do not reflect a complete picture of the transactions, or have been incorrectly characterised or labelled by the persons, or are a sham.

Where there are material differences between contractual terms and the conduct of the associated persons in their relations with one another, such as the functions they actually perform, the assets they actually use, and the risks they actually assume, considered in the context of the contractual terms, IRBM has the right, based on the factual substance, to accurately delineate the actual transaction.

2.4.2 Functional Analysis of Functions Performed, Risks Assumed and Assets Employed

In transactions between two independent persons, compensation usually will reflect the functions that each person performs (taking into account assets used and risks assumed). Therefore, in delineating the controlled transaction and determining comparability between controlled and uncontrolled transactions or entities, a functional analysis is necessary. This functional analysis seeks to identify the economically significant activities and responsibilities undertaken, assets used or contributed, and risks assumed by the parties to the transactions. The analysis focuses on what the parties actually do and the capabilities they provide.

For this purpose, the structure and organisation of the associated persons and how they influence the context in which the MNE operates must be explained, in particular, how value is generated by the group as a whole, the interdependencies of the functions performed by the associated persons with the rest of the group, and the contribution that the associated persons make to that value creation.

A. Functions

Functions are activities performed by each person in business transactions such as procurement, marketing, distribution and sales. The principal functions performed by the associated person under examination should be identified first. Any increase in economically significant functions performed should be compensated by an increase in profitability of the person.

Usually, when various functions are performed by a group of independent persons, the party that provides the most effort and, more particularly, the rare or unique functions would earn the most profit. For example, a distributor performing additional marketing and advertising function is expected to have a higher return from the activity than if it did not undertake these functions.

B. Assets

In comparing functions performed, it is also important to identify and consider the assets (tangible and intangible) that are employed, or are to be employed, in a transaction. This includes the analysis of the type of assets used, (e.g. plant and equipment, the use of valuable intangibles, financial assets) and the nature of the assets used (e.g. the age, market value, location, property right protections available, etc.

(a) Tangible assets employed

Tangible assets such as property, plant and equipment are usually expected to earn long-term returns that commensurate with the business risks assumed. Profitability of a company should rightfully increase with the increase in the amount, as well as the degree, of specificity of assets employed. Quantifying these amounts whenever possible helps determine the level of risks borne and the level of profit a company should expect.

(b) Intangible assets employed

Intangible assets are also expected to generate returns for the owners by way of sales or licensing. It is thus essential to identify the parties to whom the returns generated are attributable.

C. Risks

Risk is inherent in business activities and persons undertake commercial activities because they seek opportunities to make profits. Identifying risks goes hand in hand with identifying functions and assets and is integral to the process of identifying the commercial or financial relations between the associated persons and of accurately delineating their transactions. Evaluation of risks assumed is crucial in determining arm's length prices with the economic assumption that the higher the risks assumed, the higher the expected return.

Controlled and uncontrolled transactions are not comparable if there are significant differences in the risks assumed which appropriate adjustments cannot be made. Therefore, risks assumed by each party has to be identified and considered since the actual assumption of risks would influence the prices of the transactions between the associated persons and is an economically relevant characteristic that can be significant in determining the outcome of a transfer pricing analysis.

In this section references are made to terms that require initial explanation and definition as below:

(a) The term “risk management” is used to refer to the function of assessing and responding to risk associated with commercial activity. Risk management comprises of three elements:

   (i) the capability to make decisions to take on, lay off, or decline a risk-bearing opportunity, together with the actual performance of that decision-making function;

   (ii) the capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision-making function; and

   (iii) the capability to mitigate risk, that is the capability to take measures that affect risk outcomes, together with the actual performance of such risk mitigation.

(b) “Risk assumption” means taking on the upside and downside consequences of the risk with the result that the party assuming a risk will also bear the financial and other consequences if the risk materialises. A party performing part of the risk management functions may not assume the risk that is the subject of its management activity, but may be hired to perform risk mitigation functions under the direction of the risk-assuming party.

(c) Financial capacity to assume risk can be defined as access to funding to take on the risk or to lay off the risk, to pay for the risk mitigation functions and to bear the consequences of the risk if the risk materialises. Access to funding by the party assuming the risk takes into account the available assets and the options realistically available to access additional liquidity, if needed, to cover the costs anticipated to arise should the risk materialise.

(d) Control over risk involves the first two elements of risk management defined in (a), that is:

   (i) the capability to make decisions to take on, lay off, or decline a risk-bearing opportunity, together with the actual performance of that decision-making function; and

   (ii) the capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision-making function.

   It is not necessary for a party to perform the day-to-day mitigation, as described in (a)(iii) in order to have control of the risks. Such day-to-day mitigation may be outsourced, as Example 2 illustrates. However, where these day-to-day mitigation activities are outsourced, control of the risk would require capability and performance to determine the objectives of the outsourced activities, to decide whom to hire as provider of the risk mitigation functions, to assess whether the objectives are being adequately met, and where necessary, to decide whether to adapt or terminate the contract with that provider.

(e) Risk mitigation refers to measures taken that are expected to affect risk outcomes. Such measures may include measures that reduce the uncertainty or measures that reduce the consequences in the event that the downside impact of risk occurs.

The concept of control may be illustrated by the following examples.

Example 2

Company A appoints a specialist manufacturer, Company B to manufacture products on its behalf. The contractual arrangements indicate that Company B undertakes to perform manufacturing services, but that the product specifications and designs are provided by Company A, and that Company A determines production scheduling, including the volumes and timing of product delivery.

The contractual relations imply that Company A bears the inventory risk and the product recall risk. Company A hires Company C to perform regular quality controls of the production process. Company A specifies the objectives of the quality control audits and the information that Company C should gather on its behalf. Company C reports directly to Company A. Analysis of the economically relevant characteristics shows that Company A controls its product recall and inventory risks by exercising its capability and authority to make a number of relevant decisions about whether and how to take on risk and how to respond to the risks.

Besides that, Company A has the capability to assess and take decisions relating to the risk mitigation functions and actually performs these functions. These include determining the objectives of the outsourced activities, the decision to hire the particular manufacturer and the party performing the quality checks, the assessment of whether the objectives are adequately met, and, where necessary, to decide whether to adapt or terminate the contracts.

Example 3

Assume that an investor hires a fund manager to invest funds on its account. Depending on the agreement between the investor and the fund manager, the latter may be given the authority to make portfolio investments on behalf of the investor on a day to-day basis in a way that reflects the risk preferences of the investor, although the risk of loss in value of the investment would be borne by the investor. In such an example, the investor is controlling its risks through four relevant decisions:

(a) the decision about its risk preference and therefore about the required diversification of the risks attached to the different investments that are part of the portfolio,

(b) the decision to hire (or terminate the contract with) that particular fund manager,

(c) the decision of the extent of the authority it gives to the fund manager and objectives it assigns to the latter, and

(d) the decision of the amount of the investment that it asks this fund manager to manage.

Moreover, the fund manager would generally be required to report back to the investor on a regular basis as the investor would want to assess the outcome of the fund manager's activities. In such a case, the fund manager is providing a service and managing his business risk from his own perspective (e.g. to protect his credibility). The fund manager's operational risk, including the possibility of losing a client, is distinct from his client's investment risk.

This illustrates the fact that an investor who gives to another person the authority to perform risk mitigation activities such as those performed by the fund manager does not necessarily transfer control of the investment risk to the person making these day-to-day decisions. For entities claiming to have control over risk by outsourcing risk mitigation activities, they will have to give evidence of a sequential and scheduled monitoring and administering done by them. In cases where monitoring is performed online, the controlling entity should be able to substantiate and show proof of those activity performed by them.

Also, where a controlling entity has control over the activity done by their local subsidiary or related party, the controlling entity may have Permanent Establishment (PE) in Malaysia (subject to Double Taxation Agreement between Malaysia and the relevant country) as the local entity will be said to be performing activity on behalf of the controlling party.

D. Risk Analysis Framework

Below are the process or steps of analysing risk in a controlled transaction, in order to accurately delineate the actual transaction in relation to risk:

Step 1: Identify economically significant risks with specificity

Risk can be categorized in various ways. However, in transfer pricing analysis, emphasis is on the sources of uncertainty which gives rise to risk. Below are the non-exclusive list of sources of risk (not intended to suggest a hierarchy of risk or rigid category of risk, instead as examples of possible range of risk that can arise in a transfer pricing analysis).

(a) Strategic risks or marketplace risks

These are largely external risks caused by the economic environment, political and regulatory events, competition, technological advance, or social and environmental changes.

The assessment of such uncertainties may define the products and markets the company decides to target, and the capabilities it requires, including investment in intangibles and tangible assets, as well as in the talent of its human capital. Examples of such risks may include marketplace trends, new geographical markets, and concentration of development investment.

(b) Infrastructure or operational risks

These are likely to include the uncertainties associated with the company's business execution and may include the effectiveness of processes and operations. The impact of such risks is highly dependent on the nature of the activities and the uncertainties the company chooses to assume. In some circumstances breakdowns can have a crippling effect on the company's operations or reputation and threaten its existence; whereas successful management of such risks can enhance reputation.

In other circumstances, the failure to bring a product to market on time, to meet demand, to meet specifications, or to produce high standard products, can affect competitive and reputational position, and give advantage to companies which bring competing products to market more quickly. Some infrastructure risks are internally driven and may involve capability and availability of assets, employee capability, process design and execution, outsourcing arrangements and IT systems.

(c) Financial risks

All risks are likely to affect a company's financial performance, but there are specific financial risks related to the company's ability to manage liquidity and cash flow, financial capacity, and creditworthiness. The uncertainty can be externally driven, for example by economic shock or credit crisis, but can also be internally driven through controls, investment decisions, credit terms, and through outcomes of infrastructure or operational risks.

(d) Transactional risks

Include pricing and payment terms in a commercial transaction for the supply of goods, property, or services.

(e) Hazard risks

Includes adverse external events that may cause damages or losses, including accidents and natural disasters. Such risks can often be mitigated through insurance, but insurance may not cover all the potential loss, particularly where there are significant impacts on operations or reputation.

Determining the economic significance of risk and how risk may affect the pricing of a transaction between associated persons is part of the broader functional analysis of how value is created by the MNE. The economic significance of risk may be illustrated by the following two situations:

Example 4

The MNE Group supplies fuel oil to various industries in Malaysia. The fuel oils are mostly used by industries for process heating, steam generation and power generation, and marine vessels. Analysis of the economically relevant characteristics establishes that the product is undifferentiated, the market is competitive, the market size is predictable and players are price-takers.

In such circumstances, the ability to influence margins may be limited. The credit terms achieved from managing the relationship with the oil suppliers fund working capital are crucial to the distributor's margin. The impact of the risk on cost of capital is, therefore, significant in the context of how value is created for the distribution function.

Example 5

A multinational toy retailer buys a wide range of products from a number of third-party manufacturers. Most of its sales are concentrated in the last two months of the calendar year, and a significant risk relates to the strategic direction of the buying function, and in making the right bets on trends and determining the products that will sell and in what volumes. Trends and the demand for products can vary across markets, and so expertise is needed to evaluate the right bets in the local market. The effect of the buying risk can be magnified if the retailer negotiates a period of exclusivity for a particular product with the third-party manufacturer.

From the examples above, to determine who has control over a specific risk in a transaction, focus must be given to the decision-making role played by the entities in managing that specific risk. The entity which makes the decision will be the entity which has control over the risk.

Step 2: Contractual assumption of risk

The identity of the parties assuming risks may be set out in written contracts which typically sets out an intended assumption of risk by the parties. Some risks may be explicitly assumed in the contractual arrangements. For example, a distributor might contractually assume accounts receivable risk, inventory risk, and credit risks associated with the distributor's sales to unrelated customers. Other risks might be implicitly assumed. For example, contractual arrangements that provide non-contingent remuneration for one of the parties implicitly allocate the outcome of some risks, including unanticipated profits or losses, to the other party. However, purported assumption of risk by associated person when risk outcomes are certain or has materialised is by definition not an assumption of risk, as there is no longer any risk.

The assumption of risk has a significant effect on determining arm's length pricing between associated persons, but it should not be concluded that the pricing arrangements adopted in the contractual arrangements alone determine which party assumes risk. Therefore, one may not infer from the fact that the price paid between associated persons for goods or services is set at a particular level, or by reference to a particular margin, that risks are borne by those associated persons in a particular manner. For example, a manufacturer may claim to be protected from the risk of price fluctuation of raw material as a consequence of it being remunerated by another group company on a basis that it takes account of its actual costs. The implication of the claim is that the other group company bears the risk.

The form of remuneration cannot dictate inappropriate risk allocations. It is the determination of how the parties actually manage and control risks which will determine the assumption of risks by the parties, and consequently dictate the selection of the most appropriate transfer pricing method.

Therefore, it should not be inferred that a party bears the assumption of risk simply because it is being remunerated on cost plus basis, certain mark-up or reimbursed for cost or losses incurred. Instead, a taxpayer has to prove assumption of risk by showing the exercise of control over the risk and financial capacity to assume the risk.

Step 3: Functional analysis in relation to risk

In this step, the functions in relation to risk of the associated persons that are parties to the transaction are analysed. The analysis provides information about how the associated persons operate in relation to the assumption and management of the specific, economically significant risks, and in particular about which person or persons perform control functions and risk mitigation functions, which person or persons encounter upside or downside consequences of risk outcomes, and which person or persons have the financial capacity to assume the risk.

Example 6

Company A seeks to pursue a development opportunity and hires a specialist company, Company B, to perform part of the research on its behalf. Under step 1 development risk has been identified as economically significant in this transaction, and under step 2 it has been established that under the contract Company A assumes development risk.

The functional analysis under step 3 shows that Company A controls its development risk through exercising its capability and authority in making a number of relevant decisions about whether and how to take on the development risk. These include the decision to perform part of the development work itself, the decision to seek specialist input, the decision to hire the particular researcher, the decision of the type of research that should be carried out and objectives assigned to it, and the decision of the budget allocated to Company B.

Company A has mitigated its risk by taking measures to outsource development activities to Company B which assumes the day-today responsibility for carrying out the research under the control of Company A. Company B reports back to Company A at predetermined milestones, and Company A assesses the progress of the development and whether its ongoing objectives are being met, and decides whether continuing investments in the project are warranted in the light of that assessment.

Company A has the financial capacity to assume the risk. Company B has no capability to evaluate the development risk and does not make decisions about Company A's activities. Company B's risk is mainly to ensure it performs the research activities competently and it exercises its capability and authority to control that risk through making decisions about the processes, expertise, and assets it needs. The risk Company B assumes is distinct from the development risk assumed by Company A under the contract, which is controlled by Company A based on the evidence of the functional analysis.

Step 4: Interpreting steps 1-3

Carrying out steps 1-3 involves the gathering of information relating to the assumption and management of risks in the controlled transaction. The next step is to interpret the information resulting from steps 1-3 and to determine whether the contractual assumption of risk is consistent with the conduct of the parties and the other facts of the case by analysing;

(a) whether the associated persons follow the contractual terms under the principles of paragraph 2.4.1; and

(b) whether the party assuming risk, as analysed under (a), exercises control over the risk and has the financial capacity to assume risk.

In line with the discussion in paragraph 2.4.1, it should be considered under step 4(a) whether the parties' conduct conform to the assumption of risk contained in written contracts, or whether the contractual terms have not been followed or are incomplete. Where differences exist between contractual terms related to risk and the conduct of the parties which are economically significant and would be taken into account by third parties in pricing the transaction between them, the parties' conduct in the context of the consistent contractual terms should generally be taken as the best evidence concerning the intention of the parties in relation to the assumption of risk.

If it is established that the associated persons assuming the risk as analysed under step 4(a) either do not control the risk or do not have the financial capacity to assume the risk, then the analysis described under step 5 needs to be performed. Where the associated persons assuming risk (as analysed under step 4(a) controls that risk and has the financial capacity to assume the risk, step 5 need not be considered. Control requires both capability and functional performance in order to exercise control over a risk.

The test of control should be regarded as being met where comparable risk assumptions can be identified in a comparable uncontrolled transaction. To be comparable those risk assumptions require that the economically relevant characteristics of the transactions are comparable. If such a comparison is made, it is particularly relevant to establish that the persons assuming comparable risk in the uncontrolled transaction performs comparable risk management functions relating to control of that risk.

Step 5: Allocation of risk

If it is established in step 4(b) that the associated persons assuming the risk based on steps 1 – 4(a) does not exercise control over the risk or does not have the financial capacity to assume the risk, then the risk should be allocated to the persons exercising control and having the financial capacity to assume the risk.

If multiple associated persons are identified that both exercise control and have financial capacity to assume the risk, it should then be allocated to the associated persons exercising the most control. The other parties performing control activities should be remunerated appropriately based on the importance of the control activities performed.

Step 6: Pricing of the transaction

The accurately delineated transaction should then be priced in accordance with the tools and methods available and taking into account the financial and other consequences of risk-assumption, and the remuneration for risk management.

The assumption of a risk should be compensated with an appropriate anticipated return, and risk mitigation should be appropriately remunerated. Thus, a taxpayer that both assumes and mitigates a risk will be entitled to greater anticipated remuneration than a taxpayer that only assumes a risk, or only mitigates, but does not do both.

In the circumstances of Example 6, Company A assumes and controls the development risk and should bear the financial consequences of failure and enjoy the financial consequences of success. Company B should be appropriately rewarded for the carrying out of its development services, incorporating the risk when it fails to do so.

2.4.3 Characteristics of Property or Services

Similarity in product characteristics is more relevant when comparing prices than profit margins between controlled and uncontrolled transactions. Comparison of product characteristics is used to a greater extent in the application of the Comparable Uncontrolled Price (CUP) method than any other method. Characteristics that are compared should include:

(a) in the case of tangible property: the physical features, quality and the volume of supply of property;

(b) in the provision of services: the nature and extent of services; and

(c) in the case of intangible property: the form of transaction (e.g. licensing or sale), type of property (e.g. patent, trademark or know how), the duration and degree of protection; and the anticipated benefits from the use of property.

2.4.4 Economic Circumstances

Arm’s length prices vary across different economic circumstances. Factors that may affect the price or margin of a transaction include:

(a) the geographic location of the market;

(b) the size of the market;

(c) the extent of competition in the markets;

(d) the level of supply and demand in the market as a whole and in particular regions;

(e) customer purchasing power;

(f) cost of production including the costs of land, labour and capital, and transport costs;

(g) the level of the market (e.g. retail or wholesale);

(h) the date and time of transactions;

(i) the availability of substitute goods and services; and

(j) the extent of government intervention e.g. whether goods compared are price controlled.

Example 7

An analysis of the local market in Country D indicates that gross margin paid to distributors of product X is 20%. However, this does not necessarily mean that 20% is also an appropriate gross margin for Malaysian distributors of product X. Margins in different markets are influenced by factors such as consumer preferences which would affect the retail price of the goods, and relative competitiveness of the distribution sector which would affect the margin received.

2.4.5 Business Strategies

Business strategies adopted by an enterprise influences the price charged for a product. In a comparability analysis, it is necessary to evaluate whether an independent person in the same circumstances as that of a controlled person would have adopted similar strategies and if so, what rewards would have been expected. Business strategies that are relevant in determining comparability include innovation and new product development, degree of diversification, market penetration schemes, distribution channel selection, market level and location.

2.5 COMPARABILITY ADJUSTMENT

2.5.1 Comparability adjustment is an important element of comparability analysis that, when applied appropriately, enhances the accuracy and reliability of comparison. Differences between the transaction of the comparables and that of the tested party must be identified and adjusted for, in order for the comparables to be useful as basis for determining the arm's length price.

2.5.2 Comparability adjustments are intended to eliminate the effects of differences that may exist between situations being compared and that which could materially affect the condition being examined in the methodology (e.g. price or margin). Logically, comparability adjustments should not be performed to correct differences that have no material effect on the comparison. Thus, these adjustments are neither routine nor mandatory in a comparability analysis; rather, improvements to comparability should be shown when proposing an adjustment. Comparability adjustments include accounting adjustments and function/risk adjustments.

2.5.3 Adjustments need to be considered with much caution, on a case-by-case basis, and should only be applied to good quality comparables in light of information available in order to improve their accuracy. The following should be avoided as they do not improve comparability:

(a) adjustments that are questionable when the basis for comparability criteria is only broadly satisfied;

(b) too many adjustments or adjustments that too greatly affect the comparable as it indicates that the third party being adjusted is in fact not sufficiently comparable;

(c) adjustments on differences that do not materially affect the comparability; and

(d) highly subjective adjustments, such as on the difference in product quality.

2.5.4 Working capital adjustments should only be considered when the reliability of the comparables will be improved and reasonably accurate adjustments can be made. They should not be automatically made and would not be automatically accepted by IRBM. These adjustment make minor differences to the result when reliable comparables have been selected. In cases where significant difference is calculated, it will raise concern as whether the differences resulted from other issues.

CHAPTER III (TPGL 2012)

TRANSFER PRICING METHODOLOGIES

3.1 The following methodologies can be used in determining arm's length price:

i. Comparable uncontrolled price method
ii. Resale price method
iii. Cost plus method
iv. Profit split method
v. Transactional net margin method

The first three methods are commonly known as "traditional transactional methods". Although the taxpayer is given the right to choose any method, the emphasis should be on arriving at an arm's length price. It is advised that methods (iv) and (v), commonly referred to as "transactional profit methods", be used only when traditional transactional methods cannot be reliably applied or exceptionally cannot be applied at all. This will depend heavily on the availability of comparable data. The method that requires the fewest adjustments and provides the most reliable measure of an arm's length result is preferred by the IRBM as this will reduce the scope and nature of future disputes. Therefore, in deciding the most appropriate method, the following must be considered:

(a) The nature of the controlled transaction, determined by conducting a functional analysis,
(b) The degree of actual comparability when making comparisons with transactions between independent parties;
(c) The completeness and accuracy of data in respect of the uncontrolled transaction;
(d) The reliability of any assumptions made; and
(e) The degree to which the adjustments are affected if the data is inaccurate or the assumptions incorrect.

Where both the traditional transactional method and transactional profit method cannot be applied at all, the Director General may allow the application of other methods provided the prices arrived at is in accordance with the arm's length principle.

3.2 Comparable Uncontrolled Price Method (CUP)

The 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 arm's length, and that the price in the uncontrolled transaction may need to substitute for the price in the controlled transaction.

The method is ideal only 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 give a reliable measure of an arm's length price.

3.2.1 Comparability Analysis

A MNE using the CUP method to determine its transfer price must first identify all the differences between its product and that of an independent person. The MNE must then determine whether these differences have a material effect on the price, and adjust the price of products sold by the independent person to reflect these differences to arrive at an arm's length price.

A comparability analysis under the CUP method should consider amongst others the following:

(a) Product characteristics such as physical features and quality.
(b) If the product is in the form of services, the nature and extent of such services provided.

(c) Whether the goods sold are compared at the same points in the production chain.

(d) Product differentiation in the form of patented features such as trademarks, design, etc.

(e) Volume of sales if it has an effect on price.

(f) Timing of sale if it is affected by seasonal fluctuations or other changes in market conditions.

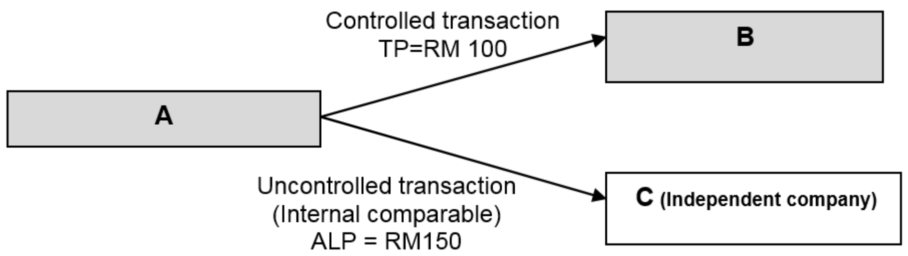
(g) Whether costs of transport, packaging, marketing, advertising, and warranty are included in the deal.

(h) Whether the products are sold in places where the economic conditions are the same.

3.2.2 CUP may be identified from either an internal comparable transaction or an external comparable transaction as shown in the following examples:

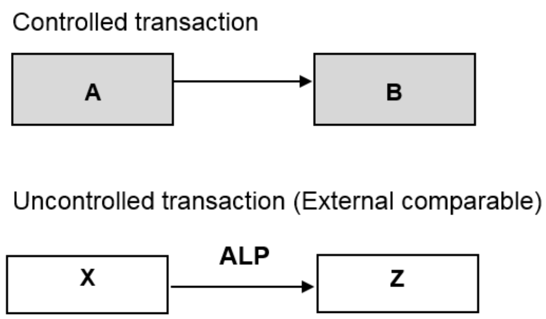
Example 1

Taxpayer A, a MNE, sells 60% of its product to an associated company B, at a price of RM100 per unit. At the same time, the remaining 40% of that product is sold to an independent enterprise C at RM150 per unit.



The products sold to B and C are the same, and the transaction between A and C may be considered as a comparable uncontrolled transaction. However, a functional analysis of B and C must first be carried out to determine any differences. If there are differences, adjustments must be made to account for these differences. Adjustments must also be made to account for product quantity discounts since volume of sales to B and C are different. Assuming there are no material differences that require adjustments to be made, the CUP method may be applied using the unit price of RM150 as a comparable arm's length price.

Example 2



Manufacturer A exports its product to associate company B. Manufacturer X exports the same product, in similar quantities and under similar terms to company Z, an independent party operating in similar markets as B. The uncontrolled sales price is a delivered price whereas the controlled sales are made FOB factory. These differences in terms of transportation and duties have an effect on price. Therefore, adjustments should be made on the uncontrolled transaction to eliminate the differences.

Selling price X to Z		RM 150
Less:		
Adjustment for freight	RM 10	
Adjustment for duties	RM 5	
Total adjustments		(15)
Arm's length price A to B		RM 135

3.3 Resale Price Method (RPM)

The resale price method is generally most appropriate where the final transaction is with an independent distributor. The starting point in the resale price method is the price at which a product that has been purchased from an associated enterprise is then resold to an independent enterprise. This price (the resale price) is then reduced by an appropriate gross margin (the resale price margin) representing an amount from which the reseller would seek to cover its selling and other operating expenses and in the light of functions performed (taking into account assets used and risks assumed), make an appropriate profit. An arm's length price for the original transaction between associated enterprises is obtained after subtracting that gross margin, and adjusting for other costs associated with the purchase of the product (e.g. custom duties). A typical adjustment may be represented as follows:

Arm's length price = Resale price – (Resale price x Resale price margin)

Where:

* Resale price margin = $\frac{\text{Sales price – Purchase Price}}{\text{Sales Price}}$

* Resale price margin must be comparable to margins earned by other independent enterprises performing similar functions, bearing similar risks and employing similar assets

As shown in the formula, the focus is on the resale price margin. This margin should ideally be established from comparable transactions between the reseller (involved in the controlled transaction) and other independent parties. In the absence of such transactions, the resale price margin may be determined from sales by other resellers in the same market. The resale price margin is expected to vary according to the amount of value added by the reseller. The factors that may be contributed to the value added depend on the level of activities performed by the reseller.

3.3.1 Comparability Analysis

In making comparisons for purposes of RPM, the focus is more on functions performed compared to product characteristics. Factors which may influence the resale price margin and other considerations when performing a comparability analysis include:

(a) The functions or level of activities performed by the reseller: whether only performing minimal services to taking on full ownership and responsibility for the risk involved in the transactions e.g. whether the reseller is merely a forwarding agent or a distributor who assumes full responsibility for marketing and advertising the product by risking its own resources in these activities;

(b) The degree of added value or alteration the reseller has done before the product is resold. The method is difficult to apply if the product has gone through a substantial number of processes;

(c) Employment of similar assets in the controlled and uncontrolled transactions e.g. a developed distribution network;

(d) Although broader product differences are allowed as compared to the CUP method, product similarities are still significant to some extent particularly when there is a high value or unique intangible attached to the product;

(e) If the resale price margin used is that of an independent enterprise in comparable transaction, differences in the way business is managed may have an impact on profitability;

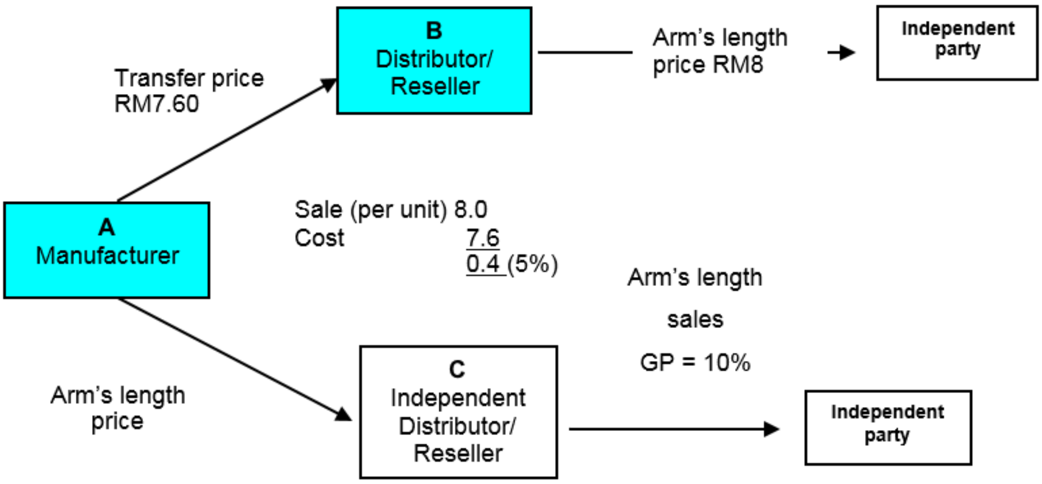
(f) A resale price margin will be more accurate if it is realized within a short time lapse between original purchase and the resale of the product as a longer time lapse may give rise to changes in the market, exchange rates, costs etc.;

(g) Whether the reseller is given exclusive rights to resell the products;

(h) Differences in accounting practices, where adjustments must be made to ensure that the components of costs in arriving at gross margins in the controlled and uncontrolled transactions are the same.

Example 3

Taxpayer **B, a distributor,** is a Malaysian subsidiary of multinational **A**, which is located overseas. **B** distributes high quality product manufactured by **A**. **A** also sells similar product of a lower quality to an independent distributor **C** in Malaysia. The cost of product purchased from **A** by **B** is RM 7.60 per unit. **B** resells the product to independent party for RM8. A functional analysis shows that B and C perform similar functions. The gross profit ratio of **C** was found to be 10%.



In this example, it is noted that there are product (quality) differences when comparing the controlled and uncontrolled transactions. However, since the focus of comparison is on margins the differences are not as material as they would have been if the basis of comparison were on prices. Furthermore, **B** and **C** carry out similar functions (**C** being another reseller in the same market), thus the resale price margin of 10% will be used as a basis to determine the arm's length price for the original purchase by **B** from **A**.

Arm's length price of product purchased (in RM) = 8 – (8 X 10%)

= RM **7.20**

Example 4

Using similar facts in Example 3, assume now that there are the following differences between the controlled and uncontrolled transactions:

- B bears warranty risk but C does not, as the risk is borne by A; and
- A provides samples and promotional materials to C free of cost while B produces its own promotional materials and bears the related costs.

The two margins are not comparable until an adjustment is made to account for these differences.

Calculation of adjusted resale price margin:

Distributor B net sales to independent customer	= RM 8.00
Arm's length resale price margin of C (%) is	= 10%

Therefore,

Arm's length resale price margin for B (10% x RM 8.00) **= RM0.80**

<u>Adjustments for functional and risk borne by B:</u>

Promotional costs	RM 0.10	
Warranty costs Total Adjustments	<u>RM 0.20</u>	
		<u>RM0.30</u>
Adjusted resale price margin for B		**<u>RM1.10</u>**

Calculation of Arm's Length Price of A to B

Distributor B net sales to independent customer	RM	8.00
Less: adjusted resale price/gross margin		<u>1.10</u>
Arm's length transfer price of A to B	**RM**	**<u>6.90</u>**

3.4 Cost plus Method (CPM)

3.4.1 The cost plus method is often useful in the case of semi-finished goods which are sold between associated persons, or when different companies in a multinational group have concluded joint facility agreements or when the manufacturer is a contract manufacturer or where the controlled transaction is the provision of services.

3.4.2 The starting point in a cost plus method, in the case of transfer of products between associated persons, is the cost to the supplier. An appropriate mark-up is added to this cost to find the price that the supplier ought to be charging the buyer. The appropriate mark-up should ideally be established by reference to the mark-up earned by the same supplier from comparable uncontrolled sales to independent parties. This is due to the fact that similar characteristics are more likely found among sales of product by the same supplier, than among sales by other suppliers. If no such transactions exist, the appropriate mark-up may be determined based on comparable transactions by independent parties operating independently. If there are material differences between the controlled and uncontrolled transaction that could affect the gross profit mark-up, appropriate adjustments must be made on the gross profit mark- up earned in the uncontrolled transaction.

Formula for arm's length price in CPM:

Arm's length price = Costs + (Cost x Cost plus mark-up)

Where:

*Cost plus mark-up = $\frac{\text{Sales price – Costs}}{\text{Cost}}$

*Cost plus mark-up must be comparable to mark-ups earned by independent parties performing comparable functions, bearing similar risks and using similar assets.

3.4.3 Comparability Analysis

Comparability when applying the cost plus method should take into account similarity of functions, risks assumed, contractual terms, market conditions, business strategies as well as any adjustments made to account for the effects of any differences in the aforementioned factors between the controlled and uncontrolled transactions. As with the resale price method, fewer adjustments are needed to account for product differences compared to the CUP method.

3.4.4 Cost Structure Consideration

(a) The method used in determining costs and the accounting policies should be consistent and comparable between the controlled and uncontrolled transaction, and over time in relation to the particular enterprise. The costs referred to in the cost plus method is the aggregation of direct and indirect costs of production. Usage of other costs must be well justified and may be considered only if they result in a more accurate estimate of the appropriate margin. In computing costs, the practice must be in accordance with generally accepted principles or normal accounting standards in Malaysia.

(i) Direct costs are costs identified specifically with a particular activity including compensation, bonuses, travelling expenses of employees directly engaged in performing such activity, or materials and supplies consumed in providing the activity. In determining the cost base incurred in providing an activity, costs that do not relate to the service under consideration must be excluded and the costs must be consistent with those incurred in comparable transactions.

(ii) Indirect costs are costs not specifically attributable to a particular activity but nevertheless relate to direct costs or relate to the process of the activity. These include utilities, rental, supervisory and clerical compensation and other overhead costs of the department incurring the direct costs. Indirect costs also include an appropriate share of costs of the supporting units and departments (e.g. accounting and secretarial units etc).

(b) The determination of costs is important in the application of CPM where the comparable mark up is to be applied to a comparable cost basis. For example, an independent supplier who leases its business assets may not be comparable to a supplier in a controlled transaction who owns its assets. Adjustments must be made to eliminate the differences in these costs.

(c) It is also important to consider differences in the level and types of expenses (operating and non-operating expenses including financing expenditures) related to the functions performed and risks assumed by the parties or transactions being compared. Consideration of these differences may indicate the following:

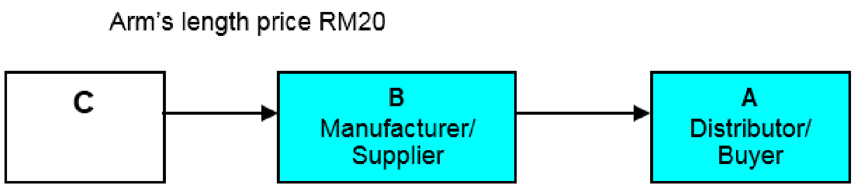
(i) If expenses reflect a functional difference which has not been taken into account in applying the method, an adjustment to the cost plus mark-up may be required;

(ii) If the expenses reflect additional functions that are distinct from the activities tested by the method, separate compensation for those functions may need to be determined. Such functions may for example amount to the provision of services for which an appropriate reward may be determined. Similarly, expenses that are the result of capital restructures reflecting non-arm's length arrangements may require separate adjustment;

(iii) If differences in the expenses of the parties being compared merely reflect efficiencies or inefficiencies of an enterprise, as would normally be the case for supervisory and general and administrative expenses, adjustments to the gross margin may be inappropriate.

Example 5

Taxpayer B is a Malaysian subsidiary of foreign multinational A. B manufactures electrical components which it exports to A. The electrical components are specially tailored to meet the requirements of A. All raw materials used in the manufacture of the product are purchased from an independent enterprise C, at RM20 per unit. The total cost per unit of manufactured product is RM80. B then sells the product to A at a price of RM100 per unit at a mark-up of 25%. An independent manufacturing company, performing the same functions, bearing similar risks and using similar assets, selling to another independent company is found to have a mark-up on cost of 40%.



Sales		100
Purchases	20	
Mfg Cost	50	
Overheads	<u>10</u>	<u>80</u>
Gross Profit		<u>20</u>

Since B's product is highly customised, there are no product comparables available. The mark-up of 40% of the other independent manufacturing company can thus be used as a basis in arriving at arm's length price. Arm's length price of electrical component sold to A by B (in RM)

= 80 + (80 x 40%) =**112**

Example 6

Company A manufactures customised moulds for independent parties using designs supplied by independent parties earning a cost plus mark-up of 10%. Under these arm's length agreements, **costs** are defined as the sum of direct costs (i.e. labour and materials) plus estimated indirect costs (estimated to be 40% of the direct costs).

Cost	=	Direct Costs	+	Estimated Indirect Costs	(40% Direct Costs)

Company A also manufactures moulds for an affiliate, F, using designs supplied by F. Under the agreement with F, **costs** are defined as the sum of direct costs plus actual indirect costs.

Cost	=	Direct Costs	+	Actual Indirect Costs

Calculation done based on this agreement shows that actual indirect cost is equivalent to 30% of direct cost for each project. In order to determine the appropriate mark-up for A's transaction with F, the cost base of its transaction with the independent parties need to be restated.

The transfer price is calculated as follows:

Original calculation under the arm's length agreement:

Direct costs	RM	1,000
Indirect costs (40% × RM1,000)		400
Total costs	RM	1,400
Mark-up 10%	RM	140
Price	RM	1,540

Recalculation of mark-up under the arm's length agreements using restated costs:

Direct costs	RM	1,000
Indirect costs (30% × RM1,000)		300
Total costs	RM	1,300

Price established above	RM	**1,540**
Mark-up based on restated costs (RM1,540 - RM1,300)	RM	240

Gross mark-up based on restated costs =RM240/RM1,300 = **18.5%**

Therefore, the arm's length transfer price between A and F:

Direct cost	RM 900
Add:	
Indirect costs (30% × RM900)	270
Mark-up (18.5% × (RM900 + 270))	216
Arm's Length Price	**RM 1,386**

This example illustrates how the cost base of a tested party and the comparable transaction must be expressed in equivalent terms. For purposes of this example, it has been assumed that the transactions between A and the independent parties are functionally comparable to the transactions between A and F. Under normal circumstances, there may be functional differences, such as marketing, that should be given consideration when determining the arm's length mark-up.

3.5 Transactional Profit Method

Transactional profit methods examine profits that arise from controlled transactions among associated persons. The profit methods that satisfy the arm's length principle are those that are consistent with the **transactional profit split method** or the **transactional net margin method** (TNMM) as described in these Guidelines.

3.5.1 Transactional Profit Split Method

(a) The transactional profit split method provides an alternative solution for cases where no comparable transactions between independent parties can be identified. This would normally happen when transactions are highly integrated that they cannot be evaluated separately. Profit split method is based on the concept that the combined profits earned in a controlled transaction should be equitably divided between associated persons involved in the transaction according to the functions performed. To arrive at an arm's length price, the value of the contributions that each associated person makes to the transaction is assessed based on how independent persons would split the profits among them under similar circumstances.

Two approaches for estimating the division of profits (projected or actual) are described in the following paragraphs. These approaches are neither exhaustive nor mutually exclusive:

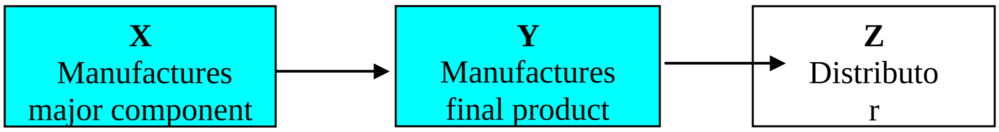
(i) <u>Residual profit split approach</u>

This approach is the most appropriate method in cases where both parties to a transaction contribute significant unique intangibles. There are two stages of profit division under this approach. First, the combined profit is apportioned according to basic returns assigned to each party to the transaction. These returns are based on the basic, non-unique, functions that each party performs, and are determined by reference to market returns obtained by independent parties in similar transactions. This basic return would generally not account for the return that would be generated by any unique and valuable assets owned by the participants. The next stage involves the allocation of the remaining residual profit/loss, also with reference to how independent parties in similar circumstances would have divided such residuals.

The following example demonstrates the application of the residual profit split approach:

Example 7

X, **Y** and **Z** are companies located in different countries. Company **X** designs and manufactures the major components of a high quality electrical product which it sells to its subsidiary. From these components, **Y** further develops and manufactures them into the final product which it exports to **Z**, an independent distributor.



The trading accounts of **X** and **Y** is as follows:

	X	**Y**
Sales	100	300
Purchases	15	100
Manufacturing cost	20	35
Gross profit	65	165
R&D	20	15
Other operating expenses	15	10
Net profit	30	140

The final product in the transaction happens to be a unique product for which there is no comparable. However, research indicates that there are several companies that carry out similar functions to that of **X** and **Y** involving similar semi-finished and final products, of a much lower quality. The average net mark- ups for these independent companies involved in transactions similar to **X** and **Y** is 30% and 20% respectively.

Application of Residual Profit Split Approach

In the above example, the CUP method cannot be used due to the uniqueness of the final product. For the sake of simplicity, assume that there is insufficient data and information to apply the cost plus method, while the resale price method is inappropriate as the product has undergone substantial transformation at **Y**. The profit split method is adopted using the residual approach.

(a) Residual analysis of the group profit

Calculation of total profit

Total Sales of transaction	300
Cost of goods sold (X)	35
Cost of goods sold (Y) [excluding purchases from X]	35
Gross profit	**230**
R&D	35
Other operating expenses	25
Net profit	**170**

Calculation of basic return

The mark-ups derived from external data will be used to calculate basic returns to **X** and **Y**.

i. Basic return to **X** = 30% of (COGS + Other operating expenses)

= 30% x (35+15) = 15

ii. The calculation of basic return to **Y** has to take into account the fact that the COGS for the comparable independent companies have included the purchase price for the semi-finished product. Since this is the transfer price for **Y**, the basic return for **Y** will be a function of the transfer price i.e.

= 20% of [(COGS – purchase price) + other operating expenses + arm's length transfer price]

= 20% [(135 –100) + 10 + TP]

= 20% (35 + 10 + TP)

= 9 + 0.2TP

(b) Residual profit split:

Calculation of residual profit

Residual profit = Net profit – [(Return to **X**) + (Return to **Y**)]

= 170 – [15 + (9 + 0.2TP)]

= 146 – 0.2TP

Assume that in this case R&D is a reliable indicator of **X** and **Y**'s relative contribution of an intangible asset, the residual profit may be split based on the relative R&D expenditure as follows:

	X	**Y**
R&D	20	15
Total R&D	35	35
R&D expenditure ratio	57%	43%

Calculation of residual profit split

For **X** = 57% of (146 – 0.2TP) = 83.22 – 0.114TP

For **Y** = 43% of (146 – 0.2TP) = 62.78 – 0.086TP

<u>Net profit for X</u>

Basic return to **X** = 15

Residual return to **X** = 83.22 – 0.114TP Total

net profit for **X** = 15 + 83.22 – 0.114TP

= 98.22 – 0.114TP

<u>Net profit for Y</u>

Basic return to **Y** = 9 + 0.2TP

Residual return to **Y** = 62.78 – 0.086TP

Total net profit for **Y** = (9 + 0.2TP) + (62.78 – 0.086TP)

= 71.78 + 0.114TP

<u>Adjustment for transfer price between X and Y:</u>

Sales price of X (Assume X makes no profit)

= 100 – 30 = 70

Adjusted sales price (i.e. TP)

= 70 + Adjusted net profit for X

= 70 + 98.22 – 0.114TP

= 168.22 – 0.114TP

TP = 168.22/1.114 = 151

Adjusted net profit:

	X	**Y**
Sales	100	300
Arm's length adjustment	**<u>51</u>**	
Adjusted sales	**151**	
Purchases		100
	(15)	
Adjustment		**<u>51</u>**
Adjusted purchases		**151**
Manufacturing cost	(20)	(35)
Adjusted gross profit	**116**	**114**
R&D	20	15
Other operating expenses	15	10
Adjusted net profit	**81**	**89**

(ii) <u>Contribution analysis approach</u>

(a) The second approach under the Transactional Profit Method is the contribution analysis approach. Under this approach, combined profits would be divided between associated persons based on the relative value of functions (i.e. contribution) performed by each of the associated persons participating in a controlled transaction. To determine the relative value of contribution, it may be necessary to focus on the nature and degree of each party's contribution of differing types (e.g. provision of services, capital invested) and assign a percentage based on the relative comparison and external market data.

Unlike the residual approach, basic returns are not allocated to each party to the transaction before the profit split is made. Generally, the profit to be combined and divided is the operating profit. Where allocation of expenses to controlled transactions is impossible, a split of gross profits may be considered, after which expenses attributable to the relevant enterprises will be deducted accordingly.

However, it is difficult to determine the relative value of contribution that each of the participants makes to the controlled transactions, and the approach will often depend on the facts and circumstances of each case. Thus, the approach requires careful judgment and the criteria should always include what adds value to the transaction and how economically important were the functions carried out by each party in earning the profits.

(b) The division of combined profits under the transactional profit split method is achievable by the use of allocation keys. The choice of allocation keys by which profits are split largely depends on the facts and circumstances that surround a case. An allocation key can be in the form of a figure (e.g. a percentage) or a variable (e.g. specific expenses). Some of the more common types of allocation keys are:

- Asset-based: useful where the controlled transaction demonstrates strong correlation between assets and the creation of value;
- Cost-based: where there is clear indication of correlation between cost and value created;
- Time spent by employees performing intragroup services;
- Units produced or sold;
- Number of employees;
- Space used.

3.6 Transactional Net Margin Method (TNMM)

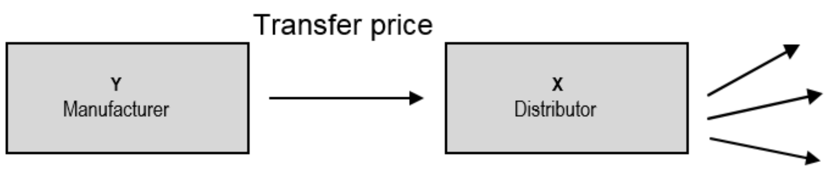
The TNMM is similar to the cost plus and resale price methods in the sense that it uses the margin approach. This method is useful in instances where it is difficult to compare at gross profit margin such as in situations where different accounting treatments are adopted. The method examines the net profit margin relative to an appropriate base such as costs, sales or assets attained by a MNE from a controlled transaction. As with the cost plus or resale price methods, this margin should preferably be derived from comparable uncontrolled transactions between the same taxpayer and independent parties. If there are no comparable uncontrolled transactions involving that MNE, reference may be made to the net profit margin that would have been earned in comparable transactions by an independent person. Functional analysis of the associated person as well as the independent person will have to be applied to determine comparability.

3.6.1 Application of TNMM

(a) Net margins (unlike gross margins or prices) tend to be significantly influenced by various factors other than products and functions (e.g. competitive position, varying cost structures, differences in cost of capital, etc). Therefore, where possible, the usage of TNMM should be confined to cases where these factors have a high degree of similarity, so as to eliminate the effects of these other conditions.

Example 8

X is a Malaysian subsidiary of **Y**, located overseas. Y manufactures computers, which it sells to X and other associated distributors in different countries. The computers distributed by X bear company Y's trademark. X also provides technical support to all its customers.



Trading account for **X**

Sales	100,000
Cost of goods sold	90,000
Gross Profit	10,000
Operating expenses	15,000
Net loss	(5000)
Margin (Net Loss)	-5%

Assume that the CUP method is not applied as no reliable adjustments can be made to account for differences with similar products in the market; and the resale price method is not used as no comparable measurement of gross margin can be found due to differences in accounting practices amongst independent distributors. The TNMM is adopted on the basis of net profit return to sales. It was found that the net profit margin to sales earned in a comparable transaction by an independent person is 5%.

Adjustments on **X** will be as follows: Net
profit of **X** = 100,000 x 5% = **5,000**
Adjusted cost of goods sold = 100,000 – 15,000 – 5,000 = **80,000**

Example 9

Company A manufactures plastic bags in Malaysia and exports them to its holding company overseas. The gross profit mark up with respect to its manufacturing operations is 15% while the cost of freight is reflected as operating cost.

Company B, another manufacturer of plastic bags in Malaysia, exports these plastic bags to independent parties overseas. The gross profit mark ups with respect to the manufacturing operations is 10%. However, unlike Company A, the freight cost is included in the cost of goods sold for B.

The cost plus method would require a comparability adjustment to the gross profit mark-up of company B to provide for accounting consistency. If the freight costs cannot be identified and there are no more reliable comparisons, it is necessary to examine the net margins.

3.7 Global Formulary Apportionment

IRBM does not accept methods based on global formulary apportionment on the basis that they are arbitrary and could not reliably approximate arm’s length conditions. Global formulary apportionment refers to a method which uses a predetermined and mechanistic formula normally based on a combination of costs, assets, payroll and sales to allocate the global profits of an MNE group among associated enterprises in different countries.

CHAPTER IV (TPGL 2012)
COMPARABILITY ANALYSIS

4.1 COMPARABLE PERIOD

4.1.1 Every taxpayer should endeavour to determine its transfer pricing for tax purposes in accordance with the arm's length principle, based upon information reasonably available at the time of the determination. Hence, the arm's length price should be determined by comparing the results of a controlled transaction with the results of uncontrolled transactions that were undertaken or carried out during the same year as the year of the taxpayer's controlled transaction.

4.1.2 This requirement is made on the basis that the arm's length principle must be complied with contemporaneously, on a year by year basis. A contemporaneous uncontrolled transaction should provide the most reliable comparable as it is carried out in an economic environment that is the same as or similar to the economic environment of the taxpayer's controlled transaction.

4.1.3 Depending on the industry concerned and the circumstances of the case, there may be cases where data in a particular financial year does not provide the most reliable comparison. For instance, if a tested party's accounting period ends at 31 March 2010, data from a company in the same industry with a financial year end at 31 December 2009 is considered a better comparable to another company with financial year end at 31 December 2010. This is because the economic environment for the company with year ending 31 December 2009 would be more relevant to that of the tested party.

4.2 MULTIPLE YEAR DATA

4.2.1 The purpose of analyzing multiple year data is to identify whether the outcome of a particular year is influenced by abnormal factors. However, the use of multiple year data does not imply the use of multiple year average.

4.2.2 In order to obtain a complete understanding of the facts and circumstances surrounding a controlled transaction, it is useful to examine data from both the years after the year under examination and prior years. The use of data from past years will show whether a taxpayer's reported loss on a transaction is part of a history of losses on similar transactions, a result of a particular economic condition in a prior year that caused an increase in cost in the subsequent year, or a reflection of the fact that a product is at the end of its life cycle.

4.3 ARM'S LENGTH RANGE

4.3.1 An arm's length range refers to a range of figures that are acceptable in establishing the arm's length nature of a controlled transaction. The range is derived from applying the same transfer pricing method to multiple comparable data. It is established that transfer pricing is not an exact science, and that the application of the most appropriate transfer pricing methodology may produce a range of results. The facts and circumstances of a case are therefore important in determining a range, or the point in a range, that is the most reliable estimate of an arm's length price or allocation.

4.3.2 The arm's length range should be constructed using only comparable uncontrolled transactions that have, or have been adjusted to, a high level of reliability in comparison to the controlled transactions. A substantial deviation among points or between the data in the range (e.g. upper quartile and lower quartile) may indicate that comparables used are not reliable, and that material differences exist in terms of FAR which warrant comparability adjustments. In such cases, the reliability of comparable data must be carefully assessed, and adjustments made for the material differences in comparability analysis and the methodology should be reviewed.

4.3.3 If every effort has been made to exclude data that have a lesser degree of comparability, but some comparability defects remain and cannot be adjusted, it may be appropriate to make transfer pricing adjustments to a value that best reflects the facts and circumstances of transactions between associated persons. This value may be derived from utilising statistical tools depending on the specific characteristic of the data set.

4.4 SEPARATE AND COMBINED TRANSACTIONS

4.4.1 To obtain the most precise approximation of an arm's length price or profit allocation, the arm's length principle should ideally be applied on a transaction-by-transaction basis. However, depending on the circumstances of the case, transfer pricing may sometimes need to be dealt with at the level of a product line or business unit rather than at the level of each particular transaction.

4.4.2 In establishing transfer prices, taxpayers should set prices separately for each transaction they enter into with an associated person. However, where transactions are so closely linked (or continuous) that they cannot be evaluated adequately on a separate basis, determination of transfer price based on bundled transactions may be considered. This is provided it can be demonstrated that it is the normal industry practice to set one price for a combination of transactions (e.g. goods and the associated intangible property) or where it may not be reasonable to expect to find quality data available to set the price for separate transactions. Lack of reliable data on comparable transactions may be due to the complexity of the dealings or the relationships between the parties. Therefore, the total amount may be on an aggregate basis.

4.4.3 It is generally acceptable to group intangibles associated with the product or service provided if comparable independent transactions also have these various transactions which cannot be disaggregated and are bundled into a package deal with all the associated costs being included in the price of the product.

Other examples include:

Example 1

Aggregation of transaction involving tangible and intangible products that are highly integrated

A company that licenses manufacturing know-how and supplies vital components that are highly integrated to an associated party may find it more reasonable to assess the arm’s length price for these two activities as an item instead of separately.

Example 2

Aggregation of transactions where one product complements the other

Aggregation of transactions may also be appropriate in situations where a taxpayer is required to carry an unprofitable product or line of products which are auxiliary to the profitable items and where there is sufficient profit available to provide an adequate return from the complete product range to reward the assets, functions and risks of the enterprise. Common types of bundled products that fall under this category include printers with cartridges, and razors with blades.

Example 3

Disaggregation of transactions where the nature of transactions are substantially different

Company M was established in Malaysia to handle the distribution, sales, after-sales service, repair and maintenance services of the X group vehicles consisting of trucks, buses and coaches which are 100% imported from its parent company in Country X. Company M is also the regional hub for X in South East Asia, covering markets such as Singapore, Thailand, Vietnam and Indonesia. This regional office also houses the regional training centre where mechanics, technicians, driver trainers and managers from the Asia Pacific region are trained to provide X's group customers in the region.

Ordinarily, in this situation, the various kinds of activities should not be aggregated and Company M is required to prepare segmental accounts as follows, in order to enable the evaluation of the arm's length nature of the controlled transactions on a transactional basis:

- Sales and distribution
- Repair and maintenance services
- Regional services

4.5 RE-CHARACTERIZATION OF TRANSACTIONS

4.5.1 Examination of a controlled transaction ordinarily should be based on the transaction actually undertaken by the taxpayer insofar as these are consistent with the methods described in the Guidelines. However, when reviewing an agreement between associated persons, consideration is not only on the terms of the agreement but also the actual conduct of the parties.

Therefore, in determining an arm's length price, the IRBM may disregard and re-characterize a controlled transaction under the following circumstances:

(a) where the economic substance of a transaction differs from its form; or

(b) where the form and substance of a transaction are the same; the arrangements made in relation to the transaction, when viewed in their totality, differ from those which would have been adopted by independent persons behaving in commercially rational manner and this actual structure practically impedes the IRBM from determining an appropriate transfer price.

4.5.2 The need to re-characterize a transaction is based on the rationale that the character of the transaction is derived from the relationship between the parties and is not determined by normal commercial conditions. The controlled transaction may have been structured by the taxpayer to avoid or minimise tax. This is supported by the fact that -

(a) associated persons are able to enter into a greater variety of contracts and agreements compared to independent persons because the normal conflict of interest which exist between independent parties is often absent;

(b) associated persons often conclude arrangements of a specific nature that are not, or very rarely, encountered between independent persons; and

(c) contracts under a controlled transaction are quite easily altered, suspended, extended, or terminated according to the overall strategies of the multinational group as a whole and such alteration may even be made retroactively.

4.5.3 The above principle can be demonstrated in the following examples extracted from the OECD Guidelines:

Example 4

An investment in an associated enterprise in the form of interest-bearing debt would not be expected to be structured in the same way had it been conducted at arm’s length, given the economic circumstances of the borrowing company. In this case, it might be appropriate for a tax administration to characterize the investment in accordance with its economic substance where the loan may be treated as subscription of capital.

Example 5

A sale under a long term contract, for a lump sum payment, gives unlimited entitlement to the intellectual property rights arising as a result of future research for the term of the contract. While it may be proper to respect the transaction as a transfer of commercial property it would nevertheless be appropriate for a tax administration to conform the terms of that transfer in its entirety to that which might reasonably have been expected between independent persons. Thus, in the case described above, it might be appropriate for the tax administration, for example, to adjust the conditions of the agreement in a commercially rational manner as a continuing research agreement.

4.6 TRANSFER PRICING ADJUSTMENT

Where the DGIR has found that a price in a controlled transaction is not at arm’s length, he may make an adjustment to reflect the arm’s length price or interest rate for that transaction by substituting or imputing the price, or interest, as the case may be. In such instances, the adjustment will also be reflected by a corresponding adjustment upon request of the other party of the controlled transaction. Adjustments will be made where:

(a) For the supply of property or services, the consideration is less than the consideration that would have been received or receivable in an arm's length arrangement;

(b) For the acquisition of property or services, the consideration is more than the consideration that would have been given or agreed to be given in an arm's length arrangement; or

(c) No consideration has been charged to the associated person for the supply of property or services.

4.7 LOSSES

4.7.1 Enterprises incur losses for a variety of economic and business reasons such as start up losses, market penetration strategies, and research and development failure. However, an independent enterprise would not endure continuous losses without taking appropriate measures to correct the situation within reasonable time, as it would contradict fundamental business objectives of making profits. The fact that an associated enterprise continuously suffers losses may be an indication that it is not being compensated fairly.

4.7.2 In determining whether the losses are acceptable, it is important to ensure that the controlled transaction entered into is commercially realistic and make economic sense. A taxpayer needs to also establish that the losses are commercial in nature within the context of its characterization. In this regard, a taxpayer is expected to maintain contemporaneous documentation which outlines the non-transfer pricing factors that have contributed to the losses.

4.7.3 A contract or toll manufacturer that only carries out production as ordered by a related party, without performing functions such as operational strategy setting, product R&D and sales, is expected to maintain a consistent level of profitability. Should the manufacturer suffer from losses, it must prove that these losses are not a result of its transactions with a related party.

CHAPTER V (TPGL 2012)

BUSINESS RESTRUCTURING

5.1 Business restructuring within a multinational group often result in a change of business characterization and reduction of profitability of a local entity. Such reduction of profits is acceptable only with reduced functions performed, assets employed and risks assumed. As long as these functions, assets and risks are actually transferred, it is viewed as commercially rational for a multinational group to restructure in order to obtain tax savings. However, if it is found that the local entity continues to perform the same functions, and bear the same risks, IRBM will make the necessary adjustments. In an arm's length situation, an independent party would not restructure its business if it results negatively for it, where it has the option realistically available not to do so.

CHAPTER VI (TPGL 2012)
INTRAGROUP SERVICES

6.1 Intragroup services are services provided by one or more members of a multinational group for the benefit of the other members within the group. In general, the types of services that members of a multinational group can provide to each other include, but are not limited to, management services, administrative services, technical and support services, purchasing, marketing and distribution services and other commercial services that typically can be provided with regard to the nature of the group's business. The costs of such services, initially borne by the parent or other service companies within the multinational group, are eventually recovered from other associated persons through intragroup arrangements.

6.2 In general, no intra-group service should be found for the following activities:

(a) Shareholder activities

Shareholder activity refers to an activity that one group member (usually the parent company) performs solely because of its responsibility as a shareholder due to its ownership interest in one or more members of the group.

Examples of non-chargeable shareholder activities include:

- Costs pertaining to the juridical structure of the parent company such as meetings of shareholders of the parent company, issuing of shares in the parent company and costs of the supervisory board;
- Costs relating to the reporting and legal requirements of the parent company such as producing consolidated accounts or other reports for shareholders, filing of prospectuses; and
- Costs of raising funds for the acquisition of new companies to be held by the parent company (distinct from fund raising on behalf of its existing subsidiaries).

(b) Duplicative services

(i) Duplicative services are services performed by a group member that merely duplicates a service that another group member is already performing in-house, or that is being performed by a third party. In such instances, any duplicative claim will be automatically disallowed. The ability of a group member to independently perform the service (for instance in terms of qualification, expertise and availability of personnel) shall be taken into account when evaluating the duplication of services performed.

Example 1

A subsidiary has qualified personnel to analyse its capital and operational budget. This analysis is then reviewed by the parent company's financial personnel. The review by the parent company is considered duplicative.

(ii) However, there are exceptions in which duplication of services can be charged such as:

- Special circumstances where duplication is only temporary. For example in implementing a new system, a company may simultaneously continue to operate an existing system for a short period, in order to deal with any unforeseen circumstances that may arise during the initial implementation; or
- To reduce the risk of a wrong business decision such as by getting a second legal opinion on a particular project.

(c) Services that provide incidental/ passive association benefits

This refers to services performed by one member of a multinational group, such as a shareholder or coordinating centre, which relates only to specific group members but incidentally provides a benefit to other members of the group. Incidental benefit may also arise as a consequence of an associated person being part of a larger concern and not because of a service that has actually been provided. Such incidental benefits would not warrant a charge to the incidental recipient because the perceived benefit is so indirect, and remote, that an independent person would not be willing to pay for the activities giving rise to the benefit and therefore should not be considered as intragroup service to the incidental recipient.

Example 2

An enterprise that had obtained a higher credit rating due to it being a member of a multinational group should not be charged for its mere association with the group. However, if the higher credit rating is due to a guarantee provided by another group member, then an intragroup service can be considered to have been rendered.

(d) On-call services

An on-call service is where a parent company or a group service centre is on-hand to provide services such as financial, managerial, technical, legal or tax advice to members of the group at any time.

(i) This service is considered non-chargeable under the following circumstances:

- Service is easily and promptly available even without any standby arrangement;
- The potential need for such service is remote;
- Where there is no/negligible benefits derived from the service.

(ii) If there are exceptional circumstances which require on- call services to be considered as chargeable services, it must be proven that an independent person in comparable circumstances would incur such charges to ensure availability of the services when the need for them arises.

6.3 Other services that are commonly found between associated persons include –

(a) activities performed by one member of a multinational group to meet the identifiable needs of its associated person;

(b) activities that are centralized in the parent company or regional headquarters companies or group service centre; and

(c) ancillary or subsidiary services which are services rendered in connection with other transactions such as the transfer of a property (e.g. intangible asset) or the commencement of the effective use of a property. IRBM requires that charges for the services are shown separately or can be shown separately should the need arise.

The following table summarizes the types of services that may be chargeable and that which are non-chargeable:

Type of service	May be Chargeable	Non Chargeable	Exceptions
Services that provide specific benefits	✓		
Centralized services	✓		
Ancillary services	✓		
Shareholder activities		✓	
Duplicative services		✓	• Temporary duplications e.g. maintaining use of existing system during early stages of implementation of a new system • To reduce risk of a wrong business decision e.g. obtain a second legal opinion on a project
Services that provide incidental benefits		✓	
Passive association benefit (benefit from being part of larger concern)		✓	
On-call services (standby charges)		✓	• Where it can be proven that an independent person is willing to incur such standby charges.

6.4 Application of arm's length principle for intragroup services

(a) In applying the arm's length principle to intragroup services, taxpayers should consider:

(i) Whether services have been provided; and

(ii) If so, whether the charge for these services are at arm's length prices.

(b) The following factors should serve as a guide in determining whether services have been provided:

(i) Whether the service recipient receives benefits that are of economic or commercial value; and

(ii) Whether an independent enterprise in comparable circumstances is willing to pay for the services or perform such services in-house.

A benefit is of economic or commercial value if it -

- enhances the recipient's return or profitability by improving its production efficiencies; or

- results in cost savings or a decrease in the recipient's operating expenses for example by decreasing production time.

(c) Charges for intragroup services must be consistent with the relative benefits intended from the services, based on the facts known at the time the services were provided, and at arm's length. Where anticipated benefits are not realised, taxpayer needs to justify that an independent party would be willing to pay for the services.

6.5 Methods of charging for provision of services

6.5.1 In charging for the provision of services, a service provider could adopt a direct charge method or an indirect charge method. The direct charge method is preferred because it facilitates the determination of whether the charge is consistent with the arm's length principal, and evidence for direct charge is usually readily available.

6.5.2 Direct Charge Method

(a) The direct charge method is applicable for a specific service where the service, the beneficiary of the service, the cost incurred and the basis of charge can be clearly identified. Hence, the cost can be allocated directly to the recipient.

(b) Direct charge method must also be applied when the specific service forms part of the main business activity of the service provider, and is provided to both associated persons and independent parties.

6.5.3 Indirect Charge Method

(a) The indirect charge method is applicable where the direct charge method is impractical or if the arrangements for the services provided are not readily identifiable i.e. where the costs are attributable to several related enterprises and cannot be specifically assigned to the recipients of services. IRBM does not encourage the use of indirect charge method, thus the service recipients must be prepared to support their claims via indirect charge method, especially if this forms a significant amount of total claims.

Example 3

Circumstances when the indirect charge method may be applicable:

- Where sales promotion activities carried out centrally at international fairs or in global advertising campaigns benefit the group members as a whole and is reflected in increased quantity of goods produced or sold by members of the group;
- The provision of information technology services like management information system which involves development, implementation and maintenance of inter-company electronic data such as transmission of marketing data, production and scheduling forecast, accounting data, etc.
- Provision of accounting services to all members of the multinational group.

(b) The method is based upon cost allocation and apportionment by reference to an allocation key which must be appropriate to the nature and purpose of service provided. For example, the provision of payroll services may be more related to number of staff than turnover, while the allocation of usage of networking infrastructure could be allocated according to the number of computer users.

(c) The arm's length principle requires that the amount allocated to a respective member of a group is in proportion to the individual member benefit or expected benefit from the services or reflects the share of the total benefits of the service attributable to that particular recipient. Taxpayers are expected to document the analysis undertaken in arriving at the choice of allocation key.

(d) IRBM does not accept allocation key based on sales unless the taxpayer can justify the correlation between sales and costs incurred.

6.6 Determination of arm's length charge for intragroup services

6.6.1 In applying the arm's length principle to intragroup services, it is necessary to consider from the perspective of both the provider and the recipient of the service. The service must be of value to the recipient and the price must be one that an independent party would be prepared to pay.

In determining arm's length prices for intragroup services the service recipient may apply external CUP together with a benefit test. For the service provider, both, the CUP and the cost plus method may be applied.

6.6.2 In determining the arm's length price charged for an intragroup service, the following factors should be taken into consideration:

(a) Nature of the service;
(b) Value / extent of the benefit of the service to the recipient;
(c) The costs incurred by the service provider in providing the service;
(d) The functions involved in providing the service;
(e) The amount an independent recipient would be prepared to pay for that service in comparable circumstances. Service recipients must show benefits commensurate with the amount charged by the service provider;
(f) Other options realistically available to the recipients.

6.7 Profit Mark-up

6.7.1 It is vital to consider whether mark-up on a cost base is justifiable since in an uncontrolled transaction an independent person would normally seek to earn a profit from providing services, rather than merely charging them out at cost. Therefore, it is necessary to understand the nature of activity, the significance of the activity to the group, the relative efficiency of the service supplier and any advantage that the activity creates for the group.

6.7.2 The nature of service and the expected value to a recipient influence the arm's length price of the service provider. Specialised services, such as engineering services in the oil and gas industry, warrant a higher mark-up than general services such as repair and maintenance.

6.7.3 When applying the cost-plus method to an associated enterprise which assumes the role of an agent or intermediary to obtain services from independent enterprises on behalf of its group members, it must be ensured that the arm's length return is limited to rewarding the agency/intermediary function only. It is not appropriate to charge a service fee based on mark-up on cost of the services obtained from independent enterprises.

6.7.4 If a tested party is the service recipient in Malaysia, a mark-up by an overseas affiliate service provider which has fulfilled an arm's length test in that service provider's country of residence need not automatically be deemed arm's length in Malaysia. A benefit test from the perspective of the service recipient must still be demonstrated.

CHAPTER VII (TPGL 2012)
COST CONTRIBUTION ARRANGEMENT (CCA)

7.1 Concept of a CCA

A CCA is a framework (in the form of contractual agreement) agreed among business enterprises to share the costs and risks of developing, producing or obtaining assets, services or rights, and to determine the nature and extent of the interests of each participant in those assets, services or rights. Each participant's proportionate share of the overall contributions to the arrangement will be consistent with the participant's proportionate share of the overall expected benefits to be received under the arrangement. The participant would be entitled to exploit its interest in the CCA separately as an effective owner, not as a licensee. Where a taxpayer enters into a CCA with its associated persons, the arrangement should reflect that of an arm's length arrangement.

7.2 Types of CCA

There are two major types of CCA most commonly encountered in practice:

(i) Arrangement for the joint development of intangible property

In this arrangement each participant contributes different assets, resources and expertise, and receives a share of rights in the developed property based on the contribution.

(ii) Service Arrangement

CCA could exist for any joint funding or sharing of costs and risks, for developing or acquiring property or for obtaining services such as pooling resources for the development of advertising campaigns common to the participants' market. However, if a service arrangement does not result in any property being produced, developed or acquired, the principles for dealing with intragroup services will apply to that arrangement whether it is described as CCA or not.

Example 1

Three members of a multinational group, marketing a product in the same regional market where consumers have similar preferences, want to enter a CCA to develop a joint advertising campaign. A fourth member of the group helps develop the advertising campaign but does not itself market the product. This fourth member is not a participant in the CCA because it does not have any beneficial interest in the services subject to the CCA activity and would not, in any case, have a reasonable expectation of being able to exploit any interest. The three participants in the CCA would, therefore, compensate the fourth member by way of an arm’s length payment for the advertising services provided to the CCA.

7.3 Applying the arm's length principle

7.3.1 To demonstrate whether a CCA accords with an arm’s length arrangement in comparable circumstances, the following matters should be addressed:

(a) CCA should be entered into with prudent and practical business judgment with a reasonable expectation of its benefits. An independent party would not enter a CCA where the value of the contribution exceeds the expected benefit. Estimation of the expected benefit to be derived from the arrangement can be computed in the following manner:

(i) Based on the anticipated additional income that will be generated or the expected cost savings; or

(ii) The use of an appropriate allocation key, perhaps based on sales, units used, produced or sold, gross or operating profits, numbers of employees, capital invested, or alternative keys.

(b) Terms of the arrangement should be agreed upon up-front and in accordance with economic substance, judged by reference to circumstances known or reasonably foreseeable at the time of entry into the arrangement.

7.3.2 Consideration for the entry, withdrawal and termination of a CCA should be dealt with at arm's length, as follows:

(a) Where a participant's contribution is not consistent with its expected share of benefits from the CCA, a balancing payment may be required between the participants to adjust their respective contributions;

(b) Where a participant transfers its pre-existing rights of a prior CCA to a new participant, the exiting participant must be compensated based upon an arm's length value for the transferred interest (buy-in payment). The amount of the buy-in payment shall be determined based on the price an independent party would have paid for the rights obtained by the new participant, taking into account the proportionate share of the overall expected benefit to be received from the CCA;

(c) Where a participant disposes off part or all of its interest, he should be compensated with an arm's length payment (buy-out payment).

CHAPTER VIII (UPDATED 15/07/2017)

INTANGIBLES

8.1 IDENTIFYING INTANGIBLES

8.1.1 Identifying intangibles

(i) Intangibles are one of the most difficult and contentious issues encountered in transfer pricing practice. The different definitions of intangibles encountered under the various laws and regulations, literatures and accounting standards also complicate matters.

(ii) For the purpose of transfer pricing “intangible” is intended to address something which is not a physical asset or a financial asset but is capable of being owned or controlled for use in commercial activities, whose use or transfer will be compensated had it occurred in transactions between independent parties in comparable transaction. This approach is independent of accounting or legal definitions or classification of intangibles into different categories.

(iii) For accounting purpose, intangible assets are generally reflected in the balance sheet. However there are situations where intangible assets are not reflected in the balance sheet thus not recognised for accounting purposes. Expenses of research and development activities are generally capitalised, hence intangibles created are reflected in the balance sheet. However expenses of marketing activities are generally expensed off, thus marketing intangibles from such activities may not be shown in the balance sheet. Depending on the facts and circumstances of the case, the intangibles may be recognised for transfer pricing purpose even though they are not reflected in the balance sheet.

(iv) Some intangibles are legally protected, while others are not. In Malaysia the provisions of the intellectual property legislations are administered and enforced by Intellectual Property Corporation of Malaysia (PHIM: Perbadanan Harta Intelek Malaysia). Intellectual property laws in Malaysia include:

(a) Trade Marks Act 1976 [Act 175];

(b) Patents Act 1983 [Act 291];

(c) Industrial Designs Act 1996 [Act 552];

(d) Copyright Act 1987 [Act 332]; and

(e) Layout Designs and Integrated Circuit Act 2000 [Act 601].

(v) The value of intangibles and their returns are often affected by the extent and availability of legal and contractual protection. However, the existence of legal protection is not a precondition for an item to be characterised as intangible for transfer pricing purpose.

(vi) Thus, whether an item can be regarded as an intangible for transfer pricing purpose does not depend on its accounting or legal definition or its characterisation for general tax purpose. Such definitions can be a useful reference for transfer pricing purpose but will not be the sole determinant.

(vii) Some intangibles may be identified separately and transferred on a segregated basis, while others may be transferred in combination with other business assets. Regardless of whether the intangible is transferred on a segregated basis or in combination, it will still be recognised as intangible for transfer pricing purpose.

8.1.2 Categories of Intangibles

(i) Distinctions are sometimes made between trade intangibles and marketing intangibles, between “soft” intangibles and “hard” intangibles, between routine and non-routine intangibles, and between other classes and categories of intangibles. However, the determination of arm’s length prices does not depend on these categorizations. Among items considered as intangible include commercial IP such as patents, know-how, designs and models that are used for the production of goods or provision of a service, and marketing intangibles.

(ii) Marketing intangibles, is a special type of commercial intangibles, which includes trademarks, trade names, marketing strategies, customer lists, customer relationships, and proprietary market and customer data that is used or aids in marketing and selling goods or services to customers; essentially assets that will help market the products. It aids in commercial exploitation of the product or service and has important promotional value for the product/services concerned.

(iii) Government licences and contractual right under certain circumstances, which grant companies special privileges or exclusivity, are intangibles for transfer pricing purpose. Examples include:

(a) Government concessions which grants the rights to exploit specific natural resources such as concession for the extraction of forest produce;

(b) Production Sharing Contract which grants oil and gas companies the rights for exploration and production of oil and gas in Malaysia (Exploration and production rights granted by PETRONAS to oil and gas companies via Production Sharing Contract); and

(c) Government licences/ agreements/ contracts that grant trade restrictions to keep out competitors or restrict the number of competitors such as licence for broadcasting or licence for Network Facilities Provider (NFP) and Network Service Provider (NSP) awarded to telecommunication companies or power purchase agreement (PPA) with independent power providers.

(iv) Other government contracts such as contracts for supply including contract to supply pharmaceutical products to government hospitals or contracts to provide consulting/technical services are also considered as intangibles for transfer pricing purposes.

(v) Grant of licence/ concessions/ contracts must be distinguished from company registration which is a requirement for doing business and does not grant the company any special privileges. Rights under a contract or agreement, for example contract with a key customer or with a supplier which supplies a major raw material are intangibles for the purpose of transfer pricing.

(vi) Exclusive rights in intangibles are generally transferred by means of a license agreement. These exclusive rights in intangibles are themselves intangibles for the purpose of transfer pricing. For example, the grant of exclusive rights for the licensee to operate in a certain geographic region. These exclusive rights in intangibles are themselves intangibles for the purpose of transfer pricing.

(vii) It should be emphasised that generic references to items such as marketing intangible or trade intangibles do not relieve taxpayers or tax administrations from their obligation in a transfer pricing analysis to identify the relevant intangible specifically nor does the use of those terms suggest that a different approach should be applied in determining arm’s length conditions for a transaction.

(viii) Goodwill and on-going value generally refers to a number of different notions. For transfer pricing purpose, the transfer of something of value, whether it is a goodwill or not, from one associated person to another may be taken into consideration and appropriately compensated to the extent of how independent person carrying out comparable transactions is remunerated.

8.1.3 Relevance of transfer pricing guidance of intangibles for other tax purpose

The guidance on the concept of intangibles and remuneration for the use or transfer of intangibles provided in this chapter is specifically for the purpose of transfer pricing and is relevant for Section 140A and Transfer Pricing Rules.

8.2 OWNERSHIP OF INTANGIBLES AND ANALYSING TRANSACTIONS INVOLVING DEVELOPMENT, ENHANCEMENT, MAINTENANCE, PROTECTION AND EXPLOITATION OF INTANGIBLES (DEMPE)

8.2.1 Ownership of Intangibles

(i) In transfer pricing cases involving intangibles, the determination of who are ultimately entitled to share in the returns derived by the MNE group from exploiting the intangibles is crucial. This includes issues regarding who should ultimately bear the costs, investments and other burdens associated with the DEMPE of the intangibles. Although a legal owner of an intangible may receive proceeds from exploitation of the intangibles, other members of the group may have performed functions, used assets, or assumed risks that contribute to the value of the intangible. Members of the MNE Group performing such functions, using such assets, and assuming such risks must be compensated for their contributions under the arm’s length principle.

(ii) The legal owner will be considered to be the owner of the intangible for transfer pricing purposes. If no legal owner of the intangible is identified under applicable law or governing contracts, then the member of the MNE Group that controls decisions concerning the exploitation of the intangibles and has the practical capacity to restrict others from using the intangibles will be considered to be the ‘legal’ owner for transfer pricing purpose.

(iii) In identifying the owner of intangibles, the intangible and any licence relating to that intangible are considered to be two separate and distinct intangibles, each having a different owner. Intangible registration and licencing agreements can help identify the legal owner of the intangible and the owner of the licence.

Example 1

Company A, the legal owner of a trademark, may provide an exclusive licence to Company B to market and distribute goods using the trademark. The first intangible is the trademark, which is legally owned by Company A. The second intangible is the license to use the trademark in connection with marketing and distribution of trademarked products, which is legally owned by Company B. Depending on the facts and circumstances, marketing activities undertaken by Company B pursuant to its license agreement may potentially affect the value of the underlying intangible legally owned by Company A, the value of Company B’s license or both.

(iv) If the legal owner neither performs the functions, nor control the functions or risks related to the development, enhancement, maintenance, protection or exploitation (DEMPE) of the intangible, the legal owner would not be entitled to that portion of return associated with the performance of the functions or the control of the functions and risks relating to the DEMPE of the intangibles. The final return to the legal owner will depend on its contributions and the contributions of the other members of the MNE Group to the value of the intangible. This value is attributable to its functions, assets and risks related to the DEMPE of the intangibles

8.2.2 Analysing transactions Involving Intangibles

For transfer pricing purpose, in analyzing transactions involving the use or transfer of intangibles between associated persons, the following factors should be taken into consideration :-

(i) Identifying the intangibles

(a) Specifically identify the intangibles used or transferred in the controlled transaction together with the economically significant risks associated with the DEMPE of the intangibles.

(b) When a taxpayer pays royalty for the use or transfer of intangibles, the taxpayer needs to provide evidence for:

- the intangibles that are involved;
- the processes where the intangibles are utilized;
- the benefit obtained from the intangibles;
- the specific, economically significant risks associated with the transactions involving the intangibles; and
- withholding tax payments that are made with regards to the royalty payment.

(ii) Analyzing the contractual terms

(a) Identify the full contractual arrangements with special emphasis on determining legal ownership of intangibles based on the terms and conditions of legal arrangements, including relevant registration, license agreements, other relevant contracts, the contractual rights and obligations and the contractual assumption of risks in the relations between the associated persons.

(b) In identifying the contractual arrangements, the following information is necessary and may be obtained from legal documents including public registration such as patent or trademark registration and written contracts such as licensing agreements:

- legal ownership;
- role, responsibilities, obligations and rights of the relevant parties including those who undertake the functions and controls the risks with respect to the DEMPE functions;
- identity the funder and level of risks assumed by the funder;
- quantum of payment and mode of payment; and
- how expenses and receipts related to intangibles are allocated.

(c) Correspondence and communications between the parties involved are also important in identifying and analyzing the controlled transactions involving intangibles and evaluating the terms of the transactions (including risks assumption involving the transfer or use of the intangibles).

(d) The determination of legal ownership is distinct from the question of remuneration. Legal ownership of intangibles, by itself, does not confer any right ultimately to retain returns derived by the MNE Group from exploiting the intangible. Even though such returns may initially accrue to the legal owner as a result of its legal or contractual right to exploit the intangible, this would depend upon the functions the legal owner performs, the assets it uses, and the risks it assumes, and upon the contributions made by other MNE group members through their functions performed, assets used, and risks assumed (refer to paragraph 8.2.3).

(iii) Functional Analysis

(a) Functional analysis needs to be done to identify the parties performing economically significant functions, using assets, and managing risks related to DEMPE of the intangibles.

(b) Taxpayer needs to identify:

- the economically significant functions that contribute to the value of the intangibles and instrumental to the success of the DEMPE of the intangibles
- ascertain the relative importance of each DEMPE functions; and
- group members who:-
    - ✓ perform and exercise control over the functions associated with the DEMPE of the intangibles;
    - ✓ provide the assets and funding, and have financial capacity necessary to bear the cost in relation to the funding; and
    - ✓ assume and exercise control over the various specific, economically significant risks associated with the intangible and have the financial capacity to bear the risks associated with DEMPE of the intangibles.

(c) Carefully evaluate the relative value of contributions by various entities to the DEMPE to ensure all affected entities in the group are appropriately compensated on an arm's length basis.

(d) The performance of activities by a Malaysian taxpayer which are economically significant and important include:

- research and development activities which leads to customization / enhancement of existing products or new products;
- activities which leads to improvement in manufacturing processes;
- the performance of advertising, marketing and promotional activities by the Malaysian taxpayer which leads to creation / enhancement of marketing intangibles such as customer lists, marketing / distribution channel, or favorable contracts; and
- managing customers' relationship, localization of products / advertisements or marketing survey including collection of local data.

(e) All these local functions performed by the Malaysian entities which improved the value of intangibles should be appropriately compensated and the costs incurred for such expenses should not be merely reimbursed to the local entity without any profit element, especially when they are performed in conjunction with the manufacturing or distribution functions.

(f) A local entity who is not the legal owner of the intangible may nevertheless be entitled to a share of returns from its exploitation if the local entity has contributed to the enhancement of the intangibles. Thus, the local entity is considered as having 'economic ownership' of the associated intangibles created.

(iv) Control of the performance of significant functions.

(a) In carrying out the functional analysis, a taxpayer needs to assess the capacity of a particular entity to exert control and the actual performance of such control functions. It is not essential that the legal owner physically performs and controls all the functions related to DEMPE of an intangible. Where associated persons other than the legal owner perform and control relevant functions that are anticipated to contribute to the value of the intangibles, they should be compensated on an arm's length basis.

(b) Similarly, where the performance of the DEMPE functions by a local entity is said to be controlled by another entity, documentary evidence has to be provided, to show that the said entity has the capability to control and perform its control functions.

(c) A local entity carrying out core functions as mentioned in paragraph 8.2.2 (iii)(e) above would control the strategic operations decisions regarding its activities and should be entitled to more than a routine low cost plus remuneration for its performance and control of the core functions. It is highly unlikely to separate the performance and control of a function.

(v) Funding

(a) Group members involved in the creation of intangibles may contribute physical assets, intangibles or funding for the project. The nature and amount of compensation attributable to any of the group members should be appropriately determined based on the arm's length principle.

(b) Funding and risks taking are closely integrated as funding is often linked with certain risks such as bad debts risks or the risks of losing all the funds. Compensation to the funder will depend on the level and extent of the risks it bears.

(c) To show control over a specific financial risk, a taxpayer must provide evidence that the funder is capable of making relevant decisions related to the risk bearing opportunities together with the actual performance of these decisions (including risk mitigation activities).

(d) Generally, a funder who only exercise control over financial risks associated with the provision of funding, without the assumption of further risks in relation to the investments, and without any control over the use of the contributed funds or the conduct of the funded activity, would only entitle the funder to a risk-adjusted rate of anticipated return on its capital.

(vi) Risks associated with DEMPE of the intangibles

(a) Many local entities are treated as contract risk free service providers, by contending that higher return to foreign entity is justified because the foreign entity:

- provides funding for the project, hence bearing the risks of failure of the R&D functions; and
- establishes and controls strategy / direction and priorities of research program or creative undertakings while the local entity is merely implementing such strategy / direction.

(b) Although the strategic decisions and overall directions from parent / foreign entities are cascaded down to the local entity, this does not imply that the foreign entity has control over the

R&D functions of the local entity or would bear the related risks.

(c) If the local entity performs important R&D functions and even customizes the know-how provided which leads to enhancement of intangibles or creation of new intangibles, and the management and personnel of the local entity are responsible for operational decisions and monitoring of its R&D activities, the local entity is in a better position to control over the operation and its related risks than an entity who is controlling the functions / risks from afar.

(d) As mentioned in paragraph 8.2.2 (v) above, provisions of funding will not entitle the funder to a premium return, if it did not perform control functions and bear risks with regards to the R&D activities. Besides that, other important assets possess by the local entity such as skilled workforce must be considered when determining the return to the local entities. The parent / foreign entity will be entitled to a return for the provision of funding and overall direction and strategy, while the local entity should also be entitled to a return on their core R&D functions and control of risks related to the operation of R&D activities. Hence, the local entity should not merely be reimbursed on a cost plus margin as a risk free service provider since the performance, control functions and its associated risks are closely linked and should not be separated and assigned to different parties.

(e) When analyzing the economic substance of a transaction in relation to risks, it is necessary to examine whether the conduct of the associated persons over a period of time has been consistent with the allocation of risks and not merely at the time when risks are realized and whether changes in the pattern of behavior of the parties have been matched by changes in the contractual arrangements.

(f) Hence, a routine service provider who earns a very low margin should not suffer the loss when certain risks are realized, as it had consistently earned a minimal margin when the risks did not materialized. In a genuine case, a local entity who bears the risks would earn a reasonable margin and have taken mitigating actions to protect itself against any risks should it materialized.

8.2.3 Application of arm's length principle in transactions involving intangibles

(i) If the legal owner of an intangible in substance:

(a) performs and controls all the economically significant functions related to the DEMPE of the intangible;

(b) provides all assets, including funding, necessary to the DEMPE of intangibles; and

(c) assumes all the risks related the DEMPE of the intangible.

then it will be entitled to all the anticipated, ex ante returns derived from the MNE Group's exploitation of the intangible.

(ii) The extent to which one or more members of the MNE Group other than the legal owner perform functions, uses assets or assumes risks related to the DEMPE of the intangible, will determine its arm's length compensation for their contributions. This compensation may, depending on the facts and circumstances, constitute all or part of the return anticipated to be derived from the exploitation of the intangible.

(iii) In evaluating whether associated persons that perform functions or bear risks related to the DEMPE of intangibles have been compensated on an arm's length basis, it is necessary to consider:

(a) the level and nature of the activity undertaken;

(b) the expected contribution of the functions performed and risks assumed to the creation of intangible value and the generation of income; and

(c) the amount and form of compensation paid.

(iv) Determining Arm's Length Compensation

(a) In determining the arm's length compensation for the functional contributions, assets used and risks assumed, the principles in accurately delineating the actual transaction, analysis and allocation of risks and the recommended process for conducting a comparability analysis apply equally to transactions involving intangibles.

(b) It is necessary to consider the following in determining the arm's length price for controlled transactions involving intangibles:

- comparability factors that may contribute to the creation of value or generation of returns derived by the MNE Group from exploitation of the intangibles;
- the availability of comparable uncontrolled transactions;
- the importance and the relative contribution of the functions performed to the creation of intangible value; and
- the realistically available options of the parties.

(c) When it is difficult to find comparable transactions involving intangibles, it may be necessary to utilize transfer pricing methods not directly based on comparable including profit split method and ex ante valuation techniques to appropriately reward performance of those important functions.

8.2.4 Entitlement to the difference between ex-ante and ex-post return

(i) An ex ante (anticipated) remuneration refers to the future income expected to be derived by a member of the MNE Group at the time of a transaction while ex post (actual) remuneration refers to the income actually earned by a member of the group through the exploitation of the intangible.

(ii) The terms of the compensation that must be paid to members of the MNE Group that contribute to the DEMPE of intangibles is determined generally at the time transactions are entered into and before risks associated with the intangible play out (ex-ante). The form of such compensation may be fixed or contingent. The actual (ex post) profit or loss of the business after compensating other members of the MNE Group may differ from these anticipated profits depending on how the risks associated with the intangible or the other relevant risks related to the transaction or arrangement actually play out.

(iii) The difference between ex ante (anticipated) and ex post (actual) return arises largely from risks associated with the uncertainty of future business outcome. The risks may materialize in a different way to what was anticipated through the occurrence of unforeseeable developments. The ex-ante contractual assumptions of risks provide clear evidence of a commitment to assume risks prior to the materialization of the risk.

(iv) The party which is entitled to the unanticipated profit (or required to bear the unanticipated loss), will be the party which is found to assume the risks when accurately delineating the actual transaction or which contribute to the control of the economically significant risks or which performed the important functions with respect to the DEMPE activities and for which it is determined that an arm's length remuneration of these functions would include a profit sharing element.

(v) In addition, consideration must be given to whether the ex-ante remuneration paid to members of the MNE Group for their functions performed, assets used, and risks assumed is, in fact, consistent with the arm's length principle. Care should be taken to ascertain, for example, whether the group in fact underestimated or overestimated anticipated profits, thereby giving rise to underpayments or overpayments (determined on an ex ante basis) to some group members for their contributions. Transactions for which valuation is highly uncertain at the time of the transaction are particularly susceptible to such under or overestimations of value.

8.2.5 Development and enhancement of marketing intangibles via marketing functions of the local entities

(i) One common situation to consider is when an entity associated with the legal owner performs advertising, marketing and promotional (AMP) functions, which would benefit the legal owner of an intangible. In this case, considerations to determine how the distributor / marketer should be compensated for its AMP activities would include whether to compensate the distributor / marketer as a service provider for providing AMP functions or whether the distributor / marketer should also be compensated for enhancing the value of the trademarks and other intangibles by sharing in the potential benefits by virtue of its functions performed, assets used, and risks assumed.

(ii) Malaysian subsidiaries of MNEs usually incur and bear very large amounts of AMP for the benefit of the legal owner of the intangible and simultaneously developed local marketing intangibles such as distribution network, customers' relationship etc. These entities are usually characterised as buy/sell or limited risk or routine distributor and only generate a nominal profit or even incurred losses at times.

(iii) Some local distributors have a well-trained and organized marketing team, which performs functions which help create marketing intangibles such as:

(a) enhancing the value of the foreign trademark or brand name or logo;

(b) enhancing brand or product loyalty in the minds of consumers;

(c) establishing networking / distribution channels;

(d) performing customers research or survey or investing in information systems leading to creation of customers list/database or customers' preference information;

(e) establishing an efficient after-sales services and support network locally; or

(f) creating a reputational goodwill.

(iv) These intangibles should attract much more than a routine reward that a "limited/routine distributor" would earn. The marketing team should be sufficiently rewarded, i.e. the marketing organisation should be rewarded for its effort with or without the creation of local marketing intangibles depending on the facts and circumstances of the case.

(v) Where the marketer / distributor actually bears the costs and associated risks of its marketing activities, the marketer / distributor will have a share in the potential benefits from those activities. The margin earned by the local entity, must be comparable to those earned by independent marketers bearing similar risks and costs. In these cases, the marketer / distributor is expected to generate higher margin which may be in the form of:

(a) a reduction in purchase price e.g. via additional discount on the purchase price to allow additional profits to reflect the functions, risks and cost incurred in promoting the products;

(b) a reduction in royalty rate as compared to previous year (if it's a licensed distributor); or

(c) a share of profits associated with the enhanced value of the trademark or other marketing intangibles.

(vi) The method of compensation for the AMP functions must be identifiable, quantifiable and easily verifiable. A statement which merely mentions that the extra return was embedded in the purchase price is not acceptable evidence that the AMP functions are appropriately compensated.

(vii) If the local entity only performs buy sell function (e.g. limited risks distributors) and undertakes marketing activities on behalf of its principal which did not result in the development of marketing intangibles, the local entity has to be compensated by the principal for the marketing functions, where it should earn;

(a) an arm's length margin from selling the products for the distribution functions it performs, the assets it uses and the risks it assumes; and

(b) a service fee for the marketing function it performs on behalf of the principal.

(viii) The service fee paid to the local entity for its marketing activities should be based on compensation paid to independent parties performing similar functions. Even if there is no written agreement covering this service, this does not prevent the application of the arm's length principle to that transaction.

8.2.6 Research, development and process improvement arrangement

(i) Generally, the arm's length compensation for research services will depend on a number of factors such as the unique skill and experience of the research team, the risks assumes (e.g. where blue sky research is undertaken), the assets and intangibles used and who performs the control functions (whether the research team is controlled and managed by another party) etc. Generally, a compensation based on reimbursement of costs plus will not reflect the anticipated value of the intangibles created or the contribution of the research team.

(ii) Research and Development (R&D) activities.

(a) Some local entities are established to carry out research and development work under a contract for its associated foreign entity where the local entities will have no ownership of the intangibles, and the results of the research and development activities will belong to the associated foreign entity. Generally, these local entities are treated as contract research and development companies with limited risks and the service fee paid to the local entity is the cost of the research and development activities undertaken plus a mark-up. However, a compensation based on reimbursement of costs plus will not reflect the anticipated value of the intangibles created or the contribution of the research team. Therefore, the local entity should be rewarded based on the functions performed, assets used and risks assumed that contribute to the value of the intangible. A proper analysis of the value provided by the contract research and development entity to the overall group operations should be provided.

(b) In determining the amount due to the local entity, the relative skill and efficiency of the research personnel, the nature of the research being conducted and other factors contributing to the value should be considered.

(c) If the local entities perform the core R&D activities, make day-to-day operational decisions and exercise substantial control over the operational risks in the R&D projects, possess sizeable assets and skilled workforce, in such case, the allocation of routine and low cost plus return will not reflect a true arm's length price of the transaction.

(d) Where in particular the research team has unique skills or experience, or where blue sky research is undertaken, compensation should be based, at least in part, on a share of profits from the future exploitation of successfully developed intangibles. This would be more in keeping with the arm's length principle and the provisions of the Transfer Pricing Rules.

(e) Similarly where the local entities create unique intangibles as a result of the R&D activities, and legal ownership are transferred to the foreign entity, such transfer normally takes place without any appropriate compensation. In these cases, compensation of such transfer should be based on a share of profit from its future exploitation, in addition to its arm's length compensation for its R&D activities.

(iii) Enhancement of product or process while performing manufacturing functions.

(a) Another situation to consider is where a manufacturer in its provision of manufacturing services to another member of the group (e.g. contract manufacturer), leads to enhancement of processes and legal ownership is assumed by another group member. The local entity should be entitled to a return on the enhancement of these processes, products or intangibles if they are transferred to or shared with the other related entities. If the enhanced intangibles is self-exploited by the local entity, an increased in margin should be reflect.

8.3 TRANSACTIONS INVOLVING THE USE OR TRANSFER OF INTANGIBLES

8.3.1 In addition to identifying with specificity the intangibles involved in a controlled transactions and identifying the owner of such intangibles, it is necessary to identify the specific controlled transactions including understanding the nature of that transactions and how the intangibles are exploited.

8.3.2 Some categories of transactions involving the exploitation of intangibles for he purpose of analyzing transfer prices are as follows:

(i) Transfers of intangibles or rights in intangibles.

(a) Controlled transactions involving transfer of intangibles or rights in intangibles can occur via an outright sale or grant of licence to an associated person. The intangible’s owner can grant a licence or right to someone else to exploit the intangibles or rights in the intangibles in return for a fee / royalty.

(b) Transfer of rights of intangibles may involve:-

- transfer of all rights in the intangibles (e.g. sales of intangibles or a perpetual, exclusive licence of the intangible); or
- transfer of limited rights (e.g. via a licence or similar transfer of limited rights to use an intangible which may be subject to geographical restrictions, limited duration, or restrictions with respect to the right to use, exploit, reproduce, further transfer, or further develop).

(c) In transactions involving the transfer of intangibles or rights in intangibles, it is essential for tax payers in a transfer pricing analysis to identify:

- with specificity the nature of the intangibles and rights in intangibles that are transferred between associated persons; and
- limitation/restrictions on the rights transferred including the nature of such limitations and the full extent of the rights transferred as the nature of limitation can affect the value of the intangibles transferred.

(ii) Transfers of combination of intangibles.

(a) Intangibles (including limited rights in intangibles) may be transferred individually or in combination with other intangibles. In considering transactions involving transfers of combination of intangibles, two related issues often arise.

(b) Firstly, the nature and economic consequences of interactions between different intangibles. Some intangibles are more valuable when considered in combination with other intangibles than if they are considered separately.

(c) Secondly, to ensure that all the intangibles transferred in a particular transaction have been identified. Sometimes the intangibles are so intertwined that it is not possible, as a substantive matter, to transfer one without transferring the other.

(iii) Transfer of intangibles or rights in intangibles in combination with other business transactions.

(a) In some situations, intangibles or rights in intangibles may be transferred in combination with tangible business assets, or in combination with services. Under such situation the taxpayer needs to provide evidence that:

- all intangibles have been transferred; and

- all of the intangibles transferred in connection with that particular transaction can be identified and taken into account in the transfer pricing analysis.

(b) Where it is possible and appropriate to separate transactions of tangible goods or services from transfers of intangibles / rights in intangibles for purposes of conducting a transfer pricing analysis, then the price of a package contract should be disaggregated in order to confirm that each element of the transaction is consistent with the arm's length principle. It should be kept in mind, however, that the interactions between various intangibles and services may enhance the value of both.

(c) In some situations it may be difficult to segregate tangible goods or service transactions from transfers of intangibles / rights in intangibles because transactions may be so closely related.

(d) However, if the arrangement of services and intangibles transferred in combination is so unique, that sufficiently reliable comparables are not available, then it may be necessary to segregate the various parts of the package for transfer pricing purpose, keeping in mind that the interactions between them may enhance the value of both.

(iv) Transactions involving the use of intangibles in connection with the sale of goods or the performance of services.

(a) Intangibles may be used in connection with controlled transactions in situations where there is no transfer of the intangible / rights in the intangible. For example, intangibles may be used by one or both parties to a controlled transaction in connection with;

- the manufacture of goods sold to an associated person;
- the marketing of goods purchased from an associated person; or
- the performance of services on behalf of an associated person.

The need to consider the use of intangibles by a party to a controlled transaction involving a sale of goods can be illustrated as follows:

A car manufacturer uses valuable proprietary patents to manufacture the cars that it then sells to associated distributors. Assume that the patents significantly contribute to the value of the cars. The patents and the value they contribute should be identified and taken into account in the comparability analysis of the transaction consisting of the sales of cars by the car manufacturer to its associated distributors, selection of the tested party and the most appropriate transfer pricing method for the transactions. The associated distributors purchasing the cars do not, however, acquire any right in the manufacturer's patents. In such a case, the patents are used in the manufacturing and may affect the value of the cars, but the patents themselves are not transferred.

(b) Under such situation the following would need to be addressed in the transfer pricing documentation:

- the nature of such a transaction should be clearly specified;
- any relevant intangibles used by either of the parties in connection with such a controlled transaction should be identified; and
- these relevant intangibles should be taken into account when performing the comparability analysis

(including the functional analysis), and in the selection and application of the most appropriate transfer pricing method for that transaction.

8.3.3 Intangibles exploit by local companies in connection with manufacturing activities.

(i) Many MNE Group outsource the 'manufacturing activities' necessary for the exploitation of the intangibles by way of a contract to Malaysian manufacturers. The intangibles may be in the form of technical know-how, secret formula etc. Generally during the initial stage of setting up of a manufacturing business operation in Malaysia, these are provided to the contract manufacturers for a fee. However, it was noticed that many of these local companies continue paying royalties (indefinitely) even though they have gained the necessary experience, are now well established and has contributed to the improvement and efficiency of the manufacturing process.

(ii) The Malaysian companies using the technical know-how of their parent may have incurred significant expenditure to customize such know-how and to enhance its value by their research and development effort. Cost of such research and development activities which contributed to enhancing the value of the original know-how owned by the parent company should be considered when determining the arm's length price for payment of royalties for technical know-how or patents.

(iii) Under such circumstances, the taxpayer needs to consider whether it should continue to pay a royalty to the parent company for the 'improved' manufacturing process. If 'yes', the taxpayer must give justification that the original intangibles continue to provide value over time. The taxpayer should also consider its entitlement to a return on the intangibles of the improved manufacturing process especially when the locally created or enhanced intangibles are used by other related companies.

(iv) IRBM may disallow royalty paid if it is not shown that the royalties currently paid are for newly developed or enhanced intangibles as the original intangibles may have become obsolete over the years.

8.4 SUPPLEMENTAL GUIDANCE FOR DETERMINING ARM'S LENGTH CONDITIONS IN CASES INVOLVING INTANGIBLES

8.4.1 Factors affecting comparability of intangibles or rights in intangibles

(i) In applying the arm's length principle, a taxpayer needs to understand the type and the characteristics of intangible properties. This would help in identifying the factors that contribute to an intangible's value and the types of comparables needed for comparability analysis.

(ii) When determining the relative value of contribution by each party or comparability of the transactions, it is necessary to examine the nature and importance of contribution, cost incurred and risks assumed in DEMPE of the intangible property. Other factors to consider include:

(a) expected benefits and usefulness of the intangible property;
(b) prevailing industry rates;
(c) terms of the agreement including geographic limitations, duration of the licence, any termination or negotiation rights and exclusivity rights;
(d) legal protection;
(e) benefits to the licensor, arising from sharing of information on the experience of the licensee contributing towards further developments of the property;
(f) possibility of sub-licensing;
(g) the extent of any capital investment, start-up expenses or development work required or stage of development of intangible;

(h) rights to receive update, revisions or modifications of the intangibles; or

(i) technical assistance, trademarks and know-how provided along with access to any patent.

8.4.2 Supplemental guidance on transfer pricing method in a matter involving the transfer of intangibles or rights in intangibles

(i) In selecting the most appropriate transfer pricing method in a case involving a transfer of intangibles or rights in intangibles, attention should be given to:

- the nature of the relevant intangibles;
- the difficulty of identifying comparable uncontrolled transactions and intangibles in many, if not most, cases; and
- the difficulty of applying certain transfer pricing methods in cases involving the transfer of intangibles.

(ii) When selecting the most appropriate transfer pricing method, consideration should be given to the economic consequences of the transaction and not an arbitrary label of the transactions itself.

(iii) It is important not to simply assume that all residual profit, after a limited return to those providing functions, should necessarily be allocated to the owner of intangibles. The selection of the most appropriate transfer pricing method should be based on a functional analysis that provides a clear understanding of the MNE Group's global business processes and how the transferred intangibles interact with other functions, assets and risks that comprise the global business. The functional analysis should identify all factors that contribute to value creation, which may include risks borne, specific market characteristics, location, business strategies, and MNE Group synergies, among others. The transfer pricing method selected, and any adjustments incorporated in that method based on the comparability analysis, should take into account all of the relevant factors materially contributing to the creation of value, not only intangibles and routine functions.

(iv) Depending on the facts and circumstances of each case, any of the five OECD transfer pricing methods may constitute the most appropriate transfer pricing method to determine the arm's length price and conditions for the controlled transaction involving intangibles. Other methods may also be used, where appropriate.

(v) The determination of arm's length prices for a transfer of intangibles or rights in intangibles can be made when comparables and information related to it can be identified to make reliable comparability adjustments to account for any differences in the controlled and uncontrolled transactions.

(vi) Where information regarding reliable comparable uncontrolled transactions cannot be identified, the arm's length principle requires use of another method to determine the price that independent parties would have agreed under comparable circumstances. In making such determination, it is important to consider:

(a) the functions, assets and risks of the respective parties to the transaction;
(b) the business reasons for engaging in the transaction;
(c) the perspectives of and options realistically available to each of the parties to the transaction;
(d) the competitive advantages conferred by the intangibles including especially the relative profitability of products and services or potential products and services related to the intangibles;
(e) the expected future economic benefits from the transaction; and
(f) other comparability factors such as features of local markets, location savings, assembled workforce, and MNE group synergies.

(vii) Due to the relationship between them, associated persons might sometimes structure a transaction involving intangibles in a manner that independent parties would not contemplate. However, where associated persons' transactional structures are not typical transactions entered into by independent parties, the effect of those structures on prices and other arm's length conditions should be taken into account in evaluating the profits that would have accrued to each of the parties at arm's length.

(viii) One sided methods, including the resale price method and the TNMM, are generally not reliable methods for directly valuing intangibles. A one sided method can be used to indirectly value intangibles, by determining values for some functions and deriving a residual value for intangibles. It is important to bear in mind that not all residual return is attributable to the legal owner. Care should be exercised to ensure that all functions, risks, assets and other factors contributing to the generation of income are properly identified and evaluated.

(ix) The use of transfer pricing method based on the cost of intangible development to estimate the value of intangibles should be avoided. There rarely is any correlation between the cost of developing intangibles and their value or transfer price once developed.

(x) The transfer pricing methods most likely to prove useful in matters involving transfers of one or more intangibles are the CUP method and the transactional profit split method. Valuation techniques can also be useful.

8.4.3 Application of the CUP Method

Where reliable comparable uncontrolled transactions can be identified, the CUP method can be applied to determine the arm's length conditions for a transfer of intangibles or rights in intangibles. In some situations, intangibles acquired by an MNE Group from independent parties are transferred to a member of the MNE Group in a controlled transaction immediately following the acquisition. In such a case, the price paid for the acquired intangibles will often (after any appropriate adjustments, including adjustments for acquired assets not re-transferred) represent a useful comparable for determining the arm's length price for the controlled transaction under a CUP method.

8.4.4 Application of transactional profit split method

Where it is not possible to identify reliable comparable uncontrolled transactions for a transfer of intangibles or rights in intangibles, a transactional profit split method can be utilised to determine the arm's length conditions for such transfer. The guidance in applying transactional profit split method is fully applicable to matters involving the transfer of intangibles or rights in intangibles. However, in evaluating the reliability of transactional profit split method, the availability of reliable and adequate data regarding combined profits, appropriately allocable expenses, and the reliability of factors used to divide combined income should be fully considered.

8.4.5 Use of valuation techniques

(i) Valuation techniques to estimate the arm's length price may be used where reliable comparable uncontrolled transactions for a transfer of one or more intangibles cannot be identified.

(ii) The application of income based valuation techniques, especially valuation techniques premised on the calculation of the discounted value of projected future income streams or cash flows derived from the exploitation of the intangible being valued, may be useful when properly applied. Depending on the facts and circumstances, valuation techniques may be used as a part of one of the five OECD transfer pricing methods, or as a tool that can be usefully applied in identifying an arm's length price.

(iii) Where valuation techniques are utilised in a transfer pricing analysis involving the transfer of intangibles or rights in intangibles, it is necessary to apply such techniques in a manner that is consistent with the arm's length principle and these Guidelines. Principles related to realistically available options, economically relevant characteristics, accurately delineating a transaction and risks analysis framework, and aggregation of transactions apply fully to situations where valuation techniques are utilised in a transfer pricing analysis. Depending on the facts and circumstances of the individual case, the calculation of the discounted value of projected cash flows derived from the exploitation of the intangible should be evaluated from the perspectives of both parties to the transaction in arriving at an arm's length price. Furthermore, the guidance laid down in these Guidelines on selection of transfer pricing methods apply in determining when such techniques should be used.

(iv) It is essential to consider the validity of the underlying assumptions used for valuation techniques and the consistency of those assumptions with the arm's length principle. A careful examination of such assumptions are essential before accepting the valuations performed for accounting purposes as determinative for transfer pricing purposes.

(v) Taxpayers making use of valuation techniques in determining arm's length prices for transferred intangibles should explicitly set out each of the relevant assumptions made in creating the valuation model, describe the basis for selecting the valuation parameters, and should be prepared to defend the reasonableness of such assumptions and valuation parameters. It is a good practice for taxpayers relying on valuation techniques to present as part of their transfer pricing documentation some sensitivity analysis reflecting the consequential change in estimated intangible value produced by the model when alternative assumptions and parameters are adopted.

(vi) IRBM will request further explanation if there are any inconsistencies in the assumptions made in a valuation of an intangible undertaken for transfer pricing purposes and valuations undertaken for other purposes. For example —

(a) if high discount rates are used in a transfer pricing analysis, when the company routinely uses lower discount rates in valuations for other purposes; or

(b) if it is asserted that particular intangibles have short useful lives but the projections used for other business purposes demonstrate that related intangibles produce cash flows for years beyond the "useful life" that has been claimed for transfer pricing purposes.

(vii) The following paragraphs identify some of the specific concerns that should be taken into account in evaluating certain important assumptions underlying calculations in a valuation model based on discounted cash flows:-

(a) Accuracy of financial projections.

- It is essential to examine carefully the assumptions underlying the financial projections of both future revenue and future expense, if the accuracy of such projections is contingent on developments in the market place that are both unknown and unknowable at the time the valuation is undertaken.

- In evaluating financial projections, the source and purpose of the projections can be particularly important. It is usually the case that projections prepared for non-tax business planning or investment purposes are more reliable than projections prepared exclusively for tax purposes, or exclusively for purposes of a transfer pricing analysis.

- The length of time covered by the projections should also be considered in evaluating the reliability of the projections. The further into the future the intangible in question can be expected to produce positive cash flows, the less reliable projections of income and expense are likely to be.

- A further consideration in evaluating the reliability of projections involves whether the intangibles and the products or services to which they relate have an established track record of financial performance. Although past performance may not be a reliable guide to the future, as many factors are subject to change, they can provide some useful guidance as to the likely future performance of products or services that rely on intangibles. Projections with respect to products or services that have not been introduced to the market or that are still in development stage are inherently less reliable than those with some track record.

- When deciding whether to include development costs in the cash flow projections it is important to consider the nature of the transferred intangible, whether the transferred intangibles are fully developed or the intangibles have indefinite useful lives and may be continually developed.

(b) Assumptions regarding growth rates.

Projections of future cash flows are often based on projected growth rates. A reliable application of a valuation technique based on projected future cash flows would examine the likely pattern of revenue and expense growth based on industry and company experience with similar products. Simple models containing linear growth rates without reasonable justifications should not be accepted.

(c) Discount rates

- The discount rate is a critical element of a valuation model. The discount rate takes into account the time value of money and the risk or uncertainty of the anticipated cash flow used in converting a stream of projected cash flows into a present value. A small variation in the selected discount rate can generate a large variation in the calculated value of intangibles using these techniques. Therefore, it is essential for taxpayers to justify the assumptions made in selecting the discount rate or rates utilised in the valuation model.

- There is no single measure for a discount rate that is appropriate for transfer pricing purposes in all instances. The specific conditions and risks associated with the facts of a given case and the particular cash flows in question should be evaluated in determining the appropriate discount rate.

- It should be recognised that some businesses are inherently more risky than others and some cash flow streams are inherently more volatile than others. The discount rate or rates should reflect the level of risk in the overall business and the expected volatility of the various projected cash flows under the circumstances of each individual case.
- Since certain risks can be taken into account either in arriving at financial projections or in calculating the discount rate, care should be taken to avoid double discounting for risk.

(d) Useful life of intangibles and terminal values

- Valuation techniques are often premised on the projection of cash flows derived from the exploitation of the intangible over their useful life. The useful life of a particular intangible can be affected by the nature and duration of the legal protections afforded to the intangible, the rate of technological change in the industry, and by other factors affecting competition in the relevant economic environment.

- Where specific intangibles contribute to continuing cash flows beyond the period for which reasonable financial projections exist, it will sometimes be the case that a terminal value for the intangible related cash flows is calculated. Where terminal values are used in valuation calculations, the assumptions underlying their calculation should be clearly set out and the underlying assumptions thoroughly examined, particularly the assumed growth rates.

(e) Assumptions regarding taxes

Where the purpose of the valuation technique is to isolate the projected cash flows associated with an intangible, it may be necessary to evaluate and quantify the effect of projected future income taxes on the projected cash flows. Tax effects to be considered include:

i. taxes projected to be imposed on future cash flows;
ii. tax amortisation benefits projected to be available to the transferee, if any; and
iii. taxes projected to be imposed on the transferor as a result of the transfer, if any.

(f) Form of payment

- In evaluating the provisions of taxpayer agreements related to the form of payment, it should be noted that some payment forms will entail greater or lesser levels of risk to one of the parties. For example, a payment form contingent on future sales or profit will normally involve greater risk to the transferor than a payment form calling for either a single lump-sum payment at the time of the transfer or a series of fixed instalment payments. The chosen form of the payment must be consistent with the facts and circumstances of the case, including the written contracts, the actual conduct of the parties, and the ability of the parties to bear and manage the relevant payment risks.

- In particular, the amount of the specified payments should reflect the relevant time value of money and risk features of the chosen form of payment. For example, if a valuation technique is applied and results in the calculation of a lump-sum present value for the transferred intangible, and if a taxpayer applies a payment form contingent on future sales, the discount rate used in converting the lump-sum valuation to a stream of contingent payments over the useful life of the intangible should reflect the increased risk to the transferor that sales may not materialize and that payments would therefore not be forthcoming, as well as the time value of money consequences arising from the deferral of the payments to future years.

CHAPTER IX (TPGL 2012)
INTRAGROUP FINANCING

9.1 Financial assistance between associated persons

Intragroup financing is another form of service between associated persons, which falls under subsection 140A(2), in the form of financial assistance that include loans, interest bearing trade credits, advance or debt and the provision of any security or guarantee. The financial assistance arrangements between associated persons can arise from the following situations:

(a) Where a taxpayer, directly or indirectly, acquires from or supplies to an associated person financial assistance for a consideration; or

(b) Where a taxpayer supplies financial assistance directly or indirectly to an associated person without consideration.

In both situations, the taxpayer should charge or pay the associated person interest at a rate which is consistent with the rate that would have been charged in a similar transaction between independent persons dealing at arm’s length.

9.2 Substitution and Imputation of Arm’s length Interest

As provided under the Rules, where the interest rate imposed or would have been imposed on a controlled financial assistance is not at arm’s length, the DGIR may make an adjustment to reflect the arm’s length interest rate or impute interest on the controlled financial assistance. Adjustments will be made where:

(a) For the supply of financial assistance, the consideration is less than the consideration that would have been received or receivable in an arm’s length arrangement;

(b) For the acquisition of financial assistance, the consideration is more than the consideration that would have been given or agreed to be given in an arm’s length arrangement; or

(c) No consideration has been charged to the associated person for the supply of the financial assistance.

Example 1

Substitution of non arm's length interest

Company A has obtained a fixed-rate 10%, medium term loan from an associated person which embeds an option to repay the loan prematurely without penalty. In the third year the market interest rate began to decline to 5%, a rate lower than the fixed-rate agreed upon with the associated person. In an arm's length situation, Company A would execute its option to repay the loan as it would not make sense to continue paying the high interest rate of 10%. However, Company A did not exercise the option and continued to pay at the higher interest rate.

In this case, the IRBM may substitute the financial assistance arrangement with an interest rate that reflects the current market situation as if Company A had exercised the option at an appropriate time and entered into similar arrangement at a lower rate.

9.3 Determination of Arm's Length Interest

An arm's length interest rate is an interest rate charged, or would have been charged, at the time the financial assistance was granted in uncontrolled transactions with or between independent persons.

In determining an arm's length interest rate for financial assistance, the comparable uncontrolled price (CUP) method is considered to provide the most reliable measure. In this context, the CUP method determines an arm's length interest rate by reference to interest rates between independent parties on loan with highly similar terms and conditions. Where differences exist, adjustments should be done to eliminate these differences.

9.4 Comparability Factors

Comparability factors to consider when searching for and analyzing financial transactions and the determination of arm’s length interest rate include:

(a) the nature and purpose of the financial assistance;
(b) the amount, duration and terms of the financial assistance;
(c) the type of interest rate (eg: fixed or floating interest rate);
(d) embedded options;
(e) guarantees involved in the financial assistance;
(f) collateral for the financial assistance;
(g) creditworthiness of the borrower;
(h) location of the lender and borrower.

When ascertaining the arm’s length interest rate, appropriate indices such as Kuala Lumpur Inter Bank Offered Rate (KLIBOR), prime rates offered by bank and/or specific rates quoted by banks for comparable loans can be used as a reference point. Adjustments are then made on the rates used as reference point based on the outcome of comparability analysis to arrive at the arm’s length interest rate.

9.5 Documenting Financial Assistance Pricing Policy

Taxpayers are required to substantiate and document that the terms of an intercompany financial assistance, specifically the interest rate applied, are arm’s length. This encompasses preparation of an analysis on the setting of the correct level of underlying interest and documentation on other factors of comparability such as loan structure, etc. Taxpayers also need to review existing inter-company agreement on a periodic basis to ensure that all the terms and conditions of the loan remain at arm’s length.

CHAPTER X (UPDATED 15/07/2017)
COMMODITY TRANSACTIONS

10.1 Subject to the guidance in Chapter III selecting the most appropriate transfer pricing method in the circumstances of a particular case, the CUP method would generally be an appropriate transfer pricing method for establishing the arm's length price for the transfer of commodities between associated enterprises. The reference to "commodities" shall be understood to encompass physical products for which a quoted price is used as a reference by independent parties in the industry to set prices in uncontrolled transactions.

10.2 **What is Quoted Price?**

The term "quoted price" refers to the price of the commodity in the relevant period obtained in a domestic or an international commodity exchange market. In this context, a quoted price may include prices recorded between independent buyers and sellers obtained from recognised and transparent price reporting or statistical agencies, or from governmental price-setting agencies, where such indexes are used as a reference by unrelated parties to determine prices in transactions between them.

10.3 **Application of the CUP Method to Commodity Transactions**

10.3.1 Under the CUP method, the arm's length price for commodity transactions may be determined by reference to comparable uncontrolled transactions and by reference to comparable uncontrolled arrangements represented by the quoted price. Quoted commodity prices generally reflect the agreement between independent buyers and sellers in the market on the price for a specific type and amount of commodity, traded under specific conditions at a certain point in time. A relevant factor in determining the appropriateness of using the quoted price for a specific commodity is the extent to which the quoted price is widely and routinely used in the ordinary course of business in the industry to negotiate prices for uncontrolled transactions to the controlled transaction.

10.3.2 Based on the facts and circumstances of each case, quoted prices can be considered as a reference for pricing commodity transactions between associated persons. Taxpayers and the IRBM should be consistent in the application of the appropriately selected quoted price.

10.3.3 For the CUP method to be reliably applied to commodity transactions, the economically relevant characteristics of the controlled transaction and the uncontrolled transactions or the uncontrolled arrangements represented by the quoted price need to be comparable. For commodities, the economically relevant characteristics include, among others, the physical features and quality of the commodity; the contractual terms of the controlled transaction, such as volumes traded, period of the arrangements, terms of credit, the timing and terms of delivery, transportation, insurance, and foreign currency terms.

10.3.4 Differences in certain economically relevant characteristics may lead to a premium or a discount. If the quoted price is used as a reference for determining the arm's length price or price range, the standardised contracts which stipulate specifications on the basis of which commodities are traded on the exchange and which result in a quoted price for the commodity may be relevant.

10.3.5 Where there are differences between the conditions of the controlled transaction and the conditions of the uncontrolled transactions, or the conditions determining the quoted price for the commodity that materially affect the price of the commodity transactions being examined, reasonably accurate adjustments should be made to ensure that the economically relevant characteristics of the transactions are comparable. Contributions made in the form of functions performed, assets used and risks assumed by other entities in the supply chain should be compensated in accordance with the guidance provided in the Guidelines.

10.4 **Evidence of Price-Setting Policy to be Provided to the IRBM**

In order to assist the IRBM in conducting an informed examination of the taxpayer's transfer pricing practices, taxpayers should provide as part of their transfer pricing documentation, reliable evidence and document comprising of:

(a) the price-setting policy for commodity transactions;

(b) the information needed to justify price adjustments based on the comparable uncontrolled transactions or comparable uncontrolled arrangements represented by the quoted price; and

(c) any other relevant information, such as pricing formulas used, third party end-customer agreements, broker price, premium or discounts applied, pricing date, supply chain information, and information prepared for non-tax purposes.

10.5 **Pricing Date**

10.5.1 A particularly relevant factor for commodity transactions determined by reference to the quoted price is the pricing date, which refers to the specific time and date selected by the parties to determine the price for commodity transactions.

10.5.2 The selection of pricing date between related parties should be justified and evidence by proposals and acceptances, contracts or registered contracts, or other documents setting out the terms of the arrangements and compared with what independent buyers and sellers would have agreed in comparable circumstances.

10.5.3 If the pricing date specified in any written agreement between the associated enterprises is inconsistent with the actual conduct of the parties or with other facts of the case, the IRBM will determine a different pricing date consistent with those other facts of the case and what independent enterprises would have agreed in comparable circumstances.

10.5.4 When the taxpayer does not provide reliable evidence and justification of the pricing date agreed by the associated enterprises in the controlled transaction and the IRBM cannot otherwise determine a different pricing date in accordance with the Guideline, the IRBM may deem the pricing date for the commodity transaction on the basis of the evidence available to the IRBM.

CHAPTER XI (UPDATED 15/07/2017)

DOCUMENTATION

11.1 RETENTION OF RECORDS

11.1.1 Taxpayers are required to keep sufficient records for a period of seven years from the end of the year to which income from the business relates, as provided under paragraph 82(1)(a) of the Act, to enable the DGIR to ascertain income or loss from the business. Subsection 82(8) further provides that all records relating to any business in Malaysia must be kept and retained in Malaysia. 'Records' under subsection 82(9) include books of accounts, invoices, vouchers, receipts and other documents necessary to verify entries in any books of accounts.

11.1.2 For transfer pricing purposes, a taxpayer who has entered into a transaction with an associated person in the basis year for a year of assessment is required to not only maintain the above records, but also prepare and keep contemporaneous documentations. Notwithstanding the exclusions under paragraph 1.3, the taxpayer is required to maintain contemporaneous documentation to assist in demonstrating whether the taxpayer's transfer pricing policy is appropriate for tax purposes. At the same time, this alleviates the risk of transfer pricing adjustment and has relevance to penalty consideration during a transfer pricing audit.

11.2 TRANSFER PRICING DOCUMENTATION

11.2.1 Contemporaneous Transfer Pricing Documentation

A documentation is deemed "contemporaneous" if it is prepared:

(a) at the point when the taxpayer is developing or implementing any arrangement or transfer pricing policy with its associated person; or

(b) if there are material changes when reviewing these arrangements prior to preparing the relevant tax return of his income for the basis year for a year of assessment.

Material changes are significant changes that would give impact to the functional analysis or transfer pricing analysis of the tested party. Material changes include changes to the operational and economic conditions that will significantly affect the controlled transactions under consideration. Examples of changes in operational conditions include the following:

(a) changes in shareholding;
(b) changes in business model and structure;
(c) changes in business activities (e.g. changes in group business activities that give impact to local business activities);
(d) changes in financial/financing structure;
(e) changes in TP policy; or
(f) merger & acquisition.

Examples of changes in economic conditions include the following:

(a) foreign exchange;
(b) economic downturn; or
(c) natural disaster.

In preparing the documentation, the arm's length transfer price must be determined before pricing is established based upon the most current reliable data that is reasonably available at the time of determination. However, taxpayers should review the price based on data available at the end of the relevant year of assessment and update the documentation accordingly.

11.2.2 Duty to prepare Transfer Pricing Documentation

Taxpayers who are involved in controlled transactions are generally required to maintain a contemporaneous transfer pricing documentation. This includes taxpayers involved in domestic controlled transactions where at least one party enjoys tax incentives or suffers from continual losses, or is taxed at a different rate, such that the effect of that transaction would result in adjustments that alter the total tax payable.

For a person that is assessable but not chargeable to tax in Malaysia due to tax incentive, or losses; or is transacting with a related party that is assessable but not chargeable to tax in Malaysia due to the same factors, that person is encouraged to prepare Transfer Pricing Documentation if the criteria in paragraph 1.3.1 is fulfilled.

The types of controlled transactions may involve:

(a) sales or purchases of raw materials, stock in trade or other tangible assets;
(b) royalties/ license fees/ other types of considerations in connection with use of intangible assets;
(c) management fees including charges for financial, administrative, marketing and training services;
(d) research and development;
(e) any other services not previously mentioned;
(f) rents/ lease of assets;
(g) interests; or
(h) guarantee fees.

As long as the operational conditions remain unchanged, the comparable searches in databases supporting part of the Transfer Pricing Documentation should be updated every three years rather than annually. However, financial data and suitability of the existing comparable should be reviewed and updated every year in order to apply the arm's length principle reliably.

11.2.3 Submission of Transfer Pricing Documentation

The Transfer Pricing Documentation is not required to be submitted with the annual Return Forms. However, the documentation should be made available within 30 days upon request by the IRBM.

With the introduction of Section 113B of the ITA1967 which comes into operation on 1 January 2021, the Transfer Pricing Documentation should be made available within 14 days upon request by the IRBM. This requirement will apply to transfer pricing audit cases which have commenced on or after 1 January 2021.

11.2.4 List of Documentation

A transfer pricing documentation may consist of the following: (Documentations for specific transactions are listed in **Appendix A**.)

(a) Organizational Structure

(i) the taxpayer's worldwide organizational and ownership structure (including global organization chart and significant changes in the relationship, if any), covering all associated persons whose transactions directly or indirectly affect the pricing of the documented transactions; and

(ii) a description of the management structure of the local entity, a local organization chart, and a description of the individuals to whom local management reports and the country(ies) in which such individuals maintain their principal offices.

(b) Nature of the business/industry and market conditions

(i) outline of the taxpayer's business including relevant recent history, the industries operated in, analysis of the general economic and legal issues affecting the business and industry, the taxpayer's business lines and the property or services in the controlled transactions;

(ii) a detailed description of the business and business strategy pursued by the local entity including an indication whether the local entity has been involved in or affected by business restructurings or intangibles transfers in the present or immediately past year and an explanation of those aspects of such transactions affecting the local entity;

(iii) the corporate business plans to the extent of providing an insight into the nature and purpose of the relevant transactions between the associated persons; and

(iv) a description of the structure, intensity and dynamics of the relevant competitive environment(s) and key competitors.

(c) Controlled Transactions

(i) description of details of the property or services to which the international/domestic transaction relates; any intangible rights or property attached thereto, the participants, the scope, timing, frequency, type and value of the controlled transactions (including all relevant related party dealings in relevant geographic markets);

(ii) names and addresses of all associated persons, with details of the relationship with each such associated person;

(iii) the nature, terms (including prices) and conditions of international transactions (where applicable) entered into with each associated person and the quantum and value of each transaction;

(iv) an overview description of the business, as well as a functional analysis of all associated persons with whom the taxpayer has transacted;

(v) all commercial agreements setting forth the terms and conditions of transactions with associated persons as well as with third parties; and

(vi) a record of any forecasts, budgets or any other financial estimates prepared by the person for the business as a whole and for each division or product separately.

(d) Pricing Policies.

Details of pricing policy for each type of controlled transaction shall include:

(i) the formula adopted, including anticipated profit margin/mark-up and cost component;
(ii) how the formula is applied;
(iii) who determine the pricing policy;
(iv) how often is the policy being revised;
(v) sample of documents to support the pricing policy; and
(vi) comparability study to ensure the arm's length price

(e) Assumption, Strategies and Information regarding Factors that Influence the Setting of Pricing Policies

(i) relevant information regarding business strategies and special circumstances at issue, for example, intentional set-off transactions, market share strategies, distribution channel selection and management strategies that influenced the determination of transfer prices;

(ii) assumptions and information regarding factors that influenced the setting of prices or the establishment of any pricing policies for the taxpayer and the related party group as a whole; and

(iii) documentation to support material factors that could affect prices or profits in arm's length dealings.

(f) Comparability, Functional and Risk Analysis

(i) a description of the characteristics of the property or service transferred, functions performed, assets employed, evaluation on management, allocation and assumption of risks (refer to the RISK Analysis Framework), terms and conditions of the contract, business strategies pursued, economic circumstances and any other special circumstances;

(ii) information on functions performed (taking into account assets used and risks assumed) of the related party involved in the controlled transaction as well as a description of the functions, assets and risks of group of the companies to the extent that they affect or are affected by the controlled transactions carried out by the taxpayer;

(iii) details of comparables including for tangible property: its physical features, quality and availability; for services: the nature and extent of the services; and for intangible property: the form of the transaction, the type of intangible, the rights to use the intangible that are assigned and the anticipated benefits from its use;

(iv) the data collected and the analysis performed to evaluate comparability of uncontrolled transactions with the relevant controlled transactions;

(v) criteria used in the selection of comparables including database screens and economic considerations;

(vi) identification of any internal comparables;

(vii) adjustments (details and reasons for those adjustments) made to the comparables; and

(viii) aggregation analysis (grouping of transactions for comparability).

(g) Selection of the Transfer Pricing Method

(i) description of data and methods considered, the analysis performed to determine the arm's length price and the rationale for the selection of this methodology including reasons for its use in preference to other transfer pricing methodologies; and

(ii) documentation of the process involved in the selection of particular methodologies.

(h) Application of the transfer pricing method

(i) documentation of assumptions and judgments made in the course of determining an arm's length outcome (refer to the Comparability, Functional and Risk analysis section above);

(ii) a list and description of selected comparable uncontrolled transactions (internal or external), if any, and information on relevant financial indicators for independent enterprises relied on in the transfer pricing analysis, including a description of the comparable search methodology and the source of such information;

(iii) documentation of all calculations made in applying the selected method, and of any adjustment factors, in respect of both the tested party and the comparable;

(iv) a description of the reasons for concluding that relevant transactions were priced on an arm's length basis based on the application of the selected transfer pricing method;

(v) a summary of financial information used in applying the transfer pricing methodology; and

(vi) appropriate updates of prior year documentation relied upon in the current year to reflect adjustments for any material changes in the relevant facts and circumstances.

(vii) A list of advance pricing arrangements (unilateral and bilateral) entered into by members of the group with respect to transactions to which the taxpayer is a party.

(viii) Documents that provide the foundation for or otherwise support, or were referred to, in the development of the transfer pricing analysis.

(i) Financial Information

(i) annual local entity financial accounts for the fiscal year concerned, if audited statements exist, they should be supplied and if not, existing unaudited statements should be supplied;

(ii) information and allocation schedule showing how the financial data used in applying the transfer pricing method may be tied to the annual financial statements; and

(iii) summary schedules of relevant financial data for comparables used in the analysis and the sources from which that data was obtained.

(j) Taxpayers should keep readily available documents and information that were used in preparing the transfer pricing documentation as they are necessary to support the transfer pricing analysis. This may include:

(i) official publications, reports, studies and databases;
(ii) reports of market research studies carried out by recognized institutions;
(iii) technical publications brought out by recognized institutions;
(iv) agreements and contracts entered into with associated persons or with unrelated persons, which may be of relevance to the cross-border transactions;
(v) letters and other correspondence documenting any terms negotiated between the person and its associated person;
(vi) supporting documents for the economically significant activities and functions undertaken by the taxpayer. For example, where skilled and experienced staff constitute human resource assets for the taxpayer, documentation pertaining to these staff which may be relevant here including:
- details of experience;
- educational qualifications;
- areas of particular expertise;
- job description and duties;
- remuneration;
- written statements provided by key staff and used by taxpayer in determining the functions, risks and asset of the company;

(vii) other relevant documents.

11.2.5 Preparation and the Submission of Master File

Taxpayers that are obliged under the Income Tax (Country-by-Country Reporting) Rules 2016 to prepare the Country-by-Country Report shall prepare the Master File and submit it together with the Transfer Pricing Documentation when requested.

In cases where the parent of the MNE Group prepares a Master File for the Group, a copy of the Master File should be submitted together with the Transfer Pricing Documentation by the subsidiary company. To the extent this functional analysis duplicates information in the Master File submitted, a cross-reference to the Master File is sufficient.

The following information should be included in the master file:

(a) Organizational structure

Chart illustrating the MNE Group's legal and ownership structure and geographical location of operating entities.

(b) Description of MNE Group's business(es)

General written description of the MNE's business including:

(i) important drivers of business profit;

(ii) a description of the supply chain for the group's five largest products and/or service offerings which are relevant to the taxpayer's controlled transactions by turnover, and any other products and/or services amounting to more than five percent of the group taxpayer's turnover (The required description could take the form of a chart or a diagram);

(iii) a list and brief description of important service arrangements between members of the MNE Group, other than research and development (R&D) services, including a description of the capabilities of the principal locations providing important services and transfer pricing policies for allocating services costs and determining prices to be paid for intra-group services;

(iv) a description of the main geographic markets for the group's products and services that are referred to in the second bullet point above;

(v) a brief written functional analysis describing the principal contributions to value creation by individual entities within the group, i.e. key functions performed, important risks assumed, and important assets used; and

(vi) a description of important business restructuring transactions, acquisitions and divestitures occurring during the financial year.

(c) The MNE's intangibles (as defined in Chapter VIII of the Guidelines)

(i) A general description of the MNE's overall strategy for the development, ownership and exploitation of intangibles, including location of principal R&D facilities and location of R&D management;

(ii) A list of intangibles or groups of intangibles of the MNE Group that are important for transfer pricing purposes and which entities legally own them;

(iii) A list of important agreements among identified associated enterprises related to intangibles, including cost contribution arrangements, principal research service agreements and license agreements;

(iv) A general description of the group's transfer pricing policies related to R&D and intangibles; and

(v) A general description of any important transfers of interests in intangibles among associated enterprises during the fiscal year concerned, including the entities, countries, and compensation involved.

(d) MNE's intercompany financial activities

(i) A general description of how the group is financed, including important financing arrangements with unrelated lenders;

(ii) The identification of any members of the MNE Group that provide a central financing function for the group, including the country under whose laws the entity is organized and the place of effective management of such entities: and

(iii) A general description of the MNE's general transfer pricing policies related to financing arrangements between associated enterprises.

(e) The MNE's financial and tax positions

(i) The MNE's annual consolidated financial statement for the fiscal year concerned if otherwise prepared for financial reporting, regulatory, internal management, tax or other purposes.

(ii) A list and brief description of the MNE Group's existing unilateral advance pricing agreements (APAs) and other tax rulings relating to the allocation of income among countries.

11.2.6 The Extent of Relevant and Adequate Contemporaneous Documentation

In complying with subsection 140A(2) of the Act, taxpayers should take into account the size and complexity of their business and transactions in determining the nature and extent of documentation appropriate to their particular circumstances. In view that the nature and amount of documentation depends on facts and circumstances of a particular transaction, every taxpayer should evaluate the significance of its transactions in reference to their own business and the additional administrative costs of preparing such documentation.

In general, it is advantageous for a taxpayer to maintain proper documentations on controlled transactions that are applicable to his circumstances and be prepared to provide additional information or documentation not listed in the Guidelines, but may be relevant for the determination of arm's length price.

11.2.7 Acceptability of Documentation

To ensure the acceptability of the contemporaneous transfer pricing documentation, reasonable efforts should be given to:

(a) undertake a transfer pricing analysis to ascertain that transfer prices comply with the arm's length principle and reflect commercially realistic outcomes for all controlled transactions;

(b) maintain documents that are applicable to the circumstances and be prepared to provide additional information or documentation not contained above, but which may be relevant for the determination of the arm's length price;

(c) prepare the documentation in accordance with the Rules and the Guidelines;

(d) implement and review the arm's length transfer pricing policies and redesign the transfer pricing policy to accommodate any changes in the business environment;

(e) prevent from providing vague, useless or inadequately founded information;

(f) apply a coherent and transparent approach in identifying uncontrolled transactions;

(g) provide detailed analysis of functions, assets, risks, market conditions and business strategies;

(h) apply a transfer pricing method in accordance with the Rules and these Guidelines;

(i) ensure that the factual, economic and empirical representations in transfer pricing documentation are company, product and market specific;

(j) ensure that the transfer pricing documentation is accurate and precise, and matches the accounting, financial and benchmarked data/comparables;

(k) highlight and document any specific event that may have hindered the MNE's performance so that appropriate fact-based adjustments can be considered;

(l) avoid from preparing documentation which is of relatively limited use, incomplete and does not properly support the transactions; and

(m) maintain adequate background documents and full records containing particulars about the factual assumptions and relevant factors that have been taken into account in working out the arm's length price.

11.2.8 Language

Taxpayers are permitted to file their transfer pricing documentation in Bahasa Malaysia or English. Where supporting documents are in a language other than Bahasa Malaysia or English, a translation should be provided upon submission of the transfer pricing documentation.

11.3 PENALTY

11.3.1 Section 140A of the Act imposed on the taxpayer an obligation to apply the arm's length principle to a controlled transaction. Section 140A(2) says, "..…. where a person in the basis period for a year of assessment enters into a transaction with an associated person for that year for the acquisition or supply of property or services, then, for all purposes of this Act, that person shall determine and apply arm's length price for such acquisition or supply". Subsection 140A(3) gives the power to the DGIR to make adjustment if the income reported is not at arm's length. The application of Section 140A has to be read together with the Rules and Guidelines.

11.3.2 The above legal provisions place the burden of proof of an arm's length price in a transaction where a taxpayer transfers goods or services with its associated persons, on the taxpayer. The contemporaneous transfer pricing documentation has to be prepared based on the requirement of the Rules and Guidelines to justify their pricing is at arm's length. The facts presented in the transfer pricing documentation will be analysed and compared with the actual transaction and condition. In cases, such as, where the facts presented by the taxpayer in the transfer pricing documentation is different from the actual conduct of the taxpayer, the information provided will be considered as incorrect information and be subjected to the penalty under paragraph 113(2)(b) of the Act.

11.3.3 Paragraph 113(2)(b) provides that where a person gives any incorrect information in relation to any matter affecting his own chargeability to tax or the chargeability to tax of any other person, then, if no prosecution was made under under subsection 113(1) in respect of the incorrect return or incorrect information, the Director General may require that person to pay a penalty equal to the amount of tax which has been undercharged in consequence of the incorrect return or incorrect information or which would have been undercharged if the return or information had been accepted as correct.

11.3.4 Below are some of the issues and conditions which may lead to a penalty being imposed when an adjustment is made to the reported income:

(a) Form and substance is not the same; i.e. where the agreement does not reflect the actual conduct between the taxpayer and its associated person.

(b) Comparables selected by the taxpayer do not meet all of the economically relevant characteristics or comparability factors set out in the Rules.

(c) Inaccurate or misleading explanation of function, assets and risk; e.g. where a taxpayer claims that it does not bear the foreign exchange risk but in substance it does, and this is reflected in its accounts.

11.3.5 Penalty will not be imposed in cases, where:

(a) transfer pricing documentation is submitted within 30 days upon request by the DGIR for transfer pricing audit cases which have commenced before 1 January 2021; or

(b) transfer pricing documentation is submitted within 14 days upon request by the DGIR for transfer pricing audit cases which have commenced on or after 1 January 2021; and

(c) the transfer pricing documentation prepared fulfils the requirement of the Rules and these Guidelines, wherein reliable and correct information is provided by the taxpayer.

11.3.6 The penalty rate is as listed in the Transfer Pricing Audit Framework.

Documentation on specific transactions

In addition to the documentation requirements in paragraph 11.2 of Chapter XI, a taxpayer engaged in the provision or acquisition of intragroup services, transfer of intangible property or participate in cost sharing arrangement is also required to prepare documentation that contain information as listed below:

(i) Documentation pertaining to Intragroup Services

(a) A detailed description of the relevant service transactions. All aspects of the transactions must be analysed and documented including:

- Who is doing what and for whom, Where are they doing it,
- Why are they doing it,
- How are they doing it, and
- What property is being used or transferred in connection therewith. A written binding service contract between payer and payee companies i.e. the charter which illustrates policies adopted,
- Services provided, costs included and excluded, etc.
- The contract should at the minimum set out:
    - ✓ Details of the group companies which will be providing and receiving management services under the contract;
    - ✓ Details of the nature and extend of services to be provided;
    - ✓ The basis for determining the fees to be charged;
    - ✓ The basis for periodic rate increases (if applicable);
    - ✓ The dates at which invoices will be issued;
    - ✓ The time for payment of fee invoices; and
    - ✓ The charges for late payment of invoices and outstanding accounts.

(b) Documents (e.g. meeting notes and draft agreements) which show that the contract was concluded only after bona fide (bilateral) negotiations regarding its terms.

(c) Proof of the provision of intragroup service (in order to demonstrate that the service recipient has benefited therefrom). A comprehensive and complete description of those benefits may consist of the following:

- Detailed description of the benefits provided by each business unit, the costs of which are being allocated;

- Documentation (e.g. correspondence, memoranda, manuals and directives) indicating a benefit to the recipient of the intragroup services;

- Job descriptions of the staffs of both the service provider and the recipient, so as to prove that there is no duplication of services;

- Documentation demonstrating that the recipient's operations have not been made to absorb a disproportionate share of the total regional/global costs of administration and management.

(d) Documentation of each of the functions, such as marketing, legal or technical functions, as the case may be;

(e) Documentation that the service provider undertakes to supply in justification of the fee for the services rendered e.g. copies of time sheets or cost centre reports. Documentation could also include letters, manuals, instructions, proof of visits, written advice, periodic activity reports and any other documents or data which tend to confirm that the service have been rendered for the benefit of the recipient and are justifiable on an arm's length basis;

(f) Where a fixed key is used under the indirect charge method, the justification for the allocation key and method adopted shall be demonstrated;

(g) In the determination of cost base for the application of cost method, it is important to document all issues considered in the calculation of the cost base including:

- nature/type of cost which have been included in the cost base;
- method of allocation of costs between associated persons;
- the basis of allocation or apportionment of all indirect costs included in the cost base.

(ii) Documentation pertaining to Intangible Property

(a) Description of the intangible property, potential market application and advantages the intangible property provides in the particular market.

(b) The prevailing industry royalty rates.

(c) The terms of the license including geographic limitations, time limitations and exclusivity rights.

(d) The singularity of the invention and the period for which it is likely to remain unique.

(e) Technical assistance, trademarks and know-how provided along with access to a patent.

(f) Profits anticipated by the licensee; and benefits to the licensor arising from sharing information on the experience of the licensee.

(g) In relation to marketing activities, an agreement to indicate the arrangement between the entities in terms of bearing the risks/expenses for the marketing activities to be undertaken; the nature of the marketing expenses incurred and the proposed treatment, in particular of the non-routine expenses.

(iii) Documentation pertaining to Intragroup Financial Assistance

(a) Loan agreement.

(b) For each financial assistance received or provided, the following information is required:-

   i. Details of lenders/ borrowers

   ii. Date of agreement, the date of loan drawn down /disburse, duration of loan

   iii. Total amount of loan, balance of loan at the end of financial year

   iv. When interest was first paid, interest paid for each financial year

   v. Interest rate charge and basis of the rate charged e.g. .the base reference rate and spread, and prove that the rate is arm's length

   vi. Withholding tax documentations if applicable

(c) Document supporting all items covered under comparability factors under paragraph 9.4 of Chapter IX

(d) Currency of loan.

(e) A copy of the accounts of the borrower (where Malaysian entity is the lender).

(iv) Documentation pertaining to Cost Contribution Arrangement

The documentations pertaining to a cost contribution arrangement should include:

(a) A copy of the CCA agreement that is contemporaneous with its formation (and any revision) and any other agreements relating to the application of the CCA between the CCA participants;

(b) The identity of participants in the CCA and any other associated persons that will benefit from the CCA;

(c) The scope of the activities covered by the arrangement, including any intangible or class of intangibles in existence or intended to be developed;

(d) The duration of the arrangement;

(e) The total amount of contributions incurred pursuant to the arrangement;

(f) The allocation of tasks and responsibilities;

(g) The form and value of each participant's initial contributions (including research) with a description of how the value of initial and ongoing contributions is determined and how accounting principles are applied;

(h) A description of the method used to determine each participant's share of the contributions including projections used to estimate benefits, any rationale and assumptions underlying the projections and an explanation of why that method was selected;

(i) The nature and extent of each participant's effective ownership interest in the results of the CCA activities;

(j) The manner or basis on which proportionate shares of the expected benefits are to be measured;

(k) The rationale and any assumptions underlying the projections of expected benefits;

(l) The procedures for entering or withdrawing from the arrangement and the consequences thereof;

(m) The policies and procedures governing balancing payments;

(n) Where material differences arise between projected benefits and actual benefits realized, the assumptions made to project future benefits need to be amended for future years and the revised assumptions documented;

(o) The extent of the use of CCA property by associated persons who are not CCA participants, including the amounts of consideration paid or payable by these non-participants for use of the CCA property; and

(p) All material changes to the arrangement.

Arm's length price

An amount that would have been the transfer price of a transaction had the persons in the transaction dealt with each other at arm's length.

Balancing payment

A payment, normally from one or more participants to a cost contribution agreement (CCA) to another, to adjust participants' proportionate shares of contributions, that increases the value of the contributions of the payer and decreases the value of the contributions of the payee by the amount of the payment.

Buy-in payment

A payment made by a new entrant to an already active CCA for obtaining an interest in any results of prior CCA activity.

Buy-out payment

Compensation that a participant who withdraws from an already active CCA may receive from the remaining participants for an effective transfer of its interests in the results of past CCA activities.

Cash boxes

Capital-rich entities without any other relevant economic activities.

Contemporaneous transfer pricing documentation

Transfer pricing documentation which is brought into existence –

(a) when the person is developing or implementing any controlled transaction; or

(b) where in the basis period for a year of assessment the controlled transaction is reviewed and there is material changes, the documentation shall be updated prior to the date for furnishing a return for that basis period for a year of assessment.

Controlled transaction

Transaction for acquisition or supply of property or services between –

(a) persons one of whom has control over the other;

(b) individuals who are relatives of each other; or

(c) persons both of whom are controlled by some other person;

Economic owner

One who is not registered as an owner but is considered to own the intangible/tangible asset by virtue of bearing the costs and risks relating to the intangible/tangible asset, as is often the case in CCAs.

Financial assistance

Includes a loan, interest bearing trade credit, advance or debt and the provision of any security or guarantee.

Financial institution

Includes:

(a) Bank or finance company which are licensed under the Financial Services Act 2013 [Act 758] to carry on banking business, insurance business or investment banking business.

(b) Bank or finance company which are licensed under the Islamic Financial Services Act 2013 [Act 759] to carry on Islamic banking business, takaful business, international Islamic banking business or international takaful business.

(c) A Development Financial Institutions (DFIs) prescribed under the Development Financial Institutions Act 2002

(d) Lembaga Tabung Haji established under the Tabung Haji Act 1995

(e) Malaysian Building Society Berhad incorporated under the Companies Act

(f) Borneo Housing Mortgage Finance Berhad incorporated under Companies Act 1965

(g) Cooperative society incorporated under Co-operative Societies Act 1993

Functional analysis

A method of finding and organizing facts about a business in terms of its functions, assets (including intangible property) and risks. It aims to identify how these are divided between the parties involved in the transaction under review.

Intangible property

Includes patents, inventions, formulae, processes, designs, models, plans, trade secrets or know-how.

Intentional set-off

A benefit provided by one associated enterprise to another associated enterprise within the group that is deliberately balanced to some degree by different benefits received from that enterprise in return.

Interest

Includes finance charge, discount, premium or other considerations.

Intragroup services

Services rendered between companies in the same group.

Legal owner

The registered owner of an intangible/asset.

Marketing intangible

Includes an intangible that is concerned with marketing activities, which aids in the commercial exploitation of the property or has an important promotional value for the property concerned.

Permanent establishment

Subject to the meaning assigned to it in the arrangement made under section 132 of the Act, a fixed place of business of a particular person through which the business of the person is wholly or partly carried on or a fixed place of business of another person, through which the particular person makes supplies, in which case the permanent establishment shall be treated as a distinct and separate enterprise form its head office and related branches.

Person

Includes a company, a body of persons and a corporation sole.

Property

Includes any goods, movable or immovable thing, intangible property and beneficially owned property.

Related party

Refers to associated persons as described in paragraph 1.5.2 of Chapter I.

Relative

Within the meaning of controlled transaction, means a parent, a child (including a stepchild and a child adopted in accordance with any law), a brother, a sister, an uncle, an aunt, a nephew, a niece, a cousin, an ancestor or a lineal descendant.

Service

Any rights, benefits, privileges or facilities that are, or to be, provided, granted or conferred under an arrangement for or in relation to any work and assistance including financial assistance.

Tested party

The participants in a controlled transaction that is the party by reference to whom a particular transfer pricing method is applied.

Traditional transactional method

The comparable uncontrolled price method or the resale price method or the cost plus method.

Transaction

Any trust, grant, covenant, agreement, arrangement or other disposition or transaction made or entered into orally or in writing (whether before or after the commencement of the Income Tax Act, 1967), and includes a transaction entered into by two or more persons with another person or persons.

Transactional profit method

The profit split method or the transactional net margin method.

Transfer price

An amount paid or payable or an amount received or receivable, as the case may be, by a person in a transaction for the acquisition or supply of property or services.

Uncontrolled transactions

Transactions carried on by independent persons dealing with one another at arm's length