



**LEMBAGA HASIL DALAM NEGERI MALAYSIA**  
INLAND REVENUE BOARD OF MALAYSIA

**DATO' ZAINOL ABIDIN BIN ABD. RASHID**  
Ketua Eksekutif/Ketua Pengarah Hasil Dalam Negeri  
(*Chief Executive/Director General of Inland Revenue*)

### **GARIS PANDUAN PINDAHAN HARGA (TRANSFER PRICING)**

Lembaga Hasil Dalam Negeri telah merumuskan satu garis panduan yang boleh digunakan oleh syarikat dalam mengendalikan urusan pindahan harga. Garis panduan ini menetapkan kaedah penentuan harga pindah (transfer price) yang konsisten dengan prinsip harga selengan (arm's length price). Ia juga menggariskan jenis rekod dan dokumen yang perlu disimpan dalam hal-hal yang berkaitan dengan pindahan harga.

Adalah diharapkan garis panduan ini dapat membantu syarikat di dalam menentukan harga pindah bagi memudahkan urusan syarikat dengan Lembaga Hasil Dalam Negeri. Usaha ini juga adalah selaras dengan hasrat Lembaga Hasil Dalam Negeri untuk meningkatkan lagi perkhidmatan kepada pembayar cukai dalam setiap bidang kerja mengikut peredaran masa.

Sekian, terima kasih.

**(TAN SRI DATO' ZAINOL ABIDIN BIN ABD. RASHID)**  
Ketua Eksekutif,  
Lembaga Hasil Dalam Negeri,  
Malaysia.

2 Julai 2003  
LHDN.01/20/(S)/42/51/197



**INLAND REVENUE BOARD MALAYSIA**

---

# **TRANSFER PRICING GUIDELINES**

---

# CONTENTS

1.	INTRODUCTION.....	2
2.	OBJECTIVE.....	2
3.	SCOPE OF GUIDELINES.....	3
4.	THE ARM'S LENGTH PRINCIPLE.....	4
5.	THE CONCEPT OF COMPARABILITY.....	5
6.	FACTORS DETERMINING COMPARABILITY.....	6
7.	ARM'S LENGTH PRICING METHODOLOGIES.....	8
8.	SPECIAL CONSIDERATIONS FOR INTANGIBLE PROPERTY.....	25
9.	SPECIAL CONSIDERATIONS FOR INTRA-GROUP SERVICES.....	27
10.	DOCUMENTATION.....	29

---

# **TRANSFER PRICING GUIDELINES**

## **1. INTRODUCTION**

Transfer pricing generally relates to the system of pricing the cross-border transfer of goods, services and intangibles between entities in a group of Multinational Enterprise (MNE). Transfer pricing also applies if such transactions were to take place between associated companies within the country. Ideally, the transfer price should not differ from the prevailing market price. However, when business dealings are made between such connected persons, they may not always reflect the dynamics of market forces as would be expected if such transactions were carried out by independent enterprises. As with any tax administration, it is the duty of the Inland Revenue Board of Malaysia (IRB) to ensure that the transfer pricing methodologies adopted by MNEs are reasonable, and that their Malaysian subsidiaries are paying their fair share of tax. In order to do so, MNEs involved must be able to provide adequate documented proof to support their transfer pricing policies.

## **2. OBJECTIVE**

The IRB Transfer Pricing Guidelines (hereinafter referred to as the Guidelines) seek to provide all MNEs concerned with information on existing domestic legislation; methodologies acceptable to IRB that can be used in determining arm's length price and administrative regulations including the types of records and documentation expected from taxpayers involved in transfer pricing arrangements. It is the prerogative of the taxpayer to choose from the various methodologies laid out with the ultimate aim of arriving at an arm's length transfer price. It is intended that these guidelines, which may be reviewed from time to time, will assist MNEs in their efforts to determine transfer prices which are consistent with the arm's length principle and at the same time comply with Malaysian tax laws as well as administrative requirements of the IRB.

### **3. SCOPE OF GUIDELINES**

- 3.1 The Guidelines are applicable on transactions between associated enterprises within a multinational where one enterprise is subjected to tax in Malaysia and the other enterprise is located overseas.
- 3.2 The Guidelines are also applicable by analogy, in relation to transactions between a permanent establishment (PE) and its head office or other related branches; where 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.
- 3.3 The type of transactions subject to adjustments will include the sale or purchase of inventory; the sale, purchase or lease of tangible assets; the provision of services; the transfer, purchase or use of intangible assets; the lending or borrowing of money; and other transactions which affect the profit or loss of the enterprise involved.
- 3.4 The Guidelines are largely based on the governing standard for transfer pricing which is the **arm's length principle** as set out under the Organisation for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines. Henceforth, all methodologies and supporting rationale will be based on the said principle.
- 3.5 Note that all examples shown under paragraph 7 of the Guidelines are for illustrative purposes only. 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 that paragraph.

## **4. THE ARM'S LENGTH PRINCIPLE**

### **4.1 Meaning of Arm's Length Principle**

The arm's length approach, which is internationally accepted as the preferred basis for determining the transfer price of a transaction between associated parties will be the basis adopted by IRB. 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 done 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. In applying the arm's length principle to an MNE, attention should be focused on the nature of the transactions between two associated entities and dealings between a PE and its head office, as each member is treated as if it is operating as a separate entity rather than as an inseparable part of a single unified business.

### **4.2 Legal Basis**

A general anti-avoidance provision under subsection 140(1) of the Income Tax Act 1967 (ITA as amended) empowers the Director General (DG) to disregard certain transactions which he believes has 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. Section 140 will also be applied in the adjustment of transfer prices. Section 140 allows the DG 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.

### **4.3 Meaning of Control and Associated Enterprises**

4.3.1 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.

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

## **5. THE CONCEPT OF COMPARABILITY**

5.1 A comparability analysis is a pre-requisite in the application of all transfer pricing methodologies that conform to the arm's length principle. This involves comparing conditions in a controlled transaction with those in transactions between independent parties. Transactions are deemed comparable if there are no material differences between the transactions being compared or, reasonably accurate adjustments can be made to eliminate any material differences in the transactions.

5.2 In a comparability analysis, focus is usually directed at circumstances surrounding the commercial and financial relations between associated enterprises, the processes involved, the economic performance such as profits and margins, and factors that influence the economic performance. Comparability must also be considered when dealing with products that are sophisticated or high-tech such as computer software, or involve services such as consultancy or engineering. A brief outline of factors to be considered in a comparability analysis is given in paragraph 6.

## **6. FACTORS DETERMINING COMPARABILITY**

### **6.1 Characteristics of Property or Services**

Similarity in product characteristics is more relevant when comparing prices rather 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) 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 and type of property.

### **6.2 Functions Performed**

6.2.1 A functional analysis must always be carried out in determining comparability of transactions. It involves the determination of how the functions, assets (including intangible property) and risks in a business are divided up between parties involved in the transactions under review. The functions that need to be compared include product design, manufacturing, marketing, advertising, and research and development (R&D). In comparing such functions, assets employed (e.g. plant and machinery) as well as the nature of such assets (e.g. age and market value), and the use of intangibles must also be considered. The type of risks to consider include market risks, financial risks including exchange rate risks and the risks associated with the success or failure of R&D that the MNE undertakes. A functional analysis by itself does not determine the arm's length result of a controlled transaction but instead should form the basis for identifying comparables.

6.2.2 An analysis of contractual terms should form part of the functional analysis. Allocation of responsibilities, risks and benefits between enterprises are normally defined in a contract agreement. The terms and conditions that may influence the price or margin include credit or payment terms, the volume of sales or purchases, the terms of warranties etc. Comparability should take into account how the conduct of associated parties conforms to the terms of a contract; just as how the terms and conditions previously mentioned would influence transactions made between independent enterprises.

### **6.3 Other Factors**

#### 6.3.1 Economic Circumstances

Economic circumstances that may affect prices charged or profits earned in controlled and uncontrolled transactions include the geographic location of the market; the size of the market; the availability of substitute goods and services; the extent of government intervention e.g. whether goods compared are price controlled and the timing of the transactions.

#### 6.3.2 Business Strategies

Business strategies that are relevant in determining comparability include innovation and new product development, degree of diversification, market penetration schemes, distribution channel selection and market level and location. In a comparability analysis, it may be necessary to see whether independent enterprises in the taxpayers' circumstances would have adopted these strategies and if so, what rewards would have been expected.

## 7. ARM'S LENGTH PRICING METHODOLOGIES

7.1 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
- } Other  
} Methods

7.2 The first three methods are commonly known as 'traditional methods'. Although the taxpayer is given the right to choose any method or any combination of the methods above, 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 methods cannot be reliably applied or exceptionally cannot be applied at all. The method that requires the fewest adjustments and provides the most reliable measure of an arm's length result is preferred by the IRB as this will reduce the scope and nature of future disputes. This will depend heavily on the availability of comparable data. Therefore, in deciding the most appropriate method, the following must be considered:

- the degree of actual comparability when making comparisons with transactions between independent parties;
- the completeness and accuracy of data in respect of the uncontrolled transaction;
- the reliability of any assumptions made; and
- the degree to which the adjustments are affected if the data is inaccurate or the assumptions incorrect.

## 7.3 Comparable Uncontrolled Price (CUP) Method

7.3.1 The CUP 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.

7.3.2 The CUP method is the most direct way of ascertaining an arm's length price. It involves the direct price comparison for the transaction of a similar product between independent parties.

### 7.3.3 Comparability Analysis

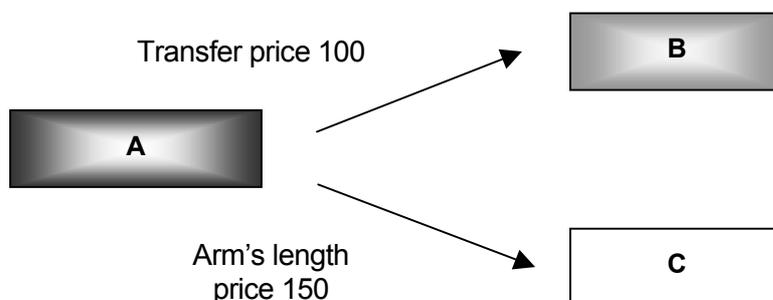
- a. An uncontrolled transaction is comparable to a controlled transaction for purposes of the CUP method if one of the following conditions is met:
  - i. None of the differences (if any) between the transactions being compared or between the enterprises undertaking those transactions could materially affect the price in the open market; or
  - ii. Reasonably accurate adjustments can be made to eliminate the material effects of such differences.
- b. An MNE using the CUP method to determine its transfer price must first identify all the differences between its product and that of the independent manufacturer. 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 manufacturer 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:

- Product characteristics such as physical features and quality.
- If the product is in the form of services, the nature and extent of such services provided.
- Whether the goods sold are compared at the same points in the production chain.
- Product differentiation in the form of patented features such as trademarks, design, etc.
- Volume of sales if it has an effect on price.
- Timing of sale if it is affected by seasonal fluctuations or other changes in market conditions.
- Whether costs of transport, packaging, marketing, advertising, and warranty are included in the deal.
- Whether the products are sold in places where the economic conditions are the same.

### Example 1

Taxpayer **A**, an MNE sells 70% of its product to an overseas associated company **B**, at a price of RM100 per unit. At the same time, the remaining 30% of that product are sold to a local independent enterprise **C** at RM150 per unit.



The products sold to B and C are the same. 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 different market conditions since B and C are located in different countries and for product quantity discounts since volume of sales to B and C are not the same. Assuming that reasonably accurate adjustments can be made to eliminate the material effects of these differences, then the CUP method may be applied using the unit price of RM150 as a comparable arm's length price.

## **7.4 Resale Price Method**

7.4.1 The resale price method is generally most appropriate where the final transaction is with an independent distributor. The usefulness of the method largely depends on how much added value or alteration the reseller has done on the product before it is resold, or the time lapse between purchase and onward sale. The method is more difficult to apply if the product has gone through a number of processes and the time lapse is too long (to the extent that market conditions might have changed) before it is resold or, when the reseller contributes substantially to the creation or maintenance of an intangible property that is attached to the product.

7.4.2 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:

$$\text{Arm's length price} = \text{Resale price} - (\text{Resale price} \times \text{Resale price margin})$$

Where:

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

\* 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. Factors that may contribute to the value added depend on the level of activities performed by the reseller.

#### 7.4.3 Comparability Analysis

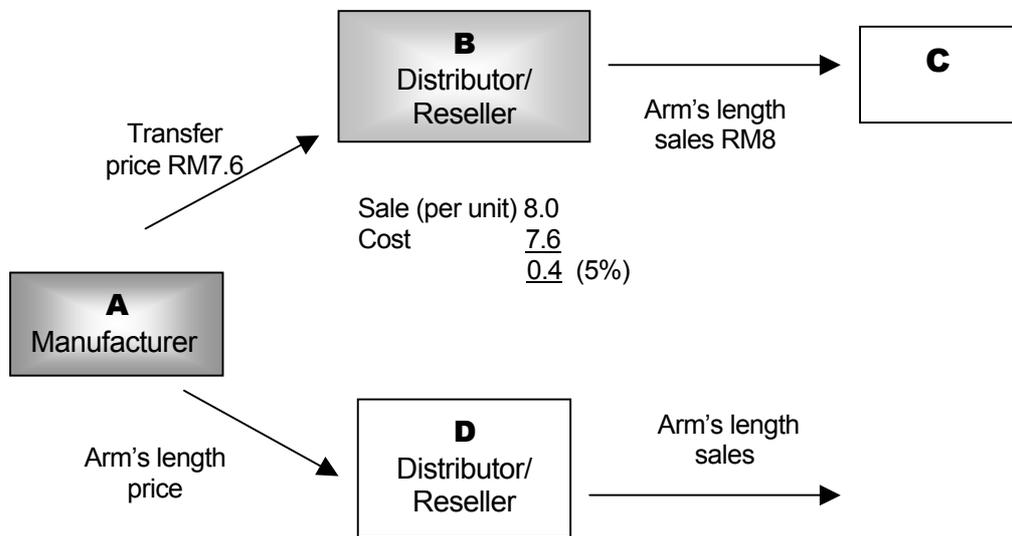
- a. An uncontrolled transaction is comparable to a controlled transaction for purposes of the resale price method if one of the following conditions is met:
  - i. None of the differences (if any) between the transactions being compared or between the enterprises undertaking those transactions could materially affect the resale price margin in the open market; or

- ii. Reasonably accurate adjustments can be made to eliminate the material effects of such differences.
- b. Factors which may influence the resale price margin and other considerations when performing a comparability analysis:
- i. Functions or level of activities performed by the reseller and the risks undertaken 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;
  - ii. Employment of similar assets in the controlled and uncontrolled transactions e.g. a developed distribution network;
  - iii. Although broader product differences are allowed as compared to the CUP method, product similarities is still significant to some extent particularly when there is a high value or unique intangible attached to the product;
  - iv. If the resale price margin used is that of an independent enterprise in a comparable transaction, differences in the way business is managed may have an impact on profitability;
  - v. The time lapse between original purchase and resale of the product as a longer time lapse may give rise to changes in the market, exchange rates, costs etc.;

- vi. Whether the reseller is given exclusive rights to resell the products;
- vii. 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 2**

Taxpayer **B** is a Malaysian subsidiary of multinational **A**, which is located overseas. **B** is a distributor of a high quality product manufactured by **A**. **A** also sells a similar product of a lower quality to an independent distributor **D** in Malaysia. The cost of product purchased from **A** by **B** is RM7.6 per unit. **B** resells the product to independent party **C** for RM8. Based on functional analysis, it was found that functions performed by **B** are similar to that of **D**. The gross profit ratio of **D** 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 material, as they would have been if the basis of comparison were on prices. Furthermore, functions carried out by **B** and **D** are similar (**D** 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) =  $8 - (8 \times 10\%) = 7.2$

## **7.5 Cost Plus Method**

7.5.1 The cost plus method is often useful in the case of semi-finished goods which are sold between associated parties, or when different companies in an MNE have concluded joint facility arrangements, or when the manufacturer is a contract manufacturer, or where the controlled transaction is the provision of services.

7.5.2 The starting point in a cost plus method, in the case of transfer of products between associated parties, 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, 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 adjustment:

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

Where:

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

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

### 7.5.3 Cost Structure Consideration

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 are the aggregation of direct and indirect costs of production (as applied in absorption costing). 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.

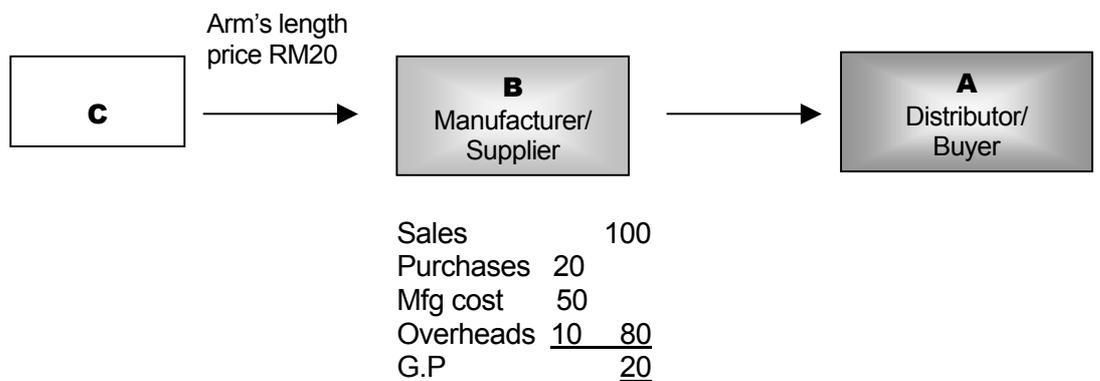
### 7.5.4 Comparability Analysis

- a. An uncontrolled transaction is comparable to a controlled transaction for purposes of the cost plus method if one the following conditions is met:
  - i. None of the differences (if any) between the transactions being compared or between the enterprises undertaking those transactions could materially affect the cost plus mark-up in the open market; or

- ii. Reasonably accurate adjustments can be made to eliminate the material effects of such differences.
  
- b. Comparability when applying the cost plus method should take into account the similarity of functions, risks assumed, contractual terms, market conditions and 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.

**Example 3**

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. A similar (unassociated) manufacturing company that sells to an independent company is found to have a mark-up of 40%.



Since the product is an extensively customised product, there are no product comparables. The mark-up of 40% from the other manufacturing company performing the same functions, bearing similar risks and using similar assets, can be used as a basis in arriving at an arm's length price.

Arm's length price of electrical component sold to A by B (in RM)

$$= 80 + (80 \times 40\%)$$

$$= 112$$

## **7.6 Other Methods**

The transactional profit methods described below should only be considered when traditional methods are not applicable. These 'last resort' methods take into account profits that arise from particular transactions among associated enterprises which are compared to the profits arising from comparable transactions between independent enterprises. IRB however will 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.

### **7.6.1 Profit Split Method**

This method provides an alternative in cases where no comparable transactions between independent parties can be identified. This would normally happen when transactions are very interrelated that they cannot be evaluated separately. The method is based on the concept that profits earned in a controlled transaction should be equitably divided between associated parties 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 enterprise makes to the transactions are assessed based on how independent enterprises under the same circumstances would expect to split the profits among them. This would normally involve making comparisons with independent enterprises that have entered into joint ventures. Two approaches for estimating the division of profits (projected or actual) are described in the following paragraphs. These approaches are not necessarily exhaustive or mutually exclusive.

**i) Residual profit split approach**

There are two stages of profit division under this approach. Firstly, the combined profit is apportioned according to basic returns assigned to each party to the transaction. These returns are based on the basic 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.

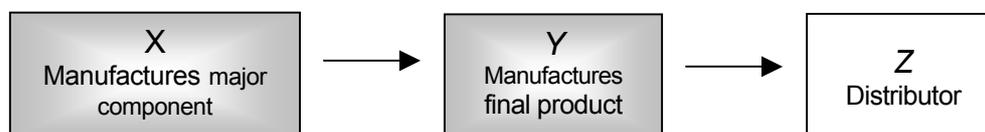
**ii) Contribution analysis approach**

Under a contribution analysis, the combined profits would be divided between the associated enterprises based on the relative value of the functions (i.e. contribution) performed by each of the associated enterprises participating in the 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 profit approach, basic returns are not allocated to each of the parties 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 enterprise will be deducted accordingly.

#### Example 4

**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 **Y**. 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** are as follows:

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

The final product in the transaction happens to be a unique product for which there are no comparables. 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 Methodology

In this 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.

### **(I) Residual analysis of the group profit**

#### **Calculation of total profit**

Total sales	300
Cost of goods sold (X)	35
Cost of goods sold (Y) - excluding purchases	<u>35</u>
Gross profit	230
R&D	35
Other operating expenses	<u>25</u>
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)
- $$= 30\% (35 + 15) = 15$$

- ii. The calculation of basic return to **Y** has to take into account 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.

$$= 20\% \text{ of } [(COGS - \text{purchase price}) + \text{other operating expenses} + \text{arm's length transfer price}]$$

$$= 20\% (35 + 10 + TP) = 9 + 0.2TP$$

## (II) Residual profit split:

### Calculation of residual profit

$$\text{Residual profit} = \text{Net profit} - [(\text{Return to X}) + (\text{Return to Y})]$$

$$= 170 - (15 + 9 + 0.2TP)$$

$$= 146 - 0.2TP$$

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:

	<b>X</b>	<b>Y</b>
R&D	20	15
Total R&D	35	35
R&D expenditure ratio	57%	43%

### Calculation of residual profit split

$$\text{For X} = 57\% \text{ of } (146 - 0.2TP) = 83.22 - 0.114TP$$

$$\text{For Y} = 43\% \text{ of } (146 - 0.2TP) = 62.78 - 0.086TP$$

### Net profit for X

$$\text{Basic return to X} = 15$$

$$\text{Residual return to X} = 83.22 - 0.114TP$$

$$\text{Total net profit for X} = 98.22 - 0.114TP$$

**Net profit for Y**

Basic return to Y =  $9 + 0.2TP$

Residual return to Y =  $62.78 - 0.086TP$

Total net profit for Y =  $71.78 + 0.114TP$

**Adjustment for transfer price between X and Y:**

Sales price if X makes no profit =  $100 - 30 = 70$

Adjusted sales price (i.e. TP) =  $70 + \text{Adjusted net profit for X}$

=  $70 + 98.22 - 0.114TP = 168.22 - 0.114TP$

TP =  $168.22/1.114 = 151$

**Adjusted net profit:**

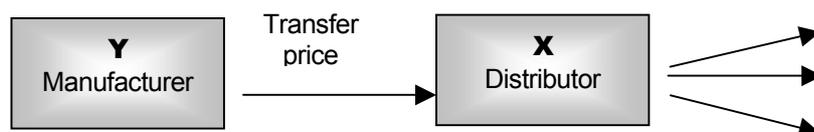
	<b>X</b>	<b>Y</b>
Sales	100	300
<b>Arm's length adjustment</b>	<b>51</b>	
Adjusted sales	<b>151</b>	
Purchases	15	100
<b>Adjustment</b>		<b>51</b>
<b>Adjusted purchases</b>		<b>151</b>
Manufacturing cost	20	35
Gross profit	65	165
<b>Adjusted gross profit</b>	<b>116</b>	<b>114</b>
R&D	20	15
Other operating expenses	15	10
Net profit	30	140
<b>Adjusted net profit</b>	<b>81</b>	<b>89</b>

### 7.6.2 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. The method examines the net profit margin relative to an appropriate base such as costs, sales or assets attained by the 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 enterprise. Functional analysis of the associated enterprise as well as the independent enterprise will have to be applied to determine comparability. Since 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), it is stressed that usage of TNMM be confined to cases where functions have a high degree of similarity, so as to eliminate the effects of these other factors.

#### Example 5

**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	100000
Cost of goods sold	<u>90000</u>
	10000
Operating expenses	<u>15000</u>
Net loss	(5000)
Margin	-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 on sales. It was found that the net profit margin to sales earned in a comparable transaction by an independent enterprise is 5%.

Adjustments on X will be as follows:

Net profit of X =  $100000 \times 5\% = 5000$

**Adjusted cost of goods sold =  $100000 - 15000 - 5000 = 80000$**

## 8. SPECIAL CONSIDERATIONS FOR INTANGIBLE PROPERTY

8.1 Types of intangible property include patents, know-how, inventions, trademarks, brand names, copyrights, registered designs, franchises, licenses, literary and artistic property rights, and other similar items, which are valued for their intellectual or intangible content. Intangibles such as trademarks and trade names are normally referred to as marketing intangibles; while intangibles such as patents, which are created through risky and costly R&D, are classified as trade intangibles.

- 8.2 The transfer of intangibles between associated parties may be carried out in the following manner:
- i. Outright sale or transfer either for consideration, or by way of gift, or capital contribution;
  - ii. In the form of lease or license where royalty is paid to the owner.
- 8.3 Due to the nature of intangibles, which are essentially unique products, special considerations are needed. These include:
- i. Determining whether the intangible does exist. Marketing activities comprising of market research, product promotion, etc need not necessarily result in the creation of a business asset; likewise not all R&D expenditures lead to the production of a trade intangible. In such instances, these expenses may be treated as current expenses. The treatment of these activities will have a bearing on the functional analysis carried out to establish comparability;
  - ii. Evaluating the terms of agreement between the transferor and transferee. The agreement will normally indicate:
    - Whether the transfer is an outright sale or a licensing agreement for royalties to be paid;
    - If royalty is to be paid, the basis of payment;
    - Whether the price of product transferred has included compensation for use of intangible property; and if so whether other payments such as royalties or payment for provision of technology are also made in relation to the same product;
    - If it involves a marketing intangible where a party that is not the legal owner undertakes marketing activities: how the marketer is compensated.

#### 8.4 Comparability Analysis and Arm's Length Application for Intangibles

The arm's length principle, the concept of comparability and the basis of choosing the most appropriate method/methods all apply to intangibles just as they do to tangible property. A comparability analysis must take into account:

- i. The expected benefits from the intangible property in both the controlled and uncontrolled transactions;
- ii. In the case of a patent, the nature and duration of the patent, the patent laws in the relevant countries, the value (of the final product) that is attributable to the patent;
- iii. In the case of marketing intangibles (e.g. trademark), the value added by the trademark taking into account consumer acceptability, geographical significance, market share, sales volumes etc.;
- iv. It is acknowledged that finding comparable uncontrolled transactions will be a difficult task. For this reason, the profit split method is often used. In determining comparability or relative value of contributions of each party, the amount, nature, and incidence of the costs incurred in developing or maintaining the intangible property must be examined.

### **9. SPECIAL CONSIDERATIONS FOR INTRA-GROUP SERVICES**

- 9.1 In most MNEs a wide range of services such as R&D, administrative, technical aid, financial or other commercial services are provided for intra-group use. Some services e.g. technical aid, often incorporate the provision of know-how. The costs of such services, initially borne by the parent or other service companies within the MNE, will through some intra-group arrangement eventually be recovered from other associated companies.

- 9.2 The main issues with regard to intra-group services are:
- i. Whether intra-group services have been provided;
  - ii. If so, whether the intra-group charge for the services are at arm's length prices.
- 9.3 The following factors should serve as a guide in determining whether services have been rendered:
- Whether the activity of one group member has provided the other group member with economic or commercial value and whether an independent enterprise in comparable circumstances be willing to pay or perform in-house for itself such activities.
  - In general, no intra-group service should be found for activities undertaken by one group member that merely duplicate a service that another group member is performing for itself, or that is being performed for such other group member by a third party.
  - Incidental benefits to an associated enterprise arising out of activities or services meant for other group members of the MNE should not be taken as intra-group services for that particular associated enterprise.
- 9.4 The methods discussed in paragraph 7 may be used to determine arm's length price for intra-group services. A functional analysis of the various group members may be performed to establish the relationship between the relevant services and the members' activities and performance.

## 10. DOCUMENTATION

### 10.1 Legal Provision

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 for under paragraph 82(1)(a) of the ITA, to enable the DG to ascertain income or loss from the business. Subsection 82(7) 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.

For transfer pricing purposes, adherence to the following documentation and record keeping requirements will be advantageous to the taxpayer as it reduces the risk of a tax audit and subsequent adjustments under section 140, which will be made according to what the DG thinks are reasonable transfer prices.

### 10.2 When to submit documents

Documents pertaining to transfer pricing are not to be submitted with Return Forms but should be made available to the IRB upon request. All relevant documentation must be in/translated into the Malay or English language, prepared at the time the transfer price is established, and contain particulars **(where applicable, depending on the type of transaction)** as stated under paragraph 10.3.

### 10.3 Information/Documentation Required

A list of documentation required is set out below. This list is neither intended to be exhaustive nor meant to apply to all types of businesses. The taxpayer should however maintain documents that are applicable to his circumstances and must be prepared to provide additional information or documentation not contained in this list, but which may be relevant for the determination of the arm's length price.

**A. Company details**

- i. Ownership structure showing linkages between all entities within the MNE.
- ii. Company organisation chart.
- iii. Operational aspects of business including details of functions performed.

**B. Transaction details**

- i. A summary of transactions with other entities in the same MNE. Indicate the name and address of each entity in the MNE with whom international transactions have been entered into and the type of transactions e.g. purchase of raw material or fixed assets, sale of finished goods, borrowing of money, etc.
- ii. A summary of transactions similar to the above, conducted with independent parties; or information derived from independent enterprises engaged in similar transactions or businesses.
- iii. Economic conditions during the time of transactions.
- iv. Terms of transactions. Also include where applicable contractual agreement with overseas associated parties with regard to: technical assistance fees, management fees, marketing fees, recruitment fees, or other services provided, royalties payable, purchase or rental of equipment or other assets, handling charges, loans, allocation of overhead expenses or any specific expenses (e.g. promotional or advertising) borne by the foreign entity, or other forms of payment made to overseas associates.

- v. Pricing policy over the past seven-year period.
- vi. Breakdown of product manufacturing costs.
- vii. Product price list.

**C. Determination of arm's length price**

- i. The pricing methodology adopted, showing how the arm's length price is derived. Please also indicate why that method is chosen over other methods.
- ii. Functional analysis taking into consideration all risks assumed and assets employed.
- iii. If a comparability analysis results in a range of arm's length outcomes, please furnish documents relating to all the outcomes. Reasons for choosing that particular arm's length price from the range of outcomes must be given.

**Note:**

All enquires with regards to this guideline can be forwarded to:

Audit Division

Inland Revenue Board

7<sup>th</sup> Floor, Block 9

Government Buildings Complex

Jalan Duta

**50600 Kuala Lumpur**

Tel. No. 62091000 ( ext. 3568, 3848, 3598 & 1615)