CHAPTER II

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 assoc persons, will be the basis adopted by IRBM. This is consistent with the objective of minimizing the possibility for double taxation. According to the a 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 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 wou made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of 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, barga power rarely comes into play. Unlike independent companies, multinational corporation group or multinational enterprises (hereinafter referred to as an " Group") usually operate based on its own set of conditions which normally do not reflect the market forces. While independent enterprises are concerned maximizing individual profits, by aiming for the lowest costs and highest returns, an MNC Group is concerned with overall group profits which may res 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 mater 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. 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 i 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 retur with value creation; and

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

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 econom 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 rel substance; and

(d) their transaction has commercial rationality and IRBM may disregard transactions when the exceptional circumstances of commercial irrationality app

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 made had the parties been independent and undertaking a comparable transaction under comparable circumstances (comparability analysis). There are tw aspects in such an analysis:

(a) to identify the commercial or financial relations between the associated persons and the conditions and economically relevant circumstances attachi 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 an 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 rel 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 fa affecting the performance of any business operating in that sector. The understanding is derived from an overview of that particular MNC Group w outlines how they respond to the factors affecting performance in the sector, including its business strategies, markets, products, its supply chain, th functions performed, material assets used, and important risks assumed. This information shall be provided by the taxpayer in support of the taxpa analysis of its transfer pricing and provides useful context regarding the commercial or financial relations between members of the MNC Group.

(b) identificatioan of how each MNC operates within the group, analysis of each MNC's activities (e.g. a production company, a sales company) identification of its commercial or financial relations expressed in transactions between them. The accurate delineation of the actual transactions bet 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 assoc 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 MNC Group), the circumstances surrounding th 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 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 transact 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 (su differences in the level of risk) when valuing those options. Therefore, identifying the economically relevant characteristics of the transaction is essent accurately delineating the controlled transaction and in revealing the range of characteristics taken into account by the parties to the transaction in reachin conclusion that the transaction adopted offers a clearly more attractive opportunity to meet commercial objectives than alternative options realisti 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 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 of Chapter II of the Guidelines.

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 tra 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 I gives priority to the availability of sufficient and verifiable information on both tested party and comparables. As such, IRBM does not accept foreign t 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 determinin 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 incurr assets employed. The use of an appropriate PLI ensures greater accuracy in determining the arm's length price of a controlled transaction. PLI is present 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 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 remuner 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 operatin expenses,
(ii) The value of the functions performed in the controlled transaction (taking account of assets used and risks assumed) is not materially affected b 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 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 assoc 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 appli either where the cost of goods sold consists of controlled purchases, however, operating expenses are reasonably independent from transfer pricing formula Unless, the operating expenses are affected by controlled transaction costs such as head office charges, rental fees or royalties paid to an associated person 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 comp 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. 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 (interna 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 fina 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 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 formalized b associated persons through written contractual agreements, those agreements provide the starting point for delineating the transaction between them and 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 unlike provide all the information necessary to perform a transfer pricing analysis. As such, further information will be required by taking into consideration evid of the commercial or financial relations provided by the economically relevant characteristics in the other four categories (see paragraph 2.5). Taken toge the analysis of economically relevant characteristics in all five categories provides evidence of the actual conduct of the associated persons. The follo example illustrates the concept of clarifying and supplementing the written contractual terms based on the identification of the actual commercial or fina relations.

Example 1

Company P is the parent company of an MNC Group situated in Country P. Company S, situated in Country S, is a wholly-owned subsidiary of Compa 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 abou marketing and advertising activities in Country S that the parties should perform. Analysis of other economically relevant characteristics and in particula functions performed, determines that Company S launched an intensive media campaign in Country S in order to develop brand awareness. This cam 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 assoc 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 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 intere 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 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 w contract, or whether the associated persons' actual conduct indicates that the contractual terms have not been followed, or do not reflect a complete pictu the transactions, or have been incorrectly characterized 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 a functions they actually perform, the assets they actually use, and the risks they actually assume, considered in the context of the contractual terms, IRBM 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 and risks assumed). Therefore, in delineating the controlled transaction and determining comparability between controlled and uncontrolled transactio entities, a functional analysis is necessary. This functional analysis seeks to identify the economically significant activities and responsibilities undert 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 provide.

For this purpose, the structure and organization of the associated persons and how they influence the context in which the MNC operates must be explaine particular, how value is generated by the group as a whole, the interdependencies of the functions performed by the associated persons with the rest o 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 func performed by the associated person under examination should be identified first. Any increase in economically significant functions performed shou 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 ra unique functions would earn the most profit. For example, a distributor performing additional marketing and advertising function is expected to h 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 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 as 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 assumed. Profitability of a company should rightfully increase with the increase in the amount, as well as the degree, of specificity of assets empl 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 w 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 hand in hand with identifying functions and assets and is integral to the process of identifying the commercial or financial relations between the assoc persons and of accurately delineating their transactions. Evaluation of risks assumed is crucial in determining arm's length prices with the econ 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 c be made. Therefore, risks assumed by each party has to be identified and considered since the actual assumption of risks would influence the prices o transactions between the associated persons and is an economically relevant characteristic that can be significant in determining the outcome of a tra 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 manage 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 decisi 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 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 financial and other consequences if the risk materializes. A party performing part of the risk management functions may not assume the risk that i 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 functio and to bear the consequences of the risk if the risk materializes. 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 material

(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 decisi 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 mitigation may be outsourced, as Example 2 illustrates. However, where these day-to-day mitigation activities are outsourced, control of the would require capability and performance to determine the objectives of the outsourced activities, to decide whom to hire as provider of the mitigation functions, to assess whether the objectives are being adequately met, and where necessary, to decide whether to adapt or terminat 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 uncertaint 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 Compa undertakes to perform manufacturing services, but that the product specifications and designs are provided by Company A, and that Company A deter 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 qu controls of the production process. Company A specifies the objectives of the quality control audits and the information that Company C should gather behalf. Company C reports directly to Company A. Analysis of the economically relevant characteristics shows that Company A controls its product recal 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 respo the risks. Besides that, Company A has the capability to assess and take decisions relating to the risk mitigation functions and actually performs these funct These include determining the objectives of the outsourced activities, the decision to hire the particular manufacturer and the party performing the qu 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 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 o 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 thr 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 th 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 outco 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 pr 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 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 risk by outsourcing risk mitigation activities, they will have to give evidence of a sequential and scheduled monitoring and administering done by the 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 Perm Establishment (PE) in Malaysia (subject to Double Taxation Agreement between Malaysia and the relevant country) as the local entity will be said 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. B 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 ran 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 s and environmental changes.

The assessment of such uncertainties may define the products and markets the company decides to target, and the capabilities it requires, inclu investment in intangibles and tangible assets, as well as in the talent of its human capital. Examples of such risks may include marketplace trends, 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 processe operations. The impact of such risks is highly dependent on the nature of the activities and the uncertainties the company chooses to assume. In circumstances breakdowns can have a crippling effect on the company's operations or reputation and threaten its existence; whereas succe 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 prod can affect competitive and reputational position, and give advantage to companies which bring competing products to market more quickly. infrastructure risks are internally driven and may involve capability and availability of assets, employee capability, process design and execu 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 ma liquidity and cash flow, financial capacity, and creditworthiness. The uncertainty can be externally driven, for example by economic shock or c crisis, but can also be internally driven through controls, investment decisions, credit terms, and through outcomes of infrastructure or operat 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 thr 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 br functional analysis of how value is created by the MNC. The economic significance of risk may be illustrated by the following two situations:

Example 4

The MNC Group supplies fuel oil to various industries in Malaysia. The fuel oils are mostly used by industries for process heating, steam generation and p generation, and marine vessels. Analysis of the economically relevant characteristics establishes that the product is undifferentiated, the market is compet 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 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 cr 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 m 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 determinin 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 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-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 b 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. risks may be explicitly assumed in the contractual arrangements. For example, a distributor might contractually assume accounts receivable risk, inve risk, and credit risks associated with the distributor's sales to unrelated customers. Other risks might be implicitly assumed. For example, contra arrangements that provide non-contingent remuneration for one of the parties implicitly allocate the outcome of some risks, including unanticipated p or losses, to the other party. However, purported assumption of risk by associated person when risk outcomes are certain or has materialised 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 tha pricing arrangements adopted in the contractual arrangements alone determine which party assumes risk. Therefore, one may not infer from the fac 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 born those associated persons in a particular manner. For example, a manufacturer may claim to be protected from the risk of price fluctuation of raw ma 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 i 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 w 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-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 fina 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 inform about how the associated persons operate in relation to the assumption and management of the specific, economically significant risks, and in parti about which person or persons perform control functions and risk mitigation functions, which person or persons encounter upside or dow 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 s development risk has been identified as economically significant in this transaction, and under step 2 it has been established that under the contract Compa 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 numb relevant decisions about whether and how to take on the development risk. These include the decision to perform part of the development work itself 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 objec 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 responsibilit carrying out the research under the control of Company A. Company B reports back to Company A at predetermined milestones, and Company A assesse progress of the development and whether its ongoing objectives are being met, and decides whether continuing investments in the project are warranted i 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 Company A's activities. Company B's risk is mainly to ensure it performs the research activities competently and it exercises its capability and authori control that risk through making decisions about the processes, expertise, and assets it needs. The risk Company B assumes is distinct from the develop 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 step is to interpret the information resulting from steps 1-3 and to determine whether the contractual assumption of risk is consistent with the condu the parties and the other facts of the case by analyzing;

(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 analyzed 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 contained in written contracts, or whether the contractual terms have not been followed or are incomplete. Where differences exist between contra terms related to risk and the conduct of the parties which are economically significant and would be taken into account by third parties in pricin transaction between them, the parties' conduct in the context of the consistent contractual terms should generally be taken as the best evidence conce the intention of the parties in relation to the assumption of risk.

If it is established that the associated persons assuming the risk as analyzed under step 4(a) either do not control the risk or do not have the fina capacity to assume the risk, then the analysis described under step 5 needs to be performed. Where the associated persons assuming risk (as analysed u 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 funct 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. T comparable those risk assumptions require that the economically relevant characteristics of the transactions are comparable. If such a comparison is m it is particularly relevant to establish that the persons assuming comparable risk in the uncontrolled transaction performs comparable risk manage 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 the financial capacity to assume the risk, then the risk should be allocated to the persons exercising control and having the financial capacity to assum risk.

If multiple associated persons are identified that both exercise control and have financial capacity to assume the risk, it should then be allocated t associated persons exercising the most control. The other parties performing control activities should be remunerated appropriately based o 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 financia 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. Th taxpayer that both assumes and mitigates a risk will be entitled to greater anticipated remuneration than a taxpayer that only assumes a risk, or 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 the financial consequences of success. Company B should be appropriately rewarded for the carrying out of its development services, incorporatin 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. Compa of product characteristics is used to a greater extent in the application of the Comparable Uncontrolled Price (CUP) method than any other me 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 a 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 20% is also an appropriate gross margin for Malaysian distributors of product X. Margins in different markets are influenced by factors such as cons 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 wheth independent person in the same circumstances as that of a controlled person would have adopted similar strategies and if so, what rewards would have expected. Business strategies that are relevant in determining comparability include innovation and new product development, degree of diversification, m 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 informa 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 c made. They should not be automatically made and would not be automatically accepted by IRBM. These adjustment make minor differences to the result reliable comparables have been selected. In cases where significant difference is calculated, it will raise concern as whether the differences resulted from issues.