TRANSFER PRICING

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Introduction

The Malaysian Transfer Pricing Guidelines explain the provision of Section 140A in the Income Tax 1967 and the Transfer Pricing Rules 2012. It governs the standard and rules based on the arm's le principle to be applied on transactions between associated persons.

Currently, the Guidelines is being updated to reinforce the existing standard and reformatted o presentation in the website. The Guidelines will be updated gradually based on Chapters. The ne updated chapter will be indicated and can be found under 'Updated version of Transfer Pricing 2012' the remaining chapters can be referred in the Transfer Pricing Guidelines 2012.

TRANSFER PRICING GUIDELINES

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**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.

## CHAPTER VIII

## INTANGIBLES

### 8.1 Identifying Intangibles

#### 8.1.1 Identifying intangibles

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

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

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

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

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

(b) Patents Act 1983 [Act 291];

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

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

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

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

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

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

#### 8.1.2 Categories of Intangibles

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

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

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

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

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

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

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

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

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

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

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

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

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

### 8.2 Ownership Of Intangibles And Analyzing Transactions Involving Development, Enhancement, Maintenance, Protection And Exploitation Of Intangibles (DEMPE)

#### 8.2.1 Ownership of Intangibles

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

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

(iii)

In identifying the owner of intangibles, the intangible and any license relating to that intangible are considered to be two separate and distinct intang each having a different owner. Intangible registration and licensing agreements can help identify the legal owner of the intangible and the owner o license.

Example 1

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

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

8.2.2 Analyzing transactions Involving Intangibles

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

(i) Identifying the intangibles

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

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

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

(ii) Analyzing the contractual terms

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

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

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

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

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

(iii) Functional Analysis

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

(b) Taxpayer needs to identify:

- the economically significant functions that contribute to the value of the intangibles and instrumental to the success of the DEMPE of the intangibles
- ascertain the relative importance of each DEMPE functions; and
- group members who:-

- perform and exercise control over the functions associated with the DEMPE of the intangibles;
- provide the assets and funding, and have financial capacity necessary to bear the cost in relation to the funding; and
- assume and exercise control over the various specific, economically significant risks associated with the intangible and have the financi capacity to bear the risks associated with DEMPE of the intangibles.

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

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

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

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

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

(iv) Control of the performance of significant functions.

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

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

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

(v) Funding

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

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

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

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

(vi) Risks associated with DEMPE of the intangibles

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

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

(b) Although the strategic decisions and overall directions from parent / foreign entities are cascaded down to the local entity, this does not imply tha foreign entity has control over the R&D functions of the local entity or would bear the related risks.

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

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

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

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

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

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

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

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

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

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

(ii) The extent to which one or more members of the MNC Group other than the legal owner perform functions, uses assets or assumes risks related t DEMPE of the intangible, will determine its arm's length compensation for their contributions. This compensation may, depending on the facts circumstances, constitute all or part of the return anticipated to be derived from the exploitation of the intangible.

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

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

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

(c) the amount and form of compensation paid.

(iv) Determining Arm's Length Compensation

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

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

- comparability factors that may contribute to the creation of value or generation of returns derived by the MNC Group from exploitation of th intangibles;

- the availability of comparable uncontrolled transactions;

- the importance and the relative contribution of the functions performed to the creation of intangible value; and

- the realistically available options of the parties.

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

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

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

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

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

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

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

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

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

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

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

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

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

(c) establishing networking / distribution channels;

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

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

(f) creating a reputational goodwill.

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

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

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

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

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

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

(vii) If the local entity only performs buy sell function (e.g. limited risks distributors) and undertakes marketing activities on behalf of its principal which di result in the development of marketing intangibles, the local entity has to be compensated by the principal for the marketing functions, where it sh earn;

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

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

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

8.2.6 Research, development and process improvement arrangement

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

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

(a) Some local entities are established to carry out research and development work under a contract for its associated foreign entity where the local en will have no ownership of the intangibles, and the results of the research and development activities will belong to the associated foreign en Generally, these local entities are treated as contract research and development companies with limited risks and the service fee paid to the local ent the cost of the research and development activities undertaken plus a mark-up. However, a compensation based on reimbursement of costs plus wi reflect the anticipated value of the intangibles created or the contribution of the research team. Therefore, the local entity should be rewarded base the functions performed, assets used and risks assumed that contribute to the value of the intangible. A proper analysis of the value provided b contract research and development entity to the overall group operations should be provided.

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

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

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

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

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

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

8.3 Transactions Involving The Use Or Transfer Of Intangibles

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

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

(i) Transfers of intangibles or rights in intangibles.

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

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

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

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

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

(ii) Transfers of combination of intangibles.

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

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

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

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

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

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

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

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

(d)

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

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

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

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

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

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

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

- the nature of such a transaction should be clearly specified;
- any relevant intangibles used by either of the parties in connection with such a controlled transaction should be identified; and
- these relevant intangibles should be taken into account when performing the comparability analysis (including the functional analysis), and in selection and application of the most appropriate transfer pricing method for that transaction.

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

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

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

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

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

8.4 Supplemental Guidance For Determining Arm's Length Conditions In Cases Involving Intangibles

8.4.1 Factors affecting comparability of intangibles or rights in intangibles

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

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

(a) expected benefits and usefulness of the intangible property;
(b) prevailing industry rates;
(c) terms of the agreement including geographic limitations, duration of the license, any termination or negotiation rights and exclusivity rights;
(d) legal protection;
(e) benefits to the licensor, arising from sharing of information on the experience of the licensee contributing towards further developments of the prop
(f) possibility of sub-licensing;
(g) the extent of any capital investment, start-up expenses or development work required or stage of development of intangible;
(h) rights to receive update, revisions or modifications of the intangibles; or
(i) technical assistance, trademarks and know-how provided along with access to any patent.

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

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

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

(ii) When selecting the most appropriate transfer pricing method, consideration should be given to the economic consequences of the transaction and n arbitrary label of the transactions itself.

(iii)

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

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

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

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

(a) the functions, assets and risks of the respective parties to the transaction;

(b) the business reasons for engaging in the transaction;

(c) the perspectives of and options realistically available to each of the parties to the transaction;

(d) the competitive advantages conferred by the intangibles including especially the relative profitability of products and services or potential products services related to the intangibles;

(e) the expected future economic benefits from the transaction; and

(f) other comparability factors such as features of local markets, location savings, assembled workforce, and MNC group synergies.

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

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

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

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

8.4.3 Application of the CUP Method

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

8.4.4 Application of transactional profit split method

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

8.4.5 Use of valuation techniques

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

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

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

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

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

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

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

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

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

(a) Accuracy of financial projections.

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

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

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

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

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

(b) Assumptions regarding growth rates.

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

(c) Discount rates

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

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

- It should be recognized that some businesses are inherently more risky than others and some cash flow streams are inherently more volatile th others. The discount rate or rates should reflect the level of risk in the overall business and the expected volatility of the various projected cas flows under the circumstances of each individual case.

- Since certain risks can be taken into account either in arriving at financial projections or in calculating the discount rate, care should be taken avoid double discounting for risk.

(d) Useful life of intangibles and terminal values

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

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

(e) Assumptions regarding taxes

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

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

(f) Form of payment

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

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

**CHAPTER X**

**COMMODITY TRANSACTIONS**

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

**10.2 What is Quoted Price?**

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

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

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

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

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

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

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

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

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

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

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

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

**10.5 Pricing Date**

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

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

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

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

## CHAPTER XI

## DOCUMENTATION

**11.1 Retention Of Records**

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

**11.1.2 For transfer pricing purposes, a taxpayer who has entered into a transaction with an associated person in the basis year for a year of assessment is requir not only maintain the above records, but also prepare and keep contemporaneous documentations. Notwithstanding the exclusions under paragraph 3 o Guidelines, the taxpayer is required to maintain contemporaneous documentation to assist in demonstrating whether the taxpayer's transfer pricing poli appropriate for tax purposes. At the same time, this alleviates the risk of transfer pricing adjustment and has relevance to penalty consideration during a tra pricing audit.**

**11.2 Transfer Pricing Documentation**

**11.2.1 Contemporaneous Transfer Pricing Documentation**

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

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

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

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

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

**Examples of changes in economic conditions include the following:**

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

**In preparing the documentation, the arm's length transfer price must be determined before pricing is established based upon the most current reliable data t reasonably available at the time of determination. However, taxpayers should review the price based on data available at the end of the relevant ye assessment and update the documentation accordingly.**

**11.2.2 Duty to prepare Transfer Pricing Documentation**

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

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

**The types of controlled transactions may involve:**

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

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

**11.2.3 Submission of Transfer Pricing Documentation**

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

**11.2.4 List of Documentation**

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

**(a) Organizational Structure**

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

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

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

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

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

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

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

(c) Controlled Transactions

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

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

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

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

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

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

(d) Pricing Policies

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

(i) the formula adopted, including anticipated profit margin/mark-up and cost component;

(ii) how the formula is applied;

(iii) who determine the pricing policy;

(iv) how often is the policy being revised;

(v) sample of documents to support the pricing policy; and

(vi) comparability study to ensure the arm's length price

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

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

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

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

(f) Comparability, Functional and Risk Analysis

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

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

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

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

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

(vi) identification of any internal comparables;

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

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

(g) Selection of the Transfer Pricing Method

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

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

(h) Application of the transfer pricing method

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

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

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

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

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

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

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

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

(i) Financial Information

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

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

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

(j)

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

(i) official publications, reports, studies and databases;
(ii) reports of market research studies carried out by recognized institutions;
(iii) technical publications brought out by recognized institutions;
(iv) agreements and contracts entered into with associated persons or with unrelated persons, which may be of relevance to the cross-border transactions;
(v) letters and other correspondence documenting any terms negotiated between the person and its associated person;
(vi) supporting documents for the economically significant activities and functions undertaken by the taxpayer. For example, where skilled and experienced staff constitute human resource assets for the taxpayer, documentation pertaining to these staff which may be relevant here including:

- details of experience;
- educational qualifications;
- areas of particular expertise;
- job description and duties;
- remuneration;
- written statements provided by key staff and used by taxpayer in determining the functions, risks and asset of the company;

(vii) other relevant documents.

11.2.5 Preparation and the Submission of Master File

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

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

The following information should be included in the master file:

(a) Organizational structure

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

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

General written description of the MNC's business including:

(i) important drivers of business profit;
(ii) a description of the supply chain for the group's five largest products and/or service offerings which are relevant to the taxpayer's controlle transactions by turnover, and any other products and/or services amounting to more than five percent of the group taxpayer's turnover (The required description could take the form of a chart or a diagram);
(iii) a list and brief description of important service arrangements between members of the MNC Group, other than research and development (R&D) services, including a description of the capabilities of the principal locations providing important services and transfer pricing polici for allocating services costs and determining prices to be paid for intra-group services;
(iv) a description of the main geographic markets for the group's products and services that are referred to in the second bullet point above;
(v) a brief written functional analysis describing the principal contributions to value creation by individual entities within the group, i.e. key functions performed, important risks assumed, and important assets used; and
(vi) a description of important business restructuring transactions, acquisitions and divestitures occurring during the financial year.

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

(i) A general description of the MNC's overall strategy for the development, ownership and exploitation of intangibles, including location of principal R&D facilities and location of R&D management;
(ii) A list of intangibles or groups of intangibles of the MNC Group that are important for transfer pricing purposes and which entities legally o them;
(iii) A list of important agreements among identified associated enterprises related to intangibles, including cost contribution arrangements, prin research service agreements and license agreements;
(iv) A general description of the group's transfer pricing policies related to R&D and intangibles; and
(v) A general description of any important transfers of interests in intangibles among associated enterprises during the fiscal year concerned, including the entities, countries, and compensation involved.

(d)

MNC's intercompany financial activities

(i) A general description of how the group is financed, including important financing arrangements with unrelated lenders;
(ii) The identification of any members of the MNC Group that provide a central financing function for the group, including the country under w laws the entity is organized and the place of effective management of such entities: and
(iii) A general description of the MNC's general transfer pricing policies related to financing arrangements between associated enterprises.

(e) The MNC's financial and tax positions

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

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

**11.2.6 The Extent of Relevant and Adequate Contemporaneous Documentation**

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

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

**11.2.7 Acceptability of Documentation**

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

(a) undertake a transfer pricing analysis to ascertain that transfer prices comply with the arm's length principle and reflect commercially realistic outcom for all controlled transactions;
(b) maintain documents that are applicable to the circumstances and be prepared to provide additional information or documentation not contained above which may be relevant for the determination of the arm's length price;
(c) prepare the documentation in accordance with the Rules and the Guidelines;
(d) implement and review the arm's length transfer pricing policies and redesign the transfer pricing policy to accommodate any changes in the business environment;
(e) prevent from providing vague, useless or inadequately founded information;
(f) apply a coherent and transparent approach in identifying uncontrolled transactions;
(g) provide detailed analysis of functions, assets, risks, market conditions and business strategies;
(h) apply a transfer pricing method in accordance with the Rules and these Guidelines;
(i) ensure that the factual, economic and empirical representations in transfer pricing documentation are company, product and market specific;
(j) ensure that the transfer pricing documentation is accurate and precise, and matches the accounting, financial and benchmarked data/comparables;
(k) highlight and document any specific event that may have hindered the MNE's performance so that appropriate fact-based adjustments can be conside
(l) avoid from preparing documentation which is of relatively limited use, incomplete and does not properly support the transactions; and
(m) maintain adequate background documents and full records containing particulars about the factual assumptions and relevant factors that have been ta into account in working out the arm's length price.

**11.2.8 Language**

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

**11.3 Penalty**

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

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

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

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

(a) Form and substance is not the same; i.e. where the agreement does not reflect the actual conduct between the taxpayer and its associated person.
(b) Comparables selected by the taxpayer do not meet all of the economically relevant characteristics or comparability factors set out in the Rules.
(c) Inaccurate or misleading explanation of function, assets and risk; e.g. where a taxpayer claims that it does not bear the foreign exchange risk but in substance it does, and this is reflected in its accounts.

11.3.5 Penalty will not be imposed in cases, where:

(a) transfer pricing documentation is submitted within 30 days upon request by the DGIR; and
(b) the transfer pricing documentation prepared fulfils the requirement of the Rules and these Guidelines, wherein reliable and correct information provided by the taxpayer.

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