INLAND REVENUE BOARD OF MALAYSIA



MALAYSIA TRANSFER PRICING GUIDELINES 2024

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APPENDIX A

DIRECTORS GENERAL'S GUIDELINES

Section 134A of the Income Tax Act 1967 ("ITA") provides that the Director General is empowered to issue guidelines in relation to the application of any provisions of the ITA.

A guidelines is published as a guide for the public and officers of the Inland Revenue Board of Malaysia. It sets out the interpretation of the Director General of Inland Revenue in respect of the particular tax laws and the policy as well as the procedure applicable to it.

The Director General may revoke, revise or amend this guidelines either wholly or in part, by notice of withdrawal or by publication of a new guidelines.

Director General of Inland Revenue,
Inland Revenue Board of Malaysia.

GLOSSARY

Arm's length price

A price which would have been determined if such transactions were made between independent entities under the same or similar economic circumstances.

Arm's length range

The arm's length range referred to in subrule 13(5) of the Income Tax (Transfer Pricing) Rules 2023 [P.U.(A) 165/2023] ("Rules").

Associated person

Persons referred to in sections 139, 140A(5) and (5A) of the ITA.

Balancing payment

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

Buy-in payment

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

Buy-out payment

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

Contemporaneous transfer pricing documentation

A transfer pricing documentation which is brought into existence prior to the due date for furnishing a return for the basis period for a year of assessment in which a controlled transaction is entered into and shall contain information as required under the Rules.

Controlled transaction

Transaction for acquisition or supply of property or services between associated persons.

Economic owner

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

Financial assistance

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

Functional analysis

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

Intangible property

An asset which is neither a physical asset nor a financial asset but such asset is capable of being owned or controlled for use in commercial purposes, whose use or transfer would be compensated had it occurred in a transaction between independent persons in comparable circumstances which includes patent, invention, formula, process, design, model, plan, trade secret, know-how or marketing intangible.

Intentional set-off

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

Interest

Includes finance charge, discount, premium or other consideration relating to a controlled transaction.

Intra-group services

Services rendered between associated persons.

Legal owner

The registered owner of an intangible property / asset.

Marketing intangible

An intangible that relates to marketing activities of a property or service which has an important promotional value for the property or service concerned which includes trademarks, trade names, customer lists, customer relationships and proprietary market and customer data that is used or aids in marketing and selling property or services to customers.

Median

The value at the mid-point of the arm's length range.

Multinational Enterprise Group (MNE Group)

A group of associated companies with business establishments in two or more jurisdictions.

Permanent establishment

Having the same meaning as provided in subrule 14(2) of the Rules.

Person

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

Property

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

Related party

Refers to 'associated person'.

Relative

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

Service

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

Tested party

The parties to a controlled transaction where a particular transfer pricing method is applied.

Traditional transactional method

The comparable uncontrolled price ("CUP") method or the resale price method ("RPM") or the cost plus method ("CPM").

Transaction

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

Transactional profit method

The profit split method or the transactional net margin method ("TNMM").

Transfer price

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

Uncontrolled transactions

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

INTRODUCTION AND OBJECTIVE

INTRODUCTION

Transfer pricing generally refers to intercompany pricing arrangements for the acquisition or supply of property or services between associated persons. Ideally, the transfer price should not differ from the prevailing market price, which would be reflected in a transaction between independent persons. However, business transactions between associated persons may not always reflect the dynamics of market forces.

The Malaysia Transfer Pricing Guidelines ("the Guidelines") are primarily based on the governing standard for transfer pricing which is the arm's length principle as set out under the Organisation for Economic Co-operation and Development ("OECD") Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("OECD TPGL"). Some references have also been made to the United Nations ("UN") Practical Manual on Transfer Pricing for Developing Countries ("UN Practical Manual on TP"). Although some parts of the Guidelines have been adopted directly from the OECD TPGL and UN Practical Manual on TP, there may be areas that differ to ensure adherence to the ITA, Rules and procedures established by the Inland Revenue Board of Malaysia ("IRBM") as well as domestic circumstances. In this regard, the Guidelines may be reviewed from time to time to reflect any changes to the requirements needed.

It is important to emphasize that the Guidelines, the Rules, and the ITA establish the primary legal obligations regulating transfer pricing conduct and issues in Malaysia. Taxpayers are required by law to comply with and adhere to those legal obligations. While certain aspects of this Guidelines may have been directly influenced by the OECD TPGL and the UN Practical Manual on TP, there may be variations in the Guidelines to ensure strict compliance with the specific requirements set forth in the Malaysian legal framework and IRBM's procedures. These modifications are designed to accommodate Malaysia's unique domestic conditions.

Notwithstanding those as mentioned above, the arm's length principle remains as the guiding principle throughout the Guidelines. Examples shown in the Guidelines are for illustrative purposes only. Thus, in dealing with actual cases, the facts and circumstances of each case must be examined with care before deciding on the applicability of any of the methods described in the Guidelines.

OBJECTIVE

The Guidelines are updated in accordance with the amendments made to section 140A, the introduction of section 113B of the ITA, and the amendments made to the Rules. These Guidelines have effect from the year of assessment 2023 and subsequent years.

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

CHAPTER 1 – SCOPE AND APPLICATION

SCOPE

1.1. The Guidelines are applicable to all controlled transactions for the acquisition or supply of property or services between associated persons, where at least one person is assessable or chargeable to tax in Malaysia. For the purpose of clarity, the acquisition or supply of property or services includes financial assistance or financial transactions.

1.2. In order to comply with the arm's length principle, a person who participated in a controlled transaction may refer to the Guidelines as guidance for the purpose of preparing contemporaneous transfer pricing documentation ("CTPD").

1.3. A CTPD refers to a transfer pricing documentation prepared in accordance with the Rules and is brought into existence prior to the due date for furnishing a return in the basis period for a year of assessment in which a controlled transaction is entered into. Therefore, taxpayers should complete the CTPD and date it before submitting their tax return for a relevant year of assessment.

1.4. A permanent establishment ("PE") shall prepare its own full CTPD separately from its head office and related branches, as specified under the Rules, regardless of whether the PE has fulfilled paragraphs 1.5 or 1.7.

1.5. To ease the compliance burden, the following persons are not required to prepare a CTPD –

(a) individuals not carrying on a business;

(b) individuals carrying on a business (including partnerships) who only engage in domestic controlled transactions;

(c) person who entered into controlled transactions with a total amounting to not more than RM1 million; or

(d) person who entered solely into domestic controlled transactions with another person where both parties –

(i) do not enjoy tax incentives;
(ii) are taxed at the same headline tax rate; or
(iii) do not suffer losses for two consecutive years prior to the controlled transactions.

1.6. Persons who are exempted in paragraph 1.5 of the Guidelines must still comply with the arm's length principle for all controlled transactions entered into and must ensure to keep all relevant documents that are related to the controlled transactions, including documentation to support and prove the determination of the arms' length price.

1.7. A person shall prepare a full CTPD as provided under the Rules if the person fulfils the following –

(a) generates gross business income of more than RM30 million in total and engages in cross-border controlled transactions totalling RM10 million or more annually; or

(b) receives or provides controlled financial assistance of more than RM50 million annually.

The following scenarios are examples that explain the threshold applied in this paragraph:

Scenario	Paragraph 1.7(a)			Paragraph 1.7(b)	Falls under the threshold in paragraph 1.7
	Gross business income (RM)	Total cross-border controlled transactions (RM)	Total domestic control transactions (RM)	Controlled financial assistance received/ provided (RM)	
A	40 million	15 million	Nil	Nil	Yes
B	40 million	12 million	10 million	Nil	Yes
C	40 million	9 million	10 million	Nil	No
D	40 million	8 million	15 million	51 million	Yes
E	5 million	9 million	Nil	51 million	Yes
F	20 million	20 million	Nil	40 million	No
G*	20 million	Nil	15 million	60 million	Yes
Note: ** A person who meets the criteria set forth in paragraph 1.5(d) is not required to prepare a CTPD*					

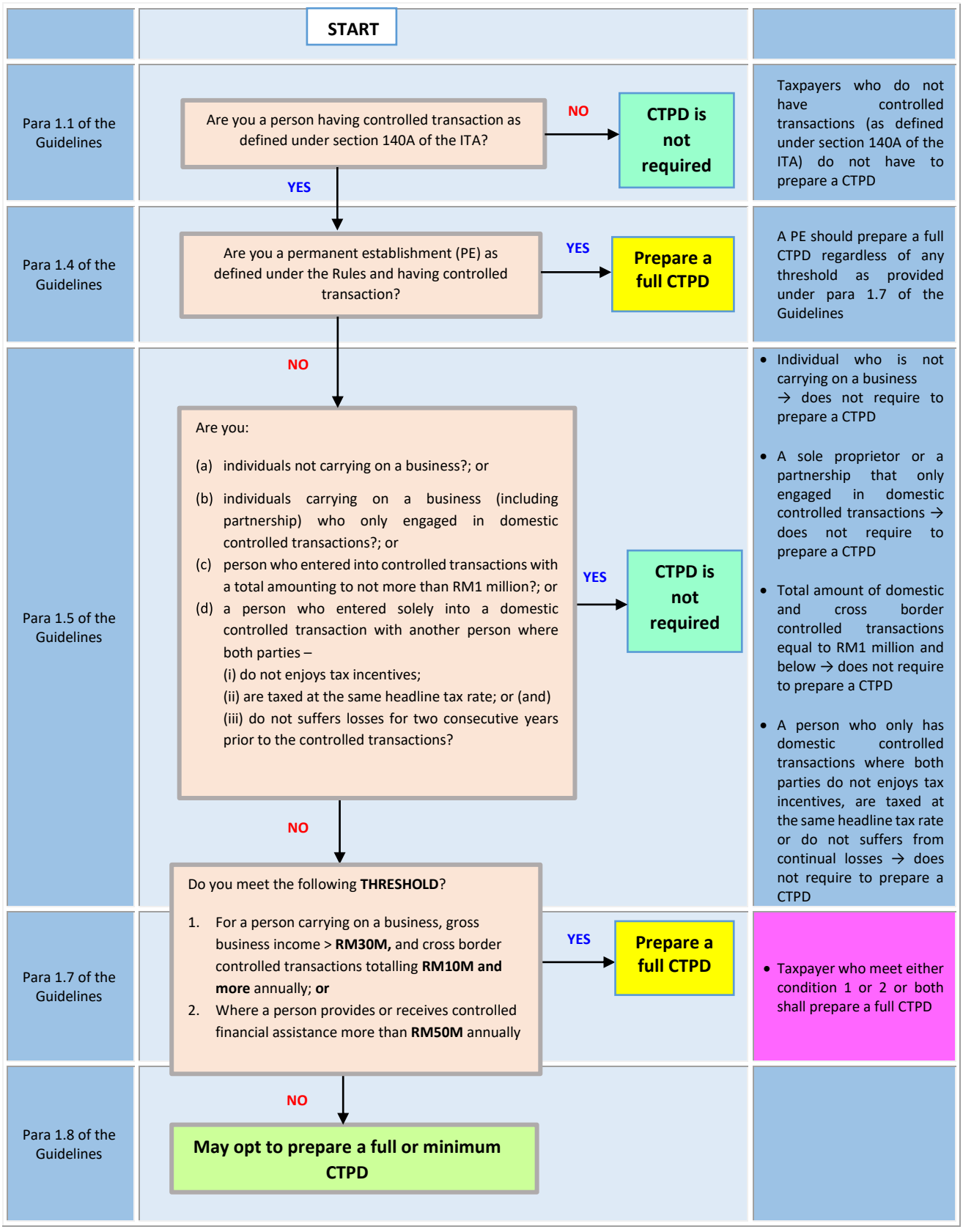
1.8. A person who enters into a controlled transaction but does not fall under paragraph 1.5 or paragraph 1.7 of the Guidelines is eligible to prepare a minimum CTPD. Thus, the person may opt to prepare a full or minimum CTPD.

1.9. A minimum CTPD refers to a transfer pricing documentation that is prepared with reduced requirements and should be completed and dated prior to the submission of a return in the basis period for a year of assessment in which a controlled transaction is entered into.

1.10. In preparing a minimum CTPD, a taxpayer is allowed to apply any method allowed by the Director General that is able to demonstrate compliance with the arm's length principle, as long as it results in a better approximation of the arm's length price. Details on the minimum CTPD are elaborated further in Chapter 11.

1.11. The following is a summary of the scope and application for the preparation of a CTPD:

Scope and Application for the Preparation of CTPD



APPLICATION

1.12. In addition to the interpretation of 'companies in the same group' provided under subsection 2(4) of the ITA, section 139 of the same ITA has established 'controlled companies' through direct or indirect control.

1.13. Under the Guidelines, two companies are associated with each other if one of the companies participates directly or indirectly in the management, control or capital of the other company; or if the same person participates directly or indirectly in the management, control or capital of both companies.

1.14. Section 140A was introduced to specifically address transfer pricing issues where taxpayers are required to determine and apply the arm's length price on controlled transactions. This section further allows the Director General of Inland Revenue ("DGIR") to make necessary adjustments, either to substitute or impute the price or interest, as the case may be, to reflect the arm's length price or interest rate, if the DGIR has reason to believe that a controlled transaction is not at arm's length. Furthermore, effective from 1.1.2021 the DGIR may also disregard any structure adopted in entering into a transaction if the economic substance differs from its form or the said structure is not commercially rational to be adopted.

1.15. Prior to 1.1.2019, 'controlled transactions' refer to transactions that occurred between:-

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

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

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

1.16. However, effective 1.1.2019, a new subsection 140A(5A) expands the meaning of "control" for transfer pricing purposes. According to this new provision, 'control' exists when a person or third person holds at least 20% of the share capital and meets one or more of the following conditions:

(a) The business operations of a person depends on the proprietary rights, such as patents, non-patented technological know-how, trademarks, or copyrights, provided by the other person or third person; or

(b) The business activities, such as purchases, sales, receipt of services, provision of services, of a person are specified by the other person, and the prices and other conditions relating to the supply are influenced by such other person or third person; or

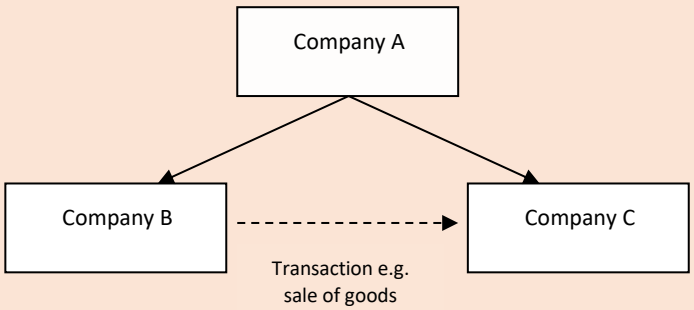
(c) One or more of the directors or members of the board of directors of a person are appointed by the other person or third person.

To ease the implementation and administration of subsection 140A(5A) of the ITA, only taxpayers having a basis period beginning on or after 1st January 2019 will be subjected to the new application of the expanded "control" definition.

EXAMPLE OF CONTROL

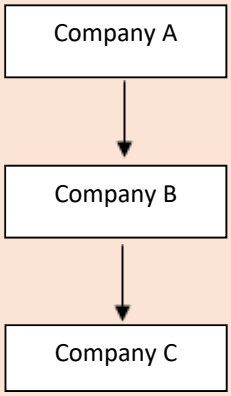
1.17. The following are scenarios for when the "control" referred to in paragraphs 1.15 and 1.16 is applicable:

Example 1.1



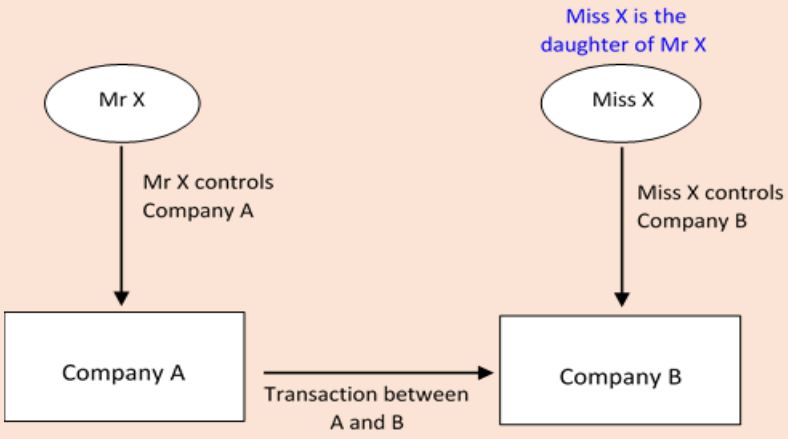
In this example, Company A controls Company B and Company C through share ownership. As Company A controls both Company B and Company C, Companies B and C are associated persons. Therefore, transfer pricing provisions apply to transactions between the two.

Example 1.2



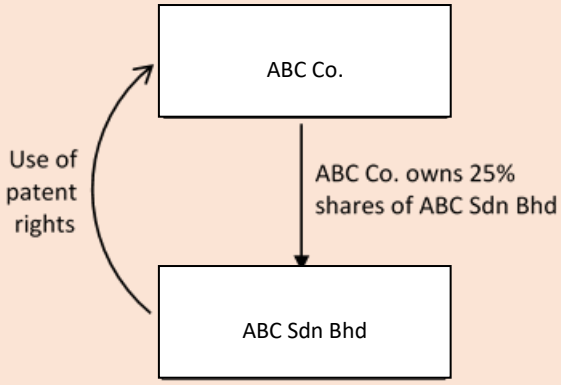
Company A controls Company B, which in turn controls Company C. Company A thus indirectly controls Company C and transfer pricing provisions apply to transactions between them.

Example 1.3



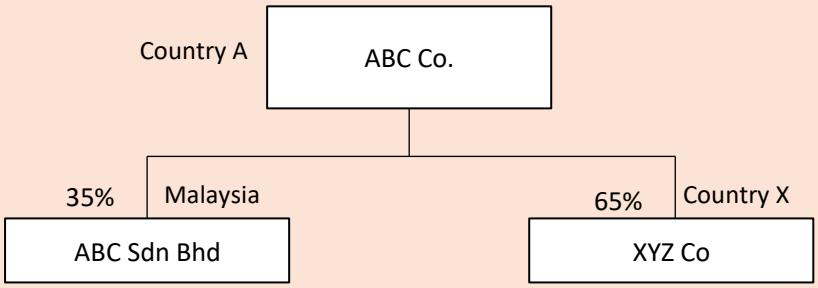
Transactions between Company A and Company B are deemed controlled transactions under the ITA due to the relationship that exists between Mr X and Miss X where Miss X is a family member of Mr X.

Example 1.4



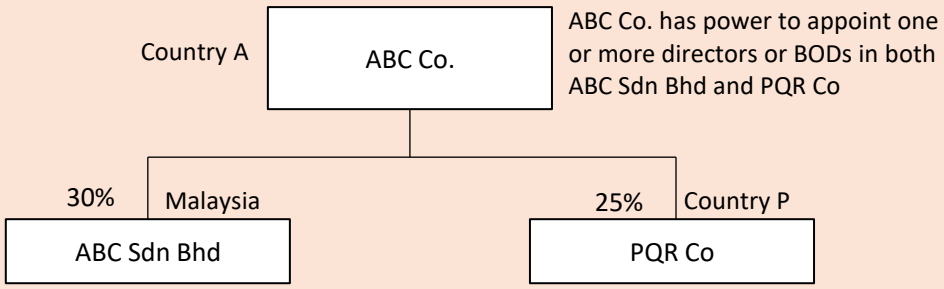
ABC Co. holds 25% of shares in ABC Sdn Bhd and the remaining shares are held by unrelated entities. ABC Sdn Bhd relies solely on the intellectual property (IP) owned by ABC Co. in its production activities in Malaysia. Therefore, any transactions between ABC Co. and ABC Sdn Bhd are controlled transactions.

Example 1.5



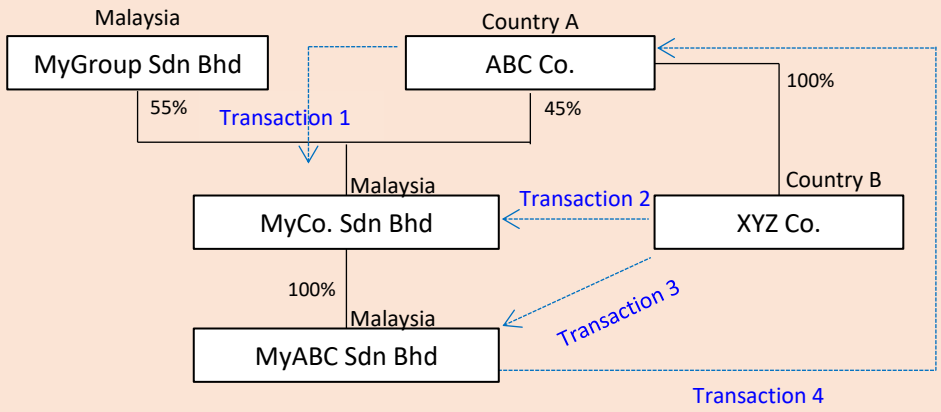
ABC Co. holds a 35% stake in ABC Sdn Bhd and also owns a 65% shareholding in XYZ Co. in Country X. ABC Co. has ordered ABC Sdn Bhd to purchase raw materials from XYZ Co. Due to this business instruction, any transactions between ABC Co and ABC Sdn Bhd are controlled transactions.

Example 1.6



ABC Co. has the power to appoint one or more directors or members of the board of directors ("BODs") in ABC Sdn Bhd and PQR Co. For the purpose of the Guidelines, the interpretation of "director" shall have the same meaning as defined in subsection 2(1) of the ITA. Therefore, any transactions among ABC Sdn Bhd, ABC Co. and PQR Co. are controlled transactions.

Example 1.7



MyCo. Sdn Bhd has five (5) Executive Directors out of which two (2) Executive Directors are appointed by ABC Co.

Based on the illustration provided in Example 1.7, the guidance on the application of subsection 140A(5A) of the Act is as follows:

(a) Transaction 1 – Purchase transaction between MyCo. Sdn Bhd and ABC Co.

ABC Co has control over MyCo Sdn Bhd due to the fact that the company holds 45% of the shareholding in MyCo Sdn Bhd and is responsible for the appointment of two directors in MyCo Sdn Bhd. Therefore, ABC Co and MyCo Sdn Bhd are associated persons for transfer pricing purposes and the purchase transaction between them is a controlled transaction.

(b) Transaction 2 – Purchase transaction between MyCo. Sdn Bhd and XYZ Co.

XYZ Co is a subsidiary of ABC Co. Since both XYZ Co and MyCo Sdn Bhd are controlled by the same person i.e. ABC Co, both of them are associated persons for the purposes of transfer pricing. Any transactions conducted between them are controlled transactions and shall comply with the arm's length principle.

(c) Transaction 3 – Purchase transaction between MyABC Sdn Bhd and XYZ Co.

Purchases between XYZ Co and MyABC Sdn Bhd are not considered controlled transactions since they were not conducted between associated persons due to the fact that XYZ Co does not hold any shareholding in MyABC Sdn Bhd.

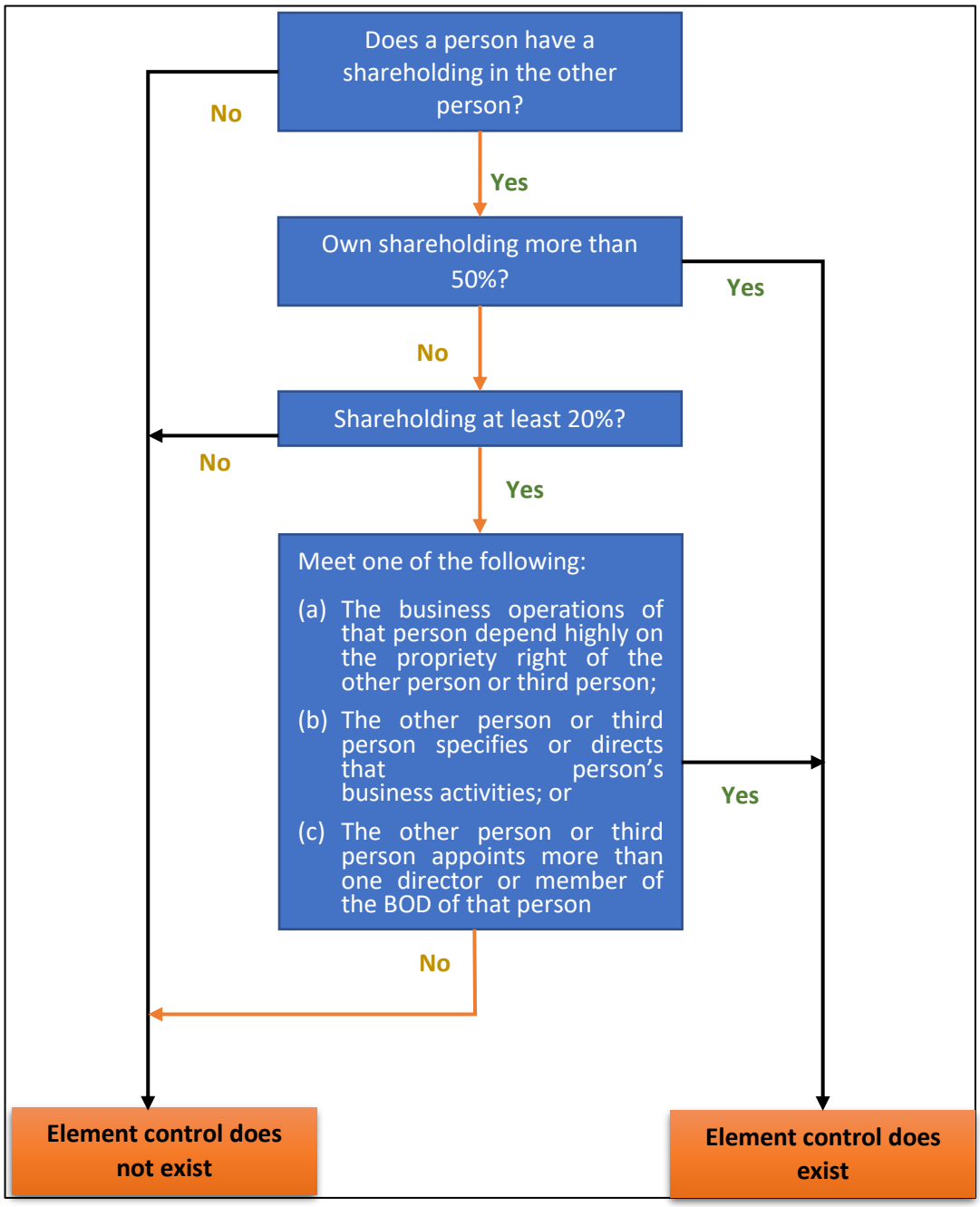
(d) Transaction 4 – Sale transaction by MyABC Sdn Bhd to ABC Co.

Similar to transaction 3, since ABC Co does not have any direct shareholding in MyABC Sdn Bhd, they are not considered associated persons. Hence, the sale transaction between them is not a controlled transaction.

1.18. The following table shows a summary of the application of subsection 140A(5A) in Example 1.7:

Transaction	Buyer	Seller	Nature of Transaction	Controlled Transaction under subsection 140A(5A) (Yes / No)	
1	MyCo. Sdn Bhd	ABC Co.	Purchase of goods	**Yes**	Element of control exist since ABC Co's shareholding in MyCo Sdn Bhd is more than 20% and ABC Co has responsibility in appointing the directors of MyCo. Sdn Bhd.
2	MyCo. Sdn Bhd	XYZ Co.	Purchase of goods	**Yes**	Element of control exists since both companies are controlled by the same person.
3	MyABC Sdn Bhd	XYZ Co.	Purchase of goods	**No**	Element of control does not exist since there is no direct shareholding between both companies.
4	ABC Co.	MyABC Sdn Bhd	Sale of goods	**No**	

1.19. General flow on the application of subsection 140A(5A) of the ITA



CHAPTER 2 – THE ARM'S LENGTH PRINCIPLE

APPLICATION OF ARM'S LENGTH PRINCIPLE

2.1 IRBM has adopted the arm's length approach in determining the transfer price of a controlled transaction. This is due to the fact that the arm's length approach is preferred internationally and consistent with the objective of minimising the possibility of double taxation. In the arm's length approach, a transfer price of a controlled transaction must adhere to the arm's length principle. According to the arm's length principle, a transfer price is acceptable if the controlled transactions are conducted at the arm's length price, which refers to the price that would have been determined if such transactions were uncontrolled transactions.

2.2 Paragraph 1 of Article 9 of the OECD Model Tax Convention on Income and on Capital has set forth the arm's length principle as:

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

2.3 When independent persons transact with each other, the conditions of their commercial and financial relations are ordinarily determined by market forces. However, in transactions between associated persons, control elements may exist that affect their commercial and financial relations and do not normally reflect market forces as in independent transactions. While independent persons are concerned with maximising individual profits by aiming for the lowest costs and highest returns, Multinational Enterprise Group ("MNE Group") usually operates based on their own set of conditions, which are normally concerned with the overall group profits and may result in an unequal distribution of profits within the group.

2.4 In other words, controlled transactions may not be priced in accordance with the arm's length principle, while uncontrolled transactions are normally arm's length compliant.

2.5 The following example illustrates the difference between controlled and uncontrolled transactions:

Example 2.1

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

However, control elements typically exist in control transactions, influencing both the price and the manner in which raw materials are to be purchased. It is unlikely for Company A to bargain for the best price, as its controlling entity sets the price. It is not impossible to witness prolonged losses in cases like Company A, which has no or low bargaining power in the price it is willing to pay for raw materials.

2.6 In essence, the application of the arm's length principle –

(a) treats associated persons as if they operate as separate and independent entities rather than as inseparable parts of a single unified business; and

(b) is generally based on a comparison of prices, margins, division of profits or other indicators of controlled transactions with uncontrolled transactions.

ARM'S LENGTH RANGE AND ARM'S LENGTH PRICE

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

2.8 The arm's length range should be constructed using only comparable uncontrolled transactions that have or have been adjusted to a high level of reliability in comparison to the controlled transactions. A substantial deviation among points or between the data in the range may indicate that comparables used are not reliable and that material differences exist in terms of functions, assets and risks ("FAR"). In such cases, the reliability of comparable data must be carefully assessed and necessary adjustments may be made for any material differences in comparability analysis. Furthermore, it is also essential to review the methodology used. If it is possible to determine comparables which have lesser degree of comparability than others, those comparables should be eliminated.

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

2.10 In a situation where a price (including the rate of interest imposed or would have been imposed in a controlled transaction) is presented by a taxpayer as arm's length-compliant using a set of comparables that do not have similar economically relevant characteristics as compared to the tested party determined under paragraphs 2.17 to 2.58 of the Guidelines, the DGIR may, on review, make an adjustment to reflect the arm's length price or arm's length interest rate for that transaction.

2.11 If the taxpayer disagrees with the adjustment made under paragraph 2.10 of the Guidelines, a detailed analysis and supporting documents should be presented by the taxpayer to demonstrate that the selected comparables have similar economically relevant characteristics to the tested party for all the five (5) characteristics as determined under paragraphs 2.17 to 2.58 of the Guidelines.

2.12 The Rules defines the arm's length range as "a range of figures or a single figure falling between the value of 37.5 percentile to 62.5 percentile of the data set and acceptable by the DGIR…". However, due to insufficient comparables in Malaysia, any benchmarking data set would have varying degrees of comparability and some dissimilarity with the taxpayer's profile. Therefore, the DGIR may adjust to the median or any point above median within the arm's length range if the DGIR has reason to believe that the comparables have a lesser degree of comparability or there are any comparability defects that cannot be identified, quantified or adjusted accordingly.

2.13 Applying a two-step process is necessary to determine the arm's length price compliance of the controlled transactions. The following examples illustrate the two-step process, which involves calculating the arm's length range and the median in accordance with the Rules.

Example 2.2

Step 1: Calculating the arm's length range

Comparables	CPM %
Co A	3.70
Co B	(2.48)
Co C	5.41
Co D	8.05
Co E	0.96
Co F	6.20
37.5 percentile [percentile inc.(data set, 0.375)]	3.36
62.5 percentile [percentile inc.(data set, 0.625)]	5.51

If the tested party's CPM is between 3.36% to 5.51%, the pricing may be regarded to be the arm's length price.

Step 2: Calculating the median

Description	CPM
37.5 percentile (a)	= 3.36%
62.5 percentile (b)	= 5.51%
Median {mid-point [(a) + (b)] / 2}	= 4.43%

If tested party CPM is below than 3.36%, it can be deduced that the pricing is not arm's length price-compliant. In this scenario, a transfer pricing adjustment may be made to the median in accordance with the Rules, i.e., 4.43% to reflect the arm's length price.

Example 2.3

Step 1: Calculating the arm's length range

Comparables	CPM %
Co A	27.17
Co B	7.76
Co C	2.33
Co D	3.47
Co E	3.60
Co F	3.60
Co G	1.15
Co H	1.13
Co I	34.18
Co J	5.63
Co K	10.87
37.5 percentile [percentile inc. (data set, 0.375)]	3.57
62.5 percentile [percentile inc. (data set, 0.625)]	8.54

If the tested party's CPM falls between 3.57% to 8.54%, the pricing may be regarded to be the arm's length price.

Step 2: Calculating the median

Description	CPM %
37.5 percentile (a)	3.57
62.5 percentile (b)	8.54
Median {mid-point [(a) + (b)] / 2}	6.05

If the tested party's CPM is less than 3.57%, then the transfer pricing adjustment may be made to the median in accordance with the Rules to best reflect the arm's length price.

**Note:*
CPM – Cost plus mark-up

GUIDANCE IN APPLYING THE ARM'S LENGTH PRINCIPLE

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

(a) ensuring that an entity does not receive inappropriate returns just because it has contractually assumed risks or provided capital, but rather aligns the returns with value creation; and

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

2.15 A taxpayer needs to ensure that:

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

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

(c) no premium returns will be allocated to capital-rich entities that have no other relevant economic activities without relevant substance as capital without functionality will generate no more than a free-risk return; and

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

2.16 The application of the arm's length principle is based on a comparison of the conditions in a controlled transaction with similar uncontrolled transactions under comparable circumstances. There are two key aspects in such an analysis:

No	Analysis
1	Identify the commercial or financial relations between the associated persons and the conditions and economically relevant circumstances attached to those relations to ensure accurate delineation of the controlled transaction.
2	Compare the conditions and the economically relevant circumstances of the accurately delineated controlled transaction with the conditions and the economically relevant circumstances of comparable uncontrolled transactions

Identifying the commercial and financial relations and the economically relevant characteristics

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

(a) a broad-based understanding of the industry sector (e.g., mining, pharmaceuticals, luxury goods) in which the associated person operates, as well as the factors affecting the performance of any business operating in that sector. The understanding is derived from an overview of that particular MNE Group, which outlines how the group responds to the factors affecting performance in the sector, including their business strategies, markets, products, supply chain, key functions performed, material assets used, and important risks assumed. This information shall be provided by

the taxpayer in support of the taxpayer's analysis of its transfer pricing as it provides useful context with regards to the commercial or financial relations between members of the MNE Group.

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

2.18 To accurately delineate the actual transaction, there is a need to identify the economically relevant characteristics of the commercial or financial relations involved in the controlled transactions. These economically relevant characteristics can be broadly categorised into five (5) themes as follows:

No	Theme
1	The contractual terms of the controlled transaction [paragraphs 2.21 to 2.26 of the Guidelines].
2	(a) The functions performed by each of the associated persons to the controlled transactions, considering the assets used and the risk assumed, including [paragraphs 2.27 to 2.54 of the Guidelines]: how those functions relate to the wider generation of value by the MNE Group to which the associated persons belong, the circumstances surrounding the transactions and industry practices; and (b) determining the economic significance of risks, contractual and actual assumption of risks, functional analysis in relation to the risks and how the risks affect the pricing of a controlled transaction.
3	The characteristics of property transferred or services provided [paragraph 2.55 of the Guidelines]

No	Theme
4	The economic circumstances of the parties to the controlled transactions and the market in which those parties operate [paragraph 2.56 of the Guidelines]
5	The business strategies pursued by the parties to the controlled transactions [paragraph 2.57 of the Guidelines]

2.19 Information on the economically relevant characteristics of the actual transaction is required under Schedule 2 of the Rules to support the taxpayer's analysis of its transfer pricing.

Information on economically relevant characteristics is used in a transfer pricing analysis in two separate but related phases. Those phases are described as follows:

Phase 1: Accurately delineating the controlled transaction.

- This phase relates to the process of accurately delineating a controlled transaction, which involves establishing the characteristics of the transaction, including its terms, the functions performed, assets used, and risks assumed by the associated persons, the nature of the products transferred or services provided, and the circumstances of the associated persons. The extent to which any one of the characteristics categorised above is economically relevant in a particular transaction depends on the extent to which it would be taken into account by independent persons when evaluating the terms of the same transaction were it to occur between them.

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

Phase 1: Accurately delineating the controlled transaction.

- When valuing realistically available options, independent persons would generally take into account any economically relevant differences (such as differences in the level of risk). Therefore, identifying the economically relevant characteristics of a controlled transaction is essential to accurately delineating the controlled transaction and in revealing the range of characteristics taken into account by the parties to the transaction.

Phase 2: Making comparisons between controlled transactions and uncontrolled transactions to determine an arm's length price for the controlled transaction.

- This phase relates to the process set out in Chapter 4 (Comparability Analysis) of making comparisons between the controlled transactions and uncontrolled transactions in order to determine an arm's length price for the controlled transactions.

- To make such comparisons, a taxpayer first needs to identify the economically relevant characteristics of the controlled transaction and accurately delineate the actual transaction. Any differences in economically relevant characteristics between the controlled and uncontrolled arrangements need to be taken into consideration to determine comparability and identify necessary adjustments to achieve the highest level of comparability.

- All methods that apply the arm's length principle can be tied to the concept that independent persons consider the realistically available options, and in comparing those options, they consider any differences between the options that would significantly affect their values. For instance, independent persons would normally be expected to consider whether a lower price for an equivalent product is available on otherwise comparable terms and conditions before purchasing a product at a given price.

Phase 2: Making comparisons between controlled transactions and uncontrolled transactions to determine an arm's length price for the controlled transaction.

- In establishing an arm's length price, it is important to decide the level at which transactions are compared. The level of transaction is determined based on the following comparison criteria:
  - (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 the gross margin level;
  - (d) results at the net margin level; or
  - (e) results of various other measures, such as return on capital, ratio of costs to gross margin, etc

2.20 The most appropriate comparable should be selected in adherence to the economically relevant characteristics as provided under the Rules and discussed in paragraph 2.18 of the Guidelines.

Identifying economically relevant characteristics: Contractual terms of the transaction [paragraph 2.18(1) of the Guidelines]

2.21 A transaction is the result or expression of the commercial or financial relations between the parties. Where a controlled transaction has been formalised through written contracts, those contracts provide the starting point for delineating the transaction and identifying how the responsibilities, risks and anticipated outcomes were intended to be divided at the time of entering into the contracts.

2.22 Other than written contracts, the terms of a transaction can also be found in communications between the parties. The written contracts alone are unlikely to provide all the information necessary to perform a transfer pricing analysis. If the other economically relevant characteristics provide evidence of commercial or financial relations, further information would be required (see paragraph 2.18 of the Guidelines). When all economically relevant characteristics are evaluated collectively, it provides a clear understanding of the actual conduct and behaviour of the associated persons.

2.23 The following example illustrates the concept of clarifying and supplementing the written contractual terms based on the identification of the actual commercial or financial relations.

Example 2.4

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

In this example, the characteristics of the control transaction that are economically relevant are inconsistent with the written contract between the associated persons. The actual conduct should define the actual transaction for the purposes of the transfer pricing analysis.

2.24 In transactions between independent persons, the divergence of interests between the parties ensures that contractual terms concluded reflect the interests of both parties and will ordinarily seek to hold each other to the terms of the contract. The contractual terms will be ignored or modified if the terms are not in the interests of both parties. However, associated persons may not experience the same divergence of interests or may manage any such divergences through the control relationship rather than solely or mainly through contractual terms.

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

2.26 Where there are material differences between contractual terms and the actual conduct of the associated persons, IRBM has the right, based on the factual economic substance, to accurately delineate the actual transaction.

Identifying Economically Relevant Characteristics: Functional Analysis of Functions Performed, Risks Assumed and Assets Employed [paragraph 2.18(2)]

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

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

Functions

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

2.30 Usually, when various functions are performed by independent persons, the party that provides the most effort and particularly the rare or unique functions earns the most profit. For example, a distributor performing additional marketing and advertising functions is expected to have a higher return from the activity as compared to those who do not perform such functions.

Assets

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

Type of Assets	Analysis
Tangible assets employed	Tangible assets such as property or plant and equipment are usually expected to earn long-term returns that are commensurate with the business risks assumed. The profitability of a company should rightfully increase with the increase in the amount as well as the degree of specificity of the assets employed. Quantifying these amounts whenever possible helps determine the level of risks borne and the level of profit a company should expect.
Intangible assets employed	Intangible assets are also expected to generate returns for the owners by way of sales or licensing. Thus, it is essential to identify the parties to whom the generated returns are attributable.

Risks

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

2.33 Controlled and uncontrolled transactions are not comparable if there are significant differences in the risks assumed for which appropriate adjustments cannot be made. Therefore, it is crucial to identify and consider the risks each party assumed, as this can significantly influence the prices of controlled transactions and is an economically relevant characteristic in determining the outcome of a transfer pricing analysis.

2.34 In this Chapter, references are made to terms that require an initial explanation and definition as below:

Terms	Explanation/ Definition
Risk management	The function of assessing and responding to risk associated with commercial activity. Risk management comprises three elements: 1. The capability to make decisions to take on, lay off, or decline a risk-bearing opportunity, together with the actual performance of that decision-making function; 2. 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 3. The capability to mitigate risk, that is, the capability to take measures that affect risk outcomes, together with the actual performance of such risk mitigation.
Risk assumption	Taking on the upside and downside consequences of the risk with the result that the party assuming a risk will also bear the financial and other consequences if the risk materialises. A party performing part of the risk management functions may not assume the risk that is the subject of its management activity but may be hired to perform risk mitigation functions under the direction of the risk-assuming party.

Terms	Explanation/ Definition
Financial capacity to assume risk	Access to funding to take on the risk or to lay off the risk, to pay for the risk mitigation functions and to bear the consequences of the risk if the risk materialises. Access to funding by the party assuming the risk takes into account the available assets and the options realistically available to access additional liquidity, if needed, to cover the costs anticipated to arise should the risk materialise.
Control over risk	It entails elements (1) and (2) of risk management
Risk mitigation	Measures taken that are expected to affect the risk outcomes. Such measures may include measures that reduce uncertainty or measures that reduce the consequences in the event that the downside impact of risk occurs

2.35 It is not necessary for a party to perform day-to-day risk mitigation in order to have control of the risks. Example 2.5 illustrates the possibility of outsourcing day-to-day risk mitigation. However, where these day-to-day risk mitigation activities are outsourced, control of the risk would require capability and performance to determine the objectives of the outsourced activities, to decide whom to hire as the provider of the risk mitigation functions, to assess whether the objectives are being adequately met and where necessary, to decide whether to adapt or terminate the contract with that provider.

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

Example 2.5

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

The contractual relationships imply that Company A bears the inventory risk and product recall risk. Company A hires Company C to perform regular

quality controls on the production process, where Company A specifies the objectives of the quality control audits and the information that Company C should gather on its behalf. Company C reports directly to Company A. An analysis of the economically relevant characteristics shows that Company A controls its product recall and inventory risks by exercising its capability and authority to make a number of relevant decisions about whether and how to take on risk and how to respond to the risks.

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

Example 2.6

Assume that an investor hires a fund manager to invest its funds. Depending on the agreement between the investor and the fund manager, the latter may be given the authority to make portfolio investments on behalf of the investor on a day-to-day basis, reflecting the investor's risk preferences, even though the investor bears the risk of loss in value of the investment. In this example, the investor is controlling its risks through these four relevant decisions:

(a) the decision about its risk preference and consequently, the required diversification of the risks associated with the various investments that comprise the portfolio;

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

(c) the decision of the extent of authority given and objectives assigned to the fund manager, and

(d) the amount of the investment managed by the fund manager

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

This illustrates the fact that an investor who gives another person the authority to perform risk mitigation activities such as those performed by the fund manager does not necessarily transfer control of the investment risk to the person making these day-to-day decisions.

2.37 For entities claiming to have control over risk by outsourcing risk mitigation activities, they will have to provide evidence of a sequential and scheduled monitoring and administering done by them. In cases where monitoring is performed online, the controlling entity should be able to substantiate and show proof of the activity performed by them.

2.38 Where a controlling entity has control over the activity done by their associated persons, the controlling entity may have PE in Malaysia (subject to Double Taxation Avoidance Agreement between Malaysia and the relevant country), as the local entity will be said to be performing the activity on behalf of the controlling party.

Risk Analysis Framework

2.39 Steps in analysing the risk in a controlled transaction to ensure accurately delineating the actual transaction with regards to risk:

Step	Process
1	Identify economically significant risks with specificity
2	Contractual assumption of the risk
3	The functional analysis in relation to the risk
4	Interpreting steps / processes in 1 to 3
5	Allocation of the risk
6	Pricing of the transaction

Step 1: Identify economically significant risks with specificity

2.40 There are numerous ways to categorise risk. However, transfer pricing analysis places emphasis on the sources of uncertainty that give rise to risk. Below is a

non-exclusive list of sources of risk (not intended to suggest a hierarchy or rigid category of risk, but rather as examples of a possible range of risk that can arise in a transfer pricing analysis):

Sources of risk	Description
Strategic risks or marketplace risks	These are largely external risks caused by the economic environment, political and regulatory events, competition, technological advances, or social and environmental changes. The assessment of such uncertainties may define the products and markets the company decides to target and the capabilities it requires, including investment in intangibles and tangible assets, as well as the talent of its human capital. Examples of such risks may include marketplace trends, new geographical markets, and concentrations of development investment.
Infrastructure or operational risks	These are likely to include the uncertainties associated with the company's business execution and may include the effectiveness of processes and operations. The impact of such risks is highly dependent on the nature of the activities and the uncertainties the company chooses to assume. In some circumstances, breakdowns can have a crippling effect on the company's operations or reputation and threaten its existence; whereas successful management of such risks can enhance reputation. In other circumstances, the failure to bring a product to market on time, to meet demand, to meet specifications or to produce high-standard products can affect competitive and reputational positions and give advantages to companies that bring competing products to market more quickly. Some infrastructure risks are internally driven and may involve the capability and availability of assets, employees' capability, process design and execution, outsourcing arrangements and IT systems.
Financial risks	All risks are likely to affect a company's financial performance, but there are specific financial risks related to the company's ability to manage liquidity and cash flow, financial capacity, and creditworthiness. The uncertainty can be externally driven, for example by an economic

Sources of risk	Description
	shock or credit crisis, or internally driven through controls, investment decisions, credit terms and the outcomes of infrastructure or operational risks.
Transactional risks	These are likely to include pricing and payment terms in a commercial transaction for the supply or acquisition of property or services.
Hazard risks	These are likely to include adverse external events that may cause damages or losses, including accidents and natural disasters. Such risks can often be mitigated through insurance, but insurance may not cover all the potential losses, particularly where there are significant impacts on operations or reputation.

2.41 Determining the economic significance of risk and how risk may affect the pricing of a controlled transaction is part of the broader functional analysis of how value is created by the MNE Group. The following situations may illustrate the economic significance of risk:

Example 2.7

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

Such circumstances may limit the ability to influence margins. 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 the cost of capital is, therefore, significant in the context of how value is created for the distribution function.

Example 2.8

A multinational toy retailer buys a wide range of products from a number of third-party manufacturers. Most of its sales are concentrated in the last two months of the calendar year and a significant risk relates to the strategic direction of the buying function, making the right bets on trends and

determining the products that will sell and in what volumes. Trends and the demand for products can vary across markets, thus, expertise is needed to evaluate the right bets in the local market. The effect of the buying risk can be magnified if the retailer negotiates a period of exclusivity for a particular product with the third-party manufacturer.

The aforementioned examples highlight the importance of focusing on the decision-making role of the parties in determining control over the risk. The decision-maker will have control over the risk.

Step 2: Contractual assumption of risk

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

2.43 The assumption of risk has a significant effect on determining arm's length pricing for a controlled transaction, but it should not be concluded that the pricing arrangements in the contractual arrangements determine which party assumes risk. The fact that associated persons set the price for goods or services at a specific level or margin does not imply that those associated persons bear the risks in a specific way. For example, a manufacturer may claim to be protected from the risk of price fluctuation of raw materials as a consequence of it being remunerated by another group company on the basis that it takes account of its actual costs. The claim implies that the other company in the group bears the risk.

2.44 The type of remuneration cannot dictate inappropriate risk allocations. It is the determination of how the parties actually manage and control risks that will determine the assumption of risks by the parties and consequently dictate the selection of the most appropriate TPM.

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

Step 3: Functional analysis in relation to risk

2.46 In this step, the analysis examines the risk management functions of associated persons in a controlled transaction, focusing on control and mitigation functions, potential outcomes and financial capacity to assume and manage significant economic risks.

Example 2.9

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

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

Company A has mitigated its risk by taking measures to outsource development activities to Company B, which assumes the day-to-day responsibility for carrying out the research under the control of Company A. Company B reports back to Company A at predetermined milestones and

Company A assesses the progress of the development and whether its ongoing objectives are being met and decides whether continuing investments in the project are warranted in light of that assessment.

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

Step 4: Interpreting steps 1 to 3

2.47 Carrying out steps 1 to 3 entails gathering information regarding the assumption and management of risks in a controlled transaction. The next step involves interpreting the results of steps 1 to 3, and determining whether the contractual assumption of risk is consistent with the conduct of the parties and other facts of the case by analysing:

(i) whether the associated persons follow the contractual terms under the principles of paragraphs 2.21 to 2.26 of the Guidelines; and

(ii) whether the party assuming risk, as analysed under step 4 paragraph 2.47(i) ("step 4(i)"), exercises control over the risk and has the financial capacity to assume the risk.

2.48 In line with the discussion in paragraphs 2.21 to 2.26 of the Guidelines, it should be considered under step 4(i) whether the parties' conduct conforms to the assumption of risk contained in written contracts or whether the contractual terms have not been followed or are incomplete. Where differences exist between contractual terms related to risk and the conduct of the parties that are economically significant and would be taken into account by third parties in pricing the transaction between them, the parties' conduct in the context of consistent contractual terms should generally be taken as the best evidence concerning the intention of the parties in relation to the assumption of risk.

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

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

Step 5: Allocation of risk

2.51 If it is established in step 4 paragraph 2.47(ii) that the associated persons assuming the risk based on steps 1 to 4(i) do not exercise control over the risk or do not have the financial capacity to assume the risk, then the risk should be allocated to the persons exercising control and having the financial capacity to assume the risk.

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

Step 6: Pricing of the transaction

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

2.54 An appropriate anticipated return should compensate for the assumption of a risk and risk mitigation should also receive appropriate remuneration. Thus, a taxpayer that both assumes and mitigates a risk will be entitled to greater anticipated remuneration than a taxpayer that only assumes a risk or only mitigates it but does not do both.

Example 2.10

In the circumstances provided in Example 2.9, Company A assumes and controls the development risk and should bear the financial consequences of failure and enjoy financial success. An appropriate reward should be awarded to Company B for its development services and for taking on the risk when it fails to do so.

Identifying the economically relevant characteristic of the transaction - Characteristics of Property or Services [paragraph 2.18(3) of the Guidelines]

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

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

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

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

Identifying economically relevant characteristics: Economic Circumstances [paragraph 2.18(4) of the Guidelines]

2.56 Arm's length prices vary across different economic circumstances. Factors that may influence a transaction's price or margin include the following:

(a) the geographic location of the market;

(b) the size of the market;

(c) the extent of market competition;

(d) the level of supply and demand in the market as a whole or 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 2.11

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

Identifying economically relevant characteristics: Business Strategies [paragraph 2.18(5) of the Guidelines]

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

2.58 For transfer pricing documentation to be regarded as contemporaneous transfer pricing documentation, complete information on economically relevant characteristics is required. Failure to do so exposes the taxpayer to a penalty under section 113B of the ITA.

RE-CHARACTERISATION OF TRANSACTIONS

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

2.60 In determining an arm's length price, IRBM may disregard and re-characterise any structure of a controlled transaction if there is evidence that:

No	Circumstances
1	the economic substance of the controlled transaction differs from its form.
2	the form and substance of the controlled transaction are the same, but the arrangements made in relation to the transaction, when viewed in totality, differ from those which would have been adopted by

No	Circumstances
	independent persons behaving in a commercially rational manner and that transaction's structure practically impedes IRBM from determining an appropriate transfer price.

2.61 The need to re-characterise a controlled transaction is based on the rationale that the character of the transaction is derived from the relationship between the associated persons and is not determined by normal commercial conditions. The controlled transaction may have been structured in such a way by the taxpayer to avoid or minimise tax. This is supported by the fact that:

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

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

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

(d) The principle in paragraph 2.60 is illustrated in the following examples:

Example 2.12

Company A Sdn Bhd (Malaysian Co.) obtains a loan from its associated company, Company B (Foreign Co.), without providing security, imposing covenants, or restricting the use of the financing. The intra-group financial transaction incurred a high interest rate due to a lack of security, financial or operational covenants on the granted debt. The DGIR concludes that for any other similar conditions, an independent entity would have been required to provide appropriate security to obtain such a level of financing and would have been subject to certain financial or operational covenants. Taking into account Company A's financial background and credit risk, no unrelated party would be willing to provide a loan to Company A, particularly without providing any security or imposing covenants or restrictions on the use of the financing.

In this situation, the DGIR will question the economic substance of the credit facility between Company A Sdn Bhd and Company B, arguing that the terms

and conditions for such a loan would not have been agreed upon between independent parties (particularly without providing security or imposing covenants or restrictions on the use of the financing).

As a result, the DGIR would not recognise the transaction and disregard its structure as provided under paragraph 140A(3A)(b) of the ITA. Once the DGIR has invoked subsection 140A(3A) of the ITA, the structure will be adjusted, resulting in the disallowance of interest payments for such a "loan".

Example 2.13

Company S1 (Malaysia Co.) has a manufacturing business that involves holding substantial inventory and making significant investments in plant and machinery. The company owns commercial property in an area that has become more susceptible to flooding in recent years. Third-party insurers experience significant uncertainty about their exposure to large claims, resulting in no active market for property insurance in the area. Company S2 (Foreign Co.), an associated person, provides insurance to S1, and an annual premium representing 80% of the value of the inventory, property and contents is paid by S1.

In this example, S1 has entered into a commercially irrational transaction since there is no market for insurance given the likelihood of significant claims and either relocation or not insuring may be more attractive and realistic alternatives.

Since the controlled transaction is commercially irrational, no price is acceptable to both companies from their individual perspectives. The DGIR may disregard the commercially irrational transaction and S1 is treated as not purchasing insurance and the payment to S2 will be disallowed.

A NON-ARM'S LENGTH APPROACH – GLOBAL FORMULARY APPORTIONMENT

2.62 Global formulary apportionment has sometimes been suggested as an alternative to the arm's length principle as a means of determining the proper level of profits across national taxing jurisdictions.

2.63 Global formulary apportionment refers to a method that uses a predetermined and mechanistic formula normally based on a consolidation of costs, assets, payroll and sales to allocate the global profits of an MNE Group among associated persons in different countries.

2.64 However, IRBM does not accept methods based on global formulary apportionment on the basis that they are arbitrary, disregard the market condition and could not reliably approximate the arm's length condition.

CHAPTER 3 – TRANSFER PRICING METHODOLOGIES

INTRODUCTION

3.1 Transfer pricing methodology (“TPM”) refers to the approach used to determine the transfer price for the acquisition or supply of property or services as well as tangible and intangible assets transferred between associated persons. TPM plays a crucial role in enabling the MNE Group to navigate the complexities of international taxation while promoting fairness, compliance, and efficient global business operations.

3.2 There are two commonly used methods to determine whether the conditions imposed in the commercial or financial relations between associated persons are consistent with the arm's length principle, namely the traditional transaction method and the transactional profit method.

3.3 The traditional transaction method is regarded as the most direct way for determining the arm's length nature of conditions in commercial and financial relations between associated enterprises. This is due to the fact that any discrepancy between the price of a controlled transaction and the price of a comparable uncontrolled transaction typically traces back directly to the commercial and financial relations established or enforced between the enterprises, and one can establish arm's length conditions by directly substituting the price of the controlled transaction for the price of the comparable uncontrolled transaction.

3.4 The transactional profit method is found to be more appropriate in cases where, for example, there is no or limited publicly available reliable gross margin information on the parties or in circumstances where each of the parties makes unique and valuable contributions in relation to the controlled transaction or where the parties engage in highly integrated activities.

3.5 The IRBM prefers a method that requires the fewest adjustments and provides the most reliable measure of an arm’s length result, as this will reduce the scope and nature of future disputes. Therefore, in deciding the most appropriate method, the following must be considered:

(a) The nature of the controlled transaction, determined through particular a functional analysis;

(b) Availability of reliable information on uncontrolled comparables needed to apply the selected method; and

(c) The degree of comparability between controlled and uncontrolled transactions, including the reliability of comparability adjustments that may be needed to eliminate material differences between them.

3.6 Where a traditional transaction method and a transactional profit method can be applied in an equally reliable manner, the traditional transaction method is preferable.

3.7 The DGIR may also allow any other method in determining the arm's length price of a controlled transaction, provided that that method is proven to provide the highest degree of comparability between the transactions and the prices arrived at are in accordance with the arm's length principle (rule 6 of the Rules).

3.8 The traditional transaction method and transactional profit method consist of the following:

TPM	Methods
Traditional Transaction Method	• Comparable uncontrolled price method • Resale price method • Cost plus method
Transactional Profit Method	• Transactional net margin method • Transactional profit split method

COMPARABLE UNCONTROLLED PRICE METHOD

3.9 The comparable uncontrolled price (“CUP”) method is the most direct way of ascertaining an arm’s length price. In the CUP method, uncontrolled comparable transactions are a must. The method compares the price in a controlled transaction for the acquisition or supply of property or services with the price in a comparable uncontrolled transaction under comparable circumstances. A

difference between the two prices may be an indication that the conditions of the commercial and financial relations of the control transaction are not arm's length and that the price in the uncontrolled transaction may need to substitute for the price in the controlled transaction.

3.10 The method is only ideal in circumstances where none of the differences (if any) between the transactions being compared or between the entities undertaking those transactions could materially affect the price in an open market or where such differences arise, reasonably accurate adjustments can be made to eliminate the material effects of those differences. If it is not possible to adjust for those material differences, other methods should be considered.

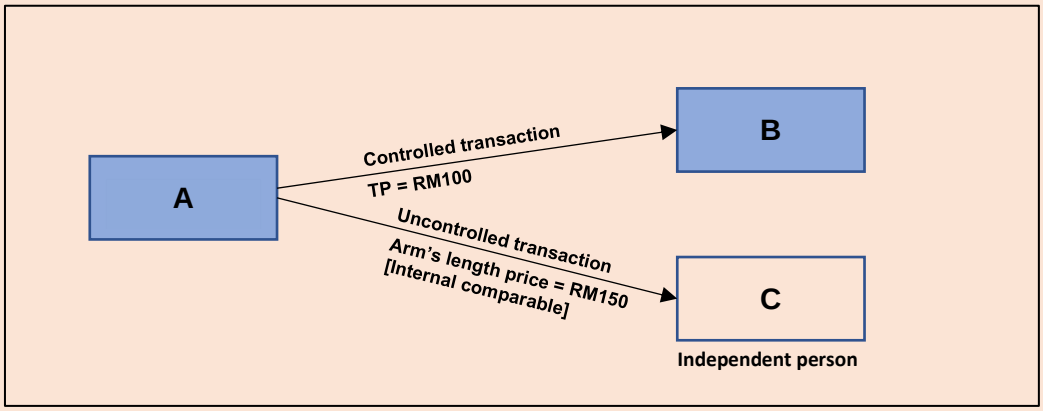
3.11 When applying the CUP method, an MNE should first identify all the differences between its transaction and that of an independent person. Then, the MNE should determine whether these differences have a material effect on the price and adjust the price of the independent person's transaction accordingly to reflect these differences to arrive at an arm's length price. The following factors, amongst others, should be taken into consideration:

Comparability factors
(a) Product characteristics: the physical features and quality; (b) If the transaction is in the form of services, the nature and extent of such services; (c) Whether the transactions are compared at the same points in the supply chain; (d) Product differentiation in the form of patented features such as trademarks, designs, etc.; (e) Volume of sales: whether it has an effect on the price; (f) Timing of sale: whether it is affected by seasonal fluctuations or other changes in market conditions; (g) Whether the costs of transportation, packaging, marketing, advertising, and warranty have been incorporated into the deal; and (h) Whether the transactions are carried out in locations with similar economic conditions.

3.12 The CUP method allows for the determination of the arm's length price through either an internal or an external comparable transaction. Internal CUP occurs when the entity to be tested also has a comparable transaction with an unrelated person. External CUP refers to situations where there are comparable transactions between two unrelated persons. The application of those two categories can be found in the following illustrations:

Example 3.1

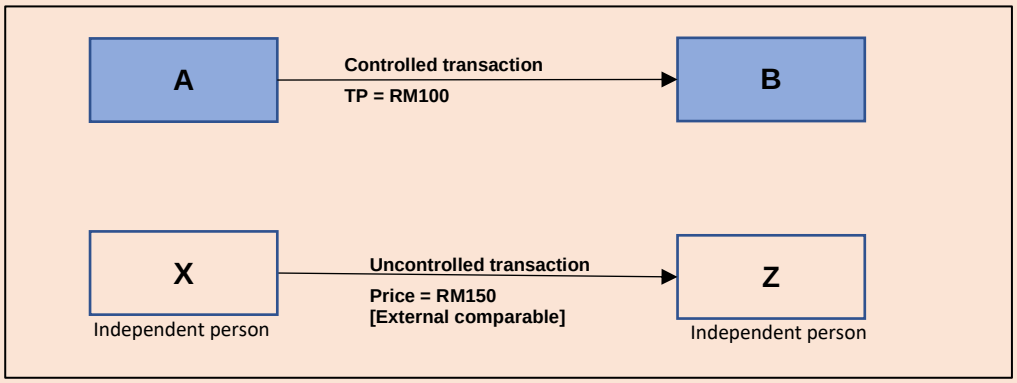
Taxpayer **A** is an MNE and sells 60% of its product to an associated person **B** at a price of RM100 per unit. The remaining 40% of the product is sold to an independent person **C** for RM150 per unit.



The products sold to **B** and **C** are identical; therefore, the transaction between **A** and **C** may be considered a comparable uncontrolled transaction. However, a functional analysis of **B** and **C** should first be carried out to identify any differences between both transactions. If such differences exist, adjustments should be made to account for those differences. Adjustments should also be made to account for product quantity discounts since the volumes of sales to **B** and **C** are different. If there are no material differences that require adjustments, the CUP method may be applied using the unit price of **RM150** as a comparable arm's length price

Example 3.2

Manufacturer **A** exports its product to **B**, an associated person. Manufacturer **X** exports the same product in similar quantities and under similar terms to **Z**, an independent person operating in the same markets as **B**. The uncontrolled sales price is a delivered price, whereas the controlled sales are made FOB factory.



These differences in terms of transportation and duties have an effect on price. Therefore, adjustments should be made to the uncontrolled transaction to eliminate the differences.

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

RESALE PRICE METHOD

3.13 The RPM is generally most appropriate where the final transaction is with an independent person and the reseller adds little value to the products. The RPM begins with the price at which a product that has been purchased from an associated person is resold to an independent person. This price (the resale price) is then reduced by an appropriate gross margin (the resale price margin), representing the amount out of which the reseller would seek to cover its selling and other operating expenses and in the light of functions performed (taking into

account assets used and risks assumed), make an appropriate profit. The remaining profit after subtracting the gross margin can be regarded as an arm's length price for the original transaction between the associated persons after adjusting for other costs associated with the purchases, such as customs duties.

3.14 The resale price margin of the reseller in the controlled transaction may be determined by reference to the resale price margin that the same reseller earns on products purchased and sold in comparable uncontrolled transactions.

3.15 A typical adjustment for determining the arm's length price under the RPM method may be represented as follows:

$$\textbf{Arm's Length Price} = \textbf{Resale price} - \left(\textbf{resale price} \times \textbf{resale price margin}^{1}\right)$$

$$^{1}\textbf{Resale price margin} = \frac{\textbf{Sales price} - \textbf{Purchase price}}{\textbf{Sales price}}$$

[1] *resale price margin must be comparable to margins earned by other independent persons performing similar functions, bearing similar risk and employing similar assets*

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

3.17 When considering RPM, the emphasis is more on the functions performed than the product characteristics. Comparability factors that may influence the margin and other considerations that should be taken into account, include:

Comparability factors

(a) Functions or level of activities of the reseller which could range from providing minimal services to assuming full ownership and responsibility for the risk involved in the transactions. For example, the reseller may function solely as a forwarding agent or a distributor who assumes full responsibility for marketing and advertising the product while risking its own resources in these activities;

(b) Degree of added value or alteration undertaken by the reseller before the product is resold. If the product has gone through a significant number of processes, the RPM is difficult to apply;

(c) Similar assets are employed in controlled and uncontrolled transactions, e.g., a developed distribution network;

(d) Product similarities are still significant to some extent, especially when there is a high value or unique intangible attached to the product;

(e) Variation in business management that may potentially impact profitability;

(f) Time lapse between the original purchase and the resale of the product, as a longer time lapse may lead to changes in the market, exchange rates, costs, etc.;

(g) Exclusivity of rights to resell the products; and

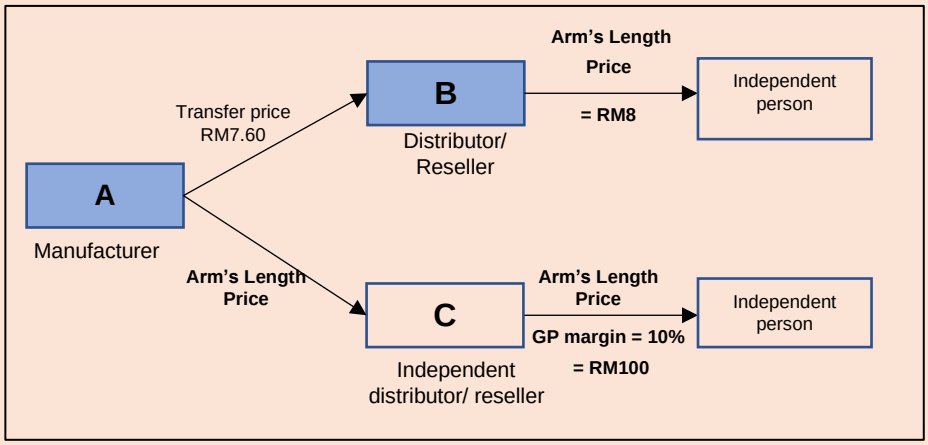
(h) Differences in accounting practices where adjustments must be made to ensure that the components of costs arriving at gross margins in controlled and uncontrolled transactions are the same.

3.18 The application of the RPM is provided in the following examples:

Example 3.3

Taxpayer **B** is a Malaysian distributor and a subsidiary of oversea based multinational **A**. While **B** distributes high-quality products manufactured by **A,** **A** also sells a lower-quality version of the product to an independent distributor, **C** also operating in Malaysia. **B** purchases the product from **A** for RM 7.60 per unit and resells it to an independent person for RM 8. A

functional analysis shows that **B** and **C** perform similar functions and the gross profit ratio of **C** is 10%.



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

	RM
Selling price by B [per unit]	8.00
Cost [purchase price from A]	7.60
Different	0.40
GP Margin	5%

The arm's length price for purchase transactions between A and B can be determined by using the GP margin of 10% as the basis under the RPM. The formula in paragraph 3.15 is used to calculate the following:

Purchase from A by B:	**RM**
Resale price	8.00
Resale price margin	10%
Arm's length price = RM8 – (RM8 X 10%)	7.20
GP Margin	10%

Therefore, the purchase price between **A** and **B** should be adjusted to RM7.20 to reflect the arms' length gross margin of 10% received by the independent person.

Example 3.4

The facts are the same as in Example 3.3, with the new assumption that controlled and uncontrolled transactions have the following differences:

(a) **B** assumes the warranty risk, but **C** does not, as the risk is borne by **A**; and

(b) **A** provides samples and promotional materials to **C** free of charge (FOC), while **B** produces its own promotional materials and bears the related costs.

Because of these differences, the two margins do not meet the comparability requirement. Thus, an adjustment needs to be made to account for those differences.

In this scenario, the following calculation illustrates how the adjustment should be made to account for the differences to achieve comparability.

Calculation of adjusted resale price margin	RM	RM
Distributor B net sales to independent customer		8.00
Arm's length resale price margin of C (%)		10%
Arm's length resale price margin for B [10% x RM 8]		**0.80**
Adjusted resale price taking into account the functional and risk borne by B:		
Promotional costs	0.10	
Warranty Costs	0.20	
Total adjustments		0.30
Adjusted resale price margin for B		**1.10**
Calculation of arm's length price of transaction A and B:		
Distributor B net sales to independent customer		8.00
Less: adjusted resale price/ gross margin		1.10
Arm's length price for transaction A & B		**6.90**

Therefore, the purchase price between **A** and **B** in this scenario should be adjusted to RM6.90 to account for the additional function and extra risk borne by **B**, which should be remunerated appropriately as compared to the pricing in Example 3.3.

COST PLUS METHOD

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

3.20 The CPM begins with the costs incurred by the supplier of property (or services) in a controlled transaction for property transferred or services provided to an associated purchaser. An appropriate cost plus mark-up is then added to this cost to determine the price that the supplier should be charging the buyer.

3.21 The appropriate cost plus mark-up should ideally be established by reference to the cost plus mark-up earned by the same supplier from comparable uncontrolled transactions. This is due to the fact that similar characteristics are more likely to be found among sales of product by the same supplier than among sales by other suppliers. If no such transactions exist, the appropriate mark-up may be determined based on comparable transactions by independent persons operating independently. If there are material differences between the controlled and uncontrolled transactions that could affect the gross profit mark-up, appropriate adjustments must be made to the gross profit mark-up earned in the uncontrolled transaction.

3.22 Formula for arm's length price in CPM:

$$\textbf{Arm's Length Price} = \textbf{Costs} + (\textbf{costs} \times \textbf{cost plus mark up}^{1})$$

$$^{1}\textbf{Cost plus mark up} = \frac{\textbf{Sales price} - \textbf{Costs}}{\textbf{Costs}}$$

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

Comparability Analysis

3.23 Similar to RPM, CPM requires a high level of functional comparability rather than product. Therefore, when applying the CPM, consideration should be given to the similarity of functions, risks assumed, contractual terms, market conditions and business strategies, as well as any adjustments made to account for the effects of any differences in the aforementioned factors between the controlled and uncontrolled transactions. Similar to the RPM, fewer adjustments are needed to account for product differences compared to the CUP method.

Cost Structure Consideration

3.24 The method used in determining costs and the accounting policies should be consistent and comparable between the controlled and uncontrolled transactions and over time in relation to the particular person. In the CPM, the costs are the

aggregation of direct and indirect production costs. The use of other costs must be well justified and may be considered only if they result in a more accurate estimate of the appropriate margin. In computing the costs, the practice must be in accordance with generally accepted principles or acceptable accounting standards in Malaysia.

Type of cost	Definition
Direct	Costs that are identified specifically with a particular activity including compensation, bonuses, travel expenses of employees directly engaged in performing such activity, or materials and supplies consumed in providing the activity. In determining the cost base incurred in providing an activity, unrelated costs to that activity must be excluded and the costs to be considered must be consistent with those incurred in comparable transactions.
Indirect	Costs that are not specifically attributable to a particular activity but are still closely related to the direct costs or to the processes of that activity. These costs include utilities, rental, supervisory and clerical compensation, and other overhead costs incurred by the department that bears the direct costs. Indirect costs also include an appropriate share of the costs of the supporting units and departments (e.g., accounting and secretarial units, etc.).

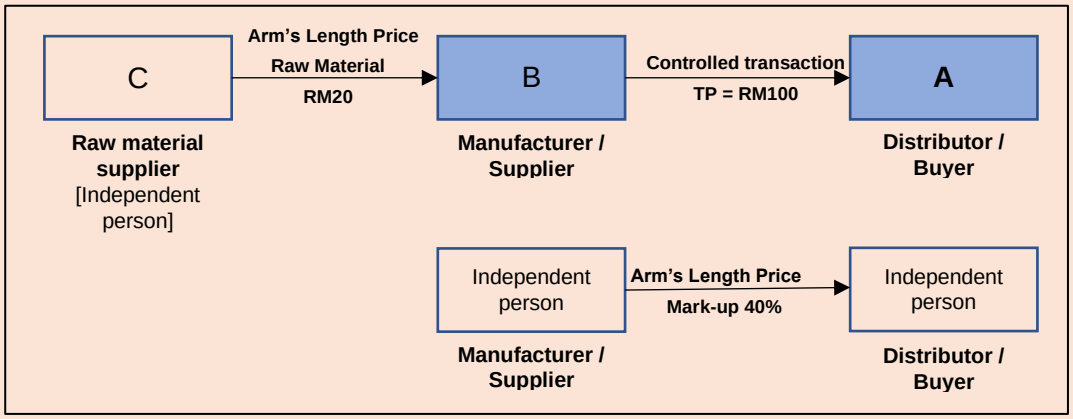
3.25 The determination of costs is important in CPM, where the comparable mark-up is to be applied to a comparable cost basis. The CPM compares the mark-up on costs in controlled and uncontrolled transactions, requiring careful analysis of differences to determine comparability adjustments. For example, an independent supplier who leases its business assets may not be comparable to a supplier in a controlled transaction who owns its business assets. Therefore, in determining the costs, adjustments should be made to eliminate these differences.

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

Circumstances	Action to be taken
If the expenses reflect a functional difference that has not been taken into account in applying the CPM;	An adjustment to the cost plus mark-up may be required
If the expenses reflect additional functions that are distinct from the activities tested by the CPM;	Separate compensation for those functions may need to be determined. Such functions may, for example amount to the provision of services for which an appropriate remuneration may be determined.
If the expenses are the result of capital restructures reflecting non-arm's length arrangements;	Separate adjustment should be undertaken.
If differences in the expenses merely reflect the efficiencies or inefficiencies of the parties being compared, as would normally be the case for supervisory and general and administrative expenses:	No adjustment to the gross margin may be appropriate.

Example 3.5

Taxpayer **B** is a Malaysian subsidiary of the foreign multinational **A**. **B** manufactures electrical components, which it exports to **A**. The electrical components produced by **B** are specially tailored to meet the requirements of **A**. All raw materials used in the manufacture of the product are purchased from **C**, an independent person, at RM20 per unit.



The total cost per unit of manufactured product is RM80. **B** then sells the product to **A** for RM100 per unit, with a 25% mark-up. An independent manufacturing company with similar functions, assets and risks (FAR) selling to another independent company is found to have a mark-up on cost of 40%.

	RM	**RM**
Sales		100
Purchase	20	
Manufacturing costs	50	
Overhead costs	10	(80)
Gross profit		20
Mark-up on cost		**25%**

Since the product produced by **B** is highly customised, there are no comparable products available. Thus, the mark-up on cost of 40% as derived by the other independent manufacturing company can be used as a basis to determine the arm's length price for sales transactions between **A** and **B**, calculated as follows:

Sales transaction B to A:	**RM**
Total costs	80
Cost plus margin	40%
Arm's Length Price = RM80 + (RM80 X 40%)	**112**

The sales price for the electrical product from B to A should be adjusted to RM112 to reflect the arm's length price of that transaction.

Example 3.6

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

Company **A** also manufactures moulds for an affiliate, **F**, using designs supplied by **F**. Under the agreement with **F**, costs are defined as the sum of direct costs plus actual indirect costs. According to this agreement, the calculation indicates that the actual indirect cost is equivalent to 30% of the direct cost for each project.

Agreement with	Cost definition
Independent parties	Costs = Direct costs + Estimated Indirect costs (40% of direct costs)
Affiliate [**F**]	Costs = Direct costs + Actual Indirect costs

Therefore, in order to determine the appropriate mark-up for transactions between **A** and **F**, the cost base of the transaction with the independent parties needs to be restated.

The original calculation under the arm's length agreements:

	RM
Direct costs	1,000
Indirect costs [40% X RM1,000]	400
Total costs	1,400
Mark-up 10%	140
Original Arm's Length Price	**1,540**

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

	RM
Direct costs	1,000
Indirect costs [30% X RM1,000]	300
Total costs	**1,300**
Original arm's length price	1,540
Mark-up based on restated costs [RM1,540 – RM1,300]	240
Gross mark-up based on restated costs [RM240 / RM1,300]	**18.5%**

The arm's length transfer price between **A** and **F**:

	RM
Direct costs	900
Indirect costs [30% X RM900]	270
Total costs	1,170
Mark-up 18.5%	216
Arm's Length Price	**1,386**

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

TRANSACTIONAL PROFIT SPLIT METHOD

3.27 The transactional profit split method ("PSM") provides an alternative solution for cases where no comparable transactions between independent parties can be identified. This would normally happen when both parties to the transaction make a unique and valuable contribution or where the transaction involves highly integrated operations for which a one-sided approach would not be appropriate. In other words, the transactions cannot be evaluated separately. This method is not appropriate to be used if the party performs only a simple function and does not make any significant contribution.

3.28 The PSM is based on the concept that the combined profits earned in a controlled transaction should be equitably divided between associated persons involved in the transaction according to the functions performed.

3.29 To arrive at an arm's length price, profit or losses should be allocated, when possible, based on how independent parties would have split the combined profit / losses in comparable circumstances. It starts with identifying the combined profit derived by associated persons from a controlled transaction and then splitting it between the parties based on their contributions to the profit based on allocation keys.

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

Residual Profit Split Approach

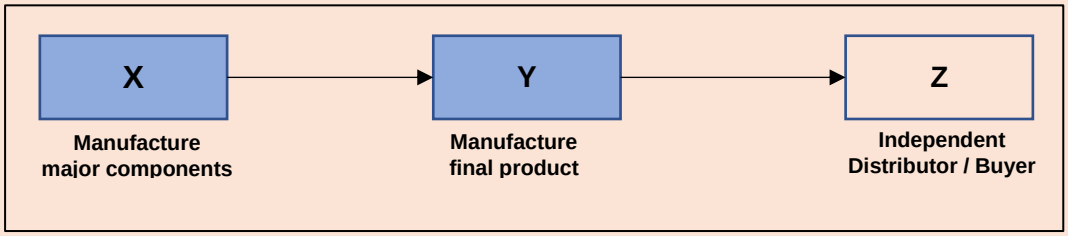
3.31 This approach is the most appropriate method in cases where both parties to a transaction contribute significant unique intangibles. This approach involves two stages of profit division as follows:

Stage	Action to be taken
One	Apportioning the combined profit according to the basic returns assigned to each party to the transaction. These returns are based on the basic, non-unique functions that each party performs and are determined by reference to market returns obtained by independent parties in similar transactions. This basic return would generally not account for the return that would be generated by any unique and valuable assets owned by the parties to the transactions.
Two	Allocating the remaining residual profit / loss, as well as considering how independent parties would have divided such residuals in similar circumstances.

3.32 The residual profit split approach is demonstrated in the following example:

Example 3.7

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



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

The financial accounts of **X** and **Y** are as follows:

Company	**X**	**Y**
Profit & Loss accounts [original]	**RM**	**RM**
Sales	100	300
Purchase	(15)	(100)
Manufacturing costs	(20)	(35)
Gross profit	65	165
Research & Development (“R&D”)	(20)	(15)
Other operating expenses	(15)	(10)
Net profit	**30**	**140**

Application of Residual Profit Split Approach

Stage One

Residual analysis of the group profit

(a) Calculation of the total profit

	RM
Total sales of transaction	300
Cost of goods sold ("COGS") X [Purchases + Manufacturing costs]	(35)
COGS Y [exclude purchases from X]	(35)
Gross profit	230
R&D [X + Y]	(35)
Other operating expenses [X + Y]	(25)
Net profit	**170**

(b) Calculation of the basic return

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

Basic return for X

= 30% of (COGS + Other operating expenses)

= 30% x (RM35 + RM15)

= RM15

The calculation of the basic return for **Y** must take into account the fact that the COGS for the comparable independent companies include the purchase price for the semi-finished product. Since this is the transfer price for **Y**, given the higher profitability compared to **X**, which is in line with industry benchmarks for similar functions, the basic return for **Y** will be a function of the transfer price calculated as follows:

Basic return for Y

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

= 20% x (RM35 + RM10 + TP)

= RM9 + RM0.2TP

Stage Two

Residual profit split

(a) Calculation of the residual profit

Residual profit
= Net profit – [(Return for **X**) + (Return for **Y**)]
= RM170 – [RM15 + (RM9 + RM0.2TP)]
= RM170 – [RM15 + RM9 + RM0.2TP]
= RM170 – [RM24 + RM0.2TP]
= RM146 – RM0.2TP

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

	X	**Y**
	RM	**RM**
R&D expenses	20	15
Total R&D for the group	35	35
R&D expenditure ratio	57%	43%

(b) Calculation of the residual profit split

X	**Y**
= 57% of [RM146 – RM0.2TP]	= 43% of [RM146 – RM0.2TP]
= RM83.22 – RM0.114TP	= RM62.78 – RM0.086TP

(c) Calculation of the net profit for **X** and **Y**

Company	**X**	**Y**
	RM	**RM**
Basic return	15	9 + 0.2TP
Residual return	83.22 – 0.114TP	62.78 – 0.086TP
Total net profit	**98.22 – 0.114TP**	**71.78 + 0.114TP**

(d) Adjustment for transfer price between **X** and **Y**

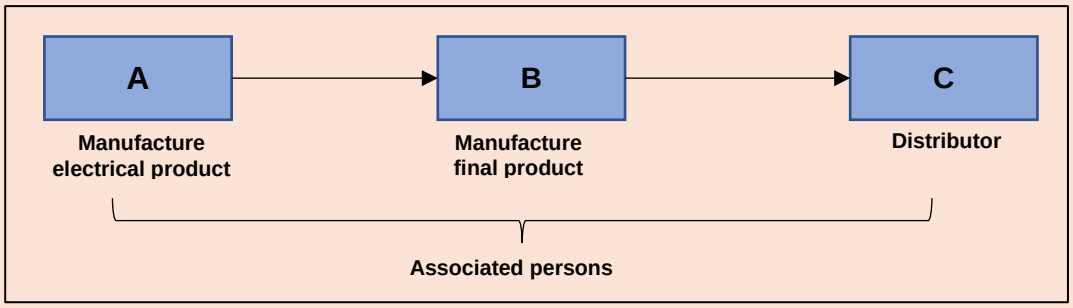
Sales price of X (assume X makes no profit) = RM100 – RM30 = RM70
Adjusted sales price (i.e. TP) = RM70 + adjusted net profit for X = RM70 + RM98.22 – RM0.114TP = RM168.22 – RM0.114TP
Transfer price (TP) = RM168.22 / RM1.114 = RM151* * *the arm's length price for sales and purchase controlled transactions*

(e) Adjustment of the net profit for tax purposes

Company		**X**		**Y**
Profit & Loss accounts [adjusted]	**RM**	**RM**	**RM**	**RM**
Sales	TP 100			300
Arm's length adjustment	51			
Adjusted Sales		151		
Purchase			100	TP
Basic return to **X**		(15)		
Arm's length adjustment			51	
Adjusted purchases				(151)
Manufacturing costs		(20)		(35)
Adjusted gross profit		116		116
R&D		(20)		(15)
Other operating expenses		(15)		(10)
Adjusted net profit		**81**		**89**

Example 3.8

Company A and B are jointly involved in designing and manufacturing an electrical product. Company A ("Co A") designs and manufactures a key component of the product and Company B ("Co B") designs and manufacture the rest of the product which then sold to Company C ("Co C"), associated person. It is assumed that transaction between Co B and Co C has complied with the arm's length principle. Another assumption is no comparable companies can be located with similar intangible assets. Consequently, the most appropriate method is PSM.



The financial accounts of **Co A** and **Co B** are as follows:

	Co A	Co B
Profit & Loss accounts [original]	**RM**	**RM**
Sales	100	200
Purchase	(20)	(100)
Manufacturing costs	(30)	(40)
Gross profit	50	60
Research & Development (R&D) costs	(30)	(20)
Other operating expenses	(20)	(20)
Net profit	**0**	**20**

Application of Residual Profit Split Approach

Step 1

Determine the routine profit

In applying PSM, basic or routine return must first be calculated to remunerate the manufacturing activities for Co A and Co B. Assume that independent manufactures earn a return on manufacturing costs (include direct and indirect costs but exclude purchases) of 10%.

	Co A RM	Co B RM
Manufacturing costs	30	40
Mark-up 10%	3	4
Arm's length price based on comparables	33	44
Residual profit = 13 [20 – 3 – 4]		

Step 2

Allocate the residual profit based on value of contribution

It is determined that the R&D is the critical component to the success of the electrical product. Therefore, residual profit is split based on the share of the total R&D costs.

	Co A RM	Co B RM
R&D costs	30	20
Residual profit allocated: [13 X (R&D costs incurred / Total R&D costs)]	8	5

Step 3

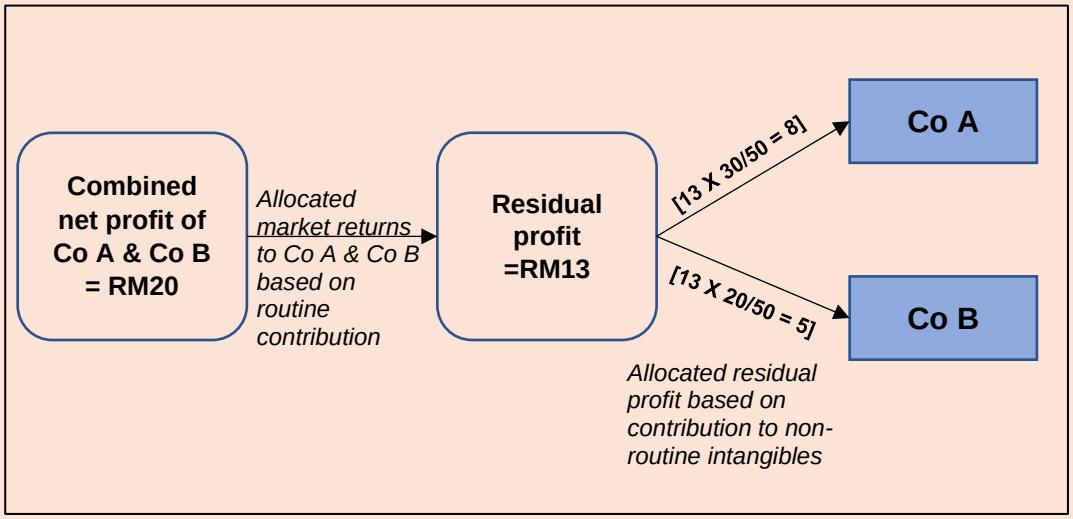
Recalculate the profits

	Co A RM	Co B RM
Basic / Routine Return	3	4
Residual profit allocated	8	5
Net profit adjusted	11	9

Recompute the profit and loss account for tax purposes

Profit & Loss accounts [adjusted]	Co A RM	Co B RM
Sales	111	200
Purchase	(20)	(111)
Manufacturing costs	(30)	(40)
Gross profit	61	49
R&D costs	(30)	(20)
Other operating expenses	(20)	(20)
Net profit	**11**	**9**

The application of PSM in this example is depicted as follows:



Contribution Analysis Approach

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

3.34 Unlike the residual approach, basic returns are not allocated to each party to the transaction before the profit split is made. Generally, the profit to be combined

and divided is the operating profit. Where allocation of expenses to controlled transactions is impossible, a split of gross profits may be considered, after which expenses attributable to the relevant enterprises will be deducted accordingly.

3.35 However, determining the relative value of each participant's contribution to the controlled transactions is difficult and the approach will often depend on the facts and circumstances of each case. Thus, the approach requires careful judgment and the criteria should always include what adds value to the transaction and how economically important the functions carried out by each party in earning the profits are.

3.36 The division of combined profits under the PSM is achievable with the use of allocation keys. The choice of allocation keys by which profits are split largely depends on the facts and circumstances that surround a case. An allocation key can be a figure (e.g., a percentage) or a variable (e.g., specific expenses).

Examples of common allocation keys
(a) Asset-based: useful in situations where the controlled transaction demonstrates a strong correlation between assets and the creation of value; (b) Cost-based: where there is a clear indication of a correlation between cost and value created; (c) Time spent by the employees performing intra-group services; (d) Units produced or sold; (e) Number of employees; and (f) Space used

TRANSACTIONAL NET MARGIN METHOD

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

Application of TNMM

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

Net Profit Indicator / Profit Level Indicator

3.39 In applying the TNMM, due consideration must also be given to the choice of net profit indicator or profit level indicator (“PLI”), which measures the entity’s profitability by evaluating the relationship between profits and sales, costs incurred or assets employed. The use of an appropriate PLI ensures greater accuracy in determining the arm’s length price of a controlled transaction.

3.40 PLI is presented in the form of a ratio, i.e., financial ratios or return on capital employed. Similar to the selection of transfer pricing methods, choosing an appropriate PLI depends on several factors, including:

(a) characterization of the business;

(b) availability of reliable comparable data; and

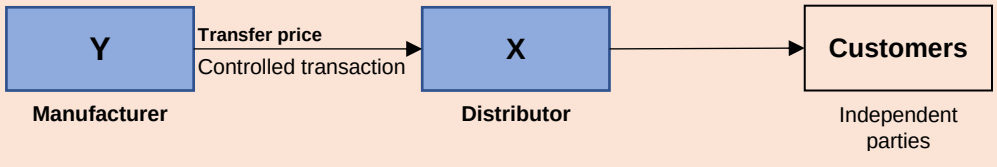
(c) the extent to which the PLI is likely to produce a reliable measure of arm's length profit.

Commonly used PLI include:

PLI	Ratio
Return on costs	• Berry ratio • Cost-plus margin • Net cost-plus margin
Return on sales	• Gross margin • Operating margin
Return on capital employed	• Return on operating assets

Example 3.9

X is a Malaysian subsidiary of **Y**, which is located overseas. **Y** manufactures computers, which it sells to **X** and other associated distributors in different countries. **X** distributes computers that bear the trademark of **Y** and **X** also provides technical support to all its customers.



Assuming based on FAR analysis, the only appropriate method to determine the arm's length compliance is TNMM and it was found that the net profit margin earned in a comparable uncontrolled transaction is 5%.

The financial account for X prior to and after the transfer price ("TP") adjustment:

	Prior to TP adjustment **RM**	*After TP adjustment* **RM**
Sales	100,000	100,000
COGS	(90,000)	(80,000)[2]
Gross profit	10,000	20,000
Operating expenses	(15,000)	(15,000)
Net profit / (loss)	(5,000)	5,000[1]
Margin net profit / (loss)	**(5%)**	**5%**

Note:

[1] Net profit of X = RM100,000 X 5% RM5,000

[2] Adjusted COGS = RM100,000 – RM15,000 – RM5,000 RM80,000

Assuming the net profit margin earned by an independent person in a comparable transaction is 3%, a TP adjustment to conform with the arm's length condition is calculated as follows:

	Prior to TP adjustment **RM**	*After TP adjustment* **RM**
Sales	100,000	100,000
COGS	(90,000)	(82,000)[2]
Gross profit	10,000	18,000
Operating expenses	(15,000)	(15,000)
Net profit / (loss)	(5,000)	3,000[1]
Margin net profit / (loss)	**(5%)**	**3%**

Note

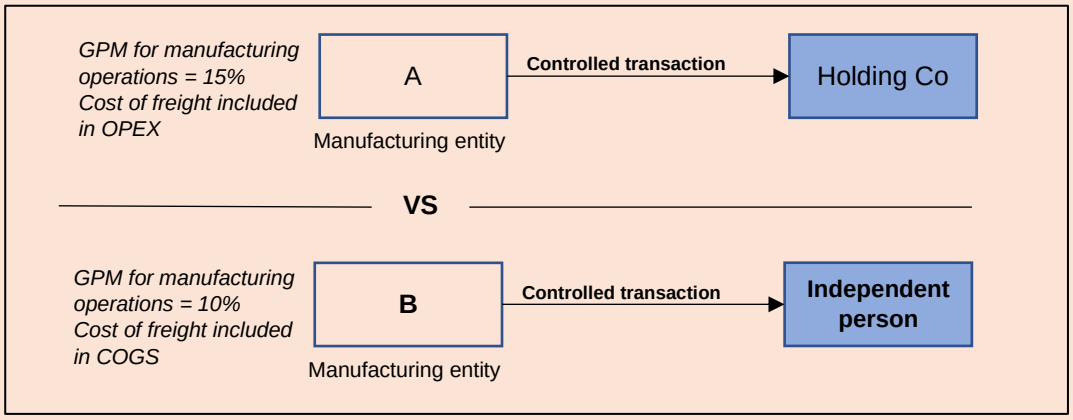
[1] Net profit of X = RM100,000 X 3% RM3,000

[2] Adjusted COGS = RM100,000 – RM15,000 – RM3,000 RM82,000

Example 3.10

Company **A** manufactures plastic bags in Malaysia and exports them to its holding company overseas. The gross profit margin ("GPM") with respect to its manufacturing operations is 15% and the cost of freight is reflected as operating expenses ("OPEX").

Another Malaysian plastic bag manufacturer, Company **B**, exports these bags to independent parties overseas. The GPM with respect to the manufacturing operations is 10%. However, unlike Company **A**, for **B**, the freight cost is included in the COGS instead of as OPEX.



If the CPM is to be used to determine arm's length compliance of the controlled transactions, a comparability adjustment to company B's gross profit margin is required in order to ensure accounting consistency. However. if the freight costs cannot be identified and there are no more reliable comparisons, it is more appropriate to examine the net margins.

Selection of the PLI

3.41 In applying the TNMM, the selection of the most appropriate PLI should be supported by explanations and reasons as provided under the Rules. A taxpayer should examine the pros and cons of each possible indicator, as well as whether or not it fits the nature of the controlled transaction under review, preferably using a functional analysis. Consideration should also be made on whether or not there is reliable information (especially on uncontrolled comparables) that is needed, as well as the level of comparability between controlled and uncontrolled transactions and the dependability of any adjustments that may be needed to get rid of differences between the transactions when applying the TNMM.

Determination of the Net Profit

3.42 As a matter of principle, only those items that:

(a) directly or indirectly relate to the controlled transaction under review; and

(b) are of operational in nature,

should be taken into account in the determination of the net profit indicator for the application of the TNMM.

3.43 Costs and revenues that are not related to the controlled transaction under review should be excluded where they materially affect comparability with uncontrolled transactions. An appropriate level of segmentation of the taxpayer's financial data is needed when determining or testing the net profit it earns from a controlled transaction. Therefore, it would be inappropriate to apply the TNMM on a company-wide basis if the company engages in a variety of different controlled transactions that cannot be appropriately compared on an aggregate basis with those of an independent person.

3.44 Similarly, when analysing the transactions between the independent persons to the extent they are needed, profits attributable to transactions that are not similar to the controlled transactions under examination should be excluded from the comparison. Finally, when the net profit indicators of an independent person are used, the profits attributable to the transactions of that independent person must not be distorted by any controlled transactions of that person.

3.45 Non-operating items such as interest income, interest expenses and income taxes should be excluded from the determination of the net profit indicator. Exceptional and extraordinary items of a non-recurring nature should generally also be excluded. Recurring items (e.g., foreign exchange gains or losses, property plant and equipment (PPE) disposal) shall not be considered exceptional or extraordinary items, regardless of their amount. Even where exceptional and extraordinary items are not taken into account in the determination of the net profit indicator, IRBM may review such items if valuable information can be obtained for the purpose of comparability analysis (for instance, by reflecting that the tested party bears a given risk).

3.46 When deciding whether to include or exclude foreign exchange gains and losses in determining the net profit indicator, there are several comparability issues. Firstly, it needs to be considered whether the foreign exchange gains and losses are of a trading nature (e.g., exchange gain or loss on a trade receivable or

payable) and whether or not the tested party is responsible for them. Secondly, any hedging of the foreign currency exposure on the underlying trade receivable or payable also needs to be considered and treated in the same way in determining the net profit. In effect, if a TNMM is applied to a transaction in which the foreign exchange risk is borne by the tested party, such foreign exchange gains or losses should be consistently accounted for, either in the calculation of the net profit indicator or separately.

3.47 For financial activities where the making and receiving of advances constitutes the ordinary business of the taxpayers, it will generally be appropriate to consider the effect of interest and amounts in the nature of interest when determining the net profit indicator.

3.48 Difficult comparability issues can arise when the accounting treatment of some items by potential third party comparables is unclear or does not allow reliable measurement or adjustment. This is especially true for depreciation, amortisation, stock options and pension costs. Any decision whether or not to include such items in the determination of the net profit indicator in applying the TNMM should depend on a weighing of their expected effects on the appropriateness of the net profit indicator to the circumstances of the transaction and on the reliability of the comparison.

3.49 The start-up and termination costs should be included in the determination of the net profit indicator if, in a similar situation, independent persons would have agreed for the party performing the functions to either bear the start-up costs and possible termination costs, or for some or all of these costs to be recharged with no mark-up, e.g. by charging the customer or a principal, or for some or all of these costs to be recharged with a mark-up, e.g. by including them in the calculation of the net profit indicator of the party performing the functions. The taxpayers should provide such analysis and proof to show that similar costs would also be included by an independent person in comparable circumstances.

Weighting the Net Profit

3.50 The denominator selection should be consistent with the comparability (including functional) analysis of the controlled transaction, and in particular, it should reflect the risk allocation between the parties. For instance, capital-intensive activities such as certain manufacturing activities may involve significant investment risk, even in those cases where the operational risks (such as market risks or inventory risks) might be limited. When applying the TNMM to such cases, the investment-related risks are reflected in the net profit indicator if the latter is a return on investment (e.g., return on assets or return on capital employed).

3.51 The denominator should be focused on the relevant indicator(s) of the value of the functions performed by the tested party in the transaction under review, taking account of the assets used and the risks assumed. Common denominators or appropriate base, subject to a review of the facts and circumstances of the case, are:

Functions performed	**Denominator / Appropriate base[1]**
Distribution activities	Sales or distribution operating expenses
Service or manufacturing activity;	Full costs or operating expenses
Capital-intensive activities such as certain manufacturing activities or utilities	Operating assets

Note:

[1] *Other denominators / bases can also be appropriate depending on the facts and circumstances of the case*

3.52 The denominator should be reasonably independent from controlled transactions, otherwise, there would be no objective starting point. For example:

(a) When analysing a transaction consisting in the purchase of goods by a distributor from an associated person for resale to independent customers, one could not weight the net profit indicator against the cost of goods sold because these costs are the controlled costs for which compliance with the arm's length principle is being tested.

(b) For a controlled transaction consisting in the provision of services to an associated person, one could not weight the net profit indicator against the revenue from the sale of services because these are the controlled sales for which adherence to the arm's length principle is being tested.

3.53 When the denominator is materially affected by controlled transaction costs that are not the object of the testing (such as head office charges, rental fees or royalties paid to an associated person), it should be conducted with reasonable care to ensure that said controlled transaction costs do not materially distort the analysis and in particular, that they are in accordance with the arm's length principle.

Cases where the Net Profit is weighted to Sales

3.54 A net profit indicator of net profit divided by sales, or net profit margin, is frequently used to determine the arm's length price of purchases from an associated person for resale to independent customers. In such cases, the sales figure at the denominator should be the re-sales of items purchased in the controlled transaction under review.

3.55 Sales revenue that is derived from uncontrolled activities (purchases from independent parties for re-sale to independent parties) should not be included in the determination or testing of the remuneration for controlled transactions, unless the uncontrolled transactions are such that they do not materially affect the comparison and / or the controlled and uncontrolled transactions are so closely linked that they cannot be evaluated adequately on a separate basis. An example of the latter situation is the uncontrolled after-sales services or sales of spare parts provided by a distributor to independent end-user customers where they are closely linked to controlled purchase transactions by the distributor for resale to the same independent end-user customers, for instance, because the service activity is performed using rights or other assets that are granted under the distribution arrangement.

3.56 One question that arises in these cases is how to account for rebates and discounts that may be granted by the taxpayer or the comparables to the customers. Depending on the accounting standards, rebates and discounts may be treated as a reduction of sales revenue or as an expense. Similar difficulties can arise in relation to foreign exchange gains or losses. When such items have a material impact on the comparison, the key is to compare like with like and follow the same accounting principles for the taxpayer and the comparables.

Cases where the Net Profit Weighted to Costs

3.57 Cost-based indicators should only be used in those cases where costs are a relevant indicator of the value of the functions performed, assets used and risks assumed by the tested party. In addition, the determination of what costs should be included in the cost base should derive from a careful review of the facts and circumstances of the case. Where the net profit indicator is weighted against costs, only those costs that are directly or indirectly relate to the controlled transaction under review or aggregated in accordance with the principle in paragraphs 4.15 to 4.20 of the Guidelines should be taken into account. Accordingly, an appropriate level of segmentation of a taxpayer's accounts is needed in order to exclude from the denominator costs that are related to other activities or transactions and materially affect comparability with uncontrolled transactions. Moreover, in most cases, only those costs that are operational in nature should be included in the denominator.

3.58 In applying a cost-based TNMM, fully loaded costs are often used, which include all the direct and indirect costs attributable to the activity or transaction, together with an appropriate allocation with respect to the overheads of the business. The question that can arise is whether and to what extent it is acceptable at arm's length to treat a significant portion of the taxpayer's costs as pass-through costs to which no profit element is attributed (i.e., as costs that are potentially excludable from the denominator of the net profit indicator). This depends on the extent to which an independent party in comparable circumstances would agree not to earn a mark-up on some of the costs it incurs. The response should not be based on the classification of costs as "internal" or "external," but rather on a comparability (including functional) analysis.

3.59 When costs treated as pass-through costs are found to be arm's length, a second question that arises is the impact on comparability and on the determination of the arm's length range. Since it is necessary to compare like with like, if pass-through costs are excluded from the denominator of the taxpayer's net profit indicator, comparable costs should also be excluded from the denominator of the comparable net profit indicator. Comparability issues may become apparent in practice when there is a lack of available information on the breakdown of comparable costs.

3.60 Depending on the facts and circumstances of the case, actual costs as well as standard or budgeted costs may be appropriate as the cost base. Using actual costs may raise an issue because the tested party may have no incentive to carefully monitor the costs. In arrangements between independent parties, it is normal that a cost-savings objective is factored into the remuneration method. It can also happen in manufacturing arrangements between independent parties that prices are set on the basis of standard costs, attributing any decrease or increase in actual costs to the manufacturer. To reflect the arrangements that would be taken between independent parties, similar mechanisms could be incorporated in the application of the cost-based TNMM.

3.61 Adopting budgeted costs as the cost base may also raise a number of concerns when large differences between actual costs and budgeted costs are found. Independent parties are unlikely to set prices on the basis of budgeted costs without agreeing on what factors are to be taken into account in setting the budget, without having regard to how budgeted costs have compared with actual costs in previous years and without addressing how unforeseen circumstances are to be treated.

Cases where the Net Profit is Weighted to Assets

3.62 Returns on assets (or on capital) can be an appropriate base in cases where assets (rather than costs or sales) are a better indicator of the value added by the tested party, e.g., in certain manufacturing or other asset-intensive activities

and in capital-intensive financial activities. Where the indicator is a net profit weighted to assets, only operating assets should be used. Operating assets used in the business include:

Type of operating assets	Examples
Tangible operating fixed assets	• Land and buildings • Plant and equipment • Machineries
Operating intangible assets	• Patent • Know-how
Working capital assets	• Inventory • Trade receivables (less trade payables)
Working capital assets (only for financial industry sector)	• Investment • Cash balances

3.63 In cases where the net profit is weighted to assets, the question arises as to how to value the assets, e.g., at book value or market value. Using the book value could potentially distort the comparison. For instance, this could occur when comparing comparables with depreciated assets to those with more recent assets that are still undergoing depreciation or when comparing comparables using acquired intangibles to those using self-developed intangibles. Choosing the market value could possibly alleviate this concern, although it can raise other reliability issues where the valuation of assets is uncertain and can also prove to be extremely costly and burdensome, especially for intangible assets.

3.64 Depending on the facts and circumstances of the case, it may be possible to make adjustments to improve the comparison's reliability. The choice between book value, adjusted book value, market value and other possibly available options should be made with a view to finding the most reliable measure, taking account of the size and complexity of the transaction and of the costs and burden involved.

Berry Ratio

3.65 The Berry Ratio ("BR") refers to the ratio of gross profit to operating expenses. The BR is sometimes used as an alternative financial indicator to compare the profitability attained by a taxpayer in a controlled transaction to that of an independent party transaction. The BR represents a return on a company's value added functions on the assumption that these value added functions are captured in its operating expenses. It has been observed in practice that the BR is used as a PLI for distributors and service providers. The BR assumes that there is a relationship between the level of operating expenses and the level of gross profits earned by distributors and service providers in situations where their value added functions can be considered to be reflected in the operating expenses.

3.66 In order for a BR to be appropriate for testing the remuneration of a controlled transaction, such as distribution activities, it is crucial to confirm the following:

a. The value of the functions performed is proportional to the operating expenses;

b. The value of the function performed is not materially affected by the value of the products distributed, i.e., it is not proportional to the sales; and

c. The taxpayer does not perform any other significant functions, such as marketing or manufacturing or any functions that add value to the products that should be remunerated using another method or financial indicator.

3.67 Berry ratios can be useful in intermediary activities where taxpayers purchase goods from an associated person and on-sell them to another associated person. In this situation, the RPM may not be applicable due to the absence of uncontrolled sales, while the CPM may not be applicable due to controlled purchases. Operating expenses however, may be reasonably independent from transfer pricing formulation. However, if the operating expenses have been materially affected by controlled transaction costs such as head office charges, rental fees or royalties paid to an associated person, the use of BR may not be appropriate.

PASS-THROUGH COSTS

3.68 Pass-through costs are third parties' costs that a person incurs on behalf of its group members or independent customers when performing functions as an intermediary, in respect of which the person neither performs any value-added functions nor assumes any risks.

3.69 IRBM may consider the costs of services obtained from third parties on behalf of its group members as pass-through costs, provided that the following requirements are met:

(a) A detailed functional, assets and risks analysis to substantiate that the person is acting as an intermediary in relation to such costs is submitted to IRBM;

(b) Documents that demonstrate the services are for the benefit of the associated service recipient(s) are submitted to IRBM;

(c) The person neither performed any added value functions nor enhanced the services in relation to the costs;

(d) The person did not assume any liability or risks in relation to the pass-through costs, e.g., did not assume any risks or liability on account of the non-payment of the associated service recipient(s). Mere reimbursement of an expense is not regarded as sufficient evidence to show that the person is risk free in terms of non-payment by the associated service recipient(s);

(e) The associated service recipient(s) assumes liabilities or risks in relation to the pass-through costs of the acquired service, e.g., the costs of the service are the legal or contractual liabilities of the associated person and it is proven with written agreements between the person and the associated service recipient(s) for the latter to assume the liabilities related to the pass-through costs;

(f) The liability associated with the failure of any services provided lies with the independent service providers; and

(g) The person is rewarded for its intermediary functions at arm's length, i.e., the person must charge an arm's length price for the functions performed in arranging, monitoring, overseeing or other responsibilities in acquiring the service on behalf of its related parties.

3.70 Consequently, if the pass-through costs were to be excluded in computing the cost based PLI of a person, the person is required to demonstrate that:

(a) Reliable adjustments can be made to remove such costs from the denominator of the comparable; or

(b) If using commercial or publicly available data, the operating margins of the comparables have excluded similar pass-through costs.

3.71 Where no evidence on adjustments or no publicly available data on the breakdown of similar pass-through cost and value-added cost is provided to IRBM, eliminating the pass-through cost from the denominator of the cost based PLI is not warranted.

3.72 If the denominator of the comparable in the cost-based PLI implicitly includes pass-through costs and those costs are not capable of being measured in a reliable and consistent manner, comparability issues may arise in practice. Thus, under such circumstances, it is warranted to include the pass-through costs in the PLI calculation for both tested party and comparable.

3.73 Depending on the type of comparable data used and if reliable data is unavailable on the pass-through costs of the comparable being used, the mark-up on the aggregate costs, including the cost of services, can be used for benchmarking purposes, but it should be lower than what would be appropriate for the costs of performing the services.

Example 3.12

DMS Intermediary Sdn Bhd (**DMS**), a subsidiary of Marketing Control Pte Ltd (**MC**) in Malaysia, is providing digital marketing services such as website design, web publishing, search engine optimisation, social media optimisation, etc., to members of its MNE group. **MC** has embarked on a worldwide marketing and promotional campaign for a newly launched product. **DMS** is instructed to place the advertisements created by **MC** in electronic media in Malaysia. **DMS** enlisted a few independent vendors to complete this task.

DMS has instructed the invoices from the vendors to be issued in the name of **MC** to ensure the liability of payment rests with **MC** and is free from credit risks in case of non-payment by **MC**. The cost of placement and rental of advertising space is paid on a 'back-to-back' basis by **DMS** to the vendors. There is an agreement between **DMS** and **MC** that the former will only make payments to the vendor upon receipt of payment from the latter. The agreement also does not obligate **DMS** to bear any contractual liabilities in the event that vendors fail to provide any services. Under such circumstances, legal action will be taken by **MC** (since invoices are in its name), although **DMS** may assist in arranging for negotiation between those parties.

DMS has recognised its revenue based on accounting standards that required an entity to include in revenue only the gross inflows of economic benefits received and receivable on its own account and exclude from revenue all amounts collected on behalf of third parties. **DMS** earns a fee for performing digital marketing services and acting as an intermediary for negotiating, arranging and overseeing the placement of advertisements. These are recognized as revenue in **DMS**'s financial statement. However, the payment received on behalf for the rental of advertising space, which is not revenue for the company, is routed through the balance sheet.

The accurately delineated transaction based on the conduct of the parties involved, the FAR and conformance to the contractual terms between **DMS** and **MC** showed that the rental of advertising space is a pass-through cost.

CHAPTER 4 – COMPARABILITY ANALYSIS

INTRODUCTION

4.1 A comparability analysis is a pre-requisite measure in conforming for the arm's length principle. It compares a controlled transaction with an uncontrolled transaction.

4.2 There are two approaches in performing comparability analysis as follows:

(a) The internal comparable approach refers to comparing a transaction between a person and a related party with a transaction between the person and an independent party where both transactions must be conducted within similar terms and circumstances; and

(b) The external comparable approach refers to comparing a transaction between two independent parties, neither of which is a party to the related party transaction and it is conducted under similar terms and circumstances.

4.3 To be deemed comparable, an uncontrolled transaction should:

(a) have sufficient similar economically relevant characteristic with the comparable transaction;

(b) if there are differences occur in respect of the economically relevant characteristics, none of the differences between the comparable transaction or the parties involved would significantly impact the prices, costs, or profits in an open market;

(c) in the event such differences are identified, reasonably accurate adjustments can be made to eliminate any material effects of such differences.

TESTED PARTY

4.4 Generally, the tested party is the one where a transfer pricing method can be applied in the most reliable manner and most reliable comparables can be found. As such, party with less complex functional activities should be selected as the tested party. In Malaysia, the IRBM gives priority to the availability of sufficient and verifiable information on both the tested party and comparables. Therefore, any selection of foreign tested parties and comparables that do not have sufficient and verifiable information would not be accepted.

COMPARABLE PERIOD

4.5 Taxpayers should determine their transfer pricing compliance towards the arm's length principle based on the most current reliable information that are reasonably available at the time of determination. Hence, the arm's length price should be determined by comparing the results of controlled transactions with the results of uncontrolled transactions that were undertaken or carried out during the same basis year.

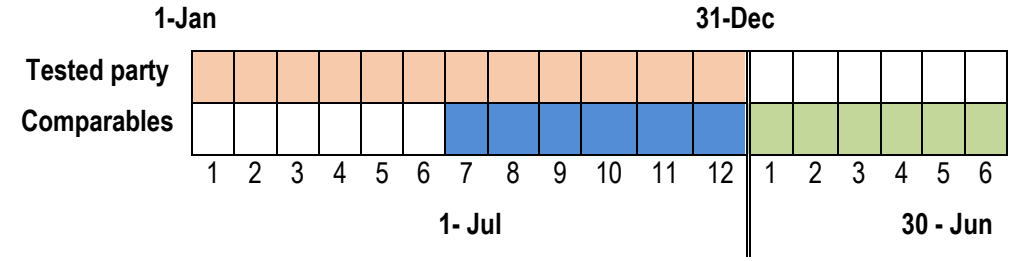
4.6 This requirement is made on the basis that the arm's length principle must be complied contemporaneously on a year-by-year basis. A contemporaneous uncontrolled transaction is the most reliable comparable to reflect the same or similar economic environment of the taxpayer's controlled transaction if it is carried out within the same basis period. However, to minimise the impact of practical issues on benchmarking analysis, the usage of financial year of comparable companies that may reflect similar economic environment of the taxpayer's controlled transactions which can increase the reliability of the comparability analysis may be allowed.

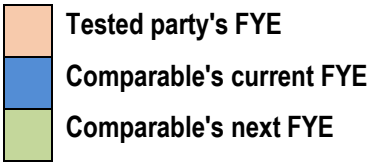
4.7 A tested party financial year end ("FYE") result may be compared with comparable companies having FYE prior to or after the tested party FYE, as long as the overlapping period is proven to have similar market conditions or economic environments as the taxpayer's controlled transactions. For instance,

comparable companies with FYE 6 months prior to or 6 months after the tested party FYE may be used to determine the arm's length price as long as there were no material changes occurred during those periods that may impact significantly on the market condition or the economic environment. A longer overlapping period may be allowed if it can be proven that that period better reflects the market condition or the economic environment.

Example 4.1

A tested party with FYE 31/12 may use comparable companies with FYE 6 months prior to or 6 months after the tested party FYE as demonstrated below:



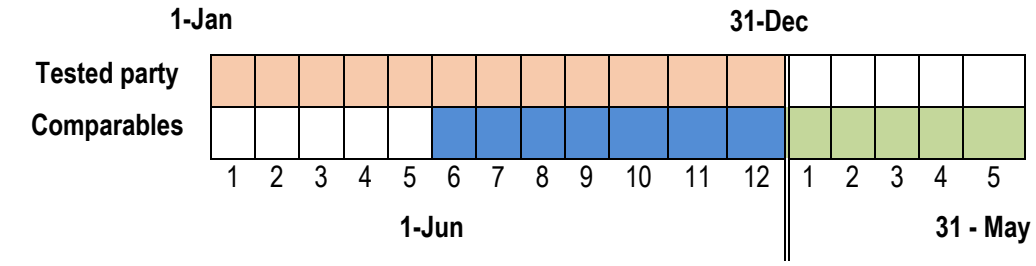


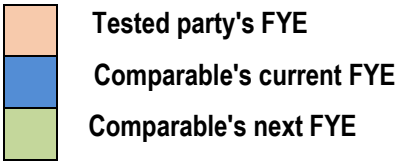
Financial Year End:

Tested Party's Year End	Comparable's Year End From	Comparable's Year End To
31.12.2021	1.7.2021	30.6.2022
31.12.2022	1.7.2022	30.6.2023
31.12.2023	1.7.2023	30.6.2024

Example 4.2

However, a tested party with FYE 31/12 may also use comparable companies with FYE 7 months prior to or 5 months after the tested FYE if those periods are proven to better reflect the taxpayer's situation.





Financial Year End:

Tested Party's Year End	Comparable's Year End From	Comparable's Year End To
31.12.2021	1.6.2021	31.5.2022
31.12.2022	1.6.2022	31.5.2023
31.12.2023	1.6.2023	31.5.2024

MULTIPLE YEAR DATA

4.8 Analysing multiple year data helps to identify factors that may have influence on the transfer prices. Multiple year data analysis on prior years and years after the examination year provides better understanding of facts and circumstances surrounding a controlled transaction. For example, multiple year data from prior years is useful in examining a loss situation to determine whether the loss is genuinely due to economic conditions or a result of transfer prices.

4.9 Multiple year data is also useful in providing information about the relevant business and product life cycles of comparables. Differences in business or product life cycles may have a material effect on transfer pricing conditions that needs to be assessed in determining comparability. Data from earlier years can help in identifying appropriate independent persons to be used as comparables. However, reasonable care should be undertaken to ensure that these comparables are engaged in comparable transactions within comparable economic conditions in order for them to qualify as comparables.

4.10 Taxpayers should use the most current reliable data of comparable companies that are readily available during the preparation of TPD. Therefore, taxpayers should not use multiple year averages as stated in the paragraph 7(6)(b) of the Rules.

LOSSES

4.11 Taxpayers may incur losses due to variety causes, including economic and business factors such as heavy start-up costs, ineffective strategic decisions, R&D failures and other exceptional and extraordinary circumstances. However, an independent person facing continuous losses will take appropriate measures to ensure the profit-making objective is achievable within a reasonable period.

4.12 The fact that an associated person continuously suffers losses while other MNE members with whom it transacts are making profit, may suggest the need for further scrutiny on its transfer pricing issues to ensure that the associated person is adequately compensated.

4.13 In determining whether the losses are acceptable, it is important to ensure that the controlled transaction entered is commercially rational and makes economic sense. Thus, taxpayers need to provide evidence that the losses are commercial in nature within the context of its characterization. In this regard, taxpayers are expected to include in their contemporaneous documentation non-transfer pricing factors such as ineffective business strategies, mismanagement, global economic situation and natural disaster that may have contributed to the losses.

4.14 A contract or toll manufacturer that operates as instructed by a related party without performing functions such as operational strategy setting, product R&D and sales is expected to maintain a consistent level of profitability. Should this entity suffer losses, it must be proven that the losses are not due to controlled transactions.

SEPARATE AND COMBINED TRANSACTIONS

4.15 Ideally, to precisely approximate arm's length conditions, the arm's length principle should be applied on a transaction-by-transaction basis. However, there are circumstances where the evaluation cannot be made adequately on a separate basis.

4.16 For transactions that are so closely linked or continuous that they cannot be evaluated adequately on a separate basis, such transactions may be considered to be evaluated together using the most appropriate arm's length method, provided that it can be demonstrated that it is a normal industry practice to set one price for a combination of transactions (e.g., goods and the associated intangible property) or where it may not be reasonable to expect to find quality data available to set the price for separate transactions.

4.17 It is also acceptable to combine intangibles associated with a product or service provided if comparable independent transactions also have similar transactions that cannot be segregated and all associated costs are included in the pricing of the product.

4.18 Other examples where combined transactions may be acceptable include:

Example 4.3

Transaction involving tangible and intangible products that are highly integrated

A company that licenses manufacturing know-how and supplies vital components to an associated party may find it more reasonable to assess the arm's length price for these two highly integrated activities together rather than separately.

Example 4.4

Transactions where one product complement the other product

Aggregation of transactions may also be appropriate in situations where a taxpayer is required to carry out an unprofitable product or line of products which serve as auxiliary to the profitable items. When these transactions are bundled together, an adequate return from the complete product range to reward the assets, functions and risks of the enterprise should be earned. Bundled products that may fall under this category include printers with cartridges and razors with blades.

4.19 However, there are circumstances where combining transactions may not be appropriate under the arm's length principle, especially if the nature of transactions varies significantly. This is to ensure a fair and accurate assessment of the arm's length nature can be made for each transaction.

4.20 Examples where combined transactions may not be accepted include:

Example 4.5

Transactions where the nature of transaction is substantially different

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

Assuming sales & distribution and repair & maintenance activities are two distinct business activities, these activities should not be aggregated. Company M is then required to prepare segmental accounts to enable an evaluation of the arm's length nature of the controlled transactions on a transactional basis. The accounts should be segmented as follows:

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

SELECTION CRITERIA FOR POTENTIAL COMPARABLES

4.21 Where an arm's length price is determined by using a set of comparables, the following qualitative and quantitative criteria should be considered when selecting good quality comparables:

(a) Qualitative Criteria

- Functional Comparability

  The functions performed and risks assumed by the selected comparable companies should be similar to those of the tested party. In instances where the tested party has additional functions or bears more risks than the selected comparables, the inclusion of such an imperfect comparable or comparable with a lesser degree of comparability in a comparability study or benchmarking analysis will have an impact on the reliability of the arm's length price generated and may allow the application of a point at median (or any other point above median) by the DGIR.

- Other examples of qualitative criteria including but not limited to product portfolios, business strategies, geographical markets and independent business activity of comparables.

(b) Quantitative Criteria

- Size criteria in terms of Sales, Assets or Number of Employees. The size of the transaction in absolute value or in proportion to the activities of the parties might affect the relative competitive positions of the buyer and seller and therefore comparability. In Malaysian scenario, comparable companies with turnover of less than ten percent (10%) of the tested party's revenue will be deemed to have a lesser degree of comparability unless they are accepted by IRBM.

- Intangible-related criteria such as ratio of Net Value of Intangibles / Total Net Assets Value, or ratio of R&D / Sales, where available, may be used for instance, to exclude companies with valuable intangibles or significant R&D activities when the tested party does not use valuable intangible assets nor participate in significant R&D activities.

- Criteria related to the importance of export sales (Foreign Sales / Total Sales), where relevant.

- Criteria related to inventories in absolute or relative value, where relevant.

- Other criteria to exclude third parties that are in particular special situations such as start-up companies, bankrupted companies, etc., when such peculiar situations are obviously not appropriate comparisons.

The choice and application of selection criteria as above is dependent on the facts and circumstances of each particular case and the above list is neither limitative nor prescriptive.

4.22 There are two approaches that can be implemented in identifying potential comparable uncontrolled transactions or comparable companies. Those are:

(a) The “deductive” approach starts with a wide set of companies that operate in the same sector of activity, perform similar broad functions and do not present economic characteristics that are obviously different. The list is then refined using selection criteria and publicly available information (e.g., from databases, Internet sites, information on known competitors of the taxpayer). In practice, the “deductive” approach typically starts with a search on a database.

(b) The "additive" approach consists of the person making the search drawing up a list of third parties that are believed to carry out potentially comparable transactions. Information is then collected on transactions conducted by these third parties to confirm whether they are in effect acceptable comparables, based on the pre-determined comparability criteria.

COMPARABILITY ADJUSTMENT

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

4.24 Comparability adjustments are made to eliminate any differences that could significantly impact the conditions of the comparable transactions (e.g., price or margin) and should only be considered if they are expected to increase the reliability of the comparability results and will have a material effect on the comparison. Comparability adjustments include accounting adjustments and function / risk adjustments.

4.25 Adjustments need to be considered with care and caution, on a case-by-case basis and should only be applied to good quality comparables in light of the information available in order to improve their accuracy. The following do not merit any adjustment 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.

4.26 Even though working capital adjustments are designed to reflect the accounting differences, they should only be considered when the reliability of the comparables will be improved and reasonably accurate adjustments can be made. The fact that such differences are common in business does not mean that they should be made automatically and acceptable by IRBM. If reliable comparables have been selected, the working capital adjustment would result in minor differences. However, if significant differences are present, such differences warrant further investigation.

4.27 However, due to the difficulties in finding good quality comparables, imperfect comparables are sometimes accepted. For instance, business strategies between tested party and comparables often result in comparability differences / defects that cannot be quantified, identified or adjusted and it may not be possible to make comparability adjustments in such instances. Hence, the DGIR may apply the price of the controlled transaction to the median or any other point above median within the range as the arm's length price in order to eliminate the effect of the differences.

TRANSFER PRICING ADJUSTMENT

4.28 Where it is found that a price in a controlled transaction is not at arm's length, the DGIR may make an adjustment to reflect the arm's length price or arm's length interest rate for that transaction by substituting or imputing the price or interest, as the case may be. However, any downward adjustment for transfer pricing purposes will not be applicable since the Rules do not provide for such adjustments. Adjustments will be made in circumstances where:

(a) For the supply of property or services, the remuneration is less than

the remuneration that would have been received or receivable in an arm's length arrangement;

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

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

4.29 The transfer pricing adjustment will also be reflected in a corresponding adjustment upon request of the other party of the controlled transaction.

SURCHARGE

4.30 Section 140A of the ITA imposes on the taxpayer an obligation to apply the arm's length principle to a controlled transaction. It also empowers the DGIR to make transfer pricing adjustment if there is evidence the controlled transaction is conducted not at arm's length. The application of section 140A of the ITA has to be read together with the Rules and the Guidelines.

4.31 The above legal provisions place the burden of proof of an arm's length price in a controlled transaction on the taxpayer. The contemporaneous transfer pricing documentation has to be prepared based on the requirements set forth in the Rules and Guidelines to justify that their pricing is at arm's length. The facts presented in the contemporaneous transfer pricing documentation will be analysed and compared with the actual transaction and condition.

4.32 When the DGIR has made an adjustment under section 140A of the ITA, a surcharge of not more than 5 percent (5%) under subsection 140A(3C) of the ITA may be imposed. The details of the surcharge imposition will be made available in the updated Transfer Pricing Audit Framework.

CHAPTER 5 – BUSINESS RESTRUCTURING

INTRODUCTION

5.1 Business restructuring within a multinational group often leads to changes in how business is characterised and a reduction in the profitability of the local entities. This reduction in profits is seen as acceptable, provided there is a corresponding decrease in the functions performed, assets employed and risks assumed by the entity. The rationale is that as long as these functions, assets and risks are genuinely redeployed, the restructuring is considered commercially reasonable for a multinational group to reorganise their businesses in order to obtain tax savings.

5.2 However, in instances where the local entity continues to undertake the same functions and bear the same risks post-restructuring, the question of whether the restructuring actually occurs arises and IRBM will make necessary adjustments if there is evidence that the actual conduct differs. In an arm's length situation, an independent person would not opt to restructure its business to its disadvantage if it has an alternative not to do so. This principle ensures that controlled transactions are conducted as if they were between independent persons, each acting in their own interests.

5.3 In the context of transfer pricing, business restructuring can be described as the cross-border reallocation of functions, assets (tangible and / or intangible) and risks, each potentially linked with profits or losses. It is critical to distinguish MNE restructurings from routine business acquisitions or ongoing concerns. Nonetheless, it is often standard practice for a MNE to restructure its supply chain operations following significant events such as acquisitions, the sale of a business unit, or a shift in the business landscape.

5.4 As a general rule, businesses have the right to structure their operations as they deem appropriate. Business restructuring efforts must align with the arm's length principle to ensure fairness and market equivalence. However, there may be

situations in which business restructurings facilitate inappropriate income shifting through non-arm's length pricing or through commercially irrational structures.

5.5 Business restructurings require that any valuation for the supply, acquisition or transfer of property align with what would reasonably occur under an agreement between independent persons dealing at arm's length. As a result, in business restructuring, it is crucial to assess whether, under an arm's length condition, a payment is justifiable for the transfer of anything of value or for the termination or substantial renegotiation of business agreements between associated parties. If so, determining the appropriate amount of remuneration that adheres to the arm's length principle becomes critical.

5.6 In a business restructuring context, applying the arm's length principle involves comparing the conditions (including the pricing) of a transaction or arrangement between associated persons to what would be expected between independent persons dealing at arm's length under similar circumstances.

5.7 In the absence of reliable uncontrolled comparable data, it is crucial to evaluate the consistency of the controlled transaction's condition with those reasonably anticipated under an agreement between independent persons.

OTHER OPTIONS REALISTICALLY AVAILABLE

5.8 The arm's length principle is based on the notion that independent persons, when evaluating the terms of a potential transaction, will compare it against other feasible alternatives, and they will only enter into the transaction if no other alternative offers a clearly more attractive opportunity to meet their commercial objective.

5.9 In applying the arm's length principle, the taxpayer should accurately delineate each transaction and evaluate the economically relevant characteristics taken into account by all parties. This evaluation should occur before reaching the conclusion that there is no realistically available option that offers a clearly more

attractive opportunity to meet their commercial objectives than the restructuring adopted.

5.10 In an arm's-length situation, there may be one or more realistic options that are better for an entity to reach its goals than agreeing to the terms of a restructuring. These options should be weighed against all the relevant factors, such as the future commercial and market conditions, the profit potential of each, and any compensation or indemnification for the restructuring. One of these could be the choice not to go through with the restructuring transaction. In such cases, an independent person may not have agreed to the restructuring conditions, and adjustments to the conditions made or imposed may be necessary.

APPLYING THE ARM'S LENGTH PRINCIPLE IN A BUSINESS RESTRUCTURING

5.11 It is important to clearly show the transactions between the restructured entity and other members of the group in order to figure out if compensation is needed at arm's length for a restructured entity within a MNE Group. This includes figuring out the amount of compensation and figuring out which member of the group is responsible for paying it.

5.12 Where the conditions of a business restructuring have been formalised by the MNE Group in writing (e.g., written contractual agreements, correspondence, and / or other communications), those agreements serve as the foundation for delineating the transactions involved in the restructuring. These contractual terms typically outline the restructured entity's roles, responsibilities, and rights both before and after the restructuring, including any changes in these areas resulting from the restructuring. However, if the actual practices of the parties involved or the facts of the situation significantly deviate from or add to the written agreements, the true nature of the transactions involved in the restructuring must be deduced from the established facts and conduct of the parties.

5.13 To accurately delineate the transactions comprising the business restructuring, a functional analysis must be performed that seeks to identify the economically significant activities and responsibilities undertaken, assets used or contributed,

and risks assumed by the parties involved before and after the restructuring. Accordingly, the analysis should focus on what the parties actually do and their capabilities, as well as the type and nature of assets used or contributed by the parties in pre-restructuring and post-restructuring scenarios.

5.14 It is important to understand the transactions undertaken by the taxpayer in the context of an MNE's operational environment. This involves executing the following tasks:

Task	Activities
1	Identify the scope, type (e.g., supply of goods, provision of services, licensing arrangements), and economic nature of the arrangements between the associated persons involved in the business restructuring.
2	Conduct a functional analysis of the activities carried out by associated persons before and after the restructuring. This analysis requires, as a starting point, reference to any relevant contracts, including those entered into to implement the business restructuring (e.g., contracts transferring the legal ownership of intangibles and those evidencing the terms and conditions of the pre- and post-restructuring arrangements for the business activities affected by the restructuring), as well as an examination of the risks assumed and functions performed by the associated persons.
3	Examine the consistency of the contractual terms with the outcome of the functional analysis of the associated persons taking part in the business restructuring in order to determine the true nature of the transactions, including the legal, economic, and tax effects thereof. It should not be automatically assumed that the contracts, though they are the starting point of any transfer pricing analysis, accurately or comprehensively capture the actual commercial or financial relations between the parties. The core part of such an examination is the performance of a thorough functional analysis, which is needed to identify the value-adding activities and functions

Task	Activities
	performed, assets employed, and risks assumed with respect to the business activities affected by the restructuring.

5.15 Choosing the most appropriate method based on the functional analysis and accurately delineating those transactions are critical steps. A business restructuring is commonly implemented through a complex series of transactions, such as transferring functions, assets, and risks to a tax-favourable location. Although this action alone should not automatically imply a deviation from the arm's length arrangement, the taxpayer should be able to justify that the pricing of the business restructuring itself and the post-restructuring arrangements are consistent with what would occur under an agreement between independent parties in comparable circumstances where the arm's length principle and its requirements are met.

5.16 In cases where relevant third-party data is not available (as the types of business restructurings maybe unique to specific business models within MNEs), the taxpayer can present the following considerations to IRBM:

Considerations to be presented to IRBM in "no" comparable instances
(a) An arm's length outcome, supported by a commercial rationale, takes into account the realistic options available for the taxpayer involved in the business restructuring; (b) An independent party dealing at arm's length would seek to protect its economic interest involved in the arrangements or be appropriately remunerated for forgoing such interest; and (c) An independent party dealing at arm's length would compare the realistic options available in comparable transactions and seek to leverage the overall value derived from the economic resources at its disposal. In certain cases, one realistically available option might be to not enter into a transaction if it does not make commercial sense.

TYPES OF BUSINESS RESTRUCTURING

5.17 Common types of business restructuring carried out by MNEs include, but are not limited to:

(a) For manufacturing activities, conversion of fully-fledged manufacturers into contract or toll manufacturers, or vice versa;

(b) For distribution activities, conversion of fully-fledged distributors into limited-risk distributors, sales agents, or commissionaires, or vice versa; and

(c) With regards to the management of valuable, unique intellectual property rights, the transfer of either trade or marketing intangibles to foreign intellectual property holding companies.

5.18 As a result, the restructured entity may end up performing limited routine functions, holding minimal assets, and assuming limited risks. Consequently, the restructured entity will have a lower "profit / loss potential" attached to it. The term "profit / loss potential" should be construed as "expected future profits or losses". This reference is relevant in the valuation phase of determining an arm's length compensation for a transfer of tangible and / or intangible assets or of an ongoing concern, or in the determination of an arm's length indemnification for the termination or substantial altering of existing arrangements.

5.19 Some taxpayers have restructured their businesses to contractually allocate economically significant risks to a group entity, perhaps located in a low-tax jurisdiction. Based on that risk allocation, economically significant risks (e.g., "key entrepreneurial risks") might purportedly be allocated to such an entity that would be presented as a "principal" contractually bearing those risks that justify the premium returns. It will be important to determine whether this principal entity has the capability to manage, and indeed does control, the economically significant risks allocated to it, as well as whether it has the financial capacity to assume those risks. This assessment ensures that the returns attributed to the entity for assuming these risks are consistent and justified.

Example 5.1

Company A was a full-fledged widget manufacturer, assuming economically significant inventory risk, among others. During a business restructuring, Company B is set up as a principal. The new contractual arrangements between Company A and Company B require Company A to produce widgets in accordance with the quality standards and production plan provided by Company B. The contractual arrangements indicate that Company B is responsible for the inventory risk. However, the functional analysis shows that Company B does not in fact have any control over the inventory risk, i.e., it does not make the key decisions in relation to the production plan and has no influence over the deployment of risk mitigation strategies if, for instance, inventory levels rise because of a sales slowdown. Instead, these key decisions remain with Company A.

In this scenario, the accurate delineation of the transaction is such that Company A appropriately assumes the risk and its associated consequences, despite the contract terms assigned to Company B. Therefore, Company A will still be regarded as a full-fledged manufacturer.

CHAPTER 6 – INTRA GROUP SERVICES

INTRODUCTION

6.1 Intra-group services ("IGS") are services provided by one or more members of an MNE Group for the benefit of the other members within the group. The services that can be provided to each other commonly include, but are not limited to, management services, administrative services, technical and support services, purchasing, marketing and distribution services and other commercial services that can be provided with regard to the nature of the group's business.

6.2 The costs of such services, initially borne by the parent or other service companies within the MNE Group, are eventually recovered from other associated persons through intra-group arrangements.

BENEFIT TEST

6.3 A benefit test is used to determine whether the IGS has been rendered when the service is performed for one or more group members by another group member. In other words, a benefit test is to ascertain the actual rendition of services.

6.4 The benefit test has two requirements, both of which must be satisfied. Those requirements are:

(i) The service will provide the service recipient with economic benefits or commercial value to the business; and

(ii) An independent person in comparable circumstances is willing to pay for the service or perform that service in-house for itself.

Intra-group services provide economic benefit or commercial value to the service recipient if they (1) enhance the recipient's return or profitability by improving its production efficiencies; or (2) result in cost savings or a decrease in the recipient's operating expenses. For example, by decreasing the production time.

6.5 Certain IGS activities should be regarded as non-chargeable activities because they do not meet the benefit test for one or more associated persons, and so charges are not warranted. If any person makes charges for IGS related to any of the following activities, those charges will be disregarded because the activities are non-chargeable activities in accordance with subrule 9(3) of the Rules:

(a) Shareholder or custodial activities

Shareholder activity refers to an activity that one group member (usually the parent company) performs solely because of its responsibility as a shareholder due to its ownership interest in one or more members of the group. This activity would not meet the benefit test since the group members do not need the activity even though it may be performed in relation to other group members. Therefore, these shareholder activities should not be recognised as IGS and thus, do not provide a basis for imposing charges on the group members. All costs associated with shareholder activities should be exclusively covered and allocated at the shareholder level.

However, there might be situations where a group member may undertake shareholder activities on behalf of the holding company. In such cases, the group member is not engaging in shareholder activities but should be recognised as offering a service to the holding company. Consequently, the holding company should remunerate the group member at arm's length

Examples of non-chargeable shareholder activities include:

- Costs pertaining to the juridical structure of the parent company such as meetings of shareholders of the parent company, issuing of shares in the parent company and costs of the supervisory board;
- Costs relating to the reporting and legal requirements of the parent company such as producing consolidated accounts or other reports for shareholders, filing of prospectuses; and

- Costs of raising funds for the acquisition of new companies to be held by the parent company (distinct from fund raising on behalf of its existing subsidiaries).
- Costs relating to compliance of the parent company with the relevant tax laws;
- Costs which are ancillary to the corporate governance of the MNE as a whole.

(b) Duplicative services

Duplicative services are services performed by a group member that merely duplicate a service that another group member is already performing in-house or that a third party is providing. Duplicative services are not commercially or practically necessary and, in such instances, any duplicative claim will be automatically disallowed. The ability of a group member to independently perform the service (for instance, in terms of qualification, expertise and availability of personnel) shall be taken into account when evaluating the duplication of services performed.

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

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

Analysing the information may determine that the intra-group services are different, additional, or complementary to the activities performed in-house. In such cases, the benefits test would be applied to evaluate those non-duplicative elements within the IGS.

Example 6.1

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

(c) Services that provide incidental / passive association benefits

This refers to services performed by one member of an MNE group, such as a shareholder or coordinating centre, which relate only to specific group members but incidentally provide a benefit to other members of the group.

Incidental benefits may also arise as a consequence of an associated person being part of a larger concern and not because of a service that has actually been provided. Such incidental benefits would not warrant a charge to the incidental recipient because the perceived benefit is so indirect and remote that an independent person would not be willing to pay for the activities giving rise to the benefit and therefore should not be considered as IGS to the incidental recipient.

Determining whether an incidental recipient should bear a service fee depends on whether, under similar circumstances, an independent party would have been willing to pay for such service.

Example 6.2

A person that had obtained a higher credit rating due to being a member of an MNE Group should not be charged for its mere association with the group. However, if the higher credit rating is due to a guarantee provided by another group member, then an IGS can be considered to have been rendered.

(d) On-call services

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

This on-call service is considered non-chargeable under the following circumstances:

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

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

The economic benefit of on-call services must be evaluated on a case-by-case basis to ensure that the associated person is actually benefiting from having a service provider available. Moreover, it must be ascertained whether an independent party in the same circumstances would have been willing to pay for such services.

6.6 Other services commonly found between associated persons include –

(i) activities performed by one member of an MNE group to meet the identifiable needs of its associated person;

(ii) activities that are centralised in the parent company, regional headquarters companies or group service centres; and

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

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

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

DETERMINATION OF ARM'S LENGTH CHARGE FOR INTRA-GROUP SERVICES

6.8 Once the IGS has satisfied the benefit test, it is necessary to determine whether the amount of the charge is in accordance with the arm's length principle.

6.9 In applying the arm's length principle to IGS, it is necessary to consider the perspectives of both the provider and the recipient of the service. The service must be of value to the recipient and the price must be one that an independent party would be willing to pay.

6.10 In determining the arm's length price charged for IGS, the following factors should be taken into consideration:

(i) Nature of the services;

(ii) Value or extent of the benefit of the services to the recipient;

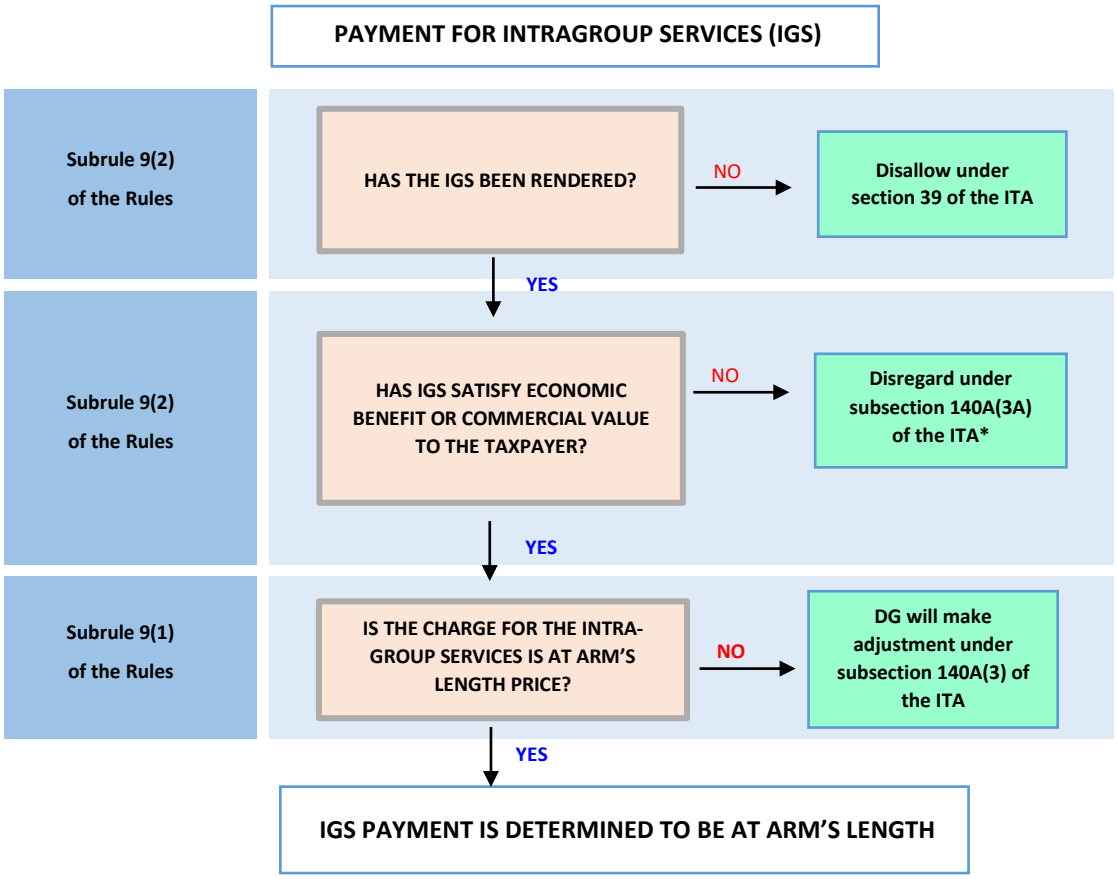
(iii) The costs incurred by the service provider in providing the services;

(iv) The functions involved in providing the services;

(v) The amount an independent recipient would be willing to pay for those services in comparable circumstances. Service recipients must show benefits commensurate with the amount charged by the service provider; and

(vi) Other options are realistically available to the recipients.

6.11 The following flowchart summarises the determination of the arm's length charge for IGS:



Note:

** When the DG disregards any structure of transaction using subsection 140A(3A), then the DG will make an adjustment to that structure to reflect the arm's length structure.*

METHODS FOR CHARGING THE INTRA-GROUP SERVICES

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

6.13 Direct Charge Method

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

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

6.14 Indirect Charge Method

(i) This method is applicable where the direct charge method is impractical or if the arrangements for the services provided are not readily identifiable, i.e., where the costs are attributable to several associated persons and cannot be designated to the recipients of services. IRBM does not encourage the use of the indirect charge method. Thus, the service recipients must be prepared to support their claims, especially if the claims form a significant portion of their total claims.

Example 6.3

Circumstances when the indirect charge method may be applicable:

- Where sales promotion activities carried out centrally at international fairs or in global advertising campaigns benefit the group members as a whole and are reflected in the increased quantity of goods produced or sold by members of the group;

- The provision of information technology services like management information system, which involve the development, implementation and maintenance of inter-company electronic data such as marketing data, production and scheduling forecasts, accounting data, etc.; or
- Provision of accounting services to all members of the MNE group.

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

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

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

PROFIT MARK-UP

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

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

6.17 When applying the CPM to an associated person who assumes the role of an agent or intermediary to obtain services from independent persons on behalf of its group members, it must be ensured that the arm's length return is limited to rewarding the agency or intermediary function only. It is not appropriate to charge a service fee based on mark-up on the cost of the services obtained from independent persons. Please refer to paragraph 3.68 of the Guidelines for the treatment of pass-through costs incurred by intermediaries or agents.

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

SIMPLIFIED APPROACH FOR LOW VALUE ADDING INTRA-GROUP SERVICES

6.19 This section provides specific guidance on a particular category of IGS referred to as low value-adding IGS (LVAS). The taxpayer may elect this simplified approach to determine arm's length charges for LVAS. A taxpayer who chooses not to elect the simplified approach set out in this section should address transfer pricing issues related to LVAS like any other IGS addressed under this chapter.

6.20 The guidance in this section does not apply to services that would ordinarily qualify as LVAS, where such services are also rendered to unrelated customers of the members of the MNE group. In such cases, it can be expected that reliable internal comparables exist and can be used for determining the arm's length price for the IGS.

6.21 This simplified approach is only applicable to the Malaysian service provider. As for Malaysian service recipients, only payments made to LVAS service providers that have similarly adopted the OECD simplified approach in their jurisdictions will be considered to be in compliance with the arm's length principle. In situations where another jurisdiction does not apply the OECD simplified approach, taxpayers must undertake comparability analysis to demonstrate that the payments made have complied with the arm's length principle.

6.22 The definition of LVAS refers to the supportive nature of such services, which are not part of the core business of the MNE group. The provision of LVAS may, in fact, be the principal business activity of the legal entity providing the service, e.g., a shared service centre, provided that these services do not relate to the core business of the group.

6.23 For example, assume that an MNE is engaged in the development, production, sale and marketing of dairy products worldwide. The group established a shared services company, the only activity to act as a global IT support service centre. From the perspective of the IT support service provider, rendering IT services is the company's principal business activity. However, from the perspective of the service recipients and from the perspective of the MNE Group as a whole, the service is not a core business activity. It may therefore qualify as LVAS.

6.24 For the purposes of the simplified approach, LVAS are services that one or more MNE group members provide on behalf of one or more other group members, which:

(a) are of a supportive nature;

(b) are not part of the core business of the MNE Group (i.e., not creating profit-earning activities or contributing to economically significant activities of the MNE group);

(c) do not require the use of unique and valuable intangibles and do not lead to the creation of unique and valuable intangibles; and

(d) do not involve the assumption or control of substantial or significant risk by the service provider and do not give rise to the creation of significant risk for the service provider.

6.25 The following activities would not qualify for the simplified approach outlined in this chapter:

(a) services constituting the core business of the MNE Group;

(b) R&D services (including software development);

(c) manufacturing and production services;

(d) purchasing activities relating to raw materials or other materials that are used in the manufacturing or production process;

(e) sales, marketing and distribution activities;

(f) financial transactions;

(g) extraction, exploration, or processing of natural resources;

(h) insurance, takaful, reinsurance or retakaful;

(i) services of corporate senior management (other than management supervision of services that qualify as LVAS).

6.26 The following table provides examples of services that would likely meet the definition of LVAS:

No	Type of Services	Example of Services
1	Accounting and auditing	• gathering and reviewing information for use in financial statements; • maintenance of accounting records; • preparation of financial statements; • preparation or assistance in operational and financial audits; • verifying the authenticity and reliability of accounting records;

No	Type of Services	Example of Services
		• assistance in the preparation of budgets through the compilation of data and information gathering; • maintaining accounting records; • reconciling financial data; • performing operational and financial internal audits; and • performing other services of a similar nature.
2	Processing and management of accounts receivable and accounts payable	• compilation of customer or client billing information; • credit control checking and processing; • organising and verifying data on accounts receivable and accounts payable for financial reporting, ageing, billing and related matters; • organising records and soliciting payments from customers; • organising records and payments to vendors, procurement; and • other purposes of a similar nature.
3	Budgeting	• compiling data to prepare budget estimates and budget reports.
4	Human resources activities	• staffing and recruitment such as hiring procedures, assistance in evaluation of applicants and selection and appointment of personnel, on-boarding new employees, performance evaluation and assistance in defining careers, assistance in procedures

No	Type of Services	Example of Services
		to dismiss personnel, assistance in programmes for redundant personnel; • training and employee development such as the evaluation of training needs, the creation of internal training and development programmes and the creation of management skills and career development programmes; • remuneration services such as providing advice and determining policies for employee compensation and benefits such as healthcare and life insurance, dental, employee incentives, compensation plans, stock option plans and pension schemes; verification of attendance and timekeeping, payroll services including processing and tax compliance; • developing and monitoring staff health procedures, safety and environmental standards relating to employment matters; and • other human resources activities of a similar nature.
5	Information technology ("IT") services (where such IT services is not a part of the principal activity of the group)	• installing, maintaining and updating IT systems used in the business; • information system support (which may include the information system used in connection with accounting, production, client relations, human resources and payroll, and email systems);

No	Type of Services	Example of Services
		• training on the use or application of information systems as well as on the associated equipment employed to collect, process and present information; • developing IT guidelines, • providing telecommunications services; • organising an IT helpdesk, • implementing and maintaining IT security systems; • supporting, maintaining and supervising IT networks (local area network, wide area network, internet); • providing technical assistance services concerning usage of computer hardware and software, maintenance of IT infrastructure, troubleshooting support, • performing general maintenance of computer databases, including data storage (excluding analytic services performed on stored data); and • other IT services of a similar nature.
6	Legal services	• general legal services performed by in-house legal counsel such as drafting and reviewing contracts, agreements and other legal documents; • legal consultation and opinions; • representation of the company (judicial litigation, arbitration panels, administrative procedures); • legal research; and

No	Type of Services	Example of Services
		• any legal and administrative work for the registration and protection of intangible property
7	Tax obligations	• information gathering and preparation of tax returns, tax computations and related forms (income tax, sales tax, SST, GST, customs, etc.); • preparing responses to queries and furnishing such responses to tax authorities; • processing tax payments; • advising on tax matters; and • other tax obligations of a similar nature.
8	General administration	• general services of an administrative or clerical nature; • internal and external communications and public relations support • monitoring and compilation of data relating to health, safety, environmental and other standards regulating the business.

6.27 Profit mark-up for the application of the simplified approach for LVAS

(a) In determining the arm's length charge for LVAS, the provider of services shall apply a profit mark-up to all costs in the pool except for any pass-through costs.

(b) The same mark-up shall be utilised for all LVAS, irrespective of the categories of services.

(c) The mark-up shall be equal to 5% of all relevant costs. The relevant cost may include direct, indirect and operating expenses relating to the LVAS.

(d) The mark-up under the simplified approach does not need to be justified by a benchmarking study, but the taxpayer should prepare all relevant document on this simplified approach.

CHAPTER 7 – COST CONTRIBUTION ARRANGEMENT

CONCEPT OF A COST CONTRIBUTION ARRANGEMENT

7.1. The CCA refers to a contractual agreement between associated persons on how to share the costs and risks of developing, producing, obtaining, or supplying assets, services or rights, as well as how each person's interests in those assets, services, or rights will be defined.

7.2. The concept of mutual benefit is fundamental to a CCA, wherein the participants agree to share the proportionate costs of creating or acquiring tangible assets, intangibles, or providing services. They accordingly agree to have corresponding proportionate interests in the tangible assets, intangibles, or services created by the CCA. Participants should thus share the benefits in a way that is consistent with their contributions to the CCA. The predictability of the benefits of participating in CCAs varies. In some CCAs, the benefits may be predictable at the outset, but in other cases, there may be uncertainty about the outcome. For instance, it may be highly uncertain whether research and development will result in the creation of intangibles such as patents, know-how, or IT software. As a result of certain unexpected contingencies, a CCA may fail to provide the predicted benefits from economies of scale in relation to services.

7.3. A participant in a CCA involving intangibles is entitled to use its interest in the intangibles in accordance with its share of the intangible and cannot be required to pay a fee or royalty to use its interest in the intangible. This is the case even where legal ownership is held by one associated enterprise on behalf of the group. In other words, the participant would be entitled to exploit its interest in the CCA separately as an effective owner, not as a licensee.

7.4. When a taxpayer enters into a CCA with its associated persons, the arrangement should mirror that of an arm’s length arrangement.

7.5. A CCA has several key features, including:

The features of CCAs are:
(a) Having at least two participants;
(b) A sharing of costs or other contributions between the participants to a CCA;
(c) There is always an expected benefit that each participant seeks from taking part in the arrangement (mutual benefit), including the right to have the CCA properly administered;
(d) The CCA's form and economic substance are consistent;
(e) There are arrangements for participants to leave the CCA ("buy out") and new participants to enter the CCA ("buy in");
(f) The participants exploit their interest in the outcomes of a CCA through their individual businesses; and
(g) The details of the CCA are well documented.

TYPES OF COST CONTRIBUTION ARRANGEMENT

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

Development CCA	Services CCA
Development CCAs are established for the joint development, production, or obtaining of intangibles or tangible assets and are expected to create ongoing, future benefits for participants. In this arrangement, each participant contributes different assets, resources, and expertise and receives a share of rights in the developed property based on their contribution. Participants may exploit the interest, rights, or entitlement without paying additional charges, such as royalty, apart from the initial contributions and balancing payments (if applicable).	Services CCAs are established for the purpose of obtaining services, usually creating current benefits for participants and often offering more certain and less risky benefits compared to development CCAs. Each participant is contractually entitled to receive services resulting from the activity of the CCA. CCA could exist for any joint funding or sharing of costs and risks, for developing or acquiring property, or for obtaining services, such as pooling resources for the development of advertising campaigns common to the participants' market. However, if a service arrangement does not result in any property being produced, developed, or acquired, the principles for dealing with intra-group services will apply, even if it is labelled as CCA.

7.7. Examples of CCAs entered by MNEs are illustrated as follows:

Example 7.1
Three members of a multinational group (A, B, and C) perform services for each other while also benefiting from the services provided by each of them. Instead of having multiple related party services agreements with separate receipts and payments among themselves, A, B, and C enter into a CCA, which provides them with a way to replace a web of separate intra-group payments with a simpler system of netted payments based on the total benefits and total contributions for the services covered by the CCA.
Example 7.2
Three members of a multinational group (X, Y, and Z Co.), marketing a product in the same regional market where consumers have similar preferences, want to enter a CCA to develop a joint advertising campaign. A fourth member of the group (D Co.) helps develop the advertising campaign but does not market the product itself. Therefore, D Co. does not participate in the CCA due to its lack of a beneficial interest in the services covered by the CCA activity, and it does not have a reasonable expectation of exploiting any such interest. The three participants (X, Y, and Z Co.) in the CCA would, therefore, compensate the D Co. by way of an arm's length payment for the advertising services provided to the CCA.

APPLYING THE ARM'S LENGTH PRINCIPLE

7.8. In general, a CCA undertaken between associated persons should meet the following requirements:

Requirements
(a) The participants would include only those who are expected to derive mutual and proportionate benefits from the CCA itself (and not just from performing a portion or all of that activity);

Requirements
(b) The arrangement would specify the nature and extent of each participant's interest in the results of the CCA activity, as well as its expected share of benefits; (c) No payment other than the CCA contributions, appropriate balancing payments, and buy-in payments would be made for the particular interest or rights in intangibles, tangible assets, or services obtained through the CCA; (d) The value of participants' contributions would be determined in accordance with the arm's length principle. And, where necessary, balancing payments should be made to ensure proportionate shares of contributions align with the proportionate shares of expected benefits from the arrangement; (e) The arrangement may include provisions for balancing payments and/or changes in the allocation of contributions prospectively after a reasonable period of time to reflect material changes in the proportionate shares of expected benefits among the participants; and (f) Adjustments would be made as necessary (including the possibility of buy-in and buy-out payments) upon participant entry or withdrawal and CCA termination.

7.9. To satisfy the arm's length principle in CCA as required under subrule 10(1) of the Rules, the value of each participant's contributions must be consistent with what independent enterprises would contribute under comparable circumstances, based on their expected share of the total anticipated benefits from the arrangement.

7.10. The distinguishing factor between contributions to a CCA and other intra-group transfers of property or services is that part or all of the compensation intended by the participants is the expected mutual and proportionate benefit from the pooling of resources and skills. Additionally, especially for development CCAs, all participants must share the upside and downside consequences of the risks associated with achieving the anticipated CCA outcomes.

7.11. To establish whether a CCA meets the requirements of an arm's length arrangement, the following steps must be taken:

Steps to be taken to exhibit adherence to the arm's length arrangement
Step 1: Determine participants in the CCA A participant in a CCA must possess an assigned interest or rights in the intangibles, tangible assets, or services covered by the CCA, along with a reasonable expectation of reaping benefits from these interests or rights. If a member of the group solely performs the subject activity, such as conducting research functions, but does not receive an interest in the CCA's output, they would not be considered a participant in the CCA, but rather a service provider to the CCA
Step 2: Determine a participant's share of expected benefits from the CCA A CCA should be entered into with prudent and practical business judgement and a reasonable expectation of its benefits. An independent person would not enter into a CCA if the contribution was worth more than the expected benefit. The expected benefit can be deduced either based on the anticipated additional income that will be generated, the expected cost savings, or the use of an appropriate allocation key, perhaps based on sales, units used, produced, or sold, gross or operating profits, numbers of employees, capital invested, or alternative keys.
Step 3: Determine the arm's length value of each participant's contribution to the CCA All contributions of current or pre-existing value made by participants to a CCA must be identified and accounted for appropriately in accordance with the arm's length principle. Since the value of each participant's relative share of contributions should accord with its share of expected benefits, balancing payments may be required to ensure this consistency. Therefore, in determining whether a CCA satisfies the arm's length principle, the value of each participant's contribution should be consistent with the value that independent persons in comparable circumstances would have assigned to that contribution.

Steps to be taken to exhibit adherence to the arm's length arrangement

Step 4: Determine the allocation of CCA contributions to each participant according to its share of expected benefits

Where the value of a participant's share of overall contributions under a CCA at the time the contributions are made is not consistent with that participant's share of expected benefits under the CCA, the contributions made by at least one of the participants will be inadequate, and the contributions made by at least one other participant will be excessive.

In this scenario, the arm's length principle necessitates adjusting the contributions by either making or imputing balancing payments. Balancing payments may be made by participants to 'top up' the value of their contributions when their proportionate contributions are lower than their proportionate expected benefits. Any balancing payment should be treated as an addition to the contribution of the payor and as a reduction in the contribution of the recipient.

Example 7.3

The participants, Companies A and B, expect to benefit from the CCA in the ratio of 75:25. In the first year, their pre-existing contributions are valued at RM10 million for Company A and RM6 million for Company B. As a result, a net balancing payment of RM2 million is required to be made to Company B by Company A in order to increase Company A's contribution to RM12 million to align with the expected benefit ratio of 75% of the total contributions. Consequently, Company B's contribution will be reduced to RM4 million (a ratio of 25%).

Participant	Co. A	Co. B	Total
Existing Contributions (RM)	10M	6M	16M
Existing Contributions (%)	62.5%	37.5%	100%
Expected benefit from CCA (%)	75%	25%	100%
Adjusted Contributions (RM)	75% x 16M = 12M	25% x 16M = 4M	
Shortage payment to top up to Co. B (RM)	2M	-	
Payment Received from Co. A by Co. B (RM)	-	2M	

7.12. As required under subrule 10(2) of the Rules, any payment made in respect of an entry, withdrawal, or termination of a CCA shall be consistent with the payment that would have been made by an independent person dealing at arm's length. A change in CCA participants will generally trigger a reassessment of the proportionate shares of participants' contributions and expected benefits.

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

7.14. Where a new participant brings existing intangibles or tangible assets to the CCA, **balancing payments** may be required from the existing participants of an active CCA. Any balancing payments to the new participant could be netted against any buy-in payments required, although appropriate records must be kept of the full amounts of the separate payments for tax administration purposes.

7.15. Where a participant disposes of part or all of its interest, the person should be compensated with an arm's length payment **(buy-out payment)**.

7.16. It is difficult to distinguish between a services CCA and intragroup services. However, the EU report has identified several differences between CCAs and services arrangements within an MNE group.

Services CCAs	Intra-group service arrangements
A CCA is an agreement to share costs, risks, and benefits in which the participants contribute cash, property, or services.	Intra-group services are limited to the provision and acquisition of specific services within an MNE group.
The CCA includes both the service provider and the recipients.	The associated person providing the services may enter into a separate agreement with each associated person. This could result in the

Services CCAs	Intra-group service arrangements
	service provider having numerous bilateral agreements for intra-group services.
If a participant joins or leaves a CCA, an adjustment is required to be made to each associated person's contributions and entitlements.	If an associated person decides to expand a service arrangement or terminate the service arrangement, there is no effect on other associated persons receiving the services.
A detailed written agreement that spells out the costs, risks, and expected benefits.	In certain instances, written contracts may not be prepared.

CHAPTER 8 – INTRA-GROUP INTANGIBLES

IDENTIFYING INTANGIBLES

8.1. For accounting purposes, intangible assets are generally reflected in the balance sheet. However, there are situations where intangible assets are not reflected in the balance sheet and are thus not recognised for accounting purposes.

8.2. Expenses incurred for research and development (R&D) activities are generally capitalised; hence, intangibles created are reflected in the balance sheet. However, the expenses of marketing activities are generally expensed off, so marketing intangibles from such activities may not be shown on the balance sheet. Depending on the facts and circumstances of the case, the intangibles may be recognised for transfer pricing purposes even though they are not reflected in the balance sheet.

8.3. While certain intangibles are not protected by law, others are. The Intellectual Property Corporation of Malaysia (*Perbadanan Harta Intelek Malaysia*) (MyIPO) is responsible for overseeing Malaysia's intellectual property. The laws that pertain to intellectual property in Malaysia include the following:

(a) Trademarks Act 2019 [Act 815];

(b) Patents Act 1983 [Act 291];

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

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

(e) Layout-Design of Integrated Circuits Act 2000 [Act 601].

8.4. The value of intangibles and their returns are often affected by the extent and availability of legal and contractual protection. However, the existence of legal protection is not a prerequisite for an item to be characterized as intangible for transfer pricing purposes.

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

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

8.7. For transfer pricing purposes, "intangible property" refers to an asset that is neither a physical nor a financial asset, but is capable of being owned or controlled for use in commercial purposes, and whose use or transfer would be compensated if it occurred in a transaction between independent persons under comparable circumstances. This includes a patent, invention, formula, process, design, model, plan, trade secret, know-how, or marketing intangible.

CATEGORIES OF INTANGIBLES

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

8.9. Marketing intangibles, a unique category of commercial intangibles, encompass trademarks, trade names, marketing strategies, customer lists, customer relationships, and proprietary market and customer data. These assets play a crucial role in marketing and selling goods or services to customers. It aids in the commercial exploitation of the product or service and has important promotional value for the product or service concerned.

8.10. Government licenses and contractual rights, which grant companies special privileges or exclusivity in certain circumstances, are intangibles for transfer pricing purposes. Examples include:

(a) Government concessions, such as those for the extraction of forest produce, grant the rights to exploit specific natural resources;

(b) Production Sharing Contract granted by PETRONAS for exploration and production rights of oil and gas in Malaysia; and

(c) Government licenses, agreements, or contracts, such as those for broadcasting, Network Facilities Provider (NFP) and Network Service Provider (NSP) awarded to telecommunication companies, or power purchase agreements (PPA) with independent power providers, impose trade restrictions to keep out competitors or limit the number of competitors.

8.11. Other government contracts, such as contracts for supply, including contracts to supply pharmaceutical products to government hospitals, or contracts to provide consulting or technical services, are also considered intangibles for transfer pricing purposes.

8.12. Grants of licenses, concessions, or contracts must be distinguished from company registration, which is a requirement for doing business and does not grant the company any special privileges. For the purpose of transfer pricing, rights under a contract or agreement, such as a contract with a key customer or a supplier that supplies a major raw material, are considered intangibles.

8.13. Exclusive rights to intangibles are typically transferred through a license agreement. These exclusive rights are themselves intangibles for the purpose of

transfer pricing. For example, the grant of exclusive rights which allows the licensee to operate in a certain geographic region.

8.14. It is important to emphasize that using terms like "marketing intangibles" or "trade intangibles" does not relieve taxpayers or tax administrations from the obligation to specifically identify the relevant intangible in a transfer pricing analysis. It also does not mean that a different method should be used to determine the arm's length conditions for a transaction.

8.15. Goodwill and ongoing value generally refer to a number of different concepts. For transfer pricing purposes, the transfer of something of value, whether it is goodwill or not, from one associated person to another may be taken into consideration and appropriately compensated to the extent of how an independent person carrying out comparable transactions is remunerated.

RELEVANCE OF TRANSFER PRICING GUIDANCE OF INTANGIBLES FOR OTHER TAX PURPOSE

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

OWNERSHIP OF INTANGIBLES

8.17. In transfer pricing cases involving intangibles, the determination of who is ultimately entitled to share in the returns derived by a group of associated persons from exploiting the intangibles is crucial. This includes issues regarding who should ultimately bear the costs, investments, and other burdens associated with the development, enhancement, maintenance, protection, and exploitation (“DEMPE”) of the intangibles. Although a legal owner of an intangible may receive proceeds from exploitation of the intangibles (if he takes part in the

performance of the functions or controls the functions or risks related to the DEMPE of the intangibles), other members of the MNE Group may have also performed functions, used assets, or assumed risks that contribute to the value of the intangibles. Any members of the group performing such functions, using such assets, and assuming such risks shall be entitled to an arm's length consideration for undertaking such activity.

8.18. For transfer pricing purposes, the legal owner will be considered the intangible owner. If no legal owner of the intangible is identified under applicable law or governing contracts, then the member of the MNE Group that controls decisions concerning the exploitation of the intangibles and has the practical capacity to restrict others from using the intangibles will be considered to be the "legal' owner" for transfer pricing purposes

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

Example 8.1

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 first intangible is the trademark, which is legally owned by Company A. The second intangible is the license to use the trademark in connection with marketing and distribution of trademarked products, which is legally owned by Company B.

Depending on the facts and circumstances, marketing activities undertaken by Company B pursuant to its license agreement may potentially affect the value of the underlying intangible legally owned by Company A, the value of Company B's license, or both.

8.20. If the legal owner neither performs the functions nor controls the functions or risks related to the DEMPE of the intangibles, the legal owner would not be entitled to any return associated with the performance of the functions or the control of the functions and risks relating to the DEMPE of the intangibles. The final return to the legal owner will depend on its contributions and the contributions of the other members of the MNE Group to the value of the intangible. This value is attributable to its functions, assets, and risks related to the DEMPE of the intangibles.

ANALYSING TRANSACTIONS INVOLVING INTANGIBLES

8.21. For transfer pricing purposes, the following factors should be considered when analysing transactions involving the use or transfer of intangibles between associated persons:

Factors	Descriptions
1. Identifying the intangibles	a. Specifically identify the intangibles used or transferred in the controlled transaction, along with the economically significant risks associated with their DEMPE. b. When a taxpayer pays royalties for the use or transfer of intangibles, they must provide evidence for the following: • the intangibles that are involved; • the processes where the intangibles are utilised; • the benefit obtained from the intangibles; • the specific, economically significant risks associated with the transactions involving the intangibles; and • withholding tax payments made with regards to the royalty payment.

Factors	Descriptions
2. Analysing the contractual terms	a. Legal rights associated with an intangible provide a starting point for the analysis. It is important to identify the complete contractual arrangements, with a particular focus on determining the legal ownership of intangibles. These may be found in the registrations, contracts, or other communications between the parties, which may establish the legal owner of the intangible and describe the roles, responsibilities, and rights associated with parties to the transaction involving the intangible. b. The following information is necessary to be obtained: • the legal ownership; • the role, responsibilities, obligations, and rights of the relevant parties, including those who undertake the functions and control the risks with respect to the DEMPE functions; • the identity of the funders and the level of risk they assumed; • the quantum of payment and mode of payment; and • the allocation of expenses and receipts related to the intangibles. c. In addition to legal documents including public registrations, such as patent or trademark registrations, and written contracts, such as licensing agreements, it is crucial to identify and analyse controlled transactions, as well as evaluate the terms of these transactions, including the risks associated with the transfer or use of intangibles. d. The determination of legal ownership is distinct from the question of remuneration. Legal ownership of

Factors	Descriptions
	intangibles, by itself, does not confer any right ultimately to retain returns derived from exploiting the intangible. Even though such returns may initially accrue to the legal owner as a result of its legal or contractual right to exploit the intangible, this would depend upon the functions the legal owner performs, the assets it uses, and the risks it assumes, as well as the contributions made by other MNE Group members through their functions performed, assets used, and risks assumed.
3. Functional analysis	a. A functional analysis is required to identify the parties performing economically significant functions, using assets, and managing risks related to the DEMPE of the intangibles. b. Taxpayers need to identify: • the economically significant functions that contribute to the value of the intangibles and are instrumental to the success of the DEMPE of the intangibles; • the relative importance of each DEMPE function; and • group members who: perform and exercise control over the functions associated with the DEMPE of the intangibles; provide the necessary assets and funding; and demonstrate the financial capacity to cover the associated costs; assume and exercise control over the various specific, economically significant risks associated with the intangibles; and have the financial capacity to bear the risks associated with the DEMPE of the intangibles. c. Taxpayers should carefully evaluate the relative value

Factors	Descriptions
	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. Taxpayers should identify activities rendered that are economically significant and important, including: • R&D activities that lead to the customisation or enhancement of existing or new products; • activities that lead to improvements in manufacturing processes; • the performance of advertising, marketing, and promotional activities by taxpayers which leads to the creation or enhancement of marketing intangibles such as customer lists, marketing and distribution channels, or favourable contracts; and • managing customers' relationships, localisation of products, advertisements, or marketing surveys, including the collection of local data. e. Taxpayers who perform tasks that increase the value of intangibles should be properly compensated. This compensation should include an element of profit on top of reimbursement of costs. This especially applies where the task was perform along manufacturing or distribution functions. f. A taxpayer who is not a legal owner of an intangible may be entitled to a share of returns from its exploitation if the taxpayer has contributed to the enhancement of the intangible. That taxpayer is considered to have 'economic ownership' of the associated intangibles created.
4. Control of the	a. In carrying out the functional analysis, taxpayers need to assess the capacity of a particular entity to exert

Factors	Descriptions
performance of significant functions	control and the actual performance of such control functions. Where associated persons other than the legal owner perform and control relevant DEMPE functions that are anticipated to contribute to the value of the intangibles, they should be compensated on an arm's length basis. b. Similarly, where the performance of the DEMPE functions by taxpayers are said to be controlled by another entity, documentary evidence as well the actual conduct of the parties is required to proof this claim. c. A taxpayer carrying out core functions as determined in the Guidelines would control the strategic operations decisions regarding its activities and should be entitled to more than a routine low cost plus remuneration for its performance and control of the core functions. It is highly unlikely that a function's performance will be separate from its control.
5. Funding	a. Group members involved in intangible creation may contribute physical assets, intangibles, or funding for the project. The nature and amount of compensation attributable to any of the group members should be appropriately determined based on the arm's length principle. b. Funding and risk-taking are closely integrated, as funding is often linked with certain risks, such as bad debt risks or the risk of losing all the funds. The funder's compensation will depend on the level and extent of the risks it bears. c. To demonstrate control over a specific financial risk, a taxpayer must provide evidence that the funder is

Factors	Descriptions
	capable of making relevant decisions related to the risk-bearing opportunities, as well as the actual performance of these decisions (including risk mitigation activities). d. Generally, a funder who only controls the financial risks associated with the provision of funding, without the assumption of further risks in relation to the investments, and without any control over the use of the contributed funds or the conduct of the funded activity, would only be entitled to a risk-adjusted rate of anticipated return on its capital.
6. Risks associated with the DEMPE of the intangibles	a. There have been instances where many taxpayers justify their treatment as contract-risk-free service providers by arguing that a foreign entity should receive a higher return because it provides funding for the project and thus bears the risk of the R&D functions failing and further the foreign entity establishes and controls the strategy, direction, and priorities of research programmes or creative undertakings, whereas the Malaysian entity merely implements such strategy and direction. b. Although the strategic decisions and overall directions from the parent or foreign entities are cascaded down to the taxpayers, this does not imply that the foreign entity has control over the taxpayers' R&D functions or bear the related risks. c. If the taxpayers perform important R&D functions and even customises the provided know-how, leading to the enhancement of intangibles or the creation of new intangibles, and if its management and personnel are responsible for operational decisions and monitoring of

Factors	Descriptions
	its R&D activities, the taxpayer is in a better position to control the operation and its related risks than an entity that is controlling the functions and risks from afar. d. As highlighted above, funding itself will not entitle the funder to a premium return if it does not perform control functions and bear risks with regards to the R&D activities. Besides that, other important assets owned by the taxpayer, such as skilled workforces, must be considered when determining the return to the taxpayer. The parent or foreign entity will be entitled to a return for the provision of funding and overall direction and strategy, while the taxpayer should also be entitled to a return on their core R&D functions and control of risks related to the operation of R&D activities. Hence, the taxpayer should not merely be reimbursed on a cost plus margin as a risk-free service provider since the performance, control functions, and associated risks are closely linked and should not be separated and assigned to different parties. e. When analysing the economic substance of a transaction in relation to risks, it is necessary to examine whether the conduct of the associated persons over a period of time has been consistent with the allocation of risks and not merely at the time when risks are realised, and whether changes in the pattern of behaviour 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 realised, as it had consistently earned a minimal margin when the risks did not materialize. In a genuine case, a taxpayer that bears the risks would earn a

Factors	Descriptions
	reasonable margin and have taken mitigating actions to protect itself against any risks should they materialise.

APPLICATION OF ARM'S LENGTH PRINCIPLE IN TRANSACTIONS INVOLVING INTANGIBLES

8.22. If the legal owner of an intangible in substance performs and controls all the economically significant functions related to the DEMPE of the intangible, provides all assets, including funding, necessary to the DEMPE of intangible, and assumes all the risks related to the DEMPE of the intangible, then it will be entitled to all the anticipated, ex ante returns derived from the MNE Group's exploitation of the intangible.

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

8.24. When assessing whether associated persons who perform functions or bear risks related to the DEMPE of intangibles have received compensation on an arm's length basis, it is necessary to consider the following factors:

(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.

DETERMINING ARM'S LENGTH COMPENSATION

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

8.26. It is necessary to consider the following matters in determining the arm's length price for controlled transactions involving intangibles:

(a) The comparability factors that may contribute to the creation of value or the generation of returns derived by the MNE Group from the exploitation of the intangibles;

(b) The availability of comparable uncontrolled transactions;

(c) The importance and relative contribution of the functions performed to the creation of intangibles' value; and

(d) The realistic options available for the parties

8.27. When it is difficult to find comparable transactions involving intangibles, it may be necessary to use transfer pricing methods that are not directly based on comparables, including the profit split method and ex ante valuation techniques, in order to appropriately reward the performance of those important functions.

ENTITLEMENT TO THE DIFFERENCE BETWEEN EX ANTE AND EX POST RETURN

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

8.29. Members of the MNE Group who contribute to the DEMPE of intangibles generally determine the terms of their compensation at the time they enter into

transactions and before the risks associated with these intangibles manifest themselves (ex-ante). Such compensation can take the form of a fixed or contingent payment. The actual (ex post) profit or loss of the business after compensating other members of the MNE Group may differ from these anticipated profits depending on how the risks associated with the intangible or other relevant risks related to the transaction or arrangement actually play out.

8.30. The difference between an ex ante (anticipated) and an ex post (actual) return is largely due to the risks associated with uncertainty about future business outcomes. The risks may materialize in a different way than what was anticipated due to unforeseeable developments. The ex-ante contractual assumptions about risks provide clear evidence of a commitment to assume risks prior to their materialisation.

8.31. The party entitled to the unanticipated profit (or required to bear the unanticipated loss) is the one who assumes the risks when accurately delineating the actual transaction, contributes to the control of economically significant risks, or performs important functions related to DEMPE activities, for which it is determined that an arm's length remuneration would include a profit-sharing element.

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

DEVELOPMENT AND ENHANCEMENT OF MARKETING INTANGIBLES VIA MARKETING FUNCTIONS OF THE LOCAL ENTITIES

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

8.34. Taxpayers usually incur and bear significant amounts of AMP for the benefit of the intangible's legal owner while simultaneously developing local marketing intangibles such as distribution networks and customer relationships. These taxpayers are typically characterised as buy-and-sell, limited-risk, or routine distributors, generating only a nominal profit or even incurring losses at times.

8.35. Some distributors have well-trained and organised marketing team that perform functions that contribute to the creation of marketing intangibles, such as:

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

(b) enhancing brand or product loyalty in consumers' mind;

(c) establishing networking / distribution channels;

(d) establishing networking and distribution channels; conducting customer research or surveys, or investing in information systems, leading to the creation of a customer list, database, or customer preference information;

(e) establishing a local, efficient after-sales service and support network; or

(f) building a goodwill reputation.

8.36. These intangibles should attract much more than a routine reward, which a "limited or routine distributor" would earn. The marketing team should be sufficiently rewarded, i.e., the marketing entities should be rewarded for their

effort with or without the creation of local marketing intangibles, depending on the facts and circumstances of the case.

8.37. Where the marketer or distributor actually bears the costs and associated risks of its marketing activities, the marketer or distributor will have a share of the potential benefits from those activities. The taxpayer's margin must be comparable to that earned by independent marketers with similar risks and costs. In these cases, the marketer or distributor is expected to generate a higher margin, which may be in the form of:

(a) a reduction in the purchase price, such as through an additional discount, to reflect the functions, risks, and costs incurred in promoting the products;

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

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

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

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

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

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

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

RESEARCH, DEVELOPMENT AND PROCESS IMPROVEMENT ARRANGEMENT

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

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

8.43. When determining the amount due to the taxpayer, consideration should be given to the relative skill and efficiency of the research personnel, the nature of the research being conducted, and other factors contributing to the value.

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

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

8.46. Similarly, where taxpayers have created unique intangibles as a result of their R&D activities and legal ownership is transferred to the foreign entities, such transfers normally take place without any appropriate compensation. In these scenarios, compensation for such a transfer should be based on a share of profit from its future exploitation, in addition to its arm's length compensation for its R&D activities.

8.47. Another scenario to take into account is when a manufacturer, while providing manufacturing services to another group member (such as a contract manufacturer), enhances processes, and another group member assumes legal ownership. The taxpayer should be entitled to a return on the enhancement of these processes, products, or intangibles if they are transferred to or shared with the other related entities. If the taxpayer self-exploits the enhanced intangibles, an increase in margin should be reflected.

TRANSACTIONS INVOLVING THE USE OR TRANSFER OF INTANGIBLES

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

8.49. Some categories of transactions involving the exploitation of intangibles for the purpose of analysing transfer prices are as follows:

Categories of exploitation of intangibles:
a. <u>Transfers of intangibles or rights in intangibles</u> Controlled transactions involving the transfer of intangibles or rights in intangibles can occur via an outright sale or grant of license to an associated person. 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 or royalty. Transfer of rights of intangibles may involve the transfer of all rights in the intangibles (e.g., sales of intangibles or a perpetual, exclusive license of the intangible) or the transfer of limited rights (e.g., via a license or similar transfer of limited rights to use an intangible that may be subject to geographical restrictions, limited duration, or restrictions with respect to the right to use, exploit, reproduce, further transfer, or further develop). In transactions involving the transfer of intangibles or rights in intangibles, it is essential for taxpayers in a transfer pricing analysis to identify with specificity the nature of the intangibles or rights in intangibles that are transferred between associated persons and limitations or restrictions on the rights transferred, including the nature of such limitations and the full extent of the rights transferred, as the nature of limitations can affect the value of the intangibles transferred.
b. <u>Transfer of combination of intangibles</u> Intangibles (including limited rights in intangibles) may be transferred individually or in combination with other intangibles. When considering transactions involving the transfer of a combination of intangibles, two related issues frequently arise: • The nature and economic consequences of interactions between different intangibles. Some intangibles are more valuable when considered in combination with other intangibles than if they are

Categories of exploitation of intangibles:

considered separately.

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

c. Transfer of intangibles or rights in intangibles in combination with other business transactions

In some cases, intangibles or intangible rights may be transferred in combination with tangible business assets or services. Under such a scenario, the taxpayer should provide evidence that all intangibles have been transferred and that all of the intangibles transferred in connection with that particular transaction can be identified and taken into account in the transfer pricing analysis.

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

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

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

Categories of exploitation of intangibles:

d. Transactions involving the use of intangibles in connection with the sale of goods or the performance of services

Intangibles may be used in connection with controlled transactions in situations where there is no transfer of the intangible or rights in the intangible. For example, intangibles may be used by one or both parties to a controlled transaction in connection with the manufacture of goods sold to an associated person, the marketing of goods purchased from an associated person, or the performance of services on behalf of an associated person.

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

Example 8.2

A car manufacturer uses valuable proprietary patents to manufacture the cars, which it then sells to associated distributors. Assume that the patents make a significant contribution to the value of the cars. The patents and the value they contribute should be identified and taken into account in the comparability analysis of the transaction, consisting of the sales of cars by the car manufacturer to its associated distributors, the selection of the tested party, and the most appropriate transfer pricing method for the transactions. The associated distributors purchasing the cars do not, however, acquire any rights in the manufacturer's patents.

In such a case, the patents are used in the manufacturing process and may affect the value of the cars, but the patents themselves are not transferred.

Under a scenario such as the above example, the nature of such a transaction should be clearly specified, and any relevant intangibles used by either of the parties in connection with such a controlled transaction should be identified and properly addressed in the CTPD. These relevant intangibles should be considered when performing the comparability analysis (including the functional analysis) and selecting and applying the most appropriate transfer pricing method for that transaction.

INTANGIBLES EXPLOIT BY LOCAL COMPANIES IN CONNECTION WITH MANUFACTURING ACTIVITIES

8.50. Many MNE Groups outsource the manufacturing activities necessary for the exploitation of intangibles through a contractual agreement. The intangibles may be in the form of technical know-how, secret formulas, etc. Generally, during the initial stage of setting up a manufacturing business operation, these are provided to the contract manufacturers for a fee. However, some taxpayers continue to pay royalties (indefinitely) even though they have gained the necessary experience, are now well established, and have contributed to the improvement and efficiency of the manufacturing process.

8.51. Taxpayers using the technical know-how of their parents may have incurred significant expenditures to customise such know-how and enhance its value through their research and development efforts. The cost of such R&D activities that contributed to enhancing the value of the original know-how owned by the parent company should be considered when determining the arm's length price for payment of royalties for technical know-how or patents.

8.52. Under such circumstances, taxpayers need to consider whether they should continue to pay a royalty to the parent company for the 'improved' manufacturing process. If the answer is "yes," the taxpayer must provide evidence that the original intangibles continue to generate value over time. Taxpayers should also consider their entitlement to a return on the intangibles of the improved manufacturing process, especially when the locally created or enhanced intangibles are used by other related companies.

8.53. IRBM may disallow royalty payments if it is not shown that the royalty currently paid is for newly developed or enhanced intangibles, as the original intangibles may have become obsolete over the years.

FACTORS AFFECTING COMPARABILITY OF INTANGIBLES OR RIGHTS IN INTANGIBLES

8.54. In applying the arm's length principle, taxpayers need to understand the type and characteristics of intangible properties involved. This would assist in identifying the factors that contribute to an intangible's value, as well as the types of comparables needed for comparability analysis.

8.55. When determining the relative value of each party's contribution or the comparability of the transactions, it is necessary to examine the nature and importance of the contribution, the costs incurred, and the risks assumed in the DEMPE of the intangible property. Other factors that should also be considered include:

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

SUPPLEMENTAL GUIDANCE ON TRANSFER PRICING METHOD IN A MATTER INVOLVING THE TRANSFER OF INTANGIBLES OR RIGHTS IN INTANGIBLES

8.56. It is important to consider the nature of the relevant intangibles, the difficulty of finding comparable uncontrolled transactions and intangibles (in many, if not most, cases), and the challenge of applying certain transfer pricing methods to the transactions when determining the most appropriate method in a case involving a transfer of intangibles or rights in intangibles.

8.57. When selecting the most appropriate method, consideration should be given to the economic consequences of the transaction and not the arbitrary label of the transaction itself.

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

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

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

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

(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 and realistic options available to each of the parties to the transaction;

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

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

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

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

8.63. One-sided methods, such as RPM and TNMM, are generally not reliable for directly valuing intangibles. A one-sided method can be used to indirectly value intangibles by determining values for some functions and deriving a residual value for intangibles. It is important to keep in mind that not all residual returns are attributable to the legal owner. Reasonable care should be exercised to ensure that all functions, risks, assets, and other factors contributing to income generation are properly identified and evaluated.

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

8.65. The transfer pricing method that is most likely to prove useful in determining the arm's length price in matters involving transfers of one or more intangibles is the CUP method. However, in cases where the intangible property is highly valuable or unique, the PSM is to be applied. The DGIR may allow the application of methods other than the CUP method and the PSM, provided that the chosen method has the highest degree of comparability.

Application of the Cup Method

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

Application of Profit Split Method

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

Use of Valuation Techniques

8.68. Besides the CUP method and the PSM, valuation techniques are also useful in determining the arm's length price for controlled transactions involving the transfer of intangibles or the rights in intangibles. Valuation techniques may be used in situations where reliable, comparable, uncontrolled transactions for the transfer of one or more intangibles cannot be identified. Depending on the facts and circumstances, valuation techniques can be used as part of one of the five transfer pricing methods or as a tool for identifying an arm's length price.

8.69. The application of income-based valuation techniques, especially valuation techniques premised on the calculation of the discounted value of projected future income streams or cash flows derived from the exploitation of the intangible being valued, may be useful when properly applied.

8.70. Where valuation techniques are applied in a transfer pricing analysis involving the transfer of intangibles or rights in intangibles, it is necessary to apply such techniques in a manner that is consistent with the arm’s length principle and the Guidelines.

8.71. The principles of realistic options available, economically relevant characteristics, accurately delineating a transaction and risk analysis framework, and aggregation of transactions fully apply to situations where valuation techniques are used in a transfer pricing analysis. Depending on the facts and circumstances of particular cases, the calculation of the discounted value of projected cash flows derived from the exploitation of the intangible should be evaluated from the perspectives of both parties to the transaction when arriving at an arm’s length price. Furthermore, the guidance on selecting transfer pricing methods in the Guidelines should be referred to when such techniques are used.

8.72. It is critical to consider the validity of the underlying assumptions used for valuation techniques, as well as their consistency with the arm's length principle. A careful examination of such assumptions is essential before accepting the

valuations performed for accounting purposes as determinative for transfer pricing purposes.

8.73. Taxpayers using valuation techniques to determine arm's length prices for transferred intangibles should explicitly state each of the relevant assumptions made in creating the valuation model, describe the basis for selecting the valuation parameters, and be prepared to defend the reasonableness of such assumptions and valuation parameters. It is a good practice for taxpayers relying on valuation techniques to incorporate in their CTPD some sensitivity analysis reflecting the consequential change in estimated intangible value produced by the model when alternative assumptions and parameters are adopted.

8.74. In situations where there are discrepancies between the assumptions made in a valuation of an intangible for transfer pricing purposes and the one conducted for other purposes, IRBM will request additional explanation. Those situations include:

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

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

8.75. The next table contains specific concerns that should be taken into account when evaluating certain important assumptions underlying calculations in a valuation model based on discounted cash flows:

Specific concerns to be considered:
a. <u>Accuracy of financial projections</u> It is essential to carefully examine the assumptions underlying the financial projections of both future revenue and future expense if the accuracy of such projections is contingent on developments in the market that are both unknown and unknowable at the time the valuation is undertaken.

Specific concerns to be considered:

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

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

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

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

b. Assumptions regarding growth rates

Projections of future cash flows are often based on projected growth rates. A reliable application of a valuation technique based on projected future cash flows would examine the likely pattern of revenue and expense growth based on industry and company experience with similar products.

Simple models containing linear growth rates without reasonable justifications should not be accepted.

Specific concerns to be considered:

c. Discounted 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. Using these techniques, a small change in the selected discount rate can generate a large variation in the calculated value of intangibles. As a result, taxpayers must justify their assumptions when selecting the discount rate or rates used in the valuation model.

In all instances, there is no single measure for a discount rate that is appropriate for transfer pricing. In determining the appropriate discount rate, the specific conditions and risks associated with the facts of a given case, as well as the particular cash flows in question, should be evaluated.

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

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 lives. The useful life of a particular intangible can be affected by the nature and duration of the legal protections afforded to it, the rate of technological change in the industry, and 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. When terminal values are used in valuation calculations, the assumptions underlying their calculation should be clearly stated and thoroughly examined, particularly the assumed growth rates.

Specific concerns to be considered:

e. Assumptions regarding taxes

Where the purpose of the valuation technique is to isolate the projected cash flows associated with an intangible, it may be necessary to evaluate and quantify the effect of projected future income taxes on the projected cash flows. Tax effects to be considered include taxes projected to be imposed on future cash flows, tax amortisation benefits projected to be available to the transferee (if any), and taxes projected to be imposed on the transferor as a result of the transfer (if any).

f. Form of payment

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

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

CHAPTER 9 – INTRA-GROUP FINANCIAL TRANSACTIONS

FINANCIAL TRANSACTIONS BETWEEN ASSOCIATED PERSONS

9.1 Financial transactions between associated persons can occur in situations where a taxpayer provides financial assistance to an associated person with or without consideration, whether directly or indirectly.

9.2 Financial assistance refers to any type of monetary help or aid that a person provides or receives. Subsection 140A(2) of the ITA will be applicable to the financial assistance that is undertaken between associated persons. According to the Rules, financial assistance includes loans, interest-bearing trade credits, advance or debt, or the provision of any security or guarantee.

9.3 Financial transactions between independent persons are based on various commercial considerations. However, members of an MNE Group have the flexibility and discretion to decide the terms and conditions that will apply to financial assistance within the group. As a result, in an intra group situation, the interest charged or paid in relation to the intra group financial transactions may not adhere to the arm's length principle.

9.4 Interest refers to, but is not limited to, finance charges, discounts, premiums, or other considerations relating to a controlled transaction. The taxpayer should charge or pay the associated person an interest rate that is consistent with the rate that would have been charged in a similar transaction between independent persons dealing at arm’s length.

9.5 Where an arm's length interest rate has not been charged on a controlled financial transaction, IRBM may make an adjustment to reflect the arm’s length interest rate or impute interest on the controlled transaction as provided under subsection 140A(3) of the Act and the Rules.

9.6 In determining compliance with the arm's length principle, accurate delineation of the actual controlled financial transactions needs to be undertaken to ensure comparability of those controlled financial transactions with the ones undertaken by an independent person in comparable circumstances.

9.7 Particular labels or descriptions assigned to the financial transactions do not limit the transfer pricing analysis. Instead, each situation must be examined on its own merits. Accurate delineation of the actual transaction will precede any pricing attempt. In the event that the intra group financial transaction arrangements differ from those that would have been adopted by independent persons behaving in a commercially rational manner in comparable circumstances when viewed in their totality, IRBM may disregard and re-characterise the controlled transaction to reflect the actual character of the transaction.

IDENTIFYING THE COMMERCIAL OR FINANCIAL RELATIONS

9.8 The assessment of a financial transaction's arm's length conditions follows the same principles that apply to any other controlled transaction. As with any controlled transaction, the accurate delineation of financial transactions requires an analysis of the factors affecting the performance of businesses in the industry sector in which the MNE group operates. Since differences exist among industry sectors, factors such as the particular point of an economic, business, or product cycle, the effect of government regulations, or the availability of financial resources in a given industry are relevant features that have to be considered to accurately delineate the controlled transaction. This analysis will take account of the fact that MNE Groups operating in different sectors may have different requirements.

9.9 The process of accurately delineating the actual transaction also requires an understanding of how the particular MNE Goup responds to those identified factors. The accurate delineation of the actual transaction should begin with a thorough identification of the economically relevant characteristics of the transaction based on the commercial or financial relations between the parties and the conditions and economically relevant circumstances attaching to those relations.

9.10 Similar to any other controlled transaction analysis, when applying the arm's length principle to intra group financial transactions, it is necessary to consider the conditions that an independent person would have agreed to in comparable circumstances.

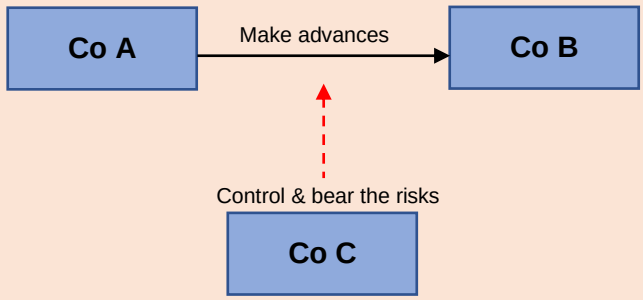
9.11 When evaluating whether to enter into a particular financial transaction, independent persons will consider all other reasonable available options and will only enter into that particular transaction if there is no alternative that offers a clearly more attractive option to meet their commercial objectives. In other words, independent persons would only enter into a transaction if they expected it would not make them worse off than their next best option.

9.12 When valuing any available options, independent persons would generally take into account the economically relevant differences. Therefore, identifying the economically relevant characteristics of the transaction is essential to accurately delineating the controlled transaction and revealing the range of characteristics taken into account by the parties to the transaction.

THE ECONOMICALLY RELEVANT CHARACTERISTICS OR COMPARABILITY FACTORS OF ACTUAL FINANCIAL TRANSACTIONS

9.13 When analysing the terms and conditions of a financial transaction to accurately delineate the actual transaction or when seeking to price the accurately delineated transaction, it is important to consider the following economically relevant characteristics:

Economic relevant characteristics	
Contractual terms	The terms and conditions of a financial transaction between independent persons are usually explicitly stated in a written agreement. However, between associated persons, the contractual arrangements may not always provide information in sufficient detail or may be inconsistent with the actual conduct of the parties or other facts and circumstances. As a result, it is necessary to look at other documents to identify the parties' actual conduct.

Economic relevant characteristics	
Functional analysis	To accurately delineate the actual financial transaction, a functional analysis is necessary. This analysis seeks to identify the functions performed, the assets used, and the risks assumed by the parties to that controlled transaction. **Example 9.1**  Company A makes advances to Company B. Based on the accurate delineation of the actual transaction, it appears that Company A does not exercise control functions related to the advances, but Company C, the parent company of the MNE Group, is exercising control over those risks and has the financial capacity to assume such risks. Therefore, Company C will bear the consequences of such risks, and Company A will be entitled to no more than a risk-free return.
Characteristics of financial instruments.	In the open market, there are a wide variety of financial instruments with very different features and attributes, which may affect the pricing of those products or services. Therefore, it is important to look for documents on those transactions' features and attributes.
Economic circumstances	Comparability necessitates that the markets in which independent and associated persons operate do not have differences that materially affect the price. If material effects exist, appropriate comparability adjustments can be

Economic relevant characteristics	
	made to eliminate those material differences. The prices of financial instruments may vary substantially depending on underlying economic circumstances, such as different currencies, geographic locations, local regulations, the business sector and the timing of the transaction. Comparability adjustments, when applied appropriately, enhance the accuracy and reliability of the comparison between controlled and uncontrolled transactions. As comparability adjustments are intended to eliminate the effects of differences that could materially affect the price or profit margins of a transaction, it follows that comparability adjustments should not be performed to correct differences that have no material effect on the comparison. As such, adjustments should be justified by illustrating improvements in comparability.
Business strategies	In determining comparability for transfer pricing purposes and accurately delineating the actual financial transaction, business strategies must also be examined. This is due to the fact that different business strategies can have a significant effect on the terms and conditions that would be agreed upon between independent persons. The analysis of the business strategies will also consider the MNE group's global financing policy and identify existing relationships between the associated persons.

9.14 Given the complexity and depth of analysis required for determining the arm's length price or condition for financial transactions, separate guidelines will be issued to address specific transfer pricing requirements in relation to intra group financial transactions.

CHAPTER 10 – COMMODITY TRANSACTIONS

TRANSFER PRICING METHOD FOR COMMODITY TRANSACTIONS

10.1. Subject to the guidance in Chapter 3 of the Guidelines on selecting the most appropriate transfer pricing method in the circumstances of a particular case, the CUP method would generally be an appropriate transfer pricing method for establishing the arm's length price or condition of commodity transactions between associated persons.

10.2. Under the CUP method, the arm's-length price for the controlled commodity transaction can be determined, not only by reference to comparable uncontrolled transactions but also by reference to a quoted price.

10.3. The term "quoted price" refers to the commodity price in the relevant period that is obtained from an international or domestic commodity exchange market. A quoted price also includes prices obtained from recognised and transparent price reporting, statistical agencies, or governmental price-setting agencies where those sources are used as a reference by independent persons to determine prices.

10.4. For the purpose of these Guidelines, the reference to "commodity" shall be understood to encompass physical products for which a quoted price is used as a reference by independent persons in the industry to set prices in uncontrolled transactions.

APPLICATION OF THE CUP METHOD TO COMMODITY TRANSACTIONS

10.5. The CUP method would generally be an appropriate transfer pricing method for controlled commodity transactions, where this method allows the arm's length price of those transactions to be determined by quoted prices.

10.6. Quoted commodity prices generally reflect the agreement between independent buyers and sellers in the market on the price for a specific type and amount of commodity traded under specific conditions at a certain point in time. A relevant factor in determining the appropriateness of using a quoted price is the extent to which that price is widely and routinely used in the industry to negotiate prices between third parties. Accordingly, depending on the facts and circumstances of each case, quoted prices can be considered as a reference for pricing commodity-controlled transactions.

10.7. When pricing the commodity transactions between associated persons, the quoted prices should be appropriately selected and applied consistently.

10.8. For the CUP method to be reliably applied, the economically relevant characteristics of the controlled transactions and the uncontrolled transactions represented by the quoted price need to be comparable. When establishing comparability in commodity transactions, it is important to consider the following economically relevant characteristics:

Economically relevant characteristics:
(a) Physical features and quality of the commodity; (b) The contractual terms of the controlled transaction, such as volumes traded, period of the arrangements, timing, and terms of delivery, transportation, insurance and foreign currency terms.

10.9. For commodities, the economically relevant characteristics include, among others, the physical features and quality of the commodity; the contractual terms of the controlled transaction, such as volumes traded, period of the arrangements, terms of credit, the timing and terms of delivery, transportation, insurance and foreign currency terms.

10.10. For several commodity transactions, certain economically relevant characteristics may lead to either a premium or a discount. In addition, if quoted prices are used as a reference, the standardised contracts that define the terms based on which the commodities are traded on the exchange may also be relevant.

10.11. If there are material differences between the controlled and uncontrolled transactions or the conditions determining the quoted price of the commodity, reasonably accurate adjustments should be made to ensure that the economically relevant characteristics of the transactions are comparable

10.12. Contributions made in the form of functions performed, assets used, and risks assumed by other entities in the supply chain should be determined and compensated in accordance with the Guidelines.

EVIDENCE OF PRICE-SETTING POLICY TO BE PROVIDED TO THE IRBM

10.13. To assist IRBM in conducting informed examinations of taxpayers' transfer-pricing practices, taxpayers should include reliable evidence and documentation of their price-setting policy, justification for any applicable price adjustments and any other relevant information for commodity transactions in their transfer pricing documentation.

Additional information to be included:
(a) Pricing formulas used; (b) Third-party, end-customer agreements; (c) Premiums or discounts applied; (d) Pricing date; (e) Supply chain information; (f) Information prepared for non-tax purposes.

PRICING DATE

10.14. When using quotations to price the commodity transaction, the date of pricing the commodity transaction is particularly relevant in determining whether such transactions between associated persons are priced appropriately.

10.15. The term "pricing date" refers to the specific time, date, or time period (e.g., a specified range of dates over which an average price is determined) selected by the parties to determine the price for commodity transactions.

10.16. When the taxpayer can provide reliable evidence of the pricing date agreed in the controlled transaction at the time the transaction was entered and this is consistent with the actual conduct of the parties, the price for the commodity transaction with reference to the pricing date agreed by the associated persons is acceptable. Reliable evidence of the pricing date may include proposals and acceptances, contracts or registered contracts, or other documents setting out the terms of the transactions.

10.17. If the pricing date agreed upon by associated persons is inconsistent with the actual conduct of the parties or with other facts of the case, IRBM may determine a different pricing date consistent with the evidence provided by those other facts and what independent enterprises would have agreed to in comparable circumstances.

10.18. In the absence of reliable evidence of the actual pricing date agreed upon by the associated enterprises, IRBM may deem the pricing date for the commodity transaction to be the date of shipment, as evidenced by the bill of lading or equivalent document. This would mean that the price for the commodities being transacted would be determined by reference to the average quoted price on the shipment date, subject to any appropriate comparability adjustments based on available information.

CHAPTER 11 - DOCUMENTATION

11.1 The requirements set forth in Rules 4 and 5 of the Rules require taxpayers who enter into controlled transactions to prepare contemporaneous transfer pricing documentation ("CTPD") for those controlled transactions prior to the due date of the tax return submission for a year of assessment. This CTPD ensures compliance with transfer pricing rules, as well as facilitates the accurate determination of arm's length prices.

CONTEMPORANEOUS TRANSFER PRICING DOCUMENTATION

11.2 A transfer pricing documentation is deemed "contemporaneous" if:

(a) the document is prepared before the due date for furnishing a tax return for the year of assessment in which a controlled transaction is entered into, and

(b) the document contains all requirements in subrule 4(2) of the Rules.

11.3 In a situation where CTPD (which includes a benchmarking analysis) has been prepared by a taxpayer and subsequently requested by the IRBM during an audit, the taxpayer can update the benchmarking analysis by using the latest comparable financial information available during that audit exercise. The practice of updating the benchmarking analysis will not make the original transfer pricing documentation non-contemporaneous, provided all other requirements have been satisfied. However, if the updated benchmarking results in a transfer pricing adjustment, a surcharge may be imposed on that adjustment.

Example 11.1

In June 2022, Syarikat ABC Sdn Bhd prepared its transfer pricing documentation ("TPD") for the FYE 31 December 2021. The taxpayer has included a benchmarking analysis using ten selected comparable companies and used the available financial information for the financial year 2020 as a comparison with its financial performance.

In July 2024, for audit purposes, the IRBM requested the TPD for the financial year 2021, and Syarikat ABC Sdn Bhd should furnish the CTPD within 14 days to avoid any penalty for failure to furnish the CPTD. During the audit exercise, Syarikat ABC Sdn Bhd is allowed to update the financial information using the latest available financial information of all the selected comparables for the financial year 2021 and submit the revised benchmarking analysis. A surcharge may be imposed if the revised benchmarking results in a transfer pricing adjustment.

Duty to Prepare a Contemporaneous Transfer Pricing Documentation

11.4 The duty to prepare a CTPD falls upon a person in Malaysia who is involved in controlled transactions. Unless the person is exempted from preparing a CTPD, that person should prepare either a full CTPD or a minimum CTPD based on specified thresholds. Failure to prepare a CTPD in accordance with the Rules, the Guidelines, and the Transfer Pricing Tax Audit Framework will result in an offence under section 113B of the Act.

11.5 A CTPD should be prepared for each year of assessment in which a controlled transaction is entered into. However, to reduce the cost burden of preparing the CTPD, taxpayers are allowed to conduct comparable searches in databases supporting the CTPD every three (3) years, as long as the operational conditions remain unchanged. Nevertheless, it is necessary to review and update the financial data and suitability of the existing comparable every year in order to apply the arm's length principle reliably.

Submission of Contemporaneous Transfer Pricing Documentation

11.6 A CTPD is not required to be submitted when filing the tax return forms. However, the CTPD should be made available and furnished within fourteen (14) days from the date of service of the notice of request by the IRBM. Failure to do so will result in an offence under section 113B of the ITA.

List of Contemporaneous Transfer Pricing Documentation

11.7 A CTPD should contain records and documents of the following:

(a) information of the MNE Group as specified under Schedule 1 of the Rules. Where an MNE Group has prepared a master file that includes all information required, such a file can be submitted as a replacement for Schedule 1;

(b) information of the person's business as required under Schedule 2 of the Rules;

(c) information and documentation as specified under Schedule 3 of the Rules regarding CCA (if applicable);

(d) information and documents related to specific transactions, as described in **Appendix A**:

(e) index to the documents;

(f) the completion date of the CTPD;

(g) any documents that serve as a foundation, provide support, or were referred to during the development of the transfer pricing analysis, including documentation for comparable searches;

(h) Any other relevant information, data, or documents that can be used to determine the arm's length price of the controlled transactions, including the effects of any material changes to the business conditions during the basis period. In this context, material changes refer to significant changes that would have an impact on the tested party's functional analysis or transfer pricing analysis. Material changes include changes to the operational and economic conditions that will significantly affect the controlled transactions under consideration.

Examples of material changes that would give impact to tested party's functional analysis or transfer pricing analysis	
Changes in operational conditions	(i) changes in shareholding; (ii) changes in business models and structures; (iii) changes in business activities (e.g., changes in

Examples of material changes that would give impact to tested party's functional analysis or transfer pricing analysis	
	group business activities that have an impact on local business activities); (iv) changes in financial and financing structures; (v) changes in transfer pricing policy; or (vi) mergers and acquisitions.
Changes in economic conditions	(i) foreign exchange; (ii) economic downturn; or (iii) natural disaster.

11.8 Where any of the required information is not applicable to a taxpayer who enters into a controlled transaction, the taxpayer should indicate such non-application in the CTPD.

The Extent of Relevant and Adequate Contemporaneous Transfer Pricing Documentation

11.9 In complying with subsection 140A(2) of the ITA, taxpayers should assess the adequacy and extent of their CTPD by evaluating the size and complexity of their business and transactions to determine the nature and extent of documentation that is appropriate to their particular circumstances. In view of the fact that the nature and extent of documentation depend on the facts and circumstances of a particular transaction, every taxpayer should evaluate the significance of their transactions in reference to their own business and the additional administrative costs of preparing such documentation.

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

Acceptability of Transfer Pricing Documentation

11.11 To ensure the acceptability of the CTPD, reasonable efforts should be made to:

(a) conduct a transfer pricing analysis to ensure that transfer prices adhere to the arm's length principle and accurately reflect the commercial outcomes of all controlled transactions;

(b) maintain documents that are applicable to the circumstances, and be prepared to provide any other additional information or documentation not contained in the Guidelines but that 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, as well as redesign them to accommodate any changes in the business environment;

(e) avoid providing vague, useless, or inadequately supported information;

(f) apply a coherent and transparent approach to identify uncontrolled transactions;

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

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

(i) ensure that the factual, economic and empirical representations in CTPD are specific to company, product and market;

(j) ensure that the CTPD is accurate and precise, matching the accounting, financial, and benchmarked data or comparables;

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

(l) avoid preparing documentation that is relatively limited, incomplete, and does not properly support the transactions; and

(m) maintain sufficient background documents and comprehensive records that detail the factual assumptions and pertinent factors considered in determining the arm's length price.

MINIMUM CONTEMPORANEOUS TRANSFER PRICING DOCUMENTATION

11.12 A taxpayer who enters into a controlled transaction but does not fall under paragraphs 1.5 or 1.7 is eligible to prepare a minimum CTPD. Thus, the taxpayer may opt to prepare a full or minimum CTPD. A minimum CTPD is a CTPD prepared with reduced requirements and should be completed and dated prior to the submission of a tax return for the year of assessment in which a controlled transaction is entered into. The reduced requirements are as follows:

(a) Worldwide group structure

The MNE's worldwide organisational group structure illustrates the location and ownership linkages among all entities in the group that transacted with the taxpayer in the basis period.

(b) Organisational structure;

(i) The taxpayer’s worldwide organisational and ownership structure (including global or group organisation chart and any significant changes in the relationship), covering all associated persons whose transactions directly or indirectly affect the pricing of the controlled transactions;

(ii) A description of the management structure of the taxpayer’s business, including the reporting lines with its associated persons, as well as a description of the individuals to whom it reports and the countries in which such individuals maintain their principal offices; and

(iii) The taxpayer's organisation chart contains information on the heads of departments, including whether they are expatriates or local, and

the number of employees in each department, as of the end of the basis period.

(c) Controlled transaction;

(i) A comprehensive explanation of the controlled transactions, including the participants, scope, timing, frequency, type, and value, as well as any intangible rights or property associated with them, includes a description of the property or services to which the controlled transaction relates. This encompasses all pertinent dealings in relevant geographic markets;

(ii) The details of the associated persons, including the names and addresses, the country in which they are incorporated, registered, or established, and the relationship with each associated person;

(iii) The details of the nature and terms of the transactions, including the prices and conditions of each transaction entered into with each associated person, as well as the quantum and value of each transaction;

(iv) A description of an overview of the business of all associated persons with whom the taxpayer has transacted;

(v) All valid contracts or commercial agreements that outline the terms and conditions of the controlled transactions as well as transactions with third parties;

(d) Pricing policy

A written explanation and justification with relevant documentation to demonstrate that the transfer price of a controlled transaction has complied with the arm's length principle. The detailed explanation of the pricing policy for each type of controlled transaction should include:

(i) The formula that was adopted includes the anticipated profit margin, mark-up, and cost component;

(ii) The application of the formula;

(iii) Party who determines the pricing policy;

(iv) How often is the pricing policy being revised, and

(v) A sample of relevant documents to support the pricing policy adopted.

11.13 For taxpayers who opt to prepare a minimum CTPD, the information required under paragraphs 11.12(c) and (d) is confined to the key controlled transactions. For the purposes of the minimum CTPD, the following transactions are referred to as key controlled transaction:

(i) Controlled transactions that are related to the taxpayer's principal activity, such as the acquisition or supply of raw materials for manufacturing activity.

(ii) Controlled transactions other than those in (i), that constitute 20% or more of the operating revenue in each year of assessment.

11.14 However, taxpayers who prepare a minimum CTPD are still required to list all controlled transactions entered into, regardless of whether the transaction is a key controlled transaction or not.

11.15 The taxpayer is permitted to use any method other than the five transfer pricing methods described in the Guidelines, provided that the method results in, or best approximates, arm's length outcomes. Even though comparability analysis is not required to be included in the minimum CTPD, taxpayers may need to prepare a comparability analysis upon request from IRBM to justify the transfer price. Nevertheless, this request will not make the original minimum CTPD non-contemporaneous.

LANGUAGE

11.16 Taxpayers should file their CTPD in Bahasa Malaysia or English only. When supporting documents are in a language other than Bahasa Malaysia or English, a translation should be provided upon submission.

RECORD RETENTION PERIOD

11.17 Paragraph 82(1)(a) of the ITA indicates that taxpayers should keep and maintain sufficient records for a period of seven years from the end of the year to which income from the business relates to enable the IRBM to ascertain income or loss from the business. The ITA further provides that all records, including books of accounts, invoices, vouchers, receipts, and other documents necessary to verify entries in any books of accounts relating to any business in Malaysia, must be kept and retained in Malaysia.

11.18 For transfer pricing purposes, a taxpayer who has entered into a controlled transaction in the basis period for a year of assessment is required to not only maintain the above records but also to prepare and keep the CTPD for the same period.

11.19 A taxpayer is required to maintain the CTPD to assist in demonstrating the appropriateness of the taxpayer's transfer pricing policy for tax purposes. Simultaneously, this alleviates the risk of transfer pricing adjustment and has relevance to penalty consideration during a transfer pricing audit.

11.20 Any taxpayer who fails to keep and maintain sufficient records, including the CTPD, for a period of seven years shall be guilty of a criminal offence under section 119A of the ITA and, if convicted, will be liable to a fine between RM300 to RM10,000 or to imprisonment for a term of not more than one year, or both.

LEGAL PROVISIONS

11.21 According to subsection 140A(2) of the ITA, taxpayers who enter into a controlled transaction, whether for the acquisition or supply of property or services, are required to determine and apply the arm's length principle to that transaction.

11.22 Subsections 140A(3), (3A), and (3B) empower the DGIR to make adjustments if the reported income is not at arm’s length, or to disregard and re-characterise a controlled transaction if its economic substance differs from its form, or when independent persons acting in a commercially rational manner would not adopt the structure.

11.23 In a controlled transaction, section 140A places the burden of proof of an arm's length price on the taxpayer. The taxpayer must prepare the CTPD in accordance with the Rules and Guidelines to demonstrate that their pricing adheres to the arm's length principle. The facts presented in the CTPD will be analysed and compared with the actual transaction and condition.

11.24 Subsection 140A(3C) of the ITA allows the DGIR, through a written notice, to impose a surcharge of not more than five percent of the transfer pricing adjustment. As long as there is a transfer pricing adjustment, a surcharge will be imposed, regardless of whether the adjustments result in tax payable or not.

11.25 Any taxpayer who fails to furnish the CTPD within fourteen days upon being served a notice of request by the IRBM has committed a criminal offence under subsection 113B(1) of the ITA and may be prosecuted for that offence. If convicted, the taxpayer is liable to a fine not less than RM20,000 and not more than RM100,000, or to imprisonment for a term not exceeding six months, or to both, for each year of assessment of the offence.

11.26 Subsection 113B(4) of the ITA gives power to the DGIR to penalise any failure to furnish the CTPD in cases where no prosecution has been instituted in

respect of the failure. The penalty ranges from RM20,000 to RM100,000 for each year of assessment in which the failure occurs.

11.27 Paragraph 82(1)(a) requires the taxpayers to retain the CTPD for a period of seven years from the end of the year to which any income from a business relates. Failure to do so is an offence under section 119A of the ITA. Taxpayers who committed the offence may be prosecuted, and if convicted, the taxpayer is liable to a fine not less than RM300 and not more than RM10,000, or to imprisonment for a term not exceeding one year, or to both.

APPENDIX A - DOCUMENTATION ON SPECIFIC TRANSACTIONS OR AVENUES

SPECIFIC TRANSACTION OR AVENUE	REQUIRED DOCUMENTATION
BUSINESS RESTRUCTURING	Taxpayers involved in business restructuring in Malaysia are required to properly document and explain the following matters in the CTPD (a) The documentation supporting the restructuring decision includes the decision-making process, feasibility studies, business plans, and consultants' reports. (b) Explanations for the following issues are necessary if the business restructuring has a negative impact on Malaysia's business operations, such as a decrease in profit margin or a loss of intangible rights: • Any monetary or non-monetary benefit received in exchange for the negative impact arising from the restructuring; • Reasons for why an independent individual would undertake a similar restructuring under similar circumstances; and • Whether there are any other realistically available options that are more attractive and should be considered in deciding the business restructuring (c) An explanation of the fundamental basis for restructuring and its impact on the taxpayer's business in Malaysia, whether it is a group-wide restructure, a regional restructure, or a one-off local restructure.

SPECIFIC TRANSACTION OR AVENUE	REQUIRED DOCUMENTATION
	(d) The functional, assets, and risks (FAR) analysis of the parties involved in the restructuring before and after the restructuring process. (e) Details of tangible assets, intangible assets (including marketing intangibles), and liabilities transferred out during the business restructuring process indicate the list and amount of tangible assets, intangible assets, and liabilities, as well as the valuation process and reports to determine the value of all those transfers. (f) The document should provide a description of the acquirer's functions, assets, and risks, along with an analysis proving their financial and human resources capabilities to support the acquisition. (g) Any other relevant information deemed necessary to justify the business restructuring and arm's length compensation.
INTRA-GROUP SERVICES	(a) A detailed description of the relevant service transactions, where all aspects should be analysed and documented, including: • Who is doing what, for whom, and where are they doing it? • Why are they doing it? • How are they doing it? • What property is being used or transferred in connection therewith? An agreement between payer and payee companies, i.e., the charter, which illustrates policies adopted.

SPECIFIC TRANSACTION OR AVENUE	REQUIRED DOCUMENTATION
	• Services provided, costs included and excluded, etc. (b) The agreement should, at a minimum, specify: • Details of the group companies that will be providing and receiving services under the agreement; • Details of the nature and extent of services to be provided; • The basis for determining the fees to be charged and periodic rate increases (if any); • The dates on which invoices are issued; • The timing for invoice settlement; and • The charges imposed for late payment of invoices and outstanding amounts. (c) Documentation such as meeting notes and draft agreements supports the claim that the agreement was concluded only after bona fide (bilateral) negotiations on its terms. (d) The provision of intra-group service serves as proof that the service recipient has benefited from it. A detailed and all-encompassing account of these benefits could include the following: • A detailed description of the benefits provided by each business unit, the costs of which are being allocated;

SPECIFIC TRANSACTION OR AVENUE	REQUIRED DOCUMENTATION
	• Documentation, including correspondence, memoranda, manuals, and directives, indicates a benefit to the recipient of intra-group services; • Job descriptions for employees from both the service provider and the recipient are required to ensure that there is no duplication of service; and • When regional or global administration and management costs are shared, the documentation demonstrating that the recipient is charged according to the actual benefit received. (e) Documentation is required for each function, including marketing, legal, and technical functions, as applicable. (f) The service provider is required to provide documentation, such as copies of time sheets or cost center reports, to justify the fee for the services rendered. Documentation could also include letters, manuals, instructions, proof of visits, written advice, periodic activity reports, and any other documents or data that tend to confirm that the service has been rendered for the benefit of the recipient and is justifiable on an arm's length basis; (g) Where a fixed key is used under the indirect charge method, the justification for the allocation key and method adopted should be demonstrated; (h) When determining the cost base for the application of cost method, it is crucial to document all the factors taken into account in the calculation of the cost base, including:

SPECIFIC TRANSACTION OR AVENUE	REQUIRED DOCUMENTATION
	• Nature or type of costs that have been included in the cost base; • Method used for allocating costs between associated persons; and • Basis used for allocating or apportioning all indirect costs that are included in the cost base.
	Simplified approach for low value-adding intra-group services (LVAS) A simplified approach is a method that can be used to determine arm's length charges for LVAS. Taxpayers who use this method to make or receive payments for LVAS should prepare the following information as part of their CTPD: (a) A description of the categories of LVAS provided, which includes: • the identity of the service providers and beneficiaries; • the reasons justifying that each type of service has met the LVAS definition; • the rationale for the provision of LVAS within the context of the business of the MNE group; • a description of the benefits or expected benefits of each category of LVAS; • a detailed explanation of the selected allocation keys, along with the arguments supporting their ability to yield results that accurately reflect the benefits received; and

SPECIFIC TRANSACTION OR AVENUE	REQUIRED DOCUMENTATION
	• confirmation of the mark-up applied (b) Written agreements for the provision of services and any modifications shall reflect the agreement of the various members of the group to be bound by the allocation rules. Such agreements should specify the entities involved, the nature of the services, and the terms and conditions under which they are provided. (c) Documentation and calculations showing the determination of the cost pool and the mark-up applied, in particular a detailed listing of all categories and amounts of relevant costs, including costs of any services provided solely to one group member; (d) Calculations showing the application of the specified allocation keys; and (e) Any additional document or explanation deemed necessary to justify the application of the simplified approach.
COST CONTRIBUTION ARRANGEMENT (CCA)	For CTPD purposes, taxpayers who participate in a CCA with associated persons are required to provide transactional information that covers: (a) a copy of the CCA that was created contemporaneously (and any revisions), as well as any other agreements pertaining to the application of the CCA between the participants; (b) the list and identity of participants in the CCA, and a list of any other associated person that will be involved with the CCA activity or that is expected to exploit or use the results from the activity;

SPECIFIC TRANSACTION OR AVENUE	REQUIRED DOCUMENTATION
	(c) the scope of the activities and specific projects covered by the CCA, and how the CCA activities are managed and controlled, including any intangible property or class of intangible property in existence or intended to be developed; (d) the duration of the arrangement, the total amount of contributions incurred pursuant to the arrangement, and the allocation of tasks and responsibilities; (e) the form and value of each participant's initial contributions (including research) with a detailed description of how the value of initial and ongoing contributions is determined (including any budgeted and actual adjustments) and how accounting principles are consistently applied to all participants in determining expenditures and the value of contributions; (f) the method used to determine each participant's share of the contributions should include a description, projections used to estimate benefits, any rationale and assumptions underlying the projections, and an explanation of why that method was selected; (g) the nature and extent of each participant's effective ownership interest in the results of the CCA activities; (h) the manner or basis on which proportionate shares of the expected benefits are to be measured, and the rationale and any assumptions underlying the projections of expected benefits; (i) the procedures for entering or withdrawing from the arrangement and the consequences thereof;

SPECIFIC TRANSACTION OR AVENUE	REQUIRED DOCUMENTATION
	(j) the policies and procedures governing balancing payments or adjusting the terms of the arrangement to reflect changes in economic circumstances; (k) where material differences arise between projected benefits and actual benefits realised, the assumptions made to project future benefits need to be amended for future years, and the revised assumptions are well documented; (l) the extent of the use of the CCA property by associated persons who are not the participants, along with the amounts of consideration paid or payable by these non-participants for use of the CCA property; (m) the anticipated allocation of responsibilities and tasks, and the mechanisms for managing and controlling those responsibilities and tasks, in particular those relating to the development, enhancement, maintenance, protection, or exploitation of tangible or intangible assets used in the cost contribution arrangement activity; and (n) all material changes to the arrangement
INTANGIBLES	The use or transfer of intangibles between associated persons must comply with the arm's length principle. Therefore, the CTPD should encompass a detailed description of all relevant transactions involving intangibles, analyse and document all aspects of these transactions, and incorporate the following:

SPECIFIC TRANSACTION OR AVENUE	REQUIRED DOCUMENTATION
	(a) The intangible property is described, along with its potential market application and the advantages it offers in the specific market; (b) The prevailing industry royalty rate; (c) The terms of the license include geographic limitations, time limitations, and exclusivity rights; (d) The uniqueness and duration of the uniqueness; (e) Technical assistance, trademarks, and know-how are provided, along with access to a patent; (f) Profits anticipated by the licensee as well as benefits to the licensor arising from sharing information on the experience of the licensee; and (g) In relation to marketing activities, an agreement that indicates the arrangement between the entities in terms of bearing the risks and expenses for the marketing activities to be undertaken, the nature of the marketing expenses incurred, and the proposed treatment, in particular the non-routine expenses.
INTRA-GROUP FINANCIAL TRANSACTIONS	Taxpayers are required to substantiate and document the terms of intercompany financial assistance, particularly in determining compliance with the arm's length principle regarding the applied interest rate. This includes preparing an analysis to determine the correct level of underlying interest, i.e., the pricing policy, and preparing documentation that accurately delineates the financial assistance, including an analysis of economically relevant characteristics, as stated in paragraph 9.13 of the Guidelines. Taxpayers also need to provide evidence that

SPECIFIC TRANSACTION OR AVENUE	REQUIRED DOCUMENTATION
	they have reviewed existing inter-company agreements on a periodic basis to ensure that all the terms and conditions of the loan remain at arm's length. General documents pertaining to supporting compliance with the arm's length principle should also be applicable to intra-group financing. For example, an agreement that consists of details on the lenders and borrowers, the date of the financing and the amount involved, the interest rate charged, and the basis of charging is necessary in delineating the actual transaction. Documentation and explanation of the economically relevant characteristics should also be provided as part of the CTPD The details of the documentation required will be included in separate guidelines to be issued specifically to address intra-group financial transactions.

CORRECTIONS TO PARAGRAPH REFERENCES IN THE MALAYSIA TRANSFER PRICING GUIDELINES 2024

No	Paragraph	Original Paragraph	Amendment Paragraph
1	Paragraph 1.4	1.4. A permanent establishment ("PE") shall prepare its own full CTPD separately from its head office and related branches, as specified under the Rules, regardless of whether the PE has fulfilled paragraph 1.13.	1.4. A permanent establishment ("PE") shall prepare its own full CTPD separately from its head office and related branches, as specified under the Rules, regardless of whether the PE has fulfilled paragraphs 1.5 or 1.7.
2	Paragraph 3.57	3.57 Cost-based indicators should only be used in those cases where costs are a relevant indicator of the value of the functions performed, assets used and risks assumed by the tested party. In addition, the determination of what costs should be included in the cost base should derive from a careful review of the facts and circumstances of the case. Where the net profit indicator is weighted against costs, only those costs that are directly or indirectly relate to the controlled transaction under review or aggregated in accordance with the	3.57 Cost-based indicators should only be used in those cases where costs are a relevant indicator of the value of the functions performed, assets used and risks assumed by the tested party. In addition, the determination of what costs should be included in the cost base should derive from a careful review of the facts and circumstances of the case. Where the net profit indicator is weighted against costs, only those costs that are directly or indirectly relate to the controlled transaction under review or aggregated in accordance with the

No	Paragraph	Original Paragraph	Amendment Paragraph
		principle in paragraph 4.17 to 4.22 of the Guidelines should be taken into account.	principle in paragraphs 4.15 to 4.20 of the Guidelines should be taken into account.
3	Paragraph 6.17	6.17. When applying the CPM to an associated person who assumes the role of an agent or intermediary to obtain services from independent persons on behalf of its group members, it must be ensured that the arm's length return is limited to rewarding the agency or intermediary function only. It is not appropriate to charge a service fee based on mark-up on the cost of the services obtained from independent persons. Please refer to paragraph 3.7 of the Guidelines for the treatment of pass-through costs incurred by intermediaries or agents.	6.17 When applying the CPM to an associated person who assumes the role of an agent or intermediary to obtain services from independent persons on behalf of its group members, it must be ensured that the arm's length return is limited to rewarding the agency or intermediary function only. It is not appropriate to charge a service fee based on mark-up on the cost of the services obtained from independent persons. Please refer to paragraph 3.68 of the Guidelines for the treatment of pass-through costs incurred by intermediaries or agents.