Updates on Malaysian Transfer Pricing Guidelines 2012

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Audit / Tax / Advisory

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Introduction

The Malaysian Transfer Pricing Guidelines 2012 have been updated by the Inland Revenue Board (IRB) of Malaysia to reinforce the existing standards based on current international taxation requirements. The updated Guidelines have been integrated in consistent with the Base Erosion and Profit Shifting (BEPS) Action Plan 8-10. The Chapters of the Guidelines that have been updated wef from **15 July 2017** are:-

- Chapter II – *The Arm's Length Principle*
- Chapter VIII – *Intangibles*
- Chapter X – *Commodity Transactions*
- Chapter XI - *Documentation*

Major Highlights

How does the Updated TP Guidelines impact businesses?

- The IRB wants to know in greater depth as to where the business drivers are as this will lead to scrutinizing transactions which could be seen as profit shifting.
- In determining the arm's length price of a controlled transaction, besides performing FAR analysis, the IRB is now emphasizing on **"Value Creation"** which is in line with the BEPS. With this in place, it is difficult to identify the value creation and address the pricing for risk allocation for a controlled transaction undertaken between associated persons.
- Taxpayer should consider actual business transactions together with contractual arrangement that reflect economic reality in determining the transfer pricing between associated persons. If the contractual term is not aligned with the conduct of the actual transactions, the returns should be allocated accordingly. There is now greater emphasis on economic substance and what actually happens on the ground vs what happens on paper.
- The updated TP Guidelines has also elaborated on the Risk Analysis whereby the taxpayer needs to identify the risks, evaluate the risks and identify the risks assumed by each party.
- With the introduction of the new Chapter X: Commodity Transactions, taxpayer is required to provide reliable evidence of price setting policy as part of transfer pricing documentation in determining the transfer prices for commodity transactions. Due to the complexity of how commodity market operates – theory vs. actual businesses involved in commodities, it may be difficult to apply in the taxpayer's actual business operations.
- Many commodity transactions have physical delivery of the goods at future dates. There can be a significant period of time between entering into a contract and taking delivery of the goods. As such, the quoted price of a commodity can fluctuate. How will IRB determine the pricing date of the commodity transaction? Would it be the date of entering the contract, the date of taking delivery of the goods, or the average of the commodity price within the period? Will IRB allow the approach of fixing the price at different periods that will be built into the contract? Further clarification is needed from the IRB.
- The updated Chapter VIII: Intangibles might give rise to the increased use of profit split method to determine the arm's length price of intangibles, which is practically difficult to imply as compared to other transfer pricing methodologies. Hence, it can lead to different views of IRB and taxpayer to apply the methodology and can lead to increased litigation cases and disputes between taxpayer and IRB.
- Taxpayers might need to develop and maintain detailed transfer pricing policy aligning with value creation and profit allocation from exploitation of intangibles as per the **DEMPE** functions performed by group entities.
- IRB may disregard commercial irrational transaction. As such, taxpayer needs to ensure substance over form in performing a controlled transaction in order to earn the profits. The cash boxes / entities located in tax haven countries / companies enjoying tax incentives are also at a higher risk of being challenged by the IRB on the factual substance.
- The burden of proof to justify the transfer prices are at arm's length lays with the taxpayer. The taxpayer is required to maintain contemporaneous documentation to assist in demonstrating the taxpayer's transfer pricing policy is appropriate for tax purposes.
- The volume of information to be included in the TP Documentation has significantly increased. Hence, the taxpayer needs to maintain good records and data should be readily available to facilitate extraction thereof. This may lead to increase in compliance cost to the taxpayer.
- Non-compliance of TP will give rise to a higher penalty as the **penalty will be increased to 100%** on the amount of tax undercharged in consequence of the incorrect return or incorrect information under Section 113(2)(b) of the Income Tax Act, 1967.

Chapter II – *The Arm's Length Principle ("ALP")*

What are the updates?

- In determining the ALP, the IRB is now emphasizing on "**Value Creation**" which is in line with the BEPS Action Plan 8 – 10.
- The actual business transaction should be considered together with contractual arrangement that reflect economic reality in determining the ALP between associated persons.
- **Risk Analysis** - Taxpayer needs to identify and evaluate the risks assumed by each party *(See Table 1)*.
- The IRB has provided a **Risk Analysis Framework** *(See Table 2)* as guidance in applying ALP*.*

Table 1: Risk Analysis

Risk Analysis	Description
Risk Management	• Who is responsible to manage the risk? • Who is capable to make decisions?
Risk Assumption	• Who will assume the risk?
Financial capacity to assume risk	• Who has the financial capacity to assume the risk?
Control over risk	• Who has the control over the risk?
Risk Mitigation	• Who will perform the risk mitigation functions?

- Companies providing capital without functionality (i.e. *"cash boxes" companies*) will generate no more than a risk-free return.
- The IRB has introduced **"Berry Ratio"** for intermediary activities.
- To ensure whether the contractual terms are consistent with the conduct of the associated persons. The IRB has the right to accurately delineate the actual transaction based on the factual substance.
- Working capital adjustments should not be automatically made and would not be automatically accepted by IRB. It should only be considered when the reliability of the comparables will be improved and reasonably accurate adjustments can be made.

Table 2: Risk Analysis Framework

Steps	Description
Step 1: Identify economically significant risks with specificity	Categorizing risk more specifically. Example:- • Strategic risks / marketplace risks • Infrastructure / operational risks • Financial risks • Transactional risks • Hazard risks
Step 2: Contractual assumption of risk	• A taxpayer has to prove assumption of risk by showing the exercise of control over the risk and financial capacity to assume the risk.
Step 3: Functional analysis in relation to risk	• How the associated persons operate? • Who performs the control functions and risk mitigation function? • Who encounter upside and downside consequences of risk? • Who has the financial capacity to assume the risk?
Step 4: Interpreting steps 1 to 3	Determine whether contractual assumption risk and the conduct of the parties are aligned by analyzing: • Whether the contractual terms has been followed; and • Whether the party assuming the risk has control and financial capacity to assume the risk
Step 5: Allocation of risk	Risk should be allocated to persons that: • Exercise control and have financial capacity to assume the risk • Has most control if multiple associated persons both exercised control and have financial capacity
Step 6: Pricing of the transaction	• The assumption of a risk should be compensated with an appropriate anticipated return, and risk mitigation should be appropriately remunerated. • A taxpayer that both assumes and mitigates a risk will be entitled to greater anticipated remuneration

Chapter VIII – *Intangibles*

What are the updates?

- The IRB has further clarified on the identification and categories of Intangibles in this Chapter.

- The categories of Intangibles have extended to include the following:
    - Marketing intangibles (commercial intangibles) includes trademarks, trade names, marketing strategies, customer lists, customer relationships, and proprietary market and customer data that is used in marketing and selling goods or services to customers; essentially assets that will help market the products.
    - Government licenses and contractual right include:
        - Government concessions;
        - Production Sharing Contract; and
        - Government licenses/ agreements/ contracts.
    - Other government contracts
    - Grant of license/ concessions/ contracts
    - Exclusive rights in intangibles
    - Goodwill and on-going value

- The IRB emphasizes on **DEMPE** functions (Development, Enhancement, Maintenance, Protection and Exploitation) to determine the significant functions performed, assets utilized and risk assumed by the members of the MNC group.

- In analyzing transactions involving the use or transfer of intangibles between associated persons, the following factors should be taken into consideration :-
  (i) Identifying the intangibles
  (ii) Analyzing the contractual terms
  (iii) Functional analysis
  (iv) Control of the performance of significant functions
  (v) Funding
  (vi) Risks associated with DEMPE of the intangibles

- The IRB may disallow royalty payment if it is not shown that the royalties currently paid are for newly developed or enhanced intangibles as the original intangibles may have become obsolete over the years. The taxpayer must give justification that the original intangibles continue to provide value over time.

Development
Enhancement
Maintenance
Protection
Exploitation

Chapter X – *Commodity Transactions*

This is a new chapter added to the Malaysian Transfer Pricing Guidelines 2012.

What is Commodity?
Commodity is defined to include physical products for which a **'quoted price'** is used as a reference by independent parties in the industry to set prices in uncontrolled transactions.

What is 'Quoted Price'?
The price of the commodity in the relevant period obtained in a domestic or an international commodity exchange market.

What is the most appropriate transfer pricing method?
The CUP method is recognised as the most appropriate method in general by the IRB for establishing the arm's length price for the transfer of commodities between associated enterprises; and reasonable accurate comparability adjustments should be made, when needed, to ensure that the economically relevant characteristics of the transactions are comparable.

Under the CUP method, the arm's length price for commodity transactions can be determined by referencing the comparable uncontrolled transactions and by referencing the comparable uncontrolled arrangements represented by the quoted price.

What are the documents and evidence required by the IRB as part of taxpayers transfer pricing documentation?
The reliable evidence and document comprise of:

- The **price-setting policy** for commodity transactions;
- The information needed to justify price adjustments based on the comparable uncontrolled transactions or comparable uncontrolled arrangements represented by the quoted price; and
- Any other relevant information, such as pricing formulas used, third party end-customer agreements, broker price, premium or discounts applied, pricing date, supply chain information, and information prepared for non-tax purposes.

A particular relevant factor for commodity transactions determined by reference to the quoted price is the 'pricing date'

What is 'pricing date'?
'Pricing date' is a specific time and date selected by the parties to determine the price for commodity transaction.

Where there is difference between written agreement and actual conduct with regard to the "pricing date', the IRB will determine a different 'pricing date' consistent with those other facts of the case.

When taxpayers do not provide reliable evidence and justification on the agreed 'pricing date' by the related parties and the IRB cannot otherwise determine a different 'pricing date' in accordance with the guidelines, the IRB will determine a different 'pricing date' on the basis of the evidence available to the IRB.

Issues affecting businesses:

Topic	Issue
Comparability adjustments	Difficult to determine the reasonable accurate comparability adjustments.
Pricing date	Different pricing dates may be used by taxpayers depending on their business approach, i.e. spot pricing, forward contracts, etc.
	How will IRB verify the pricing date of a commodity transaction? (i.e. solely based on taxpayers' documentation or IRB's experience and IRB's internal documentations.
Quoted price	Quoted prices are not set by a single individual or entity, as they are the result of the interaction of supply and demand in the market for a certain quantity of a type of product at a specific point in time.

Chapter XI - *Documentation*

What are the updates?

Who is required to prepare TP Documentation in Malaysia?

- A taxpayer who has entered into a transaction with an associated person in the basis year for a year of assessment is required to prepare and keep contemporaneous documentations.
- The taxpayer is **required** to maintain contemporaneous documentation to assist in demonstrating whether the taxpayer's transfer pricing policy is appropriate for tax purposes.
- Taxpayers that are obliged under the Income Tax (Country-by-Country Reporting) Rules 2016 to prepare the Country-by-Country Report shall prepare the **Master File** and submit it together with the Transfer Pricing Documentation when requested.

Pricing policy for each type of controlled transactions should include:

Formula adopted, including anticipated profit margin/mark-up and cost component.

How the formula is applied?

Who determine the pricing policy?

How often is the policy being revised?

Sample of documents to support the pricing policy.

Comparability study to ensure the arm's length price.

When does a taxpayer need to prepare TP Documentation?

- At the point when the taxpayer is developing or implementing any arrangement or transfer pricing policy with its associated person; or
- If there are **material changes** when reviewing these arrangements prior to preparing the relevant tax return of his income for the basis year for a year of assessment.
- If there is no material change, the benchmarking analysis should be **updated every three (3) years**.
- However, financial data and suitability of the existing comparable should be **reviewed and updated every year** in order to apply the arm's length principle reliably.

Meaning of "Material Changes"

- Material changes include changes to the operational and economic conditions that will significantly affect the controlled transactions under consideration.

Examples of changes in operational conditions	Examples of changes in economic conditions
a) changes in shareholding; b) changes in business model and structure; c) changes in business activities (e.g. changes in group business activities that give impact to local business activities); d) changes in financial/financing structure; e) changes in TP policy; or f) merger & acquisition.	a) foreign exchange; b) economic downturn; or c) natural disaster.

Penalty will be **increased to 100%** on the amount of tax undercharged in consequence of the incorrect return or incorrect information under Section 113(2)(b) of the Income Tax Act, 1967.

Adjustments may include:

- Form and substance is not the same.
- Comparables selected by the taxpayer do not meet all of the economically relevant characteristics or comparability factors set out in the Rules.
- Inaccurate or misleading explanation of function, assets and risk.

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