An Introduction to the Transfer Pricing Policy in Malaysia

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1.0 Introduction

In July 2003, the Inland Revenue Board of Malaysia (IRB) issued the Transfer Pricing Guidelines (the Guidelines), which aimed at providing multinational enterprises (MNEs) with all the necessary information pertaining to the transfer pricing policy in this country. By doing so, Malaysia has joined other developed countries and many newly industrialised nations in having a policy that basically explains the essence of transfer pricing concept and practice in examining the price charged in a transaction between related parties (Easson, 2003). The Guidelines also elucidate on the application of the arm's length principle and the recommended preparation and documentation in line with the arm's length principle (IRB Malaysia, 2003).

The term transfer pricing refers to the determination of prices at which goods and services are transacted between related parties, especially between related companies in different tax jurisdictions (Ault, 2004). The Guidelines make it very clear that the transfer pricing between entities in a group of MNEs should not differ from the prevailing market price. Generally, when independent enterprises deal with one and another, their commercial conditions and financial relations are determined by market forces. However, when associated enterprises deal with each other, they may not be directly affected by external market forces. This results in the distortion of tax liabilities of the associated enterprises and tax revenues of the host nations.

Like other competent tax authorities, the IRB hopes the Guidelines would ensure the transfer pricing methodologies used by the MNEs are reasonable. The IRB also aims to ensure the Guidelines apply not only to transactions between associated enterprises, but also to transactions between a permanent establishment and its head office or other related IRB branches.

2.0 The Arm's Length Principle

The arm's length principle is the internationally accepted and adopted principle that determines the transfer pricing standard between related parties (Tiley, 2006). Following the Organisation for Economic Co-operation and Development's (OECD) recommendation, the Guidelines expressly acknowledge the arm's length principle as the governing standard for transfer pricing in Malaysia. The arm's length principle is defined in paragraph 1 of Article 9 of the OECD Model Tax Convention 2003 as follows:

> *"(When) conditions are made or imposed between the two 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."*

Meanwhile, paragraph 2 of Article 7 of the OECD Model Tax Convention 2003 states:

> *"Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment."*

Paragraph 2 of Article 7 basically corresponds with the application of the arm's length principle and perhaps explains the IRB's stand to extend the application of the Guidelines to transactions between a permanent establishment and its head office or other related branches.

The arm's length principle has gained universal acceptance as it provides broad parity of tax treatment for MNEs and independent enterprises. The principle also avoids any possible distortion of relative competitive positions of associated enterprises as it puts the former and independent enterprises on an equal footing (OECD, 2000). The IRB's stand to accept this principle should be welcomed as it is an internationally recognised concept in many tax jurisdictions, both in OECD member and non-member countries.

As the Guidelines point out, section 140(1) of the Income Tax Act 1967 **(the Act)** will be applied in the adjustment of transfer prices and the Director-General of Inland Revenue (DGIR) may disregard transactions that are not made at arm's length and make the necessary adjustments.

3.0 Comparability analysis

The arm's length principle is based on a comparison of the conditions in a controlled transaction with the conditions in transactions between independent enterprises. The Guidelines explain that the transactions are deemed comparable if there are no material differences between the compared transactions or if it only requires minor adjustments. The OECD Transfer Pricing Guidelines further add that an understanding of how transactions between unrelated enterprises work is required to determine the degree of comparability (OECD).

There are a few characteristics outlined in the Guidelines that should be taken into consideration in determining comparability:

(a) characteristics of property or services:

Similarity in the characteristics of the property or services transferred plays a vital role in determining their values in the open market, this including:

- the physical features, quality and the volume of supply of property,
- the nature and extent of services, and
- the form of transaction and type of property.

(b) function performed:

The Guidelines also stress that a functional analysis must be carried out in order to ensure the controllable and uncontrollable transactions are comparable. The function alanalysis seeks to identify and compare the economically significant activities undertaken by the independent and associated enterprises. Among the functions that would be taken into account by the IRB are product design, manufacturing, marketing, advertising and research & development.

(c) economic circumstances:

Acknowledging that arm's length prices may differ across different markets, the IRB looks at the geographic location of the market, size of the market, availability of substitute goods and services and the extent of government intervention.

(d) business strategies:

The Guidelines further list innovation and new product design, degree of diversification, market penetration scheme and distribution channel selection as part of the business strategies that would be taken into account.

4.0 Pricing methodologies

The OECD has recommended five methods that could be utilised in evaluating the consistency of the transfer price between the associated enterprises with the arm's length principle. It must be noted that the taxpayer must endeavour to choose the best method, i.e. the method that provides reliable comparability based on sufficient independent sources with minimum or no adjustment by the tax authority. In doing so, they should take note of the following factors (IRB Malaysia):

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

A quick glance of the comparability factors drawn up by the Australian tax authority show similar factors are also taken into consideration by them (ATO, 2005):

- the nature of the activities being examined
- the availability, coverage and reliability of the data;
- the degree of comparability that exists between the controlled and uncontrolled dealings or between enterprises undertaking the dealings, including all the circumstances in which the dealings took place, and
- the nature and extent of any assumptions.

Meanwhile, the five transfer pricing methods are:

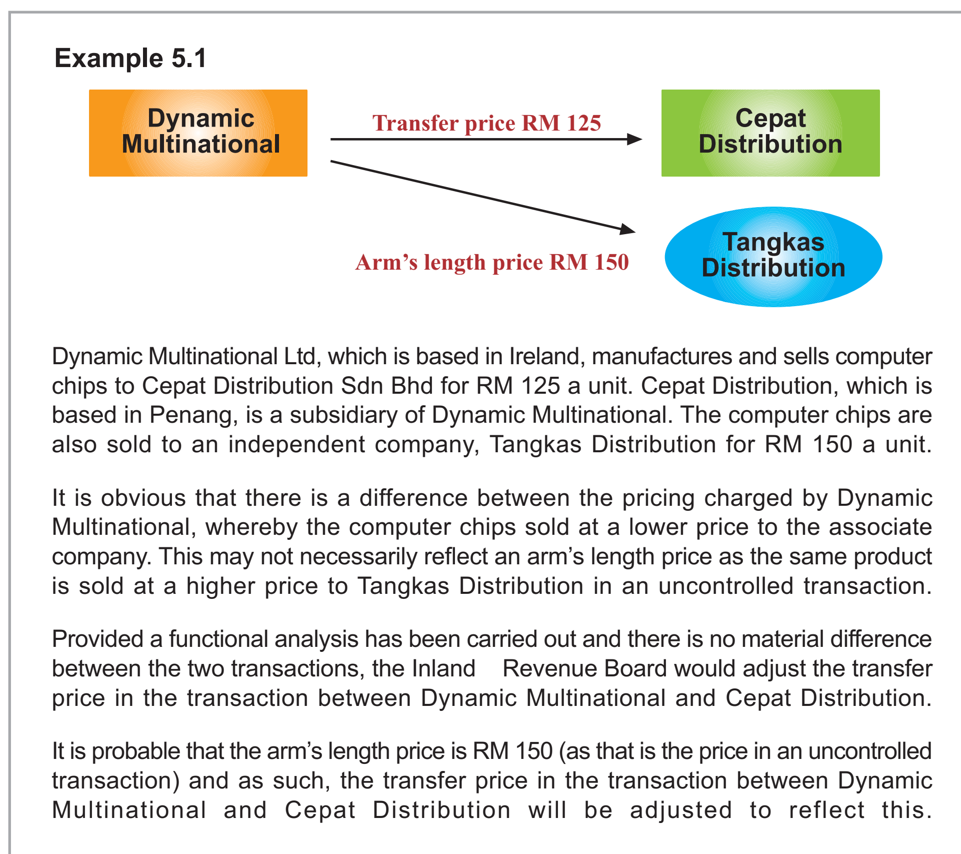
- comparable uncontrolled price method
- resale price method
- cost plus method
- profit split method
- transactional net margin method

The comparable uncontrolled price method, resale price method and cost plus method are all known as the traditional transactional methods. The remainder two are known as the transactional profit methods. The Guidelines have adopted all the five methods introduced by the OECD. Having said that, the IRB has clearly expressed that the traditional methods should be attempted first before the transactional profits methods are considered. It appears that the latter is regarded as the 'last resort' option.

There is no reason expressed by the IRB in preferring the traditional methods to the transactional profits methods as other tax authorities in Asia Pacific (namely, Singapore, Australia and New Zealand) do not impose such requirement. Nevertheless, the willingness of the IRB to consider the transactional profits methods as an alternative is welcomed as the complexities of the real life business scenarios may impose practical constraints in applying the traditional methods (OECD, 2003).

5.0 The Comparable Uncontrolled Price Method (CUP)

This method focuses directly on the price of the property or services transferred in a controlled transaction to the price charged for the property or services in a comparable independent transaction. Provided both transactions are in comparable circumstances, any price difference between the two may indicate the transfer pricing of the associated enterprises (i.e. in the controlled transaction) is not at arm's length (ATO, 2005 and OECD, 2003). The Guidelines state that the CUP method is appropriate where there is comparability between the transactions and circumstances, and more importantly, it allows the IRB to make reasonable adjustments in the event of some differences.



In undertaking the comparability analysis, the Guidelines emphasise on the need to consider among others, the product characteristics, whether goods sold are compared at the same points in the production chain, costs of transport and whether the products are sold in places where the economic conditions are the same.

6.0 The Resale Price Method

The resale price method focuses on the gross margin obtained by the distributor (Ault). As stated in the Guidelines, the resale price method is appropriate where the final transaction is with an independent distributor. The efficiency of this method depends on the value added or alteration made by the reseller on the product before it is resold. The margin of resale price would be derived from comparable transactions between the reseller and other independent parties (OECD). The Guidelines detailed a list of factors that may influence the resale price margin. This including the functions of activities performed by the reseller and the risks undertaken, employment of similar assets in controlled and uncontrolled transactions, and the time lapse between original purchase and resale of the product as a longer time lapse may give rise to changes in the market.

Example 6.1

Arm's length sales RM80

Transfer price RM75

Cepat Distribution → Independent Retailers

Dynamic Multinational

Resale price margin 10%

Tangkas Distribution → Independent Retailers

Arm's length price

Arm's length sales

Dynamic Multinational is a multinational entity based in Japan and manufactures high quality computer chips. These computer chips are distributed in Malaysia by Cepat Distribution Sdn. Bhd., a subsidiary Dynamic Multinational. Cepat buys these computer chips for RM 75 per unit and sells it to independent retailers for RM 80 a unit.

Dynamic Multinational also sells the same product to an independent company, Syarikat Tangkas, which distributes the computer chips in Malaysia.

A functional analysis was carried out and both Cepat and Tangkas appear to be carrying out similar functions except that Cepat also performs marketing and promotional functions for Dynamic Multinational.

It appears that the gross profit made by Tangkas is at 10%. As the focus of this method is on margins, the difference between the functions performed by Cepat and Tangkas is immaterial. Dynamic's transaction with Tangkas will be used as a benchmark to determine the arm's length price of the transaction between Dynamic Multinational and Cepat Distribution.

As such, the resale price margin of 10% will be used to determine the arm's length price for the original purchase by Cepat from Dynamic.

Therefore, the arm's length price of the product purchased by Cepat Distribution is:

RM 80 – (RM 80 X 10%) = RM 72

Cepat Distribution is advised that the original purchase price of the semiconductors will be adjusted from RM 75 to RM 72 per unit.

7.0 The Cost Plus Method

The cost method plus is appropriate where semi-finished goods are sold between associated parties as the parties could have concluded joint facility agreements or long-term buy and supply arrangements. This method basically looks at the costs incurred by the supplier of property in a controlled transaction for property transferred to a related party (OECD). The Guidelines explain that an appropriate mark-up is added to this cost to find the price the supplier ought to be charging the buyer. The mark-up is established by reference to the mark-up earned by the same supplier from comparable uncontrolled sales to independent parties. Again, the Guidelines stress that in considering comparability, factors like similarity of functions, risks assumed, contractual terms, business strategies and market conditions must be taken into account.

Example 7.1

Arm's length price RM50

Transfer price RM110

Supplier PLC → Cepat Distribution → Dynamic Multinational

Mark-up 10%

Independent Supplier → Syarikat Ria → Independent Retailers

Mark-up 30%

Example 7.1 *(contd)*

Cepat Distribution was established in Malaysia by Dynamic Multinational to manufacture specialised semiconductor components. Cepat Distribution obtains the materials used to manufacture this product from Supplier PLC, an independent company based in the United Kingdom, for RM 50 a unit. It costs Cepat Distribution RM 50 to manufacture each unit of the semiconductors and they are sold to Dynamic Multinational for RM 110 a unit.

Meanwhile, an unrelated company, Syarikat Ria, undertakes a similar function like Cepat Distribution, charges an average mark-up of 30% in manufacturing and selling similar product to independent companies. Assuming the functional analysis shows both Syarikat Ria and Cepat Distribution are carrying out a similar function, the average mark-up of 30% by Syarikat Ria, can used to determine the arm's length price.

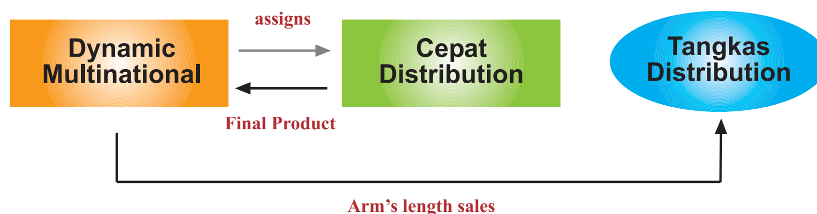
As such the adjusted price would be as the following:
= RM 100 + (RM 100 X 30%)
= RM 130

Cepat Distribution is advised that the original selling price of the semiconductors to Dynamic Multinational will be adjusted from RM 110 to RM 130 per unit.

8.0 The Profit Split Method

This method seeks to eliminate the effect of special conditions made or imposed on profits in a controlled transaction. This is done by deciding the division of profits that would have realised if the transaction involved independent enterprises (OECD, 2003). The Guidelines have suggested the residual profit split approach and the contribution analysis approach in estimating the division of profits. The strength of the profit split method lies in it not relying directly on comparable transactions (OECD, 2003). This is certainly an alternative method for a taxpayer, who cannot rely on similar transactions involving independent enterprises. The allocation of profit based on the division of functions between the associated enterprises and external data is only relevant to assess the value of the contributions made by each associated enterprise to the transaction.

Example 8.1



Cepat Distribution is assigned by Dynamic Multinational to perform some additional work to the semiconductor components before turning them into final products. These semiconductors are then sold by Dynamic Multinational to Tangkas Distribution, an independent company, for distribution in Malaysia.

There are some reliable information that suggest companies performing similar functions like Cepat Distribution and Dynamic Multinational, respectively have an average mark-up of 20% and 30%.

The simplified trading accounts of Cepat Distribution and Dynamic Multinational are as follows:

	Cepat Distribution (RM '000)	Dynamic Multinational (RM '000)
Sales	200	400
Costs of Goods sold	(120)	(100)
Gross Margin	80	300
Sales & General Expenses	(10)	(20)
Other operating costs	(10)	(20)
Net Profit	60	260

The combined profit of Cepat Distribution and Dynamic Multinational is RM 320,000.

The following two steps are to be adopted to determine Cepat Distribution and Dynamic Multinational's respective share of profit.

Step One: Calculation of the basic return

Cepat Distribution:

Cost of goods sold		RM	120,000
Cost of mark up (20% X RM 120,000)	+	RM	24,000
Transfer Pricing		RM	144,000

Dynamic Multinational:

Sales to third party		RM	400,000
Resale margin: 30% X RM 400,000	=	RM	120,000

	Cepat Distribution (RM '000)	Dynamic Multinational (RM '000)
Sales	**144**	
Costs of Goods sold	**(120)**	
Gross Margin	**24**	**120**
Sales & General Expenses	**(10)**	**(20)**
Other operating costs	**(10)**	**(20)**
Net Profit	**4**	**80**

The combined profit of both the companies is RM 84,000.

Step 2: Dividing the residual profit

The residual profit of the companies is RM 320,000 – RM 84,000 = RM 236,000.

This is assumed here that:

(i) the research & development expenses are at RM 15,000 (30%) and RM 35,000 (70%) for Cepat Distribution and Dynamic Multinational respectively, and

(ii) the companies' contributions to the residual profits are a reliable indicator.

As such;

a) Cepat Distribution's share of residual profit is: (70% X RM 236,000) = RM 165,2000

b) Dynamic Multinational's share of residual profit is: (30% X RM 236,000) = RM 70,800

The adjusted operating profit of:

a) Cepat Distribution is RM 165,200 + RM 4,000 = RM 169,200

b) Dynamic Multinational is RM 70,800 + 80,000 = RM 150,800

	Cepat Distribution (RM '000)	Dynamic Multinational (RM '000)
Sales	**309.20**	**400**
Costs of Goods sold	**(120)**	**209.20**
Gross Margin	**189.20**	**190.80**
Sales & General Expenses	**(10)**	**(20)**
Other operating costs	**(10)**	**(20)**
Net Profit	**169.20**	**150.80**

The adjustment would result in Cepat Distribution having a sale of RM 309,200 rather than RM 200,000 as declared earlier.

9.0 The Transactional Net Margin Method (TNMM)

The TNMM examines the net profit margin relative to an appropriate base such as costs, sales or assets realised by the MNE from a controlled transaction. As this method uses the margin approach, which are similar to the cost plus and resale price methods, the net margin of the MNEs are established by reference to the net margin that the MNE would have earned in a comparable uncontrolled transaction. One advantage of this method is that it takes into account the function differences between the controlled and uncontrolled transactions, rather than merely looking at the gross profit margins (OECD). The Guidelines recognise that as the net margins are significantly influenced by factors other than products and functions, the application of this method is strictly confided to cases where functions have a high degree of similarity.

Example 9.1

Transfer price

Arm's length sales

Dynamic Multinational → Cepat Distribution → Independent Retailers

manufactures

Effective Semiconductors

Dynamic Multinational sells semiconductors to Cepat Distributor, an associated company based in Malaysia. Cepat Distributor only sells and distributes the "Advanced" semiconductors manufactured by Effective Semiconductors, another subsidiary of Dynamic in India. All the semiconductors sold by Cepat Distribution bear the "Advanced" trademark.

The trading account for Cepat Distribution is as follows:

Sales	**RM200000**
Costs of Goods sold	**RM175000**
	RM25000
Operating expenses	**RM30000**
Net loss	**RM(5000)**
Margin	**5%**

It is assumed here that the CUP method is not applied as no reasonable adjustments can be made to account for the differences with similar products in the market. It has emerged that Tangkas Distribution, an independent company performs a similar activity and is a suitable comparable company. It also appears that Tangkas Distribution realizes a net mark up of 15%. The TNMM is applied here on the basis of net profit return on sales with a net mark up of 15%.

The computation of the transfer price for the semiconductors purchased by Cepat Distribution is as follows:

Net profit of Cepat Distribution is RM 200000 X 15% = RM 30000

Adjusted cost of semiconductors sold by Cepat Distributors is:
= RM 200000- RM 30000- RM 30000
= RM 140000

10.0 Global Formulary Apportionment

It must be highlighted here that like the OECD member countries, the IRB has categorically stated that the global formulary apportionment is not an acceptable transfer pricing method. This method operates by allocating the global profits of an MNE group on a consolidated basis among the associated enterprises in different countries on the basis of a predetermined and mechanistic formula. The IRB has rejected this method on the premise that it does not satisfy the arm's length conditions.

11.0 Documentation

Section 82(1)(a) of the Act requires taxpayers to maintain sufficient records for a period of seven years to enable the DGIR to ascertain income or loss from business. Section 82(9) of the Act states that 'records' among others include books of account, invoices, vouchers and receipts.

MNEs are required to furnish the IRB information and documentation that contain the following information:

- company details
- transaction details
- determination of arm's length price

Although the IRB's initiative in listing the required documents and information is welcomed, it would be more beneficial to the MNEs and taxpayers if a detailed guidance is provided as to the level of documentation and information expected of them.

Perhaps the Australian Taxation Office approach can be emulated, as they succinctly explain the levels of quality of processes and documentation for transfer pricing involving related parties. (as shown in the table below)

Levels of Quality of Processes and Documentation for International Dealings with Related Parties

1 Low quality	2 Low to medium quality	3 Medium quality	4 Medium to high quality	5 High quality
No analysis of functions, assets risks, market conditions and business strategies	No analysis of functions, assets risks, market conditions and business strategies	Inadequate analysis of functions, assets risks, market conditions and business strategies	Sound analysis of functions, assets risks, market conditions and business strategies	Sound analysis of functions, assets risks, market conditions and business strategies
No documentation or processes to enable a check on selection of methodologies	Insufficient documentation or processes to enable a check on selection of methodologies	Selection of method supported with some contemporaneous documentation	Selection of method fully supported with contemporaneous documentation	Selection of method fully supported with contemporaneous documentation
No comparables used No documentation or processes to enable a check on application of methodologies	No comparables used No documentation or processes to enable a check on application of methodologies	Broad inexact comparables used or comparability based on data from external related party comparables Application of method supported with some contemporaneous documentation	Comparability based on limited data from independent dealings Reliability assessed Application of method fully supported with contemporaneous documentation	Comparability based on adequate data from independent dealings Reliability taken into account in choice of comparables Application of method fully supported with contemporaneous documentation
No effort to implement and review arm's length transfer pricing policies	Limited effort to implement and review arm's length transfer pricing policies	Limited effort to implement and review arm's length transfer pricing policies	Genuine effort to implement and review arm's length transfer pricing policies	Genuine effort to implement and review arm's length transfer pricing policies

(Source: International Transfer Pricing: Introduction To Concepts and Risk Assessment, Australian Taxation Office, 2005)

12.0 Conclusion

The rules governing transfer pricing is significant for both taxpayers and tax administrators because it determines in large the income expenses and taxable profits of associated enterprises in different tax jurisdictions. Businesses should endeavour to practice a high integrity process in determining their pricing method and maintain adequate documentation to justify the selected transfer pricing methodology. It is also equally important for businesses to ensure the methodology chosen by them provides a commercially realistic mechanism when applying the 'transfer pricing' rules.

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Footnote

The authors acknowledge that examples 5.1, 6.1, 7.1, 8.1 and 9.1 are adapted from the examples contained in the Transfer Pricing Guidelines published by the Inland Revenue Board of Malaysia and Inland Revenue Authority of Singapore.

Author's Profile

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Errata

Part I of "An Introduction to the Transfer Pricing Policy in Malaysia" was published in the previous issue (Q4/2006) of Tax Nasional. However there were some "misplaced" sentences /paragraph. Therefore in the interest of continuity and easy reference we are reprinting Part I (in full) together with Part II as one complete article.

Tax Nasional apologises to the authors and thanks them for their gracious cooperation and understanding.