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Transfer Pricing update: Master file requirement introduced alongside other BEPS recommendations

The Inland Revenue Board of Malaysia ("IRB") has released the first set of revisions to the Malaysian Transfer Pricing Guidelines 2012 ("TPG"), to align with BEPS Actions 8-10 and Action 13 recommendations. The revisions pertain to guidance on Arm's Length Principle and Documentation, while dedicating separate new chapters to Intangibles and Commodity Transactions, and providing certain Malaysia specific examples on interpretation. The key takeaways from the revised version released earlier this week are summarised below.

Chapter II: Arm's Length Principle

- Reaffirms adoption of arm’s length principle in determining pricing of controlled transactions.

- Emphasis on achieving transfer pricing outcome that is consistent with value creation; i.e., mere contractual assumption of risk or provision of capital may not warrant super normal returns.

- Contractual arrangement should reflect economic reality and contractual allocation of risks to be respected only when supported by actual decision making.

- At most a **risk-free return on capital provision that lacks functionality** – target is “cash-box” entities.

- IRB to **disregard transactions that are commercially irrational**.

- Emphasis on accurate delineation of transactions and “options realistically available”.

- **Correlation of functional analysis with value creation (group-wide)** – more detailed analysis required moving forward, focusing on both parties to the controlled transaction. One-sided functional analysis would not work.

- **Reaffirmation of preference for local tested party** (and consequently local comparables).

- **Berry ratio** is recognised as a profit level indicator and specific circumstances elaborated for application.

- Agreements to provide starting point for delineation of controlled transactions. Emphasis on conduct over contract, and supplementing written contractual terms based on actual commercial/financial relations evidenced.

- Any increase in economically significant functions performed should be compensated by an increase in profitability.

- Acknowledgement of OECD concepts of “control over risk” and “financial capacity to assume risk”.

- **Control over the activity of a local affiliate can increase permanent establishment risk for the controlling entity**, subject to relevant DTA.

- The **form of remuneration would not be sufficient to dictate assumption/allocation of risks between affiliates**.

- **Recognition of working capital adjustments** that enhance comparability; **however, these would not be automatically accepted by IRB**.

Chapter VIII: Intangibles

- Definition of "Intangibles" consistent with OECD prescription.

- **Government licences and contractual rights to qualify as intangibles** under certain circumstances. Examples include (among others):

  - **Production sharing contracts**;
  - Licence for broadcasting or licence for Network Facilities Provider and Network Service Provider;
  - Power purchase agreement; and
  - **Contract to supply pharmaceutical products to government hospitals**.

- Exclusive rights in intangibles are themselves intangibles.

- Recognition of the DEMPE concept as well as legal ownership of intangibles, consistent with OECD.

- **Taxpayer paying royalty needs to provide evidence** for:

  - Underlying intangible;
  - Processes that utilise the intangible;
  - Benefits obtained;
  - Economically significant risks associated with DEMPE of the intangibles; and
  - Withholding tax payment.

- **Economically significant activities in connection with intangibles defined** to include:

  - Research and development activities which lead to **customisation/enhancement** of **existing** products or **new** products;
  - Activities which lead to **improvement in manufacturing processes**;
  - Advertising, marketing and promotional activities which lead to creation/enhancement of marketing intangibles; and
  - Managing customer relationship, localisation of products/advertisements or marketing survey including collection of local data.

  Where a local entity performs any of the above functions, the **costs incurred** for such expenses **should not be merely reimbursed** to the local entity **without any profit element**. A local entity carrying out such core functions would generally control the strategic operational 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 to separate the performance and the control of a function** under such circumstances.

- Where a local entity contributes towards the enhancement of an intangible, the local entity is considered as having **"economic ownership"** of the said intangible, irrespective of legal ownership of that intangible.

- **Risk-insulated contract R&D service provider characterisation would not sustain** merely on grounds of strategic decisions and overall directions from a foreign entity.

- In determining the arm's length price for controlled transactions involving intangibles, if it is difficult to find comparable uncontrolled transactions, the profit split method or ex-ante valuation techniques may be used.

- The revised guidance recognises the concept of Hard-to-Value Intangibles in connection with under/over estimation of anticipated profits (entitlement to difference between ex-ante and ex-post return).

- **Routine or Limited Risk distributor characterisation** (and consequent nominal profit) of local entity which performs significant advertising, marketing and promotional (AMP) functions and bears associated costs/risks that lead to the creation of local marketing intangibles, **would not sustain**. Such intangibles would attract more than a routine return; in fact the AMP function should be remunerated for its effort **with or without** the creation of local marketing intangibles. A **marketer-distributor is expected to generate higher margin** which may be in the form of:

  - A reduction in purchase price;
  - A reduction in royalty rate; or
  - A share of profits associated with the enhanced value of the marketing intangibles.

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

- Where a **limited risk distributor** performs marketing activities on behalf of the principal, although such activities may not create marketing intangibles, such distributor **should be compensated by way of a service fee for the marketing function**, in addition to an arm's length margin for its distribution functions. Absence of an agreement covering such service fee arrangement,

would not prevent application of the arm's length principle under these circumstances.

- A cost plus compensation will not reflect the anticipated value of the intangibles created or the contribution of the research team. Therefore, a local contract R&D service provider should be remunerated based on accurate delineation of the transaction. An analysis of the value contributed by such entity to the overall group operations should be provided.

- Where a **local entity creates a unique intangible** as a result of its R&D activities, and the legal ownership is transferred to a foreign entity without any appropriate compensation, the **remuneration** for such transfer should be **based on a share of profit from the future exploitation of the intangible**, in addition to an arm's length compensation for the R&D activities.

- Where a **contract manufacturer makes enhancements to processes** and the legal ownership is assumed by another group member, the contract manufacturer **should be entitled to a return on the enhancements** if these are transferred to or shared with other related entities. If the enhancements are self-exploited by the local entity, an increase in margin should be reflected.

- If it is possible and appropriate to separate services/tangible good transactions from transfer of intangibles/rights in intangibles, the **price of a package contract should be disaggregated**; this applies in analogy to a situation where an arrangement of services and intangibles transferred in combination is so unique that sufficient reliable comparables are not available.

- **Continued payment of royalty** (indefinitely) by a local manufacturer, although it has gained the necessary experience in due course, **would be challenged**.

- Where a local company using the technical know-how of a foreign affiliate, has incurred significant expenditure to customise such know-how and to enhance its value through own R&D efforts, the cost of such R&D activities should be considered when determining the arm's length royalty for the original know-how or patents. Under these circumstances, if the local company continues to pay a royalty to the foreign affiliate owner of the original intangible, it **must give justification that** such **original intangible continues to provide value over time**. Also, the local company may be entitled to a return on the exploitation of the locally created or enhanced intangibles by other related companies.

- **IRB would disallow royalty payment** if it is not demonstrated that the royalty currently paid is for newly developed or enhanced

intangibles, especially where the original intangibles have become obsolete over the years.

Chapter X: Commodity transactions

- **"Commodities" 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.

- **"Quoted price" defined** as the price of the commodity in the relevant period obtained in a domestic or an international commodity exchange market.

- **Comparable Uncontrolled Price method recognised as the most appropriate** method in general.

- Taxpayers required to **provide evidence of price setting policy** as part of transfer pricing documentation.

- Where there is difference between contract and conduct with regard to the "pricing date" (specific time and date selected by the parties to determine the price for commodity transaction), the IRB would have discretion over determining the "pricing date".

Chapter XI: Documentation

- Reaffirms requirement to prepare contemporaneous documentation notwithstanding the exclusion in Paragraph 3 of the TPG.

- **"Material changes"** warranting update of transfer pricing documentation ("TPD") **defined** to **include changes in operational and/or economic conditions** having a bearing on controlled transactions.

  Examples provided for "operational conditions":

  - Changes in shareholding;
  - Changes in business model and structure;
  - Changes in business activities;
  - Changes in financial/financing structure;
  - Changes in TP policy; or
  - Merger or acquisition.

  Examples provided for "economic conditions":

  - Foreign exchange;
  - Economic downturn; or
  - Natural disaster.

- Provided operational conditions remain the same, **comparables search needs to be refreshed every three years**. However,

financial data and suitability of the existing comparables should be reviewed and updated annually.

- Additional items required in TPD (some in line with OECD Local File prescription), such as management structure, **detailed information on pricing policies**, specific reference to Risk Analysis Framework for functional analysis, information on involvement of local entity in business restructuring or intangibles transfer, reconciliation between transfer pricing computations and financial statements, etc.

- **Introduction of Master File requirement**:

  - Applies to taxpayers required to prepare Country-by-Country Report under the Income Tax (Country-by-Country Reporting) Rules 2016;
  - Applies to MNC Group where the parent prepares Master File;
  - To be submitted together with TPD, upon request; and
  - Contents of Master File largely consistent with OECD prescription.

- Penalty rates would continue to be as listed in the TP Audit Framework.

- Penalty provisions elaborated:

  - Information provided in TPD would be considered incorrect and attract **penalty** under section 113(2)(b) of ITA [100% of tax undercharged], **where the facts presented in TPD are different from actual conduct**.
  - Other circumstances that may lead to a penalty include:
    - **Difference between form and substance**; i.e., contract and conduct are different;
    - **Comparables** selected by the taxpayer **do not meet all of the economically relevant characteristics or comparability factors**;
    - **Inaccurate or misleading explanation** of function, assets and risk.

- Penalty **will not be imposed** where:

  - TPD is submitted within 30 days upon request; and
  - TPD fulfils the requirements of the TP Rules and the revised TP Guidelines.

Way-forward for taxpayers

It is critical for taxpayers to identify any potential areas of risks or gaps in their intragroup pricing policies, actual practices and TPD, and make desired changes or build adequate defensible positions for audits. The revisions to TPG reflect the IRB's current stance on transfer pricing enforcement and the approach to be adopted in

transfer pricing audits moving forward. With greater clarity on the requirements, it is imperative that the IRB would enforce higher degree of compliance as reflected in the penalty elaborations.

Deloitte will conduct a seminar shortly on the above development. Please look out for information on the seminar.

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