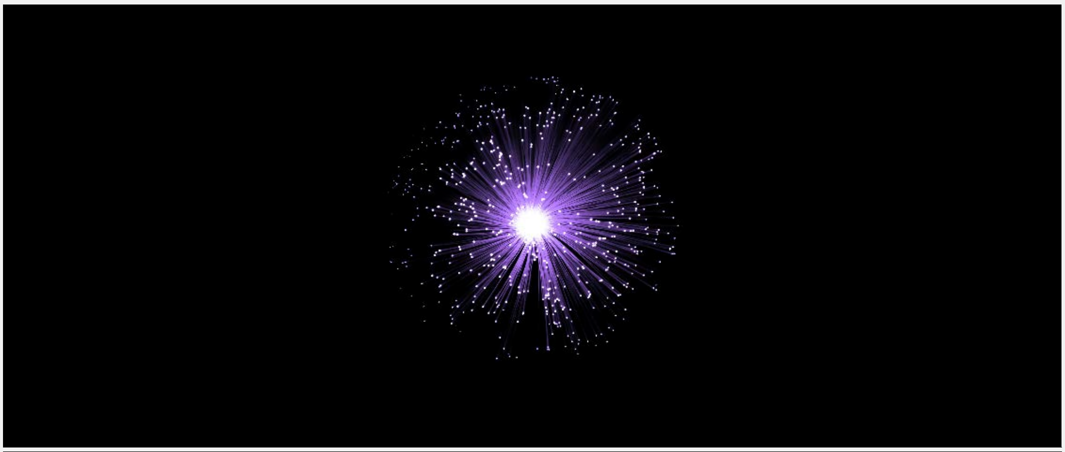

Malaysia introduces master file requirement, other BEPS recommendations

Global Transfer Pricing Alert 2017-034

Malaysia's Inland Revenue Board (IRB) has released the first set of revisions to the Malaysian Transfer Pricing Guidelines 2012, to align with BEPS Actions 8-10 and Action 13 recommendations.

The revisions pertain to guidance on the arm's length principle and documentation, dedicate separate new chapters to intangibles and commodity transactions, and provide Malaysia-specific examples on interpretation. The key takeaways from the revised version of the guidelines, effective July 15, are summarized below.

Chapter II: Arm's length principle

The revisions to Chapter II reaffirm the adoption of the arm's length principle to determine the pricing of controlled transactions.

The revised chapter emphasizes achieving transfer pricing outcomes that are consistent with value creation; that is, a mere contractual assumption of risk or provision of capital may not warrant above-normal returns.

Under the revised guidelines, contractual arrangements should reflect economic reality, and contractual allocations of risk are to be respected only when supported by actual decision-making.

Among the salient points in the revised chapter on the arm's length principle are the following:

- A capital provision that lacks functionality will generate at most a risk-free return, so that no premium returns will be allocated to "cash-box" entities.
- IRB will disregard transactions that are commercially irrational.
- Emphasis will be placed on the accurate delineation of transactions and "options realistically available."
- Correlation of functional analysis with value creation (group-wide) – a more detailed analysis will be required going forward, focusing on both parties to the controlled transaction. A one-sided functional analysis would not work.
- Reaffirmation of preference for local tested party (and consequently local comparables).
- The Berry ratio is recognized as a profit level indicator, and specific circumstances for its application are provided.
- Contractual agreements provide the starting point for delineation of controlled transactions. Emphasis is on conduct over contract, and the written contractual terms may be supplemented based on evidence of the actual commercial/financial relations.
- 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 the relevant double tax agreement.
- The form of remuneration would not be sufficient to dictate the 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

The revised guidelines include a definition of "intangibles" that is consistent with the OECD guidance.

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

- Production-sharing contracts
- License for broadcasting or license for Network Facilities Provider and Network Service Provider
- Power purchase agreement
- Contract to supply pharmaceutical products to government hospitals.

Exclusive rights in intangibles are themselves intangibles.

The revised guidelines recognize the DEMPE concept (the development, enhancement, maintenance, protection, and exploitation of intangibles), as well as legal ownership of intangibles, consistent with the OECD guidance.

A taxpayer paying a royalty for the use or transfer of intangibles must provide evidence of:

- The underlying intangible
- Processes that utilize the intangible
- Benefits obtained
- Economically significant risks associated with DEMPE of the intangibles
- Withholding tax payments

Economically significant activities in connection with intangibles are defined to include:

- Research and development activities that lead to customization/enhancement of existing products or new products;
- Activities that lead to improvement in manufacturing processes;
- Advertising, marketing, and promotional activities that lead to creation/enhancement of marketing intangibles; and
- Managing customer relationship, localization of products/advertisements, or marketing surveys including collection of local data.

When a local entity performs any of the above functions, the costs incurred 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.

Under the revised guidelines, when a local entity contributes to the enhancement of an intangible, the local entity is considered to have “economic ownership” of the intangible, irrespective of the legal ownership of that intangible.

Characterization as a risk-insulated contract R&D service provider would not be sustained merely on grounds of strategic decisions and overall direction 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 recognizes 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* returns).

Characterization of a local entity that performs significant advertising, marketing, and promotional (AMP) functions and bears associated costs/risks that lead to the creation of local marketing intangibles as a routine or limited-risk distributor (and the consequent nominal profit) would not be sustained. Such intangibles would attract more than a routine return; in fact, the entity's AMP function should be remunerated for its effort with or without the creation of local marketing intangibles. A marketer-distributor is expected to generate a 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 that merely mentions that the extra return was embedded in the purchase price is not acceptable evidence that the AMP functions are appropriately compensated.

When a limited-risk distributor performs marketing activities on behalf of the principal, even though those activities may not create marketing intangibles, the 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. The absence of an agreement covering such service fee arrangement would not prevent application of the arm's length principle under those circumstances.

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 the accurate delineation of the transaction. An analysis of the value contributed by the entity to the overall group operations should be provided.

When 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 appropriate compensation, the remuneration for that transfer should be based on a share of the profits from the future exploitation of the intangible, in addition to an arm's length compensation for the R&D activities.

When 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 they 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 transfers of intangibles/rights in intangibles, the price of a package contract should be disaggregated; this applies by analogy to a situation whereby an arrangement of services and intangibles transferred in combination is so unique that sufficient reliable comparables are not available.

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

When a local company, using the technical know-how of a foreign affiliate, has incurred significant expenditures to customize such know-how and to enhance its value through its 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 those circumstances, if the local company continues to pay a royalty to the foreign affiliate owner of the original intangible, it must provide a justification that the 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.

The IRB would disallow a royalty payment if it is not demonstrated that the royalty currently paid is for newly developed or enhanced intangibles, especially when the original intangibles have become obsolete over the years.

Chapter X: Commodity transactions

Under the revised guidelines, "commodities" are 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" is defined as the price of the commodity in the relevant period obtained in a domestic or an international commodity exchange market.

The revised guidelines recognize the comparable uncontrolled price method as the most appropriate method in general.

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

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

Chapter XI: Documentation

The revisions reaffirm the requirement to prepare contemporaneous documentation, notwithstanding the exclusion in Paragraph 3 of the Malaysian transfer pricing guidelines.

"Material changes" warranting an update of transfer pricing documentation are defined to include changes in operational and/or economic conditions that have a bearing on controlled transactions.

The revisions provide examples of "operational conditions":

- Changes in shareholding
- Changes in business model and structure
- Changes in business activities
- Changes in financial/financing structure
- Changes in transfer pricing policy
- Merger or acquisition

In addition, the revisions provide examples of “economic conditions”:

- Foreign exchange
- Economic downturn
- Natural disaster

Under the revised guidelines, comparable searches must be refreshed every three years, provided operational conditions remain the same. However, financial data and suitability of the existing comparables should be reviewed and updated annually.

Additional items are required as part of transfer pricing documentation (some in line with OECD local file guidance), such as management structure, detailed information on pricing policies, specific reference to risk analysis framework for functional analysis, information on involvement of a local entity in business restructuring or intangibles transfer, reconciliation between transfer pricing computations and financial statements, etc.

The newly introduced master file requirement applies to taxpayers required to prepare a country-by-country report under the Income Tax (Country-by-Country Reporting) Rules 2016. The requirement also applies to a multinational enterprise (MNE) group when the parent prepares the master file. The master file is to be submitted together with transfer pricing documentation, upon request. The contents of the master file are largely consistent with the OECD guidance.

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

The revised guidelines elaborate on the penalty provisions:

- Information provided as part of transfer pricing documentation would be considered incorrect and attract a penalty under section 113(2)(b) of ITA [100 percent of tax undercharged], when the facts presented in documentation are different from actual conduct.
- Other circumstances that may lead to a penalty include:
  - Differences between form and substance; for instance, if a 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.

Penalties will not be imposed when transfer pricing documentation is submitted within 30 days upon request, and the documentation fulfils the requirements of the transfer pricing rules and the revised transfer pricing guidelines.

Way forward for taxpayers

It is important for taxpayers to identify any potential areas of risk or gaps in their intragroup pricing policies, actual practices, and transfer pricing documentation, and make desired changes or build adequate defensible positions for audits. The revisions to the transfer pricing guidelines 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 enforce a higher degree of compliance as reflected in the penalty elaborations.

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