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Global Tax Alert
News from Transfer Pricing

Malaysia updates transfer pricing guidelines and introduces master file requirements

Executive summary

On 15 July 2017, Malaysia's updated transfer pricing guidelines (the Guidelines) became effective, which modify its transfer pricing rules and introduce documentation requirements that conform to the Organisation for Economic Co-operation and Development's (OECD) Base Erosion and Profit Shifting recommendations. Key changes include adopting a substance-focused arm's-length principle, expanding the definition of intangibles and introducing the Development, Enhancement, Maintenance, Protection and Exploitation (DEMPE) concept, requiring additional considerations to support pricing of intercompany commodity transactions, and updating transfer pricing documentation policies including a requirement to submit a master file by certain taxpayers.

Detailed discussion

Arm's-length principle

The Guidelines adopt a substance over conduct principle associated with contracts and require a more detailed analysis of functions performed, assets employed and risks assumed. The analysis should emphasize the substance and value creation between the affiliates to ascertain the transfer price outcomes. In addition, funding without functionality will generate no more than risk-free return, assuring that no premium returns will be allocated to "cash boxes"[1] without substance.

The Guidelines require the functional analysis to align value-creating activities with transfer pricing outcomes by increasing remuneration for significant functions undertaken, with an emphasis on financial capacity to assume risk and exercise control over risk. Failure to conform to the terms of the written contract may cause the transaction to be recharacterized according to the factual substance, and transactions without a commercial substance can be disregarded.

The Guidelines also introduce the following steps to be followed in a controlled transaction:

- Step 1: Identify economically significant risks with specificity[2]
- Step 2: Contractual assumption of risk
- Step 3: Functional analysis in relation to risk
- Step 4: Interpreting steps 1-3
- Step 5: Allocation of risk
- Step 6: Pricing of the transaction

In determining the remuneration for intermediary activities, the Guidelines allow taxpayers to use a Berry Ratio as a profit level indicator for intercompany purchases and sale of goods, subject to satisfying certain criteria. Working capital adjustments are recognized in enhancing the comparability analysis, given that reasonable adjustments can be made and that such adjustments result in minor differences.

Intangibles

The Guidelines broaden the definition of intangibles to cover government licenses and contractual rights under certain circumstances, which grant companies special privileges or exclusivity.

The government has also introduced the DEMPE concept for taxpayers to analyze transactions involving intangibles, and identify the legal and economic owners who are entitled to an arm's length remuneration for their contribution to the development and exploitation of intangibles, respectively. The Guidelines also provide further guidance on how to determine arm's length compensation for research, development and process improvement arrangements, distributors and manufacturers.

For intercompany transfer of intangibles, the Guidelines permit taxpayers to use valuation techniques in addition to the currently accepted comparable uncontrolled price (CUP) method and profit split method to estimate the arm's-length price.

Commodity transactions

The Guidelines require taxpayers to use a quoted price obtained from domestic or international commodity exchange markets to apply the CUP method. Evidence of price-setting policy, price adjustments and/or other relevant information should be included as part of the transfer pricing documentation in order for the government to reasonably assess the arm's-length pricing of intercompany commodity transactions.

Transfer pricing documentation

On 23 December 2016, Malaysia adopted country-by-country reporting (CbCR) requirements for the ultimate parent entities of Malaysian multinational corporations (MNCs) with at least RM3 billion (US$680 million) to prepare a CbC report.[3] Under the Guidelines, companies required to submit a CbC report, including subsidiaries of foreign MNCs, must also file a master file upon request including an organizational structure, the description of the business and industry conditions, pricing policies, application of transfer pricing method and financial information.

The Guidelines also define "material changes" as significant changes that would give impact to the functional analysis or transfer pricing analysis of the tested party, including changes to the operational and economic conditions that will significantly affect the controlled transactions under consideration. The Guidelines clarify when taxpayers are required to update their transfer pricing documentation due to "material changes" to the operating conditions that impact their functional analysis or transfer pricing analysis.

Other updates include the expansion of the list of required information and documentation to be included as part of the transfer pricing documentation, and clarification that taxpayers are responsible for preparing transfer pricing documentation for domestic controlled transactions if one party is taxed at a different rate.

To ease the compliance burden and costs to taxpayers, the benchmarking study may be updated once every three years instead of every year, as long as the taxpayer's operational profile remains unchanged. The Guidelines also waive penalties if transfer pricing documentation is submitted within 30 days upon request and was prepared within the requirements of the Guidelines.

Endnotes

1. Capital-rich entities without any other relevant economic activities.
2. **Strategic risks or marketplace risks, Infrastructure or operational risk, Financial risks, Transactional risks, Hazard risks (Non-exhaustive list of sources of risks).*
3. See EY Global Tax Alert, *Malaysia introduces Country-by-Country Reporting requirements*, dated 25 January 2017.

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