
## What is Transfer Pricing?

Transfer pricing refers to the price of transfers and transactions entered into between related parties or subsidiaries. Transfer pricing generally refers to intercompany pricing arrangements for the transfer of goods, services and intangibles between associated persons. The transfer price should ideally match the prevailing market price, as it would in a transaction involving independent persons.

## Malaysian Transfer Pricing Guidelines

The Malaysian Transfer Pricing Guidelines (hereinafter referred to as ("**the Guidelines**"), provides detailed guidelines and standards on how companies should manage transfer pricing in compliance with Section 140A of the Income Tax Act 1967 ("**the Act**") and the Income Tax (Transfer Pricing) Rules 2023 ("**TP Rules 2023**").

The Guidelines are largely based on the governing standard for transfer pricing which is the arm's length principle as set out under the Organization for Economic Cooperation and Development (OECD) Transfer Pricing Guidelines ("**OECD Transfer Pricing Guidelines**"). Although some parts of the Guidelines are directly adopted from the OECD Transfer Pricing Guidelines, certain sections may vary to ensure compliance with the Act and the procedures of Inland Revenue Board of Malaysia ("**IRBM**"), as well as local conditions. In this regard, the Guidelines may be reviewed from time to time.

## Controlled Transactions vs Uncontrolled Transactions

A controlled transaction is a transaction entered into between two or more parties that are associated with each other. It is defined in the OECD Transfer Pricing Guidelines as transactions between two enterprises that are associated enterprises with respect to each other.[1]

According to the OECD Transfer Pricing Guidelines, parties are associated if:[2]

- A party participates directly or indirectly in the management, control or capital of another party; and
- The same persons participate directly or indirectly in the management, control or capital of another party

An uncontrolled transaction involves independent person dealing with one another at arm's length.[3] It is also defined in the OECD Transfer Pricing Guidelines as transactions between enterprises that are independent enterprises with respect to each other.[4]

## **Arm's Length Principle**

The arm's length approach, which is internationally accepted as the preferred basis for determining the transfer price of a transaction between associated persons, will be the basis adopted by IRBM. This is consistent with the objective of minimizing the possibility for double taxation and compliance with international tax regulations. According to the arm's length principle, a transfer price is acceptable if all transactions between associated parties are conducted at arm's length price. Arm's length price is the price which would have been determined if such transactions were made between independent entities under the same or similar circumstances.[5]

The arm's length principle is stated in Article 9 of the OECD Model Tax Convention as:

"*Where…conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent 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.*"[6]

When associated persons enter into a transaction, the element of control which one party has over the other may exist. Under this circumstance, bargaining power rarely comes into play. Unlike independent companies, multinational corporation group or multinational enterprises ("**MNE Group**") usually operate based on its own set of conditions which normally do not reflect the market forces. While independent enterprises are concerned with maximizing individual profits, by aiming for the lowest costs and highest returns, an MNE Group is concerned with overall group profits which may result in unequal distribution of profits within the group.[7]

In summary, the application of the arm's length principle:[8]

(a) treats associated persons as not dealing at arm's length and as if they operate as separate entities rather than as inseparable parts of a single unified business; and

(b) is generally based on a comparison of:

(i) prices, margins, division of profits or other indicators of controlled transactions; with

(ii) prices, margins, division of profits or other indicators of uncontrolled transactions.

**Transfer Pricing Methodologies**[9]

In determining the arm's length price, the most suitable method must be chosen based on the facts and circumstances of each particular transaction. The following methodologies can be used in determining arm's length price, which can be categorised into traditional transactional methods, and transactional profit methods. (**Refer to Diagram 1**)

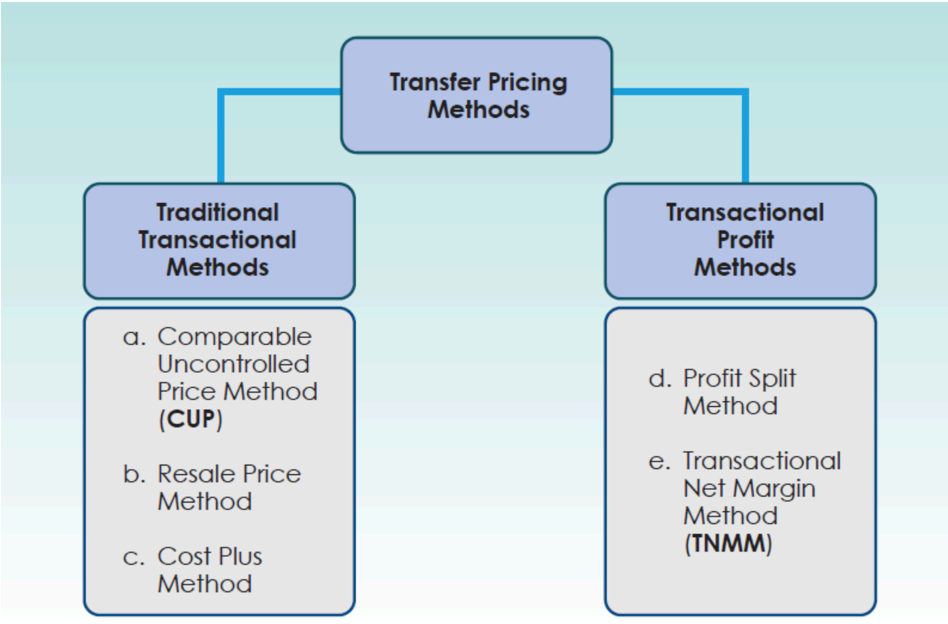


**DIAGRAM 1**

(a) Comparable Uncontrolled Price Method ("**CUP**")
CUP compares the price of goods or services in a controlled transaction with prices used in comparable transactions made between unrelated parties under comparable conditions.

(b) Resale Price Method
The Resale Price Method is based on the price at which a product that has been purchased from an associated party is resold to an independent party, otherwise known as the resale price. It arrives at an arm's length price by reducing the resale price with a resale price margin.

(c) Cost Plus Method
The Cost Plus Method uses the costs incurred by the supplier of goods or services in a controlled transaction to which one adds a gross profit mark up. What is arrived at after adding the cost plus mark up to the above costs may be regarded as an arm's length price of the original controlled transaction.

(d) Profit Split Method

It is based on the concept that combined profits earned in a controlled transaction should be equitably divided between associated persons involved in the transaction according to the functions performed.

This method is usually used when transactions are highly integrated that they cannot be evaluated separately. The value of the contributions that each associated person makes to the transaction is assessed based on how independent persons would split the profits among them under similar circumstances, to arrive at an arm's length price.

(e) Transactional Net Margin Method ("**TNMM**")

TNMM is similar to the cost plus and resale price methods in that it uses the margin approach. This method examines the net profit that a taxpayer realises from a controlled transaction divided by an appropriate metric, such as costs, sales, or assets.

Although the taxpayer is given the right to choose any method, the emphasis should be on arriving at an arm's length price. It is advised that methods (d) and (e) be used only when traditional transactional methods cannot be reliably applied or exceptionally cannot be applied at all.

In deciding the most appropriate method, the following must be considered: [10]

(i) The nature of the controlled transaction, determined by conducting a functional analysis;

(ii) The degree of actual comparability when making comparisons with transactions between independent parties;

(iii) The completeness and accuracy of data in respect of the uncontrolled transaction;

(iv) The reliability of any assumptions made; and

(v) The degree to which the adjustments are affected if the data is inaccurate or the assumptions incorrect.

Where both the traditional transactional method and transactional profit method cannot be applied at all, the Director General of IRBM may permit the use of alternative methods, provided the resulting prices adhere to the arm's length principle.

## **Conclusion**

Transfer pricing is a key area of focus for the IRBM. MNE Groups should ensure that their transfer pricing practices are consistent with the arm's-length principle, and that appropriate documentation is maintained as required under the TP Rules 2023 and the Guidelines.

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