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MALAYSIA TRANSFER PRICING GUIDELINES
CONTROLLED FINANCIAL TRANSACTIONS: INTRA-GROUP LOANS
(MFTIL)

TABLE OF CONTENTS

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DIRECTORS GENERAL'S GUIDELINES

Section 134A of the Income Tax Act 1967 ("ITA") provides that the Director General of Inland Revenue ("DGIR") is empowered to issue guidelines in relation to the application of any provisions of the ITA.

A guideline is published as a guide for the public and officers of the Inland Revenue Board of Malaysia. It sets out the interpretation of the DGIR in respect of the particular tax laws and the policy as well as the procedure applicable to it.

The DGIR may revoke, revise or amend this guideline either wholly or in part, by notice of withdrawal or by publication of a new guideline.

Director General of Inland Revenue
Inland Revenue Board of Malaysia

GLOSSARY

Arm's Length Interest Rate

An interest rate which would have been charged if such financial assistance were made between independent persons under the same or similar economic circumstances.

Associated person

A person referred to in sections 139, 140A(5) and (5A) of the ITA.

Average Lending Rate

The average lending rate ("ALR") of commercial banks published by the Bank Negara Malaysia ("BNM") at the end of the calendar month or where there is no such average lending rate, such other reference lending rate as may be prescribed by the DGIR.

Central Credit Reference Information System (CCRIS)

A system maintained by BNM that collects and provides credit information on borrowers from participating financial institutions in Malaysia, for the purpose of assessing the creditworthiness of a person.

Controlled Financial Transactions

Financial transactions between associated persons where a taxpayer provides or receives financial assistances, directly or indirectly, to or from another associated person with or without consideration.

Credit Tip-Off Service ("CTOS")

A private credit reporting agency in Malaysia that compiles information from public sources and trade references to provide credit reports on individuals and companies for the purpose of evaluating credit risk.

Deposit Rate

The average fixed deposit rate of commercial banks published by the BNM at the end of the calendar month, or where there is no such average lending rate, such other reference lending rate as may be prescribed by the DGIR.

Financial assistances

Includes a loan, interest bearing trade credit, advance or debt, or the provision of any security or guarantee.

Functional analysis

A method of finding and organizing facts about a business in terms of its functions, assets (including intangible property) and risks. It aims to identify how these are divided between the parties involved in the transaction under review.

Interest

Includes finance charges, discount, premium or other consideration relating to controlled transactions.

Internal fund

Surplus funds that may arise from the injection of capital, retained earnings and company reserves.

Special Purpose Vehicle ("SPV")

A separate legal entity established by a company to isolate the financial business risks.

Sukuk

Has the same meaning as assigned to it under the Capital Markets and Services Act 2007.

Notes: The glossary for any other terms used in this document but not defined in this section shall refer to the Malaysia Transfer Pricing Guidelines 2024.

INTRODUCTION AND OBJECTIVE

INTRODUCTION

The Malaysia Transfer Pricing Guidelines 2024 (“MTPG 2024”), published on 24 December 2024, are primarily based on the arm’s length principle, which serves as the governing standard for transfer pricing. This principle is outlined in the Organisation for Economic Co-operation and Development (“OECD”) Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (“OECD TPGL”). In addition to the OECD TPGL, reference may also be made to the United Nations Practical Manual on Transfer Pricing for Developing Countries.

However, certain areas may deviate from these references to ensure compliance with the ITA, the Income Tax (Transfer Pricing) Rules 2023 [*P.U.(A) 165/2023*] (“the Rules”) and procedures established by the IRBM and to address specific domestic circumstances. These differences are intended to reflect Malaysia's unique domestic conditions.

OBJECTIVE

As mentioned in Chapter 9 Intra-Group Financial Transactions of the MTPG 2024, given the complexity and depth of analysis required for determining the arm’s length price or conditions for financial transactions, these guidelines are aimed to address specific transfer pricing requirements needed for intra-group loans.

These guidelines serve as comprehensive guidance to determine whether the intra-group loan in is consistent with the arm's length principle, as required by the ITA , the Rules, and the MTPG, which are currently in force.

CHAPTER 1 - APPLICATION OF THE ARM'S LENGTH PRINCIPLE TO CONTROLLED FINANCIAL TRANSACTIONS

INTRODUCTION

1.1. MNEs routinely engage in intercompany financial transactions to facilitate their global operations. These transactions may encompass loans to finance capital investments or acquisitions, short-term working capital loans, factoring arrangements to release cash at a subsidiary, and cash pooling strategies to optimise the group's internal cash usage while minimizing external interest expenses.

1.2. Financial transactions are primarily contractual obligations and were previously considered less subjective compared with other areas of transfer pricing. In addition, extensive and reliable market data exist for determining the arm's-length price, or interest rate, for most financial transactions. However, as intercompany financing has grown in volume and complexity, increasing concerns have emerged over the past few decades about whether these arrangements reflect arm's-length conditions and arm's-length interest rates.

DELINEATION OF FINANCIAL TRANSACTIONS

1.3. In determining the arm's length interest rate for controlled financial transactions, the principles for accurately delineating the actual controlled transactions, analysing functions, allocating risks, and conducting a comparability analysis also apply to financial transactions.

1.4. The thorough process outlined in Chapter 2 of the MTPG 2024 should be applied when delineating the financial transactions. The core objectives of these delineation processes are to identify the following:

Issues	Explanation
Substance over form	Merely labelling a transaction is insufficient. The terms, risks, and actual behaviour of the parties involved must align with what would occur among independent persons to ensure that the arrangement reflects genuine economic reality.
Risk control and capacity	A legal entity must possess the capacity to manage the financial risks it undertakes. Otherwise, the entity may not be entitled to the returns associated with those risks.
Functional analysis	The return on financial transactions must align with the functions performed, assets used, and risks assumed by each party involved in the transactions. This alignment ensures that all parties involved are fairly compensated for their contributions and exposures.

1.5. The accurate delineation of the actual transactions should begin with a thorough identification of the economically relevant characteristics of the transaction based on the commercial or financial relations between the parties and the conditions and economically relevant circumstances attaching to those relations.

1.6. The economically relevant characteristics as outlined in Chapter 9 Intra-group Financial Transactions of the MTPG 2024 should be considered when delineating the actual transactions.

1.7. Particular labels or descriptions assigned to the financial transactions do not restrict the transfer pricing analysis. Instead, each situation must be examined on its own merits. In circumstances where the arrangements for the controlled financial transactions are deemed to be conducted in a commercially irrational manner, particularly when compared with those of independent persons, the DGIR may disregard and re-characterize the controlled financial transactions to accurately reflect the true nature of the transactions.

DETERMINATION OF WHETHER A PURPORTED LOAN SHOULD BE REGARDED AS A LOAN

1.8. In some cases, the balance between debt and equity in the funding arrangements of a borrowing entity within an MNE group may differ from what would normally be expected if the entity were an independent person operating under similar circumstances. Such discrepancies can significantly influence the amount of interest payable by the borrowing entity and the taxable profits reported in Malaysia. Therefore, it is essential to identify which transaction genuinely constitutes a loan and which does not.

1.9. It is crucial to ascertain not only whether the interest rate stated in a loan agreement is at an arm's length rate, but also whether a prima facie loan should be classified as a loan or regarded as a different form of payment, particularly as a contribution to equity capital.

1.10. A "purported loan" refers to a financial arrangement that is labelled or presented as a loan between associated persons, typically within an MNE group. However, upon closer examination, the transaction may not exhibit the true characteristics of a loan as would be expected in dealings between independent persons operating at arm's length. In other words, while the financial transaction may be designated as a loan, the actual nature of the financial transaction and the underlying economic realities may indicate that it is, in fact, a contribution to equity.

1.11. As part of the accurate delineation of a financial transaction, it is essential to assess whether a purported loan arrangement exhibits the characteristics of debt or equity. This distinction is crucial in transfer pricing analysis, as it affects both the pricing and tax treatment of the transaction.

1.12. In this context, it is essential to conduct a test to determine whether the purported loan constitutes debt or equity before the arm's length interest can be established.

DEBT VERSUS EQUITY CHARACTERISTICS

1.13. In assessing whether a purported loan constitutes debt or equity for tax purposes, the following characteristics may be considered to determine the true nature of the financial transaction:

General Characteristics	
Debt	**Equity**
The right to distributions or profits is fixed	Entitled to partake in a share of the distributions or profits of the entity, namely dividend, distribution in Real Estate Investment Trust and return, interest or premium arising from profit
Entitled to reimbursement of the principal amount of debt during liquidation	Entitled to residual assets of the company after the repayment to debt holders upon liquidation
Has a maturity date	No maturity date
No voting rights	Has voting rights
Legal right to demand payment of distributions or profits	Payment of distributions or profits is subject to the discretion of the management of the entity

1.14. There are various criteria may be used to determine whether a purported loan is debt or equity. Common criteria for comparing debt and equity include, but are not limited to:

Criteria	Description
a. Existence of a legal obligation to repay	The presence of a binding contractual requirement for the borrower to repay the principal and, where applicable, interest to the lender.
b. Fixed maturity date	A predetermined maturity date on which the principal amount of a financial transaction must be repaid.
c. Expectation of return	The anticipated financial benefit or yield that the holder of the financial transaction is expected to receive.
d. Ranking upon liquidation or dissolution	The order of priority of claims to be settled if the issuer is liquidated or dissolved.
e. Participation in management or control	The extent to which the holder of the instrument has rights to influence or take part in the issuer's decision-making processes.
f. Right to enforce repayment	The legal entitlement of the holder to compel repayment of the amount owed.
g. Treatment in accounting and financial reports	The classification and presentation of the financial transaction in the financial statements under the applicable accounting standards.
h. Tax treatment under the relevant tax laws	The manner in which the financial transaction is recognised, classified, and taxed under the applicable provisions of tax laws.
i. Intent of the parties	The expressed purpose and mutual understanding of the contracting parties regarding the true nature of the financial arrangement.

1.15. Table 1 presents a comparison of debt and equity based on the criteria outlined in paragraph 1.14. The table is intended to assist taxpayers in Malaysia in achieving accurate classification. A clear understanding of these distinctions is crucial for correctly identifying the true nature of financial transactions.

Table 1: Criteria comparison debt versus equity

Criteria	Debt	Equity
a. Existence of a legal obligation to repay	Fixed and enforceable obligation to repay principal and interest	No obligation to repay; repayment depends on profits or discretion of the management
b. Fixed maturity date	Repayment scheduled on a specific date or upon demand	No fixed maturity; perpetual or redeemable at issuer's discretion
c. Expectation of return	Interest is predetermined, independent of borrower's profitability	Return depends on profits/ dividends; not fixed
d. Ranking upon liquidation or dissolution	Ranks as a creditor (before equity holders)	Ranks as equity (after debt obligations)
e. Participation in management or control	No participation in the borrower's management	Usually includes voting rights or influence in management
f. Right to enforce repayment	Enforceable in courts as a debt contract	Legal recourse is limited; depends on the residual claim
g. Treatment in accounting and financial reports	Classified as liability (loan)	Classified as equity
h. Tax treatment under the relevant tax laws	Treated as interest-bearing loan	Treated as capital contribution or equity
i. Intent of the parties	Intent to create a debtor-creditor relationship	Intent to create ownership interest

1.16. The existence of any single criterion is insufficient to classify a financial transaction as either equity or debt. It is important to weigh the combination of criteria together with other relevant facts and circumstances.

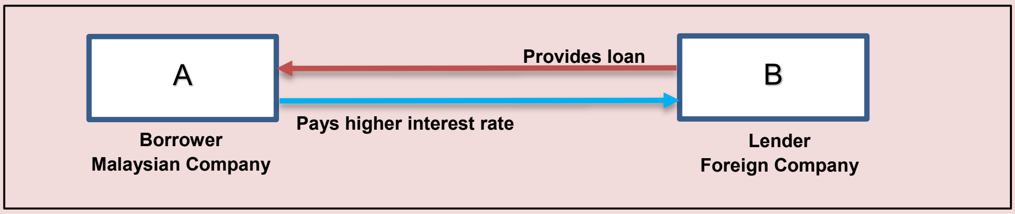
1.17. It is important to note that even if a financial transaction possesses typical characteristics of a loan, such as a fixed repayment schedule, stated interest rate, and formal loan agreement, this does not automatically mean that the transaction qualifies as a loan for transfer pricing purposes. The mere presence of these characteristics is insufficient. Instead, the transaction must be accurately delineated by examining its economic substance and underlying commercial or financial relationship between parties.

1.18. This approach ensures that the transaction is not, in essence, a disguised form of equity contribution, capital funding, or another type of financial arrangement. Accordingly, a comprehensive analysis of all relevant facts and circumstances is essential to determine the true nature of the financial transaction.

POTENTIAL RECHARACTERISATION AS AN EQUITY

1.19. In instances where the DGIR has reason to believe that a purported loan does not possess the characteristics of a genuine loan, the transaction may be recharacterised as an equity contribution instead. Such recharacterisation may result in the disallowance of interest deductions and could give rise to additional tax liabilities, together with the imposition of surcharges.

Example 1



Company A Sdn. Bhd. obtains a loan from its associated company, Company B, without providing security, imposing covenants, or restricting the use of the financing. Company A Sdn. Bhd. incurs a high interest rate due to the absence of security, and the lack of financial or operational covenants on the loan.

The DGIR concludes that, under similar conditions, an independent person would have been required to provide appropriate security to obtain such financing and would have been subject to certain financial or operational covenants. Taking into account Company A Sdn. Bhd.'s financial background and credit risk, no independent person would be willing to provide a loan to Company A Sdn. Bhd., particularly without requiring security or imposing covenants or restrictions on the use of the financing.

In this situation, the DGIR will question the economic substance of the loan facility between Company A Sdn. Bhd. and Company B, arguing that the terms and conditions for such loan would not have been agreed upon between independent persons.

The DGIR will not recognise the loan transaction and may disregard its structure by applying subsection 140A(3A) of the ITA if:

a. the economic substance of that loan transaction differs from its form; or

b. the form and substance of the loan transaction are the same, but the arrangement made in relation to the loan transaction, viewed in totality, differs from those which would have been adopted by independent persons behaving in a commercially rational manner and the actual structure impedes the DGIR from determining an appropriate arm’s length interest.

Once the DGIR has invoked subsection 140A(3A) of the ITA, the structure will be adjusted accordingly and the transaction may be recharacterised as an equity contribution, resulting in the disallowance of interest payments on the purported loan.

Alternatively, if the DGIR agrees with the structure of the loan transaction but not with the interest rate, the interest rate charged will be substituted with an arm's length interest rate to ensure compliance with the arm's length principle.

CHAPTER 2 – INTRA-GROUP LOANS

INTRODUCTION

2.1 Intra-group loans are the most common form of financing within MNE groups, where one person lends funds to another within the group. The DGIR requires that the interest rates on these loans reflect what independent persons would have agreed upon under similar circumstances.

LENDER’S AND BORROWER’S PERSPECTIVES

2.2 When evaluating the commercial and financial relations between the associated borrower and lender, and in an analysis of the economically relevant characteristics of the transaction, both the lender's and borrower's perspective should be taken into account.

2.3 It is essential to consider the risks associated with funding arrangements for both the party providing the funds (the lender) and the party receiving the funds (the borrower). These risks involve the repayment of the amount transferred, the compensation expected for the use of that amount over time, and compensation for other related risk factors.

The Lender’s Perspectives

2.4 From the lender’s perspectives, the decision on whether to provide a loan, including the amount and terms, requires evaluating various factors related to the borrower, broader economic conditions affecting both parties, and other realistic options for the use of the funds.

2.5 An independent lender will conduct a comprehensive credit assessment of the potential borrower. This process enables the lender to identify and evaluate the associated risks, as well as to consider appropriate methods for monitoring and managing the funds. The credit assessment involves developing a thorough understanding of the borrower's business, the purpose of the loan, its structure, and the source of repayment. This procedure may include analysing the borrower's cash flow forecasts and assessing the strength of its balance sheet.

2.6 In an intra-group loan from the parent entity of a MNE group, the parent already exercises control over and owns the borrower. This reduces the significance of granting security in its risk assessment as a lender. Therefore, when assessing the pricing of an intra-group loan, it is essential to acknowledge that the absence of contractual rights over the assets of the borrowing entity may not accurately reflect the economic reality of the inherent risk associated with the loan. If the business's assets are not already being used as security for something else, it is important to evaluate whether the funds could be used as collateral for the "unsecured loan" and how that will affect the loan's pricing.

2.7 Another key factor for the lender is credit risk. The credit risk refers to the possibility that the borrower may not meet its payment obligations under the terms of the loan. In assessing credit risk, lenders will also consider potential changes in economic conditions that may affect the borrower's risk profile, such as rising interest rates or exchange rate volatility.

The Borrower's Perspectives

2.8 Borrowers strive to minimise its overall financing costs while ensuring that the funds align with their short-term and long-term business requirements. An independent borrower would select the most cost-effective financing option based on its commercial objectives and the assets it could offer as security.

2.9 Borrowers will evaluate the impact of fluctuating economic conditions, including changes in interest rates and exchange rates, as well as risks associated with business performance and future capital-raising capacity. They will also consider how these economic changes might affect their ability to make timely loan repayments in the event of unforeseen challenges, together with the potential difficulties in securing additional capital if required.

2.10 Macroeconomic circumstances may lead to changes in the financing costs in the market. In this context, a transfer pricing analysis regarding the potential renegotiating of the loan terms by the borrower or the lender to achieve better conditions may be informed by the options realistically available to both the borrower and the lender.

EVALUATING THE CREDITWORTHINESS OF THE BORROWER

2.11 The creditworthiness of the borrower is one of the primary factors that independent lenders consider when determining the interest rate they will charge. Credit ratings can be a valuable indicator of creditworthiness, assisting in the identification of potential comparables or the application of economic models in the context of controlled transactions. In the case of intra-group loans, the borrower's membership within a group may also be an economically significant factor that influences the pricing of these loans.

2.12 A credit rating is an independent assessment of a borrower's capacity to fulfil its debt obligations in full and on time. It provides a significant measure of creditworthiness, reflecting the borrower's likelihood of default based on factors such as financial health and past repayment history. Credit ratings are generally assigned by independent credit rating agencies and serve as a benchmark for lenders and investors in evaluating the risk associated with lending to or investing in a particular entity. In the context of transfer pricing for intra-group financing, it is crucial to understand a borrower's credit rating, as it directly affects the arm's length interest rate that would be applied in comparable uncontrolled transactions.

2.13 Credit risk may be measured by assigning a rating (e.g. credit rating) to the borrower or to a specific instrument issued by a debtor. In some cases, these ratings may be derived from independent commercial credit rating agencies. A credit rating expresses the probability of default and thus the level of risk to the potential lender. Independent credit rating agencies generally consider both quantitative and qualitative factors. Quantitative factors include financial metrics such as the debt-to-equity ratio and the gearing ratio, which are frequently used to evaluate credit risk. Qualitative factors relate to the industry and jurisdiction in which the MNE or MNE group operates.

2.14 In Malaysia, recognised credit rating agencies, such as RAM Ratings, Moody’s, and Standard & Poor’s, may be referred to for credit evaluations. For Small and Medium-sized Enterprises , agencies such as CTOS and the CCRIS provide assessments of creditworthiness and reports based on credit history and financial performance.

The Credit Rating of an MNE or MNE Group

2.15 When applying credit ratings in transfer pricing analysis, it is essential to ensure that the comparisons are made under similar terms and conditions for both the borrower’s credit profile and the features of the financial instrument.

2.16 The borrower’s profile includes various factors that can significantly impact the assigned credit rating, such as financial strength, profitability, repayment history, cash flow stability, level of existing debt, and exposure to market or currency risks. For instance, even when two loans have identical nominal terms, a borrower with a weaker financial health or inconsistent income is likely to receive a lower credit rating.

2.17 The features of the financial instrument, including currency denomination, maturity period, repayment terms, senior debt or subordinated debt, collateral or guarantees, and contractual covenants, can also significantly affect the risk profile. For instance, a five-year unsecured loan in a volatile currency presents a different level of risk than a two-year secured loan in a stable currency, even if the borrower's credit standing remains unchanged.

2.18 Determining a credit rating is a complex process that can pose significant challenges in certain situations. It should be noted that similar financial indicators do not always result in the same credit rating. This is because rating standards may vary across industries. For instance, borrowers in riskier or less stable industries may need stronger financial ratios to achieve the same credit rating as those in more stable sectors.

2.19 Ensuring comparability in both the borrower's circumstances and the loan's features provide a more accurate and reliable basis for determining an arm's length outcome.

2.20 Once an appropriate credit rating framework is established, the next step is to identify reliable market data for benchmarking. Sources of comparable interest rates may include publicly available bond yields, loan market data, interbank lending rates, or commercial financial databases. However, the reliability of this data must be carefully assessed to ensure consistency with the tested transaction. Adjustments may be required for differences in transaction size, currency, geographical market, and prevailing economic conditions to maintain comparability.

2.21 Certain circumstances can lead to distortions in the credit rating assigned to an entity. These may include implicit support from a parent company, government guarantees, or other forms of credit enhancement that might not be available in an uncontrolled transaction. It is important to consider these special situations, as they may require appropriate adjustments.

2.22 Taxpayers must maintain clear and comprehensive documentation of the credit rating evaluation in their Contemporaneous Transfer Pricing Documentation ("CTPD"). The documentation should include the rationale for the credit rating used, any changes made to make the data more comparable, and proof that the chosen market data is reliable. Adequate documentation not only supports the arm's-length nature of the intra-group interest rate but also mitigates the risk of disputes with the tax authority.

The Credit Rating of a Specific Debt Issuance

2.23 The credit rating of a particular debt issuance ("issue rating") is an opinion on the creditworthiness of the issuer with respect to a specific financial instrument. The issue rating takes into account the specific features of the financial instrument, such as guarantees, securities, and its level of seniority.

2.24 The credit rating of an MNE group may differ from an issue rating because the credit risk associated with a financial instrument is tied to its specific characteristics, rather than solely to the risk profile of the borrowing MNE. When both issuer and issue ratings are available, and there is comparability between the third-party debt issuance and the controlled transactions, the issue rating for the specific debt issuance would be more appropriate to use to price the controlled financial transactions.

Credit Rating Determinations

2.25 Particular considerations must be taken into account when determining a credit rating for a specific entity within an MNE group for the purposes of assessing controlled transactions. If the entity has a publicly available credit rating from an independent credit rating agency, this rating can provide helpful guidance when conducting an independent analysis of the entity's controlled financial transactions. However, it is important to note that, in most cases, publicly available credit ratings are only issued to the MNE group as a whole.

2.26 A common approach to assessing a specific entity involves conducting both quantitative and qualitative analysis of its individual characteristics using publicly available financial tools or the methodologies of independent credit rating agencies to replicate the rating process applied to the MNE group. Key factors in determining the creditworthiness of an entity within an MNE group include ownership structure, management and strategy, asset quality, funding and liquidity position, financial performance, and capital adequacy, among others. This approach also takes into account the enhancement in creditworthiness that the specific entity is expected to gain by being part of the MNE group.

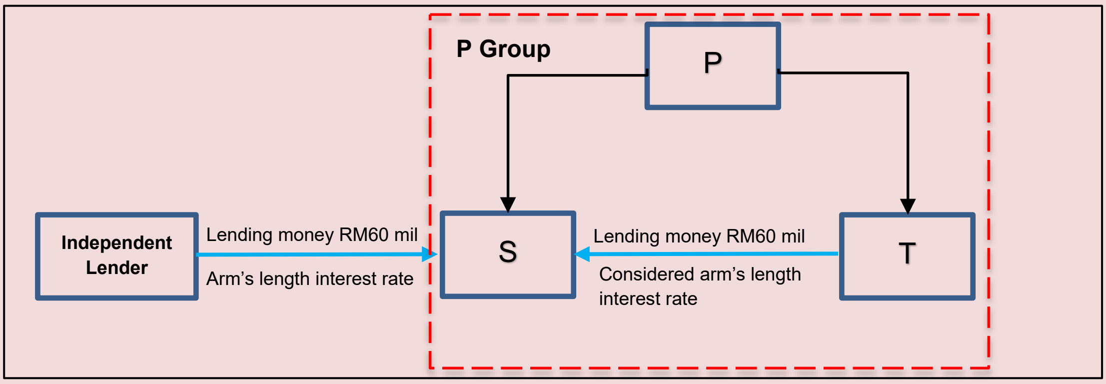
Effect of Group Membership

2.27 Being part of an MNE group can affect the borrowing conditions of an entity in two main ways. First, the financial policies and practices of the MNE group often influence the type of loan, its terms, and the pricing that the entity could obtain from an independent lender. Second, the entity may benefit from the expectation that the MNE group will provide support if the entity faces difficulties in meeting its financial obligations. This implicit support arises simply because the entity belongs to the MNE group. Such support can improve the entity's credit rating and reduce borrowing costs. However, since this benefit occurs naturally within the MNE group, it does not require any additional payments or transfer pricing adjustments.

2.28 The extent of implicit support depends on the entity's role and importance within the MNE group. An entity that is central to the MNE group's business or future strategy is more likely to receive support, resulting in a credit rating closer to that of the MNE group. On the other hand, an entity with weaker links or less significance may be assessed primarily on its own financial position. Where it is clear that no support would be provided, the entity should be evaluated on a stand-alone basis.

2.29 Other factors such as legal or regulatory obligations, strategic importance, operational integration, use of the MNE group's name, reputational risks, potential negative effects on the MNE group as a whole, and the MNE group's past practice of supporting entities may also influence the likelihood of MNE group support. The relevance of these factors may vary depending on the industries and circumstances.

Example 2



P is the parent company of an MNE group engaged in a financial services business. The strength of the MNE group's consolidated balance sheet makes it possible for P to maintain AAA credit rating on a consistent basis. S is an entity of the MNE group, also engaged in providing the same type of financial services as other group members. On a stand-alone basis, however, the S's balance sheet would only support BBB credit rating, which is lower than AAA credit rating. Nonetheless, due to S's membership in the P MNE group, independent lenders are willing to offer S loans at interest rates comparable to those charged to independent borrowers with AAA rating. This rate is lower than what would be charged if S were assessed solely on its own financial position or existing balance sheet but higher than the rate available to P.

Assuming that S borrows RM60 million from an independent lender at the market interest rate applicable to borrowers with AAA credit rating. At the same time, S also borrows RM60 million from T, another subsidiary of P, on the same terms and at the same interest rate as the independent lender. T has similar characteristics to those of an independent lender.

In this situation, the interest rate charged by T to S is considered at arm's length because:

(i) it matches the rate charged by an independent lender in a comparable transaction; and

(ii) no additional payment or adjustment is required for the benefit that S receives from being part of the MNE group. This benefit, known as implicit support, arises naturally from S's membership in the MNE group and does not result from any deliberate or contractual action by other entities of the MNE group.

* Note: A credit rating of BBB is lower than AAA, indicating a higher level of credit risk.

CHAPTER 3 - DETERMINING THE ARM'S LENGTH INTEREST RATES

INTRODUCTION

3.1 If a company provides a loan or advances money from its internal fund to a person who is a director of that company, section 140A of the ITA will not be applicable to that transaction. Section 140B of the ITA will govern the computation of interest for that transaction. This is because section 140B contains a specific provision for calculating the interest income that a company is deemed to receive during the basis period for a year of assessment on loans or advances given to directors, irrespective of their status as shareholders. The interest calculated under section 140B of the ITA will be regarded as being at arm's length.

3.2 However, if the intra-group loan is made to the company by a director, section 140A of the ITA will still be applicable in determining the arm's length interest rate for such a transaction. The interest income will be assessed under paragraph 4*(c).*

3.3 A comparability analysis is a vital process for assessing whether the terms of a controlled transaction, including controlled financial transaction, comply with arm's length condition. To ensure that the interest rate of an intra-group loan is consistent with arm's length principle, it is essential to conduct a comparability analysis that evaluates the terms and conditions of the controlled transaction in relation to those of uncontrolled transactions.

COMPARABILITY ANALYSIS FOR INTRA-GROUP LOANS

3.4 In performing a comparability analysis for intra-group loans, taxpayers must take into account all economically relevant characteristics associated with the loan, including, but not limited to:

Economically Relevant Characteristics	
Contractual terms	In some instances, contractual arrangements between associated persons may lack sufficient detail or fail to correspond with the actual conduct of the parties involved, as well as other pertinent facts and circumstances. Consequently, it is essential to produce a comprehensive document that accurately reflects the parties' intentions and actions.
Functional analysis	The key functions performed, together with commercial considerations and economic circumstances must be taken into account when deciding whether to provide a loan and the terms of the loan. This process involves analysing and evaluating the inherent risks associated with the loan, assessing the business's capacity to commit capital to the investment, determining the loan terms, and organising and documenting them.
Characteristics of financial instruments	In the case of an intra-group loan, the characteristics of the financial instrument may include, but are not limited to: (a) the nature and purpose of the loan; (b) market conditions at the time the loan is granted; (c) principal amount, duration and terms of the loan; (d) currency in which the loan is denominated; (e) exchange risks borne by the lender or borrower; (f) creditworthiness of the borrower.

Economically Relevant Characteristics	
	(g) security offered by the borrower; (h) guarantees involved in the loan; (i) embedded options, for example, covenants to prohibit certain actions by the borrower without the lender's consent, or requirements for the borrower to meet certain financial indicators at regular, predetermined intervals during the term of the loan; (j) ranking of the loan (senior or subordinated); and (k) whether the interest rate is fixed or floating.
Economic circumstances	The prices of financial instruments can vary significantly based on underlying economic factors, including different currencies, geographic locations, local regulations, the borrower's business sector, and the timing of the transaction. Additionally, macroeconomic trends such as central bank lending rates and interbank reference rates, as well as financial market events like credit crises, can influence these prices.
Business strategies	Different business strategies can significantly affect the terms and conditions agreed upon between independent persons. For instance, independent lenders may be willing to extend loans under terms and conditions to a person involved in a merger or acquisition that would likely be deemed unacceptable if the same business were in a stable state. In such scenario, the lender may adopt a longer-term perspective, taking into account the borrower's business plans and forecasts. This approach acknowledges that there will be temporary changes in the borrower's business's financial metrics as the business undergoes these changes.

PRICING APPROACH

3.5 The selected pricing approach must correspond to the actual transactions as accurately delineated, and it should represent the most appropriate method for establishing the arm's length interest rate.

Comparable Uncontrolled Price Method (CUP Method)

3.6 Arm's length interest rates can be determined by considering the borrower's credit rating, the specific issuance, all applicable terms and conditions, and other comparability factors, after accurately delineating the actual transactions.

3.7 The reliability and practicality of the CUP Method in financial transactions are supported by the widespread existence of markets for borrowing and lending money, as well as the frequency of transactions between independent borrowers and lenders. This reliability is further enhanced by the extensive availability of information and analysis regarding loan markets. Consequently, taxpayers can identify reliable third-party comparables, which provides more accurate basis for establishing arm’s-length pricing in intra-group loan arrangements.

3.8 Given the depth and liquidity of global and domestic financial markets, the available information often includes details regarding the characteristics of the loan, as well as the credit rating of the borrower or the rating of the specific issuance. Characteristics that typically heighten the risk for the lender such as long maturity dates, the absence of security, subordination, or the allocation of the loan to a high-risk project will generally lead to an increase in the interest rate. On the contrary, factors that mitigate the lender's risk, such as strong collateral, a high-quality guarantee, or restrictions on the borrower's future behaviour, will usually result in a lower interest rate.

3.9 The arm's length interest rate for a tested loan can be benchmarked against publicly available data for other borrowers with the same credit rating, particularly for loans that possess sufficiently similar terms, conditions, and other comparability factors. Given the competitive nature of lending markets, one might expect that, based on the characteristics of the loan and the borrower's credit rating, or the rating of the specific issuance, there would be a single rate at which the borrower could secure funds and a single rate at which a lender could invest funds to achieve an appropriate return. However, in practice, it is unlikely that a single "market rate" exists, instead, there is probably a range of rates. Nevertheless, competition among lenders and the availability of pricing information typically serve to narrow this range.

3.10 In the search for comparables, it is important to note that reliance is not restricted to stand-alone entities. For instance, a commercial loan secured by an entity of an MNE group from an independent lender may serve as a valid comparison, provided that all economically relevant characteristics are sufficiently similar. Likewise, loans made to or between entities of different MNE groups can also be considered as valid comparables.

3.11 An arm's length interest rate can be benchmarked against realistic alternative financial transactions that share comparable economic characteristics. Depending on the circumstances, these alternatives may include bond issuances, third-party loans, deposits, convertible debentures, or commercial papers. When applying such alternatives, it may be necessary to make appropriate adjustments to account for differences in liquidity, maturity, collateral, or currency between the tested loan and the selected comparable.

3.12 Taxpayers should also consider potential internal CUP, such as other independent loans received or granted by the taxpayer or its related group entities. These may provide valuable comparisons when they are sufficiently similar in nature. However, an MNE group's average external borrowing rate is generally unsuitable as an internal CUP because it fails to meet the strict comparability requirements. Specific loans obtained within the MNE group's independent financing arrangements may serve as valid comparables if they share sufficiently similar characteristics. As with external CUP, appropriate adjustments may be required to enhance comparability.

Loan Fees and Charges

3.13 In considering arm's length pricing for loans, the issue of associated fees and charges may arise. Independent commercial lenders often impose fees as part of the loan's terms and conditions, such as arrangement fees or commitment fees related to an undrawn facility. When a loan exists between related companies that includes such charges, it should be treated in the same manner as any other intra-group transactions. Fees imposed by independent lender may reflect costs incurred in raising capital and in meeting regulatory requirements that associated enterprises might not have.

Cost of Funds Method

3.14 In the absence of comparable uncontrolled transactions, the cost of funds method may be employed to ascertain the arm's-length interest rate for intra-group loans. The cost of funds represents the borrowing expenses that the lender incurs in acquiring the necessary capital for lending. This encompasses the costs associated with borrowing funds, as well as the expenses related to arranging and servicing the loan. Furthermore, it includes a risk premium that reflects economic factors, together with an appropriate profit margin that includes the incremental cost of equity required to support the loan.

3.15 The application of the cost of funds method must be evaluated in the context of prevailing market conditions. A lender's cost of funds should not be viewed in isolation but rather in comparison to other lenders within the market, acknowledging that cost structures and access to funding can vary significantly among them. This is crucial as a lender cannot merely set prices based on its own cost of funds, especially if there are competitors that are capable of securing funds at a lower cost. In a competitive market, an arm’s-length lender would typically offer loans at the most attractive rates to draw in borrowers while also striving to minimise operating and funding costs.

3.16 The application of the cost of funds method requires an assessment of the options that are realistically available to the borrower. A borrowing MNE would not reasonably engage in a transaction priced under this method if it could obtain more favourable funding from alternative sources.

3.17 The cost of funds method may be more appropriate for pricing loans in circumstances where capital is sourced externally and subsequently passes through one or more associated intermediary entities as a series of loans before reaching the ultimate borrower. In such cases, where only agency or intermediary functions are performed, arm's-length pricing should exclusively reflect the costs and risks associated with the agency or intermediary function itself, rather than encompassing a full financing margin.

3.18 The cost of funds method is typically determined based on the lender’s internal funding sources and cost structures. However, for transfer pricing purposes, this determination must be validated against observable market rates. If cost of funds higher than prevailing market averages is applied, taxpayers are required to carry out a comprehensive comparability analysis to demonstrate that the rate aligns with arm’s length principles.

3.19 In determining the cost of funds, it is important to distinguish between borrowed and internal funds, such as retained earnings. While the cost of externally sourced funds is typically observable through borrowing rates, internal funds carry an opportunity cost. For instance, if retained earnings could have been invested in an interest-bearing instrument, such as a fixed deposit, the foregone income represents an economic cost that should be recognised in the transfer pricing analysis.

3.20 The cost of funds method is also applicable for structured financing arrangements that involve SPVs, such as sukuk issuances. In these cases, it is essential to identify the underlying source and nature of the funds in order to appropriately support the pricing of intra-group loans.

Simplified Method

3.21 In order to help taxpayers to comply with the transfer pricing requirements and to reduce their compliance burden, Malaysia has introduced a simplified method for determining the arm’s length interest rate on intra-group loans. The simplified method allows eligible taxpayers to elect designated interest rates to be applied to the intra-group loans without the need to perform a detailed comparability analysis.

3.22 However, this simplified method cannot be used in a case where the capital of an intra-group loan is borrowed from one entity and transferred from the original borrower to the ultimate borrower.

3.23 Taxpayers may opt for the simplified method to ascertain the arm's length interest rate, provided they meet the required criteria. On the contrary, a taxpayer who chooses not to elect the simplified method should conduct a comparability analysis to identify the most appropriate pricing method as specified in these guidelines to determine the arm's length interest rate.

3.24 The simplified method designates two rates: the deposit rate and the ALR. Both rates are published by BNM and are publicly available on its official website. The eligibility criteria for applying these rates as arm's length interest rates are as follows:

Deposit Rate
(a) The taxpayer is not in the business of borrowing and lending;
(b) The interest income from the intra-group loan is taxed under paragraph 4*(c)* of the ITA;
(c) The source of the loan is from taxpayer's internal funds;
(d) The loan is denominated in Ringgit Malaysia;
(e) The aggregate amount of intra-group loan in the year of assessment does not exceed RM50 million; and
(f) The taxpayer only engages in intra-group loan with associated person who is resident in Malaysia.

Average Lending Rate
(a) The taxpayer is not in the business of borrowing and lending;
(b) The interest income from the intra-group loan is taxed under paragraph 4*(c)* of the ITA;
(c) The loan is denominated in Ringgit Malaysia; and
(d) The aggregate amount of cross border intra-group loan in the year of assessment does not exceed RM50 million.

3.25 Taxpayers who choose to apply the simplified method may continue to do so as long as they meet all the conditions stipulated in paragraph 3.24. In the event the taxpayers fail to meet any of these conditions, they must conduct a comparability analysis to identify the most appropriate pricing method as specified in these guidelines to determine the arm's length interest rate.

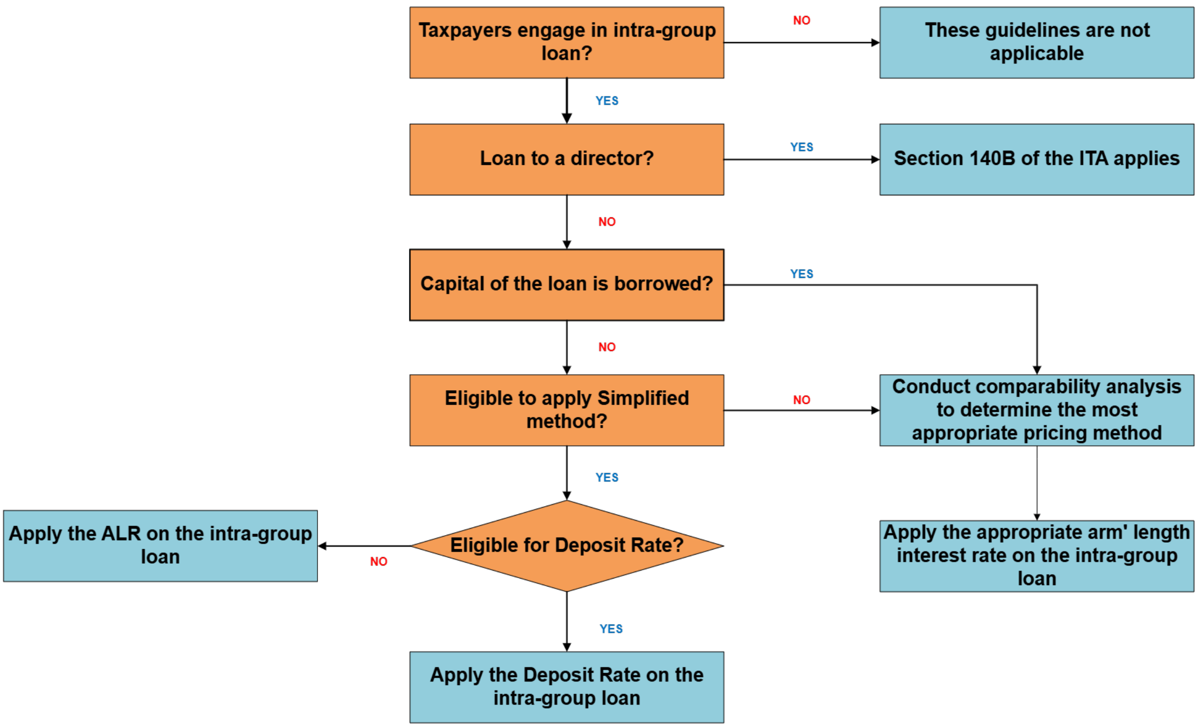
3.26 If the DGIR, upon review, has reason to believe that the taxpayer's pricing approach is not the most appropriate method for determining the arm's length interest rate, the DGIR may replace the taxpayer's pricing method with the one deemed most appropriate by him for establishing the arm's length interest rate.

3.27 In cases where the DGIR has reason to believe that the interest rates of intra-group loans are not arm's length interest rates, the DGIR may choose to either substitute or impute the interest rates, as necessary, to reflect the arm's length interest rates of the intra-group loans. Any transfer pricing adjustments made could expose taxpayers to the risk of surcharges.

3.28 In order to minimise compliance costs, taxpayers are permitted to review the arm's length interest rates established through the most appropriate pricing method, other than the simplified method, once every three (3) years, provided that all facts and circumstances remain unchanged.

3.29 Taxpayers who are not required to prepare CTPD as outlined in paragraph 1.5 of the MTPG 2024 or who are eligible to prepare a minimum CTPD, may use the simplified method to demonstrate compliance with the arm's length principle of the intra-group loans.

3.30 The following flowchart summarises the applicability of the simplified method in determining the arm's-length interest rate of intra-group loans:



CHAPTER 4 - DOCUMENTATION AND COMPLIANCE REQUIREMENTS

INTRODUCTION

4.1 Taxpayers are required to prepare CTPD in accordance with the Rules and the MTPG 2024. Taxpayers who are not required to prepare a CTPD must nevertheless comply with the arm's length principle for all controlled transactions entered into, including intra-group loans. They must ensure to keep and retain all relevant documents that are related to the controlled transactions, including documentation to support and substantiate the determination of the arm's length prices or the arm's length interests.

CTPD COMPLIANCE REQUIREMENTS

4.2 Taxpayers engaging in intra-group loans must maintain relevant documentation, which includes agreements, credit assessments, and supporting evidence demonstrating compliance with arm's length principle. They are required to substantiate and document the terms of the intra-group loans, with particular emphasis on the applicable interest rates. This process involves preparing a comparability analysis to determine the appropriate pricing approach for establishing the arm's length interest rates. Accurate delineation of financial transactions is critical to ensure that subsequent processes are conducted appropriately. Furthermore, taxpayers must demonstrate that they have consistently reviewed their existing intra-group loan agreements to confirm that all terms and conditions adhere to the arm's length principle.

4.3 The intra-group loan agreements must encompass key information, including the identities of the lenders and borrowers, the date of the financing, the amount involved, the interest rates applied, and the policy regarding interest charges. This information is vital for clearly delineating the actual transactions. Furthermore, documentation and explanation of the economically relevant characteristics of the transactions should also be incorporated into the CTPD.

4.4 Taxpayers who choose to use the simplified method must keep and retain evidence and supporting documentation regarding their eligibility. This information includes, but is not limited to:

(a) a copy of the agreement;
(b) confirmation that the source of the intra-group loans is from the company's internal funds;
(c) confirmation of currency, amount, and loan terms;
(d) confirmation that the company is not in the business of borrowing and lending;
(e) proof that the loan is denominated in Ringgit Malaysia and, where applicable, that the loan amount does not exceed the stipulated threshold; and
(f) proof that the interest rates applied, either the deposit rate or the ALR, is based on the official publication of BNM or the IRBM website.

4.5 A CTPD is not required to be submitted when filing the tax return. However, the CTPD must be made available and submitted within fourteen days from the date the DGIR serves a written notice. Failure to do so may constitute an offence under section 113B of the ITA.

4.6 Taxpayers should maintain proper documentation on controlled transactions, including intra-group loans, tailored to their specific circumstances. They should also be prepared to submit any additional information or documentation not mentioned in the Guidelines that may be relevant for determining the arm's length interest rates.

4.7 Taxpayers should prepare and submit their CTPD in Bahasa Malaysia or English only. Where supporting documents are in a language other than Bahasa Malaysia or English, a translation must be provided upon submission of the supporting documents.

4.8 Taxpayers are required to keep and maintain adequate records for a duration of seven (7) years from the end of the year to which the business income relates. This includes all records, such as books of accounts, invoices, vouchers, receipts, and any other documents necessary to verify entries in the books of accounts relating to any business operating in Malaysia. For transfer pricing purposes, the records must include the CTPD. All records must be kept and retained in Malaysia.

4.9 Any taxpayer who fails to keep and maintain sufficient records, including the CTPD, for a period of seven (7) years may be guilty of a criminal offence under section 119A of the ITA and, if convicted, will be liable to a fine between RM300 and RM10,000 or to imprisonment for a term of not more than one year, or both.

OTHER LEGAL PROVISIONS RELATED TO INTRA-GROUP LOAN

4.10 Generally, controlled transactions, including intra-group loans, are subject to section 140A of the ITA. However, where the intra-group loans are made to the company's directors, section 140B of the ITA will apply to determine the interest rate for such transactions.

4.11 When taxpayers claim an interest deduction for a year of assessment, they must ensure compliance with paragraph 33(1)*(a),* subsection 33(2), and subsection 33(4) of the ITA. These provisions stipulate that interest expenses incurred and payable on money borrowed during the basis period for a year of assessment are deductible in determining the adjusted income only when the interest is due to be paid.

4.12 The total amount of interest deductible from adjusted business income for each year of assessment remains subject to the interest restrictions specified in section 140C of the ITA, even if the interest is calculated at an arm’s length rate.

4.13 Subsection 29(3) of the ITA clarifies that a lender is deemed to be able to obtain interest on demand from a loan transaction between related persons during the basis period for a year of assessment. This is contingent upon the borrower's interest being due within that period. Consequently, the lender is regarded as having received interest income on the date it becomes due from the borrower, regardless of whether the actual payment has been made.