CHAPTER VIII

INTANGIBLES

8.1 Identifying Intangibles

8.1.1 Identifying intangibles

(i) Intangibles are one of the most difficult and contentious issues encountered in transfer pricing practice. The different definitions of intangibles encoun under the various laws and regulations, literatures and accounting standards also complicate matters.

(ii) For the purpose of transfer pricing "intangible" is intended to address something which is not a physical asset or a financial asset but is capable of owned or controlled for use in commercial activities, whose use or transfer will be compensated had it occurred in transactions between independent p in comparable transaction. This approach is independent of accounting or legal definitions or classification of intangibles into different categories.

(iii) For accounting purpose, intangible assets are generally reflected in the balance sheet. However there are situations where intangible assets are not refl in the balance sheet thus not recognized for accounting purposes. Expenses of research and development activities are generally capitalized, h intangibles created are reflected in the balance sheet. However expenses of marketing activities are generally expensed off, thus marketing intangibles such activities may not be shown in the balance sheet. Depending on the facts and circumstances of the case, the intangibles may be recognized for tra pricing purpose even though they are not reflected in the balance sheet.

(iv) Some intangibles are legally protected, while others are not. In Malaysia the provisions of the intellectual property legislations are administered enforced by Intellectual Property Corporation of Malaysia (PHIM: Perbadanan Harta Intelek Malaysia). Intellectual property laws in Malaysia include:

(a) Trade Marks Act 1976 [Act 175];
(b) Patents Act 1983 [Act 291];
(c) Industrial Designs Act 1996 [Act 552];
(d) Copyright Act 1987 [Act 332]; and
(e) Layout Designs and Integrated Circuit Act 2000 [Act 601].

(v) The value of intangibles and their returns are often affected by the extent and availability of legal and contractual protection. However, the existen legal protection is not a precondition for an item to be characterized as intangible for transfer pricing purpose.

(vi) Thus, whether an item can be regarded as an intangible for transfer pricing purpose does not depend on its accounting or legal definition o characterization for general tax purpose. Such definitions can be a useful reference for transfer pricing purpose but will not be the sole determinant.

(vii) Some intangibles may be identified separately and transferred on a segregated basis, while others may be transferred in combination with other bus assets. Regardless of whether the intangible is transferred on a segregated basis or in combination, it will still be recognized as intangible for tra pricing purpose.

8.1.2 Categories of Intangibles

(i) Distinctions are sometimes made between trade intangibles and marketing intangibles, between "soft" intangibles and "hard" intangibles, between ro and non-routine intangibles, and between other classes and categories of intangibles. However, the determination of arm's length prices does not depen these categorizations. Among items considered as intangible include commercial IP such as patents, know-how, designs and models that are used fo production of goods or provision of a service, and marketing intangibles.

(ii) Marketing intangibles, is a special type of commercial intangibles, which includes trademarks, trade names, marketing strategies, customer lists, cust relationships, and proprietary market and customer data that is used or aids in marketing and selling goods or services to customers; essentially asset will help market the products. It aids in commercial exploitation of the product or service and has important promotional value for the product/ser concerned.

(iii) Government licenses and contractual right under certain circumstances, which grant companies special privileges or exclusivity, are intangibles for tra pricing purpose. Examples include:

(a) Government concessions which grants the rights to exploit specific natural resources such as concession for the extraction of forest produce;
(b) Production Sharing Contract which grants oil and gas companies the rights for exploration and production of oil and gas in Malaysia (Exploratio production rights granted by PETRONAS to oil and gas companies via Production Sharing Contract); and
(c) Government licenses/ agreements/ contracts that grant trade restrictions to keep out competitors or restrict the number of competitors such as licens broadcasting or license for Network Facilities Provider (NFP) and Network Service Provider (NSP) awarded to telecommunication companies or p purchase agreement (PPA) with independent power providers.

(iv) Other government contracts such as contracts for supply including contract to supply pharmaceutical products to government hospitals or contrac provide consulting/technical services are also considered as intangibles for transfer pricing purposes.

(v) Grant of license/ concessions/ contracts must be distinguished from company registration which is a requirement for doing business and does not gran company any special privileges. Rights under a contract or agreement, for example contract with a key customer or with a supplier which supplies a raw material are intangibles for the purpose of transfer pricing.

(vi) Exclusive rights in intangibles are generally transferred by means of a license agreement. These exclusive rights in intangibles are themselves intang for the purpose of transfer pricing. For example, the grant of exclusive rights for the licensee to operate in a certain geographic region. These excl rights in intangibles are themselves intangibles for the purpose of transfer pricing.

(vii) It should be emphasized that generic references to items such as marketing intangible or trade intangibles do not relieve taxpayers or tax administra from their obligation in a transfer pricing analysis to identify the relevant intangible specifically nor does the use of those terms suggest that a diff approach should be applied in determining arm's length conditions for a transaction.

(viii) Goodwill and on-going value generally refers to a number of different notions. For transfer pricing purpose, the transfer of something of value, whethe a goodwill or not, from one associated person to another may be taken into consideration and appropriately compensated to the extent of how indepe person carrying out comparable transactions is remunerated.

8.1.3 Relevance of transfer pricing guidance of intangibles for other tax purpose

The guidance on the concept of intangibles and remuneration for the use or transfer of intangibles provided in this chapter is specifically for the purpo transfer pricing and is relevant for Section 140A and Transfer Pricing Rules.

8.2 Ownership Of Intangibles And Analyzing Transactions Involving Development, Enhancement, Maintenance, Protection And Exploitation Of Intangibles (DEMPE)

8.2.1 Ownership of Intangibles

(i) In transfer pricing cases involving intangibles, the determination of who are ultimately entitled to share in the returns derived by the MNC group exploiting the intangibles is crucial. This includes issues regarding who should ultimately bear the costs, investments and other burdens associated wit DEMPE of the intangibles. Although a legal owner of an intangible may receive proceeds from exploitation of the intangibles, other members of the g may have performed functions, used assets, or assumed risks that contribute to the value of the intangible. Members of the MNC Group performing functions, using such assets, and assuming such risks must be compensated for their contributions under the arm's length principle.

(ii) The legal owner will be considered to be the owner of the intangible for transfer pricing purposes. If no legal owner of the intangible is identified u applicable law or governing contracts, then the member of the MNC Group that controls decisions concerning the exploitation of the intangibles and ha practical capacity to restrict others from using the intangibles will be considered to be the 'legal' owner for transfer pricing purpose.

(iii)

In identifying the owner of intangibles, the intangible and any license relating to that intangible are considered to be two separate and distinct intang each having a different owner. Intangible registration and licensing agreements can help identify the legal owner of the intangible and the owner o license.

Example 1

Company A, the legal owner of a trademark, may provide an exclusive license to Company B to market and distribute goods using the trademark. The intangible is the trademark, which is legally owned by Company A. The second intangible is the license to use the trademark in connection with marketin distribution of trademarked products, which is legally owned by Company B. Depending on the facts and circumstances, marketing activities undertake Company B pursuant to its license agreement may potentially affect the value of the underlying intangible legally owned by Company A, the value of Com B's license or both.

(iv) If the legal owner neither performs the functions, nor control the functions or risks related to the development, enhancement, maintenance, protecti exploitation (DEMPE) of the intangible, the legal owner would not be entitled to that portion of return associated with the performance of the functio the control of the functions and risks relating to the DEMPE of the intangibles. The final return to the legal owner will depend on its contributions an contributions of the other members of the MNC Group to the value of the intangible. This value is attributable to its functions, assets and risks related t DEMPE of the intangibles

8.2.2 Analyzing transactions Involving Intangibles

For transfer pricing purpose, in analyzing transactions involving the use or transfer of intangibles between associated persons, the following factors should be taken into consideration :-

(i) Identifying the intangibles

(a) Specifically identify the intangibles used or transferred in the controlled transaction together with the economically significant risks associated with DEMPE of the intangibles.

(b) When a taxpayer pays royalty for the use or transfer of intangibles, the taxpayer needs to provide evidence for:

- the intangibles that are involved;
- the processes where the intangibles are utilized
- the benefit obtained from the intangibles;
- the specific, economically significant risks associated with the transactions involving the intangibles; and
- withholding tax payments that are made with regards to the royalty payment.

(ii) Analyzing the contractual terms

(a) Identify the full contractual arrangements with special emphasis on determining legal ownership of intangibles based on the terms and conditio legal arrangements, including relevant registration, license agreements, other relevant contracts, the contractual rights and obligations an contractual assumption of risks in the relations between the associated persons.

(b) In identifying the contractual arrangements, the following information is necessary and may be obtained from legal documents including p registration such as patent or trademark registration and written contracts such as licensing agreements:

- legal ownership;
- role, responsibilities, obligations and rights of the relevant parties including those who undertake the functions and controls the risks with res to the DEMPE functions;
- identity the funder and level of risks assumed by the funder;
- quantum of payment and mode of payment; and
- how expenses and receipts related to intangibles are allocated.

(c) Correspondence and communications between the parties involved are also important in identifying and analyzing the controlled transactions invo intangibles and evaluating the terms of the transactions (including risks assumption involving the transfer or use of the intangibles).

(d) The determination of legal ownership is distinct from the question of remuneration. Legal ownership of intangibles, by itself, does not confer any ultimately to retain returns derived by the MNC Group from exploiting the intangible. Even though such returns may initially accrue to the legal o as a result of its legal or contractual right to exploit the intangible, this would depend upon the functions the legal owner performs, the assets it uses the risks it assumes, and upon the contributions made by other MNC group members through their functions performed, assets used, and risks ass (refer to paragraph 8.2.3).

(iii) Functional Analysis

(a) Functional analysis needs to be done to identify the parties performing economically significant functions, using assets, and managing risks related DEMPE of the intangibles.

(b) Taxpayer needs to identify:

- the economically significant functions that contribute to the value of the intangibles and instrumental to the success of the DEMPE of the intangibles
- ascertain the relative importance of each DEMPE functions; and
- group members who:-

- ◦ perform and exercise control over the functions associated with the DEMPE of the intangibles;
- ◦ provide the assets and funding, and have financial capacity necessary to bear the cost in relation to the funding; and
- ◦ assume and exercise control over the various specific, economically significant risks associated with the intangible and have the financi capacity to bear the risks associated with DEMPE of the intangibles.

(c) Carefully evaluate the relative value of contributions by various entities to the DEMPE to ensure all affected entities in the group are appropriately compensated on an arm's length basis.

(d) The performance of activities by a Malaysian taxpayer which are economically significant and important include:

- research and development activities which leads to customization / enhancement of existing products or new products;
- activities which leads to improvement in manufacturing processes;
- the performance of advertising, marketing and promotional activities by the Malaysian taxpayer which leads to creation / enhancement of marketing intangibles such as customer lists, marketing / distribution channel, or favorable contracts; and
- managing customers' relationship, localization of products / advertisements or marketing survey including collection of local data.

(e) All these local functions performed by the Malaysian entities which improved the value of intangibles should be appropriately compensated an costs incurred for such expenses should not be merely reimbursed to the local entity without any profit element, especially when they are perform conjunction with the manufacturing or distribution functions.

(f) A local entity who is not the legal owner of the intangible may nevertheless be entitled to a share of returns from its exploitation if the local entit contributed to the enhancement of the intangibles. Thus, the local entity is considered as having 'economic ownership' of the associated intang created.

(iv) Control of the performance of significant functions.

(a) In carrying out the functional analysis, a taxpayer needs to assess the capacity of a particular entity to exert control and the actual performance of control functions. It is not essential that the legal owner physically performs and controls all the functions related to DEMPE of an intangible. W associated persons other than the legal owner perform and control relevant functions that are anticipated to contribute to the value of the intang they should be compensated on an arm's length basis.

(b) Similarly, where the performance of the DEMPE functions by a local entity is said to be controlled by another entity, documentary evidence has provided, to show that the said entity has the capability to control and perform its control functions.

(c) A local entity carrying out core functions as mentioned in paragraph 8.2.2 (iii)(e) above would control the strategic operations decisions regardin 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 h unlikely to separate the performance and control of a function.

(v) Funding

(a) Group members involved in the creation of intangibles may contribute physical assets, intangibles or funding for the project. The nature and amou compensation attributable to any of the group members should be appropriately determined based on the arm's length principle.

(b) Funding and risks taking are closely integrated as funding is often linked with certain risks such as bad debts risks or the risks of losing all the fu Compensation to the funder will depend on the level and extent of the risks it bears.

(c) To show control over a specific financial risk, a taxpayer must provide evidence that the funder is capable of making relevant decisions related t risk bearing opportunities together with the actual performance of these decisions (including risk mitigation activities).

(d) Generally, a funder who only exercise control over financial risks associated with the provision of funding, without the assumption of further ris relation to the investments, and without any control over the use of the contributed funds or the conduct of the funded activity, would only entitl funder to a risk-adjusted rate of anticipated return on its capital.

(vi) Risks associated with DEMPE of the intangibles

(a) Many local entities are treated as contract risk free service providers, by contending that higher return to foreign entity is justified because the forei entity:

- provides funding for the project, hence bearing the risks of failure of the R&D functions; and
- establishes and controls strategy / direction and priorities of research program or creative undertakings while the local entity is merely implementing such strategy / direction.

(b) Although the strategic decisions and overall directions from parent / foreign entities are cascaded down to the local entity, this does not imply tha foreign entity has control over the R&D functions of the local entity or would bear the related risks.

(c) If the local entity performs important R&D functions and even customizes the know-how provided which leads to enhancement of intangibl creation of new intangibles, and the management and personnel of the local entity are responsible for operational decisions and monitoring of its activities, the local entity is in a better position to control over the operation and its related risks than an entity who is controlling the functions / from afar.

(d) As mentioned in paragraph 8.2.2 (v) above, provisions of funding will not entitle the funder to a premium return, if it did not perform control func and bear risks with regards to the R&D activities. Besides that, other important assets possess by the local entity such as skilled workforce mu considered when determining the return to the local entities. The parent / foreign entity will be entitled to a return for the provision of funding overall direction and strategy, while the local entity should also be entitled to a return on their core R&D functions and control of risks related t operation of R&D activities. Hence, the local entity should not merely be reimbursed on a cost plus margin as a risk free service provider sinc performance, control functions and its associated risks are closely linked and should not be separated and assigned to different parties.

(e) When analyzing the economic substance of a transaction in relation to risks, it is necessary to examine whether the conduct of the associated pe over a period of time has been consistent with the allocation of risks and not merely at the time when risks are realized and whether changes i pattern of behavior of the parties have been matched by changes in the contractual arrangements.

(f) Hence, a routine service provider who earns a very low margin should not suffer the loss when certain risks are realized, as it had consistently ear minimal margin when the risks did not materialized. In a genuine case, a local entity who bears the risks would earn a reasonable margin and have t mitigating actions to protect itself against any risks should it materialized.

8.2.3 Application of arm's length principle in transactions involving intangibles

(i) If the legal owner of an intangible in substance:

(a) performs and controls all the economically significant functions related to the DEMPE of the intangible;

(b) provides all assets, including funding, necessary to the DEMPE of intangibles; and

(c) assumes all the risks related the DEMPE of the intangible.

then it will be entitled to all the anticipated, ex ante returns derived from the MNC Group's exploitation of the intangible.

(ii) The extent to which one or more members of the MNC Group other than the legal owner perform functions, uses assets or assumes risks related t DEMPE of the intangible, will determine its arm's length compensation for their contributions. This compensation may, depending on the facts circumstances, constitute all or part of the return anticipated to be derived from the exploitation of the intangible.

(iii) In evaluating whether associated persons that perform functions or bear risks related to the DEMPE of intangibles have been compensated on an a length basis, it is necessary to consider:

(a) the level and nature of the activity undertaken;

(b) the expected contribution of the functions performed and risks assumed to the creation of intangible value and the generation of income; and

(c) the amount and form of compensation paid.

(iv) Determining Arm's Length Compensation

(a) In determining the arm's length compensation for the functional contributions, assets used and risks assumed, the principles in accurately delineatin actual transaction, analysis and allocation of risks and the recommended process for conducting a comparability analysis apply equally to transac involving intangibles.

(b) It is necessary to consider the following in determining the arm's length price for controlled transactions involving intangibles:

- comparability factors that may contribute to the creation of value or generation of returns derived by the MNC Group from exploitation of th intangibles;
- the availability of comparable uncontrolled transactions;
- the importance and the relative contribution of the functions performed to the creation of intangible value; and
- the realistically available options of the parties.

(c) When it is difficult to find comparable transactions involving intangibles, it may be necessary to utilize transfer pricing methods not directly base comparable including profit split method and ex ante valuation techniques to appropriately reward performance of those important functions.

8.2.4 Entitlement to the difference between ex-ante and ex-post return

(i) An ex ante (anticipated) remuneration refers to the future income expected to be derived by a member of the MNC Group at the time of a transaction ex post (actual) remuneration refers to the income actually earned by a member of the group through the exploitation of the intangible.

(ii) The terms of the compensation that must be paid to members of the MNC Group that contribute to the DEMPE of intangibles is determined generally time transactions are entered into and before risks associated with the intangible play out (ex-ante). The form of such compensation may be fix contingent. The actual (ex post) profit or loss of the business after compensating other members of the MNC Group may differ from these antici profits depending on how the risks associated with the intangible or the other relevant risks related to the transaction or arrangement actually play out.

(iii) The difference between ex ante (anticipated) and ex post (actual) return arises largely from risks associated with the uncertainty of future business outc The risks may materialize in a different way to what was anticipated through the occurrence of unforeseeable developments. The ex-ante contra assumptions of risks provide clear evidence of a commitment to assume risks prior to the materialization of the risk.

(iv) The party which is entitled to the unanticipated profit (or required to bear the unanticipated loss), will be the party which is found to assume the risks accurately delineating the actual transaction or which contribute to the control of the economically significant risks or which performed the impo functions with respect to the DEMPE activities and for which it is determined that an arm's length remuneration of these functions would include a sharing element.

(v) In addition, consideration must be given to whether the ex-ante remuneration paid to members of the MNC Group for their functions performed, a used, and risks assumed is, in fact, consistent with the arm's length principle. Care should be taken to ascertain, for example, whether the group in underestimated or overestimated anticipated profits, thereby giving rise to underpayments or overpayments (determined on an ex ante basis) to some g members for their contributions. Transactions for which valuation is highly uncertain at the time of the transaction are particularly susceptible to such u or overestimations of value.

8.2.5 Development and enhancement of marketing intangibles via marketing functions of the local entities

(i) One common situation to consider is when an entity associated with the legal owner performs advertising, marketing and promotional (AMP) funct which would benefit the legal owner of an intangible. In this case, considerations to determine how the distributor / marketer should be compensated f AMP activities would include whether to compensate the distributor / marketer as a service provider for providing AMP functions or whethe distributor / marketer should also be compensated for enhancing the value of the trademarks and other intangibles by sharing in the potential benefi virtue of its functions performed, assets used, and risks assumed.

(ii) Malaysian subsidiaries of MNCs usually incur and bear very large amounts of AMP for the benefit of the legal owner of the intangible and simultane developed local marketing intangibles such as distribution network, customers' relationship etc. These entities are usually characterized as buy/se limited risk or routine distributor and only generate a nominal profit or even incurred losses at times.

(iii) Some local distributors have a well-trained and organized marketing team, which performs functions which help create marketing intangibles such as:

(a) enhancing the value of the foreign trademark or brand name or logo;

(b) enhancing brand or product loyalty in the minds of consumers;

(c) establishing networking / distribution channels;

(d) performing customers research or survey or investing in information systems leading to creation of customers list/database or customers' preference information;

(e) establishing an efficient after-sales services and support network locally; or

(f) creating a reputational goodwill.

(iv) These intangibles should attract much more than a routine reward that a "limited/routine distributor" would earn. The marketing team should be suffici rewarded, i.e. the marketing organization should be rewarded for its effort with or without the creation of local marketing intangibles depending on the and circumstances of the case.

(v) Where the marketer / distributor actually bears the costs and associated risks of its marketing activities, the marketer / distributor will have a share i potential benefits from those activities. The margin earned by the local entity, must be comparable to those earned by independent marketers bearing si risks and costs. In these cases, the marketer / distributor is expected to generate higher margin which may be in the form of:

(a) a reduction in purchase price e.g. via additional discount on the purchase price to allow additional profits to reflect the functions, risks and cost inc in promoting the products;

(b) a reduction in royalty rate as compared to previous year (if it's a licensed distributor); or

(c) a share of profits associated with the enhanced value of the trademark or other marketing intangibles.

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

(vii) If the local entity only performs buy sell function (e.g. limited risks distributors) and undertakes marketing activities on behalf of its principal which di result in the development of marketing intangibles, the local entity has to be compensated by the principal for the marketing functions, where it sh earn;

(a) an arm's length margin from selling the products for the distribution functions it performs, the assets it uses and the risks it assumes; and

(b) a service fee for the marketing function it performs on behalf of the principal.

(viii) The service fee paid to the local entity for its marketing activities should be based on compensation paid to independent parties performing si functions. Even if there is no written agreement covering this service, this does not prevent the application of the arm's length principle to that transacti

8.2.6 Research, development and process improvement arrangement

(i) Generally, the arm's length compensation for research services will depend on a number of factors such as the unique skill and experience of the res team, the risks assumes (e.g. where blue sky research is undertaken), the assets and intangibles used and who performs the control functions (whethe research team is controlled and managed by another party) etc. Generally, a compensation based on reimbursement of costs plus will not reflec anticipated value of the intangibles created or the contribution of the research team.

(ii) Research and Development (R&D) activities.

(a) Some local entities are established to carry out research and development work under a contract for its associated foreign entity where the local en will have no ownership of the intangibles, and the results of the research and development activities will belong to the associated foreign en Generally, these local entities are treated as contract research and development companies with limited risks and the service fee paid to the local ent the cost of the research and development activities undertaken plus a mark-up. However, a compensation based on reimbursement of costs plus wi reflect the anticipated value of the intangibles created or the contribution of the research team. Therefore, the local entity should be rewarded base the functions performed, assets used and risks assumed that contribute to the value of the intangible. A proper analysis of the value provided b contract research and development entity to the overall group operations should be provided.

(b) In determining the amount due to the local entity, the relative skill and efficiency of the research personnel, the nature of the research being cond and other factors contributing to the value should be considered.

(c) If the local entities perform the core R&D activities, make day-to-day operational decisions and exercise substantial control over the operational ris the R&D projects, possess sizeable assets and skilled workforce, in such case, the allocation of routine and low cost plus return will not reflect a arm's length price of the transaction.

(d) Where in particular the research team has unique skills or experience, or where blue sky research is undertaken, compensation should be based, at in part, on a share of profits from the future exploitation of successfully developed intangibles. This would be more in keeping with the arm's l principle and the provisions of the Transfer Pricing Rules.

(e) Similarly where the local entities create unique intangibles as a result of the R&D activities, and legal ownership are transferred to the foreign e such transfer normally takes place without any appropriate compensation. In these cases, compensation of such transfer should be based on a sha profit from its future exploitation, in addition to its arm's length compensation for its R&D activities.

(iii) Enhancement of product or process while performing manufacturing functions.

(a) Another situation to consider is where a manufacturer in its provision of manufacturing services to another member of the group (e.g. con manufacturer), leads to enhancement of processes and legal ownership is assumed by another group member. The local entity should be entitled return on the enhancement of these processes, products or intangibles if they are transferred to or shared with the other related entities. If the enha intangibles is self-exploited by the local entity, an increased in margin should be reflect.

8.3 Transactions Involving The Use Or Transfer Of Intangibles

8.3.1 In addition to identifying with specificity the intangibles involved in a controlled transactions and identifying the owner of such intangibles, it is necessa identify the specific controlled transactions including understanding the nature of that transactions and how the intangibles are exploited.

8.3.2 Some categories of transactions involving the exploitation of intangibles for he purpose of analyzing transfer prices are as follows:

(i) Transfers of intangibles or rights in intangibles.

(a) Controlled transactions involving transfer of intangibles or rights in intangibles can occur via an outright sale or grant of license to an associated pe The intangible's owner can grant a license or right to someone else to exploit the intangibles or rights in the intangibles in return for a fee / royalty.

(b) Transfer of rights of intangibles may involve:-

- transfer of all rights in the intangibles (e.g. sales of intangibles or a perpetual, exclusive license of the intangible); or
- transfer of limited rights (e.g. via a license or similar transfer of limited rights to use an intangible which may be subject to geographical restrictions, limited duration, or restrictions with respect to the right to use, exploit, reproduce, further transfer, or further develop).

(c) In transactions involving the transfer of intangibles or rights in intangibles, it is essential for tax payers in a transfer pricing analysis to identify:

- with specificity the nature of the intangibles and rights in intangibles that are transferred between associated persons; and
- limitation/restrictions on the rights transferred including the nature of such limitations and the full extent of the rights transferred as the natur limitation can affect the value of the intangibles transferred.

(ii) Transfers of combination of intangibles.

(a) Intangibles (including limited rights in intangibles) may be transferred individually or in combination with other intangibles. In considering transac involving transfers of combination of intangibles, two related issues often arise.

(b) Firstly, the nature and economic consequences of interactions between different intangibles. Some intangibles are more valuable when consider combination with other intangibles than if they are considered separately.

(c) Secondly, to ensure that all the intangibles transferred in a particular transaction have been identified. Sometimes the intangibles are so intertwined it is not possible, as a substantive matter, to transfer one without transferring the other.

(iii) Transfer of intangibles or rights in intangibles in combination with other business transactions.

(a) In some situations, intangibles or rights in intangibles may be transferred in combination with tangible business assets, or in combination with servi Under such situation the taxpayer needs to provide evidence that:

- all intangibles have been transferred; and
- all of the intangibles transferred in connection with that particular transaction can be identified and taken into account in the transfer pricing analysis.

(b) Where it is possible and appropriate to separate transactions of tangible goods or services from transfers of intangibles / rights in intangible purposes of conducting a transfer pricing analysis, then the price of a package contract should be disaggregated in order to confirm that each eleme the transaction is consistent with the arm's length principle. It should be kept in mind, however, that the interactions between various intangible services may enhance the value of both.

(c) In some situations it may be difficult to segregate tangible goods or service transactions from transfers of intangibles / rights in intangibles be transactions may be so closely related.

(d)

However, if the arrangement of services and intangibles transferred in combination is so unique, that sufficiently reliable comparables are not avail then it may be necessary to segregate the various parts of the package for transfer pricing purpose, keeping in mind that the interactions between may enhance the value of both.

(iv) Transactions involving the use of intangibles in connection with the sale of goods or the performance of services.

(a) Intangibles may be used in connection with controlled transactions in situations where there is no transfer of the intangible / rights in the intangible example, intangibles may be used by one or both parties to a controlled transaction in connection with;

- the manufacture of goods sold to an associated person;
- the marketing of goods purchased from an associated person; or
- the performance of services on behalf of an associated person.

The need to consider the use of intangibles by a party to a controlled transaction involving a sale of goods can be illustrated as follows:

A car manufacturer uses valuable proprietary patents to manufacture the cars that it then sells to associated distributors. Assume that the pa significantly contribute to the value of the cars. The patents and the value they contribute should be identified and taken into account i comparability analysis of the transaction consisting of the sales of cars by the car manufacturer to its associated distributors, selection of the tested and the most appropriate transfer pricing method for the transactions. The associated distributors purchasing the cars do not, however, acquire any in the manufacturer's patents. In such a case, the patents are used in the manufacturing and may affect the value of the cars, but the patents thems are not transferred.

(b) Under such situation the following would need to be addressed in the transfer pricing documentation:

- the nature of such a transaction should be clearly specified;
- any relevant intangibles used by either of the parties in connection with such a controlled transaction should be identified; and
- these relevant intangibles should be taken into account when performing the comparability analysis (including the functional analysis), and in selection and application of the most appropriate transfer pricing method for that transaction.

8.3.3 Intangibles exploit by local companies in connection with manufacturing activities.

(i) Many MNC Group outsource the 'manufacturing activities' necessary for the exploitation of the intangibles by way of a contract to Mala manufacturers. The intangibles may be in the form of technical know-how, secret formula etc. Generally during the initial stage of setting up manufacturing business operation in Malaysia, these are provided to the contract manufacturers for a fee. However, it was noticed that many of these companies continue paying royalties (indefinitely) even though they have gained the necessary experience, are now well established and has contribut the improvement and efficiency of the manufacturing process.

(ii) The Malaysian companies using the technical know-how of their parent may have incurred significant expenditure to customize such know-how a enhance its value by their research and development effort. Cost of such research and development activities which contributed to enhancing the val the original know-how owned by the parent company should be considered when determining the arm's length price for payment of royalties for tech know-how or patents.

(iii) Under such circumstances, the taxpayer needs to consider whether it should continue to pay a royalty to the parent company for the 'impro manufacturing process. If 'yes', the taxpayer must give justification that the original intangibles continue to provide value over time. The taxpayer sh also consider its entitlement to a return on the intangibles of the improved manufacturing process especially when the locally created or enha intangibles are used by other related companies.

(iv) IRBM may disallow royalty paid if it is not shown that the royalties currently paid are for newly developed or enhanced intangibles as the ori intangibles may have become obsolete over the years.

8.4 Supplemental Guidance For Determining Arm's Length Conditions In Cases Involving Intangibles

8.4.1 Factors affecting comparability of intangibles or rights in intangibles

(i) In applying the arm's length principle, a taxpayer needs to understand the type and the characteristics of intangible properties. This would he identifying the factors that contribute to an intangible's value and the types of comparables needed for comparability analysis.

(ii) When determining the relative value of contribution by each party or comparability of the transactions, it is necessary to examine the nature and impor of contribution, cost incurred and risks assumed in DEMPE of the intangible property. Other factors to consider include:

(a) expected benefits and usefulness of the intangible property;
(b) prevailing industry rates;
(c) terms of the agreement including geographic limitations, duration of the license, any termination or negotiation rights and exclusivity rights;
(d) legal protection;
(e) benefits to the licensor, arising from sharing of information on the experience of the licensee contributing towards further developments of the prop
(f) possibility of sub-licensing;
(g) the extent of any capital investment, start-up expenses or development work required or stage of development of intangible;
(h) rights to receive update, revisions or modifications of the intangibles; or
(i) technical assistance, trademarks and know-how provided along with access to any patent.

8.4.2 Supplemental guidance on transfer pricing method in a matter involving the transfer of intangibles or rights in intangibles

(i) In selecting the most appropriate transfer pricing method in a case involving a transfer of intangibles or rights in intangibles, attention should be given t

- the nature of the relevant intangibles;
- the difficulty of identifying comparable uncontrolled transactions and intangibles in many, if not most, cases; and
- the difficulty of applying certain transfer pricing methods in cases involving the transfer of intangibles.

(ii) When selecting the most appropriate transfer pricing method, consideration should be given to the economic consequences of the transaction and n arbitrary label of the transactions itself.

(iii)

It is important not to simply assume that all residual profit, after a limited return to those providing functions, should necessarily be allocated to the o of intangibles. The selection of the most appropriate transfer pricing method should be based on a functional analysis that provides a clear understandi the MNC Group's global business processes and how the transferred intangibles interact with other functions, assets and risks that comprise the g business. The functional analysis should identify all factors that contribute to value creation, which may include risks borne, specific market characteri location, business strategies, and MNC Group synergies, among others. The transfer pricing method selected, and any adjustments incorporated in method based on the comparability analysis, should take into account all of the relevant factors materially contributing to the creation of value, not intangibles and routine functions.

(iv) Depending on the facts and circumstances of each case, any of the five OECD transfer pricing methods may constitute the most appropriate transfer pr method to determine the arm's length price and conditions for the controlled transaction involving intangibles. Other methods may also be used, w appropriate.

(v) The determination of arm's length prices for a transfer of intangibles or rights in intangibles can be made when comparables and information related can be identified to make reliable comparability adjustments to account for any differences in the controlled and uncontrolled transactions.

(vi) Where information regarding reliable comparable uncontrolled transactions cannot be identified, the arm's length principle requires use of another m to determine the price that independent parties would have agreed under comparable circumstances. In making such determination, it is importa consider:

(a) the functions, assets and risks of the respective parties to the transaction;

(b) the business reasons for engaging in the transaction;

(c) the perspectives of and options realistically available to each of the parties to the transaction;

(d) the competitive advantages conferred by the intangibles including especially the relative profitability of products and services or potential products services related to the intangibles;

(e) the expected future economic benefits from the transaction; and

(f) other comparability factors such as features of local markets, location savings, assembled workforce, and MNC group synergies.

(vii) Due to the relationship between them, associated persons might sometimes structure a transaction involving intangibles in a manner that independent p would not contemplate. However, where associated persons' transactional structures are not typical transactions entered into by independent parties effect of those structures on prices and other arm's length conditions should be taken into account in evaluating the profits that would have accrued to of the parties at arm's length.

(viii) One sided methods, including the resale price method and the TNMM, are generally not reliable methods for directly valuing intangibles. A one method can be used to indirectly value intangibles, by determining values for some functions and deriving a residual value for intangibles. It is importa bear in mind that not all residual return is attributable to the legal owner. Care should be exercised to ensure that all functions, risks, assets and other fa contributing to the generation of income are properly identified and evaluated.

(ix) The use of transfer pricing method based on the cost of intangible development to estimate the value of intangibles should be avoided. There rarely i correlation between the cost of developing intangibles and their value or transfer price once developed.

(x) The transfer pricing methods most likely to prove useful in matters involving transfers of one or more intangibles are the CUP method and the transact profit split method. Valuation techniques can also be useful.

8.4.3 Application of the CUP Method

Where reliable comparable uncontrolled transactions can be identified, the CUP method can be applied to determine the arm's length conditions for a transf intangibles or rights in intangibles. In some situations, intangibles acquired by an MNC Group from independent parties are transferred to a member of the Group in a controlled transaction immediately following the acquisition. In such a case, the price paid for the acquired intangibles will often (after appropriate adjustments, including adjustments for acquired assets not re-transferred) represent a useful comparable for determining the arm's length price fo controlled transaction under a CUP method.

8.4.4 Application of transactional profit split method

Where it is not possible to identify reliable comparable uncontrolled transactions for a transfer of intangibles or rights in intangibles, a transactional profit method can be utilized to determine the arm's length conditions for such transfer. The guidance in applying transactional profit split method is fully applicab matters involving the transfer of intangibles or rights in intangibles. However, in evaluating the reliability of transactional profit split method, the availabili reliable and adequate data regarding combined profits, appropriately allocable expenses, and the reliability of factors used to divide combined income shou fully considered.

8.4.5 Use of valuation techniques

(i) Valuation techniques to estimate the arm's length price may be used where reliable comparable uncontrolled transactions for a transfer of one or intangibles cannot be identified.

(ii) The application of income based valuation techniques, especially valuation techniques premised on the calculation of the discounted value of proj future income streams or cash flows derived from the exploitation of the intangible being valued, may be useful when properly applied. Depending o facts and circumstances, valuation techniques may be used as a part of one of the five OECD transfer pricing methods, or as a tool that can be use applied in identifying an arm's length price.

(iii) Where valuation techniques are utilized in a transfer pricing analysis involving the transfer of intangibles or rights in intangibles, it is necessary to such techniques in a manner that is consistent with the arm's length principle and these Guidelines. Principles related to realistically available opt economically relevant characteristics, accurately delineating a transaction and risks analysis framework, and aggregation of transactions apply ful situations where valuation techniques are utilized in a transfer pricing analysis. Depending on the facts and circumstances of the individual case calculation of the discounted value of projected cash flows derived from the exploitation of the intangible should be evaluated from the perspectives of parties to the transaction in arriving at an arm's length price. Furthermore, the guidance laid down in these Guidelines on selection of transfer pr methods apply in determining when such techniques should be used.

(iv) It is essential to consider the validity of the underlying assumptions used for valuation techniques and the consistency of those assumptions with the a length principle. A careful examination of such assumptions are essential before accepting the valuations performed for accounting purpos determinative for transfer pricing purposes.

(v) Taxpayers making use of valuation techniques in determining arm's length prices for transferred intangibles should explicitly set out each of the rel assumptions made in creating the valuation model, describe the basis for selecting the valuation parameters, and should be prepared to defen reasonableness of such assumptions and valuation parameters. It is a good practice for taxpayers relying on valuation techniques to present as part of transfer pricing documentation some sensitivity analysis reflecting the consequential change in estimated intangible value produced by the model alternative assumptions and parameters are adopted.

(vi) IRBM will request further explanation if there are any inconsistencies in the assumptions made in a valuation of an intangible undertaken for tra pricing purposes and valuations undertaken for other purposes. For example —

(a) if high discount rates are used in a transfer pricing analysis, when the company routinely uses lower discount rates in valuations for other purposes;

(b) if it is asserted that particular intangibles have short useful lives but the projections used for other business purposes demonstrate that related intang produce cash flows for years beyond the "useful life" that has been claimed for transfer pricing purposes.

(vii) The following paragraphs identify some of the specific concerns that should be taken into account in evaluating certain important assumptions underlyi calculations in a valuation model based on discounted cash flows:-

(a) Accuracy of financial projections.

- It is essential to examine carefully the assumptions underlying the financial projections of both future revenue and future expense, if the accura such projections is contingent on developments in the market place that are both unknown and unknowable at the time the valuation is undertake

- In evaluating financial projections, the source and purpose of the projections can be particularly important. It is usually the case that projec prepared for non-tax business planning or investment purposes are more reliable than projections prepared exclusively for tax purpose exclusively for purposes of a transfer pricing analysis.

- The length of time covered by the projections should also be considered in evaluating the reliability of the projections. The further into the futur intangible in question can be expected to produce positive cash flows, the less reliable projections of income and expense are likely to be.

- A further consideration in evaluating the reliability of projections involves whether the intangibles and the products or services to which they r have an established track record of financial performance. Although past performance may not be a reliable guide to the future, as many factor subject to change, they can provide some useful guidance as to the likely future performance of products or services that rely on intang Projections with respect to products or services that have not been introduced to the market or that are still in development stage are inherently reliable than those with some track record.

- When deciding whether to include development costs in the cash flow projections it is important to consider the nature of the transferred intan whether the transferred intangibles are fully developed or the intangibles have indefinite useful lives and may be continually developed.

(b) Assumptions regarding growth rates.

Projections of future cash flows are often based on projected growth rates. A reliable application of a valuation technique based on projected future flows would examine the likely pattern of revenue and expense growth based on industry and company experience with similar products. Simple m containing linear growth rates without reasonable justifications should not be accepted.

(c) Discount rates

- The discount rate is a critical element of a valuation model. The discount rate takes into account the time value of money and the risk or uncertainty of the anticipated cash flow used in converting a stream of projected cash flows into a present value. A small variation in the sele discount rate can generate a large variation in the calculated value of intangibles using these techniques. Therefore, it is essential for taxpayer justify the assumptions made in selecting the discount rate or rates utilized in the valuation model.

- There is no single measure for a discount rate that is appropriate for transfer pricing purposes in all instances. The specific conditions and risk associated with the facts of a given case and the particular cash flows in question should be evaluated in determining the appropriate discount

- It should be recognized that some businesses are inherently more risky than others and some cash flow streams are inherently more volatile th others. The discount rate or rates should reflect the level of risk in the overall business and the expected volatility of the various projected cas flows under the circumstances of each individual case.

- Since certain risks can be taken into account either in arriving at financial projections or in calculating the discount rate, care should be taken avoid double discounting for risk.

(d) Useful life of intangibles and terminal values

- Valuation techniques are often premised on the projection of cash flows derived from the exploitation of the intangible over their useful life. useful life of a particular intangible can be affected by the nature and duration of the legal protections afforded to the intangible, the rate of technological change in the industry, and by other factors affecting competition in the relevant economic environment.

- Where specific intangibles contribute to continuing cash flows beyond the period for which reasonable financial projections exist, it will sometimes be the case that a terminal value for the intangible related cash flows is calculated. Where terminal values are used in valuation calculations, the assumptions underlying their calculation should be clearly set out and the underlying assumptions thoroughly examined, particularly the assumed growth rates.

(e) Assumptions regarding taxes

Where the purpose of the valuation technique is to isolate the projected cash flows associated with an intangible, it may be necessary to evaluate an quantify the effect of projected future income taxes on the projected cash flows. Tax effects to be considered include:

(i) taxes projected to be imposed on future cash flows;
(ii) tax amortization benefits projected to be available to the transferee, if any; and
(iii) taxes projected to be imposed on the transferor as a result of the transfer, if any.

(f) Form of payment

- In evaluating the provisions of taxpayer agreements related to the form of payment, it should be noted that some payment forms will entail gr or lesser levels of risk to one of the parties. For example, a payment form contingent on future sales or profit will normally involve greater ris the transferor than a payment form calling for either a single lump-sum payment at the time of the transfer or a series of fixed instalment payments. The chosen form of the payment must be consistent with the facts and circumstances of the case, including the written contracts, th actual conduct of the parties, and the ability of the parties to bear and manage the relevant payment risks.

- In particular, the amount of the specified payments should reflect the relevant time value of money and risk features of the chosen form of payment. For example, if a valuation technique is applied and results in the calculation of a lump-sum present value for the transferred intang and if a taxpayer applies a payment form contingent on future sales, the discount rate used in converting the lump-sum valuation to a stream o contingent payments over the useful life of the intangible should reflect the increased risk to the transferor that sales may not materialize and payments would therefore not be forthcoming, as well as the time value of money consequences arising from the deferral of the payments to future years.