

# The rise of intangibles and the impact on TP analysis

**Subhabrata Dasgupta and Jimit Parikh of Deloitte Malaysia explain why taking note of intangible actions will make for better transfer pricing analysis.**

Intangibles in a business context have increased in manifold ways over recent decades. This rise has brought an increased focus on intangibles in global tax and transfer pricing (TP), among thinktanks such as the OECD, leading to the BEPS action.

However, amid the TP guidance issued by the OECD, other think-tanks, local governments and courts, efforts should also be made to appreciate how businesses think and operate, the role and rise of intangibles in business, and key actions that are not directly reflected in financial statements but significantly influence business outcomes. This would aid better TP analysis.

In this article, we present two case studies to highlight how some MNE groups may have taken resilient action during the pandemic, the rise of intangibles within their businesses, with technology itself becoming the end-product/service, technology embedded within the product/service and integration of the technology in how businesses operate, and their potential impact on TP analysis. Current accounting practices face a challenge to appropriately capture the true picture.

## **Exogenous v. endogenous technology-based framework**

Paul M Romer, professor of economics and a Nobel Prize winner, explained in his 1994 publication ‘The Origins of Endogenous Growth’, that most economic models incorrectly assumed that technology was an exogenous factor (i.e. external) driving growth.

Examples of exogenous technologies could include hardware, software, and downloadable applications used for business activities supplied by external firms. However, Romer stated that growth is the result of endogenous factors (i.e. internal). These factors are internal to a system and combine building blocks already existing in the system. While the building blocks in such a framework could be tangible, the steps for

putting these blocks together are intangible and not easily replicable. Examples could be the ‘network effects’ of social media companies/platforms that are explicitly based on such endogenous technology-based frameworks.

While the abovementioned technology-based businesses are easier to identify for most of us, there is also a second category of businesses that may not explicitly sell a tech-based end-product, but they embed the technology into their DNA in a way that helps them to sustain and deepen their competitive advantage.

Such a business, to an outsider, may appear to sell cookies or apparel. However, its management would consider it to be a technology company that just happens to sell cookies or apparel. TP analysis for MNEs integrating technologies into their daily operations may require a different outlook as we attempt to explain below.

### Case study 1: Diagnostics

Investment in understanding consumer footfall to decide the location, size and merchandise of collection centres and laboratories (data analytics)

Company A in Country A (head office) has franchises (associated enterprises) in multiple countries. Its business objective is to differentiate from its competitors through investment in a hub-and-spoke supply chain network to optimise the location, size and merchandise of its collection centres and laboratories (path labs), thereby improving the profitability of each collection centre and laboratory and gaining market share.

Over the years, Company A (head-office) has developed expertise in Country A in quick generation of diagnostic reports after sample collections at thousands of locations throughout the country, thereby developing a strong competitive advantage and barriers to entry.

Company A gathered data on the most popular diagnostic tests in demand (high frequency vs low frequency), periods of the day during which patient footfall increased, demographics of the given area, nearby hospital and clinic networks, tests that generated the highest return on capital employed, competitor movements, etc.

Company A then ran the data through its in-house data analytics platform and generated insights on the attractive areas to set up collection centres, laboratories that can serve multiple collection centres, optimum use of equipment and workforce, demographics within the given locality, identifying tests, such as radiology-based ones, that are less frequently demanded but require heavy capital investment in medical devices and equipment and accordingly, identify locations where their use could be optimised for consistent profitability.

All of the above led to Company A generating the highest return on capital employed and market share within Country A. After global expansion through franchisees (associated

enterprises), the business performance matched the success in Country A.

Franchisees are primarily required to ensure that operations remain efficient and adhere to the quality standards set by Company A, and Company A has control over where these centres are set up. Franchisee B in Country B only has to make a limited capital investment while generating high revenue and profitability. Franchisees use the capital investment saved per collection centre and laboratory and invest this, along with the retained earnings, in setting up additional collection centres and laboratories within the country, thereby enjoying new avenues to reinvest the capital and increase the absolute value of profits generated for both Company A and the franchisees without diluting the return on capital employed (%).

Company A charges a franchise fee of 18% of revenue from Franchisee B, while the search in the online databases for comparable uncontrolled agreements suggests the franchise fee to be in the range of say, 6% to 12% of the revenue (assumed). Even after paying a high franchise fee to Company A, Franchisee B’s profitability is consistent with (or higher than) the interquartile range of the profitability earned by comparable companies (application of transactional net margin method).

Additionally, as Company A’s proprietary analytics platform absorbs more and more data over the years, it will be able to consistently improve its predictability of targeting optimal locations for collection centres and laboratories for an even higher return accretive business.

### TP considerations (non-exhaustive)

In an industry not selling an end-product/service that is explicitly technology-oriented, rather the technology is integrated within the business processes, Company A has carved out a significant competitive advantage through its intangibles (business processes and insights).

While the determination of arm’s length price for any controlled transaction depends on the facts and the TP analysis, the following practical considerations may arise:

- Characterising this business as a diagnostics play or a technology play?
- If a comparable uncontrolled price method is the most appropriate one for comparability analysis of franchise fees, should a search for the comparable uncontrolled agreements be directed towards the diagnostics industry only or technology licensing in general?
- Company A’s intangibles do not eliminate, but support, mitigation of marketplace risk (consistency in customer footfall and reduced threat of disruption from competitors) and financial risk (less capital remains tied up in the business).
- If the franchisee’s profitability is consistent with (or higher than) the comparable companies, would the tax authority still push back on optically higher franchise

fees? Is this an apt case for a unilateral/bilateral advance pricing arrangement?

- If Company A's intangibles open up opportunities to grow the profit pie even further, both as a % of capital employed and in absolute terms, isn't this a further justification for a higher franchise fee to Company A? These considerations can be explored on a case-by-case basis.

The above serves as an example that even businesses seemingly selling routine end-products may be creating competitive advantages through the integration of technology in each step of their business processes, thereby minimising costs and generating higher revenue and returns.

### Digitalised supply chain

Let us now look at some resilient actions by MNEs during the pandemic, especially for an industry at the epicentre of enabling these actions, and discuss potential TP implications.

### Case study 2: Software developer and IT solutions provider

#### Digitalised supply-chain, new routes-to-market and shifting value creation

Multiple associated enterprises of the MNE are spread globally that shift their role from delivery centres to client-facing resellers, depending on the business needs of each client project and location.

The group's main business objective was sustenance of the supply-chain throughout the pandemic and capturing tremendous demand for digitalisation and automation of the client supply-chains and increased demand for offshore IT services. This includes talent retention, digitalisation of supply-chain (delivery) through maximum remote working, high integration amongst innovation and delivery centres spread globally, training and/or retraining employees for nimbleness, and extended partnerships with cloud vendors.

This MNE deployed a strategic process of delivery using artificial intelligence to autonomously match individuals with the requisite skill profiles to the opportunities, irrespective of their physical location, thereby enabling access to a larger pool of talent, better fitment, faster project allocations and delivery.

They explored new routes-to-market by allocating the individuals with the requisite and complementary skillset to a perfect sales team during the digitalised client pitch. They also collaborated with cloud vendors to offer cloud solutions (for example, launching cloud architecture to assist the client in accelerating its digital enterprise transformations).

The abovementioned actions resulted in business sustenance, delighted clients, and market-share growth, a nimble business organisation ready for future digital business models (for example, Company A can be a reseller in Project A, innovator in Project B and delivery centre in Project C) and talent retention.



### Subhabrata Dasgupta

Partner

Deloitte Malaysia

T: +603 7610 8376

E: sudasgupta@deloitte.com

Subhabrata Dasgupta (Subho) is a partner and the TP leader for Deloitte Malaysia. He has more than 15 years' experience in serving clients on global and regional TP documentation and planning engagements involving business restructuring, due diligence, policy design and implementation, and monitoring elements. He also leads the TP technology offerings from Deloitte in Malaysia.

Subho has facilitated workshops for the local tax office and is a member of the Technical Committee on Transfer Pricing of the Chartered Tax Institute of Malaysia. He was recognised as a leading TP advisor in the 2019 and the 2021 editions of the 'Guide to the World's Leading Transfer Pricing Advisors'.

### Tax considerations (non-exhaustive):

- **Intercompany agreements:** Manage and standardise a complex web of intercompany agreements to the extent possible.
- **Intangibles:** Creation of new intangibles through strategic processes of delivery and new routes-to-market, and a talent cloud that leads to value creation becoming non-static, circular, and shifting. Also, this may result in changes in employees' work profiles through training/retraining. Lastly, who would economically own these intangibles?
- **Location of intangibles:** Identify the locations to situate the newly created or acquired intangibles, know-how and customer contracts, such that it provides commercial flexibility while remaining tax efficient.
- **TP method:** Is profit split a more practical option given a multiplicity of entities within the same supply-chain, and in shifting roles on a given project?
- **Operational TP:** Does the MNE group have tax supportive structures and ERPs in place that help finance and tax appreciate the circular and shifting digitalised supply-chain? Is there a system in place to regularly update multiple intercompany contracts given that the

business models are undergoing rapid transformation? Are there board resolutions and other internal communications in place that articulate the business objective, transformative actions and expected outcomes that would help support the tax positions?

- **Other considerations:** Royalty v. service fee, harmonising tax attributes/incentives, withholding tax rates, and effective tax rates in multiple countries with business presence including Pillar One & Pillar Two impact, personal income tax, immigration and mobility-related challenges in view of changing employee location and work profile due to remote working models and creation of permanent establishment.

The tax strategy in response to the abovementioned considerations would depend on the facts and the functional analysis, local regulations, business objectives, and the MNE's appetite to invest in finance and tax transformation, which has now also become critical to comply with sustainability and governance goals.

#### Way forward

Understanding the business and the various factors including intangibles that drive business outcomes need to be allocated time in conversations between operations, finance, tax and TP practitioners, since accurate delineation of the controlled transaction goes in tandem with the underlying business. Without this, any TP analysis may remain incomplete and ineffectual during a TP audit, which may delay the audit closure or result in protracted dispute.

Further, with gradual crystallisation of the next steps in the OECD's Two-Pillar solution, finance and tax professionals of MNEs are likely to be busy with impact assessment and actions, which might further reduce their bandwidth to recognise the changes to the business models, products,



#### Jimit Parikh

Associate director

**Deloitte Malaysia**

T: +603 7610 7607

E: [jparikh@deloitte.com](mailto:jparikh@deloitte.com)

Jimit has more than nine years' experience in tax consulting in India and Malaysia. He specialises in planning and restructuring engagements, IP migration/valuation, profit split arrangements, and commodities.

Jimit is experienced in driving country-by-country reporting and documentation projects, providing value-chain modelling and business restructuring advice, assisting MNEs in regional principal hub implementation, assisting in post-merger alignment of intercompany pricing policies, IP and royalty modelling, assisting clients with APAs, MAPs and TP audits, and advising on profit attribution for permanent establishments.

suppliers, customers, supply chains and more importantly the ways in which intangibles may be getting developed, enhanced and exploited throughout the MNE. Accordingly, it may be an opportune time to revisit these now.