TaXavvy

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MIDA Guideline on Incentive for Intellectual Property Development

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In order to continue promoting Malaysia as a research and development (R&D) centre, the Government announced a full income tax exemption of up to 10 years for qualifying intellectual property (IP) income derived from patent and copyrighted software.

The ratio of income which qualifies for the tax exemption will be proportional to the R&D that is carried out in Malaysia. This ratio will be based on the Modified Nexus Approach under the OECD's Base Erosion and Profit Shifting (BEPS) Action Plan No. 5.
The MIDA Guideline is issued following the Budget 2020 announcement.

The Malaysian Investment Development Authority (MIDA) has recently published a Guideline on the Incentive for IP Development ("the MIDA Guideline") dated 1 January 2020 on its website. The MIDA Guideline is issued pursuant to the Budget 2020 proposal.

Recap on the exclusion of IP income from the scope of Malaysian tax incentives

As member of the Inclusive Framework on BEPS, Malaysia is required to ensure that its tax incentives comply with certain safeguards which are based on the OECD's Forum on Harmful Tax Practices criteria ("FHTP" criteria).

The FHTP criteria is chiefly predicated on the basis that preferential tax treatments should be linked to the underlying economic activities and value creation. This is also known as the "substantial activities requirement".

IP income removed from scope of Malaysian tax incentives

From an R&D perspective, the FHTP criteria requires tax incentives granted to be proportionate to R&D activities that are carried out in the country based on a formula that is known as the Modified Nexus Approach (MNA). Therefore, Malaysian tax incentives which cover income derived from IP should be MNA-compliant in keeping with Malaysia's commitment under the Inclusive Framework on BEPS. Pending the necessary legislative review / changes to achieve alignment with the MNA, Malaysia has passed the necessary enabling laws by 31 December 2018 to remove IP income from the scope of various Malaysian tax incentives. The tax incentives which were impacted include:

- Principal Hub
- Green Technology Services
- Pioneer Status and Investment Tax Allowance for High Technology Companies
- Pioneer Status for Contract R&D Companies
- MSC Malaysia
- Bionexus Status Companies
- Iskandar Malaysia (IDR Status Companies)
- East Coast Economic Region
- Sabah Development Corridor

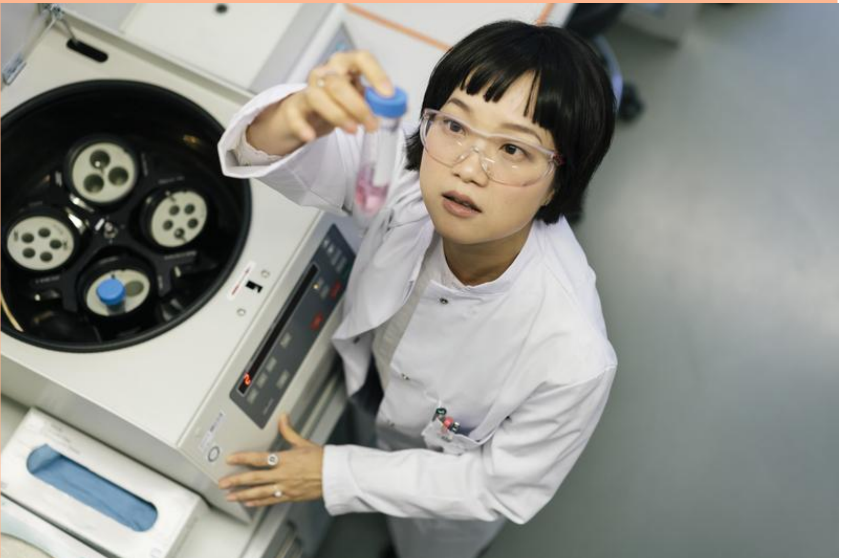
With the exclusion of IP income from the scope of the incentives, IP income becomes fully taxable. The commencement dates of the exclusion are generally as follows:

- Income from new IP – 1 July 2018
- Income from existing IP – 1 July 2021

Please refer to TaXavvy Issue 5-2019 for further details on Malaysia's response to BEPS Action 5.

Modified Nexus Approach - R&D expenditure as a proxy to substance

Based on the substantial activities requirements, the approach takes into account the level of R&D activity in a country and the income arising from that R&D activity which should qualify for tax incentives.



Nexus Approach

The Nexus Approach under BEPS Action 5 requires a direct nexus between the income generated (and hence the tax benefits from the incentive given) and the R&D activities undertaken directly by the taxpayer. This may be measured from the qualifying R&D expenditure ("QE") incurred by the taxpayer. Depending on each jurisdiction, the tax benefits may take the form of income exemption, tax deduction/allowance equivalent to the QE incurred, R&D credit/rebate against income tax payable, etc. Under the MIDA Guideline, the tax incentive which is offered is in the form of income exemption.

Nexus ratio

Under the Nexus Approach, the portion (ratio) of income which qualifies for tax benefit shall be made in proportion to the QE which bears to total QE and non-QE. This concept may be illustrated using the following formula:

$$\frac{QE}{QE + \text{Non-}QE} \times \text{IP income} = \text{IP income which qualifies for tax benefits}$$

Modified Nexus Approach

The Nexus Approach only allows a company to benefit from a tax incentive to the extent that the company itself incurred and performed the R&D which gave rise to the IP income. However, concerns were raised for situations where R&D activities are outsourced to group companies. It also disregards cost incurred for IPs which are acquired from other parties for commercial expediency. Taking into account these concerns, the Nexus Approach was subsequently revised and the revised approach is referred to as the Modified Nexus Approach ("MNA"). The key revision is to provide for an allowance of up to a 30% uplift of QE. The uplift works by allowing Non-QE which may include expenditure from IP asset acquisition and R&D outsourced to related parties to be added to QE subject to a maximum of 30% of the underlying QE.

Note: The above is for illustration purposes only. Details of the MNA formula which is applicable to the Malaysia IP Development Incentive is still pending from the authorities.

Modified Nexus Approach (cont'd)

Below are two illustrations on the uplift mechanism which allows up to 30% of R&D expenditure which is not directly performed by the company:

	Example 1 (RM)	Example 2 (RM)
Cost of R&D incurred and performed directly by a company **[A]**	100	100
Cost of IP assets acquired **[B]**	10	5
R&D expenses outsourced to a related company **[C]**	40	20
Maximum uplift amount (30% of A) **[D]**	30	30
Overall qualifying expenses uplift amount **[A + (B+C, capped at D)]**	130 (100 + 30)	125 (100 + 25)
	The uplift amount (RM10 + RM40) is subject to maximum of 30.	*The uplift amount (RM5 + RM20) is below the maximum of RM30.*

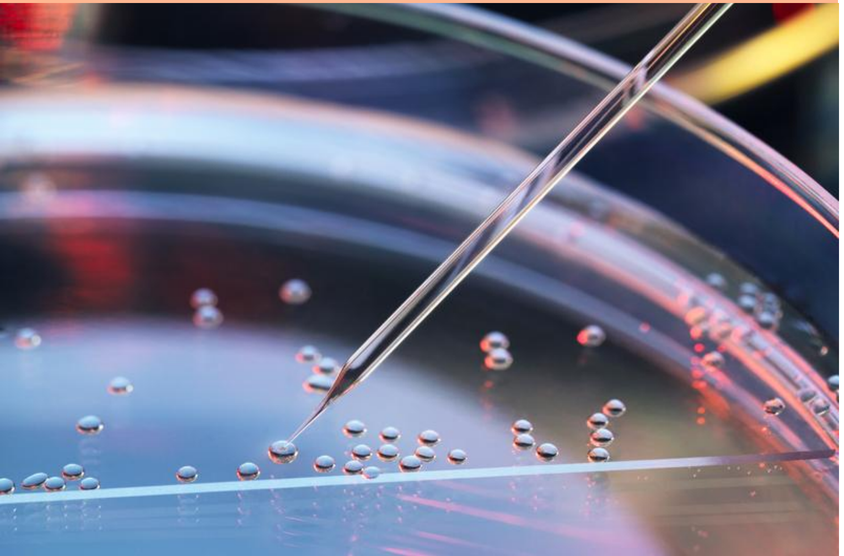
Source: OECD/G20 Base Erosion and Profit Shifting Project - Action 5: Agreement on Modified Nexus Approach for IP Regimes

Note: The above is for illustration purposes only. Details of the MNA formula which is applicable to the Malaysia IP Development Incentive is still pending from the authorities.

MIDA Guideline

The MIDA Guideline sets out the incentive framework covering eligibility criteria, application procedures, etc. Details of the MNA are however still pending.

The MIDA Guideline is available on MIDA's website www.mida.gov.my (Forms and Guidelines > Services Sector > Research and Development and IP).

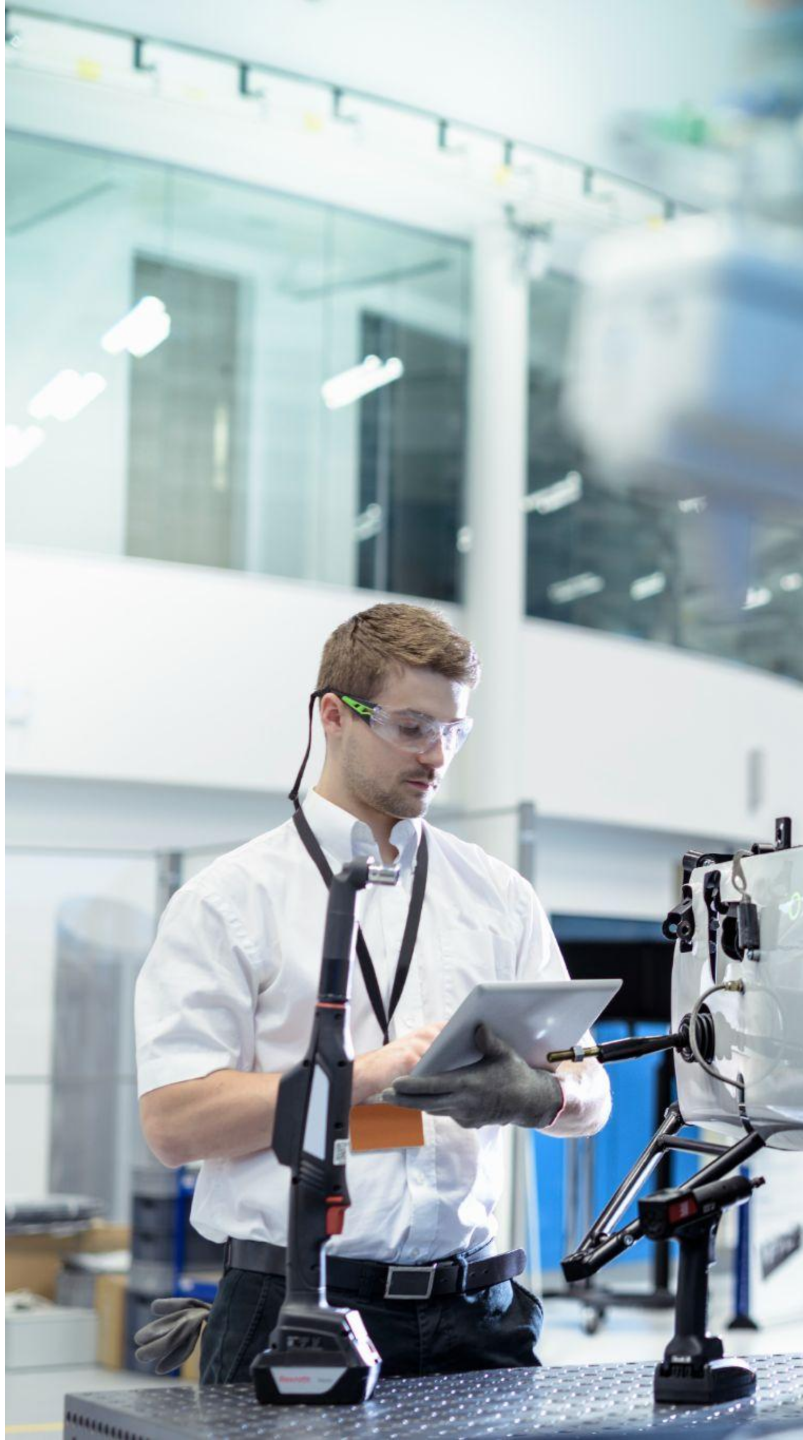


Salient points of the MIDA Guideline which applies for applications made during the period from 1 January 2020 until 31 December 2022 are as follows:

Incentive	Full income tax exemption on qualifying IP income for up to 10 years in relation to IP developed in Malaysia, subject to the MNA.
Qualifying person	New/Existing companies that: ● own the rights of the qualifying IPs; and ● receive income from the qualifying IP activities related to the promoted activities prescribed under the Promotion of Investments Act 1986 and Income Tax Act 1967 (ITA 1967).
Qualifying conditions	● Incorporated under the Companies Act 2016 ● Resident in Malaysia ● Conducts R&D activities in Malaysia that lead to the development, improvement, modification or creation of the qualifying IP assets ● IP registered / filed with the Intellectual Property Corporation of Malaysia (MyIPO) or any equivalent body outside of Malaysia ● At least 30% of staff are in science and technical having degree or diploma with a minimum 5 years of experience from related fields ● Adequate amount of annual business operating expenditure is incurred in Malaysia
Qualifying IP assets*	● Patent or utility innovation under the Patents Act 1983 or the equivalent law of any country. ● Copyrighted software under the Copyright Act 1987 ● Family qualifying IPs (two or more qualifying intellectual property rights that are interlinked and not possible to be identified)
Qualifying IP income*	● Royalty ● License fees

* Only IP filed and first invoiced on or after 1 July 2018 will be considered for the incentive

Qualifying R&D expenditure (QE)	● QE which forms part of the calculation of the MNA ratio shall be in line with expenditure under Section 34A of the ITA 1967 **Comment**: The following are examples of such expenditure from the IRB's Public *Ruling* No. 6/2020 - Tax Treatment of Research and Development Expenditure, Part II – Special Deductions ("PR 6/2020"): ● raw materials used directly in R&D activities ● cost of employees involved in R&D activities ● payment for technical services ● travelling cost for the purposes of visiting R&D stations ● cost of transporting raw materials used directly in R&D activities ● maintenance costs and rental for motor vehicles, buildings, equipment and machinery used directly in R&D activities PR 6/2020 is available on Inland Revenue Board's website http://www.hasil.gov.my/ (Legislation > Public Rulings) ● QE includes expenditure under cost sharing agreements, provided that the cost of payable R&D is clearly stated in the agreement ● QE can be backdated up to 3 years from the date the IP is registered / filed
Non-application	Companies which enjoy the following incentives are not eligible for the IP Development incentives: ● Double deduction for approved in-house research expenditure under Section 34A of the ITA 1967. ● Double deduction for contribution to / payment for services of an approved research institute under Section 34B of ITA 1967.



Key takeaways

- It is noted that the scope of income under the IP Development Incentive comprises “royalty and license fees”. This appears to be narrower as compared to the income which was initially removed from the scope of Malaysian tax incentives which in general, is more broadly defined as “royalty or other income which is derived from IP rights”.
- Taxpayers which were impacted by the removal of IP income from the scope of their incentive previously should now consider the IP Development Incentive.
- Pending issuance of detailed rules on the MNA, prospective applicants should consider looking into the following:
    - Tracing of expenditure - Establishing internal control and systems to track, trace and record QE to the related IP asset and IP income. Consideration needs to be given to challenges arising from the inherent nature of R&D cycles which may involve long cycles from early stage experiments to prototyping stage to successful outcome and income generation. Businesses may not necessarily be able to determine what IP Asset can be registered or income to be generated at the time of incurring the R&D expenditure. It is noted that the MIDA Guideline provides that QE can be backdated up to 3 years from the date the IP is registered / filed.
    - Cost sharing agreements - Where R&D activities are carried out under cost sharing arrangements, a comprehensive review should be undertaken to ensure that the relevant R&D expenditure can be identified.
    - Composition of workforce - The requirement to have at least 30% of workforce to comprise of science and technical staff (degree or diploma with at least 5 years of experience from related fields) is to be focused on as it may be onerous in certain situations.
- Prospective applicants to look out for the issuance of legislation / rules on the Modified Nexus Approach to have a complete picture of the scheme of the incentive.

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