Bridging the Divide: Valuations for Financial Reporting and Tax/Transfer Pricing

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Agenda

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Section 1

Introduction

Purpose and Benefits of Presentation

- Understanding the potential differences in the stated objectives in valuing intangible assets/intellectual property for financial reporting and transfer pricing purposes.

- Understanding the differences in the valuation guidance and framework for intangible assets/intellectual property for financial reporting and transfer pricing purposes, especially in light of the rules under § 367.

- Understanding appropriate points of consistency between financial reporting and transfer pricing valuations.

- Understanding some of the valuation impacts of TCJA.

Section 2

Overview of Financial Reporting and Transfer Pricing Analyses

Intellectual Property Guidance

Regulatory Framework

Financial Reporting

- Accounting Standards Codification (ASC) 805, Business Combinations / IFRS 3
- ASC 820, Fair Value Measurement
- ASC 350, Intangibles – Goodwill and Other
- ASC 360, Impairment or Disposal of Long-Lived Assets

Fair Value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Transfer Pricing

- The OECD (Organisation for Economic Co-operation and Development) has issued transfer pricing guidelines (OECD Guidelines) that have been adopted in some form by more than 50 countries, including the U.S.
- Local Country Rules: Many countries, including those that follow the OECD framework, have issued transfer pricing regulations with country-specific requirements.
- U.S. transfer pricing regulations are in Section 482 of the Treasury Regulations of the Internal Revenue Code, and these regulations are among the most voluminous and comprehensive in the world.
- The § 367 and § 482 regulations, as well as certain provisions under U.S. tax reform, provide specific guidelines on valuing assets and intellectual property to be sold on an intercompany basis. New interpretations of OECD Guidelines are aligning to U.S. transfer pricing guidelines.
- Under the Base Erosion and Profit Shifting (BEPS) Project, several initiatives have been introduced to price intangibles.
  - Intangibles will be evaluated under the realistic alternatives framework. Independent enterprises will only enter into a transaction if it is not expected to make them worse off than their next best option.
  - The concept of hard to value intangibles (HTVI) has been introduced. Ex post adjustments may be warranted if actual outcomes are significantly different from projections.

Arm's-length standard is achieved if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances.

Intellectual Property Guidance

Financial Reporting Valuations

- Under ASC 805, the cost of an acquired company should be assigned to the tangible and intangible assets acquired and liabilities assumed on the basis of their Fair Values at the date of the acquisition.
- An intangible asset does not derive its value from physical attributes but rather from the intellectual content of the item or from other intangible properties.
  - It is identifiable
  - Provides control over a resource
  - Results in future economic benefits
  - Should be considered equivalent to Intangible Property
  - Categories include: Technology-based, Marketing-related, Customer-related, Artistic-related and Contract-based
- An intangible asset is recognized separately from goodwill if it meets the following criteria:
  - Arises from contractual or legal rights (even if cannot be separated and/or sold); or
  - Is capable of being separated or divided and sold, transferred, licensed, rented or exchanged.
    - » Regardless of intent
    - » Either individually or with a related contract, asset or liability
- Excess of the purchase price over the Fair Value of the net assets acquired, including the identified intangible assets, is recorded as goodwill.

Intellectual Property Guidance

Transfer Pricing

- Under Section § 1.482-7 cost sharing regulations, the definition for a Platform Contribution Transaction ("PCT") is much broader than § 482 and § 936 below and allow for more similarities with the definitions used in a financial reporting valuation.
- Under Section § 1.482-4(b), intangibles comprise any of the following items and have substantial value independent of the **services of any individual**: **moving people may not be enough.**
  - Patents, inventions, formulae, processes, designs, patterns or know-how;
  - Copyrights and literary, musical or artistic compositions;
  - Trademarks, trade names or brand names;
  - Franchises, licenses or contracts;
  - Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists or technical data; and
  - Other similar items.
- An adjustment to the § 482 regs (aggregation regs) and § 367(d) definitions of compensable intangibles to include consideration of realistic alternatives and thereby effectively include foreign goodwill and going concern value.
- Action Items 8-10 of the OECD BEPS project expressly include goodwill in the definition of compensable intangibles and; and suggests the consideration of both the buyer's and seller's perspective (including tax attributes) in the valuation.
- BEPS project raises the bar for economic ownership of intangibles with an emphasis on substance and direct involvement in management and decision making around investments and risks ("DEMPE" Functions).

Factors Behind Valuations

Financial Reporting Valuations

- Low value for intangibles means low amortization; however, there's a trade off…
- Need to consider potential for future intangible asset and goodwill impairment:
  - Indefinite-lived intangibles and goodwill are not amortized; they are tested annually for impairment under ASC 350
    - » Impairment test based on standalone intangible asset cash flows exposes asset to an annual impairment test based on fair value.
    - » Reporting Unit structure and relative contribution of organic growth vs. growth via acquisition are significant factors in goodwill impairment testing.
  - Long-lived intangibles are tested for impairment under ASC 360
    - » Test depends on the way in which "Asset Groups" are defined and, in practice, is typically based on pre-tax, undiscounted cash flow.

Factors Behind Valuations

Transfer Pricing

- Tax authorities are keenly focused on protecting the domestic tax revenue base
- Tax rate management (Decreasing ETR - the largest cost item on the income statement)
  - IP migration / centralization, maximizing amortizable basis in assets, and interest deductions
- Optimization of tax and operating structures in a post OECD BEPS and U.S. tax reform world
  - Location of IP, types of transactions, amount of debt and utilizing existing tax attributes
- Non-compliance can lead to adjustments on audit, penalties on top of those adjustments, potential double taxation, and then impacting the tax provisions
- Mitigate risks, time and costs related to Audits (e.g., US ASC 740)
- Compliance with US Contemporaneous Annual Requirement (§ 1.6662-6(d)) and expansive new foreign tax and transfer pricing disclosure requirements (BEPS Action Item 13)
- Characterization under Section 367 impacts the timeline of gain recognition
- U.S. tax reform
  - Highlights the role of tangible property in creating income which likely will put a spotlight on valuation of tangible assets.
  - Analysis of GILTI (Global Intangible Low Tax Income) income related to foreign-owned intangibles.

Intellectual Property Guidance

Key Differences in IP Definitions

Financial Reporting Valuations	Transfer Pricing Valuations
• Asset rather than entity perspective; bifurcates similar assets based on **Unit of Account; highest and best use** premise of value	• Analyses typically look at a **bundle of intangible assets / legal entity**
• **Buyer-specific synergies** are excluded from IP values; they would be reflected in the residual goodwill amount to the extent they were paid for as part of the purchase price	• **Buyer-specific synergies may be included in arm's length price** to the extent they would affect the arm's length outcome • May **increase the value of the intellectual property** compared to PPA
• Values **existing technology** as a wasting asset as it exists at the date of acquisition	• Values not only the contributions of technology as it exists currently, but **also the contributions of that technology to future development efforts and related goodwill** • May also **increase the value of the intellectual property** compared to PPA
• Valuation is generally on a post-tax basis considering the tax impact of the transaction on the market participant buyer (Post Tax + TAB value).	• § 482 values on a pre-tax basis, equivalent to seller's perspective (post-seller's tax + gross up for tax on sale where CGT = CT rate) • OECD values are post-tax from the perspective of the buyer and the seller • Fair Market Value "willing buyer and willing seller"
• For financial reporting purposes, there is annual testing for impairment for the carrying value on the balance sheet • Intangibles assets are never written up and can only be written down	• § 482 states where intangible is transferred under an arrangement covering more than a year, each year will be examined separately to ensure it is **commensurate with the income** attributable to the intangible; periodic adjustments may be made • If there is a significant difference between projected and actual results, there is a presumption that the value of the HTV Intangible is misstated and the tax authorities may increase or decrease the value unless taxpayers can show that the value was reasonably determined at the time

Section 3

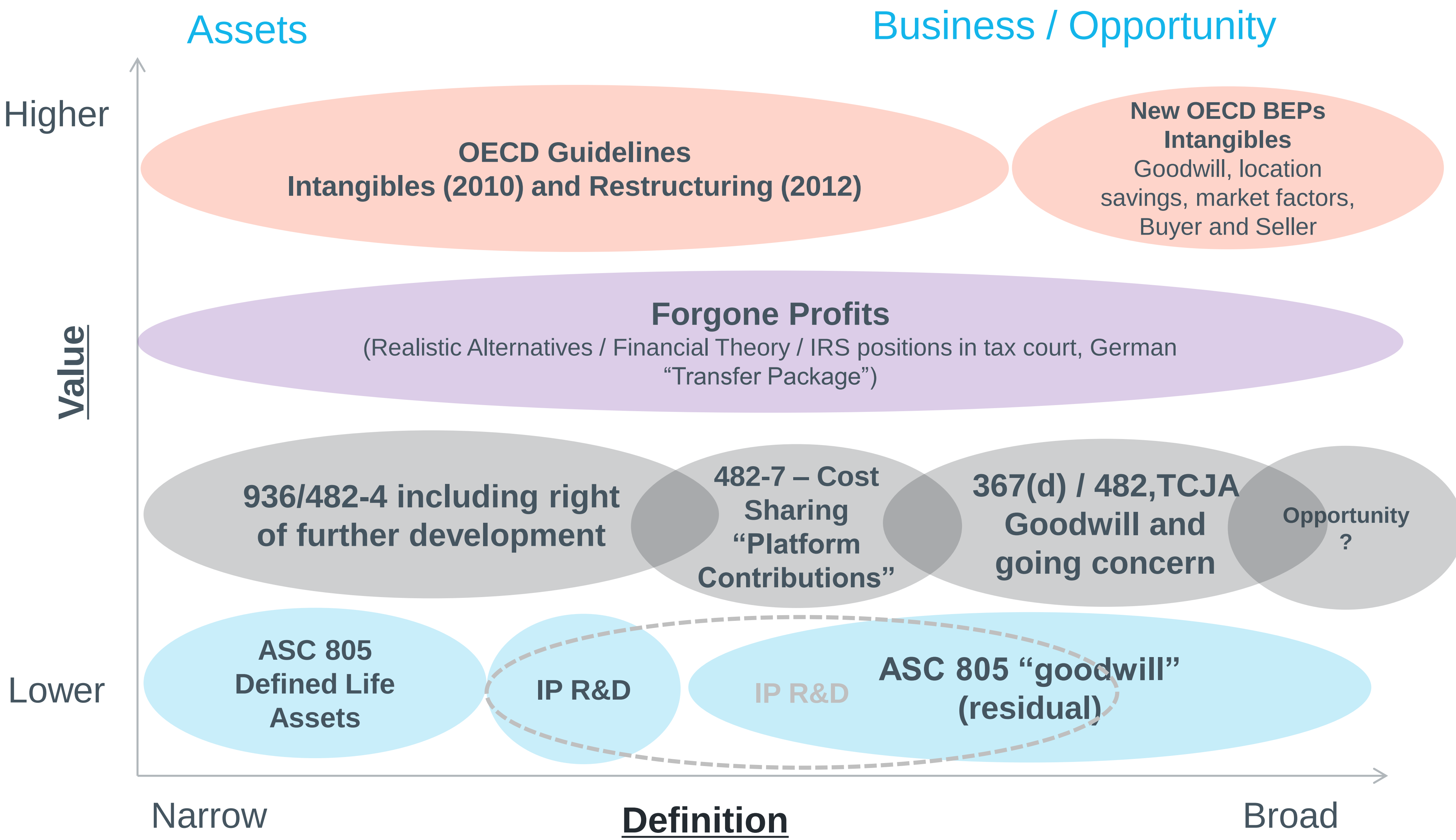
Overview of Valuation Methodologies

Intellectual Property Guidance

IP Valuation Methodologies

Valuation Approach	Financial Reporting	OECD	Section 482
Income Approach	• Income Approach is used for income producing intangible • Multi-Period Excess Earnings Method (MPEEM) • Relief-from-Royalty Method	• OECD income methods are referenced for IP valuation • NPV of income or cash flows attributable to relevant contributions/intangibles may be considered for valuation purposes • Consideration should be given for 1) realistic available options; 2) assumptions of risks; 3) aggregation of transactions • Tax effects should be considered: 1) taxes on projected cash flows; 2) tax amortization benefits to the transferee; 3) taxes on transferor as result of the transfer	• There are a number income approaches: ➢ -4 / -6 Residual Profit Split / CPM ➢ -4 / -6 Comparable Profit Split ➢ -7 Income Method / Valuation Date Profit Split ➢ -7 methods are “unspecified methods” under -4 • PV of profits attributable to relevant intangibles is used to derive lump-sum values • TCJA: Consideration should be given for 1) realistic alternatives; and 2) aggregation of transactions when performing the valuation
Market Approach	• Value based on market prices in actual transactions and on asking prices for comparable assets • Difficult to apply to intangible assets due to the lack of available public data • This approach can be used to determine market-based royalty rates to apply in the Income Approach, Relief-from-Royalty Method	• The Market Approach would be considered under the adjusted Comparable Uncontrolled Price Method	• Comparable Uncontrolled Transaction Method in -4 and Acquisition Price Method in -7 are similar to a market approach • A Market Capitalization Method (“MCM”) approach is rarely applied, but could be considered a market approach • Both APM and MCM can be applied as “Unspecified Methods” under -4
Cost Approach	• Considers the concept of replacement cost as an indicator of value • Value determined on the basis of what it would cost to replace the asset in its current form/functionality • Considers elements of developer’s profit and opportunity cost • Distinguishable from a cost savings approach based on expected future savings	• In the OECD intangibles guidance, it states that cost-based methods will rarely be reliable for valuing intangibles • Not typically used in Transfer Pricing Analyses • Relative intangible development costs are sometimes used as a proxy for relative value of contributions by each party in Residual Profit Split Method applications or in cost sharing	• Not typically used in Transfer Pricing Analyses (only special circumstances) • Relative intangible development costs are sometimes used as a proxy for relative value of contributions by each party in Residual Profit Split Method applications or in cost sharing

Changing Definitions of Intangibles



Section 4

High Level Examples

Fair Value Reporting and Transfer Pricing Valuations: Examples of Differences

To highlight the differences and opportunities to coordinate valuations for financial reporting and transfer pricing purposes, we have selected a few areas where we frequently see variations, including:

- Technology
- Customer Relationships
- Captive Service Affiliate

Technology

Valuation of Technology: Impact of Assumptions on Value

	Financial Reporting	Transfer Pricing
Method	MPEE after contributory asset charges	Residual Profit Split after Routine Returns
Assumptions		
Base	Cash Flows	Operating Profits or Cash Flows
Useful Life	**5 years** (existing products & IPR&D)	5 Years (existing) 10 Years (derivatives)* **Total = 15 years**
Obsolescence Rate	Straight line	Survivor Curve (convex with tail)
Adjustments	Contributory assets	Contributory activities (including assets)
Adjustments	Maintenance R&D	Further development initially profiled to maintenance
Total Valuation	**$45m**	**$65m**

** Use in next generation products*

Customer Relationships

Valuation of Customer Relationships

	Financial Reporting		Transfer Pricing
Method	MPEE		Entrepreneur / Distributor Return
Assumptions			
Base	Cash Flows		Operating Profits or Cash Flows
Attrition Rate	10% turnover rate		10% turnover rate
Charges	Contributory assets (including other intangibles)		Contributory activities (including other intangibles)
Legal Entity Contributions	Aggregated value		Disaggregate value between entrepreneurial returns and routine (distribution return)
Total Useful Life	**10 years (limited to material economic impact)**		**13 years (extended decline)**
Total Valuation	**$30m**		**$35m**
		Excess Customer Return	*$30m*
		Routine Distribution Return	*$5m*

Captive Service Affiliate

Valuation of Captive Service Affiliate: Impact on Assumptions of Value

	Valuation as an ongoing business	Tax valuation Taking into account cessation of business
Method	Discounted Cash Flow	Replacement Cost Approach
Assumptions		
Value	Cash flow stream into perpetuity	Liquidation value of operating assets and replacement cost of WFIP with opportunity cost
Assumed Use of the Business	On going business operations	Consider assets and liabilities individually
Total Valuation	**$3.5m**	**$1.4m**

Fair Value Reporting and Transfer Pricing Valuations: Examples of Differences

Other areas of consideration:

- Work force in place valuations
- Valuation of service or support affiliate legal entities
- Push down enterprise valuations vs legal entity valuations
- Tax amortizable asset valuation rules

Section 6

Impact of TCJA and International Tax Changes on Valuations

TCJA Big Picture Impacts

Cash Flows

- Company future cash tax amounts and timing profiles have changed significantly under TCJA with a material impact on valuations
- TCJA is part of a large shift in global taxation and tax rules
- Also watch for:
    - Digital Sales Taxes
    - New G20/OECD proposals for broad international tax reform

Accounting

- Additional scrutiny of valuation inputs and assumptions (consistent with all valuations overall)
- Standard question: “Show us how have you considered Tax Reform and Global tax uncertainty in your estimates”?

TCJA Big Picture Impacts

Key TCJA Changes

Including, but not limited to:

- Deemed Repatriation "Transition" Tax: *2017 item but still related liabilities*
- Lower Corporate Tax Rate: *21% Federal Corporate tax rate, but for how long?*
- State and local taxes: *not necessarily the same as Federal rules*
- NOL limitations: *80% of taxable income, indefinite excess c/fwd*
- Interest Expense Limitation § 163(j): *30% EBITDA pre 2022, 30% EBIT post 2021, indefinite excess c/fwd*
- Capex Tax Expensing: *Pre-2023 immediate 100% expensing for qual assets, ramping to just 20%*
- R&E capitalization and amortization post 2021: *5 years for U.S. R&D, 15 years foreign*
- Global Intangible Low Tax Income: *tax on U.S. parent on income earned in local affiliates at 50% (37% deduction after 2025)*
- No further U.S. tax on foreign affiliate dividends: *no foreign tax credits (some exceptions)*
- Foreign Derived Intangible Income: *37.5% deduction for U.S. taxpayer*
- Base Erosion And Tax Shifting payments: *minimum tax, effectively a 5~10% additional tax on I/C payments including amortization of IP transfers, above certain thresholds*
- Anti-Hybrid Rules: *non-deductible hybrid payments or payments to hybrid entities*

Discount Rates

The impact of TCJA changes, other things remaining the same…

Cost of Debt

- Likely will
- Because interest rate shield will
- After cost tax of debt will

Cost of Equity

- Likely will
- Betas will likely
- Because of additional risk to equity holders from limited tax shield from debt.

WACC

…but there have been a lot of other things that haven't remained the same!

Income Approach: Forecasts and Tax Rates

- Important to have a discrete forecast period in the DCF extend to **2027 or later** to account for some of the tax policy implications that are temporary

- Expected impact on tax savings in initial years likely leads to an **increase in operating cash flow**. This may not always translate to **Free Cash Flow**.

- Capex and R&D rule changes mean that **mid-term cash flows may reduce significantly.**

- How should valuations take into account tax uncertainty?
  - Will there be challenges to FDII at the WTO?
  - Some concern in the tax community about potential reversals of tax rates by subsequent administrations.
  - What's the impact of digital taxes on international tax developments?
  - **Valuations should only include expectations of events that are known or knowable**

Overall Valuation Conclusions

- Immediate impact to the Tax Cuts and Jobs Act was positive to the market.
- More recent volatility, tariff wars, China's economy, Brexit and North Korean crisis are just some of the uncertainties which have also impacted valuations as well as taxes. In the long-term, the market outlook is perhaps uncertain than in recent years.
- Lower taxes mean increases in operating cash flow, but potential partial / complete / more than offset by **an increase in the discount rate (WACC)** and **reduced mid-term cash flows** from tax reform changes **or increased volatility/uncertainty**.
- These changes flow down into **asset, legal entity and tax valuations**.
- For tax valuations, there have also been significant definitional changes of what needs to be compensated in taxable transfers with the inclusion of goodwill.
- Accounting and tax rules may be different for finite and indefinite lived assets.
- Countries often have asymmetric rules for inbound and outbound tax valuation, accounting, asset amortization and gains which may significantly impact tax planning.

Section 6

Summary

Summary

Risks if PPA and Transfer Pricing Analysis are Not Coordinated:

- Tax risks due to differences in values between analyses.
- Misalignment of the placement of IP in global transfer pricing policy.
- Audit risks due to inconsistent values of intellectual property (External Auditor or Tax Authority).
- Challenges to transfer intellectual property post acquisition.
- Changing tax rules may lead to significant differences in valuations for tax and PPA and tensions in financial reporting and tax treatments.

Benefits of Performing PPA and Transfer Pricing Analysis Jointly:

- Time savings company management and operational personnel through joint interviews.
- Leverage information gathering from company (and have same starting point).
- Cost saving through use of same initial comparables joint team efficiencies.
- Enhance ability to support tax positions (e.g., ASC 740) upon audit by IRS and/or other taxing authorities through bridging differences.
- Reduce audit risks in both the U.S. and non-U.S. locations.
- Enable identification of potential planning and risk mitigation opportunities at an earlier stage.

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Nate Levin is a managing director in the Boston office, part of the Valuation Advisory Services business unit, and the global leader of the tax valuation service line. He has 24 years of experience and focuses on consumer and industrial product companies.

Nate's areas of expertise include the valuation of business enterprises, debt and equity securities, intangible assets, intellectual property and options and warrants for purposes of financial and tax reporting, intercompany transfer pricing, mergers and acquisitions planning, reorganizations and restructurings, joint venture planning, financing and stockholder litigation.

Nate has testified on valuation matters in New York State Supreme Court, Commonwealth of Massachusetts' Trial Court, U.S. District Court in New Hampshire and Superior Court of Justice, Ontario, Canada and served as a valuation arbitrator in minority shareholder disputes.

Prior to Duff & Phelps, Nate was a managing director at Standard & Poor's Corporate Value Consulting (CVC), the predecessor firm to Duff & Phelps. Prior to S&P, Nate was a partner in PricewaterhouseCoopers' CVC practice.

Nate received his M.B.A. in finance, with high honors, from Boston University's Graduate School of Management, his B.S. in finance and accounting, magna cum laude, from Boston University and attended Northwestern University, where he majored in anthropology. He is also a Chartered Financial Analyst ("CFA") charterholder, an accredited member of the American Society of Appraisers ("ASA"), certified in business valuation and a member of the Boston Security Analysts Society.

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Susan Fickling-Munge is a managing director in the Chicago office of Duff & Phelps. She is a member of the Transfer Pricing practice, leveraging more than 15 years of transfer pricing and valuation experience. Susan has worked closely with global companies in a vast range of industries, assisting them with transfer pricing planning, documentation and defense.

Susan has extensive experience in international and multistate tax planning projects, employing various transfer pricing techniques to help support her clients' tax strategies. She has also assisted clients on unilateral advance pricing agreements. She has helped to develop real options models and valuation techniques to support complex transfer pricing and tax structuring scenarios.

Before joining Duff & Phelps, Susan was a vice president of transfer pricing for Charles River Associates, a transfer pricing manager in the international tax division of Arthur Andersen LLP and a transfer pricing consultant at KPMG LLP.

Susan earned her MBA at the University of Chicago Booth School of Business and her BA from Scripps College. She also studied at the Universidad San Francisco de Quito in Quito, Ecuador, and is fluent in Spanish.

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Simon Webber joined Duff & Phelps in 2012 as a managing director who provides global transfer pricing advice to organizations that range from Fortune 500 companies to start-up businesses. He has a particular focus on the Silicon Valley and Bay Areas. Drawing on his experience as both a Big 4 professional and an industry expert, Simon helps clients with cost sharing and intangibles transfers. He also helps with all aspects of transfer pricing planning, documentation, FIN 48, controversy and advanced pricing agreements.

Prior to joining Duff & Phelps, Simon worked for Ceteris. He is an international transfer pricing expert whose North American, European and Asian experience provides a solid platform for supply chain restructuring and worldwide transfer pricing documentation projects for clients in the high-technology sector - including computer, software, semiconductor, internet, telecommunications, solar energy, medical devices, and emerging technology industries. He also has industry experience in consumer brand products, retail, pharmaceutical, logistics, beverages, metals and mining, and biotech.

Simon is an honors graduate in Business and Managerial Administration from the University of Aston in Birmingham, England. He is a member of the Institute of Chartered Accountants in England and Wales. Simon is a regular speaker on transfer pricing issues and developments, especially cost-sharing and foreign transfer pricing risk management. In addition, he has written and contributed to a number of transfer pricing articles.