IP Valuation in the Wake of COVID-19

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Presenters

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Duff & Phelps

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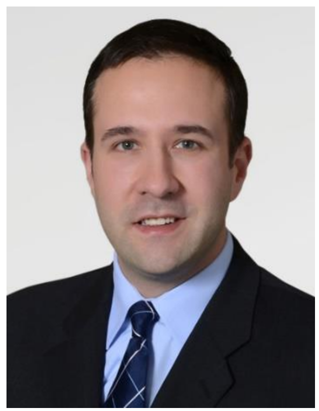
Agenda and Presenters

Agenda

1. Introduction
2. IP Valuations in Uncertain Times
3. IP Valuations for Financial Reporting vs. Transfer Pricing
4. Conclusion and Outlook
5. Q&A

Presenters

Ted Keen



David Ptashne

Daniel Othmann

IP Valuations in Uncertain Times

IP Valuations

Historical and Recent Past IP Transactions

Current / Future IP Transactions (Post COVID-19 Onset)

Primer on IP Valuation: Back to the Fundamentals

- **IP valuations best practices consider:**
  - The intangibles and their profit potential
  - Transaction date and structure
  - Economic and business facts and circumstances
  - The most reliable valuation method(s) considering their inputs and assumptions
  - Perspectives for the valuation (arm's length, market participant, going concern, distress, etc.)
  - As long term assets, IP values are dependent on current situation but also expectations about the future
- **Ex-post outcomes or events:**

  GAAP
  - Generally not considered under GAAP valuation principles for the initial valuation
    - » Ex-ante information "known or knowable" as of the valuation date.
  - May trigger an impairment study
    - » Does not change the original transaction price
    - » write-down of asset carrying values
    - » Special rules (not necessarily a revaluation)

  Tax/Transfer Pricing
  - ***Ex-post outcomes may be considered by the taxpayer or the tax authority***
  - What is arm's length practice? (e.g., observable, rationale, realistic alternatives)
  - Limitations on amended returns
  - Tax return disclosures or reporting

Recent Intercompany IP Valuations

Additional Tax Considerations

- **Ex-Post Adjustments for Tax Purposes**

  Taxpayer Initiated

  – What does your agreement say?
    » Required (periodic reviews)
    » Possible (adjustment clauses and related limitations)
    » Payment structure (lump sums, royalties, installments, other contingent payments)

  – Tax characterization (sale, license, contribution)

  – When was the transaction?
    » Interpretations of ex-ante vary depending on local rules and facts and circumstances
    » E.g., U.S. taxpayers may have some flexibility for transactions in the current year / on unfiled tax returns based on interpretation of case law and/or some IRS notices

  – Economic and business rationale for both parties

  – Other considerations:
    » Potentially lowers the bar for tax authority adjustments for example if the value goes up
    » Financial reporting considerations (possible indicator for a financial reporting impairment)

Recent Intercompany IP Valuations
Additional Tax Considerations

- **Ex-Post Adjustments for Tax Purposes**
  Tax Authority Initiated
  – Initial audits vs subsequent audits
  – Tax authorities have given themselves additional powers to combat perceived asymmetry of information

- **OECD**
  – HTVI Approach in Chapter VI
    » Significant variation of ex-post actual experience vs ex-ante forecast is a rebuttable presumption that not arm's length and adjustment
    » Approach similar to U.S rules
    » More of an emphasis on support for transactions structure especially if high levels of uncertainty
    » Exceptions to adjustments are also similar to U.S. rules
    » However, adjustment mechanism is different:
    » ***Potentially redetermine ALP based on appropriate structure and ex-ante assumptions***

  – U.S. Tax - IRC 482 commensurate with income standard for intangibles
    » Arm's length standard applies "taking into consideration all the facts and circumstances"
    » Regs provide IRS with broad powers of adjustment to open years
    » Absence of adjustments in prior years does not preclude adjustments in later years
    » Structure generally not at issue unless undermined by conduct or economic substance
    » Includes specified exceptions and limitations
      – **Extraordinary or unforeseen or foreseeable events**
    » ***Adjustments under 482 may replace forecasts with actuals + new forecasts***

  – Local Rules
    » Often closer links between tax and GAAP values/charges and amortization and impairment

Recent Intercompany IP Valuations

Recommendations

- **If making changes:**
  - Consider all the facts and circumstances
  - Consider the implications
  - Build appropriate support and documentation for the legal and economic basis for the changes from both parties’ perspectives

- **If sustaining historical transactions:**
  - Know or knowable – extraordinary exemption
  - Review supporting analysis and documentation now
  - Better not to wait for an inquiry from a tax authority
  - Gather relevant information:
    - » Clear and accurate description of the state of the COVID-19 outbreak at the time of the transaction
    - » Sufficient and specific detail on how COVID-19 was or was not considered with respect to each key value driver

IP Valuations

Historical and Recent IP Transactions

Current / Future IP Transactions (Post COVID-19 Onset)

Current and Future Intercompany IP Transactions and Valuations
Opportunities

- **Companies with depressed IP values may want to consider changes where high IP values are a constraint**
  - Outbound IP transfers
  - U.S. IP repatriations
  - Foreign IP transfers at lower exit cost
  - Realization of losses to offset current, prior or future income
  - Correction of royalties going forward

- **Other taxable transactions with significant entry valuation components**
  - Legal entity reorgs
  - Unchecking or recharacterizing entities
  - Creating Subpart F income

Current and Future Intercompany IP Transactions and Valuations
Considerations

- **COVID-19 is not an unforeseeable event for post COVID-19 transactions**
  – Valuation will need to take pandemic impacts into account

- **Valuation best practices very important**

- **Tax authority scrutiny very likely**
  – Initial audits
  – Subsequent audits

- **CWI and HTVI provisions put increased pressure on the structure of the transactions and the valuation**

- **Coordinate with business and finance:**
  – There may be relevant financial reporting valuations and analyses already in play, and relevant resources
  – Tax transactions for the same IP at lower values may be a financial reporting factor signaling a need for an impairment assessment

Current and Future Intercompany IP Transactions and Valuations
Valuation Best Practices

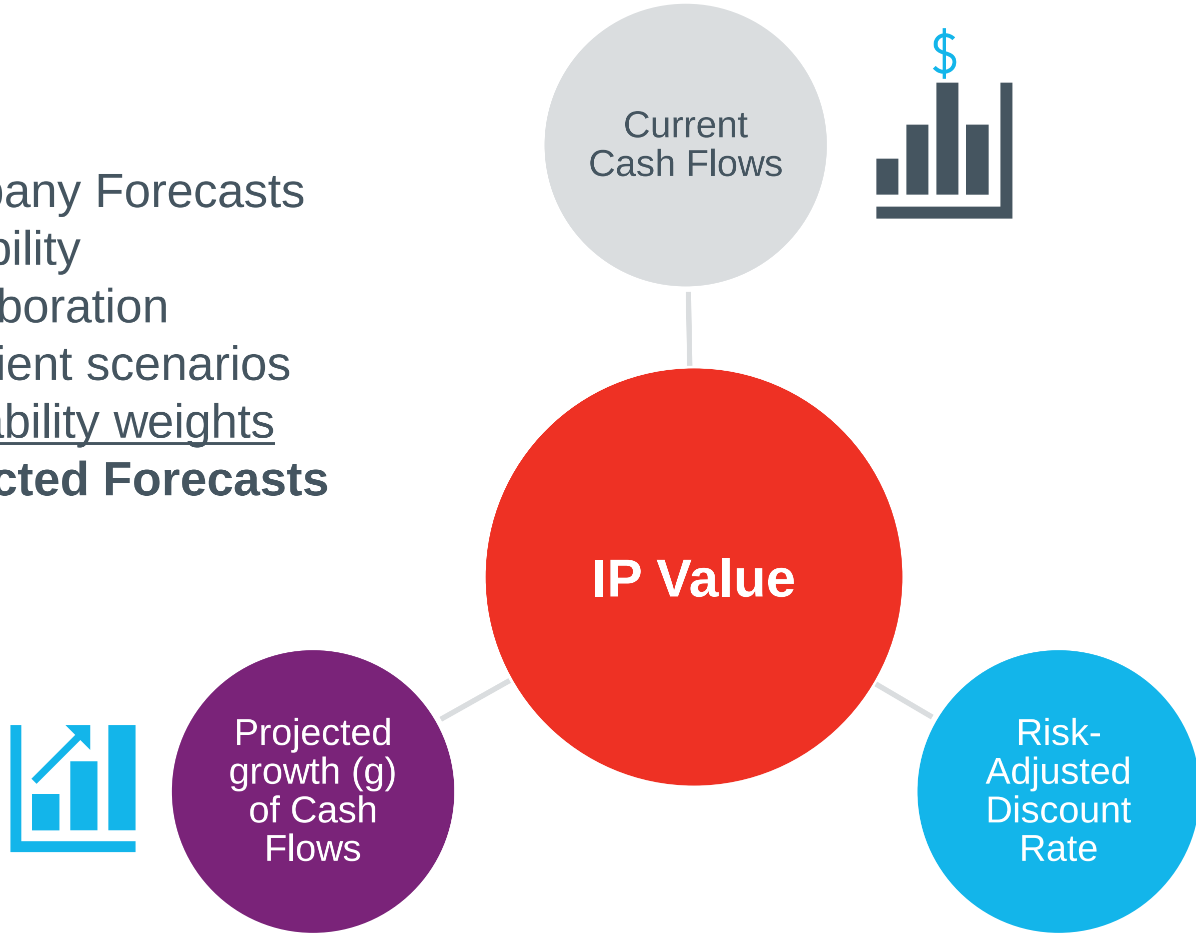
- **Current facts and circumstances necessitate a more robust process**
  - Identify and characterize key uncertainties
  - Apply scenario-based approach to address valuation uncertainty around market disruption and availability of reliable market inputs
  - Be careful with historical data
  - Validate and test input data
  - Relevant independent support for inputs and assumptions
  - Use multiple methods / corroborate
  - Coordination and consistency with finance and business

Current and Future Intercompany IP Transactions and Valuations

Income Approach

Care, Consideration, Support

Company Forecasts
Reliability
Corroboration
Sufficient scenarios
Probability weights
Expected Forecasts



WACC
Debt / Equity
Debt value
Cost of Equity
Risk Free Rate
Equity Risk Premiums
Country risk premiums
Alpha adjustments
IRRs

Intercompany IP Valuation
Closing Thoughts

- **Recent events may call into question historical IP valuations– be prepared**
- **There may be flexibility to review and adjust historical transactions**
- **Lower values may present opportunities for planning**
- **Defensible values are still possible during period of increased uncertainty**
  - Reliably established through a well-supported and considered valuation analysis on an ex-ante basis
- **Tax authority concerns may well be heighted in light of COVID-19**
  - Especially if actual outcomes are significantly different from expected forecasts
- **Mitigation of ex-post adjustment risk through transaction structures, valuation rigor, and documentation**
- **Controller and Tax / TP dept coordination is highly recommended**

IP Valuations for Financial Reporting vs. Transfer Pricing

Introduction

- The aim is to keep this presentation relatively general, hence there is no reference to specific accounting standards such as US-GAAP or IFRS
- Typical context: Acquisitions are often followed by relocating ("integrating") the IP of the target company to a different jurisdiction
  - After closing of the transaction a PPA assigns a value (for financial reporting purposes and often on a consolidated basis) to the acquired IP
  - Shortly thereafter, the IP is transferred from one legal entity to another in the combined group and the question arises what value should be assigned to that transaction

Financial Reporting

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 Arm's-length principle is adhered to 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

What the OECD Transfer Pricing (TP) Guidelines Say…

Accounting and business valuation measures of goodwill and ongoing concern value do not, as a general rule, correspond to the arm's length price of transferred goodwill or ongoing concern value in a transfer pricing analysis."

(para 6.29 OECD TP guidelines)

For sound accounting purposes, some valuation assumptions may sometimes reflect conservative assumptions […]. This inherent conservatism can lead to definitions that are too narrow for transfer pricing purposes and valuation approaches that are not necessarily consistent with the arm's length principle.

In particular, valuations of intangibles contained in purchase price allocations performed for accounting purposes are not determinative for transfer pricing purposes and should be utilised in a transfer pricing analysis with caution and careful consideration of the underlying assumptions.

(para 6.155 OECD TP guidelines)

Key Differences in IP Definitions

Perspective	Financial Reporting Valuations	Transfer Pricing Valuations
• Consolidation and aggregation	• Asset rather than entity perspective; bifurcates similar assets based on Unit of Account; highest and best use premise of value	• Analyses typically looks at a bundle of intangible assets / legal entity
• Synergies	• 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
• Useful life	• 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
• Consideration for tax	• Valuation is generally on a post-tax basis considering the tax impact of the transaction on the market participant buyer (Post Tax Value + TAB).	• Values are post-tax from the perspective of the buyer (Buyer's Post Tax Value + TAB = Maximum Price) and the seller (Seller's Post Tax Value + gross up for tax on sale = Minimum Price).
• Ex-post considerations	• 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	• 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 • In the U.S.: commensurate with the income principle;

IP Valuation Methodologies

Valuation Approach	Financial Reporting	Transfer Pricing
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
Market Approach	• 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
Cost Approach	• 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

Examples

Technology

- PPAs may undervalue transferred intangibles from a transfer pricing perspective because of definition of the economic life for intangible assets
- Considerations for Economic (or remaining useful) Life
  - For financial reporting purposes, technology is a wasting asset with a finite life
  - Residual value to the business is captured in goodwill as a reflection of future R&D investments
- The definition of intangibles for tax and transfer pricing purposes is broader
  - Tax and transfer pricing valuations require that a portion of the value attributable to in process R&D and future technology (i.e., goodwill) should be affixed to the value of the existing (or “platform”) technology

Customer relationships

- The methodology to determine the value of the customer relationship should reflect the significance of the customer relationship to the business (primary / second asset)

- For example, a Software as a Service (“SaaS”) business model is frequently valued using an excess earnings approach which reflects the primary / secondary asset character nature of customer relationships for SaaS businesses

- Consideration should be given to what drives “stickiness” in a customer relationship
  - What drives this customer to maintain the relationship?

Conclusion and Outlook

Conclusion and Outlook

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 within the MNE / inconsistency with global transfer pricing policies
- Audit risks due to inconsistent values of intellectual property (External Auditor or Tax Authority)
- Challenges to transfers of intellectual property post acquisition
- Unnecessary gains or lost amortization deductions

Benefits of Performing PPA and Transfer Pricing Analysis jointly:

- Time savings for company management and operational personnel through joint interviews and valuation exercises
- Leverage information gathering from company (and have same starting point)
- Cost saving through use of same initial comparables
- Enhance ability to support tax positions upon audit by tax authorities through bridging differences
- More thorough understanding of PPA and transfer pricing valuation differences
- Enable identification of potential planning opportunities

AUDIENCE QUESTIONS

Useful COVID-19 Resources

OECD COVID-19 Landing Page

www.oecd.org/coronavirus/en/

Duff & Phelps COVID-19 Resource Center

www.duffandphelps.com/coronavirus-COVID-19-managing-risks-organization

Kroll COVID-19 Heat Map

www.kroll.com/en/COVID-19-heat-map

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Ted Keen is a managing director in the London Office and European Leader of Duff & Phelps' Transfer Pricing practice, bringing to the firm 24 years of transfer pricing consulting experience gained at Big Four accounting and economic consulting firms.

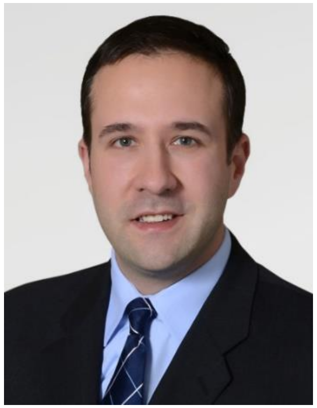
Ted is recognized as one of the world's leading transfer pricing experts and has presented on the application of the OECD Guidelines on Transfer Pricing in the UK, the U.S., Mexico, Japan, Russia, India, Germany, Sweden, Finland, Poland, Belgium, Portugal, South Africa and Malawi. Additionally, he was a featured speaker at an OECD-sponsored conference for European tax authorities in Budapest, and frequently speaks at numerous conferences on Transfer Pricing and to hundreds of multinational taxpayers worldwide.

Prior to joining Duff & Phelps, Ted established his own consulting practice where he worked closely with corporate clients and law firms on technical transfer pricing matters. He has advised clients on numerous global planning and documentation projects, applying economic analysis to complex transfer pricing valuation across a wide range of industries, including life sciences, high-tech, consumer and industrial products, natural resources and business services.

Ted holds a Ph.D. in Economics from Claremont Graduate University, and a B.S.Ch.E. from Case Western Reserve University. While completing his graduate studies, he held positions as a Lecturer in Economics at Pomona, Claremont McKenna, Pitzer and Scripps Colleges, as well as conducted courses at the California Youth Authority through LaVerne University.

David Ptashne, CFA, ASA

Director, Transfer Pricing



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David Ptashne joined Duff & Phelps in 2012 as a Director in the Chicago office and leverages 17 years of valuation and economic consulting experience. In addition to transfer pricing knowledge, David has significant experience leading and performing valuation studies of businesses, interests in businesses, and intangible property. His services have been rendered for a variety of purposes including tax planning and compliance (frequently in connection with transfer pricing), financial reporting, litigation and international arbitration, mergers and acquisitions, management planning, and estate and gift tax matters.

David has performed analysis and valuation services for clients representing many industries including: semiconductors and other high tech, healthcare, financial services, global technology, professional services, consumer and industrial products, retail, hospitality, oil and gas, advertising and communications, and entertainment.

Prior to joining Duff & Phelps, David was a valuation services director with Ceteris, a firm specializing in transfer pricing and tax valuation matters. Before joining Ceteris, David was a Vice President with Duff & Phelps in the Valuation Advisory Services practice. David has also held roles as a market planning analyst for Walgreens and as a business process analyst with Accenture.

David holds the Chartered Financial Analyst (CFA) and Accredited Senior Appraiser (ASA) designations and received his BS in Finance with High Honors from the University of Illinois at Urbana.

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He has more than eight years of experience in international taxation and transfer pricing. In particular, Daniel has worked with clients from various industries such as the automotive industry, the pharmaceuticals industry and the financial services industry and has managed various projects focusing on tax audit defense, tax effective supply chain management, transfer pricing documentation and planning, advance pricing agreements, mutual agreement procedures and M&A. Daniel also gained experience as a tax auditor trainee with a German tax authority and qualified as a tax inspector. In the recent years he has focused on complex TP restructuring and planning projects.

He holds a German undergraduate degree in tax law and accounting as well as a M.Sc. in Quantitative Finance from the University of Strathclyde in Glasgow and also passed the German Certified Tax Advisor ("Steuerberater") Examination. Previously Daniel worked for EY in Munich as a Transfer Pricing Economist and Manager.