Transfer Pricing Guidance: IP Valuation, Benchmarking and Tax Administration Implications of the COVID-19 Outbreak

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DUFF & PHELPS

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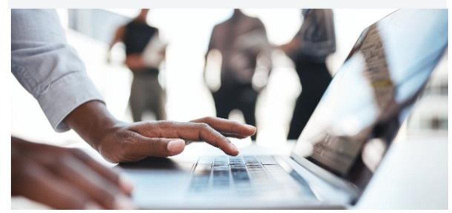

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Agenda and Presenters

1. **IP Valuation: Opportunities and challenges associated with intangible valuations in uncertain times and IP valuation best practices**

   Simon Webber, Managing Director, U.S. Transfer Pricing

   David Ptashne, Director, U.S. Transfer Pricing

2. **Benchmarking: Challenges of relying on one-sided pricing methods in crisis environments, and the pros and cons of changing your transfer pricing policies in response to business shocks**

   Matt Billings, Managing Director, Canada Transfer Pricing

   Fabian Alfonso, Managing Director, LATAM Transfer Pricing

3. **Tax Administration: Near-term delay or deferral of ongoing inquiries and impact on compliance deadlines and APAs**

   Ted Keen, Managing Director, European Transfer Pricing

IP Valuation: Opportunities and challenges associated with intangibles valuations in uncertain times and IP valuation best practices

Historical and Recent Past IP Transactions

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

Primer on IP Valuation: Back to the Fundamentals

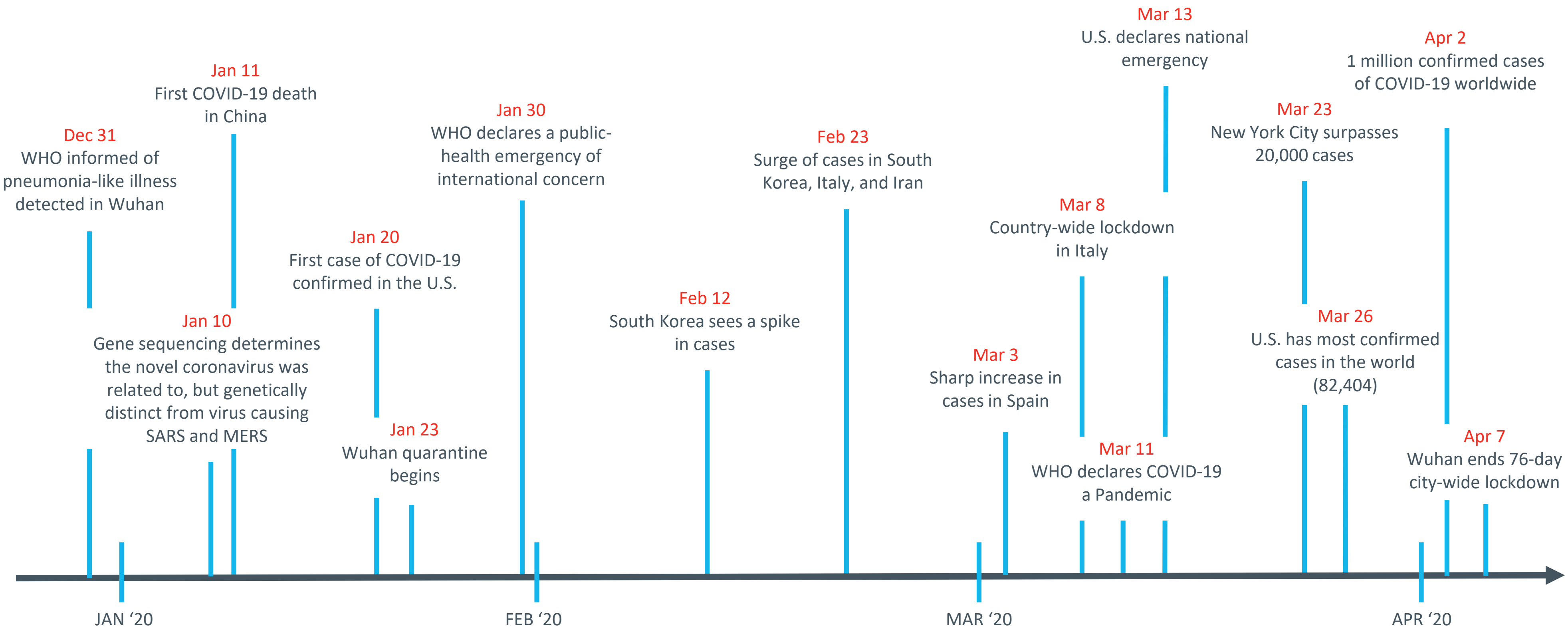
- **IP valuations best practices consider:**
  - The intangibles and their profit potential
  - Transaction date and structure
  - Economic and business facts and circumstances
  - The most reliable valuation method(s) considering their inputs and assumptions
  - Perspectives for the valuation (arm's 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**

  <u>GAAP</u>
  - 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)

  <u>Tax/Transfer Pricing</u>
  - ***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
    - » e.g., 6662 contemporaneous documentation – relevant significant post year end events

Supporting an Existing Valuation:
What did we know and when did we know it?

COVID-19 Brief Timeline



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

  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**
    - » Other exceptions vary depending on the form of the intercompany transaction,
    - » For example:
      - General transfer or license of intangibles - § 1.482-4(f)
      - Cost sharing transactions - § 1.482.7(i)(2)
      - Platform Contribution ("buy-in") transactions - § 1.482.7(i)(6) or § 1.482-4(f)
      - Contributions of intangibles - section 367(d) with its in built CWI
    - » ***Adjustments under 482 may replace forecasts with actuals + new forecasts***

Recent Intercompany IP Valuations
Additional Tax Considerations

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

  Tax Authority Initiated

  Foreign Tax

  – Local rules / OECD Hard to Value Intangibles (HTVI)

  – 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***

  – 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

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

- **<u>COVID-19 is not an unforeseeable event for post COVID-19 transactions</u>**
  - » 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
<u>Probability weights</u>
Expected Forecasts

Current Cash Flows

IP Value

Projected growth (g) of Cash Flows

Risk-Adjusted Discount Rate

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 heightened 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 / transfer pricing department coordination is highly recommended**

Benchmarking: Challenges of relying on one-sided pricing methods in crisis environments, and the pros and cons of changing your transfer pricing policies in response to business shocks

Topics

- Challenges facing tax directors
- One-sided pricing methods
- Sharing profits and losses
- Whether to revise policies
- Impact of internal contracts
- Challenges in benchmarking

Business Priorities

Transfer Pricing and Business Priorities in Response to COVID-19

- Dealing with uncertainty, productivity shocks, financial impact
  - Cash preservation and repatriation
  - Cost reduction
  - Government programs

- One-sided pricing methods
  - Prevalence
  - Practical implications

- Implementation challenges

- Effective tax rates, indirect tax, customs duty

- When to act

Selection of Pricing Method

Reliability of One-sided Pricing Methods in Times of Crisis

- Transfer pricing methods focus on either:
  - Transactional pricing (CUP, cost plus, resale price)
  - Profit outcomes for one participant (TNMM, CPM)
  - Profit outcomes for multiple participants (profit splits)
- One-sided transfer pricing methods:
  - What they assume
  - Why they are so popular
  - When they exceed their limitations
- Importance of intra-group contracts and prior risk allocations
- Price adjustments vs. changes to pricing methodology

Benchmarking

Arm's Length Benchmarking in a Year of Crisis

Developing benchmarks:

- Selection of comparables
  - Time lags (i.e., European practice vs. U.S. practice)
  - Market, product and industry comparability
  - Comparables with operating losses

- Adjustment to comparables
  - Where are the COVID-19 expenses in the financial statements?
  - Single year data vs. multiple-year averages

Implementing benchmarks (operational transfer pricing):

- Choosing placement within the range to calculate true-ups/adjustments?
- Adjustments to tested party data
  - » Forecasting revenue
  - » Non-recurring COGS and SG&A
  - » Idle or less productive assets
  - » doubtful accounts receivable

Implementing benchmarks (documentation)

- How are you going to explain your crisis though process?
- Verify your assumptions don't go against local regs.

Takeaways

- Is the “limited risk” strategy viable if the entrepreneur/principal cannot bear the risks materialized by COVID-19?
- Consider implications for prior and future tax years – sustaining your limited risk model and audit benefits
- Benchmarking will require more proactivity and more adjustments
- Carefully documenting the reasons for your choices
- Profit/loss sharing may become more common, formally or otherwise
- What would arm’s length parties do? What are they doing now?

Tax Administration: Near-term impact of delay or deferral of ongoing inquiries and impact on compliance deadlines and potential impacts on APAs

Government Reactions

- **OECD coordination of tax policy responses**
  – As the COVID-19 pandemic took hold around the world, the OECD encouraged tax authorities to implement a range of targeted and temporary measures intended to help keep households and businesses afloat during the economic emergency.

  – Measures included:
    » Extension of deadlines to file tax returns and make tax payments
    » Deferral of tax payments to ease cash flow
    » Remitting penalties and interest for late filing or payment
    » Debt payment plans and suspending debt recovery
    » Quicker refunds
    » Providing early tax certainty where appropriate
    » Not auditing taxpayers during the crisis (other than in cases of fraud)

Government Reactions

- **Tax administration impact**
  - Countries globally have reacted to the economic impact of the various COVID-19 containment strategies applied with measures designed to help businesses to stay afloat, to support households and to help preserve employment.

  - Tax administrations are having to adapt to the situation. While very few employees in tax administrations may actually be off work with COVID-19, many are now working from home and only a core may remain in offices. Their focus is on implementing critical matters, in particular the government responses to COVID-19.

Government Reactions

- **Audits and open inquiries**
  - Tax administrations in most countries are unlikely to be pursuing most audits in the short term, while their focus remains on implementing governments' COVID-19 business and household measures. Taxpayers can expect ongoing interaction with tax administrations to be extended or deferred and delays in progressing non-critical matters are to be anticipated.
  - In France and Italy, all current audits have been suspended and no new tax audit will be started. In the UK, HMRC has written to many business taxpayers to inform them of a temporary suspension on open tax inquiries.
  - Not all compliance work is being stopped in the UK, but priority is being given to work supporting businesses and individuals and to tackling serious criminal activity and tax avoidance generated by the crisis (e.g. fraudulent schemes set up to obtain refunds or to access government support payments, etc.).

Government Reactions

- **APAs and tax rulings**
  - Taxpayers may find that the altered market and economic conditions impose changes on their business that impact critical assumptions of their existing tax rulings, placing businesses in an invidious position.
  - Ongoing APA negotiations and new applications for rulings are likely to be deferred in some countries. Italy has placed a temporary hold on issuing tax rulings and responding to new agreements until May 31. However, countries like the U.S. and the UK have indicated they will help companies to deal with the impacts of the crisis on existing APAs.
  - Companies are encouraged to start discussions with tax authorities as soon as possible, though they should not anticipate a swift resolution while the authorities are focused on tackling more urgent issues. In the UK, HMRC has indicated that it will be pulling staff from non-urgent matters to prioritize critical services, such as the government's job retention scheme.

Government Reactions

- **Permanent Establishments**
  - Many employees are now working from home and unable to travel to their normal place of work, even dislocated to countries other than their regular country of work, triggering fears of creating PE risks for businesses.
  - The OECD issued emergency guidance on April 3, 2020 to address the dislocations, emphasizing that a degree of permanence is required for a PE and that it must be at the disposal of an enterprise.
  - Governments, including the UK and Ireland, have issued assurances that companies need not worry that they will become tax-resident, just because a few board meetings are held there or because some decisions are taken there over a short period of time.
  - Countries such as Belgium, France, Germany, the Netherlands and the UK have also issued guidance to reassure individuals habitually working across borders concerned about changes to their residence status.

Government Reactions

- **Tax payment deferral**
  – The most common type of tax measure to enhance business cash flow among countries has been the deferral of tax payments.

  – Three quarters of countries have introduced deferrals of some kind for tax payments, generally for advance corporate income tax or personal income tax payments, VAT and social security contributions.

- **Tax filing deferral**
  – Many countries have also introduced measures to provide business taxpayers with additional time to file tax returns, e.g. Austria, Belgium, Czech Republic, Estonia and Finland.

Government Reactions

- **Other tax measures for supporting businesses**
  - Some countries have introduced measures to allow 2020 tax losses to be carried back against profits of earlier years, e.g. Norway, Poland and the Czech Republic.
  - Other countries are increasing the loss carry-forward period for 2020 losses, e.g. the Slovak Republic.
  - Other measures include the acceleration of tax refunds, of VAT and other taxes, where taxpayers are owed money, and more flexible tax debt repayment plans.
  - Some tax administrations are remitting penalties and interest for late filing of tax returns or for late tax payments.

Government Reactions

- **Taxpayer experience**
  - Most taxpayers are under pressure. In anticipation of recession and a drop in customer revenues, executive committees are curbing any travel not already prohibited, freezing hiring and cutting non-essential spending.
  - Tax departments are being hampered by having to work remotely and, to a lesser degree, by having key team members fall ill and/or be required to isolate themselves.
  - Heads of Tax are being required to pare back discretionary projects and to establish priorities for the best use of their resources in the face of dwindling budgets.

Government Reactions

- **Key country policy responses**
  - Details of governmental responses to the COVID-19 pandemic are perhaps most easily accessed here:
    - » http://www.oecd.org/coronavirus/en/

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

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Simon Webber joined Duff & Phelps in 2012. Simon is a managing director who has been providing global transfer pricing advice to organizations that range from Fortune 50 companies to start-up businesses for over 25 years. He has a particular focus on the Silicon Valley and Bay Areas. Drawing on his professional and industry experience, Simon is a recognized expert in intangibles valuation and planning, acquisition integration, and related tax valuations under BEPS and TCJA. He also has significant expertise and experience in all aspects of transfer pricing planning, documentation, reserves, audit defense and advanced pricing agreement controversy support.

Prior to joining Duff & Phelps, Simon was a managing director at Ceteris and a partner in Big Four. As an international transfer pricing expert with North American, European and Asian experience, he provides a solid platform for supply chain restructuring and worldwide transfer pricing documentation projects for clients in the high-technology sector – including biotech, Internet, SaaS and derivative companies, computer, software, semiconductor, telecommunications, equipment, solar energy, medical devices, payments, blockchain and emerging technology industries. He also has industry experience in consumer brand products, retail, pharmaceutical, manufacturing services, logistics, beverages, metals and mining.

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 writer and speaker on transfer pricing issues and developments, especially cost-sharing, intangibles, tax valuation and transfer pricing risk management. He has written and contributed to a number of transfer pricing articles, spoken at the OECD on Blockchain transfer pricing issues and regularly contributes to policy debates and public commentaries on changes in his field of expertise.

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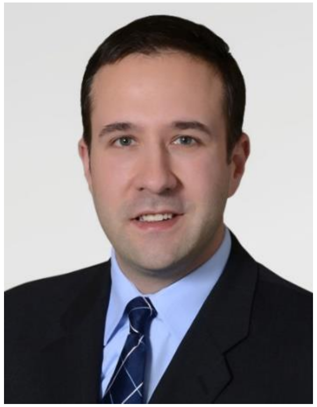

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David Ptashne joined Duff & Phelps in 2012 as a Director in the Chicago office and leverages 17 years of valuation and economic consulting experience. In addition to transfer pricing knowledge, David has significant experience leading and performing 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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Matt Billings is a managing director in the Toronto Office and leader of the firm's Canadian Transfer Pricing practice. Leveraging more than 20 years of transfer pricing experience, Matt has experience guiding both Canadian and foreign-based multinationals on transfer pricing and related matters.

Matt's experience includes a wide variety of transfer pricing planning, dispute resolution and compliance projects.

Matt has assisted clients in developing post-acquisition planning to meet both their tax and business objectives. In addition, he has guided clients to establish frameworks for entering new foreign markets, deal with market exits and production relocations, obtain tax certainty through Bilateral and Unilateral Advance Pricing Arrangements, and negotiate favorable conclusions to tax audits and litigation.

Prior to joining Duff & Phelps, Matt served as a transfer pricing partner at PricewaterhouseCoopers (PwC). During his tenure at PwC, he counseled clients located across Canada and internationally, with a primary focus on dispute resolution.

Matt speaks regularly at seminars on topics such as transfer pricing audit defence, BEPS and intangibles, pricing guarantee fees, permanent establishments, intellectual property migration, transfer pricing and thin capitalisation, and transfer pricing implementation and monitoring. He has published articles through the Canadian Tax Foundation, International Transfer Pricing Journal, and BNA Tax Management Transfer Pricing Report.

Matt holds a Master's degree in economics from Queen's University, with dual concentrations in international economics and financial economics. He also holds a Bachelor of Business Administration degree from the University of New Brunswick, with a major in economics and a concentration in international business.

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Fabian Alfonso is a managing director in the Transfer Pricing practice, based in the Miami office. He leverages more than 17 years of experience in implementing, documenting and defending cross-border transactions for multinational companies.

Prior to joining Duff & Phelps, Fabian served as a partner at BaseFirma, a member of Duff & Phelps' Transfer Pricing Alliance. Fabian has been involved in numerous transfer pricing projects for companies operating in various industries, including private banking, transportation and logistics, insurance, energy, personal goods and telecommunications. He specializes in managing multi-country transfer pricing projects for multinationals throughout the Americas.

Fabian is a frequent speaker at international transfer pricing seminars and a contributor to international tax publications, such as *International Tax Review-UK* and the Bureau of National Affairs of Washington. In addition, he was recognized as Americas Transfer Pricing Adviser of the Year at *Finance Monthly*'s Global Awards in 2017.Fabian has a degree in business administration with an emphasis in finance from Universidad de los Andes in Bogota and a graduate degree in international tax law from Universidad Externado de Colombia. He is fluent in Spanish and English.

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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.