
Impact of COVID-19 on Intangible Assets

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Asia Pacific Transfer Pricing, Valuation and Legal Perspectives

Presenters

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DESIGN

- Understand objectives
- Review of current state
- Location selection
- Economic modeling
- Implementation assistance
- Internal policy manuals (e.g. Treasury Manuals)
- IT, operational and transfer pricing systems design

DOCUMENT

- Global Master file documentation
- Local file documentation
- CbC reporting
- CbC risk assessment
- Filing of CbC reports and documentation
- Transfer pricing policy reports
- Tax file memoranda
- Regulatory compliance documentation
- Legal agreement review

DEFEND

- Risk reviews and gap analyses
- Transfer pricing audit readiness reviews
- Strategic transfer pricing audit management
- Expert witness testimony
- MAP negotiation
- Assistance in arbitration and State Aid proceedings
- Negotiation and conclusion of unilateral, bilateral and multilateral APAs

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Context for today

- Intangible assets:
 - provide competitive advantages to their owners or users;
 - drive excess profits;
 - for transfer pricing are a key driver of profit allocation in global value chains; and
 - are a major focus of revenue authorities given their contribution to value creation
- New concepts and approaches have been introduced to arm tax administrators with more tools to challenge taxpayers whilst providing a higher bar for taxpayers to comply in relation to their use of intangible assets
- In times of crisis cash preservation often becomes a higher priority for multinational enterprises and taxes represent a significant cash outlay that can be impacted by effective management of transfer pricing models. It raises questions:
 - of where intangible assets should be owned;
 - the appropriate charges for rights to use these assets; and
 - the most appropriate transfer pricing method to be used.
- Today we are bringing our valuation expertise together with our transfer pricing specialisation, with legal input from our Webinar partner MDP law. Together we will lay the appropriate groundwork and reveal opportunities to capture value in this pandemic and manage risks.

AGENDA

- **Valuations:** basis of value during times of market dislocation, factors to consider when valuing IP and recommended best practices for robust valuation process
 - [Ashish McLaren](#), Director, Valuation, Singapore
- **Transfer Pricing:** valuation impacts for transfer pricing, planning considerations and defending changes to transfer pricing models
 - [David Lewis](#), Managing Director, Australia Transfer Pricing Leader, Melbourne
- **Legal:** lessons learned and key considerations of relevant commercial and IP license agreement provisions
 - [Mark Millard](#), Special Counsel, MDP Law, Melbourne

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Valuations: basis of value during times of market dislocation, factors to consider when valuing IP and recommended best practices for robust valuation process



Basis of Value During Times of Market Dislocation

- Common basis of value for Financial Reporting and Tax Purposes
 - OECD defines Fair Market Value as the price a willing buyer would pay a willing seller in a transaction on the open market;
 - Inland Revenue Authority of Singapore (“IRAS”) defines Open Market Price as the arm’s length price at which an asset would change hands, on the date of valuation, between a willing buyer and will seller; and
 - Under IFRS 13, 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.
- Notwithstanding the presence of distressed transactions arising from COVID-19 pandemic; above bases of value are not intended to reflect a forced or involuntary sale (at a distressed sale prices)
- However, the bases of value should account for the following:
 - Takes into account current market conditions
 - Incorporates information that is known or knowable as of the measurement date

What is Known and Knowable ?



Known and Knowable

- **Public market prices** have decreased significantly and then increased
- **Energy prices**, in particular oil, have decreased drastically and recovered
- **Selected industries** have been considerably impacted by the response to the pandemic
- Many companies are facing a **liquidity crunch** impacting cash resources
- **Uncertainty and risk** have increased, and therefore a market participant required rate of return has likely increased
- Central banks and governments are implementing **monetary and fiscal stimuli**



NOT Known and Knowable

- When **effective treatments** for COVID-19 will be **available**
- When a **vaccine** will be available to prevent the spread of COVID-19
- Whether and when spread of **COVID-19 will return** if spread is curtailed
- How long shelter in place and travel **restrictions** will remain in effect
- Is the public market recovery a sustained **V** or could it be a **W** or **VL** or **?**
- When will **consumer spending return** to pre COVID levels (savings rates are increasing)
- The **full impact** of government and central bank **fiscal and monetary policy** legislation and initiatives

Factors to Consider when Valuing IPs under Covid-19

- **Enterprise-level value considerations**
 - Revenue
 - » Impact on customer demand
 - » Timing
 - » Customer financial health
 - Supply Chain
 - » Timing and availability of goods
 - » Cost of goods
 - » Supplier financial health
 - Operations
 - » Employee availability
 - » Employee productivity
 - » Ability to work remotely and maintain appropriate cybersecurity
 - EBITDA or other metrics in arrears need to be updated in real time when benchmarking with comparable companies
 - Future cash flow projections need to be updated to consider short-term, medium-term and long-term expected impacts

Factors to Consider when Valuing IPs under Covid-19

- **IP-level value considerations**

- Royalty Rates

- » Negotiated rate for the IP
- » Number of potential licensees
- » Impact on margins and profit split (i.e. 25% thumb rule)
- » Market benchmarks for similar IPs (i.e. observed royalty rates)

- Royalty Base

- » Impact on long-term revenue projections
- » Sustainable level of units (or volume of sales)

- Incremental / Excess Earnings

- » Industry / Market competition
- » Price premiums (with other comparable products or generics)

- Discount Rate

- » Equity market risk and volatility
- » Country risk premiums
- » Cost of debt finance (i.e. corporate debt spreads)

Polling Question 1

Choose one! 

Has your company adjusted cash flow projections downwards / upwards to reflect the impact of COVID-19?

- Do not anticipate seeing meaningful changes to projections
- Started to evaluate the impact, but have not yet made any adjustments
- Begun to make some downward adjustments
- Begun to make some upward adjustments
- Other / Not Applicable

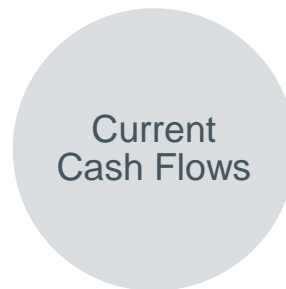
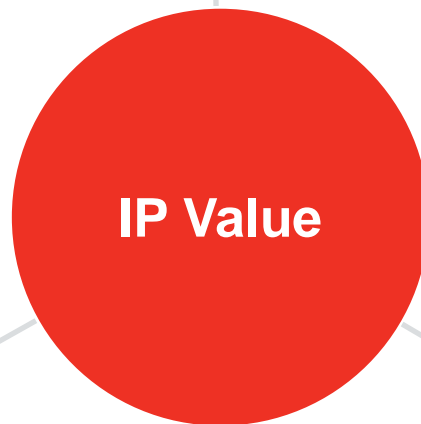
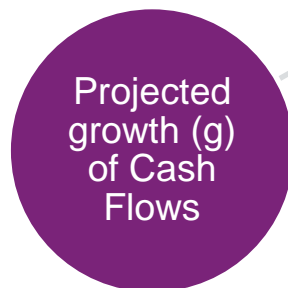
Recommended Best Practices for Robust Valuation Process

- **Evaluate legal, functional and economic assessment of the IPs**
 - 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
- **Current circumstances necessitate more robust review and 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

IP Valuation Approach – Income Approach

Care, Consideration, Support

Company Forecasts
Reliability
Corroboration
Sufficient scenarios
Probability weights
Expected Forecasts



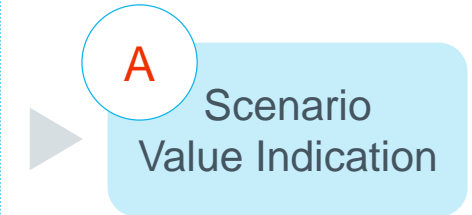
WACC
Debt / Equity
Debt value
Cost of Equity
Risk Free Rate
Equity Risk Premiums
Country risk premiums
Alpha adjustments
IRRs

Base Case Scenario – Starting Point for Projections

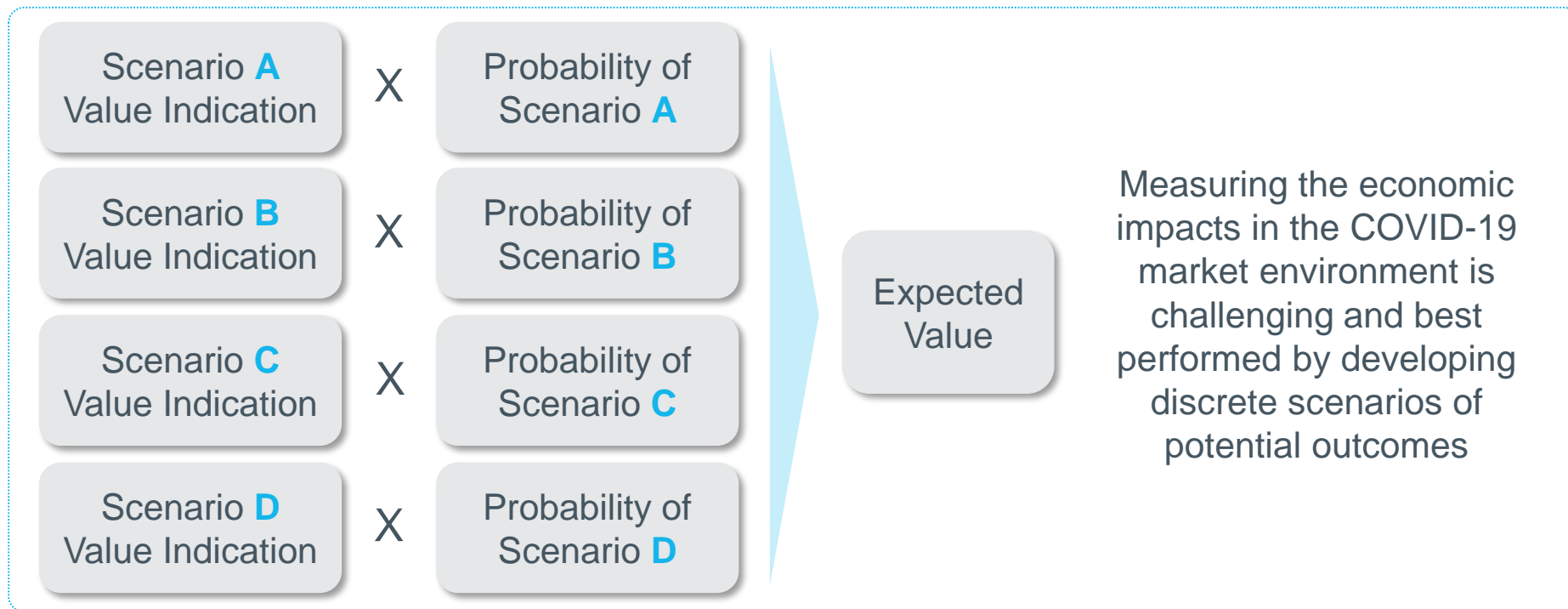
- If the company has not considered the impact of COVID-19 on prospective financial information (“PFI”) scenarios, we recommend starting with a “Base Case” cash flow forecast based on pre-market volatility conditions
- Alternative scenarios would then be built off of this “Base Case”
- Alternative scenarios become critical if the company believes market participant cash flow expectations overweight downside case scenarios
- The “Base Case” serves as a reference scenario; however, it may be given little or no weight based on the change in economic conditions. Its purpose is to provide a framework to assess what has changed in developing various scenarios

Assessing Scenarios – Scenario Based Approach

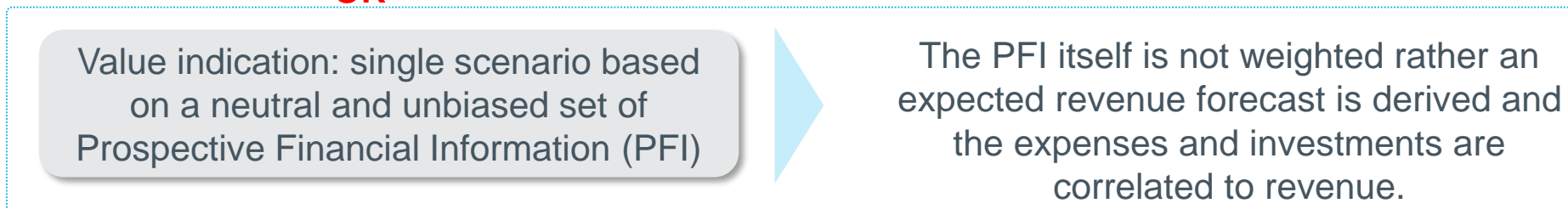
- The company should evaluate scenarios and associated probabilities considering factors such as:
 - 1 Customer demand, pricing and diversification
 - 2 Supply chain diversification and disruptions, including increased costs from the relocation of operations or a need to replace suppliers
 - 3 The company's industry, location, and the expected duration of the outbreak
 - 4 Competitors' activities
 - 5 Government and central bank measures
 - 6 Workforce disruptions
 - 7 Credit downgrades and covenant breaches
 - 8 Government and other authorities' estimates of the expected duration of the crisis
 - 9 GDP growth, projections and outlook
 - 10 Interest rate and foreign exchange rate fluctuations, and
 - 11 Other impacts
- Cash flow projections should consider short-term, medium-term and long-term expected impacts.

























Scenario-based Approach vs. Single Scenario Representative of Expected Value



OR



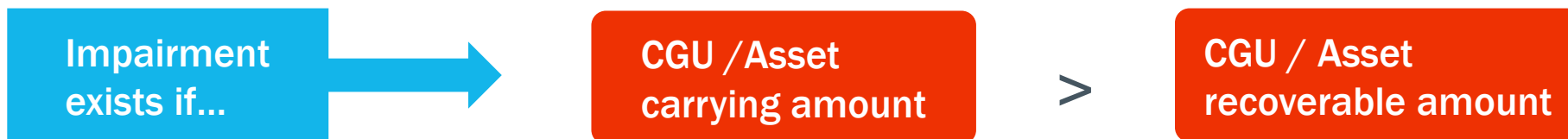
IP Valuation Approach – Discount Rate Factors

Factor	Change	Effect on ERP
U.S. Equity Markets		
Implied Equity Volatility		
Corporate Debt Spreads		
EPU and Equity Uncertainty		
GDP Growth and GDP Growth Forecasts		
Unemployment Environment		
Consumer Sentiment		
Business Confidence		
Sovereign Credit Ratings		
Default Spread Model		
Damodaran Implied ERP Model		

Goodwill Impairment Testing – IAS 36 Overview

Key concepts:

- Goodwill acquired is allocated to those Cash generating units (CGU) that are expected to benefit from the synergies of the combination
- No amortization
- Tested annually for impairment, or more frequently if there is an **indicator of impairment**
- Impairment losses first allocated to goodwill and then other assets in CGU
- Unlike long-lived assets, impairment losses are never reversed for goodwill
- Goodwill is tested for impairment by comparing the recoverable amount of a CGU of a group of CGUs to its carrying amount



Goodwill Impairment – Triggering Events That May Be COVID-19 Related

Indicators	Relevant to COVID-19?
Macroeconomic conditions	Yes
Industry and market considerations	Possibly
Cost factors	Possibly
Overall financial performance	Possibly
Other relevant entity-specific events	Possibly
Events affecting a CGU	Possibly
A sustained decrease in share price	Possibly

Polling Question 2

Choose one! 

Do you anticipate taking a goodwill impairment?

- Yes
- No
- Uncertain at this point
- Not applicable

Transfer Pricing: valuation impacts for transfer pricing, planning considerations and defending changes to transfer pricing models



Transfer pricing considerations for valuations

- Transfer pricing considers a wider scope for intangible assets, some of which may not be recognised on financial statements or included in goodwill
- OECD definition of an 'intangible' *'..something which is not a physical asset or a financial asset which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances'*
- Income based valuation techniques are acceptable for tax and transfer pricing purposes but need to be applied in accordance with the arms length principle and assumptions and other motivations that underlie their application need to be considered
- Taxpayers need to carefully document relevant assumptions made in creating the valuation model, the basis for selecting valuation parameters and be prepared to defend their reasonableness. Sensitivity analysis of alternate assumptions and parameters is also necessary
- There are specific additional requirements under the Transfer Pricing Guidelines that need to be considered - Tax administrators can consider **ex post returns**

Transfer pricing considerations for valuations cont.

Ex post outcomes

- Can be considered for tax especially for *Hard to Value Intangibles*
 - Asymmetry of information
 - An approach that Tax Administrations can adopt to assess whether taxpayer pricing arrangements are at arms length and are based on an appropriate weighting of foreseeable events
 - Ex post outcomes provide presumptive evidence as to the existence of uncertainties at the time of the transaction and the reliability of the information used ex ante in determining the price for the transfer of intangibles
 - Which are rebuttable where either:
 - » Taxpayer provides details of probability weighted ex ante projections and appropriateness of its consideration of reasonably foreseeable events and other risks; and
 - » Reliable evidence of unforeseeable events that could not have been anticipated; or the playing out of probability of occurrence of foreseeable outcomes which were not over or underestimated.
 - Covid-19 will increase intangible assets which fall into the HTVI category

Transfer pricing considerations for valuations cont.

Highly uncertain valuations at the time of the transaction

- When valuations of intangible assets are highly uncertain at the time of the transaction how can pricing be determined?
- Reference what independent enterprises would have done in comparable circumstances to take account of valuation uncertainty:
 - Price adjustment clauses
 - Contingent payments
- Tax administrations can determine the pricing of an intangible using such mechanisms.

Planning - Recent Intercompany IP Transactions

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:

- Known or knowable
- 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

Planning - Current and Future Intercompany IP Transactions

- Taxpayers may need or want to move intangible assets
 - forced to restructure, both voluntarily and involuntarily, as a result of the pandemic, shutting down or scaling back their operations in various jurisdictions
 - Taxpayers may also wish to move their intangible assets to more favourable jurisdictions
 - Companies with depressed IP values may want to consider changes where high IP values have been a constraint
- The impact of the pandemic may be to lower valuations of intangible assets
- The need to transfer intangible assets may therefore trigger lower tax costs
- Considering the valuation tools available, it may not be necessary—or prudent—to postpone intercompany intangible sales because of the COVID-19 pandemic
 - COVID-19 is not an unforeseeable event for post COVID-19 transactions
 - Valuations will need to take pandemic impacts into account
- Highly uncertain and HTVI provisions will put increased pressure on the structure of the transactions and the valuation
- Coordinate with business and finance
 - Ensure accounting and tax valuations are aligned.

Planning - Adjustment of royalties

- The economic dislocation arising from the pandemic may cause the value of intangibles to fall which could impact on the level of royalties that can be charged within a MNE group. An impairment to goodwill could also highlight similar issues
- Licensees may be incurring losses raising questions also about the value of licensed intangibles
- Not tax efficient for loss making entities in a group to be paying royalties given WHT leakage. It also creates higher tax audit risks in the licensee country
- Independent licensees would seek to renegotiate license fees if they are not economically sustainable. This could be subject to the terms of the license agreement. Force majeure clauses could be applicable
- Need to consider the options realistically available to the parties

Planning – Change of Transfer Pricing Method

- The difficulty with pricing the right to use intangible assets is that they are by nature unique & comparable transactions may not exist
- One sided methods such as TNMM are typically not reliable for intangible assets
- In these uncertain times it might be difficult to price a right to use intangible assets
- A residual profit split method may be a more appropriate method as a basis for a transfer pricing policy
 - More sensitive to profit
 - Deals with DEMPE activities
- It attempts to replicate how independent parties would share residual profits
- Needs careful analysis of value drivers to determine relative contributions
 - Can use either qualitative and quantitative analysis
- The use of a residual profit split will enable royalty payments to adjust to economic circumstances lowering WHT and local risk
- Risks of changing the method and options realistically available should be considered
- Scope for market support payments.

Managing risk

On the other side of this pandemic revenue authorities will be very active on MNEs and transfer pricing as they were after the GFC

Intangible transfers:

- Intangible asset valuations should carefully consider how to incorporate current economic uncertainty into valuation model inputs.
- Detailed notes and files should clearly and carefully document the basis for model assumptions.
- Clear and careful documentation of the model will mitigate transfer pricing audit risk, as will consideration of the type of intercompany agreement and payment terms that are most appropriate given the facts and circumstances of the transaction
- Some Revenue Authorities are very focussed on migration of intangible assets – ATO

Royalty changes:

- Need to consider options realistically available and document
- What were the commercial reasons for decisions made?
- Capture evidence of what is happening in your industry as a result of Covid-19 to provide support.
- Maintain a 'live' file

Polling Question 3:

Is your organisation contemplating moving intangibles assets or changing the approach to calculating royalties as a result of the COVID-19 pandemic?

1. Yes, moving intangible assets
2. No, not contemplating a move of intangible assets
3. Yes, re-pricing royalties
4. No, no change to royalties
5. Not sure yet

Legal: lessons learned and key considerations of relevant commercial and IP license agreement provisions





lawyers, patent attorneys
& commercial advisors

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Protect, Restore and Maximize Value

INTELLECTUAL PROPERTY CONSIDERATIONS POST COVID-19

PRESENTED BY

Mark Millward

Special Counsel

INTRODUCTION TO MDP LAW

- Overview of practice
- Specialist trade mark practice
- mdp Patents
- Michael McDonald
- Mark Millward
- mdp's broader team

DEFINITION OF IP. WHAT DO WE REALLY MEAN?

- Copyright – a multiplicity of valuable content including software
- Trade marks – your brand
- Patents – your crown jewels; your 20 year monopoly right
- Design rights – your creativity including your design future-proofing

But also:

ESOTERIC IP

- Confidential Information – underlying your potential patent rights
- Unregistered trade marks/ mastheads/ passing off rights
- Database rights/ primarily capitally European considerations
- Applications for registrable IP/ priority dates and protocalls
- OECD definition of IP

QUESTION FOR THE AUDIENCE

Notwithstanding COVID-19 has any business experienced a situation where it realises that it is unsure of the current status of its IP portfolio?

1. Yes
2. No
3. I haven't considered about it

COVID-19: LEARNING A LESSON

- Realisation that our “house is not in order”
- 3rd party suppliers and customers – defaulting on contracts
- Force majeure provisions which are not “crisp”
- Lack of adequate dispute resolutions
- What if there is no force majeure provision
- Anticipation of right to renegotiate royalty rate and other pricing

INADEQUATE INTRA-GROUP IP PROTECTION

- Fast pace of the COVID-19 impact YET: no option of retrospective solution
- IP portfolio “all over the shop”
- Realise the vulnerability of our subsidiaries and the impact on our parent/group
- If COVID-19 and other drastic, unforeseen events occur, where are we left with IP in the wrong place?

WORST CASE SCENARIO

- Subsidiary with “trapped” IP in an insolvency scenario
- No ability to “claw back” IP/ cost of buy back
- In ability to move IP assets in a tax and accounting manner
- Vulnerability of parent/group applications for global registered rights
- No ability to terminate irrevocable intra-group licences
- Potential loss of access to market
- Incorrect agreements/ licensing vs distribution vs manufacturing vs consulting

CHAOS

- No intra-group agreement:
 - No control of IP
 - Risk of IP being sold to competitor
 - Exclusion from market
- Inadequate intra-group agreement:
 - “Not worth the paper it is written on”
 - No rights to terminate for convenience
 - No rights to terminate in insolvency event
 - Same as above – complete loss of control

HOW TO RESOLVE THIS DRASTIC SITUATION

- Due diligence of group IP portfolio
- Seek accounting and tax advice; your legal team needs to work closely with your professional advisors
- Organise transfer/assignment documents intra-group
- Remember regulatory authorities scrutinise your intra-group arrangements
- Leverage your ability to restructure your agreements
- Implement appropriate intra-group licensing arrangements at “arms length” – see later commentary
- Reorganising your IP portfolio may trigger a tax and transfer pricing event resulting in an exit charge
- Post COVID-19 may create the ability to leverage opportunities

TAX AND ACCOUNTING; NEGATIVE IMPACT

- Local tax implications
- Exit fees and other tax and accounting negative implications

SIMPLE SOLUTION

- Consolidation of all IP with accountancy, tax and legal advice
- Strong, well thought out, intra-group agreements:
 - No “irrevocable” IP licences
 - Termination rights
 - For convenience
 - For insolvency
 - for force majeure
 - No automatic assignment agreement
 - Determine the correct nature of agreement
 - Agreements must be at arms length
 - Force majeure – how to structure in a pandemic situation
 - Structure – intragroup agreements to align with transfer pricing considerations

CONCLUSION

- In short, a 3rd-party IP licensing scheme at “arms length”
- Accurate and appropriate intra-group agreements
- “You’re sorted” Done and Dusted!



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