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IP Valuation for 482 and Financial Reporting Contrasts and Pitfalls

National Association of Business Economists
Transfer Pricing Roundtable Webinar
October 11, 2011

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Agenda

1. Why do we care?

- Regulatory Framework
- Definition of Intangibles
- Differences & Examples

2. Case Study

Regulatory Framework

Jurisdictions	Financial Statement Reporting	Tax/Transfer Pricing
U.S.	FASB ASC 805	Section 482 and 367(d)
International	IFRS	OECD Guidelines
Local	Local GAAP Regulations	Local Transfer Pricing Regulations

Definitions

Comparison Definitions	
<u>Transfer Pricing: IRC § 482</u>	<u>Financial Statement Reporting: ASC805 & ASC 820</u>
Patents, inventions, formulae, processes, designs, patterns, or know-how;	Technology-Based Intangible Assets, which include patented technology, computer software unpatented technology, trade secrets.
Copyrights and literary, musical, or artistic composition	Artistic-Related Intangible Assets, which include plays, books, magazines, newspapers, other literary works, pictures, photographs
Franchises, licenses, or contracts;	Contract-Based Intangible Assets, which arise from and which include customer contracts, Licensing agreements, supply contracts, leases, franchises
Trademarks, trade names, or brand names;	Marketing-Related Intangible Assets, which include trademarks, trade dress (unique color, shape, package design), newspaper mastheads, etc.
Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data;	Customer-Related Intangible Assets, which include: customer lists, backlog, customer contracts and related customer relationships, non-contractual customer relationships
Other similar items that do not derive their value from physical attributes, but from the intellectual content of the item from other intangible properties	

Examples

- Post acquisition transfer of IP from Company A to Company B
- Assumptions made in Company A's valuation of Intangible A, e.g., intercompany royalty rates vs. royalty rates in a relief from royalty valuation of Intangible A
- Valuation of Entity B under Company A, e.g., Entity B's risk profile under the discounted cash flow method vs. Entity B's intercompany risk profile for tax purposes

Use of Financial Statement Valuations for Tax and Transfer Pricing?

It may provide a very useful start, but

There are differences

- Different objectives and uses
- Inconsistent methods and assumptions
- Expected level of documentation around assumptions and methods

Differences – Example 1

Residual Profit vs. Excess Earnings

Similarities:

- **Estimate IP value based on “residual” over remaining economic life discounted at risk-adjusted rate**

Differences – Example 1 cont.

Residual Profit vs. Excess Earnings

Differences:

- **After-tax vs. pre-tax**
- **Routine profit vs. contributory asset charges**
- **Discount rate**
- **Life**

Differences – Example 2

Discount Rate – Transfer Pricing

- Post vs. pre-tax discount rate

$$I_{Post-Tax} \times \frac{1}{k} = I_{Pre-Tax} \times \frac{1}{k} \times (1 - t)$$

- Typically, WACC plus IP risk premium

Differences – Example 2 cont.

Discount Rate – Financial Reporting

- **Start with Deal Internal Rate of Return (IRR)**
 - The higher the purchase price, *ceteris paribus*, the lower the Deal IRR
- **Estimate IP discount rate based on Deal IRR and Weighted Average Return on Assets (WARA) computation**
 - May yield relatively low discount rate (e.g. \leq WACC)

Differences – Example 3

Royalty Rate Analysis / Relief from Royalty

Transfer Pricing:

- Detailed analysis of comparables and possibly multiple methods

Financial Reporting:

- Higher-level analysis of applicable royalty rates

Case Study

Case Study - Background

NABE Co.

- U.S. multi-national in business software industry
- Established CSA in 2008 with CFC
 - Buy-in based on CUT – 8% royalty
 - 18% discount rate
 - R&D costs shared in proportion to US vs. foreign sales

In 2011, NABE Co. acquires BANE Co.

- BANE Co makes complementary products
- Purchase price is 100
- 80% sales are US, but strong foreign sales expected

Case Study – Purchase Price Allocation

BANE Co. Assets	Assigned Value
Tangible Assets	10
Technology IP	20
Goodwill	70
Total	100

Case Study – Financial Forecasts

BANE Co	2010 Act.	2011 Fcst.	2012 Plan	2013 Plan	2014 Plan
Sales	100	105	120	150	200
R&D	20	20	20	20	20
Operating Profit	5	10	20	30	50
Operating Margin	5%	9.5%	16.7%	20%	25%

IRR = 11%

Discount rate chosen for IP/GW valuation: 12%

Case Study - Questions

- Could NABE Co simply use the purchase accounting valuation to support the IP buy-in payment? Why or why not?
- The excess earnings method was used to value the developed technology IP. The excess earnings implied by the model are 15 percent. What issues may that raise?
- What discount rate should NABE Co use to value the technology for purposes of the buy-in payment?
- What other issues will NABE Co have to consider with respect to the cost sharing agreement?

Thank you



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