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Intangible Asset Valuation Considerations in Times of Uncertainty

by Simon Webber, David Ptashne, and Judd Schneider

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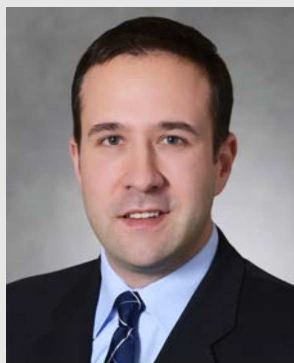

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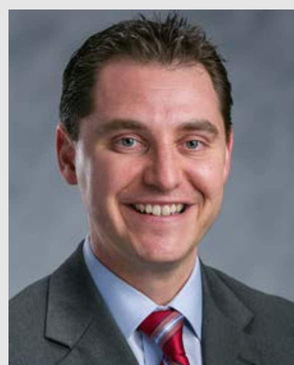

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In this article, the authors examine opportunities involving significant business and intangible value changes, financial reporting value effects from a tax perspective, and tools for mitigating valuation-related risks in the uncertain environment caused by the COVID-19 pandemic.

I. Introduction

The outbreak of the novel coronavirus was declared a Public Health Emergency of International Concern on January 30 by the World Health Organization and a U.S. National Emergency on March 13. The pandemic is first and foremost a tragic global health crisis that has led to unprecedented economic and social turmoil around the world. Equity and debt markets have been dislocated with stock prices bouncing wildly on waves of news about the spread of the virus, its casualties, government interventions, flights to quality, and pure speculation. It is unclear how long this disruption will continue.

At the time of this article's drafting, parts of the nonessential economy are readying to reopen. While actions to protect employees, customers, and other business assets remain paramount, it is critical for companies to consider and respond to a new world and how best to position within it.

Externally, many industries will find that the pandemic has cemented some very different behaviors and constraints in their markets. There are likely to be significant shifts in what services or products are used or bought by businesses and consumers, and how they are purchased or consumed. Internally, businesses are having to rethink or adjust supply chains, customer experiences, and business continuity measures. No matter the industry, business prospects and therefore values have likely changed post-COVID-19. The pandemic will also likely cast a long shadow in terms of perceived general economic risk until vaccines or other longer-term solutions are found. Thus, related intangible asset and goodwill values are likely to have moved materially, perhaps temporarily, but in some cases more permanently. Much will depend on the facts and circumstances of each industry and business.

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This article first discusses issues and opportunities involving significant business and intangible value changes. We then explore some implications of changes in intangible value for completed transactions, looking specifically at financial reporting value effects from a tax perspective. We finish with thoughts on some key issues arising in the valuation of intangibles in a post-COVID-19 environment, identifying useful tools and analyses for mitigating valuation-related risks in this more uncertain environment.

II. Issues and Opportunities

Both immediate and longer-term issues and opportunities have arisen from the pandemic. Many deals or reorganizations that were ongoing when the crisis began have continued because they still fundamentally make sense or the costs of stepping away are prohibitive. Other transactions have been postponed, collapsed altogether, or fallen into dispute. Continuing disruptions (or even prospects for the new normal) may require a reorganization of assets to access needed financing, or the sale of non-core businesses to generate cash.

Cash conservation and generation measures, as well as other business changes, should also consider taxes, including intercompany transfer pricing, in light of the pandemic to see whether they can yield supportable benefits. Changes in tax rules enacted because of the pandemic offer an opportunity for tax refunds or other advantages of realizing existing tax attributes or creating new ones because of changes in circumstances.

For companies that have recently acquired, integrated, or reorganized intangible assets, or have ongoing intangible-related transactions, there may be opportunities to revisit intercompany pricing, taking into consideration a more current view of expectations for the future. It may be possible to reverse internal transactions executed this year to deploy cash elsewhere or when benefits have evaporated with changed economic conditions. Also potentially attractive are transactions that realize losses or release otherwise trapped tax attributes that can be used to reduce current cash taxes or generate tax refunds.

For companies that were contemplating intangible planning before the crisis, we recommend a reevaluation to ensure these plans remain appropriate. The benefits of available options may have changed. For example, if implementation costs from high intangible values were an issue, they may be less of an impediment if values have decreased. Alternatively, if higher intangible values generate greater benefits, it may be best to postpone the transaction. Even if the desired structure for a business remains the same, current circumstances offer a unique timing opportunity for making changes, integrating acquired businesses, or otherwise cleaning up misaligned tax and transfer pricing structures for which business or intangible values were gating items. For those in settled structures, a review of operating and tax profiles is warranted to ensure that they remain best suited for the future.

A. Other Factors to Consider

Intangible values and business prospects are certainly not the only factors to consider when evaluating potential changes. Care should be taken to consider all material aspects. Recent changes in tax rules have added more complexity to planning decisions. The intricacies of the U.S. tax rules under the Tax Cuts and Jobs Act, as changed by the Coronavirus Aid, Relief, and Economic Security (CARES) Act (P.L. 116-136), and their interaction with continuing historical tax laws must be considered along with longer-term expectations for U.S. corporate income tax rates. Similar considerations are important outside the United States with the OECD base erosion and profit-shifting initiatives, local taxes, subsidies, and incentives, along with any pandemic-specific fiscal responses.

The post-pandemic world will see countries saddled with high levels of governmental debt. Long-term plans to alleviate debt may also factor into decision-making. Regarding intercompany transactions and transfer pricing for intangibles, other relevant considerations include customs and duties, VATs, stamp duties, registration fees, and any extraterritorial tax rules, for example, those for German registered IP, assets situated in Ireland, and the taxation of offshore receipts related to IP in the United Kingdom.

III. Acquired Intangibles and Goodwill

Much of the above discussion focuses on potential changes in intangible asset values

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associated with changing economic conditions. Regarding the impact of the pandemic on the values of historically transacted intangible assets and goodwill, the considerations and requirements for financial reporting and tax purposes are very different.

A. Book Impairment Testing

For financial reporting valuations of intangible assets, the issues arising from a COVID-19-related decline in business or intangible values is confined to whether any or all of the carrying value of historically acquired intangible assets and goodwill on the company financial statements must be impaired, that is, written down or written off the books. The impairment testing rules for intangibles differ across categories depending on whether they are classified as finite or indefinite lived assets.

The extensive rules and requirements for impairment testing are set out in the relevant accounting standards, Accounting Standards Codification Topics 360 and 350 for finite- and indefinite-lived assets under U.S. GAAP; IAS 36 under international accounting standards; and other local accounting or financial reporting requirements. These rules are all generally similar but may have their own nuances, examples, and guidance.

Assets with finite economic lives are amortized over their remaining useful lives for book purposes. In the context of an impairment, their net book values may have declined sufficiently through amortization so that the risk and amount of any impairment could be limited. For these assets, reviews of their carrying values are generally required only if there has been a "triggering event" that suggests the possibility that an asset has suffered a permanent diminution in value.

On the other hand, goodwill and other indefinite-lived intangibles generally aren't amortized for book purposes (although there is an exception under ASU 2014-02 for private companies). These include some trademarks, trade names, and brands. Instead they are tested for potential impairment annually, unless there is a triggering event that prompts an earlier review (again, with the exception for private companies that have elected to amortize goodwill under the accounting alternative).

Whether a triggering event has occurred is ultimately an accounting determination. The relevant rules consider several factors, including the expected longevity of the financial impact of the event. Stock price declines, forecast revisions, or tax valuations indicating significant value declines are all other potential indicia in this assessment. Once a triggering event is determined, impairment testing ensues.

Impairment testing is performed based on the relevant, discretely measurable business reporting units, units of account, or asset groups. When companies have more than one reporting unit, unit of account, or asset group for impairment testing purposes, interbusiness unit transactions and related transfer pricing may affect impairment testing results and may also need to be reconsidered in light of the change in economic circumstances. For example, the economic downturn could affect the appropriate pricing of product, services, or use of intangibles between reporting units. These should also be recalibrated with the arm's-length standard to correctly delineate the profits and cash flows between reporting units, as necessary. Given the potential effect of intercompany transfer pricing on an impairment testing analysis for financial reporting purposes, it's imperative that a company's controllership and tax department coordinate and align on any impairment testing exercise.

An impairment analysis has multiple steps and considerations, which are not discussed here. The results from these steps are the basis for deciding the amount of any write-down or write-off. When a previously acquired asset has its book value impaired, there are usually associated changes to deferred tax liabilities that may have been set up for the potential unrealized gain represented by the carrying value. Because triggering events are out of the ordinary, by definition, the financial reporting effect of any write-down of assets may be separately disclosed in the financial statements as exceptional or in some cases extraordinary items.

Financial reporting asset impairment discussions likely have been, or will be, going on between company management and financial statement auditors because of the economic effects of the COVID-19 pandemic. Many of the near-term discussions will focus on determining

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whether a triggering event has occurred. Time will tell to what extent asset impairment charges follow.

B. Book Impairment Tax Impact

Financial reporting impairments may have both direct and indirect effects on tax-related values and corporate tax returns. For countries in which tax values and related tax amortization of intangibles are driven from book values, book impairments may also lead to additional tax write-downs. Application of these charges against taxable income is, in essence, an acceleration of the tax benefits from amortization. The effect depends on how quickly the impairment can be used to shelter income in past, current, or future tax years. Within the cohort of countries with coordinated or blended book and tax amortization rules, there are a few remaining countries (for example, Ireland and Singapore) where some intangible assets, such as goodwill or customer relationships, are not amortizable for tax purposes, sometimes despite being taxable if sold in the case of Ireland. Impairments of those assets for financial reporting purposes in those countries will have no tax impact.

In other countries, intangible assets may be subject to separate tax amortization rules, which operate independently of the book accounting. In those countries, a write-down of an intangible asset for financial reporting purposes has no bearing on the tax value of the asset or its amortization for tax purposes. For example, U.S. tax amortization rules are governed by section 197. This section generally allows amortization of most types of acquired intangibles, including acquired goodwill, over 15 years on a straight-line basis (there are some exceptions to this amortization period for specific types of finite-lived intangible assets), and this amortization is unaffected by any related financial statement impairments.

As vital as it is to consider tax and transfer pricing in a financial reporting impairment exercise, it is equally important to consider recent financial reporting impairment studies in any tax-related intangible or business/legal entity valuation exercises. Different business forecasts may have been developed and used for the impairment exercise in comparison with others that may exist and be used in the business for other purposes. Each plan or forecast may reflect different expectations depending on its purpose. In uncertain times, more outcomes may have a higher likelihood of occurring. Therefore, it is important to consider and weigh alternative reference points when performing a transfer pricing or tax valuation.

IV. Ex Post Tax Adjustments

One important difference between valuation for financial reporting purposes and valuation for transfer pricing purposes involves the potential for adjustment to transacted prices based, at least in part, on ex post outcomes. Rules within the U.S. tax regulations and international transfer pricing guidance could affect the valuation of historical intangible transactions. Unlike the financial reporting impairment analysis, which potentially adjusts the current book value of intangible assets but does not change the historical valuation, tax authorities may adjust the historical transaction value and its tax effects in the year of the transaction and subsequent years.

Companies should consider the transfer pricing effect of changes in value on historical transactions. Below, we separately explore the tax considerations for historical intercompany intangibles transactions from the perspectives of the tax authorities and the company. Within these discussions, the reader should note that related issues and opportunities may differ in the short term versus the long term. Our discussion is primarily focused on the United States and countries that follow the 2017 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. Similar considerations may apply in other countries. Care should always be taken to ensure the applicability of your facts and circumstances to specific country rules and practices.

A. Tax Authority Perspective

Most tax authorities generally follow the arm's-length principle and respect the legal form of transactions and structures that have appropriate economic substance. While remaining advocates of the arm's-length standard, however, tax authorities have long been concerned that taxpayers may make

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inappropriate assumptions to yield tax-favorable results when valuing intangible assets. Tax authorities argue that these distortions can be difficult to detect and prove, particularly because audits often happen years after the transaction in question, and because there is a natural information asymmetry between what is known and knowable for taxpayers relative to revenue authorities. Thus, tax authorities have additional tools that may be used to review the historical transaction value of acquired intangible assets, or even the structure of a transaction.

Especially relevant are rules that allow for an ex post review of the transaction, such as those inherent in the commensurate with income (CWI) law for intangibles within section 482, and related periodic adjustments guidance for different assets and methods under the related reg. section 1.482-4(f)(2) and -7(i). Similar guidance is provided in the most recent 2017 OECD guidelines section D.4, "Hard to Value Intangibles" (HTVI), in Chapter VI, "Special Considerations for Intangibles." Ironically, these rules, designed to help tax authorities, introduce their own asymmetries from the transactional risk perspective, which can themselves affect transfer pricing and how taxpayers set up their arrangements.

Generally, tax authorities view significant divergence between projections used in the valuation and actual outcomes as an indication of possible issues with a valuation. The CWI/HTVI rules therefore look to divergence as a trigger for potential adjustment considerations under the auspices of the arm's-length standard. Projections that diverge beyond 80 percent to 120 percent from actual results are generally considered an inflection point, but the U.S. cost-sharing rules also contain different provisions based on a comparison of overall returns with the arrangement for the parties involved.

In both cases, there are several listed exceptions and other considerations that can be applied to counter the applicability of an adjustment based solely on a divergence of ex post actual results. When adjustments are to be made, there are important differences between the U.S. periodic adjustment provisions and the OECD's HTVI guidance on how adjustments will be determined. The U.S. periodic adjustment provisions are based on replacing forecasted results with actuals to determine the valuation adjustment, while the OECD HTVI approach looks to redetermine the historical value by reestablishing the "expected" forecast used in the valuation with weight placed on the actual outcomes. Theoretically, the OECD approach would seem to be more appropriate, while the U.S. approach follows the related U.S. law.

The applicability of the CWI/HTVI approaches and the level of tax authority concern and scrutiny may depend on the characterization of the intangible transaction. For example, intangible transactions with a tax impact, such as cost-sharing-related transactions, transfers, sales, or distributions of intangibles are likely to receive more scrutiny than those with a delayed tax effect. The level of review may also depend on whether the transaction consideration was structured as a sale with fixed payments, or with contingent consideration, in whole or part (for example, as a royalty on sales); contingent arrangements may, at least to some extent, naturally adjust compensation based on actual results depending on the contingency involved. We note that there are special rules for U.S. outbound contributions of intangibles within section 367(d) that provide for annual inclusions of the actual income attributable to the contributed intangible, which effectively make periodic adjustment considerations redundant.

In today's tax environment, detailed tax authority reviews of material intangible transactions are almost inevitable for any open, unaudited tax return year. Tax authorities generally don't have to specifically invoke CWI/HTVI or any other ex post review provisions for adjustments to intangibles in an initial audit. All valuation factors can be scrutinized, and adjustments may be proposed. Tax authority adjustments are more likely to be sustained if taxpayers don't have sufficiently strong support for the transfer pricing or tax valuations they used. This point is highlighted in the discussions within the recently issued IRS "Transfer Pricing FAQ" guidance, echoing the OECD guidelines and guidance from other tax authorities on the benefits of good documentation.

Under the CWI/HTVI provisions, tax authorities can look at and adjust the value of a historical intangible transaction in periods after an initial audit, even if they have not made prior

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adjustments. In some countries, the rules permit the tax authorities to review and amend intangible values and transaction pricing for extended periods in some circumstances. For example, in the United States, the periodic adjustment provisions under the 2009 reg. section 1.482-7 for conforming intangible development cost-sharing arrangements (otherwise not grandfathered) contemplate the potential for tax authority adjustments for up to 15 years after the original transaction date for platform contributions. Other intangible transactions and grandfathered cost-sharing arrangements are subject to periodic adjustment rules in the United States under reg. section 1.482-4(f)(2), which also envisages review periods of several years. In the United States, the CWI provision of section 482 has been in the tax law since 1986 and the periodic adjustment rules of reg. section 1.482-4 since 1994.

To date, there have been no decided directly related U.S. tax court cases in which these elements of the statute and regulations have been specifically litigated. The 2009 cost-sharing reg. section 1.482-7 contains a more formulaic set of periodic adjustment rules. These and the newer OECD HTVI approach remain untested in the courts. However, they could be used in the future, especially given the efforts involved in achieving consensus for the OECD rules, and the pressure heavily indebted governments will likely feel to maximize tax revenues in the aftermath of COVID-19.

One final comment from the tax authority perspective involves the structure of an intercompany intangible transaction. In the United States, a taxpayer's chosen structure (for example, sale versus license, lump sum versus contingent payments) is generally respected if it is in writing, followed by the taxpayer, and has appropriate economic substance and business purpose. This usually leaves the IRS to focus on whether the transfer pricing or valuation of the transaction as structured was consistent with the arm's-length standard; noting some exceptions under which the tax authorities may deem a specific structure or terms as arm's length as in the case of safe harbors, or impose their view of arm's-length behavior, for example, in the case of stock-based compensation inclusions in intangible cost sharing.

Under the OECD HTVI approach, however, there may also be focus on whether the chosen transaction structure is consistent with the form independent parties would choose under similar circumstances. As we discuss in the next section, this may have broader tax consequences for taxpayers.

B. Taxpayer Perspective

Before embarking on a discussion of the nuances of the tax world around intangible valuation and adjustments, it's worth reminding ourselves of some principles that should be kept in mind as taxpayers reassess their transfer pricing and tax valuation positions and options regarding intercompany transactions involving intangibles.

As under more general contract law, taxpayers set out their intended arrangements between related parties for a transaction in their intercompany agreements, whether written, oral, or implied by conduct. While arrangements may be clear from oral or informal agreements or the conduct of the parties in normal times, written agreement terms become essential in determining the rights and obligations of the parties in the face of unusual events, uncertainties, or disputes. Further, in instances involving the ownership, use or exploitation of valuable intangibles, signed written agreements are important to preserve the ability of the legal owners to effectively enforce or protect their intangible assets commercially. They are also a primary method to memorialize the effective timing of the transaction or any changes in rights between parties that require compensation. In short, written agreements are generally recommended for all intercompany arrangements.

While the tax authorities consider the CWI/HTVI rules to be for their use and are skeptical of taxpayer-initiated ex post adjustments to transfer pricing, as we will discuss below in more detail, taxpayers may also choose to adopt similar provisions within their intercompany agreements. When a company can or should review and possibly change the pricing or valuation of an already executed intercompany transaction therefore depends on the terms and conditions in the intercompany agreement.

As a general rule, taxpayers are bound by and will be held (by tax authorities) to the terms and

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conditions of the arrangements that govern the intercompany transaction as set out in their intercompany agreements. This includes the timing of the transaction and changes thereto. Within this framework, taxpayers in some countries and some situations may have a limited amount of flexibility. This flexibility may come from permissible timing for intercompany agreements (and the terms therein) to be determined, from some flexibility in the information to be considered in the valuation, and even from the potential to rescind a transaction altogether under the right conditions.

Preferably, all intercompany agreements should be agreed to and signed concurrently or contemporaneously with the effective date of the arrangement. When there is flexibility for tax purposes, it is preferable that agreements should be signed within the tax year of the transaction. In some instances, however, intercompany agreements involving some types of intangible rights may be validly prepared and signed after the intended start of the arrangement under the related tax rules. For example, the 2009 U.S. cost-sharing regulations allow for execution of a cost-sharing agreement up to 60 days after the start of the arrangement.[1]

In addition to allowance periods set out in regulations, there may be facts and circumstances in which signing and retroactively applying agreement terms into prior years may be considered reasonable conduct consistent with arm's-length dealings and the application of contract law. This may require parties to have acted in a specific way, and evidence of the intent of the parties before or at the stated effective date may well be critical in sustaining longer periods for memorializing arrangements.[2]

Additionally, the agreement of key terms, such as transaction consideration, may be deferred for practical reasons or even specifically permissible under the related tax rules. For example, it may take time to perform required pricing studies or valuations to determine final pricing to show that the related parties are conducting the transaction consistent with the arm's-length principle.

In this case, an intercompany agreement may include "placeholder" provisions for the arm's-length valuation of the transaction and even its compensation structure. Specifically, in the case of a conforming cost-sharing arrangement under the U.S. regulations, participants are required to specify the form of payment for a platform contribution transaction by the earliest due date for a timely filed tax return by one of the parties.[3] Given payment terms are a material element of any transaction price valuation (as well as a determinant of taxable income for a given year), it follows that taxpayers probably have a similar time frame to finalize a related valuation.

We should note that independent parties would be unlikely to consider a transaction agreed to and executed without some acknowledgement of an acceptable range of considerations in advance. Open terms in an agreement, especially material ones, may provide needed flexibility, but they may also be risky and problematic. Therefore, if a delay in finalizing key terms is necessary, many lawyers recommend putting some form of value indication or consideration into the initial agreement to avoid a risk of challenge over when the agreement was really effective, and amending and restating the agreement with the finalized terms and conditions when they are determined.

Making changes retroactively can carry a risk of challenge, especially if they amend a prior agreement, potentially change the sharing of risks and reward between the parties, or cross tax years. A tax authority perspective on such changes can be seen in the analysis and discussion in FSA 200225009, which analyzed a taxpayer fact pattern involving amendments to a cost-sharing arrangement (entered into and relating to years before the 2009 changes to those regulations) that were retroactively applied to the arrangement from its inception in prior years. While not law or precedent, this FSA gives a sense of the burden taxpayers have to make their case.

In terms of the information considered in a valuation, the general rule is that transaction

[1] Reg. section 1.487-7(k)(1)(ii).

[2] *See United States Mineral Products Company v. Commissioner*, 52 T.C. 177 (1969); and *Myron C. Poole and Marjory S. Poole v. Commissioner*, 46 T.C. 392 (1966).

[3] Reg. section 1.487-7(h)(2)(iii).

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values should take into account relevant information (known or reasonably knowable) up to the transaction date. For U.S. tax purposes, they may also take into consideration information available to the taxpayer after the transaction date, both during the tax year[4] and even up to the date of the tax return — arguably, as part of best efforts of a taxpayer to comply with the commensurate with income standard for intangibles under section 482.

Interestingly, taxpayers in the United States may also be able to completely rescind transactions and treat them as never occurring under principles established through contract and common law, and even IRS guidance (Rev. Rul. 80-58, 1980-1 C.B. 181). This is possible if specific requirements are met, such as execution of the rescission document by the parties within the same tax year as the original transaction and the restoration of the parties to their pre-transaction positions. We note that it's unclear whether a similar transaction entered into after a rescission would be acceptable, say, if it was just redone at a different price.

In light of this potential flexibility, the definition of ex post regarding a transaction might reasonably be thought of as contemporaneous with the tax year or even tax return filing date for some intercompany transactions. Much of the precedent in this area is from court cases that form a body of common law. What is possible or permissible can therefore differ among states, countries, and venues. Thus, due care and consideration must be taken, and taxpayers must act rationally and reasonably from both sides of the transaction (and document the same), have sufficient substance, and follow any agreement terms they do in fact make for themselves.

Looking beyond the period immediately around the initial transaction date and the filing of tax returns, taxpayers can agree to their own review and periodic adjustment clauses within the terms and conditions of their agreements. Many companies expressly include general periodic review and adjustment terms for the transfer pricing of transactions within their intercompany agreements, and it is helpful if these or similar provisions can be observed in arm's-length dealings. As mentioned previously, it is also relatively common to see the U.S. periodic adjustment rules directly referenced and incorporated into intercompany intangible transfer or cost-sharing-related agreements. This provides some level of symmetry between the parties regarding the tax rules that also govern the transaction — noting that there may be different tax rules on both sides of the transaction. Importantly, in both cases, adoption of such terms in intercompany agreements also obligates the parties to perform periodic reviews and follow those rules (and exceptions) and adjust consideration, as necessary, in the ordinary course of the arrangements, not just when it may benefit them. Thus, taxpayers should carefully weigh the pros and cons including such terms.

When reference is made to the periodic adjustment rules, the related exceptions could apply unless expressly excluded. These exceptions and considerations include allowances for what are considered acceptable levels of variation between forecasts and actual outcomes (for example, 20 percent variation tests) and limitations to making adjustments in initial years after a transaction, or a long time after the transaction, among others. In the current environment, there is also a specific exception if the variation in results is attributable to a subsequent extraordinary event that was unforeseen or unforeseeable at the time of the transaction. This exception is directly applicable to transactions that were executed (and priced) before and the potential economic effects of the COVID-19 pandemic were known.

For more recently executed intercompany intangible transactions, a strong record of what was known or knowable as of the valuation date will be important for taxpayers looking to sustain their pricing positions. For intangible transactions entered into since the onset of the COVID-19 pandemic, the extraordinary events exemption does not apply to COVID-19, and valuations will need to expressly account for the pandemic. It also raises a question about future events or uncertainties that would be reasonably unforeseen or unforeseeable in a potentially volatile and uncertain economic future. One event that might well rise to that level might be the

[4] For example, cost-sharing transactions under reg. section 1.482-7(e)(1)(i).

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discovery of a viable and effective antidote or vaccine to COVID-19.

As mentioned, another mechanism to mitigate ex post adjustment risk or outcome uncertainty is through the transaction structure and the use of contingent consideration. This is already common in some industries and transactions. For example, we see this in transactions of pharmaceutical intangibles during the clinical trials phase, in which combinations of fixed milestone payments and royalties are common, although other transaction structures are also observed in that industry.

The prevalence of contingent arrangements might increase in the face of increased economic uncertainty. However, full or partial contingent consideration terms are neither a rule in times of uncertainty, nor an exception in times of stability, and we observe many different forms of consideration agreed on between independent parties under different economic circumstances. It should be noted that there are also restrictions on the use of transfer pricing to reduce income other than on a timely filed tax return (for example, in an amended return), so taxpayer periodic review and adjustment terms in an intercompany agreement also should consider the timing and recognition of any periodic adjustments.

We note that contingent arrangements may not be possible or desirable for tax reasons because they carry a risk of changing the tax character of a transaction (for example, from a sale to a license) with associated secondary tax and customs consequences. Further, some transaction types — such as contributions, distributions, or those that result in a step-up in basis of the intangible because of some other event or election — may require a single point fair market valuation of the related intangible.

Finally, we consider situations in which a taxpayer may be required to change a previously executed transaction outside its contractual terms. Much like the tax authorities, under the appropriate facts and circumstances, a taxpayer may reasonably conclude after executing a transaction that the transaction lacks sufficient economic substance for its legal form, and an adjustment is required to reliably reflect income in its tax returns. While unusual, an example of this might be when an intangible transaction also required an operational reorganization to provide the managerial substance to support it, and because of the pandemic, these operational changes were not made or were far more limited.

In the context of the post-BEPS OECD guidelines, a similar example of that might be when the development, enhancement, maintenance, protection, and exploitation activities related to the intangibles are insufficient to support the transacted value for the intangibles. In this instance, under the OECD guidelines, the legal owner would only be eligible to earn a risk-free rate of return, or presumably, pay an equivalently adjusted amount to acquire such restricted income earning rights. We note that these may well be untested principles when used proactively by taxpayers and should be contemplated with due caution and legal advice based on the facts and circumstances.

V. Valuation Considerations

We now look more closely at the types of issues that arise when valuing intangibles after the COVID-19 outbreak.

In general (keeping in mind the discussion above), valuations should be prepared using appropriate methods and with the best ex ante information known or knowable at the time of the transaction and valuation. While this is true of any intangible valuation at any time, the effect of the COVID-19 pandemic will necessitate an additional degree of rigor and documentation to satisfy interested parties such as financial statement auditors, return preparers, and tax administrations.

All aspects of an intangible valuation may be affected by increased levels of uncertainty, including factors related to the type of intangible, the industry it is in, the valuation method selection, corroboration, financial forecasts, market benchmarks, and discount rates. The relative reliability of methods may well have changed; reasonable expectations of outcomes have likely become much wider; and applying different methods may yield more divergent results that make corroboration more difficult. All those factors now make determination of point values and even contingent consideration for intangibles much more nuanced. Some issues relevant to the various valuation inputs are discussed below.

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A. Liquidity

The liquidity of any market is key to the value of assets traded in it, and values may vary depending on how long a seller is willing to wait to do a deal. Cash constraints for companies and other market participants may affect transaction frequency, value, and payment terms. Adjustments for liquidity and its effect on valuation are generally inherent within external transactions (like acquisitions) that involve the same intangible. In many instances, illiquidity may be adequately addressed in other aspects of the valuation without need for a specific adjustment. For valuations of transactions without a direct-market analogue or those that are subject to fair-value or market-value considerations, however, there may be an increased need to consider potential market illiquidity in the analysis.

B. Methods

Valuation standards and transfer pricing rules require consideration of the relative reliability of available valuation methods, which include applications of the market, income, or replacement cost approaches depending on the applicable rules. The reliability of the approaches and methods thereunder may be affected differently by the COVID-19 crisis.

Market-based methods, while preferred in many countries, will often be less reliable in periods of dislocation if they rely on data observed or measured from transactions and other indirect market measures preceding the pandemic. Transactional benchmarks may not reflect current market conditions or profit potential. For example, when an independent transaction price is determined before the COVID-19 emergence, but a related intercompany transaction closes afterward, the independent transaction value may not be directly comparable with the value of an intercompany transaction conceived and executed post-COVID-19 even for the same intangible. Further, indirect market methods such as market multiples or market capitalization analyses are of more limited reliability now because increased volatility in financial markets indicate that the markets may not be pricing rationally based on long-term expectations.

Income-based methods have the advantage of being more adaptable to differences in intangibles and markets by attempting to measure the worth of the intangible based on the expected income from its exploitation. Income-based methods are also consistent with the application of the CWI/HTVI approaches for tax. Under an income-based method, an intangible asset's value today equals the future cash flows it is expected to generate, discounted to present value at a discount rate that considers the relative risk of achieving those cash flows and the time value of money. This axiom should still hold during this period of uncertainty, although estimating the key valuation inputs may require relatively more effort and professional judgment, as we discuss below.

Cost methods are usually considered methods of last resort, but replacement cost (which includes consideration of lost income during the replacement period) or return-on-investment measures remain valid reference points for early-stage, non-core, or component intangibles when market or income-based methods are difficult to apply reliably.

C. Projections

Opinions of value developed through the appraisal process either directly or implicitly include projections of future outcomes, which cannot be known with certainty. There are several common methods applied in more usual circumstances to develop and assess the reliability of financial projections. These include analysis of actual historical results, audits of prior period forecasts, research and reconciliation to research analysts' expectations for the company and industry, competitor and implied market share analyses, and bottom-up reviews of the individual drivers (for example, pricing, units of production against capacity constraints, fixed and variable costs, etc.) to name a few. For publicly traded companies, a market capitalization reconciliation analysis is often an additional tool to assess the reasonableness of financial projections (and corresponding discount rates, discussed below, and overall conclusions) during more stable periods. While still valuable analyses, these might not be as reliable as they once were.

Traditional tools and techniques to develop projections may be less effective in the current

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environment. For many businesses, there is a good chance that previous years are not good indicators of what to expect for 2020 and beyond. Management is less confident amid the COVID-19 pandemic, and analysts who study companies and industries are also uncertain. Everyone is learning how to interpret and incorporate the new information and developments that the pandemic has brought.

Where does that leave us? The common approach of developing a deterministic model in which a single set of inputs form the basis for the projections is not ideal. Instead, forecasters could combine the more traditional methods with a process that first identifies and characterizes the key uncertainties and then develops scenarios around them. Under these extraordinary circumstances, we believe that a scenario-based approach is a best practice, especially for industries that are more heavily affected. A scenario-based approach would allow company management to break down the challenge in preparing projections in the current environment by thinking through various circumstances, assumptions, and underlying inputs under a few discrete scenarios. In preparing scenarios, some key areas to consider may include the following:

- customer demand, pricing, and diversification;
- supply chain diversification and disruptions, including increased costs from the relocation of operations or a need to replace suppliers;
- the company's industry and location;
- competitors' activities;
- government and central bank measures;
- workforce disruptions;
- credit downgrades and covenant breaches;
- GDP growth, projections, and outlook; and
- interest rate and foreign exchange rate fluctuations.

A primary goal of the scenario analysis should be to help address the valuation uncertainty around market disruption and availability of reliable inputs because of COVID-19. While this involves developing reasonable possible outcomes based on ranges of possible alternative inputs that consider the current and longer-term effects of COVID-19, it does not necessarily require identifying the far tails of the distribution of outcomes, which result from reasonably unforeseen circumstances.

Further, because the period and shape of the eventual recovery are as yet unknown, scenarios should vary in these elements. These scenarios can be informed by current models developed by health and economic organizations as well as real-time research and analysis provided by consulting organizations. For example, as the COVID-19 crisis evolves, Duff & Phelps's Kroll Division prepares a COVID-19 Index, which provides snapshots of forecasted economic effects of the pandemic and government pandemic-related restrictions across multiple geographies and sectors, and usefully references many key independent sources.

While it involves an additional level of rigor, incorporating scenario analysis provides some advantages. Under the OECD HTVI approach, reasonable upside or downside scenarios allow taxpayers to demonstrate that the projections applied to value the intangibles appropriately reflected what was reasonably known or knowable as of the valuation date. This is particularly important if the intangible value is subject to scrutiny after the resolution of key uncertainties. As discussed, the U.S. periodic adjustment provisions apply more of a bright-line test against actual results, but if scenarios and associated probabilities are appropriately considered, this lowers the likelihood that probability-weighted projections will fall outside the safe harbor range around actual results. Further, if they do vary by a significant amount, it is more likely attributable to extraordinary events that could not be reasonably anticipated.

D. Discount Rates

In a valuation analysis, the discount rate reflects an investor's required return for taking on the relative risks of the investment and the time value of money. From a financial perspective, risk can be distilled down into the level of variation in amount and timing, and investors are primarily concerned with downside risk (that is, that they will receive less than expected or they will receive return on their investments later than expected). The discount rate reflects the current price of financial risk based on expectations as of the valuation date.

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Even with a more rigorous process that results in probability-weighted financial projections, the current COVID-19 environment presents higher hurdles to developing appropriate discount rates. As during the economic crisis in 2008-2009, the traditional methods typically used to develop discount rates, including cost of capital measures, are once again subject to significant estimation and data input challenges. For example, the equity risk premium (ERP) is a key input used to calculate the cost of equity capital, and Duff & Phelps regularly reviews fluctuations in economic and financial market conditions that warrant a periodic reassessment of a normalized long-term ERP.

Equity volatility measures are at levels last seen during the 2008 global financial crisis. Corporate credit spreads have also surged. In the meantime, projections for global economic growth have deteriorated significantly, with many economists predicting a global economic recession for 2020 and beyond. Thus, effective March 25, Duff & Phelps increased its recommended U.S. ERP from 5 to 6 percent, to be used in conjunction with a normalized, risk-free rate of 3 percent and 2.5 percent for valuation dates before and after June 30, 2020, respectively. Industry-, company-, transaction-, and asset-specific factors will also weigh on the development of discount rates for intangibles.

A change to the ERP is certainly not the only change to inputs recommended during the crisis. Valuation professionals performing intangible valuations for tax purposes should consider and separately identify and document adjustments made specifically regarding the uncertain effects of the COVID-19 pandemic, which must be quantified with care and support.

E. Corroboration

While not required under prevailing U.S. regulatory and OECD guidance, the use of multiple valuation approaches and methods in the current environment is recommended when available and reliable. Similarly, within the application of individual methods, it's even more important to perform sensitivity analyses. These supplemental analyses can be used to derive alternate indications of value, corroborate the results from a primary method, or provide guidance on the extent or range of potentially reasonable values. When multiple methods are performed, it is important to establish and document a clear process to analyze and interpret the value indications in arriving at a valuation conclusion, including any significant limitations.

VI. Conclusion

The economic crisis spawned by the COVID-19 pandemic has likely materially changed the value of business intangibles or could cause them to have depressed values for some time. These changes in value create issues and opportunities. Impairments of the book-carrying values of intangibles for financial reporting purposes may be needed, with associated tax accounting and collateral tax amortization consequences in some countries.

The changes may also create tension and controversy around the value of historical intangible transactions for tax purposes, and we recommend companies consider their valuation support to assess whether it is adequate to support the valuation at that time. For companies that engaged in intercompany intangible transactions more recently, there may be opportunities or even a requirement to review the pricing of those transactions and potentially make adjustments. In some cases, it may even be possible to rescind them entirely.

Changes in business operations generally resulting from the pandemic, and in intangible value, may mean that optimal future operational structures have changed. Transactions with exit costs caused by high business or intangible values that are an issue may be relatively more attractive, and this might be an opportune moment to reorganize or clean up structures. Intangible transactions may also be used to release trapped tax attributes (capital losses or foreign tax credits) that reduce cash taxes or create cash flow.

Despite current uncertainties and even ex post review tax rules, reliable and supportable valuations of intangibles can still be performed by applying valuation best practices; they just take more care, effort, experience, and judgment, which should be shown and documented. ■

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