IP Valuation in Practice &
IP Valuation for Transfer Pricing
Budapest 2008

*connectedthinking

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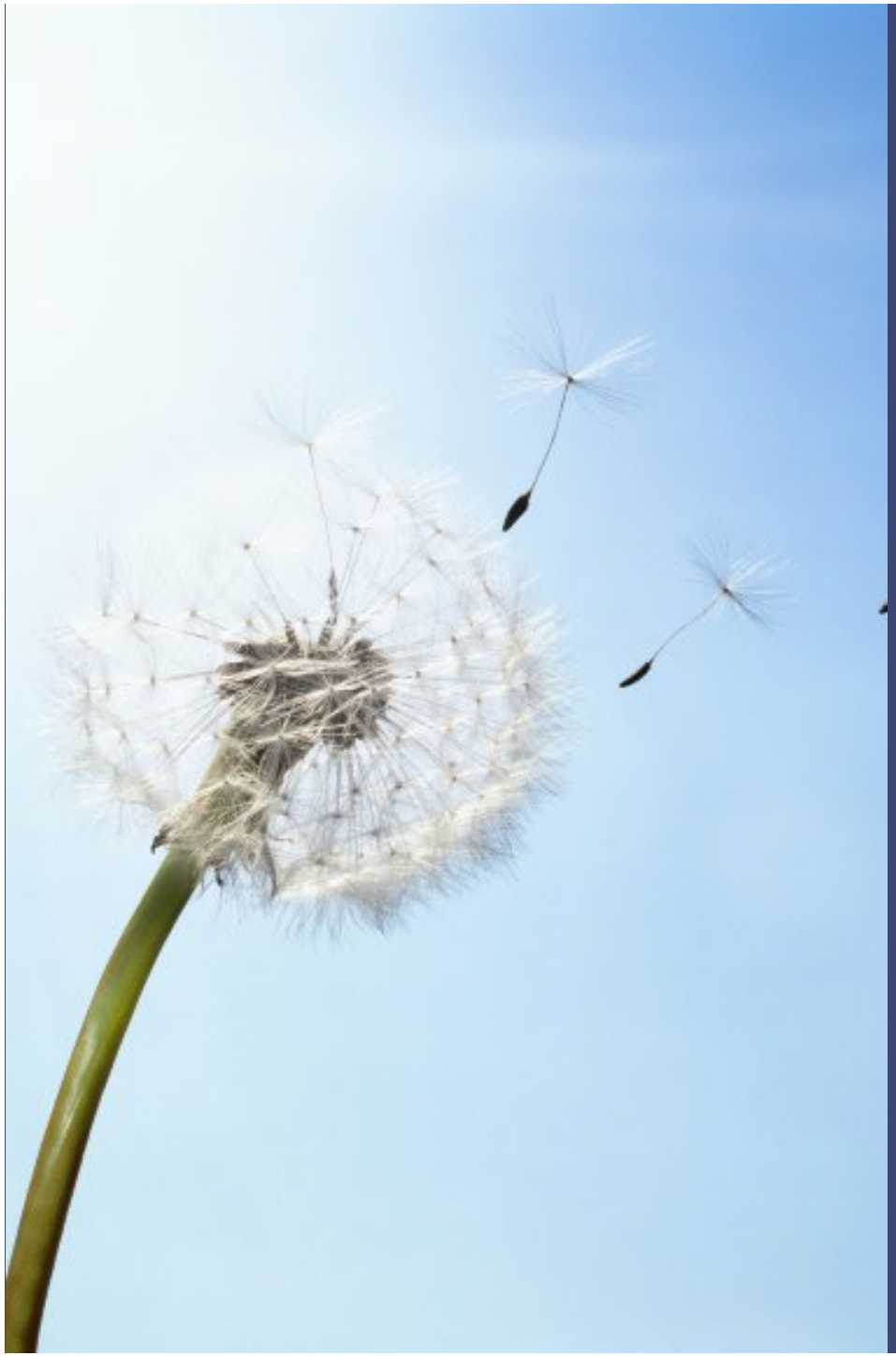


Part 1

Introduction

Transfer Pricing

What is Transfer Pricing?

Rules for determining taxable profits (losses) of a company in an specific country which is trading with another company, in the same or different country, when both companies are members of the same Group.

Why?

Countries need to reconcile their legitimate right to tax the profits of a company (taxpayer) based upon income and expenses that can reasonably be considered to arise within their territory.

Transfer Pricing in Hungary

Hungarian regulation on transfer pricing requires taxpayers to prepare transfer pricing documentation providing evidence that their intercompany transactions were done at market value 5 months after the end of the taxpayer's financial year. (Section 18 of the *Corporate and Dividend Tax Act & Decree No. 18/2003 of the Ministry of Finance).*

Transfer pricing documentation does not need to be filed but should be available in a course of a tax audit.

Hungarian TP rules follow OECD guidelines.

Transfer Pricing & Intellectual Property

- Transfer Pricing apply to transactions involving the transfer of assets – tangible & intangible.
- IP is an intangible asset.
- Types of IP:
  - Patents
  - Trademarks, trade names, brand names
  - Copyrights and design rights (including film and computer software)
  - Goodwill
  - Know-how
  - Customer lists, distribution networks

Transfer Pricing, IP & Valuation

- As IP is unique for determining the market value - fair value of them Transfer Pricing rely on the valuation of such assets.
- Why is IP valuable?
  - Provide a barrier to entry
  - Differentiate products (even commodities)
  - Provide a more stable and profitable earnings stream
  - Have a long life (e.g. brands, trademarks)
  - Provide international recognition
  - Leverage into new geographic or product markets

Fair value concept

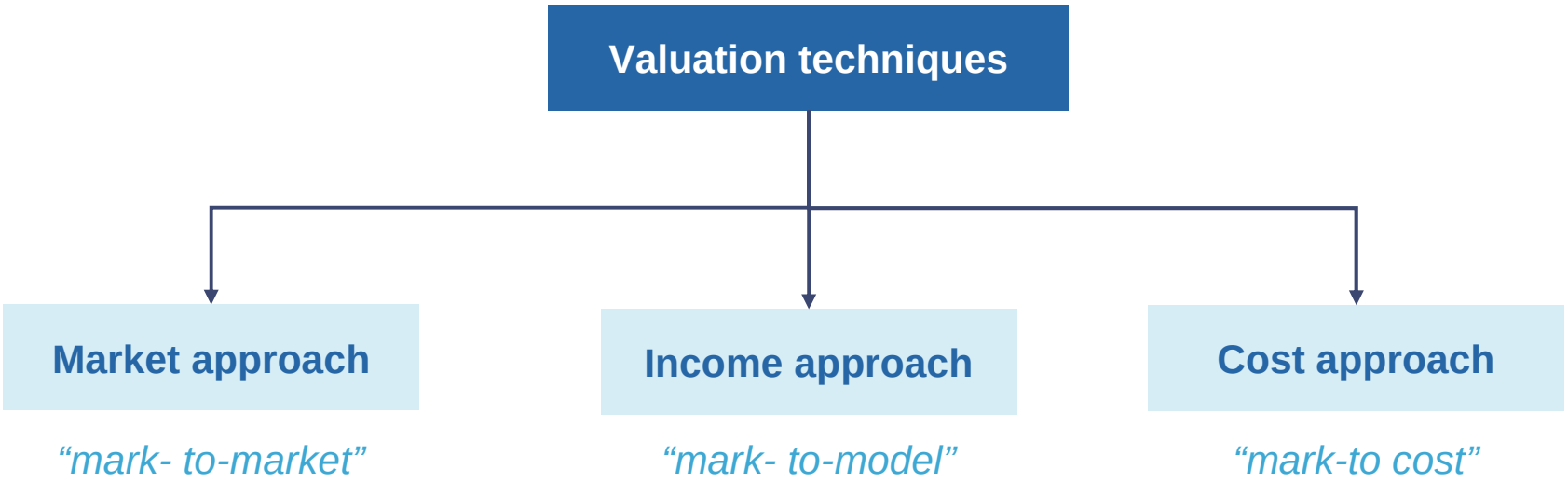
Fair value

"**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."

market- based measurement

Source: FAS 157. 5; Similar: ED IFRS 3 Appendix E

Overview on valuation techniques



Apply most appropriate method considering economic benefits and valuation inputs available

Fair value of the respective asset or liability

Part 2

Cost approach

Premise of value

"An investor will pay no more for an asset than the cost to purchase or construct an asset of equal utility!"

Components of cost

Typical components of all cost approaches are:

Cash cost	Opportunity cost
Material	Developer's profit
Labor	Entrepreneurial incentive
Overhead	

All these cost components should be considered in an appraisal

Cost approach

Cost approach valuation methods

Reproduction cost method

"cost to construct an exact duplicate"

Using same materials, production standards, design ...

Replacement cost method

"cost to construct equivalent utility"

Using modern materials, production standards, design ...

Derived fair value from these methods should be the same!

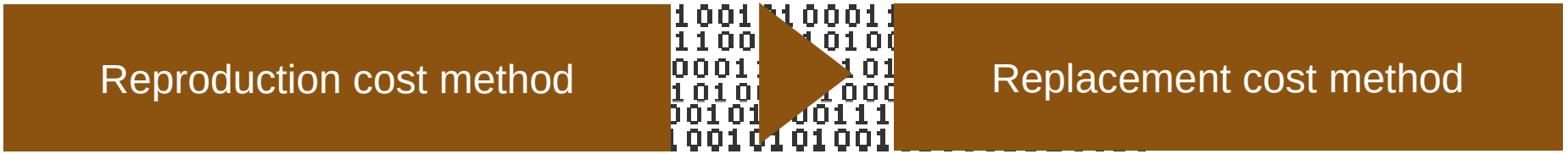
From cost to value

Cost approach provides a reasonable indication of value when all components of cost are included and all forms of obsolescence are considered

	Reproduction cost (new)
-	Curable functional and technological obsolescence
=	Replacement cost (new)
-	Physical deterioration
-	Economic obsolescence (external)
-	Incurable functional and technological obsolescence
=	**Value of intangible (used) asset**

Example: Reproduction versus replacement cost

A company has a software written in the programming language Cobol.
PwC was asked today to estimate the value of the software.



Consider all cost to reproduce the software based on the programming language ***Cobol***

− Curable Obsolescence =

Consider all cost to replace the software based on the programming language ***C++***

Intangible asset obsolescence

Forms of obsolescence

Physical	Functional	Technological	Economic (external)
Due to physical wear and tear resulting from continued use	Inability to perform the function for which it was originally designed	Due to improvements in technology	Effects, events, or conditions, that are not controlled by the current use or condition of the asset

Identifying and estimating obsolescence is crucial

Part 3

Market approach

Premise of value

"Prices from previous transactions provide empirical evidence for the value of an intangible asset"

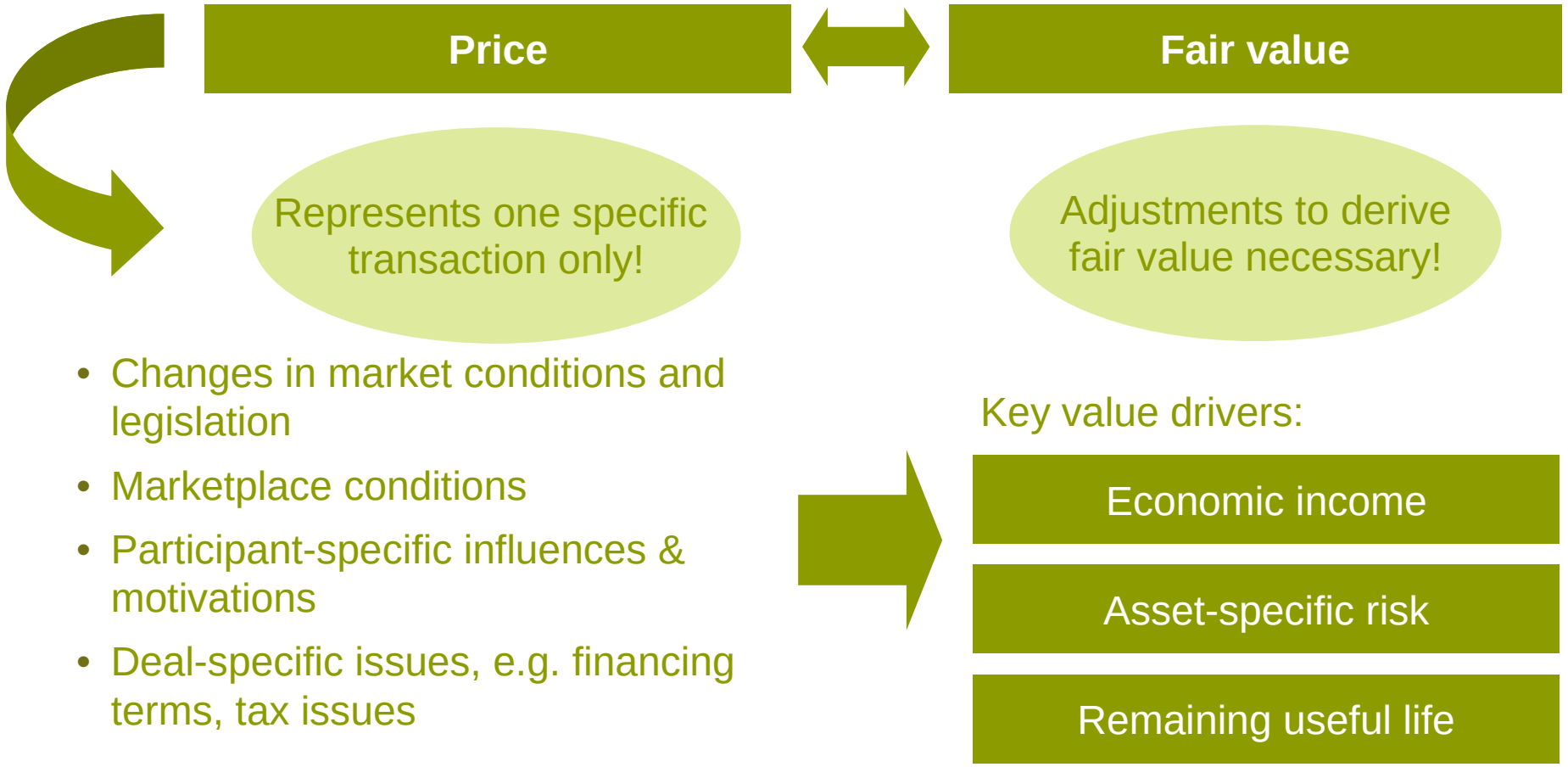
Multiples

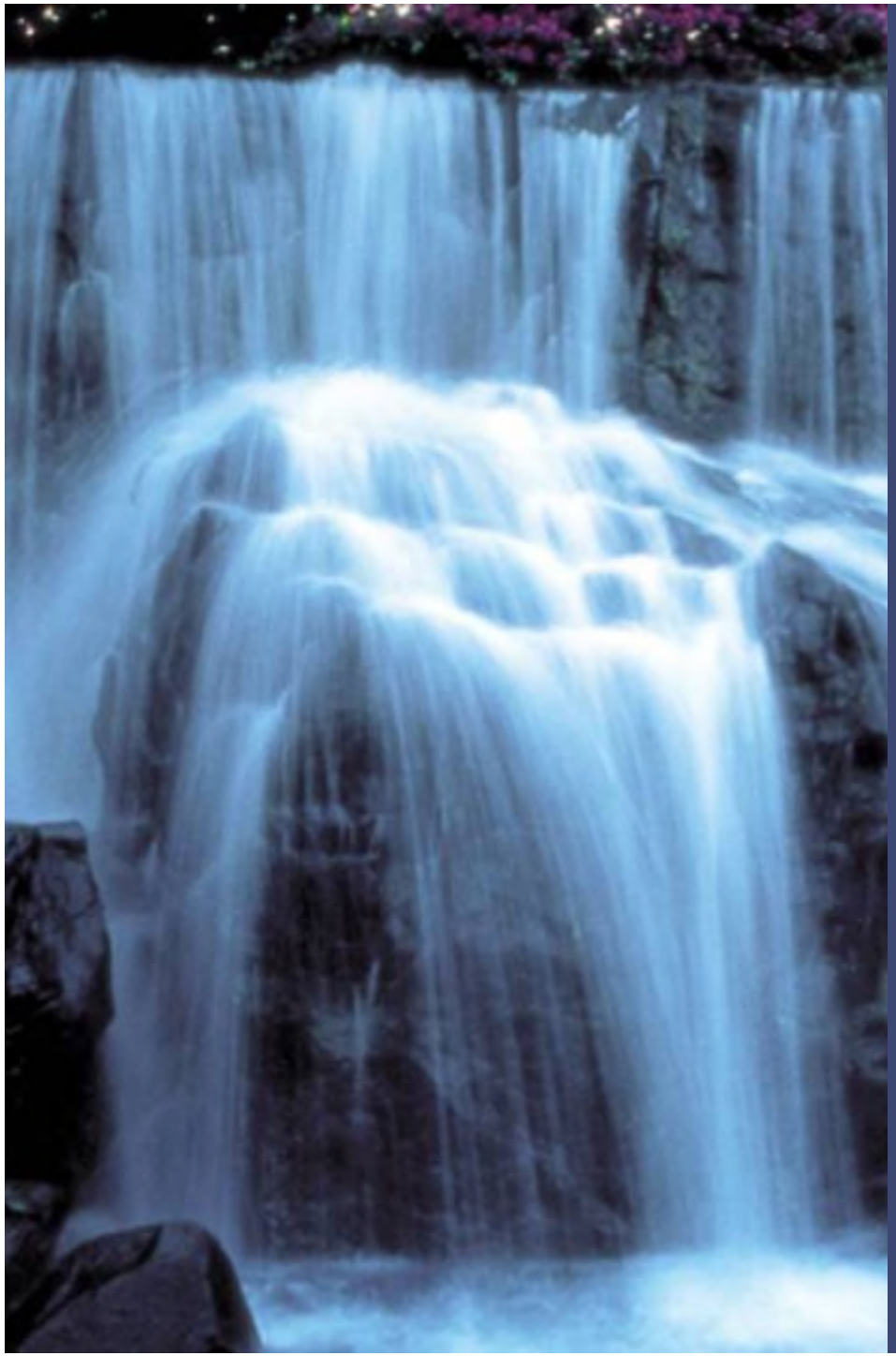
Multiples can be used for valuation of individual asset

Factors influencing subject asset	x	$\frac{\text{Value of comparable asset}}{\text{Factors influencing comparable asset}}$	=	Value of subject asset
Tons of pollutants allowed	x	Value per ton of pollutants emitted	=	Value of emission right
Number of customers	x	Value per customer	=	Value of customer list

Analyse **similar** intangible assets that have **recently been sold** and compare these intangible assets to the subject asset.

Market approach





Part 4

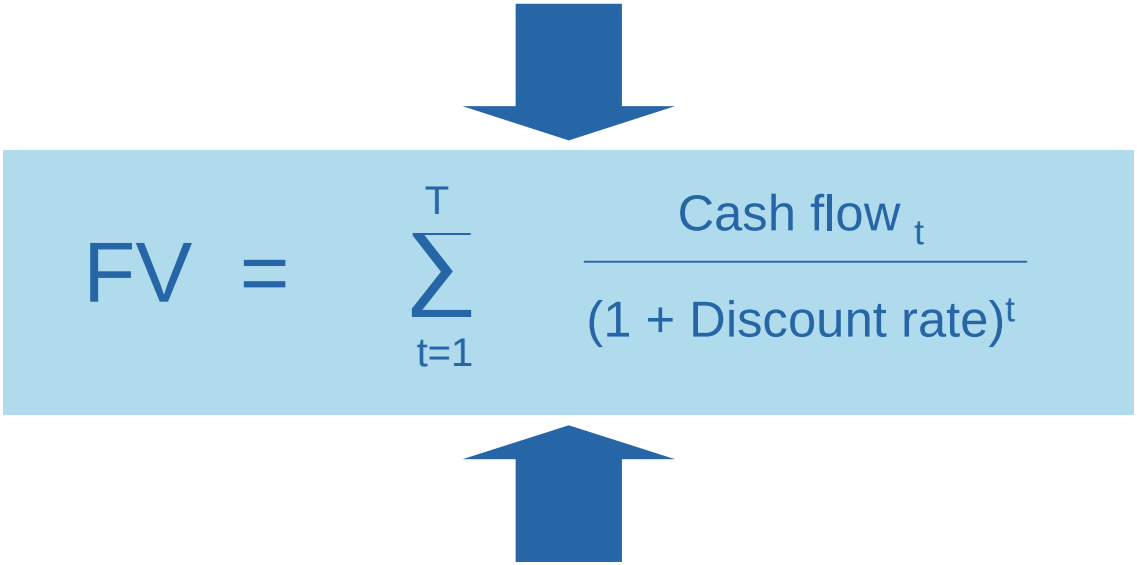
Income approach
Valuation principles

Valuation principles
Premise of value

“An intangible asset is worth what it can earn!”

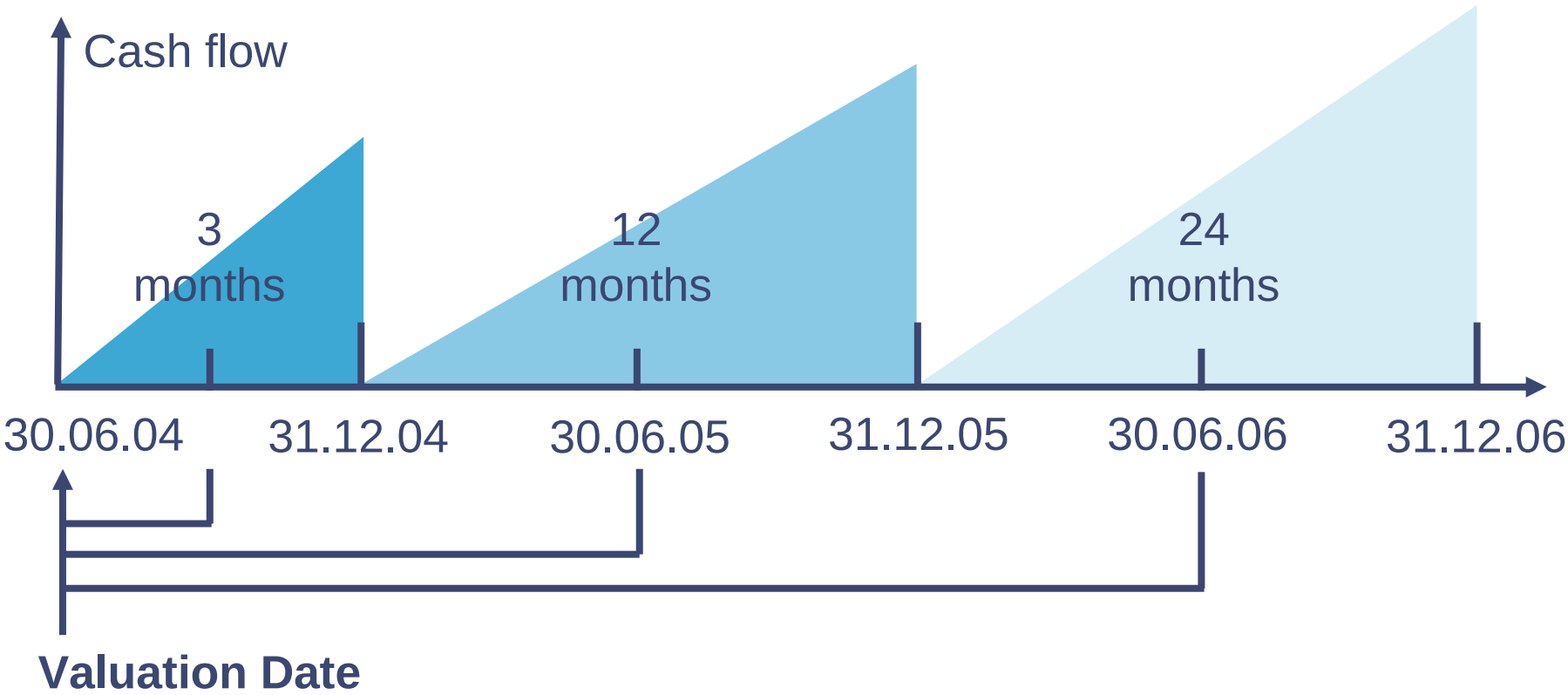
Valuation principles

1. Isolate the future cash flows an investor would expect the subject intangible asset to generate



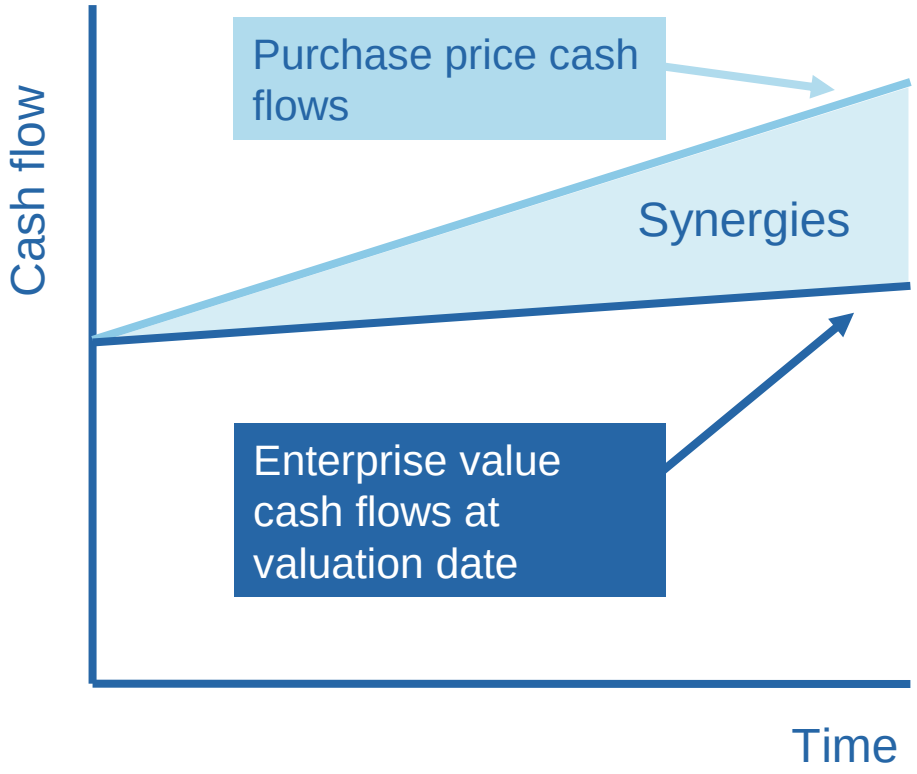
2. Discount future cash flows with an appropriate discount rate

Valuation principles
Mid-year discounting



Simplifying assumption: Continuous cash flows during the year

Valuation principles
Selecting prospective financial information



Choose most appropriate prospective financial information

AND

Eliminate any acquirer specific synergies

AND

adjust projections such that assumptions are consistent with those of market participants

Part 5

Cost of capital

Cost of capital
Company WACC

$$WACC = r_E \times \frac{E}{E + D} + r_D \times (1 - t) \times \frac{D}{E + D}$$

Risk-free rate, market-risk premium and underlying index used for beta regression should correspond.

Determinants of the WACC calculation should be derived from peer group.

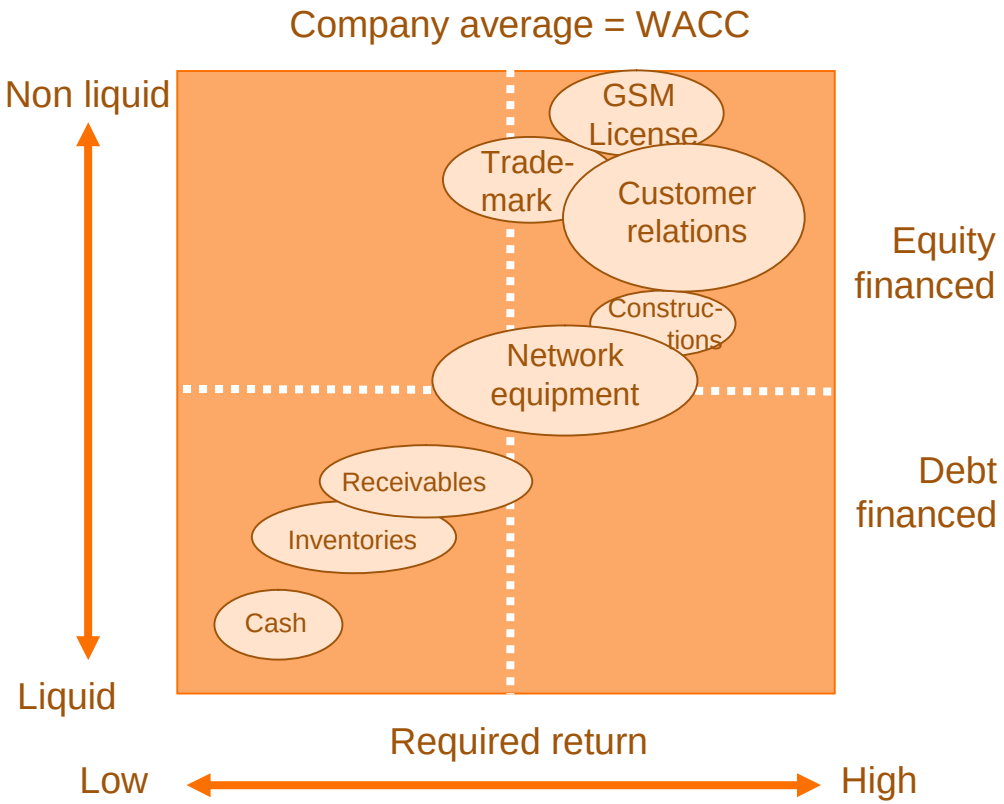
Apply interest rate from hypothetical buyer (e.g. YTM of corporate bonds).

One index for the whole peer group.

Take the perspective of a hypothetical buyer!

Cost of capital
Return on individual assets

- The view of a business as portfolio of several individual assets and liabilities is reflected by the requirement of fair value measurement.
- Fair value measurement of all assets (including intangibles), liabilities and contingent liabilities closes the gap between business enterprise valuation and the measurement of the business' components.
- By considering all assets, the rate of return of each individual asset should reconcile to the rate of return of the business.



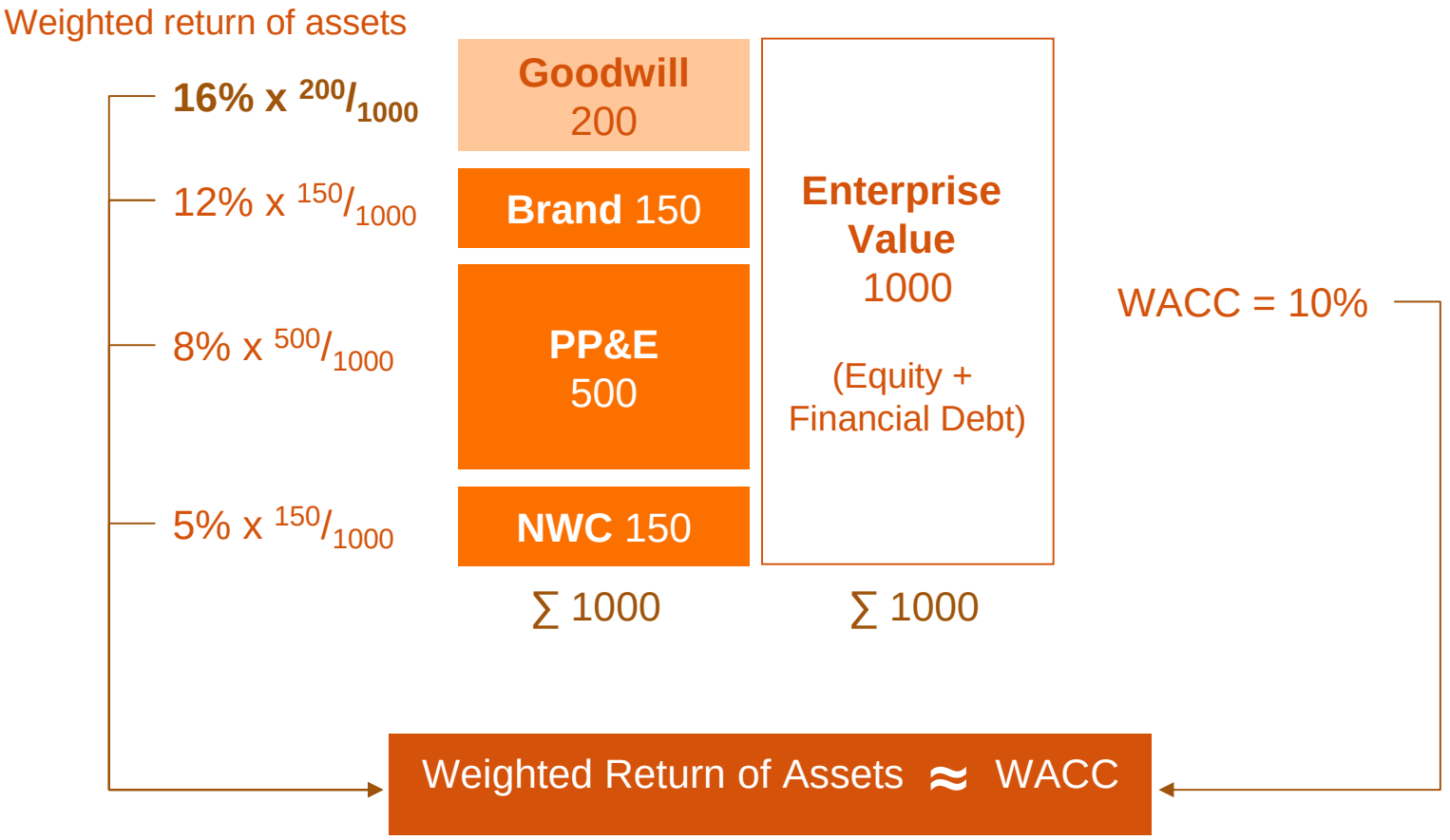
Source: Smith, Parr – Valuation of Intellectual Property, 3rd edition

Cost of capital
Typical rates of return on subject assets*

Working capital	Short-term lending rates for market participants
Fixed assets (for example PP&E)	Financing rate for similar assets for market participants (e.g. terms offered by vendor financing), or rates implied by leases
Workforce, **customer lists**, **trademarks**, and **trade names**	Weighted average cost of capital (WACC) for young, single-product companies
Patents	In cases where risk of realizing economic value of patent is close to as risk of realizing a project, rates would be equivalent to that of the project
Other intangibles, including base (or core) **technology**	Rates appropriate to the risk of the subject intangible

* from the perspective of a hypothetical buyer; AICPA Practice Aid IPR&D 5.3.64

Cost of capital
Reasonability – WACC reconciliation



Part 6

Why IP is relevant to TP issues

Transfer Pricing OECD

OECD members follow the “functionally separate entity” approach in order to determine taxable profits between related companies.

Following Transfer Pricing rules the estimation of the profits (or losses) of related companies is done by comparing uncontrolled transactions or profit made by unrelated companies considering the functions performed, risk assumed and assets owned.

OECD give particular attention to “significant functions” relevant to the assumption and/or management (subsequent to the transfer) of risks performed by people working in the specific company as well as the economic ownership of assets.

Ownership

- Legal
  - Legal term defined in contract law
  - Can be protected from infringement (e.g. patents, copyrights)
  - Title to the IP will be registered in the name of the legal owner
- Beneficial
  - Able to benefit from the assets and any income stream created by those assets
  - It is possible to have both legal and beneficial ownership; however, beneficial ownership may be easily transferred without change in legal ownership
- Economic
  - OECD definition
  - Able to exploit and develop the IP but without having the legal ownership

Utilisation

- IP can be utilised in different ways within a group:
  - Centralised ownership
  - Licensing
    - Need to determine a royalty
  - Cost sharing
    - May need to determine value of pre-existing IP for buy-in payments (or buy-out)
  - Transfer of ownership
    - Need to determine value of IP to determine arm's length remuneration

Thank you

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