Valuing intangibles – a tax perspective

Large Corporate | Tax voice



16 May 2018

Alex Haigh outlines the lessons to be learnt from the recent US case involving Amazon.com

On 1 July 2018, the OECD's new Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (BEPS) will come into effect. This represents a collective effort by Governments in the OECD to reduce opportunities for tax avoidance by multinational enterprises who might have previously sought to transfer assets to low-tax jurisdictions. While it has been signed

by 78 jurisdictions, initially, it will take effect in just the Isle of Man, Austria, Jersey, Poland and Slovenia which have each already completed their domestic ratification processes at the time of writing. The remaining 73 signatories, plus a handful of other jurisdictions which have expressed their intent to sign the convention, are expected to complete the ratification processes required by their respective domestic legal frameworks in the near future. As a result, it is essential that multinational enterprises take appropriate action to ensure that future transactions comply with the BEPS rules.

Pricing of intangibles

One area that can pose a significant risk to organisations is the pricing of intangible assets. Since they are often unique in their characteristics, lack an open and liquid re-sale market and cannot physically be touched or handled, they are often particularly difficult to value. As a result, a company's internal pricing for intangible assets can be disputed by tax authorities

Consequently, multinational enterprises are required to use a reasonable process to fairly assess the value of intangible assets when they are transferred between associated subsidiaries. Increasingly, tax officials are working to ensure that tax rules in this area reflect the best commercial practice. This means that while brand valuation was formerly the primary domain of marketing and M&A departments, in the future, brand valuation will be an important shared task for the whole company, including marketing, finance, tax, C-Suite and even right up to Non-Execs through audit committees.

Amazon.com Inc

One landmark case from last year on how to do this is from the US Tax Court, *Amazon.com, Inc. v. Commissioner 148 T.C. 8 (2017)*, which offers great clarity from that jurisdiction on how to best comply with transfer pricing regulations. While this case was decided under existing American tax law (before the introduction of the new BEPS rules) many of the principles are likely to be instructive and informative for considering similar cases in the future.

This case centred on a dispute over Amazon's tax bill in conjunction with the transfer of various intangible assets from Amazon US (and, to a lesser extent, former Amazon operations in the UK, France and Germany) to a single European subsidiary

established in Luxembourg. Taking place in 2004, it revolves around the valuation of the rights to the Amazon brand and technology in Europe, more than a decade before it became the world's most valuable brand according to Brand Finance research.

Initially, the IRS argued that Amazon had placed a very low valuation on the assets concerned. These internal valuations determined that its European operations should make a "buy-in payment" of US$254.5 million over seven years to its American operations. After conducting an audit, the IRS disagreed with this valuation for a variety of reasons, and the IRS provided a significantly higher valuation of the transferred assets. In creating that valuation, the IRS initially found that the assets should be valued at approximately US$3.6 billion (subsequently reduced to US$3.468 billion).

In this case, Brand Finance and fellow expert witnesses provided by both Amazon and the IRS, agreed that the best process to find a fair and accurate valuation of the brand was to use a royalty relief methodology. This method was used to account for the transfer of the existing brands from the pre-existing European subsidiaries to Luxembourg, and to also account for the partial transfer of brands from Amazon US to Luxembourg. As explained above, the expert witnesses in this case needed to use this valuation process because there was obviously no liquid pre-existing market for the Amazon brand, and thus, the court needed to apply a methodology that was fair, reasonable and reflected best commercial practice.

While the tax court broadly found in favour of the royalty relief methodology following the precedent set by *Veritas Software Corp. v. Commissioner, 133 T.C. 297 (2009)*, it disagreed substantially with many of the assumptions and valuations that underpinned Amazon's initial valuation, resulting in the court finding valuations much above Amazon's assessments. Thus, while Amazon won the headlines, with much news reporting focusing on the Court's finding that the valuation technique used by the IRS was "arbitrary, capricious, and unreasonable", the court did find that the fair price for the transferred intangible assets to be substantially higher than Amazon's pre-audit assessment.

Royalty Relief brand valuation process

The notional value established for the transaction is expressed as a royalty rate, and the Net Present Value (NPV) of all forecast royalties represents the value of the

brand to the business (after discounting the future cash flows that would come from owning the brand). Brand Finance has been a long-term advocate for this method because it is soundly based on commercial best practice in the real world. Its foundation is estimating likely future sales derived from the brand, applying an appropriate royalty rate to that revenue, and then discounting estimated future, post-tax royalties, to arrive at an NPV.

This is a particularly attractive process to tax officials (and the courts!) because it calculates brand values by reference to documented, third-party transactions. In the Amazon case, like many others, it could be performed based on publicly available financial information, and thus, can be demonstrated to external reviewers such as tax officials and the court system, although different experts come up with different conclusions in their assessments of the relevant inputs.

The Royalty Relief brand valuation process requires the analysis of various inputs, the most important of which are: the branded business' revenue forecasts, the useful economic life of the branded business, the notional royalty rate, the discount rate and the long-term growth rate. To corroborate other assumptions, the strength of the brand in influencing stakeholder decision making is also an essential part of the process. The future hypothetical royalty income stream is calculated by Brand Finance using the notional royalty rate, forecast revenue, and brand strength. This result delivers a hypothetical future royalty stream which can be discounted to create a fair and reasonable NPV.

In this case, the court was required to go through the process of creating a valuation of the intangibles that were transferred by Amazon. When it came to the brand part of this transfer (distinct from other intangible assets, such as software and so on) while the witnesses agreed on the underlying approach, the court needed to adjudicate disputes on three key areas to form a brand valuation:

- the royalty rate;
- the useful economic life of the brand; and
- the appropriate discount rate.

This brand valuation needed to include several intangible marketing assets, including the Amazon name, domain names, trademarks and associated intellectual property rights.

Royalty rate

To determine the royalty rate, the court looked for comparable licensing agreements that were created under broadly similar circumstances and which were publicly reviewable. Because Amazon is a unique and remarkable brand (especially today) it was extremely difficult to find a comparable licensing arrangement to obtain a royalty rate. The best that the court could do were four agreements, licensing the Field of Dream trademark in the USA in 1991, the Radio Shack brand into Australia in 1999, the Sports Authority trademark into Japan in 1991, and the Rampage trademark in the USA in 2001. To put it mildly, the Amazon brand (even in 2004) had far greater strength than any of those brands, but because those were the only comparable transactions in the eyes of the court, the court took the highest of those royalty rates (1%) and used that.

Useful economic life

Finding the useful economic life of the brand provoked significant debate, with the court eventually finding that the brand had a useful economic life (in 2004) of twenty years. While whether the brand had an “indefinite” life, in the end, it decided that the brand’s useful life is limited – but then set that limit at twenty years. Because of the interaction of the future royalty discounting, there was little difference between this outcome and indefinite – royalties more than twenty years into the future would only have a very small net present value anyway.

Discount rate

Finally, on the issue of the discount rate, the court decided on a rate of 18% substantially because that same rate was used for the intangible software and website technologies, with no strong reason to treat other marketing intangibles differently. The court chose that rate for those other intangibles on the advice of finance experts who calculated Amazon’s weighted average cost of capital by applying the capital asset pricing model.

Intangible Development Costs (IDCs)

A final key issue when calculating the value of the transaction was to recognise both the pre-existing value of intangible assets in Europe, and to understand how the European subsidiaries had – and were – contributing to the on-going IDCs. In this,

although the Amazon case related to activity in 2004, the court’s findings were similar to the OECD’s rules on the Development, Enhancement, Maintenance, Protection and Exploitation (DEMPE) of intangible assets. These rules were first published in 2015 by the OECD as part of its BEPS initiative and recognised that different subsidiaries and teams (located in different jurisdictions) within a multinational enterprise may make contributions to IDCs. In this process, the court sought to differentiate between the legal ownership of the intangible assets and the economic ownership – that is, to understand what activities to develop, maintain and use the intangible assets were being performed in which jurisdictions.

Conclusion

There are many lessons to be learnt from this case, which fleshed out some further details around what constitutes “reasonable” valuation of intangible assets here – multinational enterprises will need to obtain professional expert advice on how best to value these intangible assets. This work is important to justify valuations and to ensure that such valuations will stand up to tax officials who are working increasingly hard to combat the erosion of their tax bases.