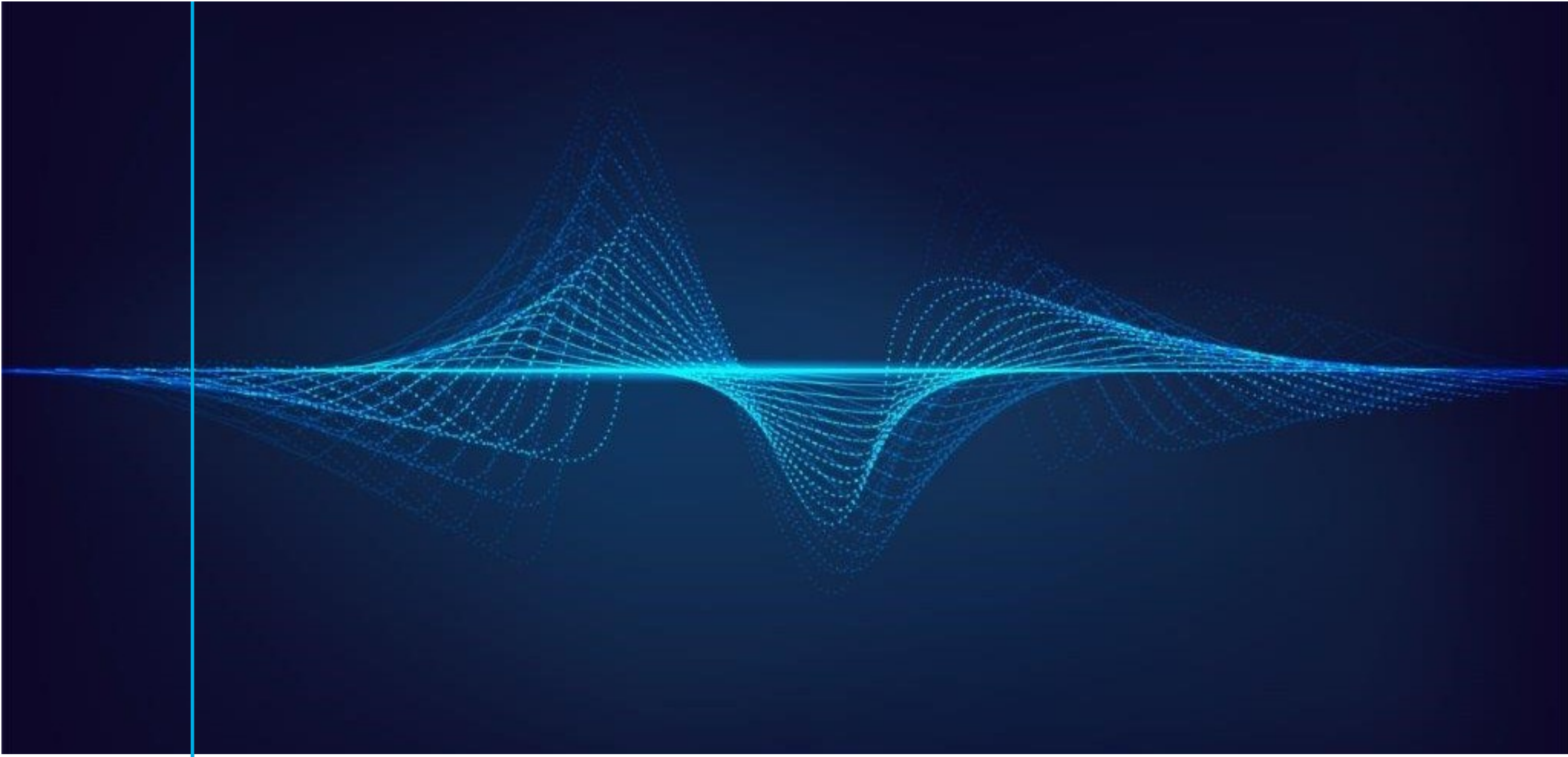

Covid-19: Impact on (the Other) TP

The Impact of Covid-19 on Valuations and Debt

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The Impact of Covid-19 on Valuations and Debt

I. INTRODUCTION

Covid-19, in a matter of a few weeks, has turned everything we viewed as normal on its head. The valuations area is no different. Companies and assets that were reaching all-time highs have seen precipitous declines and record volatility. This, of course, is not due to any underlying economic issue, but rather a health crisis that everyone knows (or at least dearly hopes) is temporary. In this environment, the complexity of valuations for transfer pricing and general tax purposes has increased tremendously. In addition, the recent declines in financial performance highlight various debt capacity and debt restructuring factors that may have previously been less critical. Valuation has always been viewed as more of an art than science, but in times like this, where so much is unknown and even less is known and knowable, there are a few steps multinational enterprises ("MNEs") can take to adequately and reasonably navigate the challenging terrain. The following sections will provide a brief discussion of the major areas of consideration.

II. VALUATIONS OF LEGAL ENTITIES, BUSINESSES, AND INTANGIBLE PROPERTY

Many intercompany transactions that require legal entity and business valuations have not halted despite the business challenges posed by Covid-19. For example, after an acquisition, companies typically engage in post-acquisition integration to combine operations to achieve synergies and reduce the cost of duplicative legal entities. Such exercises often require valuations of legal entities being eliminated or consolidated. Other companies may be planning restructuring transactions to comply with law changes in various countries. These projects often include movements of intangible property to better align the economic ownership with development, enhancement, maintenance, protection, and exploitation ("DEMPE") substance and where arriving at a proper value of the transferred intangible property is particularly important.

Traditional business valuation techniques rely on the income, market, and asset approaches – each having relative merits depending on particular business and market circumstances.[1] In the current environment, the market approach can be distorted by panic selling, bargain hunting, and/or low transactions volume. Also, market multiples derived under these volatile market conditions may not be indicative of long-term expectations. With large fluctuations in stock prices from day to day (and hour to hour), market capitalization alone is unlikely to be a reliable indicator of value. The asset approach typically is not a favored method for business valuations because, even during stable market conditions, it does not take into account self-developed intangibles and the goodwill of a company.[2] Therefore, the income approach may often be the most suited to address valuations in the context of Covid-19. The two main aspects of

[1] The market approach determines value by reference to guideline companies or transactions, the asset approach considers the net book value at a given point in time, and the income approach determines value by calculating the net present value of future cash flows.

[2] The asset approach may be an appropriate business valuation method in certain situations where the value of self-developed intangible assets and/or goodwill may be insignificant, such as in a very early stage company, a company in bankruptcy, where a company may have limited ability to continue as a going concern.

the income approach are forecasted cash flows and the required rate of return. The degree to which both of these aspects are influenced by the pandemic are discussed below.

A. Forecasted Cash Flows

The fair market value and fair value standards of valuation only consider what is "known or knowable" as of the valuation date. Therefore, for valuation dates prior to the Covid-19 pandemic, forecasts would not include cash flow projections reflecting the economic and business disruptions of the virus. Conversely, those valuation dates falling after the Covid-19 pandemic must include cash flow projections that properly account for the current and future impact of the virus. Although there is still uncertainty about when life will return to normal, it would be inappropriate for most businesses to use cash flow projections that ignore a recovery in the long-term. Accordingly, one should consider a long-term growth rate based on the long-term performance of the economy in which the company or legal entity operates. Due diligence is critical to ensure that cash flow projections not only reflect current realities but also include reasonable expectations for the long-term. Tax authorities and statutory auditors alike will most certainly view cash flow projections with a critical eye. Based on our experience, tax authorities are prone to use hindsight and ex-post outcomes as presumptive evidence about the reasonableness of the cash flows. Therefore, it is important for MNEs to maintain proper documentation and work papers to support the reasonableness of the cash flow projections supporting their valuations. Moreover, given the elevated level of uncertainty, scenario analysis, probability weighted forecasts, and sensitivity analysis are prudent and frequent updates may be needed as forecasts are reevaluated until such time as the transaction is implemented. For example, the probability-weighted expected return method ("PWERM") can be used to determine the value of assets and businesses under different scenarios and assign different probabilities to the outcome of each scenario. Under the PWERM, the concluded value is determined after weighing the values determined under each scenario against the probability of their outcome.

B. Required Rate of Return

The required rate of return (i.e., discount rate) applicable to most business valuations is the weighted average cost of capital ("WACC"). The WACC represents the weighted after-tax costs (or required rates of returns) for debt and equity. Typically, the WACC is calculated using the capital asset pricing model, which relies on a number of market inputs including the risk-free rate, the equity risk premium, guideline company betas, and the cost of debt. Under stable market conditions, inputs that are contemporaneous to the valuation date typically serve as reasonable indicators for a longer-term view. However, given the current market turmoil, market inputs can yield materially different values over time. For example, the risk-free rate and the pre-tax cost of debt have deviated significantly from longer-term levels due to the emergency monetary easing initiated by the Federal Reserve and other central banks — essentially driving certain benchmark rates to near-zero. Fiscal stimulus by governments also has an impact, given the need in many cases to issue sovereign debt. If valuations rely solely on current market inputs, the impact will be an abnormally low discount rate and a potentially inflated valuation. The same holds true in instances where the underlying parameters of the discount rate are abnormally high, leading to a potentially underpriced asset. To avoid this disconnect between market values and values derived under the income approach, it is reasonable to consider the following adjustments to support a discount rate that leads to a more reasonable value conclusion:

- To capture the volatility in debt rates, consider using a longer time horizon for the risk-free rate or pre-tax cost of debt (e.g., 90-day average), for valuations that are being performed as of a current date or within the next few months. For valuations with valuation dates that are further away, average yields over a less turbulent time period might be considered.

- To reduce the impact of short-term equity volatility, consider use of long-term betas adjusted to account for movement toward the market average (i.e., Blume Method, Bloomberg Method, and Vasicek Method).

- To achieve a balanced measure of country risk, consider both historical and current data/information (e.g., government relief efforts, changes to sovereign debt ratings, changes to the rates of credit default swaps, etc.). For example, the 2008-2010 financial crisis reduced the reliability of credit default swap curves, and data points that were previously considered as appropriate parameters for risk measurement were abandoned temporarily or completely.

- To account for exposure to certain supply chain risks that might not be applicable to the guideline public companies, consider use of company-specific risk premiums. For example, the perceived risk associated with non-diversified supply chains, particularly those that rely on most products coming from one or two specific markets, is clearly much higher today based on what we have seen with Covid-19.

C. Documentation of Intercompany Transactions Involving Transfers of Legal Entities, Businesses, and Intangible Property

While care should be exercised when preparing the documents involving transfers of legal entities, businesses, and intangible property, it is especially important in the current environment. For example, where a company's business forecasts used in a valuation have not yet been updated to reflect the impact of Covid-19, the parties may need to include a true-up/price adjustment clause in the document so long as the applicable law allows for one. If so, the documents should memorialize the intent of the parties at the time of the transaction with regard to any uncertainty around the value and the desire for a change if needed when updated forecasts are available and establish a clear date by which any adjustment needs to be made, ideally within the same taxable year as the transaction. Additionally, once finalized, the support for the valuation should be very clear as to what the assumptions are at the time the valuation was done and why different inputs were selected.

MNEs may also consider reviewing documents associated with recent transactions to determine if it is necessary to revisit the related intercompany payments in light of the Covid-19 pandemic. This may not be possible for "closed" transactions in which there were transfers of legal or economic ownership involving lump-sum payments, but other transactions, such as those structured as licenses, may have specific provisions that invite adjustment of royalty rates upon specified conditions. For example, depending on the terms of the agreement and the structure of the transaction, it may be possible to make an adjustment to the current consideration paid for intangible assets under the commensurate with income standard contained in the §482[3] regulations (and consistent with the guidance on hard-to-value intangibles from the Organization of Economic Co-operation and Development ("OECD")).

III. IMPAIRMENT CONCERNS

As part of an annual process, MNEs perform impairment testing to ensure that the current book value of certain assets like goodwill,

[3] All Section references herein are to the U.S. Internal Revenue Code (the Code), as amended, and the regulations promulgated thereunder, unless otherwise stated. §165(g).

intangible assets, and fixed assets is no greater than the amount that can be realized from their use or sale (see IAS 36). However, interim impairment testing is required if there is a change in circumstances and/or a triggering event. Examples of a triggering event might include supply chain disruptions, volatility in commodity prices, workforce limitations, curtailed operations, and a significant drop in stock price. Covid-19 has produced a number of potential triggering events and many companies may be subject to an unscheduled impairment test. Under such circumstances, the threshold analysis is to determine whether a company's market capitalization is lower than the book value of its net assets, as of a measurement date. In such a circumstance, management could consider determining the average market capitalization over a longer time period and adjusting the implied control premium to display the reasonableness of the valuations of the individual reporting units. In addition, a case could be made that a valuation performed using an income approach may serve as evidence that the subject assets are worth more than their carrying values regardless of the market capitalization because the market has not baked in the timing and extent of the recovery. In any case, companies should still expect to prepare a reconciliation to market capitalization and provide detailed support for the relevant inputs and assumptions to make sure that they are reasonable and well-supported. In other words, a company will need to substantiate why market capitalization is not the most reasonable indication of value and why differing assumptions under an asset-specific approach are warranted.

IV. REVIEW OF DEFERRED TAX ASSETS AND VALUATION ALLOWANCES

Many companies have deferred tax assets ("DTAs") such as net operating loss carryforwards (“NOLs”) that can be used to reduce future taxable income (and cash taxes). The value of DTAs is an important aspect of legal entity valuations as it directly impacts the value conclusion. Under U.S. Generally Accepted Accounting Principles ("U.S. GAAP"), where there is more than a 50% chance (more likely than not) that some portion of the DTA will not be utilized, a valuation allowance must be created.[4] A valuation allowance is applicable if there is a high likelihood that a portion of the NOLs will expire due to a prolonged period of expected operating losses (e.g., the prospect of future taxable income against which the losses may be used is not good or can no longer be used because of multiple years of losses). Given the current Covid-19 environment, companies may need to establish valuation allowances and/or re-assess current valuation allowances to account for any expected long-term business disruption. Conversely, companies should also consider whether government intervention may extend the life of DTAs and/or allow for their use in carryback periods. Companies previously on the cusp of triggering a valuation allowance may see themselves recording an allowance even for short-term disruptions if losses continue to mount. To avoid increased valuation allowances, companies should consider whether supportable changes to transfer pricing policies can be made or other actions taken such as deferring tax reliefs to increase the taxable income of the relevant entities. Proper analysis and modeling is needed to show that the forecasted profit is sufficient to utilize any loss carryforwards prior to expiration.

V. WORTHLESS STOCK DEDUCTIONS

Multiple companies across multiple industries, including oil and gas, travel, aviation, and

[4] Under U.S. GAAP, the full DTA is recorded and then offset with an applicable valuation allowance. Under the International Financial Reporting Standards ("IFRS"), a DTA is recorded if it is probable (i.e., greater than a 50% likelihood) that it will be realized in the future (see IAS 12). The net DTA amount is consistent between both accounting frameworks but the presentation differs. Therefore, the issues raised in this section may also apply to companies that prepare financial statements under IFRS, as the DTA may need to be adjusted if its full realization is no longer probable.

hospitality have seen the value of their publicly traded stock decline as a result of Covid-19 . Similarly, privately held companies and subsidiaries also are experiencing difficulties where their long-term solvency is called into question. Companies should consider their ability to take worthless stock deductions[5] and, where applicable, prepare valuations to demonstrate insolvency in order to take advantage of this tax benefit. Specifically, certain worthless stock deductions realized in 2020 may be treated as ordinary losses. Given the ability to carryback losses under the Coronavirus Aid, Relief, and Economic Security Act, these ordinary losses may possibly be used to offset income in pre-tax reform years when the corporate tax rate was 35%.

VI. DEBT CONSIDERATIONS

Central banks have responded to Covid-19 by cutting benchmark interest rates in an attempt to promote liquidity. In the United States, the lower limit of the federal funds rate has been reduced to near zero. On one hand, companies are considering refinancing existing debt to take advantage of potential lower rates, but on the other, they are dealing with difficulty servicing existing debt. In the case of intercompany debt arrangements, the following provides a brief overview of the main debt related points of attention.

Accurate Delineation and the Behavior of Parties. As a result of the §385 regulations, many companies revamped their intercompany loan agreements to be more consistent with certain terms contained in third-party loan agreements. These revised agreements more clearly laid out the rights of the lender and the obligations of the borrower with respect to penalties for missed payments and stated a variety of covenants. As stated in some agreements, breaching the covenants may result in the loan requiring immediate repayment. Companies that are experiencing financial difficulties due to Covid-19 may breach one or more of covenants, depending on what such agreements state; for example, financial covenants that specify that the borrower's financial ratios need to be within a certain band might be breached. Here, the parties need to consider the behavior of unrelated parties, while ensuring that the funding needs of the related borrower are met. Proactive steps can and should be taken to amend terms or refinance the intercompany debt in certain circumstances and where allowed by law.

Realistic Alternatives. Many intercompany loans have fixed interest rates that were established when the loan was originated. In a stable interest rate environment, the cost and administrative burden of refinancing debt may offset the benefits that can be realized. This may be especially true if the loan agreement includes a prepayment penalty clause. However, under the current rate environment, there is a possibility that certain borrowers may be able to take advantage of significantly lower rates. In the context of intercompany loans, companies should consider the implications of considering realistic alternatives as tax authorities may assert that the debt should have been refinanced.

AFR/Safe Harbor Rates Versus Market Rates. Historically, the U.S. applicable federal rate ("AFR") and other safe harbor interest rates have been lower than market rates. The situation may arise, however, where the safe harbor rates converge with the market rates or the market rates may be lower than AFR rates for certain credit ratings. Therefore, instead of selecting the AFR as the default for intercompany loans, companies should consider using market rates. In certain cases, the companies' intercompany loan agreement templates explicitly specify AFR as the applicable interest rate. Companies should consider amending this language to give them greater flexibility to choose between using a safe harbor rate and a market rate.

Availability of Market Benchmarks. Similar to conditions during the subprime mortgage crisis, there is an anticipation that Covid-19 will produce further restrictions on liquidity and a lack of interest rate benchmarks at certain credit ratings. Paradoxically, more debt facilities may be granted to below investment grade companies, creating an "abnormal" market for corporate lending. Companies should evaluate their internal processes and build in the flexibility to use different data sources and approaches to establishing arm's-length interest rates. Careful consideration of all current market information will be required for transfer pricing purposes.

Debt Capacity Analysis. As part of a debt capacity analysis, various financial ratios are computed for the subject entity and comparable companies. To increase the reliability of the analysis and insulate against any distortions in the data that may be caused by Covid-19, it is advisable to consider a longer horizon for the look-back period (e.g., weighted average five years).

Parent Guarantees. It is likely that the prevalence of parent guarantees may become more common when subsidiaries borrow directly from third-party financial institutions. As a result, it is important that this guarantee be evaluated to determine whether an incremental benefit beyond implicit support is provided and if so, that a proper intercompany charge is established. Moreover, consistent with guidance from the OECD, it is important to distinguish between guarantees that allow for more favorable terms and those that allow for the ability to borrow larger sums. In the latter case, the portion of the loan that would not have been made without the guarantee may need to be re-characterized as a loan to the guarantor, which would be contributed as equity to the borrower. MNEs can proactively address such risks by potentially restructuring existing arrangements.

VII. CONCLUSION

Although Covid-19 is having a profound impact on the economy, many transactions requiring valuations and financing persist. The discussion above highlights some of the major areas companies should keep in mind when it comes to the selection/application of valuation methods; documenting transfers of legal entities, businesses, and intangible property; and analyzing intercompany debt arrangements in the current Covid-19 environment. Moreover, intangible asset impairment, valuation allowances, and worthless stock deduction issues should be considered in the context of their potential impact on financial statements and tax positions.

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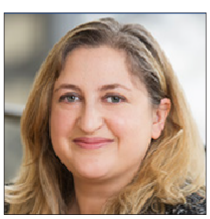

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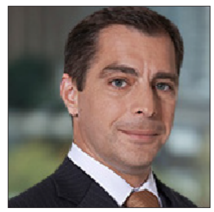

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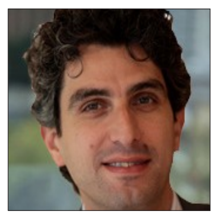

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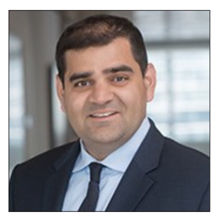

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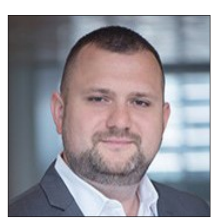

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