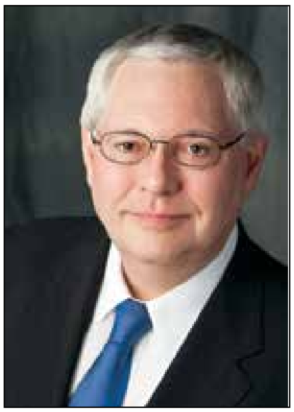
Tax Implications Of The Intellectual Property Valuation Process



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Understanding the principal procedures in the valuation process — and the reasons for the principal procedures — will help the tax counsel use the intellectual property valuation for income, gift, or estate tax planning, compliance, or litigation purposes.

TAX COUNSEL are often involved in the valuation of the taxpayer's intellectual property for a number of tax-related reasons. These tax reasons include: purchase price allocations in taxable transactions, owner's gift and estate tax planning and compliance, charitable contributions, intercompany transfers between foreign and domestic controlled subsidiaries, as a component of a corporation's insolvency analysis related to COD recognition, a C corporation to S corporation conversion, the reasonableness of the investor's royalty rate changed to his/her closely held C corporation, the basis of partnership units where the partners contributed intellectual property in exchange for units, etc. For these and other tax reasons, counsel often retain, rely on, defend, and examine valuation analysts who have valued the taxpayer's intellectual property. For purposes of this discussion, intellectual property includes patents, copyrights, trademarks, and trade secrets.

The intellectual property valuation process represents a systematic framework for the analyst to answer a specific question about intellectual property value. That specific question can originate from the taxpayer owner/operator, tax counsel, a regulatory or taxing authority, or some other interested party. The valuation process begins when the valuation analyst identifies the specific question. And, the valuation process ends when the analyst reports the result of the valuation to the client, tax counsel, or other interested party. This discussion summarizes what tax counsel needs to know to work with the analyst during the intellectual property valuation process.

Although there are generally accepted components of the valuation process, each intellectual property valuation has unique elements. For example, while fair market value is appropriate for most tax valuations, many different standards of value may be estimated for the intellectual property. Even considering these unique elements, the valuation process provides an overall analytical framework for estimating intellectual property value.

The valuation process provides a systematic framework for:

- Performing market research, due diligence, and data analysis;
- Selecting and applying the generally accepted valuation approaches, methods, and procedures;
- Synthesizing the value indications derived from each selected method into a final value conclusion;and
- Reporting the valuation development and the value conclusion.

This discussion summarizes the elements of this intellectual property valuation process. The principal components of the valuation process are illustrated in Exhibit 1.

Exhibit 1
The Intellectual Property Valuation Process

IDENTIFICATION OF THE INTELLECTUAL PROPERTY VALUATION PROBLEM

Subject intellectual property description	Highest and best use analysis	Selected standard of value
Subject ownership and property rights description	Selected premise of value	Appropriate valuation date

DATA COLLECTION, DUE DILIGENCE, AND ANALYSIS

Intellectual property characteristics	External economic factors
History and outlook (owner/operator and industry)	Supply and demand variables
Financial information (owner/operator and subject asset)	Prior sale and/or license transactions

GENERALLY ACCEPTED VALUATION APPROACHES

Cost approach	Market approach	Income approach
- various cost approach methods	- various market approach methods	- various income approach methods
- develop value indications	- develop value indications	- develop value indications

VALUE SYNTHESIS AND CONCLUSION

Synthesis of value indications within each approach	Effect of any contingent and limiting conditions
Synthesis of value indications among all applicable approaches	Report of the final value conclusion

THE NATURE OF THE VALUATION PROCESS • The intellectual property valuation process has evolved significantly during the past decade. This evolution includes the consensus of professional practitioners as to what constitutes generally accepted intellectual property valuation approaches, methods, and procedures. And, this evolution includes the development of professional standards, including the American Institute of Certified Public Accountants ("AICPA") Statement on Standards for Valuation Services ("SSVS"), Valuation of a Business, Business Ownership Interest, Security, or Intellectual property.

As with most property types, the intellectual property value is influenced by the present value of the future income that the property is expected to generate. Therefore, a common procedure in the intellectual property valuation is to analyze projections of future economic events. Such events include:

- The generation of intellectual property owner (e.g., license) income;
- The generation of intellectual property operator (e.g., business operations) income; and
- The proceeds from an intellectual property transfer.

In many ways, the valuation is the culmination of the analyst's research into the expected future economic performance of the intellectual property. This exploratory research typically includes these general analytical procedures:

- Question;
- Analyze;
- Test;
- Conclude.

The intellectual property valuation process expands these four general analytical procedures as follows:

- Identify the intellectual property valuation problem;
- Collect, confirm, and analyze relevant empirical data;
- Select and apply one or more of the three generally accepted valuation approaches; and
- Estimate the defined value conclusion.

The intellectual property value estimate is sensitive to the prevailing economic conditions as of the valuation date. Therefore, actual economic events that have taken place subsequent to the valuation date are typically relevant only to the extent that they were predictable as of the valuation date. The analyst is asked to estimate value without the benefit of the certain knowledge of future events. In fact, the analyst performs the valuation considering only the events that could be known or knowable as of the valuation date. In such retrospective valuations, this perspective on what constitutes known or knowable empirical data is particularly important to the process.

One procedure of the intellectual property valuation process, then, is to make reliable predictions of future economic events. If the predictions are reasonably accurate, then the value conclusion will be reasonable and supportable. If the predictions are not reasonably accurate, then the valuation procedures may need to be revised until more accurate predictions are achieved.

Another procedure in the intellectual property valuation process is to postulate a conceptual model from which the observable behavior of market participants may be predicted. The identity of the relevant market participants varies based on the intended standard of value. The valuation model is typically validated by performing these three procedures:

- Postulate a model based on existing experimental observations or measurements;
- Check the predictions of the selected model against further observations or measurements; and

- Adjust or replace the model as required by the new observations or measurements.

The third of these above-listed procedures leads back to the first procedure, and the valuation model development process continues without end. The criterion for assessing the quality of a valuation model is the reasonable prediction of economic performance from the simplest (also called the most elegant) model.

No prediction of a market participant's future behavior is either perfectly accurate or perfectly certain. Analysts should be prepared to observe experimental results that will necessitate the adjustment or replacement of the valuation model. Valuation models should predict with reasonable accuracy. Valuation models should also conform to the generally accepted analytical standards and practices. The development of a valuation model for a taxpayer intellectual property is an iterative process. However, the validation of the model follows the valuation process. Valuation models are never certain and are always subject to revision. Each new valuation model includes the successful parts of older models.

Intellectual property valuation models are not proved, they are validated. The process of being validated means that the valuation model has made reasonably accurate predictions. In considering the continued application of a previously validated model, the analyst expects that the valuation model will continue to predict as accurately in the future as it has in the past. However, there is no guarantee of any valuation model's continued predictive ability.

The valuation process is a formalization of learning by experience. All analysts who learn by experience are implicitly using the valuation process. The basic premise of any valuation analysis is that the behavior of the relevant market participants is predictable. The intellectual property valuation process has this objective: to evoke new thinking or to reveal new approaches to old problems. Analysts rarely achieve a perfect valuation model. Rather, the analyst begins with the question, "How do I estimate value?" And, the analyst concludes with the question, "How can I estimate value more accurately?"

IDENTIFICATION OF THE VALUATION PROBLEM • Identifying the right valuation question is sometimes more difficult than concluding the correct valuation answer. In the intellectual property valuation, the analyst first identifies the central issues to be addressed and plans a strategy for completing the assignment. The inability to complete the intellectual property valuation is usually the result of poor communication between the analyst and the taxpayer or tax counsel about the objectives of the assignment. Tax counsel who are unfamiliar with the valuation process may not understand how the implementation of the valuation methods may affect the intellectual property value conclusion. Different property types, ownership interests, legal rights and privileges, and intended uses of the valuation can affect both the valuation process and the value conclusion.

The tax counsel and the analyst should fully understand and reach agreement on the assignment, preferably in writing, before the valuation analysis begins. This is because any change in the selected standard of value, premise of value, or valuation date can affect the value conclusion for the subject intellectual property.

The identification of the intellectual property valuation problem should include the following:

- A description of the taxpayer intellectual property;
- A description of the taxpayer intellectual property rights;
- A statement of the objective of the intellectual property valuation assignment;
- A statement of the purpose of the intellectual property valuation assignment;

- A definition of the appropriate standard of value;
- A statement of the as of valuation date;
- A listing of any counsel-imposed hypothetical assumptions or limiting conditions.

The subject property rights include the rights that are legally held, or may be held, by the intellectual property owner/operator. The analyst may estimate the fee simple interest or a partial ownership interest created by the division of the total bundle of ownership rights. Information regarding the subject ownership rights and any transaction involving those ownership rights may be important to the assignment. Depending on the ownership rights included in the taxable transaction, these factors may affect the data assembled, analyses performed, and value concluded.

The sum of the values of the intellectual property partial ownership interests may not equal the intellectual property fee simple value. To estimate the value of an intellectual property partial ownership interest, the analyst typically assesses evidence of the market participants' attitude to such a partial interest. The clear identification of the intellectual property assignment will help inform the analyst of the relevant empirical data and will help the analyst avoid unnecessary and unproductive tangential analyses.

HIGHEST AND BEST USE • Through the highest and best use ("HABU") analysis, the analyst interprets the market forces that influence the intellectual property, and the analyst identifies the use upon which the final value estimate is based. The HABU analysis helps the analyst to identify guideline sale or license transactions and to identify any obsolescence factors that may affect the intellectual property value and/or remaining useful life ("RUL").

Some of the relevant valuation factors that are identified during the HABU analysis include: systematic and nonsystematic risk, income projection estimates, and income discount rate or capitalization rates. During the course of the valuation, the analyst may test the sensitivity of the selected valuation variables. Based on this sensitivity analysis, the analyst may conclude a reasonable range of intellectual property values.

The analyst may identify and analyze various owner/operator operating scenarios during the HABU analysis. The analyst may consider the procedure in the valuation process interrelationships between the selected valuation variable factors — and their probability of occurrence in the future. This consideration may also help the analyst to conclude a reasonable range of intellectual property values.

DATA COLLECTION AND DUE DILIGENCE • After defining the valuation problem, the next procedure in the valuation process is data collection and analysis. In performing this procedure, the analyst typically develops the analytical work plan. The analyst gathers, confirms, analyzes, and adjusts empirical data, as appropriate, when performing the valuation. Such empirical data typically include the following:

- Characteristics of the taxpayer intellectual property: subject ownership interest, including registration, rights, privileges, conditions, and factors affecting the intellectual property ownership or operational control;
- Nature, history, and outlook of the taxpayer owner/operator's business and industry;
- Historical financial information related to the intellectual property development, maintenance operations, protection, and license;
- Any related tangible or intellectual property required for the efficient operation of the intellectual property;
- The nature and conditions of any relevant industry that may have an impact on the intellectual property;

- Local, national, and international economic factors that affect the intellectual property;
- Available rates of return on alternative investments and a description of any relevant market transactions;
- Prior sale or license (both inbound and outbound) transactions involving the intellectual property; and
- Any other relevant information.

The engagement work plan may include an analysis of the market for the intellectual property and the asset's supply and demand relationships. To efficiently complete the intellectual property valuation, the valuation process should be planned and scheduled. Engagement time and staffing requirements vary with the complexity of the assignment objective and with the complexity of the available data. Some assignments can be completed in a few days, while other engagements require several months to gather and analyze the relevant data.

On some assignments, the analyst may seek the assistance of specialists with expertise in other fields. For example, the valuation of the contract rights associated with the distribution of a particular entertainer's work product may benefit from the opinion of an entertainment industry agent.

The analyst is ultimately responsible for the value opinion and the valuation work product. Therefore, the analyst will have a clear understanding of the responsibilities of each of the assignment team members. Taking a comprehensive view, the assignment's principal analyst will recognize the type, volume, and sequence of all of the work to be performed.

The amount and type of empirical data collected may depend on how the valuation assignment is defined. For example, the valuation problem may indicate that one valuation approach be given greater emphasis in the final value estimate. Ultimately, the analyst's assessment of the quality and quantity of available data will determine the applicability of any valuation approach or approaches. The empirical data collected and analyzed affect the judgments made in the intellectual property valuation. Therefore, the valuation report typically includes a description of all of the information considered by the analyst.

GENERALLY ACCEPTED VALUATION APPROACHES • The valuation process is applied to develop a well-supported estimate of fair market value (or any other defined value) based on consideration of all relevant data. The analyst estimates the intellectual property value after considering the three generally accepted valuation approaches: cost, market, and income. The analyst will select and apply one or more of these generally accepted approaches in all estimates of intellectual property value. Which of the three generally accepted approaches is most applicable in the particular analysis depends on the type of intellectual property, the intended use of the valuation, and the quality and quantity of empirical data available for analysis.

All three generally accepted valuation approaches are applicable to many intellectual property valuation analyses. Depending on the specific assignment, one or more of the valuation approaches may have greater significance. Where possible, the analyst selects and applies more than one approach. Alternative value indications can serve as useful benchmarks for assessing the reasonableness of the value indication of the primary valuation approach.

CONTINGENT AND LIMITING CONDITIONS • It is often necessary for the analyst to make general assumptions in order to carry out the valuation assignment in an efficient manner. General assumptions deal with issues such as legal and title considerations, liens and encumbrances, information furnished by other parties (e.g., engineering studies, market research studies), hidden conditions and environmental hazards, and compliance with applicable laws and regulations.

The analyst will make it clear that the possession and use of the valuation report is limited to the specific purpose and to the specific audience for which it was prepared. Unless otherwise agreed to with tax counsel, the analyst typically has no responsibility to update the valuation report or to provide further taxpayer consultation or litigation expert testimony services.

The intellectual property valuation report is based typically on all the information available to the analyst as of the date of the report. The analyst typically assumes the accuracy of information provided by the taxpayer or tax counsel. Even if the analyst is a certified public accountant ("CPA"), the analyst typically will not audit such information for accuracy. The financial projections that the analyst uses as part of the analysis are typically based on information that is current as of the valuation date. Such financial projections are typically subject to change due to changes in future economic conditions and market conditions.

The valuation report typically indicates that the analyst personally conducted the valuation and has no present or prospective interest in the subject intellectual property. The analyst reports that he or she has no personal interest or bias with respect to the parties involved. With regard to independent valuations, the report usually specifies that the assignment fee for performing the analysis is not contingent on the value reported or the attainment of a stipulated event. Depending on the professional qualifications of the analyst, the intellectual property value development and the valuation report may be prepared in compliance with a specified set of professional standards. Such professional standards may include SSVS, the Uniform Standards of Professional Appraisal Practice ("USPAP"), or some other organization's professional standards.

VALUE CONCLUSION • From an overall engagement perspective, the valuation analyst should consider the question: "Did I accomplish what I set out to accomplish in the intellectual property valuation?"

The analyst's final review of the intellectual property valuation assignment should consider the following:

- Identification of the taxpayer intellectual property (including the subject ownership interest);
- The objective of the intellectual property valuation;
- The purpose of the intellectual property valuation;
- The subject intellectual property ownership interest (including the bundle of legal rights);
- The date of the value estimate;
- Definition of the appropriate standard of value to be estimated;
- Definition of the appropriate premise of value (based on tax counsel's instruction or the analyst's HABU conclusion).

The valuation is performed to answer a value, transfer price, or amortization question about the intellectual property value. Even within the same valuation approach, different methods will typically conclude different value indications. For example, it is likely that different indicated values would result from two different income approach methods (e.g., from the multiperiod excess income method versus from the discounted incremental income method).

The process of reconciliation involves the analysis of the alternative value indications in order to arrive at a final value estimate. Before reaching a final value estimate, the analyst reviews the entire intellectual property valuation for appropriateness and accuracy. It is noteworthy that the definition of value estimated, and its relationship to each procedure in the valuation process, should be carefully considered during the reconciliation process.

REPORTING THE VALUE CONCLUSION • For most assignments, the results of the intellectual property valuation process are typically presented to the taxpayer and tax counsel in a valuation report. The valuation report may be a written report followed by an oral report (e.g., expert testimony).

Regardless of whether it is prepared in accordance with any specified set of professional standards, the intellectual property valuation report should clearly and accurately set forth the valuation in a manner that is not misleading. The valuation report should contain sufficient information to enable the audience to understand it properly. And, the valuation report should disclose any extraordinary assumptions or contingent or limiting condition that may impact the value conclusion.

The analyst's professional qualifications and experience are typically included in the independent valuation report. Such disclosures provide evidence of the analyst's competence to perform the valuation assignment.

In valuation reports prepared for tax litigation purposes, there may be specific disclosure requirements in order for the analyst's work product to be accepted into evidence as an expert report. Such disclosures may include the analyst's prior expert testimony experience and prior publications, as well as the analyst's professional qualifications. Analysts who expect to provide expert testimony should confer with tax counsel regarding all applicable expert report form and format requirements.

CONCLUSION • Understanding the principal procedures in the valuation process — and the reasons for the principal procedures — will help tax counsel use the intellectual property valuation for income, gift, or estate tax planning, compliance, or litigation purposes. The valuation process provides a general analytical structure that assists the analyst in the collection, assessment, analysis, and interpretation of market-derived valuation evidence. These procedures provide a logical framework that allows the analyst to synthesize and conclude a reasonable intellectual property value estimate. These procedures also assist the analyst in communicating the results of the intellectual property valuation in a well-reasoned and well-supported report.

The most complex intellectual property valuation problem can be more easily understood and more effectively solved if the analyst addresses the problem in terms of the valuation process. This discussion summarized what tax counsel needs to know to work with, rely on, and defend the analyst during the intellectual property valuation process.