How to manage trade secrets – *Video Transcript*

Trade secrets and tax: What do you need to know?

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Why exactly is the taxman becoming increasingly interested in trade secrets?

Well, it’s all down to the growing importance of intangible assets as a source of economic growth and tax revenue. Also, fact that their non-physical nature makes it easier for taxpayers to engage in tax strategies such as income-shifting or transfer pricing. For this reason, tax authorities and international organizations have been designing ways to link intangible assets to the place where they were created, hence defining nexus.

This interest by the tax authorities applies to trade secrets as well. After all trade secrets may be among some of the most valuable intangible assets within an organisation.

In this short video, I will explore a number of issues which link trade secrets and tax together

This will include:

- Trade secrets as an asset
- The OECD BEPS guidelines
- The valuation of trade secrets
- Trade secrets and transfer pricing

Let's first of all consider assets. An asset is something valuable that a business entity owns, benefits from, or has use of. In financial accounting, an asset is an economic resource. Any tangible or intangible resource that can be owned or controlled to produce value and that is held by a company to produce positive economic benefit is an asset. Simply stated, assets represent value of ownership that can be converted into cash.

There are different definitions of an asset and how different assets may be classified.

From an accounting perspective, assets are divided into the following categories:

- current assets (cash and other liquid items)
- long-term assets (real estate, plant, equipment)
- prepaid and deferred assets (expenditures for future costs such as insurance, rent, interest)
- intangible assets

An intangible asset is an asset that lacks physical substance and includes patents, copyrights, franchises, goodwill, and trademarks.
The International Accounting Standards Board standard 38 (IAS 38) defines an intangible asset as: "an identifiable non-monetary asset without physical substance."

IAS 38 specifies the three critical attributes of an intangible asset to be …

- identifiability
- control (power to obtain benefits from the asset)
- future economic benefits (such as revenues or reduced future costs)

IAS 38 contains examples of intangible assets such as customer lists, copyright, patents and franchise agreements.

IAS 38 clearly indicates that a trade secret is also an example of an intangible asset, so long as it meets the three critical attributes – identifiability, control and future economic benefit.
Trade secrets are a very important part of any intangible asset portfolio. It is no exaggeration to say that virtually every business possesses trade secrets, regardless of whether the business is small, medium or large.

A trade secret is therefore any information that is:

- Not generally known or readily accessible to the relevant business circles or to the public.
- Confers some sort of economic benefit on its owner. This benefit must derive specifically from the fact that it is not generally known, and not just from the value of the information itself. It must have commercial value because it is a secret. Commercial value encompasses potential as well as actual value.
- The trade secret must be subject to reasonable steps by its owner to keep it secret. What is reasonable can vary depending on the specific circumstances.

On reflection, perhaps it is better to say that every business has assets that could and should be protected as trade secrets, but the truth is that many fail to do so properly.

The Organization for Economic Co-Operation and Development (OECD) is at the forefront of efforts to improve international tax co-operation between governments to counter international tax avoidance and evasion.

The OECD/ G20 Base Erosion and Profit Shifting (BEPS) package of measures has been agreed upon and over 100 countries and jurisdictions have confirmed their commitment to the consistent implementation of this comprehensive package.

An essential new feature of the new regulations is an emphasis on intangible assets. It is increasingly recognised that intangible assets create a substantial part of the business value. However, until now there is no single definition of intangible assets in use by tax authorities or the OECD, and no proper guidance on how such assets should be reported.
The accurate and complete identification, taxation and valuation of intellectual property and other intangible assets is now recognized as one of the most important areas of the international tax reform and transfer pricing legislation.

In the OECD BEPS guidelines, it defines intangible assets as including the following categories:

- Patents
- Know-how and trade secrets
- Trademarks, trade names and brands
- Rights under contracts and government licenses
- Licenses
- Goodwill

Trade secrets are included. Trade secrets are specifically included in the OECD BEPS definition of intangibles.

OECD BEPS Action #5; Section A.1: Identifying Intangibles; Sub-section 6.20: Know-how and Trade Secrets is where trade secrets are defined.
"Know-how and trade secrets are proprietary information or knowledge that assist or improve a commercial activity, but that are not registered for protection in the manner of a patent or

Know-how and trade secrets generally consist of undisclosed information of an industrial, commercial or scientific nature arising from previous experience, which has practical application in the operation of an enterprise.

Know-how and trade secrets may relate to manufacturing, marketing, research and development, or any other commercial activity. The value of know-how and trade secrets is often dependent on the ability of the enterprise to preserve the confidentiality of the know-how or trade secret. In certain industries the disclosure of information necessary to obtain patent protection could assist competitors in developing alternative solutions.

Accordingly, an enterprise may, for sound business reasons, choose not to register patentable know-how, which may nonetheless contribute substantially to the success of the enterprise.

The confidential nature of know-how and trade secrets may be protected to some degree by (i) unfair competition or similar laws, (ii) employment contracts, and (iii) economic and technological barriers to competition.

Know-how and trade secrets are intangibles within the meaning of Section A.1."

What is OECD BEPS asking of organisations?

As a result of these OECD guidelines, organisations, specifically multi-national enterprises (MNEs), will now or in the near future need to recognize the value of intangible assets for their businesses. Businesses will need to consider a regular assessment of their value chains to ensure that intangible assets have been correctly identified, including existing contracts and arrangements for the development, enhancement, maintenance, protection and exploitation of intangibles in light of the new international tax rules.

These functional and economic assessments and analyses will require a depth of knowledge of definitional aspects of intangibles, ownership issues, identification and characterisation of intangibles and valuation that identifies arm's length prices for transactions involving intangibles.

What does this mean in practice?

As a result of these OECD guidelines, organisations will now or in in the near future need to be able to do the following:

- Enhance their definition of IP to include all of the intangible assets as listed by the OECD. Too often in-house IP functions define IP as being patents and trademarks and exclude unregistered IP e.g. know-how and trade secrets, even when such unregistered IP is more valuable than their registered IP.
- Identify all valuable intangible assets within the group by member / country, including its valuable trade secrets.
- Define the legal owner of each valuable intangible asset including its trade secrets.
- Identify specific members of the group that perform functions, use, or assume risks related to development, enhancement, maintenance, protection, and exploitation of all valuable intangible assets, including trade secrets. (This is the DEMPE concept).
- Ensure re-imbursement by the legal owner to other group members for their contribution
- And… Disclose the financial agreements in existence between group members relating to valuable intangible assets, including trade secrets, and confirm that such agreements were enacted at arm's length.

Companies may find themselves in a dilemma or difficult circumstance from which there is no escape because of mutually conflicting or dependent conditions if they decide to omit trade secrets from their OECD BEPS activities.

This is because trade secret laws are being enhanced at present across key jurisdictions, and we are witnessing a dramatic increase in trade secret litigation cases.
First we had the US strengthen their trade secrets laws with the DTSA in May 2016. Let's not forget that the US also added trade secret theft to their Racketeering Laws (RICO).
Then we had the Europeans strengthen their trade secret laws with the EU Directive on Trade Secrets approved in June 2016 and due to be enacted by all EU member states by 9 June 2018.

Now we have the Chinese strengthen their trade secret laws with a revision of the Anti-Unfair Competition Law. This revision of the Chinese Law is effective from 1 Jan 2018.
It may be challenging for a company to tell the courts that it possesses really valuable trade secrets and at the same time inform the tax authorities that it possesses no valuable trade secrets.

Challenge and opportunity:

MNEs will need to conduct an exercise rather sooner than later to determine if they are OECD BEPS compliant and to take the necessary actions. This assessment should check if the MNE has the skills and competencies, knowledge and experience, process and systems in place to enable the MNE to complete these IP data management related tasks, and if not, what actions need to be taken to remedy the situation.

This provides a unique opportunity for IP professionals to extend their service offering and aggressively occupy this no man's land – the area of intangible assets and OECD BEPS compliance.

The market research shows that until recently transfer pricing and intangibles have been mostly in focus of the Big Four accounting firms and transfer pricing professionals. However, there are examples of some Law firms and IP Firms showing interest towards this new area.
OECD BEPS compliance offers a great opportunity to IP professionals, but, to win, it requires a cross discipline team with knowledge and understanding of the different forms of intangible assets (including trade secrets), their identification and valuation in the context of business strategy and value chain, with experience of the different IP activities as listed by the OECD, with insights into how MNEs organise and operate their IP activities (including trade secret asset management), and with an appreciation of the goals and objectives of the OECD BEPS guidelines.

Valuation of trade secrets:

Any business professor will tell you that the value of companies has been shifting markedly from tangible assets, "bricks and mortar", to intangible assets like intellectual property (IP) in recent years.

For instance, IP in its various forms is increasingly used as the basis of many business and commercial transactions. It is fundamental for company valuations (merger, acquisition, bankruptcy); negotiations (selling or licensing); dispute resolution (fair recovery and quantification of damages); fundraising (bank loans and raising capital); assisting in decision making (corporate strategy); and reporting (tax and accounting).

Why Conduct a Trade Secret Valuation:

Before delving into the details of the valuation of a trade secret, it is important to appreciate that the rationale for conducting such a valuation may vary.

- For management information purposes
- For strategic planning
- For value reporting
- For accounting purposes
- For liquidation reasons
- To support a legal transaction
- For licensing
- For litigation support
- For dispute resolution
- For taxation planning and compliance
- For fundraising purposes

Transfer Pricing:

For the purpose of this review, one particular valuation rationale will be analysed, namely transfer pricing.

Transfer pricing is probably the most important issue in international corporate taxation. In taxation and accounting, transfer pricing refers to the rules and methods for pricing transactions between enterprises under common ownership or control.

A transfer price is the price at which members of a group transact with each other, such as the trade of goods and services between group members.

Transfer pricing also comes into play when the transaction between group members involves intangible assets and IP like trade secrets. In other words, transfer pricing is not limited to just tangible assets.

Due to the rather broad the definition of intangibles for transfer pricing established by the OECD, the scope of the valuation as well as the resulting value will often differ from analyses performed for accounting and management information purposes; as stated in the OECD Guidelines (paragraph 6.7):
“Intangibles that are important to consider for transfer pricing purposes are not always recognised as intangible assets for accounting purposes. For example, costs associated with developing intangibles internally through expenditures such as research and development and advertising are sometimes expensed rather than capitalised for accounting purposes and the intangibles resulting from such expenditures therefore are not always reflected on the balance sheet. Such intangibles may nevertheless be used to generate significant economic value and may need to be considered for transfer pricing purposes”.

With trade secrets being a prominent example of intangibles that are not being reflected on the balance sheet, but which may nevertheless generate significant economic value, it is evident that trade secrets cannot be disregarded for transfer pricing purposes. Trade secrets are explicitly recognized within the OECD Guidelines in Chapter VI Section A.4.2.

Tax practitioners that fail to identify relevant trade secrets as well as to develop a clear understanding of the attributable economic value face a high degree of uncertainty in respect to the question of whether their transfer prices reflect an arm's length compensation for the intangibles contributed by individual group members.

Hence, with the growing importance of intangibles as the core value drivers within highly integrated value chains, understanding how to properly cope with intangibles and IP like trade secrets in transfer pricing is one of the key challenges faced by tax practitioners. Conducting a thorough stock-tracking analysis and compiling a respective analysis will be invaluable first steps to reduce uncertainty and risks.

The Requirements for Trade Secret Valuation:

Conducting an IP valuation exercise requires transparent inputs, reliable and sufficient data, and objectivity of the person conducting the valuation. This applies also if the IP in question is a trade secret. Ideally, the valuation of the trade secret should have …

- Transparency - Qualification of the valuation inputs, assumptions, risks, sensitivity analysis, and disclosure
- Validity - Valid inputs and assumptions as of the value date.
- Reliability - If a valuation is repeated, it should reliably give a comparable and reconcilable result
- Sufficiency - The valuations should be based on sufficient data and analysis to form a reliable conclusion
- Objectivity - The appraiser should conduct the valuation free from any form of biased judgment
- Various financial and legal parameters - When performing a monetary IP valuation, various financial and legal parameters should be taken into account

From a transfer pricing perspective observing and documenting the above requirements will greatly contribute to the defensibility of the valuation. Tax practitioners need to be aware of, in this context, that tax authorities are extremely sensitive about the effects of information asymmetries. The basic assumption here, whether justified or not, is that tax authorities are generally at a disadvantage when assessing transactions involving intangibles. As a result, they will frequently second guess the valuations during tax audits.

The recent discussion in the context of the BEPS point towards an increased (even reversed) burden of proof for taxpayers, as the OECD explicitly stated in the implementation guidance for hard-to-value-intangibles (BEPS Action 8, Public Discussion Draft, 23. May 2017) that:
"This guidance protects tax administrations from the negative effects of information asymmetry by ensuring that tax administrations can consider ex post outcomes as presumptive evidence about the appropriateness of the ex ante pricing arrangements. At the same time, the taxpayer has the possibility to rebut such presumptive evidence by demonstrating the reliability of the information supporting the pricing methodology adopted at the time the controlled transaction took place".

Without observing the above requirements for the valuation process, rebutting presumptive evidence (hindsight) presented by tax authorities will be challenging indeed.

Let's now delve into the details.

There are a number of techniques / methods in use when conducting IP valuation exercises. Here are some of the quantitative IP valuation methodologies used.

Income approach

The income approach measures the value of the IP by reference to the present value of the economic benefits expected to be received over the remaining life of the IP

Market approach

The market approach measures value based on what other purchasers in the market have paid for assets that can be considered reasonably similar to those being valued

Cost approach

The cost approach measures the value of a IP based on the cost invested in building the IP, or its replacement or reproduction cost

Discounted cash flow (DCF)

DCF analysis uses future free cash flow projections and discounts them, using a required annual rate, to arrive at present value estimates.

DCF is one methodology used when conducting a trade secret valuation exercise. DCF analysis is a method of valuing a trade secret asset using the concept of the time value of money. All future cash flows associated with the trade secret asset are estimated and discounted by using cost of capital to give their present values.

When conducting a DCF analysis in the context of transfer pricing (i.e. a sale of intangible assets and / or the relocation of corresponding functions), one should be aware that the valuation should consider the perspective of the buyer as well as the perspective of the seller (i.e. at arm's length the buyer will generally anticipate to earn higher profits from the use of the intangibles than the seller and the parties will negotiate a price within a corresponding bid-ask range).

Here are some of the rational economic considerations when attempting to calculate the valuation of a trade secret. They may be broken down into four 'buckets – costs, timing, benefits and risks. These are the inputs as such which feed into the DCF valuation calculation.
Investment outlays. The economic outlay to create or develop the trade secret. This may include such details as the time taken to develop the trade secret, time taken to test it, labour costs involved, investment in physical capital (e.g., equipment, property, etc.) plus other related expenses.

Protection outlays: The economic outlay to provide reasonable protection to the trade secret, and may include administrative, legal and technical protection mechanisms deployed to protect the trade secret over time.

Protection period: The anticipated protection period as impacted by the likelihood of a competitor discovering through reverse engineering or other proper means. Of course, the trade secret owner himself may decide to declassify the trade secret after a period of time for various reasons.

Alternatives: The existence or expected development of acceptable alternatives or substitutes that could diminish or eliminate competitive advantages provided by the trade secret.
Investment returns. The economic benefits expected as a result of the trade-secret's use in a product or service, such as greater sales, price premiums, or cost reduction.
Internal capabilities: The benefits gained by the organisation possessing the trade secret in terms of its internal capabilities, and/or improved efficiency and effectiveness.

License or sale: a trade-secret owner might also consider licensing or selling a trade secret—whether as part of a specific IP transaction or as part of a larger business transaction.
Prior User Rights: Having a trade secret in use prior to another entity filing a patent application gives the trade secret owner prior user rights. The trade secret owner does not require a license to continue to use the patent belonging to that other entity.
Recovery of damages: While typically not a preferred way of generating a ROI on a trade secret, litigation involving misappropriation can also provide investment returns through the recovery of damages.

The risk that the company themselves fails to treat the information as a trade secret, by not controlling access and not putting reasonable protection mechanisms in place.
The risk that the trade secret is misappropriated by say a disgruntled employee, a former executive, a collaboration partner, a competitor or a hacker.

The risk that an independent party either patents or publishes the information thereby putting the information into the public domain.

All of these economic considerations are also relevant for transfer pricing professionals. Having access to respective information will greatly enhance the reliability (defensibility) of respective calculations.

Trade Secret Valuation Report:

A proper and professional trade secret valuation report should ideally contain the following sections.

- position and status of the appraiser
- purpose of the IP valuation
- identification of the subject IP
- details of any IP-related assets valued
- addressed audience/addressees
- premise of the IP value
- approach and methods used
- valuation date
- value date
- data sources used
- key assumptions and sensitivities
- And… limitations

When compiling the report, it is highly recommended to keep the Corporate Tax Department / Function and/or the external Accountancy & Tax Firm in the loop, as the contents will also be of immediate value for transfer pricing purposes. Not only does an overview (list) of the intangibles constitute a compulsory part of the required transfer pricing documentation, the so-called Master File (see OECD Guidelines, paragraph 5.19), it will also be an invaluable source of information to verify whether the trade secrets have been adequately taken into account in the context of intercompany transactions.

Trade secret valuation is a challenging task that frequently fails to demonstrate transparency in terms of how it reaches conclusions on asset value. In general, trade secret valuation requires thorough analysis and deliberation, the application of complex methodologies, and good levels of business judgement.

Anti-tax avoidance:

At the end of the day, OECD BEPS must be understood primarily as an anti-tax avoidance regulation.

The OECD recognizes two important aspects of base erosion and profit shifting, namely
(i) That value creation is increasingly driven by intangibles including trade secrets.
(ii) Most tax avoidance schemes are based on artificially separating ownership of intangibles (by entities based in low-tax countries) from the economic or value creating activity.
Consequently, the main reform, embodied in the OECD BEPS DEMPE functions concept, is that legal ownership of intangibles like trade secrets alone no longer justifies the allocation of residual profits.

Historically, trade secrets have, generally, been ignored by the finance and tax community. Since legal ownership of intangibles used to dominate the transfer pricing community, trade secrets were largely an afterthought. However, as a consequence of the OECD BEPS developments, transfer pricing professionals will be forced to adopt a much more comprehensive and nuanced understanding of intangibles, including trade secrets, and how they relate to value creation.

When we think of the increasing importance of the digital economy, the above effects will be further magnified. Ensuring an arm’s length profit allocation will only be feasible when based on a solid understanding and consistent analysis of the profit drivers, which will often be trade

Getting these economic basics wrong or providing ambiguous or insufficiently substantiated documentation will result in substantial tax risks. This also applies for providing a coherent justification for choosing a specific transfer pricing method. In a post-BEPS world, the viability of a CUP analysis is debased due to concerns of limited comparability. On the other hand, we are starting to see an advocacy towards the profit split method, build-on the new DEMPE concept (delineation of individual value contributions rather than ownership rights). Thus, applying a CUP by default (without adequate justification) will no longer be sustainable

The benefits (and dangers) of taking trade secret asset management seriously:
From a finance and tax perspective, are there clear tax benefits for a company that decides to take trade secret asset management seriously, and log such assets and track their associated costs and value over time? Well it depends on the business model!

There will always be a trade-off between administrative burden and benefits, such as limiting the tax risk, obtained by ensuring a sustainable transfer pricing system.

When dealing with a business model that is characterized by a fairly high degree of integration and where the competitive advantage is derived from valuable intangibles like trade secrets, the trade-off in favour of a systematic trade secret asset management will certainly be positive.
Naturally, a higher tax bill could result from the OECD BEPS reforms in cases where trade secrets were previously ignored or the company's previous transfer pricing system was based on legal ownership and license fees that are no longer sustainable. However, proper and professional trade secret asset management could be utilized as a risk mitigation tool in helping to modify the existing system, make targeted changes, and work to keeping the increased tax bill as small as possible.

Limiting uncertainty:

For those companies seeking to adopt highly aggressive tax avoidance schemes, life has certainly become more difficult as these schemes increasingly come under attack. Well, tough luck, but such companies will eventually have to find creative ways to navigate within the OECD BEPS framework.

For more conservative companies, the adjustment to OECD BEPS should not be dramatic. It can reasonably be assumed that their transfer prices are already more or less adequately aligned with their value creation and trade secret asset management will simply help provide these taxpayers with a tool to make sure.

Final thoughts:

Much has been written about trade secrets since the passage of the Defend Trade Secrets Act in the US and the EU Directive on Trade Secrets back in 2016.

The recent spate of high profile trade secret misappropriation cases has generated wide-spread attention. However, the emphasis has very much been on the legal aspects of trade secrets, especially when misappropriated.

On the other hand, the growing attention of the finance and tax community towards these trade secrets has generated much less exposure.
Looking to the future, with OECD BEPS Guidelines' implementation at a national level, there is a growing sense that the asset management of trade secrets is facing some interesting times ahead.