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ACCOUNTING ALERT

OPEN TEXT CORP.

TSX-OTEX; NASDAQ-OTEX

A Look Into Open Text's Simplified Tax Structure

Recommendation	**N/A**
Current Price	C$43.85
Veritas Intrinsic Value	N/A
Market Cap (C$ millions)	11,672
Yield	1.45%
Average 30 Day Volume (thousand shrs)	191
Float Shares Outstanding (million shrs)	250

Technology

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A Look Into Open Text's Simplified Tax Structure

Over the years, Open Text Corporation ('OTEX') has relied on a relatively low tax rate to pursue its growth by acquisition strategy and sustain its free cash flows. Up until 2016, the company's low tax rate was underpinned by a Luxembourg-based tax structure. In early F17, management reorganized the company's tax structure by moving the Intellectual Property from Luxembourg to Canada. Based on our analysis, we see the change as proactive and likely to significantly de-risk the company's tax structure. We note, however, that OTEX's non-GAAP tax rate is likely to rise over time, from 15% in F17, to an estimated ~19% by the end of F22. However, in our opinion, the benefit of a more transparent and stable Canadian-based tax structure justifies the gradual increase in tax rate.

Our report profiles the following issues:

- **Luxembourg became too risky**: The end of Luxembourg's favourable patent box regime, coupled with pending implementation of reforms by OECD and G20 nations that target tax avoidance, as well as intensifying investigations by the European Commission into various tax havens, necessitated the change in OTEX's tax structure.

- **The essence of the new tax structure:** The transfer of IP to Canada triggers a legitimate Canadian tax shield, which we estimate at $2.6 billion, available for use against future Canadian income tax, which will enable OTEX to keep its non-GAAP tax rate at ~15% in the near term (i.e. the estimated current tax rate on OTEX' non-GAAP earnings). We estimate that the IP transfer could enable OTEX to take an annual deduction of ~$180 million against taxes payable.

- **Non-GAAP rates are likely to rise to 19% by the end of F22:** Assuming future organic growth in pre-tax income and given the gradual depletion of the tax shield over time, we estimate that OTEX's tax rate could rise by ~400 basis points by the end of F22, all else equal. We note, however, that OTEX' tax rate may be lower than our forecast if it accesses additional R&D tax credits and/or employs other tax planning tools.

- **Future acquisitions could be used to replenish the tax shield:** Under the new Canadian structure, OTEX could migrate IP from potential future acquisitions into Canada, while writing the related intangibles up to their fair value. This will replenish the tax shield and reduce effective tax rate on earnings from future deals.

- **Lack of clarity continues on OTEX' US$575 million reassessment by the Internal Revenue Service ('IRS'):** Despite our questions, management did not elaborate on the IRS's arguments and the company's own position that the IP transfers, back in F10 and F12, underlying the reassessment, were non-taxable. Further, management could not refer us to specific legal precedents that support their position. Hence, we are unable to independently assess the merits of the OTEX's position or conclude on the likely risk exposure. Nonetheless, based on recent litigation history between various companies and the IRS, we expect that it is more likely than not that the ultimate resolution will occur well below the headline US$575 million reassessment figure.

- **Non-GAAP tax rate calculation methodology:** We believe that OTEX's calculation is fair and properly reflects the substance of underlying transactions.

Overall, we view OTEX's new tax structure favorably. However, we remain concerned about a potential overhang from the IRS reassessment and any future tax challenges related to prior Luxembourg arrangements. On balance, however, we believe these tax risks are relatively muted, given the company's size.

What's Wrong With Luxembourg?

In a series of transactions dating to 2010 and 2012, OTEX centralized its Intellectual Property (IP) in Luxembourg. Beyond consolidating IP in one place, which simplified OTEX' corporate structure and avoided a spider web of intercompany transfers and payments. The moves enabled OTEX to materially lower its taxes, given Luxembourg's favourable tax treatment of IP-related income. In addition, we understand that the company was able to secure a tax ruling from Luxembourg authorities that provided further clarity and stability to the company's tax arrangement at that time.

Since then, however, government attitudes towards corporate tax avoidance have shifted, notably in the European Union and in the U.S., as corporate inversions proliferated and a variety of other creative tax structures enabled multinational corporations to move their IP off-shore. The resulting tax leakage eroded the tax base of the U.S. and EU countries as profits generated in high tax rate jurisdictions were diverted to tax havens.

More specifically, we highlight the following developments over the past few years that increased the risk of a challenge to OTEX' Luxembourg tax arrangements:

- **Proposed changes in tax laws related to base erosion and profit shifting ("BEPS"):** The Organization for Economic Co-operation and Development (OECD), which includes Canada, the U.S. and the European Union, in conjunction with all G20 countries, have drafted measures designed to close gaps in international tax rules that allow multinationals to artificially shift profits to low tax jurisdictions. Once adopted, which we expect to happen sometime over the next few years, the measures could result in a substantial increase in cash taxes paid by multinational companies. The proposed reforms will revise transfer pricing guidelines to focus on economic substance, rather than legal form. The intention is to allocate greater profits to jurisdictions where the intellectual property (IP) is exploited and/or developed, not where it resides. The new guidelines will also crack down on intercompany financing arrangements that enable companies to deduct same interest in two different tax jurisdictions at the same time and/or shift profits into low tax jurisdiction via intercompany interest/dividends. In addition, the actions are designed to prevent treaty abuse by denying tax benefits for setting up foreign subsidiaries that channel profits to low tax rate jurisdictions.

- **A crackdown by the E.U. Commission:** As part of a broader investigation into arrangements that allow major multinationals to pay little or no tax, the European Commission (EC) has been investigating Luxembourg since 2013, looking for tax deals that breach E.U. state aid rules by conferring an unfair advantage to one company over others. In similar investigations, the EC has already ruled against Ireland and Belgium, requiring the local authorities to recover unpaid taxes from multiple companies, including Apple Inc. The European authorities are currently pursuing in-depth investigations into Amazon and McDonald's tax arrangements with the Luxembourg authorities, which according to the EC use intercompany transactions and transfer pricing to divert profits from other countries into Luxembourg, where these profits are effectively exempt from taxation. In addition, the EU has been investigating Luxembourg's patent box regime, which has been used to exempt 80% of IP-related profits from tax. In 2016, under the pressure from the EC, Luxembourg has discontinued its patent box regime in its current form, with a transition period ending in 2021. The new patent box regime will comply with the BEPS principles and will be directly linked to the "real" R&D costs incurred by Luxembourg entities, removing the advantages of intercompany IP transfers and cost sharing arrangements, where related-party R&D is funded (but not performed) by a low tax rate jurisdiction. We believe that this change would have negatively affected OTEX's ability to maintain its low tax rate and transfer new IP into the Luxembourg structure.

In light of the above developments, we believe that OTEX' Luxembourg arrangements ceased to be an attractive or sustainable tax strategy for the company. Hence, unwinding the structure with an IP transfer to Canada was a viable and logical next step.

THE CANADIAN PERSPECTIVE

The Company's recent IP move to Canada could be viewed as a sequence of the following steps:

- **Step 1 - Fair value (write up) of the IP for tax purposes:** Under Canada's transfer pricing guidance, transactions must be valued at fair value, which likely involved a write-up in the value of OTEX' Luxembourg based IP. Based on our discussions with management, the write-up transaction did not attract any meaningful taxes in Luxembourg.

- **Step 2 - Transfer of the assets to Canada at fair value:** The transferred IP qualifies as Eligible Capital Property (ECP), in Canada, recorded at fair value for tax purposes. This in turn, will enable OTEX to take an annual tax deduction calculated as a certain percent of the IP's fair value. (More on this tax value later.)

- **Step 3 - Claim of the related deduction against future income streams**: Since the IP will be located in Canada, any income streams related to the transferred IP from abroad will also be taxed in Canada at its much higher rate of 26%, instead of Luxembourg at ~6% (our estimate). However, the company will be able to offset much of the increase in tax rate with Cumulative Eligible Capital (CEC) tax deductions, lowering the company's overall non-GAAP tax rate back to ~15%.

ESTIMATING OPEN TEXT'S PROSPECTIVE TAX RATES AND TAX SHIELDS

According to OTEX's disclosure, the transferred IP was recorded at fair value for tax purposes and the company has also recognized a deferred tax asset of $876 million in connection with IP transfer (a benefit to OTEX). Under OTEX's U.S. GAAP reporting, the deferred tax asset is calculated by applying the Canadian statutory tax rate of 26% to the difference between the tax value and accounting net book value of the underlying assets. Given the recognition of the deferred tax asset, it appears that the fair valuing of OTEX' IP for tax purposes resulted in a higher tax value compared to the reported accounting net book value under U.S. GAAP.

From the U.S. GAAP perspective, there was no revaluation, and therefore no change in the net book value of intangible assets, since the IP transaction was an intercompany arrangement and the revaluation to fair value happened solely for tax purposes. Therefore, the tax value of the IP has increased above the accounting value, which has not changed, creating a temporary difference between the tax and accounting values. This difference, under U.S. GAAP guidance gives rise to a deferred tax asset.

To estimate the tax value of the transferred IP, and by extension the amount of the tax shield, we add the temporary difference between OTEX' tax and accounting values to its reported accounting net book value for *'technology assets'*, disclosed on OTEX's Q1-F17 balance sheet (the quarter of the transfer). Figure 1 details our calculation:

Figure 1
Estimated Tax Value Arising on the IP Transfer
Amounts in millions of U.S. dollars

Deferred tax asset arising from the reorganization – reported	A	876
Canadian statutory tax rate – reported	B	26.5%
Implied excess of IP tax value over accounting net book value	C = A/B	3,306
Accounting net book value of *'technology assets'* – reported per Q4-F16 statements	D	204
Estimated tax value of transferred IP	**E = C+D**	**3,510**

Source: Company reports and Veritas.

The transferred IP qualifies as Eligible Capital Property (ECP) for Canadian tax purposes.[1] Under Canadian tax rules, ECP acquired or transferred before 2017 is eligible for a 75% inclusion rate and is deductible against taxable income on a declining balance basis at a 7% rate.[2] Figure 2 details our estimate of the total tax shield created by the IP transfer, as well as the annual deduction that OTEX could take against future taxable income related to the transferred IP:

Figure 2
Estimated Tax Shield And Annual Deduction Arising on the IP Transfer
Amounts in millions of U.S. dollars

Total tax value of transferred IP, from Figure 1	A	3,510
Cumulative Eligible Capital inclusion rate	B	75%
Estimated tax shield	C = A x B	2,632
Cumulative Eligible Capital deduction rate	D	7%
Est. annual tax deduction (future deductions are calculated on a declining balance basis) *	**E = C x D**	**184**

**Half year rule is not applicable to ECP acquired before January 1, 2017.*
Source: Canada Revenue Agency, company reports and Veritas.

[1] *Some of the IP could have also qualified as other Capital Cost Allowance classes, which are also deductible for tax purposes but at a different rate.*

[2] *Effective January 1, 2017 Canadian government has changed the rules related to Eligible Capital Property. Under the new rules, eligible expenditures on intangibles will be added at 100% of their cost to the Capital Cost Allowance pool and will be deductible at 5%, on a declining balance basis. Purchases after January 1, 2017 are also subject to half year rule, which limits the amount of deduction by 50% in the first year. Eligible capital expenditures incurred before 2017 will remain deductible at 7% on a declining balance basis until 2027.*

Note that OTEX' tax deduction will be lower in future years, as the balance of Cumulative Eligible Capital is drawn down. Figure 3 illustrates:

Figure 3
Estimated Tax Shield Depletion And Impact on Non-GAAP Tax Expense
Amounts in millions of U.S. dollars

	F17	F18	F19	F20	F21	F22	CAGR/ Cumulative
CEC - opening balance, from Figure 2	2,632	2,448	2,277	2,117	1,969	1,831	
Less: annual tax deduction at 7%	184	171	159	148	138	128	**-7%**
CEC - ending balance	2,448	2,277	2,117	1,969	1,831	1,703	
Decline in annual deduction, YoY		(13)	(12)	(11)	(10)	(10)	**(56)**
$ increase in non-GAAP tax expense *		3	3	3	3	3	**15**
Expected F17 non-GAAP tax expense **							91
% increase in non-GAAP tax expense							**16%**

**Decline in annual deduction x 26% Canadian tax rate.*

***As per management's guidance of 15% non-GAAP tax rate and Bloomberg consensus non-GAAP earnings.*

Source: Canada Revenue Agency, company reports and Veritas.

All else equal, we estimate that OTEX's non-GAAP tax expense may increase by $15 million, or 16%, over the next five years due to the decline in the available tax shield.

Further, given the declining balance of the CEC tax shield, all else equal, OTEX's non-GAAP tax rate should gradually rise, if the company's earnings before tax (EBT) also grows organically. For illustrative purposes, assuming an organic EBT growth of 5% per year over the next five years, in Figure 4 we estimate that the company's non-GAAP tax rate may rise from 15% in F17, to 17% by the end of 2022.

Figure 4
Estimated Impact of Increase in Pre-Tax Earnings on Non-GAAP Tax Expense
Amounts in millions of U.S. dollars

Expected F17 non-GAAP EBT *	A	608,824
Projected F17 non-GAAP tax expense **	B	91,324
Est. increase in non-GAAP EBT through 2022 ***	C	168,207
Canadian tax rate on incremental EBT above F17 level	D	26%
Est. tax expense on incremental EBT above F17 level	E = C x D	43,734
Estimated non-GAAP tax expense on F22 EBT before the impact of tax shield depletion, from Figure 3	F = B+E	135,057
Estimated non-GAAP tax rate on F22 EBT before the impact of tax shield depletion, from Figure 3	**G = F /(A+C)**	**17%**
Add: est. increase in tax expense due to depletion of the CEC balance, from Figure 3	H	14,579
Est. non-GAAP tax expense on F22 EBT	I = F + H	149,636
Est. non-GAAP tax rate on F22 EBT	**J = I / (A + C)**	**19%**

** Bloomberg consensus and Veritas.*

*** Based on 15% rate, as guided by management.*

**** For illustrative purposes, we assume 5% organic annual EBT growth rate.*

Source: Company reports and Veritas.

Note that our simplistic illustration assumes that OTEX's expected F17 EBT of $608 million is high enough to absorb tax deductions stemming from the existing CEC balance, special charges and other losses, which are excluded from the company's non-GAAP earnings. Therefore, incremental increase in EBT will be taxed at an effective rate of 26%.

Lower EBT growth would result in a lower non-GAAP tax rate than we have illustrated above. We estimate that each 5% in annual EBT growth translates into approximately 150 bps increase in OTEX' non-GAAP tax rate. We also note that our estimated increase in tax rate up to 19% by the end of F22 may be too aggressive to the extent OTEX will be able to deduct eligible R&D tax credits and employ other tax planning tools.

What If Future Growth Comes From New Acquisitions?

Based on our discussions with management, we understand that the company plans to migrate IP from any potential future acquisitions into Canada. This will involve writing up the acquired IP assets to fair value at the time of transfer, which will create additional tax shield in Canada against the related future IP income.

We believe that investors could gauge the approximate value of the resultant tax shied from acquisition note disclosure, where OTEX has historically disclosed the fair value of acquired intangibles. Note that goodwill may not always be tax deductible, and therefore has to be excluded. OTEX has historically disclosed the portion of goodwill deductible for tax purposes.

Although future transfers will likely result in taxable gains abroad, which will not be subject to as favorable tax treatment as in Luxembourg, we believe that OTEX could offset some of the one-time tax costs through acquisition specific tax attributes and structures, such as buying assets instead of shares and using loss carry forwards and other deferred tax assets. Therefore, we believe that earnings from future deals would likely attract an effective tax rate below 26%.

Weighing the Risk Profile

Overall, we view OTEX' new tax structure as less risky for the following reasons:

- **No longer dependent on a tax haven that is under pressure:** OTEX departs Luxembourg at a time when the jurisdiction is under investigation by the powerful EU Commission.
- **Proactive move to address the BEPS challenges:** As noted, BEPS reforms will materially curtail companies' ability to avoid taxes by locating IP in tax havens and using transfer pricing to shift profits away from high tax rate areas. In our view, the move to Canada substantially alleviates this risk.
- **A more transparent arrangement:** The Luxembourg structure depended on a murky and potentially preferential tax ruling (a common practice in Luxembourg) that could be disputed as anti-competitive by other jurisdictions. By moving IP to Canada, OTEX now relies on a transparent and commonly used capital cost deduction mechanism.

We are concerned, however, with potential back taxes, if the EC were to rule against Luxembourg. However, it seems that currently the EC is pursuing giants, like Amazon and McDonalds, rather than all companies that may have benefited from potentially preferential tax rulings from Luxembourg authorities. Therefore, we view the risk of material back taxes as moderate at this stage. Nonetheless, it is a risk worth monitoring.

The IRS Reassessment

The IRS has reassessed OTEX for $575 million, including penalties and interest, related to the company's tax treatment of the IP transfers from the U.S. to Luxembourg, back in F10 and F12. On the surface, it appears that the dispute has to do with the valuation of the transferred IP. However, based on our discussions with management, the real issue is whether OTEX is even liable for taxes in the U.S.. The original transfer was made with little upfront tax because OTEX and its advisors had concluded that most of the transfer was non-taxable. The IRS takes the position that the transfer should give rise to taxes at the time of the transfer.

Despite our questions, management did not elaborate on the IRS's arguments or the company's own position that the transfer was non-taxable. Further, management could not refer us to specific legal precedents that support their position because, according to management, none of the precedents are sufficiently similar. OTEX reticence to outline their case reflects a view that available precedents include certain similar steps but one needs to aggregate separate pieces from multiple distinct precedents to approximate OTEX's facts and circumstances.

Therefore, based on existing disclosures it is very difficult to assess the merits of the OTEX's position or to conclude on the likely risk exposure. We note that OTEX had no transfer pricing agreement with the IRS when they transferred IP to Luxembourg. Thus, the transfer was not preapproved by the IRS, which increases the risk of an adverse outcome for the company.

However, while we know that the maximum exposure is limited to $575 million, IRS settlements and court resolutions often settle for less than the disputed amounts. If history is an indication, we believe it is reasonable to expect a lower payout as the IRS moves to save on legal costs and avoid years of litigation. Figure 5 lists four recently-concluded, high profile litigation cases involving the IRS. As illustrated, ultimate settlements and court rulings are significantly lower than the reassessments initially proposed by the IRS.

Figure 5
Recent Litigation Outcomes
Amounts in U.S. dollars.

Company	Issue	Original Re-assessment	Tax years	Resolved	Outcome
Medtronic PLC	IP related transfer pricing	$1.2 B	2005 & 2006 tax years	2017	Court ruled against the IRS and nullified the reassessment
Boston Scientific Corp.	IP related transfer pricing	$1.16 B	2001-2007	2016	Settlement: $275M
Amazon.com Inc.	IP related transfer pricing	$1.5 B	2005 and 2006	2017	Court ruled against the IRS
Tyco International PLC	Intercompany interest payments	$2.8 B	1997-2000	2016	Settlement: $475M - $525M

Source: Medtronic, Inc. v. Commissioner, No. 6944-11; Tyco Elec. Corp. v. Commissioner, No. 16651-13, Guidant LLC (Boston Scientific) et al. v. Commissioner, Nos. 5989-11, 5990-11, 10985-11, 26876-11, 5501-12 and 5502-12; AMAZON.COM, INC. v. COMMISSIONER, No. 31197-12; Wall Street Journal; Reuters.

Further, based on our discussion with management, at this stage there is no indication that the Canadian tax authorities (CRA) intend to reassess F10-F12 IP transfers to Luxembourg.

NON-GAAP TAX METHODOLOGY IS FAIR

One of the issues recently pursued by the SEC relates to non-GAAP tax rates reported by companies. The SEC is concerned that companies exclude various expenses from their pre-tax non-GAAP earnings, but reduce their non-GAAP tax expense by the tax benefits related to those excluded expenses. This, of course, helps report lower non-GAAP tax rates and higher non-GAAP net earnings.

We reviewed OTEX's calculation of non-GAAP tax expense and tax rates and note that the company's calculation methodology is reasonably defensible. OTEX's reported non-GAAP tax expense/rate do not benefit from tax deductions related to the excluded expenses. Specifically, the company's non-GAAP tax expense and the related non-GAAP tax rate exclude the tax benefits from: intangibles amortization; share based compensation; special charges, including restructuring; acquisition costs; etc. Further, OTEX's non-GAAP tax expense excludes the impact of changes in valuation allowance, which in our experience, are subjective and susceptible to timing.

Updates to OTEX' Non-GAAP Calculations Also Make Sense

Effective Q1-F17, OTEX has modified its non-GAAP tax expense calculation by including a portion of the $876 million tax benefit related to the IP transfer made in early F17, which we discussed in detail, above. Essentially, the tax benefit of $876 million was recognized in its entirety in earnings under the U.S. GAAP (by reducing GAAP tax expense) at the time of IP transfer to Canada, in Q1-F17. However, only a small (albeit undisclosed) fraction of the $876 million tax benefit was included in OTEX's Q1-F17 non-GAAP tax expense. Instead, the tax benefit will be gradually allocated to future fiscal periods based on forecasted utilization of the tax shield and included over time in the company's non-GAAP tax expense. We believe that the recent change is appropriate because it reflects the substance of the transaction and the actual pattern of tax savings arising from the $876 million deferred tax asset.

Much Simpler, Much Better

Overall, we like OTEX's new tax structure. While there continue to be tax risks related to the IRS reassessment and any challenges that might arise from the company's past Luxembourg arrangements, even if realized these risks are likely to be small relative to Open Text's market value.

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Our Vision

To seek the truth from the facts.

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To be our clients' trusted source of independent knowledge and advice.

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