To date there have been countless articles about the potential effect of tax reform on companies both large and small, with the focus of these articles on the potential outcomes of tax reform on companies’ effective tax rates (please see the links below to A&M Taxand articles). However, we have not encountered any discussions of what will be a key factor in planning for and reacting to tax reform: the fair market value of legal entities, intellectual property and tangible assets. This edition of Tax Advisor Weekly delves into the implications of having to value legal entities, intellectual property and tangible assets, as well as what you may need to consider relative to the prospect of tax reform.

Given that the U.S. federal tax rate of 35 percent is among the highest tax rates in the world, companies frequently implement strategies to maximize operational efficiencies and correspondingly reduce their effective tax rate through restructuring of their global entities and assets. These structures often include relocating intellectual property (IP) into jurisdictions where the product/service would be sold/provided; e.g., the non—U.S. rights for IP related to sales in a European country would be moved into that country. Similar arrangements are made relative to legal entities and tangible assets; e.g., operations in countries that do not possess any IP and act solely in a sales or distribution role would be resident in a local legal entity that operates as a limited risk distributor. Additional methods for improving operational efficiencies and effective tax rates include supply chain realignment, out—from—under transactions, legal entity rationalization, and transfer of fixed assets/manufacturing operations, among others.

As we have documented in numerous Tax Advisor Weekly articles, there are multiple potential outcomes for tax reform based on proposals by both the House and the Trump administration, all of which are designed to lower the effective tax rate of U.S. companies and make them more competitive on the world stage. The various tax reform proposals could have a profound effect on both international and domestic tax planning, a focal point of which will be the fair market value of legal entities, intellectual property and tangible assets.

The question of value must therefore be considered in advance of the implementation of any tax reform—related structuring, as it could play a significant role in the decision—making process. Furthermore, tax reform could also create changes in the fair market value of entities and assets; these changes must also be considered as part of the tax planning process.

**Intellectual Property**

We commence the discussion with IP, as it tends to be the asset that garners the most publicity relative to global tax planning strategies. Historically, U.S. companies have incorporated structuring plans to move the non—U.S. rights of their IP — ranging from trade names to patents and other intangible assets — to lower tax jurisdictions, thereby simultaneously aligning their operations and creating a more tax—efficient structure. But if the U.S. were to have a 15 percent federal tax rate, a few questions would arise. Would it make sense to change the approach and keep IP — even the non—U.S. rights — in the U.S.? Should the rights to IP currently residing outside of the U.S. be brought back to the U.S.?

Within these questions are myriad possibilities that require thorough consideration of all factors, including the fair market value of the IP. Each situation will depend on the facts and circumstances, not to mention that the decision could also be driven in part by the stage of the company in its lifecycle.

Let’s examine a multinational company with IP residing in various jurisdictions worldwide. With a 15 percent tax rate in the U.S.,
it may make sense to move the global IP back to the U.S. to take advantage of the lower tax rate. To take it a step further, in the event a border—adjustment tax (BAT) is implemented (although that possibility looks less than probable these days), if the IP is owned by the U.S. entity and the product is sold outside of the U.S., the revenues from the sale may not be taxed under the current BAT proposal. Even if a BAT is not part of final tax reform, the low tax rate in the U.S. and territorial tax system could be a reason to move the IP back to the U.S. Before making plans to do so, companies must be cognizant of the fair market value of the IP in the non—U.S. jurisdictions, as there could be negative tax consequences in the local countries (i.e., exit taxes akin to a capital gains tax) that could be a barrier to or would mitigate to a degree the future benefits of moving the IP. A potential offsetting factor could be the motivation to move the IP back to the U.S. to take advantage of the tax deduction that would only be available if the IP resided in the U.S., another potential implication of a BAT.

In terms of IP that is owned in the U.S. but currently (or in the future) generates revenues outside the U.S., the answer resides in the facts and circumstances of each situation, with a primary driver of the decision centered on the value of the IP. Many companies may want to simply keep the IP in the U.S. for the reasons outlined above. However, what about an emerging company with significant net operating losses (NOLs) that would be worth significantly less to the company if the U.S. tax rate dropped from 35 percent to 15 percent?

In this case, it may be prudent for the emerging company to sell its IP to a non—U.S. entity prior to the effective date of the tax reform. Why? The sale of the IP will likely generate a gain, which could then be offset by the NOLs, thereby providing an accelerated use of the NOLs at the 35 percent tax rate rather than a more drawn—out usage of the NOLs at a 15 percent tax rate and obtaining deferral from U.S. tax on the future earnings of the IP. For companies that prefer to have their IP aligned with their global operations, if NOLs are present this could be a preferable approach. One key driver in this decision is the fair market value of the IP.

Legal Entities

Many companies encounter situations in which their legal entities are owned directly by a U.S. entity, which often does not provide for the most tax—efficient structure or effective organizational alignment. Companies traditionally have remedied this situation through “out—from—under” transactions that move the non—U.S. entities out from under the U.S. entity and into local entities within the country in which they operate. Even with a 15 percent U.S. tax rate, this could still make sense for a variety of reasons, but what is the economic cost of doing so? Once again, the key driver of that decision could be the fair market value of each legal entity, given that the company will pay tax on the gain associated with the sale of the entity to a related—party entity.

Companies undergo supply chain realignments to transform their organizational and functional structure, with the goal of maximizing their value chain and hence profitability and shareholder value. In many supply chain transformations, a direct effect is the movement of legal entities and assets across jurisdictions, thereby triggering a taxable event. Furthermore, another result is a categorization of entities as limited risk distributors, contract manufacturers, entrepreneurs, etc. These categorizations will often be accompanied by transfer pricing that dictates the economic performance of these legal entities. The final step will be to understand the fair market value of each entity. In the event of a much lower U.S. federal tax rate, a company seeking to maximize the efficiency of its supply chain should be mindful of the value of the relevant entities as part of the planning phase of the supply chain realignment to ensure it is fully aware of the associated tax effect.

As detailed in both the out—from—under and supply chain realignment examples (and there are numerous more relevant situations), a key factor in any structural planning analysis must be to consider the value of each legal entity and the resulting tax consequences.

Repatriation

A possibility as part of proposed tax reform is a one—time repatriation tax holiday that would allow companies to repatriate cash at a much lower tax rate. Does a repatriation holiday affect the value of an entity?

The answer is that it potentially could, depending on the position the company has taken relative to repatriation. For example, if a company has not made an assertion that it will permanently reinvest its earnings in the home country, the company would record a deferred tax liability to reflect the future tax payment it would incur upon repatriation of the cash.

When estimating the value of a non—U.S. legal entity, a key component — and one that is often missed in these specific valuations — is the company’s position on repatriation. If a company has recorded a reserve for a future U.S. tax liability
pursuant to APB 23, the valuation of the entity assumes the projected income would be taxed at a U.S. federal rate of 35 percent. But what if some of that income will be repatriated at a much lower rate as part of the repatriation tax holiday? The effect could be an increased value in the legal entity due to the cash and potentially some portion of income being taxed at a rate much lower than 35 percent (or 15 percent).

Tax Valuation Nuances

Given the significant potential role that valuation of entities and assets could play as part of tax reform, it is worthwhile noting that there are nuances related to a valuation for income tax purposes relative to other purposes, namely financial reporting, gift and estate tax reporting, etc. Without providing a tutorial on how to value an entity or asset specifically for tax purposes, here are several key factors that must be considered to ensure the valuation is conducted correctly:

- treatment of intercompany transactions
- nature of the entity
- transfer pricing/profit margin
- entity risk
- IP ownership
- repatriation position/tax rates

Alvarez & Marsal Taxand Says:

Whether your company is a large multinational business with a complex legal entity structure or an emerging company that is in its early stages, tax reform is expected to usher in significant changes. A key component of this change is to have insight into the fair market value of your company’s entities and/or assets to ensure in advance that you are appropriately prepared for tax reform. It is difficult to plan your tax strategy if you do not have a full comprehension of the various benefits and costs, both of which could be driven by valuation. Thus, it is important to incorporate a valuation of entities and assets — conducted consistent with appropriate tax valuation approaches — as part of any tax reform planning. The fair market value of an entity or an asset could drive what the most viable or beneficial tax planning opportunity is for any company.

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Related Issues:

Ambitious Tax—Cut Plan Short on Details [4]

The Trump administration yesterday (April 26, 2017) shared its ambitious but very short outline for U.S. Tax Reform as presented by Treasury Secretary Steven Mnuchin and National Economic Council Director Gary Cohn during a press briefing.

Foreign Tax Credits: A Go—To Tax Planning Tool in the Pre—Reform Landscape [5]

Almost two years ago, we wrote in these pages about the importance of companies taking a fresh look at their foreign tax credit profile as many began to eat through loss carryforwards and emerge as cash taxpayers once more.


You may already be modeling out the tax impact on your company’s financial statements of various tax reform scenarios, just as we have been doing for a number of our clients.

Source URL: https://www.alvarezandmarsal.com/insights/tax-reform-and-effect-valuation

Links


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