Understanding the Nuances of Valuations for Tax Purposes

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A business or intangible asset is typically valued using a combination of the income, market and asset approaches. A valuation conducted specifically for tax purposes introduces added layers of complexity due to nuances specific to this type of valuation, often causing critical assumptions and values to differ from valuations conducted for other purposes.

Many of the complexities arise for multinational companies with legal entities and operations located worldwide that provide a defined service or goods for related entities. This article focuses on the treatment of intercompany transactions that must be addressed in a valuation for tax purposes, with specific focus on the income approach because of the limitations often encountered with the market and asset approaches in valuing certain types of legal entities.

Viewed through this lens, the issue of how to treat intercompany transactions in an income approach is vital.

While this article focuses primarily on valuing an entity or assets for U.S. tax purposes, valuations conducted for entities located in non–U.S. jurisdictions that are being used or required for non–U.S. tax purposes can also carry their own specific approaches and assumptions, and are not covered here.

We complement the discussion with an example: Company A has just completed the acquisition of the stock of Company B, and is now planning to transfer patents to a related–party entity located outside the U.S. In doing so, Company A requires a valuation of the patents to ascertain capital gain treatment on the outbound transfer of the intellectual property (IP). The products protected by the patents will be sold both to related parties and direct to third–party customers, with related–party sales governed by intercompany transfer pricing agreements.

Key Factors

The factors that must be considered in a valuation for tax purposes include:

1. Treatment of intercompany transactions;
2. Nature of the entity;
3. Transfer pricing / profit margin;
4. Entity risk;
5. IP ownership; and
6. Repatriation position / tax rates.

1. Treatment of Intercompany Transactions

The treatment of intercompany transactions is one of the more misunderstood, yet often the most vital, facets of a valuation for tax purposes. Types of intercompany transactions commonly encountered include:

- Sale of goods or services;
- Use of IP; and

- Intercompany financing.

The key question is whether or not intercompany transactions should be included or excluded from the valuation. The answer? Intercompany transactions should be included when valuing a business or asset as part of an analysis for U.S. tax purposes.

Excluding intercompany revenues from the valuation would significantly undervalue the business or asset. The premise that a third party would not pay for a revenue stream or expect to settle intercompany debt can potentially cause significant tax issues for the company, and may cause the user to:

- Erroneously ignore the seller's motivation to maximize value in the event of a sale to a third party;
- Assume revenues would not be present in a third–party scenario, thus calling into question the purpose of the entity;
- Contradict transfer pricing positions that are based on arm's length scenarios; and
- Compromise the position that purported debt is debt, as opposed to equity, for tax purposes, and call into question the ability to deduct the interest expense.

2. Nature of the Entity

The nature of the entity provides the foundation for many of the other key factors and dictates the valuation approach and assumptions. Following are common entity structures and the valuation approach typically used:

- Holding companies with minimal operations — net asset approach
- Intangible holding companies — income approach
- Operating companies: full–service operating companies — combination of income and market approaches; contract manufacturing / logistics operations with a cost plus arrangement — income approach; limited risk distribution companies with a designated profit margin — income approach

3. Transfer Pricing / Profit Margin

Transfer pricing plays a critical role in valuing an entity with intercompany transactions; therefore, to avoid having the valuation contradict the transfer pricing structure, the key assumptions for both analyses — e.g., revenues, profit margins, etc. — should be consistent.

While this seems like a basic point, it is actually one that is often overlooked.

4. Entity Risk

The nature of the entity will drive the risk inherent in the operations, ranging from a distributor with no IP rights and a defined return, up to a full–service operating entity that acts as an entrepreneur in the overall company and thus bears the greatest risk.

One element to capture risk in a valuation using a discounted cash flow approach is the discount rate. This is used to estimate the present value of the future cash flows associated with the entity. The selection of a discount rate cannot be performed in a vacuum — it must consider the nature of the operations, functions and rights of the entity, transfer pricing, and profit margins, among others.

5. IP Ownership

The nature of the entity will often dictate the role of IP. Limited risk distributors and contract manufacturers often do not retain any IP rights, whereas full–service operating entities and IP holding companies do possess IP rights. Entities without IP rights typically generate lower profit margins and risk relative to entities that hold the rights. The entity's IP situation should be factored into the transfer pricing and discount rate.

6. Repatriation Position / Tax Rate

The income tax rate applied in the discounted cash flow approach is a key factor in determining the value of an entity. In this analysis, one must incorporate the entity's position relative to repatriating its earnings.

If the entity's position is to permanently reinvest its earnings, the valuation should incorporate the statutory tax rate of the local country in which the entity resides and pays taxes. If, however, the entity's position is to eventually repatriate its earnings to its U.S. shareholder — something that will be reflected in an APB 23 reserve (Accounting Principles Board Opinion No. 23 was issued in part to establish accounting policy for the treatment of undistributed earnings of non–U.S. subsidiaries)— the cash flows should be taxed at U.S. federal and state statutory tax rates, using the applicable rules for use of foreign tax credits.

Applying a tax rate that is inconsistent with the company's APB 23 position is a key factor that is often overlooked in a valuation for tax purposes.

Tax versus Financial Reporting
Finally, we use our example to highlight a significant difference between valuations conducted for U.S. income tax purposes and valuations for financial reporting purposes.

At the time of its acquisition, Company A was required to allocate the purchase price to all of the tangible and identifiable intangible assets of Company B pursuant to U.S. financial reporting purposes.

A widely accepted and commonly used approach for valuing IP assets for financial reporting purposes is the relief from royalty method (a form of the income approach), which is based on a royalty rate as a percent of revenues that a licensee would be willing to pay a licensor for the use of the IP. However, this approach may not be appropriate for U.S. income tax purposes.

Treasury Regulation Section 482–7(g)(2)(vii)(A) states: "Allocations or other valuations done for accounting purposes may provide a useful starting point but will not be conclusive for purposes of the best method analysis in evaluating the arm's length charge..., particularly where the accounting treatment of an asset is inconsistent with its economic value."

Furthermore, a recent OECD Discussion Draft — Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions — specifically states: "In particular, valuations of intangibles contained in purchase price allocations performed for accounting purposes are not relevant for transfer pricing purposes."

Instead, another form of the income approach known as the excess earnings method may be to value IP for U.S. tax purposes. The excess earnings method incorporates not only returns attributable to the patents but also other intangible assets that may contribute to the value of the patents or be part of the transferred IP. This approach is consistent with examples cited in Treasury Regulation Section 482–7(g)(2)(vii)(B), as well as the OECD's position that portions of value that were categorized as goodwill for financial reporting purposes may in fact be included as part of the fair market value of transferred intangible assets for income tax purposes.

If Company A had used the value of the patents derived for the financial reporting analysis, it could create unwanted tax risk.

Alvarez & Marsal Taxand Says:
Valuations conducted for tax purposes must consider specific nuances. This is vital in today's environment, especially considering the scrutiny placed on transactions, including intercompany debt and transfers of entities and intangible property, all of which are heavily influenced by the fair market value of the subject interest.

It is crucial to integrate a valuation expert, in addition to a transfer pricing expert, as part of any tax structuring project. Insights from a tax valuation specialist can enhance the design, planning and implementation of a structuring project.

reminded to consult with their tax or other professional advisors before determining if any information contained herein remains applicable to their facts and circumstances.

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