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Finding An Intersection Between Intangibles Valuation And Transfer Pricing In The US

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Valuations of intangibles for financial reporting and transfer pricing are prominent and challenging areas in the entire M&A transaction process. The objective of this article is to dissect the differences and find the intersection that can turn the divergence into opportunities for convergence.

Cross-border mergers and acquisitions (M&A) are at their hottest pace since before the financial crisis, and a large proportion of transactions has increasingly involved intangible assets or intellectual property (IP) as the dominant acquired asset. As multinational companies shift ownership of intangible assets between legal entities and across jurisdictions for various strategic purposes, the most critical considerations in cross-border M&A, therefore, are the identification and valuation of intangible assets and transfer pricing. Simultaneously and of equal importance are valuations for financial reporting that involve the allocation of purchase price among the target company's tangible and intangible assets and the resulting annual goodwill impairment testing.

The initial perception is that the value of any transaction and the largely acquired intangible assets is driven by financial reporting valuation rather than by transfer pricing valuation. However, it is important to ask in such transactions whether the valuation of intangible assets in purchase price allocations can be used for transfer pricing purposes, or whether the same can be tweaked to address transfer pricing requirements for intangible assets.

Differences: The Devil Is In The Detail

In recently published papers, the US Internal Revenue Service (IRS) as well as many tax authorities in many countries drew the distinction between valuations for financial reporting purposes and valuations for transfer pricing purposes, stating that financial reporting valuations, specifically purchase price allocations, should only be used as a "starting-point" for transfer pricing purposes and may not be probative. The recent US Tax Court cases involving Veritas[1] and Xilinx[2] sharply demonstrate the divergence of the two perspectives.

The OECD is moving in a direction similar to the IRS in tightening controls, making sure that OECD member countries do not assign a low

Table 1. Valuations for transfer pricing and financial reporting: key differences.

	TRANSFER PRICING	FINANCIAL REPORTING
Regulatory standards	OECD, local transfer pricing regulations, and in the USSection 482 of the Internal Revenue Code	IVSC, IASB, IFRS, ASC 805-Business Combinations, ASC 350 – Goodwill and Other, ASC 820 - Fair Value Measurement
Standard and premise of value	Arm's length standard	Fair value
Reporting unit versus legal entity	Legal entity level analysis	Fair Value measured in aggregate and allocated to RUs
Definition of intangible asset and goodwill	Goodwill is subsumed in the value of intangible asset. Buyer-specific synergies are included in arm's length value	Goodwill is a residual concept, and projections used to value intangible assets include market participant assumptions
Valuation methodologies	Valuation is performed on a pretax basis	Valuation is performed on a posttax basis
Useful lives	Considers fixed term and longer useful lives	Considers perpetual term

ASC – Accounting Standards Committee; IASB, International Accounting Standards Board; IFRS – International Financial Reporting Standards; IVSC – International Valuation Standards Council; OECD – Organisation for Economic Co-operation and Development; RU – reporting unit.

value to intangible assets for purposes of transferring them out of one jurisdiction into a more favorable tax jurisdiction.

The skepticism and hesitancy of the IRS and the OECD stem from intangible asset values determined within the context of financial reporting, being notably different from (and often lower than) the values determined for transfer pricing purposes. To better understand the dynamic between valuations for transfer pricing and financial reporting, we highlight some of the key differences underlying each framework in Table 1.

Most important to note among the differences is that in financial reporting, goodwill is a residual concept as projections used to value intangible assets only include market participant assumptions and exclude buyer-specific synergies. In transfer pricing, goodwill is embedded in the intangible value and consists of buyer-specific synergies, future customer relationships, future technology and all future opportunities that are part of residual goodwill value in financial reporting and are not considered goodwill in transfer pricing. In transfer pricing, there is a broader view of the definition and what comprises intangible asset value.

The difference in the treatments of goodwill and the definition of an intangible asset from the perspective of a specific buyer (transfer pricing) versus a market participant buyer (financial reporting) leads to higher valuations done for transfer pricing than those performed for financial reporting.

Similarities: Shall The Twain Ever Meet?

Given all the differences, financial reporting valuations share general concepts with transfer pricing valuation such as the concept of comparables in a Market Approach, use of present value and discounting under an Income Approach, and the fact-finding process – *i.e.*, the industry

analysis and functional analysis in transfer pricing are conducted and performed in a similar fashion as part of due diligence in financial reporting. In addition, the documentation process is very similar: transfer pricing contemporaneous documentation requirements (*Treas. Reg. 1.6662*) mirror the standards set by the American Society of Appraisers (ASA) and the American Institute of Certified Public Accountants (AICPA) on the requirements of a comprehensive valuation report.

Finding An Intersection

It is clear that valuations done for financial reporting purposes should not be fully relied upon for transfer pricing purposes. Relying on the valuation from a purchase price allocation results in undervaluation of transferred intangibles for transfer pricing purposes because of different treatment, including definitions of intangibles, goodwill, intangible life, buyer-specific synergies, pre-tax versus post-tax analyses, *etc.*, as mentioned above.

However, aligning the two disciplines, especially in the context of M&A, presents opportunities for practitioners to become value-added service providers. This presents tax risks due to differences in value between the two frameworks and misalignment of the placement of intangible assets when setting a company's global transfer pricing policy. In addition, and more importantly, audit risks are higher due to inconsistent values of IP and challenges to post-acquisition transfers.

Coalescing the two disciplines early in the process saves time and cost rather than having to justify different methodologies later when potentially material tax consequences may arise. For instance, fact-finding and due diligence meetings can be conducted as one, and both disciplines leverage from the same information using the same set of projections and one similar set of market comparables. In addition, analytical models from both frameworks can be aligned to have similar inputs and assumptions. The documentation requirements of both can also be synchronized and performed jointly as there are many intersecting portions between the reporting requirements of transfer pricing and financial reporting valuation. This leads to a more enhanced ability to support tax positions and reduce audit risks.

Synchronized project teams and advisers with the skills, knowledge and experience from both disciplines enable both transfer pricing and financial reporting frameworks to be supported more consistently, with fewer discrepancies and potential disputes between all tax, accounting and corporate stakeholders.

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Endnotes

1 *Veritas Software Corp. & Subs. v. Commissioner*, 133 T.C. No. 14 (2009).

2 *Xilinx v. Commissioner*, 125 T.C. 37 (2005), and *Xilinx v. Commissioner*, 598 F.3d 1191 (2010).