Differences between transfer pricing and financial reporting valuations

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FOREIGN INCOME & TAXPAYERS

Companies today navigate an increasingly complex global tax system, with governments vying to claim a greater share of the global tax revenue pie. According to BDO USA LLP's 2021 Tax Outlook Survey (April 2021), over 70% of tax executives say their companies' total tax liability has increased and is expected to continue to do so in the next 12 months. Further, the 2020 Global MNC Tax Complexity Survey (June 2021), which surveys 635 tax consultants from 110 countries around the world, shows that transfer pricing is considered the most complex tax issue facing multinational companies today.

Valuations of intangibles for tax purposes are among the most heavily scrutinized transactions that multinationals engage in. If performed improperly, these valuations can lead to significant income tax adjustments (and penalties), which could, in turn, jeopardize any perceived tax savings associated with an intangible transfer and valuation.

The transfer of intangibles between related parties is often connected to a broader business restructuring or business "event." Through its life cycle, a company may frequently enter into a transaction that qualifies as a business combination, which is an acquisition of a business or asset(s) that are capable of being conducted or managed as a business. When this occurs, the acquirer is required to prepare a purchase price allocation (PPA) for financial statement reporting purposes that allocates the purchase price of the acquired company to various assets (including identified intangibles and goodwill) and liabilities for financial reporting purposes. Subsequent to a business event, the acquirer may then undergo certain business restructurings, such as a legal entity rationalization exercise, to integrate and simplify its overall tax structure.

What happens when the acquired company intends to migrate intangibles between related parties as part of its restructuring? Would it be appropriate under U.S. and international transfer-pricing rules to use a financial statement valuation (such as a PPA) as the transfer price of the intangibles?

While the valuation and support required for the intercompany transfer of intangibles do overlap with financial statement valuations, material differences exist that could have an impact on concluding values, thereby increasing a company's risk to tax and penalty adjustments. The underlying valuation standard for transfer pricing is the arm's-length standard, which is defined as a price that is consistent with the results that would have occurred if uncontrolled taxpayers had engaged in the same transaction under the same circumstances.

The standard of value for financial reporting purposes relies on "fair value," which is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction

between market participants at a specific point in time. The difference in valuation standards between financial reporting and transfer pricing leads to the use of different valuation methods for each. This may significantly affect the valuation of the asset for transfer-pricing purposes.

The remainder of this item focuses on answering three key questions:

- What is the issue?
- Why does it matter?
- What should you do about it?

The issue

The valuation of intangibles for tax purposes must follow specific requirements related to economic substance, valuation methods, and transfer-pricing documentation, including the U.S. transfer-pricing regulations under Sec. 482 of the Internal Revenue Code, the transfer-pricing guidelines issued in January 2022 by the Organisation for Economic Co-operation and Development (OECD), and similar guidance issued by virtually all tax administrations around the world. While the starting point for transfer-pricing valuations may be similar to that for financial statement valuations, differences exist in a number of key areas, as discussed below.

Transfer-pricing valuations require identifying and compensating each legal entity that economically owns the intangibles: A PPA allocates the purchase price to identifiable assets and liabilities, with the residual value being goodwill. The PPA is valued for the acquired company as a whole as of the date of an acquisition and thus is agnostic to the legal entity or entities that own or contribute to the development of the intangibles.

Transfer-pricing valuations, conversely, must identify and compensate each legal entity that is involved in the development or exploitation of the intangibles being valued. It is important to note that Regs. Sec. 1.482-4 specifies that the owner of intangibles for transfer-pricing purposes is not necessarily the legal entity that will have rights to any intangible-related income. This is further highlighted in Regs. Sec. 1.482-1(d)(3)(ii)(B), which states that the IRS may disregard contractual terms (including legal ownership) if they are inconsistent with the economic substance of the transaction.

For transfer-pricing purposes, the definition of intangibles and, thus, what the intercompany seller should be remunerated for is different than in a PPA context: In a PPA analysis, intangibles (such as technology, trademarks, and customer relationships) are valued as wasting assets whose value is measured as if development or contributions were to stop immediately. Sec. 482 states, by contrast, that the income related to any transfer of intangibles should be commensurate with the income attributable to the intangible being valued. Further, Sec. 482 refers to Sec. 367(d)(4) regarding the definition of the types of intangibles that are compensable, which include goodwill, going concern value, workforce in place, and any other value that is not attributable to tangible property or services.

For example, the PPA value of technology software may be based solely on the next five years of cash flows because a company believes the software will be fully updated and replaced by new

software code it develops on its own by year 5. However, the broader definition of compensable intangibles under Sec. 482 could require transfer-pricing valuations to include projected income related to future versions of technology — an amount embedded in goodwill in the PPA analysis.

Further, Sec. 482 requires (and the OECD transfer-pricing guidelines generally support) the valuation of intangibles in aggregate if it is determined that the intangibles are very closely linked. For example, it is not uncommon for transfer-pricing valuations to yield one single intangible value rather than separate values for technology, trademarks, customer relationships, and goodwill.

The transfer-pricing valuation must take into account business and economic substance thresholds that must be satisfied for the legal entity to have the rights to the intangibles: Regs. Sec. 1.482-1(d) (3)(ii)(B) provides that greater weight is put on the actual business and economic substance of a transaction than on the contractual arrangement itself. A transfer of intangibles to a related party has business purpose if there is a nontax purpose for the transaction. This may include transferring intangibles to a non-U.S. regional headquarters because it will drive the decision-making and future success of the business. Further, economic substance exists if the purchaser has the capacity to own and exploit the intangibles (through its own workforce).

Similarly, the OECD transfer-pricing guidelines have adopted the DEMPE framework that focuses on the development, enhancement, maintenance, protection, and exploitation of intangibles. The DEMPE framework intends to ensure that profits (or value) align with the legal entities that in substance create economic value for a company.

Other differences between financial statement and transfer-pricing valuations are beyond the scope of this item but should be considered as part of a robust analysis. Taxpayers and practitioners are encouraged to discuss these issues with transfer-pricing experts.

Why it matters

When clients lack sufficient or accurate support for these often high-risk/high-profile transactions involving the transfer of intangibles between related parties, the risk to their companies can come in many forms.

Some of these risks include:

■ *Compliance risk*: Regs. Sec. 1.482-4(f) (2) and ¶6.155 of the OECD transfer-pricing guidelines expressly state that financial reporting valuations should not be used for transfer-pricing purposes. For example, using intangible values calculated for a PPA for transfer-pricing purposes tends to understate the value of the acquired intellectual property (IP) and can leave the transaction open to an audit adjustment.

■ *Penalty risk*: In addition to leaving transactions vulnerable to audit adjustments, noncompliance with tax rules regarding valuations of IP transfers can also result in the application of penalties to the adjustments (which can be up to 40% on a gross valuation misstatement under U.S. rules) and potential double taxation. A company's tax provision may also be affected.

■ *Tax optimization risk*: Incorrect valuation approaches can yield reduced tax savings, misstatements of taxable income, and increased time spent responding to tax authority inquiries and audits and

on requests for competent authority relief.

■ *Reputational risk*: Valuations for tax transactions can impose a risk to a company's reputation if a tax controversy spills into the public domain. This negative publicity can have an impact on the company's reputation as a contributor to local markets and economies by paying its "fair share" of taxes.

Potential solutions

Being proactive in addressing the risks of misstated valuation in business, financial reporting, and tax is the most effective approach to preventing surprises. The OECD transfer-pricing guidelines recognize this and highlight in ¶6.29 that "accounting valuations and information supporting such valuations can provide a useful starting point in conducting a transfer pricing analysis." Areas where these different types of valuations converge include financial projections, discount rates (or reconciliation to overall discount rates), general business descriptions, and a description of the business event. The overlap between some aspects of financial reporting and transfer-pricing valuation methodologies provides an opportunity for streamlined information and data gathering. This will result in time and cost savings for management and operational personnel.

If taxpayers have failed in the past to recognize the differences between transfer-pricing valuations and financial statement valuations, they should engage transfer-pricing experts to do a risk assessment and develop corrective strategies going forward. For example, if it is determined that, after an IP migration, a specific jurisdiction lacks sufficient economic substance from a transfer-pricing perspective, then certain DEMPE functions and personnel may be moved to that jurisdiction to mitigate risks. Furthermore, such a risk assessment also helps with a requirement in the regulations under Sec. 482 for taxpayers to examine annually the actual vs. projected results after a transfer/license of intangible property and to ensure that the valuation is "commensurate with income."

Taxpayers who frequently undertake valuation exercises (for example, due to acquisitions and restructuring) will benefit from keeping a valuation playbook/checklist that includes transfer-pricing considerations among other considerations. Such taxpayers should make transfer pricing an integral part of their strategy and planning discussion.

Taxpayers should recognize the transfer-pricing risks and opportunities inherent in intangibles valuations. In most cases, the best course of action is as simple as involving transfer-pricing professionals early in the process (at strategy and planning meetings). Given the growing number of transfer-pricing controversies globally and the changing transfer-pricing landscape in many countries, it is more important now than ever before to ensure that the transfer of intangibles is appropriately analyzed in accordance with transfer-pricing rules and regulations.

Editor Notes

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