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INSIGHT: Valuations for Financial Reporting, Tax and Transfer Pricing in the TCJA Era

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There are many factors contributing to the current climate around merger and acquisition (M&A) activity, and tax reform in the shape of the Tax Cuts and Jobs Act of 2017 (TCJA or Act) is one. The new law has reshaped the way U.S. and many foreign businesses look to optimize their international operations and tax profiles. TCJA along with broader global tax reform has given rise to new tax considerations, challenges, and potential tax opportunities. Against this backdrop of continued corporate growth, acquisition activity, and tax change, financial reporting, tax, and transfer pricing valuation have become even more prominent. TCJA has changed many valuation inputs and materially affects many valuations of assets and businesses for each purpose.

Many multinational companies are considering tax reform-related global planning and restructuring. This planning, which may be undertaken in association with M&A activity, includes reorganizing legal entity structures and moving the economic ownership of developed and acquired intangible assets within the group. The associated need for valuations under financial reporting, tax, and transfer pricing also raises questions over whether valuations for one purpose (say financial reporting) can or should be used for transactions for similar assets or businesses for other purposes (say tax or transfer pricing).

While far from an exhaustive analysis of these issues, this article provides some insights into the impact of TCJA on valuations and some of the main considerations and differences between valuations for tax, transfer pricing, and financial reporting.

The Wide-Reaching Effect of the TCJA

The TCJA has resulted in sweeping changes to the U.S. tax code. From a valuation perspective, a number of TCJA changes have certainly given a lift to corporate profits and cash flows.

The markets were especially enamored with the lower federal tax rate. The changes also offered other benefits such as accelerated deductions for capital expenditures (at least initially) to encourage capital investment, reduced taxes on Foreign Derived Intangible Income (FDII), and elimination of U.S. tax on qualifying dividend distributions.

These benefits were partially offset by other provisions that caused near or longer-term increases in U.S. corporate income taxes for many taxpayers. These provisions included the acceleration of U.S. taxes on historical non-U.S. earning and profits in a transition tax revenue-raiser—which companies can pay over eight years—along with broadening of the U.S. corporate tax base to include earnings by foreign affiliates over a basic return on assets with taxation (at reduced rates) for Global Intangible Low Taxed Income (GILTI).

Another detrimental provision is a requirement that all research and development (R&D) expenditures are now to be capitalized and amortized for U.S. tax purposes over either five or fifteen years. While this latter change, as a timing difference, is not likely to have much of an effective tax rate impact, it will have a significant impact on the cash flows of many research and development-intensive companies. The Act also introduced limitations on interest deductibility, which have (all else equal) increased the cost of debt and, therefore, the cost of corporate and acquisition financing structures. Lastly, the Base Erosion and Anti-Abuse Tax (BEAT) acts as an alternative minimum tax that measures income without regard to deductions for intercompany transactions not included in cost of goods sold or qualifying for certain exemptions.

As this summary of select TCJA changes highlights, the complexity, and interaction of the various provisions of the Act, as well as changing foreign tax rules, mean that companies need to carefully model their overall tax positions and the impacts of acquisitions and reorganizations.

The TCJA has also had a significant impact on valuations of assets and businesses by changing many of the key financial inputs and assumptions, directly for income and cost-based valuation approaches, and indirectly for other methods. Specifically, it has affected many aspects of cash flows including post-tax profits, amortization, depreciation, capital expenditures, and R&D deductions. Changes in the costs of capital caused by increased costs of debt have also had an impact, although this is less independently obvious as many other economic factors also have a bearing on the cost of capital.

For financial reporting valuations and tax valuations that reference fair values, fair market values, or market values, TCJA's complexity makes estimating the tax impact on cash flows for ''market participants'' an increasingly more subjective exercise. For tax and transfer pricing valuations conducted under the arm's-length standard, the TCJA introduced important changes to the definition of compensable intangibles for tax purposes to include goodwill and going concern value. This has increased the cost of moving intangible assets between group members and raises questions about when those attributes are present and need to be compensated. It also closed a loophole in the U.S. tax rules that permitted (at least in some interpretations), outbound transfers of value without sufficient compensation—a position that Treasury has challenged repeatedly both in audit contexts and through (to date largely unsuccessful) litigation. Ironically, the combined effect of the new and existing tax rules, along with uncertainty around the longevity of the low federal tax rate, may be restricting the repatriation of non-U.S. intellectual property rights that might otherwise return to the U.S.

Historically transfer pricing for intercompany transactions has been determined using a pre-tax analysis which is appropriate for operational transactions, but less so for asset transfers. This position serves a net exporter of assets such as the U.S., because it's the equivalent of a post-tax seller's value where capital gains tax rates equal the corporate tax rate, but generally will overvalue an asset from a buyer's perspective, other things being equal. The OECD in its latest transfer pricing guidelines now formally recognizes the unique tax attributes of asset transactions. TCJA did so indirectly by introducing into the statute the need to consider the realistic alternatives (of the buyer and seller) to an intercompany transaction in its valuation, which effectively means that post-tax valuation techniques and the tax impact of the transaction (i.e., capital gains tax and tax amortization benefits) are needed to properly evaluate the buyer's and seller's sides of an asset transfer.

All these TCJA related changes effectively mean that tax, transfer pricing, and financial reporting valuations of assets have converged to some extent, however, fundamental differences still exist that companies, planners, and valuers should note.

Continuing Differences: Financial Reporting vs. Transfer Pricing

The first and most noticeable difference between financial reporting and transfer pricing is the general use of operating profits in transfer pricing versus the use of cash flows in financial reporting. The debate around this difference has swirled on-and-off for many years. Cash flows are generally a better reflection of value to investors while operating profits generally align more with taxable income. While there is a clear preference for the use of profits in transfer pricing, the use of cash flows in appropriate circumstances is acknowledged and generally respected by most tax authorities. In our experience, good valuations under both methods should yield defensible results in situations where businesses are relatively stable. In periods of change, however, the timing of free cash flows can be starkly different from accounting profits. In our opinion, these differences would likely be considered by independent third parties entering into related transactions, and therefore they should not be ignored under any valuation standard. For example, as noted in our discussion of the impact of TCJA on cash flows in the prior section, increases in capital expenditures and the capitalization and amortization of R&D for tax deduction purposes are factors that we are seeing have a material and divergent impact on cash flow versus profit-based valuations. In these circumstances, more reliable values may result from the use of cash flow-based valuations. Profit-based valuations will generally over-value transactions for businesses undertaking significant capital investment projects.

The next difference we note relates to the perspective underlying the valuations. With respect to acquired assets, the carrying value of separable assets for financial reporting, at least under U.S. and international financial reporting standards, is based on the perspective of what the new holder of the asset might realize from its hypothetical sale to a market participant (i.e., its sale value on ''Day 2''). This fair value standard and viewpoint is therefore not informed as much by the seller's perspective as the buyer's and, importantly, also excludes buyer specific synergies (i.e., synergies in the transaction that only the actual buyer might realize, but a market participant would not). In comparison, fair market value and arm's-length transfer pricing standards consider both the positions of the buyer and seller for tax purposes. Fair market value considers these in the context of market participants, while the arm's-length standard considers the actual participants. These participants may be the same, but it is not always the case. As such, transfer pricing valuations require the inclusion of both buyer-specific and market participant synergies. In addition, transfer pricing valuations generally take into account the circumstances of the actual transaction, i.e., actual transaction, actual parties, actual circumstances, and actual use. This may also contrast with fair value and fair market value standards, which may require the value to be based on the highest and best use of the asset.

Another important difference between financial reporting and transfer pricing valuations is the definition of what should be included in an asset's value. Specifically, the definition of a separable asset is such that financial reporting values, which tend to conservatism following long-standing accounting conventions around prudence, generally only include the value of the intangible as it exists at the date of the transaction in existing products and services, or those that are under active development (in-process R&D). Under tax and transfer pricing rules, the earning power and therefore value of intangible assets are considered more broadly and may capture their contribution to the development of subsequent generations of products and services, extending the period of economic life considered in their valuation.

In some circumstances, tax and transfer pricing valuations are indifferent between asset types and even goodwill, either because of similar tax treatment, or because they are considered part of aggregate rights in a particular arrangement, like an intangible development cost sharing arrangement. This more expansive view of intangibles, their economic life, and value in transfer pricing, often crosses the lines between financial reporting assets and goodwill values in business combinations. It may also give rise to differences in contributory development and maintenance R&D charges in intangible valuations as well as the selection of discount rates to apply to existing intangibles as opposed to goodwill when using an income-based method.

The final difference between financial reporting values and tax and transfer pricing values we would like to highlight relates to how the profits and/or cash flows attributable to an intangible are determined when using indirect or residual valuation approaches—namely, the residual profit or income method approaches in transfer pricing, or the multiple period excess earnings method in financial reporting valuations. These are reductive methods, i.e., the valuation is the result of deducting profits, cash flows, or associated value for other contributions from a larger whole to derive the value of intangibles. As reductive methods, they share an important characteristic compared to direct or build up methods—specifically, errors in the valuation of the non-intangible contributions compound onto the residual value of intangibles. In this respect, financial reporting analyses approach excess earning-based valuations by making appropriate charges for the use of other contributory assets including workforce in place. In comparison, transfer pricing residual profit valuations generally take a functional view and make appropriate charges for contributory activities, which often implicitly include remuneration for the same assets but also reward the activity. In a perfect world, these approaches should yield similar results, but differences in the comparables referenced to determine the charges can create significant divergences in valuation results. This is especially prevalent where the starting point for the valuation is income projections that cover multiple legal entities in the supply chain, and transfer pricing adjustments aren't first made to narrow profits to a legal entity view before asset charges are determined. These differences can also be informative and may be an indication of potential problems with either financial reporting asset charges and/or transfer pricing practices in the respective valuations.

Conclusion

In summary, changes under TCJA have caused some fundamental changes to taxes and cash flows that are affecting business and intangible valuations and will do for some years to come. The complexity and interrelationships between the various provisions of TCJA and the changes in associated tax assets and liabilities it creates make each valuation potentially unique.

While there has been a convergence of valuation requirements under financial reporting, tax and transfer pricing as a result of TCJA and other international tax changes, the standards of value under each still differ in important ways, and these differences can materially affect the values of similar intangible assets. Consequently, companies implementing reorganizations or acquisition-related integrations need to be aware that there are different methods used to value intangible assets depending on the purpose, facts, and circumstances of the valuation, and that there are benefits that can be realized by understanding the valuation standards that will be applied to the transaction, asset valuations, and related tax amortizable values and their differences. Further, in the context of acquisitions, performing simultaneous valuations for financial reporting and transfer pricing can help identify issues earlier in the process, protect against unwitting problems down the road, and provide efficiencies, consistency, and independence.

With increased scrutiny and coordination of tax audits, deeper consideration and documentation of tax assumptions is needed and expected in all valuations. In the context of acquisitions, companies should be very cautious about using asset valuations from financial reporting analyses for tax or transfer pricing purposes or vice versa. In situations where financial reporting and transfer pricing valuations appear to be in conflict, our recommendation is that companies consider preparing explanations of the differences in the form of a bridging memorandum while knowledge of the transactions and related valuations is fresh. This may well save considerable time and effort down the round in an audit controversy.

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