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Intangibles Valuation in the Crosshairs

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Although there is a great deal of overlap between valuation, financial accounting and transfer pricing, the gulf between standards is most critically seen with respect to intangibles. **Organisation for Economic Co-operation and Development (OECD)** Working Party 6 has recently called for comments to its discussion draft (due September 14); a final draft is expected sometime in 2013. Whichever direction the OECD takes, however, coordination with transfer pricing valuations is important to address when preparing financial valuations.

Valuation, financial accounting and **transfer pricing (TP)** overlap far more than is often thought. **Multinational enterprises (MNEs)** commonly undertake global planning, structuring and restructuring for the purpose of streamlining their business operations and consequent cost base (supply chain management). These efforts also have material income tax consequences in all affected jurisdictions. In turn, the valuations and tax consequences have a material impact on the MNE's financial accounting results before and after transactional planning.

A question that is often posed is whether the financial accounting valuation standards traditionally used (to account for a business combination, for example) can be used for TP purposes, or whether such appraisal work can be modified to address TP requirements. This question can be raised by the MNE, its auditor or a pertinent tax authority, depending on the issues developed and the particular circumstances of the MNE.

Business and accounting valuations share general concepts with TP valuation, such as the use of comparables in a market approach or present value and discounting under an income approach. However, the global TP guideline arbiter (the Organisation for Economic Co-operation and Development, or OECD), as well as tax authorities in many countries, have indicated that while business valuations may provide a useful starting point for TP analysis, they may not be probative. Recent U.S. tax cases involving Xilinx and Veritas provide stark illustrations of just how divergent these two perspectives can be.

The gulf between valuation and TP standards can perhaps be most critically seen with respect to the elusive concept of "intangibles." The location and ownership of intangibles are often pivotal determinants of the TP results of an MNE group, which, in turn, often drive the group's global effective tax rate (ETR). The term "elusive" is used here because there is a potentially huge range of uncertainty, and therefore a huge potential for controversy, surrounding the financial and TP

treatment of such critical elements of value as “goodwill,” “business opportunities,” “location savings,” “market advantage” and so on.

OECD Working Party 6 recently issued its discussion draft on intangibles, indicating that it is likely to give little weight to the principles established by valuation-industry bodies (such as the International Valuation Standards Council) and international accounting standards bodies (such as the International Accounting Standards Board). On the other hand, the tax authorities of several important countries take the opposite position and commonly assert material deficiencies based on valuation of intangibles that have been transferred to affiliates in low-tax countries. Such deficiencies often result from a reliance on prior financial valuation studies or concepts borrowed from non-TP disciplines.

In short, the divergence between financial and TP valuation standards can provide opportunities for MNEs to arrange and defend their ETRs using different approaches to intangibles valuation depending on the issues at hand. The absence of any consensus between the respective disciplines, coupled with the fact that different analyses may be performed by different preparers for different purposes within the MNE, can result in widely divergent intangible asset valuations. If the OECD was to completely ignore financial valuation standards in its intangibles project, it would, in essence, be endorsing such differentiation and increasing the likelihood of tax controversy.

On the other hand, the OECD may tack toward the position of certain of its member countries and seek to coordinate financial and TP valuation concepts. In this case, MNE ETR strategies could be supported more consistently, with less divergence between tax and financial reporting positions … and less potential disagreement between corporate, tax and accounting stakeholders.

Regardless of the direction the OECD takes, coordination with TP valuations is important to address when preparing financial valuations. It is far more efficient to document areas of convergence (or divergence) of the methodologies early in the process, rather than having to justify different approaches later, when potential material tax deficiencies may arise as a tax authority utilizes a financial valuation as its “Exhibit A” to support its proposed assessment.

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