Managing risk in tax valuations

Best practices and common pitfalls

Valuations performed for tax purposes often carry significant financial implications and continue to receive heavy scrutiny from the Internal Revenue Service (IRS), the courts, and foreign revenue agencies. With these risks in mind, it is important to understand the most critical elements of a valuation; as well as, consider the following best practices and common pitfalls whenever a tax valuation is performed.

Financial projections

When performing a valuation of a business or an asset, one of the first items requested by the valuation advisor is the financial forecast. Sometimes, projections may not be available at the level desired and need to be developed from available business plans. Since these forecasts are usually prepared for purposes that do not necessarily contemplate a tax use, it is essential to understand how they were developed. It is also important to gain clear insight into the underlying assumptions and value drivers.

When assessing the reliability of the projections, one should ask the following questions:

- Are the projections arm's length in nature and appropriately reflect the functions performed, risks borne, and assets employed by the subject entity?
- What is the functional currency of the business being valued and in what currency is the financial information denominated? If the financial information is denominated in a foreign currency, the discount rate should appropriately capture any currency risk. Similarly, long-term growth rates should also reflect differences in currency inflation. On the other hand, if the projections were converted to another currency, it is important to confirm that reasonable forward exchange rates were used.
- What accounting standards do the projections reflect? U.S. valuation advisors typically assume that projections provided by company management reflect US GAAP. Insight into the accounting standards for which the projections are prepared will help to ensure that appropriate adjustments are reflected when deriving the projected cash flows.

Tax attributes

The tax characteristics and attributes of the subject entity (or asset) can have a meaningful impact on value. As such, it is important to ensure the appraiser understands the following when determining the appropriate tax assumptions:

- The jurisdiction in which the entity or asset is located and the countries in which the earnings are generated;
- Current holding structure of the subject entity (or economic and legal owner of the asset) and how earnings are currently taxed;
- Tax characteristics of the subject entity or asset (e.g., pass-through nature, net operating losses, tax credits, etc.);
- The existence and nature of deferred tax assets and liabilities; and
- Anticipated transaction structure (i.e., taxable or nontaxable) upon a hypothetical sale. If the subject transaction is taxable, consideration should be given to the applicable tax rules for the tax amortization benefit calculation.

Royalty rates

The royalty rate can often be an area of risk in the valuation of trade names, technology, and other intangible assets. A common pitfall to avoid is the use of royalty assumptions that are inconsistent with intercompany transfer pricing policies. These differences may generally arise due to inadequate analysis or a faulty understanding of the entity's transfer pricing. When differences arise, it is advisable to reconcile and document these differences to avoid potential transfer pricing exposure.

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Intercompany debt

One frequently overlooked area of risk in tax valuation is the treatment of intercompany debt. For some legal entities, intercompany debt can be a significant liability that needs to be deducted from a business enterprise value to derive the equity value of the legal entity. In addition, intercompany receivables can represent a significant asset that affects the legal entity's value for holding companies and financing companies.

Book value of debt is often used as a proxy for fair market value (FMV) when performing a valuation analysis. While this simplifying assumption may be reasonable in some cases, it can sometimes lead to incorrect values. To minimize this risk, one should obtain a thorough understanding of the terms and nature of the debt obligations and explore the following items:

- Does the coupon rate of the debt reflect market rates on the valuation date? If not, the FMV of the debt could materially diverge from book value if it has a significant remaining term.
- Does the borrower have sufficient cash flow or assets to service the debt? If not, FMV could be lower than book value absent any loan guarantees.
- Is the debt appropriately characterized? In some cases, there may be differences between debt and equity classifications under financial reporting and tax standards.
- Is new intercompany debt contemplated under the proposed transaction? In order to avoid future audit risk, additional analysis may be needed to support there is adequate borrowing capacity and that the intercompany financing arrangement is arm's length in nature.

Time lag between the valuation date and the transaction date

Due to delays in the transaction process and potential lags in the timing of available financial information, it is not uncommon that the valuation date will sometimes differ from the transaction date. When these differences occur, they are usually short in duration and generally pose minimal risk. However, it is advisable to review and document any changes in market and economic conditions during the time gap to confirm that the valuation has not changed materially between these dates. One should also confirm that there have not been any significant changes in the entity's balance sheet or financial conditions during this time gap. The greater the time gap and the more volatile the market, the greater level of quantitative support is recommended.

Value of tangible assets

Depending on the nature of the transaction and valuation purpose, a determination of the FMV of the property, plant, and equipment (PP&E) may be required. There is a common misconception that net book value (NBV) of PPE is a reasonable approximation of FMV. While this assumption can be reasonable in some cases, there are a number of factors that can create divergence between the asset's NBV and FMV.

It is recommended that a review of the company's PP&E and accounting history be performed with a qualified appraiser to determine if there are conditions present that could lead to a divergence between NBV and FMV. In addition to mitigating potential risks, these discussions may also identify a possible step up in values that could result in tax savings.

Divergence in valuations for tax and financial reporting

Valuations of assets or entities may sometimes be required for both financial reporting and tax purposes on, or around, the same date. When these situations arise, the value determined for financial reporting purposes may sometimes be used for tax purposes. Conceptually, this may appear reasonable given the similarities between the definitions of FV and FMV. However, in many situations, these values will significantly diverge due to differences in the standards of value and acceptable methodologies.

Summary

While additional tax-related issues are certain to arise; these best practices may provide the company, its tax advisors, and the appraiser with a foundational overview of the critical steps necessary to develop a defensible valuation.

Have questions?

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