

Understanding book versus tax valuation differences improves M&A planning and reporting

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At a glance

The value of assets can be different for tax purposes, versus financial reporting purposes.

Key differences in purchase price allocation standards determine the appropriate valuation in reporting an M&A transaction, restructuring or other corporate action.

Awareness of the issues arising from book and tax valuation differences will improve planning and reporting.

M&A transactions and other corporate transactions trigger different rules and procedures for allocations of purchase price under US GAAP and US federal tax principles. While changes to financial reporting standards have eliminated some inconsistencies, fundamental differences between financial reporting and tax reporting continue to exist.

Acquisitions, international tax restructurings and other corporate tax planning strategies depend heavily on valuation estimates of intellectual property and corporate legal entities. Finance, accounting, and tax professionals constantly ask whether it is appropriate to use financial reporting valuation estimates for tax purposes and whether there are parts of valuations for financial reporting or tax that are interdependent.

Did recent changes to accounting rules provide convergence with tax rules? No!

Key differences

Current financial reporting standards did eliminate some inconsistencies, but fundamental differences between the purchase price allocation rules for financial reporting purposes and tax continue to exist. These differences result in the need for separate valuation procedures to ensure proper analysis for each exercise.

Three key differences include:

1. The transaction purchase price will not be the same for financial reporting and tax.

One common misconception is that the purchase price is the same for tax and financial reporting exercises. This is rarely the case. Purchase price differences exist between financial reporting and tax for a variety of reasons including the treatment of transaction costs, contingent consideration, contingent liabilities, accrued liabilities, the value of debt assumed, and deferred taxes. Different purchase prices will lead to different values allocated to reporting units, legal entities, and assets (including goodwill).

2. The standards governing allocation methodologies are different.

Once the purchase price has been determined, book and tax principles provide different methods for allocating the respective purchase prices to the acquired company's assets. For financial reporting, this exercise is performed at the reporting unit level while for US tax purposes it is performed at the legal entity level. As illustrated in the charts below, this and other procedural variations will lead to differences in materiality thresholds and different intangible values in a bargain purchase.

3. Standards and definitions of value are different.

Financial reporting uses a "fair value" standard, which is based on a market participant concept. This may result in the assignment of value to assets the buyer does not intend to use. For US tax reporting purposes the standard of value is "fair market value," which assumes a hypothetical transaction between a willing buyer and seller.

In theory, the market participant's and hypothetical willing buyer's approaches are similar and the economic value of an asset is unchanged under either approach. In practice, however, the amount attributed to an asset and reported for a specific purpose may differ due to various statutory reasons.

Purchase price allocations—Book and tax differences

The table below highlights some of the significant differences between the standards governing valuations performed for tax and financial reporting purposes in the context of mergers and acquisitions.

US financial reporting allocations	US tax allocations
Standards	
ASC 805, 810 (formerly FAS 141, 141(R), 160) ASC 350, 820 (formerly FAS 142, 157)	IRC Sections 338, 754, 1060, 197 Rev Ruling 59–60, various other rulings and court cases
Purchase price differences	
Excludes transaction costs	Includes certain transaction costs
Contingent consideration and liabilities may be measured at fair value	Contingent consideration and liabilities not included
Accounting purchase price includes deferred taxes	No deferred taxes are included in the tax balance sheet
All accrued liabilities are included	Most accrued liabilities are not included
Debt assumed measured at fair value	Debt assumed measured at face value
Certain restructuring costs are not included	Restructuring costs are not included
Allocation differences	
Need to value businesses and assets at the reporting unit level	Need to value businesses and assets at the legal entity level, generally country
Goodwill can be allocated to the buyers' preexisting reporting units	Goodwill is allocated only to the acquired entities
Bargain purchase results in gain	Sequential allocation performed only to the extent of the purchase price (may result in limitation on intangible or other assets)
Valuation differences	
Fair value standard <ul style="list-style-type: none"> • Market participant considerations 	Fair market value standard <ul style="list-style-type: none"> • Willing buyer/willing seller
Categories of assets (e.g., trade name) may be aggregated by reporting unit	Specific intangibles should be valued individually by legal entity but are often subsumed into goodwill
May not consider legal ownership or transfer pricing	Must consider tax "economic ownership," which may differ from legal ownership and reflect transfer pricing policies
Tax amortization benefit always included in fair value, irrespective of transaction structure	Includes tax amortization benefit only to the extent amortization is deductible

Financial reporting valuations must use assumptions consistent with those of market participants while tax valuations often reflect buyer-specific assumptions.

Where the standards diverge

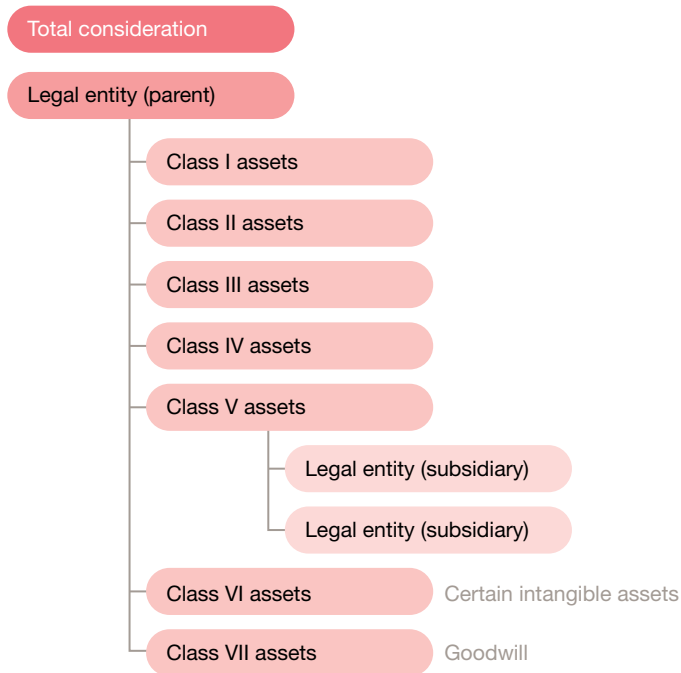
Most of the differences relate to the application of market participant versus buyer assumptions, how assets are defined, which assets are valued, how assets are aggregated, and how intercompany charges are incorporated.

Examples include:

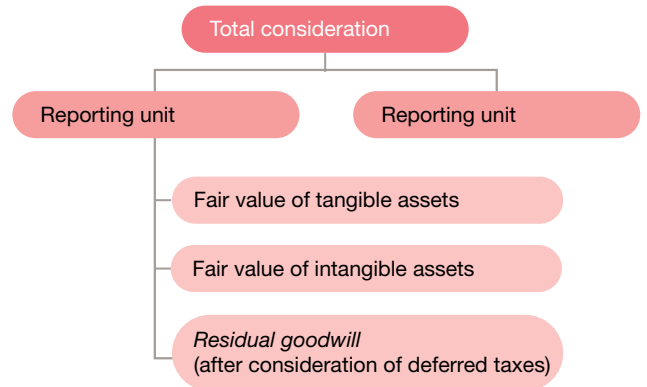
- **Transfer pricing assumptions—** Valuations performed for tax purposes must reflect the legal and economic ownership of the subject assets within the proper legal entities. Given that financial reporting valuations often are performed at a consolidated level, legal ownership may not be considered.
- **Buyer-specific assumptions—** Financial reporting valuations must use assumptions consistent with those of market participants while tax valuations often reflect buyer-specific assumptions. For example, the benefit of amortization is always added to asset values for financial reporting purposes. For tax purposes, the inclusion of this benefit is based on buyer-specific facts and circumstances.
- **Aggregation—** Financial reporting exercises often aggregate similar assets by reporting unit (trade names, technology) and allow complementary intangible assets (for example, a trade name, formula, and technology) to be reported as a single intangible asset if the assets that comprise the group have similar lives. For tax purposes, however, the value of each asset may need to be determined.
- **Defensive assets/intended use—** To the extent an asset is valuable to market participants, it must be recorded at its fair value for financial reporting purposes. This may include defensive assets and other assets that may not be used by the acquirer. The value of such assets likely would be different in a tax context.

Example of differences in allocation: Tax vs. book valuation

IRC § 338 (Tax)



ASC 805 (Book)



Companies need to be aware of the differences between the rules governing purchase price allocations for financial reporting and US tax purposes prior to relying on a valuation analysis performed for either.

Bottom-line impact

Companies need to be aware of the differences between the rules governing purchase price allocations for financial reporting and US tax purposes prior to relying on a valuation analysis performed for either. The differences discussed above should highlight why it might not be possible to imply the tax valuation of a legal entity, intangible asset, or goodwill based upon the review of an analysis prepared pursuant to financial reporting standards.

Unfortunately, many valuation practitioners do not have the in-depth tax knowledge to be able to contrast and compare a valuation for financial reporting with the tax reporting consequences. As a result, companies are often left to reconcile the differences and decipher the consequences for their transaction.

Consider a scenario in which an acquiring company makes a 338(h)10 election for tax purposes and therefore requires a tax allocation of purchase price as illustrated on page 5. In performing this allocation, the company relies upon a valuation analysis prepared for financial reporting purposes, which does not reflect the transfer pricing policies related to the subject entities.

As a result, profits associated with intangible assets owned by a US entity are allocated to foreign jurisdictions. In turn, a lower value will be attributed to the US entity and its assets. Other negative consequences include the following:

- The benefit associated with amortizing the intangible assets for tax purposes may not be fully realized as a result of lower tax rates in the foreign jurisdictions, thereby increasing the company's cash taxes.
- If the US assets were concurrently or subsequently transferred to a foreign jurisdiction, the company could face exposure upon audit related to the value of the asset transferred.

Conclusion

The issues highlighted above exhibit why best practice is to perform an integrated analysis where both book and tax valuations are performed simultaneously to ensure accurate reporting and increase the efficiency of the valuation process. This approach helps the buyer understand the impacts of both and facilitates tax and financial accounting after the acquisition. A qualified tax valuation specialist can help evaluate your situation and recommend an approach to help achieve optimal results.

To have a deeper conversation about how this subject may affect your business, please contact:

Alberto Dent

Partner, Tax Valuation Services
678 419 1170
alberto.w.dent@us.pwc.com

Peter Corcoran

Principal, Transaction Services,
Valuations practice
617 530 4849
peter.t.corcoran@us.pwc.com

For a deeper discussion on deal considerations, please contact one of our regional leaders or your local PwC partner:

Martyn Curragh

Partner, US Practice Leader,
Transaction Services
646 471 2622
martyn.curragh@us.pwc.com

Scott Snyder

Partner, East Region Leader,
Transaction Services
(267) 330-2250
scott.snyder@us.pwc.com

Gary Tillet

Partner, New York Metro Region
Leader, Transaction Services
646 471 2600
gary.tillett@us.pwc.com

Mel Niemeyer

Partner, Central Region Leader,
Transaction Services
(312) 298-4500
mel.niemeyer@us.pwc.com

Mike Dillon

Partner, West Region Leader,
Transaction Services
(415) 498-8234
mike.dillon@us.pwc.com

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