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Transfer Pricing, Financial Reporting Differ on Acquired Intangibles

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Grant Thornton practitioners discuss the significant differences between valuations for transfer pricing versus financial reporting purposes in the treatment of synergies and goodwill, enforcement, etc. and how executives can best approach these differences to mitigate risks.

Executives of multinational companies are increasingly using mergers and acquisitions to enhance their capabilities in strategic assets (collectively, “acquired intangibles”). These M&A activities can be either domestic or international. A cross-border M&A offers access to new markets, customers, talent, and technologies, but it also introduces complex challenges. One such challenge is reconciling differences between the valuations of acquired intangibles for transfer pricing, which impacts taxes, versus for financial reporting purposes.

Importance of Tax Certainty for Intangibles

In a cross-border M&A, a common source of confusion is the extent to which financial reporting valuations can be used for transfer pricing of acquired intangibles in a business reorganization. Executives that rely solely on financial reporting valuations for transfer pricing purposes may be surprised to learn of significant tax uncertainty and transfer pricing penalty risks. Others may be unaware that results differ depending on the valuation standard.

This article will clarify:

1. The differences between valuation standards for transfer pricing versus financial reporting purposes; and
2. How executives can best approach these differences to mitigate risk.

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Recent Transfer Pricing Enforcement for Intangibles

Transfer pricing enforcement for intangibles is a high priority in the US. Recent wins by the Internal Revenue Service in transfer pricing disputes over the valuation of intangibles raise the stakes for multinational companies to comply with US transfer pricing regulations under §482 (US transfer pricing regulations) during cross-border business reorganizations. In January 2025, the IRS issued a General Legal Advisory Memorandum (GLAM) on enforcing the commensurate with income standard, including retroactive transfer pricing adjustments using actual financial results (AM 2025-001).

Transfer pricing enforcement for intangibles is also a priority in many other countries. The OECD guidelines emphasize that value does not disappear and is not destroyed in a business reorganization (OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022). Tax authorities routinely challenge transfer pricing valuations that allocate substantial amounts of acquired intangibles to goodwill. For these reasons, executives must be prepared to address differences in financial reporting versus transfer pricing valuations for acquired intangibles.

Summary of Differences

The following table summarizes key differences between a valuation for US financial reporting (often referred to as a Purchase Price Allocation or "PPA") versus US transfer pricing.

Issue	For US Financial Reporting	For US Transfer Pricing
Standards	*Fair value standard* (ASC 820 & ASC 805)	*Arm's length standard* and *commensurate with income standard* (§482)
Scope	Separately identifiable assets and liabilities. Private companies can elect to exclude intangibles like customer relationships; that value would reside in goodwill	Broader scope of intangibles including goodwill or going concern value, and potentially synergies (§367(d)). Identifiability of intangibles is not a prerequisite
Basic Principle	Future economic benefit addressed from *accounting conservatism* lens	*Economic substance* (Treas. Reg. §482-1)
Methods	Income/market approach, Relief-from-royalty, Comparative (with-and-without), Multi-period excess earnings method, and Replacement cost method	Comparable Uncontrolled Transaction (CUT), Comparable Profits Method (CPM), Profit Split Method (PSM); Income method and Acquisition price method
Financial projections-perspective	Intangibles often valued from a consolidated group perspective, instead of by legal entity	Intangibles are valued from the legal entity perspective, instead of the consolidated group. *Aggregation* of interrelated transactions may be used
Discount rate	Risk-adjusted rates based on market	Normally based on market interest rates

Issue	For US Financial Reporting	For US Transfer Pricing
	participant perspective and company specific risks	with adjustments for risks. Considers discount rates from transferor and transferee perspectives
Useful life	Value is determined without consideration of future development beyond maintenance of the existing, acquired asset. Accounting lens focuses on useful economic life	Value includes potential for future developed versions of intangibles

As shown in the table above, a financial reporting valuation is a conservative estimate of intrinsic value that separately identifies an intangible asset from goodwill. It allows private companies to assign customer relationship value to goodwill.

A transfer pricing valuation covers a broader definition of compensable intangibles including a portion of goodwill, permits the IRS to retroactively adjust a valuation when applying the commensurate with income standard, and emphasizes consistency in arm's length results from transferor and transferee perspectives.

Valuations for transfer pricing and financial reporting are unlikely to be similar. The following sections break down the differences.

US Financial Reporting

Fair Value Standard

The Financial Accounting Standards Board ("FASB") has defined the fair value measurement standard in Accounting Standards Codification (ASC) 820 along with concepts of fair value applied in business combinations in US financial reporting through ASC 805:

"Fair Value Standard: the price at which an asset is sold or a liability is transferred in an orderly transaction between market participants at the measurement date."

Fair value is:

- an estimate of an asset's intrinsic value;
- considered an exit price rather than an entry price;
- determined through orderly transactions, not forced sales;
- involves market participants, not related parties; and

- includes consideration of the tax benefit of amortization regardless of the form of the transaction (i.e., post-tax instead of pre-tax).

Scope

For financial reporting, fair value is assigned to each of the separately identifiable assets from goodwill based on legal contracts and values determined by valuation specialists through a PPA.

Private companies can elect not to recognize certain intangible assets separately from goodwill, such as customer relationships, through a private company council (PCC) election.

Principle of Conservatism in Accounting

The principle of conservatism requires company accounts to be prepared with caution and high degrees of verification. Probable losses are recorded when discovered, while gains can only be registered when fully realized.

Methods

Valuation approaches used for US financial reporting purposes include:

- *Market approach:* Uses prices from market transactions of similar assets sold under similar conditions (uncommon for intangible assets due to unavailability of reliable data);
- *Income approach:* Uses the present value of future income streams including the multi-period excess earnings method (MPEEM) and the relief-from-royalty method (RFRM), among others (most appropriate when significant value is derived from operations that generate positive cash flows based on reliable data and projections); and
- *Cost approach:* Uses replacement cost including the reproduction cost method and replacement cost method.

The MPEEM is a specific application of the discounted cash flow ("DCF") method that is most often used to value the primary asset acquired in a transaction. In applying the MPEEM, revenue derived from the intangible asset is estimated using the overall business revenue, adjusted for attrition or obsolescence. After expense deductions, required returns attributable to other assets employed in the business are subtracted. These deductions account for the use and contribution of other assets employed that are necessary to achieve the prospective cash flows of the intangible asset. The "excess" earnings are attributable to the subject intangible asset.

The RFRM involves the estimation of an amount of hypothetical royalty savings earned by the entity that owns the intangible asset because that entity is relieved from having to license that intangible asset from another owner. In using this method, third-party arm's-length royalty or license agreements are analyzed. The licensing transactions selected should reflect similar risks and characteristics that make them comparable to the subject asset.

Replacement cost is the cost, as of the measurement date, that would be incurred to obtain a property equivalent utility to the subject. For computer software, replacement cost would be a system written in the newest, most efficient language for current hardware configurations. It also would suit the most current usage and would have the same utility as the old system but would likely accomplish its required tasks in a quite different manner. For assembled workforce, replacement cost would be the hypothetical cost to recruit, interview, train, and hire new employees, as of the measurement date.

Assumptions

- Financial projections: The PPA often values intangibles for the company as a whole and does not always assign value to each legal entity that economically owns the intangibles.
- Discount rate: The PPA determines risk-adjusted discount rates based on market participant perspective and company specific risks.
- Useful life: The useful life of an intangible asset. Intangibles are valued as if future development of new intangibles stopped as of the valuation date.

US Transfer Pricing

Arm's Length Standard and Commensurate with Income Standard

The IRS employs the arm's length standard under §482 to determine a taxpayer's true taxable income from intercompany transactions.

"Arm's Length Standard: requires that a taxpayer deals with related affiliates as if they were unrelated. A controlled transaction meets this standard if its results are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's length result)."

The arm's length standard:

- has criteria and qualitative factors that improve the degree of comparability;
- aims for comparability between controlled and uncontrolled transactions under similar circumstances; and

- has qualitative factors that improve comparability (including an analysis of each party's functions performed, assets employed, and risks assumed when comparing controlled to uncontrolled transactions).

The commensurate with income standard:

- is an additional requirement applied to intangibles transactions; and
- can have periodic adjustments imposed by the IRS to intangibles sales even several years after the fact because actual results instead of forecasts at the time of the transaction may be used.

Scope

The US transfer pricing regulations reference §367(d) to define compensable intangibles. This definition includes goodwill, going concern value, workforce in place, etc. A transfer pricing valuation must identify and compensate the legal entity economically involved in developing the intangibles.

Economic Substance Principle

The IRS may impute contractual terms based on the economic substance of the transaction and a transaction that lacks substantial business purpose (I.R.C. §7701(o). *See Perrigo Co. v. United States,* No. 1:17-cv-00737 (W.D. Mich. 2021)).

Methods

Section 482 specifies several methods for valuations of intangibles, including:

- *Comparable Uncontrolled Transaction (CUT):* Compares intercompany charges to similar transactions. Internal (between related companies) and external (between unrelated companies) CUTs may be used.
- *Comparable Profits Method (CPM):* Compares the profitability of similar companies with comparable functions, assets, and risks.
- *Profit Split Method (PSM):* Splits combined operating profit (loss) relative to each taxpayer's contribution. Typically used when both parties in a transaction make significant non-routine contributions and the business is highly integrated.
- Unspecified methods:
- *Acquisition Price Method:* Used when most of the target's assets are non-routine. Adjustments are made for liabilities and tangible property, and it should be applied within a year of the acquisition to remain reliable.
- *Income Method:* Values future economic benefits of transferred intangibles, using the best realistic alternatives principle. Can corroborate results from other methods or serve as the primary method if others are not contemporaneous.

Assumptions

- Financial projections: The IRS can combine two or more transactions if the transactions, taken as a whole, are so interrelated that aggregating multiple transactions is more reliable (*Guidant LLC v. Commissioner,* 146 T.C. No.5 (2016); *Medtronic Inc. vs. Commissioner,* T.C. Memo 2016-112).
- Discount rate: Requires both transferor and transferee to avoid arrangements that worsen their economic position if a better alternative exists, as this indicates a price that is not arm's length. Technically, an arm's-length licensing alternative must be considered and compared to a platform contribution transaction (PCT) valuation. In the case of a cost sharing arrangement, the owner of intangibles using it to make a product itself is another alternative that must be considered.
- Economic life: A transfer pricing valuation requires projected income for future versions of developed intangibles that would otherwise be included in goodwill.

How Executives Can Approach Differences To Mitigate Risks

Executives may desire a coordinated approach of specialized valuations, addressing both tax uncertainty and financial reporting risks. Information gathered for one purpose is useful for the other, leading to time and cost savings and avoiding duplicate requests. Comparing methodologies, assumptions, and documentation enhances the quality of each valuation. While these valuations are unlikely to have the same results, reconciling them can be beneficial, as tax authorities often request a reconciliation. Additionally, financial reporting valuations can indicate reasonable values for transfer pricing.

Some executives may prefer separate analyses for complex situations. Separate analyses may be necessary if significant time has passed between a M&A versus a business reorganization, making old data and assumptions irrelevant. Alternatively, executives can plan ahead by having an intercompany contract include the option of periodic adjustments to proactively align transfer pricing valuations with actual financial results. This can help mitigate transfer pricing penalty risks from the IRS enforcing the commensurate with income standard.

In any case, by understanding the differences in valuing intangibles for transfer pricing versus financial reporting, executives will be better prepared to seize cross-border M&A opportunities, manage regulatory expectations, and mitigate risks.

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