



Managing risk in tax valuations

Planning considerations



Navigating an evolving economic and regulatory landscape can prove challenging for any business, especially when faced with difficult valuation questions that can affect the company's cash tax position.

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 challenges in mind, it is critical that the company, its tax advisers, and the appraiser address the most critical project planning considerations before beginning the valuation process. The following sections summarize four critical steps needed to plan an effective framework when developing a defensible tax position.

1. Clearly define the scope and purpose

Coordination among the relevant parties should begin once the need for a valuation is determined. It is critical that the valuation adviser has a clear understanding of the scope and purpose of the valuation. In addition, an understanding of the applicable tax regulations is important when selecting the appropriate valuation methodology and approach.

For example, valuations prepared for Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) should be compliant with guidance provided under Internal Revenue Code 897 (IRC 897). Similarly, valuations prepared for cross-border transfers of intangible property should be compliant with guidance provided under Internal Revenue Code 482 (IRC 482) and by the Organisation for Economic Co-operation and Development (OECD). Ignoring the applicable tax regulations and purpose may put the valuation at risk of being unable to withstand scrutiny under an audit or a dispute.

2. Determine how the transaction is structured

At the onset of the project, the valuation adviser should gain a sufficient understanding of the current organizational chart and the anticipated transaction steps pertaining to the relevant legal entities. An understanding of the transaction steps can help the valuation adviser assess the subject interest being valued and the appropriate financial statements to be used in the valuation. A misunderstanding of the organizational or transaction structure can result in an incorrect identification of the subject interest and an unsupportable value.

3. Identify the relevant tax jurisdictions

For global transactions, each foreign tax authority should be considered, as they may have different expectations and requirements for the valuation. A mutually agreed-upon scope between the relevant parties will help identify the applicable tax jurisdictions where the valuation will be relevant. Failure to adequately consider the expectations of foreign tax authorities can lead to a dispute or rejected appraisal. This can occur due to jurisdictional differences regarding acceptable valuation methodologies and assumptions. Challenges may also arise because of potential prescribed requirements around the form and language of the anticipated deliverables.

If the valuation will be used for foreign tax purposes, some level of involvement from a local appraiser may be required to ensure consistency with local regulations and practices.

4. Consider relevant guidance

A variety of specific guidance (statutory, administrative, and judicial) exists and can be referenced in the tax research process. Tax valuations for U.S. tax purposes ultimately fall under the purview of the IRS and relevant tax guidance can be found in the Internal Revenue Code, along with regulations, revenue rulings, bulletins/notices, and various other sources. Additionally, tax court rulings can sometimes set precedent, and offer additional interpretations. An understanding of the authoritative guidance and its specific application should be incorporated to prepare a supportable valuation. Failure to do so may weaken the valuation advisor's ability to withstand scrutiny from the auditors and the IRS.

Summary

As a foundation for an effective and supportable tax valuation, the relevant parties should establish all the pertinent facts early in the valuation process, which will help establish the goal of the valuation engagement and develop an effective analytical framework. While additional tax-related issues can arise, addressing the aforementioned critical steps can eliminate many common mistakes and mitigate risk.

Have questions?

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