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Importance of Valuations in M&A Tax Planning

Valuations underpin every stage of the M&A process from target identification, to quantifying the impact of a particular deal on Earnings per Share, to post-close reporting and compliance activities. The value of a business, its legal entities, and underlying assets and liabilities will not just influence the financial and strategic outcomes of a transaction, but also be critical to each party's tax planning and compliance.

During diligence, tax executives are often called upon to provide early estimates of value by entity or key geography. While legal entity values may inform both parties' pre-deal tax planning and structuring, it is common for the seller to lead this process. Similarly, many transactions include a component of the total consideration that is contingent on the future performance of the business or achievement of certain milestones (e.g., an earn-out). The valuation of the earn-out may be significant in determining the amount of tax gain or loss on the sale. As valuations require both detailed financial information and input from a wide range of stakeholders, it is recommended that both buyers and sellers prepare early for this process.

Standard of Value

Fair market value ("FMV") is the standard of value used for tax planning purposes. FMV is defined as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."
As a result of a given a transaction, valuations may also be prepared for financial reporting purposes and under a fair value standard of value. While FMV and fair value are related concepts, they serve different purposes and utilize different standards. It is important to consider the governing standards for each purpose and use of a valuation.

Valuation Approaches and Methodologies

Choosing the appropriate methodology to value a business depends on various factors including the nature of the business, the purpose of the valuation, the availability of data, and the industry in which the business operates. The three traditional approaches to value are the 1) income approach, 2) market approach and 3) cost approach.

In selecting a methodology to value a legal entity, it is critical to understand the structure of the organization, function of each entity, and the transfer pricing in place in selecting a methodology. A discounted cash flow ("DCF") methodology is often the preferred and most robust methodology utilized in the valuation of an entity that is operating in nature. For example, entities that function as distributors, manufacturers, and intellectual property owners are frequently valued with a DCF. Whereas holding companies and finance entities are often valued with a variation of the Cost Approach – the Net Asset Value method – which values the business based on the FMV of its assets less liabilities. The selection of a market approach requires sufficient comparable public companies or recent transactions to employ its use in an analysis. Similarly in performing an asset valuation, variations of the three traditional approaches are employed depending on the facts and circumstances of each asset class.

Purchase Price Allocation (IRC Section 1060)

One common valuation requirement in M&A stems from Internal Revenue Code ("IRC") Section 1060 which pertains to transactions involving the purchase of assets rather than stock. The purpose of Section 1060 is to ensure that both the buyer and seller of a business allocate the purchase price consistently and accurately among the various asset classes.

For sellers, the 1060 valuation informs the amount of gain or loss recognized on the sale of each asset, impacting the seller's tax liability. Further, it enables the transaction to be reported accurately and consistently with the buyers reporting. Similarly, for the buyers, the allocation sets the tax basis of the acquired assets which then impacts future depreciation and amortization. With that said, the valuation will also set the stage for future planning.

We note that large transactions often include many countries, and each may have different requirements with respect to valuations, including whether a local valuation report is deemed necessary or whether a valuation is required for purposes of determining whether indirect transfer taxes apply to a transaction. It is key to work with your tax advisors to understand any local nuances that may drive the need for in-country valuation requirements.

Investor Insights

Investors often focus on value allocation due to the potential impact of tax attributes such as future tax depreciation and amortization deductions from taxable income. Occasionally, buyers or sellers may not initially agree on the allocation of purchase price for tax purposes. In an M&A transaction, consideration should be given to negotiating the allocation of purchase price in the purchase and sale agreement whereby the parties contractually agree to a specific purchase price allocation or valuation methodology to avoid the potential risks resulting from inconsistent tax reporting post-closing. Section 1060(a)(2) states that: "If in connection with an applicable asset acquisition, the transferee and transferor agree in writing as to the allocation of any consideration, or as to the fair market value of any of the assets, such agreement shall be binding on both the transferee and transferor unless the Secretary determines that such allocation (or fair market value) is not appropriate." In addition, the IRS and certain courts have often cited what is referred to as the 'Danielson Rule' (Commissioner v. Danielson, 378 F.2d 771,775 (3d Cir. 1967), where taxpayers are generally bound by their written agreements with another party. In Commissioner v. Danielson, the court held that where taxpayers executed a contract containing specific terms, conditions, and allocations, taxpayers may not alter or avoid the tax consequences of that agreement in the absence of fraud, duress, or undue influence. It is important for investors to consider specificity in the purchase and sale agreement regarding the intended purchase price allocation prior to entering into a transaction.

Contingent Consideration for Tax Purposes

Contingent considerations may be payments made based on future performance of an acquired/divested business (e.g., revenue targets or payments triggered by achieving specific milestones). Appropriate methodologies for contingent considerations may vary in complexity and differ from those utilized in the valuation of an entity or asset. When a wide range of possible future scenarios dictate the likelihood of a future payment being made, a rigorous model such as a Monte Carlo Simulation might be warranted. Whereas when a discrete number of possible outcomes with varying probabilities are forecast, a Probability Weighted Expected Return Method may be the preferred approach.

In closed transactions or in a qualifying installment sale transaction where the taxpayer elects out of the installment sales method, the IRS requires the FMV of contingent considerations be included in the initial purchase price allocation under IRC Section 1060, as well as in proceeds in the year of the sale. The valuation of contingent considerations can significantly impact the tax consequences in these transactions as the taxpayer recognizes additional gain in the year of the sale for the FMV of the contingent consideration versus deferring the gain until the payments are made in the future.

We note there is no specific guidance issued by the IRS on the valuation of contingent considerations for tax purposes. As there is defined guidance published by The Appraisal Foundation for fair value analyses, most appraisers utilize the same guidance when valuing contingent considerations for tax purposes under FMV.

Transforming Valuations for Tax Planning

Valuations require a comprehensive and transparent process, leveraging accurate data and employing appropriate methodologies. During the M&A life cycle both a buyer and seller may require an understanding of the FMV or fair value of various businesses, entities, assets, or liabilities. Understanding valuation requirements associated with a deal and aligning with key stakeholders early on can help drive an efficient and collaborative process.

Look out for future M&A Tax Talks that take a deeper dive into tax valuations related to transfer pricing, structuring, and more.

Want to learn more?
Reach out to our contacts below.

Chrissy Scott
Valuation & Modeling
Principal
Deloitte Transactions & Business Analytics LLP
christinescott@deloitte.com

Dan Peckham
Valuation & Modeling
Principal
Deloitte Transactions & Business Analytics LLP
dpeckham@deloitte.com

Jeff Kennedy
Valuation & Modeling
Principal
Deloitte Transactions & Business Analytics LLP
jefkennedy@deloitte.com

Megan Sullivan
Mergers & Acquisitions
Tax Senior Manager
Deloitte Tax LLP
megansullivan@deloitte.com