The Impact of the Standard of Value on Transfer Pricing and Financial Accounting in the United States

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Tangible property and intangible property are valued in a variety of different contexts and for a variety of different reasons. As such, multiple standards of value have developed, not all of which yield equivalent results for the same property. One context in which tangible property and intangible property are valued is income-tax-related intercompany transfer pricing. In estimating a value for tangible property and intangible property in this transfer pricing context, the analyst should understand the nuances of the arm's-length price standard and how it differs from the fair value and fair market value standards of value. This discussion (1) provides an overview of the different standards of value used for financial reporting and tax-related transfer pricing purposes and (2) analyzes the similarities and differences between fair value and the arm's-length price standard of value.

Introduction

Multinational companies often transfer tangible and intangible property from a U.S. parent corporation to foreign subsidiaries or to other affiliated entities.

Analysts are often asked to estimate the transfer price of the tangible property and/or intangible property for income tax purposes. The transfer price is important for establishing and reporting the correct tax base of the transferred property. If the Internal Revenue Service (the "Service") believes that the intercompany transfer price is incorrect or "mispriced," the Service may call for transfer price adjustments to be made.

Understanding the transfer pricing regulations and how the selected standard of value can affect the transfer price conclusion are important considerations in any transfer pricing analysis.

In the United States, the analyst can rely on several different standards of value depending on the purpose of a valuation assignment. The purpose of a valuation, and the standard of value that is applied, can have significant effects on the subject property value conclusion. In other words, valuations performed for different purposes, using different standards of value, can result in different value conclusions. These different value conclusions can be attributed to differences in the definition (and intent) of the standard of value. The appropriateness of the standard of value depends on the context and purpose of the valuation.

Fair market value, the standard of value used in valuations prepared for certain federal tax matters, is generally considered by courts and other income tax practitioners to be consistent with the arm's-length price standard, the standard of value used in transfer pricing analyses.

Not far removed from the two aforementioned standards of value is *fair value*. Fair value is the standard of value used for U.S. generally accepted accounting principles (GAAP) financial reporting purposes.

In general, each of these standards of value attempts to estimate the price of a property that would be agreed to by independent parties. If all three standards attempt to estimate a price that would be agreed to by independent parties, one may conclude that they should yield equivalent results. However, this is not always the case. This is because these three standards of value diverge from each other in subtle yet significant aspects.

This discussion examines and compares three valuation standards, fair value, fair market value, and arm's-length price. It also addresses why analysis performed under these three seemingly equivalent standards will not always equate.

Valuation Standards

In the United States, the standard of value used for financial accounting is fair value. Fair value is defined by the Financial Accounting Standards Board (FASB) in Accounting Codification Standards topic 820 (ASC 820), as follows:

> Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction in the principal (or most advantageous) market at the measurement date under current market conditions (that is, an exit price) regardless of whether that price is directly observable or estimated using another valuation technique.[1]

In addition to the fair value standard used in financial reporting, there is also fair value derived from state shareholder rights statutes. This statutory fair value standard of value is typically the standard applied in valuations related to dissenting shareholders or minority oppression actions. The definition of fair value in this context can vary from state-to-state, and sometimes even among courts within the same state. Fair value is also the standard used by some states for marital dissolution matters.

For this reason, analysts work closely with client legal counsel to understand the statutes and relevant standards of value applicable to the subject analysis.

Under U.S. income tax law,[2] fair market value is the relevant standard of value for income tax purposes. Fair market value is not explicitly defined in the Internal Revenue Code, but it is defined in the Treasury regulations (the "regulations"). The regulations generally carry the full force of law in the United States.[3]

The Treasury regulations define fair market value as follows:

> 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 sell and both having reasonable knowledge of relevant facts.[4]

Despite fair market value being considered the relevant standard of value under U.S. tax law, the arm's-length price standard may also be applicable in certain income tax matters, such as for intercompany transfer pricing purposes.

The arm's-length price standard states that the amount charged by one related party to another for a given product should be the same as if the parties were not related. The definition of arm's-length price as it applies in the United States is presented in the Section 482 regulations.

According to the Section 482 regulations:

> A controlled transaction meets the arm's length standard if the results of the transaction 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).[5]

Although the arm's-length price standard is the relevant standard of value for intercompany transfer pricing purposes in the United States, other standards may be applied by international tax authorities. For example, the Organisation for Economic Co-Operation and Development (OECD) provides the authoritative international definition of the arm's-length principle. This standard of value is applicable for intercompany transfer pricing purposes in many other (non-U.S.) countries.

According to the OECD:

> [Where] conditions are made or imposed between the two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.[6]

For purposes of this discussion, it is important to recognize the differences between the Treasury regulation definition and interpretation of the arm's-length price standard and the OECD definition and interpretation of the arm's-length principle.

In general, however, these two definitions and standards are largely equivalent, and an in-depth analysis comparing and contrasting the subtle differences between these definitions is beyond the scope of this discussion. For this discussion, we rely on the Treasury regulation definition of the arm's-length price standard.

Arm's-length price standard and fair market value have subtle differences. However, for purposes of this discussion, these differences will also be omitted and we will assume them to be equivalent. This assumption comports with the general position taken by many practitioners.

Comparison of Arm's-Length Price and the Fair Value Standard

Fair value and arm's-length price are not directly compared to each other in the Internal Revenue Code, the regulations, or in ASC 820. However, the definitions can be compared by analyzing certain key attributes of value that are identified in each definition.

Table 1 is reproduced (with minor editorial changes) from an April 2011 article in *Tax Notes International*.[7] The table presents a comparison of the following specific attributes of arm's-length price and the fair value standard of value, based on the current definitions of each standard:

1. The controlled transaction
2. The application context
3. The comparable transaction
4. The valuation

Table 1
Comparison of the Arm's-Length Price Standard and the Fair Value Standard

	Arm's-Length Price Standard (Based on Section 482)	Fair Value Standard (Based on ASC 820)
Subject Transaction	Recognized as actually structured	Recognized as actually structured
Application Context	Dual perspective	Single perspective
Comparable Transaction	Independence requirement Comparability requirement: - Actual transaction - Actual transaction - Actual participants - Actual market	Independence requirement Comparability requirement: - Actual object - Hypothetical transaction - Hypothetical participants - Hypothetical market
Valuation	Pretax basis Arm's-length range Profit maximization	Post-tax basis Highest and best use principle Profit maximization
End Result	Subjective, entity-specific value	Objective, value

The Subject Transaction

As stated above, arm's-length price and the fair value standard are similar in regards to the subject transaction. For both, the subject transaction is recognized as it is actually structured.

The regulations establish that "[t]he Commissioner will evaluate the results of the transaction as actually structured by the taxpayer unless its structure lacks economic substance. However, the Commissioner may consider the alternatives available to the taxpayer in determining whether the terms of the controlled transaction would be acceptable to an uncontrolled taxpayer faced with the same alternatives and operating under comparable circumstances."[8]

For transfer pricing purposes, the subject transaction involves the transfer of property or services between related companies that belong to the same multinational enterprise group. These transactions are referred to as "controlled" transactions, or non-arm's-length transactions.

Controlled transactions are distinctly different from uncontrolled transactions. Uncontrolled transactions occur between companies that are assumed to operate independently from each other, or on an arm's-length basis.

For financial accounting purposes, the FASB offers a similar position in ASC 820 by stating, "A fair value measurement is for a particular asset or liability. Therefore, when measuring fair value a reporting entity shall take into account the characteristics of the asset or liability if the market participants would take those characteristics into account when pricing the asset or liability at the measurement date."[9]

These characteristics often include the condition and location of the asset, and whether or not there were any restrictions on the sale or use of the asset at the time of the transaction.

Comparing the two standards from a broad perspective, it is evident that both standards attempt to evaluate the economic structure of the subject transaction based on the transaction characteristics that unrelated parties would use to determine a price for the subject transaction.

Adjustments to the structuring of the transaction can occur in the arm's-length price, but only if the Service believes the structure lacks economic substance (i.e., was not comparable to an uncontrolled transaction of similar nature).

The Application Context

For intercompany transfer pricing purposes, the context of the subject transaction is analyzed from a dual prospective. That is, in a transfer pricing analysis, the interests of both the buyer and the seller, both dealing at arm's length, are evaluated to determine a price for the subject transaction.

By comparison, the objective of a fair value financial accounting analysis is to determine an exit price that would be received to sell an asset or paid to transfer a liability,[10] which effectively is a one-sided perspective.

Transactions that consider only one perspective can result in a value that is different than if both the buyer's perspective and the seller's perspective are considered. This is because by only considering the transaction from the perspective of the seller, and not the buyer, the analyst may omit pertinent information about what the buyer stands to gain in the transaction.

In other words, the potential benefits of the subject transaction, negotiated from the buyer's perspective, can have an influence on the arm's-length price of the subject transaction.

Thus, arm's-length price attempts to estimate the price of a transaction by including factors that are relevant to each specific buyer *and* seller.

The inclusion of such factors in an analysis leads the arm's-length price standard towards a more subjective and company-specific value conclusion. Fair value, which as noted is a one-sided perspective, generally leads to a more objective valuation analysis and value conclusion.

The Comparable Transaction

For transfer pricing purposes, analysts typically use methods that rely on comparable uncontrolled transactions. These comparable uncontrolled transactions provide market-based transactional data involving property comparable to the subject property that was transacted under circumstances comparable to the subject transaction.

The lack of data on such comparable transactions can make a particular method more or less reliable, and even inapplicable. The comparable transactions are referred to as uncontrolled transactions because the parties involved in the transactions are independent of each other.

In the context of both arm's-length price and the fair value standard, a comparison between a controlled transaction and a comparable transaction may be required. In the process of selecting and analyzing potentially comparable transaction(s), the two standards diverge in a few subtle, but important, ways. The primary differences relate to the following:

1. The reference transaction
2. The market where the reference transaction occurs
3. The participants involved in the reference transaction

These three differences are discussed next.

The Reference Transaction

When performing an analysis within the arm's-length price and the fair value context, one consideration is the reference transaction. The two valuation frameworks differ on what types of reference transactions should be analyzed in the valuation.

According to the regulations, when estimating the true taxable income of a controlled taxpayer, the standard to be applied "in every case"[11] is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer (i.e., unrelated or unaffiliated).

The controlled transaction meets the arm's-length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances.

However, because identical uncontrolled transactions can rarely be located, whether a transaction produces an arm's-length result generally will be determined by reference to the results of comparable transactions under similar circumstances.[12]

By comparison, ASC 820 does not require an actual transaction to have occurred in order for it to have a fair value. According to ASC 820, fair value is based on an "orderly transaction" between market participants.[13]

An orderly transaction is not necessarily a real transaction. In fact, an orderly transaction can be a hypothetical transaction that is assumed to have taken place on the measurement date. This hypothetical transaction assumes that the subject asset has been exposed to the market for the usual and customary period of time for marketing activities.

In this regard, the fair value standard directly conflicts with the arm's-length price standard. In other words, the two standards are different with regard to the reference transaction. This is because the reference transaction(s) in a fair value analysis may include *hypothetical* comparable transactions and, conversely, the reference transaction(s) in an arm's-length analysis are typically considered to be *actual* comparable transactions.

The Reference Market

The market in which the reference transaction is expected to have taken place is also a noteworthy difference between the two standards. Fair value assumes that the transaction to sell the asset or transfer the liability occurs in the principal or most advantageous market to the reporting entity.[14]

Within the principal market, the reporting entity is able to sell the asset or transfer the liability at the price that maximizes the amount that would be received for the asset or, minimizes the amount that would be paid to transfer the liability.

The regulations offer different guidance on selecting the comparable transactions, noting that comparable transactions should be derived from a comparable geographic market[15] in which the taxpayer operates and how there may need to be adjustments based on location savings.[16]

This guidance implies that the comparable transaction need not occur in the principal or most advantageous market. This is an important consideration, because there may be significant differences in the economic conditions between markets and/or countries (i.e., the actual market may not be the same as the most advantageous market).

The Participants

The regulations indicate that comparable transactional data involving unrelated parties provide the most objective basis for determining whether a controlled transaction is at arm's length. In this context, unrelated parties are generally considered to be unrelated, actual market participants.

By comparison, the fair value standard supports the use of hypothetical market participants. According to ASC 820, "a reporting entity need not identify specific market participants. Rather, the reporting entity shall identify characteristics that distinguish market participants generally."[17]

The difference between the two frameworks' interpretation of the reference transaction participants is, as mentioned above, whether or not they are actual or hypothetical participants. Arm's-length price supports the use of actual market participants involved in actual market transactions.

The fair value standard does not require the use of actual transaction and supports the use of hypothetical market transactions involving hypothetical market participants.

The Analysis

In comparing the analytical processes of the arm's-length price standard and the fair value standard, both standards are transactional and price based.[18] Although the actual analytical process is quite similar between the two standards, there are two important differences that can yield materially different values in most instances.

The Treasury regulations and the accounting standards have differing aspects on how the property involved should be taxed and by what application (e.g., the use of the asset) they should be assessed. These two issues are discussed next.

Tax Treatment

Fair value analyses prepared for financial accounting purposes are generally prepared on an after-tax basis. Buy-in price analyses prepared for transfer pricing purposes are sometimes prepared on a pretax basis.

The issue with these procedures, and where they conflict, is that something that is transacted is, by its very nature, a pretax transaction price, regardless of the basis used to determine that price.

In both fair value and the arm's-length standard, it is assumed that both the buyer and seller are knowledgeable of the relevant facts and are rational. Rational and independent parties would consider the tax consequences of transactions when evaluating price, which could cause different buyers to estimate different values for the same subject property.

Regulation 1.482-7 discusses the pretax basis of transfer pricing under multiple circumstances, specifically the investor model, discount rates, and the income method:

> *Treas. Reg*. §1.482-7(g)(2)(iii)—Consistency of evaluation with realistic alternatives
>
> In general. The relative reliability of an application of a method also depends on the degree of consistency of the analysis with the assumption that uncontrolled taxpayers dealing at arm's length would have evaluated the terms of the transaction, and only entered into such transaction, if no alternative is preferable. . . .<u>In principle, this comparison is made on a post-tax basis</u> but, in many cases, a comparison made on a pre-tax basis will yield equivalent results [emphasis added].
>
> *Treas. Reg.* §1.482-7(g)(2)(v)(B)(4)—Discount Rates
>
> Post-tax rate. In general, discount rate estimates that may be inferred from the

> operations of the capital markets are post-tax discount rates. Therefore, an analysis would in principle apply post-tax discount rates to income net of expense items including taxes (post-tax income) [emphasis added]. However, in certain circumstances the result of applying a post-tax discount rate to post-tax income is equivalent to the product of the result of applying a post-tax discount rate to income net of expense items other than taxes (pre-tax income), and the difference of one minus the tax rate. Therefore, in such circumstances, calculation of pre-tax income, rather than post-tax income, may be sufficient.
>
> *Treas. Reg.* §1.482-7(g)(4)(i)(G)—Income method
>
> The effect of taxation on determining the arm's length amount. (1) In principle, the present values of the cost sharing and licensing alternatives should be determined by applying post-tax discount rates to post-tax income (including post-tax value to the controlled participant of the PCT [platform contribution transaction] Payments) (emphasis added). If such approach is adopted, then the post-tax value of the PCT Payments must be appropriately adjusted in order to determine the arm's length amount of the PCT Payments on a pre-tax basis.

The tax treatment under the regulations is meant to provide a shortcut that ensures both the buyer and the seller are willing to enter into the transaction in question after tax costs and benefits are taken into account. The different tax treatments used in the two standards of value may lead to differences in the analysis conclusion.

Arm's-Length Price Range and the Highest and Best Use Principle

Estimating the value of an asset or liability under the fair value standard assumes the asset(s) will be used at the highest and best use (HABU). According to ASC 820, "Highest and best use is determined from the perspective of market participants, even if the reporting entity intends a different use. However, a reporting entity's current use of a nonfinancial asset is presumed to be its highest and best use unless market or other factors suggest a different use by market participants would maximize the value of the asset."[19]

The definition provided by FASB considers that the HABU of an asset (i.e., the use that provides the most profit return on the asset) is the one for which it is to be used.

By comparison, the arm's-length price standard attempts to estimate the price of a transaction based on the results of comparable transactions. "In some cases, application of a pricing method will produce a single result that is the most reliable measure of an arm's length result. In other cases, application of a method may produce a number of results from which a range of reliable results may be derived. A taxpayer will not be subject to a transfer pricing adjustment if its results fall within such range (an arm's length range)."[20]

". . . using the HABU will maximize the asset value by assuming the subject property is sold into the most advantageous market, even if the subject asset currently is not being used in that market."

Based on the HABU analysis, and assuming all other factors are held constant, the fair value standard may result in the same, or greater, value than the arm's-length price standard. This is because the fair value standard uses a single-sided perspective from the side of the seller.

That is, using the HABU will maximize the asset value by assuming the subject property is sold into the most advantageous market, even if the subject asset currently is not being used in that market.

On the other hand, the arm's-length price appears to take a more unbiased (or neutral) prospective with regard to the subject market. This is because arm's-length price considers both the buyer and seller (i.e., it employs a dual-sided perspective).

Conclusion

This discussion provided an overview and comparison of the arm's-length price standard and the fair value standard. The arm's-length price standard and the fair value standard are distinct standards of value that differ in several significant aspects.

The arm's-length price standard considers the motivations of both buyers and sellers in transactions. That is, it attempts to perform the analysis from an unbiased, dual-sided perspective. The arm's-length price standard relies on actual comparable uncontrolled transactions to estimate the arm's-length price of a controlled transaction.

The analysis conclusion of an arm's-length price analysis is typically a range of prices from which the

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original transaction is compared and adjusted based on company-specific factors. Accordingly, the arm's-length price standard offers a subjective and entity-specific analysis.

The fair value standard, unlike the arm's-length price standard, develops a one-sided value conclusion based on the perspective of the seller. Instead of including information about the buyer in the analysis, or developing a range of values, the fair value standard requires the analyst to assume the highest and best use for the subject property, regardless of the intended or actual use of the subject asset or liability. In general, the fair value standard offers a more objective analysis.

Analyses performed for different purposes, using different standards of value, can result in different value conclusions. The arm's-length price standard and the fair value standard have inherent conceptual differences which can result in the difference between a subjective value conclusion and an objective value conclusion.

Notes:

1. ASC 820-10-35-9A.
2. Internal Revenue Code Sections 84A(2), 475(a)(1), 307(b)(1)(B), et al.
3. 26 U.S. Code § 7805 – Rules and regulations.
4. Treas. Reg. §1.170A-1(c)(2), 20.2031-1(b), and 25.2512-(1).
5. Treas. Reg. §1.482-1(b)(1).
6. Para. 1.6 of the OECD guidelines.
7. Jens Wittendorff, "The Arm's-Length Principle and Fair Value: Identical Twins or Just Close Relatives?" *Tax Notes International* (April 18, 2011): 223–249.
8. Treas. Reg. §1.482-1(f)(2)(ii)(A).
9. ASC 820-10-35-2B.
10. ASC 820-10-35-9A.
11. Treas. Reg. §1.482-1(b)(1).
12. Ibid.
13. ASC 820-10-35-2.
14. ASC 820-10-34-5.
15. Treas. Reg. §1.482-1(d)(4)(ii).
16. Treas. Reg. §1.482-1(d)(4)(ii)(C).
17. ASC 820-10-35-9.
18. Treas. Reg. §1.482-1(d)(1) and ASC 820-10-35-9.
19. ASC 820-10-35-10C.
20. Treas. Reg. §1.482-1(e)(1).

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