

May 2003

Section 482 Documentation Supports State Tax Purposes

“Proper valuation work supported the business purpose and verified the intercompany changes.”

An important decision was recently issued in Massachusetts upholding the use of Delaware IP holding companies where those companies charged intercompany royalties back to the parent company. The case illustrates that business purposed coupled with proper IP valuation can withstand a challenge of deductions for intercompany royalty payments by state tax authorities.

FACTS OF THE CASE

Sherwin-Williams had organized two Delaware IP holding companies to which it transferred its trademarks. The two Delaware companies retained full ownership rights to the trademarks and actively managed them by third party licenses, maintenance, protection, etc. The Delaware companies also licensed the trademarks back to Sherwin-Williams for its use and for an agreed upon amount of fees per an intercompany license agreement. The trademarks were valued by an outside valuation firm to set the basis for the fair market value transfer of shares of the Delaware holding companies and for the purpose of setting the appropriate arms-length intercompany royalty rates. The fair market values upon date of contribution to the Delaware holding companies were about \$328 million and intercompany royalty rates were established at between 1% and 4.5%.

ISSUES

The legal issues raised by Massachusetts in disallowing Sherwin-Williams deductions for trademark royalties were twofold. First, were the formation of the holding companies and intercompany royalty arrangements, sham transactions that could be disregarded for tax purposes? Second, were the royalty payments made by Sherwin-Williams also sham payments either because the entire arrangement was a sham or because they were not arms-length?

HOLDINGS

The Massachusetts Supreme Court reversed the lower court and held for Sherwin-Williams on both issues. On the first issue, the Court held that the Delaware companies served a valid business purpose. Documentation from board meetings clearly indicated non-tax business reasons for their formation. On the second issue, the Court recognized the validity and accuracy of the valuation process and upheld the amounts of intercompany royalties deducted by Sherwin-Williams as proper arms-length amounts.

Notably, the Court distinguished the Sherwin-Williams situation from another case, *Syms vs. Dept. of Revenue*, 436 Mass. 505 (2002), in which the state did sham the Delaware companies and did not allow the intercompany royalty deductions. In *Syms*, the Court noted that the Delaware companies provided no more than a circular flow of cash because they remitted the royalty payments they received as dividends back to the parent. In addition, there was no apparent non-business tax purpose to the Delaware companies unlike the well-documented business purpose of those companies in Sherwin Williams.

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VRC NEWS

With this issue of the *Valuation Researcher Alert*, we are unveiling a new look for the newsletter. Let us know what you think of our new format. Please e-mail your comments to tmiller@valuationresearch.com.

Alfred King will present “Vital Issues in Accounting for Middle Market Transactions,” at the Mergers and Acquisitions Advisor Conference June 17-18 in New York City.

Robert Cronin will present, “The Role of Valuation Experts in Financial Statement Presentation,” as part of the CITE (Council for International Tax Education) Conference, “Managing The Global Effective Tax Rate.” The conference will be held July 28-29 in Chicago.

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CONCLUSIONS

For state tax planning purposes, we are finding that valuation analyses to establish related party transfer pricing should meet federal standards. Federal standards are based on a detailed economic analysis designed to identify the best method of transfer pricing to employ. This analysis focuses on the relative functions and business risks assumed by each of the related parties in the commercial transaction. Through a combination of proper valuation techniques and economic analysis, the functions and risks of the related parties can be benchmarked to appropriate industry or financial standards to determine both the best method of transfer pricing and an appropriate range within which the transfer pricing will be accepted by tax authorities. Where facts and circumstances permit, a transfer pricing analysis done for one purpose, either state or federal, could be used as a basis for both tax purposes.

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Transfer pricing, whether done for state or federal tax purposes, must consider other related economic and valuation exercises that might be required for financial reporting purposes. Specifically, the requirements of SFAS 141 and 142 entail drawing conclusions regarding the valuations of intangible property or business segments. A purchase price allocation under FAS 141 requires the identification and valuation of both definite and indefinite lived intangibles (customer based, market based, technology based, etc.). In addition, the first step of a FAS 142 valuation analysis requires the overall valuation of a reporting unit while the second step focuses on the value of goodwill within the reporting unit.

From a transfer pricing tax perspective, it is important to understand the FAS 141 and 142 valuation rationales and to reconcile them if necessary to the underlying rationales behind the transfer pricing methodology. For example, goodwill impairment that relates to a predominantly foreign based reporting unit could be inconsistent with a federal tax transfer pricing method which looks for technology fees from the legal entities within that reporting unit to be paid to the U.S. parent. Therefore, the rationale behind economic and valuation analyses for tax transfer purposes must be aligned with the rationale employed for other purposes where necessary. For more information regarding transfer pricing, contact your Valuation Research representative or Tom Courtright at 414/221-6258. **VR**

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