Transfer pricing considerations in mergers and acquisitions, focus on UK

The KPMG member firm in the UK prepared a series of articles addressing transfer pricing considerations in mergers and acquisitions (M&A).

The articles specifically address M&A transfer pricing considerations with respect to:

- Deal funding
- Separations
- Post-merger integration
- Intangible assets

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Funding in the deal

Darren Woolhouse - Transfer Pricing Senior Manager at KPMG UK
March 20, 2023

Recent rises in interest rates and market fluctuations have been causing headaches in finance and treasury departments all over the world. For those with ongoing M&A transactions, it is more important than ever to consider the funding of your deal and avoid any transfer pricing bear-traps. From our work in the market, we are seeing that current lender appetite is reduced compared to 12 months ago, so although the lending in the market is still there, it is at a slightly higher margin, which is compounded by the rise in base rates to give a double-whammy to leveraged borrowers.

Key considerations

So what can you do to minimise transfer pricing risk in your deal? Below is our 6 step plan to achieve peace of mind on the TP aspects of your financing.

1) **Pricing appropriately:**

Where leveraged borrowers historically had a large amount of senior debt from a third party bank with a smaller slice of related party or Private Equity shareholder debt on top, it was relatively easy to use the senior debt as a comparable to sense check the pricing of the shareholder debt and defend any tax authority challenge. Now lots of deals have no third party debt, so it is more important than ever to undertake a robust benchmarking process to price your related party loans in line with current market conditions; often a blended interest rate may be appropriate.

2) **Intragroup finance:**

If the debt that comes in at the top also needs to cascade through the group, the pricing of the intercompany debt becomes even more important – all central banks are raising rates, but some are doing so faster than others. It’s therefore vital that you look carefully at intercompany rates to see if they need to be repriced. Where a finance company is funded with floating rate debt (internal or external), rises in interest rates will raise its interest costs. If the finance company lends to affiliates on a long term fixed rate basis (e.g. a 5 year term loan), the finance company cannot increase its interest income, resulting in a loss which is likely to be scrutinised from a transfer pricing perspective.

Conversely, if the finance company raises the rate on its intercompany lending, a tax authority could challenge whether this is arm’s length for the borrower. Contractual terms are an important aspect of the analysis but other factors such as how financial risks are controlled within the group and the extent of the group’s exposure should be considered. This includes whether the benefits of any external hedging arrangements (e.g. swap contracts) are recognised in the entity where the exposure sits.

If you have a vehicle within the group to effect the on-lending of external finance (perhaps using the Qualifying Asset Holding Company “QAHC” regime), it is worth considering how you price this. We are seeing some businesses applying a flat 15 bps margin on a significant on-lending balance ending up with a huge profit compared to their cost base, due to the limited functions in the company. Consider how much profit your QAHC gets through both a traditional margin on on-lending and a cost plus method to see which is more in keeping with the functions, assets and risks in line with Chapter X of the OECD Guidelines.

3) **Consider the borrowing terms (lender position):**

Recent case law has highlighted the importance of reviewing the funding terms, deal flow and structure carefully to make sure that it all makes sense. Does the borrower have access and control over the assets it needs to service the debt? Are there capital controls or negative reserves anywhere in the group that will make regular access to cash difficult? There is no point in spending time on the tax structure, if you then lose your interest deduction because your holding company doesn’t control the

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business it borrowed against. Again, for intercompany borrowing, if you have old agreements that talk about pricing in terms of LIBOR plus a base, might it be time to switch them over to SONIA?

Where a loan carries interest at a fixed rate but is repayable on demand, a lender (particularly one funded by floating rate debt) may at arm's length initiate a renegotiation of the interest rate to mitigate the risk of a loss. It is therefore crucial to understand what the legal agreements say for each of your loans, and decide whether to reprice or amend any terms to mitigate the impact of the rate rises.

4) **Consider the borrowing terms (borrower position):**

Affordability is a key factor in supporting an arm's length position and where we are seeing clients have real issues in this area is when they have modelled the funding focused solely on the deal internal rate of return. Have you worked through the day to day operation of the loans including the waterfalls and cashflows including any dividend blocks? Structures are complicated enough, without having to have large unpaid intercompany interest balances because you can't get the cash in place quickly enough to service the debt. The risks to the lender of the structure of the payment of interest (such as PIK notes) and principal repayment (for example, bullet or amortising payment) will then feed into your pricing analysis.

5) **Financial guarantees:**

Parental or other intra-group guarantee arrangements that maintain access to the lowest interest rates (or a higher debt quantum) from third party lenders may become more beneficial in a higher interest rate environment. This will lead to complex considerations around the arm's length amount of a fee for such a guarantee and could also call into question the treatment of the third party debt. Challenges from parent company tax authorities arguing for the imposition of guarantee fees are still reasonably rare, but it is worth considering whether it is better to make the guarantee charge pre-emptively rather than waiting for a parent jurisdiction challenge and have to go through the Mutual Agreement Procedure.

6) **Capital structure**:

We have left this one to last as it's the most obvious (see, we don't just think about thin cap in TP). Rising interest expense makes debt financing less attractive than before. We are seeing third party transactions place more emphasis on equity funding, which means that the amount of intercompany debt that could be supported as arm's length will reduce accordingly. Given pressure on EBITDA from rising inflation, it will also be more difficult to meet notional maintenance covenants for existing debt arrangements, increasing the risk of tax authority challenge. The pace of change means it is more important than ever to ensure the analysis is informed by current market conditions including lender appetite which is increasingly variable depending on factors such as industry sector and the size of the borrower.

Interest rate rises may also mean interest expense is more susceptible to being restricted under the borrower country's earnings stripping rules, such as the UK's Corporate Interest Restriction ("CIR"). For example with a higher interest rate, more debt arrangements will exceed the £2m de minimis interest expense threshold requiring a UK CIR analysis to be performed. In general though, if you have new finance coming into the group, is it worth looking again at your group funding structure to ensure that where the intragroup debt sits, is in line with the EBITDA, to maximise interest relief?

So what should I do?

The common thread among all these things is thinking ahead to what the day-to-day picture will be like *after* the deal goes through. So in amongst all the rush to complete, just take the time to think about what things will look like after completion, and how this will impact your transfer pricing. The arrangements will need to align to the post-completion needs of the business and provide sufficient flexibility to meet future needs. A lot of the above steps will also have broader business benefits (no more hunting for old intercompany loan agreements if you take the time to refresh now), so take the time to look at your TP as early as you can. It can be complex and costly to 'fix' an inappropriate capital structure once in place.

Many thanks to Lucy Titchener for her invaluable help in writing this article.

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Consider TP as you approach your next M&A separation

Malcolm Manekshaw - Transfer Pricing Director at KPMG UK
April 18, 2023

What we do we mean by carve-outs / separations?

2021 was a bumper year for M&A. However, market conditions meant a slowdown in deals in the latter half of 2022 and start of 2023. While there are some promising signs of a turnaround in Q2, businesses will be looking to reinforce their balance sheets against future market disruptions and economic uncertainty, reduce costs and optimise their operational efficiency.

A carve-out — in which a company either floats part of the business on the public market or divests it in a sale — may be an attractive option for companies that want to restructure, refocus on core competencies, or adjust to major regulatory policy changes in certain sectors of the economy.

Planning for a successful carve-out takes time and attention. It probably has never been more important to take the effort to get this right due to uncertain market conditions and increased likelihood of price reductions.

There are many tax considerations that need to be thought through to achieve a successful carve-out. We have focussed below on the one of the more overlooked tax considerations – transfer pricing, and what M&A teams should consider from the outset.

How intertwined is the business you want to carveout?

In an ideal world, the proposed business to be carved out would already be its own division, encompassed in its own legal structure, with all cross divisional transactions priced on an arm's length basis i.e. packaged and ready to sell!

However, experience suggests that is rarely the case. The commercial, operational, legal and tax steps to successfully implement a separation take time and effort. For example, lifting and shifting functions from 'Existing Co' to 'New Co' will have a knock on impact on the transactional flows – be it product or services. A new transfer price would need to be set. The simplest solution would be to replicate the Existing Group's transfer pricing policy. However, this is not always the best solution. The New Group will have its own identity and unique value proposition and will ultimately require its own tailored transfer pricing policy.

Identifying the options and putting in place a detailed plan for implementation in advance of the sale can result in a more attractive target from a tax perspective and potentially realise a higher premium from bidders. This is especially the case for financial investors who would be more likely to pickup a 'clean' asset than corporate buyers.

What are the plans for IP?

Intangible property, whether it be brands, technology or trade secrets, goes to the heart of what drives value in many deals. As part of the pre-disposal steps, a seller is going to need to get the IP in the right place pre-sale and ensure the destination is sustainable from a TP perspective.

For example, if the valuable trademarks for New Group are all held in 'Existing IP Co', consideration would need to be given to how that IP is transferred out, what the valuation is, whether it triggers an exit tax charge, and what entity should acquire that IP. The decision on a New IP Co should be informed by the expected location of DEMPE[1] activities to be carried out by the New Group and the availability

[1] Development, enhancement, maintenance, protection and exploitation activities in relation to intangible assets (2022 OECD Transfer Pricing Guidelines).

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of tax relief for the cost of acquiring the trademarks. This may be known where a division is being spun-off to operate as an independent public company, as an example. However, where separation is through a sale to a corporate buyer, it may depend on the identity of the buyer and its plans for integration. A corporate buyer may prefer a mixed shares and assets transaction where specific IP assets are acquired directly by existing IP owner entities within its group.

Without due thought and consideration, buyers could become daunted about the effort to implement a new IP model and the tax risk being inherited. This could lead to potential adjustments to the purchase price for the tax impact and cost to implement. As such, it is worth considering by the sellers at the start of the separation exercise.

Consider the impact of transitional arrangements

A Transition Service Agreement (TSA) is an agreement between a buyer and seller whereby the seller agrees with the buyer to provide its services and know-how for a specific length of time to support the buyer while it builds up its own systems and processes. For example, Existing Group providing customer support services on behalf of the New Group, or internal support on finance and HR.

A TSA, like any business relationship, needs to be scoped and priced for accordingly, with adequate protections for both seller and buyer. This would typically form part of the negotiation process with the buyer. Depending on when the New Group is carved out, this transaction can also be subject to transfer pricing rules if the two groups are still related through common control or management. Even post separation, where the parties are considered independent of each other, the pricing of TSAs has historically been used by tax authorities as an 'internal comparable' with a knock on impact on Existing Group's transfer pricing.

For example, if the TSA for support services to New Group is priced at cost plus 10%, while the Existing Group's internal support services is at cost plus 5%, a tax authority could legitimately challenge the arm's length pricing of the internal services. This is based on an actual deal where the Existing Group priced the TSA with a relatively high mark-up to incentivise the New Group to develop its own support capabilities as soon as possible. The reverse can also hold where TSA are priced at cost with no or a lower margin to push through the overall sale process.

While functional, risk and timing differences could explain potential differences in pricing, and that the TSA is linked to the sale itself, this is often not documented at the deal stage. Subsequently it becomes difficult to explain when preparing TP documentation or explaining to a tax authority during audit.

What documentation will you be providing?

The standard information request upon diligence is for all the TP documentation (Master File / Local File / Country by Country Reporting) to be provided. For a standalone group this is relatively straight forward, assuming it has been prepared. For a New Group that is legally intertwined with the Existing Group, it can be more burdensome that expected. The documentation would likely include information for the entire Group, and rightfully there would be concerns with oversharing with prospective buyers.

However, failure to provide any documentation leads to a subsequent long list of questions on management calls, and potentially a misunderstanding of the TP model by the buyer. Workarounds have included redacting the TP files – though in one example, most of the document was redacted leaving the reader with more questions than answers!

A more elegant solution would be to prepare TP documentation or a memo that is specific to the group that is being carved out and which clearly explains the historic position, as well as any reorganisations that have taken place, and hopefully lead to a smoother diligence exercise.

Practically, when should we think about this?

As you will note there are a lot of tax and transfer pricing touchpoints on a carve-out. It is important to get the right people (i.e. tax and TP professionals) into the right room (e.g. deal governance and strategy meetings) at the right time (i.e. at the earliest opportunity!) This means that opportunities and

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workstreams are identified, scoped and incorporated into the wider deal process so everyone is on the same page.

For sellers, identifying the transfer pricing priorities in the separation can ultimately help preserve value in the deal.

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Transfer Pricing & Deals - Challenges and considerations of post-merger integration

Kevin Perry - Transfer Pricing and Value Chain Senior Manager at KPMG UK
Drashti Sanghavi, Transfer Pricing Assistant Manager at KPMG UK

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Introduction

Integration is a key consideration in many large corporate acquisitions and mergers and may be critical to the realisation of anticipated synergies driving the transaction and bid price. Integration can have important transfer pricing consequences for the enlarged group post-acquisition.

This article considers key transfer pricing aspects of integration in relation to aligning deal drivers with the Group's transfer pricing model, changes to the functional profile of the Group, how intangible assets are developed and exploited, systems integration and transfer pricing compliance.

Transfer pricing and post-merger integration

Deal drivers and transfer pricing

A transfer pricing model, properly set up, should align transfer pricing returns with where value is being created. In developing a Group's transfer pricing model, care should have been taken to understand the Group's market position and how the Group drives profit. Large acquisitions inherently impact this dynamic for the Group and pose the question post-acquisition - how does the Group now drive value and what its market position is in the new world? This will impact a Group's transfer pricing model. An initial assessment of this can be made pre-deal based on information available from the Due Diligence process and the intentions of the buyer and aid preparation of any future work that will be required.

Ideally, however not always, the commercial case – the drivers of the deal – should help in understanding this. The rationale for the acquisition can support the changes to the Group's transfer pricing model which can be reflected in the identification of key functions and returns for key assets.

Clarity of vision here to support the transfer pricing model can sometimes be lacking. A sensible starting point in corporate business combinations is to understand the governance arrangements for key business decisions post acquisition, but this may develop over time. While a Group is working through the detail on how to structure itself post-acquisition, it inevitably runs dual transfer pricing models, leading to inconsistencies which risk becoming embedded over time. A defined and integrated transfer pricing model ultimately drives simplification and limits risks in future years as the transfer pricing consequences of changes that often occur on integration, such as changing the Group's manufacturing footprint; pulling out of certain jurisdictions; rationalisation and centralisation of IP; and moving HQ locations are considered and managed proactively, rather than under tax audit.

Responding to tax authority queries several years post-acquisition requires contemporaneous evidence and support of decision making and commercial drivers. In this regard, strong business partnering relationships between tax and business leaders are key to adopting a proactive approach to transfer pricing compliance (e.g. gathering evidence in real time of the basis on which key decisions are taken and that governance processes operated as expected).

Transfer pricing and synergies on integration

A core part of the business case for many acquisitions is the opportunity to drive synergies across the legacy and acquired business. Operational synergies (revenue or operating expense) which will generally require steps to be taken to integrate and/or consolidate business operations, for example

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integration of how key customer accounts are managed, consolidation of production volumes into strategic sites and divestment or re-purposing of others and rationalisation of enabling functions.

This integration and rationalisation piece will inevitably have consequences for transfer pricing at a transactional level but understanding the decision making on the strategy for integration may provide insights into broader transfer pricing model considerations. A changing Group footprint represents an opportunity to drive standardisation where the functional profile of group entities allows for this. To the extent that post integration, a highly integrated operating model is driving value from two separate locations, for example the legacy business and the acquired business, this inevitably brings challenging transfer pricing considerations around how to remunerate the component functions of this new supply chain and whether complex transfer pricing methods are required such as profit splits or cost contribution arrangements. Where a rationalisation of the Group's footprint leads to distributors or manufacturers being closed down, the management of the position on exit from these businesses must be looked into to understand whether an exit tax charge would be due.

It is also important to review the consistency of transfer pricing policies post-acquisition and identify any areas of risk. For example it may be possible to align a Group's manufacturing structure and returns across the Group or ensure that similar services are being rewarded uniformly. Inconsistencies in transfer pricing policies should be understood and justified, and changes carefully considered. Where there has been a change in the characterisation of Group entities, tax authorities will be very sceptical that both the pre-acquisition and post-acquisition transfer pricing was correct, especially if a functional analysis suggests that there has been very little change to the underlying functions.

Acquisition funding and cash optimisation

Acquisition of the target will either be funded through cash, debt or equity financed and likely a combination of the three. Recent structural changes in market interest rates, thin capitalisation rules, new transfer pricing guidelines on funding, and interest limitation rules make the debt financing a higher risk area than it has been in recent years.

The deductibility of interest expense on acquisition financing will have to be supported not only at the transaction stage but throughout the whole deal lifecycle. Additionally, with an increased importance placed on cash optimisation, revisiting the wider intragroup funding arrangements post deal can ensure cash is worked across the group in the most optimal manner to service external debt obligations and passed back to shareholders.

Systems

A key challenge for tax departments following an acquisition is managing dual systems and processes. The integration of the acquired Group requires embedding processes across the Group to support standardised tax reporting so that tax reporting for financial statements, operational transfer pricing and Country by Country Reporting etc., can be performed through a consolidated process. If this however is not to be an Excel based exercise, this does of course require the implementation of a common ERP system across the Group, which is not a straightforward or inexpensive matter.

Compliance

The current tax landscape is characterised by an increasing compliance burden for MNEs. More and more countries are introducing mandatory transfer pricing documentation requirements, while Pillar 2 looms around the corner. Post-acquisition, the Group will have an increased compliance burden, and likely have requirements to prepare additional transfer pricing local files, possibly in new jurisdictions where it is not familiar with the compliance regime or specific transfer pricing documentation for business restructurings. The transfer pricing documentation should of course capture organisational changes relevant to that entity and take into account any specific country rules relating to business restructurings as applicable.

To the extent this is not done, a lack of contemporaneous documentation may lead to scepticism by a tax authority on the robustness of a multinational Group's transfer pricing affairs. More generally, recently acquired/ restructured Groups are more likely to undergo tax audits, given the higher likelihood of material business change. The acquisition will also likely require redrafting of the group's Master File

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and consideration of whether internal legal agreements are still valid, and if new legal agreements need to be drafted.

Conclusion

Getting transfer pricing on the table in a post-deal environment can be a challenging proposition, however by understanding the direction of the Group, opportunities arise to plan the future footprint of the Group, driving efficiencies and limiting risks.

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Deals, Intangible Assets and Transfer Pricing

Gareth Hann – Transfer Pricing Director, KPMG UK.
Ankit Bhatia, Transfer Pricing Assistant Manager, KPMG UK

June 7, 2023

After the turmoil of the two years from the start of the COVID-19 pandemic, FY2021 was one of the busiest years ever for merger and acquisition (M&A) professionals, with total deal value reaching an all-time high of $5.9 trillion. With recent macroeconomic developments, the M&A market slowed again in the latter half of 2022 and start of 2023 but, despite the global uncertainties as we move into the second half of 2023, CEOs continue to view M&A and JV arrangements as an important strategy to drive growth.

Meanwhile, intangible assets constitute an increasing portion of businesses' – and hence deals' – value.

Given tax authorities' continuing focus on the Transfer Pricing ("TP") implications of intangible assets – which is unlikely to abate as they seek to help repair pandemic-hit government balance sheets – careful consideration of TP aspects of these assets is of vital importance throughout the deal process.

Types of Intangible Assets

Intangible assets that are important for TP purposes may not always be recognised as intangible assets for accounting purposes. The TP definition of intangibles is wide-ranging and can include anything that: *"is not a physical or a financial asset, which is capable of being owned or controlled in commercial activities, and whose use of or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances."*
(OECD Guidelines 2022)

There may therefore be instances where costs related to R&D, marketing, promotion, or advertising may be expensed rather than capitalised for accounting purposes but nevertheless generate significant value to the business and so require careful consideration for TP purposes.

Transfer Pricing considerations

Scenarios involving Intangible Assets that would need to be carefully reviewed through a TP lens in a deal due diligence include:

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- Transfers of Intangible Assets within the group, which are common when target groups are being prepared for whole or partial sale, and the valuation of these assets;
- Licensing of IP within a group (e.g. patents, trademarks, and know-how);
- Group entities collaborating to jointly develop technology and sharing R&D costs; and
- Legal ownership of intangible assets not being aligned with the performance of related DEMPE functions. Transfer Pricing rules generally require returns to primarily accrue to the latter to ensure alignment with value creation.

Due to the tax compliance risk posed by transfer pricing, indemnities are a common feature of deals to protect the buyer against future tax liabilities in connection with tax authority challenges to historical transfer pricing (as well as other tax) positions. Incorrect pricing can also affect the value of an acquisition target, for example where a company/division to be divested transacts with vendor group members that are not being sold. Both of these can influence deal price negotiations and so a thorough understanding of circumstances, policies and risks is essential for both vendor and buyer.

The following examples illustrate some of these considerations.

1. Royalties for manufacturing rights

GlobeCo has developed Product X, legally owns the technical and manufacturing know-how to manufacture Product X and licenses this to its overseas affiliate, FabCo, which manufactures and sells Product X in its market. FabCo pays no royalty to GlobeCo for this licence.

GlobeCo plans to divest FabCo.

Discussion
The primary TP risk here is incorrect pricing of technical know-how, leaving a higher share of profits in FabCo. Any would-be buyer of FabCo must identify and assess the potential impact of this on its historical and future results and factor this into pricing negotiations. One possible outcome, if FabCo is to continue manufacturing Product X post-deal, is that it may need to pay royalties to GlobeCo for the use of the IP.

From GlobeCo's perspective, this may lead to a risk of TP assessments for earlier years, if its tax authority takes the introduction of royalties from a now-third party as evidence that they should have been imputed all along. It may be possible for FabCo to get a compensating adjustment for any adjustments to these earlier years (e.g. through MAP) and GlobeCo may want to ensure that the new owner co-operates with such a process and that GlobeCo benefits from the adjustment.

2. R&D activities under-rewarded

Although GlobeCo originally designed Product X, its affiliate R&DCo has, over time, played an increasingly important role in R&D, to the point that it has become primarily responsible for taking decisions on maintaining and enhancing the product-related IP through successive generations of the product. For TP purposes, however, R&DCo has always been characterised as a Contract R&D service provider and been given a routine cost-plus return.

GlobeCo Group (including both GlobeCo and R&DCo) is to be acquired by AcquirerCo.

Discussion

There are potentially serious TP risks due to incorrect alignment between value creation and reward. Since key functions are performed by R&DCo, a routine cost-plus return is unlikely to properly remunerate it.

Potential exposure to AcquirerCo could be TP audits in R&DCo's country of residence. Tax authorities are generally able to reopen and adjust earlier years so, absent an indemnity arrangement, AcquirerCo may suffer additional tax even for the years before it acquires the company.

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As in example 1, compensating adjustments may be available through MAP, but if the tax rate in R&DCo's jurisdiction is higher than that in GlobeCo's head office location, then there may still be an overall net tax cost.

3. Post-deal restructuring

AcquirerCo later decides to restructure the acquired GlobeCo business.
GlobeCo's valuable intangible assets, which were the primary reason for AcquirerCo's interest in the group in the first place, and for which it therefore paid a premium, are transferred from GlobeCo to AcquirerCo for commercial reasons. The transfer is cross-border and is undertaken at net book value.

Discussion

Particularly given that the intangible assets were of such value to AcquirerCo when acquiring GlobeCo, it is unlikely that net book value will provide an appropriate valuation at the time of reorganisation.

Consideration of evidence including any valuation of the business carried out by AcquirerCo around the time of the acquisition and AcquirerCo's purchase accounting[2] would likely be a starting point. It is important to also take into account current projections of future income associated with the IP, why this may have differed from that expected at the time of acquisition (for example due to how AcquirerCo may have changed the way the IP is exploited/marketed) and any associated changes to related functions, other assets and risks, since the acquisition.

This is therefore one of the many factors to be weighed when embarking on any post-acquisition restructuring.

Conclusion

Given the increasing importance and awareness of Intangible Assets to businesses of all types, as well as tax authorities' emphasis on ensuring alignment between IP-related value creation and TP outcomes, it is essential that both vendors and acquirers pay close attention to this before, during and after deals to reduce the risk of tax compliance issues, price-chipping and additional deal costs. As well as risks, however, we often find that opportunities arise, as the appropriate recognition of IP in a particular jurisdiction can lead to tax efficiencies. For all of these reasons, it is essential for both parties to look closely at the transfer pricing of IP early in the process.

[2] When preparing its consolidated financial statements, AcquirerCo would assign fair values to the identifiable intangible assets acquired and may also recognise goodwill. Where these amounts are large relative to the carrying value of intangible assets in GlobeCo, this may be an indicator that the arm's length price of the GlobeCo intangibles is greater than their book value.

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