Monday, October 15, 2012

It appears there may soon be a bit of light emanating from the long, dark tunnel that is intangibles. The Organisation for Economic Co-operation and Development (OECD) recently closed the comment period on its discussion draft and is ready to “hunker down”—having received more than 900 pages of comments from more than 60 respondents—and try to craft a consensus document. In addition, the American Bar Association has taken up the cause and established a task force to undertake a systematic review of historic tax and legislative treatment, current proposals and academic writings (See Bloomberg BNA, “21 Transfer Pricing Report 470”).

The OECD’s objective for its intangibles project is fairly daunting in its simplicity, namely attempting to define:

- What is an intangible?
- Who is entitled to its benefits?
- What is the value attributable to the intangible?

It is an overwhelming task before them, both in terms of its complexity as well as the administrative and fiscal stakes involved. Whether these efforts can bring about actual consensus is debatable (and would be truly remarkable), but if they can at least bring some clarity, if not some practical principles, they will have greatly advanced the cause of both corporate and sovereign tax administration.

One of the key areas that needs a bit of illumination is goodwill. The OECD has characterized goodwill (and going concern) as an intangible, which is also the position of the Obama Administration. While most tax practitioners would not disagree with the definition, the question most immediately raised—generally, by my legal friends—is whether it is compensable. However, there would appear to be, especially within a transfer pricing context, an even a more fundamental question: just what is goodwill, specifically?

In standard valuation practice, goodwill is treated as a residual—in the context of financial reporting (valuation), the excess of the price paid of the fair value of assets (both tangible and intangible) acquired and liabilities assumed; in standard accounting, e.g., under U.S. Generally Accepted Accounting Principles (GAAP), the future economic benefits arising from other assets acquired that are not individually identifiable and separately recognized. That is to say, goodwill is the value “left over” (positive or negative) after you have valued everything that you can easily identify and value.

So if goodwill is the excess, what is its “source”? What is it comprised of? Certainly, buyers do not pay for (nor do sellers insist upon) an exchange of consideration for some vague future expectation of “something of value”.

Up until now there has been little practical need for rigorous, even theoretical analysis of goodwill. For much of our modern business history, before intangibles became so omnipresent, and their financial relevance so significant—and their operational (and tax) fungibility so strategic—such vague definitions and such gross valuations of goodwill were sufficient. But this was before the time when goodwill valuations exceeded the market value of S&P 500 companies, it was not necessary to delineate and isolate at least some of the “source” (both cause and location) of goodwill value. (See The Wall Street Journal, “Buyers Beware: The Goodwill Games,” by
Today, when modern multi-national enterprises are acquiring businesses all across the globe in which goodwill “accounts” for 60 percent or more of the purchase price, only to later write-off (write-down) nearly 47 percent of the purchase value (See “Goodwill Reporting Internationally,” Intangible Business, 2008), we need a more refined definition, a more precise valuation of goodwill. There is clearly “something of value” here—what is it? Is it compensable?

Recent accounting-valuation research, and even legal analyses are beginning to suggest theories, and even evidence, that goodwill is not a monolithic construct. There are separate, identifiable components, in addition to a true, “core” residual. If the OECD (or some other entity) is going to unravel the Gordian knot that is “intangible,” goodwill cannot be left an unexamined and enigmatic black box. Now is time to lift the lid off goodwill. Hopefully someone will remember to bring a flashlight.

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