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Managing risk in tax valuations

Relying on net book value as a proxy for fair market value

Property, plant, and equipment (PP&E) often represents a material portion of an entity's balance sheet. On the financial statements, PP&E is typically reported at net book value (NBV). However, the fair market value (FMV) of PP&E may be required for certain tax planning and reporting needs and can be a significant input into determining a taxpayer's liability. As critical as the FMV can be in supporting a specific tax position, taxpayers often rely on NBV as a proxy for FMV without substantiation. This is most likely due to its availability and convenience, limitations on time and budget, or taxpayers believe it to be a conservative position.

Is the convenience of using NBV as a proxy for FMV worth the risk of underpaying taxes and increasing scrutiny by the IRS, or are tax-savings opportunities being missed? This document discusses the need for FMV, why NBV is often not a good proxy for FMV, and the IRS's recent positions on the topic.

When is the FMV of PPE needed?

The need to estimate FMV of PP&E is often required to support certain tax positions, determine tax liability, or establish tax basis. Examples include:

- Asset acquisitions and like-kind exchanges
- Pass-through entity provisions including partnership contributions, distributions, and transfers of interest
- Transactional planning involving transfer of property, leasing, and restructurings
- FIRPTA[1]
- Tax reform provisions including immediate expensing, QOZ,[2] 199A,[3] 864(c),[4] GILTI,[5] and FDII.[6]

While the preceding list is not an exhaustive list of circumstances under which the FMV of PP&E would be required, FMV is a key input in determining tax liability in many areas.

Is NBV equal to FMV? Typically, no.

In our experience, there is a common misconception that NBV for financial statement reporting purposes is a reasonable proxy for FMV.

NBV for financial statement purposes is based on depreciation accounting guidance from Accounting Standards Codification (ASC) Topic 360, *Property, Plant, and Equipment*; however, ASC Topic 360 makes it clear that depreciation accounting is merely a *process of allocation, and not of valuation*. Unless the accounting guidance requires mark-to-market reporting, NBV is based on the asset's historical cost and an allocation of that cost over the useful life of the asset.

While it is possible that NBV can approximate FMV, a number of factors can create divergence between an asset's NBV and its FMV, including:

- Differences between accounting treatment for depreciation purposes and actual use of assets (e.g., useful lives, residual values, asset existence, prior accounting adjustments, etc.)
- Changes to the company's financial performance driven by economic and industry pressures impacting cash flows
- Increases or decreases in costs to replace similar assets today compared to their historical cost
- Changes to asset utility due to technological advances and fluctuating consumer demand.

1 The Foreign Investment in Real Property Act of 1980 (FIRPTA), enacted in 1980, is a U.S. tax law that imposes income tax on foreign persons disposing of U.S. real property interests.

2 Qualified Opportunity Zones

3 Qualified business income deduction for certain passthrough entities

4 Tax on gain on sale of partnership interest by foreign partner

5 Global Intangible Low Tax Income

6 Foreign Derived Intangible Income

Given these common areas of divergence between NBV and FMV, the IRS has previously challenged the assumption that the two would be equal.

Recent IRS positions

Over the past several years, a number of IRS positions have challenged the notion that NBV is representative of FMV for PP&E. Some examples include:

IRS Field Attorney Advice[7]

In 2010, the IRS's Office of Chief Counsel issued a memorandum to IRS field service employees on the issue of a taxpayer electing the FMV method of interest expense apportionment, pursuant to Treas. Reg. §1.861-9T. The taxpayer relied on the assets' financial statement NBV as a substitute for FMV, claiming that the NBV was a conservative estimate of FMV.

In our experience, the most common reason why taxpayers rely on NBV as a proxy for FMV is because the taxpayer believes it is a conservative position that minimizes their risk.

The Office of Chief Counsel disagreed and concluded that without the taxpayer valuing the assets, the taxpayer could not substantiate their estimate of FMV in relation to the NBV. While the FMV method of interest apportionment was repealed by H.R.1, the need for taxpayers to substantiate their FMV estimate remains, even if the taxpayer believes that NBV is a conservative estimate for FMV.

Master Limited Partnership Association[8]

In 2016, IRS officials met with the Master Limited Partnership Association (MLPA) Regulatory Committee. The IRS officials acknowledged that some master limited partnerships (MLP) have historically assigned values to assets for partnership property basis adjustments without substantiating those values. The Internal Revenue Code requires that values assigned to assets for partnership property basis adjustments be based on the FMV of the assets.

The IRS officials warned that audits of large partnerships would be more likely under the new audit rules contained in Bipartisan Budget Act of 2015 and that it will be essential for MLPs to have appropriate documentation on how values assigned to their assets are determined. While the issue of relying on NBV as a proxy for FMV was not a specific topic of discussion, any values assigned to assets, including values based on NBV, would need substantiation and documentation.

Summary

When considering reliance on NBV as a proxy for FMV for a specific tax purpose, the taxpayer should consider whether that position could be substantiated and supported. The taxpayer should also consult with a qualified appraiser to perform a review of the company's PP&E and accounting history to determine if there could be a divergence between NBV and FMV and if a valuation is warranted. A properly performed valuation can mitigate potential risk by providing substantiation for FMV assigned to the PP&E as well as enhance potential tax savings.

Have questions?

If you have a need to estimate the FMV of PP&E or are considering relying on NBV, please contact your local KPMG adviser for more information.

Contact us

Yuwon Pak
Managing Director
Washington National Tax - Valuations
T: 202-533-4021
E: ywpak@kpmg.com

Milind Shah
Principal
Washington National Tax - Valuations
T: 202-533-8984
E: milindshah@kpmg.com

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8 Master Limited Partnership Association (MLPA). (2016). 2016 Report of the Regulatory Committee: Tax Guidance and Issues in the Past Year. Retrieved from https://www.mlpassociation.org/wp-content/uploads/2016/09/Reg-Comm-Report-2016.pdf

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