

Goodwill impairment testing: Tax considerations



In financial accounting, goodwill is an asset representing the future economic benefits arising from other assets acquired in a business acquisition that are not separately recognized. The measurement of goodwill can be generally described as having mixed attributes: It is a residually calculated amount derived both from assets and liabilities which are measured at fair value and others (including income taxes) which are not measured at fair value.

Subsequent to a business acquisition in which goodwill was recorded as an asset, post-acquisition accounting (ASC 350, *Intangibles—Goodwill and Other*) requires that goodwill be tested to determine whether there has been an impairment loss. Goodwill impairment testing is a two-step process, performed at least annually, on a “reporting unit” basis.

In step 1 of the testing process, the fair value of the reporting unit (“RU”) is determined and compared to its book value, including goodwill. If the fair value of the RU exceeds its book value, goodwill of the RU is not impaired; if the book value of the RU exceeds its fair value, the testing proceeds to step 2. In step 2, the RU’s fair value is allocated to its assets and liabilities following acquisition accounting procedures to determine the *implied* fair value of goodwill. This hypothetical acquisition accounting process is applied only for the purpose of determining whether goodwill must be reduced; it is not used to adjust the book values of other assets or liabilities.

There is an impairment if (and to the extent) the carrying value of goodwill exceeds its implied fair value. An impairment loss reduces the recorded goodwill and cannot subsequently be reversed.

Numerous tax law and tax accounting considerations can impact whether there is an impairment of goodwill as well as the amount of impairment. This paper discusses five primary tax focal points, beginning at the outset of step 1 with the determination of the fair value of the reporting unit.

Tax focal point #1

The fair value of the RU is determined from the perspective of appropriate “market participants”. That means giving consideration to the potential buyers likely to consider acquiring a controlling interest in the RU at the time of testing. In other words, the fair value is the price that would be received if the RU were sold in an orderly transaction between market participants at the testing date. Specific market participants need not be identified; the emphasis

instead is on identifying the relevant distinguishing characteristics of likely buyers. Market participants might even be identified as a group, such as strategic versus financial buyers, industry and/or geographic competitors and so forth. **The fair value in step 1 should reflect the assumed impact that tax considerations would have on the price market participants would be willing to pay for the RU.**

The structure of a business disposal transaction, including relevant tax elections and planning, can affect the income taxation of both the seller and the buyer. The structure of a disposal can also dictate whether existing tax attributes (e.g., net operating loss or tax credit carry-forwards) of the RU would be transferred to a buyer. As a result, the disposal structure can impact what a market participant would pay to acquire a reporting unit. Indeed, it is not uncommon for a business disposal to attract alternative pricing offers depending upon how the seller and buyer ultimately agree to structure the transaction in order to optimize the associated tax consequences. That can be the case even when a market-based rather than income-based valuation model is used as the primary pricing methodology.

Generally, the income tax consequences of a business disposal follow one of three patterns. Cash (or other monetary consideration) sales are taxable to the seller and can be either taxable or nontaxable to the buyer. In a taxable transaction, the net assets are considered sold and the buyer takes a fair value tax basis in the net assets. In a nontaxable transaction, the stock of the company (or RU holding company) is sold and the buyer takes a fair value tax basis in the acquired stock but carryover (or predecessor) tax basis in the net assets. The third type of disposal is a nontaxable exchange wherein the transaction consideration is stock of the acquiring company or a minority equity interest in the disposed and recapitalized business. In a nontaxable exchange, the seller does not recognize taxable gain or loss and the buyer takes a carryover tax basis in both the acquired stock and net assets. Tax attributes of the acquired business generally would be carried forward in nontaxable sales and exchanges, though possibly subject to limitation on subsequent use.

The applicable taxing pattern may also vary among the relevant taxing jurisdictions. A disposal may, for example, be a nontaxable sale for federal income tax purposes while taxable for state income tax purposes, or taxable for federal income tax purposes while nontaxable in a foreign jurisdiction.

The comparative tax effect on transaction pricing of each type of disposal is influenced by various factors. For example, it may be expected that a buyer would pay more to acquire an RU in a taxable transaction if such a transaction structure would provide a step-up in the tax basis of the acquired net assets. A seller might also be motivated to have a taxable transaction if its tax basis in the net assets is greater than its tax basis in the stock. However, a seller may have a higher stock (as compared with net asset) tax basis in the RU and therefore require an increased sale price for a taxable transaction. In some instances, a buyer may even obtain greater tax benefits from nontaxable sales or exchanges. Nontaxable sales and exchanges, for example, can preserve existing tax basis that is above current fair value as well as tax attributes of the acquired business. Certain buyers may obtain little, if any, benefit from a step-up in tax basis or acquired tax attributes. The impacts of these and other tax considerations on transaction pricing would be considered in relation to the profile of the market participant buyers.

While most business disposals are structured as either taxable or nontaxable sales, circumstances may also be conducive to nontaxable exchanges with market participant buyers. In assessing whether a nontaxable exchange with a market participant would be feasible, in addition to tax consequences, consideration should be given to other factors that could impact the viability of such a transaction. For example: Is a likely buyer willing and able to offer shares to a corporate seller? Is the seller willing and able to hold a likely buyer's shares (or minority equity interest)? The answers to these and other relevant questions may depend on overall market and business conditions, industry considerations, and company-specific factors. Anti-competitive/trust laws and other federal and state regulations applicable to a particular industry should also be considered.

Tax focal point #2

Next in step 1, the fair value (or gross proceeds) expected to be realized from an RU disposal is reduced by the seller's tax cost. The seller's tax cost would typically be measured on a discounted (fair value) basis. **The seller's tax cost in step 1 should reflect, and can vary with, the structure of a disposal.**

In a nontaxable sale, the seller's gain (or loss), and thus the seller's tax cost, is measured by reference to its tax

basis in the stock of the RU (or its holding company); in a taxable sale, the seller's taxable gain (or loss) is measured by reference to the tax basis in the net assets of the reporting unit. Similarly, the effect of existing tax attributes of the seller and/or the RU on the seller's taxation would be considered in measuring the seller's tax cost. There may also be differing tax rates depending upon the disposal structure. Consideration should also be given to any expected deferred or contingent purchase price arrangements.

In a nontaxable exchange disposal, while there is no current tax cost to the seller, consideration would be given to the eventual tax the seller would incur upon a subsequent disposition of the shares received in the exchange.

The disposal structure which provides the highest economic value to the seller (i.e., after-tax fair value) becomes the framework for applying certain aspects of the remaining impairment testing procedures.

Tax focal point #3

Step 1 is concluded by comparing the fair value of the reporting unit, based upon the assumed disposal structure, to its book value. **The determination of the book value of an RU can be affected by the allocation and assignment of tax assets and liabilities.**

Because the testing is performed on a reporting unit, rather than on a legal entity or tax reporting basis, in determining the book value of the RU it may be necessary to allocate tax accounts which relate both to the RU and other operations or legal entities. The allocation of consolidated deferred tax accounts to the RU follows the guiding principle used to allocate assets and liabilities, including corporate assets and liabilities. That is, the deferred tax balance related to an asset or a liability is included in the determination of the RU's carrying value if (1) the underlying asset is used by the RU or a liability relates to the RU's operation, and (2) the asset or liability will be considered in determining the RU's fair value. Deferred taxes that relate to such specific assets or liabilities are allocated to the RU regardless of the assumed disposal method. An allocation of the tax basis of goodwill would be included. Deferred taxes which relate to assets or liabilities that are not assigned to a reporting unit would not be allocated.

After deferred taxes are allocated, it is also necessary to allocate deferred tax asset valuation allowances and unrecognized tax benefits for income tax uncertainties when the RU is included with other businesses or legal entities in tax returns.

The allocation of a valuation allowance should be based on the proportionate amount of deferred tax assets assigned to the reporting unit. If all of a reporting group's deferred tax liabilities provide a source of income to support realization of the deferred tax assets, the valuation allowance may be allocated pro-rata based upon net deferred tax assets assigned to the reporting unit. A valuation allowance assessment should not be performed on a hypothetical separate company basis for this purpose.

At the same time, the assumed disposal structure may impact whether the tax attributes of an RU, and therefore such respective deferred tax assets, impact the fair value of the reporting unit. Those deferred tax assets would only be assigned to the RU for purposes of determining the book value of the RU if the assumed disposal structure would preserve the tax attributes for the buyer. Accordingly, such deferred tax assets would typically be assigned to the RU only when the assumed disposal structure is a nontaxable sale or exchange. The assumed disposal structure may similarly impact the assignment of tax uncertainties. Further, with respect to tax uncertainties, consideration should be given to tax indemnification expected to be provided to the buyer based upon the assumed disposal structure.

Tax focal point #4

In step 2, hypothetical acquisition accounting is applied to the RU as if the RU was acquired in the assumed disposal structure at the time of testing. **The fair values of assets and liabilities which are determined using an income or discounted cash flows analysis, in step 2, should consider "tax amortization benefits" regardless of the assumed structure.**

Tax amortization benefits are the cash flows expected from tax depreciation or amortization deductions. Those benefits are reflected on a market participant basis, in asset and liability fair values that are based upon an income or discounted cash flows valuation methodology. Even if the hypothetical acquisition is assumed to be nontaxable or the owner is not a tax paying entity, it may be appropriate to reflect tax amortization and similar benefits when determining the fair values of individual assets and

liabilities. The benefits are included from the viewpoint of an independent market participant.

Consideration should be given to market participant tax rates and, potentially, acquisition-related tax planning strategies that would typically be available to market participants. It is also important to consider the relevant tax laws governing valuation methodologies and purchase price allocation, which may differ from those used in pretax financial reporting.

This is a judgmental analysis and process of estimation, tempered by a presumption that the tax benefits should reflect the tax laws of the jurisdiction(s) that applies to the assets or liabilities. Accordingly, if there are no tax benefits possible (in any circumstance) under the relevant jurisdiction's tax laws, the fair value measurement should not include tax benefits. To the extent market participant information and assumptions are not available, it would be appropriate to apply the perspective of the existing RU and make reasonable adjustments based upon available market participant information.

Tax focal point #5

Finally, in step 2 deferred taxes and tax uncertainties in acquisition accounting are also determined based upon the assumed disposal structure. Deferred taxes must be recognized for the differences between the assigned values and income tax bases of the assets and liabilities, as well as tax attributes, acquired in the assumed acquisition.

Accounting for income taxes and tax uncertainties can result in hypothetical acquisition accounting adjustments which directly impact the implied fair value of goodwill.

For example, if a taxable transaction is assumed, there would be no deferred taxes included as the net assets would have tax basis consistent with book basis. Deferred taxes would be provided, however, in an assumed nontaxable sale or exchange. Deferred tax accounting would be performed using market participant assumptions. The process includes consideration of acquired tax attributes, an assessment of the need for valuation allowances with respect to deferred tax assets and assertions with respect to subsidiary stock basis differences and unremitted foreign earnings.

Similarly, income tax uncertainties as well as uncertainties with respect to taxes that are not based on income (e.g., sales and use, property, payroll, gross receipts, VAT, duties and excise taxes) would be reflected in the hypothetical acquisition accounting. Consideration should also be given to respective tax indemnification.

The following illustrates, in a general directional manner, how tax considerations could affect impairment testing:

	Nontaxable Exchange	Nontaxable Sale	Taxable Sale
Book value of reporting unit	110	110	100 ^a
Gross proceeds (fair value)	75	80	90
Seller tax	0 ^b	(15) ^c	(22) ^c
Economic value to seller	75	65	68
Implied purchase price	75	80	90
Implied fair value of goodwill	20	25 ^d	15
Book value of goodwill	20	20	20
Potential goodwill impairment	0	0	5

In this illustration, if a sale transaction was considered to be the only likely market participant disposal structure, the taxable sale would result in the highest economic value to the seller. In turn, that transaction would result in goodwill impairment.

If the nontaxable exchange was also considered a likely market participant disposal structure, there would be no goodwill impairment even though such an exchange attracts the lowest gross selling price.

In Conclusion

Tax management and tax advisers can, and should, play a significant role in assessing the tax considerations which may impact goodwill impairment testing. Given the significance of impairments resulting from challenging market conditions, the testing outcomes may become more sensitive to impacts from tax considerations.

Companies may also be including financial reporting disclosures relating to goodwill impairment testing. Disclosures might include a discussion of methodologies, market participant and other key assumptions considered in impairment testing. Tax considerations may be an appropriate aspect of such disclosures.

The importance of interdisciplinary coordination among the various expert resources involved with impairment testing cannot be overemphasized.

^a The book value of the RU in a taxable sale would not include deferred tax assets representing tax attributes since the attributes would not be acquired by the buyer.

^b A seller may have future tax consequences on a later disposition of the shares received or retained in the exchange. Depending on how long the seller intends to hold the investment, it may be appropriate to ascribe some tax cost to a nontaxable exchange. In step 1, the seller's tax is discounted to net present value consistent with an economic measurement of net income on disposal.

^c The difference in effective tax rates in the sales may be due, for example, to the seller having a higher basis in the stock of the RU as compared with the RU's inside basis in net assets as a result of a prior acquisition of the reporting unit. Or, there may be a difference in tax rates applicable to a sale of stock as compared with a sale of assets.

^d Deferred taxes are assumed to be the same in the nontaxable exchange and the nontaxable sale; hence, the implied fair value of goodwill is higher in the nontaxable sale due to the incremental selling price. In circumstances where the carryover tax basis is higher than the current value of the RU, the selling price may be higher in an assumed nontaxable exchange.

Contacts

The paper is intended not just to inform but to raise questions. Clients of PricewaterhouseCoopers may want to open a dialogue with their PwC engagement partner or the primary authors of this paper who welcome any questions or comments:

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