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Taxable or Not, That is the Question

(and other issues – EITF 2-13/ASC 350-20)

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January 12, 2010

ASA NYC Fair Value Conference
New York, New York

Presentation Outline

- Intro to EITF 2-13 & transaction types
- How to determine if taxable or not (EITF 2-13 issue 1)
- How transaction type affects company value
- Accounting considerations (EITF 2-13 issues 2 and 3)
- Examples of how to handle both types of transactions
- Other considerations
- Q & A (time permitting)

Purpose/Speaker Background

- The purpose of this presentation is to educate and provide insights about a topic rarely (if ever) publicly discussed.
- The thoughts in this presentation are intended to reflect one viewpoint and are not suggested to provide any type of definitive roadmap or cookbook on how to handle this issue.
- Also, the speaker is a valuation professional, not a tax guru! If you try to stump me with arcane tax questions you no doubt will be successful.
- Please also note too that this presentation was prepared assuming the listener already has some background/ experience with financial reporting valuations and impairment testing valuations.

Introduction

- Economics of a transaction vary based on deal-type
- Can be problematic when performing impairment testing
- EITF 2-13 addresses problem
  - EITF 2-13 pertains to goodwill impairment testing/reporting unit values
  - Abstract issued in 2002
  - Text “codified” in ASC 350-20 (sections 35-7, 35-20/21, 35-25-27, 55-10 to 16, 55-18 to 23)
- According to EITF 2-13, guidance was provided due to questions about the effect transaction type has on the:
  - Fair value of the reporting unit
  - Carrying value of the reporting unit
  - “Step two” implied goodwill fair value

Taxable vs. Nontaxable Transactions

- Two types of transactions to consider are taxable and non-taxable transactions
- Taxable transactions are most typically thought of as asset sales
- Nontaxable transactions are most commonly thought of as equity sales
- Other factors can affect whether a transaction is taxable or not, but for purposes of this presentation only asset (taxable) deals vs. equity (non-taxable) deals will be discussed

Taxable vs. Nontaxable Transactions

- It is useful to better understand why these transactions are structured the way they are
- However, one must remember to adhere to the guidance in 2-13/350-20
- The following pages summarize key attributes of stock deals versus asset deals, as well as key pros and cons for the buyer and seller
- Source: ACG NJ 2006 Due Diligence Symposium Presentation by Jill Harris
- Caveats:
  - Summary was not prepared for financial reporting purposes
  - No verification has been made that all information is still applicable
  - For this presentation, slides only summarize asset vs. stock deals and exclude 338(h) (10) elections and exclude certain other points

Buyer-side Considerations

	Asset Deal IRC Sec. 1060	Stock Deal IRC Sec. 1221
Buyer Pros	1) Maximize future tax deductions (assets stepped up to fair [mkt.] value)	1) Lower purchase price 2) May obtain NOLs 3) Assets don't need to be transferred/assigned
Buyer Cons	1) Higher purchase price 2) Lose potential NOLs 3) May have to do many asset transfers, assignments of contracts, etc.	1) No step up of assets/not maximizing future depreciation/amortization tax deductions 2) Inherit all liabilities and corporate history
Buyer Tax Treatment	Allocate purchase price to individual assets then depreciate amortize over tax lives (intangibles 15 years)	Purchase price is basis of stock. Buyer "steps into shoes" of seller. Do not step up asset values, do not restart clock on deprecation.

Seller-side Considerations

	Asset Deal IRC Sec. 1060	Stock Deal IRC Sec. 1221
Seller Pros	1) Higher selling price 2) May want/need to keep corporate shell 3) May be able to use NOL and credits to offset gain on asset sale	1) Single level of tax (shareholder gain/loss) 2) Get rid of corporate shell and liabilities/corp. history 3) Capital gain/loss on sale
Seller Cons	1) Recognize gain/loss on each asset 2) Keep corporate shell/liabilities 3) If liquidated, second level of tax [seller has capital gain on disposition of stock]	1) Lower selling price 2) Lose future use of NOL and c/o credits
Seller Tax Treatment	Allocate purchase price to individual assets, recognize (generally ordinary gain/loss)	Compute gain/loss on stock basis (generally capital gain/loss)

Tax Issues – GW Impairment Testing

- EITF 2-13 identified three key issues to consider. These are:
- <u>Issue 1:</u> Whether the fair value of a reporting unit should be estimated assuming that the unit would be bought or sold in a nontaxable transaction versus a taxable transaction
- <u>Issue 2:</u> Whether deferred income taxes should be included in the carrying amount of a reporting unit for purposes of step 1 goodwill impairment testing
- <u>Issue 3:</u> For step 2 of the goodwill impairment testing, what income tax bases should an entity use to measure deferred tax assets and liabilities

Issue 1 – Taxable vs. Nontaxable

- According to EITF 2-13 (ASC 350-20), there are three factors to consider:

  1) Is the assumption consistent with what marketplace participants incorporate into their estimates of fair value

  2) Feasibility of the assumed structure

  3) Whether the assumed structure results in the highest economic value to the seller, including consideration of tax implications

Issue 1 (taxable?) – Market Participants

- Determining fair value requires consideration of market participants
- Can try to identify market participants and how specific factors might affect the sale of the reporting unit
  - If buyers all have large NOL balances, an equity deal may have less sale value and be less likely
  - Non profits – sale to a for-profit or not-for-profit?
- Consider historical transactions in reporting unit's industry as a benchmark
  - I.e., run a search to see what types of transactions are typical in the industry as a benchmark
  - If most transactions over the last year were asset deals, this supports the notion that the reporting unit might be sold in an asset deal

Issue 1 – Market Participants (cont.)

- One benefit of looking at benchmark transactions is that they provide objective evidence of what type of deal is most likely to occur in the reporting unit's marketplace
  - This is especially useful if estimates of highest economic sale value are difficult to ascertain
- One problem with this approach is that the target companies identified in the search often have different tax attributes, and these differences often will be hard to identify and quantify
  - Put another way, this approach only focuses on one side of the equation (the potential buyers but not the seller)
- Another problem with this approach is that the data can be skewed by 338 (h)(10) elections, which are classified as equity deals but not distinguished separately from "traditional" equity deals

Issue 1 (taxable?) - Feasibility

- EITF 2-13 discusses the need to consider the feasibility of the assumed structure
- The guidance indicates that, in considering the feasibility of a nontaxable transaction, the following factors should be considered:
  - –Whether the reporting unit could be sold in a nontaxable transaction
    - For example, is an equity deal possible if the reporting unit is a division with no associated legal entity?
  - –Whether there are any laws, regulations, or other corporate governance requirements that could limit a non-taxable sale
- <u>This determination requires assistance from management and possibly an outside expert</u>

Issue 1 (taxable?) – Highest Economic Value

- Considers which type of transaction would result in the highest net value to the seller
- Can incorporate previous two factors (mkt. part. assumptions, feasibility), i.e. factors are not mutually exclusive
- Intuitively this is the obvious best approach, but
  - From a practical standpoint it is not always easy to ascertain
  - The process of finding the right person to analyze and determine highest economic value can be laborious

Valuation Adjustments to RU Value

- Asset deal (taxable)
  - Need to consider tax benefit of being able to amortize intangibles/depreciate fixed assets based on fair value at the acquisition date
- Equity deal (non-taxable)
  - Need to consider benefit of acquired net operating loss carry forwards (“NOLs”) with change of control limitation (Sec. 382)
    - Change of control limitation results in a maximum allowable usage per year equal to the applicable federal rate (“AFR”) times the equity value
  - Since corporate entity/shell being acquired, need to consider potential impact of any related liabilities such as current/future lawsuits
- Do not double count!
  - For example, if assume an asset sale likely, should not include value of NOLs to the acquirer.

Valuation Adjustments to RU Value (cont.)

- If transaction is an asset deal, fair values for the assets are determined, and new amortization/depreciation schedules are estimated.
- This presentation will focus just on the intangible amortization adjustment, as the fixed asset adjustment is more likely to be properly estimated in the company DCF and/or is less material
- One can estimate the aggregate intangible asset value on the valuation date based on the concluded reporting unit value and balance sheet at the valuation date
- After the aggregate intangible asset value is determined, can estimate the intangible benefit
  - If just doing a DCF approach, could calculate similar to how calculated for an intangible asset using a tax amortization benefit factor

Intangible Amortization Value - Example

- Fact pattern:
  - Reporting unit value using DCF (excluding TAB) is $100 million
  - Current assets = $15 million
  - Fixed assets = $5 million
  - Other assets = $1 million
  - Assumed liabilities = $10 million (no debt)
  - TAB premium = 20%
- Aggregate intangible value = $89 million
  - =($100 million+$10 million [liabilities]-$21 million [tangible assets])
- Intangible TAB = .20*$89 million = $17.8 million

Note 1: Remember to exclude all projected amortization from DCF if you calculate this benefit separately

Note 2: Benefit can be modeled discretely using a DCF

NOL Benefit - Example

- Fact pattern:
  - Reporting unit equity value using DCF (excluding NOLs) is $100 million
  - NOLs acquired = $10 million; AFR rate = 4%
  - Projected Pretax Income (millions) = Yr 1: $3.0; Yr 2: $4.5, Yr. 3: $5.0
  - Assumed tax rate = 40%
  - NOL discount rate = 15%
- Maximum NOL credit used per year =$4 million
  - =($100 million X .04)
- NOLs used per year
  - Year 1 = $3 million; Year 2 = $4.0 million; Year 3 = $3.0 million
  - After tax benefit of NOLs= NOLs used times tax rate
    - Year 1 = $1.2 million; Year 2 = $1.6 million; Year 3 = 1.2 million
- Value of NOLs
  - = $1.2 * 1/(1.15)^.5 + $1.6 * 1/(1.15)^1.5 + $1.2 * 1/(1.15)^2/5
    = $3.3 million

NOL/TAB – Other Considerations

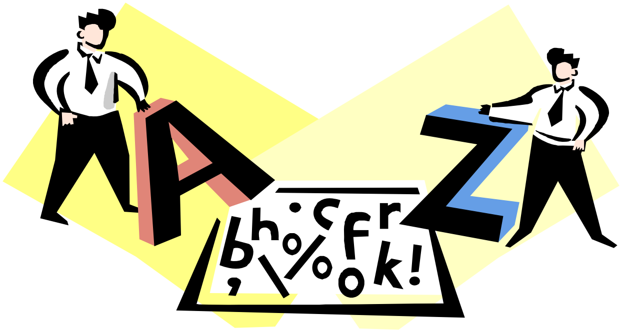
- Guideline Transaction Values
  - NOL benefits or intangible benefits are already included in deal price
  - However, acquired companies will have different intangible and NOL levels, so it is possible a further adjustment would be required
- Guideline Company Values
  - NOL or TAB may both be included in company value/stock price, however it would be for the company on a minority, stand-alone basis (not if sold)
  - May be difficult if not impossible to compare versus subject company but some process should be considered
- Level of benefit to include
  - Would buyer give up full benefit to the seller? (usually assumed for TAB)
  - Answer likely based on nature of bidding process

One bidder → Many bidders

Little/no benefit → (Near) Full benefit

Issues 2 & 3 – Accounting Issues

- Issue 2 – Deferred income taxes <u>should</u> be included in the RU carrying value regardless of the type of transaction assumed
- Issue 3 – Income tax bases for assets/liabilities should be based on type of transaction assumed
  - –Use existing income tax bases if assuming a nontaxable transaction
  - –Use new income tax bases if assuming a taxable transaction
- Important Note – Issues 2 and 3 are accounting considerations and not the valuation expert's responsibility.



Example 1 (nontaxable) - Overview

- Company A performing GW impairment test at 12/31/02
- Fact pattern
  - Net assets (excl. GW & def. income taxes) =$60
  - Net assets tax basis = $35
  - Goodwill = $40
  - Net deferred tax liabilities = $10
  - Sale price: $80 – nontaxable; $90 – taxable
  - Tax rate: 40%
  - Feasibility – either type of transaction is feasible
- Taxes payable from transaction
  - Non-taxable transaction = $10
  - Taxable transaction = (sale price-tax basis) X tax rate
    = ($90-35) X .40
    = $22

Note: Examples 1 and 2 from EITF 2-13

Example 1 (nontaxable) – Issue 1

- It was determined that either type of transaction was feasible
- Based on an analysis of the fact pattern, it was concluded that Company A would realize the highest economic value by selling the reporting unit in a nontaxable transaction as outlined below:

	Nontaxable	Taxable
Gross proceeds	$80	$90
Less: Taxes from transaction	(10)	(22)
Economic Value to Company A	$70	$68

Note: Examples 1 and 2 from EITF 2-13

Example 1 (nontaxable) – Issue 2

- Deferred income taxes are included in the carrying value as outlined below:

Net Assets	$60	
Goodwill	40	
Deferred Taxes	(10)	
Carrying Value	$90	(carrying value 100 w/o adjustment)

Note: Examples 1 and 2 from EITF 2-13

Example 1 (nontaxable) – Issue 3

- This is a nontaxable transaction so the reporting unit's existing income tax bases should be used.
- Implied fair value of goodwill calculation:

Fair Value of Reporting Unit	$80
Less: Net Asset Value	65
Plus: Deferred Tax Liabilities	12
Implied fair value of goodwill	27 (would be 15 w/out adjustment)

- Remember – issues 2 and 3 are accounting related, not valuation related.

Note: Examples 1 and 2 from EITF 2-13

Example 2 (taxable) - Overview

- Company A performing GW impairment test at 12/31/02
- Fact pattern
  - Net assets (excl. GW & def. income taxes) =$60
  - Net assets tax basis = $35
  - Goodwill = $40
  - Net deferred tax liabilities = $10
  - Sale price: $65 – nontaxable; $80 – taxable ← Different from example 1
  - Tax rate: 40%
  - Feasibility – either type of transaction is feasible
- Taxes payable from transaction
  - Non-taxable transaction = $4 ← Different from example 1
  - Taxable transaction = (sale price-tax basis) X tax rate
    = ($80-35) X .40
    = $18 ← Different from example 1

Note: Examples 1 and 2 from EITF 2-13

Example 2 (taxable) – Issue 1

- It was determined that either type of transaction was feasible
- Based on an analysis of the fact pattern, it was concluded that Company A would realize the highest economic value by selling the reporting unit in a taxable transaction as outlined below:

	Nontaxable	Taxable
Gross proceeds	\$65	\$80
Less: Taxes from transaction	(4)	(18)
Economic Value to Company A	\$61	\$62

Note: Examples 1 and 2 from EITF 2-13

Example 2 (taxable) – Issue 2

- Deferred income taxes are included in the carrying value as outlined below:

Net Assets	$60	
Goodwill	40	
Deferred Taxes	(10)	
Carrying Value	$90	(carrying value 100 w/o adjustment)

- Note this is the same result as in example 1/nontaxable

Note: Examples 1 and 2 from EITF 2-13

Example 2 (taxable) – Issue 3

- This is a taxable (asset) transaction so the reporting unit's new income tax bases should be used.
  - In other words, there is no adjustment for deferred income taxes.
- Implied fair value of goodwill calculation:

Fair Value of Reporting Unit	$80
Less: Net Asset Value	65
Deferred Income Taxes	---
Implied fair value of goodwill	15

- Again, remember – issues 2 and 3 are accounting related, not valuation related.

Note: Examples 1 and 2 from EITF 2-13

Other Considerations - Materiality

- If your analysis before consideration of transaction type indicates no impairment, it is likely to still arrive at the same conclusion after making the adjustments
  - Adjusting for the intangible TAB or NOLs raises the reporting unit value
  - Adjusting for deferred income taxes (issue 2) lowers the carrying value
- Therefore, if your step 1 goodwill impairment analysis indicates no impairment, do you need to go through all of this? Maybe not, but before concluding this…
- This would be an issue to be discussed with management and the auditors.
- If the step 1 analysis pre-consideration of transaction type indicates impairment, the argument that this analysis needs to done is fairly compelling.

Other Considerations – PPA IRR Calculation

- EITF 2-13/ASC 350-20 specifically apply to goodwill impairment testing.
- However, for an IRR calculation, wouldn't you also want to consider the impact on projected cash flows based on the type of transaction?
- Personal opinion – yes you would!
- In including NOLs or an intangible TAB as part of the IRR calculation, one would hope that the market participant assumption would be consistent with the type of transaction that just occurred (i.e., if the deal was an equity deal, one would hope that the IRR analysis would be done assuming an equity deal)

Thank You!

- Please feel free to ask any questions after the session or you can contact me:

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