

# *Tax accounting services*

## Goodwill impairment testing – tax considerations prior to adopting ASU 2017-04

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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 that are measured at fair value and others (including income taxes) that 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 performed at least annually, on a reporting unit (RU) basis<sup>1</sup>.

Under the current guidance for assessing goodwill for impairment, an entity can choose to first assess qualitative factors (often referred to as Step 0) to determine whether a quantitative goodwill impairment test is necessary. When an entity bypasses or fails the qualitative assessment, a quantitative two-step goodwill impairment test is performed. Step 1 compares the fair value of a reporting unit to its carrying amount to determine if there is a potential impairment. If the carrying amount exceeds fair value, Step 2 must be completed. Step 2 requires the determination of the implied fair value of goodwill through a hypothetical purchase price allocation, and a comparison of that goodwill to the carrying amount of goodwill to measure the impairment loss, if any.

On January 26, 2017, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2017-04, *Intangibles – Goodwill and Other (Topic 350)*, which is intended to simplify goodwill impairment testing. Under the revised guidance, the optional qualitative assessment (Step 0) and the first step of the quantitative assessment (Step 1) remain unchanged. However, the second step of the goodwill impairment test is eliminated. As a result, Step 1, when performed, will be used to determine both the existence and amount of a goodwill impairment. An impairment will be recognized for the amount by which the reporting unit's carrying amount exceeds its fair value, not to exceed the carrying amount of the goodwill in that reporting unit. The revised standard is effective for annual or interim goodwill impairment tests performed in fiscal years beginning after December 15, 2019<sup>2</sup>. Early adoption is permitted for any impairment test performed on testing dates on or after January 1, 2017.

While early adoption is permitted, companies may choose to continue to apply the current two-step impairment guidance for goodwill impairment tests performed prior to the effective date. As a result, this publication provides an overview of the current (pre-ASU 2017-04) guidance as well as specific income tax factors that should be considered when performing such procedures. Companies that intend to early adopt the new standard can find a similar overview and income tax specific considerations under the revised impairment guidance in our publication [\*Goodwill impairment testing: tax considerations when adopting ASU 2017-04\*](#).

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<sup>1</sup> Eligible private companies that elect to follow the Private Company Council alternative for goodwill (ASU 2014-02) are only required to test goodwill for impairment upon occurrence of a triggering event, and may make an accounting policy election to test goodwill for impairment at the entity level.

<sup>2</sup> Public business entities who are SEC filers should adopt the new standard for annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2019. Other public business entities will have an additional year (fiscal years beginning after December 15, 2020). All other entities that have not elected the Private Company Council alternative for goodwill will be required to apply the guidance in fiscal years beginning after December 15, 2021.

## Overview

An entity that chooses to apply Step 0 is required to perform quantitative impairment testing only if it concludes in Step 0 that it is more likely than not that an RU's fair value is less than its carrying amount. The revised guidance provides examples of events and circumstances that an entity should consider when performing the qualitative assessment, such as the entity's overall financial performance, macroeconomic conditions, industry and market considerations, other relevant entity-specific events, and events affecting a reporting unit. More weight should be given to those events and circumstances that most significantly impact an RU's fair value.

Due to its qualitative nature, the Step 0 assessment brings even more subjectivity and judgment to the goodwill impairment testing process. Companies working through the goodwill impairment process should consider how the qualitative assessment under Step 0 can be affected by the company's tax profile and the tax consequences of a disposal. Tax-specific considerations affecting Step 0 assessments may include:

- macroeconomic conditions, including the domestic and global tax legislative environment;
- overall financial performance, including a company's forecasted cash tax position and effective tax rate; and
- the difference between the fair value and the carrying amount of an RU if the entity recently performed a fair value calculation. To the extent there were significant tax factors in the initial fair value calculation and it is known that these factors have changed due to recent events (e.g., a decline in tax rates that would reduce the value of deferred tax assets such as net operating loss ("NOL") carryforwards), the updated fair value in a Step 0 assessment would be adjusted.

If a company concludes that it did not pass Step 0, or chooses not to perform it, it would undertake the quantitative assessment of the impairment testing process.

In Step 1 of the testing process, the fair value of the RU is determined and compared to its carrying value, including goodwill. If the fair value of the RU exceeds its carrying value, goodwill of the RU is not impaired; if the carrying 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 carrying 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 affect whether there is an impairment of goodwill as well as the amount of impairment. This paper discusses five primary tax focal points, beginning with Step 1. While the first three focal points discuss tax considerations in applying Step 1, they should also be considered in step zero assessments, albeit in a less granular manner than under Step 1 due to the qualitative nature of a Step 0 assessment.

### 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 carryforwards) of the RU would be transferred to a buyer. As a result, the disposal structure can affect 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 RU (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, depending upon the jurisdiction.

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.

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 affect 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 laws, anti-trust laws and other federal and state regulations applicable to a particular industry should also be considered.

Ultimately, various factors influence the comparative tax effect on transaction pricing for each type of disposal. 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.

## **Tax focal point #2**

In addition to considering the perspective of appropriate market participants in assessing the nature of the disposal, an entity should consider the feasibility of the assumed disposal structure. For example, if a reporting unit is not a legal entity, assuming a nontaxable stock sale would also require consideration of the structuring necessary to convert the reporting unit into a legal entity. It must also consider whether the assumed structure results in the highest and best use and would provide maximum value to the seller for the reporting unit, including consideration of related tax implications. In assessing the maximum value, the fair value (or gross proceeds) expected to be realized from a reporting unit disposal is reduced by the seller's tax cost. The seller's tax cost is typically 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 that 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 carrying value. **The determination of the carrying 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 carrying value of the RU it may be necessary to allocate tax accounts that 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.

The assumed disposal structure may impact whether the tax attributes of an RU, and therefore such respective deferred tax assets, affect the fair value of the reporting unit. Those deferred tax assets would be assigned to the RU only for purposes of determining the carrying 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.

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. If a company files a consolidated tax return and has established a valuation allowance against its deferred tax assets at the consolidated level, 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 unit'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 return basis for this purpose.

Unrecognized tax benefits for income tax uncertainties may also need to be allocated when the reporting unit is included with other businesses or legal entities in tax returns. The assumed disposal structure may affect the assignment of tax uncertainties. Entities should consider any tax indemnifications 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 were acquired in the assumed disposal structure at the time of testing. **The fair values of assets and liabilities that are determined using an income or discounted cash flows analysis in Step 2 should typically 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 is typically 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.

Step 2 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 apply 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 that 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. 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 to the deferred taxes and valuation allowance assessments based upon available market participant information.

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. In this example, the RU is assumed to have \$10 of deferred tax assets for tax loss carryforwards. The book value of the RU in a taxable sale does not include that amount since those tax attributes would not be acquired by the buyer. In addition, the seller's taxes are also assumed amounts for purposes of illustrating potential differences in taxes among the disposal structures. The difference in effective tax rates in the sales could 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 RU. Alternatively, there may be a difference in tax rates applicable to a sale of stock as compared to a sale of assets.

	Nontaxable exchange	Nontaxable sale	Taxable sale
Carrying value of reporting unit	<b>110</b>	<b>110</b>	<b>100</b>
Gross proceeds (fair value) (1)	75	80	90
Seller tax (2)	0 <sup>3</sup>	15	22
Economic value to seller (1) - (2)	<b>75</b>	<b>65</b>	<b>68</b>
Implied purchase price (1)	75	80	90
Implied fair value of goodwill (3)	20	25 <sup>4</sup>	15 <sup>4</sup>
Book value of goodwill (4)	20	20	20
Potential goodwill impairment [If (3)<(4), impairment]	<b>0</b>	<b>0</b>	<b>5</b>

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.

<sup>3</sup> 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.

<sup>4</sup> 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 [gross proceeds differential between nontaxable sale (\$80) and nontaxable exchange (\$75) is \$5, resulting in higher implied fair value of goodwill for nontaxable sale]. 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. The implied fair value of goodwill for the taxable sale would be \$10 less than the nontaxable sale because the net assets would have tax basis consistent with book basis.

## ***In conclusion***

Tax management and tax advisors can, and should, play a significant role in assessing the tax considerations that may impact goodwill impairment testing. Given the significance of impairments resulting from continued 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 inputs, 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.

## ***Let's talk***

To have a deeper conversation about how these issues may affect your organization, please contact your PwC engagement team or one of the following PwC tax accounting specialists:

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