The McLean Group
INVESTMENT BANKING

Valuation Vantage©

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The McLean Group's Valuation Practice

As a core competency and complement to its mergers & acquisitions (M&A) practice, The McLean Valuation Service Group provides business valuation services, including intangible asset and financial security valuations for a variety of transaction, financial reporting and tax purposes.

Intangible and Long-Lived Asset Impairment Testing – ASC 360

Impairment testing for intangible and other long-lived assets is important, but it recently has been overshadowed by goodwill testing. Whereas it is mandatory to test goodwill for impairment every year, intangible assets and other long-lived assets only need to be tested when events or circumstances indicate the asset's Carrying Value (the net book value as of the valuation date) may not be recoverable. In other words, one only needs to perform an impairment test when one reasonably believes the asset may be impaired. FASB provides the following guidance in ASC 360 on when long-lived assets should be tested:

- A significant decrease in the market price of a long-lived asset (asset group).
- A significant adverse change in the extent or manner in which a long-lived asset (asset group) is being used or in its physical condition.
- A significant adverse change in legal factors or business climate that could affect the value of a long-lived asset (asset group), including an adverse action or assessment by a regulator.
- An accumulation of costs significantly in excess of the amount originally expected for the acquisition or construction of a long-lived asset (asset group).

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Built-In Gains: S Corporations and the Sale of Appreciated Assets

The McLean Group's Andy Smith (Principal and Senior Managing Director) and Brian Sullivan (Managing Director of the firm's Silicon Valley office) recently authored an article entitled, "Built-In Gains: S Corporations and the Sale of Appreciated Assets," published in Thomson Reuters' *Valuation Strategies*. The below summaries the 10-page article which may be viewed in its entirety here.

The tax implications of built-in gains has become a recent topic of discussion as the IRS and state tax authorities focus efforts to collect taxes. Companies should be aware of the importance of accurately valuing assets when converting from a C corporation to an S corporation as significant tax penalties are applicable if not properly valued.

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- A current-period operating or cash flow loss combined with a history of operating or cash flow losses or a projection or forecast that demonstrates continuing losses associated with the use of a long-lived asset (asset group).
- A current expectation that, more likely than not, a long-lived asset (asset group) will be sold or otherwise disposed of significantly before the end of its previously estimated useful life.

If an asset group may be impaired, there is a two step test to verify if the asset actually is impaired. The general procedures related to testing intangible assets are summarized below:

Intangible and Long-Lived Asset Impairment Testing
Step 1 - Recoverability Test
Determine the Carrying Value of the Asset Group
Determine the Sum of Undiscounted Cash Flows of the Asset Group
Step 2 - If Carrying Value > Undiscounted Future Cash Flows
Determine Fair Value of the Asset Group and compare the resulting Fair Value of the Asset Group to its Carrying Value

In Step 1, determine the sum of the undiscounted future cash flows based on management's estimates and compare it to the Carrying Value. If the carrying amount is greater than the sum of the undiscounted cash flows, then the asset is impaired and Step 2 is required. The amount of the impairment loss is the difference between the Fair Value of the asset and the Carrying Value of the asset. A present value technique is often the best method to estimate the Fair Value of a long-lived asset. If a present value technique is used, estimates of future cash flows should be consistent with Fair Value measurement procedures. Assumptions marketplace participants would use in their estimates of Fair Value should be incorporated in the analysis.

There are two important takeaways to remember when testing for impairment. First, if an asset fails Step 1, a severe impairment loss will most likely be taken for that asset. This is attributable to the estimated future earnings being undiscounted, so present valuing those earnings will further decrease the Fair Value of the asset. Second, even if an intangible or long-lived asset is not impaired, it may be appropriate to change the useful life of the asset. Although it is not required to change the useful life of the asset, one should take the possibility into consideration. The best argument for assessing the useful life is the fact that events or circumstances have already occurred which require impairment testing in the first place. Any subsequent changes to the useful life should be reflected when developing estimates of future cash flows.

"Built-In Gains..." continued from p. 1

In a recent tax court case with Ringgold Telephone Co. vs. the IRS under Section 1374 of Internal Revenue Code ("IRC"), many issues arose over the valuation measures followed in valuing the company's Fair Market Value of a minority interest. The minority interest was considered to be an appreciating asset that was sold shortly after the company converted to an S corporation. The Ringgold case is important to valuation practitioners as it provides insight into how the Tax Court analyzed the valuation of appreciating assets that may be sold soon after the election date. Below are some important points from the case:

- **Tax code for built-in gains.** Under IRC Section 1374 (d)(1), "an S corporation's gain on disposition of an appreciating asset is treated as taxable built-in gain to the extent the Fair Market Value of the asset at the beginning of its first year in which is it treated as an S corporation exceeds the asset's adjusted basis on that date." A company is taxed on a portion of the built-in gain if an asset is sold within the recognition period. Important to note: the recognition period was recently reduced under the American Recovery and Reinvestment Act of 2009 from a 10-year period to a seven-year period.
- **Accurate Documentation.** All of the factors influencing the business appraisal need to be accounted for. The specific value drivers of a company and the economic factors surrounding the S election date valuation should be clearly documented to support any change in value that may occur after the S election date.
- **Conversion of C Corp to S Corp.** A thorough valuation of assets is of the utmost importance before converting from a C Corp to an S Corp. Due to ASC 820's hierarchy of Fair Value inputs, there is a potential risk that the sales price (level 1 input) from selling the appreciating asset close to the S election valuation date would be considered by the Tax Court a better indication of value than the value from the business appraisal on the S election date (level 2 and level 3 inputs). Therefore, the Tax Court may argue that the accurate Fair Market Value is the price the assets were sold for after the S election date and not the value represented in the business appraisal on the S election date, resulting in higher tax penalties.
- **Acting Responsibly and In Good Faith.** The Tax Court considers the taxpayer's intentions when analyzing tax penalties. A company should document its efforts in obtaining an accurate valuation of the appreciating assets to demonstrate it acted responsibly.

Through analyzing the Ringgold case, the benefit to high-growth companies making an S election while holding appreciating assets and then selling the assets during the recognition period is evident. However, a company that plans to do this must carefully follow the proper precautions of documentation and accurate valuations to safeguard against any potential tax penalties or negative repercussions.

Practice Highlights

The McLean Valuation Services Group has been actively authoring articles and participating in speaking engagements for various industry-focused publications and organization events, including:

- Andy Smith and Brian Sullivan co-authored the article, "We Are Not Paid to Agree With Our Clients," for the *Financial Valuation and Litigation Expert*'s April/May 2011 edition.
- Andy Smith was a speaker and panelist for SECAF's, "Educational Forum Secrets of Success – Understanding Value Drivers in a Government Contractor," in March 2011.
- Brian Sullivan and Andy Smith authored the article, "Built-in Gains – S Corporations and the Sale of Appreciated Assets," for Thomson Reuter's January/February edition of *Valuation Strategies*.
- Andy Smith presented, "The Art of M&A: Valuation," at a national webinar presented by eKnow in January 2011.
- Zane Markowitz, Brian Sullivan and Andy Smith co-authored the article, "Keys to Creating a Sustainable and Productive Financial Forecast," for *NACVA Ambassadors' QuickRead*'s December 2010 edition.

The McLean Valuation Services Group Offices

The McLean Group is a national middle market investment bank providing mergers & acquisitions (M&A), capital formation, market intelligence, business valuation, litigation support and exit planning services with bankers in more than 30 offices in the US. Its affiliate, The McLean Valuation Services Group, performs business valuation services for transaction, financial reporting and tax purposes. The McLean Valuation Services Group has dedicated business valuation offices in the following locations:

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