Tax Amortization Benefit: Usage in Healthcare Transactions

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This outline is a brief summary of the tax amortization benefit ("TAB") and how it is incorporated into business valuations. A brief history of the TAB will be provided, followed by the definition, followed by the formula to calculate TAB. We must then understand when utilizing TAB is appropriate. Upon understanding the history, calculation, and when to utilize it, we will provide VMG Health's position on the TAB and usage within healthcare transactions.

History of TAB

Since the beginning of the Tax Code, amortization of intangible assets has been permitted in some form. For a lengthy period of time, Section 167, which was passed by Congress in 1954, was the main chapter of the Code which dealt with the amortization of intangible assets. For decades, the IRS and businesses fought over meaning and interpretation of Section 167. Many of these disputes came to a rest with the enactment of the Revenue Reconciliation Act of 1993, which created Section 197 of the Tax Code. One major aspect of Section 197 was that almost all forms of intellectual property could now be amortized instead of capitalized. Further, for the first time, goodwill was allowed to be amortized. Another important change created by Section 197 was the amortization period no longer had to relate to the useful life of the asset. Rather, Section 197 established a uniform 15-year amortization period for all intangible assets.

Definition of TAB

The TAB value reflects the additional value resulting from the tax savings generated by the buyers ability to deduct amortization related to the intangible assets over their 15 year tax life. The amortization benefit applies only to intangible assets that are deductible for tax purposes. If the subject asset were a tangible asset, a depreciation benefit would apply[1]. The TAB is the present value of tax benefits resulting from intangible asset amortization. (Click here for the TAB formula and example.)

Why is TAB Used

A major tax advantage to the acquirer of structuring a transaction as a taxable asset purchase[2] is that the acquirer receives stepped-up tax basis in the target's net assets (assets minus liabilities). This means that the acquired net assets are written up (or down) from their carrying values on the seller's tax balance sheet to fair market value (FMV) on the acquirer's tax balance sheet. The higher resulting tax basis in the acquired net assets will minimize taxes on any gain on the future sale of those assets. Additionally, goodwill and other intangibles acquired in a taxable asset purchase are required by the IRS to be amortized over 15 years, and this amortization is tax-deductible.

Stepped-Up Basis
Buyer assumes a FMV tax basis in the acquired net assets equal to the purchase price. In a taxable asset sale, the seller pays tax on any gain on the sale of its assets. The seller will receive a benefit from the TAB to offset the additional tax burden of an asset sale while the acquirer enjoys the benefit of a tax step-up. The TAB value allows the seller to equalize the after tax transaction value under an asset purchase. Given the current tax disparity between capital gains tax versus ordinary income tax there has been an increase in equity purchases. VMG has observed the buyer will often pay a higher purchase price (relative to a stock acquisition) to the seller as compensation for the seller's tax liability. Including the tax effects in the valuation process is common in the income and cost approaches but not typical in the market approach, because any tax benefit is already factored into the quoted market price[3].

<u>VMG Health's Position on TAB</u>
VMG continually researches and stays abreast of the latest valuation industry trends and methodologies. Over the last several years VMG Health has begun using the TAB with certain appraisals. A few of the key criteria to use the TAB asset are as follows:

- Businesses in which VMG relies largely/primarily on the Income Approach;
- Businesses in which the Market Approach is difficult to ascertain an appropriate value;
- The appraisal includes intangible asset values; and,
- The acquisition is based on an asset purchase.

<u>For-Profit vs Non-Profit</u>
We recognize many buyers in healthcare transactions are non-profit healthcare providers. One could argue that a TAB asset is not applicable to a non-profit buyer due to the fact the non-profit buyer would not participate in the tax benefit. In our opinion there are several reasons why the TAB should be a component of the purchase price:

- Fair Market Value ("FMV") by definition is the price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller. (Considering only the Non-Profit buyer attributes would not be considered FMV.)
- The Income Approach valuation conclusion is based on the present value of the after tax cash flows (Use of the after tax cash flows is consistent with the consideration of TAB.)

Therefore, certain valuations warrant usage of the TAB regardless of the tax status of the buyer of the business.

<u>Conclusion</u>
The TAB asset has been recognized by the IRS since the beginning of the Tax Code and was further defined in 1993. The recognition of the TAB in the valuation industry has increased over the years and has been recognized as a generally accepted valuation assumption in situations when warranted. The application of TAB within in healthcare transactions is applicable for both for-profit and non-profit buyers.

Sources / Notes:

[1]*Fair Value Measurements* by Mark L. Zyla 2010 pg 132

[2] Asset Purchase – The acquirer buys some or all of the target's assets/liabilities directly from the seller. If all assets are acquired, the target is liquidated.

[3] *Valuation for Financial Reporting* by Michael Mard, James Hitchner, Steven Hyden pg 43