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INSIGHT: Purchase Price Allocations—the Old and the New

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Buyers and sellers often think that a successful conclusion of the due diligence processes means that the deal is ''done.'' In a straight corporate stock transaction, that is often correct. In a taxable asset transaction (either actual or deemed), it is not always that simple. After going through the diligence process and negotiating purchase price adjustments, the total purchase price must still be allocated to all of the tangible and intangible assets acquired, some of which may not have been previously recorded on the target's books or have tax basis. While the parties may be indifferent to some allocations, buyers' and sellers' conflicting priorities regarding the value ascribed to certain assets may create tension, as these allocations can impact each party's perceived success of the transaction.

Allocations to the various classes of assets acquired can affect the timing of investment recovery for buyers and the character of gain for sellers. Allocation to shorter-lived assets can accelerate a buyer's investment recovery, resulting in a greater time-value of money, but such allocations may alter the character of a seller's gain from capital gain to ordinary income, which is taxed at a higher rate for non-corporate taxpayer sellers (20% for capital gain vs. a maximum 37% for ordinary income). Some buyers are more sensitive to this than others. Strategic buyers may be more flexible because they likely intend to hold and use the acquired assets for a longer time frame. Private equity purchasers are generally more sensitive to the allocations and recovery times because of their typically shorter window for holding the investment.

The Old

Accounts receivable and inventory are two assets for which common allocation missteps can occur for unwary buyers. A seller-drafted purchase price allocation will frequently allocate to those assets based on generally accepted accounting principles (GAAP) balances, which are net of reserves for uncollectible accounts and obsolete inventory, respectively. As a practical matter, the reserve amounts not allocated to those current assets end up increasing the allocation to goodwill. Since the reserves are not deductible for tax purposes, allocating net of reserves will cause the seller to recognize ordinary losses with respect to those assets and more capital gain with respect to the goodwill (effectively giving the seller a rate arbitrage). The buyer is left with less basis in the receivables and inventory. If the receivables are collected and inventory sold in their entirety, the buyer will recognize ordinary income to the extent of the reserves. Rather than having enough tax basis to offset against the collections and sales of acquired assets that have already been the subject of ordinary income taxation to the seller, the buyer will now recover the amount of the reserves over 15 years as the goodwill is amortized.

Another commonly overlooked inventory issue that arises from allocating based on the GAAP inventory balance is the tax code Section 263A, or uniform capitalization (UNICAP), adjustment. Section 263A requires that taxpayers capitalize into inventory, for tax purposes, a portion of the indirect costs associated with manufacturing or purchasing and maintaining inventories. The amount capitalized is deducted through cost of goods sold (COGS) in the subsequent year (as the inventory is presumably sold) and a portion of the subsequent year's indirect inventory costs are capitalized into ending inventory for that year. Using the GAAP inventory balance, or the tax basis where the seller has not complied with Section 263A, a buyer will (a) have less allocated to inventory to offset post-transaction sales and more allocated to goodwill with a 15-year recovery period, and (b) have an unfavorable adjustment that in-

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creases taxable income on the buyer's first post-transaction tax return as the initial 263A amount is capitalized into inventory by the buyer.

Accordingly, buyers should require purchase price allocations to receivables and inventory based on gross, rather than on a net-of-reserve, basis, as well as including any Section 263A adjustment that may not have been properly included by the seller in tax basis inventory.

The New

The new is not so much new as it is exacerbated. Prior to the 2017 Tax Cuts and Jobs Act (TCJA), some limited expensing was allowed by Section 179 and bonus depreciation was intermittently allowed, but fixed assets were primarily depreciated using accelerated depreciation (MACRS), with many assets having a recovery period of between three and seven years. Buyers typically pushed to allocate as much purchase price as could reasonably be supported as fair market value to such acquired assets. Allocating more to assets subject to accelerated depreciation reduced tax expense by increasing deductions, thereby recovering investment more quickly.

However, to the extent that a seller claimed depreciation deductions (that reduced ordinary income), allocation of purchase price to depreciated assets caused the seller to recognize ordinary income from depreciation recapture, rather than capital gain. Therefore, sellers desired to limit allocation to depreciable assets to remaining tax basis, which would result in no gain or loss recognized with respect to such assets, and to allocate the remainder of the total purchase price to other assets that would result in capital gain.

The TCJA poured gasoline on the fixed asset allocation fire. Property that used to be depreciated over three, five, seven, or more years is now potentially eligible for current year expensing as bonus depreciation (*i.e.*, 100% deduction) in the year acquired. Moreover, whereas bonus depreciation was previously allowed only for brand new assets, newly purchased used assets are also eligible. So, whereas buyers were vying for the difference between 15-year straight-line amortization for good will and accelerated depreciation over three to 10 years for fixed assets before, they are now chasing the difference between 15-year straight-line amortization for good will and current deduction for fixed assets.

Work Toward Agreement

While agreement is not required, conflicting allocations invite Internal Revenue Service scrutiny. The greater the size of the transaction and the greater the differential between the parties, the more likely that the IRS will disagree with one or the other (or both). Nevertheless, sometimes circumstances are such that the potential benefit of filing a more favorable, divergent allocation outweighs the potential risk of adjustment and reallocation by the IRS.

Particularly in middle market deals, disagreement on allocation is highly unlikely to cause a deal to fail. However, agreement is most often preferable. Advisors typically recommend that the parties work toward an agreed-upon allocation and, in practice, most do.

Generally speaking, agreed-upon allocations between unrelated willing buyers and sellers will be respected by the IRS. Section 1060 requires the total purchase price to be allocated across seven asset classes, starting with the most liquid (cash) and ending with the least liquid (goodwill, as a residual amount). Agreed upon allocations are usually respected by the IRS because of the previously described tension—what is beneficial to one party is often detrimental to the other, at least for some of the items within the overall allocation. If the fair market value of a particular asset is what an unrelated willing buyer and seller with opposing interests say it is, their agreement will usually be respected.

Some deals naturally lack tension. For example, corporate sellers don't have a different tax rate for ordinary income versus capital gain, so there may be no consequence when they move an allocation from one asset to another, even if the asset was previously depreciated. If the entire purchase price was allocated to tangible personal property and none to intangible assets, a corporate seller might be indifferent, but the buyer could greatly benefit.

Similarly, a seller might take the position that current value resides in new intangible assets rather than existing previously amortized intangibles, allowing the seller to avoid recharacterization of capital gain into ordinary income from amortization recapture. Since the buyer would obtain 15-year amortization regardless of the intangibles to which the allocation is made, the buyer will likely not oppose the seller's request.

In such cases, the IRS is less likely to be deferential to the parties' allocation and may apply a greater degree of scrutiny. Accordingly, the party with the one-sided potential benefit should take care to ensure that any beneficial allocations are not unreasonable. Support by outside evidence, such as valuations may be advisable.

Reaching agreement on purchase price allocations often requires back-and-forth discussions and negotiation. As with any negotiation, each party should go in understanding what it is willing to accept based on its tax and net cash modeling. If both parties are satisfied with the overall economics of the deal, the tax consequences of the allocations should be the cherry, not the sundae.

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