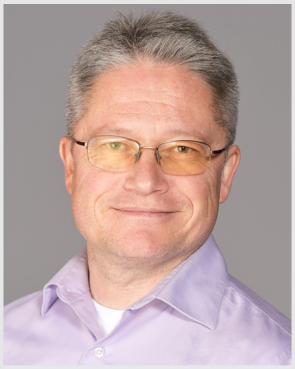
Purchase Price Allocation Exhibit: More Than Meets the Eye?

by Vadim Mahmoudov



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In this article, Mahmoudov explains the significant tax implications of purchase price allocations under section 1060, which are often intensely negotiated between buyers and sellers, and he provides drafting tips for tax lawyers.

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You are a junior tax associate working on an all-cash taxable asset purchase, representing the buyer. From a tax perspective, this is typically not a heavy lift. Your client is not buying any legal entities, so there is usually no need to worry about historic tax exposures or to draft elaborate tax indemnities. No fancy structuring steps are needed (on the buyer's side, anyway) to acquire the assets, and there is no getting around the fact that the transaction is fully taxable for both sides. The seller will recognize gain or loss, and the buyer will take a tax basis in the purchased assets equal to cost.[1] Easy peasy. In fact, this deal has required so little tax work that you even forgot you were staffed on it, and have not heard about the deal in weeks.

Suddenly, a corporate associate calls. We are about to sign! The parties are now finalizing ancillary documents and exhibits, and they noticed that a "Schedule 2.09" is mentioned in section 2.09 of the asset purchase agreement. It seems to be something about a method for allocating purchase price under section 1060 of the code.[2] Everyone thought the accountants would prepare this document, but it turns out that accountants don't do drafting. Can you prepare a draft of this method before the end of the day?

Section 2.09 of the asset purchase agreement reads like this, which is fairly typical:

> *Price Allocation*. For U.S. federal, state and local income Tax purposes, the Parties agree that the Purchase Price (and any other amount treated as included in the amount realized for Income Tax purposes) shall be allocated among the Purchased Assets in accordance with the provisions of Section 1060 of the Code and the Treasury Regulations thereunder (the "Price Allocation"). Buyer shall prepare and deliver a draft Price Allocation to Seller within 90 days after the Closing Date based on the methodology outlined in Schedule 2.09 hereto. Buyer shall consider in good faith any reasonable comments provided by Seller to the Price Allocation, provided that such comments are received within 30 days following the Buyer's delivery of the Price Allocation to the Seller. If Buyer and Seller are unable to agree on any of Seller's timely raised

[1] *See* section 1012(a).

[2] For purposes of this article, it is assumed that the hypothetical asset purchase is an "applicable asset acquisition" subject to the requirements of section 1060.

> comments to the draft Price Allocation, then Buyer and Seller shall engage an independent accounting firm, mutually selected by Buyer and Seller (the "Accounting Firm"), to resolve the matter. Buyer, Seller and their respective Affiliates shall report, and file Tax Returns (including, but not limited to, IRS Form 8594) in all respects and for all purposes consistent with the Price Allocation (as finally determined) and neither Buyer nor Seller shall take any position (whether in audits, Tax Returns or otherwise) that is inconsistent with such allocation unless required to do so by a "determination" as that term is defined in Section 1313(a) of the Code.

Since you are still learning the ropes of the tax world, you might ask yourself (as I did when this happened to me more than two decades ago): What's so hard about this, and why do the parties need to agree on an exhibit with a method? Doesn't the tax law require the purchase price to be allocated automatically by asset categories based on their fair market values? Before we proceed, a quick detour is necessary to explain the origins of section 1060 and how it operates mechanically.

I. A Little Bit of Background

Before Section 1060 was enacted as part of the Tax Reform Act of 1986, the world of purchase price allocations was a messy landscape. Although the tax law always required allocations to be based on FMVs, many taxpayers took liberties with their allocations, in particular for intangible assets, some of which were amortizable while others (such as goodwill) were not. Further, buyers and sellers often allocated purchase price inconsistently, producing asymmetric tax outcomes. This free-for-all spawned frequent litigation between taxpayers and the IRS. The legislative history of section 1060 summarized the problems that prompted its enactment:

> The committee is aware that the allocation of purchase price among the assets of a going business has been a troublesome area of the tax law . . . [and] an endless source of controversy between the Internal Revenue Service and taxpayers. . . . The Service lacks the resources to challenge allocations to goodwill or going concern value. . . .
>
> The committee is also concerned about the potential for abuse inherent in the sale of a going business where there is no agreement between the parties as to the value of specific assets. In many instances the parties' allocations for tax reporting purposes are inconsistent, resulting in a whipsaw of the government. The committee expects that requiring both parties to use the residual method . . . may diminish some of this "whipsaw" potential.[3]

Enter section 1060, which sought to bring this chaos under control by mandating the use of the residual method, mentioned above, which is fleshed out in Treasury regulations promulgated under section 338(b)(5). The residual method forces the allocable purchase price to cascade through a waterfall of seven available asset classes, starting with the most liquid assets and ending with the most nebulous ones (goodwill and going concern value). After the relevant class has received an allocation equal to the FMV of assets in that class, we move on to the next class. The process continues until either there is no more purchase price to allocate or we reach the last tier of the waterfall (Class VII), to which any remaining purchase price is allocated:

- Class I: cash and cash equivalents;
- Class II: actively traded personal property, for example, U.S. Treasury bonds or publicly traded stock;
- Class III: debt instruments (including accounts receivable) and assets marked to market at least annually for federal income tax purposes;
- Class IV: inventory and similar assets held for sale to customers;
- Class V: all other assets not included in a particular class (this typically includes fixed assets such as equipment and buildings);

[3] S. Rep. No. 99-313, at 253-254 (1986).

- Class VI: section 197 intangibles other than goodwill and going concern value (this may include patents, copyrights, or other specific contractual rights like a noncompete agreement); and
- Class VII: goodwill and going concern value.[4]

Separately, in 1993 Congress also permitted goodwill and going concern value, in addition to most other intangible assets, to be amortized over a 15-year period under section 197.[5] This eliminated a buyer's incentive to allocate purchase price disproportionately to Class VI as opposed to Class VII, although we will soon see that the distinction between the two classes may still matter for a seller in some cases.

II. What Are We Agreeing On?

OK, you might say. All this sounds sensible, and having both parties agree on amounts allocable to each asset class seems like a good idea. But still, why do the buyer and the seller need to draft a method prescribing how to allocate to each class? And as long as we have decided to draft a method, shouldn't Schedule 2.09 simply say: "Amounts treated as consideration for tax purposes shall be allocated *first* to Class I assets in an amount equal to their fair market value; *second*, any remaining amount shall be allocated to Class II assets in an amount equal to their fair market value" and so on?

The problem is that FMV is a fluffy concept. For some items, like cash or Treasury bonds whose value is readily ascertainable, it's straightforward. For most other assets that are less liquid, not so much. In many cases, no formal appraisal breaking down the purchased assets by section 1060 classes is ever done. (Some valuation may be done later for purposes of purchase accounting, but it may not necessarily align with a section 1060 allocation required for tax purposes.) In the absence of a formal valuation, the parties need to come up with, and hopefully agree on, shortcuts for assigning values to asset classes to avoid surprises or disputes later. For example, they may often agree to use book values from the closing day balance sheet as a rough proxy for FMVs. While this is often an imperfect proxy, life is short and the IRS (and the courts) historically have shown some degree of respect for an allocation agreed to by unrelated parties bargaining at arm's length.[6]

But what if the parties don't want to agree? Suppose that the buyer and the seller have different views on how to allocate purchase price. (As we will soon discover *infra*, in many cases it is a zero-sum game in which a good tax outcome for one party leads to a bad tax outcome for the other party.) Nothing in the code requires them to agree. Section 1060 merely states that *if* the buyer and seller "agree in writing as to the allocation of any consideration, or as to the fair market value of any of the assets, such agreement shall be binding" on both parties, unless the IRS determines that the allocation or FMV is inappropriate.[7] Although this language makes it clear that agreeing is optional, it also contains a "gotcha" for parties who do agree on an allocation: Once you have agreed on it, you may be stuck with it. Forever. More on that in a bit.

What if the parties try to agree but get bogged down in a disagreement over certain assets and their values? Note that the sample language for section 2.09 of the asset purchase agreement we saw above includes binding arbitration by an independent accountant. But some clients simply cannot accept being forced by some third-party expert into a reporting position that their own tax advisers don't agree with. In that case, an alternative ending to this provision would sometimes read like this:

> The Parties shall use their commercially reasonable efforts to reach agreement on

[4] *See* reg. section 1.338-6(b).

[5] *See* section 197 (1993).

[6] *See, e.g., Ullman v. Commissioner*, 264 F.2d 305, 308 (2d Cir. 1959) ("The tax avoidance desires of the buyer and seller in such a situation are ordinarily antithetical, forcing them, in most cases, to agree upon a treatment which reflects the parties' true intent."); *Balthorpe v. Commissioner*, 356 F.2d 28, 32 (5th Cir. 1966) ("The parties' competing tax interests will be a solid barrier to unrealistic allocations."); *Schulz v. Commissioner*, 294 F.2d 52, 55 (9th Cir. 1961) ("Generally speaking, the countervailing tax considerations upon each taxpayer should tend to limit schemes or forms which have no basis in economic fact. The Commissioner should be slow in going beyond the values which the taxpayers state when such countervailing factors are present. Such a result gives certainty to the reasonable expectations of the parties and relieves the Commissioner of the impossible task of assigning fair values.").

[7] *See* section 1060(a).

> the disputed items or amounts in order to determine the allocation of the Purchase Price (together with all other relevant amounts). The allocation, as prepared by Buyer if no Seller's Objection Notice has been given, or as adjusted pursuant to any agreement between Seller and Buyer in accordance with this Section 2.09, shall be conclusive and binding on the Parties, *provided*, that if Seller and Buyer are unable to fully resolve all of the disputed items within the twenty (20) day period following the delivery of Seller's Objection Notice, then Seller and Buyer may separately determine the allocation of the Purchase Price (together with all other relevant amounts).

However, if there is no mutually agreed allocation and the parties report inconsistently from each other, this would likely be a red flag for the IRS. Inconsistent reporting exposes the government to a classic whipsaw, when each taxpayer adopts an approach that produces a lower tax bill — at the expense of the fisc. As discussed above, this is precisely the type of abuse that Congress sought to curb by enacting section 1060.

Not surprisingly, IRS Form 8594, "Asset Acquisition Statement Under Section 1060," which must be filled out by each party to the asset deal in reporting the purchase price allocation, asks the following questions in line 5:

> Did the purchaser and seller provide for an allocation of the sales price in the sales contract or in another written document signed by both parties?. . . . Yes __ No __

> If "Yes," are the aggregate fair market values (FMV) listed for each of asset Classes I, II, III, IV, V, VI, and VII the amounts agreed upon in your sales contract or in a separate written document?. . . . . Yes ___ No ___

Filling out Form 8594 with either of these questions answered "No" will alert the IRS that the parties may be reporting inconsistent allocations. It's the equivalent of putting up a bright neon sign saying, "Please audit me."

Finally, what if the parties agree but later develop second thoughts about the allocation? In the most stark example, suppose the agreed allocation is reviewed by one of the parties' tax advisers in the course of preparing tax returns, and they conclude that the allocation is not compliant with section 1060. The statutory language regarding the agreement being binding on both parties suggests that both are stuck with the agreed-on allocation unless the IRS allows them to change it. The Treasury regulations provide a little more wiggle room, but not much, by saying the parties are not bound in a narrow set of circumstances:

> If the parties are able to refute the allocation or valuation under the standards set forth in *Commissioner v. Danielson*, 378 F.2d 771(3d Cir.), *cert denied*, 389 U.S. 858 (1967) (a party wishing to challenge the tax consequences of an agreement as construed by the Commissioner must offer proof that, in an action between the parties to the agreement, would be admissible to alter that construction or show its unenforceability because of mistake, undue influence, fraud, duress, etc.).[8]

This means that a taxpayer hoping to disavow an agreed allocation must meet the high bar of *Danielson*.[9] Simply having buyer's remorse, or belatedly realizing that your allocation is inconsistent with actual asset values, doesn't seem good enough. (Of course, the IRS is always free to challenge the allocation.) While it may not be good policy to force taxpayers to be bound by an allocation that is clearly invalid under section 1060, that seems to be the law.

One taxpayer who learned this the hard way was the buyer of poultry processing plants in *Peco Foods*.[10] After having agreed with the seller on a

[8] Reg. section 1.1060-1(c)(4).

[9] *Commissioner v. Danielson*, 378 F.2d 771 (3d Cir. 1967).

[10] *Peco Foods Inc. v. Commissioner*, T.C. Memo. 2012-18, *aff'd*, 522 Fed. Appx. 840 (11th Cir. 2013).

very detailed purchase price allocation (which assigned values to specific buildings and certain equipment instead of just lumping them all together in a single Class V line item as most section 1060 exhibits do), Peco Foods hired a third-party expert to do a cost-segregation analysis. The study concluded that some of the amounts initially assigned to buildings and improvements (real property) included amounts that should have been assigned to mechanical systems (personal property), which are eligible for accelerated depreciation. Peco Foods tried to reassign these amounts from real property to equipment to claim more depreciation deductions in the early years, and it was challenged by the IRS. The court found that the parties' agreed allocation was unambiguous, having already assigned separate amounts to buildings and machinery, and Peco Foods could not deviate from this allocation by peeling off a slice of the amounts allocated to real property and redesignating it as personal property.[11]

III. Sample Section 1060 Method Exhibit

Let's assume that after being advised on the pros and cons of agreeing to an allocation method, your client tells you to draft the exhibit. What does a typical section 1060 method schedule look like? Here is a very simple sample, which defers to book values in all cases:

Asset Class	Allocation
Class I Assets	The amount of cash reflected on the Closing Statement
Class II Assets	Such amount taken into account in Closing Working Capital for purposes of determining the Purchase Price
Class III Assets	Such amount taken into account in Closing Working Capital for purposes of determining the Purchase Price or, for any such asset not taken into account in the calculation of Closing Working Capital, the net book value of such asset as of the close of business on the Closing Date
Class IV Assets	Such amount taken into account in Closing Working Capital for purposes of determining the Purchase Price or, for any such asset not taken into account in the calculation of Closing Working Capital, the net book value of such asset as of the close of business on the Closing Date
Class V Assets	The net book value of such assets as of the close of business on the Closing Date
Class VI & VII Assets	Remaining balance

Note that all references to "closing working capital" in the example above are relevant only in a deal that has a working capital purchase price adjustment. Otherwise, we would just need to rely on "net book values" for all asset classes, as the example above already does for assets that are not picked up by the working capital definition in the asset purchase agreement.

It's also worth highlighting that the sample above (which is consistent with the layout of Form 8594) requires only a single amount to be allocated to a particular asset class. It does not require any suballocation within a particular class — for example, there is no need to break down Class V into real property, equipment, and other assets, which is what the taxpayer in *Peco Foods* screwed up. Therefore, any taxpayer that wants to retain maximum flexibility for allocating various amounts to particular assets within a class would be well-advised to stick to a single amount for each class. (On the other hand, if it is important to agree on a particular amount for a specific building — for example, for state and local transfer tax purposes — a more specific allocation may be unavoidable.) If you want more wiggle room, less is more when filling out this chart.

Now let's walk through each asset class above and examine potential variations that the buyer or seller may want to consider.

A. Class I

Class I should not be controversial or hard to figure out. Cash is cash. Sometimes the purchase price adjustment includes a discount for "restricted cash" that is subject to competing claims, restrictions on repatriation from a foreign

[11] *But see Freres Lumber Co. Inc. v. Commissioner*, T.C. Memo. 1995-589 (buyer allowed to introduce evidence to disprove agreed-on values, because allocation was unilaterally inserted into the agreement by the buyer, and was not negotiated because seller did not care about it).

jurisdiction, or potential withholding tax leakage. For this reason, it is safer to simply refer to the amount of cash acquired, rather than the amount taken into account in computing the purchase price, to avoid any inference that the amount of purchase price allocated to cash is less than the gross amount of cash. One way or another, the buyer should get tax basis in cash equal to the total amount of cash it acquired.

B. Class II

Class II should be similarly straightforward: publicly traded stock and government securities.

C. Class III

Class III is accounts receivable, and here things start getting interesting. For starters, note the use of "net" book value in the sample exhibit above. For receivables, this is generally understood to mean "net of allowance for bad debts," which may exist for book purposes but not tax purposes. In other words, receivables with a face amount and tax basis of $100 (for a seller that is an accrual-method taxpayer) may have a net book value of $90 if there is a reserve for bad debts that reflects the expectation that $10 will not be collected. In limited circumstances, certain accrual-method taxpayers may reduce their initial income inclusions upon earning the receivables by the percentage that, in their experience, is usually uncollectible.[12] A buyer may be tempted to allocate based on the seller's tax basis, which (for an accrual-method taxpayer) is likely higher than net book value if there is an expectation of collecting the receivables in full (or at least in an amount greater than the allowance for bad debt). This would minimize the risk of the buyer recognizing any gain on receivables when they are collected post-closing. Even if the allocation to receivables is excessive, it will generally be recovered quickly and produce an ordinary loss.

However, if the seller is a cash-basis taxpayer, its tax basis in receivables would be zero, so don't agree to use tax basis in that case. Otherwise, the entire amount of receivables will produce taxable income to the buyer upon collection — a bad way to start one's ownership of the purchased assets. Net book value is the way to go in that case.

In one recent deal, the sellers proposed the following for classes III and IV: "net book value times 99 percent," which means the buyer gets a tax basis slightly less than book value in the receivables. In another deal, the sellers proposed: "net book value plus $10,000," which seems to create a small amount of artificial gain (and is better for the buyer, who gets a step-up that was not bargained for). Why would a seller request this?

The tax treatment of these deals was that several sellers (some of which were S corporations) were contributing assets into a partnership and then selling a portion of their partnership interests to a buyer with a section 754 election. Since the buyer was receiving a section 743(b) adjustment in the inside basis of the partnership's assets for the purchased partnership interest, the section 1060 allocation method was being used by the parties.[13] The sellers, whose tax treatment (subject to the "hot asset" rules of section 751(a)) would be capital gain from the sale of a partnership interest,[14] were concerned about the bifurcated holding period rules of reg. section 1.1223-3. These rules could split their gain into short-term (taxed at ordinary income rates) and long-term components because of contributions made to the partnership within 12 months of selling the partnership interest. Since most of the contributed assets consisted of goodwill and intellectual property that had been owned by the sellers for well over 12 months, their holding period would tack to the partnership interest issued in exchange for those assets, resulting in long-term capital gain. However, to the extent the other assets they contributed were cash or hot assets described in section 751(c) or (d), a portion of the partnership interests they received in exchange would be treated as having a short-term holding period.[15] Note that this could convert a portion of any capital gain recognized on the sale

[12] *See* section 448(d)(5); and reg. section 1.448-3.

[13] *See generally* section 755; reg. section 1.755-1(a)(2) and (3). Although the residual method is only required to be used in this case for section 197 intangibles, as a practical matter the parties usually undertake the standard section 1060 allocation approach for all the partnership's assets.

[14] *See* section 741.

[15] *See* reg. section 1.1223-3(b)(1) and (b)(4).

of the partnership interest into short-term gain even though section 751(a) also operates to convert any built-in gain attributable to those assets into ordinary income, thus potentially duplicating (or worse, if the contributed cash and hot assets were assets without any built-in gain) adverse tax consequences for noncorporate taxpayers.[16] This feels like the wrong result.

Fortunately, this rule is turned off for hot asset contributions if the contributing partner "recognizes ordinary income or loss on account of such a Section 751 asset in a fully taxable transaction."[17] In other words, since section 751(a) already denies capital gain treatment for the portion of the seller's gain attributable to the partnership's hot assets, there is no need to create a double whammy by also sticking the seller with a partially short-term holding period in its partnership interest because of its contribution of the same hot assets immediately before the sale. Thus, magically, a mixed holding period issue can be reduced or eliminated entirely by forcing a small amount of gain or loss recognition for assets that would normally produce zero gain or loss.[18] This seemed like a contrived solution to a flawed rule, but the buyer didn't care much and the sellers got their wish.

D. Class IV

Class IV is inventory. Here, the seller's tax basis is likely close to book value regardless of whether the seller is on the accrual or cash method, since it paid something for the inventory originally. It is also possible for the seller's tax basis to exceed the FMV of actual inventory on hand if the inventory has depreciated in value or been tracked using the last-in, first-out method.[19]

On the other hand, if the seller is a retailer that buys its inventory at wholesale prices but then marks it up for resale at retail prices, the buyer may want the allocation method to require that an amount equal to net book value (or tax basis) plus a markup (say, 30 percent or more, depending on the expected profit margin on resale) be allocated to Class IV. Otherwise, the buyer again faces the sad prospect of recognizing gain on inventory soon after buying the business. (On the flip side, if a markup is used, the seller would be forced to recognize ordinary income to the extent of the markup, which may prompt an objection if the seller is an individual sensitive to the tax rate difference between ordinary income and capital gain.) Bottom line: In a deal that is inventory-intensive, you need to talk to accountants who are doing financial and tax due diligence, as well as the client's businesspeople, to figure out what approach should be taken for Class IV in your proposed exhibit. Note that if your deal has a purchase price adjustment based on net working capital, the amounts used by accountants for that adjustment generally should also be used for the section 1060 allocation, to the extent relevant.[20]

Class IV is also sometimes the break point in the section 1060 allocation waterfall, where one may simply run out of purchase price. This "bargain purchase" problem is often the case in a fire sale of a distressed business, either as part of a bankruptcy or a liquidation. Not much can be done about this; clever drafting cannot create more purchase price out of thin air. However, a buyer that is focused on modeling the post-closing tax profile of the business should ask accountants to prepare a tentative section 1060 allocation to figure out whether it will be faced with a "day 2" taxable income problem upon

[16] *See* reg. section 1.1223-3(c)(1) and Example 1 of reg. section 1.1223-3(f). For example, suppose the sellers contributed goodwill (with basis of zero and a value of $100) with a long-term holding period and receivables (with basis and value both equal to $50) with a short-term holding period to the partnership. Even though all the sellers' gain on the sale of the partnership interests is attributable to goodwill and none of it is subject to section 751(a), the mixed holding period rules could result in one-third of the gain being treated as short-term gain, subject to the exception discussed *infra*.

[17] *See* reg. section 1.1223-3(b)(4); Example 2 of reg. section 1.1223-3(f).

[18] Arguably, the policy of this recognition exception should not require any gain or loss, as long as the partnership interest was sold in a fully taxable transaction. Accordingly, some practitioners take the position that this rule applies even when hot assets are sold for an amount equal to their basis, *i.e.*, zero gain or loss is recognized.

[19] *See generally* section 472. One of the requirements for adopting the LIFO method for tax purposes is that the taxpayer must also use LIFO for book purposes. *See* section 472(a) and reg. section 1.472-2(e).

[20] However, one potential pitfall in blindly following the accountants' net working capital numbers is that they usually don't take into account separate entities. If the asset deal includes stock of a corporate subsidiary, the assets of that subsidiary (*e.g.*, cash and receivables) would be included in the net working capital calculation but should not be included in the section 1060 allocation. For tax purposes, the asset being purchased is the stock of that subsidiary.

monetizing inventory (or Class III receivables, in an even more dire case), and, if so, the extent of this problem. Ironically, if the buyer is dissatisfied with the answer and decides to reduce the purchase price, that would only exacerbate the potential day 2 tax leakage.

E. Class V

Class V is a catchall category that picks up all remaining assets (other than section 197 intangibles). This includes equipment such as trucks and computers, real property (both land and buildings), and illiquid investments (for example, a minority investment in another company). Some of these assets are nondepreciable; others can be depreciated, but at different speeds, depending on their prescribed useful lives and the depreciation method used. Mindful of the taxpayer's fiasco in *Peco Foods*, it may be wise to provide for a single number assigning an aggregate value to all Class V assets and figure out the details later (without necessarily having to agree with the other side on values assigned to specific assets).

That said, stating a value for certain assets (perhaps in a separate document) may be unavoidable if their sale triggers a transfer tax, which is typically due promptly after the closing. Aside from transfer taxes, some buyers are keen to lock in a specific value for an asset that they intend to resell quickly, such as real estate — if maintaining ownership is not essential for the business. (Often, a buyer executes a sale-leaseback soon after the closing, thus recovering a portion of the purchase price it has paid.) Of course, pushing more purchase price to a particular asset may mean less purchase price available to allocate to other assets, especially if there is a risk of running out of purchase price before all Class V assets are fully covered. As one example, a Class V entry in a recent deal read as follows:

> Net book value (determined in accordance with [generally accepted accounting principles]) plus 10 percent for Class V fixed assets other than land, and net book value for all other Class V assets, *provided* that $5 million shall be allocated to Blackacre.

In other words, let's first make sure we have Blackacre fully covered, and then any remaining purchase price can be spread across the other Class V assets (if there is enough purchase price to go around), with the further wrinkle that land gets an allocation of book value while other assets (for example, building and fixtures) get an allocation of book value plus 10 percent. Presumably, that was motivated by the fact that land is not depreciable, while buildings and fixtures are depreciable, and fixtures may even be eligible for bonus depreciation.[21]

What about the seller's tax concerns? From time to time, sellers request that Class V allocations be based on tax basis (sometimes referred to as "tax value") rather than book value. This is an attempt to avoid depreciation recapture on the sale of depreciable property, which is taxed as ordinary income under section 1245. Since tax basis is typically lower than book value (because tax depreciation is typically more accelerated and front-loaded than book depreciation) or, for that matter, FMV, this method is questionable and could have a detrimental impact on the buyer. Instead of getting more basis in depreciable assets, the buyer may end up with more basis shifted to Class VI and VII intangibles, which are amortized more slowly (over 15 years and using the straight-line method).[22]

On balance, unless the buyer intends to quickly resell some of the Class V assets, the seller has more at stake here. Its tax detriment from allocating an incrementally greater amount to depreciable assets instead of goodwill is a permanent difference in the tax rate applicable to its gain on the asset sale (37 percent on ordinary income versus 20 percent on long-term capital gain, assuming an individual seller). For the buyer, the difference is mostly timing — front-loaded deductions in the early years versus deductions spread out over a longer period. Character is not in play for the buyer in this transaction — either way, the depreciation or

[21] *See* section 168(k).

[22] *See* section 197(a).

amortization deductions will reduce ordinary income earned post-closing.[23] Finally, if the IRS were to challenge this allocation, the seller bears all the downside risk. Therefore, although allocating based on tax basis does not feel right from a technical perspective, the buyer is sometimes willing to accept the seller's proposal and move on.

F. Class VI and Class VII

Class VI and Class VII both cover section 197 intangible assets. The buyer is generally indifferent about how the remaining purchase price is split up among these two buckets. Either way, this amount is usually amortized over 15 years unless an exception applies (for example, the antichurning rules of section 197(f)(9)). For this reason, our sample exhibit above lumped classes VI and VII together in a single entry, as does Form 8594.

But as we saw in Class V, sellers are more sensitive because certain items in Class VI may give rise to ordinary income. The most frequent source of tension is whether anything should be allocated to a covenant not to compete (a noncompete), in a deal that includes such a covenant. A deep dive into the large body of case law on the taxation of noncompetes is beyond the scope of this article. Suffice it to say that if an amount is specifically allocated to the noncompete, this portion of the purchase price would be taxable to the seller as ordinary income.[24]

Sometimes, sellers try to insert language saying that no amount shall be allocated to the noncompete or designate a specific nominal amount (say $50,000) to try to minimize the damage. While the buyer would have no tax problem with doing so (because it is indifferent as between the noncompete or goodwill), its corporate lawyers don't love it because this language suggests that inadequate consideration was paid for the noncompete. This could be used by the seller later to argue that the noncompete is not enforceable.

One potential compromise would be to sidestep the issue of the value of the noncompete by saying that the parties will not allocate specific amounts to *any* intangibles. Consider the following sample:

> The parties hereby agree that (i) they will not assign a specific dollar value to any particular identifiable intangible in Class VI, and (ii) they will not assign an aggregate value to Class VI assets or to Class VII assets, but shall instead use a combined aggregate value for Class VI and Class VII assets.

Form 8594 attempts to combat such obfuscation by asking the following questions in line 6:

> In the purchase of the group of assets (or stock), did the purchaser also purchase a license or a covenant not to compete, or enter into a lease agreement, employment contract, management contract, or similar arrangement with the seller (or managers, directors, owners, or employees of the seller)?. . . . . . Yes ___ No ___
>
> If "Yes," attach a statement that specifies (a) the type of agreement and (b) the maximum amount of consideration (not including interest) paid or to be paid under the agreement. See instructions.

After asking numerous tax return preparers how they handle line 6 in a deal that includes a noncompete but (like most deals) does not include a specific allocation, I have yet to hear a satisfactory answer. It appears that most people answer "No" on the theory that the noncompete was not separately "purchased" but was simply ancillary to the asset deal.[25]

This brings us to one final point that affects the entire allocation process: Who should draft the initial allocation, and what standard should govern objections and disputes? Recall that the sample "Section 2.09" we saw at the outset lets the

[23] However, note that a buyer that plans to resell some of the purchased assets in the future may face a potential character difference that could cause it to favor Class V over Class VI. Amortization of intangibles is generally recaptured as ordinary income on exit under section 1245(b)(8), which is not necessarily true for depreciation of fixed assets that are subject to section 1250 rules.

[24] *See, e.g.*, Rev. Rul. 69-643, 1969-2 C.B. 10.

[25] *But see* reg. section 1.1060-1(b)(7) (noncompete "is treated as an asset transferred as part of a trade or business").

buyer take a first crack at the allocation, then the seller can object, and if we don't agree we end up with an independent accountant as the arbitrator. (This assumes the buyer feels up to the task; the seller should be more familiar with the assets that it is selling and is likely more capable of preparing the initial allocation.) Sometimes, sellers that are sensitive to the potential detriments of allocating too much to assets that produce ordinary income insist on preparing the first draft. In most cases, this should be fine.

On rare occasions, the seller also tries to put a thumb on the scale by saying that its draft must be accepted (either *ab initio*, or in arbitration after a dispute arises) unless its position has "no reasonable basis." Of course, this is a lesser standard than "more likely than not" and would be objectionable to most buyers. That said, when the stakes are asymmetrical and the downside of an IRS challenge rests with the seller, this is not a crazy request.

IV. Other Issues With Section 1060 Allocations

Now that you have finished your initial draft of the purchase price allocation method exhibit and are ready to negotiate it with the other side, let's pause on a few additional issues that often pop up during these negotiations.

A. Purchase Price Adjustments

What happens if the purchase price is subsequently adjusted? In most deals, there is some kind of a post-closing adjustment mechanism, normally centered on working capital and debtlike items (which can be estimated before the closing but typically are not definitively quantified until sometime after the closing). Also, many deals feature deferred contingent payments, such as an earnout payable after one year or more, which are generally excluded from the initial purchase price reported on Form 8594. Treasury regulations make clear that, in such a case, the parties must update the initial allocations by filing a supplemental Form 8594 with their tax returns for the year in which the purchase price is adjusted.[26] To avoid any attempts by either party to renegotiate the allocation principles that were previously agreed upon, it is prudent to specify in the relevant provision of the asset purchase agreement that the exhibit you drafted governs both the initial allocation and any updates that may be needed later:

> The Price Allocation shall be amended by the parties, consistent with the procedures set forth herein and the methodology set forth in Schedule 2.09, to reflect any subsequent adjustments to the consideration paid pursuant to this Agreement, and Buyer shall deliver such draft amendments to Seller as soon as reasonably practicable following any such adjustments.

B. Multiple Sellers or Buyers

What if there are several seller entities, or several buyer entities, albeit wholly owned by the same parent entity in each case? This can happen when the relevant assets are scattered across various subsidiaries in the seller's consolidated group, or when the buyer needs to put certain assets into different entities for regulatory, tax, or other reasons. Do you need multiple Forms 8594 and several distinct allocations?

Treasury regulations are silent on this point. If a single buyer and single seller are involved, the key threshold inquiry (to determine whether section 1060 applies at all) is whether the purchased assets constitute a trade or business, determined by aggregating all transfers "from a seller to a purchaser" in a series of related transactions.[27] After clearing that initial hurdle, we are told the following:

> If the assets transferred *from a seller to a purchaser* include more than one trade or business, then, in applying this section, all of the assets transferred (whether or not transferred in one transaction or a series of related transactions and whether or not part of a trade or business) are treated as a

[26] *See* reg. section 1.1060-1(e)(1)(ii)(B).

[27] *See* reg. section 1.1060-1(b)(5).

single trade or business.[28] [Emphasis added.]

This regulation makes it clear that if only two parties are involved,[29] a single section 1060 allocation is warranted, but it leaves open the question of what happens if assets are coming from multiple entities or being bought by multiple entities.

The answer can make an important difference if, for example, there is a bargain purchase of a distressed business from A by B, while C is separately selling a valuable asset (say, a building) for a fair price to D, who intends to flip that property shortly thereafter. In that case, the affiliated buyers (B and D) would likely prefer to treat the transactions as two separate asset deals and prepare two separate section 1060 allocations to avoid the risk that there is not enough purchase price (if both deals were lumped together) to reach Class V and provide D with full basis in the building. It may be wise to legislate two separate allocations explicitly in the contract if the overall transaction is governed by a single asset purchase agreement, just in case the sellers have a different vision. If both sides agree on bifurcated treatment, it is also helpful to follow the correct formalities — separate funds flows between A and B versus C and D, separate bills of sale, and so on.

C. Multiple Selling Jurisdictions

The potential stakes for both sides become even more elevated if assets are coming from different jurisdictions. In that case, multiple taxing authorities are entitled to tax the sale, and each will have an incentive to argue that more purchase price should be allocated to assets located in its country. The seller, on the other hand, may have an incentive to push more purchase price to countries where the tax rate is relatively low, or where its selling entity has net operating losses or other tax attributes that could offset the gain on sale. (Of course, the buyer may also not be indifferent as to whether it gets more basis in Canadian or Mexican assets, for example.) This is not so much a matter of getting the section 1060 allocation right among various asset classes,[30] but rather making sure that correct portions of the overall purchase price are paid to each local seller entity for the assets that particular entity is selling. The parties should agree on an explicit apportionment of amounts paid to each jurisdiction, and ideally have some justifiable method (for example, based on respective earnings before interest, taxes, depreciation, and amortization of each selling subsidiary, or other similar metrics). Things get even more complicated if there is a purchase price adjustment, which again needs to be apportioned among various sellers in different countries unless it can be specifically traced to assets or liabilities transferred from a particular country.

D. Income to the Buyer?

Sometimes buyers worry that their assumption of a liability such as deferred revenue in an asset deal, for which purchase price paid to the seller is reduced, could be viewed as (1) a deemed payment from the buyer to the seller in the amount of the purchase price reduction, followed by (2) a payment of a fee by the seller to the buyer in the same amount for assuming the liability. This could create the unfortunate result of the buyer incurring taxable income at closing, even though it may be able to defer the recognition of that income and offset it later with deductions related to the performance of services or delivery of goods giving rise to the deferred revenue obligations. The concern originates from some old case law and revenue rulings concerning prepaid subscriptions,[31] although most commentators believe the correct treatment is for the buyer to simply capitalize the assumed liability into asset basis without recognizing any income.

One buyer who seemed concerned enough about this issue included the following in the section 1060 allocation principles exhibit:

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[28] *See* reg. section 1.1060-1(b)(6).

[29] For this purpose, one should assume that several disregarded entities acting as buyers (or sellers) but owned by the same regarded entity would be a single buyer (or seller) for income tax purposes and therefore subject to this "single allocation" rule.

[30] Keep in mind that section 1060 is only relevant in the United States and has no bearing on how Canada or Mexico may tax the asset sale or require purchase price to be allocated among the assets.

[31] *See James M. Pierce Corp. v. Commissioner*, 326 F.2d 67 (8th Cir. 1964); Rev. Rul. 71-450, 1971-2 C.B. 78.

> For the avoidance of doubt, no liability assumed or deemed assumed in connection with the transactions contemplated by the Agreement shall be treated as a fee paid to Buyer in a manner analogous to the holding in [*James M. Pierce Corp.*].

This seems innocuous to agree to, from a seller's perspective. Even without any imputed fee treatment, the seller generally should get a deduction for a deductible liability being assumed by the buyer.[32]

E. Whose Goodwill Is It?

In some cases, sellers may ask for a separate allocation of a portion of the purchase price to "personal goodwill" of a business founder as an asset that is owned, and is being sold, by that founder in their individual capacity rather than by the selling entity that holds all the remaining assets of the target business. This is usually an attempt to minimize taxes incurred at the selling entity's level, if that entity is a C corporation or has a less favorable state and local tax profile than the individual founder (for example, if the founder lives in a state that does not impose any income tax). Occasionally, sellers may also advocate for personal goodwill sale treatment in cases in which a valuable employee has been promised a slice of the sale proceeds but has no formal ownership interest in the business, such that a payment of sale proceeds to that employee would normally be treated as compensation taxed at ordinary income rates.

Although there is some authority for respecting a sale of personal goodwill in appropriate cases,[33] the buyer should examine these claims very carefully before agreeing to any bifurcation of the purchase price. If the seller of personal goodwill will be employed by the buyer post-closing, payments to that individual could be recharacterized as compensation (for example, a sign-on bonus), exposing the buyer to potential liability for unpaid payroll taxes and failure to withhold on employee wages.

F. Earnouts

Similar concerns arise when the purchase price includes contingent payments to be made post-closing and they can be forfeited by certain sellers who are expected to remain employed by the acquired business but are not so employed by the time the deferred payment is due. Depending on the facts, the IRS may argue that those payments are disguised compensation and do not constitute purchase price at all. The buyer may actually prefer this recharacterization because compensation is generally deductible immediately upon payment, whereas purchase price treatment merely increases the buyer's basis in purchased assets (which is, at best, recoverable over time in the form of depreciation or amortization deductions). However, the individual sellers usually insist on treating those amounts as sale proceeds (once again driven by the disparity in tax rates applicable to ordinary income versus capital gain) and sometimes require that sale treatment be explicitly agreed to in the contract regarding the deferred payments (to ensure that the buyer will not withhold taxes on them). Since the buyer is keen on retaining these valuable employees (which is why the deferred proceeds are contingent on their continued employment to begin with), it may choose to bite the bullet and accept the tax risks in order to keep the sellers happy.

V. Conclusion

The purchase price allocation method exhibit is often an overlooked component of an asset deal, and there is a natural temptation to simply clone the "model from the last deal." However, as you parse through the line items on this form, you will soon realize that there is more to it than initially meets the eye. Some of these items can raise serious tax implications, which are often intensely negotiated.

While this article is not a deep dive into the world of section 1060 allocations, hopefully it covers most of the basic issues and will be useful to young practitioners. Before copying and pasting from a precedent, give some thought to the nature of the business being purchased and

[32] *See* reg. section 1.461-4(d)(5)(i) and (g)(1)(ii)(C). *But see Hoops LP v. Commissioner*, 77 F.4th 557 (7th Cir. 2023) (seller's deduction for deferred compensation liabilities assumed by buyer was denied because of section 404(a)(5) requirements).

[33] *See, e.g.*, *Martin Ice Cream Co. v. Commissioner*, 110 T.C. 189 (1998).

consider whether any of the issues described above require further discussion with the client and its accountants. When in doubt, it helps to talk to people who do balance sheets for a living. Good luck! ■