The Importance of Purchase Price Allocations in Asset Acquisitions

Tax Section

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The maxim "don't let the tax tail wag the business dog" is often bandied about in the business world. Tax attorneys know, however, there are times, such as in Section 1060 allocations in asset acquisitions, when tax issues are an important part of the business negotiation.

Section 1060 applies when a business sells assets constituting its trade or business. Asset acquisitions can be more attractive to a purchaser than stock acquisitions because of its concerns about hidden liabilities associated with the stock. Additionally, purchasing assets directly increases the tax basis in the assets to a cost basis consistent with the purchase price. This step-up in basis translates to larger depreciation deductions for the purchaser, resulting in long-term tax savings. In contrast, a stock acquisition results only in an increased basis in the stock itself, not in the underlying assets of the company. Since stock cannot be depreciated, this increased stock basis remains unused, for the most part, unless and until the stock is later sold. If a purchaser and seller agree to an asset acquisition, how the purchase price is allocated among the purchased assets is important. That is where Section 1060 comes into play.

There is generally an adversarial interest between seller and purchaser in an asset acquisition. The purchaser wants to allocate as much of the total purchase price as possible to inventory (to minimize its gain on that inventory's future sale) and to equipment and other depreciable assets to increase depreciation deductions. In contrast, the seller generally prefers to allocate as much of the purchase price as possible to goodwill to minimize ordinary income. Goodwill is the value of the established reputation and operations of a business, and is a capital asset. Gain from its sale is generally taxed at favorable capital gains rates (assuming the seller is not a C corporation). Thus, allocating value to goodwill results in less tax to the seller than allocating the purchase price to non-capital assets such as inventory or depreciated equipment. The IRS generally respects an allocation agreed on by the parties if they negotiated at arm's length. Section 1060 allocations are an important negotiation point in drafting an asset purchase agreement.

After an asset purchase, the parties are both required to file IRS Form 8594 with their federal income tax returns for that year. The form lays out the Section 1060 allocation for the transaction. The parties' two forms should be identical. Some asset purchase agreements require the parties' tax return preparers to work together on the Form 8594 or otherwise share with each other their drafts of the form to ensure they are consistent. Because inconsistent filings may trigger an IRS audit, it is beneficial to both sides to get it right and be consistent.

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