# Allocation of Purchase Price Asset classification to maximize return and lessen taxes is part science and part art.

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Allocating the purchase price (total sale price) of a business amongst the various asset components (asset "classes") of a business is usually necessary when a business is sold, whether it is via a stock sale or a non-stock sale.

This article discusses the Allocation of Purchase Price for the sale of a non-public corporation and the sale of other business entity types, such as sole proprietorships, partnerships, LLC's and LLP's. The audience for this article are business brokers and professionals dealing in "Main Street" business brokerage transactions (usually less than $2 million sale price; usually the buyer is an individual or a partnership).

In the sale of a business, we are usually selling an ongoing concern, thus we are usually dealing with one of the following:

- The sale of the stock of a corporation, or
- The sale of the tangible and intangible assets of a corporation, or another business entity, e.g., a sole proprietorship, a partnership, an LLC or LLP.

With respect to Allocation of Purchase Price for a *non-public corporation*, the first consideration is usually whether the sale is to be a *stock sale* or a *non-stock sale*. A non-stock sale is frequently referred to as an "asset sale." Unfortunately, there are at least two commonly used definitions of an "asset sale":

- The sale of most, or all, of the tangible and intangible assets of an ongoing business concern.
- The sale of some, or all, of the fixed assets (only) of a business, which is also referred to as the "liquidation" of assets. In this scenario, oftentimes the business is closed, or about to close.

Allocating the purchase price to specific assets in a business acquisition transaction is part science and part art. The science comes into play with regard to following the rules that the Internal Revenue Service has established, as well as documenting the assumptions and support that were used. The art comes into play with regard to allocating value to the intangible assets that are present in most ongoing businesses. Key points being:

- Internal Revenue Code (IRC) Section 1060 and Reporting Requirements (Form 8594)
- Dealing with hard ("tangible") assets
- Dealing with intangible assets
- The real world (purchase price negotiated first, then the pieces are given values)

It is important that both the seller's and the buyer's tax advisors are consulted when the allocation is being negotiated. Frequently, the Allocation of Purchase Price can become another area of negotiation after the price, terms and conditions of the sale have been agreed to by the buyer and seller. Since the typical tax impacts are "whatever is good for the seller is bad for the buyer, and vice versa," occasionally the *Allocation of Purchase Price* negotiations can be as critical as the purchase price negotiations.

In both Stock Sales and Non-Stock Sales, the sale usually includes all the assets of the business including, but not limited to all equipment, trade fixtures, leaseholds, leasehold improvements, contract rights, business records (with seller retaining a reasonable right of inspection), licenses, franchises, customer list, goodwill, covenant not to compete, trade secrets, trade names, telephone numbers, supplies, work in progress ("WIP"), saleable and consumable inventories, plus training on managing the business from the principals/seller. A non-stock sale frequently does not include accounts receivable, bank accounts, deposits, cash, or most business liabilities.

# Stock Sale - Allocation of Purchase Price

In a stock sale, the corporation is the legal "owning entity" of the company, and the purchase price may be allocated completely (100%) to the sale of the stock. However, in tightly held non-public corporations, the purchase price is frequently allocated to the company's stock in addition to "service contracts" or "service agreements" such as:

- Value of the stock
- Value of the Covenant Not to Compete, which is provided the buyers from key individuals selling the corporate stock
- Value of Training, which is provided the buyers by the key individuals selling the corporate stocks who also manage/operate the company

Due to the current U.S. tax structure, sellers usually prefer to have most (if not all) of the purchase price allocated to the value of the stock, since that is usually taxable at Capital Gains tax rates, and that tax rate currently is usually much more favorable than the seller's Ordinary Income tax rate. Of course, buyers usually prefer to minimize the value attributed to the stock in order to place larger values to the Covenant Not to Compete and the Training & Transition, since the covenant and training values allow the buyers to "write off" those portions of the overall purchase price.

# Non-Stock Sale - Allocation of Purchase Price

When the buyers are purchasing the tangible and intangible assets from a corporation, or purchasing the business from a sole proprietor, a partnership, an LLC or LLP, the purchase price is usually allocated to some, or all, of the following components:

- Tangible Personal Property (trade fixtures, furniture, equipment)
- Leasehold Improvements
- Value of Premise Lease (if the lease is at below market rent)
- Covenant Not to Compete (include time and distance of covenant)
- Training & Transition (include schedule of time, hours, etc.)
- Registered Vehicles (do not include in Tangible Personal Property above)
- Liquor License (include license type and number)
- Customer List
- Goodwill
- Buildings
- Land
- Inventory

The total value allocated to all of the appropriate assets should equal the total of the purchase price. IRC Section 1060 further delineates specific items included in each of the seven "classes" of assets.

Please be aware in states that collect sales tax on both (1) the tangible personal property ***and*** sales tax associated with (2) the transfer of vehicle licenses, it is very important that the value of the Registered (licensed) Vehicles not be included with the other Tangible Personal Property on the allocation, lest the escrow officer may inadvertently collect sales tax on the licensed vehicles in escrow while the buyer will again have to pay sales tax to the licensing department when they re-register the vehicles to the new owners/buyer.

# Tax Implications - General Guidelines

*(as of January 2001, Federal Taxes only; State Taxes additional)*

## Stock Sales

Value placed on ***Stock:***

- Seller: Capital gains tax rate (currently at 15%) for stock held more than one year
- Buyer: No write off; must accept assets at current book value (i.e., existing depreciation schedule)

Value placed on ***Covenant Not to Compete:***

- Seller: Ordinary income to recipient (is considered personal to seller/principal)
- Buyer: Amortize value over 15 years

Value placed on ***Training/Consulting Agreement:***

- Seller: Ordinary income to recipient
- Buyer: Expense out as paid

## Non-Stock ("asset") Sales

Value placed on ***Tangible Personal Property*** (trade fixtures, furniture, equipment)***:***

- Seller: If held more than one year, the gains in excess of depreciation are long-term capital gain; otherwise ordinary income
- Buyer: Establishes basis, depreciate per IRS schedules

Value placed on ***Leasehold Improvements:***

- Seller: If held more than one year, the gains in excess of depreciation are long-term capital gain; otherwise ordinary income
- Buyer: Establishes basis, depreciate per IRS schedules

Value placed on ***Premise Lease*** savings (if the lease is at below market rent, it is an intangible asset)***:***

- Seller: If held for more than one year, is long-term capital gain
- Buyer: Amortize value over 15 years

Value placed on ***Covenant Not to Compete*** (include time and distance of covenant)***:***

- Seller: Ordinary income as received
- Buyer: Amortize over 15 years

Value placed on ***Training/Consultation*** (include schedule of time, hours, etc.)***:***

- Seller: Ordinary income as received
- Buyer: Expense out as paid

Value placed on ***Registered Vehicles*** (do not include in Tangible Personal Property above)***:***

- Seller: If held more than one year, the gains in excess of depreciation are long-term capital gain; otherwise ordinary income
- Buyer: Establishes basis, depreciate per IRS schedules

Value placed on ***Liquor License*** (include license type and number; is an intangible asset)***:***

- Seller: If held for more than one year, is long-term capital gain
- Buyer: Amortize over 15 years

Value placed on ***Customer List:***

- Seller: Ordinary income as received
- Buyer: Amortize over 15 years

Value placed on ***Goodwill:***

- Seller: If held for more than one year, is long-term capital gain
- Buyer: Amortize over 15 years

Value placed on ***Buildings:***

- Seller: If held more than one year, the gains in excess of depreciation are long-term capital gain; otherwise ordinary income
- Buyer: Establishes basis, depreciate per IRS schedules

Value placed on ***Land:***

- Seller: If held more than one year, the gains in excess of depreciation are long-term capital gain; otherwise ordinary income
- Buyer: No immediate tax impacts

Value placed on ***Inventory:***

- Seller: Ordinary income, to the extent that it is over basis
- Buyer: Treated as "cost of goods sold" upon sale of products

# Key Points

- Consistency between the seller and buyer in their reporting of the allocation is important. Work with professionals (licensed and/or accredited Brokers, CPA's, attorneys) in these transactions to save you time and money down the line. Tax laws change frequently, so treat this article as a guideline subject to change by the IRS, and subject to interpretation by the appropriate professionals/advisors.
- The larger the transaction the more likely there will have to be a formal valuation performed, wherein some, or many of the various asset values may be indicated.

About The Author

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