Considerations for an Asset Purchase Transaction

A business that is contemplating the acquisition of another business is faced with a variety of options with regard to how to structure the transaction. The most common form of small business acquisition is an asset purchase, where the buyer obtains the underlying assets of a business without assuming its liabilities. This article will walk you through a sample asset purchase from the buyer's perspective to highlight some of the salient components of such a transaction.

In an asset purchase, the buyer's primary tax concern is to apportion as much of the purchase price as possible to those assets that will depreciate the fastest. Section 167 of the Internal Revenue Code provides for a depreciation deduction of certain property from taxable gross income, therefore, the shorter the depreciation period is, the sooner the buyer receives that benefit.[1] Each type of asset to be acquired in the transaction must be analyzed individually to determine its priority to the buyer.

The first category of assets, and one that is often an element of this type of transaction, is inventory and fixed goods, which is where the buyer would like to apportion as large of a share of the purchase price as possible. Inventory assets provide the best benefit to the buyer because their cost can be expensed as soon as the inventory is sold in the course of the business, thereby reducing the buyer's taxable gross income from sales. Similarly, according to §168(e)(3)(C), fixed goods (e.g., equipment) are depreciated over a relatively short 7-year period of time. The second and third categories of assets in this transaction are goodwill and a non-compete covenant. Both of these categories are considered intangible assets, which provide the buyer with a period of time over which the assets can be amortized (essentially depreciation for intangible assets). According to §197(d), goodwill and any covenant not to compete must be amortized over a 15-year period. Thus, when presented with the above categories of assets, a buyer's preference would be to apportion primarily towards inventory, then fixed goods, and finally to goodwill and the non-compete agreement.

However, there are two critical restrictions on the buyer's ability to allocate the purchase price; both are found in §1060. The first is that the buyer and seller must agree to the structure of the allocation of the purchase price or to the fair market value of assets being transferred. The second restriction on the buyer's apportionment is also found in §1060 and its accompanying Treasury regulations, which provide for a residual allocation method. According to this method, there is a 7-class hierarchy to which assets are assigned, preventing the possibility of a free-for-all allocation of the entire price to one asset or any other blatant misappropriation effectuated purely for a tax benefit. Of the assets being considered in this transaction (inventory, fixed goods, goodwill, and the non-compete agreement), inventory ranks highest (Class IV) in the §1060 residual allocation hierarchy. Therefore, the agreed upon fair market value of the inventory assets will be the first amount allocated out of the total purchase price. The remainder of the purchase price after the allocation to inventory will then flow to the agreed fair market of the fixed goods (Class V). Finally, the remainder is then allocated to whatever values are determined for the non-compete agreement (Class VI), and the goodwill (Class VII).

It should be noted that since the buyer is indifferent in a tax sense to the values of the goodwill and the non-compete agreement, that this may be a critical position in the negotiations where the buyer and seller can agree to allocate more to goodwill because of its benefit to the seller. From the seller's perspective goodwill is a capital asset and would therefore generate a more favorable capital gains tax for the seller than the non-compete agreement, which would be taxed as ordinary income at a higher rate. As stated, this has no bearing on the buyer's tax consequences and would show an effort by the buyer to ease seller's own tax burden, hopefully adding to the amicability of the transaction and perhaps leading to the seller's agreement to more buyer-friendly valuations.

[1] All references to section numbers in this article refer to the Internal Revenue Code.

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Finally, with regard to the buyer's basis in the purchased assets going forward from the date of the transaction, §1012 states that the buyer's basis in the acquired assets shall be the same as the consideration paid for such property. Therefore, at the time of the transaction, the basis of each asset to the buyer should equal their corresponding fair market values.

This provides a brief overview of some of the issues encountered by businesses that are engaging in an asset purchase transaction. Depending on the specific factual situations of each business, there may be numerous other considerations, so it is important to consult with a legal professional to ensure that the transaction is properly, and most beneficially, executed. For assistance related to a matter similar to the one discussed above, or any other legal matters, please contact General Counsel, P.C. at (707) 556-0411 or via e-mail at info@generalcounsellaw.com.

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