With the new tax bill now official, companies making acquisitions that are asset purchases (or treated as asset acquisitions for tax purposes) will want to pay close attention to the agreed-upon purchase price allocation. Given the ability to expense acquired personal property assets immediately, acquirers could enjoy a significant tax benefit by maximizing the amount of the purchase price that is allocated to non–real property assets.

The Old Environment

The ability to step-up assets to fair market value (FMV) as part of a taxable acquisition has been incorporated by acquirers for quite some time. A transaction involving the acquisition of assets, or treated as an asset acquisition through, for example, a Section 338(h)(10) election, provides the acquirer with the ability to depreciate the acquired tangible assets based on their respective FMVs. For capital-intensive targets, this often provides a significant financial benefit for acquirers, given that the FMV of an asset is typically higher than its tax basis. However, it is worth noting that a step-up in asset value is often a contentious point for sellers, as it can result in more tax to the seller due to a shift in tax character and/or recapture. Keep this important point in mind as we discuss the effect of the new tax law.

What Changed?

With the new tax bill, the impact of capital expensing comes into focus for any taxable acquisition. Why? First, the new tax bill allows companies to immediately expense capital expenditures for a five–year period, retroactively effective as of September 27, 2017. This alteration to the depreciable system does not include a permanent expensing provision, but rather an allowance for 100 percent bonus depreciation, which is similar yet has its limitations. Second, and perhaps the most substantial change to depreciable lives in the tax bill, is that bonus depreciation is now expanded to allow for the eligibility of “in–use” assets, which had been previously exempt from bonus altogether. This is a significant change, as it will motivate buyers to attempt to allocate more of the total purchase price of a business to personal property assets in the purchase price allocation negotiations.

The Need for a Cost Segregation Study

Immediate write–offs are not exactly new, as 100 percent bonus depreciation was in effect for the entirety of 2011 and the last quarter of 2010. The basic rules of bonus still apply, and the tax bill does not change the general Section 168(k)(2)(A)(i) requirements of qualified property, meaning assets must have a life of 20 years or less. Section 1250 property — or buildings — are still excluded from this benefit. Section 1245 property, which is usually depreciated over 5, 7 or 15 years, will be the primary beneficiary of this provision. Capital–intensive industries (e.g., telecommunications or mining) would especially benefit from immediate expensing. Bonus depreciation had been set to gradually phase out by the end of 2019. A reinvigorated five–year window will now allow companies to plan accordingly and take advantage of the benefit to the fullest extent in the near future. After the five–year period has lapsed, bonus is scheduled to scale back at a rate of 20 percent per year thereafter until complete phase–out.

The mechanism to appropriately support the reclassification of assets from 39 or 27.5 years to a 5–, 7– or 15–year life is through a cost segregation study. A cost segregation study is conducted in order to identify and segregate property into its respective U.S. federal income tax recovery class lives. A cost segregation differs from a valuation of the assets, as the cost segregation study is purposed to reclassify assets rather than just ascribing FMV. Thus, acquirers should consider a cost
segregation study at the time of the acquisition to reclassify as much asset value into shorter-lived categories, thereby enabling the immediate expensing of the acquired personal property assets. The simultaneous application of a cost segregation study and FMV analysis of the personal property will maximize the benefit of the new tax law related to immediate expensing of certain assets.

**Negotiating with the Seller**

Let us now revisit the comment we made earlier about the seller not being too pleased with any step-ups to FMV for personal property assets. The flip side to the acquirer being able to depreciate the personal assets (as well as real property over much longer lives) for tax purposes is that the seller may pay more tax based on the step-ups. Given that the seller clearly has no desire to pay any additional taxes, they are not motivated to agree to any step-up. These disparate interests create an issue, given that the acquirer and seller should agree to the purchase price allocation as part of the purchase agreement and have identical allocations on their respective Forms 8594. The key point? To agree with the seller — as part of the purchase agreement — on the allocation of assets for tax purposes. Buyers and sellers often have a clause in the purchase agreement that stipulates a window of time — e.g., within 90 days of the closing of the transaction — to come to an agreement on the allocation of the purchase price. Therefore, it is vital to conduct a cost segregation analysis and valuation of fixed assets of the target company within this window to ensure there is an agreed-upon allocation of assets in the final purchase agreement.

Given the objections of sellers over a step-up in assets to FMV, some acquirers historically did not want to jeopardize the transaction, and would therefore agree to allocate the purchase price based on the tax basis of the fixed assets. However, the ability to immediately expense personal property assets will likely provide too much financial benefit for the acquirer to ignore allocating as much value as possible to personal property assets. As the seller will offer resistance, a common solution is for the acquirer to increase the purchase price to offset the seller's incremental tax liability (often called a "gross-up"). This could result in a win for both parties, as the acquirer still enjoys a tax benefit on the immediate expensing of personal property assets while the seller does not incur any additional net tax liability. We note that the seller should also consider conducting a cost segregation study and valuation of fixed assets to ensure they have also developed a position with regards to the purchase price allocation.

There is also a second and very important reason for agreeing to the allocation of the purchase price as part of the purchase agreement. The U.S. Tax Court's 2012 ruling in Peco Foods, Inc., T.C. Memo. 2012–18 disallowed a taxpayer's changes to a purchase price allocation based on a post-acquisition cost-segregation study. The effect of this ruling is that once the purchase price allocation has been agreed to by both parties, the acquirer is restricted from making any changes to this allocation. Thus, a cost segregation analysis cannot be performed subsequent to an agreed-upon purchase price allocation, as it would in fact change the allocation of assets by reclassifying personal property assets into different asset categories.

The resistance of the seller to a step-up in personal property assets, combined with the inability to subsequently change the purchase allocation, necessitates the need to conduct a cost segregation study and personal property valuation as part of the purchase agreement.

**International Acquisitions**

Acquirers purchasing companies with foreign entities should consider making a Section 338(g) election, which provides a step-up of the acquired assets to FMV. The reason? The new tax bill includes a tax on global intangible low-taxed income that is based in part on the adjusted tax basis of the tangible assets of the controlled foreign corporation. As a Section 338(g) election provides a step-up of assets to FMV, this election will result in an adjusted tax basis of the tangible assets based on FMV, which is typically higher than the prevailing tax basis. The higher adjusted tax basis increases the deemed tangible income return, which, in turn, reduces the global intangible low-taxed income and associated tax.

**Alvarez & Marsal Taxand Says:**

A cost segregation study should be on the mind of anyone who is considering an acquisition of a company with extensive tangible property assets. What immediate action should be undertaken by acquirers in a taxable asset transaction? The answer is to conduct a cost segregation and valuation of personal and real property assets — at the time of the transaction to ensure the allocation of value is included in the purchase agreement — to allocate as much value as possible to non-real property assets.
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Authors:
Philip Antoon, pantoon@alvarezandmarsal.com, +1 212 763 9830
Mark Young, myoung@alvarezandmarsal.com, +1 713 221 3932
Jeffrey Richman, jrichman@alvarezandmarsal.com, +1 202 688 4225