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VALUATION observations

Purchase Price Allocation Impacts on Taxes and Financial Statements

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A time of transition can be a stressful one for many business owners, especially when involving the ownership transfer of a company's assets or stock.

During this process, a purchase price allocation is often obtained to assist both the buyer and seller in the allocation of the purchase price for both tax and financial reporting purposes. The two allocations are similar in many respects, but there are some key differences to understand. Given these differences, it may be beneficial to involve employees from both a company's financial reporting group and tax group in the valuation process. This joint effort can create synergistic savings for the company in relation to the scope of the valuation analyses required subsequent to a transaction. Without coordination amongst these groups, each group may end up completing separate valuation analyses, which is costly and potentially inefficient from a tax and financial reporting perspective.

A recent court case helps to highlight the benefits of pre-planning, coordination, and engaging a valuation professional at the time of the transaction to perform the tax and financial reporting purchase price allocation. In Peco Foods, Inc. ("Peco") vs. Commissioner of IRS ("Commissioner"), both the U.S. Tax Court, and, upon appeal, the U.S. Court of Appeals for the Eleventh Circuit, agreed that for depreciation purposes, Peco could not unilaterally change its original purchase price allocations made in two asset purchase agreements entered into when Peco acquired certain assets at two poultry processing plants.

The background of the case is as follows:

- Peco is engaged in the business of poultry processing. In an attempt to expand its operations, Peco acquired two poultry processing plants.
- 1995 — Peco entered into an asset purchase agreement with Green Acre Farm, Inc., in which the two companies agreed to allocate the $27.15 million purchase price among 26 assets "for all purposes (including financial accounting and tax purposes)" in accordance with the original allocation schedule.
- 1998 — Peco entered into an asset purchase agreement with Marshall Durbin Food Corp., in which the two

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Purchase Price Allocation Impacts on Taxes and Financial Statements (continued)

companies agreed to allocate the $10.50 million purchase price among 3 assets "for all purposes (including financial accounting and tax purposes)" in accordance with the original allocation schedule.

- 1999 — Peco commissioned an appraisal company to conduct a cost segregation study for the two processing plants acquired in 1995 and 1998. The cost segregation study contained revised allocation schedules, subdividing the acquired assets into various subcomponents, which would entitle Peco to take additional depreciation expense of $5.26 million from 1998 to 2002.

After revising its asset purchase agreements and original tax allocation schedules, Peco applied for a change in accounting method with its 1998 tax return in order to adopt a different method of depreciation for its revised asset allocation schedules. Upon doing so, the Commissioner issued notices of deficiency to Peco, disallowing the retroactive adjustments in the allocation schedules.

After petitioning the U.S. Tax Court in response to these notices of deficiency, the U.S. Tax Court agreed with the Commissioner that Peco agreed to, was bound by, and could not modify, the original purchase price allocations set forth in the asset agreements, in order to obtain more favorable tax benefits.

The U.S. Tax Court found that under I.R.C. § 1060(a) where parties to an asset acquisition agree in writing, as to the allocation of any amount of consideration, or, as to the fair market value of any of the assets transferred, that agreement is binding on the seller and buyer, unless the Commissioner determines that the allocation or fair market value is not appropriate. The Commissioner did not dispute the propriety of the original allocation schedules, thus, the U.S. Tax Court only analyzed the enforceability of each agreement upon Peco.

Both agreements contain the statement that the original allocation shall be used "for all purposes (including financial accounting and tax purposes)". Peco argued that both agreements were unenforceable because certain terms used ("Processing Plant Building" and "Real Property: Improvements") were ambiguous and did not encompass certain assets that would be treated as different property classes for tax purposes. The U.S. tax court found that both contracts are enforceable as unambiguous, and Peco is bound by the original allocation schedules and the U.S. Court of Appeals for the Eleventh Circuit affirmed the U.S. Tax Court's judgment by stating that in binding Peco to both agreements, the Commissioner can be assured that both Peco and the respective sellers treat the assets consistently for federal tax purposes.

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While Peco was determined to be bound to the original asset purchase agreement for tax purposes, a company in Peco's situation may not be bound by the asset purchase agreement for financial reporting purposes. Therefore, while an agreement based on the allocation of assets in a purchase agreement may bind a company for tax purposes, it is typically not binding for the treatment of acquired assets for financial reporting purposes.

The issues described in the Peco case are entirely avoidable if proper pre-acquisition planning and coordination takes place. Pre-planning may also provide a company with synergistic cost savings if a purchase price allocation for tax and financial reporting purposes can be performed together. By consulting with a qualified valuation expert with experience in business combinations and a wide range of financial reporting and tax contexts, a company can better understand the specific issues with regards to the allocation of a purchase price for both tax and financial reporting purposes.

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THOMA BRAVO

Thoma Bravo, LLC

Has acquired

SRSsoft

SRSsoft

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Gardner

Gardner, Inc.

Has acquired

Atlantic Power Inc.

Atlantic Power, Inc.

Purchase Price Allocation

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SWISHER

Swisher Hygiene, Inc. (NASDAQ: SWSH)

Has acquired

Savoy

Savoy Linen Service, Inc.

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ADS

Advanced Drainage Systems, Inc.

Has acquired

QUALITY CULVERT

Plastic Pipe Business of Quality Culvert, Inc.

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cgp Chicago Growth Partners

Chicago Growth Partners

Has acquired

MARATHON DATA SYSTEMS

Marathon Data Systems LLC

Purchase Price Allocation

GBQ

cgp Chicago Growth Partners

Chicago Growth Partners

Has acquired

the tie bar

The Tie Bar

Purchase Price Allocation

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DentalEZ

DentalEZ, Inc.

Has acquired

TRIMIRA

Trimira LLC

Purchase Price Allocation

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ENVISIONRx OPTIONS

Envision Pharmaceutical Services

Has acquired

DESIGNRx

Design Rx, LLC

Purchase Price Allocation

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PALMER-DONAVIN

Palmer Donavin Manufacturing Company

Has acquired

Seal-Rite

Seal-Rite

Purchase Price Allocation

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GBQ Consulting is a national valuation practice with offices in New York (NY), Philadelphia (PA), Columbus (OH), Cincinnati (OH), and Indianapolis (IN). Our valuation professionals have extensive experience in the valuation of businesses, business interests, and intangible assets of both privately held and publicly traded companies in a broad range of contexts, including:

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