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The Hazards of (Mis)allocation of Purchase Price

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What is the appropriate allocation of purchase price between the tangible and intangible assets of a business that is being sold and covenants or commitments to provide services by owners of the business?

Under Code section 1060, the amount paid must be allocated under a "residual method," *i.e.*, first to accounts receivable, inventory, and other specified categories of tangible and intangible assets to the extent of the fair market value of those assets, with any amount in excess of the value of those assets being allocated to a residual class of intangibles that includes goodwill. The fair market value of the relevant assets, and sometimes even the question of who is transferring the key assets, remains a subject of frequent controversy on audit and in the courts.

Bemidji Distributing Co. v. Commissioner (TC Memo 2001-260), a recent memorandum decision of the Tax Court, illustrates the potential adverse consequences of specifying an allocation of consideration that is difficult to justify. It also addresses the consequences of payment by a corporate seller of transaction costs arguably incurred primarily for the benefit of its shareholder.

Facts of 'Bemidji' Case

BDC was a Minnesota corporation founded in 1933 that became the largest wholesale beer distributor in Northern Minnesota, with an estimated 53% of wholesale beer sales in its geographic area in 1990. BDC benefited from exclusive distribution rights from Miller Brewing Co., Stroh's Brewing Co., and other breweries.

Cortland Langdon, the president and sole shareholder of BDC, decided in early 1990, when he was 69 years old, to explore a possible sale of BDC. It is not clear from the opinion what motivated Langdon to sell, but it is noted that he did not have any family to whom he wanted to pass on the business; moreover, in light of past difficulties, he wanted to avoid having to renegotiate a Teamsters' union contract that would expire in 1994.

Langdon contacted a broker and appraiser of beer distribution businesses, and agreed to have the broker appraise the business and commence marketing it. The broker appraised BDC's business at almost $2 million.

The broker then assembled an information package to market the business. The package stressed the exclusive distribution agreements that BDC had with its suppliers and assigned estimated values of $765,000 in the aggregate to the accounts receivable, inventory and other tangible property of BDC, and $1,200,000 to "intangibles." The amount allocated to intangibles was "to be allocated among company intangible assets (customer lists, franchise rights, goodwill, etc.) and agreements with owner."

In June 1992, BDC agreed to sell the assets for $2,017,461, and Langdon agreed to enter into a 2-year consulting agreement with the buyer and to grant a 5-year covenant not to compete.

In accordance with the buyer's wishes, the purchase agreement allocated $817,461 to the tangible operating assets and accounts receivable of BDC, $200,000 to the consulting agreement, and $1 million to the covenant not to compete. Nothing was allocated to the intangible assets of BDC. There were no negotiations with respect to the allocation of purchase price.

The sale closed in October 1992. BDC incurred and deducted $107,815 for expenses of the sale transaction, but, so far as is indicated by the opinion, Langdon did not pay any selling expenses. Langdon reported $1.2 million as income on his personal return.

Issues

The IRS issued a notice of deficiency to BDC on the basis that it had failed to report $1.2 million of proceeds from the sale transaction.

The IRS also asserted in the alternative that, if the parties' allocation of consideration was upheld, the selling expenses paid by BDC, to the extent attributable to Langdon's consulting agreement and covenant not to compete, were not deductible by BDC (or otherwise to be taken into account by BDC in computing its gain), but resulted in a constructive dividend to

Langdon. The notice of deficiency determined that the portion of the selling expenses attributable to the consulting agreement and the covenant was about 60%, based on the proportion of the overall consideration that was allocated to the consulting agreement and the covenant. A notice of deficiency was issued to Langdon to include a portion of the payment of selling expenses in his income as a constructive dividend.

The IRS conceded before trial that the consulting agreement had a value of $200,000. Thus, the principal issue was the fair market value of the covenant, which would in turn determine whether the allocation of $1 million of consideration to the covenant would be respected.

Discussion

The court observed in its analysis that "adverse tax interests deter allocations which lack economic reality." Because there were no adverse tax interests between the parties in this case, however, the allocation was subject to strict scrutiny.

Elaborating on this point, the opinion notes that the agreed-upon allocation permitted BDC to avoid the corporate-level tax that would be imposed if the $1 million amount had been paid to the corporation and then distributed to Langdon as a dividend.

The opinion also indicates that, in light of the relatively small differential in effect during 1990 between the tax rates for ordinary income and capital gain, the fact that proceeds from the grant of the covenant to the buyer constituted ordinary income to Langdon rather than capital gain may not have been meaningful to him; in other words, Langdon probably did not have a strong incentive to structure the transaction in a manner that maximized capital gains. The opinion also notes that, under the law applicable in 1992, buyers too generally preferred to allocate consideration to a covenant not to compete, so that its cost could be recovered through amortization over the term of the covenant; by contrast, amounts allocated to goodwill and similar assets were not then subject to amortization.

The opinion described the circumstances relevant to valuing a covenant not to compete as including: the seller's ability to compete; the seller's intention to compete; the seller's economic resources (bearing on his ability to compete); the potential damage to the buyer if the seller does compete; the seller's expertise in the business; the seller's contacts and relationships with customers and suppliers; the buyer's interest in minimizing competition; the period and geographic scope of the covenant; and the seller's intentions to remain in the same area.

The taxpayers argued that the above factors supported the allocation they made to the covenant, but did not support their argument with an expert witness. The government *did* offer the testimony of an expert witness to establish the value of the covenant, but did not address the factors identified by the court.

The court concluded that all or almost all of the factors favored a substantial allocation of consideration to the covenant, citing Langdon's ability to compete, his economic resources to do so, his expertise, the likelihood that such competition would adversely affect the buyer, the buyer's insistence on avoiding such competition by obtaining the covenant, the reasonable duration and geographic scope of the covenant, and Langdon's strong ties to the area and intention to remain there. The only factor favoring a low value for the covenant was Langdon's lack of intent to compete; the court noted, however, that, but for the covenant, he could have changed his mind.

The court also concluded that the existence of the consulting contract did not negate the value of the covenant, noting an earlier Tax Court decision holding that an employment contract for the duration of a covenant not to compete was entitled to some weight (as tending to reduce the separate value of the covenant), but was not dispositive. The government's expert valued the covenant by estimating the potential net income of the business, the extent of the potential loss of business if Langdon competed, and the probability of Langdon's doing so; and concluded that the value of the covenant was $121,000. The discussion in the opinion suggests that the court found the appraiser's credentials and experience to be unimpressive, and the opinion criticized certain of the discounts applied by the appraiser. The court did not, however, dismiss the valuation altogether.

The court agreed with the government that, under the circumstances, it was unreasonable to allocate nothing to goodwill and going concern value. The buyer was acquiring an established and profitable business, with a work force in place, and, in addition to the tangible assets, was acquiring customer lists and exclusive distribution rights. Taking into account the projected income of the business ($1,075,000 over five years) and the likelihood that competition by Langdon would reduce the buyer's business revenue but not prevent the buyer from retaining some of the customers, the court ultimately concluded that the covenant had a fair market value of $334,000. The remaining $666,000 of the $1 million initially allocated to the covenant was treated as received by BDC in exchange for its other intangibles, and then distributed to Langdon as a dividend.

Selling Expenses

The government asserted that the selling expenses paid by BDC should be treated as a constructive dividend to Langdon (and as not deductible by BDC) to the extent allocable to the consulting agreement and the covenant not to compete.

The opinion cites various cases as supporting the conclusion that payment by a corporation of a shareholder's expense will be a constructive dividend, unless it is established that the corporation was the primary beneficiary of the payment.

The court concluded that payment by BDC of selling expenses was not deductible by BDC and was a constructive dividend, to the extent those expenses were attributable to the consulting agreement and covenant, and that the portion so attributable should be determined, apparently, by reference to the portion of the overall consideration allocated to the covenant and the consulting agreement.

Observations

The amounts at issue in *Bemidji* were relatively modest, which suggests that caution is warranted in considering whether the same result would have applied in similar circumstances if, for example, a taxpayer obtained its own expert and fully briefed such issues as, for example, the possibility that the goodwill and customer contacts were largely personal to Langdon (cf. *Martin Ice Cream Co. v. Commissioner*, 110 T.C. 189 (1998)) or the appropriate allocation of selling expenses.

The more important lessons from this case, however, may include the following: that allocations that are almost impossible to justify are likely to be overturned if scrutinized; that attention should be paid to marketing materials and positions taken during negotiation, as potentially affecting the credibility of positions taken thereafter regarding purchase price allocations (or other tax matters); and, with respect to selling expenses, that individual owner/employees of closely held businesses should be urged to make at least a reasonable effort in appropriate cases to determine the portion of selling expenses that is attributable to them and to pay that portion, and should be advised as to the potential consequences if they fail to do so.