Business Combination Accounting for Tax and GAAP Purposes

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Business Combination Accounting, sometimes referred to as purchase price allocation ("PPA"), is an important part of the M&A transaction for both tax purposes and for GAAP accounting purposes. In many cases, determining the value of the assets purchased is necessary for either a security transaction or an asset purchase transaction. The business assets of the entity purchased should be recorded at their current value, either Fair Market Value for tax purposes or Fair Value for GAAP purposes.

Subsequent to all transactions involving a change in control, companies are required to complete business combination accounting (regardless of whether the transaction is structured as an asset deal or a stock deal) for financial reporting purposes. Sections 1060 and 338 of the Internal Revenue Code (IRC) detail procedures for completing PPAs for U.S. tax reporting purposes. Section 754 of the IRC provides similar guidance for organizations structured as limited liability companies or partnerships.

Income Tax Reporting

U.S. tax regulations include PPA requirements only for transactions that are structured as an asset deal (or as a deemed asset sale in the instance in which a transaction is structured as an equity deal, but an election is taken under § 338(h)(10) or § 754 of the IRC). So, if a pure equity deal (neither of §§ 338(h)(10) nor 754 are applicable), then the allocation of the purchase price for the buyer of the equity is not an issue. This follows the reasoning that the buyer maintains the tax basis of the assets in an equity transaction as the transfer is of the equity and not the assets.

Current Federal Tax law requires the buyer and seller to complete a reporting form, Form 8594, which reports the values of the different "Classes" of assets purchased/sold in an asset transaction or deemed asset transaction (heretofore to be). Most asset purchase agreements we see call for the buyer and seller to agree on the allocation of the value to the various Classes of assets. This type of language is likely included in the purchase agreement

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to ensure parity between the buyer and seller to avoid inconsistency in the respective allocation of value. An agreement reached by the parties and memorialized in writing becomes binding upon the parties under the internal revenue code ("IRC") unless the Service determines the allocation to be inappropriate.

The IRC calls for the asset value Classes to be stated at fair market value ("FMV"). The asset Classes of the utmost importance are certain current assets, sometimes referred to as "Hot Assets," which may cause income to be realized in the period of the sale as ordinary income and the fixed assets ("Hard Assets") on which period of sale ordinary income may be recognized due to depreciation recapture.

The asset Classes, which address the intangible assets purchased, including goodwill, are mostly considered to be the "fall-out" after the value is allocated to the Hot Assets and the Hard Assets. The intangible assets, including goodwill, are amortizable over 15 years, no matter the nature or life of the actual asset.

In practice, we typically see a negotiated amount between the buyer and seller for the Hard Assets. That asset Class receives the greatest amount of attention as the seller will usually recognize ordinary income from depreciation recapture, thereby desiring to limit the amount of purchase price allocated to this Class to as little as possible. Conversely, the buyer will likely wish to maximize the amount allocated to these assets as the period for write-off through depreciation is shorter than the 15 years for intangible assets, including goodwill. And, in certain circumstances, the buyer may be able to take accelerated depreciation in the year purchased.

The Hot Asset value is what it is. In most cases, the FMV of the asset is usually equal to the carrying value of the asset. Cash basis taxpayers may be required to report accrual basis amounts (i.e., accounts receivable, accounts payable) in the year of sale as ordinary income items.

Financial Reporting

In the United States, guidance pertaining to completing Business Combination accounting is contained in Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") Topic 805, Business Combinations ("FASB ASC 805" or "ASC 805") and Topic 350, Intangibles – Goodwill and Other ("FASB ASC 350" or "ASC 350"). In 2014, FASB ASC 805 and FASB ASC 350 were amended to provide privately held companies with accounting alternatives to simplify the accounting and reporting process for PPAs. Under Accounting Standards Update ("ASU") 2014-18 and ASU 2014-02, privately held companies have the option to elect certain accounting alternatives related to the recognition and measurement of certain intangible assets (the "Intangibles Accounting Alternative") and the amortization and impairment testing of goodwill (the "Goodwill Accounting Alternative"). This recent guidance for private companies results from efforts of the Private Company Council ("PCC") and resulting FASB endorsements.

Business Combination accounting is required when a transaction or other event takes place in which an acquirer obtains control of one or more businesses. Transactions, sometimes referred to as "true mergers" or "mergers

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of equals," are also business combinations. The definition of a business, for purposes of determining if this requirement is applicable, is defined in ASC 805 as "an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants." Therefore, an asset sale involving the transfer of a business must apply the provisions of ASC 805.

The acquirer shall measure the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree at their acquisition-date fair values. As with the income tax valuation exercise, the Hot Assets are valued, also known as net working capital assets. Usually, the value is the carrying value. Hard Assets are also valued, as is the case in the income tax treatment of the purchase price allocation. The difference arises with respect to the intangible assets and goodwill acquired in the transaction.

Intangible assets are valued if they are identifiable intangible assets. An intangible asset is identifiable if it meets either of the following criteria:

- It is separable, that is, capable of being separated or divided from the entity and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, identifiable asset, or liability, regardless of whether the entity intends to do so.

- It arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

The accounting alternative previously mentioned allows for certain customer-related assets and non-compete agreements, which initially meet the criteria to be identifiable intangible assets, to be subsumed into goodwill. The accounting alternative is typically able for election only by a privately held company.

Income Tax v. GAAP

The disparity between income tax PPA and GAAP business combination accounting begins here. The existence of separately identifiable intangible assets is not an issue under income tax PPA, as all intangible assets are bundled into the same bucket, including goodwill. For GAAP business combination accounting, the identifiable intangible assets are identified, useful life is determined (if applicable), and they are valued separately from goodwill. The value of goodwill is also determined. Differences also exist between tax reporting and GAAP reporting regarding the periodic write off of the intangible assets, including goodwill.

In addition to the value of identifiable intangible assets and goodwill being separately stated in the GAAP PPA, contingent consideration (earn-outs) in the form of cash, shares, or other consideration that mitigates a key risk the buyer or seller is facing to get the deal done may be treated differently under income tax reporting rules and GAAP. A transaction includes contingent consideration when the quantity of the consideration transferred

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depends on an uncertain condition, situation, or set of circumstances that future events will ultimately resolve. In certain cases under income tax reporting, the fair market value of the contingent consideration must be determined and added to the purchase price paid in the transaction. In GAAP, the contingent consideration is a part of the transaction price. Both instances occur if the payment is part of the sale transaction and not part of a compensation arrangement.

The discussion presented in this article is at a high level. Many nuances and decisions that need to be considered for both the income tax and the financial reporting of a business combination transaction. Rivero, Gordimer & Company, P.A.'s tax team, attest team, and valuation and advisory team are well-versed in navigating these nuances and decisions to guide you through the tax and financial reporting issues of your transaction.

About the Authors

Mr. Brett Cooper has more than 20 years of experience as a business consultant and more than 35 years of experience in the CPA profession, including a period of time as the CFO of a light manufacturing concern. He has been retained as a business appraiser, expert witness and financial consultant by business owners and attorneys to provide services in the following disciplines: Appraisal & Valuation, Litigation Support, Transaction Advisory, Forensic Accounting, and ESOPs. Mr. Cooper is one of a select few individuals within the American Society of Appraisers who has earned the specialty credential of "ASA in Intangible Asset Valuation."

Dennis Paleveda joined Rivero, Gordimer & Company in 2016. Prior to joining Rivero, Gordimer & Company, Mr. Paleveda spent three years in public accounting with a statewide accounting firm, where he served clients in multiple industries including financial institutions, auto financing, not for profit, and insurance. Prior to his time in public accounting, Mr. Paleveda worked as a Tax Auditor for the State of Florida in the Alcoholic Beverages and Tobacco division.

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