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Cost Segregation Studies and Acquisitions: Allocating Assets After *Peco Foods*

By Robert W. Wood • Wood LLP • San Francisco

In *Peco Foods, Inc. & Subsidiaries* (103 TCM 1120, Dec. 58,920(M), TC Memo. 2012-18), the Tax Court addressed a fairly common fact pattern in asset acquisitions. How much is the buyer paying for particular assets? Yet it is one with important ramifications for tax lawyers, accountants and finance professionals.

If nothing else, the case suggests that there should be earlier and more careful thought given to purchase price allocations. Moreover, the case suggests that sometimes being too specific—something that is generally a good thing in the tax law—can be a mistake.

Chicken Feed

Alabama-based Peco Foods Inc. is the 13th largest poultry producer in the United States. In the mid-1990s, Peco purchased two chicken-processing plants. These were operational and involved large bundles of assets, including all the equipment that was needed to keep the processing plants up and running. Of course, as asset purchases, they required a breakdown of the costs under Code Sec. ("Code Sec.") 1060 of the Internal Revenue Code.

Peco and the seller agreed on a detailed allocation of the purchase price across the assets and filed a Form 8594 to finalize their purchase price allocations. Among other items, the allocation included values for "Processing Plant Building," "Real Property Improvements," "Machinery and Equipment" and "Furniture, Fixtures and Equipment." Peco and the seller agreed that the values for these various assets would be used "for all purposes including financial accounting and tax purposes."

All that seemed to be as it should be. A few years after this transaction, however, Peco must have had second thoughts. It

ALSO IN THIS ISSUE

contracted with a third party to complete a cost segregation study. There was no mystery here. The objective of such a study is to further allocate the purchase price of the components within the Processing Plant Building and Real Property Improvement categories. Peco argued that the parties did not intend to include the values of the Code Sec. 1245 building property components in the allocation of personal property from their purchase agreement.

Thus, Peco wanted to adjust the amount associated with its buildings on the Form 8594. The IRS, however, said it was too late to do that. According to the IRS, once the Code Sec. 1060 allocations have been performed and filed, they are permanent and cannot be adjusted.

Agreeing to Agree

When the parties to an applicable asset acquisition agree to an allocation of purchase price in writing, or agree to the fair market value of any of the assets transferred, the agreement is binding. In fact, both transferor and transferee are stuck with it, unless the IRS determines that the figures are not appropriate. The legislative history of Code Sec. 1060 is strongly supportive of this rule.

In fact, it states that the agreement will be binding unless the parties can meet the standards set forth in *C.L. Danielson*, CA-3, 67-1 USTC ¶9423, 378 F2d 771 (1967). *Danielson* was an important case in which the court ruled that a taxpayer could challenge the tax consequences of a written agreement as construed by the IRS only in limited cases. To do so, the taxpayer must have proof that would be admissible in an action *between* the parties, to alter the construction or show the agreement was unenforceable because of mistake, undue influence, fraud or duress.

That is a pretty high standard. In fact, the IRS told Peco Foods that Code Sec. 1060 and the *Danielson* rule meant it was unable to change the allocation. Undeterred, Peco went to Tax Court. Peco hoped for a decision that it could adjust the asset allocations from those originally stated on Form 8594 through a cost segregation study and subsequent Form 3115 filing.

The court, however, disallowed the cost segregation study. In fact, the Tax Court ruled that the Form 3115 was ineffective. The court said that the values assigned to personal property in the purchase agreement were inclusive of all Code Sec. 1245 tangible personal property. In short, the court said the asset allocation agreement was binding.

Code Sec. 1060 was enacted back in 1986 on the heels of many years of litigation over purchase price allocations. For applicable asset acquisitions, the new Code provision meant the parties had to agree. The *Danielson* rule was added into the provision in 1990, giving the IRS even more useful tool. The flavor is virtually one of estoppel. The IRS is entitled to rely on the written agreement of the parties in the absence of fraud or the like.

Battered and Feathered

This decision has generated significant interest, but it is overstated to suggest that it signals a big change in the law. In fact, in *N. Spector* (67

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TCM 2601, Dec. 49,768(M), TC Memo. 1994-147), the court suggested that it would be wrong-headed to allow a taxpayer to bargain over and agree to an allocation for tax purposes and then violate it. That's what was going on here, said the Tax Court.

To the IRS, the course of taxpayer conduct here seemed to smack of a do-over. The IRS and the courts do not want one side of a purchase transaction to make an adjustment without the other side also being involved and making a corresponding adjustment. This keeps things on the up and up.

How Will Taxpayers Respond?

What will be the taxpayer and advisor responses to *Peco Foods?* There are several possibilities. The decision *may* prompt some taxpayers to be somewhat less detailed in their Form 8594 filings. The Form 8594 lumps all depreciable assets into category V.

The case suggests that sometimes being too specific—something that is generally a good thing in the tax law—can be a mistake.

Another possible response is to do cost segregation study work *before* closing, not afterwards. That would presumably enable the buyer to file a Form 8594 reflecting the results of the cost segregation study. Indeed, *Peco Foods* shows the importance of making sure that the Form 8594 is filed effectively.

Optimally, discussions over segregation studies should take place prior to the filing of this form. Cost segregation studies should be an afterthought no longer. If a purchase agreement includes real estate, taxpayers and their advisors should ensure that the purchase agreement lays out the intent of the parties.

Broad language can be another potential minefield. Be cautious about using all-encompassing language that indicates a purchase price allocation will be used for all financial and tax purposes. At the very least, more nuanced language should be considered. Another thought is to make your definitions explicit.

The Tax Court in *Peco Foods* considered the definitions from the Regulations. Based on that regulatory definition, the Tax Court rejected Peco's contention that the term "Processing Plant Building" is ambiguous. The Tax Court also relied on dictionary definitions for "building" and "plant."

WEBSTER'S definition for "plant" includes "the land, buildings, machinery, apparatus, and fixtures employed in carrying on a trade or an industrial business," and "the buildings and other physical equipment of an institution." WEBSTER'S describes a building as "a roofed and walled structure built for permanent use." The Tax Court used these definitions to say that the buyer and seller would have simply referred to "Processing Plant" rather than "Processing Plant Building" had they intended to include special mechanical systems and other Code Sec. 1245 components typically identified in a cost segregation study.

Timing also matters. The transactions scrutinized in *Peco Foods* actually occurred before the IRS had formally acquiesced in the cost segregation concept. Had this been considered, it might have raised doubts about the parties' awareness of all the issues related to the depreciation of a building and its contents.

If the purchase involves more than real estate, such as an ongoing trade or business, it may be in the buyer's best interest to perform a cost segregation study prior to finalizing an asset allocation agreement between the buyer and seller. By doing so, better and more correct allocations can be imbedded into the contract before it is signed.

Conclusion

Is the *Peco Foods* decision a surprise? It shouldn't be. Purchase price allocations can be very important parts of a deal. They should not be an afterthought.

Written agreements are hard to undo. The *Danielson* standards are difficult to meet. The IRS feels entitled to rely on the parties' statements, and variations from them are almost always going to be difficult to justify.