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ASCSP Comments on Peco Foods, Inc. v. Commissioner ©

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While the law regarding the binding nature of an asset allocation agreement under IRC Section 1060 is well established, ASCSP notes the specific facts and circumstances of the Peco Foods case in making our recommendations below. In any event, the case suggests that discussions with an ASCSP Certified or Senior Member should be strongly considered before any comparable transaction is completed.

Facts:

Peco Foods purchased two poultry processing plants (including all equipment) in the 1990s. Since this type of asset purchase requires an asset breakdown according to Section 1060, Peco and the seller included schedules showing how the purchase price would be allocated and then filed Form 8594 to finalize their purchase price allocations. The allocation included values for “Processing Plant Building”, “Real Property Improvements”, “Machinery and Equipment”, and “Furniture, Fixtures and Equipment” among other items. It’s also important to note that their agreement stated that these values would be used “for all purposes including financial accounting and tax purposes”.

Several years after the purchase, Peco performed a cost segregation study to further allocate the purchase price of the components within the Processing Plant Building and Real Property Improvement categories. Peco argued that they did not intend to include the values of the 1245 *building property components* in the allocation of personal property from their purchase agreement. The court, however, disallowed the cost segregation study and asserted that the values in the purchase agreement assigned to personal property were inclusive of all 1245 tangible personal property thus making the asset allocation agreement binding.

ASCSP Observations:

The details of this case leave us with some questions on the applicability of this ruling on other transactions involving an asset allocation agreement. The Tax Court’s opinion was that the contract was clear and unambiguous.

The purchase agreement in this case defined the terms “Real Property” and “Equipment” without regard to the Federal Income Tax Regulations definition of Real Property under 1.245-3(c) and Tangible Personal Property under 1.48-1(c). When reviewing the Peco agreement definitions, the courts considered the definitions from the Tax Regulations. Because the courts could not discern whether the Peco definitions were intended to characterize Real Property as anything other than what is described in the Tax Regulations, the tax courts rejected Peco’s contention that the term Processing Plant Building is ambiguous. Further, the Tax Court found that the inclusion of the word “building” was significant in its conclusion.

The Tax Court also relied on definitions found in the Merriam Webster's Dictionary for "buildings" and "plant". The definition in Webster's 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". In light of these definitions, the Tax Court believed 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 1245 components typically identified in a cost segregation study.

Although the Tax Court Memo did not emphasize the relevance of Peco's definition of equipment, ASCSP observes that this too may have influenced their decision. The Peco agreement defined "equipment" as specifically including "tangible personal property". Anyone familiar with cost segregation and depreciation case law knows that this can only weaken Peco's position since most items found in a cost segregation study are considered tangible personal property in the Federal tax regulations.

Another noteworthy opinion of the Tax Court was that Peco's decision to allocate almost twice as much of the purchase price to machinery and equipment as compared to the building, demonstrated Peco's "intent that the original schedule allocated the purchase price among the specific assets conclusively". Without knowing exactly what machinery and equipment was included in the transaction, it's difficult to know if the allocation was aggressive or reasonable. It would be interesting to know how much this may have influenced the final decision.

Finally we note that each transaction occurred before the IRS had formally acquiesced to the concept of cost segregation (Chief Counsel Advice was issued on May 28, 1999). Had this been considered by the Court, it may have raised doubts about the extent of certainty and awareness by both parties about all the issues related to the depreciation of a building and all of its contents.

Conclusion & Areas of Opportunity:

As such, careful consideration must be paid to the descriptions and definitions that clients use when drafting their purchase documents. In situations where the purchase involves more than just real estate, such as a 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, the correct allocations can be worked into the contract so both parties are in mutual agreement.

As a precaution, we strongly recommend having an ASCSP Certified or Senior Member assist in drafting your agreement for an applicable asset acquisition.

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