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Price Allocation: Is Goodwill the Devil?

Sometimes we come across uninformed buyers that want the majority of their purchase price allocated to equipment because they can get an immediate tax write-off under Internal Revenue Code Section 179 of up to $125k and $250k in very recent years. However, part of our job is to understand and educate ourselves about the state/locality that the transaction will occur in and educate our buyer/client on ALL the tax considerations of price allocation, not just income tax.

Many, many years ago goodwill was the devil in the eyes of every buyer. Why?

There was a time when goodwill was NOT deductible under the tax code, therefore from a buyer’s perspective, any allocation to goodwill was NOT providing them with any income tax savings. However, goodwill was always treated as a capital asset and subject to capital gains to sellers, therefore, sellers wanted most (and in some cases ALL) of the price allocated to goodwill. I remember when this one issue, the allocation between goodwill and tangible assets, was the most stressful part of most transitions. Not anymore though.

Now, buyers can write off goodwill over 15 years, so in my mind, that was a decent compromise from an income tax perspective between buyers/sellers when negotiating the allocation.

Enter the Sec. 179 write-off issue where the IRS increased the write-off election from $25,000 to over $100,000 and in recent years $250,000. All of a sudden, buyers were reverting back to the "old ways" of trying to minimize goodwill while trying to maximize equipment/furniture/computers and other areas that would generate a faster tax deduction, let alone ANY deduction. STILL, sellers wanted their capital gains so this issue of price allocation was once again a hurdle, though a low one that could usually be jumped fairly quickly.

Then the long term capital gains rates were lowered to 15%, down from 20% and at one time 28% so sellers once again began pushing firmly for more goodwill allocation while the buyers wanted more equipment due to the ability to write off $100,000 under Sec. 179 immediately. When the IRS recently increased the Sec. 179 write-off to $250,000, those that were purchasing large practices where the value of equipment could easily reach that level, began pushing for

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the higher equipment allocation and price allocation once again became a struggle.

These days, states & local governments are finding other ways to tax businesses aside from income tax, which usually means higher sales tax, personal property tax, transactional tax, etc. Therefore, buyers need to be educated on how the allocation of the purchase price can affect them from EVERY tax perspective, not just income tax.

Take Maryland for example. We have a 6% sales tax (was 5% a couple of years ago) on the allocation to equipment/furniture/computers and supplies, so on an allocation of $100,000 to those items you just cost yourself $6,000 DUE AT SETTLEMENT. Then our counties also assess a personal property tax on business assets, and on $100,000 over 10 years, that's easily another $10k-$15k. So the buyer’s allocation to tangible assets/supplies might cost them more than $20,000 in other taxes compared to $100,000 allocated to goodwill where there is no sales or personal property tax in most jurisdictions....YET.

Keep in mind the income tax savings on $100,000 will likely be nearly the same over 15 years whether it's goodwill OR equipment, with the only difference coming from the income tax brackets the deductions are taken in. The income tax benefit with equipment and supplies is the ability to get those tax savings sooner rather than later. However, if you run the numbers out over 15 years (the life of goodwill under the tax code), the allocation to equipment/supplies will almost always cost you more due to the other taxes you incur, at least here in Maryland and other jurisdictions we've seen.

This is just one reason why buyers should consider seeking advice from an advisor that has many years of experience with practice transactions & transitions, this one area can keep a buyer from making a mistake AND save them money.

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