Ep #65: Purchase Price Allocation: What Restaurant Buyers and Sellers Need to Know with CPA Sheikh Idrees



Full Episode Transcript

With Your Hosts

Patrick Totah and Andy Mirabell

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Welcome to *Restaurant Deal Making EXPOSED!*, the only show that equips you with everything you need to know about restaurant transactions. In this show, we tell you all about how to make the sale or purchase of your restaurant not just possible, but successful. Now, here are your hosts, ex-restaurateurs, and seasoned brokers, Patrick Totah and Andy Mirabell.

Andy: Okay, welcome back to another episode of *Restaurant Deal Making Exposed*. I'm Andy. I'm here with Patrick. Today, we're talking about a topic that has a significant impact on both buyers and sellers: allocation of purchase price. To help us understand the basics, we're joined by Sheikh Idrees, CPA of Idrees CPA, an accounting and tax firm in Sacramento. I've worked with Sheikh for many years. He's a wonderful and very professional, intelligent man. Sheikh brings his experience in accounting, taxation, and business finance to help us better understand an important part of buying and selling a business. You can reach Sheikh on his website. It has all of his contact information at idreescpa.com.

We're going to start with a simple question. What exactly is purchase price allocation and why does it matter? Today, we're going to discuss how purchase price is allocated amongst the various assets and categories of a business, how the allocation can affect taxes and tax liability for both the buyer and seller, and what role it can play in escrow. Most importantly, we want to give the buyers and sellers a practical understanding of what they should know and what questions they should be asking before they decide on purchase price allocation. Here we are, Patrick.

Sheikh, welcome. Thank you so much for spending some of your valuable time with us today to break down a subject that we don't get to talk about that much until we're in a transaction.

Patrick: When Andy gives you all his tax information, does he give it to you at the last second, or is he very organized and gives you many months to get it done?

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Sheikh: He's somewhat organized, but somewhat. He's pretty good. He kind of helps me. He gives me somewhere in the middle of it.

Andy: Yeah, that's right. When we turn in tax paperwork, it's personal. So you don't get the professional Andy that my clients work with. There's a lot of extra post-its and notes for you, Sheikh. So, in your words, what is purchase price allocation, Sheikh?

Sheikh: So, it's normally the price people normally agree on, buyer and seller. It has an implication as far as the capital gain goes for the seller. The buyer, under the new law, has a lot of deductions which are associated with purchase price allocation. So this big beautiful bill, you can take a lot of these allocation parts. So let's say you agree on a price, like a fixed asset, you have plant, equipment, those things. So the buyer gets the fair market value of it. The seller has a capital gain on the purchase price. So that does not change that much.

Andy: You pointed out a couple of the categories though, Sheikh, that you commonly see, whether it's furniture, fixture, equipment. You know, goodwill is one we deal with a lot.

Patrick: Yeah, I mean, I think a majority of people usually put something under goodwill, something under leasehold improvements, furniture, fixtures, and equipment. Typically, inventory is not included in the sale, so I usually have a zero allocation there. And then you have the ABC license, which has to have some value, right? So, Sheikh, this is always a discussion that I have on every single sale. And the buyer will say, what do I have to do? And the seller says, what do I have to do? And I'm like, I can't give you legal advice, accounting advice.

Andy: Or financial advice.

Patrick: Or financial advice. You need to talk to your accountant. And then, you know, I have to kind of tell them. And my simple elevator story is that for the

buyer, it sets your depreciation schedule. And for the seller, it's how you receive either income gain or capital gain.

Sheikh: That's correct. Normally under the big beautiful bill, we try to lump sum more into fixed assets and the leasehold improvement because those are deductible right away, first year, for the buyer.

Patrick: So this is for the buyer. You try to put as much under leasehold improvements and...

Sheikh: The fixed asset and equipment.

Patrick: The equipment is the one that gets the quicker depreciation schedule, right? Like a very aggressive one.

Sheikh: That is correct. So we call it fixture, which is normally in a restaurant will be, let's say, your seating in the restaurants, some other things, you know. And then your leasehold improvement can be, you know, something which is built in the four walls of the building. Those are your leasehold improvements, which can go up to 15 years in depreciation. These all three items are deductible 100% first year. So that gives the buyer a big advantage in it.

So normally, if you buy a building, let's say October, November, you got, let's say, 200,000 allocated to that. So your depreciation is 200,000, no matter what. So if you ran it for two, three months, you most likely first year will have a so-called negative income. And then you will not end up paying tax on it, technically, you know what I'm saying? So the goodwill part is the part which goes over 15 years. That is a straight line depreciation. If the real estate is involved in a business, I would like the buyer to get a cost segregation study done.

Andy: Can you tell us what that is?

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Sheikh: Cost segregation is basically, those are CPA and engineers in a team. So they figure it out. So in a hotel business, let's say you bought something for 10 to $12 million, you may have a $3 million depreciation first year.

Patrick: Oh, wow. That's great. Can a buyer and seller have a separate allocation?

Sheikh: Normally they agree on something. I have seen that if there is no recapture of depreciation for the seller, then everything is capital gain for him. Recapture can be somewhat ordinary income. So that is the one element sometimes sellers try to stress, that, okay, I don't want to have too much ordinary income, I want to have more capital gain. So some balance can be reached between buyer and seller because the price is a price. Everything in between can be figured out, and that's my opinion.

Andy: If you were advising a buyer, we typically see a lot of buyers allocate a smaller amount of purchase price to equipment because they also pay sales tax on that immediately upon close of escrow. So, in order to capture that first-year total depreciation, do you advise some of your clients who are buyers to put more in the leasehold improvement section rather than in equipment? Because equipment will have that immediate sales tax liability as well.

Sheikh: That is correct. Sometime, let's say sales tax is 8 to 10%. And you are getting 100% deduction. So at a 35% tax rate, you still come ahead.

Patrick: Yeah, I try to explain this to my clients, and typically you have the buyer who understands that and wants to take advantage of that. And then you have the other client who just doesn't want to pay the sales tax because they see the immediate charge that they have to deal with. And so you have typically two separate buyers.

Sheikh: So, there are a couple of things. You can look at it, a seller's depreciation schedule. So he has what we call it net book value. And then the

seller would like probably fair market value. So if in case there is an audit, then CDTFA will get, let's say depreciation schedule from that, and then appraise fair market value. So they normally would like to see, okay, you got fair market value, then there's a tax on it. I have not seen that much audit lately. At some point, this was a pretty sticking point for the Board of Equalization at that time we used to call it. But if you are going with fair market value on equipment, then yes, there's a sales tax. But I normally tell buyers, don't worry about it because you're getting 35% tax break. So you still are ahead 25%. You have to look at it both ways.

Andy: I think because from our perspective, in our role, we often times ask the buyer to come up with an allocation suggested or preferred allocation of purchase price, and then we will get that from the buyer and take it to the seller so they can also check with their trusted professional and see if they agree or agree with it. So I think from the buyer perspective, we most often are able to see the kind of patterns of how they allocate price. But from a seller perspective, can you expand a little bit on the implications of purchase price allocation for a seller? I know you touched on capital gains tax quite a bit, but what other implications come into play with the seller side?

Sheikh: The seller normally, let's say you bought something, you know, it has a five-year life on the depreciation. And then you are turning around and then you are selling, you know, that equipment within less than five years. So then there is a recapture part of it that becomes ordinary income. And so that is one, sometime, but if you kept everything for five years, there is no recapture.

Andy: Anything beyond five years is not a recapture of this income. Got it.

Sheikh: That is correct on the equipment side of it, yes. So that they can have peace of mind that, okay, I don't have any ordinary income for the recapture part. So capital gain, I have to pay that tax anyway, whatever I do.

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Andy: That makes sense. And we see restaurants turnover faster than a lot of businesses. So I would think that this five-year milestone is harder to meet in our industry than it is in many others. So that implication is there more often.

Sheikh: But if somebody is buying with the real estate, then I would recommend going with a cost segregation study because cost segregation is becoming a pretty big issue in hotels, gas stations, and real estate, any transaction in real estate now.

Andy: Patrick, what do you say when we get a buyer and seller who does not agree on purchase price allocation? What is your go-to response? How do you instruct them from there?

Patrick: So when you have a couple hundred thousand dollar transactions, it's a little easier to get people, you're closer in general. It's when you start getting into those million-dollar transactions where you could be several hundred thousand dollars difference because I think we all understand that usually where it comes down to is goodwill. The seller will say, "I want to put a majority under goodwill," because that's long-term capital gains. And then the buyer is like, "Well, I want it in this area," and then you end up being several hundred thousand dollars apart.

The other thing to take into consideration is if you put too much on furniture, fixtures, and equipment, the county could come back to you, and depending on the current depreciated value of the equipment, they could give the seller, they'll go back three years.

Andy: Retroactive.

Patrick: So if the buyer's like, "Hey, I want to put 300,000 under furniture, fixtures, and equipment," and the current depreciated value is 50,000, that's going to end up costing the seller a lot of money. So you basically say, "Hey, this is a negotiation. Everybody has to hurt a little bit, and at some point here we have to get this agreed to per the state of California." So I've had a few that

have gone the distance on negotiating and I truly was like, "Is this ever going to get done?" But it always does, like everything else.

Sheikh: I think my argument normally is that okay, I think what Patrick is referring to is the property tax. So again, that is only 1%. Tell them okay, it's a 1% a year. Here's how that is going to affect you. Then sales tax is, let's say, 8 to 9% of it. So given the whole thing is not more than 11% technically. So 35 tax rate, 11% out of it, you still come ahead big time.

Andy: That makes sense. The exposure sounds greater than it really is.

Sheikh: People just get panicked. They don't look at a big picture. They just have something stuck in their mind, and it's tough to get out of it. But again, my theory is and that's what I deal with my client. I said, "Okay, you're looking at 1% property tax and then you're looking at 8% sales tax. So your first year, not more than 10%. But you're saving 35% in federal tax, 10% in state. So 45% minus 10, you have net gain of 35% in saving towards the taxes and depreciation and other things." So yeah, so it's a little bit massage and kind of convincing client, "Okay, don't get stuck what is in your mind, but here is the big picture."

Andy: Yeah. Patrick, do you want to go through an example?

Patrick: Yeah, let's do an example. Let's say we have a restaurant for sale for $1 million is the price that it went into contract at. It's a long-standing restaurant and the buyer is going to continue the name. It has a Type 47 liquor license. Say it's 5,000 square feet and has a decent amount of equipment and other fixtures.

Andy: So what happens if there's a $200,000 of this million-dollar purchase price is allocated to equipment and we said $100,000? Do we account for working inventory or not?

Sheikh: Working inventory is not part of your purchase price, technically.

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Andy: Right. Good. And what would you say to your client who's buying a million-dollar restaurant, they come back and says, "I just want to put $800,000 to goodwill and $200,000 to equipment." How would you massage that to make it tax savvy for them? How would you advise them?

Sheikh: Okay. So my idea is okay, $200,000 equipment, if you can get some kind of appraisal done on it, what is the real appraised value, fair market value, we call it. So we can, let's say on $200,000, so let's say it's $20,000 will be sales tax. And then 1% of that will be $2,000 is the property tax. So it's a $22,000 tax liability for you. But at the end of the day, you're going to get the $200,000 depreciation. And that is between federal and state, 10% state, 35% federal, that's 45% saving.

Patrick: Would you look at this differently if your client was planning on being there 15 to 20 years versus, "Hey, I'm going to be there five, maybe 10 years?" Would you allocate a lot differently because…

Andy: More aggressively.

Patrick: Yeah.

Andy: Yeah.

Sheikh: I would normally like to take the approach of thinking of depreciating everything first year.

Patrick: No matter what.

Sheikh: Because restaurant business, a lot of equipment goes bad. If you are a franchise business, there might be some improvement coming in. So there are a lot of these expenses. Sometime seller is trying to get out of some improvement because franchise company is pushing him, "Okay, can do this improvement." So then the buyer will be stuck with it. I would like to take the first-year approach as much as I can.

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Andy: That's a good tidbit, though, to remember that restaurants obviously because of their volatility and their need for constant replacement of equipment and such, that you as a CPA are going to really push the first-year aggressive depreciation model.

Patrick: And Sheikh, if you are unable to take the full 100% of the depreciation, does that carry forward to the next year?

Sheikh: Definitely. Yeah, if you in a shape of your net operating loss carryover, so you can use it next year. Again, if you don't want to take aggressive depreciation under a big beautiful bill, you can take a five-year approach with 200% double decline, we call it. So yeah, so you can take that approach if you are thinking that okay, no, I don't want to create too much loss. I would like to be steady and know my depreciation expense on yearly basis. So we can opt out of aggressive depreciation and do the five-year double decline method, we call it.

Andy: So you don't oftentimes suggest or use a 10-year or more depreciation for any of the categories on price allocation with your clients?

Sheikh: Leasehold improvement is 15 year. Fixture is a seven to 10 year. Equipment is five year. So we can devise whatever clients wants to see on yearly basis, what they want to see on first-year basis. So yeah, so if you are in expansion mode, you're going to buy something next year, then these things are available every year for you whenever you're buying a new restaurant. Plus, a lot of time, even if you go for financing at some point, depreciation is always an add back for loan purpose because it is a first-year, it's a one-time deduction. Banks are pretty lenient on it. Finance company are lenient on it, say, "Okay, I'm not going to count that against you that you didn't have a profit."

Andy: Can you change that year to year if it's not working in your favor? Are you locked in?

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Sheikh: You are mostly locked in, but if I can get a cost segregation study done, then at least I have something in case we are audited that okay, I got this segregation study done and based on that, I'm changing it.

Andy: Interesting. Well, we thank you so much, Sheikh, for talking about this. It's definitely a subject that doesn't get highlighted a lot and comes up in every transaction, of course.

Patrick: I'm going to play this episode every transaction. I'm going to tell them to listen to this, then come talk to me.

Andy: Yeah.

Sheikh: Exactly.

Andy: Yeah. And I think we often say this time and time again is do ask these questions to your professionals, your CPA. Don't make these decisions without reaching out to them and getting their professional advice. So yeah. Sheikh, thank you so much for being here today. We really appreciate your expertise on this in this subject matter in particular.

Sheikh: Okay, thank you.

Thank you all for listening to this week's episode of *Restaurant Deal Making EXPOSED!* If you're considering selling your business and would like a free consultation, reach out to patrickAndAndy@therestaurantsalesbroker.com or visit TheRestaurantSalesBroker.com to learn more.