Income Tax Allocation of Sale/Purchase of Practice

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As financial planning practices are transferred from one owner to the next we find it necessary to provide a basic discussion of the issues that both the buyer and seller will encounter from an income tax perspective. Our discussion is not intended to be all inclusive by any means, as the facts and circumstances related to each sale can vary substantially. We encourage you to discuss the specifics of your situation with a qualified tax advisor, as the below information is not intended to provide and should not be construed as providing income tax advice in any manner.

Elements of Transaction

Typically, the sale of any business can be structured in one of two ways: 1) The sale of the individual assets (less agreed to liabilities) of the business and 2) the transfer of an ownership interest (such as stock or membership interest). With regards to the sale of financial planning practices it is the former that we will concentrate on, as generally asset sales are more typical because they allow for a faster writing off of the purchase price.

The idea behind the asset sale is to allocate the purchase price to the various assets associated with the subject practice. Consequently, a portion of the price would be attached to the current assets, fixed assets and (most importantly) the intangible assets and customer list. This allocation is agreed to by the buyer and seller and reported to the Internal Revenue Service on Form 8954. This form is to be attached to the income tax returns of both parties by the due for filing those returns (depending on the type of entity), plus any allowable extensions.

In a typical situation, there are essentially no current assets, and a limited amount of fixed assets associated with the sale of any practice. Current assets are comprised of cash and accounts and notes receivable. Fixed assets are associated with property and equipment (furniture, computers, printers, software). The portion of the selling price allocated to the fixed asset is deductible to the purchaser over the useful life determined by the asset class (often times from 5 – 7 years). There is an additional provision to take advantage of immediate expensing (Section 179 depreciation) as long as the purchased practice is reflecting net income in the year of acquisition that is at least equal to the amount of the deduction. The income tax ramifications to the seller often reflect an element of both capital gain (which are taxed at lower income tax rates) and ordinary income (generally attributable to the recapture of depreciation).

The income tax ramifications of the sale of the intangible assets (goodwill, customer list) is capital gains in nature to the seller and is deductible to the purchaser over a 15 year period of time. This asset category is also inclusive of non-compete agreements, which are treated in a similar manner for the purchaser, but are treated as ordinary income to the seller.

Another element of the buy/sell transaction is typically a separate agreement that allows for the consulting services of the seller over period of time. This agreement is designed to ease the transition from the old owner to the new one. Specifically designed to facilitate customer relationships and practice policies, this consulting agreement generally should not exceed 2 – 3 years, however, in certain situations can extend well beyond that. Consulting agreements are tax deductible to the purchaser in the year that the consulting fees are paid and are taxable as ordinary income (in addition to self-employment tax) to the seller. This type of arrangement also gives the seller the potential to take income tax deductions for any ordinary and necessary business expenses relating to the services that he/she is to provide.

The below table summarizes the income tax treatment of the transaction to both the buyer and the seller.

Tax Characteristic	Impact on Buyer	Impact on Seller
Allocation to fixed assets	Deductible under class life of asset (usually 5-7 years). Section 179 available up to income limitations	Capital and Ordinary to extent of recaptured depreciation
Goodwill/Customer List	15 year amortization	Capital Gain
Non-Compete Agreement	15 year amortization	Ordinary Income
Consulting Agreement	Deductible in year paid	Ordinary Income (plus self-employment tax). Allows for deductibility of necessary business expenses
Interest	Deductible in year paid	Ordinary Income in year received

<u>Additional Considerations</u>

The results of any buy/sell transaction can be inclusive of payments made from the purchaser to the seller over a period of time. Any such transactions must involve an element of interest, which would be tax deductible to the purchaser in the year of payment and should be considered as taxable income to the seller at ordinary income tax rates.

Sales over time may be reported by the seller under the installment method on Form 6252, unless the seller elects out of such treatment. It is recommended that the tax treatment under these circumstances be discussed with a qualified income tax preparer.

ABOUT THE AUTHOR

Alan Salomon is a CPA and M&A Expert at Key Management Group. He has provided business valuation services for closely held businesses nearly two decades. He specializes in appraising businesses for buy/sell agreements, estate tax, divorces, business start-ups, and shareholder/owner disputes. Alan was the owner of his own public accounting firm for 14 years and has extensive knowledge in the areas of valuation, tax and business consulting.

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