There are typically three ways practices are bought and sold (each with varying tax consequences): Asset sale, stock sale and revenue sharing agreement.

Different deal structures result in different tax consequences to both the buyer and the seller.

The buyer and seller may enter into several contractual relationships during the deal.
UNIVERSAL ADVICE

When making a major decision, you understand it’s critical to look at a situation holistically. For example, you wouldn’t make investment recommendations to your clients based solely on tax considerations. You would, however, assess the tax advantages and consequences prior to advocating a particular strategy to provide a fair and balanced presentation.

Similarly, if you are considering or have already inked a deal to purchase or sell a practice, it’s a good idea to adhere to this counsel for your own situation. The transfer of an advisory practice is a lengthy, multilayered process, and one of those layers is taxes. This paper is dedicated to explaining the types of deals you may participate in with the sale or purchase of a practice, and the related tax issues of which you should be aware.

Stephen Covey, author of the highly successful book “The 7 Habits of Highly Effective People,” lists the ability to “begin with the end in mind” as the second habit. By this he means that to successfully forge a path for yourself, you need to have an idea of where it is you want to go.

At this point it’s probably important to bear in mind that significant tax consequences are frequently the result of highly successful transactions. This is true for the seller, who is responsible for paying taxes on the proceeds resulting from the sale of his or her practice. It is also true for the buyer who, on the heels of a successful transaction and the subsequent growth of his business revenues, will benefit from the taxable deductions and depreciation and potentially depreciation/amortization of purchased assets. With that in mind, let’s get started.
UNDERSTANDING THE TAX IMPLICATIONS BEFORE THE INK IS DRY

While you may have thought of the tax implications of transferring a practice, do you fully understand the specific tax consequences of the agreement and – equally as important – do you understand the tax consequences to both the buyer and seller?

Given that the transaction’s success is in part dependent upon the buyer’s ability to service the debt on an after-tax basis, this is one step that should not be overlooked by either party.

There are typically three ways financial advisory practices are bought and sold:

1. Asset sale
2. Stock sale¹
3. Revenue sharing agreement

This paper will address the implications of each transaction. Please be aware, however, that this paper is intended to provide an overview only and is not a substitute for specific transaction guidance from an attorney, certified public accountant, enrolled agent or other subject matter expert. For specific transactional related advice, please consult your own tax and/or legal counsel.

¹The term “stock sale” is broadly used within this document and is for illustrative purposes only and encompasses corporate stock, Limited Liability Company interest, Limited or General Partner interest(s), but is not intended to provide fact specific guidance that is germane to a specific transaction.
THREE TYPES OF SALES AGREEMENTS

1. ASSET SALE

For private party transactions, the most commonly utilized transaction structure is the asset sale, regardless of whether the transaction is between current employees, family members or external parties.

As the name implies, an asset sale is a transaction in which the parties agree to buy or sell the business assets that make up a business. There are many reasons why participants choose to structure a transaction as an asset sale, but typically the two driving factors are (1) the assumed legal liability for the buyer, and (2) the ability of the buyer to amortize the purchase price of the business over a finite period of time.

Typically in an asset sale, the buyer and seller contractually agree to the specific assets that will be purchased and to what (if any) liabilities will be assumed by the buyer. The contract will detail exactly what business assets will be sold. Tangible assets may include business equipment, furniture, fixtures and inventory. The contract will also detail other intangible assets – which may include goodwill, trade names, telephone numbers, website address/URLs, etc. For each line item asset, the contract should specify how the purchase price is allocated. The allocation of the purchase price can have a significant impact on both the buyer and seller, as the different asset classes result in different tax consequences for each party involved in the transaction.

It is imperative that the contractual agreement provides the specific allocation of the purchase price to specific assets. That's because this allocation will determine the ultimate tax consequences for the buyer and the seller. It is a key negotiation point that cannot be overlooked.

GLOSSARY OF TERMS

Amortize – accounting for the decrease of an amount over time
Cost basis – original cost of an asset
Depreciation – decrease in the value of assets, frequently over the period of time in which the asset is expected to be used
Goodwill – the value of an intangible asset that offers a quantifiable value, such as a firm’s reputation or intellectual capital
Intangibles – property that has no physical substance, but which can be owned and transfer ownership, such as copyrights and trademarks
Note that both the buyer and the seller are required to file Form 8594, Asset Acquisition Statement. The IRS expects the asset allocations provided in the forms filed by both the buyer and the seller to match. You can imagine the consequences if these forms were filed and did not match. For details on the specific filing deadlines and due dates for Form 8594, please see the Resources section on page 11, specifically the instructions for IRS Form 8594, Asset Acquisition Statement.

From a practical standpoint, the seller will generally desire to have an allocation that results in a long-term capital gain. Conversely, the buyer would prefer to have an allocation that results in an immediate deduction. Then there is the IRS and the specific rules relating to the amount allocated to the assets purchased. This is why it’s important to tap experienced counsel, as these divergent interests can cause unintended tax consequences or cause a deal to break down completely. It is important for each party to understand the implications for the other.

For example, allocating the purchase price of business equipment, furniture and/or fixtures would likely result in the recognition of capital gains and potentially ordinary income by the seller. If the sale results in capital gains, the seller will have to pay the short-term and/or long-term capital gain tax based on how long the assets were owned and whether or not the seller had depreciated them in earlier tax returns. For the buyer, the assets would be eligible for a depreciation deduction over a 3-, 5-, 7-, 10-, 15-, 20-, 25-, or 39-year time period, depending on the types of business assets acquired.

For the purchase price that is allocated to goodwill, the seller is eligible for long-term or short-term capital gains tax treatment, while the buyer would capitalize and amortize the amount paid over 15 years (180 months).

In a transaction where the purchase price is paid in full at closing, the tax accounting is fairly straightforward. However, this is extremely uncommon in the purchase of any business. Most of the time an asset sale/purchase agreement is structured over a long duration, oftentimes with an amount paid at closing and the remainder paid over a period of years.
When the transaction is structured to take place over a period of years and the purchase price is not fixed and determined at closing, the IRS requires the installment sale methodology for reporting and requires the filing of Form 6252 each year until the transaction is fully closed. You can omit this filing if you make a specific and timely election to opt out of the installment method.

**ASSET SALE CASE STUDY**

Let’s take the case of ABC Asset Management, which has entered into an agreement to purchase the assets of Main Street Advisors (“MSA”) for a purchase price of $1,000,000. For purposes of this and all other examples, MSA is a single member Limited Liability Company taxed as a sole proprietorship.

**Scenario A: All cash at closing**

The deal assumes an all-cash closing on January 1, wherein both buyer and seller agree that the price is allocated as follows:

- $10,000 for computers (assume no depreciation)
- $35,000 for furniture and fixtures (assume no depreciation all 7-year property)
- $15,000 for website and URL (unamortized basis of $5,000)
- $940,000 for goodwill (no basis for tax purposes)

All assets have been held for longer than one year, and the amount allocated to each “class” does not exceed the assets’ current fair market value. This would result in a $995,000 long-term capital gain for the seller in the year of disposition [$1,000,000 purchase price less the $5,000 unamortized basis (cost) for the website and URL.]

On the other side of the transaction, the buyer will acquire property that is depreciable as follows (rounded to whole dollar):

- Computers, $10,000 depreciated over 5 years ($2,000 annually)
- Furniture and fixtures, $35,000 depreciated over 7 years ($5,000 annually)
- Website and URL, $15,000 amortized over 3 years (36 months) ($5,000 annually)
- Goodwill, $940,000 amortized over 15 years (180 months) ($62,667 annually)
- Employment agreement
- Consulting agreement
- Noncompete/nonsolicit

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2 Negotiated separately and addressed on page 10
Now consider that while the buyer has used $1,000,000 of after-tax dollars to make the purchase, he or she will receive an annual deduction based upon the following amounts and time frames:

<table>
<thead>
<tr>
<th>TAX DEDUCTION</th>
<th>YEARS</th>
</tr>
</thead>
<tbody>
<tr>
<td>$74,667</td>
<td>... in years 1 – 3</td>
</tr>
<tr>
<td>$69,667</td>
<td>... in years 4 – 5</td>
</tr>
<tr>
<td>$67,667</td>
<td>... in years 6 – 7</td>
</tr>
<tr>
<td>$62,667</td>
<td>... in years 8 – 15</td>
</tr>
</tbody>
</table>

**Scenario B: Fixed price paid / Fixed number of years to pay**

Now, we can add another layer of complexity to the deal by adding a provision in which the purchase price is paid over five years, or $200,000 each year. In this situation, the total purchase price would be depreciated and amortized for a period of 20 years and could span longer if the transaction occurs midyear.

### 2. STOCK SALE

Whereas the asset sale is the most common business acquisition method, the stock sale is probably the least common transaction. The top considerations come down to the buyer potentially assuming legal liabilities and tax consequences. Typically, in a stock purchase the legal liability will follow the ownership of the stock. This is the main reason why, when corporations make stock acquisitions, there is typically a very robust indemnification agreement along with amounts withheld in escrow. The indemnification agreement specifically addresses the known and/or unknown legal costs that may be acquired along with the stock of the entity and the escrow provides an amount certain should the buyer receive a claim.

As with any stock purchase, the seller will generally be eligible to receive short-term or long-term capital gain tax treatment on the sale of stock, based on the seller’s holding period. The buyer’s cost basis will generally be what he or she paid for the stock, and that basis is generally not available for depreciation or amortization. Furthermore, that basis is realized only when the stock is sold or disposed of in some other manner.

There are certain instances in which a buyer can make an election to treat a stock purchase as an asset purchase. Specifically, this is a §338(h)(10) election, and it is generally only available to the buyer during a limited time period. Further discussion of this tactic is outside the scope of this paper.
STOCK SALE CASE STUDY

Utilizing the same example as before, ABC Asset Management agrees to purchase Main Street Advisors for $1,000,000. In this case, the practice is sold for the stated purchase price in an all-cash closing. Assuming the seller has an adjusted basis in the stock of $5,000 with a holding period of longer than one year, the amount subject to long-term capital gain taxation is $995,000.

Assuming that a §338(h)(10) election is unavailable to the buyer, the buyer would have an adjusted basis in the stock of $1,000,000 (what the buyer paid for the stock). He or she would not be able to amortize or depreciate any amount of the purchase price, and could only use the $1,000,000 of stock basis for tax purposes in the year of disposition.

However, what if there is no buyer for the stock? What if the buyer wants to sell the practice in the future, but the only buyers are those who prefer an asset purchase?

If we assume:

1. That the business assets are going to be sold for $1,000,000 at some point in the future
2. The business has owned the assets for greater than a year and has an adjusted tax basis in those assets of $0
3. The transaction is structured as an installment sale where $200,000 (plus a nominal amount for interest) is paid annually for 5 years

Then ...

4. The selling corporation must stay open to report the annual sale proceeds
5. The selling corporation recognizes long-term capital gain and annually files the appropriate tax forms and pays the tax due

Only after receiving the last payment can the corporation wind down and, at that point, the corporation would have recognized $1,000,000 in capital gain as well as some interest income for the installment payments and would have paid taxes accordingly.

In year six, the owner can then dispose of the corporation’s stock to yield a $1,000,000 long-term capital loss. Assuming he or she has no other capital gains to offset this capital loss, under current law, he or she may start deducting $3,000 a year on his or her tax return for 333 years or until the long-term capital loss is fully utilized.

Other items:

- Employee agreement
- Consulting agreement
- Noncompete/nonsolicit

3 Negotiated separately and addressed on page 10
3. REVENUE SHARING AGREEMENT

Often only in employee/employer or other fact-specific situations are practices transitioned via a revenue sharing arrangement. The most common occurrence, outside of the employee/employer relationship, is where two parties have entered into a written business continuity arrangement (for death, disability, and in some instances retirement purposes). For the purposes of this discussion we will focus on a situation in which the advisor is permanently disabled and no longer licensed or active in the business. In this case, pursuant to the terms of the written business continuity agreement, the new advisor takes over the servicing of the client accounts and shares the subsequent revenue with the disabled advisor for a period of years (see FINRA IM-2420-2).

REVENUE SHARING CASE STUDY

In a revenue sharing arrangement, the advisor who is assuming the client relationships would agree to pay a share of the revenue, typically net of broker/dealer retention. For illustration purposes, we will assume that the net revenues are $400,000 annually and the sharing agreement calls for a 25% annual payment to the disabled advisor for five years.

Under this scenario, the party that is paying $100,000 is eligible for an ordinary tax deduction in the year paid, and the party receiving is liable for both ordinary income and self-employment taxes on the amount received (assuming there are no other business-related costs he or she can use to offset the income).

Two potential advantages of a revenue-sharing arrangement are (1) the current-year deduction for the party making the payments, and (2) the contribution to the receiving party’s Social Security wage base.

From a tax reporting standpoint, the paying party would issue an IRS Form 1099-MISC annually for the gross amounts paid, and the receiving party would report the income he or she receives on IRS Form 1040.
SAMPLE TAX TREATMENTS ILLUSTRATE
THE COMPLEXITY OF A SINGLE SALE

<table>
<thead>
<tr>
<th>DESCRIPTION</th>
<th>TAX IMPLICATION TO SELLER</th>
<th>TAX IMPLICATIONS TO BUYER</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tangible Business Property (e.g., computers, printers, furniture, fixtures, and other business equipment or property)</td>
<td>If held more than a year, gains in excess of depreciation are generally subject to long-term capital gain rates, however there may be an ordinary income component (e.g., depreciation recapture).</td>
<td>Establishes new tax basis for depreciation proposes. The assets then can be depreciated per applicable IRS rules and depreciation tables.</td>
</tr>
<tr>
<td>Intangible Business Property (e.g., website address/domain name, telephone number(s))</td>
<td>If held more than a year, gains in excess of amortization are subject to long-term capital gain rates, however there may be an ordinary income component (e.g., depreciation recapture).</td>
<td>Establishes new tax basis for amortization purposes. The assets then can be amortized per applicable IRS tables.</td>
</tr>
<tr>
<td>Goodwill</td>
<td>If held more than one year, long-term capital gain rates apply.</td>
<td>Amortizable over 180 months.</td>
</tr>
<tr>
<td>Restrictive Covenants (e.g., covenant not to compete, nonsolicitation agreement)</td>
<td>Ordinary income tax rates apply.</td>
<td>Amortizable over 180 months.</td>
</tr>
<tr>
<td>Consulting Agreement</td>
<td>Ordinary income tax rates apply and subject to Social Security and Medicare taxes.</td>
<td>Current deduction in year paid with the consultant being responsible for Social Security and Medicare taxes.</td>
</tr>
<tr>
<td>Employment Agreement</td>
<td>Ordinary income tax rates apply and employer responsible for withholding and remitting Social Security and Medicare taxes.</td>
<td>Current deduction in year paid with employer being responsible for proportionate withholding and remitting all Social Security, Medicare taxes and other employment related taxes.</td>
</tr>
</tbody>
</table>

*There may be additional state specific tax implications as this chart is not all inclusive nor does the chart provide for specific circumstances. Please consult your independent counsel for specific tax consequences at both the federal and state level.*
ADDITIONAL CONSIDERATIONS

Whether buying the assets or the stock of a practice, the purchaser generally enters into two or three additional contractual relationships with the seller. The most common of these agreements include the:

- Consulting agreement
- Employment agreement
- Noncompete/nonsolicit agreement

Note that all contractual agreements should be vetted by appropriate counsel as they are subject to applicable state laws.

The consulting agreement differs from an employment agreement, wherein you define the specific scope of consulting services the seller will provide and the time frame for those services during the transition. In an employment agreement, the party is an employee and will be expected to act as an employee and will have differing rights and responsibilities when compared to an independent contractor/consultant. It is particularly important to understand and define the nature of the relationship as the consulting and employment agreements are not mutually exclusive.

These types of agreements permit the buyer to claim an ordinary tax deduction for the amounts paid to the seller in his specific role as a consultant or an employee. The seller would recognize ordinary income subject to self-employment taxes, as reported on Form W-2 or Form 1099-MISC.

NONCOMPETE/NONSOILICIT

If you buy business assets or stock from an individual, the last thing that you want is for that person to then go into business under a different trade name and start soliciting the clients of the practice he or she just sold. To prevent this situation, the buyer typically will require the seller to enter into a noncompete/nonsolicit agreement.

The sales proceeds allocated to noncompete/nonsolicit agreement are taxed as ordinary income, and are not likely to be subject to self-employment taxes since the seller is being paid not to do something. Conversely, the paying party would not receive an immediate deduction but instead would capitalize and amortize over a period of 15 years.

PLANNING TIP:
Before entering into any noncompete/nonsolicit agreement, you should check with local counsel to ensure the agreement is enforceable in the applicable state(s) of coverage.
ADDITIONAL TAX CONSIDERATIONS

WHY IS IT IMPORTANT TO HAVE A SEPARATE EMPLOYMENT OR CONSULTING AGREEMENT?

It is highly unusual for a business to simply transfer from one party to another without the active engagement of the selling party. And since the seller is expected to be active in business transactions over a period of time, it is advisable that the nature of that relationship and time frame be contractually spelled out and separate from the purchase of the business’s assets or stock.

Also there may be other tax consequences arising out of the transaction and specific transactional guidance should be solicited from your own tax and/or legal counsel; some of which may include:

• Alternative minimum tax
• §338(h)(10) election
• Depreciation recapture
• State and/or local taxes
• Medicare surtax

CONCLUSION

Tax implications can have a significant impact on a buyer’s ability to fully service the debt incurred when purchasing another practice. This is why it is extremely important to understand the cash flows on an after-tax basis when structuring a deal. Clearly an acquisition is not a transaction you would want to pursue without competent tax and legal counsel.

By discussing the tax considerations discussed in this paper with your tax and legal advisors, you may be able to avoid many unintended tax consequences. As with investment recommendations for your clients, it is not likely you let the tax tail wag the transaction dog. However, before you enter into a contract, the best advice is to follow Habit No. 2 from author Stephen Covey: “Begin with the end in mind.”

This paper likely does not address the implications of each specific transaction. Please be aware that this paper is intended to provide an overview only and is not a substitute for specific transactional guidance from an attorney, certified public accountant, enrolled agent or other subject matter expert. For specific transactional related advice, please consult with your own tax and/or legal counsel.

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RESOURCES

IRS Form 8594

Instructions to IRS Form 8594

IRS Publication 537, Installment Sales

IRS Form 6252

Instructions to IRS Form 6252

IRS Publication 544, Sales and Dispositions of Assets

IRS Form 4797, Sales of Business Property
www.irs.gov/uac/Form-4797,-Sales-of-Business-Property

IRS Schedule D (Form 1040), Capital Gains and Losses

IRS Form 1099-MISC Form and Instructions
www.irs.gov/uac/Form-1099-MISC,-Miscellaneous-Income-