TAXATION OF AN ASSET SALE IN A FINANCIAL SERVICES BUSINESS

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The parties to the sale of an independent financial services businesses can, in most cases, choose whether to record the sale as either an asset sale or a stock sale. Generally, most external transactions (between a selling advisor and a third-party buyer) are structured as asset sales. Most internal transactions (between partners, between an employer and an employee, or between family members) are structured as stock (or equity) sales. Unlike the buyer of stock in a stock sale, an asset buyer does not typically assume any of the business's liabilities. This white paper focuses on the tax treatment of an asset-based sale; for information on internal stock-based transactions, please see FP Transitions' white paper The Lifestyle Succession Plan.

KEY POINTS

1. An asset sale of a financial advisory business can provide the seller with many of the tax benefits of a stock sale, without the buyer incurring the liabilities that come with purchasing stock.
2. The seller can receive favorable tax treatment because, typically, most of the assets in a financial advisory business are subject to capital gains rates.
3. The buyer and seller will need a properly drafted Asset Purchase Agreement, Consulting Agreement, and Non- Competition/Non-Solicitation Agreement to achieve the intended results.

In an asset-based transaction, the assets to be acquired or sold are specified in an Asset Purchase Agreement ("APA"). If the seller will provide some amount of post-closing consulting support to transition the business to the buyer, those intentions and the associated agreed terms are also noted in the APA and a separate Consulting Agreement. Together, the purchase price of the assets and the proposed post-closing consulting fees equal the total consideration the buyer will foreseeably spend and the total figure the seller will receive. The APA should also lay out the agreed tax allocation for each asset type included in the proposed transaction. In other words, the parties agree exactly how much the buyer is paying for each of the seller's primary assets. The total of the allocations for all asset types will equal the purchase price at the time of closing. In general, the purchase price is allocated among three primary asset classes:

a) Seller's goodwill and other capital assets;
b) Seller's restrictive covenants (e.g. an agreement to not compete with the buyer for the business of the sold client accounts for a specified amount of time); and
c) Seller's furniture, fixtures and equipment (if included).

Depending on how the total purchase price is allocated among the various assets, an asset transaction can provide favorable tax consequences for both parties.

The buyer will acquire a new cost basis in the assets equal to the purchase price, which may allow for an amortization deduction to be taken, and the expenses the buyer pays associated with seller's post-closing consulting work could be expensed as paid. Thus, asset buyers are typically able to amortize the entire purchase price over time rather than simply acquire basis in their investment. The seller must pay taxes on the difference between his or her basis in the assets and the price paid by the buyer for the business assets, but the portion of the purchase price allocated to the capital assets (goodwill, client list, cash flow, etc.) usually results in long-term capital gains tax treatment to the seller for the majority of the purchase price. The table in Figure 1 presents the tax treatment from the buyer's and seller's perspective in an asset- based transaction.

The table in Figure 1 presents the typical tax treatment from the buyer's and seller's perspective in an asset-based transaction.

The bulk of the total consideration is usually allocated to the client list and to the seller's name and goodwill, all of which are taxed at capital gains rates. The remainder of the total consideration is allocated to the seller's post-closing support in the form of a ***Consulting Agreement***, and to a ***Non-Competition/Non- Solicitation Agreement*** - both of which are taxed as ordinary income. Typically, only a small amount of the total consideration is allocated to electronic equipment, furniture, and fixtures.

FIGURE 1. How Asset Sales are Reported

Types of Assets	Life of Asset on Buyer's Tax Return	Reported on Seller's Tax Return
Client List	15 Years	Capital Gain
Seller's Name & Goodwill	15 Years	Capital Gain
Non-Competition Agreement	15 Years	Ordinary Income
Seller's Continued Assistance After Sale	Expenses as Paid	Ordinary Income Subject to FICA Tax
Computer & Other Electronic Equipment	5 Years with Option to Expense in First Year	Capital Gain with Recapture of Depreciation as Ordinary Income
Furniture & Fixtures	7 Years with Option to Expense in First Year	Capital Gain with Recapture of Depreciation as Ordinary Income
Office Supplies	Expenses as Paid	Ordinary Income
Leasehold Improvements	39 Years or Expensed with Abandoned	Capital Gain with Recapture of Depreciation at 25%
Real Estate	39 Years	Capital Gain with Recapture of Depreciation at 25%

This chart shows how the buyer can expense or depreciate the purchase price and how the seller must report that gain.

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