

Agency Purchase Price Allocation: Tax Considerations for Buyers and Sellers

By Michael B. Ryan, CPA

The sale of an insurance agency requires the buyer and seller to report the allocation of the sales price among the assets sold.

When a business sells its assets, the seller must allocate the purchase price among the various assets to determine the amount realized on the sale of each asset. Similarly, the buyer must allocate the purchase price among the acquired assets to determine the tax basis of each asset.

Allocation of the purchase price can be critical to both the buyer and seller.

The requirement to report is imposed under IRC section 1060 and related regulations. Form 8594 is filed by both buyer and seller in the year of sale, reporting the purchase price allocation and disclosing any agreements related to the sale such as employment/consulting agreements, covenants not to compete, leases or similar arrangements.

The regulations require the allocation be made using the residual method. Under the residual method, the purchase price

is generally allocated to cash, accounts receivable and other tangible and intangible assets up to their fair market value.

Any remaining amount is allocated to goodwill.

Tax Implications of Price Allocation

The typical independent agency sale involves only the key assets required to transfer the agency customer base to the buyer. The buyer purchases those assets from the seller's business entity, which is usually a sole proprietorship, S Corporation or LLC/partnership.

Most of the assets sold are intangible assets, including goodwill, customer expiration lists and covenants not to compete.

Tangible assets sold generally include office furniture, equipment and computers.

Impact on Buyers

The main goal of the buyer is to allocate

the purchase price to the assets that will allow for the deduction of the purchase price in the quickest manner possible. Intangible assets including goodwill, customer expiration lists and covenants not to compete are amortized over 15 years on a straight-line basis.

Additional costs to the buyer related to the acquisition (legal and professional) must be allocated to the assets purchased and included in the amortizable tax basis.

Tangible furniture and equipment qualify for depreciation over three to seven years, but can also qualify for the Section 179 election to expense the cost in the year of acquisition. The buyer would want to allocate as much as possible to the tangible assets.

Buyers should also be aware that if they incur a success fee in connection with the purchase of an agency, they can elect to expense 70% of the fee in the year of acquisition. The remaining 30% would be capitalized like other professional fees related to the transaction. Success fees are generally paid to professional advisors on mergers and acquisitions upon

the successful closure of the transaction.

Impact on Sellers

The seller's goal is to minimize the tax cost of the sale to realize as much of the sales proceeds as possible. Generally, this would require allocating most of the sales price to assets qualifying for long-term capital gains treatment. Goodwill, customer lists and similar intangible assets would qualify for preferable long-term capital gains rates. Proceeds from covenants not to compete are ordinary income to the seller and do not qualify for capital gains rates.

The sale of depreciable furniture and equipment usually results in deprecia-

tion recapture to the extent the sales price exceeds the net book value of those assets. This will result in ordinary income to the seller to the extent of depreciation taken on those assets. To minimize the tax impact, the seller will want to allocate the sales price first to tangible furniture and equipment equal to the net book value of those assets. Secondly, the seller would like to allocate the purchase price to intangible capital gains assets to the extent possible, and lastly to covenants not to compete taxable as ordinary income (but not subject to self-employment taxes).

Sellers should be aware that the sale of these business assets is not subject to the additional 3.8% net investment income

tax and should be excluded from the tax on Form 8960.

In my experience, the allocation of the purchase price is often an afterthought performed after the deal has been negotiated. In some cases, the allocation has been performed after the sale has taken place. Since the allocation can have significant adverse tax consequences to both parties, the allocation should be a meaningful part of any negotiation and result in a definitive allocation included in the sale closing documents. ■

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