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## NEWS RELEASE

### TAXES A FACTOR WHEN YOU SELL

#### **Primary goal should be to ensure proceeds are considered capital gains and not income**

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With thousands of aging financial advisers hoping to sell their practices over the next decade, a big consideration is how much tax the owners will have to pay if and when they sell their businesses.

The most tax-efficient means of "selling" your practice is to give it away.

Circumstances are ideal for small-business owners to make a gift of their companies to their children or other individuals — if they plan to bequeath the business to them anyway, according to David Scott, an estate-planning expert with Penn Mutual Life Insurance Co.

The exemption for estate and gift taxes is \$5 million per individual and \$10 million for a married couple. Unless the owner of the advisory practice is counting on funds from the sale of his or her practice for retirement, he or she can bestow the business entirely tax-free.

In cases in which a practice is worth more than \$10 million, the owner also can extend loans to family members on extremely favorable terms to finance the rest of the purchase, paying capital gains tax on the amount above \$10 million. The exemption — unless Congress extends it — will revert to \$1 million at the end of next year.

"Right now, it's an extremely attractive opportunity," Mr. Scott said.

Much more often, however, adviser/owners don't have a child or other relative prepared to continue managing the business. Instead, they are looking to sell their businesses to non-family employees, to other advisers, or to aggregator firms or other buyers such as banks or trust companies.

Keeping the tax bill down for a seller largely boils down to ensuring that the proceeds from a sale or series of transactions will be taxed as capital gains, at 15%, rather than ordinary income, which is 35% for those in the top tax bracket.

A trend in advisory practice sales over the past several years has been for the owner of the firm to stay on for several years to smooth the transition process. In that case, they continue to draw a salary from the firm, according to **Dan Seivert**, chief executive of investment banking firm **ECHELON Partners**.

One strategy that can reduce taxes from the seller's point of view is to shift some of the salary consideration to the purchase price for the firm and thereby have it taxed as a capital gain.

An adviser selling a firm and continuing to draw a \$200,000 salary for four years could save \$80,000 by having half the salary treated as part of the purchase price.

Of course, the benefit of this strategy to the seller is a cost to the buyer.

"Salary expenses can be deducted from the buyer's taxable income," Mr. Seivert said. "Shifting some of that expense to the purchase price increases the buyer's taxable income, and they may not be comfortable with that."

Indeed, in advisory practice sales, tax strategies that benefit the seller very often hurt the buyer and can result in lower valuations for the business. Chief among the tax issues is whether the transaction is treated as a sale of equity or a sale of assets.

"Sellers always want to sell equity, while buyers always want to buy assets," said Rick Bailine, managing director of tax services for accounting and consulting firm RSM McGladrey.

For sellers, an equity sale is clean and easy, and the proceeds are taxed at the 15% capital gains rate. If the deal is structured as an asset purchase, the price paid has to be allocated to each of the assets, and the tax treatment can vary.

"It's a much more complicated analysis, and the results can be that some of the proceeds are treated as ordinary income," Mr. Bailine said.

Buyers want the deals to be asset purchases for two reasons: They can depreciate the assets for tax purposes, and they can protect themselves from future liabilities.

"If the buyer purchases assets, any future lawsuits against the firm or regulatory transgressions are assumed by the seller," Mr. Seivert said.

Two-thirds of firms' transactions are now asset sales, he said.

The tax consequences of practice sales depend to a large degree on the corporate structures of the buyer and seller.

A stock-for-stock deal between two corporations can be treated as a tax-free merger. Capital gains taxes ultimately are levied on the selling adviser when the stock changes hands.

If the firm is structured as a pass-through entity — either an S corporation or a limited liability company — both buyer and seller can get the tax treatment they want by agreeing to an Internal Revenue Service section 338(h)(10) election.

"If both companies are corporations, the seller treats it as an equity sale and the buyer treats it as an asset sale," Mr. Bailine said. "They don't have to worry about it."

If the selling firm is a C corporation — about 15% of registered investment advisory firms use this corporate structure — the situation gets more difficult.

At C corporations, income is taxed at the corporate level, as are any distributions to shareholders. They aren't allowed to make the 338 election.

Although virtually all advisory firms founded in the past two decades are either S corporations or LLCs, many older firms are C corporations.

One way to encourage a buyer to do an equity transaction with a C corporation is to create a goodwill asset as part of the transaction.

Because the value of an adviser's business largely depends on his or her own skills and experience, it isn't a stretch to value goodwill at 30% of the business or more, Mr. Bailine said.

Case law supports the practice, but it is essential that buyer and seller clearly document the amounts being paid for equity and goodwill, he said.

### ABOUT ECHELON PARTNERS

ECHELON Partners (ECHELON) was formed in 2001 to offer investment banking and consulting to a subset of the financial services industry known as "investment product developers and distributors" (IPDADs). Since that time, ECHELON's professionals have helped hundreds of senior executives envision, initiate, and execute a multitude of complex business strategies and transactions. ECHELON's business is making companies more valuable through delivering advice and orchestrating transactions. Accordingly, ECHELON measures its success in the enterprise value it creates for its clients. Companies that strive to outperform their peers choose to work with ECHELON because we are as passionate about their results as they are.

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