

Tax Considerations When Buying or Selling an Accounting Firm

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The traditional methods of allocating the base purchase price in an acquisition of an accounting firm have been goodwill; restrictive covenants; client lists (and other similar intangible assets); and furniture, fixtures and equipment. The tax treatment for amortizing intangibles changed in 1997. The updated law requires intangible assets in an acquisition be amortized over 15 years. This requirement has the advantage of avoiding the previous wholly non-deductible treatment for goodwill. This comes at the expense of the loss of the favorable treatment that was afforded other intangibles such as restrictive covenants.

Payments to sellers are rarely treated as the acquisition of capital stock. This often affects internal succession planning. Of course, the acquisition of capital stock affords the buyer no tax deduction at all.

When valuing an accounting practice, the terms of the deal are most critical. The potential profitability to the successor firm dictates these terms. If a buyer is forced into treating the payments to the seller as deductions over 15 years, while paying off the balance in 3–10 years, this obviously reduces potential profitability.

Buyers and sellers often compromise between the seller's desire to have a capital gain treatment and the buyer's goal of a current deduction through:

- **Internal Revenue Code, Section 736** — Utilized in both internal and external sales of accounting firms. Payments from the firm to the seller are treated as ordinary income (not earned), and the buyer has a current deduction. This is important to a seller who has concerns about the self-employment tax or income affecting Social Security payments.

- **Furniture, Fixtures and Equipment** — Hard assets in an acquisition are covered by the bulk sales tax codes for New Jersey residents. In most other states, purchase proceeds allocated to furniture, fixtures and equipment can create additional costs for sales tax.

Consulting Services

Many deals include a substantial amount allocated to consulting services. The justification is that without the seller's consulting assistance, client retention will suffer greatly. Consulting is a Catch-22. Buyers relish this allocation, as it provides the firm a current deduction. Sellers, however, not only lose the capital gain treatment but normally must also treat this portion as earned income.

Why would a seller not want capital gains treatment for the entire acquisition price? Ideally, sellers wish to structure deals as goodwill without suffering a reduction in the value of their practices. However, sellers of a CPA practice should realize that buyers will want to avoid this allocation. If a buyer is acquiring a firm and paying the debt over five years, but deducting it over 15 years, they will initially have to pay taxes on unavailable cash flow. This often results in a lower valuation for the firm.

While consulting sounds risky for the seller, allocating a portion to consulting can bring significant benefits. First, buyers are likely to offer a higher multiple if they have an opportunity for a better tax treatment. Second, when sellers collect payments as consulting compensation, they use certain deductions in a pre-tax approach, such as allowable business expenses that might otherwise be treated as itemized deductions. Although the

consulting proceeds are taxable as earned income, much of the tax liability can be offset by combining the aforementioned deductions. Finally, the payments also should qualify as earned income for purposes of determining retirement contributions.

Goodwill

Martin Ice Cream Company v. Commissioner established the "personal goodwill" concept. Under certain circumstances, goodwill that would normally be attributed to a practice can be sold by the firm's practitioners. This can be a helpful tactic if the goodwill is tied up in a C corporation or in internal acquisitions where the parties want to create capital gains treatment for part of the proceeds.

So whether you are selling or buying an accounting firm, no proposal is truly complete until each party understands and agrees on the treatment of payments for tax purposes. 🧩

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