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Purchase Price Allocation When Selling Your Practice

By Dan Schulte, JD
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Question: I'm working with a broker to sell my practice. We received an offer, and I was given a letter of intent. It contained an allocation of the purchase price. How does this matter? The total amount I am being paid is pretty much what I asked for. Should I worry about this now, or is it not binding, like much of what is contained in this letter of intent?

Answer: Reducing the tax liability that you will incur upon the sale of your practice to the greatest extent possible should be one of the early considerations when planning a practice sale. You should be sure to involve your attorney and accountant in this process.

The purchase price and its allocation are not terms that should be binding in a letter of intent (in fact, there is no reason the allocation should be included at all). The only terms that should be binding in a letter of intent have to do with access/due diligence, exclusivity, an earnest money deposit, if any, and certain other non-economic terms. A binding agreement on the amount of the purchase price and its allocation should come later in connection with the negotiation of the purchase agreement and other documents necessary to close the sale.

The allocation of the purchase price can have a material effect on the amount of taxes the seller pays for the year the sale closes and the ability of the buyer to utilize tax deductions in future years. Most sales of dental practices are structured as sales of assets vs. a sale of stock or other ownership interests. This column will focus on an asset sale.

The seller and buyer are not free to allocate the purchase price in any way they choose. Instead, they must comply with Internal Revenue Code (Section 1060 and Form 8594). That law requires that the final purchase price be allocated in a certain manner, starting with tangible assets, and moving to intangible assets. The tangible assets of a dental practice being sold are usually supplies, equipment, furniture, etc. The intangible assets consist of goodwill and a covenant not to compete. The portion of the purchase price first allocated to the tangible assets should be equal to their fair market value. The balance of the purchase price is then allocated to goodwill and the covenant not to compete.

Despite the requirements of the tax law making it fairly clear how to go about a purchase price allocation, there can be tension/negotiation between a seller and buyer in coming to an agreement. This is because of the differing tax consequences to each resulting from the allocation. The buyer will want to allocate as much as possible to the tangible assets, and the seller will want the opposite. This is because, first, the buyer will be able to depreciate (and possibly write off immediately) these amounts and obtain tax deductions much more quickly (right away or over three to seven years) than the amounts allocated to goodwill and a covenant not to compete (15 years). Secondly, amounts allocated to tangible assets will result in gain taxed to the seller at ordinary income rates vs. the lower capital gain rates applicable to the gain resulting from amounts allocated to goodwill and a covenant not to compete. The allocation of the purchase price to tangible assets should be based on a valuation or other reasonable estimate of their fair market value. A valuation/reasonable estimate usually cannot be obtained until after due diligence is completed and is unknown at the letter of intent stage.

The allocation of the purchase price can cost or save the parties thousands of dollars in taxes. It should be done after due diligence has been completed and a valuation of the tangible assets is available, or some other reasonable estimate of fair market value has been obtained. ●

Send legal questions for publication to Journal Managing Editor Dave Foe at dfoe@michigandental.org.