

Deploying Post-Sale Liquidity: Tax Planning and Capital Allocation After a Business Exit

A Guide to the Ordinary Income Spike Created by Asset Sale Reclassification, Recapture, and Transition Agreements, and How to Sequence Capital Decisions in the Closing Year

TAX STRATEGY | BUSINESS EXIT | CAPITAL ALLOCATION

Introduction: The Gap Between Headline Price and Spendable Capital

Closing a company sale is rarely a single tax event. For founders within the first twelve months of a transaction, the headline purchase price and the amount that actually lands as spendable, after-tax capital in the closing year are often two very different numbers. The gap is frequently driven less by the overall deal size than by how the purchase price was allocated across asset categories, how depreciation recapture is triggered on equipment and other depreciated property, and whether a consulting or transition services agreement was built into the deal to retain the founder's knowledge during handoff.

Each of these mechanisms converts a portion of proceeds from the comparatively favorable long-term capital gains column into the ordinary income column, and all of it typically lands in the same twelve-month filing period. This guide walks through why that happens, how to model it before the return is filed, and how to think about sequencing any new capital allocation decision so that the tax exposure is addressed deliberately rather than reactively.

Asset Allocation

How purchase price is divided across categories determines your tax rate on each dollar

Depreciation Recapture

Past deductions on equipment trigger ordinary income in the year of sale

Transition Agreements

Consulting and non-compete payments are taxed as ordinary compensation, not sale proceeds

What You Will Learn in This Guide

This guide explains the full mechanics of the closing-year tax picture for exiting founders — from deal structure through capital deployment sequencing.

1 Asset Sale Tax Blending

Why an asset sale, the structure most buyers prefer, routinely produces a blend of capital gain and ordinary income rather than a single tax rate

2 Depreciation Recapture Rules

How Section 1245 and Section 1250 depreciation recapture work, and why the two are taxed differently

3 Consulting Agreement Treatment

Why consulting, transition, and non-compete arrangements are generally treated as ordinary compensation, not sale proceeds

4 Stacking Ordinary Income

How these ordinary income items stack together in the closing year and why the character of each dollar matters as much as the amount

5 Deduction Framework

A framework for evaluating whether a current-year, trade-or-business deduction such as the intangible drilling cost election under IRC Section 263(c) is relevant to the ordinary portion of proceeds specifically

6 Timing Mechanics

Why addressing the timing mechanics early avoids a rushed, year-end capital decision

Why the Closing Year Return Rarely Shows One Tax Rate

Buyers in middle-market transactions overwhelmingly prefer to acquire assets rather than stock, because an asset purchase lets them step up the cost basis of what they are buying and depreciate it going forward. Sellers prefer to sell their stock since the owners will receive capital gains treatment on the sale, but an asset sale usually results in part of the gain taxed at ordinary income rates, because buyers prefer to buy assets rather than stock so they can increase the cost basis in the acquired assets up to fair market value and maximize their future depreciation deductions. That structural preference is the starting point for the ordinary income exposure most sellers encounter in the closing year.

Purchase Price Allocation

In an asset transaction, the purchase price is not a single number for tax purposes. It is divided among categories such as equipment, inventory, goodwill, a covenant not to compete, and any consulting or transition arrangement. That allocation determines which amounts are taxed at capital gains rates and which are taxed at ordinary income rates, with both buyer and seller required to report the allocation consistently on Form 8594. The schedule is negotiated, not automatic, which is why setting the purchase price allocation in the letter of intent, rather than leaving it to be worked out after signing, is the point at which a seller still has leverage over how much value lands in each category.

Depreciation Recapture

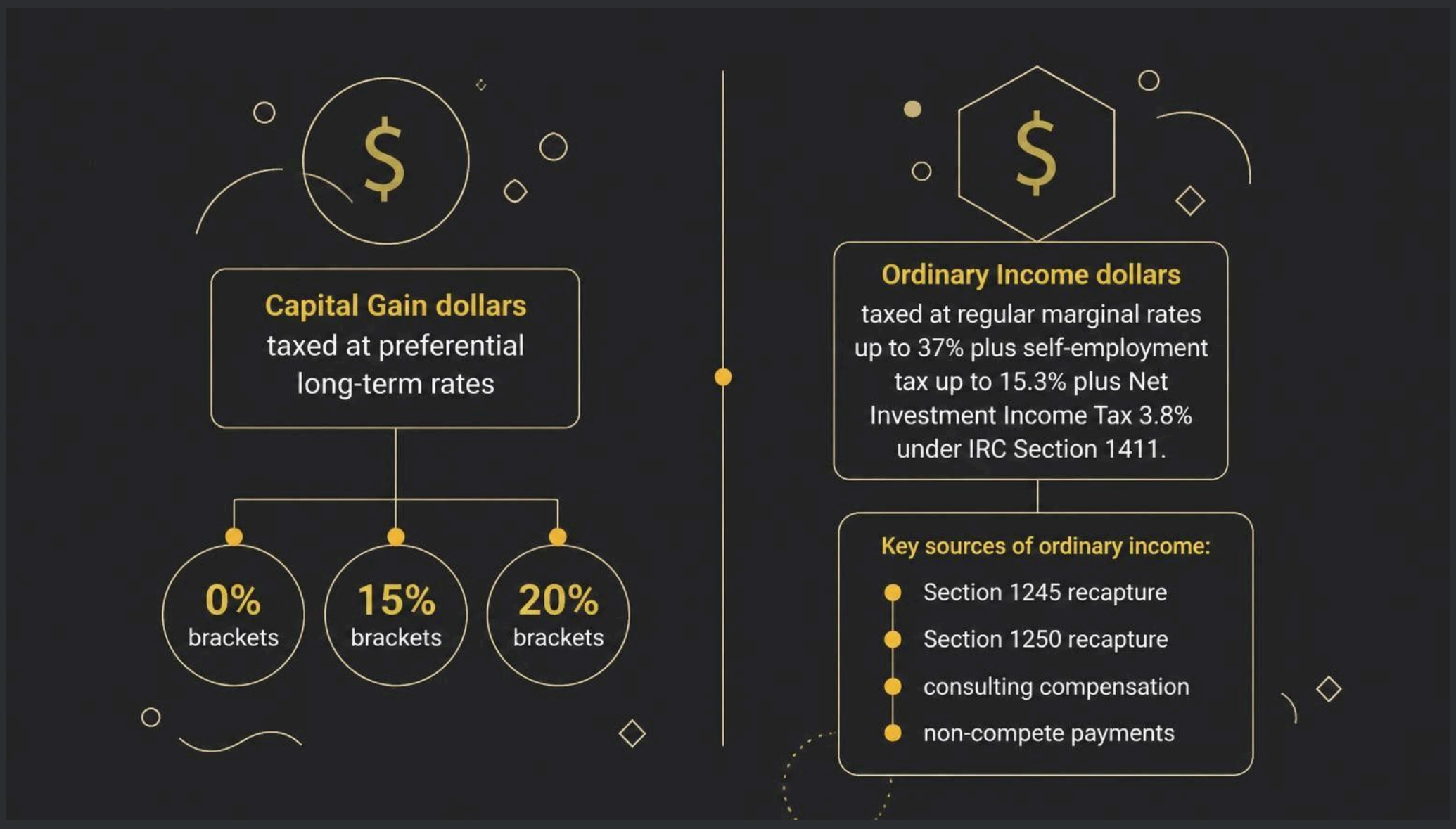
When depreciated equipment, vehicles, or other tangible business property is sold at a gain, the tax code does not allow the full gain to be treated as a capital gain. All depreciation deductions previously taken for the property, or allowed even if not actually taken, are recaptured and taxed as ordinary income under Section 1245. Real property depreciated on a straight-line basis is treated somewhat differently: the depreciation portion of the gain is taxed as unrecaptured Section 1250 gain, capped at a maximum 25 percent federal rate, while the remaining appreciation above the original purchase price gets standard long-term capital gains treatment. In either case, the recapture figure is tied to past deductions already taken on the business's books and is calculated independently of how the rest of the deal is structured, and all depreciation previously claimed on Section 1245 property is recaptured at ordinary income rates, up to 37 percent in 2026.

Consulting and Transition Agreements

Many buyers condition a deal on the founder staying available for a defined transition period, often documented as a separate consulting agreement. Amounts allocated to a covenant not to compete or to consulting and transition services are generally treated as ordinary income, with compensation for services potentially subject to employment taxes as well, while amounts allocated to goodwill may be taxed as long-term capital gain when holding-period requirements are met. Consulting payments may face 15.3 percent self-employment tax on top of ordinary income tax, so the price allocation itself can change what a seller actually keeps, and payments for services are generally treated as compensation rather than purchase-price capital gain, with payroll, withholding, or self-employment tax issues potentially arising from that characterization.

⚠ Depreciation recapture generally is recognized in the year of sale, even if the buyer pays the related proceeds later — meaning the ordinary income portion tied to recapture typically cannot be deferred into a lower-income future year the way some of the capital gain can.

Why the Character of a Dollar Matters as Much as the Amount



A founder evaluating what to do with sale proceeds needs two numbers, not one: the total proceeds, and the portion of those proceeds that will be taxed as ordinary income in the closing year specifically. These are taxed on fundamentally different schedules. Long-term capital gain is taxed under the preferential brackets established by the tax code, while the ordinary income created by recapture and consulting compensation is taxed at the seller's regular marginal rate, which can reach the top federal bracket, plus any applicable self-employment tax on the compensation piece and the Net Investment Income Tax under IRC Section 1411 on the applicable portion of the gain.

The practical effect is that two sellers with identical headline sale prices can keep meaningfully different amounts, depending entirely on how their respective purchase agreements allocated value among goodwill, equipment, and consulting compensation. A deal weighted toward a long consulting period and a large equipment recapture figure will generate a materially larger ordinary income spike in the closing year than a deal weighted toward goodwill, even at the same total price.

> If too much value is shifted away from goodwill and into ordinary-income categories such as a noncompete or consulting arrangement, the seller's after-tax proceeds can drop quickly — which is why it is worth modeling the tax impact of any proposed allocation before agreeing to it.

This is also why the planning conversation should start with the allocation schedule and the depreciation history of the business, not with the wire amount.

Decision Framework: Matching Deduction Character to Income Character

Once the ordinary income component of the closing year return is estimated, a founder is in a position to evaluate whether any current-year planning tool is relevant, and specifically which portion of the proceeds it is relevant to.

A capital contribution into a direct working interest in an oil and gas well can generate a current-year deduction for intangible drilling costs under IRC Section 263(c), covering the non-salvageable costs of drilling such as labor, fuel, and site preparation. Because this deduction arises from active participation in a trade or business rather than from a passive activity, it is not confined to offsetting only passive income under the working interest exception in IRC Section 469(c)(3), provided the interest is held directly or through an entity that does not limit the participant's liability. That structural requirement is the mechanism that allows the deduction to reach ordinary income, including compensation from a consulting agreement and the ordinary income recognized from depreciation recapture, not merely capital gain.

The Disciplined Use Case

This points to a specific, disciplined use case rather than a blanket recommendation. The relevant question is not "how much of my total proceeds should I deploy," but "how much of my closing-year ordinary income exposure, specifically the recapture figure and the consulting compensation figure, would benefit from an offsetting trade-or-business deduction in the same tax year."

Capital Gain Portion Stays Separate

Capital allocated beyond that ordinary income figure is not offsetting anything that needs offsetting, since the capital gain portion of the sale is already taxed under the preferential long-term rate structure. Sizing any working interest capital contribution to the actual ordinary income exposure keeps the decision tied to the problem it is meant to address rather than to the full size of the liquidity event.

Two Statutory Constraints

The at-risk rules under IRC Section 465 limit the deductible loss to the amount of cash actually placed at risk, and the excess intangible drilling cost preference under IRC Section 57(a)(2) can affect alternative minimum taxable income for a portion of the deduction. These are not reasons to avoid the planning conversation, but they are reasons to have it with a qualified tax advisor before year end rather than after.

A Sequencing Framework for the Closing Year

The following six-step framework gives exiting founders a structured path through the closing year — from deal negotiation through capital deployment.

01

Request the Allocation Schedule Before Signing

The Form 8594 allocation determines how much of the price is goodwill, equipment, and consulting compensation. Once it is signed, the character of each dollar is largely fixed. Negotiate during the letter of intent stage, not after closing.

02

Separate Ordinary Income from Total Proceeds

Ask the deal's tax advisor to isolate the recapture amount tied to depreciated equipment and the total consulting or non-compete compensation scheduled for the closing year.

03

Model the Blended Tax Liability Before Year End

Not after the return is drafted. This is the number that determines whether a current-year, ordinary-income-offsetting strategy is worth evaluating at all.

04

Treat Capital Gain Proceeds Separately

This capital does not need an ordinary-income offset and is better evaluated against its own reserve, income, and longer-term allocation objectives rather than folded into a tax-driven decision.

05

Start Working Interest Due Diligence Early

Current-year deductibility under IRC Section 263(c) generally requires economic performance — meaning drilling activity has commenced — within the tax year, subject to the 90-day exception under IRC Section 461(h). Beginning the evaluation in the first half of the year removes time pressure without changing the statutory deadline.

06

Confirm the Holding Structure With Counsel

The active-income offset under IRC Section 469(c)(3) depends on holding the interest directly or through an entity that does not limit liability. A structure that limits liability, including many standard limited partnership or LLC interests, does not preserve this treatment.

A Practical Example of the Sequencing Decision

Consider an illustrative scenario — not an actual transaction and not a projection of any specific outcome. A founder closes an asset sale in which the purchase agreement allocates a portion of the price to depreciated manufacturing equipment, a portion to goodwill, and a portion to a two-year consulting and transition agreement.

The equipment allocation triggers Section 1245 recapture, taxed as ordinary income in the year of closing regardless of when the related cash is received. The consulting allocation is paid out over the transition period and is taxed as ordinary compensation as it is received, with self-employment tax layered on top. The goodwill allocation, assuming it meets the applicable holding-period and characterization requirements, is taxed under the long-term capital gains brackets.

In this illustration, the founder's tax advisor isolates the recapture figure and the first year of consulting compensation as the specific ordinary income exposure for the closing year. The founder then evaluates, with that advisor, whether a direct working interest capital contribution — sized to that ordinary income figure rather than to the total sale price, and structured to preserve the IRC Section 469(c)(3) active-income offset — is consistent with the founder's broader allocation plan for the remaining, capital-gain-taxed proceeds.

No dollar figures, deduction percentages, or return outcomes are implied by this illustration. The specific allocation determined by the authorization for expenditure on any given well, and the resulting deduction, depends on individual facts and current professional tax guidance.

Three Buckets in the Illustrative Sale

Equipment Allocation
Triggers Section 1245 recapture → taxed as ordinary income in year of closing, regardless of payment timing

Consulting Agreement
Paid over transition period → taxed as ordinary compensation + self-employment tax as received

Goodwill Allocation
Meets holding-period requirements → taxed under long-term capital gains brackets

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The Advisor's Task: Isolate the recapture figure + first-year consulting compensation = the specific ordinary income exposure to address in the closing year

Tips, Best Practices & Common Mistakes

✓ Best Practices

- Negotiate the Form 8594 allocation schedule during the letter of intent stage, when there is still leverage to shift value between goodwill and ordinary-income categories.
- Request a CPA-prepared projection of the closing year return, broken out by capital gain, Section 1245 and Section 1250 recapture, and consulting compensation, before the deal closes rather than after.
- Keep the capital-gain-taxed portion of proceeds in a separate planning track from the ordinary-income-taxed portion, since they call for different tools and different timelines.
- If a working interest capital contribution is under evaluation as an ordinary-income offset, confirm in writing with counsel that the holding structure meets the direct-ownership requirement under IRC Section 469(c)(3).
- Build the evaluation timeline around the IRC Section 461(h) economic performance window from the start of the year, rather than discovering the deadline in the fourth quarter.

✗ Common Mistakes

Planning around the headline sale price instead of the after-allocation, after-character tax exposure. The number on the signed purchase agreement is rarely the number that determines the closing year tax bill.

Underestimating the self-employment tax layered on consulting compensation. The additional tax to the seller from a consulting arrangement can be significant enough to function as a deal breaker on its own, particularly where the consulting payments are not offset by other considerations.

Waiting until the return is being prepared to discover the recapture figure. Depreciation recapture is calculated from the business's own depreciation schedule and can be estimated well before closing.

Sizing a current-year deduction strategy to the entire sale price rather than to the specific ordinary income exposure. This overstates the planning need and can push capital into a position for reasons unrelated to the actual tax problem.

Assuming any entity structure preserves the active-income offset. A limited partnership interest or an LLC membership interest that limits personal liability generally does not qualify under IRC Section 469(c)(3), even if the underlying asset is the same working interest.

Treating the consulting agreement's length and compensation as a formality. Consulting fees are typically ordinary income, and sellers should plan for self-employment taxes, withholding rules, and how the agreement is structured well before the terms are finalized.

Moving Forward With a Sequenced Decision

The size of a sale price is a headline. The mix of capital gain, depreciation recapture, and consulting compensation behind that headline is the number that actually determines what a founder keeps in the closing year. Addressing that mix starts with the purchase agreement itself, continues through a CPA-prepared projection of the closing year return, and only then moves to evaluating whether any current-year planning tool is relevant, and to which specific piece of the exposure.

> Summit Ventures works with exiting founders at this stage as an entrepreneurial joint venture platform built around direct working interest participation in producing and development-stage oil and gas assets. Business participants hold a direct working interest position — not a fund share or a limited partnership interest that would forfeit the active-income offset under IRC Section 469(c)(3) — and retain governance rights and operational transparency into how capital is deployed in the field.

For a founder whose closing-year return includes a meaningful ordinary income component from recapture or a transition agreement, a capital contribution sized to that specific exposure — evaluated with enough lead time to respect the IRC Section 461(h) timing window — is a more disciplined starting point than a reaction to the total headline figure.

The deployment decision that follows a sale deserves the same rigor a founder applied to building the business in the first place. Understanding the mechanics first, before evaluating any specific allocation, is what allows that decision to be made on the founder's own timeline rather than the calendar's.

Questions to Bring to Your Advisory Team

- What percentage of our purchase price has been allocated to goodwill versus equipment, inventory, and consulting or non-compete compensation, and has that allocation been modeled for its tax impact rather than just its legal terms?
- What is our actual Section 1245 or Section 1250 recapture exposure based on the business's depreciation schedule, and is that figure fixed regardless of how or when we receive the related payments?
- How much of our consulting or transition agreement compensation will be subject to self-employment tax in addition to ordinary income tax?
- Of our total proceeds, what specific dollar amount is taxed as ordinary income in the closing year, separate from the portion taxed as long-term capital gain?
- If we are evaluating a working interest capital contribution as a current-year offset, does the proposed holding structure satisfy the direct-ownership requirement under IRC Section 469(c)(3), and has our at-risk basis under IRC Section 465 been confirmed?
- What is the realistic timeline for completing due diligence on any working interest participation given the economic performance requirements under IRC Section 461(h), and can we begin that evaluation well before year end rather than in the final weeks of the tax year?

Ready to Sequence Your Post-Sale Capital Decisions?

Summit Ventures partners with exiting founders to evaluate direct working interest participation as a disciplined, ordinary-income-specific planning tool — with full governance rights and operational transparency.

Connect With Summit Ventures