

Closing the Ordinary Income Gap

What Business Brokers and M&A Advisors Need to Know Before the Letter of Intent

PROFESSIONAL BRIEF

ASSET SALE ALLOCATIONS · CONSULTING AGREEMENT TAXATION · STATUTORY OFFSET OPTIONS

Executive Takeaway: Why This Matters

> Lower middle market deals rarely fall apart over price. They fall apart over the after-tax number a seller actually keeps once a CPA runs the purchase price allocation.

In an asset sale, the headline figure in the letter of intent and the number that lands on the seller's Schedule D are two different calculations, and the gap between them is driven by how much of the price is classified as ordinary income rather than capital gain. For business brokers and M&A advisors representing founders in lower middle market transactions, this gap is the single most common cause of late-stage renegotiation, cold feet, and walked deals.

Understanding the statutory mechanics behind that gap — and the legitimate, statute-grounded offset options a seller's CPA can evaluate — gives the deal team a way to address the objection at the letter of intent stage rather than during the final week of due diligence.

The Problem

Ordinary income exposure discovered late in due diligence triggers seller remorse and renegotiation

The Cause

Purchase price allocation treated as a back-office exhibit rather than a negotiated LOI term

The Solution

Move the allocation conversation to the LOI stage and arm the seller's CPA with statutory offset tools

Context: How Asset Sale Allocations Work

Most lower middle market transactions below roughly fifty million dollars in enterprise value are structured as asset sales rather than stock sales, largely because buyers want a stepped-up basis in depreciable assets and want to avoid inheriting unknown liabilities. Internal Revenue Code Section 1060 governs how the purchase price in an asset sale is allocated across seven defined asset classes, reported on IRS Form 8594, and both buyer and seller are required to report the allocation consistently.

The buyer has a natural incentive to push value into asset classes that generate immediate or accelerated deductions, such as depreciable equipment, inventory, and covenants not to compete or consulting agreements. The seller has the opposite incentive: value sitting in goodwill generally receives long-term capital gain treatment, while value sitting in equipment recapture, consulting fees, or non-compete payments is taxed as ordinary income — often with no cap on the rate and, in the case of consulting arrangements paid to an individual, an added 15.3 percent self-employment tax layer.

⚠ These two incentives are structurally opposed, and the allocation schedule is one of the few parts of a deal where that tension is negotiated line by line rather than resolved by a single price number.

The Timing Problem — and the Opportunity

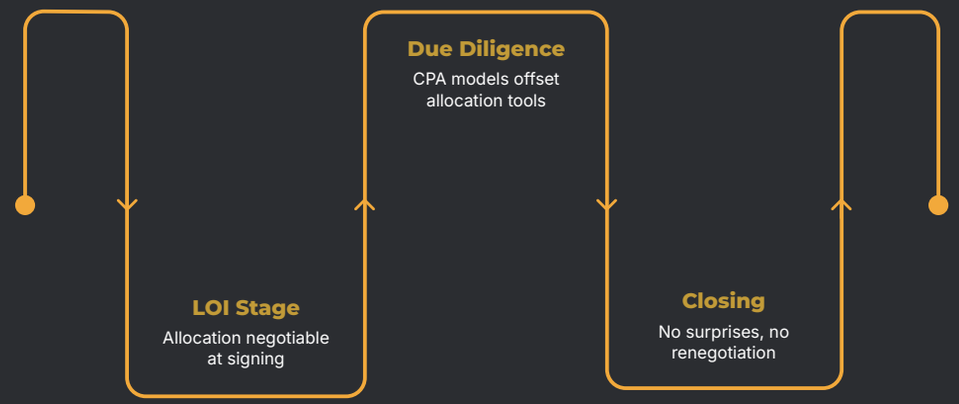
The Predictable Failure Pattern

The purchase price allocation is frequently treated as a back-office exhibit to be finalized during legal drafting, long after the letter of intent sets the headline price. By the time the seller's CPA models the actual tax outcome — often during final due diligence or even after signing — the seller sees for the first time how much of the proceeds will be taxed at ordinary rates instead of the capital gains rates they assumed when they agreed to the price.

This late discovery creates a predictable failure pattern: the seller feels the deal was mispriced, pushes back on terms that were already verbally agreed, and the advisor is left renegotiating from a weaker position with less goodwill on both sides.

The Strategic Opportunity

The opportunity for the deal team is to move this conversation to the letter of intent stage, when the allocation schedule is still a negotiable term rather than a signed exhibit, and to arm the seller's CPA with a full picture of statutory tools that exist specifically to offset ordinary income exposure — not just general tax planning advice delivered after the fact.



Key Findings: The Statutory Mechanics

Nine statutory findings define the ordinary income gap and the tools available to address it. Every deal team should understand these before the letter of intent is signed.

1	**Section 1245 Recapture — No Cap** Depreciation recapture on tangible personal property is taxed entirely as ordinary income, with no percentage cap, up to the seller's marginal ordinary rate. For 2026, the top 37% federal bracket begins at $640,600 (single) and $768,700 (married filing jointly) under the One Big Beautiful Bill Act.
2	**Section 1250 — Capped at 25%** Unrecaptured gain attributable to real property depreciation is capped at a 25% federal rate — a materially different outcome than Section 1245 property, making the asset class used in the allocation schedule a direct driver of the seller's blended tax rate.
3	**Section 453 — Recapture Cannot Be Deferred** Depreciation recapture on Section 1245 property is recognized in the year of sale even when the transaction otherwise qualifies for installment sale treatment. The capital gain portion can sometimes be spread across future tax years; the recapture portion cannot.
4	**Consulting & Non-Compete Payments** Consulting agreements, transition services agreements, and covenants not to compete are treated as ordinary compensation — not sale proceeds — and when paid to an individual they commonly carry an additional 15.3% self-employment tax exposure on top of ordinary income rates.
5	**Goodwill Allocation Advantage** Goodwill allocated to the business itself generally retains the strongest claim to long-term capital gain treatment. Any shift of value from goodwill into equipment, inventory, consulting fees, or non-compete payments lowers the seller's net after-tax proceeds even when the headline purchase price stays exactly the same.

Key Findings: The Statutory Offset Tools

Four additional statutory provisions define the offset mechanism available to a seller's CPA when ordinary income exposure has been identified in the allocation schedule.

Section 469(c)(3)(A) — Working Interest Exception

Excludes a working interest in an oil or gas property from the passive activity loss rules when the taxpayer holds the interest directly or through an entity that does not limit the taxpayer's liability. This is a direct holding requirement — not a material participation or hours-based test — and it is the statutory basis for treating a working interest deduction as available against ordinary income.

Section 263(c) — Intangible Drilling Cost Election

Allows a working interest holder to elect to expense intangible drilling costs in the year incurred rather than capitalizing them, producing a current-year ordinary deduction tied to the taxpayer's trade or business activity rather than a passive loss.

Section 465 — At-Risk Limitation Rules

Limits any such deduction to the taxpayer's actual cash contribution and recourse debt. Nonrecourse financing does not count toward the at-risk basis, which matters when sizing a capital contribution against a specific ordinary income target rather than the full transaction value.

Section 57(a)(2)(A) — AMT Preference Item

Excess intangible drilling cost deductions are an alternative minimum tax preference item for independent producers, except to the extent the excess does not exceed 65% of the taxpayer's net income from oil and gas properties for that year — a statutory relief valve worth confirming with the seller's CPA before finalizing any contribution size.

Analysis: How the Offset Mechanism Works

The Participation Model

A working interest in an oil and gas property is a direct ownership position in the underlying mineral and production rights — not a security or a fund share. When a seller's CPA is evaluating how to address an ordinary income exposure created by an asset sale allocation, the relevant comparison is not between "taking the deduction" and "not taking the deduction." It is between deduction types that are available against ordinary income and deduction types that are not.

A capital contribution into a working interest, structured so the holder participates directly or through an entity that does not limit liability, preserves the Section 469(c)(3)(A) exception and keeps the resulting intangible drilling cost deduction classified as a nonpassive, trade or business expense. That classification is what allows the deduction to offset ordinary income — such as Section 1245 recapture or consulting agreement compensation — rather than being trapped as a passive loss that can only offset other passive income.

Three Structural Elements

Three structural elements determine whether this mechanism applies cleanly to a given seller's situation:

1

Holding Structure

Must satisfy Section 469(c)(3)(A). An LLC or limited partnership interest that limits the holder's liability will not qualify, regardless of how the underlying asset performs.

2

At-Risk Basis

Under Section 465, cash and recourse debt count but nonrecourse financing does not. The at-risk basis must actually support the deduction being claimed.

3

Timing — 90-Day Window

Section 461(h) economic performance rules generally require drilling to begin within ninety days of a prepaid intangible drilling cost to support current-year deductibility.

⚠ Because most lower middle market closings happen on a compressed calendar, a capital contribution considered after closing may not leave enough runway to satisfy that ninety-day window within the same tax year as the ordinary income event it is meant to offset. This is the direct reason the conversation needs to start at the letter of intent stage rather than after signing.

Tax and Legal Considerations

None of this changes the allocation negotiation itself. A buyer and seller still need to agree on how the purchase price is divided across the Form 8594 categories, and that negotiation should proceed on its own commercial merits. What changes is the seller's calculus once the CPA can model a specific, statute-grounded tool against a specific ordinary income number, rather than facing the recapture and consulting fee exposure with no planning option on the table.

Percentage Depletion — Ongoing Benefit

Percentage depletion under Sections 611 and 613A provides a further, ongoing 15% allowance against gross income from production for independent producers once a well is producing. This is a separate benefit from the upfront intangible drilling cost deduction and continues after the original contribution's basis is exhausted.

2026 Capital Gain Rate Context

The capital gain portion of a deal is already taxed preferentially under the 2026 long-term capital gain brackets of 0%, 15%, and 20% federal, with a 23.8% top effective rate once the 3.8% net investment income tax under Section 1411 applies. The offset tools described here are specifically relevant to the ordinary income portion — the portion that does not benefit from these preferential rates.

Important Disclaimer

None of these provisions eliminate tax liability, and the specific deduction available to any seller depends on the authorization for expenditure governing the particular well, the seller's individual facts, and current professional tax guidance.

Up to 100% tax benefit potential exists under these provisions depending on the specific intangible drilling cost and tangible drilling cost split confirmed for a given participation, individual circumstances, and applicable tax treatment — which is why this conversation belongs with a CPA or tax attorney, not inside the term sheet itself.

Recommendations & Implications for the Deal Team

Three Actions for Advisors

1 Request a Preliminary Form 8594 Estimate

Ask both sides' counsel or accountants for a preliminary allocation estimate before the letter of intent is signed, even if the final numbers move during due diligence.

2 Flag Ordinary Income Categories Early

Explicitly identify for the seller and their CPA which portions of the proposed structure are likely to generate Section 1245 recapture or ordinary consulting and non-compete income — these are the categories that most often surprise sellers later.

3 Ensure the CPA Knows the Statutory Toolkit

Where the seller's CPA determines there is a meaningful ordinary income exposure and sufficient lead time before closing, make sure the CPA is aware that a working interest capital contribution, properly structured under Section 469(c)(3)(A) with the at-risk and economic performance rules in mind, is one of the statutory tools available to directly offset that specific portion of the proceeds.

Why This Changes the Dynamic

Advisors who raise this topic early change the negotiating dynamic in a specific way: the seller stops treating the allocation schedule as a binary win or loss and starts treating it as one input into a broader after-tax planning conversation that their own CPA controls.

That shift reduces the odds that a seller walks away from agreed terms during the final weeks of a transaction, and it strengthens the advisor's credibility as someone who understands the full economics of the deal — not just the headline multiple.

It also reduces rework for transaction counsel, since an allocation schedule negotiated with the ordinary income consequences already understood by all parties is less likely to be reopened after signing.

- Advisors who introduce the ordinary income question at the LOI stage give their sellers a better foundation for agreeing to terms they will not want to revisit during the final weeks before closing.

Questions for the Deal Team & Next Steps

Five Questions to Ask Before the LOI

- Has the seller's CPA modeled the blended effective tax rate implied by the proposed Form 8594 allocation, separate from the headline purchase price?
- How much of the proposed allocation sits in Section 1245 property, consulting agreements, or non-compete payments — and is that proportion consistent with the seller's expectations going into the letter of intent?
- Is there sufficient lead time before closing for the seller's CPA to evaluate a statutory ordinary income offset option, given the Section 461(h) economic performance timing constraints?
- Has the seller's tax advisor confirmed the at-risk basis and holding structure requirements that would need to be satisfied before any offset strategy could apply?
- Are buyer and seller counsel aligned on a consistent Form 8594 filing position to avoid a mismatch that could draw IRS scrutiny on either side?

Next Steps with Summit Ventures

Business brokers and M&A advisors do not need to become tax specialists to manage this risk — they need a reliable way to put the seller's CPA in front of the right statutory framework before the allocation schedule is finalized.

Summit Ventures provides educational materials built specifically for transaction CPAs and advisory teams evaluating direct working interest participation as one input into post-sale tax planning, including the statutory basis for the Section 469(c)(3)(A) exception and the structural elements a CPA would need to confirm.

Advisors working on an active deal where the proposed allocation includes meaningful Section 1245 recapture or consulting agreement income can request this educational material for the seller's advisory team as part of the letter of intent discussion — with no obligation and no change to the underlying deal terms.

Request Educational Materials from Summit Vent...

Sources & References

IRC §1060 & Form 8594 · IRC §1245 · IRC §1250 · IRC §453 · IRC §469(c)(3)(A) · IRC §263(c) & Treas. Reg. 1.612-4 · IRC §465 · IRC §461(h) · IRC §57(a)(2)(A) · IRC §§611 & 613A · IRC §1411 · IRS Rev. Proc. 2025-32 · One Big Beautiful Bill Act (2026 bracket thresholds)