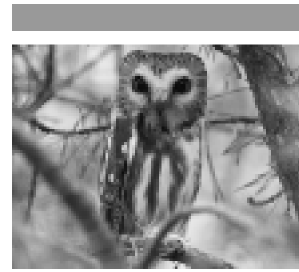

SALE OF A BUSINESS

INTRODUCTION

The tax consequences governing the sale of a going business depend in part on the form in which the business has been operating. There are some tax aspects unique to proprietorships, and other rules unique to partnerships and partners. C corporations are subject to other tax considerations, whereas S corporation tax laws have their own unique twists. Since the consequences of selling a business should be considered when forming a business, it is necessary to understand the tax rules governing each of these business forms to competently advise clients on the choice of an entity.

This chapter discusses the tax rules that relate to sales of all businesses regardless of the form of operation. It also integrates the rules with those of the various forms of business enterprise in a rudimentary manner.

In addition, the tax consequences to the purchaser of the business are covered. It is important for the tax advisor to understand both sides of the transaction. First, the same tax advisor might be advising a client on the sale of one business and the purchase of another. Second, when a professional is giving advice to one party in a transaction, it can be extremely helpful to know what the other side wants in the deal. By being familiar with both parties' desires, it may be possible to make compromises that can result in the proverbial "win-win" scenario.

A. GENERAL RULES

The purchase or sale of all of the assets of a business for a lump-sum amount is treated as a purchase or sale of **each** individual asset. This fragmentation approach was first enunciated in *Williams v. McGowan*, 152 F.2d 570 (CA-2, 1945), in which the seller had attempted to treat the sale of a "business" as the sale of a capital asset. In this case, the Court of Appeals for the Second Circuit held that the sale of a sole proprietorship could not be treated as a unified "capital asset."

As a result, whenever a business sells its assets, the seller must allocate the purchase price among the various assets in order to determine the amount realized on the sale of each asset. Similarly, the buyer must allocate the purchase price among the acquired assets for purposes of determining the basis of each asset. Allocation of the purchase price can be critical to both the buyer and the seller.

1. CONSIDERATIONS FOR THE SELLER OF THE BUSINESS

From the seller's perspective, the sales price can be allocated among several categories of assets.

- **Capital assets (I.R.C. §1221)**. Any gain recognized on the sale of a capital asset held for more than one year is treated as long-term capital gain rather than ordinary income. Capital losses of

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an individual are normally deductible to the extent of capital gains plus $3,000. Capital losses of a corporation may not offset ordinary income; they can only be deducted to the extent of capital gains. As a practical matter, **businesses typically own very few capital assets.** Examples include marketable securities and land held for investment. In addition, goodwill of a business is considered a capital asset, unless it has been subject to the allowance for amortization under I.R.C. §197.

- **Ordinary-income assets**. Allocation of the sales price to certain assets produces ordinary income. Such assets include inventory, accounts receivable, and the depreciation recapture portion of any I.R.C. §1231 assets (including recapture of amortization of goodwill allowed under I.R.C. §197). In addition, any amount paid for a covenant not to compete is considered ordinary income on the theory that such payments are a substitution of income.
- **Section 1231 assets**. As a general rule, if the gains on the sales of I.R.C. §1231 assets exceed the losses on such assets, the net gain is treated as a long-term capital gain. If the losses exceed the gains, the net loss is treated as an ordinary loss and can be deducted without limitation. Section 1231 property generally includes all depreciable and real property used in a trade or business that is held for more than one year. Examples include machinery and equipment, buildings, and land used in the trade or business.
- **Installment sale considerations.** The installment sale rules generally allow the seller of property to report the gain (if any) on a deferred schedule. This rule applies when the seller receives the buyer's note, some or all of which may be paid after the year of the sale. [See I.R.C. §453 for the rules governing installment sales.]

When installment obligations are part of the consideration package given by the buyer, the seller will want to minimize the amount of the installment obligations allocated to any recapture assets since any gain recaptured is ordinary income and must be reported in the year of sale.

Practitioner Note. Until December 17, 1999, the installment sale rules applied to both cash method and accrual method taxpayers. However, legislation enacted in late 1999 prohibited accrual method taxpayers from using this method, and required all gains from sales to be reported in the year of sale. [Ticket To Work And Work Incentives Improvement Act of 1999, PL 106-478, Sec. 536]. This provision was enacted with little legislative history or public discussion. It was unpopular from the outset, and there were immediate outcries for retroactive repeal. As of this writing, the outcome of installment sales for accrual method taxpayers is unknown. In early 2000, in an attempt to reduce some of the hostility toward the new rule, the IRS issued Rev. Proc. 2000-22 [2000-20 IRB], discussed in the Recent Rulings and Cases chapter. This rule allows taxpayers with no more than $1,000,000 average annual gross receipts to use the cash method, even if they sell or produce goods. Thus, these businesses that adopt the cash method will not be precluded from using the installment method.

2. CONSIDERATIONS FOR THE BUYER OF THE BUSINESS

For the buyer, the allocation of the purchase price affects the relative basis of the various assets acquired. The main goal of the buyer is to allocate the purchase price to the assets that will enable the buyer to deduct the purchase price in the quickest manner possible. In short, the buyer tries to maximize the present value of the tax savings inherent in the purchase price. Therefore, the amount of allowable depreciation and amortization, as well as gain or loss on subsequent disposition of the assets acquired, may be affected by the allocation.

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Observation. Before 1993, there were numerous cases dealing with allocations. The IRS was often trying to allocate purchase price to goodwill, which was not amortizable before the Revenue Reconciliation Act of 1993. This controversy and the resultant litigation have been dramatically reduced since the 1993 enactment of I.R.C. §197, which allows purchasers to amortize the cost of certain intangible assets, including goodwill.

After 1993, buyers may want to allocate more of the purchase price to goodwill or noncompete agreements, which may be amortized over 15 years, and less to buildings, which are depreciable over 27.5 or 39 years.

B. BACKGROUND TO CURRENT LAW

Pre-1986 buyers and sellers had a great deal of flexibility in how they approached the allocation.

No Allocation Agreement. Many buyers and sellers simply agreed on a lump-sum sales price and made no effort to allocate it among the assets being sold.

When the contract simply stated the total purchase price, the parties lost the certainty associated with a contractual allocation and left the door open to the IRS to make the allocation as it believed appropriate. Although this approach was somewhat risky, it was appealing because the buyer and seller were essentially free to do as they pleased. The buyer may have allocated the purchase price one way while the seller took a wholly different approach. Both parties generally walked away happy, often whipsawing the IRS by taking inconsistent positions. As might be expected, the stakes were so great that many parties would take this approach, simply stating the total sales price, allocating it as they wished, and hoping that the IRS would never notice. Unfortunately, the IRS occasionally did notice and controversy resulted since the allocation did not arise from an arm's-length negotiation between the buyer and seller.

Allocation Agreements. Buyers and sellers who were knowledgeable of the tax consequences often agreed to a specific allocation of the purchase price among the assets and this allocation was reflected in the sales contract.

Agreeing on a purchase price allocation and incorporating it into the sales agreement provided some assurance to the parties as to the proper tax treatment. **If a purchase price allocation was negotiated at arm's-length, the IRS usually respected it,** and the parties to the agreement obtained a degree of certainty over the tax consequences of the arrangement.

The IRS did not necessarily honor specific allocations unless the parties had adverse interests. If the buyer and seller were not in adverse positions they could contractually agree to the most advantageous result. In this case, the contractual agreement was usually suspect. The courts allowed the IRS to challenge such allocations on the grounds that they had no basis in economic reality.

In cases where adverse interests were lacking, the IRS and the courts normally accepted two valuation methods.

- **Second-Tier Allocation.** This method relied on a valuation of each asset followed by a proportional allocation of the purchase price to each asset based on its relative value. Assuming an accurate valuation of intangibles, including goodwill, the IRS approved of this method even though it resulted in an allocation of some of the purchase price premium to assets such as inventory, equipment, and realty and away from non-amortizable goodwill. This method was quite favorable because each asset received an allocation in excess of its value.
- **Residual Method.** The IRS preferred to use the "residual method," as adopted in the temporary regulations interpreting I.R.C. §338. Under the residual method, the purchase price is gen-

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erally allocated to cash, accounts receivable, and other tangible or intangible assets up to their fair market value. Any remaining amount of the purchase price is allocated to goodwill and other non-amortizable intangibles.

Observation. The Regulations under I.R.C. §338 are concerned with acquisitions of subsidiary corporations by parent corporations in taxable stock acquisitions. **I.R.C. §338 allows certain buyers to elect to treat a stock purchase as an asset purchase.** This election has limited applicability in general tax practice, and tax professionals who do not deal extensively in complex corporate transactions will have little reason to be knowledgeable in this complicated set of rules. However, the residual method adopted under this provision has become much more widespread than the underlying Code provisions. As a consequence, any tax practitioner involved in the purchase or sale of a business will need to be aware of certain provisions in these regulations. The most important rules are cited in this chapter, in the discussion of I.R.C. §1060.

C. I.R.C. §1060

To eliminate the possible whipsawing of the IRS and to ensure that improper allocations could be easily spotted, Congress enacted I.R.C. §1060 as part of the Tax Reform Act of 1986. **I.R.C. §1060 specifically requires buyers and sellers to use the residual method.** By requiring both parties to use the same method, it is much more difficult to take inconsistent positions. Moreover, **I.R.C. §1060 imposed new reporting rules** that required both the buyer and seller to report how the total consideration was allocated. As a result, it is much easier for the IRS to identify inconsistent positions.

1. GENERAL RULES

In the case of an **applicable asset acquisition,** I.R.C. §1060(a) requires the sales price to be allocated among the assets in the same manner as amounts are allocated to assets under I.R.C. §338(b)(5). Note that I.R.C. §338, which is restricted to certain corporate acquisitions, has "loaned" some of its provisions to I.R.C. §1060, which has broad applicability.

If I.R.C. §1060 applies, as it usually does whenever a business sells its assets, the exchange price must be allocated using the residual method as detailed in the regulations under I.R.C. §338(b)(5) and I.R.C. §1060. The residual method must be used for tax purposes, regardless of the method set forth in the purchase agreement.

I.R.C. §1060(a) also provides that a written agreement governing the allocation of the sales price to an asset acquisition shall be binding on both parties unless the Treasury determines that the allocation is not appropriate. This change, added by the Revenue Reconciliation Act of 1990, prevents parties from contractually agreeing to a purchase-price allocation and then altering their position. It was not uncommon for parties to agree to a particular allocation approach and then deviate from it.

a. Reporting Requirements

I.R.C. §1060(b) and (e) contain reporting rules. I.R.C. §1060(b) requires both the buyer and the seller in an applicable asset acquisition to furnish the IRS with information regarding the amount of consideration that is allocated to goodwill or going-concern value, any modification of that amount, and any other information with respect to other assets transferred in the acquisition that the IRS may find necessary for enforcing the rules (e.g., information regarding covenants not to compete and consulting arrangements).

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I.R.C. §1060(b) requires the buyer and seller in an applicable asset acquisition to report certain information concerning the transaction. Temp. Treas. Reg. §1.1060-1T requires buyers and sellers to file **Form 8594** with their income tax return for the taxable year in which the purchase occurred if the purchase is an **applicable asset acquisition** (discussed below). The information reported on Form 8594 includes:

1. The purchase date.
2. The total amount of consideration for the assets.
3. The **aggregate fair market value of the assets of each class and the amount of consideration allocated** to each class. Note that the amount allocated to each asset is not required, only aggregate information concerning the various classes. Because both buyer and seller must disclose this information, it is easy to determine whether the parties are taking inconsistent positions.
4. A statement as to whether the fair market values that were assigned to the various classes were agreed upon in the sales contract or another written document signed by both parties.
5. A statement as to whether related agreements were entered into between the buyer and seller, such as covenants not to compete, employment contracts, licenses, leases, and similar items. In addition, the statement must mention the maximum amount of the consideration paid or to be paid pursuant to the agreement.

Noncompete agreements. As a practical matter, a selling corporation has no right to prevent its employees and shareholders from competing with the buyer after the sale. Consequently, the buyer will normally pay those persons directly for the noncompete agreement. Such assets are not the assets of the seller and might not be considered to be within the scope of I.R.C. §1060.

However, Congress expanded the reporting requirements in the Revenue Reconciliation Act of 1990 by adding I.R.C. §1060(e). Under this provision, **the parties must report additional information if a person owns at least 10% of the value of an entity immediately before a transaction and transfers both an interest in the entity and enters into an employment contract, covenant not to compete, royalty, lease, or other agreement with the buyer.**

Other transactions. The buyer and seller must also report certain other transactions related to the transfer of assets. **The buyer may enter into a lease or royalty arrangement, or an employment, management, and/or consulting contract with the seller.** The buyer might also enter into such an agreement with a party related to the seller, such as a shareholder of the selling corporation or another corporation or partnership that is under common control with the seller. **In such cases, the buyer (but not the seller) is required to report the nature of such an arrangement on Form 8594.** If the seller of the assets is a corporation, the buyer must inform the IRS of any dealings of this nature with a person who owns at least 10% (including attribution rules of I.R.C. §318) of the selling corporation's stock[I.R.C. §1060(e)].

The regulations make it clear that all of the facts and circumstances surrounding a transaction will be taken into account in determining whether a group of assets constitute a trade or business, including any related transactions between the buyer and seller such as a lease agreement, covenant not to compete, license arrangements, and employment and/or management contracts between the buyer and the seller [Temp. Treas. Reg. §1.1060-1T(b)(2)].

In addition, **if the total consideration paid exceeds the aggregate book value of the assets purchased (excluding goodwill), such excess presumably suggests that goodwill exists and, therefore, will trigger I.R.C. §1060.** This will be true even if the group of assets acquired did not constitute a trade or business.

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Practitioner Note. A well-constructed agreement governing the exchange of assets should completely account for the value of all assets. However, some informal agreements may disguise certain side dealings between the buyer and seller. The tax professional who comes into contact with such a situation should consider the need to file Form 8594, or to revise the valuation of specific assets exchanged.

Penalty for failure to file Form 8594. Form 8594 is treated as an information return and failure to file this form when required triggers a penalty under I.R.C. §6721(a) and (b).

The penalty for failure to file an information return on the prescribed date is generally $50 per return, but in the case of intentional disregard, the penalty becomes the **greater** of $100 or 10% of the "aggregate amount of items required to be reported" without limitation [I.R.C. §6721(d)]. Since the entire amount of consideration must be reported on Form 8594, the penalty for intentionally disregarding the filing requirement could be enormous.

b. Applicable Asset Acquisitions

The allocation and reporting rules of I.R.C. §1060(a) apply only in the case of an **"applicable asset acquisition." As a practical matter, this term encompasses most routine sales of a business where the assets are sold.** However, the definition of this term is so murky that many practitioners, fearing possible penalties, elect to follow the required procedures of I.R.C. §1060 upon the sale of any asset.

I.R.C. §1060(c) defines an applicable asset acquisition as **any transfer of a group of assets that constitute a trade or business** in the hands of the buyer *or* seller if the buyer's basis in the assets is determined wholly by the consideration paid for the assets. Assets acquired in a like-kind exchange under I.R.C. §1031 are also subject to this rule if they constitute a trade or business. See also Temp. Treas. Reg. §1.1060-1T(b)(1).

According to the regulations, **a group of assets constitutes a trade or business if the use of such assets would qualify as an active trade or business under I.R.C. §355.** Under I.R.C. §355, an operation is considered an active trade or business if it consists of every operation that forms a part of, or a step in, the process of earning income [Treas. Reg. §1.355-3(b)(2)(ii)].

Even if the assets do **not** qualify as a trade or business under I.R.C. §355, **they still will be treated as a business if goodwill or going-concern value could under any circumstances attach to the assets purchased.**

I.R.C. §1060 covers the purchase and sale of an unincorporated business, and is thus applicable to a sole proprietorship, or a branch or division of a business entity. It applies to all of the following situations:

1. A corporation buys a partnership or proprietorship.
2. A corporation makes an I.R.C. §338 election for a newly purchased subsidiary.
3. A proprietor buys another proprietorship and continues to operate as a proprietorship.
4. A partnership buys a proprietorship and continues to operate as a partnership.
5. A proprietorship or partnership buys a going business from a corporation, whether or not the corporation is liquidated.

The trade or business test is met if the assets constitute a business in the hands of either the buyer or the seller. Thus, it can be applicable to a part of a seller's business.

Example 1. Steve owns a machine shop that manufactures microwave connectors. He decides to retire and sell the entire business to Bigco, Inc., which operates an integrated electronics firm. Bigco purchases Steve's assets to use them in its own business, but will not use the assets to manufacture microwave connectors or continue Steve's business.

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This is an applicable asset acquisition. Both Steve and Bigco must file Form 8594 or face penalties. Even though the assets purchased do not constitute a business in the hands of Bigco, they did constitute a business in the hands of Steve, and this is sufficient to meet the test [Temp. Treas. Reg. §1.1060-1T(b)(3) Ex. 1.].

Observation. Note that the buyer or the seller's treatment can depend on the other party's use of the assets. For example, if a seller sells assets that are not considered a trade or business in its hands, it could still be subject to the reporting and allocation requirements of I.R.C. §1060 if the assets become a business in the buyer's hands. **In effect, each party is affected by the other and is at risk of a penalty. Filing Form 8594 protects each party.**

c. Nontaxable and Partially Taxable Transactions

An acquisition comes under I.R.C. §1060 only if the basis in the acquired assets is determined **wholly** by reference to the consideration paid for the assets. However, a transfer is not treated as failing to be an applicable asset acquisition merely because a portion of the assets is transferred in a like-kind exchange. Thus, I.R.C. §1060 generally does not cover certain tax-free or partially taxable events. It **excludes** all of the following:

1. A corporation acquires assets from another corporation in a tax-free reorganization. Even if some shareholders of the target corporation receive boot and recognize gain, I.R.C. §1060 does not apply.
2. A corporation liquidates its subsidiary. This transaction is exempt under I.R.C. §§332 (to the parent) and 337 (to the subsidiary).
3. A corporation distributes a going business and the distribution is a tax-free transfer under I.R.C. §355.
4. A proprietor transfers his or her going business to a controlled corporation in exchange for stock and/or securities. This transaction is exempt from some or all of the income tax under I.R.C. §351.
5. Even if there is a transfer of other (boot) property in connection with an I.R.C. §351 transfer, I.R.C. §1060 does not cover the transaction.
6. A proprietor contributes his or her going business to a partnership or limited liability company in exchange for an interest therein.
7. An individual or business entity purchases stock in a corporation (and does not make a special election under I.R.C. §338).
8. An individual or business entity purchases an interest in a partnership or limited liability company, and the partnership does not have an election under I.R.C. §754 in effect for the year of the purchase. (However, if the partnership does have such an election in effect, it must allocate basis adjustments pursuant to the residual method.)
9. A complete or partial interest in a business of any form is transferred due to death of an owner.
10. An owner disposes of a complete or partial interest in a business by gift.

2. ALLOCATION OF CONSIDERATION EXCHANGED

I.R.C. §1060(a) requires that the purchase price be allocated in the same manner as amounts are allocated under I.R.C. §338(b)(5). As discussed below, the regulations mandate the use of the **residual method.**

Before the consideration can be allocated to the various assets, the amount of consideration to be allocated must be determined.

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The regulations make it quite clear that the total amount to be allocated by the buyer and the seller may **differ.**

- The regulations define the purchaser's consideration as the cost of the assets acquired while the seller's consideration is the amount realized from the sale.
- The buyer's cost may not be the same as the seller's amount realized due to transaction costs. It would appear that the buyer's transaction costs increase the amount to be allocated while those of the seller decrease the allocable amount. Neither taxpayer's costs affect the consideration of the other [Temp. Treas. Reg. §1.1060-1T(c)(1)].

3. OPERATING RULES FOR I.R.C. §1060

The purchaser and the seller must each use the **residual** method of allocating the cost and sales price of the individual assets transferred. The process is a step allocation to seven classes of assets [Temp. Treas. Reg. §1.1060-1T, 1.338-6T]. (Before January 5, 2000 there were five classes.) At each step, the amount allocated is the total consideration (less any consideration allocated to a senior class) or the identifiable fair market value of the asset within the class, whichever is less. **The classes in order of seniority are:**

Class	Description
I	Cash and demand deposits
II	CDs and government and marketable securities
III	Accounts receivable incurred in the ordinary course of business
IV	Inventory
V	All assets not included in other classes.
VI	Intangible assets, other than goodwill and going-concern value
VII	Goodwill and going-concern value [Treas. Reg. §1.338-6T(b)(2)]

a. Allocation Methodology

The application of these rules is best illustrated by a continuing problem, based on an actual business. This continuing example will begin with a simple set of facts, and will then be modified in order to incorporate additional problems in context.

Example 2. Andrea Lyndon is a proprietor of a gourmet restaurant, *Cuisine Extraordinaire.* She started the business on May 1, 1950. In 2000 she decides to sell the restaurant and retire. She has used the accrual method of accounting consistently throughout the 50 years of operation.

She has agreed to sell the entire business to James Roberts.

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The balance sheet of the restaurant at the date of sale (January 5, 2000) is as follows:

Assets	Adjusted Basis	Fair Market Value
Cash	$4,500	$4,500
Certificates of Deposit	18,750	18,750
Accounts receivable	6,700	6,700
Food inventory	17,275	25,000
Wine and liquor inventory	47,890	70,000
Supplies	21,981	25,000
Cookware	23,875	30,000
Dining room ware	11,469	18,000
Kitchen equipment	187,350	200,000
Dining room furnishings	32,645	35,000
Building	-0-	345,000
Land	50,000	125,000
Liquor license	12,380	37,500
Recipes	-0-	45,000
Registered business name	1,250	60,000
Total assets per balance sheet	**$436,065**	**$1,045,450**
Liabilities		
Working capital financing	$32,500	
Payroll and property taxes	14,750	
Equipment loans	172,333	
Total liabilities	**$219,583**	

Practitioner Note. This example shows that the supplies have a basis, and have not been expensed when they were purchased. This treatment is mandated by Treas. Reg. §1.162-3, which requires supplies that are not immaterial in amount to be deducted when used or consumed, not when purchased.

James has offered her $1,000,000, plus assumption of all of the liabilities. Andrea agrees to that price, and incurs $17,250 costs (legal, etc.) in connection with the sale. Her **net consideration** received is:

Cash and notes	$1,000,000
Liabilities assumed	219,583
Transaction costs	(17,250)
Total sales price to be allocated	**$1,202,333**

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Using the residual method, her allocation of the purchase price will be as follows:

Allocation		
To Class I:		
Consideration		$1,202,333
Value of Cash	$4,500	
Lesser of two amounts		(4,500)
To Class II:		
Consideration (after I)		1,197,833
Value of Certificates of Deposit	18,750	
Lesser of two amounts		(18,750)
To Class III:		
Consideration (after II)		1,179,083
Value of Accounts receivable	6,700	
Lesser of two amounts		(6,700)
To Class IV:		
Consideration (after III)		1,172,383
Value of Food inventory	25,000	
Wine and liquor inventory	70,000	
Total Class IV	95,000	
Lesser of two amounts		(95,000)
To Class V:		
Consideration (after IV)		1,077,383
Value of Supplies	25,000	
Cookware	30,000	
Dining room ware	18,000	
Kitchen equipment	200,000	
Dining room furnishings	23,000	
Building	345,000	
Land	125,000	
Total Class V	766,000	
Lesser of two amounts		(766,000)
To Class VI:		
Consideration (after V)		311,383
Value of Liquor license	37,500	
Recipes	45,000	
Registered business name	60,000	
Total Class VI	142,500	
Lesser of two amounts		(142,500)
To Class VII Goodwill:		168,883
Total allocation of sales price		**$1,202,333**

The excess of the total sales price over the values of the individual assets is allocated to goodwill. From an accounting point of view, this makes a good deal of sense. After all, the parties have stipulated the values of the individual assets, and the total consideration exceeds the total of the individual values. This excess value represents goodwill or going-concern value.

b. Computation of Gain or Loss to Seller

After the seller has properly allocated the sales price of the different assets, the gain or loss is computed as if **each** of the assets had been sold **separately.** Thus, it is necessary to find the adjusted basis of each, as well as the character, such as capital, I.R.C. §1231, or ordinary. For any depreciable asset, the seller must determine the applicability of recapture provisions, such as I.R.C. §1245.

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Example 2 (continued). Additional information about the assets of the business.

Cash and CD's are in Eighth Local Bank, under the proprietorship name. Pursuant to the banking agreement, these balances must remain with the business as partial security for the working capital loans. The bank has agreed to let the purchaser assume the working capital loans, but the seller will continue to be a guarantor.

Andrea's computation of gain or loss follows, by class of asset sold:

Class I. This class is only cash, and thus there is no gain or loss.

Class II. In this situation, the certificates' value is the same as basis, and thus there is no gain or loss.

Class III. The value of the accounts receivable is the same as the adjusted basis. This is typical for an accrual method taxpayer. Again there is no gain or loss.

Class IV. The selling price of the inventories is $95,000. The total adjusted basis of these assets is $65,165. Thus, **there is ordinary gain of $29,835 ($95,000 – $65,165).**

Class V. In this example, the Class V computations are the most complex.

The original costs of the tangible fixed assets are:

Cookware	43,917
Dining room ware	24,777
Kitchen equipment	475,000
Dining room furnishings	48,000
Building	100,000

Class V Assets	Original Cost	Depreciation Allowed	Adjusted Basis	Amount Realized	Gain (Loss)
Supplies	$21,981	$-0-	$21,981	$25,000	$3,019
Cookware	43,917	20,042	23,875	30,000	6,125
Dining room ware	24,777	13,308	11,469	18,000	6,531
Kitchen equipment	475,000	287,650	187,350	200,000	12,650
Dining room furnishings	48,000	15,355	32,645	23,000	(9,645)
Building	100,000	100,000	-0-	345,000	345,000
Land	50,000	-0-	50,000	125,000	75,000

The gains on the supplies, cookware, dining room ware, and kitchen equipment are ordinary income under the depreciation recapture rule of I.R.C. §1245. The loss on the dining room furnishings is an I.R.C. §1231 loss.

The gain on the building is more complicated. Andrea purchased the land and building in 1982 for $150,000, of which $50,000 was allocated to land. Under ACRS, the building is now fully depreciated. Andrea used the original ACRS method with a straight-line election. (This election allows her to avoid I.R.C. §1245 recapture on the disposition of the building.)

Her gain is taxed at 25% to the extent of unrecaptured I.R.C. §1250 gain. In this case, the $100,000 of straight-line depreciation is unrecaptured I.R.C. §1250 gain. The remaining $245,000 gain is taxed at 20%, assuming it is not offset by current or prior I.R.C. §1231 losses.

The gain on the land is also taxed at 20%, assuming it is not offset by current or prior I.R.C. §1231 losses.

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Class VI. All of the intangible assets except for the liquor license were self-created. Thus, they have no original cost and there has been no depreciation or amortization deducted. The liquor license had a total capitalized cost of $18,000. Andrea has claimed $5,620 of amortization with respect to the license and its related costs.

Class VI assets	Original Cost	Amortization Allowed	Adjusted Basis	Amount Realized	Gain (Loss)
Liquor license	18,000	5,620	12,380	37,500	25,120
Recipes	-0-	-0-	-0-	45,000	45,000
Registered business name	1,250	-0-	1,250	60,000	58,750

The gain on the liquor license is ordinary income to the extent of the depreciation allowed in the amount of $5,620. The remaining gain of $19,500 (25,120 – 5,620) is I.R.C. §1231 gain.

The recipes and business name have never been depreciated. They are treated as capital assets. The entire gain of $103,750 (45,000 + 58,750) is capital gain.

Class VII. Andrea did not purchase the goodwill, and it has never had a basis. Thus, it has never been subject to the allowance for depreciation. Accordingly, it is a capital asset. In this situation, it is the ultimate residual after all of the other assets have been accounted for. **Therefore $168,883, the entire amount allocated to goodwill, is capital gain.**

c. Seller's Gain and Loss Reporting

The next step for the seller is to report the various gains and losses on the tax return for the year of sale. (In some cases, the seller may qualify for installment reporting. See discussion below.) The continuing example illustrates the reporting requirements.

Example 2 (continued). Andrea is a U.S. citizen, who must file Form 1040 for the year of the sale. She must file Form 8594 to inform the IRS of the sale. However, this form is not a substitute for the usual schedules, such as Schedule D and Form 4797. There is no requirement to reconcile Form 8594 with the actual gain and loss forms. This example will provide such a reconciliation.

In this example there was no gain or loss to report on the Class I (cash), Class II (CDs), or Class III (accounts receivable), since the amount realized equaled the adjusted basis for each of these. The other classes must now be identified with the tax character, as well as the amount, of gain or loss recognized on each asset.

A review of the sales agreement and the expenses of sale paid by Andrea show the total overall gain or loss recognized on the sale, which will be a convenient proof figure:

Total sales price to be allocated	1,202,333
Less total asset basis per balance sheet	– 436,065
Total gain on sale	**$766,268**

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Next, Andrea must enter each component of gain or loss on the appropriate form or schedule on Form 1040, as follows:

Ordinary income to Schedule C	
Inventory ($95,000 – $65,165)	**$29,835**
Depreciation recapture to Form 4797, Part III	
Cookware ($30,000 – $23,875)	6,125
Dining room ware ($13,000 – $11,469)	6,531
Kitchen equipment ($200,000 – $187,350)	12,650
Liquor license ($5,620 of amortization)	5,620
Total Form 4797, Part III	**$30,926**
Gains and losses to Form 4797, Part I	
Dining room furnishings ($23,000 – $32,645)	(9,645)
Building ($345,000 – $0)	345,000
Land ($125,000 – $50,000)	75,000
Liquor license ($37,500 – $12,380 – $5,620)	19,500
Total Form 4797 Part I	**$429,855**
Gains and losses to Form 4797, Part II	
Supplies ($25,000 – $21,981)	**$3,019**
Gains and losses to Schedule D	
Recipes ($45,000 – $0)	45,000
Registered business name ($60,000 – $1,250)	58,750
Goodwill ($168,883 – $0)	168,883
Total Schedule D	**$272,633**
Summary of gains and losses:	
Schedule C	$29,835
Form 4797, Part III	30,926
Form 4797, Part I	429,855
Form 4797, Part II	3,019
Total Schedule D	272,633
Total on Form 1040	**$766,268**

Practitioner Note. The regulations specifically require that costs of sale be treated as a reduction of the selling price. [Temp. Treas, Reg. §1.1060-1T(c)(3)] Accordingly, there are no expenses of sale to be added to the basis of assets on Schedule D and Form 4797.

The appropriate tax forms for this example are shown below.

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Form **1040** Department of the Treasury—Internal Revenue Service
U.S. Individual Income Tax Return 2000 (99) IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 1999, or other tax year beginning , 1999, ending , OMB No. 1545-0074

Label (See W-2G here. LA

Your first name and initial	Last name	Your social security number
Andrea A	*Lyndon*	*123 - 45 - 6789*

Also attach Form(s) 1099-R if tax was withheld.

If you did not get a W-2, see page 20.

Enclose, but do not staple, any payment. Also, please use Form 1040-V.

Line	Description		Amount
11	Alimony received	11	
12	Business income or (loss). Attach Schedule C or C-EZ	12	*29,835*
13	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐	13	*702,488*
14	Other gains or (losses). Attach Form 4797	14	*33,945*
15a	Total IRA distributions 15a ___ b Taxable amount (see page 22)	15b	*0*
16a	Total pensions and annuities 16a ___ b Taxable amount (see page 22)	16b	*0*
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E	17	
18	Farm income or (loss). Attach Schedule F	18	*0*
19	Unemployment compensation	19	
20a	Social security benefits 20a ___ b Taxable amount (see page 24)	20b	
21	Other income. List type and amount (see page 24)	21	*0*
22	Add the amounts in the far right column for lines 7 through 21. This is your **total income** ▶	22	*766,268*

8

SCHEDULE C (Form 1040)

Department of the Treasury Internal Revenue Service (99)

Profit or Loss From Business

(Sole Proprietorship)

▶ Partnerships, joint ventures, etc., must file Form 1065 or Form 1065-B.

▶ Attach to Form 1040 or Form 1041. ▶ See Instructions for Schedule C (Form 1040).

OMB No. 1545-0074 2000 Attachment Sequence No. 09

Name of proprietor	Social security number (SSN)
Andrea A Lyndon	*123 - 45 - 6789*

Part I Income

Line	Description		Amount
1	Gross receipts or sales. **Caution:** *If this income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked, see page C-2 and check here* ▶ ☐	1	*95,000*
2	Returns and allowances	2	
3	Subtract line 2 from line 1	3	*95,000*
4	Cost of goods sold (from line 42 on page 2)	4	*65,165*
5	**Gross profit**. Subtract line 4 from line 3	5	*29,835*
6	Other income, including Federal and state gasoline or fuel tax credit or refund (see page C-3)	6	
7	**Gross income**. Add lines 5 and 6 ▶	7	*29,835*

Part II **Expenses.** Enter expenses for business use of your home **only** on line 30.

Line	Description		Amount
28	**Total expenses** before expenses for business use of home. Add lines 8 through 27 in columns ▶	28	*0*
29	Tentative profit (loss). Subtract line 28 from line 7	29	*29,835*
30	Expenses for business use of your home. Attach **Form 8829**	30	*0*
31	**Net profit or (loss).** Subtract line 30 from line 29. • If a profit, enter on **Form 1040, line 12,** and ALSO on **Schedule SE, line 2** (statutory employees, see page C-6). Estates and trusts, enter on Form 1041, line 3. • If a loss, you MUST go on to line 32.	31	*29,835*

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SCHEDULE D (Form 1040)

Department of the Treasury
Internal Revenue Service (99)

Capital Gains and Losses

► Attach to Form 1040. ► See Instructions for Schedule D (Form 1040).
► Use Schedule D-1 for more space to list transactions for lines 1 and 8.

OMB No. 1545-0074
2000
Attachment Sequence No. 12

Name(s) shown on Form 1040: *Andrea A Lyndon*

Your social security number: *123 45 6789*

Part II Long-Term Capital Gains and Losses—Assets Held More Than One Year

	(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-5)	(e) Cost or other basis (see page D-5)	(f) GAIN or (LOSS) Subtract (e) from (d)	(g) 28% RATE GAIN or (LOSS) * (see instr. below)
8	*Recipes*	*5/1/1950*	*1/5/2000*	*45,000*	*0*	*45,000*	
	Business name	*5/1/1950*	*1/5/2000*	*60,000*	*1,250*	*58,750*	
	Goodwill	*5/1/1950*	*1/5/2000*	*168,883*	*0*	*168,883*	

Line	Description		(d)	(f)	(g)
9	Enter your long-term totals, if any, from Schedule D-1, line 9	9			
10	**Total long-term sales price amounts.** Add column (d) of lines 8 and 9	10	*273,883*		
11	Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824	11		*429,855*	
12	Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1	12			
13	Capital gain distributions. See page D-1	13			
14	Long-term capital loss carryover. Enter in both columns (f) and (g) the amount, if any, from line 13 of your 1998 Capital Loss Carryover Worksheet	14		( )	( )
15	Combine lines 8 through 14 in column (g)	15			
16	**Net long-term capital gain or (loss).** Combine lines 8 through 14 in column (f) ► **Next:** Go to Part III on the back.	16		*702,488*	

* **28% Rate Gain or Loss** includes **all** "collectibles gains and losses" (as defined on page D-5) and up to 50% of the eligible gain on qualified small business stock (see page D-4).

Form **4797**

Department of the Treasury
Internal Revenue Service (99)

Sales of Business Property

(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))

► Attach to your tax return. ► See separate instructions.

OMB No. 1545-0184
2000
Attachment Sequence No. 27

Name(s) shown on return: *Andrea A Lyndon*

Identifying number: *123 - 45 - 6789*

1	Enter here the gross proceeds from the sale or exchange of real estate reported to you for 1999 on Form(s) 1099-S (or a substitute statement) that you will be including on line 2, 10, or 20	1	

Part I Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Property Held More Than 1 Year

	(a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) GAIN or (LOSS) Subtract (f) from the sum of (d) and (e)
2	*Dining Room Furnish*	*6/20/1985*	*1/5/2000*	*23,000*	*15,355*	*48,000*	*-9,645*
	Building	*5/1/1950*	*1/5/2000*	*345,000*	*100,000*	*100,000*	*345,000*
	Land	*5/1/1950*	*1/5/2000*	*125,000*	*0*	*50,000*	*75,000*

Line	Description		Amount
3	Gain, if any, from Form 4684, line 39	3	
4	Section 1231 gain from installment sales from Form 6252, line 26 or 37	4	*0*
5	Section 1231 gain or (loss) from like-kind exchanges from Form 8824	5	*0*
6	Gain, if any, from line 32, from other than casualty or theft	6	*19,500*
7	Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows:	7	*429,855*

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8	Nonrecaptured net section 1231 losses from prior years (see instructions)	8	*0*
9	Subtract line 8 from line 7. If zero or less, enter -0-. Also enter on the appropriate line as follows (see instructions): **S corporations.** Enter any gain from line 9 on Schedule D (Form 1120S), line 14, and skip lines 11 and 12 below. **All others.** If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below, and enter the gain from line 9 as a long-term capital gain on Schedule D.	9	

Part II Ordinary Gains and Losses

10 Ordinary gains and losses not included on lines 11 through 17 (include property held 1 year or less):

Supplies	*various*	*1/5/2000*	*25,000*	*0*	*21,981*	*3,019*

11	Loss, if any, from line 7	11	( )
12	Gain, if any, from line 7 or amount from line 8, if applicable	12	
13	Gain, if any, from line 31	13	*30,926*
14	Net gain or (loss) from Form 4684, lines 31 and 38a	14	*0*
15	Ordinary gain from installment sales from Form 6252, line 25 or 36	15	*0*
16	Ordinary gain or (loss) from like-kind exchanges from Form 8824	16	*0*
17	Recapture of section 179 expense deduction for partners and S corporation shareholders from property dispositions by partnerships and S corporations (see instructions)	17	*0*
18	Combine lines 10 through 17. Enter the gain or (loss) here, and on the appropriate line as follows:	18	*33,945*
a	For all except individual returns: Enter the gain or (loss) from line 18 on the return being filed.		
b	For individual returns:		
	(1) If the loss on line 11 includes a loss from Form 4684, line 35, column (b)(ii), enter that part of the loss here. Enter the part of the loss from income-producing property on Schedule A (Form 1040), line 27, and the part of the loss from property used as an employee on Schedule A (Form 1040), line 22. Identify as from "Form 4797, line 18b(1)." See instructions	18b(1)	
	(2) Redetermine the gain or (loss) on line 18, excluding the loss, if any, on line 18b(1). Enter here and on Form		*33,945*

Form 4797 (1999) Page 2

Part III Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255

19	(a) Description of section 1245, 1250, 1252, 1254, or 1255 property:	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)
A	*Cookware*	*various*	*1/5/2000*
B	*Dining room ware*	*various*	*1/5/2000*
C	*Kitchen equipment*	*various*	*1/5/2000*
D	*Liquor license*	*5/1/1950*	*1/5/2000*

	These columns relate to the properties on lines 19A through 19D. ▶		Property A	Property B	Property C	Property D
20	Gross sales price (**Note:** *See line 1 before completing.*)	20	*30,000*	*18,000*	*200,000*	*37,500*
21	Cost or other basis plus expense of sale	21	*43,917*	*24,777*	*475,000*	*18,000*
22	Depreciation (or depletion) allowed or allowable	22	*20,042*	*13,308*	*287,650*	*5,620*
23	Adjusted basis. Subtract line 22 from line 21	23	*23,875*	*11,469*	*187,350*	*12,380*
24	Total gain. Subtract line 23 from line 20	24	*6,125*	*6,531*	*12,650*	*25,120*
25	**If section 1245 property:**					
a	Depreciation allowed or allowable from line 22	25a	*20,042*	*13,308*	*287,650*	*5,620*
b	Enter the **smaller** of line 24 or 25a	25b	*6,125*	*6,531*	*12,650*	*5,620*

Summary of Part III Gains. Complete property columns A through D through line 29b before going to line 30.

30	Total gains for all properties. Add property columns A through D, line 24	30	*50,426*
31	Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	31	*30,926*
32	Subtract line 31 from line 30. Enter the portion from casualty or theft on Form 4684, line 33. Enter the portion from other than casualty or theft on Form 4797, line 6	32	*19,500*

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Form **8594** (Rev. July 1998)
Department of the Treasury
Internal Revenue Service

Asset Acquisition Statement
Under Section 1060

▶ Attach to your Federal income tax return.

OMB No. 1545-1021
Attachment Sequence No. 61

Name as shown on return: *Andrea A Lyndon*
Identification number as shown on return: *123-45-6789*

Check the box that identifies you: ☐ Buyer ☐ Seller

Part I **General Information—**To be completed by all filers.

1 Name of other party to the transaction: *James Roberts*
Other party's identification number: *123-45-6789*
Address (number, street, and room or suite no.): *10 N. First Avenue*
City or town, state, and ZIP code: *Indianapolis, IN 12345*

2 Date of sale
3 Total sales price: *$1,202,333*

Part II **Assets Transferred—**To be completed by all filers of an original statement.

4 Assets	Aggregate Fair Market Value (Actual Amount for Class I)	Allocation of Sales Price
Class I	$ *See Schedule on line 6 below*	$
Class II	$	$
Class III	$	$
Classes IV and V	$	$
Total	$	$

5 Did the buyer and seller provide for an allocation of the sales price in the sales contract or in another written document signed by both parties? . . . . ☒ Yes ☐ No
If "Yes," are the aggregate fair market values listed for each of asset Classes I, II, III, IV and V the amounts agreed upon in your sales contract or in a separate written document? . . . . ☒ Yes ☐ No

6 In connection with the purchase of the group of assets, did the buyer also purchase a license or a covenant not to compete, or enter into a lease agreement, employment contract, management contract, or similar arrangement with the seller (or managers, directors, owners, or employees of the seller)? . . . . ☐ Yes ☒ No
If "Yes," specify (a) the type of agreement, and (b) the maximum amount of consideration (not including interest) paid or to be paid under the agreement. See the instructions for line 6.

Assets	*Aggregate Fair Market Value (Actual Amount for Class I)*	*Allocation of Sales Price*
Class I	*$4,500*	*$4,500*
Class II	*18,750*	*18,750*
Class III	*6,700*	*6,700*
Class IV	*95,000*	*95,000*
Class V	*766,000*	*766,000*
Class VI & VII	*311,383*	*311,383*
Total	*$1,202,333*	*$1,202,333*

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Practitioner Note. As of publication date, the IRS has not released a new version of Form 8594. The form still shows five classes of assets, rather than the seven required as of January 5, 2000. The IRS National Office has advised the author to use a supplemental schedule, or paste-over to show the allocation to the seven classes when it is necessary to use the old form. All practitioners need to be on the alert for the publication of the new Form 8594.

d. Purchaser's Reporting

When the purchaser pays an amount in excess of the identifiable values of the assets, the excess is shifted toward goodwill. Thus, there is no opportunity to step up the basis of tangible assets above the value agreed upon. **The buyer must also file Form 8594 for the transaction.** It is attached to the buyer's tax return (Form 1040, 1120, 1065, 1041, 1120S, or other return required for the taxpayer).

Example 3. Refer to Example 2. Given these same facts, it is now time to look at the reporting requirements applicable to James, the purchaser. There is no need to repeat the entire analysis, as long as the buyer and the seller have agreed upon the allocation. However, there is one essential difference. The amount "paid" by James includes the cash and notes given, plus liabilities assumed, equivalent to the entire proceeds received by Andrea, inclusive of her selling expenses. In addition, James pays $27,450 as expenses of the purchase. These costs will increase his amount paid, or basis for the entire business. Thus the differences can be demonstrated as follows:

Cash and notes	$1,000,000
Liabilities assumed	219,583
Expenses of purchase paid by James	27,450
Total basis to James	$1,247,033

James must repeat the same steps in the allocation shown in Example 2. A review of the first six classes shows the following:

To Class I	$ 4,500
To Class II:	18,750
To Class III:	6,700
To Class IV:	95,000
To Class V:	766,000
To Class VI:	142,500
Total classes I–VI	$1,033,450

Comparing this amount with the $1,247,033 total amount paid by James leaves **$213,583** (1,247,033 – 1,033,450) to account for. From James's perspective, **this is the residual and must be allocated to goodwill.**

As Example 2 and Example 3 illustrate, there is an inherent inconsistency involved in the residual method. As a result, the combination of buyer's expenses of purchase and seller's expenses of sale adjust the goodwill calculations. Thus, any decrease to the seller as a result of his or her expenses reduces the amount of goodwill sold, which is usually a reduction of long-term capital gain.

From the buyer's perspective, any expenses of the purchase are added to goodwill. This usually means that the buyer can deduct these expenses by claiming amortization of an intangible asset under I.R.C. §197.

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4. BARGAIN PURCHASE

In the case of a bargain purchase, the bargain element may only serve to reduce the basis of identifiable assets. In a case where the total consideration is less than the agreed value of the individual assets, the bargain element reduces the amount allocated to the higher-numbered classes, in reverse order.

Observation. There are few instances when a sales price is less than the fair market value of the assets. Occasionally, a seller is desperate for immediate cash flow and is unwilling or unable to wait for the cash flow that results from an orderly liquidation. In these instances, accountants will sometimes create a negative asset, or deferred liability, known as "negative goodwill." The tax treatment of this bargain purchase may not include negative goodwill, but must observe the residual method.

Example 4. Refer to Example 2. Assume the same facts, except that Andrea was desperate to sell the business. She settles for total consideration of $900,000, after all expenses of sale, and including all liabilities assumed by the purchaser. In this case, total receipts are less than the amounts identified in asset classes I through VI, which were:

To Class I:	$ 4,500
To Class II:	18,750
To Class III:	6,700
To Class IV:	95,000
To Class V:	766,000
To Class VI:	142,500
Total Classes I–VI	**$1,033,450**

The residual method requires the following allocation:

To Class I:	$ 4,500
To Class II:	18,750
To Class III:	6,700
To Class IV:	95,000
To Class V:	766,000
To Class VI:	9,050
Total Classes I–VI	**$900,000**

A review of the various classes shows that the price is sufficient to assign the fair market value to each asset in classes I through V. However, Class VI is allocated an insufficient amount to cover the fair market values of the assets. In this case, Andrea must assign each of these assets a proportionate share of the $9,050 remaining for this class.

	Value	Percent	Allocate
Liquor license	$37,500	26.3	$2,380
Recipes	45,000	31.6	2,860
Registered business name	60,000	42.1	3,810
Total Class VI	**$142,500**		**$9,050**

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5. SUBSEQUENT CHANGES IN ALLOCATION WITH NO CHANGE IN AGREED PRICE

When the buyer and seller both agree on the allocation of the price to individual properties, they are generally bound by the values assigned. In the case of *Danielson*, for example, the parties had structured a transfer to include a covenant by the seller not to compete with the buyer. The seller, having discovered that an amount received for a covenant constitutes ordinary income, later decided to report the transfer as a sale of a capital asset (stock). **The court held that, absent duress or material misrepresentation, the parties were bound by the values assigned to each asset transferred** [*Danielson*, 50 TC 77 (1966), aff'd *Commissioner v. Danielson*, 378 F.2d 771 (3d Cir.), cert. denied, 389 U.S. 858 (1967)]. Also see Temp. Treas. Reg. §1.1060-1T(c)(4).

6. SUBSEQUENT CHANGES IN AGREED PRICE

In some cases, the amount of consideration paid by the buyer may increase or decrease after the sale has occurred. This might occur where there is some contingency or renegotiation. Contingent payments are disregarded until they have altered the buyer's basis or the seller's sales price under normal principles of tax law.

If there is a change in consideration, the allocations change. The seller must amend the sales price and thus restate the gain or loss on each asset. The nature and amount of the gain or loss is determined by reallocating the revised consideration for the year of sale. The reporting of the revised gain or loss is included on the seller's return for the year of the change.

The buyer adjusts the basis of any asset still held at the time of the change. Assets disposed of prior to the year of change are subject to a revised calculation of gain or loss. Any revisions that result in immediate gain or loss to the buyer are reported in the year of the change. There is a supplemental statement on Part III of Form 8594 for this purpose. [Temp. Treas. Reg. §1.1060-1T(f); also see *F. D. Arrowsmith*, 52-2 USTC 9527 (S.Ct.)]

For example, if part of an allocation increase is to an asset that has been completely depreciated or sold, the buyer receives an ordinary or capital loss deduction for such amount in the year of reallocation. If the asset has been partially depreciated at the time, the newly allocated amount is depreciated thereafter under special rules in Treas. Reg. §1.168-2(d)(3).

Subsequent decreases are allocated in reverse order: goodwill is reduced first, Class VI assets next, and so on [Temp. Treas. Reg. §1.1060-1T(g) Ex. 2].

Any reduction in a secured liability after the sale would not come under the general reallocation rules of I.R.C. §1060. Such reduction would be treated as cancellation of debt income under I.R.C. §108.

7. COVENANTS NOT TO COMPETE

A noncompete agreement usually prevents the seller or the seller's employees (in an asset sale) from entering into the same business as the sold business. The courts have generally applied **two tests** to police allocations to covenants, the **"economic reality"** test and the **"severability"** test. While the stakes were much different at the time many of these cases were decided, they do provide some guidance as to when allocations to a covenant will be respected.

A covenant not to compete and goodwill are closely related in that the purpose of the covenant is to ensure that the buyer benefits from the continued customer loyalty transferred by the seller. In short, **if a covenant is negotiated, that in and of itself suggests that goodwill exists.** Because the two are so intertwined, it is often difficult to sever the value of the covenant from the goodwill. **The severability test prevents an allocation to goodwill on the grounds that goodwill and the covenant cannot be severed.**

The **economic reality test** tries to determine whether the parties in fact intended to allocate a portion of the purchase price to the covenant or whether the covenant was a mere afterthought. **The test seeks to determine whether the covenant had an independent basis in fact or some relationship to business reality.**

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In order to demonstrate that the covenant is severable from goodwill and has an independent basis, the taxpayer should consider doing the following:

1. **Establishing the seller as a potentially competitive threat to the buyer.** For example, if the seller is nearing retirement age, is in poor health, or has relocated, there is probably little threat that the seller would compete. In such case, allocation to a covenant would not reflect reality.
2. **Separately negotiating for a covenant.** As noted above, the covenant should not simply be an afterthought. A specific value for the covenant should be identified in the sales agreement. Finally the covenant should contain specific provisions concerning the covenant's length, geographic location, and remedies for breach.
3. **Periodically monitoring the seller's activities** to determine if the seller is in fact complying with the covenant.

Valuing the Covenant. To value the covenant, the buyer estimates the after-tax present value of the cash flow that would be lost if the covenant did not exist and the seller could compete with the buyer.

- In estimating this amount, the buyer must consider not only the loss of cash flow but also the probability that the seller would actually compete.
- In determining the probability that the seller would compete, a complete assessment of the seller's ability to compete must be made. Some of the factors to consider include the seller's intention or willingness to compete, the type of business, the size of the business, barriers to entry (e.g., market saturation, initial capital requirements, product differentiation, and cost advantages), and general economic conditions.

Amounts paid for a covenant not to compete are **ordinary income to the seller.** However, the covenant is **not** subject to self-employment tax. A sole proprietor seller reports covenant payments in Part II, Form 4797, Ordinary Gains and Losses.

See Treas. Reg. §1.197-2(k) Example 7 to see how a series of payments for a covenant not to compete to be paid over a three-year period were discounted to their present value with amortization beginning in the year of acquisition rather than at the time of the payment. This example illustrates the difference between the total amount paid for a covenant and its present value at the time of the applicable asset acquisition.

8. EMPLOYMENT AND CONSULTING ARRANGEMENTS

An effective employment/consulting arrangement may provide an option to the buyer and seller.

For the buyer, the arrangement enables a quick deduction of part of the consideration.

For the seller, the arrangement produces ordinary income rather than capital gain. Another potential drawback is that the seller does not get the compensation up-front as he or she would in the case of a lump-sum purchase. However, if the parties had contemplated a deferred arrangement in the first place, this would not be a consideration. In addition, the parties could consider front-end loading of the sales agreement so that much of the compensation is paid when the sale is made.

In those instances where the seller does not desire capital gains, an employment agreement can be quite beneficial since it allows the buyer a much quicker write-off of the purchase price than do allocations to a covenant not to compete or goodwill.

An employment/consulting arrangement agreement will not work if the seller is really an investor and has little or no experience in operating the business. To ensure that the arrangement will not be recharacterized, the parties should be prepared to demonstrate that good reasons exist to employ the seller. Factors supporting such arrangements include the following:

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- The seller has expertise that contributes to the success of the business and such expertise would be valuable to any similarly situated buyer.
- Continued presence of the seller enables a smooth transition from one management team to another.
- The seller is familiar with the customers, suppliers, and/or regulators of the business and his or her continued presence aids the buyer in retaining the business relationships.

Since employment agreements can be used to circumvent I.R.C. §197 (e.g., allocating amounts to an employment agreement rather than a covenant not to compete), it is clear that they will be carefully scrutinized. To support the legitimacy of the employment or consulting agreement, the parties should separately negotiate the terms and provision of the employment relationship and put these terms and provisions in a separate binding agreement. In addition, **the seller should be obligated to expend a specified minimum number of hours per week involved in the buyer's business.**

9. AMORTIZATION OF GOODWILL AND CERTAIN OTHER INTANGIBLES

Various definitions have been offered for goodwill. In *Boe v. Comm.*, 62-2 USTC 9699 (CA-9, 1962), the court explained that goodwill is the "sum total of those imponderable qualities which attract the customers of a business . . . the essence of goodwill is the expectancy of continued patronage for whatever reason." In *Metallics Recycling Co. v. Comm.*, 79 TC. 730 (1982), the court stated that goodwill is the "expectancy that old customers resort to the old place of business." Revenue Ruling 59-60 states that the presence of goodwill is evidenced by the potential of a business to earn a return in excess of the industry average on tangible assets. When this latter definition is employed, it is incumbent on the taxpayer to identify those assets that enable the above average return to be earned.

Many taxpayers have shown a great deal of creativity in identifying assets other than goodwill. This strategy still has some importance where the seller or buyer wants a particular allocation.

Accountants' creativity in finding intangibles other than goodwill led to the enactment of I.R.C. §197. At the time of its enactment, the GAO estimated that nearly $9 billion of deductions were at stake relating to such intangibles as customer lists, pizza recipes, a company's shrinking market, and a business's nonunion status. As the GAO report explained, it had identified more than 100 different intangibles.

The Revenue Reconciliation Act of 1993 enacted new I.R.C. §197, which allows amortization of intangible assets, including goodwill. **The 15-year amortization rules apply to all intangible assets,** regardless of any other arrangement between the buyer and the seller. As a result of this legislation, goodwill and going-concern value are currently subject to more liberal depreciation allowances than buildings and other assets with a life greater than 15 years.

The 15-year amortization rule applies to the identified intangibles regardless of their estimated useful life. **There is no alternative minimum tax adjustment for the depreciation of any of these intangibles, including goodwill.**

a. Intangible Assets Subject to Amortization

Intangible assets subject to 15-year amortization are found in I.R.C. §197(d).

- **Goodwill, I.R.C. §197(d)(1)(A).** Goodwill is generally the value of a trade or business attributable to the expectancy of continued customer patronage (e.g., due to the business's name, reputation, or any other factor) [Treas. Reg. §1.197-2(b)(1)].
- **Going-concern value, I.R.C. §197(d)(1)(B).** Going-concern value is the additional value that attaches to property by reason of its existence as an integral part of an ongoing business activity [Treas. Reg. §1.197-2(b)(2)].

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- **Work force in place, I.R.C. §197(d)(1)(C)(i).** Sometimes referred to as assembled work force or agency force. Work force in place includes the value attributable to the composition of a work force (e.g., the experience, education, or training of a work force), the terms or conditions of employment, and any other value placed on employees or any of their attributes. For example, this intangible might include the value attributable to the existence of a highly skilled work force, an existing employment contract, or a relationship with employees or consultants. It does not include a covenant not to compete [Treas. Reg. §1.197-2(b)(3)].
- **Information base, I.R.C. §197(d)(1)(C)(ii).** Business books and records, operating systems, or any other information base (including lists or other information with respect to current or prospective customers). For example, any portion of the purchase price attributable to technical manuals, training manuals or programs, data files, or accounting or inventory control systems might be considered an information base intangible. Other examples include the cost of acquiring customer lists, subscription lists, insurance expirations, patient or client files, or lists of newspaper, magazine, radio, or television advertisers [Treas. Reg. §1.197-2(b)(4)].
- **Know-how, etc., I.R.C. §197(d)(1)(C)(iii).** Patent, copyright, formula, process, design, pattern, know-how, format, package design, computer software, or interest in a film, sound recording, videotape, book, or similar property, or any other similar item [Treas. Reg. §1.197-2(b)(5)].
- **Customer-based intangible, I.R.C. §197(d)(1)(C)(iv).** The term customer-based intangible means composition of market, market share, and any other value resulting from future provision of goods or services pursuant to relationships (contractual or otherwise) in the ordinary course of business with customers. It may include the existence of a customer base, a circulation base, an undeveloped market or market growth, insurance in force, or a mortgage-servicing contract. In the case of a financial institution, the term "customer-based intangible" includes deposit base and similar items such as the value represented by existing checking accounts, savings accounts, and escrow accounts [Treas. Reg. §1.197-2(b)(6)].
- **Supplier-based intangible, I.R.C. §197(d)(1)(C)(v).** The term supplier-based intangible means any value resulting from future acquisitions of goods or services pursuant to relationships (contractual or otherwise) in the ordinary course of business with suppliers of goods or services to be used or sold by the taxpayer. For example, this intangible would include a favorable relationship with persons providing distribution services (e.g., favorable shelf or display space at a retail outlet), the existence of a favorable credit rating, or favorable supply contracts [Treas. Reg. §1.197-2(b)(7)].
- **Licenses, permits, and other rights granted by a governmental unit or an agency or instrumentality thereof, I.R.C. §197(d)(1)(D).** For example, these rights include a liquor license, a taxicab medallion or license, an airport landing or takeoff right, a regulated airline route, or a television or radio broadcasting license. The renewal of such items would also be subject to these rules [Treas. Reg. §1.197-2(b)(7)].
- **Covenant not to compete and similar arrangement, I.R.C. §197(d)(1)(E).** This intangible includes a covenant not to compete or other arrangement to the extent that such an arrangement has substantially the same effect as a covenant not to compete entered into in connection with an acquisition (directly or indirectly) of an interest in a *trade or business* or substantial portion thereof. The acquisition may be made in the form of an asset acquisition, a stock acquisition or redemption, or the acquisition or redemption of a partnership interest [Treas. Reg. §1.197-2(b)(9) and (k), Examples 4 and 7].
- **Franchise, trademark, or trade name, I.R.C. §197(d)(1)(F).** The term franchise agreement includes any agreement that provides one of the parties to the agreement with the right to distribute, sell, or provide goods, services, or facilities within a specified area [I.R.C. §1253(d)]. The term includes distributorships [Treas. Reg. §1.197-2(b)(10) and (k), Example 6].

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- **Contracts for the use of, and term interests in other I.R.C. §197 intangibles are also considered I.R.C. §197 intangibles.** This precludes arrangements that otherwise would allow a quicker write-off of the intangible [Treas. Reg. §1.197-2(b)(11)].

Practitioner Note. The intangibles listed above are subject to the 15-year amortization if they are acquired as part of an entire **trade or business.** Most of these assets, except for goodwill and going-concern value, can be amortized over their **useful lives,** depending on facts and circumstances, if they are acquired **separately,** rather than as part of an integrated trade or business.

b. Other Assets not Subject to I.R.C. §197

There are specific exclusions from the definition of amortizable intangible assets [I.R.C. §197(e)]. See Treas. Reg. §1.197-2(c).

- **Financial interests [I.R.C. §197(e)(1)].** Any interest in a corporation, partnership, trust, or estate. For example, amortization is not available for the cost of stock or an interest in a partnership. Similarly, I.R.C. §197 does not include an interest under an existing futures contract, foreign currency contract, notional principal contract, interest rate swap, or other similar financial contracts [Treas. Reg. §1.197-2(c)(2)].
- **Land [I.R.C. §197(e)(2)].** This intangible includes a fee interest, life estate, remainder, easement, mineral right, timber right, grazing right, riparian right, air right, zoning variance, or any other similar right such as a farm allotment, quota for farm commodities, or crop acreage base [Treas. Reg. §1.197-2(c)(3)].
- **Certain computer software [I.R.C. §197(e)(3) and Treas. Reg. §1.197-2(c)(4)].** Section 197 intangibles do not include any computer software that is readily available for purchase by the general public, is subject to a nonexclusive license, or has not been substantially modified for the user. For this purpose, computer software will not be treated as having been substantially modified if its cost does not exceed the greater of 125% of the price at which the unmodified version of the software is available to the general public, or $2,000.

c. Computation of Amortization

The I.R.C. §197 intangible is amortized ratably over a 15-year period beginning with the month in which the property is acquired [Treas. Reg. §197-2(f)]. Salvage value, if any, is ignored.

- There is no amortization in the month of disposition.
- Contingent amounts added to the basis of the intangible after the first month of the 15-year period are amortized ratably over the remaining months of the 15-year period.
- Amounts added to the basis after the 15-year period has elapsed are immediately expensed in full.

Dispositions of intangible assets may or may not allow the taxpayer to claim a loss [I.R.C. §197(f) and Treas. Reg. §1.197-2(g)].

- A taxpayer who owns an intangible asset that becomes worthless (e.g., a covenant not to compete that expires) is not allowed to claim a loss deduction, **unless the taxpayer has no other remaining intangible assets, including goodwill,** which were acquired in the same transaction.
- In this situation, the taxpayer must add the nonrecovered basis of the worthless intangible to the amortizable basis of the remaining intangibles, and amortize over the remaining period.

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Example 5. Refer to Example 3 (buyer's calculation, with the original assumptions). **The basis of the intangible assets to James includes the amounts allocated to Classes VI and VII.**

Class VI and VII Assets	James's Cost
Liquor license (VI)	$37,500
Recipes (VI)	45,000
Registered business name (VII)	60,000
Goodwill (VII)	213,583
Total	**$356,083**

In addition, assume that James decides to change the theme of the restaurant after two years. He stops using the recipes immediately. He lets the registered business name lapse after four years. At the end of year five, the clientele has changed so dramatically that the original goodwill has disappeared. However, he continues to use the liquor license, which is subject to perpetual renewal. **He may not accelerate the amortization of any of these intangibles.** As each one expires he must allocate the remaining amortization to the other intangibles that were acquired in the purchase from Andrea. His schedule is as follows:

	License	Recipes	Name	Goodwill	Total
	37,500	45,000	60,000	213,583	356,083
Basis Year					
1	2,500	3,000	4,000	14,239	23,739
2	2,500	3,000	4,000	14,239	23,739
3	2,862	-0-	4,579	16,299	23,739
4	2,862	-0-	4,579	16,299	23,739
5	3,545	-0-	-0-	20,193	23,739
6	23,739				23,739
7	23,739				23,739
8	23,739				23,739
9	23,739				23,739
10	23,739				23,739
11	23,739				23,739
12	23,739				23,739
13	23,739				23,739
14	23,739				23,739
15	23,739				23,739

d. Amortization Is Treated as Depreciation

The amortization claimed is subject to depreciation recapture upon the disposition [I.R.C. §1245(a)(3)]. Thus the character is ordinary income, and the seller cannot claim installment sale treatment on the disposition of any previously amortized intangible asset.

Since goodwill is now depreciable, it is automatically classified as I.R.C. §1231 property. Therefore, any loss on the subsequent disposition of goodwill or any other intangible asset subject to I.R.C. §197 **is ordinary.**

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D. INSTALLMENT SALES

The installment sale rules generally allow the seller of property to report the gain (if any) on a deferred schedule. This rule applies when the seller receives the buyer's note, some or all of which may be paid after the year of the sale. [See I.R.C. §453 for the rules governing installment sales.]

Until December 17, 1999 the installment sale rules applied to both cash method and accrual method taxpayers. However, legislation enacted in late 1999 prohibited accrual method taxpayers from using this method, and required all gains from sales to be reported in the year of sale [Ticket To Work And Work Incentives Improvement Act Of 1999, PL 106-478, Sec. 536]. This provision was enacted with little legislative history or public discussion. It was unpopular from the outset, and there were immediate outcries for retroactive repeal. As of this writing, the outcome of installment sales legislation for accrual method taxpayers is unknown.

Example 6. Refer to Example 2. Assume that instead of $1,000,000 cash, Andrea received $200,000, plus James's note for $800,000. The note bears sufficient interest to avoid imputation under I.R.C. §1274. It matures at the rate of $200,000 per year for each of the next nine years. Under the law as it existed prior to December 17, 1999, Andrea could defer a substantial portion of the gain by using the installment method. However, as was noted in the initial set of facts, the restaurant uses the accrual method of accounting for tax purposes. Thus it appears that Andrea must account for all of her gain in the year of sale. However, the provisions of Rev. Proc. 2000-22 may allow her to accomplish this deferral.

In early 2000, the IRS was concerned about the possible repeal of the 1999 law disallowing the installment method of accounting to accrual method taxpayers. **In order to provide relief for small businesses, the IRS issued Rev. Proc. 2000-22 and 2000-20 IRB. This procedure allows taxpayers with no more than $1,000,000 gross receipts to use the cash method of accounting. Thus, these taxpayers are still eligible to use the installment method.**

The cash method is now permitted for these taxpayers, even if they are manufacturers or resellers who would be required to use the accrual method under Treas. Reg. §1.446-1(c). The cash method requires some modification for taxpayers who have physical inventories of goods. The allowance for cost of goods sold must be based on the amount actually consumed [Rev. Proc. 2000-22, 2000-20 IRB, Sec. 4. Also see Treas. Reg § 1.162-3].

In order to qualify for the cash method, the taxpayer must keep its books and records by the cash method. It is permitted to issue accrual basis reports for certain purposes [Rev. Proc. 2000-22, 2000-20 IRB. Sec. 5.07].

In order to meet the gross receipts test, the particular taxpayer in question must be aggregated with those of other entities under common control. The taxpayer must meet this test for the three years preceding the current tax year, but only for years beginning after December 17, 1998 [Rev. Proc. 2000-22, 2000-20 IRB, Section 5].

Taxpayers that have been required to keep inventories are generally on the accrual method, which was the only method allowable for sellers and manufacturers before Rev. Proc. 2000-22. These taxpayers are allowed to change their methods without prior permission from the IRS. See Rev. Proc. 2000-22, Sec. 6.02(1)(b) and Rev. Proc. 99-49, 1999-52 IRB 725 for specific instructions on changing an accounting method.

Example 7. Refer to Example 2 and Example 6. Assuming that Andrea's gross receipts for the last three years (testing only years beginning after December 17, 1998) do not exceed $1,000,000, she may change to the cash method for the year of the sale of the business. Since she would not be using the accrual method in the year of the sale, she could qualify for deferral under the installment method of accounting.

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E. OTHER TAX ENTITIES

The rules of I.R.C. §1060 are applicable to all types of taxpayers. Thus, a sale of the assets constituting a going business would require both the buyer and the seller to make the computations shown in the above examples. Of course, the tax treatment of specific gains and losses would differ, depending upon the tax status of the seller, but the basic allocation rules are the same. Similarly, the depreciation and amortization rules regarding the intangible assets are identical for all taxpayers. The installment sale rules and disallowance of this method for accrual basis taxpayers applies to all entities.

However, when the seller of a business is a corporate tax entity, there are new complications added to the transaction. Following is a highlight of some of the principal tax considerations involving the C corporation

1. THE C CORPORATION

Although there are variety of techniques for buying and selling corporations, most of these can be classified into one of two categories:

- Sale of stock.
- Sale of assets.

In most deals, the first hurdle the parties must negotiate is whether the purchaser will buy assets or buy stock. Once this initial decision is made, most stock and asset sales follow a similar pattern.

a. Asset Sales

When the parties decide that **assets** are to be sold, the sale normally takes one of two forms.

1. From the seller's perspective, the corporation could sell the assets desired by the buyer and distribute the proceeds and any unwanted assets to the shareholder(s) in liquidation.

Example 8. Refer to Example 2. Assume the same facts, except that the restaurant is operated as a C corporation, Anlyn Corporation. Andrea is the sole shareholder of Anlyn. She had a basis of $150,000 in her Anlyn stock before the sale.

Anlyn sells all of its assets to James for cash and the assumption of its liabilities, as specified in the original text of Example 2. Anlyn would compute all of the allocations and gains and losses in the exact same manner as was originally shown. The corporation would report all gains and losses on its Form 1120. It would then have cash in the amount of $1,202,333 and no liabilities, except for the income tax it owed as a result of the sale. Assuming a flat 34% rate and no complications such as carryforwards, the tax is:

Amount realized by Anlyn	$1,202,333
Less adjusted basis of assets	(436,065)
Gain	766,268
Tax rate	×34%
Federal income tax	**$260,531**

After payment of this tax, Anlyn would have

Before tax cash	$1,202,333
Less federal income tax	(260,531)
Net assets	**$941,802**

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Now that Anlyn has no business operations, it would most likely become a personal holding company, although it might avoid this status if it invested in a new operating business.

In many cases, a corporation that no longer conducts any business decides to liquidate. Pursuant to I.R.C. §§336 and §331, a liquidation is fully taxable for both the corporation and its shareholder.

Example 9. Refer to Example 8. If Andrea decides to **liquidate the corporation,** there will be an additional round of tax. First, the corporation must recognize any gain or loss on property distributed in complete liquidation. In this case, since the only asset left is cash, the corporation recognizes nothing at this point, which is the last act of its existence.

However, Andrea must now consider her tax ramifications. She would receive the corporation's after-tax cash of $941,802. None of the corporation's dealings would have affected her stock basis of $150,000. Thus, she would report the following gain:

Amount received in liquidation of Anlyn	$941,802
Less Andrea's adjusted basis in her stock	(150,000)
Long-term capital gain	$791,802
Andrea's capital gain tax at 20%	$158,360

Thus, Andrea's after-tax cash would be:

Amount received in liquidation of Anlyn	$941,802
Less tax on liquidation gain	(158,360)
Cash, after tax	$783,442

This is the most important aspect of the entire deal to the seller!

2. Alternatively, the corporation could distribute all of the assets in liquidation and the shareholder could make the sale.

Example 10. Refer to Example 8. If Anlyn distributed the assets to Andrea, the corporation would recognize all gains and losses in the exact same fashion as it would in a sale of those assets. Similarly, Andrea would take the assets into account at their fair market values, and would report the gain on her stock at the time of liquidation. Her after-tax cash should be the same as shown above in Example 9.

b. Stock Sales

In a **stock acquisition**, the format is somewhat more straightforward. On the seller side, the shareholder merely sells the stock, while on the buyer side, the acquiring corporation may either keep the target corporation alive or liquidate it. However, the buyer is now left with a corporation that has historic asset basis. If the buyer liquidates the corporation, it will then face the tax consequences of liquidation. Several **non-tax factors** may affect the form of the transaction:

1. Stock sales are usually **easier** to carry out than asset sales. In an asset sale, titles must be changed–perhaps for hundreds of assets–and creditors must be notified in conformance with the applicable bulk sales laws. A stock sale is much simpler since the seller merely sells the stock to the buyer.
2. The presence of some **nonassignable right** held by the corporation, such as a license or other contractual arrangement. In such a case, only a sale of stock will preserve this right.
3. The possibility for **unknown or contingent liabilities.** In a risky business, the seller wants to absolve himself from all liability. Consequently, he wants to sell the stock and along with it all of the known and contingent liabilities. The purchaser is in the opposite position since he does not

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want to accept any responsibility for the unknown. Where a stock sale is otherwise desirable, this problem may be alleviated by having the seller indemnify the buyer for any undisclosed liabilities.

4. The presence of **minority shareholders** who are unwilling to sell their stock.
5. The existence of **undesirable assets**, such as polluted land.
6. Special requirements that may be imposed by **regulatory** agencies or local law.
7. The **consideration package** to be given to the seller. Very few deals are cash only. More often, the buyer wants to buy on credit over an extended period of time so that the purchase price can be paid with the profits of the business. In some situations the buyer is cash poor and may not be able to borrow sufficiently. Therefore, an installment sale may be the only solution.

- The seller may help the buyer out by reducing the cash required by using the so-called **bootstrap** technique, which is a form of a **leveraged buyout** arrangement. Under this approach, the corporation redeems some of the shares of the seller while the buyer purchases the remaining shares.

- In a stock sale, the seller may easily defer gain by making an **installment** sale. (Note the problems for **accrual method taxpayers** at the time of publication of this chapter.)
- An installment sale may not be as advantageous if assets are sold. To the extent of **depreciation recapture**, the selling corporation will not be able to use the installment method. (There are also complications when a corporation sells its assets on the installment method and liquidates.)

Example 11. Assume the same facts as in Example 8 except that Andrea sold all of her stock. The buyer would now have the entire corporation, and would have a basis in his stock equal to the amount paid. However, there would be no change in the corporation's basis in its various assets from those shown at the opening of the problem in Example 2.

If the buyer wanted the step up in basis of the individual assets, it would be necessary to liquidate the corporation. This would result in the corporate level tax shown in Example 8, and a reduction of the corporation's assets.

In short, the sale of a business illustrates one of the worst disadvantages of the C corporation as a tax entity. Someone, either the seller or the buyer, is left with a round of taxation upon liquidating the corporation, or the buyer foregoes any opportunity to obtain a step up in asset basis to reflect the purchase price.

A sophisticated buyer will always discount the value of a stock sale to reflect the tax cost of obtaining asset basis.

c. Liquidation Reporting Requirements

The IRS requires that a corporation undergoing complete liquidation file Form 966 within 30 days after the adoption of the plan to liquidate [Treas. Reg. §1.6043-1. Return regarding corporate dissolution or liquidation].

Practitioner Note. Failure to file Form 966 is not necessarily fatal to treatment of distributions as distribution in complete liquidation of the corporation. See Rev. Proc. 86-16, 1986-1 CB 546, 4.02.1(b), which allows a corporation to submit evidence of adoption of a plan to liquidate prior to 30 days before filing Form 966. Also see *Rendina,* T.C. Memo 1996-392, in which the Tax Court honored an informal liquidation with no filing of Form 966.

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d. Tax Reduction Techniques

When a C corporation holds the assets of the target businesses, both buyers and sellers may resort to a variety of techniques to reduce or defer tax. Some of the more popular include:

- Purchasing assets directly from the selling shareholders. Most often these have taken the form of **covenants not to compete**. Note that such asset transfers must be reported on Form 8594 if the selling shareholder owns more than 10% of the stock in the selling corporation. Note that this is not an asset of the corporation per se, and thus is not subject to the corporate income tax. However, it is subject to tax at ordinary income rates for the seller. In addition, the buyer is subject to the I.R.C. §197 15-year amortization, regardless of its actual duration.
- Another asset that has recently received attention is "**personal goodwill.**" This asset was recognized by the Tax Court in the *Martin Ice Cream* case [see *Martin Ice Cream Co.,* 110 TC No. 18 (1998)]. The personal goodwill should be a capital asset in most cases, resulting in a maximum tax rate of 20% to the seller. If the selling shareholder uses the cash method of accounting and receives a note from the purchaser, the seller will generally be able to use the installment method to report the gain from the goodwill. The buyer will amortize the asset over the 15-year period specified in I.R.C. §197.
- **Avoid C corporation tax status.** The S corporation, the partnership, and the limited liability company all avoid the problem of the double tax on liquidation if the sale is properly planned. However, this technique requires early planning, since the point of imminent sale is too late to take advantage of the full tax effects of these business entities.
- **Use one of the tax-free reorganization** provisions. The rules can become complicated, and the parties must observe strict compliance with federal, state, and local tax and regulatory requirements. In addition, the seller must retain at least some degree of equity interest in the business.

2. THE S CORPORATION

The S corporation allows buyers and sellers to avoid many of the double tax problems that are present with a C corporation. However, the proper use of this election requires familiarity with the various provisions of Subchapter S of the Internal Revenue Code. There are some hazards in the use of the S corporation. For example:

1. If a C corporation converts to S status and the corporation sells its assets within ten years of the conversion, the corporation is subject to a corporate level tax. This tax, known as the **built-in gains tax,** may reduce, or even negate, the benefits of the S election. This tax usually does not apply if the selling corporation has never been a C corporation.
2. A purchase of the stock of a corporation may not allow the buyer to receive a step up in basis of the assets. These problems can be mitigated by having an S election in place from the corporation's inception, or at least for several years before the asset sale.

In addition, the S corporation provides several other tax and non-tax benefits. As a corporation under state law, it provides the owners with the maximum legal shield from business liabilities. It has the added advantage of being able to become a C corporation instantaneously if there is an opportunity for a tax-free reorganization, or if the owners are able to take the business public.

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3. THE PARTNERSHIP

The partnership allows a complete avoidance of the double taxation on the sale of a business. It is also possible to sell assets or interests in the partnership. However, if there is a single buyer, either transaction is treated as a sale of assets. There are some considerations that might mitigate the ability to use a partnership.

1. If the business is already incorporated, conversion to a partnership will be treated as a liquidation. The business will face the double tax described above.
2. If the owner(s) have the opportunity to receive stock in a corporation as consideration, it will not be a tax-free reorganization. Thus the disposition will be completely taxable.
3. If the owners intend to take the business public, the corporation is the only form of business they may use. Incorporating the partnership shortly before a public offering may cause the IRS to treat the incorporation as a fully taxable event.

4. THE LIMITED LIABILITY COMPANY

The limited liability company does not exist as a tax entity per se. In most cases a limited liability company with a single owner is treated as a sole proprietorship. If it has multiple members, it is usually treated as a partnership. In either case it is possible for the limited liability company to be treated as a corporation, although there are few situations in which this is advantageous.

Thus the sale of assets or of equity in a limited liability company does not have any unique tax treatment. It is treated as the sale of a proprietorship, a partnership, or a corporation depending on the classification of the entity. Many of the nontax factors of a stock or asset sale described above under the C corporation also apply to limited liability companies.

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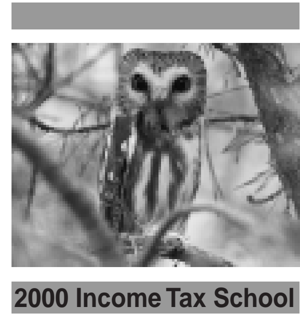

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