Chapter 7: Small Business Issues

Corrections were made to this workbook through January of 2007. No subsequent modifications were made.

ISSUE 1: IRC §409A — NONQUALIFIED DEFERRED COMPENSATION PLANS

In this discussion of nonqualified deferred compensation plans, the term "employee" includes any nonemployees to the extent they are permitted to participate in these plans. A "nonemployee" for this purpose includes a(n):

- Individual
- Corporation
- S corporation
- Partnership
- Personal service corporation as defined in IRC §269A(b)(1)
- Noncorporate entity that would be a personal service corporation if it were a corporation
- Qualified personal service corporation as found in IRC §448(d)(2)
- Noncorporate entity that would be a qualified personal service corporation if it were a corporation

This generally includes an individual in the capacity of an independent contractor. However this does not apply to an independent contractor if:

1. The individual actively engages in the trade or business of providing services other than as an employee or director of the company to whom the services are being provided,
2. The individual provides significant services to two or more companies to which the individual is not related, and that are not related to one another, and
3. The individual is not related to the company to whom the services are being provided.

MOST DEFERRED COMPENSATION PLANS

Most tax practitioners are familiar with the deferred compensation plans covered under SIMPLEs, SAR-SEPS, IRC §401(k) plans, and IRC §403(b) plans. When an employee defers part of his compensation into these plans, the amount deferred is still considered wages for purposes of FICA and FUTA.

The employee's Form W-2, *Wage Statement*, indicates the amount deferred in box 12 with the applicable code (D for the §401(k), E for the §403(b), and so on.). This amount is excluded from box 1 wages, but included in boxes 3 and 5, social security and Medicare wages. Since the deferrals are excluded from wages, the employee is paying income taxes on his compensation less the deferrals.

The amount the employee defers into these plans is normally 100% vested. Therefore the employee is immediately entitled to all the deferred amounts plus (or minus) any earnings on these amounts. The employer's contributions, including any earnings attributed to employer contributions, have different vesting provisions.

When these amounts are withdrawn from deferred accounts, the taxpayer receives Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*, showing the amount withdrawn. The amount of the withdrawal is taxable income. If the taxpayer is under age 59½ at the time of the withdrawal, the taxable amount may be subject to an additional early distribution penalty. This penalty is commonly referred to as the "IRC §72(t) penalty." There are various exceptions to this penalty.

NONQUALIFIED DEFERRED COMPENSATION PLANS

Nonqualified deferred compensation plans operate under different rules. When an employee defers compensation into a **nonqualified plan**, it is similar to the employee telling his company "give me a cut in pay today and pay me the money in the future, if I meet the conditions in our employment contract." Since an employee may never receive the amount deferred, nonqualified deferrals usually are not reported on Form W-2 in the year of deferral.

Assuming the company is still in existence in the future, and the contract conditions have been met, the employee then receives the deferred amounts. At the time the deferred amounts are vested for the employee, or no longer subject to a substantial risk of forfeiture, they are subject to FICA withholding and matching. This is often the same time the employee receives the distribution from the plan, although the vesting could occur earlier than the distribution year.

When deferred amounts from a nonqualified deferred compensation plan are paid to the employee, they are reported on Form W-2, subject to federal income tax withholding. FICA withholding applies if this occurs when the funds are first vested to the employee. The employee reports these amounts as wages. They are earned income for various tax purposes such as allowing the employee to contribute to a traditional or Roth IRA. Regardless of the employee's age, these amounts are not subject to the early distribution penalty since they are not distributions from IRAs or qualified retirement plans.

An employee may pay more social security taxes when participating in a nonqualified deferred compensation plan if his compensation for the deferral year exceeds the maximum compensation subject to FICA.

Example 1. Renaldo earned $150,000 in 2006. He deferred $20,000 into a nonqualified deferred compensation plan. This deferral saves Renaldo income tax and $290 of Medicare tax. It does not save social security taxes since Renaldo is over the maximum social security earnings for 2006.

In 2016 (Year 10), Renaldo becomes vested in the $20,000. His 2016 social security earnings, before the distribution, are only $50,000. Assuming the same FICA rates in 2016, Renaldo's $20,000 of nonqualified deferred compensation is subject to Medicare withholding of $290, plus social security withholding of $1,240. Renaldo paid $1,240 more in social security withholding than if he had not deferred the funds in 2006.

Taxpayers who participate in nonqualified deferred compensation plans are subject to the rules of IRC §409A, created as part of the American Jobs Creation Act of 2004. The IRS released several regulations dealing with these plans. Notice 2005-1 (question and answer format), and Notices 2005-94 and 2006-33 are designed to help clarify questions and cover the details of §409A.

In order to avoid taxation of deferred compensation in the year earned, a nonqualified plan must comply with the following three tests:

1. Distribution test,
2. Acceleration of benefits test, and
3. Election test.

Distribution Test

Nonqualified deferrals are not required to be reported in an employee's gross wages, nor are they subject to FICA or FUTA at the time of the deferral, **if the amount deferred is subject to a substantial risk of forfeiture**. "Substantial risk of forfeiture" is defined as existing when the employee's "rights to such compensation are conditioned upon the future performance of substantial services by any individual."[1]

For a deferral to be excluded from income, a plan cannot allow the acceleration of benefits, except as provided by IRS regulations, nor allow distributions any earlier than:[2]

1. When an employee separates from service,
2. When an employee becomes disabled,
3. When an employee dies,
4. At a time specified under the plan,
5. When there is a change in the ownership or effective control of the corporation with the plan (defined as during a 12-month period having either a 35% or larger ownership or a replacement of a majority of the members on the board of directors), or
6. Upon the occurrence of an unforeseeable emergency such as severe financial hardship resulting from an illness or accident of the participant, the participant's spouse or a dependent; a loss of property due to a casualty; or other extraordinary and unforeseeable circumstances beyond the participant's control. In case of hardship, the amount available to be distributed is limited to the costs necessary to deal with the emergency and an amount anticipated to be needed to cover taxes on the distribution.

If a plan fails these tests, the entire amount deferred, that was not previously included in the employee's income, is subject to tax in the year of the failure. This amount is also subject to interest and penalty. The interest is equal to the underpayment rate plus 1% and is applicable for the period starting with the earlier of the year of the deferral or the year the substantial risk of forfeiture no longer exists. The penalty is equal to 20% of the amount required to be included in income.

Acceleration of Benefits Test

This test is met if a plan does not permit the time or schedule of any payment under the plan to be accelerated, except as provided in the regulations.

Election Test

To meet the requirements of the election test, a participant must make an election within 30 days after the date he first is eligible to participate in the plan. If the plan is performance-based on services to be performed over a period of at least 12 months, the election must be made no later than six months **before** the end of that period.

If a plan permits, under a subsequent election, a delay in payment or change in the form of payment may not take place until at least 12 months after the date the election was made. Except for payments made because of disability, death, or unforeseen circumstances, payments must be deferred for at least five years from the date the payment would otherwise have been made. In addition, the election to defer may not be made less than 12 months prior to the date of the first scheduled payment.

---

1. IRC §409A(d)(4)
2. Treas. Reg. §1.409A-3(g)

ISSUE 2: SALE OF AN ACCOUNTING PRACTICE[3]

At some point in time, owners of tax and accounting practices may decide to sell their practices. This section focuses on some of the issues that arise when transitioning out of a practice.

TIMING A SALE

Deciding when to place a practice on the market can be a difficult decision. The time of year a practice is put on the market can make a difference in how long it takes to find a buyer. If a practice is predominantly tax-oriented, a seller may wish to sell immediately after a tax season ends, when most of the annual billing has been completed.

Retaining a tax practice during the off-season generally results in negative cash flow. However, buyers also realize that a tax practice normally does not generate much money in the off-season. Therefore, most buyers prefer to wait until fall to make a purchase.

Some practices sell within 60 days, while other practices may take up to 120 days to sell. Often, the legal process takes an additional 60 days after the buyer and seller have agreed upon a price.

When an estate sells the practice, the buyers substantially discount the practice value. Unlike artwork, a tax or accounting practice is worth more if it is sold while the owner is still living. Once clients hear that their tax preparer or accountant has died, they begin looking for a replacement. Also, uncertain of the future of the business, staff members may begin searching for new employment. Some may even decide to open their own businesses and solicit clients from their former employer.

VALUATION OF A PRACTICE

After making the decision to sell, the first issue is how to value a practice. Price usually is based on a percentage (multiple) of a practice's gross receipts for the prior year. However, certain other factors also enter into the valuation process, such as:

- **Will the current owner continue to be associated with the business?** If so, will he be paid for the time spent working with his former clients or is his time included in the sales price? Experience has shown that if a former owner continues with the firm for a period of time, fewer clients are lost in the transition. The duration of any transition period may factor into the valuation.

- **Will the price be fixed at the time of sale or will it be set later based on client retention?** If a price is based on client retention, the multiple is usually higher. While an agreement to fix a price after the calculation of client retention decreases a buyer's risk, it increases risk for a seller.

- **Where is the practice located?** A practice in metro Chicago usually sells for a higher multiple than a practice in rural Iowa. Recent sales have seen multiples ranging from 90% of the prior year's gross billings up to 140%. It is more common for practices in rural areas to value their practices at 100% to 110% of gross billings, while 110% to 125% is the norm for large metropolitan areas.

- **Does the overall price include office furniture and fixtures?** Usually the sale of furniture and fixtures is separately negotiated, unless a large practice is being sold. Sellers should keep in mind that the market for used office furniture and equipment is not good, and the FMV probably is substantially less than what was paid.

- **Is an office building included in the transaction?** Real estate should be transacted separately. If a seller owns a building, he may choose either to sell it to the buyer, or lease it to him. If a seller leases a building, he may be able to transfer his existing lease to a buyer.

3. Parts of this chapter are based on information furnished by Larry Naab, CPA, Midwest Region Professional Accounting Sales, larry@cpasales.com

ALLOCATION OF SALES PRICE

Tangible Assets

If tangible assets are included in the sales price, such as office equipment or real estate, the price of these items should be separately stated in the contract. It is easier to prepare the tax returns of both the buyer and seller if each item is individually listed by price and description.

Intangible Assets

Two of the most common intangible assets included in the sales price of an existing business are covenants not to compete and goodwill. Other intangible assets may include the workforce in place, business books and records, computer operating systems and databases, and franchise fees.

Noncompete Covenants. Covenants not to compete are important if the seller plans to continue practicing his profession once the practice is sold. A covenant not to compete is a written agreement that restrains a seller from competing against a buyer for the same customer base after a sale is transacted. Usually a noncompete covenant will specify that a seller must refrain from doing business within a certain geographic location for a specified period of time. The terms of these covenants generally are governed by state law.

Necessity. The necessity of a noncompete covenant should be realistic. The IRS regularly takes the position that the existence of such a covenant is not realistic when the buyer and seller are related, such as a father and daughter. The necessity of a covenant is also questionable when the likelihood of the seller competing is very low, such as a 10-year noncompete covenant for a seller who is currently age 95 and in ill health.

The length of a noncompete covenant is also an issue in determining its necessity. For example, a 10-year covenant is probably not necessary in the sale of an accounting or tax practice, since clients tend to stay where they are if they have been with a business for three years or more. Therefore a three to five year covenant not to compete may be seen as more realistic.

Separate Contracts. Ideally, the noncompete covenant should be separate from the contract for the sale of a business' assets, such as equipment, buildings, and goodwill. If a buyer defaults on payments for the assets of a business, repossession may be required. Tying a noncompete covenant into the overall purchase contract may make it hard to separate.

If a practice is incorporated, there is often a concern that a shareholder might compete with a buyer, which a corporation could not prevent. If a buyer enters into a separate agreement with a shareholder not to compete and makes a payment to the shareholder for this agreement, he should be able to eliminate this concern.

Valuation and Allocation of Contract Price. A noncompete covenant may have a higher value in its first year than in later years. For example, a seller who enters into competition with a purchaser is more likely to retain or regain his clients if the seller competes with the buyer during the year following the sale, as opposed to five years later.

For sales transacted on or after August 11, 1993, the allocation of the purchase price between goodwill and a covenant not to compete is of no tax consequence to **buyers**, since both are amortized over 15 years. However the allocation has significant tax consequences to **sellers** since the amount allocated to goodwill is eligible for capital gain treatment, while the amount allocated to the noncompete covenant is treated as ordinary income**.**

Goodwill. Goodwill includes items that are tied into a business' name that do not fall elsewhere. An example is a client list. Often the amount of the purchase price allocated to goodwill is made by default, since any "leftover" amount not separately stated in the negotiated contract is allocated to goodwill.

Form 8594, *Asset Acquisition Statement*

When a practice is sold, both the buyer and the seller may be required to attach a completed Form 8594, *Asset Acquisition Statement Under Section 1060*, to their respective income tax returns. Form 8594 is required when there is a transfer of a group of assets:

1. To which goodwill, or going concern value attaches or could attach; **and**
2. A purchaser's basis in such assets is determined wholly by the amount paid for the assets.

This form is required regardless of whether a group of assets is considered a trade or business in the hands of the buyer, the seller, or both.

Asset Classifications. The overall transfer price of a group of assets must be allocated between the following seven asset classes:

Class I. Cash and general deposit accounts, other than certificates of deposit

Class II. Actively-traded personal property,[4] with the following exceptions:

- Stock of targeted affiliates is **not** included, other than actively-traded stock described in IRC §1504(a)(4)
- Certificates of deposit and foreign currency are included, regardless of whether they are actively traded

Class III. Debt instruments, including accounts receivable,[5] and assets that the taxpayer marks-to-market at least annually

Class IV. Inventory and similar property held for sale to customers in the ordinary course of business

Class V. Assets that do not fall into any other class, such as equipment, furniture, fixtures, vehicles, buildings, and land

Class VI. IRC §197 intangible assets,[6] **other than** goodwill and going concern value

- §197 assets **include** intangibles such as noncompete covenants, workforce in place, business books and records, operating systems and databases, franchise fees, and others
- §197 assets **do not include** intangibles such as an interest in a corporation, partnership, trust or estate, interests under certain financial contracts, interests in land, certain computer software, interests under leases of tangible property, and others

Class VII. Goodwill and going concern value

The amount allocated to an asset, other than goodwill or going concern, cannot exceed the FMV of the asset on the purchase date or the applicable limit under the Code or general principles of tax law. **The total consideration should be allocated in class order, starting from Class I and continuing through Class VII, if applicable. Any residual consideration is allocated to Class VII (goodwill).**

---

4. Actively traded personal property within the meaning of IRC §1092(d)(1) and Treas. Reg. 1.1092(d)-1, as determined without regard to IRC §1092(d)(3).

5. See the instructions for Form 8594 for debt instruments that are excepted from Class III.

6. IRC §197(e)

Consideration is allocated within each class to individual assets, in proportion to the FMV of each on the purchase date. If an asset falls into more than one class, it is assigned to the highest applicable class (e.g., if an asset could be included in Class III or Class IV, assign it to Class III).

Note. Form 8594 must be amended whenever there is an increase or decrease in the purchaser's cost or the seller's amount realized from a sale. See Form 8594 instructions for more information regarding the reallocation of consideration.

CONTINGENT SALE PAYMENTS

If a sale is contingent on retained business, the seller receives a down payment at closing based on a percentage of the maximum agreed-upon sales price. The actual price usually is determined the year after the sale, based on the amount of business retained. The seller then receives the balance of the recalculated sales price over the number of years stipulated by the contract.

Example 2. Sam, a sole proprietor, decides to sell his tax business to Joseph in 2005. Joseph agrees to purchase the business for a maximum price of $385,000, or 110% of Sam's 2005 gross billings of $350,000. However, the actual sales price is contingent on the amount of retained business. The final price will be determined one year from the date of sale, based on 110% of Joseph's gross billings for the first year.

The contract calls for Joseph to pay Sam 75% of the maximum selling price at the time of closing, with the balance due in annual installments of equal amounts over a 5-year period. Interest is separately stated. Joseph pays Sam a down payment of $288,750 ($385,000 × 75%) at closing.

At the end of the first year, Joseph's gross billings are $325,000. This sets the final price for the sale at $357,500 ($325,000 × 110%). Joseph owes Sam a balance of $68,750 ($357,500 – $288,750) or $13,750 per year for five years ($68,750 ÷ 5), plus interest.

REPORTING THE SALE

Tangible Assets

The sale of a practice's tangible assets is reported on Form 4797, *Sales of Business Property*, in the same manner as if the assets had been sold in the ordinary course of business.

Intangible Assets

Noncompete Covenant. Income received from a noncompete covenant is reported on Form 4797, Part II. It is taxed as ordinary income.

Goodwill. Prior to August 10, 1993, purchased goodwill generally could not be amortized. Thus, the subsequent sale of purchased goodwill was reported on Schedule D, *Capital Gains and Losses*. IRC §197, implemented under the Revenue Reconciliation Act of 1993, altered the tax treatment of purchased goodwill.

After August 9, 1993, purchased goodwill and other §197 assets can be amortized on a **straight-line** basis over a period of **15 years**. The subsequent sale of these amortized assets is reported on Form 4797 as IRC §1245 property. Any gain realized up to the amount of allowed or allowable amortization is taxable as ordinary income (Form 4797, Part II). Any excess gain is eligible for capital gain treatment (Form 4797, Part I).

Installment Sale

Reporting the sale of a practice can be somewhat confusing when a business is sold contingent on the retention of business. The delay involved in determining the final contract price usually requires the sale to be reported on the installment method.[7]

7. Treas. Reg. §15A.453-1(c)(2)(i)(A)

7

Example 3. Use the same facts as **Example 2,** except the $385,000 maximum contract sales price is allocated first to a $30,000 covenant not to compete, and the balance is allocated to goodwill. Sam purchased his client base for $15,000 and his unamortized basis is $10,700. He sold his fully depreciated office furniture and equipment separately for $5,000.

Since the contract price is not finalized until the end of the first year, the installment method must be used to report this sale. Because the value of the covenant not to compete is fixed in the contract, the amount allocated to the purchase of goodwill must be modified in 2006. The 2005 down payment is allocated as follows:

Year 1

Gross billing	$350,000
Multiple	110%
Sale price	$385,000
Covenant not to compete	(30,000)
Goodwill	$355,000
Covenant not to compete	$ 30,000
Downpayment	× 75%
Payment in Year 1	$ 22,500
Goodwill	$355,000
Downpayment	× 75%
Payment in Year 1	$266,250

The forms Sam must use to report this transaction in the year of sale (2005) and the first year after the sale (2006) are shown below, starting with Forms 6252 and 4797 for 2005. The sale of goodwill and the covenant not to compete have been reported as separate installment sales.

For Example 3

Form **6252** | **Installment Sale Income** | OMB No. 1545-0228

Department of the Treasury
Internal Revenue Service

► Attach to your tax return.
► Use a separate form for each sale or other disposition of property on the installment method.

2005
Attachment Sequence No. **79**

Name(s) shown on return	Identifying number
Sam Seller	123-45-6789

1 Description of property ► Goodwill

2a Date acquired (month, day, year) ► 07 / 07 / 2001 **b** Date sold (month, day, year) ► 09 / 01 / 2005

3 Was the property sold to a related party (see instructions) after May 14, 1980? If "No," skip line 4 . . . . ☐ Yes ☑ No

4 Was the property you sold to a related party a marketable security? If "Yes," complete Part III. If "No," complete Part III for the year of sale and the 2 years after the year of sale . . . . ☐ Yes ☐ No

Part I **Gross Profit and Contract Price.** Complete this part for the year of sale only.

5	Selling price including mortgages and other debts. **Do not** include interest whether stated or unstated			5	355,000
6	Mortgages, debts, and other liabilities the buyer assumed or took the property subject to (see instructions)	6			
7	Subtract line 6 from line 5	7	355,000		
8	Cost or other basis of property sold	8	15,000		
9	Depreciation allowed or allowable	9	4,300		
10	Adjusted basis. Subtract line 9 from line 8	10	10,700		
11	Commissions and other expenses of sale	11			
12	Income recapture from Form 4797, Part III (see instructions)	12	4,300		
13	Add lines 10, 11, and 12			13	15,000
14	Subtract line 13 from line 5. If zero or less, **do not** complete the rest of this form (see instructions)			14	340,000
15	If the property described on line 1 above was your main home, enter the amount of your excluded gain (see instructions). Otherwise, enter -0-			15	0
16	**Gross profit.** Subtract line 15 from line 14			16	340,000
17	Subtract line 13 from line 6. If zero or less, enter -0-			17	0
18	**Contract price.** Add line 7 and line 17			18	355,000

Part II **Installment Sale Income.** Complete this part for the year of sale **and** any year you receive a payment or have certain debts you must treat as a payment on installment obligations.

19	Gross profit percentage. Divide line 16 by line 18. For years after the year of sale, see instructions			19	95.7746%
20	If this is the year of sale, enter the amount from line 17. Otherwise, enter -0-			20	0
21	Payments received during year (see instructions). **Do not** include interest, whether stated or unstated			21	266,250
22	Add lines 20 and 21			22	266,250
23	Payments received in prior years (see instructions). **Do not** include interest, whether stated or unstated	23			
24	**Installment sale income.** Multiply line 22 by line 19			24	255,000
25	Enter the part of line 24 that is ordinary income under the recapture rules (see instructions)			25	0
26	Subtract line 25 from line 24. Enter here and on Schedule D or Form 4797 (see instructions)			26	255,000

Part III **Related Party Installment Sale Income. Do not** complete if you received the final payment this tax year.

27 Name, address, and taxpayer identifying number of related party

28 Did the related party resell or dispose of the property ("second disposition") during this tax year? . . . . ☐ Yes ☐ No

29 **If the answer to question 28 is "Yes," complete lines 30 through 37 below unless one of the following conditions is met. Check the box that applies.**

- **a** ☐ The second disposition was more than 2 years after the first disposition (other than dispositions of marketable securities). If this box is checked, enter the date of disposition (month, day, year) ► / /
- **b** ☐ The first disposition was a sale or exchange of stock to the issuing corporation.
- **c** ☐ The second disposition was an involuntary conversion and the threat of conversion occurred after the first disposition.
- **d** ☐ The second disposition occurred after the death of the original seller or buyer.
- **e** ☐ It can be established to the satisfaction of the Internal Revenue Service that tax avoidance was not a principal purpose for either of the dispositions. If this box is checked, attach an explanation (see instructions).

30	Selling price of property sold by related party (see instructions)	30	
31	Enter contract price from line 18 for year of first sale	31	
32	Enter the **smaller** of line 30 or line 31	32	
33	Total payments received by the end of your 2005 tax year (see instructions)	33	
34	Subtract line 33 from line 32. If zero or less, enter -0-	34	
35	Multiply line 34 by the gross profit percentage on line 19 for year of first sale	35	
36	Enter the part of line 35 that is ordinary income under the recapture rules (see instructions)	36	
37	Subtract line 36 from line 35. Enter here and on Schedule D or Form 4797 (see instructions)	37	

For Paperwork Reduction Act Notice, see page 4. Cat. No. 13601R Form **6252** (2005)

7

For Example 3

Form **6252** | Department of the Treasury Internal Revenue Service

Installment Sale Income

▶ Attach to your tax return.
▶ Use a separate form for each sale or other disposition of property on the installment method.

OMB No. 1545-0228 | **2005** | Attachment Sequence No. 79

Name(s) shown on return: **Sam Seller** | Identifying number: **123-45-6789**

1 Description of property ▶ **Covenant not to compete**

2a Date acquired (month, day, year) ▶ / / **b** Date sold (month, day, year) ▶ **09 / 01 / 2005**

3 Was the property sold to a related party (see instructions) after May 14, 1980? If "No," skip line 4. ☐ Yes ☑ No

4 Was the property you sold to a related party a marketable security? If "Yes," complete Part III. If "No," complete Part III for the year of sale and the 2 years after the year of sale ☐ Yes ☐ No

Part I Gross Profit and Contract Price. Complete this part for the year of sale only.

5	Selling price including mortgages and other debts. **Do not** include interest whether stated or unstated		5: 30,000
6	Mortgages, debts, and other liabilities the buyer assumed or took the property subject to (see instructions)	6	
7	Subtract line 6 from line 5	7	
8	Cost or other basis of property sold	8	
9	Depreciation allowed or allowable	9	
10	Adjusted basis. Subtract line 9 from line 8	10	
11	Commissions and other expenses of sale	11	
12	Income recapture from Form 4797, Part III (see instructions)	12	
13	Add lines 10, 11, and 12		13
14	Subtract line 13 from line 5. If zero or less, **do not** complete the rest of this form (see instructions)		14: 30,000
15	If the property described on line 1 above was your main home, enter the amount of your excluded gain (see instructions). Otherwise, enter -0-		15
16	**Gross profit.** Subtract line 15 from line 14		16: 30,000
17	Subtract line 13 from line 6. If zero or less, enter -0-		17
18	**Contract price.** Add line 7 and line 17		18: 30,000

Part II Installment Sale Income. Complete this part for the year of sale **and** any year you receive a payment or have certain debts you must treat as a payment on installment obligations.

19	Gross profit percentage. Divide line 16 by line 18. For years after the year of sale, see instructions		19: 100%
20	If this is the year of sale, enter the amount from line 17. Otherwise, enter -0-		20: 0
21	Payments received during year (see instructions). **Do not** include interest, whether stated or unstated		21: 22,500
22	Add lines 20 and 21		22: 22,500
23	Payments received in prior years (see instructions). **Do not** include interest, whether stated or unstated	23	
24	**Installment sale income.** Multiply line 22 by line 19		24: 22,500
25	Enter the part of line 24 that is ordinary income under the recapture rules (see instructions)		25: 0
26	Subtract line 25 from line 24. Enter here and on Schedule D or Form 4797 (see instructions)		26: 22,500

Part III Related Party Installment Sale Income. Do not complete if you received the final payment this tax year.

27 Name, address, and taxpayer identifying number of related party

28 Did the related party resell or dispose of the property ("second disposition") during this tax year? ☐ Yes ☐ No

29 **If the answer to question 28 is "Yes," complete lines 30 through 37 below unless one of the following conditions is met. Check the box that applies.**

a ☐ The second disposition was more than 2 years after the first disposition (other than dispositions of marketable securities). If this box is checked, enter the date of disposition (month, day, year) ▶ / /

b ☐ The first disposition was a sale or exchange of stock to the issuing corporation.

c ☐ The second disposition was an involuntary conversion and the threat of conversion occurred after the first disposition.

d ☐ The second disposition occurred after the death of the original seller or buyer.

e ☐ It can be established to the satisfaction of the Internal Revenue Service that tax avoidance was not a principal purpose for either of the dispositions. If this box is checked, attach an explanation (see instructions).

30	Selling price of property sold by related party (see instructions)	30
31	Enter contract price from line 18 for year of first sale	31
32	Enter the **smaller** of line 30 or line 31	32
33	Total payments received by the end of your 2005 tax year (see instructions)	33
34	Subtract line 33 from line 32. If zero or less, enter -0-	34
35	Multiply line 34 by the gross profit percentage on line 19 for year of first sale	35
36	Enter the part of line 35 that is ordinary income under the recapture rules (see instructions)	36
37	Subtract line 36 from line 35. Enter here and on Schedule D or Form 4797 (see instructions)	37

For Paperwork Reduction Act Notice, see page 4. Cat. No. 13601R Form **6252** (2005)

For Example 3

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 — 2005 — Attachment Sequence No. 27

Name(s) shown on return: **Sam Seller** — Identifying number: **123-45-6789**

1	Enter the gross proceeds from sales or exchanges reported to you for 2005 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20 (see instructions)	1	

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

	(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							

3	Gain, if any, from Form 4684, line 42	3	
4	Section 1231 gain from installment sales from Form 6252, line 26 or 37	4	255,000
5	Section 1231 gain or (loss) from like-kind exchanges from Form 8824	5	
6	Gain, if any, from line 32, from other than casualty or theft	6	
7	Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows:	7	255,000

Partnerships (except electing large partnerships) and S corporations. Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 10, or Form 1120S, Schedule K, line 9. Skip lines 8, 9, 11, and 12 below.

Individuals, partners, S corporation shareholders, and all others. If line 7 is zero or a loss, enter the amount from line 7 on line 11 below and skip lines 8 and 9. If line 7 is a gain and you did not have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain from line 7 as a long-term capital gain on the Schedule D filed with your return and skip lines 8, 9, 11, and 12 below.

8	Nonrecaptured net section 1231 losses from prior years (see instructions)	8	
9	Subtract line 8 from line 7. If zero or less, enter -0-. 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 the Schedule D filed with your return (see instructions)	9	255,000

Part II — Ordinary Gains and Losses (see instructions)

10 Ordinary gains and losses not included on lines 11 through 16 (include property held 1 year or less):

From Form 6252						22,500

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	9,300
14	Net gain or (loss) from Form 4684, lines 34 and 41a	14	
15	Ordinary gain from installment sales from Form 6252, line 25 or 36	15	
16	Ordinary gain or (loss) from like-kind exchanges from Form 8824	16	
17	Combine lines 10 through 16	17	31,800
18	For all except individual returns, enter the amount from line 17 on the appropriate line of your return and skip lines a and b below. For individual returns, complete lines a and b below:		
a	If the loss on line 11 includes a loss from Form 4684, line 38, 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 18a." See instructions	18a	
b	Redetermine the gain or (loss) on line 17 excluding the loss, if any, on line 18a. Enter here and on Form 1040, line 14	18b	31,800

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 13086I Form **4797** (2005)

7

For Example 3

Form 4797 (2005) Page **2**

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

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 **Office furniture and electronic equipment**	**Various**	**09/01/2005**
B **Purchased goodwill**	**07/07/2001**	**09/01/2005**
C		
D		

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	**5,000**	**355,000**		
21 Cost or other basis plus expense of sale	21	**15,000**	**15,000**		
22 Depreciation (or depletion) allowed or allowable	22	**15,000**	**4,300**		
23 Adjusted basis. Subtract line 22 from line 21	23	**0**	**10,700**		
24 Total gain. Subtract line 23 from line 20	24	**5,000**	**344,300**		
25 **If section 1245 property:**					
a Depreciation allowed or allowable from line 22	25a	**15,000**	**4,300**		
b Enter the **smaller** of line 24 or 25a	25b	**5,000**	**4,300**		
26 **If section 1250 property:** If straight line depreciation was used, enter -0- on line 26g, except for a corporation subject to section 291.					
a Additional depreciation after 1975 (see instructions)	26a				
b Applicable percentage multiplied by the **smaller** of line 24 or line 26a (see instructions)	26b				
c Subtract line 26a from line 24. If residential rental property **or** line 24 is not more than line 26a, skip lines 26d and 26e	26c				
d Additional depreciation after 1969 and before 1976	26d				
e Enter the **smaller** of line 26c or 26d	26e				
f Section 291 amount (corporations only)	26f				
g Add lines 26b, 26e, and 26f	26g				
27 **If section 1252 property:** Skip this section if you did not dispose of farmland or if this form is being completed for a partnership (other than an electing large partnership).					
a Soil, water, and land clearing expenses	27a				
b Line 27a multiplied by applicable percentage (see instructions)	27b				
c Enter the **smaller** of line 24 or 27b	27c				
28 **If section 1254 property:**					
a Intangible drilling and development costs, expenditures for development of mines and other natural deposits, and mining exploration costs (see instructions)	28a				
b Enter the **smaller** of line 24 or 28a	28b				
29 **If section 1255 property:**					
a Applicable percentage of payments excluded from income under section 126 (see instructions)	29a				
b Enter the **smaller** of line 24 or 29a (see instructions)	29b				

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	**349,300**
31 Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	31	**9,300**
32 Subtract line 31 from line 30. Enter the portion from casualty or theft on Form 4684, line 36. Enter the portion from other than casualty or theft on Form 4797, line 6	32	**0**

Part IV Recapture Amounts Under Sections 179 and 280F(b)(2) When Business Use Drops to 50% or Less (see instructions)

		(a) Section 179	**(b)** Section 280F(b)(2)
33 Section 179 expense deduction or depreciation allowable in prior years	33		
34 Recomputed depreciation (see instructions)	34		
35 Recapture amount. Subtract line 34 from line 33. See the instructions for where to report	35		

Form **4797** (2005)

For Example 3

Form **8594** (Rev. February 2006) Department of the Treasury Internal Revenue Service

Asset Acquisition Statement Under Section 1060

▶ Attach to your income tax return. ▶ See separate instructions.

OMB No. 1545-1021

Attachment Sequence No. **61**

Name as shown on return	Identifying number as shown on return
Sam Seller	**123-45-6789**

Check the box that identifies you:
☐ Purchaser ☑ Seller

Part I General Information

1 Name of other party to the transaction	Other party's identifying number
Joseph Buyer	**987-65-4321**

Address (number, street, and room or suite no.)
101 South Lane

City or town, state, and ZIP code
Anytown, WI 55555

2 Date of sale	3 Total sales price (consideration)
09/01/2005	**390,000**

Part II Original Statement of Assets Transferred

4 Assets	Aggregate fair market value (actual amount for Class I)	Allocation of sales price
Class I	$	$
Class II	$	$
Class III	$	$
Class IV	$	$
Class V	$ **5,000**	$ **5,000**
Class VI and VII	$ **385,000**	$ **385,000**
Total	$ **390,000**	$ **390,000**

5 Did the purchaser 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 (FMV) listed for each of asset Classes I, II, III, IV, V, VI, and VII the amounts agreed upon in your sales contract or in a separate written document? . . . . . . ☑ Yes ☐ No

6 In the purchase of the group of assets (or stock), did the purchaser 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," attach a schedule that specifies **(a)** the type of agreement and **(b)** the maximum amount of consideration (not including interest) paid or to be paid under the agreement. See instructions.

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 63768Z Form **8594** (Rev. 2-2006)

7

The sale price is determined in 2006, after the first year's gross billings are determined. Because the selling price decreases from a maximum of $385,000 to the set price of $357,500, the gross profit ratio for the installment sale must be recomputed. The allocation of the recalculated profit is shown below, followed by Sam's 2006 tax forms.

Year 2

Goodwill	
Actual billing	$325,000
Multiple	× 110%
Finalized sale price	$357,500
Covenant not to compete	(30,000)
Finalized goodwill	$327,500
Year 1 payment	(266,250)
Remaining balance	$ 61,250
Remaining years for payments	÷ 5
Year 2 payment	$ 12,250
Covenant not to compete	
Sale price	$ 30,000
Downpayment	(22,500)
Remaining balance	$ 7,500
Remaining years for payments	÷ 5
Year 2 payment	$ 1,500

For Example 3

Form **6252**

Department of the Treasury
Internal Revenue Service

Installment Sale Income

▶ Attach to your tax return.
▶ Use a separate form for each sale or other disposition of property on the installment method.

OMB No. 1545-0228
2006
Attachment Sequence No. 79

Name(s) shown on return: **Sam Seller** | Identifying number: **123-45-6789**

1 Description of property ▶ **Covenant not to compete**
2a Date acquired (month, day, year) ▶ / / b Date sold (month, day, year) ▶ **09 / 01 / 2005**
3 Was the property sold to a related party (see instructions) after May 14, 1980? If "No," skip line 4 . . . . ☐ Yes ☑ No
4 Was the property you sold to a related party a marketable security? If "Yes," complete Part III. If "No," complete Part III for the year of sale and the 2 years after the year of sale . . . . ☐ Yes ☐ No

Part I Gross Profit and Contract Price. Complete this part for the year of sale only.

5	Selling price including mortgages and other debts. **Do not** include interest whether stated or unstated		
6	Mortgages, debts, and other liabilities the buyer assumed or took the property subject to (see instructions)		
7	Subtract line 6 from line 5		
8	Cost or other basis of property sold		
9	Depreciation allowed or allowable		
10	Adjusted basis. Subtract line 9 from line 8		
11	Commissions and other expenses of sale		
12	Income recapture from Form 4797, Part III (see instructions)		
13	Add lines 10, 11, and 12		
14	Subtract line 13 from line 5. If zero or less, **do not** complete the rest of this form (see instructions)		
15	If the property described on line 1 above was your main home, enter the amount of your excluded gain (see instructions). Otherwise, enter -0-		
16	**Gross profit.** Subtract line 15 from line 14		
17	Subtract line 13 from line 6. If zero or less, enter -0-		
18	**Contract price.** Add line 7 and line 17		

Part II Installment Sale Income. Complete this part for the year of sale **and** any year you receive a payment or have certain debts you must treat as a payment on installment obligations.

19	Gross profit percentage. Divide line 16 by line 18. For years after the year of sale, see instructions		100%
20	If this is the year of sale, enter the amount from line 17. Otherwise, enter -0-		
21	Payments received during year (see instructions). **Do not** include interest, whether stated or unstated		1,500
22	Add lines 20 and 21		1,500
23	Payments received in prior years (see instructions). **Do not** include interest, whether stated or unstated	22,500	
24	**Installment sale income.** Multiply line 22 by line 19		1,500
25	Enter the part of line 24 that is ordinary income under the recapture rules (see instructions)		
26	Subtract line 25 from line 24. Enter here and on Schedule D or Form 4797 (see instructions)		1,500

Part III Related Party Installment Sale Income. Do not complete if you received the final payment this tax year.

27 Name, address, and taxpayer identifying number of related party

28 Did the related party resell or dispose of the property ("second disposition") during this tax year? . . . . ☐ Yes ☐ No

29 **If the answer to question 28 is "Yes," complete lines 30 through 37 below unless one of the following conditions is met. Check the box that applies.**

a ☐ The second disposition was more than 2 years after the first disposition (other than dispositions of marketable securities). If this box is checked, enter the date of disposition (month, day, year) ▶ / /

b ☐ The first disposition was a sale or exchange of stock to the issuing corporation.

c ☐ The second disposition was an involuntary conversion and the threat of conversion occurred after the first disposition.

d ☐ The second disposition occurred after the death of the original seller or buyer.

e ☐ It can be established to the satisfaction of the Internal Revenue Service that tax avoidance was not a principal purpose for either of the dispositions. If this box is checked, attach an explanation (see instructions).

30	Selling price of property sold by related party (see instructions)	
31	Enter contract price from line 18 for year of first sale	
32	Enter the **smaller** of line 30 or line 31	
33	Total payments received by the end of your 2006 tax year (see instructions)	
34	Subtract line 33 from line 32. If zero or less, enter -0-	
35	Multiply line 34 by the gross profit percentage on line 19 for year of first sale	
36	Enter the part of line 35 that is ordinary income under the recapture rules (see instructions)	
37	Subtract line 36 from line 35. Enter here and on Schedule D or Form 4797 (see instructions)	

For Paperwork Reduction Act Notice, see page 4. Cat. No. 13601R Form **6252** (2006)

7

The recalculated gross profit ratio for the goodwill payments received in tax year 2006 and beyond is shown below. Form 6252, Part I that reports the 2006 principal payment received for goodwill should be left blank. The gross profit percentage reported on Form 6252, line 19 should be changed to reflect the recalculated profit of 93.877%, with the notation "See statement."

Sam attaches the following statement showing the recalculated gross profit percentage to his 2006 return.

Sam Seller
123-45-6789
Attachment to Form 6252:

Year 2 fixed sale price	$327,500	
Year 1 payments	(266,250)	
Balance due	$ 61,250	$61,250
Original basis	$ 15,000	
Basis recovered in Year 1	(11,250)	
Remaining basis	$ 3,750	(3,750)
New gross profit		$57,500
Balance due		÷ 61,250
New gross profit percentage		93.877%
Balance due		$61,250
Number of remaining payments		÷ 5
Year 2 payment		$12,250
New gross profit percentage		× 93.877%
Taxable gain in Year 2		$11,500

For Example 3

Form **6252** | **Installment Sale Income** | OMB No. 1545-0228 **2006**

Department of the Treasury Internal Revenue Service

▶ Attach to your tax return.
▶ Use a separate form for each sale or other disposition of property on the installment method.

Attachment Sequence No. 79

Name(s) shown on return	Identifying number
Sam Seller	123-45-6789

1 Description of property ▶ Goodwill

2a Date acquired (month, day, year) ▶ 07 / 07 / 2001 **b** Date sold (month, day, year) ▶ 09 / 01 / 2005

3 Was the property sold to a related party (see instructions) after May 14, 1980? If "No," skip line 4 ☐ Yes ☐ No

4 Was the property you sold to a related party a marketable security? If "Yes," complete Part III. If "No," complete Part III for the year of sale and the 2 years after the year of sale ☐ Yes ☐ No

Part I Gross Profit and Contract Price. Complete this part for the year of sale only.

5	Selling price including mortgages and other debts. **Do not** include interest whether stated or unstated	5	
6	Mortgages, debts, and other liabilities the buyer assumed or took the property subject to (see instructions)	6	
7	Subtract line 6 from line 5	7	
8	Cost or other basis of property sold	8	
9	Depreciation allowed or allowable	9	
10	Adjusted basis. Subtract line 9 from line 8	10	
11	Commissions and other expenses of sale	11	
12	Income recapture from Form 4797, Part III (see instructions)	12	
13	Add lines 10, 11, and 12	13	
14	Subtract line 13 from line 5. If zero or less, **do not** complete the rest of this form (see instructions)	14	
15	If the property described on line 1 above was your main home, enter the amount of your excluded gain (see instructions). Otherwise, enter -0-	15	
16	**Gross profit.** Subtract line 15 from line 14	16	
17	Subtract line 13 from line 6. If zero or less, enter -0-	17	
18	**Contract price.** Add line 7 and line 17	18	

Part II Installment Sale Income. Complete this part for the year of sale **and** any year you receive a payment or have certain debts you must treat as a payment on installment obligations.

19	Gross profit percentage. Divide line 16 by line 18. For years after the year of sale, see instructions	19	93.877% See Stmt
20	If this is the year of sale, enter the amount from line 17. Otherwise, enter -0-	20	
21	Payments received during year (see instructions). **Do not** include interest, whether stated or unstated	21	12,250
22	Add lines 20 and 21	22	12,250
23	Payments received in prior years (see instructions). **Do not** include interest, whether stated or unstated	23	266,250
24	**Installment sale income.** Multiply line 22 by line 19	24	11,500
25	Enter the part of line 24 that is ordinary income under the recapture rules (see instructions)	25	0
26	Subtract line 25 from line 24. Enter here and on Schedule D or Form 4797 (see instructions)	26	11,500

Part III Related Party Installment Sale Income. Do not complete if you received the final payment this tax year.

27 Name, address, and taxpayer identifying number of related party

28 Did the related party resell or dispose of the property ("second disposition") during this tax year? ☐ Yes ☐ No

29 **If the answer to question 28 is "Yes," complete lines 30 through 37 below unless one of the following conditions is met. Check the box that applies.**

- **a** ☐ The second disposition was more than 2 years after the first disposition (other than dispositions of marketable securities). If this box is checked, enter the date of disposition (month, day, year) ▶ / /
- **b** ☐ The first disposition was a sale or exchange of stock to the issuing corporation.
- **c** ☐ The second disposition was an involuntary conversion and the threat of conversion occurred after the first disposition.
- **d** ☐ The second disposition occurred after the death of the original seller or buyer.
- **e** ☐ It can be established to the satisfaction of the Internal Revenue Service that tax avoidance was not a principal purpose for either of the dispositions. If this box is checked, attach an explanation (see instructions).

30	Selling price of property sold by related party (see instructions)	30	
31	Enter contract price from line 18 for year of first sale	31	
32	Enter the **smaller** of line 30 or line 31	32	
33	Total payments received by the end of your 2006 tax year (see instructions)	33	
34	Subtract line 33 from line 32. If zero or less, enter -0-	34	
35	Multiply line 34 by the gross profit percentage on line 19 for year of first sale	35	
36	Enter the part of line 35 that is ordinary income under the recapture rules (see instructions)	36	
37	Subtract line 36 from line 35. Enter here and on Schedule D or Form 4797 (see instructions)	37	

For Paperwork Reduction Act Notice, see page 4. Cat. No. 13601R Form **6252** (2006)

7

For Example 3

Form **8594** (Rev. February 2006) Department of the Treasury Internal Revenue Service

Asset Acquisition Statement Under Section 1060

▶ Attach to your income tax return. ▶ See separate instructions.

OMB No. 1545-1021

Attachment Sequence No. 61

Name as shown on return	Identifying number as shown on return
Sam Seller	**123-45-6789**

Check the box that identifies you:
☐ Purchaser ☑ Seller

Part I General Information

1 Name of other party to the transaction	Other party's identifying number
Joseph Buyer	**987-65-4321**

Address (number, street, and room or suite no.)
101 South Lane

City or town, state, and ZIP code
Anytown, WI 55555

2 Date of sale	3 Total sales price (consideration)
09/01/2005	**367,500**

Part II Original Statement of Assets Transferred

4 Assets	Aggregate fair market value (actual amount for Class I)	Allocation of sales price
Class I	$	$
Class II	$	$
Class III	$	$
Class IV	$	$
Class V	$ **5,000**	$ **5,000**
Class VI and VII	$ **357,500**	$ **357,500**
Total	$ **362,500**	$ **362,500**

5 Did the purchaser 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 (FMV) listed for each of asset Classes I, II, III, IV, V, VI, and VII the amounts agreed upon in your sales contract or in a separate written document? . . . . ☑ Yes ☐ No

6 In the purchase of the group of assets (or stock), did the purchaser 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," attach a schedule that specifies **(a)** the type of agreement and **(b)** the maximum amount of consideration (not including interest) paid or to be paid under the agreement. See instructions.

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 63768Z Form **8594** (Rev. 2-2006)

For Example 3

Form 8594 (Rev. 2-2006) Page 2

Part III **Supplemental Statement—**Complete only if amending an original statement or previously filed supplemental statement because of an increase or decrease in consideration. See instructions.

7 Tax year and tax return form number with which the original Form 8594 and any supplemental statements were filed.

2005 Form 1040

8 Assets	Allocation of sales price as previously reported	Increase or (decrease)	Redetermined allocation of sales price
Class I	$	$	$
Class II	$	$	$
Class III	$	$	$
Class IV	$	$	$
Class V	$ **5,000**	$ **0**	$ **5,000**
Class VI and VII	$ **385,000**	$ **(27,500)**	$ **357,500**
Total	$ **390,000**		$ **362,500**

9 Reason(s) for increase or decrease. Attach additional sheets if more space is needed.

The sale price was based on a retained business basis. After the first year the final price was determined and the sale price reduced by $27,500.

TRANSFER OF CLIENT FILES

Generally, it is a matter of state law whether a client's permission must be obtained before transferring files to a new owner. Since a buyer usually requires prior records to adequately service clients, the contract should provide the seller with rights to access files in order to resolve any problems with work performed while he owned the business. It is advisable for both the buyer and seller to consult with their respective legal counsel, and any applicable regulatory agencies regarding the transfer of files.

Maintaining Records

IRS Requirements. IRC §6107 requires an income tax return preparer to keep a copy of each return or claim for refund prepared. Alternatively, a preparer may maintain a list including the name and identification number of each taxpayer for whom such a return or claim was prepared. This information must be made available to the IRS upon request.

These returns or lists must be kept for a period of three years after the close of a return period. A "return period" is defined as any 12-month period beginning July 1 and ending the following June 30.[8] Information regarding extended returns due after July 1 must be retained until the end of the 3-year period that includes the extended due date.

Example 4. Bob prepares 250 individual tax returns for tax year 2005 between January 1, 2006 and April 17, 2006. Bob extends 10 returns for tax year 2005, which he completes in May 2006.

Since the due date for the unextended returns falls on April 17, 2006 — between July 1, 2005 and June 30, 2006 — Bob must maintain records of these returns until June 30, 2009. The 10 extended returns, due October 16, 2006, must be kept until June 30, 2010 since the extended due date falls between the dates of July 1, 2006 and June 30, 2007.

8. IRC §6060(c)

Rev. Rul. 79-400 provides guidance on the transfer of records when an accounting or tax practice is sold. In brief, the ruling states that it is permissible for a preparer to transfer copies of tax returns to the purchaser of the preparer's practice. The ruling specifically states:

Section 301.7216-2(1) of the Regulations on Procedure and Administration provide that for purposes of disclosure or use of information by preparers of returns, a preparer is permitted to transfer copies of returns to a person acquiring the preparer's business. The transfer of possession of manually signed copies of income tax returns and claims for refund to the purchaser of an income tax return preparer's business is not prohibited by the Code or by the regulations.

Caution. Rev. Rul. 79-400 holds the **seller** responsible for maintaining business records in compliance with §6107. If a purchaser fails to comply with an IRS request in regard to any year the seller was the paid preparer, the seller is responsible for any noncompliance penalties. **Although the contract between the seller and purchaser may require such compliance, the seller still is ultimately responsible.**

Corporations and Partnerships. If a business dissolves prior to the end of a 3-year return period, the person responsible for settling the business' affairs is also responsible for maintaining any necessary records. If state law does not specify who is responsible for maintaining records, the responsibility generally falls on directors or partners. These parties may be held jointly and severally liable for penalties relating to any failure to maintain necessary records.

ISSUE 3: LIKE-KIND EXCHANGE

INCOME RECOGNIZED FROM A LIKE-KIND EXCHANGE

A taxpayer does not recognize gain from a like-kind exchange when like-kind property is received. However, if a taxpayer receives money or unlike-kind property in addition to like-kind property, often referred to as **boot**, the taxpayer may have to recognize gain on the transaction. The amount of gain recognized is the smaller of:

1. The taxpayer's realized gain, or
2. The amount of boot received.

Boot can be received in the form of unlike property, cash, or net liability relief resulting from an exchange. **Net liability relief** is the difference between the amount of liabilities from which a taxpayer receives relief and the amount of new liabilities he assumes.

Consideration **received** in the form of cash or other property **is not offset** by consideration given in the form of an assumption of liabilities or a receipt of property subject to a liability. However, consideration **given** in the form of cash or other property **is offset** against consideration received in the form of an assumption of liabilities or a transfer of property subject to a liability.[9]

Like-kind exchanges are reported on Form 8824, *Like-Kind Exchanges*. Gain recognized in relation to an exchange is taxable in the same manner as if the property had been sold: Depreciation recapture is taxed first, followed by unrecaptured IRC §1250 gain, and then IRC §1231 or capital gain. The amount of any recaptured depreciation or unrecaptured §1250 gain that is taxed reduces the amounts of these items considered taken on the new property.

9. Treas. Reg. §1.1031(d)-2

Example 5. Robert exchanges rental real estate with an FMV of $400,000 for replacement rental real estate with an FMV of $300,000. He also receives $100,000 of cash boot in the exchange. The property Robert relinquished had a cost of $250,000, on which Robert claimed depreciation of $80,000.

Robert computes the amount of gain he must recognize by comparing the amount of gain realized on the exchange to the amount of boot received, as follows:

1. **Realized gain: $230,000**

FMV of like-kind property received	$300,000	
Boot received	100,000	
Total consideration received	$400,000	$400,000
Cost of relinquished property	$250,000	
Less: depreciation claimed	(80,000)	
Less: adjusted basis of relinquished property	$170,000	(170,000)
Gain realized on exchange		$230,000

2. **Boot received: $100,000**

Robert must recognize $100,000 as gross income on this exchange, since the $100,000 boot he received is less than the $230,000 amount of gain he realized.

Form **8824** — **Like-Kind Exchanges**
(and section 1043 conflict-of-interest sales)
► Attach to your tax return.
OMB No. 1545-1190 — 2006 — Attachment Sequence No. 109
Department of the Treasury Internal Revenue Service

Name(s) shown on tax return: **Robert** — Identifying number: **333-33-3333**

Part I Information on the Like-Kind Exchange

Note: *If the property described on line 1 or line 2 is real or personal property located outside the United States, indicate the country.*

1 Description of like-kind property given up ► **Apartment building**

2 Description of like-kind property received ► **Apartment building**

3 Date like-kind property given up was originally acquired (month, day, year) . . . . . . — 3 — 2 / 10 / 2000

4 Date you actually transferred your property to other party (month, day, year) . . . . . . — 4 — 3 / 15 / 2006

5 Date like-kind property you received was identified by written notice to another party (month, day, year). See instructions for 45-day written notice requirement . . . . — 5 — 4 / 20 / 2006

6 Date you actually received the like-kind property from other party (month, day, year). See instructions — 6 — 7 / 1 / 2006

7 Was the exchange of the property given up or received made with a related party, either directly or indirectly (such as through an intermediary)? See instructions. If "Yes," complete Part II. If "No," go to Part III . . . ☐ Yes ☑ No

Related Party Exchange Informati

For Example 5

Form 8824 (2006) Page **2**

Name(s) shown on tax return. Do not enter name and social security number if shown on other side.	Your social security number

Part III **Realized Gain or (Loss), Recognized Gain, and Basis of Like-Kind Property Received**

Caution: *If you transferred* ***and*** *received* ***(a)*** *more than one group of like-kind properties or* ***(b)*** *cash or other (not like-kind) property, see* ***Reporting of multi-asset exchanges*** *in the instructions.*

Note: *Complete lines 12 through 14* ***only*** *if you gave up property that was not like-kind. Otherwise, go to line 15.*

12	Fair market value (FMV) of other property given up	12	400,000		
13	Adjusted basis of other property given up	13	170,000		
14	Gain or (loss) recognized on other property given up. Subtract line 13 from line 12. Report the gain or (loss) in the same manner as if the exchange had been a sale **Caution:** *If the property given up was used previously or partly as a home, see* ***Property used as home*** *in the instructions.*			14	230,000
15	Cash received, FMV of other property received, plus net liabilities assumed by other party, reduced (but not below zero) by any exchange expenses you incurred (see instructions)			15	100,000
16	FMV of like-kind property you received			16	300,000
17	Add lines 15 and 16			17	400,000
18	Adjusted basis of like-kind property you gave up, net amounts paid to other party, plus any exchange expenses **not** used on line 15 (see instructions)			18	170,000
19	**Realized gain or (loss).** Subtract line 18 from line 17			19	230,000
20	Enter the smaller of line 15 or line 19, but not less than zero			20	100,000
21	Ordinary income under recapture rules. Enter here and on Form 4797, line 16 (see instructions)			21	0
22	Subtract line 21 from line 20. If zero or less, enter -0-. If more than zero, enter here and on Schedule D or Form 4797, unless the installment method applies (see instructions)			22	100,000
23	**Recognized gain.** Add lines 21 and 22			23	100,000
24	Deferred gain or (loss). Subtract line 23 from line 19. If a related party exchange, see instructions			24	130,000
25	**Basis of like-kind property received.** Subtract line 15 from the sum of lines 18 and 23			25	170,000

THE EFFECT OF A LIKE-KIND EXCHANGE ON DEPRECIATION

Treasury Decision 9115 replaced Notice 2000-4 regarding the methods required for depreciating MACRS property received in a like-kind exchange for other MACRS property. **The notice does not apply to any nonMACRS property**, including property depreciated under ACRS, or for any vehicle for which the taxpayer claimed a standard mileage deduction.

The provisions of T.D. 9115, effective for dispositions and replacements occurring **after February 27, 2004**, are reviewed in this section.

> **Note.** Additional information can be found in the 2005 *University of Illinois Federal Tax Workbook,* Chapter 10, "Like-Kind Exchanges," including extensive information on T.D. 9115.

Depreciation for the Year of Exchange

The method of depreciation required for assets acquired in a like-kind exchange varies according to the type of asset being depreciated (i.e., exchanged basis or excess basis) and the length of the replacement asset's recovery period as compared to the length of the relinquished property's recovery period.

Exchanged basis refers to the taxpayer's basis in any **replacement** property received, up to the amount of his adjusted basis in the **relinquished** property.

Excess basis refers to any excess of the taxpayer's basis in the **replacement** property over his exchanged basis in the **relinquished** property. Excess basis is generally the amount of boot paid in the exchange.

Example 6. Use the same facts as **Example 5,** except Robert exchanged property with a value of $300,000 plus a $100,000 cash boot for property with a basis of $400,000.

Robert's **exchanged basis** is $170,000, the lesser of his basis in the replacement property or his adjusted basis in the relinquished property, computed as follows:

Basis of relinquished property	$170,000
Cash boot	100,000
Basis of replacement property	**$270,000**
Adjusted basis of relinquished property	**$170,000**

Robert's **excess basis** is $100,000, the excess of his $270,000 basis in the replacement property over the $170,000 basis in the relinquished property. His excess basis is equal to the boot paid.

Depreciation of Exchanged Basis. The depreciation method and recovery period required for depreciating the **exchanged basis** is based on the length of the replacement property's recovery period and depreciation method compared to the length of the relinquished property's recovery period and depreciation method.

If the recovery period for the new property is **shorter than or the same as** the recovery period for the old property, the exchanged basis depreciation is calculated using the same recovery period that existed for the old property. **The recovery period that is longer, is used for the replacement property,** regardless of whether it is the old or new property recovery period.

If the depreciation method for the new property is slower than the depreciation method for the old property, the depreciation method for the exchanged basis is calculated using the slower method. If the depreciation method for the new property is faster than the depreciation method for the old property, the depreciation method for the exchange basis is calculated using the method used on the old property (i.e., the slower of the two methods).

Example 7. David acquired a truck for $50,000 in February of 2005, which he depreciated using straight-line MACRS with a 5-year recovery period and a half-year convention. His 2005 depreciation deduction was $5,000 [($50,000 ÷ 5)] × 50%]. His projected 2006 depreciation deduction is $10,000 ($50,000 ÷ 5).

On July 5, 2006, David trades his truck for an over-the-road tractor unit, a 3-year MACRS asset, as an even trade. Since the recovery period for the tractor unit (replacement property) is shorter than the recovery period for the truck (relinquished property), David continues depreciating the truck's basis over its remaining recovery period. His 2006 depreciation allowance is $10,000 ($50,000 ÷ 5).

Placed in Service and Exchanged in Same Year. An asset relinquished in an exchange is treated as if it is "disposed of," and as such, depreciation is not allowed on any relinquished MACRS property that is placed in service during a tax year and exchanged or involuntarily converted in the same year. If the replacement property received in an exchange is disposed of in the same year, no depreciation deduction is permitted for either property.[10]

Allocation for Year of Exchange. If a replacement property has a longer recovery period or uses a less accelerated method of depreciation than a relinquished property, the depreciation allowance must be allocated between the two assets for the year of the exchange.[11] The relinquished property's depreciation is computed by multiplying its scheduled depreciation allowance for the year by a fraction. The numerator of the fraction is the number of months, including parts of the month, the property was deemed to be in service during the year. The denominator is 12 (adjusted for short taxable years).

10. Temp. Treas. Reg. §1.168(i)-6T(c)(5)

11. Temp. Treas. Reg. §1.168(i)-6T(c)(5)(ii)

The replacement property's depreciation is based on the exchanged basis over the remaining life of the replacement property, computed as if the replacement property had been placed in service on the same date as the relinquished property. The recovery period for the exchanged property is the normal recovery period for the replacement property, less the number of years and months for which the relinquished property had been depreciated.

Depreciation for the exchanged basis begins on the date the replacement property is acquired. However, this amount is prorated for the year of exchange based on a fraction. The numerator is the number of months, including parts of the month, the property was deemed to be in service during the year. The denominator is 12 (adjusted for short taxable years).

Note. The above calculations do not apply in deferred transactions when the replacement property is not acquired until after the relinquished property is disposed, or when a taxpayer elects out of this regulation (discussed later). It also does not apply when the taxpayer uses the optional depreciation tables for MACRS property.

Example 8. Molly exchanges a residential rental unit, which she purchased in June of 2001 for $60,555, for a commercial beauty shop (building only) on October 10, 2006. Molly's exchanged basis in the rental property is $50,000. (Land values have been disregarded in this example.)

Since the MACRS recovery period for the beauty shop is 39 years, which is longer than the 27.5-year MACRS recovery period for the rental unit, Molly must depreciate the beauty shop using the exchanged basis of $50,000 over the remaining life of the beauty shop. The remaining life is 34 years 5.5 months (413.5 months) which is computed as if Molly had placed the beauty shop in service June 15, 2001 (mid-month convention).

Since both properties have mid-month conventions, Molly is deemed to have had the residential rental in service for 9.5 months (January 1, 2006–October 14, 2006) and the beauty shop for the remaining 2.5 months (October 15, 2006–December 31, 2006) in 2006. She allocates her 2006 depreciation between the relinquished residential rental and the beauty shop as follows:

Residential rental:	
2006 scheduled depreciation ($60,555 ÷ 27.5) = $2,202 × 9.5 ÷ 12 =	**$1,743**
Beauty shop:	
2006 full year depreciation ($50,000 ÷ 413.5 × 12) = $1,451 × 2.5 ÷ 12 =	**$302**
	$2,045

Molly's allowable depreciation for 2006 is $2,045. Starting in 2007, her annual depreciation deduction for the beauty shop will be $1,451 until she disposes of it or it depreciates out in June of 2040.

Depreciation Rates for Replacement Property. When a depreciation method changes, or when the replacement property has a longer life **and** uses a more accelerated depreciation method than the relinquished property, the depreciation rates must be recalculated manually. The following steps may be used to determine the recalculated depreciation rates that apply to replacement property:

Step 1. Total the **remaining** depreciation rates for the new method and/or recovery period.

Step 2. Divide each year's rate by this total to get the new annual depreciation rate.

Step 3. Multiply this rate by the **adjusted basis** of the old property as of the date of the exchange or conversion.

Example 9. On June 1, 2005, Kurt placed into service Machine 1, a 5-year asset, at a cost of $10,000. Kurt elected to use regular MACRS. His depreciation for 2005, applying the half-year convention, was $1,000 ($10,000 ÷ 5 × 50%), leaving Machine 1 with a $9,000 adjusted basis.

On April 3, 2006, Kurt makes an even exchange for Machine 1 with Machine 2. Kurt wants to use straight-line MACRS for Machine 2. Since the straight-line depreciation method Kurt will use for Machine 2 is less accelerated than the regular MACRS used for Machine 1, Kurt recomputes the depreciation for the exchanged basis using the 3-step process described above.

Step 1. Total the remaining depreciation rates for the straight-line method used for the replacement property:

Year	Straight-Line %
2006	20%
2007	20%
2008	20%
2009	20%
2010	10%
Total	**90%**

Step 2. Divide each year's rate by the total:

Year	Annual Rate/Total	New Annual Rate
2006	20%/90%	22.22%
2007	20%/90%	22.22%
2008	20%/90%	22.22%
2009	20%/90%	22.22%
2010	10%/90%	11.12%
Total		**100.00%**

Step 3. Multiply the result by the **adjusted basis** of the old property as of the date of the exchange or conversion.

2006	22.22% × $9,000	$1,999.80
2007	22.22% × $9,000	$1,999.80
2008	22.22% × $9,000	$1,999.80
2009	22.22% × $9,000	$1,999.80
2010	11.12% × $9,000	$1,000.80
Total	**100.00%**	**$9,000.00**

Depreciation of Excess Basis. Any excess basis in the replacement property (boot) is treated as a new asset, and is subject to the recovery period, depreciation method, and convention rules in effect at the time the replacement property is placed in service.

Deferred Transactions

Depreciation is not allowed during the period between the disposition date of the old property and the acquisition date of the new property. The recovery period of the new property is considered suspended during this time.

Mixed Exchange of Depreciable and Nondepreciable Properties

If both nondepreciable property and depreciable property are acquired in an exchange for other depreciable property, only the basis allocated to the depreciable property is eligible for depreciation. Land, regardless of whether it was obtained in a like-kind exchange or otherwise, cannot be depreciated.

Replacement Property Acquired Prior to Disposition of Relinquished Property

When replacement property is acquired prior to the disposition of relinquished property (a reverse like-kind exchange), the replacement property's depreciation is calculated using the method, recovery period, and convention applicable to its placed-in-service date. When the relinquished property is disposed of, the exchanged basis and excess basis are calculated and future depreciation is determined by the rules presented previously.

Depreciation for the replacement property in the period prior to disposition of the relinquished property is compared to the amount that would have been allowed if the exchanged basis and excess basis had been used. Any excess depreciation is reported as income upon disposition of the relinquished property.

Example 10. Roger acquired a nonresidential building for $100,000 on October 3, 2006 that he intends to use as a replacement building for a §1031 exchange. His 2006 depreciation on this building (New) is $534 ($100,000 ÷ 39 × (2.5 ÷ 12)).

On January 5, 2007, the qualified intermediary received and disposed of Roger's former nonresidential property (Old) for exactly $100,000. The amount was enough to take care of the purchase price of New without Roger having to pay any boot.

Roger's Old building, purchased for $60,000 on July 26, 2002, was depreciated under MACRS 39-year straight-line. His adjusted basis in Old at the beginning of 2007 was $53,000.

New's depreciation for 2006 would have been $283 ($53,000 ÷ 39 × (2.5 ÷ 12)) if the exchanged basis had been used. Roger must report $251 of income ($534 – $283) in 2007, the year he disposed of Old in the qualified like-kind exchange. Roger computes all future depreciation for New using the exchanged basis of $53,000 over its remaining life of 34 years, 6.5 months.

Mid-Quarter Convention. Mid-quarter testing must be performed in a like-kind exchange to determine which convention applies to the replacement property. The exchanged basis generally is disregarded for this testing and only excess basis is considered. Excess basis is considered placed in service in the quarter in which the replacement property is placed in service.

The exchanged basis is required to be used in mid-quarter testing only if the relinquished property is placed in service in the same year in which it is relinquished as part of an exchange. In this case, the date the exchanged basis is deemed to be placed in service depends on whether the new property is acquired in the same year, or a later year.

- If the relinquished property is placed in service in the same year as the exchange or conversion, **and** the replacement property is placed in service in the same year, the exchanged basis is considered placed in service on the date the relinquished property is placed in service.
- If the relinquished property is placed in service in the same year as the exchange or conversion, **and** the replacement property is placed in service in the following year, the exchanged basis is considered placed in service on the date the replacement property is placed in service.
- If the relinquished property is placed in service in one year, and is disposed of in an exchange or involuntary conversion in a subsequent year, the exchanged basis is not taken into account in the year of replacement, but only applies in the first year.

ELECTION AVAILABLE

A taxpayer can elect to avoid this complicated method for calculating the depreciation of property acquired in a like-kind exchange by entering "ELECTION MADE UNDER SECTION 1.168(i)-6T(i)" at the top of Form 4562, *Depreciation and Amortization*. This election may be revoked only with the consent of the IRS.[12]

By making this election, the taxpayer combines his exchanged basis and any excess basis into a single basis. This amount is treated as the basis of the replacement asset, which starts depreciating on the date the replacement property is placed in service.

PRIOR DEPRECIATION FROM A LIKE-KIND EXCHANGE

Any depreciation allowed/allowable on a relinquished asset carries over to the replacement asset. When the replacement asset is sold, the carryover depreciation and any depreciation allowed/allowable on the replacement asset are combined for purposes of determining any depreciation recapture or unrecaptured §1250 gain.

12. Temp. Treas. Reg. §1.168(i)-6T(j)