Chapter 2: Terminating a Business Interest

Note. Corrections were made to this workbook through January of 2023. No subsequent modifications were made. For terms used in this chapter, see the **Acronyms and Abbreviations** section following the index.

For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

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SALE OF A SERVICE BUSINESS

Most owners at some point sense the time has come to close their business. The closing chapter may come from a change in health, from the decision that the long hours are no longer tolerable, or perhaps from observing that the business itself no longer provides the necessary level of profitability. One of these events may lead the owner of a business to decide the time has come to transfer the business to another provider or firm. This section focuses on various considerations involved in selling a business, specifically service-related businesses such as tax practices.

TIMELINE OF THE SALES PROCESS

Several Years Before the Sale

Preparing for the sale of a service business years in advance is most likely to yield superior results. One of the first questions a selling service business owner should consider is the form of their business's legal organization. Changes take time, and with some forethought, the seller may contemplate changing from a sole proprietorship to a limited liability company (LLC) that is taxed as an S corporation, for example. This change in organization makes the sale of an equity interest a possibility, and this potentially results in a better tax result for the selling service business owner. Different forms of legal organization are discussed later.

Sales and Marketing. For most service businesses, more revenue results in a more valuable business. Greater revenue typically spreads fixed costs over more customers. Adding a marketing program should be a high priority. Because valuations of service-based businesses[1] are generally based on percentages of sales, adding revenue is likely the fastest way to add value to a firm.

Financial Reporting.[2] Having several years of dependable financial records is critical to the sale of any business. Before serious buyers talk to anyone, they want a high-level indication of the business's value. The business owner should ensure that several years of records are clean and reconciled, showing revenues recorded using the proper procedures for their accounting software.

Human Resources. The buyers of service businesses are often concerned that the employees might leave the business to set up their own competing businesses, likely taking existing clientele with them. Such an event may not violate a noncompete agreement because employees may not be a party to it.

In contrast, if employees connect their own futures to the success of the acquiring entity, the chances of such an adverse occurrence are reduced. Retirement plans that vest over time is one approach that may accomplish this purpose. If an employee resigns from the company, they lose the company's non-vested contributions to their retirement.

To complement an employee benefit plan, the business owner may wish to implement a **noncompete agreement** that attempts to prevent them from soliciting existing clients should they decide to set up a competing business and invite clients to join them. The input of a labor attorney is critical to this plan, especially because not all courts enforce noncompete agreements. If the attorney has reason to believe that a court would not honor the noncompete agreement, it makes little sense to implement it.

Preliminary Offering Circular. To provide the selling owner with a vision for the sale of their business, the service business owner may wish to prepare a preliminary offering circular. This short document introduces the business to potential buyers, as well as advisors. It conveys some basic information about the types of services offered and the number of clients served. Because of confidentiality concerns, this document should be seen **only** by the seller's closest advisors.

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1. *Pricing issues for small firm sales.* Oct. 1, 2014. Journal of Accountancy. [www.journalofaccountancy.com/issues/2014/oct/small-cpa-firm-pricing-issues.html] Accessed on Mar. 2, 2022.
2. Richard S. Ruback and Royce Yudkoff, *HBR Guide to Buying a Small Business*. (Harvard Business Review Press, 2017).

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A Year Before the Sale

About a year before the proposed sale, a selling service business owner should increasingly think about the sale of their business. The shift in thinking arises as the sale of the business becomes a relatively near-term event. The seller may begin turning over substantial responsibilities associated with the asset to another individual or entity.

Tax Records. The tax records of any business should be pristine. When a little less than a year remains before the sale of a service business, it is critical to double-check all necessary tax filings have been made. The owner should also ensure organized records of the filings can support the due diligence process.

Confidentiality. Confidentiality is essential during the sale of any business. Knowledge of an imminent sale of a service business may be unsettling to its clients, perhaps leading them to seek another provider of the same service. When employees possess knowledge of an impending sale, they may seek other employment or establish competing businesses. Either of these two occurrences is likely to be interpreted negatively in the eyes of a prospective buyer. The seller should anticipate the negative impact this knowledge could have on the valuation of their business.

Nondisclosure Agreements (NDA).[3] To ensure confidentiality of a potential sale, the selling business owner should have an NDA ready for a prospective purchaser's signature before they provide any information to them. Because the prospective buyer anticipates sharing some information with the seller, they should expect some constraints on their sharing of information. One possible consideration is to ask an attorney to prepare a mutual NDA that the selling business owner provides to every prospective buyer. While this places some burden on the seller, the ready availability of a set form makes it less likely that negotiations take place over the wording of the NDA.

Noncompete Agreements.[4] These agreements are usually in effect for several years, and the attorney representing the selling service business owner should be involved in its preparation. Sellers of service businesses should expect that the buyers of their businesses want to protect their investments from the seller reacquiring the same clients. Because the clients have existing relationships with sellers of businesses, the clients of the business may find it easy to ask the seller after the sale to continue to do their work.

Noncompete agreements protect a business buyer's relationship with clients of the business it acquires. Business buyers use them to prevent the seller of a service business from taking advantage of strong relationships with clients to circumvent the sales agreement. Without a noncompete agreement, the seller might start working with the same clients again, disrespecting the sales agreement. Some amount of the sales price of the business should be allocated to any noncompete agreement, as discussed later.

> **Observation.** A seller typically has no right to prevent its employees from competing with the buyer after the sale. Consequently, a buyer may consider employment agreements with retained employees.[5]

Noncompete agreements can prohibit a selling business owner from working in a competing business or engaging in any of the following activities.

- Contacting a client
- Acting as a consultant to other related service businesses
- Employing any employees of either the business being sold or the acquiring business

3. *Nondisclosure agreement.* Jul. 2020. Cornell Law School Legal Information Institute. [www.law.cornell.edu/wex/nondisclosure_agreement] Accessed on Mar. 2, 2022.

4. Richard S. Ruback & Royce Yudkoff, *HBR Guide to Buying a Small Business*. (Harvard Business Review Press, 2017).

5. Ibid.

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Financial Records. Prospective business sellers should have an accurate set of financial statements to present to a prospective buyer once an NDA is signed.

> **Observation.** A year before the sale of a business leaves little time for implementing a new system, including financial systems, but there is sufficient time to ensure that systems have appropriate security in place. The selling owner should update the business's data security plan and train employees in any changes. This may also be the last opportunity to perform any clean-up of existing records.

Identifying the Business Buyer. It is one thing to make the hard decision to sell a business, as this is often an emotional decision. But it may be even more challenging to decide on the nature of the buyer, as this decision usually requires hard thought in an arena where sellers may lack experience.

Family Member in Planned Succession.[6] A business owner may wish to transfer their business to a child or perhaps another relative. Some of the common manners of transferring ownership to a family member include the following.

- Gifting

> **Note.** Sellers considering gifting their business to family members should consider the annual gift tax exemption, any potential estate tax, generation-skipping tax, portability issues, etc. For more information on estate tax issues, see the 2022 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 4: Tax Considerations in the Distribution of Estate Assets.

- Bequests
- Establishing family limited partnerships, family LLCs, or family trusts

> **Note.** For more information on family limited partnerships and family trusts, see the 2012 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 5: Succession Planning. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

However, because many businesses do not pass on to second or third generations, a seller should consider selling to other parties.

Other Partners, Shareholders, Owners, or Employees. If the business does not already have a succession plan to transfer one owner's equity to another co-owner,[7] it now has reason to create one. A succession plan or buy/sell agreement may prescribe the transfer of equity to other co-owners in the event that one retires or dies (often referred to as a **right of first refusal).** This plan would preclude the departing co-owner's equity from being transferred to an unknown outsider, possibly causing the continuing co-owners to lose control. Life insurance policies covering other co-owners may provide funds to facilitate the buyout process after a co-owner's death.[8]

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6. *Family Business Succession Planning Opportunities.* Saymaz, Savas and Lambert, Hugh. Jan. 2020. CPA Journal. [www.cpajournal.com/2020/01/08/family-business-succession-planning-opportunities] Accessed on Jul. 12, 2022.

7. *Succession Planning.* Feb. 27, 2022. Wikimedia Foundation, Inc. [en.wikipedia.org/wiki/Succession_planning] Accessed on Apr. 6, 2022. In this text, the term "co-owner" refers to either a partner or a shareholder, depending on whether the business is organized as a partnership or a corporation.

8. *Using a Buy/Sell Agreement to Transfer Ownership.* Dec. 11, 2011. The Tax Adviser. [www.thetaxadviser.com/issues/2012/jan/casestudy-jan2012.html] Accessed on Mar. 2, 2022.

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Sellers could consider employee stock ownership plans (ESOPs) as a possible strategy to transfer the business to employees. ESOPs are stock bonus plans and/or money purchase plans that invest primarily in employer securities.[9]

> **Note.** For more information on ESOPs, see the 2017 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 1: Investments. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

Unrelated Third Party. If family members or related parties are not viable successors to the practice, the seller may consider selling to an unrelated third party. Selling the practice to a **larger business** in the same industry would follow a trend toward firm specialization. This is seen among law firms, medical practices, and tax practices to some extent that get folded into a larger firm.[10]

Similarly, a **related business** may want to purchase the practice to streamline their service offerings. For example, a financial services firm may be interested in acquiring a smaller tax practice. The tax firm would provide potential customers for investment products. These customers' needs might be better served by receiving financial and tax services from the same source.

If the selling business is part of a **franchise organization,** the franchisor may require another franchisee acquire the business. That reduces the field of obvious candidates for acquiring the firm. This type of sale ensures consistency in handling clients' needs.

ASSEMBLING THE TEAM

Building a team of accomplished specialists is a key approach to maximizing the seller's personal wealth. Because of the way it values the goodwill from prior years of hard work, the sale of a service business may constitute a major source of wealth for the seller.

Attorney

The attorney should play a substantial role in preparing and reviewing any documentation, including the following.

- Mutual NDA
- A non-binding letter of intent, if used
- Any sales documentation
- Bulk sales agreement
- Noncompete agreement
- Any other documentation associated with the sale of the business

The selling business owner should anticipate that their attorney will carefully evaluate all possible outcomes arising from a particular document. This time-consuming process may result in a delay in reaching an agreement with the buyer and their attorney. Although the attorney is a valuable expert in the law, the selling business owner possesses ultimate responsibility for the outcome of the sale.

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9. *Employee Stock Ownership Plans (ESOPs).* Aug. 31, 2021. IRS. [www.irs.gov/retirement-plans/employee-stock-ownership-plans-esops] Accessed on Jul. 12, 2022.

10. *Local accounting firms disappearing in 'upward mergers.'* Lavin, Nancy. Dec. 10, 2021. Rhode Island Society of Certified Public Accountants. [www.riscpa.org/advocacy/62/local-accounting-firms-disappearing-in-lsquo-upward-mergers-rsquo/view-blog] Accessed on Mar. 2, 2022.

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Practitioner Planning Tip

A practitioner may be well served by recommending the seller engage the services of an attorney conversant in sales transactions.

Sales Agent or Broker

A business seller may find it beneficial to engage the services of sales agents, such as a business broker. They often have networks of potential buyers, and virtually all have ways of publicizing the availability of a business while cloaking its identity. While most business brokers facilitate sales of various types of businesses, some may specialize in the industry in which the selling business operates.

Sales agents typically have ways to ensure the sale moves forward. They have dealt with potential buyers who get cold feet, perhaps reluctant to commit either the funds or the time required for a business acquisition. The presence of a broker may encourage an attorney, especially one representing the seller, to devote the time needed to consummate the transaction. The broker's compensation is typically a percentage or a fixed fee of the closing price of the business, which a seller should consider when pricing the business. To this point, a broker may increase the price realized on the sale of the business.

Accountant

Business sellers need dedicated tax and accounting experts to assist them in navigating the challenges of a business sale. They could advise on the following topics.

- Preparation of financial statements required by potential buyers of the practice
- Terms of the sale and allocation of the sales price
- Preparation of Form 8594, *Asset Acquisition Statement Under Section 1060*
- Evaluation of the tax consequences of an asset sale or equity sale

Additionally, they would be available to lend an external perspective on the sale of the business.

Networking Among Peers

Professional associations are established means to identify potential buyers of service businesses. For example, an individual wanting to acquire another tax business could benefit from connecting with other tax professionals.

Going beyond identifying a potential purchaser, a service professional's peers may provide an effective sounding board for the sale of the business. The selling business owner must be alert to the loss of confidentiality associated with these discussions. The dangers of allowing peers and the local market to become aware of the impending sale of one's practice are discussed later.

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VALUING A SERVICE BUSINESS

The valuation of a service business can vary widely by the service provided, demographics, and location. The use of a valuation service may be critical to determine a fair market value (FMV) for the business. The following are some key factors affecting valuation.[11]

- Timing and size of revenues relative to closing
- Whether an outsider or an insider (such as an employee, an existing shareholder, or a partner) is buying the service business
- Whether the business requires significant capital expenditures, such as technology upgrades
- The cash flow and profitability of the business once ownership passes to the buyer
- Terms, which are discussed later, such as an all-cash deal that may decrease the purchase price
- Consideration of any negative factors, such as an unfavorable location, staffing issues, or other factors

> **Observation.** The potential seller of a service business needs to ask which other assets, if any, may be included in the sale (such as real estate) and to what degree they want to continue to be involved in the business after the sale. These issues should be considered and shared with a business valuation broker or potential buyer before determining the FMV of the business.

Valuation of any business is a subjective matter, particularly for a small business. A long-held market assumption for tax practices, for example, is that they generally sell for one times revenue.[12] Some practices sell for more, some for less, but most tax practice values refer to this metric. There is some evidence that this multiple is declining because of market forces associated with many baby boomers wishing to retire.[13]

While multiple-of-revenues valuations are commonly used for tax practices and accounting firms, other service businesses use other approaches to establish their values. The American Institute for Certified Public Accountants (AICPA) introduced standards for asset valuation in general, including businesses in a formal statement issued in 2007.[14] The standard most applicable to businesses offers several approaches to valuation, including the following.

- **Income approach** includes the following two methods for calculating the value of a business.
  - **Capitalization of benefits method.** This method examines how a business's earnings or cash flows are affected by many items, including the following.
    - Normalization adjustments
    - Nonrecurring revenue and expense items
    - Taxes
    - Capital structure and financing costs

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11. *How to value a CPA firm for sale*. Sinkin, J. and Putney, T. Nov. 1, 2013. Journal of Accountancy. [www.journalofaccountancy.com/issues/2013/nov/20138232.html] Accessed on Apr. 21, 2022.

12. *Accounting Firms/CPAs*, pp. 1–2. 2012. The Business Reference Guide. [businessreferenceguide.com/wp-content/uploads/2012/07/accounting-firmscpas-2.pdf] Accessed on May 2, 2022; Accounting *Practice Valuation Details*. Gipple, Ryan. Berkshire Business Sales and Acquisitions. [berkshirebsa.com/accounting-practice-valuation-details] Accessed on Apr. 29, 2022.

13. *What's Your Accounting Practice Really Worth?* Carlino, Bill. Jul. 14, 2021. Pennsylvania Institute of Certified Public Accountants. [www.picpa.org/articles/cpa-now-blog/cpa-now/2021/07/14/what-is-your-accounting-practice-worth] Accessed on Apr. 29, 2022.

14. *Statements for Standards on Valuation Services*, Jun. 2007. AICPA. [www.aicpa.org/resources/download/statement-on-standards-for-valuation-services-vs-section-100] Accessed on Apr. 29, 2022.

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  - Capital investments
  - Noncash items
  - Capitalization rates
  - Changes in the above items
- ♦ **Discounted future benefits method.** This method examines the projected earnings or cash flow implications for the items listed previously. It adds assumptions about future cash flow and earnings, as well as a terminal value for the asset. Additional adjustments must be made for intangible assets, such as goodwill, that are particularly significant in selling a business.

- **Asset approach** values a business based on the value of its assets and liabilities, subsequently taking into account replacement costs for intangible assets, such as goodwill and customer lists.
- **Market approach** values a business by examining the values of public companies and comparable sales of similar businesses, subject to the availability of data.

The two methods described in the AICPA statement for the income approach bear some resemblance to discounted cash flow (DCF) analysis.[15] Generally, because DCF techniques are widely understood, the income approach is likely to be most helpful in determining the values of service businesses.

TERMS OF THE SALE

Cash Buyers

Business sellers may prefer doing business with a buyer prepared to pay cash at closing. This preference may be unrealistic. Many buyers of a small business may want to pay over time, and some may want an **earnout** with pricing adjusted as revenue is realized **after** closing.[16] A business seller should expect that receipt of all funds at closing reduces the price received from the sale of their business, perhaps significantly.[17]

Seller Financing[18]

If sellers do not require the receipt of the entire sales proceeds at closing, they widen the pool of potential buyers. More potential buyers can fund the acquisition with earnings from the service business itself. They reduce their dependence on outside financing because the business seller finances part of the sale. In doing so, the seller accepts some of the risks associated with the sale. This practice motivates the seller to help the business succeed after the buyer assumes ownership. It is common for seller financing to cover a significant portion of the purchase price.

> **Observation**. Receiving sales proceeds over a period of time may help manage the tax consequences of the sale, as discussed later. However, recognition of depreciation recapture under IRC §1245 for the sale of personal property occurs in the year of the sale, regardless of how long it may take to receive the payments.[19] Also, in an environment where tax rates may be on the rise, taxpayers receiving installment sale payments may decide to elect out of installment sale treatment and claim all gains in the year of sale even though payments may continue for years.[20]

15. *Discounted Cash Flow (DCF)*. Fernando, Jason. Dec. 19, 2021. Investopedia. [www.investopedia.com/terms/d/dcf.asp] Accessed on May 2, 2022.
16. *Earnout.* Aug. 1, 2021. Wikipedia. [en.wikipedia.org/wiki/Earnout] Accessed on Apr. 28, 2022.
17. *Maximize proceeds in accounting firm sales.* Olson, Harry L. Nov. 1, 2015. Journal of Accountancy. [www.journalofaccountancy.com/issues/2015/nov/accounting-firm-sales.html] Accessed on Apr. 28, 2022.
18. Richard S. Ruback and Royce Yudkoff, *HBR Guide to Buying a Small Business*, 193-194 (Harvard Business Review Press, 2017).
19. IRC §§453(i), 1245(a)(1).
20. IRC §453(d)(3).

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Third-Party Financing

Potential buyers may acquire service businesses with borrowed funds. Often, buyers use the 7(a) program of the Small Business Administration (SBA), which is authorized for loans up to $5 million.[21]

SELECTING THE TYPE OF SALE

Once a service business owner reaches the decision to sell, the owner must decide whether to sell assets or equity.

Asset Sale

If the service business owner decides to sell the assets of their business, goodwill generally constitutes the bulk of the purchase price.[22] Goodwill is an intangible asset, defined as "the value of a trade or business attributable to the expectancy of continued customer patronage."[23] It is usually transferred to the buyer with other intangible assets, including:[24]

- Workforce in place,
- Going concern value,
- Covenant not to compete,
- Customer lists and other customer-based intangibles, and
- Books and records.

Physical assets, such as computer equipment, scanners, and printers may also be sold, but they generally constitute a small portion of the service business's sales price. One advantage to the seller of treating the sale of the business as the sale of assets is that the business owner can readily decide which assets to include. For example, if the owner has registered an automobile in the name of the business, they can keep that asset.

Practitioner Planning Tip

Sole proprietors have no choice but to convey ownership of their businesses as sales of assets. By definition, they, as individuals, are the business entity, and accordingly, there is no interest in the business's equity that can be conveyed. When it comes time to sell, the sole proprietor should consult with an attorney to determine if the laws require them to withdraw the assumed name.[25]

21. *Terms, conditions, and eligibility.* SBA. [www.sba.gov/partners/lenders/7a-loan-program/terms-conditions-eligibility] Accessed on Jul. 12, 2022; *Types of 7(a) Loans.* SBA. [www.sba.gov/partners/lenders/7a-loan-program/types-7a-loans] Accessed on Jul. 12, 2022.

22. Treas. Reg. §1.338-6.

23. Treas. Reg. §1.197-2(b)(1).

24. IRC §§197(d)(1) and (2).

25. For example, businesses using an assumed name in Illinois are required to file a supplementary certificate with the county clerk to state when they have ceased doing business under the assumed name. For further details, see 805 ILCS 405/3a.

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Equity Sale

Alternately, the owner may sell their equity in the service business. However, this is only possible for a business organized as a corporation, a partnership, or an LLC not taxed as a sole proprietorship. Sole proprietors cannot sell the equity in their businesses because the business is part of their identity. The business may have goodwill and other intangible assets; these are assets the business may sell.[26]

Comparison

Generally, sellers prefer to sell the equity in their service businesses, as this typically results in capital gain income instead of ordinary income. In contrast, most buyers would prefer to acquire the assets of the businesses they purchase. The costs allocated to these assets can generally be recovered through depreciation over known periods of time. However, the buyers can only recover their investments in equity after they sell their interests at an uncertain time in the future. In most cases, buyers do not prefer acquiring the stock of a corporate entity for the following reasons.

1. The capital used for the purchase is tied up in the stock basis until the buyer liquidates the stock. However, the buyer may elect to treat the stock purchase as an asset acquisition under certain circumstances.[27]
2. The purchaser "steps into the shoes" of the corporation because the corporation cannot increase its basis in the assets it purchased. The business continues as usual unless the buyer makes the IRC §338 election to enable the business buyer to treat the purchase of stock as the purchase of assets (discussed later).
3. Because potential liabilities usually stay with the business entity, the buyer acquires them along with the stock.

Conversely, a seller may be less interested in a sale of business assets as these items may result in more ordinary income tax treatment[28] and perhaps double tax. Two examples follow that clarify the tax differences between asset sales and equity sales for C corporations and S corporations. More details about reporting the sale of a service business follow the examples.

Comparing Asset and Equity Sale (C Corporation). The sale of a C corporation's stock often results in a better tax result than the sale of assets when viewed from the seller's perspective. The following example shows how the seller of a business can expect lower tax liability if the sale of the business is conducted as a stock sale, rather than an asset sale, provided all other terms of the sale are held constant.

Example 1. Greg's architecture firm is an established C corporation. The company does not owe personal holding company tax because of its regular practice of paying annual dividends to Greg equal to undistributed personal holding company income prior to December 31 each year. Greg owns 100% of the corporation's stock and he receives an offer for the corporation's assets for $2 million. The sale closes in 2022. Because the corporation has fully depreciated its assets, the proceeds are taxed at the C corporation level at a flat 21% rate.[29]

The issue is getting the after-tax proceeds into Greg's hands. The corporation could redeem the stock, creating capital gain income on Greg's individual income tax return. Alternately, the corporation could declare a dividend that would also be taxed similarly to a long-term capital gain.[30] If Greg can convince the buyer to purchase the corporate stock, he must account for one transaction at the personal level.

26. IRC §1060(b)(1).
27. IRC §§338(a) and (b).
28. IRC §1231(c)(1).
29. IRC §11(b), as amended by the *Tax Cuts and Jobs Act of 2017* (TCJA), PL 115-97, §13001.
30. *Topic No. 404 Dividends.* Feb. 4, 2022. IRS. [www.irs.gov/taxtopics/tc404] Accessed on Mar. 1, 2022.

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1. Sale of C corporation assets	$2,000,000		
Assumed basis in assets	(0)		
Taxable gain to the C corporation	$2,000,000	$2,000,000	
Corporate tax rate	× 21%		
Corporate tax	$ 420,000	(420,000)	$420,000
Cash remaining after federal corporate tax		$1,580,000	
Liquidation dividend or stock redemption	$1,580,000		
Assumed capital gain rate	× 20%		
Tax to shareholders assuming no basis	$ 316,000		316,000
Total federal tax cost of the transaction			$736,000
2. Sale of shareholder's stock	$2,000,000		
Assumed basis in assets	(0)		
Gain to shareholders	$2,000,000		
Maximum capital gain rate	× 20%		
Tax to shareholders	$ 400,000		(400,000)
Tax savings			**$336,000**

This example treats Greg's distribution as a liquidation distribution and, therefore, subject to capital gains rates.[31] Because the basis in the example is zero, the entire liquidation distribution is taxable, but only at capital gains rates. The sale of C corporation stock involves taxation at only one level, unlike an asset sale. Therefore, Greg would like to structure the sale as an equity sale to benefit from the $336,000 tax savings.

Note. This analysis of tax paid by sellers of C corporations' assets takes into account the double-taxation effect that subjects C corporation shareholders to tax at two levels. These shareholders must pay tax at the corporate level and the tax on the shareholders' individual income tax returns.

Observation. The difference in tax creates a bargaining scenario between the buyers and the sellers. The sellers may want a higher price to sell assets or be willing to settle for a smaller selling price if the buyer purchases stock.

Caution. For illustration purposes and computational simplicity, this example ignores the net investment income tax, the qualified business income deduction, and the effect of the graduated income tax rate schedule.

31. IRC §§302(a) and (b).

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Comparing Asset and Equity Sale (S Corporation). If the corporation has elected S corporation treatment, the sale of assets again results in a greater tax liability to the seller, although the additional tax is not nearly as great as shown with a C corporation. Because S corporations generally pass through their income to shareholders, the selling shareholder avoids the double taxation that subjects C corporation shareholders to tax on two levels.

Example 2. Use the same facts as **Example 1,** except Greg's architecture firm is an S corporation. Assume further that the bill of sale allocates:

- $200,000 to fully depreciated assets having an unadjusted basis of $200,000; and
- $1,800,000 to goodwill.

The sale of corporate assets potentially creates both ordinary income and capital gain income.

1. Sale of S corporation assets				
Goodwill	$1,800,000	$1,800,000		
Fully-depreciated assets	200,000		$200,000	
Total assets	$2,000,000			
Assumed basis in assets	(0)			
Taxable gain	$2,000,000			
Corporate tax	$ 0			
Gains allocated to shareholders via Schedule K-1:				
Capital gain maximum rate		× 20%		
Tax on capital gain		$ 360,000		$360,000
Ordinary income maximum rate			× 37%	
Tax on ordinary income			$ 74,000	74,000
Total tax				$434,000
2. Sale of shareholder's stock	$2,000,000			
Assumed basis in assets	(0)			
Gain to shareholders	$2,000,000			
Maximum capital gain rate	× 20%			
Tax to shareholders	$ 400,000			(400,000)
Tax savings				**$ 34,000**

In step 1 above, gain is allocated to Greg regardless of whether cash is distributed to him.[32] The gain increases his stock basis[33] to $2 million, assuming the beginning basis on January 1, 2022, was $0. The distribution of $2 million of proceeds to Greg by December 31, 2022, reduces his stock basis to $0.[34]

Caution. Timing is extremely important in this type of situation. If the sale proceeds are not distributed until the following year, the taxpayers would still have reported the taxable gain in 2022.

32. IRC §1377(a)(1).
33. IRC §1367.
34. Ibid.

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Installment Sale[35]

The installment sale rules apply when at least one payment for the sale of an asset is received after the tax year in which the sale of the asset is realized.[36] It is not specific to asset sales and can also apply to the sale of an equity interest in a business. The installment sale rules generally require the property seller to report the gain, but not the loss, on a deferred schedule. However, the seller of the business can elect out of installment treatment.[37] This rule applies when the seller receives the buyer's promissory note, which may be paid after the year of the sale.

> **Note.** A seller may opt out of installment sale treatment to accelerate any gain into the year of sale. This election may be an important planning consideration if the seller anticipates tax rates may rise during the life of the installment sale. For more information about installment sales, see the 2017 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 1: Installment Sales. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

The sale of a service business's assets to a related party can have serious tax ramifications for the owner if an installment sale is present. If, after the original sale (disposition 1), a relative or other related party subsequently sells the business (disposition 2), the original owner immediately recognizes the proceeds of disposition 1 due to disposition 2, following the guidelines of IRC §453(e). A related person may be a member of one's family, parents, or grandparents.[38] The definition of related persons includes relationships established by trusts, estates, and corporations, primarily in IRC §267(b).[39] Significantly, there is a time limit on the installment sale when it does not involve marketable securities.[40] If disposition 2 occurs **more than two years** after disposition 1, the related party rules no longer apply, and the first owner is not required to recognize the remaining income immediately.[41]

The related party rules usually come into play when a business transfers to a family member, and would potentially require the immediate recognition of the proceeds of the installment sale, regardless of the amount of cash that has changed hands. The following example illustrates how the related party rules can affect the sale of a business when a relationship is established by a trust, rather than by familial relationship.

Example 3. In 2020, Howard Craig decided to sell his insurance agency. A good friend of his, George Clark, has a son, Phil, who recently became a licensed insurance agent and has expressed an interest in acquiring an insurance agency.

Several years before that, however, George set up a trust listing his wife Kim as the income beneficiary and Phil and his sister Shirley as residual beneficiaries. **Howard agreed to be the trustee of this trust.**

Howard and Phil reached terms, and on October 19, 2020, Phil acquired the assets of Howard's agency. The price they reached was $150,000, to be paid under an installment agreement over three years. This amount is classified entirely as goodwill. On October 15 of each of the next three years, Phil committed to pay $50,000 of principal plus interest.

George was very proud of his son for owning a business, especially because George was in failing health. He died on December 1, 2020, and his trust became irrevocable that day. Because his wife was the trust's income beneficiary, the trust remained in effect.

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35. IRC §453; See IRS Pub. 537, *Installment Sales*, p. 2. (2020).
36. IRC §453(b)(1).
37. IRC §453(d).
38. IRC §§267(b) and 318(a).
39. IRC §453(f)(1).
40. IRC §453(e)(2).
41. Ibid.

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Sadly, Phil struggled in the insurance agency, and in 2022 he made the tough decision to sell it. On August 22, 2022, Phil signed an asset sales agreement conveying the assets of the agency to an unrelated insurance agency in a nearby town for $110,000.

Because of the related party rules in §§453(e) and 267(b), Howard and Phil are related parties because Howard is a fiduciary of a trust and Phil is a beneficiary of the same trust,[42] even though they are **not** related by blood. Because the second disposition occurs within two years of the first disposition, §453(e)(2) requires Howard to recognize any payments not received under the installment agreement as income.

IMPLEMENTING AN ASSET SALE

After selecting which type of sale (asset or equity), the seller of a business must then implement the sale. The sale of assets conveys ownership of a small business. A buyer may avoid liability for the seller's past errors, mistakes, and omissions by only acquiring the assets. If the seller organized the business as a sole proprietorship, the only option available to sell the business is an asset sale.

Practitioner Planning Tip

Depending on state law, some income tax, sales tax, or payroll tax liability may be transferred to the buyer even if structured as an asset sale. Buyers are encouraged to work with their attorneys to obtain tax clearance letters from state departments of revenue. Sometimes called "bulk sales letters," these documents confirm all taxes owed have been paid and the buyer is obtaining the assets unburdened by any of the seller's tax liabilities. Various counties and cities may also impose this requirement.

The seller of a business allocates the sale of the business's assets for a set dollar amount as the sale of individual assets.[43] Courts first applied this fragmentation approach in *Williams v. McGowan.*[44] In this case, Mr. Williams attempted to treat the sale of his business as the sale of a capital asset. However, the Court of Appeals for the Second Circuit held Mr. Williams could not treat the sale of his sole proprietorship as a unified capital asset.

As a result of this case, whenever a business sells its assets, the seller must allocate the sales price among the various assets to determine the amount realized on the sale of each asset.[45] Similarly, the buyer must allocate the purchase price among the acquired assets to determine the basis of each asset.[46] Allocation of the purchase price can be critical to both the buyer and the seller.

42. IRC §267(b)(6).

43. *Sale of a Business.* May 28, 2021. IRS. [www.irs.gov/businesses/small-businesses-self-employed/sale-of-a-business] Accessed on Mar.1, 2022.

44. *Williams v. McGowan,* 152 F.2d 570 (2nd Cir. 1945).

45. IRC §1060.

46. Ibid.

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Compliance for Asset Sales

IRC §1060 requires both the buyer and seller to treat asset allocation of the selling price of a business in the same manner. Requiring the seller to use the same method as the buyer, the IRS made it more difficult for inconsistent positions to be taken. It also means that the IRS is more readily able to identify inconsistent positions. Requiring both parties to use the same method imposes reporting rules requiring both the buyer and seller to report the allocation of the total consideration.[47]

Residual Method for Sales Price Allocation[48]

Both the business buyer and seller must allocate the cost and sale price by applying the residual method. The residual method sequentially applies the price of the business to successive classes of assets, as defined in Treas. Reg. §1.338-6(b). Starting with Class I, the sale price of the business is allocated up to the FMV of the assets in a class, leaving the remaining sales price or **residual** to "spill over" into the next class.[49] The classes are listed below in the order to which the sales price is applied to them.

Class I. Cash and demand deposits

Class II. Certificates of deposit and government and marketable securities

Class III. Accounts receivable incurred in the ordinary course of business

Class IV. Inventory

Class V. All assets not included in other classes

Class VI. IRC §197 intangible assets other than goodwill and going concern value

Class VII. Goodwill and going concern value

The allocation and reporting rules of §1060(a) apply only in the case of an **applicable asset acquisition.** As a practical matter, this term encompasses most routine business sales in which the seller conveys assets rather than the business's equity. However, the definition of this term is so murky that many sellers, fearing possible penalties, follow the required procedures of §1060 upon the sale of any asset, even if the requirement to use it in a specific situation is not clear.

IRC §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 IRC §1031 are also subject to this rule if they constitute a trade or business.[50]

A group of assets constitutes a trade or business if the group's use qualifies as a trade or business under IRC §355, i.e., it consists of every operation that forms a part of, or a step in, the process of earning income.[51] Even if the assets do not qualify as a trade or business under §355, they are treated as a business if goodwill or going concern value could, under any circumstances, attach to the assets purchased.[52]

47. Treas. Reg. §1.1060-1(e).
48. Treas. Regs. §§1.338-6 and 1.1060-1(c).
49. Treas. Reg. §1.338-6(b)(2).
50. Treas. Reg. §§1.1060-1(b)(1) and (2).
51. Treas. Reg. §1.355-3(b)(2)(ii).
52. Treas. Reg. §1.1060-1(b)(2)(i)(B).

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IRC §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 the following situations.

- A corporation buys a partnership or proprietorship.
- A corporation makes a §338 election for a newly purchased subsidiary.
- A proprietorship buys another proprietorship and continues to operate as a proprietorship.
- A partnership buys a proprietorship and continues to operate as a partnership.
- A proprietorship or partnership buys a going business from a corporation, whether or not the shareholders liquidate the corporation.

The trade or business test is met if the assets constitute a business in the hands of either the buyer or the seller. Therefore, the §1060 rules can apply when the assets constitute a part of the seller's business.

Allocation of Consideration Exchanged. The purchase price must be allocated in the same manner as amounts are allocated under §338(b)(5). Before the consideration can be allocated to the various assets, the amount of consideration to be allocated must itself be determined. The total amount allocated by the buyer and the seller may differ.[53]

- The purchaser's consideration is the cost of the assets acquired, while the seller's consideration is the amount realized from the sale.[54]
- The buyer's cost may not be the same as the seller's amount realized due to the transaction costs. Thus, the buyer's transaction costs **increase** the amount to be allocated and the seller's transaction costs **decrease** the allocable amount. Neither taxpayer's costs affect the consideration of the other.[55] This is illustrated later in **Example 5.**

IRC §1060(a) also provides that a written agreement governing the **allocation of the sales price to the sale of business assets shall be binding on both parties** unless the Treasury determines that the allocation is not appropriate. This change prevents parties from contractually agreeing to a purchase price allocation and then altering their positions.[56]

Reporting Requirements.[57] IRC §§1060(b) and (e) contain reporting rules that implement the residual method. Buyers and sellers of business assets must use Form 8594 to report information on the business transaction to the IRS. The form is attached to their income tax returns for the taxable year the purchase occurred if the purchase is an applicable asset acquisition. A copy of Form 8594 follows.

53. Treas. Reg. §1.1060-1(c)(1).
54. Treas. Regs. §§1.338-6, 1.338-7, 1.1060-1(c)(2), (c)(3), and (c)(4).
55. Ibid.
56. *Revenue Reconciliation Act of 1990*, PL 101-508, §11323(a).
57. IRC §1060.

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Form **8594**
(Rev. November 2021)
Department of the Treasury
Internal Revenue Service

Asset Acquisition Statement
Under Section 1060

▶ Attach to your income tax return.
▶ Go to *www.irs.gov/Form8594* for instructions and the latest information.

OMB No. 1545-0074
Attachment Sequence No. **169**

Name as shown on return	Identifying number as shown on return

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
Address (number, street, and room or suite no.)	
City or town, state, and ZIP code	

2 Date of sale	3 Total sales price (consideration)

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	$	$
Class VI and VII	$	$
Total	$	$

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 statement 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. 11-2021)

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Form 8594 (Rev. 11-2021) 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.

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	$	$	$
Class VI and VII	$	$	$
Total	$		$

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

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Both the buyer and the seller in an applicable asset acquisition are required to furnish the IRS with information regarding the allocation to goodwill or going-concern value and any subsequent modifications. They must also provide the IRS with information concerning other assets transferred in the business sale transaction that the IRS may find necessary for enforcing the rules. The list could include information regarding covenants not to compete and consulting arrangements. Important information reported on Form 8594 includes the following.

1. The aggregate FMV of the assets of each class and the amount of consideration allocated to each class. 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.
2. A statement as to whether both parties agreed to an allocation of the sales price in the sales contract. If they did, another statement must answer whether the sales agreement contained the same FMVs listed in Form 8594, part II, item 4.
3. A statement as to whether the sales contract conveyed intangible assets, such as covenants not to compete, employment contracts, licenses, leases, and similar items. If yes, a statement must be included attesting to the type of agreement and the maximum sales price for the assets conveyed.

Some unique reporting issues associated with the Form 8594 are explored next.

Noncompete Agreements or Covenants Not to Compete. Business sellers may wish to minimize the amount of the sales price allocated to a noncompete agreement because it is taxed as ordinary income when received by the seller, as discussed earlier, on the theory that such payments are a substitution of income.[58] **The amount allocated is not subject to self-employment tax or payroll tax,** however.[59]

The parties must report additional information if a person owns at least 10% of the value of an entity immediately before a transaction, transfers an interest in the entity, and enters into an employment contract, covenant not to compete, royalty, lease, or other agreement with the buyer. Presently, the additional information includes only an acknowledgement on Form 8594 that this situation exists. IRC §1060(e) grants authority to the IRS to implement additional requirements. A covenant not to compete is a **Class VI asset.**

Goodwill.[60] The Code considers a business's goodwill a capital asset unless it has been subject to amortization under §197. Thus, **owner-created goodwill** is a nonamortizable capital asset. In contrast, goodwill acquired through the **purchase of a business** is an intangible asset, and therefore the business buyer can amortize it. As an amortizable §197 intangible asset, it is treated as an IRC §1231 capital gain subject to §1245 recapture.[61]

As mentioned previously, generally, the primary asset conveyed by the sale of a service business is the goodwill of the company. The principle of goodwill carries the anticipation of net earnings being greater than a fair return on net tangible assets.[62] Conceptually, goodwill exists due to the business's relationships with its customers. By purchasing an established service business, its buyer benefits from the rapid acquisition of clients and, therefore, cash flow.

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58. Rev. Rul. 69-643, 1969-2 CB 10.

59. *Milligan v. Comm'r*, 38 F.3d 1094 (9th Cir. 1994); *Selling a Business: Substance and Form Really Do Count*. Oct. 1, 2008. The Tax Adviser. [www.thetaxadviser.com/issues/2008/oct/sellingabusinesssubstanceandformreallydocount.html] Accessed on Mar. 2, 2022.

60. IRC §197(d)(1)(A).

61. IRC §§1245(a)(2) and (b)(8).

62. Rev. Rul. 59-60, 1959-1 CB237; *Going Concern Value: Goodwill by Any Other Name?* Wiener, H. M. The Tax Lawyer, [www.jstor.org/stable/20768041] Accessed on Aug. 24, 2022.

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Goodwill can have two different sources. If the seller started their own business and never acquired an existing business, the sale of a practice's goodwill cannot be amortized by its original owner.[63] However, if the service business previously acquired another business, recapture of the amortized goodwill results in ordinary income. Goodwill is a **Class VII asset.**[64]

Going Concern Value.[65] This quantity reflects the "additional value that attaches to property because the property is an integral part of an ongoing business activity."[66] It is also an amortizable §197 asset when acquired by purchase.

Although this term is frequently confused with goodwill, it has a distinct meaning that figured prominently in a 1930s Supreme Court case.[67] While the IRS definition focuses on the value of the property being part of a larger entity, in contrast, the *Los Angeles* case decided by the Supreme Court adopts a philosophy of the whole being greater than the sum of a business enterprise's parts. Despite their differences, the two definitions are similar in one important respect; they both focus on the business's ability to continue to operate profitably rather than on customer relationships, as the definition of goodwill does. Going concern value is also a **Class VII asset.**

Workforce in Place.[68] This asset is the value of the labor associated with the business, including the training, experience, and prior education of the business's employees.[69] It reflects the ability of the labor force to undertake the activities for which the business was organized to serve its customers. Workforce in place is a **Class VI asset** because it is an intangible asset other than goodwill or going concern value.

Business Books and Records.[70] This grouping of assets consists of information about customers. This may be a customer list, customer data files, inventory control systems, any operations manuals, data security manuals, training manuals, accounting procedures, and even insurance expirations.[71] Business books and records are **Class VI assets.**

Franchise Rights.[72] If a business seller conveys the franchise rights to a new owner, the owner may need to apply to the franchise to join it. Alternately, the franchise may prohibit the sale of the franchised service business to a new owner who is not already a participant in the franchise. A franchise right conveyed in a business sale is a **Class VI asset.**

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 §1231 assets (including the recapture of amortization of goodwill allowed under §197 for a prior acquisition). Accounts receivable is generally a **Class III asset,** while inventory is a **Class IV asset.**

IRC §1231 Assets. If the gain on the sale of §1231 assets exceeds the losses on such assets, the net gain generally is treated as a long-term capital gain. Conversely, the taxpayer can treat the net loss as ordinary and deduct it without limitation if the losses exceed the gains. IRC §1231 property generally includes all depreciable and real property used in a trade or business held longer than one year. Examples include machinery and equipment, buildings, and land used in a trade or business. Except for §197 assets described previously, §1231 assets are generally **Class V assets.**

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63. IRC §197(c)(2). The practice's original owner has self-created goodwill.

64. Treas. Reg. §1.338-6(b).

65. IRC §197(d)(1)(B).

66. Treas. Reg. §1.197-2; IRS Pub. 551, *Basis of Assets*, p. 13 (2018).

67. *Los Angeles Gas & Elect. Corp. v. Railroad Commission*, 289 U.S. 287 (1933); *Going Concern Value: Goodwill by Any Other Name?* Wiener, H. M. The Tax Lawyer, [www.jstor.org/stable/20768041] Accessed on Aug. 24, 2022.

68. IRC §197(d)(1)(C)(i).

69. Treas. Reg. §1.197-1(b)(3).

70. IRC §197(d)(1)(C)(ii).

71. Treas. Reg. §1.197-2(b)(4).

72. IRC §197(d)(1)(F).

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Other Transactions. The buyer and seller must also report certain other transactions related to the transfer of assets such as the following.

- Lease or royalty arrangement
- Employment contract, management contract, or consulting contract with the seller
- Agreement with a party related to the seller, such as a shareholder of the selling corporation or another corporation or partnership 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% of the selling corporation's stock.[73] The attribution rules of §338 may expand the list of persons subject to this.

Regulations regarding the attribution rules[74] raise the possibility that the facts and circumstances of a transaction may lead the IRS to conclude a group of assets constitutes a trade or business. The existence of any related agreements, such as an employment agreement, a lease agreement, a promise not to compete, a license, and especially a management contract, may constitute assets in the form of agreements that also should be reported on Form 8594.[75]

If the total consideration paid exceeds the aggregate **book value** of the assets purchased (excluding goodwill), such excess presumably suggests that goodwill exists[76] and, therefore, **triggers §1060.** The assets may not constitute a trade or business in the hands of the seller. However, if they constitute a trade or business in the hands of the buyer, the transaction should be reported on Form 8594.

Note. A well-constructed agreement governing the exchange of assets should completely account for the value of all business assets.

Caution. The requirement to apply §1060 and allocate purchase price goes into effect when the consideration exceeds the **book value** of the assets purchased, not the asset value. If a business seller is conveying appreciated assets that have been owned a long time, the requirement to allocate purchase price may come into effect with relatively small deals. As a service business can often be started with relatively little investment, sellers should plan on preparing Form 8594.

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 IRC §§6721(a) and (b).[77] The penalty for failure to file an information return due in 2023 on the prescribed date is generally $290 per return.[78] However, if one party intentionally disregards the reporting requirement, the penalty becomes $580 or 10% of the "aggregate amount of items required to be reported," whichever is greater.[79] Because a buyer and seller report the entire amount of consideration, the penalty for intentionally disregarding the filing requirement could be significant.

Residual Method Examples. The following two examples illustrate the application of the residual method and §1060 to the sale of a service business and specifically the allocation of the sales price to different classes of assets.

73. IRC §1060(e).
74. Treas. Reg. §1.1060-1(b)(2).
75. Treas. Reg. §1.1060-1(b)(2)(iii)(C).
76. Treas. Reg. §1.1060-1(b)(2)(iii)(B); *Purchase Price Allocation.* Corporate Finance Education Inc. [corporatefinanceinstitute.com/resources/knowledge/deals/purchase-price-allocation] Accessed on Apr. 28, 2022.
77. IRC §6724(d)(1)(B)(xvii); For further detail see instructions for Form 8594.
78. IRC §6721(a), adjusted for inflation as shown in Rev. Proc. 2021-45, 2021-48 IRB 764.
79. IRC §6721(d).

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Example 4. Andrea Lyndon has operated a small alternative medicine practice as an S corporation since 1980, using the name Twin Cities Med, Inc. (TCM). In 2022, she decides to sell the practice and retire. She has used the accrual method of accounting consistently during all the years she has owned the practice. Since starting her practice, she has acquired no other medical practices; consequently, there is no goodwill on her business's books. She expects her business's revenue for the year to be $100,000.

On October 18, she and James Roberts sign an asset sales agreement conveying all assets of her business other than cash to him for $100,000 or one times the business's annual revenue. Although TCM is technically the seller of the assets, Andrea retains ownership of her stock in the S corporation. The price excludes the corporation's cash, which was $5,000 at the time. Andrea plans to use some of this cash to pay off the $1,500 balance on the corporation's credit card. She and James agree that the value of the covenant not to compete is $2,000. The business's receivables of $6,000 are included in the asset purchase agreement. However, Andrea and James agree to reduce the FMV by $295 to account for the doubtful collection of an outstanding medical bill. The terms of the asset sales agreement require Andrea to rename the corporation, so it does not reflect any link to medical services. James has acquired the right to use the existing name of the medical practice he has acquired so that he can benefit from name recognition built over the decades that Andrea operated the business. Assume that neither Andrea nor James incurs any legal or other closing costs associated with the transaction.

The following assets are conveyed, shown here with their FMVs. Besides its three computers, TCM had fully depreciated all Class V assets. Andrea and James determined their FMVs by reviewing used equipment pricing on a used equipment website.

Class	Asset	Adjusted Basis	FMV
III	Accounts receivable	$6,000	$ 5,705
V	Table	0	200
V	Computers	1,000	600
V	Scanner	0	250
VI	Covenant not to compete	0	2,000
VII	Goodwill	0	91,245
	Sale price		$100,000

Goodwill is computed using the residual method, as shown next.

Allocation available to Class III		$100,000
Value of accounts receivable	$ 5,705	
Consideration	100,000	
Lesser of two amounts	5,705	(5,705)
Allocation available to Class V		$ 94,295
Table	200	
Computers	600	
Scanner	250	
Total Class V	$ 1,050	
Consideration (after class III)	94,295	
Lesser of two amounts	1,050	(1,050)
Allocation available to Class VI		$ 93,245
Covenant not to compete	2,000	
Consideration (after class V)	93,245	
Lesser of two amounts	2,000	(2,000)
Allocation available to Class VII		$ 91,245
Goodwill	91,245	

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Example 5. Use the same facts as **Example 4,** except TCM, owned by Andrea, incurs legal expenses of $2,000 associated with the sale, and James incurs legal fees of $3,000. Andrea pays the secretary of state an additional fee of $50 to change the name of her corporation.

The regulations supporting §1060 require Andrea to consider both legal fees and the fee to change the name of her corporation.[80] Applying the residual method, the value of the goodwill she realizes decreases to $89,195 ($91,245 – $2,000 legal fees - $50 secretary of state fee). The amount of goodwill that James accepts into his financial statements is **increased** by the legal expenses he incurs. In his case, the goodwill on his books and available for amortization is $94,245 ($91,245 + $3,000 legal fees). Transaction expenses that the buyer incurs act to **increase** the allocation to goodwill, which usually increases their subsequent noncash amortization expense.

Consequently, the Forms 8594 submitted by James and Andrea are not identical in all respects, even though the numbers may be identical for Classes I through VI.

	Buyer (James)		Seller (TCM)	
Cash and liabilities assumed		$100,000		$100,000
Transaction costs		3,000		(2,050)
Total allocation		$103,000		$ 97,950
Allocation available to Class III		$103,000		$ 97,950
Value of accounts receivable	$ 5,705		$ 5,705	
Consideration	103,000		97,950	
Lesser of two amounts	5,705	(5,705)	5,705	(5,705)
Allocation available to Class V		$ 97,295		$ 92,245
Table	$ 200		$ 200	
Computers	600		600	
Scanner	250		250	
Total Class V	$ 1,050		$ 1,050	
Consideration (after Class III)	97,295		92,245	
Lesser of two amounts	1,050	(1,050)	1,050	(1,050)
Allocation available to Class VI		$ 96,245		$ 91,195
Covenant not to compete	$ 2,000		$ 2,000	
Consideration (after Class V)	93,245		91,195	
Lesser of two amounts	2,000	(2,000)	2,000	(2,000)
Allocation available to Class VII		$ 94,245		$ 89,195
Goodwill	94,245		89,195	

This example demonstrates the difference between the Class VII goodwill reported by buyer and seller is the $5,050 total transaction costs incurred by the parties ($3,000 legal fees incurred by the business buyer + $2,000 paid to the seller's attorney + $50 paid to the secretary of state). This would **not** be the case if the transaction costs incurred by the seller were more than the allocation of goodwill.

80. Treas. Reg. §§1.338-6, 1.338-7, 1.1060-1(a)(1), and 1.1060-1(c)(3).

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Computation of Gain or Loss to Seller. After the seller appropriately allocates the sales price to different assets, the gain or loss is computed as if **each** asset was sold separately. Therefore, it is necessary to find the adjusted basis of each asset and its character as a capital asset, a §1231 asset, or an ordinary asset. The seller must determine the applicability of recapture provisions for any depreciable asset, such as §1245 or IRC §1250.

Example 6. Use the same facts as **Example 5.** The treatment of each class of assets is as follows.

- **Class I assets** consist only of cash, with which no gain or loss is associated. In the case of TCM, no cash is being transferred to the buyer.
- **Class II assets** consist of certificates and marketable securities. While a gain or loss on marketable securities is possible, small firms rarely hold them. In the case of TCM, no marketable securities are being transferred.
- **Class III assets** include accounts receivable, for which a loss is possible if the amount realized is less than the adjusted basis. Nevertheless, it is uncommon for an accrual method business seller to have a Class III gain or loss, so TCM does not include any gain or loss on the transfer of Class III assets to James.
- **Class IV assets** consist of inventory, for which sale at a gain is conceivable in most businesses. Service businesses in many industries typically do not have inventory, however. In this example, TCM has no Class IV gain or loss.
- **Class V assets** include assets not included in other classes. Because this class includes depreciable assets, gain or loss calculations for these assets are more complex because the calculations must consider depreciation recapture. TCM incurs gains or losses, as shown in the following table.

	Table		Computers		Scanner	
Amount realized		$200		$ 600		$ 250
Original cost	$550		$2,500		$1,035	
Less: depreciation allowed	(550)		(1,500)		(1,035)	
Adjusted basis	$ 0	(0)	$1,000	(1,000)	$ 0	(0)
Gain/(Loss)		$200		($ 400)		$ 250

Caution. If the business owned the real estate in which it operated, computing the gain or loss on the building would be more complicated. For example, if the practice purchased its building and land when it first opened in 1980 and depreciated the building under the Accelerated Cost Recovery System (ACRS),[81] it would likely be fully depreciated by the time of the sale. Recapture of depreciation would be treated under §1245 instead of §1250.

Capital Assets.[82] Any capital gain recognized on the sale of a capital asset held for more than one year is treated as a long-term capital gain rather than ordinary income. Capital losses incurred by 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. Examples include marketable securities and land held for investment.

81. IRC §168.

82. IRC §1221.

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IMPLEMENTING AN EQUITY SALE[83]

A seller may also sell a service business by transferring to the buyer their equity interest. To accomplish this, the seller conveys to the buyer their corporate shares, partnership units, LLC membership units, or other incidents of ownership. By accepting equity, the selling business owner conveys to the new owner all the aspects of ownership, including responsibility for the firm's liabilities, such as leases, contracts, and debt obligations, including any installment sale obligations.

> **Note.** For a comparison of the tax consequences of equity (stock) sales with asset sales, see **Example 1** and **Example 2,** discussed previously.

S Corporation

An owner may sell the business organized as an S corporation for its assets or sell equity in the firm itself. However, if the S corporation was previously a C corporation and filed an election to be an S corporation within the past five years, the S corporation may have built-in gains (BIG) tax to pay when it sells its assets.[84] The 5-year period starts with the first day of an S corporation election. Because assets sold within five years after the election are subject to the BIG tax, selling an S corporation service business within five years of conversion may result in those assets being taxed as though a C corporation still owned them.[85]

> **Note.** For more information about the BIG tax, see the 2016 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 4: S Corporation Entity Issues. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

IRC §338 elections serve to benefit **corporate** buyers and sellers who want to treat an equity sale as an asset sale for federal tax purposes.

IRC §338(g) Election. The §338(g) election treats the deemed sale and repurchase transactions as if they both occurred **immediately after the stock transfer.** If the election under §338(g) is made, the buyer reports the gain associated with the increased value of the assets. Because this places the burden of claiming the gain from the asset sales on the buyer of firm's stock, this method is rarely used.[86] If the election under §338(g) is made, the buyer reports the gain associated with the increased value of the assets. This election can be done by the buyer of the business without the consent of the seller.

IRC §338(h)(10) Election. The more common election is the one made under §338(h)(10). This election shares the responsibility with the business seller by treating the deemed **sale** of the acquired business's assets as taking place immediately **before the stock transfer.** If it is taxed as an S corporation, the selling shareholder recognizes any gain on the sale of the assets. The deemed **purchase of assets** is treated as occurring immediately **after the stock transfer.** This election requires the consent of both the seller and the purchaser of the business's stock.

> **Note.** For more information about the election to treat a stock sale as an asset exchange, see the 2016 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 4: S Corporation Entity Issues. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

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83. *Equity Interest: Everything You Need To Know.* 2022. UpCounsel Technologies, Inc. [www.upcounsel.com/equity-interest] Accessed on Mar. 7, 2022.

84. IRC §1374(d)(7).

85. IRC §1374(b)(1).

86. Robert W. Jamison, *S Corporation Taxation,* ¶1707.01, p. 1422 (CCH, 2017).

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Caution. Both §338 elections involve complex requirements. The service business owner and their tax practitioner should undertake it with the knowledge and advice of competent legal counsel, as the elections warrant specific provisions in sales agreements.

C Corporation

Before the Tax Cuts and Jobs Act (TCJA), personal service corporations faced a 35% flat tax rate.[87] Because the TCJA reduced this to 21%,[88] some service businesses switched to this form of organization.[89] Equity buyers of businesses organized as C corporations cannot increase the value of assets they acquire unless the buyer makes an election under §338.

If the business is legally organized as a corporation or an association, the acquiring owner becomes owner through the acquisition of common stock. If it is organized as an LLC, the acquiring owner becomes owner through the acquisition of membership units. An attorney's involvement may be needed to guide the selling business owner and the acquiring business owner through the process of admitting the new owner to membership in the LLC.[90] The new equity acquired is common stock,[91] even though the relevant regulations term the entity an "association."[92]

Partnership

The tax treatment of the sale of a single partner's interest may differ significantly from the sale of all partners' interests.[93] A difference between the inside and outside basis of an individual partner's interest further complicates tax accounting for the sale of a partnership interest.[94] Sale of an individual partner's interest is generally governed by IRC §§741 and 751(a). A liquidation takes place when all partners' interests end.[95] Thus, the selling partner of a service business that is treated as a partnership for tax purposes should expect the following when their interest is sold, assuming the entire business changes hands.

- Generally, the individual partner of the selling service business has capital gain or loss. The holding period reflects the partner's period of ownership, not the partnership's.
- To the extent that the selling business has ordinary income, such as might result from the sale of inventory or accounts receivable (also known as "hot assets"), the partner must recognize ordinary income.[96]
- The complete transfer of the partnership does not constitute a technical termination of the partnership, as it would have before TCJA.[97]

Note. For more information about partnerships, see the 2017 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 5: Partnership Issues. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

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87. IRC §11(b)(2).

88. *Another look at C corp. vs. S corp. in light of tax reform.* Kolk, J. Michael. Aug. 1, 2018. The Tax Adviser. [www.thetaxadviser.com/issues/2018/aug/c-corp-s-corp-tax-reform.html] Accessed on Mar. 7, 2022.

89. IRC §269A(b).

90. *Rights and responsibilities of LLC members*. Sep. 18, 2018. Wolters Kluwer. [www.wolterskluwer.com/en/expert-insights/rights-and-responsibilities-of-llc-members] Accessed on Jun. 29, 2022.

91. Treas. Reg. §§301.7701-3(g)(1)(i) and (iv). Under the terms of this regulation, an LLC starts off as either a partnership, if it has more than one member, or a sole proprietorship if has a single member. It may also convert to an association, which is normally interpreted as a corporation.

92. Treas. Reg. §§301.7701-3(a), (g)(1)(i) and (g)(1)(iv).

93. *Tax Treatment of Liquidations of Partnership Interests*. Smith, Eric. Feb. 2021. The CPA Journal. [www.cpajournal.com/2021/02/09/tax-treatment-of-liquidations-of-partnership-interests] Accessed on Apr. 28, 2022.

94. IRC §§734, 743, and 754, as well as supporting regulations.

95. IRC §§731-735, and 751(b), as well as supporting regulations.

96. IRC §751.

97. *Tax Cuts and Jobs Act*, PL 115-97, §13504(a).

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Organized as a Partnership.[98] If the selling business owner organized the business as a partnership or a multi-member LLC (MMLLC) taxed as a partnership, the purchaser acquires a partnership interest instead of common stock. This treatment assumes at least one other owner. If the original owner organized the conveyed entity as an LLC, the acquiring owner usually treats it as a sole proprietorship after acquisition, assuming no other owners become involved. The new owner is the sole member of a disregarded entity.

AFTER THE SALE

Informing Clients[99]

With rare exceptions, clients should be notified of the transfer of ownership **after** the sale of the business. An informed customer may decide to find an alternative provider upon learning that a service business is for sale. This is especially true of professional practices, such as tax practices. Consequently, the campaign to inform clients should be planned several weeks **before** closing. For example, the business seller should check the accuracy of clients' email addresses and postal addresses to ensure they can communicate relevant information regarding the sale to their clients.

After the sale, it is important to advise clients quickly that ownership of the service business has changed. This message should come from either the seller or buyer of the business rather than another customer. The parties to the business sale may wish to accomplish this in two steps.

- The first step is an email message sent to each customer. If a unique email address is available for each spouse, the message should be sent to both.
- The second step involves sending letters by the U.S. Postal Service. Although printing and mailing a letter is an expensive and time-consuming process, it reaches many clients who do not regularly check their email messages or receive so many that they miss the message about the sale of the business.

Forms to File

Bulk Sales Laws.[100] Bulk sales laws exist in many states to protect creditors of the selling business. If the bulk of a business's assets is conveyed without appropriate consideration, the business's creditors might not be able to collect debts owed to them. Generally, forms associated with bulk sales laws would be prepared by a seller's attorney.

> **Note.** For example, the Illinois Department of Revenue requires either sellers or buyers of businesses in Illinois to file Form CBS-1, *Notice of Sale, Purchase, or Transfer of Business Assets*.[101] This form specifically deals with sales and use taxes as well as income taxes. In so doing, it protects the interests of the State of Illinois. This form must be filed no later than **10 business days before** the sale.

Change of Responsible Person.[102] If the buyer acquires the business through an equity purchase, they file Form 8822-B, *Change of Address or Responsible Party — Business*. This form advises the IRS of the business's new address and the name, address, and social security number of the business's new responsible party. The responsible party is most likely the buyer.

If the buyer acquires the business's assets but not its equity, the seller may be required to change the business's legal address. In this event, the seller files Form 8822-B to notify the IRS of any new address for the legal entity, even if there is no change in the responsible party.

98. IRC §751.

99. *What To Expect When Selling Your Tax Practice Or CPA Firm.* Lazuric, Christina. BizBen.com [www.bizben.com/blog/posts/what-to-expect-when-selling-your-tax-practice-or-cpa-firm-77823.php] Accessed on Mar. 7, 2022.

100. *What is a Bulk Sales Law and How Does It Apply to a Closing Business?* [allbusiness.com/what-is-a-bulk-sales-law-and-how-does-it-apply-to-a-closing-business-2975952-1.html] Accessed on Jan. 11, 2022.

101. 35 ILCS 5/902(d); 820 ILCS 405/2600; 86 IDOR Reg. §130.1701.

102. See Form 8822-B.

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Change of Business Name

Secretary of State. If a buyer acquires the assets of a service business, it is not unusual for them to require a change in the business's name as one of the intangible assets of the business. The buyer claims the name of the selling business to ensure ownership of the acquired business's branding and ensure that any client inquiries are directed to the new ownership. To accomplish this, the selling business owner must release rights to the business's name and change the name of the corporation. This is typically done with the secretary of state for the state in which the business is organized.

IRS. The simplest way of changing a business's name on the IRS records is to file an income tax return with the new name and indicate a name change using the checkbox for the appropriate form, as indicated.

- Form 1120-S, *U.S. Income Tax Return for an S Corporation*, item H, box 2.
- Form 1065, *U.S. Return of Partnership Income*, item G, box 3.
- Form 1120, *U.S. Corporation Income Tax Return*, item E, box 3.

Changing Bank Records and Merchant Services

The seller's business bank needs to know about the transaction, particularly if it has extended loans to the business. The sale of a business can be an event that precipitates the immediate maturity of any loan, depending on the loan covenants.

If pursuant to an asset sale the buyer requires the seller to change the name of the continuing entity, the seller's bank must be informed. The required documentation for the name change on the bank's records likely includes any copies of revised articles of incorporation from the state's secretary of state.

Credit card processing, accounts receivables, and accounts payables can cause ongoing accounting and financial disagreements between buyers and sellers. Not only should these issues be addressed in the sales documents, but there should also be a date established in the sales documents for a final accounting of these issues, between six months and one year after the sale date.

Period for Earnout[103]

As discussed earlier, earnouts may motivate sellers to work alongside the buyer to ensure the business's future success. If the business grows and produces greater sales, the seller may reap a greater price.

Both seller and buyer must cooperate to ensure that this method of financing works. The business seller often wishes to cut ties as soon as possible. In other circumstances, the business's cash flow may not permit the refinancing of seller debt until several years have passed since the sale.

> **Caution.** A seller of a service business who continues to work in the new practice should consider purchasing errors and omissions insurance. They should consider this cost, and any other associated fixed costs, into the amount of consideration paid at closing, even if that amount is a small portion of the purchase price. Some portion of this consideration is usually earmarked for insurance premiums. If the seller becomes an employee of the buyer, this factor diminishes in importance.

103. *Benefits and Drawbacks of an Earn-out in a Business Sale.* Murray, Jean. Jan. 19, 2019. Thebalancesmallbusiness. [www.thebalancesmb.com/what-is-an-earn-out-in-a-business-sale-398241] Accessed on Apr. 28, 2022.

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Nonperformance and Repossession

A business buyer who does not perform on the debt owed to the seller that finances the purchase of a business may lose the business to repossession by the seller.

A bank reacting to a loan default typically has collateral it can seize. A bank likely employs specialists, including lawyers, with training to accomplish this with minimal effort. When a default on a loan prompts the business seller to repossess the business, however, there are likely no assets they can readily seize, and it is unlikely that a repossession team is readily available to assist. Therefore, a service business seller, likely with no experience in repossessions, could be forced to repossess the business that was sold.

For this reason, the business seller must have confidence in the character of the business buyer. Creditworthiness may not be an issue because the business seller knows the cash-generating potential of the business. However, the character of a debtor is always an important factor in making credit decisions and the funds that the business buyer owes to the business seller warrant investigation of the buyer's credit history.

> **Note**. For more information on repossessions and foreclosures in general, see the 2017 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 1: Installment Sales. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

Changing Vendors and Subscriptions

The selling business owner may need to terminate subscriptions no longer needed once the business sale closing has taken place. These services may range from annual software subscriptions to postage meters, each requiring time and effort to cancel. A buyer of a service business should expect to devote a significant amount of time to analyzing and potentially changing a variety of vendors and subscriptions after taking control of the business. The seller should consider canceling their subscriptions to any systems or software that the buyer is taking over after the sale.

Customer Relationship Management (CRM) System. The business's CRM system could be a well-known CRM system or a desk drawer full of unsorted business cards. If the seller has used a CRM system, discussions with the buyer should address the buyer's willingness to acquire the data and possibly license the software.

Information Technology (IT) Services. The seller may use a different IT services firm than the buyer does, assuming the buyer already has an established practice. It is more likely that a buyer without an existing practice may elect to use the same IT services firm. Retaining the same firm provides a level of consistency that benefits all parties, but this is difficult to arrange.

OPTION TO WALK AWAY[104]

Given the personal, business, technical, and other challenges raised during the sale of a practice, it is not surprising that many sellers who contemplate leaving their practice choose just to walk away from it. However, there are circumstances in which a business must be properly dissolved. One is the death of a principal operator. Unless there is a clearly established succession plan with a licensed operator, the deceased owner's heirs have few alternatives. In other cases, an operator of a business may lose their license, leaving the owner with few alternatives other than dissolving the business.

104. *Close or sell your business.* SBA. [www.sba.gov/business-guide/manage-your-business/close-or-sell-your-business] Accessed on Apr. 28, 2022.

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SPECIAL CONSIDERATIONS FOR THE SALE OF A TAX PRACTICE

In many regards, a tax practice is like any service business in that what the business produces is not a tangible product. However, there are some unique considerations for owners of a tax practice to consider when selling their business.

Notifying Various Agencies

IRS e-Services.[105] The tax practice's seller and its buyer should review IRS Pub. 3112, *IRS E-File Application and Participation.* This publication contains essential restrictions governing the use of any tax practice's electronic filing identification number (EFIN). Most importantly, the selling business's EFIN cannot be conveyed to the new owner, even if the business sale conveys the equity of the tax practice.

If the equity of the tax practice is sold, the IRS requires the buyer to advise it of the change of ownership. They must send proof of acquisition to the following address.

Internal Revenue Service
Electronic Products & Services Support
310 Lowell Street, Stop 983
Andover, MA 01810

Note. IRS Pub. 3112 does not specify what form of proof is acceptable. Presumably, an executed stock sale agreement or partnership equity sales agreement is acceptable.

This application must be sent to the IRS no more than 30 days after the sale. If the seller sends it before the sale is closed, it can be sent no more than 45 days before the sale. This process is also followed if the tax practice is conveyed by gift or any other method of transfer.

It is not uncommon for a business sales agreement to require the seller of a tax practice to change the business's name, even if just the assets of the practice are being conveyed. In this case, the seller of the tax practice must advise IRS e-Services of the name change. However, the name update cannot be accomplished until the selling tax practice files a tax return, as the company name in the IRS's integrated data retrieval system (IDRS) must be updated.[106] IDRS can only be updated when a tax return is filed, therefore, the selling tax practice must first file a tax return before the name can be changed on an updated e-file application. Because the business return with the new business name must be processed, it may be a month or two after filing the business income tax return before the business's name can be changed through e-Services.

Note. If the selling business owner is an enrolled agent and the sale of the tax practice involves a change of address, this individual should notify the IRS within 30 days. This correspondence can be faxed to 855-889-7959 or mailed to the following address.[107]

Internal Revenue Service
Enrolled Agent Policy & Management
PO Box 33968
Detroit, MI 48232

The selling practitioner should update their information in the preparer tax identification number (PTIN) directory if they plan to continue working. Alternatively, they should deactivate their PTIN.

105. IRS Pub. 3112, *IRS E-File Application and Participation*.

106. IRM 3.42.10.12.4 (2020).

107. *Maintain Your Enrolled Agent Status*. Oct. 15, 2021. IRS. [irs.gov/tax-professionals/enrolled-agents/maintain-your-enrolled-agent-status] Accessed on Jan. 11, 2022.

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IRS External Services Authorization Management.[108] The seller should notify the IRS within 30 days of any changes to their IRS e-file application.

The EFIN of the selling tax practice is **not** transferrable to the purchaser. The change of a corporation's name or address does not require an application for a new EFIN. However, the granting by the state's secretary of state of a new charter requires an application for a new employer identification number (EIN), which in turn triggers the need to cancel the old EFIN and apply for a new one.[109]

Changing the name on the income tax form (described earlier) does not update the tax practice's name in the EFIN application record. In the event that the selling business owner does not want to close the office in the External Services Authorization Management page of the IRS's website, they should contact the e-services help desk at 866-255-0654.

Professional Boards. Enrolled agents should advise the Office of Practitioner Enrollment within 30 days when their address changes. Letters should be sent to the address noted earlier. CPAs should notify their state licensing boards of changes to their address upon sale of their tax practices.

Record Retention

Tax preparers are considered financial firms under the **Gramm-Leach-Bliley Act** (GLBA) because they deal with financial information. Although not explicitly mentioned in the language of GLBA, they are included by reason of federal regulations.[110] The IRS requires that the return preparer who signs the return maintain for a 3-year period at minimum a list of returns prepared and filed or a completed copy of the return of a claim for refund.[111] Therefore, the preparer is responsible for maintaining records after they sell their business if they are still within the 3-year period.

Tail Liability Protection[112]

Presumably, the seller has maintained errors and omissions insurance during the time they operated their business. This insurance is typically offered on a claims-made basis, meaning that coverage is provided when the insurer is notified of a possible loss, regardless of when the underlying occurrence happened.

When the business seller exits their practice, it is unlikely they continue activities that result in new errors or omissions. But it is very likely that any errors or omissions made during the last few years of active operation of the tax practice only come to light after the business sale. It may take the IRS a few years to identify and address any problems for which the preparer may be liable.

For this reason, errors and omissions insurance companies offer special policies that cover professionals after they leave their practices. Because these policies cover claims made after retirement for actions that previously took place, they are often said to provide "tail liability" coverage.

Best Practices for Transitioning to the New Practice[113]

Tax practice sellers may have difficulty anticipating all the changes once they close the sale of their business. For virtually all tax practitioners, the sale of a practice is a rare event, possibly one that happens once in a lifetime. The seller and the buyer must work together to make a transition successful.

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108. IRS Pub. 3112, *IRS E-File Application and Participation*.

109. *Do You Need a New EIN?* Mar. 16, 2022. IRS. [www.irs.gov/businesses/small-businesses-self-employed/do-you-need-a-new-ein] Accessed on Aug. 25, 2022.

110. 12 CFR §225.28(b)(6)(vi).

111. IRC §6107(b).

112. *How "Tail Coverage" Can Protect a Retiring Firm Partner*. Thompson, William & Fontaine, R. Peter. Oct. 2, 2019. CPA Practice Advisor. [www.cpapracticeadvisor.com/firm-management/article/21108627/how-tail-coverage-can-protect-a-retiring-firm-partner] Accessed on Mar. 9, 2022.

113. *Your Company Has Been Sold: Here's What to Expect.* Schmitt, Jeff. May 7, 2013. Forbes. [www.forbes.com/sites/jeffschmitt/2013/05/07/your-company-has-been-sold-heres-what-to-expect] Accessed on Mar. 28, 2022.

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Before the sale closes, the selling tax practitioner should plan their responses to current clients. Asking to prepare their tax returns outside of the new owner's control could violate the terms and conditions of the sale and may also conflict with any noncompete agreement. Sellers understandably have built a history with clients, and clients who understand this may not be bashful in requesting the seller's continued involvement with their tax compliance needs. Planning a response in advance and discussing it with the business's buyer builds trust that can work to resolve other issues that may arise after the sale.

The following topics are issues that the buyer and/or seller may encounter following the sale of the practice.

Paid Preparer Default in Tax Software. If the buyer of the tax practice uses the same tax preparation software as the seller, it is possible that the seller's name could continue to appear as the paid preparer or the electronic return originator (ERO). The seller should ensure that their identification information is removed to accurately reflect the new preparer or ERO.

Accounting Software. Especially for business or fiduciary income tax returns, the seller may license accounting software to prepare reports for clients. Early discussions with the buyer should address their desire to license the same software.

Powers of Attorney and Tax Information Authorizations. Possession of a power of attorney or tax information authorizations has always been important to tax practices, as they enable licensed tax practitioners to obtain information directly from the IRS. Unfortunately, the documents do not automatically pass to the tax practice's buyer.[114]

LLC MEMBER DISSOLVING S CORPORATION TO SOLE PROPRIETORSHIP

An entity must be a corporation for federal income tax purposes if it was chartered in a U.S. jurisdiction as a corporation.[115] If it qualifies for and elects to be an S corporation, it is treated as a pass-through entity for many aspects of the tax law.[116] Any other corporation is termed a C corporation.[117] Thus, C corporation is the default status for any entity classified as a corporation for tax purposes. Moreover, if an S corporation runs afoul of any of the eligibility rules, it becomes a C corporation.

A single-member limited liability company (SMLLC) can easily elect S corporation status by "checking the box."[118] However, reverting to a sole proprietorship is a much more complicated process. This discussion reviews rules that an LLC taxed as an S corporation must follow if it chooses to remain in business as an LLC but wishes to revoke a subchapter-S election.

Note. There are various reasons that an SMLLC may choose to revoke its S corporation election. Some of these reasons include seeking the simplicity of operation and bookkeeping. If the owner is the only employee, and would like to stop filing Forms 941, *Employer's Quarterly Federal Tax Return,* compliance with federal and state withholding and payroll tax rules, and being worried about previous issues of reasonable compensation may contribute to wanting to dissolve an S corporation. Some may find that corporate rules are challenging to follow. There are also annual state renewal fees, although these are typically minimal, and the costs of additional tax returns, etc. This is not an exhaustive list of reasons, but some examples that may motivate an individual to unwind an S corporation election.

114. Treas. Reg. §310.6103(c)-1 restricts disclosure of IRS information to "such person or persons as the taxpayer may designate."

115. IRC §§7701(a)(3) and 11(a); Treas. Reg. §1.6012-2(a)(2).

116. IRC §§1361(a)(1) and 1366(a)(1).

117. IRC §1361(a)(2).

118. IRC §7701.

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> **Caution.** Dissolving a corporation or LLC subjects the owner to personal liability for all claims against the business, past, present, and future. Consequently, it is a good practice to keep the corporate charter in effect until the business has discontinued and statutes of limitations have closed all potential claims against the company.

This material discusses options for achieving these objectives. Unfortunately, unless the business no longer has any assets or operations, there are costs. Some of these may be prohibitive. In that case, there may be no viable choice except to continue with the chosen form and engage the professional help that can ameliorate the compliance problems.

Understanding the procedures for revoking the S corporation election requires some knowledge of the election to be treated as an association (corporation) for federal income tax purposes.[119]

The tax issues arising from the conversion of an LLC back to a sole proprietorship are shown in the following table.

Entity Type	Sole Proprietorship Tax Issues
SMLLC	
SMLLC (default disregarded)	None
C corporation-LLC	Treated as corporate dissolution and assets treated as a sale at FMV
S corporation-LLC	Treated as corporate dissolution and assets treated as a sale at FMV
MMLLC	
Partnership	Partnership dissolution rules
C corporation-LLC	Treated as corporate dissolution and distributed assets treated as sold at FMV
S corporation-LLC	Treated as corporate dissolution and distributed assets treated as sold at FMV

S CORPORATION ELECTION

No unincorporated entity has default status as an S corporation under tax law. Therefore, the entity and the owner must have undertaken some actions to attain that status. First, there must be an actual entity. Then the entity must file Form 2553, *Election by a Small Business Corporation,* to choose S corporation status.

Use the following fact pattern for examples 7 through 13.

> Wilton Palminter has operated a successful old west memorabilia shop called Wild Eagle Enterprises for more than 20 years. In 2005, he was advised by an attorney to convert his sole proprietorship to an LLC for liability protection, and he was further advised to elect subchapter S corporation treatment for tax purposes. The entity's name is Wild Eagle Enterprises, LLC. The decision to change his entity choice has been a nightmare. Twice he has been audited by the IRS over issues of reasonable compensation for himself. His bookkeeping and tax preparation fees are more than three times what he paid when he was a sole proprietor. When he needs additional borrowing, bankers require personal guarantees before they lend the company money, although he always needs to borrow on a recourse basis. Ultimately, Wilton feels he has lost control over the financial aspects of his business and longs for a simpler life. In early 2022, Wilton meets with a tax professional, Morgan O'Rourke, to discuss revoking the S corporation election and returning to operating his business as a sole proprietorship.

119. All states recognize the federal association election and treat the entity as a corporation for income tax purposes. However, this tax election has no effect on the nontax status of the entity under state law.

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Example 7. Wilton needed to charter Wild Eagle Enterprises as an LLC under state law. Then he could cause the LLC to elect S corporation status. He could not have made the election for a mere business name.[120] After establishing the entity, Wilton filed Form 2553.

Qualifications for S Corporation Status

In addition to filing the election, the entity must be eligible to be treated as an S corporation. The following table shows the requirements that an unincorporated entity must meet to become a valid S corporation.

Eligibility of an Unincorporated Entity to Be an S Corporation

Code Section	Rule for Corporation	Adaptation to Unincorporated Entity
IRC §1361(b)(1)(A)	No more than 100 shareholders [a]	No more than 100 owners (members or partners) [a]
IRC §1361(b)(1)(B)	No shareholder other than an individual, an estate, a trust described in subsection (c)(2) [b], or an organization described in subsection (c)(6) [c] Includes ESOPs	No owner other than an individual, an estate, a trust described in subsection (c)(2) [b], or an organization described in subsection (c)(6) [c] ESOPs cannot own interests in unincorporated entities
IRC §1361(b)(1)(C)	No nonresident alien shareholder	No nonresident alien owner
IRC §1361(b)(1)(D)	One class of stock	Ownership interests must have equal priority in current and liquidating distributions A partnership or operating agreement may not base liquidating distributions on capital account balances

[a] Exception for family attribution

[b] The trust rules can become extraordinarily complex. Attorneys drafting these instruments may need to specify that the trust can own equity interests in unincorporated entities treated as S corporations.

[c] Qualified IRC §501(c) nonprofits and IRC §401 pension trusts. Individual retirement arrangements do not qualify. Tax practitioners should be aware of prohibited transactions.

Example 8. If Wild Eagle Enterprises had not met any of the conditions in the preceding chart, the compliance problems would have been magnified. The IRS could have asserted that Wild Eagle was a C corporation and assessed corporate income tax on any income in open years. If there had been any losses in those years, the IRS could have disallowed any deduction claimed by Wilton. Moreover, any cash or property he removed from the company could be subject to double taxation as dividends.

120. Treas. Reg. §301.7701-3 specifically applies only to a business entity. A Schedule C, *Profit and Loss From Business,* proprietorship does not meet this criterion.

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Filing the Election

Although an entity with a corporate charter must be treated as a C corporation or an S corporation, an unincorporated entity has more flexibility. If it is organized as an LLC in a U.S. state or other jurisdiction, it may elect to be treated as a corporation for tax purposes.[121] The "check the box" election has been available for over 25 years. It allows any LLC to elect to become an "association." Once it makes that election, it is treated as a corporation for U.S. tax purposes.[122] Procedurally, the election is straightforward. The requirements are the following.

1. There must be an unincorporated entity, which might be a partnership, a limited partnership, or an LLC.[123]
2. The entity must have a charter from a U.S. state, possession, or the District of Columbia.[124] (The default status of a foreign entity is a corporation. Some of these entities may elect pass-through status. This material does not address these entities.)
3. The entity files the appropriate election with the IRS.
   a. If it intends to be treated as a C corporation, it files Form 8832, *Entity Classification Election.*[125]
   b. If it intends to be treated as an S corporation, it files Form 2553. To be treated as an S corporation, it must meet the ownership and class of stock interests that govern S corporation eligibility (see previous table).
4. Each owner, shareholder, or member must consent to the election.[126]

For C corporation status, the entity must file Form 8832 within 75 days of the first date that the classification is to take effect.[127] However, the entity may file a late election and request relief under Treas. Reg. §301.9100-3. For S corporation status, the entity must file Form 2553 within two months and 15 days of the first date that the classification is to take effect.[128] In this case, the entity must file for late election relief using procedures specified in Rev. Proc. 2013-30.[129]

The IRS normally grants the relief if the entity and its owners have filed returns consistent with the status being sought and request relief within three years and 75 days of the intended effective date.[130] For a request that does not meet these conditions, the entity must request a private letter ruling.

Observation. The simplicity of this election hides the complicated assumptions that lie beneath the surface. Once an unincorporated entity elects to be treated as a corporation, it becomes subject to all the tax rules pertaining to corporations.

121. Treas. Reg. §301.7701-3(c)(1)(v)(C).
122. Treas. Reg. §301.7701-3(a).
123. Ibid.
124. Treas. Reg. §301.7701-3(b)(1).
125. Treas. Reg. §301.7701-3.
126. Treas. Reg. §301.7701-3(c)(2) for Form 8832; Treas. Reg. §1.1362-6(b) for Form 2553.
127. Treas. Reg. §301.7701-3(c)(1)(iii).
128. IRC §1362(b)(1)(B).
129. Rev. Proc. 2013-30, 2013-36 IRB 173.
130. Rev. Proc. 2009-41, 2009-39 IRB 439; Rev. Proc. 2013-30, 2013-36 IRB 173.

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Entity Becomes Corporation for All Income Tax Purposes

An entity cannot pick and choose which of the corporate attributes (other than the option of electing S status) apply to its current and future transactions. The following table[131] highlights the tax treatment of stages in a corporation's existence.

Stages of a Corporation's Existence

Stage	Actions	Statutory Authority
Formation (tax-deferred or partially taxable)	• Owners transfer property in exchange for stock.	IRC §351
	• The corporation assumes liabilities of owners.	IRC §357
	• Often there are no immediate tax liabilities. However, owners may recognize gain, but never loss.	IRC §351(b)
	• Owners transfer asset basis, less liabilities, plus any gain, to stock basis.	IRC §358
	• Owner's basis in transferred assets (plus any gain recognized) becomes the corporation's basis in each asset.	IRC §362
	• Corporation recognizes no gain or loss.	IRC §361
	• Shareholders who transfer property must own at least 80% of the stock after the transfer.	IRC §368(c)
Operation (as C corporation)	• Corporation computes income and pays tax.	IRC §63(a), IRC §11
	• Corporation carries losses forward to use against future income.	IRC §172
	• Distributions are taxable to shareholders as dividends.	IRC §61(a)(7)
Operation (as S corporation)	• Corporation computes taxable income or loss.	IRC §1363
	• Corporation separately states items that affect individuals' potential tax calculations.	IRC §1363
	• Shareholders include corporate income, loss, etc. on their tax returns.	IRC §1366
	• Shareholders adjust basis for income and losses.	IRC §1367
	• Distributions to shareholders are tax free and reduce basis (some exceptions apply).	IRC §1368
	• Loss deductions are limited to shareholder basis in stock and debt (other limits may also apply).	IRC §1366
Liquidation [a]	• Corporation recognizes gains and losses on distribution of property in **complete liquidation.**	IRC §336
	• Shareholders recognize gain or loss on receipt of property in exchange for stock.	IRC §331

[a] Exception for liquidation of a subsidiary corporation into a parent corporation that owns at least 80% of the stock.

Note. For more information on establishing an S corporation from a sole proprietorship, see the 2021 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 5: Transferring a Sole Proprietorship to an LLC.

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ELECTION TO REVERT TO DEFAULT STATUS

When an individual has elected to treat an SMLLC as an S corporation, they may decide eventually that the benefits of operating as an S corporation are no longer worth the headaches. One such headache is the need to file Form 1120-S, especially now that the filing requirements include Schedules K-2, *Shareholder's Pro Rata Share Items — International* and K-3, *Shareholder's Share of Income, Deductions, Credits, etc. — International*.

Three ways in which the taxpayer may cease being treated as an S corporation include the following.

1. The owner may revoke the company's entity classification with the IRS.
2. The owner admits an ineligible shareholder.
3. The owner may dissolve the company.

To revoke the entity's classification, the owner files Form 8832 with the IRS, checking a box on page 2 to indicate that the entity is seeking classification as a disregarded entity. However, the entity must be eligible to make this election, even though it is the default status for unincorporated entities.[132]

- If the LLC has been treated as an S corporation since its inception, it may file for reversion to default status at any time.
- If the entity was a disregarded entity and then elected to be an association taxable as a corporation, it must wait until at least 60 months have elapsed since its election to be an association took effect.

For tax purposes, Option 3 is a liquidation of the corporation.[133] This necessitates filing final federal, state, and local tax returns. For this reason, many revocations of the association election take effect on the first day of a tax year. Therefore, the business does not need to file any income tax returns for the entity for the year of the reversion to disregarded entity status.

If there are employees other than the owner, the entity must continue to comply with all federal and state payroll taxes, withholding, and filing reports. However, if the owner is the only employee, their status as an employee ceases when the entity reverts to disregarded entity status.

After the election to revert to disregarded entity status, the entity no longer files any separate federal income tax returns. Instead, income is reported on the owner's Schedule C, *Profit or Loss From Business,* Schedule E, *Supplemental Income or Loss,* or Schedule F, *Profit or Loss From Farming*.[134] Thus, revoking the entity classification election accomplishes the majority of the goals of simplification but preserves the owner's protection from claims against the business. Retaining the entity may be preferable to dissolving it entirely in many circumstances.

> **Note.** The EIN of the LLC remains the same.[135]

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132. Treas. Reg. §301.7701-3(c) and IRC §1362.
133. IRS Pub. 3402, *Taxation of Limited Liability Companies.*
134. Ibid.
135. IRS Pub. 1635, *Understanding Your EIN.*

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Election Out Classification

To revert to its default classification is not as easy as checking the box. The entity files another Form 8832 electing to be treated as a disregarded entity (if it has one owner) or a partnership (if it has more than one owner). The procedures are similar to those for filing the initial election. However, if the business has been operating as an S corporation, it filed Form 2553 when it elected S corporation status. It files Form 8832 to elect default status as a disregarded entity.[136]

Minimum 60-Month Waiting Period

As mentioned previously, if an entity operated under its default status and then changed its classification, it cannot change its classification again until the election has been in effect for 60 months.[137]

> **Example 9.** If Wild Eagle Enterprises had elected to be an association beginning on its first day of existence, it could revert to its default status as a disregarded entity at any time. If the company had operated as a disregarded entity and later elected to be treated as an S corporation, it would need to wait until 60 months of association status had elapsed before it could elect to be a disregarded entity.

Costs of Converting to Unincorporated Entity for Tax Purposes Only

It is best to first read the superficial description of the election, and then discern its underlying meaning. The regulations contain the following language.[138]

> ***Association to partnership:*** *If an eligible entity classified as an association elects under paragraph (c)(1)(i) of this section to be classified as a partnership, the following is deemed to occur: The association distributes all of its assets and liabilities to its shareholders in liquidation of the association, and immediately thereafter, the shareholders contribute all of the distributed assets and liabilities to a newly formed partnership.*
>
> ***Association to disregarded entity:*** *If an eligible entity classified as an association elects under paragraph (c)(1)(i) of this section to be disregarded as an entity separate from its owner, the following is deemed to occur: The association distributes all of its assets and liabilities to its single owner in liquidation of the association.*

Each one of these rules contain the phrase "liquidation of the association." Although several complications affect the liquidations of corporations, there are two essential rules.

1. The corporation recognizes gain or loss on each asset distributed as if it was disposed of using FMV to its shareholders in the liquidating distribution.[139]
2. The shareholders recognize gain or loss on the receipt of property from the corporation in exchange for their shares.[140]

> **Example 10.** To address Wilton's dissatisfaction with his entity arrangement, Morgan O'Rourke has him file Form 8832 (shown following) to elect disregarded entity status. At that time, Wild Eagle Enterprises, LLC has \$450,000 in accounts receivable and equipment valued at \$4 million. Due to rapid depreciation deductions, the equipment has an adjusted basis of \$1 million. The LLC has used the cash method, so the accounts receivable has zero basis. Moreover, the employees of the business have developed customer relationships that have created enterprise goodwill of \$1 million.

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136. See instructions for Forms 8832 and 2553.
137. Treas. Reg. §301.7701-3(c) and IRC §1362.
138. Treas. Reg. §301.7701-3(g)(1).
139. IRC §336.
140. IRC §331.

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For Example 10

Form **8832**
(Rev. December 2013)
Department of the Treasury
Internal Revenue Service

Entity Classification Election

▶ Information about Form 8832 and its instructions is at *www.irs.gov/form8832*.

OMB No. 1545-1516

Type or Print	
Name of eligible entity making election: **Wild Eagle Enterprises, LLC**	Employer identification number: **99-9999903**
Number, street, and room or suite no. If a P.O. box, see instructions.: **123 Aquila Rd**	
City or town, state, and ZIP code. If a foreign address, enter city, province or state, postal code and country. Follow the country's practice for entering the postal code.: **Eyrie, IL 61250**	

▶ Check if: ☐ Address change ☐ Late classification relief sought under Revenue Procedure 2009-41
☐ Relief for a late change of entity classification election sought under Revenue Procedure 2010-32

Part I Election Information

1 **Type of election** (see instructions):

a ☐ Initial classification by a newly-formed entity. Skip lines 2a and 2b and go to line 3.
b ☒ Change in current classification. Go to line 2a.

2a Has the eligible entity previously filed an entity election that had an effective date within the last 60 months?

☒ **Yes.** Go to line 2b.
☐ **No.** Skip line 2b and go to line 3.

2b Was the eligible entity's prior election an initial classification election by a newly formed entity that was effective on the date of formation?

☒ **Yes.** Go to line 3.
☐ **No.** Stop here. You generally are not currently eligible to make the election (see instructions).

3 Does the eligible entity have more than one owner?

☐ **Yes.** You can elect to be classified as a partnership or an association taxable as a corporation. Skip line 4 and go to line 5.
☒ **No.** You can elect to be classified as an association taxable as a corporation or to be disregarded as a separate entity. Go to line 4.

4 If the eligible entity has only one owner, provide the following information:

a Name of owner ▶ **Wilton Palminter**
b Identifying number of owner ▶ **333-44-2222**

5 If the eligible entity is owned by one or more affiliated corporations that file a consolidated return, provide the name and employer identification number of the parent corporation:

a Name of parent corporation ▶
b Employer identification number ▶

For Paperwork Reduction Act Notice, see instructions. Cat. No. 22598R Form **8832** (Rev. 12-2013)

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For Example 10

Form 8832 (Rev. 12-2013) Page **2**

Part I **Election Information** (Continued)

6 **Type of entity** (see instructions):

a ☐ A domestic eligible entity electing to be classified as an association taxable as a corporation.
b ☐ A domestic eligible entity electing to be classified as a partnership.
c ☒ A domestic eligible entity with a single owner electing to be disregarded as a separate entity.
d ☐ A foreign eligible entity electing to be classified as an association taxable as a corporation.
e ☐ A foreign eligible entity electing to be classified as a partnership.
f ☐ A foreign eligible entity with a single owner electing to be disregarded as a separate entity.

7 If the eligible entity is created or organized in a foreign jurisdiction, provide the foreign country of organization ▶

8 Election is to be effective beginning (month, day, year) (see instructions) . . . . ▶ **01/01/2022**

9 Name and title of contact person whom the IRS may call for more information	10 Contact person's telephone number
Wilton Palminter	**309-555-1212**

Consent Statement and Signature(s) (see instructions)

Under penalties of perjury, I (we) declare that I (we) consent to the election of the above-named entity to be classified as indicated above, and that I (we) have examined this election and consent statement, and to the best of my (our) knowledge and belief, this election and consent statement are true, correct, and complete. If I am an officer, manager, or member signing for the entity, I further declare under penalties of perjury that I am authorized to make the election on its behalf.

Signature(s)	Date	Title
		Managing Member

The LLC, taxed as a subchapter S corporation, recognizes the following gain on the liquidating distribution.

Asset	Value	Basis	Gain to LLC
Accounts receivable	$ 450,000	$ 0	$ 450,000
Equipment	4,000,000	1,000,000	3,000,000
Goodwill	1,000,000	0	1,000,000
Total	$5,450,000	$1,000,000	$4,450,000

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Example 11. Use the same facts as **Example 10.** Assuming that Wild Eagle Enterprises, LLC has never violated the rules of subchapter S and has never revoked its S corporation election, then the LLC passes these gains through to the sole owner, Wilton. All the gains are ordinary income to Wilton, for the following three reasons.

1. The accounts receivable are not capital assets, nor are they real depreciable property used in a trade or business.[141]
2. The equipment most likely has a cost in excess of its current value of $4 million. Therefore, this gain represents recapture of previous depreciation up to the original depreciable cost basis ($1 million) and no §1231 or capital gain.[142] Moreover, even if any item of equipment has value in excess of its original basis, it is depreciable to Wilton and is subject to **IRC §1239.**[143]
3. The goodwill was internally generated and therefore has no basis. However, it is an intangible asset amortizable under §197, generating **ordinary** income based on the following factors.
   - For purposes of depreciation recapture, amortization is depreciation.[144]
   - Gain on any property which is depreciable to a transferee is ordinary income if the transfer is between related persons.[145]
   - Related parties include a corporation and an individual who owns more than 50% of the stock.[146]
   - Upon cancellation of Wild Eagle Enterprises, LLC's corporate status, the distribution of the self-created goodwill represents the sale of a depreciable asset, resulting in ordinary income to Wild Eagle.[147]

Wilton must now account for the receipt of property in exchange for his stock. Assume that he has taken distributions equal to the taxable income every year and has no basis before the liquidation. The income generated by the gains of the LLC increases Wilton's basis to $5.45 million.

Assume there are liabilities of $2.5 million attributable to the purchases of equipment, and there are $150,000 of accounts payable and other accrued expenses. Wilton must now compute a gain or loss on the deemed exchange of his stock.

Amount realized (FMV of all property)	$4,450,000
Less: liabilities	(2,650,000)
Amount received for stock	$1,800,000
Less: basis, after adjustment for corporate gain	(4,450,000)
Capital loss	($2,650,000)

Thus, Wilton finds himself in the unfortunate situation of having $5.45 million ordinary income, and a long-term capital loss of $2.65 million. When he made the election to treat the LLC as a corporation, he would have recognized gain to the extent that the liabilities on the effective date of the election exceed the aggregate basis of the assets transferred to the business.[148]

141. IRC §1221(a)(4).
142. IRC §1245.
143. IRC §1239(a).
144. IRC §§197(f)(7) and1245(b)(8).
145. IRC §1239(a).
146. IRC §1239(c)(1)(A).
147. IRC §1239(a); *Fish v. Comm'r*, TC Memo 2013-270 (Nov. 25, 2013)
148. IRC §357(c).

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Practitioner Planning Tip

Tax practitioners working with SMLLC owners wishing to change from S corporation status to a disregarded entity should be alert to the need to treat the entire transaction as ordinary income. Under §1239, sales of assets to related parties must be treated as ordinary income if the assets are subject to depreciation under IRC §167.

Special Filing Requirements

In most cases, the election to become an association creates a tax fiction of contributing property to a corporation in exchange for stock, which may be wholly or partially tax deferred by reason of IRC §351. However, the deemed liquidation is a fully taxable event. Therefore, when the entity electing out continues to operate a trade or business, it is subject to the same reporting requirements of an actual sale of a going concern.[149]

On its final Form 1120-S, the LLC must check a box on page 1 indicating that it is the final return. It is also advisable to file Form 966, *Corporate Dissolution or Liquidation.* This form is not required but can help avoid future inquiries about returns that are no longer necessary.[150]

Each party must file Form 8594, reporting the amount deemed paid for each class of asset, using the residual method.

Note. For more information on Form 8594, see the 2015 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 5: Small Business Issues. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

For more information on the residual method, see the Sale of a Service Business discussion in this chapter.

Example 12. Use the same facts as **Example 11.** If Wilton elects default status for Wild Eagle, the company must attach Form 8594 to its final Form 1120-S. Wilton must also file a copy with his Form 1040, *U.S. Individual Income Tax Return*.

Caution. The IRS may view failure to file Form 8594 as failure to file a return. In that case, the statute of limitations does not begin to run until the entity, the proprietor, or both file amended returns with Form 8594 attached.

Note. For more discussion regarding reporting requirements under §1060, see the Sale of a Service Business discussion in this chapter.

149. IRC §1060.

150. See instructions for Form 1120-S and Form 966.

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DISSOLUTION OF THE ENTITY

One of the primary purposes of the LLC is the protection offered to the owner from claims against the business. These could range from rightful ownership of the goods to injuries on the business property and nearly every other conceivable reason that someone could bring an action. In theory, it also includes protection from creditors of the business, although most commercial enterprises require guarantees by the owners. Conducting the business in this form also creates an identifiable business entity. In case of divorces, estate planning, bankruptcy, and other events, a person might have claims against the owners of the business but would not have claims against the individual properties of the business.

Perhaps a primary reason for **not dissolving** an LLC is that it shifts unlimited liability back to the owner. Thus, any potential creditor, known or unknown, or any other claimant may now bring an action directly against the owner. The owner is assuming potential liability for any claim, past, present, or future that would have been protected if the LLC remained in existence. Obviously, a crucial step in this process is to evaluate the cost of a business insurance policy to insulate the owner from catastrophic risk.

Practitioner Planning Tip

In most cases, dissolution of the entity is advisable only when the owner has decided to discontinue the business.

However, if the owner has decided that dissolution of the entity is the preferred route, it **should** complete the following partial list of procedures.

- Filing articles of dissolution with the state and local authorities
- Canceling EIN
- Filing final sales tax returns
- Closing entity bank accounts
- Transferring any property held by the company to the proprietor (This includes paying any state and local transfer taxes, retitling any property, relicensing vehicles, etc.)
- Renegotiating every lease, contract, lending covenant, or other agreement in effect
- Dealing with every creditor of the business so that the proprietor is substituted as the debtor without defaulting on any loan provisions
- Posting legal notices such as state and local laws may require upon the dissolution of a business

In contrast, if the business owner wants to liquidate the entity entirely, they **must** complete all the above procedures. When dissolving a business entity, it is always advisable for the owner to retain competent tax and nontax legal advice. In most cases, dissolution of the entity is advisable only when the owner has decided to discontinue the business.

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Example 13. Use the same facts as **Example 12.** Assume that Wild Eagle's business has dwindled considerably. Its furniture fixtures and other fixed assets now have negligible value, and it has substantially satisfied all its debts. Inventory is minimal and Wild Eagle intends to have a going-out-of-business sale. Wilton ceases to operate the business in any form. In this case, the tax consequences of electing out of association status are minimal or nonexistent. Under these circumstances, Wilton decides to dissolve the business.

Caution. Even though dissolution is an appropriate action, the owner should consider the effects of losing the liability shield. It might make sense to renew the entity's charter until statutes of limitations for claims against the business have lapsed.

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