Buying and Selling a Business: Tax and Structuring Overview

SEL4/24/V1

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Table of Contents

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NOTES

Starting the Process

Starting the Process

Learning objectives

Upon reviewing this chapter, the reader will be able to:

- Explain the nature of, and typical provisions in, a confidentiality statement;
- Describe the purposes, dangers, practical limitations of, and typical provisions in, a letter of intent;
- Identify the representations, warranties, and indemnification provisions typically found in the agreement of sale of the business;
- Discuss secured and unsecured claims, the role they play in a sale of a business, and the setting of a floor on claims;
- State the legal issues that surround the disposal of hazardous substances on or off a piece of property by one of the parties or its predecessors, or the generation or use of hazardous substances in the course of general business activities; and
- Identify the accountant's analysis function, including the proper way to investigate previous audit workpapers, earnings and dividends, production facilities, assets, liabilities, and the tax profile and position of the business.

I. Memoranda of understanding

A. Confidentiality statement

1. Purpose

Part of the preliminary negotiating process is the prospective buyer's development of the purchase price. To do so, as has been mentioned, the financial advisor will need to review many of the **company's inside papers**. The seller in effect has to be willing to give, before an agreement is reached, access to outsiders of information of a proprietary nature, because the buyer should not and will not offer to buy a company without knowledge as to its financial condition.

2. Provisions

The buyer will have to execute a **confidentiality statement** for the protection of the seller. Basically, the seller would not appreciate the buyer divulging to everyone whatever is learned about the business from the inside information. The Confidentiality Statement should cover the following:

- Kinds of information subject to the restriction; and
- Provision for liquidated damages. The exact amount of damages caused by a public disclosure will generally be difficult, if not impossible, to prove. To prevent the prospective buyer from breaching with impunity, the agreement should provide for a fixed dollar amount so that once the seller establishes the disclosure by the prospective buyer, the damages are fixed.

August 1, 2024

ABC Corporation
404 E. Lancaster Ave.
Wayne, PA 19087

Dear Sirs:

We are discussing with you the possibility of our company acquiring the ABC Corporation (the "Company"). In connection with this, you will be providing us with the financial statements and other information that is confidential and proprietary to the Company. The financial statements and other information provided to us are hereinafter referred to as the "Evaluation Materials."

We acknowledge that the Evaluation Materials are confidential and that the fact that the sale of the Company is being considered is confidential. Intending to be legally bound, we agree that we will:

a. Maintain the confidentiality of the Evaluation Materials and of the fact that the sale of the Company is being considered.

b. Disclose the fact that the sale of the Company is being considered and show the Evaluation Materials to only those individuals employed by us and any outside advisers retained by us if necessary, to our determination of whether to make a proposal for the acquisition of the Company. In this regard, there shall be no disclosure to employees other than senior officers of the company or to outside advisers unless and until approved in writing by the Company.

c. Prior to disclosing to any person the fact that a sale of the Company is being considered, require that such person agree to maintain the confidentiality of the possible sale and the Evaluation Materials.

d. Use the Evaluation Materials solely for the purpose of determining whether or not we wish to make a proposal for the acquisition of the Company and not in any way detrimental to the Company.

e. Not make copies of any of the Evaluation Materials.

f. Return all of the Evaluation Materials to Company and destroy all notes, reports, and other materials prepared by us if we or you decide to terminate our discussions.

We understand that it is extremely important that we maintain the confidentiality of the fact that a sale is being considered and of the Evaluation Materials. We understand that the Company may suffer irreparable damage in the form of loss of customers and loss of profits if we or our employees or our advisers disclose in violation of this agreement the fact that the sale of the Company is being considered. We understand that our agreement to maintain confidentiality shall survive any termination of our evaluation of the Company. In the event of any such violation we agree in advance to be liable for liquidated damages in the sum of twenty thousand dollars ($20,000).

Sincerely,

Agreement by Individuals

The undersigned have read carefully the foregoing letter and agree to maintain the confidentiality of the fact that a sale of the Company is being considered and to be bound by all of the terms of the foregoing letter.

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B. Letter of intent[1]

1. In general

After the purchaser has reviewed various aspects of the business and a search of the **security interests** of record is made, a memorandum of understanding, or **letter of intent**, normally accompanied by a deposit sets the groundwork for the purchase of a business. There is no set legal form or clauses in drafting such a document.

2. Practical limitations

Of course, it would be better for all parties to immediately sign and agree to all terms of a final contract. This is not always practical, however. The buyer, for example, wants some assurance that the buyer alone has the right to purchase. The seller, on the other hand, wants to make sure that he is spending time with a serious buyer and would like to commit that buyer to a deposit.

a. Further, in many cases the seller would be unwilling to disclose tax returns and financial statements without a warranty not to disclose and a cash deposit. Obviously at this preliminary stage, all of the detail cannot be completed in a final contract.

b. Depending on whom you represent and their interest in the business, determines the extent to which this letter of intent binds the parties.

3. Purposes

While a letter of intent can be quite different and very flexible, the purpose of such a document is to provide both the buyer and the seller assurances of the price and terms of a sale. Further, this agreement normally gives the buyer the exclusive right to buy for a set period of time. This document precedes the signing of any final contract.

4. Dangers

In many instances the buyer and seller negotiate for the purchase of a business without obtaining professional advice. The buyer or seller drafts their own letter of intent without consulting counsel or their accountant.

5. Provisions

The buyer and the seller normally have adverse interests to most of the terms and conditions of a letter of intent. The significant items that should be included in such an agreement are summarized in the following chart.

C. Agreements of sale

1. In general

The contract to sell a business should basically cover all items discussed in the letter of intent including areas that were not fixed as of the date of signing the memorandum. An attorney should always be involved in drafting such a contract. Often, however, the negotiations are made by the seller and his CPA, and the buyer and his CPA so that the lawyer receives his information second hand. It is of primary importance that the CPA reviews the contract prior to it being signed. Important aspects might be missing simply because the attorney is not aware of them. A meeting with the attorney to question how the contract would operate in a worst-case scenario is time well spent. If the contract does not specifically address a particular problem that could arise, an amendment should be made.

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[1] This case implicates the question of when a party is bound by terms stated in a signed letter of intent that itself is intended as the precursor to a more formal contract of sale.

2. *Representations*

Representations, warranties, and indemnification provisions are important in all negotiated transactions. From an accounting standpoint, a number of facts will not be readily determinable even though you diligently review all existing records. These representations or warranties will permit reliance on them. From a legal standpoint, a number of purposes are secured by such provisions.

a. First, they provide a basis for not going through with the purchase once the purchaser discovers them to be false. Second, they permit the purchaser to sue for damages or rescind if they are proven untrue after the sale.

b. Representations and warranties almost always survive in the case of acquisitions of privately held corporations. From a negotiating point of view, seller does not want the representations to survive at all. The purchaser should insist on periods in the two- to three-year time frame so that at least two full audits are conducted. Tax and litigation matters may require a longer period.

c. The representations and warranties should be as broad as possible. Remember that in part, the purpose of these provisions is to obtain the assurance of the seller with respect to certain facts and the purchaser will want to know as part of his investigation of the business why the seller cannot represent or warrant without exception. These qualifications by the seller can themselves have an impact on the purchase price.

d. A representation that accounts receivable may be collected in the ordinary course of business may protect the buyer in the event of the bankruptcy of the trade debtor, but it would be better to provide that any accounts not collected within 90 days will be assigned to the seller in exchange for their face value.

e. Of course, some representations may be too narrow. For example, typical representation that the financial statements of the seller fairly present only protects the buyer against undisclosed liabilities that are material for accounting for financial reporting purposes. More is needed to make the seller responsible for liabilities that arise out of events or facts occurring before the closing.

Note:

> The seller should be sure that the agreement contains detail about what is NOT being sold. Any personal property that the seller wishes to keep should be detailed in the agreement. This is usually done with a statement in the agreement that refers to an appendix.

3. *Indemnification*

Indemnification provisions afford the buyer protection against the breach of a representation or warranty. They are also needed even in an asset purchase. One of the advantages of an asset acquisition relative to a stock acquisition is the elimination of liabilities of the seller from the assets. However, the buyer always takes assets subject to the lien of a security interest or creditors' lien on a bulk sale, discussed below. These can ordinarily be detected by a search of the recorded liens and compliance with the bulk sale law. One contingent liability that may attach to the assets are those arising out of product liability, so the purchaser should always have an indemnification provision for such claims.

4. *Scope of liability*

The protection offered by a representation that the seller has no liabilities, contingent or otherwise, other than as shown on its financial statements may depend on what a court decides the term "liability" means, so it is advisable to state that the seller will be responsible for all liabilities arising out of events or facts predating the closing.

5. Floor claims

Often the seller will insist on not being continually hounded by numerous small claims, by setting a **floor amount of claims**, less than which in the aggregate, the buyer will not press the seller. However, certain liabilities should be addressed, such as litigation. Each party has an interest in its outcome. The buyer wants to be sure that the seller will be able to indemnify, while the seller is concerned that the buyer may not treat the liability properly if it is entitled to indemnity. Which party will defend against such claims is an important negotiating point. The seller is confident that if he were to continue to run the business, there would be no problems; he would not sell for less than x dollars in any event, and without fear that he will have to return part or all of the consideration he received for a business that took him years to build.

6. Read the agreement!

The recent *Makric Enterprises, Inc.* case reminds us how important it is to read the documents, especially the purchase agreement.[2] In affirming the Tax Court, the Fifth Circuit ruled that shareholders of a company could not reform the transaction as the sale of the parent company stock.

In 2008, the shareholders of Makric Enterprises, Inc., entered into an agreement to sell 100 percent of the stock of a wholly owned subsidiary, Alpha Circuits, Inc. The original agreement called for two steps: (1) the parent company, Makric Enterprises, Inc., would be dissolved, distributing shares of the subsidiary to the Makric shareholders, and (2) the shareholders would then sell the stock of the former subsidiary. After being advised that this would have undesirable tax consequences, they decided to restructure the sale and sell the stock of the parent company, and therefore receive favorable capital gain treatment. They completed the transaction, and reported the sale of Makric Enterprises, Inc., stock as a capital transaction and paid tax at the favorable capital gains rates.

The problem? They executed a version of the sales agreement said defined the transaction as a sale of the subsidiary stock by the parent, and several other documents supported that premise. The IRS assessed tax to Makric Enterprises, Inc., for the sale of the subsidiary, which resulted in ordinary income at the corporate level and double taxation! The taxpayers argued that they should be allowed to “reform” the transaction because it was due to a mutual error. In March 2016, the U.S. Tax Court upheld the IRS decision.

In the appeal, the Makric shareholders claimed that the Tax Court erred in not allowing a reformation of the transaction due to mutual error. The two elements that must be present for reformation are: (1) the party claiming relief was able to show what the true agreement was, and (2) that the documentation is incorrect because of a mutual mistake.[3] The taxpayers relied on a single e-mail that described the transaction as a sale of Makric stock. The IRS and the Tax Court relied on 12 versions of the purchase agreement, other documentation, and a signed affidavit from the purchasing entity. The Fifth Circuit upheld the Tax Court decision.

One critical element cited by the court was that the taxpayers did not have their CPA review the documentation. The tax returns were prepared by the CPA based on the facts of the transaction as stated by the taxpayers and the attorney for the taxpayers.

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[2] *Makric Enterprises, Inc. v. CIR*, No. 16-60410 (5th Cir. 2017).
[3] *Estes v. Republic Nat. Bank of Dallas*, 462 S.W.2nd 273, 275 (Texas 1970).

Question to ponder:

> Your client comes to you and wants to sell his business and S corporation. He has employed the services of a business broker, but not an attorney. He says, “Attorneys are too expensive. Can’t you handle everything for me?” What is your response?

D. Uniform commercial code

1. In general

The buyer of assets must determine or eliminate liabilities that he or she may inherit if assets are acquired. Some of the seller’s creditors may acquire a security interest or lien in any or all of the business’ assets.

2. Liens against property

This lien gives a creditor the right to force the sale of the asset if the creditor is not paid. Only the equity in such assets is acquired by the purchaser. It is not unusual for the seller’s prime lender to have a “blanket” lien in all inventories, receivables, or other current assets. As the inventory is turned over the lien continues to attach to inventory acquired after the security interest is filed, in after acquired receivables, etc. **Watch for tax liens!**

3. Recording of security interests

Although the creditor may enforce the lien against the debtor-seller, the creditor may not do so if the assets are acquired without knowledge of the lien. Such knowledge will be presumed if the lien has been recorded under the state law (Article 9 of the Uniform Commercial Code). Such recorded liens mean that a purchaser of the assets will be in the economic position of paying the seller’s debts if the seller does not pay.

4. Unsecured claims

On the other hand, unsecured debts or unrecorded security interests (at the time of closing) generally do not follow the assets. Recorded security interests should be viewed as liabilities, which the purchaser will economically assume, thus reducing the amount to be paid to the seller. Once the liabilities covered by the security interest are paid, the creditor should file a release of the lien, which will appear on the records. No matter what the seller tells you, the purchaser must regard the unreleased recorded security interest as representing an unsatisfied debt. An escrow should be established until the seller obtains such release.

5. Bulk sales laws

Article 6 of the Uniform Commercial Code imposes special requirements regarding the sale of a business’ inventory in bulk. A notice of the sale must be given to the seller’s creditors beforehand. This gives the general creditors the opportunity to make arrangements with the seller for final payment of the amounts owed before the seller disappears. The bulk sale law recognizes that creditors rely upon the sale of inventory to generate the cash with which they will be paid. As long as the seller remains in business the existence of the inventory gives them something of value to liquidate their claims. Once completely sold, the creditors are in a much different situation. The notice is designed to protect them.

E. Environmental liability

1. Nature of the problem

There may have been disposal of hazardous substances on or off a piece of property involved by one of the parties or its predecessors, or generation or use of hazardous substances in the course of general business activities. The Federal Resource Conservation and Recovery Act and the Federal Comprehensive Environmental Response, Compensation and Liability Act are of primary importance in general business transactions. Responsibilities may also accrue under the Federal Clean Water Act, Toxic Substances Control Act, and Clean Air Act, among others.

2. CERCLA

Comprehensive Environmental Response, Compensation and Liability Act (**Superfund** or **CERCLA**), as amended by the Superfund Amendments and Reauthorization Act of 1986 (**SARA**). **CERCLA** imposes strict, joint, and several liability for cleaning up sites that are releasing or threaten to release hazardous substances to the environment on anyone with certain specified connections to the site, unless the parties can prove a reasonable basis for apportioning that liability.

3. Persons liable

Liability for cleanup costs can be imposed on:

- (i) The owner or operator of the site at the time the hazardous substances were placed there;
- (ii) The owner or operator of the site at the time that the release or threat of release made the cleanup necessary;
- (iii) Any person who arranges for disposal of hazardous substances at the site; and
- (iv) Any transporter who brought hazardous substances to the site if the transporter also chose the site.

The owner/lessor of a site may be liable under CERCLA, as may a lessee/sublessor. The only corporate officers, directors and employees who have been held liable under CERCLA were also:

- (i) Shareholders in the company that owned or operated the site or the company that generated the wastes; and
- (ii) Anyone personally involved in or responsible for managing or disposing of hazardous substances.

A parent corporation **may** be liable for the acts of its subsidiary:

- (i) When the parent's involvement with its subsidiary is so pervasive as to make the subsidiary merely the parent's alter ego and the distinctions between the corporations merely a sham so that the corporate veil has been pierced;
- (ii) When the parent actively participates in the conduct that causes injury: the more active the parent in the affairs and operations of the subsidiary the more likely that the parent has a duty to avoid the harm; and
- (iii) Merely owning shares in a company has not rendered the shareholder – individual or corporate – liable.

4. Defenses to liability

Defenses to liability are extremely limited under CERCLA. Defenses include:

a. An act of God;

b. An act of war; or

c. An act or omission of a third party other than an employee or agent of the defendant, or than one whose act or omission occurs in connection with a contractual relationship, existing directly or indirectly, with the defendant, if the defendant establishes by a preponderance of the evidence that:

   (i) The defendant exercised due care with respect to the hazardous substance concerned, taking into consideration the characteristics of such hazardous substance, in light of all relevant facts and circumstances; and

   (ii) The defendant took precautions against foreseeable acts or omissions of any such third party and the consequences that could foreseeably result from such acts or omissions.

There is also an **innocent landowner** defense. A purchaser who buys property after release of hazardous substances thereon is not liable if it can prove by a preponderance of the evidence that the time it acquired the facility it did not know and had no reason to know that any hazardous substance that is the subject of the release or threatened release was disposed of on, in, or at the facility.

(i) The new owner **must have undertaken appropriate inquiry** into previous ownership and uses at the property consistent with good commercial or customary practice at the time of acquisition.

(ii) If the new owner obtained actual knowledge of the release during its period of ownership and then sold the property without disclosing the release, it will be liable no matter what it knew when it acquired the property.

5. What the EPA can do

In cases of imminent and substantial danger, the EPA can act to remove or arrange for the removal and provide remedial action relating to the hazardous substance that has been or threatens to be released.

If the EPA pursues this option, the EPA can use money from the Superfund to pay for the removal or remedial actions.

If the EPA pursues this option, it will later bring a cost recovery action against those liable for the costs of removal or remedial action by the United States or a state government, and any damages for injury to, destruction of, or loss of natural resources including the reasonable costs of assessing such injury, destruction, or loss from such a release. The EPA can request a court order to require responsible parties to abate the danger or threat. The EPA may issue an administrative order requiring responsible parties to take action to abate the danger or threat.

II. Accountant's role in the due diligence process

A. Preliminary evaluation

1. From the buyer's side

There should be an accountant's consultation and meeting with investors to:

- Assess preliminary cash flows and perform sensitivity analysis for various economic possibilities and transaction structure ("what if" analysis);
- Outline potential tax consequences of various alternatives in the deal structure; and
- Detail regulatory reporting consequences.

2. From the seller's side:

The accountant for the seller should:

- Assist in the preparation of data that the buyer will need to assess cash flows etc. above. The accountant should assess cash flows with a "buyer's eye" to prepare to answer anticipated questions that the buyer may ask.
- Outline potential tax consequences of various alternatives in the deal structure; and
- Remind the seller that in-pocket money is what matters, not gross proceeds.

B. Formulating the due diligence program

After proposed transaction is studied, the review team would prepare a formal due diligence program designed to:

- Provide assurance and comfort as to specified accounts and representations.
- Provide assistance in pricing and structuring the transaction.
- Identify high-priority elements of the transaction ("deal breakers") and important fact-finding considerations.
- For the seller, determine the buyer's ability to fulfill their financial obligation.

C. Reviewing the previous audit workpapers

1. From the buyer's side

The accountant for the buyer should meet with seller's accountants to evaluate the various items specified below:

- Evaluate the procedures performed in previous audit.
- Review any information regarding the financial and operating system internal controls.
- Evaluate bad debt and inventory reserve calculations and other reserves.

2. From the seller's side

The account for the seller should clean up the workpapers and make sure they are easy to follow. Be prepared to explain and defend any calculation of reserves for bad debt, environmental issues, etc. Be prepared to explain any departures from GAAP. If there are liabilities not being assumed or assets that are not being sold, a "what if" summary or statement omitting those liabilities and assets should be considered.

D. Performing agreed-upon compliance-oriented procedures

1. From the buyer's side

The accountant should focus on obtaining and reviewing information to expand the investor's knowledge of the company including:

- Adequacy of insurance coverage;
- Existing accounting policies and potential alternatives;
- Assessing records relating to fixed assets;
- Key employee agreements; and
- Ratio analysis.

2. From the seller's side

Anticipation is the key:

- Evaluate the adequacy of insurance coverage. Be sure there have been no changes since your last verification procedures.
- Help the seller summarize accounting policies for both financial statement and non-financial statement purposes.
- Clean up the fixed asset records.
- Have key employee agreements readily available.
- Perform a ratio analysis and be prepared to explain year-to-year variations and/or variations from the norm for the industry.

E. Communication and reporting

Throughout the process, communication is important with all parties involved:

- Meetings with lending institutions are helpful to assure that concerns are addressed;
- Convey important findings to purchaser or seller as they occur;
- Discuss important contracts and agreements to assess impact on the company; and
- Prepare a report of all findings of the target company to the purchaser. The accountant representing the seller should evaluate the findings of the buyer and be prepared to challenge any negative findings.

F. Analysis of earnings and dividends

1. From the buyer's side

The accountant should analyze earnings results compared with budget, if one exists, for the past five years and for the last 12 months, gross profit margins, and reasons for variations, nonrecurring income, and expenses.

- Compare earnings with the industry for the past five years.
- Dividend and earnings record for the past five years in total and per share.
- Assess the level of, and changes in, fixed and variable costs.
- Assess the effect of government wage or price controls.
- Analyze selling and general and administrative expenses. Determine cuts and consolidations that can be made to reduce these expenses.
- Consider anticipated economies and cost changes.

2. From the seller's side

Again, anticipation is the key:

- The seller's accountant should not be surprised by the buyer's accountant's findings. Perform the same analysis. The seller's accountant knows the business better than the buyer's accountant and may be able to explain away negative items or find discrepancies in the buyer's analysis.
- Know what is in general and administrate expenses. Don't be surprised by personal expenses being paid, items that should have been capitalized, etc. This is especially important when the seller's accountant has not audited the prior years. In many smaller transactions, the whole transaction is done using prior year compiled or reviewed statements. Greater analysis needs to be done by the accountant to identify items that the accountant is not aware of that will be found in the buyer's due diligence.

G. Production facilities

The accountant for the buyer should analyze the production facility for the following items. The accountant for the seller should make sure the records are cleaned up and readily available.

- Land:
  - (i) Acreage and location;
  - (ii) Cost;
  - (iii) Assessed value (e.g., real estate taxes); and
  - (iv) Fair market value.
- Buildings:
  - (i) Description, location, layout, and floor space;
  - (ii) Age and condition;
  - (iii) Capability to expand or add on;
  - (iv) Depreciation, reserve, method, rate, and policies;
  - (v) Assessed value (e.g., real estate taxes);
  - (vi) Fair market value; and
  - (vii) Insurance coverage.
- Title to realty. Ownership of all assets.
- Machinery and equipment:
  - (i) Description;
  - (ii) Age, condition, efficiency, and insurance coverage;
  - (iii) Depreciation, reserves, methods, rates, and replacement policies;
  - (iv) Total acquisitions during the past five years; and
  - (v) Analysis of most recent additions.
- Future plant, machinery, and equipment requirements.
- Capitalization versus repair policies.
- Capital expenditures and repairs for the past five years.
- Percentage relationship of production costs and comparison with industry.
- Efficiency of operations in light of technological change.
- Subcontracting done by others.
- Capital commitments.
- Facility contracts or leases.
- Surplus or idle buildings or equipment.

H. Assets[4]

Assets include:

- Cash position, present, and projected (e.g., restrictions, compensating balances, etc.).
- Age and number of accounts receivable (several years normally analyzed).
- Provision for bad debts for the past five years and current allowance.
- Inventories:
  - (i) Location, including consigned goods;
  - (ii) Finished goods by product;
  - (iii) Work-in-process by product;
  - (iv) Raw materials by product;
  - (v) Pricing methods;
  - (vi) Accounting procedures and practices; and
  - (vii) Provisions for obsolete or slow-moving stock (several years normally analyzed).
- Analysis of notes receivable.
- Analysis of investments.
- Subsidiaries:
  - (i) Assess impact on parent company's balance sheet; and
  - (ii) Obtain businessperson's review checklist information in areas of significant impact.
- Analysis of other assets.
- Patents held (e.g., rights, licenses granted, and values).
- Goodwill and other intangibles (e.g., basis of evaluations and/or amortization).

I. Liabilities

Liabilities include:

- Short-term borrowings and unused lines of credit.
- Analysis of accounts payable.
- Commitments for new buildings, machinery, and inventories.
- Long-term loans outstanding and terms, assets pledged, and payment status.
- Debentures outstanding and terms.
- Dividends and interest accrued.
- Lease commitments.
- Insurance coverage, fidelity bonds, and amounts of present claims, if any.
- Unfunded pension costs.
- Contingent liabilities (e.g., warranties, patent infringements, loss contracts, compensation for services, and contracts subject to termination or renegotiation).
- Litigation history and present status, unasserted claims, etc.

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4 For items H through O below the buyer's accountant will analyze. Much of the data will be prepared by the seller's accountant. The seller's accountant should anticipate what will be found and be ready to respond.

J. Analysis of tax profile and position

In analyzing the tax profile and position, consider:

- Federal income tax returns for the past five years.
- Results of past IRS examinations (latest year examined and open years).
- Is a consolidated federal income tax return filed? Are taxes allocated in accordance with a formal agreement?
- List of foreign subsidiaries, foreign tax credits, and analysis of taxes provided on undistributed foreign earnings.
- Domestic/foreign intercompany pricing policies, including DISC sales.
- States in which company conducts business.
- State tax returns filed for the past five years and type-results of past examinations and open years.
- Taxes paid versus amounts recorded in financial statements for the past five years.
- Accounting policy regarding deferred taxes (details of all significant timing differences).
- Tax provision versus "expected" tax provision for past five years (details of significant reconciling items).
- Current federal and state tax liability versus tax payments for the past five years.

K. Analysis of financial data

In analyzing the financial data, consider:

- Annual financial statements and accountants' reports, if any, for the past five years.
- Interim financial information.
- Management reports.
- Reports to regulatory agencies, if any.
- Chart of accounts and description of accounting records.
- Working capital for the past five years and normal requirements based on trade practices, credit terms to customers, and inventory levels maintained.
- Net working capital ratios for the past five years.
- Net quick position for the past five years.
- Annual depreciation compared with capital additions for the past five years.
- Inventory and accounts receivable turnover for the past five years.
- Accounts payable turnover for the past five years.
- Interest expense for the past five years.
- Is stock traded? What are current market and book values?
- Recent stock transactions and prices paid.

L. Comparison with comparable companies

Compare company ratios with those of comparable companies for the past five years and by quarters for the current year:

- Price to earnings;
- Price to book value;
- Gross profit percentage;
- Working capital ratio;
- Working capital turnover;
- Accounts receivable turnover;
- Inventory turnover;
- Accounts payable turnover;
- Return on investment; and
- Return on equity.

M. Prospective financial information

Prospective financial information includes:

- Earnings projection;
- Projection of cash requirements;
- Projected balance sheets;
- Underlying assumptions and key factors; and
- Capital and operating budgets; long-term plans.

N. Pro forma financial statements

Preparation objectives:

(i) Provides information about the continuing impact of a transaction showing how it might have affected historical financial statements; and

(ii) Assists investors in analyzing the future prospects of the company since it illustrates the possible scope of the change in financial position and results of operations caused by the transaction.

Presentation:

(i) Should be prepared in condensed form; balance sheet captions less than 10 percent and income statement captions less than 15 percent are usually combined;

(ii) Should provide financial statements, notes, and a description of the pro forma effects of the transaction; and

(iii) Adjustments related to the pro forma statements should be sufficiently explained and should include adjustments that give effect to events that are directly attributable to the transaction and factually supported, regardless of whether they have a continuing impact.

Difficulties in preparation.

(i) Historical information of existing entity may be difficult to obtain if not reported separately in the past. This is usually the case when an entity was previously a division of a consolidated group since records may not be in sufficient detail.

(ii) Calculation of actual expenses directly related to entity may be difficult to arrive at when charges such as corporate overhead, interest or taxes have been charged to the entity through an allocation method.

(iii) Adjustments relating to expenses that would have been incurred by the entity as a result of the transaction must be carefully examined. For instance, interest expense arising from revised debt structures, advertising costs incurred on behalf of the divested business, executive salaries, and other costs.

(iv) Depreciation calculations are sometimes difficult to break out if fixed asset records have not been clearly segregated.

(v) Tax effects of pro forma adjustments.

O. Other items to review

Other items to review include:

- Payment of all payroll, property (tangible and intangible), and sales taxes. This is extremely important, because in most states, liens apply to the property of a business that has delinquent property tax and or sales tax. The purchaser could buy property to subsequently have it taken by a state or local government.
- Presence of off-balance sheet financing (leased items).
- Potential lawsuits or claims against the company? Get a letter from seller’s attorney.
- Are there any outstanding taxes due or exposure to state or local taxes?
- Is uniform capitalization of inventory being used for financial statement purposes?

Learning Questions

1. Which of the following statements best describes acquisition documents?

   A. A confidentiality statement is used to protect the buyer from being identified as being in the market for businesses.
   B. The letter of intent lays out the price and other terms of the acquisition that the buyer can execute for a set period of time by drafting an agreement of sale including such terms.
   C. The contract to sell a business should only cover all items discussed in the letter of intent.

2. With respect to environmental liability, which of the following is TRUE?

   A. Superfund generally requires a showing of fault in holding the owner of land liable for environmental liability arising from the release of hazardous substances.
   B. A parent corporation is generally liable for the acts of its subsidiary in reference to hazardous waste infractions.
   C. In order to avoid liability for the cleanup by a purchaser that buys property after the release of hazardous substances, the purchaser must show that it did not know and had no reason to know of the release of hazardous substances at the time of acquisition.

Learning Questions – Answers

1. A is **incorrect** because a confidentiality statement is used to protect the seller from having proprietary business information from being divulged.

   B is **correct**. The letter of intent is a preliminary agreement of sale that sets forth the basic terms to be included; however, it is not binding if such a final agreement cannot be drafted within a specified period of time or where facts are discovered that change the premises on which the letter is crafted.

   C is **incorrect** because the letter of intent is preliminary in nature and not as comprehensive as the contract for sale, which will include contingencies, warranties, and indemnities that are generally discovered after the letter of intent is executed.

2. A is **incorrect** because CERCLA imposes a strict liability in tort that requires no showing of fault. CERCLA imposes strict joint and several liability for cleaning up sites that are releasing or threaten to release hazardous substances into the environment on anyone with certain specified connections to the site, unless the parties can prove a reasonable basis for apportioning that liability.

   B is **incorrect** because one of the purposes of having a subsidiary is to isolate liabilities of the separate entity from those of the parent or other related corporation. The parent corporation is liable when the parent's involvement with its subsidiary is so pervasive as to make the subsidiary merely the parent's alter ego and the distinctions between the corporations merely a sham so that the corporate veil has been pierced, or when the parent actively participates in the conduct that causes injury; the more active the parent in the affairs and operations of the subsidiary, the more likely that the parent has a duty to avoid the harm.

   C is **correct**. A purchaser who buys property after release of hazardous substances thereon is not liable if the purchaser can prove by a preponderance of the evidence that at the time the purchaser acquired the facility, the purchaser did not know and had no reason to know (the "innocent landowner defense") that any hazardous substance that is the subject of the release or threatened release was disposed of on, in, or at the facility.

Seller's Concerns

Seller’s Concerns

Learning objectives

Upon reviewing this chapter, the reader will be able to:

- Describe the general tax features that are present in a sale of business structured as an asset sale;
- Calculate the gain recognized on the sale of an entity and the applicable tax rate;
- Discuss the special problems in the sale of S corporation stock, including post-sale income and distributions, basis adjustments, and closing of the books issues;
- Distinguish between hot assets and other assets of a partnership and LLC and the impact on the gain recognized on the sale of the entity interest;
- Identify the special holding period issues of a partnership/LLC interest;
- Explain how entity-level basis adjustments may be made on the sale of a partnership/LLC interest;
- Describe the basis allocation issues that must be brought to bear on a sale of either the interest or the assets of partnership/LLC interests; and
- Discuss the special problems in asset sales with respect to §1231 assets, assets that bear depreciation recapture, and the assets of an S corporation.

I. General acquisition structures

A. Overview

Forms of acquisitions:

a. Interest in the business entity of the seller;
b. Interest in the business assets of the seller; and
c. Interest in the business of the seller treated for tax purposes as an interest in business assets.

Types of buyers and sellers:

a. C corporations;
b. S corporations; and
c. LLCs and tax partnerships.

B. Asset sales

1. Liability issues

In general, the sale of stock of a C or S corporation preserves the liabilities of the corporation; a sale of corporate assets generally enables the purchaser to take the assets free from the company’s **unsecured liabilities**. Assets that secure a liability with a perfected lien generally carry that lien when they are sold.

In the case of a general partner, the general partner retains liability with respect to liabilities incurred by the partnership prior to the general partner’s disposition of the general partnership interest or the disposition of partnership assets. The sale, however, does cut off liability of the selling general partner for future claims arising out of the partnership’s activities following the sale of the partnership interest, or, in the case of an asset sale, those claims arising from the activities relating to those assets occurring after such a disposition.

In the case of a limited partner, the limited partner is generally not subject to liability.

Note:

> No disposition will void any guarantee the shareholder, partner, or member has incurred.

2. Asset-by-asset approach

The sale of all of the assets of a going trade or business for a lump-sum amount is considered to be a sale of each individual asset, rather than the sale of a single capital asset.[1] In such a case, the purchaser must allocate the purchase price among the acquired assets for purposes of determining the basis of each asset acquired. Similarly, the seller must allocate the purchase price for determining the amount realized on the sale of the individual assets, and in some cases the character of the resulting gain or loss.

a. Section 1060(a) provides uniform rules of allocation applicable to both the buyer and seller.

b. Under §1060(b), the Treasury has authority to impose information-reporting requirements (see Form 8594) to ensure compliance with these allocation rules.

c. Treasury has issued final regulations implementing §1060.[2]

3. Indemnity

In certain cases, the seller may later be required to make good on an indemnity, guarantee, or other covenant with respect to contingent liabilities of the company. The *Arrowsmith* case holds in this situation that amounts paid by the sellers generally would be capital loss.[3]

The case is premised on the fact that the character of all the gain on the disposition of corporate stock was capital. In the case of a partnership/LLC, the gain, loss, or gain and loss may have to be divided between capital and ordinary. In this case, the payment of liabilities subsequent to the sale of assets or entity may have to be properly apportioned to determine the extent of reduction in the amounts realized on ordinary assets, generating an ordinary loss to the seller, or to capital, generating a capital loss to the seller.

4. Covenants not to compete

A covenant not to compete that is entered into in connection with the acquisition of a trade or business (or a substantial portion thereof) is not part of the assets sold by the business but rather is a payment for services. The negotiated amount specifically allocated to a covenant not to compete in connection with the purchase of a business generally controls the value of the covenant for federal income tax purposes.

Negotiation point:

> The seller would generally prefer an amount to be paid for goodwill than for a covenant not to compete because, as noted later, in general the amounts received for goodwill are eligible for capital gains taxation at a maximum rate of 20 percent, while the payments for foregone services is taxed at a maximum 37 percent.

Amounts received for a **covenant not to compete**, or for an employment, management, or consulting contract would be treated as ordinary income, although the allocation of the parties between the stock and the service contract may no longer hold up.

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1 See *Williams v. McGowan*, 152 F.2d 570.

2 See T.D. 8940, 66 Fed. Reg. 9925 (February 13, 2001), applicable to asset acquisitions after March 15, 2001.

3 344 U.S. 6 (1952): IRC §23(g), 26 U.S.C.A. §23(g), treats losses from sales or exchanges of capital assets as "capital losses" and IRC §115(c), 26 U.S.C.A. §115(c), requires that liquidation distributions be treated as exchanges.

5. Goodwill versus other intangibles

For sellers who have not already engaged in a transaction governed by §197 or by an offer under the intangibles settlement program, most of the intangibles will have no basis and not be subject to recapture. Hence, sale of these assets at capital gains rates will be the seller's preference.

a. On the other hand, any property treated as an amortizable §197 asset is treated as property that is of a character subject to the depreciation allowance.[4] This has several consequences.

   (i) First, this makes the intangible a §1231 asset, subject to special rules regarding the characterization of gains and losses.

   (ii) Second, this makes the disposition of the intangible subject to depreciation recapture.[5]

***Negotiation point*:**

> Goodwill may be owned outside of the company. This is extremely important with an asset sale of a C corporation. Goodwill may be purchased directly from the owner and avoid the double tax trap of the C corporation. This works best with a corporation with one owner or very few owners. It also works best for an owner that has owned the company for several years and/or founded the company.[6]

II. Sales of entity interests

A. Gain or loss

1. In general

Gain or loss from the sale or exchange of a capital asset is the difference between the amount realized (gross sales price) and the adjusted basis, plus any expenses of the sale. Gain results if the amount realized is more than the adjusted basis plus any expenses. Loss results if the adjusted basis plus any expenses is more than the sales price. This is no different in the sale of a business. However, the proceeds must be determined, the sales proceeds must be allocated among all of the assets being sold, and the character of the gain or loss must be determined.

2. Amount realized

The amount realized on a sale of property is the sum of money received and the fair market value of any property received.[7] When real estate is sold subject to a mortgage, the face amount of any mortgage is included for purposes of computing the amount realized regardless of whether the taxpayer was personally liable for it.[8]

Example: A purchases property for $250,000 that is subject to a $750,000 mortgage and three years later sells the property for $450,000; it is still subject to the $750,000 mortgage. A's amount realized is $1.2 million.[9] The sale of assets of a business would be no different. The proceeds equal cash and other property conveyed, plus liabilities assumed.

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4 IRC §197(f)(7).
5 IRC §1245.
6 *Martin Ice Cream Company v. Commissioner*, 110 T.C. 189 (1998).
7 IRC §1001(b).
8 *Crane v. Commissioner*, 331 U.S. 1 (1947).
9 Treas. Regs. §1.1001-2.

Note:

> Note that even if the **nonrecourse** mortgage has a face amount greater than the fair market value of the property, the entire amount will be included.[10]

a. Selling expenses, brokerage commissions, title costs, legal fees, and similar items are treated as a reduction in the amount realized.[11]

b. If the seller reserves a term interest, the reserved term could be part of the amount realized if the burdens and benefits have passed. This is a major problem in sale-leaseback transactions.

3. Adjusted basis

The property's adjusted basis is the original basis with adjustments required by the Code. In most cases, the original unadjusted basis is the cost to the purchaser.[12] The cost includes the amount of any purchase-money mortgage except if the payment is contingent on the happening of uncertain future events that are speculative. The Service has ruled that where payment is to be made only from future cash flow the receipt of which is speculative, the mortgage cannot be included in basis except to the extent of cash flow so received.[13]

Practice point:

> The seller often gets dollar signs in their eyes when looking at the gross amount of the contract. The accountant must sometimes remind them that gross dollars and net after tax dollars are very different. Also, the seller often does not understand that debt assumed by the buyer is part of gross proceeds. A seller could sell a highly leveraged business and receive very little after-tax cash. Also, the seller not familiar with accounting practices will sometimes assume that the taxable gain is the amount that proceeds exceed cost. Cost and adjusted basis are also very different. The accountant may have to explain to the seller how depreciation affects the basis. They often don't understand why they owe tax on a transaction when they sold it for less than original cost.

4. Gain realized

The amount of realized gain is the difference between the amount realized and the property's adjusted basis at the time of the sale.

Gain and loss may be either **ordinary** or **capital**. Generally, a sale or trade of a capital asset results in a capital gain or loss, whereas a sale or trade of a noncapital asset generally results in ordinary gain or loss.

B. Stock sale

1. Character of gain

In a stock sale, the selling shareholders will recognize taxable gain or loss (generally capital) unless the stock was §306 stock.[14]

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[10] *Tufts v. Commissioner*, 461 U.S. 300 (1983).
[11] Note, however, that the Form 1099-S will report the full sales price unreduced by such selling expenses.
[12] IRC §1012.
[13] Rev. Rul. 80-235, 1980-2 C.B. 229.
[14] This is generally a tax-free preferred stock dividend on the common stock.

2. Corporate-level accounts

The buyer receives a **cost basis** in the stock, but in general no changes occur at the corporate level. Thus, basis, **earnings and profits**, carryforwards, etc., are unchanged.

C. Sale of stock of an S corporation

1. In general

The shareholders of a target S corporation may decide to sell the stock of their corporation instead of the assets. A sale of stock generally will affect the S election only if the stock is sold to an ineligible shareholder or the sale causes the total shareholders to exceed the limit of 100 shareholders.

2. Allocations

If the election is terminated, income or loss will be allocated between the C and S short years on a daily pro rata basis absent an election to "close the books."

a. When the S election is not terminated, the corporation, all the selling shareholders, all the buying shareholders, and any other shareholders may elect to close the books if there is a complete termination of a shareholder's interest.[15]

b. The closing-of-the-books method may also be permitted where there is a qualifying disposition of stock. A qualifying disposition[16] is:

   (i) A disposition by a shareholder of 20 percent or more of the outstanding stock of the corporation in one or more transactions during any 30-day period during the corporation's taxable year;

   (ii) A redemption treated as an exchange of 20 percent or more of the outstanding stock of the corporation from a shareholder in one or more transactions during any 30-day period during the corporation's taxable year; or

   (iii) By a shareholder of 20 percent or more of the outstanding stock of the corporation in one or more transactions during any 30-day period during the corporation's taxable year.

3. Post-sale distributions

If the S election is not terminated, post-sale distributions to the acquiring shareholders may be treated as nondividend distributions under §1368(e)(1)(A) as the accumulated adjustments account is a corporate account – that is, such account is not personal to the shareholder. This is an advantage for the buyer that should be considered by the seller when negotiating a selling price.

4. Presale distributions

A presale distribution by the S corporation may result in a tax-free distribution to the selling shareholder. Under §1368, the selling shareholder could cause the S corporation to distribute excess cash to the extent of basis. The stock could then be sold on the installment basis for a reduced price. Each installment would carry a higher percentage of gain, but such gain would be deferred. The shareholder could receive immediate cash without gain recognition.

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15 IRC §1377(a)(2)(A).

16 Treas. Reg. §1.1368-1(g)(2). The creation of two partial short taxable years is for the treatment of distributions.

5. Acquisition of an S corporation by a consolidated group

The consolidated-return regulations provide that a subsidiary becomes (or ceases to be) a member of the consolidated group at the end of the day on which its status as a member changes, and its tax year ends at that time for all federal income-tax purposes. A subsidiary becomes a member of the consolidated group at the end of the day on which its status as a member changes, and its tax year ends at that time for all federal income-tax purposes. The subsidiary's items for the period beginning on the day after it becomes a member of the consolidated group are generally included in the consolidated return of the group. The subsidiary's items for the period prior to its becoming a member generally are included in a separate return. The consolidated return must include the common parent's items of income, gain, deduction, loss, and credit for the consolidated return year and each subsidiary's items for the portion of the year for which the subsidiary is a member.

a. However, the general rule for the termination of an S election, such as by having a corporate shareholder, is that this is effective on the day the corporation becomes a shareholder. When the termination of an S corporation election becomes effective on any day other than the first day of the taxable year, the taxable year in which the termination occurs is an S termination year. The S termination year is comprised of a short taxable year for which the corporation is an S corporation (the portion of the S termination year ending on the day before the terminating event occurs, or S short year) and a short taxable year for which the corporation is a C corporation (the remainder of the S termination year, or C short year).

   (i) If the election is terminated by the sale, allocations will be made between the C and S short years on a daily pro rata basis. The corporation and all the affected shareholders owning S stock during the taxable year may elect to have the normal rules of tax accounting apply to each short year. The affected shareholders for these purposes include the selling shareholder, all shareholders on any day of the S short year, and all shareholders on the first day of the C short year.

   (ii) If there is a change in ownership of 50 percent or more of the stock in a corporation during the S termination year, items of income, gain, loss, deduction, and credit must be allocated between the S short year and the C short year on the basis of the corporation's normal method of accounting, as determined under §446 (also referred to as a closing of the corporation's books) as of the close of the S short year, rather than a daily proration or other method. The S short year and the C short year are treated as two separate taxable years for most purposes. Separate returns are required for the S short year and the C short year, and the due date for the S short year return is the date by which the C short year return must be filed.

   (iii) If an S corporation becomes a member of a consolidated group, the interaction of the consolidated-return regulations and the S rules results in the corporation having three taxable periods for the year of the acquisition for which federal income tax returns are due: (a) an S short year that ends on the day before the acquisition by the consolidated group; (b) a C short year consisting solely of the day of the acquisition; and (c) a short taxable year (included in the consolidated return) for any items occurring after the day of the acquisition. Items from the C short year or the consolidated year cannot be allocated to the S short year by a daily proration of the items attributable to the year of the acquisition.

b. Under the final consolidated-return regulations, if the S corporation becomes a member in the consolidated group, the S corporation will become a member at the beginning of the day the termination of its S corporation election is effective. Its tax year ends for all federal income-tax purposes at the end of the preceding day. Consequently, the acquired corporation has two short tax years – one for the period in which it was an S corporation, and the other for the period in which it was a consolidated group member. They preclude the availability of ratable allocation, so that if an S corporation joins a consolidated group, the items must be allocated between the two short taxable years that begin and end with the corporation joining the consolidated group on the basis of a closing of the books. This applies to transactions occurring after November 10, 1999.

Note:

There was some fear by practitioners that the separate return of the acquired corporation was accelerated to the fifteenth day of the third month following the end of the short taxable year that resulted from the corporation joining or leaving the consolidated group. This was not intended and conflicts with the general application of the separate return filing due date requirements addressed elsewhere in the consolidated-return regulations. Accordingly, the Service has issued proposed regulations that permit the separate return to be due on the earlier of: (i) the date its S corporation return would have been due if its tax year had not ended; or (ii) the date the consolidated group's return is due for the tax year that includes the acquisition. This is applicable to corporations that became or ceased to be members of consolidated groups on or after January 1, 1995.

c. A major exception to these rules is an S corporation acquired in a qualifying stock purchase for which the §338(g) election has been made.

Example: **Acquisition of S corporation**[17] – Z is a small business corporation for which an S election was in effect at all times since year 1. At all times, Z had only 100 shares of stock outstanding, all of which were owned by individual A. On July 1 of year 3, P (the purchaser corporation) acquired all of the Z stock. P does not make an election under §338(g) with respect to its purchase of the Z stock.

As a result of P's acquisition of the Z stock, Z's S election terminates. Z's tax year ends for all federal income-tax purposes on June 30 of year 3. If no extension of time is sought, Z must file a separate return for the period from January 1 through June 30 of year 3 on or before March 15 of year 4. Z will become a member of the P consolidated group as of July 1 of year 3. P group's year 3 consolidated return will include Z's items from July 1 to December 31 of year 3.

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[17] Treas. Reg. §1.1502-76(b)(5), Example 7.

D. Sales of LLC interests

1. Adjustments in sales of LLC interests

The IRS has published final regulations relating to:[18]

- The optional adjustments to the basis of LLC property following transfers of LLC interests under §743;
- The calculation of gain or loss under §751(a) following the sale or exchange of an LLC interest;
- The allocation of basis adjustments among LLC assets under §755; and
- The allocation of a member's basis in LLC interest to properties distributed to the member by the LLC under §732(c).

Note:

The Service noted that it intends to issue guidance outlining rules for determining the fair market value of LLC assets in some situations, including for purposes of allocating §743(b) basis adjustments on the transfer of an LLC interest. Under that guidance, the IRS says, §7701(g) will apply in determining the fair market value of LLC assets (not less than any nonrecourse loan securing such assets) for purposes of allocating §743(b) basis adjustments.

2. Unrealized receivables and inventory items

The income or loss realized by a member upon the sale or exchange of its interest in §751 property is the amount of income or loss from §751 property (including any remedial allocations) that would have been allocated to the member (to the extent attributable to the LLC interest sold or exchanged) if the LLC had sold all of its property in a fully taxable transaction for cash in an amount equal to the fair market value of such property (taking into account §7701(g)) immediately prior to the member's transfer of the interest in the LLC. Any gain or loss recognized that is attributable to §751 property will be ordinary gain or loss. The difference between the amount of capital gain or loss that the member would realize in the absence of §751 and the amount of ordinary income or loss determined is the transferor's capital gain or loss on the sale of its LLC interest.[19]

LLC §751 ordinary income assets consist of unrealized receivables and **all** inventory items.[20] Unrealized receivables consist of two types.

(i) Actual unrealized receivables, which are LLC rights to payment for services, whether or not yet rendered, and LLC rights to payment for inventory and similar "ordinary income" goods delivered or to be delivered that have not yet been includable in the LLC's gross income under its method of accounting.[21]

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18 T.D. 8847.
19 Treas. Regs. §1.751-1(a)(2).
20 IRC §§751(c) and (d); Treas. Regs. §§1.751-1(c) and (d).
21 IRC §§751(c)(1) and (2); Treas. Regs. §1.751-1(c).

Example: P LLC, which uses the cash method and has a calendar taxable year, contractually obligates itself to perform services for a client in exchange for $300,000. P sends a bill for $40,000 on July 1, which is paid, and a bill for $70,000 on December 1, which remains unpaid as of December 31. As of December 31, P has an unrealized receivable of $260,000, which includes the unpaid $70,000 and the uncharged $190,000. The other $40,000 is not an unrealized receivable because P realized it when including it in gross income.[22]

(ii) Deemed unrealized receivables, which consist of recapture amounts and financial instrument ordinary income amounts, of which the most significant is depreciation recapture.[23]

Inventory items consist of three types.

(i) Inventory items and items held by the LLC primarily for sale to customers in the ordinary course of business.[24]

(ii) Other LLC property that, if sold, would not be treated as either a capital asset or §1231 asset.[25] Thus, by definition, unrealized receivables are also inventory items.

(iii) LLC property that would be in either of the previous categories if held directly by the selling member.[26]

Example: P LLC uses the accrual method and has $50,000 of outstanding accounts receivable, which are not unrealized receivables because P realized and recognized income with respect to them. P also has inventory worth $125,000 in which its adjusted basis is $100,000. The inventory items also include the accounts receivable because they are neither capital assets nor §1231 assets. The aggregate adjusted basis of the inventory items is $150,000 and the aggregate fair market value is $175,000. Thus, the $25,000 gain is treated as ordinary income.

Note:

A member selling or exchanging any part of an interest in an LLC that has any §751 property at the time of sale or exchange must submit with its income tax return for the taxable year in which the sale or exchange occurs a statement setting forth separately the following information:

- The date of the sale or exchange;
- The amount of any gain or loss attributable to the §751 property; and
- The amount of any gain or loss attributable to capital gain or loss on the sale of the LLC interest.[27]

In determining the amount of the sale price attributable to such unrealized receivables, or their value in a distribution treated as a sale or exchange, full account shall be taken not only of the estimated cost of completing performance of the contract or agreement, but also of the time between the sale or distribution and the time of payment.[28]

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22 See *Ledoux v. Commissioner*, 77 T.C. 293, aff'd, 695 F.2d 1320 (11th Cir. 1983).
23 IRC §751(c).
24 IRC §751(d)(1); Treas. Regs. §1.751-1(d)(2)(i).
25 IRC §751(d)(2); Treas. Regs. §1.751-1(d)(2)(ii).
26 IRC §751(d)(3); Treas. Regs. §1.751-1(d)(2)(i).
27 Treas. Regs. §1.751-1(a)(3).
28 Treas. Regs. §1.751-1(c)(3).

Example:[29] A and B are equal members in personal-service LLC PRS. B transfers its interest in PRS to T for $15,000 when PRS's balance sheet (reflecting a cash receipts and disbursements method of accounting) is as follows.

Assets	Adjusted Basis	Fair Market Value
Cash	$ 3,000	$ 3,000
Loans receivable	10,000	10,000
Capital assets	7,000	5,000
Unrealized receivables	0	14,000
Total	$20,000	$32,000
Liabilities and Capital	**Adjusted Per Books**	**Fair Market Value**
Liabilities	$ 2,000	$ 2,000
Capital:		
A	9,000	15,000
B	9,000	15,000
Total	$20,000	$32,000

None of the assets owned by PRS is §704(c) property, and the capital assets are nondepreciable. The total amount realized by B is $16,000, consisting of the cash received, $15,000, plus $1,000, B's share of the LLC liabilities assumed by T. B's undivided half-interest in the LLC property includes a half-interest in the LLC's unrealized receivables items. B's basis for its LLC interest is $10,000 ($9,000, plus $1,000, B's share of LLC liabilities). If §751(a) did not apply to the sale, B would recognize $6,000 of capital gain from the sale of the interest in PRS. However, §751(a) does apply to the sale.

If PRS sold all of its §751 property in a fully taxable transaction immediately prior to the transfer of B's LLC interest to T, B would have been allocated $7,000 of ordinary income from the sale of PRS's unrealized receivables. Therefore, B will recognize $7,000 of ordinary income with respect to the unrealized receivables. The difference between the amount of capital gain or loss that the member would realize in the absence of §751 ($6,000) and the amount of ordinary income or loss determined ($7,000) is the transferor's capital gain or loss on the sale of its LLC interest. In this case, B will recognize a $1,000 capital loss.

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29 Treas. Regs. §1.751-1(g)(i)(B).

3. *Review exercise*

Assume the same facts as the example above, except the unrealized receivables are $26,000 and the capital assets FMV is $4,000 as follows:

Assets	Adjusted Basis	Fair Market Value
Cash	$ 3,000	$ 3,000
Loans receivable	10,000	10,000
Capital assets	7,000	4,000
Unrealized receivables	0	26,000
Total	$20,000	$43,000
Liabilities and Capital	**Adjusted Per Books**	**Fair Market Value**
Liabilities	$ 2,000	$ 2,000
Capital:		
A	9,000	20,500
B	9,000	20,500
Total	$20,000	$43,000

B transfers his interest to T for $20,500.

Question 1: What are the total proceeds of the sale?

Question 2: What is the total gain on the sale?

Question 3: How much ordinary income must B report under §751?

Question 4: What is the residual capital gain or loss?

4. *Allocation of basis*

An LLC that has an election in effect under §754 must adjust the basis of LLC property under the provisions of §734(b) and §743(b) pursuant to the provisions of §755. The basis adjustment is first allocated between the two classes of property described in §755(b). These classes of property consist of capital assets and §1231(b) property (capital gain property), and any other property of the LLC (ordinary income property). For purposes of this section, properties and potential gain treated as unrealized receivables under §751(c) and the regulations thereunder shall be treated as separate assets that are ordinary income property. The portion of the basis adjustment allocated to each class is then allocated among the items within the class.[30]

In general, the portion of the basis adjustment allocated to one class of property may be an increase while the portion allocated to the other class is a decrease. This would be the case even though the total amount of the basis adjustment is zero. Also, the portion of the basis adjustment allocated to one item of property within a class may be an increase while the portion allocated to another is a decrease. This would be the case even though the basis adjustment allocated to the class is zero.[31] For these purposes, the allocation of the basis adjustment under §743(b) between the classes of property and among the items of property within each class are made based on the allocations of income, gain, or loss (including remedial allocations) that the transferee member would receive (to the extent attributable to the acquired LLC interest) if, immediately after the transfer of the LLC interest, all of the LLC's property were disposed of in a fully taxable transaction for cash in an amount equal to the fair market value of such property (the **hypothetical transaction**).[32]

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30 Treas. Regs. §1.755-1(a).
31 Treas. Regs. §1.755-1(b)(1)(i).
32 Treas. Regs. §1.755-1(b)(1)(ii).

a. The amount of the basis adjustment allocated to the class of ordinary income property is equal to the total amount of income, gain, or loss (including any remedial allocations) that would be allocated to the transferee (to the extent attributable to the acquired LLC interest) from the sale of all ordinary income property in the hypothetical transaction. The amount of the basis adjustment to capital gain property is equal to:[33]

(i) The total amount of the basis adjustment under §743(b); less

(ii) The amount of the basis adjustment allocated to ordinary income property under the preceding sentence; provided, however, that in no event may the amount of any decrease in basis allocated to capital gain property exceed the LLC's basis (or in the case of property subject to the remedial allocation method, the transferee's share of any remedial loss from the hypothetical transaction) in capital gain property. In the event that a decrease in basis allocated to capital gain property would otherwise exceed the LLC's basis in capital gain property, the excess must be applied to reduce the basis of ordinary income property.

Example 1: A and B form equal LLC PRS. A contributes $50,000 and Asset 1, a nondepreciable capital asset with a fair market value of $50,000 and an adjusted tax basis of $25,000. B contributes $100,000. PRS uses the cash to purchase Assets 2, 3, and 4. After a year, A sells its interest in PRS to T for $120,000. At the time of the transfer, A's share of the LLC's basis in LLC assets is $75,000. Therefore, T receives a $45,000 basis adjustment.

Immediately after the transfer of the LLC interest to T, the adjusted basis and fair market value of PRS's assets are as follows.

Assets	Adjusted Basis	Fair Market Value
Capital gain property:		
Asset 1	$ 25,000	$ 75,000
Asset 2	100,000	117,500
Ordinary income property:		
Asset 3	$ 40,000	$ 45,000
Asset 4	10,000	2,500
Total	$175,000	$240,000

If PRS sold all of its assets in a fully taxable transaction at fair market value immediately after the transfer of the LLC interest to T, the total amount of capital gain that would be allocated to T is equal to $46,250 ($25,000 §704(c) built-in gain from Asset 1, plus 50 percent of the $42,500 appreciation in capital gain property). T would also be allocated a $1,250 ordinary loss from the sale of the ordinary income property.

The amount of the basis adjustment that is allocated to ordinary income property is equal to ($1,250) (the amount of the loss allocated to T from the hypothetical sale of the ordinary income property).

The amount of the basis adjustment that is allocated to capital gain property is equal to $46,250 (the amount of the basis adjustment, $45,000, less ($1,250), the amount of loss allocated to T from the hypothetical sale of the ordinary income property).

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33 Treas. Regs. §1.755-1(b)(2)(i).

Note:

> Where an LLC interest is transferred as a result of the death of a member, the transferee's basis in its LLC interest is not adjusted for that portion of the interest, if any, which is attributable to items representing income in respect of a decedent under §691. Accordingly, if an LLC interest is transferred as a result of the death of a member, and the LLC holds assets representing income in respect of a decedent, no part of the basis adjustment under §743(b) is allocated to these assets.[34]

d. In the case of exchanges in which the transferee's basis in the interest is determined in whole or in part by reference to the transferor's basis in the interest, such as where an LLC interest is contributed to an LLC in a transaction to which §721(a) applies, the basis adjustments under §743(b) are determined as follows.

(i) If the total amount of the basis adjustment under §743(b) is zero, then no adjustment to the basis of LLC property will be made. If there is an increase in basis to be allocated to LLC assets, such increase must be allocated to **capital gain property** or **ordinary income property**, respectively, only if the total amount of gain or loss (including any remedial allocations) that would be allocated to the transferee (to the extent attributable to the acquired LLC interest) from the hypothetical sale of all such property would result in a net gain or net income, as the case may be, to the transferee; if an increase in basis may be allocated to both capital gain assets and ordinary income assets, the increase is allocated to each class in proportion to the net gain or net income, respectively, which would be allocated to the transferee from the sale of all assets in each class. If there is a decrease in basis to be allocated to LLC assets, such decrease must be allocated to capital gain property or ordinary income property, respectively, only if the total amount of gain or loss (including any remedial allocations) that would be allocated to the transferee (to the extent attributable to the acquired LLC interest) from the hypothetical sale of all such property would result in a net loss to the transferee; if a decrease in basis may be allocated to both capital gain assets and ordinary income assets, the decrease shall be allocated to each class in proportion to the net loss that would be allocated to the transferee from the sale of all assets in each class.[35]

(ii) If there is an increase in basis to be allocated within a class, the increase must be allocated first to properties with unrealized appreciation in proportion to the transferee's share of the respective amounts of unrealized appreciation before such increase (but only to the extent of the transferee's share of each property's unrealized appreciation). Any remaining increase must be allocated among the properties within the class in proportion to the transferee's share of the amount that would be realized by the LLC upon the hypothetical sale of each asset in the class.[36]

(iii) If there is a decrease in basis to be allocated within a class, the decrease must be allocated first to properties with unrealized depreciation in proportion to the transferee's shares of the respective amounts of unrealized depreciation before such decrease (but only to the extent of the transferee's share of each property's unrealized depreciation). Any remaining decrease must be allocated among the

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34 Treas. Regs. §1.755-1(b)(4)(i).
35 Treas. Regs. §1.755-1(b)(5)(ii).
36 Treas. Regs. §1.755-1(b)(5)(iii)(A).

properties within the class in proportion to the transferee's shares of their adjusted bases (as adjusted under the preceding sentence).[37]

(iv) If a decrease in basis must be allocated to capital gain assets, ordinary income assets, or both, and the amount of the decrease otherwise allocable to a particular class exceeds the transferee's share of the adjusted basis to the LLC of all depreciated assets in that class, the transferee's negative basis adjustment is limited to the transferee's share of the LLC's adjusted basis in all depreciated assets in that class.[38]

(v) If a transferee's negative basis adjustment under §743(b) cannot be allocated to any asset, because the adjustment exceeds the transferee's share of the adjusted basis to the LLC of all depreciated assets in a particular class, the adjustment is made when the LLC subsequently acquires property of a like character to which an adjustment can be made.[39]

Example 3: A is a member of LLC LTP, which has made an election under §754. The three members in LTP have equal interests in capital and profits. Solely in exchange for an LLC interest in UTP, A contributes its interest in LTP to UTP in a transaction described in §721. At the time of the transfer, A's basis in its LLC interest ($5,000) equals its share of inside basis (also $5,000). Under §723, UTP's basis in its interest in LTP is $5,000. LTP's only two assets on the date of contribution are inventory with a basis of $5,000 and a fair market value of $7,500, and a nondepreciable capital asset with a basis of $10,000 and a fair market value of $7,500. The amount of the basis adjustment under §743(b) to LLC property is $0 ($5,000, UTP's basis in its interest in LTP, minus $5,000, UTP's share of LTP's basis in LLC assets). Because UTP acquired its interest in LTP in a transferred basis exchange, and the total amount of the basis adjustment under §743(b) is zero, UTP receives no special basis adjustments under §743(b) with respect to the LLC property of LTP.

5. Capital gains look-through for sales or exchanges of interests in an LLC

When an interest in an LLC held for more than one year is sold or exchanged, the transferor may recognize ordinary income (e.g., §751(a)), collectibles gain, §1250 capital gain, and residual long-term capital gain or loss.[40] The Taxpayer Relief Act of 1997 (TRA97) added a 25 percent capital gains rate applicable to "unrecaptured §1250 gain," and a 28 percent rate applicable to collectibles gain. TRA97 also authorized the IRS to issue regulations applying those provisions to sales of interests in pass-through entities, and specifically provided that any gain from the sale of a LLC interest attributable to unrealized appreciation in the value of collectibles is to be treated as gain from the sale of a collectible.[41] Accordingly, the IRS issued regulations that provide that, if a taxpayer sells an interest in a LLC that holds collectibles, rules similar to those under §751(a) apply to determine the amount of capital gain attributable to unrealized gain in the collectibles. In addition, similar rules apply to determine the capital gain attributable to unrealized gain in §1250 property held by a partnership upon the sale of an interest in the LLC. The regulations do not apply in the case of a redemption of an LLC interest.[42] Look-through capital gain is the

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37 Treas. Regs. §1.755-1(b)(5)(iii)(B).

38 Treas. Regs. §1.755-1(b)(5)(iii)(C).

39 Treas. Regs. §1.755-1(b)(5)(iii)(D).

40 Treas. Regs. §1.1(h)-1(a).

41 IRC §§1(h)(6)(B) and (h)(11).

42 Treas. Regs. §1.1(h)-1(b)(2): "This paragraph (b)(2) does not apply to a transaction that is treated, for Federal income tax purposes, as a redemption of an interest in a partnership, S corporation, or trust." Treas. Regs. §1.1(h)-1(b)(3): "This paragraph (b)(3) does not apply to a transaction that is treated, for Federal income tax purposes, as a redemption of a partnership interest."

share of collectibles gain allocable to an interest in an LLC plus the share of §1250 capital gain allocable to an interest in an LLC, as illustrated below.[43]

Example: A and B are equal members in a personal service LLC (PRS). B transfers B's interest in PRS to T for $15,000 when PRS's balance sheet (reflecting a cash receipts and disbursements method of accounting) is as follows.

Assets	Adjusted Basis	Fair Market Value
Cash	$3,000	$3,000
Loans owed to LLC	10,000	10,000
Collectibles	1,000	3,000
Other capital assets	6,000	2,000
Capital assets	7,000	5,000
Unrealized receivables	0	14,000
Total	$20,000	$32,000
Liabilities and capital		
Liabilities	$2,000	$2,000
Capital:		
A	9,000	15,000
B	9,000	15,000
Total	$20,000	$32,000

At the time of the transfer, B has held the interest in PRS for more than one year, and none of the property owned by PRS is §704(c) property. The total amount realized by B is $16,000, consisting of the cash received, $15,000, plus $1,000, B's share of the LLC liabilities assumed by T. B's basis for the LLC interest is $10,000 ($9,000 plus $1,000, B's share of LLC liabilities). B's undivided one-half interest in PRS includes a one-half interest in the LLC's unrealized receivables and a one-half interest in the LLC's collectibles.

If PRS were to sell all of its §751 property in a fully taxable transaction immediately prior to the transfer of B's LLC interest to T, B would be allocated $7,000 of ordinary income from the sale of PRS's unrealized receivables. Therefore, B will recognize $7,000 of ordinary income with respect to the unrealized receivables. The difference between the amount of capital gain or loss that the member would realize in the absence of §751 ($6,000) and the amount of ordinary income or loss ($7,000) is the member's capital gain or loss on the sale of the LLC interest under §741. In this case, the transferor has a $1,000 pre-look-through long-term capital loss. If PRS were to sell all of its collectibles in a fully taxable transaction immediately prior to the transfer of B's LLC interest to T, B would be allocated $1,000 of collectibles gain from the sale of the collectibles. Therefore, B will recognize $1,000 of collectibles gain on account of the collectibles held by PRS. The difference between the transferor's pre-look-through long-term capital gain or loss (-$1,000) and the look-through capital gain determined under this section ($1,000) is the transferor's residual long-term capital gain or loss on the sale of the LLC interest. Under these facts, B will recognize a $2,000 residual long-term capital loss on account of the sale or exchange of the interest in PRS.

43 Treas. Regs. §1.1(h)-1(b)(1).

6. Holding periods of LLC interests[44]

A member has a divided holding period in an interest in an LLC if the member acquired portions of an interest at different times; or the member acquired portions of the LLC interest in exchange for property transferred at the same time but resulting in different holding periods determined under §1223.[45]

The portion of an LLC interest to which a holding period relates is determined by reference to a fraction that is the fair market value of the portion of the LLC interest received in the transaction to which the holding period relates over the fair market value of the entire LLC interest (determined immediately after the transaction).[46]

Planning point:

> For purposes of determining the holding period of an LLC interest (or portion thereof) that is sold or exchanged (or with respect to which gain or loss is recognized upon a distribution under §731), if a member makes one or more contributions of cash to the LLC and receives one or more distributions of cash from the LLC during the **one-year period** ending on the date of the sale or exchange (or distribution with respect to which gain or loss is recognized under §731), the member may reduce the cash contributions made during the year by cash distributions received on a last-in-first-out basis, treating all cash distributions as if they were received immediately before the sale or exchange (or at the time of the distribution with respect to which gain or loss is recognized under §731).[47] The Commissioner may prescribe by guidance published in the Internal Revenue Bulletin a rule disregarding certain cash contributions (including contributions of a de minimis amount of cash) in applying the general rule to determine the holding period of an LLC interest (or portion thereof) that is sold or exchanged.[48]

(i) For these purposes to determine the holding period of an LLC interest (or portion thereof) that is sold or exchanged, if a member receives a portion of the LLC interest in exchange for §751 assets within the one-year period ending on the date of the sale or exchange of all or a portion of the member's interest in the LLC, and the member recognizes ordinary income or loss on account of such a §751 asset in a fully taxable transaction (either as a result of the sale of all or part of the member's interest in the LLC or the sale by the LLC of the §751 asset), the contribution of the §751 asset during the one-year period shall be disregarded. However, if, but for this provision, a member would not be treated as having held any portion of the interest for more than one year (e.g., because the member's only contributions to the LLC are contributions of §751 assets or §751 assets and cash within the prior one-year period), this adjustment is not available.[49]

(ii) Deemed contributions of cash and deemed distributions of cash are generally disregarded.[50]

If a member sells or exchanges the member's entire interest in an LLC, any capital gain or loss recognized shall be divided between long-term and short-term capital gain or loss in the same proportions as the holding period of the interest in the LLC is divided between the portion of the interest held for more than one year and the portion of the interest held for one year or less.[51]

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44 Preamble to Treas. Reg. §1.1223-3: "Section 311 of the Taxpayer Relief Act of 1997, Public Law 105-34 (111 Stat. 788, 831) (the 1997 Act), as modified by sections 5001 and 6005(d) of the Internal Revenue Service Restructuring and Reform Act of 1998, Public Law 105-206 (112 Stat. 685, 787, 800) (the 1998 Act), reduced the maximum statutory tax rates for long-term capital gains of individuals in general and provided regulatory authority to apply the rules to sales and exchanges of interests in pass-thru entities and to sales and exchanges by pass-thru entities."

45 Treas. Regs. §1.1223-3(a).

46 Treas. Regs. §1.1223-3(b)(1).

47 Treas. Regs. §1.1223-3(b)(2).

48 Treas. Regs. §1.1223-3(b)(5).

49 Treas. Regs. §1.1223-3(b)(4).

50 Treas. Regs. §1.1223-3(b)(3).

51 Treas. Regs. §1.1223-3(c)(1).

Planning point:

Strategies to reduce the net contribution to zero within the 12-month window should be explored. For example, if there are sufficient funds to repay, the LLC might consider a full repayment coupled by a recontribution in the form of a convertible loan. If there are not sufficient funds, then the LLC could assume a liability of one or more of its members, because such assumption is treated as though the LLC had distributed cash in the amount of the assumed liabilities.

Another alternative is for an entity affiliated with a member (rather than the member himself) to make the capital contribution to the LLC. This segregates the short-term nature of a subsequent disposition without impacting the long-term character of the member's potential gain. In effect, this creates separable investment units in the LLC that are generally not allowed under the final regulations for a single member. This could be attacked by the Service as a mere sham under certain circumstances.

Planning point:

Since a member's divided holding period depends on the relative fair market value of the member's interest owned before and acquired after the transaction, valuation techniques are an important aspect of planning in these circumstances.

Planning point:

Where additional LLC funding is necessary but the member providing the funds anticipates the possible sale of the LLC interest within 12 months after the infusion, a convertible loan may preserve favorable long-term capital gain treatment for that member-lender as an alternative to the one-year net cash contribution rule (reducing to zero if a corresponding one-year distribution is made). This may be cleaner than the use of proportionate loans, since there the Service may easily argue that they are disguised equity, i.e., capital contributions triggering the split-holding-period approach.

Capital borrowed from third-party lenders is also a possibility and even a proportionate guarantee should not be treated as an assumption of LLC debt that would cause a separate holding period to begin.

Other than a publicly traded LLC[52] if a member has a divided holding period in an LLC interest, then the holding period of the transferred interest is divided between long-term and short-term capital gain or loss in the same proportions as the long-term and short-term capital gain or loss that the transferor member would realize if the entire interest in the LLC were transferred in a fully taxable transaction immediately before the actual transfer.[53]

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52 Treas. Regs. §1.1223-3(c)(2)(i) describes the regime with respect to PTP interests.
53 Treas. Regs. §1.1223-3(c)(2)(ii).

Planning point:

> An LLC's holding period in its assets generally has no impact on the holding period of the members' interests in the LLC.[54] Take a good look at the LLC assets: if they qualify for long-term capital gain treatment, a sale of the assets should be considered, and the holding period rules cause the gain or loss on a sale of the LLC interests to be treated as short-term in part. On the other hand, if the LLC owns significant assets with short-term holding periods, even a partial allocation to short-term may produce a better tax result; the Service has ruled that if all LLC interests are purchased by a single purchaser, the form of the transaction as a sale of the LLC interests will be recognized.[55]
>
> The same issues apply with respect to charitable contributions where the contribution of short-term holding period property reduces the amount of the contribution to the adjusted basis of an intangible asset, such as an LLC interest. (Of course, the contribution of assets might also be reduced to basis if they are not related to the charity's tax-exempt function.)

Planning point:

> Look for the silver lining. The current sale of many an LLC interest would, in a declining economy, result in long-term capital loss. The split-holding-period approach has the effect of converting a portion of the member's long-term holding period into short-term where, for example, the member purchases an additional interest in the same LLC from another member, holding both for a short but not insignificant time, and then selling both interests. This will effectively convert a portion of the loss from long-term to short-term. Alternatively, if a member makes a substantial capital contribution to the LLC within 12 months of the sale, the member may withdraw a substantial portion or all of that capital contribution.[56]

A member's holding period in an LLC interest is not affected by distributions from the LLC.[57] However, if a member is required to recognize capital gain or loss as a result of a distribution from an LLC, then the capital gain or loss recognized is divided between long-term and short-term capital gain or loss in the same proportions as the long-term and short-term capital gain or loss that the distributee member would realize if such member's entire interest in the LLC were transferred in a fully taxable transaction immediately before the distribution.[58]

***Example 1*:** A contributes $5,000 of cash and a nondepreciable capital asset A has held for two years to an LLC (PRS) for a 50 percent interest in PRS. A's basis in the capital asset is $5,000, and the fair market value of the asset is $10,000. After the exchange, A's basis in A's interest in PRS is $10,000, and the fair market value of the interest is $15,000. A received one-third of the interest in PRS for a cash payment of $5,000 ($5,000/$15,000). Therefore, A's holding period in one-third of the interest received (attributable to the contribution of money to the LLC) begins on the day after the contribution. A received two-thirds of the interest in PRS in exchange for the capital asset ($10,000/$15,000). Accordingly, A has a two-year holding period in two-thirds of the interest received in PRS.

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54 Rev. Rul. 68-79, 1968-1 C.B. 310.

55 Rev. Rul. 99-6, 1999-1 C.B. 432.

56 According to the regulations, a member who receives one or more distributions of cash from the LLC during a one-year period "may" reduce (but presumably is not required to reduce) the cash contributions made during the year by cash distributions received during the year. Treas. Regs. §1.1223-3(b)(2).

57 Treas. Regs. §1.1223-3(d)(1).

58 Treas. Regs. §1.1223-3(d)(2).

Six months later, when A's basis in PRS is $12,000 (due to a $2,000 allocation of LLC income to A), A sells the interest in PRS for $17,000. Assuming PRS holds no inventory or unrealized receivables and no collectibles or §1250 property, A will realize $5,000 of capital gain. As determined above, one-third of A's interest in PRS has a holding period of one year or less, and two-thirds of A's interest in PRS has a holding period equal to two years and six months. Therefore, one-third of the capital gain will be short-term capital gain, and two-thirds of the capital gain will be long-term capital gain.

III. Asset sales

A. Applicable asset acquisition

1. In general

An **applicable asset acquisition** is any transfer, whether direct or indirect, of a group of assets if the assets transferred constitute a trade or business in the hands of either the seller or the purchaser and, except as provided in nonrecognition exchanges, the purchaser's basis in the transferred assets is determined wholly by reference to the purchaser's consideration.[59]

a. For these purposes, a group of assets constitutes a trade or business if the use of such assets would constitute an **active trade or business** under §355; or its character is such that **goodwill or going-concern value could under any circumstances attach** to such group.[60]

b. Goodwill is the value of a trade or business attributable to the expectancy of continued customer patronage. This expectancy may be due to the name or reputation of a trade or business or any other factor.

  (i) Going-concern value is the additional value that attaches to property because of its existence as an integral part of an ongoing business activity. Going-concern value includes the value attributable to the ability of a trade or business (or a part of a trade or business) to continue functioning or generating income without interruption notwithstanding a change in ownership. It also includes the value that is attributable to the immediate use or availability of an acquired trade or business, such as, for example, the use of the revenues or net earnings that otherwise would not be received during any period if the acquired trade or business were not available or operational.[61]

  (ii) In making the determination as to whether goodwill or going-concern value could attach to a group of assets, all the facts and circumstances surrounding the transaction are taken into account. Whether sufficient consideration is available to allocate to goodwill or going-concern value after the residual method is applied is not relevant in determining whether goodwill or going-concern value could attach to a group of assets.[62] Factors to be considered include:

    - The presence of any intangible assets (whether or not those assets are §197 intangibles), provided, however, that the transfer of such an asset in the absence of other assets will not be a trade or business for purposes of §1060;

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59 Treas. Regs. §1.1060-1(b)(1).
60 Treas. Regs. §1.1060-1(b)(2)(i).
61 Treas. Regs. §1.1060-1(b)(2)(ii).
62 Treas. Regs. §1.1060-1(b)(2)(iii).

- The existence of an excess of the total consideration over the aggregate book value of the tangible and intangible assets purchased (other than goodwill and going-concern value) as shown in the financial accounting books and records of the purchaser; and
- Related transactions, including lease agreements, licenses, or other similar agreements between the purchaser and seller (or managers, directors, owners, or employees of the seller) in connection with the transfer.

Example 1: S is a high-grade machine shop that manufactures microwave connectors in limited quantities. It is a successful company with a reputation within the industry and among its customers for manufacturing unique, high-quality products. Its tangible assets consist primarily of ordinary machinery for working metal and plating. It has no secret formulas or patented drawings of value. P is a company that designs, manufactures, and markets electronic components. It wants to establish an immediate presence in the microwave industry, an area in which it previously has not been engaged. P is acquiring assets of a number of smaller companies and hopes that these assets will collectively allow it to offer a broad product mix. P acquires the assets of S in order to augment its product mix and to promote its presence in the microwave industry. P will not use the assets acquired from S to manufacture microwave connectors. The assets transferred are assets that constitute a trade or business in the hands of the seller. Thus, P's purchase of S's assets is an applicable asset acquisition. The fact that P will not use the assets acquired from S to continue the business of S does not affect this conclusion.

Example 2: S, a sole proprietor who operates a car wash, both leases the building housing the car wash and sells all of the car-wash equipment to P. S's use of the building and the car-wash equipment constitute a trade or business. P begins operating a car wash in the building it leases from S. Because the assets transferred together with the asset leased are assets that constitute a trade or business, P's purchase of S's assets is an applicable asset acquisition.

2. Asset classes

For applicable asset acquisitions after March 15, 2001, under the §1060 residual method, consideration generally must be allocated to the following seven classes of assets, in descending order of priority:[63]

a. Class I assets are cash and general deposit accounts (including savings and checking accounts) other than certificates of deposit held in banks, savings and loan associations, and other depository institutions.[64]

b. Class II assets are actively traded personal property within the meaning of §1092(d)(1) and Treas. Regs. §1.1092(d)-1 (determined without regard to §1092(d)(3)). In addition, Class II assets include certificates of deposit and foreign currency even if they are not actively traded personal property. Examples of Class II assets include U.S. government securities and publicly traded stock.[65]

c. Class III assets are assets that the taxpayer marks to market at least annually for federal income-tax purposes, and debt instruments (including accounts receivable).[66] However, Class III assets do not include:

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63 Treas. Regs. §1.338-6(b).
64 Treas. Regs. §1.338-6(b)(1).
65 Treas. Regs. §1.338-6(b)(2)(ii).
66 Treas. Regs. §1.338-6(b)(2)(iii).

- Debt instruments issued by persons related at the beginning of the day following the acquisition date to the target under §§267(b) or 707;
- Contingent debt instruments issued in connection with the sale or exchange of property, unless the instrument is subject to the noncontingent bond method; and
- Debt instruments convertible into the stock of the issuer or other property.

d. Class IV assets are stock in trade of the taxpayer or other property of a kind that would properly be included in the inventory of taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business.[67]

e. Class VI assets are all §197 intangibles, except goodwill and going-concern value. Class V assets include stock of target affiliates other than actively traded stock described in §1504(a)(4).[68]

f. Class VII assets are goodwill and going-concern value (whether or not the goodwill or going-concern value qualifies as a §197 intangible). All remaining consideration, *i.e.*, "residual" consideration, must be allocated to Class VII assets.[69]

g. Class V assets are all assets other than Class I, II, III, IV, VI, and VII assets.[70]

Note:

The Service has announced its intention to add similar items to any of the above classes by designation in the Internal Revenue Bulletin.[71]

3. Asymmetrical transfers of assets

If, under general principles of tax law, a seller is not treated as transferring the same assets as the purchaser is treated as acquiring, the assets acquired by the purchaser constitute a trade or business, and, except for partial nonrecognition exchanges, the purchaser's basis in the transferred assets is determined wholly by reference to the purchaser's consideration, then the purchaser is subject to §1060.[72]

4. Related transactions

Whether the assets transferred constitute a trade or business is determined by aggregating all transfers from the seller to the purchaser in a series of related transactions. Except with respect to partial nonrecognition exchanges, all assets transferred from the seller to the purchaser in a series of related transactions are included in the group of assets among which the consideration paid or received in such series is allocated under the residual method. The general principles are also applied in determining which assets are included in the group of assets among which the consideration paid or received is allocated under the residual method.[73]

5. More than a single trade or business

If the assets transferred from a seller to a purchaser include more than one trade or business, then, in applying this section, all of the assets transferred (whether or not transferred in one transaction or a series of related transactions and whether or not part of a trade or business) are treated as a single trade or business.[74]

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67 Treas. Regs. §1.338-6(b)(2)(iv).
68 Treas. Regs. §1.338-6(b)(2)(vi).
69 Treas. Regs. §1.338-6(b)(2)(vii).
70 Treas. Regs. §1.338-6(b)(2)(v).
71 Treas. Regs. §1.338-6(b)(3).
72 Treas. Regs. §1.1060-1(b)(4).
73 Treas. Regs. §1.1060-1(b)(5).
74 Treas. Regs. §1.1060-1(b)(6).

6. Covenant entered into by the seller

If, in connection with an applicable asset acquisition, the seller enters into a covenant (e.g., a covenant not to compete) with the purchaser, that covenant is treated as an asset transferred as part of a trade or business.[75]

7. Partial nonrecognition exchanges

A transfer may constitute an applicable asset acquisition notwithstanding the fact that no gain or loss is recognized with respect to a portion of the group of assets transferred. All of the assets transferred, including the nonrecognition assets, are taken into account in determining whether the group of assets constitutes a trade or business. The **allocation of consideration** is done without taking into account either the nonrecognition assets or the amount of money or other property that is treated as transferred in exchange for the nonrecognition assets (together, the nonrecognition exchange property). The basis in and gain or loss recognized with respect to the nonrecognition exchange property are determined under such rules as would otherwise apply to an exchange of such property. The amount of the money and other property treated as exchanged for nonrecognition assets is the amount by which the fair market value of the nonrecognition assets transferred by one party exceeds the fair market value of the nonrecognition assets transferred by the other (to the extent of the money and the fair market value of property transferred in the exchange). The money and other property that are treated as transferred in exchange for the nonrecognition assets (and that are not included among the assets to which §1060 applies) are considered to come from the following assets in the following order: first from Class I assets, then from Class II assets, then from Class III assets, then from Class IV assets, then from Class V assets, then from Class VI assets, and then from Class VII assets. For this purpose, liabilities assumed (or to which a nonrecognition exchange property is subject) are treated as Class I assets.[76]

8. Consideration

The seller's consideration is the amount, in the aggregate, realized from selling the assets in the applicable asset acquisition.[77] The purchaser's consideration is the amount, in the aggregate, of its cost of purchasing the assets in the applicable asset acquisition that is properly taken into account in basis.

a. For purposes of determining the seller's amount realized for each of the assets sold in an applicable asset acquisition, the seller allocates consideration to all the assets sold by using the residual method. For purposes of determining the purchaser's basis in each of the assets purchased in an applicable asset acquisition, the purchaser allocates consideration to all the assets purchased by using the residual method. In allocating consideration, separate rules apply in addition to the general rules of allocation and reallocation.[78]

b. The seller and purchaser each adjust the amount allocated to an individual asset to take into account the specific identifiable costs incurred in transferring that asset in connection with the applicable asset acquisition (e.g., real estate transfer costs or security interest perfection costs). Costs so allocated increase, or decrease, as appropriate, the total consideration that is allocated under the residual method. No adjustment is made to the amount allocated to an individual asset for general costs associated with the applicable asset acquisition as a whole or with groups of assets included therein (e.g., nonspecific

[75] Treas. Regs. §1.1060-1(b)(7).
[76] Treas. Regs. §1.1060-1(b)(8).
[77] Treas. Regs. §1.1060-1(c)(1).
[78] Treas. Regs. §1.1060-1(c)(2).

appraisal fees or accounting fees). These latter amounts are considered only indirectly through their effect on the total consideration to be allocated.[79]

c. If, in connection with an applicable asset acquisition, the seller and purchaser agree in writing as to the allocation of any amount of consideration to, or as to the fair market value of, any of the assets, such agreement is binding on them except to the extent prior case law has permitted parties to refute the allocation or valuation.[80] However, nothing restricts the Service's authority to challenge the allocations or values arrived at in an allocation agreement.[81]

Example 1: A transfers assets X, Y, and Z to B in exchange for assets D, E, and F plus $1,000 cash.

Assume the exchange of assets constitutes an exchange of like-kind property to which §1031 applies. Assume also that goodwill or going-concern value could under any circumstances attach to each of the DEF and XYZ groups of assets and, therefore, each group constitutes a trade or business under §1060.

Assume the fair market values of the assets and the amount of money transferred are as follows.

By A		By B	
Asset	Fair Market Value	Asset	Fair Market Value
X	$ 400	D	$ 40
Y	400	E	30
Z	200	F	30
		Cash (amount)	1,000
Total	$ 1,000	Total	$ 1,100

For purposes of allocating consideration, the like-kind assets exchanged and any money or other property that are treated as transferred in exchange for the like-kind property are excluded from the application of §1060.

Since assets X, Y, and Z are like-kind property, they are excluded from the application of the §1060 allocation rules.

Since assets D, E, and F are like-kind property, they are excluded from the application of the §1060 allocation rules. In addition, $900 of the $1,000 cash B gave to A for A's like-kind assets is treated as transferred in exchange for the like-kind property in order to equalize the fair market values of the like-kind assets. Therefore, $900 of the cash is excluded from the application of the §1060 allocation rules.

$100 of the cash is allocated under §1060.

A, as transferor of assets X, Y, and Z, received $100 that must be allocated under §1060. Since A transferred no Class I, II, III, IV, V, or VI assets to which §1060 applies, in determining its amount realized for the part of the exchange to which §1031 does not apply, the $100 is allocated to Class VII assets (goodwill and going-concern value).

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79 Treas. Regs. §1.1060-1(c)(3).
80 *Commissioner v. Danielson*, 378 F.2d 771 (3d Cir.), cert. denied, 389 U.S. 858 (1967).
81 Treas. Regs. §1.1060-1(c)(4).

A, as transferee of assets D, E, and F, gave consideration only for assets to which §1031 applies. Therefore, the allocation rules of §1060 are not applied to determine the bases of the assets A received.

B, as transferor of assets D, E, and F, received consideration only for assets to which §1031 applies. Therefore, the allocation rules of §1060 do not apply in determining B's gain or loss.

B, as transferee of assets X, Y, and Z, gave A $100 that must be allocated under §1060. Since B received from A no Class I, II, III, IV, V, or VI assets to which §1060 applies, the $100 consideration is allocated by B to Class VII assets (goodwill and going-concern value).

9. Reporting requirements

Unless otherwise excluded from this requirement by the Commissioner, the seller and the purchaser in an applicable asset acquisition each must report information concerning the amount of consideration in the transaction and its allocation among the assets transferred. They also must report information concerning subsequent adjustments to consideration.[82]

a. The seller and the purchaser each must file asset acquisition statements on Form 8594, "Asset Acquisition Statement Under Section 1060," with their income tax returns or returns of income for the taxable year that includes the first date assets are sold pursuant to an applicable asset acquisition. This reporting requirement applies to all asset acquisitions.[83]

b. When an increase or decrease in consideration is taken into account after the close of first taxable year that includes the first date assets are sold in an applicable asset acquisition, the seller and the purchaser each must file a supplemental asset acquisition statement on Form 8594 with the income tax return or return of income for the taxable year in which the increase (or decrease) is properly taken into account.[84]

B. Section 1231 assets

1. In general

Business real estate or any depreciable property used in a trade or business is excluded from the definition of "capital assets" under the Code. However, if the property qualifies as §1231 property all of the dealings of such property are considered together to determine a net §1231 gain or net §1231 loss. If the gains from dealings in such property exceed any losses for the year, then the net §1231 gain is potentially treated as though it were derived from the sale of a long-term capital asset. This would normally yield capital gain. However, some or all of the gain will be treated as ordinary income to the extent of nonrecaptured net §1231 losses, defined in the following paragraph. If the losses from dealing in §1231 property exceed the gains, the net §1231 loss is treated as an ordinary loss.

Nonrecaptured §1231 losses are net §1231 losses in the prior five years that have not been recaptured against §1231 gain (i.e., converted the gain that would have been capital gain back to ordinary income).

82 Treas. Regs. §1.1060-1 (e)(1)(ii).
83 Treas. Regs. §1.1060-1(e)(1)(ii)(A).
84 Treas. Regs. §1.1060-1(e)(1)(ii)(B).

Note:

> From a practice standpoint, this means that if it appears that a taxpayer has a §1231 gain in 2024, the preparer does not know the correct character (capital or ordinary) unless the preparer obtains tax returns for 2023, 2022, 2021, 2020, and 2019.

2. Categories of §1231 assets

The major categories of §1231 assets are as follows:

- Depreciable tangible personal property used in a trade or business and held for more than one year;
- Real property used in a trade or business and held for more than one year;
- Trade or business property held for more than one year and involuntarily converted;
- Timber, coal, or domestic iron with a retained economic interest; and
- Livestock (not including poultry).

Note:

> If real property is used in a trade or business, it is not a capital asset but rather a §1231 asset. Familiar examples would include office and apartment buildings[85] as well as incorporated land leased out to sharecropping or mineral development. The net gain on a §1231 asset is generally considered capital gain while a net loss on the sale of a §1231 asset is generally ordinary loss. To qualify, such real estate must be held for more than one year.

C. Sections 1245 and 1250 assets

1. Section 1245 assets

Section 1245 property is §1231 property on which depreciation has been taken, or has been expensed under §179, that is sold or disposed of at a gain. Section 1245 property includes:[86]

- Certain elevators and escalators;
- Certain other tangible property (except a building or its structural component); and
- All property placed in service after December 31, 1980, that meets the definition of ACRS property (other than 15-year, 18-year, and 19-year property).

Negotiation point:

> Since §1245 assets generate ordinary income, allocation to the §1245 property is a key negotiation point when selling a pass-through entity. The seller, as part of the purchase price allocation, should try to negotiate a favorable allocation to these assets to minimize ordinary income and maximize long term capital gain, such as gain on goodwill. The seller may point out that, under current law, the purchaser can amortize the goodwill. The purchaser can write off the purchase price allocated to goodwill, but it takes 15 years. It is a good compromise to negotiate when comparing an asset sale to a stock sale. Also, even in selling a C corporation, allocation can be negotiated away from §1245 property to personal goodwill as previously mentioned to avoid double tax.

2. Section 1250 assets

Section 1250 property is depreciable real property and includes all real property that is, or has been, depreciable but is not subject to recapture under §1245. It also includes intangible real property such as leases of land or buildings and their structural components, except §1245 property.

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85 For these purposes, rental operations are a business.

86 For a detailed description of §1245 assets, obtain a copy of the Instructions for Form 4797 for line 25.

D. Depreciation recapture

If a §1231 asset that has been depreciated, or expensed under §179, is sold at a gain, part III of Form 4797, "Sales of Business Property," must be completed to determine the amount of gain that is subject to recapture as ordinary income. This recapture amount does not enter into the computation of §1231 gain in determining net §1231 gain or loss.

1. Section 1245 property recapture

If depreciable personal or similar property is disposed of, any gain is treated as ordinary income to the extent of **all depreciation taken** (including §179 expense), generally after 1961. The rules for the treatment of gain on the sale or other disposition of §1245 property are the same for MACRS, ACRS, and non-ACRS property.

Example: John Taxpayer sold a business machine for $3,000 on April 2, 2024, that he bought on January 15, 2022, for $2,800. The machine had an adjusted basis of $2,380 and its accumulated depreciation was $420. John's §1245 income is $420, figured as follows.

Amount realized	$3,000
Adjusted basis	2,380
Gain	620
Section 1245 ordinary income	420
Section 1231 capital gain	$200

2. Section 1250 property recapture

Generally, gain on the sale or disposition of §1250 property is treated as ordinary income rather than capital gain to the extent of the excess of depreciation allowances over the depreciation that would have been available under the straight-line method. Any gain that is not recaptured as ordinary income gets §1231 treatment. Since straight-line depreciation is the only method allowed with respect to real property since 1987, there will be no depreciation recapture for §1250 property placed into service since that time. Multiple rules apply for years prior to 1987 and the practitioner must check the specific rules for the tax year in question for the specific type of property involved. This discussion is considered beyond the scope of this manual.

3. Section 1250 unrecaptured gain

The term **unrecaptured §1250 gain** means the excess (if any) of certain gains over any losses not absorbed in the 28 percent-rate-gain category.[87] The gains include any long-term capital gain, not otherwise recaptured as ordinary income, attributable to prior depreciation of real property and which is from property held for more than one year reduced by an excess of 28 percent-rate-gain losses.[88] Generally, only an applicable percentage of the additional depreciation (aggregate depreciation in excess of the aggregate depreciation taken under the straight-line method) is treated as recaptured depreciation taxed as ordinary income.[89] The excess of 100 percent of the applicable depreciation of all depreciation taken over the amount so recaptured is the long-term capital gain not otherwise recaptured as ordinary income.

87 IRC §1(h)(7)(A).
88 IRC §1(h)(7)(A)(i)(II).
89 IRC §1250(b).

Note:

Section 1250 continues to treat gain attributable to certain depreciation (generally the amount of depreciation in excess of the amount allowable under the straight-line method) as ordinary income.

The amount of the gains for any taxable year may not exceed the net §1231 gain (§1231 gains reduced, but not below zero, by §1231 losses) for such year.[90] This means that §1231 losses from any §1231 asset may reduce the amount of the §1231 gain from real property that may be included in the gains attributable to the unrecaptured §1250 gain category, but only after they have offset other §1231 gains.

Note:

In the case of a disposition of a partnership interest held more than 12 months, the amount of long-term capital gain (not otherwise treated as ordinary income) that would be treated as ordinary income under §751(a) if §1250 applied to all depreciation, is taken into account in computing unrecaptured §1250 gain.

Example 1: An office building that had originally cost $200,000 was sold for $220,000. Depreciation of $100,000 had been taken under the straight-line method. What is the amount and character of the gain and how is it taxed?

The gain on the sale would be $120,000 ($220,000 sales price less $100,000 adjusted basis). There would be no §1250 recapture since there was no excess depreciation taken. Therefore, of the total gain of $120,000, $100,000 (limited to the total depreciation taken) would be unrecaptured §1250 gain and the $20,000 balance of the gain would be §1231 gain. The unrecaptured §1250 gain would be taxed at a maximum rate of 25 percent and the §1231 gain would be netted with other like items and possibly be taxed at a maximum capital gains rate of 20 percent (or 15 or 0 percent).

4. Recapture under ACRS

Gain on the disposition of **personal property and nonresidential real property** is treated as ordinary income to the extent of previously allowed ACRS deductions. However, since no ACRS deduction is allowed in the year of disposition of personal property, the adjusted basis used for computing gain or loss is the property's adjusted basis as of the first day of the year of disposition.

Gain on the disposition of **residential real property** is treated as ordinary income to the extent that the aggregate ACRS deductions exceed the hypothetical straight-line ACRS depreciation over the applicable recovery period. As a result, if the straight-line ACRS method was elected, no recapture is required.

5. Recapture under MACRS

Gain on the disposition of tangible personal property is treated as ordinary income to the extent of previously allowed MACRS deductions. Since all residential and nonresidential real property acquired after December 31, 1986, must be depreciated under the straight-line MACRS method, no depreciation recapture is required.

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90 IRC §1(h)(7)(B).

E. Sale of assets by the S corporation

1. Continuation of the S election

The sale of assets by the S corporation to the purchaser alone should not cause the termination of the S election. However, if the S corporation has Subchapter C earnings and profits, interest income on any installment note received or investment income derived from cash proceeds may cause a termination of the election under §1362(d)(3) (excess passive income).

2. Accounting issues

Income or loss is allocated to the shareholder as the corporation recognizes income under its normal method of accounting. Where an installment obligation is received, gain generally may be deferred until payment is received if the requirements of IRC §453(h) are satisfied;[91] however, a taxable asset sale may trigger more immediate gain recognition than a stock sale would. Installment method reporting is **not** available on the sale of inventory.[92] Also, recapture income is recognized in the year of sale.[93]

3. Built-in gains tax

A sale of assets by the S corporation may generate corporate-level tax under §1374 if the S election was made after December 31, 1986. However, avoidance of the tax does not appear possible in the case where the seller is disposing of recapture property.[94] This applies only during the first 10 years (five years for taxable years beginning in 2009 and 2010; five[95] years in 2011 and years thereafter) after the election is made. The total amount of gains that can be taxed to the corporation in any year cannot exceed the corporation's taxable income for that year, so operating losses can reduce the gain that is taxed to the corporation; however, net recognized gains not taxed because of this provision are carried over to the following taxable year.

F. Net investment income

1. In general

The tax on net investment income is an issue to be considered on the sale of a business.

a. In the case of an individual, Code §1411 (the NII tax) imposes a tax (in addition to any other tax under the income tax, including regular income tax and AMT). This tax is equal to 3.8 percent of the lesser of: (A) the individual's net investment income (NII) for such taxable year; or (B) the excess (if any) of: (i) the individual's modified adjusted gross income for such taxable year, over (ii) the threshold amount. The threshold amount is: (1) in the case of a taxpayer making a joint return or a surviving spouse, $250,000; (2) in the case of a married taxpayer filing a separate return, $125,000; and (3) in the case of any other individual, $200,000. For these purposes, modified adjusted gross income is defined as adjusted gross income increased by the excess of: (1) the amount excluded from gross income as foreign earned income or foreign housing allowance; over (2) the amount of any deductions (taken into account in computing adjusted gross income) or exclusions disallowed with respect to the amount excluded from gross income under the foreign earned income and housing allowance provisions.

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91 See IRC §453B(h).
92 IRC §453(b)(2)(B).
93 IRC §453(i).
94 See, e.g., IRC §453(i).
95 The five-year recognition period was made permanent by the Protecting Americans From Tax Hikes Act of 2015.

b. In general, the NII tax applies to an individual who is a citizen or resident of the United States but does not apply to nonresident alien individuals.

c. Net investment income includes **net gain** (to the extent taken into account in computing taxable income) attributable to the disposition of property ("category 3"), **except to the extent excluded by the exception for gain or loss attributable to property held in a trade or business other than a passive activity or a trader of financial instruments or commodities.**[96] Net gains arise from a disposition of property, including a sale, exchange, transfer, conversion, cash settlement, cancellation, termination, lapse, expiration, or other disposition (including a deemed disposition, for example, under §877A [Tax responsibilities of expatriation]).[97]

  (i) The gain from the sale of C corporation stock is fully included in net investment income because C stock is not property held in a trade or business.

  (ii) The sale of a proprietorship is a sale of the business's assets and almost by definition solely property held in a trade or business. The sale generally does not result in net gain that is included in net investment income if the active trade or business exception applies.

  (iii) The sale of a pass-through entity presents an apparent conflict:

    - If the assets are sold, the sale implicates largely or substantially all property that is held in the trade or business and thus neither the gain nor the loss is included in the seller's net investment income.
    - If the interest in the pass-through is sold, the sale seems to involve property (the interest in the entity) that is not held in a trade or business and seemingly any gain or loss should be included in the net investment income base. A **partnership interest or S corporation stock** generally is **not property held in a trade or business**. Therefore, gain from the sale of a partnership interest or S corporation stock is generally gain not subject to the trade or business exception. However, net gain does not include certain gain or loss attributable to the disposition of certain interests in partnerships and S corporations as provided in other proposed regulations.[98]

2. Final regulations

The issuance of the final regulations was accompanied by a withdrawal of the original proposed regulations and the promulgation of new proposed regulations dealing with the disposition of partnerships and S corporation stock. If a pass-through entity sells its assets, the owners are distributed gain on those assets, but since the character of the assets in general is "property held in a trade or business," the **business exception will tentatively apply** (**unless** the trade or business is the trading of financial instruments or the **owner is passive with respect to the trade or business activity** in which such property was held). By contrast, at the owner level, neither a partnership interest nor S corporation stock is property held in a trade or business, so the sale of an interest in the pass-through entity (as opposed to a sale of the entity's assets) would seemingly result in gain for which the business exception does not apply. Rather than make the incidence of NII tax depend on the form of the sale, both the original and the newly proposed regulations provide special rules to approximate similar results regardless of the form of the sales transaction.

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96 Treas. Regs. §1.1411-4(a)(1)(iii).

97 Treas. Regs. §1.1411-4(d)(1).

98 Treas. Regs. §1.1411-4(d)(4)(i)(B)(1).

a. With respect to certain **qualified dispositions** of an active interest in a pass-through,[99] the gain or loss recognized that is taken into account as gain or loss in category 3 for NII purposes is calculated in a special way that attempts to back out from such category gains or losses that would have been excluded on a sale of assets by the entity at the fair market value of said assets immediately before the disposition of such interest.[100]

(i) The term §1411 Holding Period means the year of disposition and the transferor's two taxable years preceding the disposition or the time period the transferor held the interest, whichever is less; provided, however, that for these purposes, the transferor will include the period that:

- A previous owner or owners held the interest transferred if the transferor acquired its interest from another pass-through in a nonrecognition transaction during the year of disposition or the prior two taxable years;
- The transferor held an interest in a subsidiary pass-through if the transferor transferred that interest to a pass-through in a nonrecognition transaction during the year of disposition or the prior two taxable years; and
- A previous owner or owners held the interest transferred if the transferor acquired its interest by gift.[101]

(ii) The term §1411 Property means property owned by or held through the pass-through that, if disposed of by the entity, would result in net gain or loss allocable to the transferor of a type that is includable in determining net investment income of the transferor under category 3.[102]

(iii) A subsidiary pass-through means an interest in a pass-through owned, directly or indirectly, by another pass-through entity.[103]

b. A qualified disposition in this context is a disposition of the pass-through under these conditions: (i) it is engaged in one or more §162 trades or businesses – or owns an interest (directly or indirectly) in a subsidiary pass-through that is engaged in one or more trades or businesses – that is not trading in financial instruments or commodities; and (ii) one or more of the trades or businesses of such pass-through is not a passive activity trade or business of the transferor.[104]

Note:

Where a pass-through entity (the "holder") disposes of an interest in a subsidiary pass-through entity, that disposition qualifies as a qualified disposition with respect to a partner or shareholder of the pass-through if the partner or shareholder would satisfy the requirements if it held the interest in the subsidiary pass-through directly. For this purpose, the partner or shareholder shall be treated as owning a proportionate share of any subsidiary pass-through in which the partner or shareholder owns an indirect interest through one or more tiers of pass-throughs.[105]

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99 Prop. Regs. §1.1411-7(a)(2)(i) defines this as an entity taxed as a partnership or an S corporation. For purposes of this section, a reference to an interest in any S corporation shall mean a reference to stock in such S corporation.
100 Prop. Regs. §1.1411-7(a)(1).
101 Prop. Regs. §1.1411-7(a)(2)(iii).
102 Prop. Regs. §1.1411-7(a)(2)(iv).
103 Prop. Regs. §1.1411-7(a)(2)(v).
104 Prop. Regs. §1.1411-7(a)(3)(i).
105 Prop. Regs. §1.1411-7(a)(3)(ii).

Caution:

Be careful in determining whether the owner is passive or active with respect to the trade or business activity of the subsidiary pass-through even if not passive with respect to trade or business activities of the pass-through holder.

(i) However, if a fully taxable disposition of all of the pass-through's assets is followed by the complete liquidation of the pass-through as part of a single plan, then the disposition will be treated as an asset sale for purposes of the NII, and no additional gain or loss will be included in net investment income on the subsequent liquidation of the pass-through by any transferor who would have satisfied qualified disposition requirements prior to the sale.[106]

(ii) A sale of stock in an S corporation with respect to which an election under §336(e) or §338(h)(10) is made shall be treated as a fully taxable disposition of the pass-through's assets followed by the liquidation of the pass-through for purposes of this recharacterization of the form of the transaction.

c. The difference between the amount of gain or loss taken into account in computing taxable income for income tax purposes and the amount of gain or loss taken into account after the application of this rule shall constitute excluded income or excluded loss, as applicable.[107]

Note:

With respect to S corporations, if the transfer of an interest causes the S election to terminate on the day of the transfer, then the corporation shall continue to be treated as an S corporation for purposes of applying these NII rules to the transferor.[108]

d. For purposes of the calculation of includable/excludable gain or loss from category 3, the amount of gain or loss allocated to the transferor is determined under the general rule of pass-through, and the allocation does not take into account any reduction in the transferor's pro rata share of gains resulting from the hypothetical imposition of built-in gains tax as a result of the deemed sale.[109]

Note:

In the case of a disposition of S corporation stock by a QSST, these rules are applied by treating the QSST as the owner of the S corporation stock.[110]

106 Prop. Regs. §1.1411-7(a)(4)(i).
107 Prop. Regs. §1.1411-7(a)(4)(ii).
108 Prop. Regs. §1.1411-7(a)(4)(iii)(A). However, for regular income tax purposes, Treas. Regs. §1.1362-3(a) continues to treat the day of the transfer as the first day of the corporation's C corporation short year.
109 Prop. Regs. §1.1411-7(a)(4)(iii)(B).
110 Prop. Regs. §1.1411-7(a)(4)(iii)(C).

e. The general method of calculation of the amount of gain or loss included in NII category 3 is as follows:

(i) If the transferor recognized a gain from the disposition, the amount of the net gain included in category 3 is the lesser of:

- The transferor's gain on the disposition of the interest in the pass-through as determined in accordance with the income tax; or
- The transferor's allocable share of the income tax net gain from a deemed sale of the pass-through's §1411 Property as determined using the principles of **passive loss regulations regarding the allocation of gain or loss to activities of the pass-through** where the net gain is the sum of the amounts of net gain and net loss allocable to the transferor as determined under the regulations[111] that would constitute income to the transferor for purposes of the NII if sold by the pass-through. The general rules of those regulations[112] apply in calculating the transferor's allocable share of the net gain under this section; however, the gain recharacterization rules of certain dispositions as nonpassive gain do not apply in any case. The calculation of net gain shall not be less than zero.

(ii) If the transferor recognizes a loss from the disposition, the amount of the net loss included in category 3 is the lesser of:

- The transferor's loss (expressed as a positive number) on the disposition of the interest in the pass-through as determined in accordance with the income tax; or
- The transferor's allocable share of the income tax net loss (expressed as a positive number) from the deemed sale of the entity's §1411 Property as determined in accordance with the **passive loss regulations allocating gain or loss to activities of the pass-through** where the net loss is the sum of the amounts of net gain and net loss allocable to the transferor as determined under the passive loss regulations that would constitute income or loss to the transferor for purposes of §1411 if sold by the pass-through. The general rules of those regulations apply in calculating the transferor's allocable share of the net gain under this section; however, the gain recharacterization rule shall not apply in any case. The calculation of net shall not be less than zero. For these purposes, the loss limitation provisions imposed by §704(d) and §1366(d) shall not apply.

3. Allocation of gain or loss on the disposition of a pass-through interest

In the case of the sale, exchange, or other disposition (a "disposition") of an interest in a pass-through entity, the amount of the seller's gain or loss from each activity in which such entity has an interest is determined, for purposes of §469, under special rules. In the case of any such disposition, except as otherwise noted below, the general rule that follows shall apply. The §469 regulations also provide rules for determining the character of gain or loss, respectively, recognized upon a disposition of an interest in an activity held through a pass-through.[113]

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[111] Temp. Regs. §§1.469-2T(e)(3)(ii)(B)(1)(i) and 1.469-2T(e)(3)(ii)(B)(2)(i).

[112] Temp. Regs. §1.469-2T(e)(3).

[113] Temp. Regs. §1.469-2T(e)(3)(i).

a. In general, if a holder of an interest in a pass-through disposes of such interest, a **ratable portion** of any gain or loss from such disposition shall be treated as gain or loss from the disposition of an interest in each trade or business, rental, or investment activity in which such pass-through entity owns an interest on the **applicable valuation date**.[114]

(i) The ratable portion of any gain from the disposition of an interest in a pass-through entity that is allocable to a trade or business, rental, or investment activity above is determined by[115] multiplying the amount of such gain by the fraction obtained by dividing:

- The amount of **net gain**[116] that would have been allocated to the holder of such interest with respect thereto if the pass-through entity had sold its entire interest in such activity for its fair market value on the applicable valuation date;[117] by
- The sum of the amounts of net gain that would have been allocated to the holder of such interest with respect thereto if the pass-through entity had sold its entire interest in each such **appreciated trade or business**, **rental**, or **investment activity**[118] for the fair market value of each such activity on the applicable valuation date.[119]

(ii) The ratable portion of any loss from the disposition of an interest in a pass-through entity that is allocable to a trade or business, rental, or investment is determined by[120] multiplying the amount of such loss by the fraction obtained by dividing:

- The amount of **net loss**[121] that would have been allocated to the holder of such interest with respect thereto if the pass-through entity had sold its entire interest in such activity for its fair market value on the applicable valuation date;[122] by
- The sum of the amounts of net loss that would have been allocated to the holder of such interest with respect thereto if the pass-through entity had sold its entire interest in each **depreciated trade or business**, **rental**, or **investment activity**[123] for the fair market value of each such activity on the applicable valuation date.[124]

b. If the gain or loss recognized upon the disposition of an interest in a pass-through entity cannot be allocated under the above, such gain or loss shall be allocated among the **trade or business**, **rental**, or **investment activities** in proportion to the respective fair market values of the pass-through entity's interests in such activities at the **applicable valuation date**, and the gain or loss allocated to each activity of the pass-through entity shall be treated as gain or loss from the disposition of an interest in such activity.[125]

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114 Temp. Regs. §1.469-2T(e)(3)(ii)(A).
115 Temp. Regs. §1.469-2T(e)(3)(ii)(B)(1).
116 The term "net gain" means, with respect to the sale of a pass-through's entire interest in an activity, the amount by which the gains from the sale of all of the property used by (or representing the interest of) the pass-through in such activity exceed the losses (if any) from such sale. Temp. Regs. §1.469-2T(e)(3)(ii)(E)(3).
117 Temp. Regs. §1.469-2T(e)(3)(ii)(B)(1)(i).
118 An activity is an appreciated activity with respect to a holder that has disposed of an interest in a pass-through if a net gain would have been allocated to the holder with respect to such interest if the pass-through had sold its entire interest in such activity for its fair market value on the applicable valuation date. Temp. Regs. §1.469-2T(e)(3)(ii)(E)(1).
119 Temp. Regs. §1.469-2T(e)(3)(ii)(B)(1)(ii).
120 Temp. Regs. §1.469-2T(e)(3)(ii)(B)(2).
121 The term "net loss" means, with respect to the sale of a pass-through's entire interest in an activity, the amount by which the losses from the sale of all of the property used by (or representing the interest of) the pass-through in such activity exceed the gains (if any) from such sale. Temp. Regs. §1.469-2T(e)(3)(ii)(E)(4).
122 Temp. Regs. §1.469-2T(e)(3)(ii)(B)(2)(i).
123 An activity is a depreciated activity with respect to a holder that has disposed of an interest in a pass-through entity if a net loss would have been allocated to the holder with respect to such interest if the pass-through entity had sold its entire interest in such activity for its fair market value on the applicable valuation date. Temp. Regs. §1.469-2T(e)(3)(ii)(E)(2).
124 Temp. Regs. §1.469-2T(e)(3)(ii)(B)(2)(ii).
125 Temp. Regs. §1.469-2T(e)(3)(ii)(C).

c. In general, the applicable valuation date with respect to any disposition of an interest in a pass-through entity is whichever one of the following dates is **selected** by the pass-through entity:

(i) The beginning of the taxable year of the pass-through in which such disposition occurs; or

(ii) The date on which such disposition occurs.[126]

However, the applicable valuation date shall be the date immediately preceding the date on which such disposition occurs if, after the beginning of a pass-through's taxable year in which a holder's disposition of an interest in such pass-through occurs and before the time of such disposition:

(i) The pass-through disposes of more than 10 percent of its interest (by value as of the beginning of such taxable year) in any activity;

(ii) More than 10 percent of the property (by value as of the beginning of such taxable year) used in any activity of the pass-through is disposed of; or

(iii) The holder of said interest contributes to the pass-through **substantially appreciated property**[127] or **substantially depreciated property**[128] with a total fair market value or adjusted basis, respectively, which exceeds 10 percent of the total fair market value of the holder's interest in the pass-through entity as of the beginning of such taxable year.[129]

- Any adjustment to the basis of partnership property under §743(b) made with respect to the holder of an interest in a partnership is taken into account in computing the net gain or net loss that would have been allocated to the holder with respect to such interest if the partnership had sold its entire interest in an activity.[130]
- In the case of a disposition of an interest in a pass-through (the "subsidiary pass-through") by a holder that is also a pass-through, any gain or loss from such disposition that is taken into account by any person that owns (directly or indirectly) an interest in such holder shall be allocated among the activities of the subsidiary pass-through by applying these rules to the person taking such gain or loss into account as if that person had been the holder of an interest in said subsidiary pass-through and had recognized such gain or loss as a result of a disposition of that interest.[131]

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126 Temp. Regs. §1.469-2T(e)(3)(ii)(D)(1)(i).

127 The term "substantially appreciated property" means property with a fair market value that exceeds 120 percent of its adjusted basis. Treas. Regs. §1.469-2T(e)(3)(vi)(B).

128 The term "substantially depreciated property" means property with an adjusted basis that exceeds 120 percent of its fair market value. Treas. Regs. §1.469-2T(e)(3)(vi)(C).

129 Temp. Regs. §1.469-2T(e)(3)(ii)(D)(1)(ii).

130 Temp. Regs. §1.469-2T(e)(3)(ii)(D)(2).

131 Temp. Regs. §1.469-2T(e)(3)(ii)(D)(3).

Note:

For passive loss activity purposes, the gain of the holder (or such other person) that is described in paragraph (i) below is treated as gain that is not from a passive activity to the extent that such gain does not exceed the amount of the gain of the holder (or such other person) described in paragraph (ii) in certain circumstances ("the recharacterization rule"). For purposes of applying the recharacterization rule to the disposition of an interest in a partnership, the amount of gain that would have been allocated to the holder (or such other person) if all of the property used in an activity had been sold is determined by taking into account any adjustment to the basis of partnership property made with respect to such holder (or such other person) under §743(b).

The circumstances in which the recharacterization rule applies are:

(i) An amount of gain recognized on account of such disposition by the holder of such interest (or any other person that owns, directly or indirectly, an interest in such holder if such holder is a pass-through entity) is allocated to a passive activity of such holder (or such other person);

(ii) An amount of gain that would have been treated as gain that is not from a passive activity because of substantially appreciated property formerly used in a nonpassive activity, certain oil or gas properties, certain property rented incidental to development, property rented to a nonpassive activity, or certain interests in a pass-through engaged in the trade or business of licensing intangible property would have been allocated to the holder (or such other person) with respect to the interest if all of the property used in passive activity had been sold immediately prior to the disposition for its fair market value on the applicable valuation date; and

(iii) The amount of the gain of the holder (or such other person) described in paragraph (ii) exceeds 10 percent of the amount of the gain of the holder (or such other person) described in paragraph (i) above.

Example 1: (i) Facts: A owns a one-half interest in P, a calendar year partnership. In year 1, A sells its interest for $200,000. A's adjusted basis for the interest sold is $120,000. Thus, A recognizes $80,000 of gain from the sale for income tax purposes. P is engaged in three trade or business activities, X, Y, and Z, none of which are trading in financial instruments or commodities trades or businesses. P also owns marketable securities. For year 1, A materially participates in activity Z, thus it is not a passive activity trade or business of A. A, however, does not materially participate in activities X and Y, so these activities are passive trades or businesses of A. Because P is engaged in at least one trade or business and at least one of those trades or businesses is not passive to the transferor A, A determines its amount of category 3 gain or loss from net investment income under the qualified disposition rules. Assume that A is not eligible to compute its category 3 gain or loss under the optional simplified reporting method. The fair market value and adjusted basis of the gross assets used in P's activities are as follows:

	Adjusted Basis	Fair Market Value	Gain/Loss	A's Share Gain/Loss
X (Passive as to A)	$136,000	$96,000	-$40,000	-$20,000
Y (Passive as to A)	60,000	124,000	64,000	32,000
Z (Nonpassive as to A)	40,000	160,000	120,000	60,000
Marketable securities	4,000	20,000	16,000	8,000
Total	240,000	400,000	160,000	80,000

(ii) A must determine the portion of gain or loss from the sale of P's §1411 Property allocable to A. A's allocable share of gain from P's §1411 Property is $20,000 (($20,000) from X + $32,000 from Y + $8,000 from the marketable securities). Because the $20,000 allocable to A from a deemed sale of P's §1411 Property is less than A's $80,000 income tax gain, A will include $20,000 as category 3 gain.

Example 2: Assume the same facts as **Example 1**, but A materially participates in activities Y and Z and does not materially participate in activity X. A's allocable share of P's §1411 Property is ($12,000) (($20,000) from X + $8,000 from the marketable securities). Because A sold its interest for an income tax gain, the amount allocable to A from a deemed sale of P's §1411 Property cannot be less than zero. Accordingly, A includes no gain or loss as category 3 gain or loss.

4. Optional simplified reporting

A transferor of an interest in a pass-through in a qualified disposition may use the simplified reporting rules below if it satisfies the eligibility requirements and is not described in the Note box below. All other transferors of interests in pass-through entities in qualified dispositions must use the general calculation set forth above.[132]

a. In general, a transferor of an interest in a pass-through in a qualified disposition may determine the amount of net gain or net loss that is taken into account as category 3 gain or loss in accordance with the optional reporting below if **either** or both of the requirements below are satisfied:

(i) The sum of separately stated income, gain, loss, and deduction items (with any separately stated loss and deduction items included as positive numbers) of a type (any category) the transferor would take into account in calculating net investment income that are allocated to the transferor in respect of the transferred interest is 5 percent or less of the sum of all separately stated items of income, gain, loss, and deduction (with any separately stated loss and deduction items included as positive numbers) allocated to the transferor in respect of the transferred interest during the §1411 Holding Period, and the total amount of income tax gain or loss recognized by the transferor from the disposition of interests in the pass-through does not exceed $5 million (including gains or losses from multiple dispositions as part of a plan).[133]

Note:

All dispositions of interests in the pass-through that occur during the taxable year will be presumed to be part of a plan. In calculating the percentage described above, if the transferor acquired the transferred interest in either a gift transaction or in a nontaxable transaction during the year of disposition or the preceding two taxable years, then items of income, gain, loss, or deduction allocated to the transferor include any such items allocated to the transferor's predecessor (or predecessors) in interest during the §1411 Holding Period. If the transferor transferred an interest in a subsidiary pass-through to the pass-through during the year of disposition or the preceding two taxable years, then items of income, gain, loss, or deduction allocated to the transferor include any items allocated to the transferor during the §1411 Holding Period in respect of the interest in the subsidiary pass-through.

(ii) The total amount of income tax gain or loss recognized by the transferor from the disposition of interests in the pass-through does not exceed $250,000 (including gains or losses from multiple dispositions as part of a plan). All dispositions of interests in the pass-through that occur during the taxable year will be presumed to be part of a plan.[134]

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[132] Prop. Regs. §1.1411-7(c)(1).
[133] Prop. Regs. §1.1411-7(c)(2)(i).
[134] Prop. Regs. §1.1411-7(c)(2)(ii).

Note:

A transferor is not eligible to use the simplified reporting method if **any of the following conditions** are met:

(i) The transferor has held directly the interest in the pass-through (or held the interest indirectly in the case of a subsidiary pass-through) for less than twelve months preceding the qualified disposition.[135]

(ii) The transferor transferred, directly or indirectly, §1411 property (other than cash or cash equivalents) to the pass-through (or a subsidiary pass-through), or received a distribution of property (other than §1411 property) from the pass-through (or a subsidiary pass-through), during the §1411 holding period as part of a plan that includes the transfer of the transferor's interest in the pass-through. A transferor who contributed, directly or indirectly, §1411 property (other than cash or cash equivalents) within 120 days of the disposition of the interest in the pass-through is presumed to have made the contribution as part of a plan that includes the transfer of the interest in the pass-through.[136]

(iii) The pass-through is a partnership, and the transferor transfers a partial interest that represents other than a proportionate share of all of the transferring partner's economic rights in the partnership.[137]

(iv) The transferor knows or has reason to know that the percentage of the pass-through's gross assets that consist of §1411 property has increased or decreased by 25 percentage points or more during the transferor's §1411 holding period due to contributions, distributions, or asset acquisitions or dispositions in taxable or nonrecognition transactions.[138]

(v) The pass-through, which is the subject of the qualified disposition, was taxable as a C corporation during the §1411 holding period, but during that period elects to be taxable as an S corporation.[139]

b. The amount of net gain or loss from the transferor's qualified disposition that is includable in category 3 NII is determined by multiplying the transferor's income tax gain on the disposition by a fraction. The numerator of this fraction is the sum of income, gain, loss, and deduction items (with any separately stated loss and deduction items netted as negative numbers) of a type that are taken into account in the calculation of net investment income that are allocated to the transferor during the §1411 Holding Period. The denominator of the fraction is the sum of all items of income, gain, loss, and deduction allocated to the transferor during the §1411 Holding Period (with any separately stated loss and deduction items netted as negative numbers). If the quotient of the fraction is either greater than one or less than zero, then the fraction shall be one; provided, however, that if the numerator is a negative amount in connection with a computation of overall income tax gain on the sale or a positive amount in connection with a computation of overall income tax loss on the sale, then the fraction shall be zero. In calculating the fraction described in the first sentences, if the transferor acquired the transferred interest in a gift or in a nontaxable transaction in the year of disposition or the two preceding taxable years, then items of income, gain, loss, or deduction allocated to the transferor include any such items allocated to the transferor's predecessor (or predecessors) in interest during the §1411 Holding Period. If the transferor transferred an interest in a subsidiary pass-through to the pass-through where the transferor transferred that interest to a pass-through in a nonrecognition transaction during the year of

[135] Prop. Regs. §1.1411-7(c)(3)(i).
[136] Prop. Regs. §1.1411-7(c)(3)(ii).
[137] Prop. Regs. §1.1411-7(c)(3)(iii).
[138] Prop. Regs. §1.1411-7(c)(3)(iv).
[139] Prop. Regs. §1.1411-7(c)(3)(v).

disposition or the prior two taxable years, then items of income, gain, loss, or deduction allocated to the transferor include any items allocated to the transferor during the §1411 Holding Period in respect of the interest in the subsidiary pass-through.[140]

For purposes of the following examples, assume that the taxpayer is a United States citizen and uses a calendar taxable year, and that year 1 and all subsequent years are taxable years in which the NII tax is in effect.

Example 1: (i) A owns a one-half interest in P, a partnership. In year 1, A sells the interest for $2,000,000. A's adjusted basis for the interest sold is $1,100,000. Because P is engaged in at least one trade or business and at least one of those trades or businesses is not passive to the transferor A, A determines its amount of category 3 gain or loss from net investment income. None of the nonapplicability conditions apply. The aggregate net income from P's activities allocable to A for the year of disposition and the two preceding tax years are as follows:

	Aggregate Income/(loss)
X (Nonpassive as to A)	$1,800,000
Y (Passive as to A)	-$10,000
Marketable securities	$20,000

(ii) During A's §1411 Holding Period, A was allocated $30,000 of gross items of a type taken into account in the calculation of net investment income ($10,000 of loss from activity Y and $20,000 of income from marketable securities). The total absolute value of A's allocated net items during the §1411 Holding Period equals $1,830,000 ($1,800,000 income from activity X, $10,000 loss from activity Y, and $20,000 income from marketable securities). Thus, less than 5 percent ($30,000/1,830,000) of A's allocations during the §1411 Holding Period are of a type that are taken into account in the computation of net investment income, and because A's regular income tax gain recognized of $2,000,000 is less than $5,000,000, A qualifies to use the optional simplified method.

(iii) A's percentage of §1411 Property is determined by dividing A's allocable shares of income and loss of a type that are taken into account in the calculation of net investment income that are allocated to the transferor by the pass-through during the §1411 Holding Period is $10,000 ($10,000 loss from Y + $20,000 income from marketable securities) by $1,810,000, which is the sum of A's share of income and loss from all of P's activities ($1,800,000 + ($10,000) + 20,000). Thus, A's gain for purposes of NII category 3 is $4,972.32 ($900,000 income tax gain multiplied by the fraction 10,000/1,810,000).

5. Deferred recognition transactions

In the case of a disposition of a pass-through in an installment sale (or in exchange for an annuity contract), the calculations described above shall be applied in the year of the disposition as if the entire amount of gain recognized for income tax purposes is taken into account by the transferor in the year of the disposition. For this purpose, it is assumed that any contingencies potentially affecting consideration to the transferor that are reasonably expected to occur will occur, and in the case of annuities based on the life expectancy of one or more individuals, the present value of the annuity (using existing federal tax valuation methods) is used to determine the estimated gain. If the calculations in this section result in a transferor excluding only a portion of the income tax gain from net investment income, the amount of

[140] Prop. Regs. §1.1411-7(c)(4).

excluded gain will constitute an addition to basis for purposes of applying §453 to determine the amount of gain that is includable in net investment income category 3 as payments are received.[141]

G. Impact of the Tax Cuts and Jobs Act of 2017

1. The §199A deduction

For taxable years beginning after December 31, 2018, the Tax Cuts and Jobs Act of 2017 (TCJA) adds additional variables to the calculation of the tax impact of an asset sale of a pass-through entity, and possibly to the sale of a partnership interest involving §751 hot assets. The TCJA adds a new code section, §199A, that creates a new deduction commonly referred to as the Pass-Through Deduction (PTD). Analysts believe that a significant part of the income flowing through the K-1 from an asset sale of a business should qualify for the deduction. Some of the income from the sale of a business will qualify for the §199A deduction and thus reduce the tax impact of the sale of the business.

In tax planning for the sale of a business, we must consider the following items to determine what qualifies for the §199A deduction:

a. Qualified trade or business income passed through to the owner on a final K-1 will qualify. Qualified business income is any item of income, deduction, gain, or loss that is attributable to a qualified trade or business and is not otherwise excluded by the code and regulations.[142]

b. §§179, 1245, and 1250 ordinary income recapture will qualify if the related assets were used in a trade or business.[143]

c. §481 adjustments will qualify if related to a qualified trade or business and incurred in a year after December 31, 2017.[144]

d. If the owner has passive loss or at-risk carry forwards that are freed up by the disposition of the activity, the losses will reduce the §199A deduction if the losses originally arose in a tax year that began after December 31, 2017.[145]

e. Ordinary income from §751 "hot assets" qualifies for the §199A deduction if the assets were used in a qualified trade or business.[146]

f. §1231 gains will be netted with §1231 gains and losses on the owners return. If the net amount is positive and is not recaptured under the five-year look-back rule, all §1231 gains and losses are excluded from the §199A deduction.[147]

g. If the net amount of §1231 gains is negative, §1231 gains and losses are included in the §199A deduction calculation if the related assets were used in a qualified trade or business.[148]

h. The income from the sale of the business will likely cause the owners to be subject to the full wage limitation for the §199A deduction. This could cause a disallowance of much of the §199A deduction, as it is much more likely in the year of the sale that 20 percent of QBI will exceed the wage limitation.

i. Investment income is excluded from the calculation.[149]

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141 Prop. Regs. §1.1411-7(d).
142 Treas. Reg. §1.199A-1(b)(5).
143 Treas. Reg. §1.199A-1(b)(5) and preamble to the final regulations.
144 Treas. Reg. §1.199A-3(b)(iii).
145 Treas. Reg. §1.199A-3(b)(iv).
146 Treas. Reg. §1.199A-3(b)(i).
147 Treas. Reg. §1.199A-1(b)(5) and preamble to the final regulations.
148 Treas. Reg. §1.199A-1(b)(5) and preamble to the final regulations.
149 §199A(c)(3)(B).

j. Adjustments to income that are attributable to a qualified trade or business will reduce the §199A deduction. These may include the deduction for 50% of self-employment tax, the deduction for self-employed health insurance, and the deduction for qualified retirement plan contributions.[150]

2. The pass-through loss limitation

Note:

> The pass-through loss limitation has been suspended through 2020 by the Coronavirus Aid, Relief, and Economic Security (CARES) Act of 2020 passed by Congress in response to the outbreak of COVID-19. The suspension is retroactive to the enactment of the provision. This section is still included in the materials because the pass-through loss limitation will be effective beginning in 2021. The expiration date of the pass-through loss limitation was delayed from 2026 to 2027 by the American Rescue Plan Act (ARPA) of 2021. The Inflation Reduction Act extended the provision through 2028.

The TCJA creates a limitation on pass-through losses. Pass-through losses are limited to the amount of pass-through income plus a threshold amount. The threshold amount is $500,000 for married-filing-joint status and $250,000 for other taxpayers. Any disallowed loss is carried forward and treated under the net operating loss rules.[151] The significance of this in evaluating the impact of the sale of a business is that it gives us another possible carryforward loss that will offset some of the tax impact:

IV. Answers to review exercises

Assume the same facts as the example above, except the unrealized receivables are $26,000 and the capital assets FMV is $4,000 as follows:

Assets	**Adjusted Basis**	**Fair Market Value**
Cash	$ 3,000	$ 3,000
Loans receivable	10,000	10,000
Capital assets	7,000	4,000
Unrealized receivables	0	26,000
Total	$20,000	$43,000
Liabilities and Capital	**Adjusted Per Books**	**Fair Market Value**
Liabilities	$ 2,000	$ 2,000
Capital:		
A	9,000	20,500
B	9,000	20,500
Total	$20,000	$43,000

B transfers his interest to T for $20,500.

Question 1: What are the total proceeds of the sale?

Cash received:	$20,500
Liabilities relieved:	1,000
Total proceeds:	$21,500

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150 Treas. Reg. §1.199A-3(b)(vi).
151 IRC §461(l).

Question 2: What is the total gain on the sale?

Total realized proceeds:	$21,500
Basis:	(10,000)
Gain on the sale	$11,500

Basis is equal to B's tax basis in the capital account ($9,000) plus B's share of liabilities before the transfer ($1,000).

Question 3: How much ordinary income must B report under §751?

If the hot assets (unrealized receivables) were sold for FMV, B would report $13,000 ordinary income. Therefore, B reports $13,000 income under §751.

Question 4: What is the residual capital gain or loss?

The residual is a loss of $1,500, the amount that the ordinary income recognized under §751 exceeds the recognized gain:

Total gain:	$11,500
Less §751 gain:	(13,000)
Residual capital loss:	($1,500)

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)

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.

Form **8594** (Rev. 11-2021)

Learning Questions

1. Which of the following statements is NOT CORRECT?

   A. In the case where the seller may later be required to make good on an indemnity, guarantee, or other covenant with respect to contingent liabilities of the company, the payment is treated as an ordinary and necessary business deduction.
   B. If a buying member in turn sells the LLC interest, the §732(d) special basis adjustment is taken into account in determining that member's adjusted basis in LLC ordinary income assets, if the LLC had not made a §754 election at the time that the partnership interest was acquired.
   C. An LLC making a §754 election can adjust the inside basis of assets with respect to the transferee member.

2. What is the purpose of §751?

   A. §751 prevents the shifting of capital gains from one partner to another.
   B. §751 requires the buyer and seller of an applicable business to allocate the proceeds among the classes of assets and report the allocation to the IRS.
   C. §751 prevents the shifting of ordinary income from one partner to another in partnership transactions.

Learning Questions – Answers

1. A is **correct**. Had the seller paid the expense before the sale it would have reduced the purchase price and thereby have reduced the capital gain on the sale of corporate stock; accordingly, the payment reduces the capital gain from an earlier year by treating the payment as a capital loss.

   B is **incorrect** because if a buying member in turn sells the LLC interest, the §732(d) special basis adjustment is taken into account in determining that member's adjusted basis in LLC ordinary income assets because that determination is based on what the member's adjusted basis in the member's share of those assets would have been if a §754 election had been made at the time of the original purchase and such assets were distributed to the member.

   C is **incorrect** because when a §754 election is in effect; a basis adjustment is made to equalize the member's share of the LLC's adjusted basis in its assets ("inside basis") and the new member's adjusted basis in the LLC interest ("outside basis"). If the outside basis exceeds the inside basis, the adjustment is an increase (or "upward") adjustment. If the inside basis exceeds the outside basis, the adjustment is a decrease (or "downward") adjustment.

2. A is **incorrect**. §751 prevents the shifting of ordinary income from one partner to another, not capital gains.

   B is **incorrect** because it describes §1060, not §751.

   C is **correct.** §751 prevents the shifting of ordinary income from one partner to another during partnership transactions.

Buyer’s Considerations

Buyer’s Considerations

Learning objectives

Upon reviewing this chapter, the reader will be able to:

- Define an applicable acquisition and its tax impact;
- Discuss the role cost recovery plays in an asset acquisition and the methodologies available to a buyer to allocate cost to assets acquired;
- Identify miscellaneous intangibles that arise in, and facilitate, an acquisition transaction and the tax consequences to such identification;
- Describe how cost segregation techniques may be used effectively in the allocation of basis to assets;
- Distinguish the proper recovery class categorizations;
- Discuss the special considerations when the buyer of stock or assets is an S corporation;
- Identify §197 assets, explain how the purchase price is allocated to assets when §197 assets are acquired, and discuss various strategies to maximize deductible expenses; and
- Explain the extent to which a net operating loss of a C corporation is available following an acquisition and the extent to which other carryforwards apply following an acquisition.

I. Basis and holding period

Note:

It is important to determine the basis and holding period of the property. They relate both to the determination of depreciation deductions on rental properties and the computation of gain or loss on the disposition of the property. A buyer will be interested in the allocation of the purchase price to depreciable assets and among those with the shortest recovery periods to maximize the present value of depreciation and amortizable assets.

A. Overview

1. In general

Basis is essentially the investment in the property. If property is purchased, the initial basis is what was paid for the property. However, there are other ways to acquire real estate, such as by inheritance or gift. These different methods of acquiring real estate each have their own special rules for computing basis and holding period.

Holding period is the length of time a property is held by the legal or equitable owner. It is essential for two reasons.

(i) In the first year of operation, the amount of depreciation deductions for the building is prorated according to the number of months the property was in service in that first year, which cannot begin any earlier than the time when the taxpayer begins to hold the property for tax purposes. Therefore, the longer the holding period in that first year, the higher the depreciation on the building.

(ii) The holding period determines the length of time necessary to receive preferential tax treatment on long-term capital gain. The highest ordinary income rate is 37 percent. The highest long-term capital gain rate is much lower at 20 percent. If a property is held for the required holding period, it will be taxed at a top rate of 20 percent. If not, it is taxed at 37 percent.

2. *Rules for determining basis and holding period*

The rules for determining the basis and the long-term holding period will depend on **how** the asset was acquired as follows.

a. **The property is acquired by purchase.** The basis includes not only the taxpayer's basis in the real property that is acquired but also certain expenses and costs paid or incurred in acquiring the property.

(i) **Basis** – When you first acquire property, the property's basis is known as the **unadjusted basis** (or its initial basis). However, basis will increase or decrease because of certain adjustments such as capital improvements (which increase basis) and depreciation deductions (which reduce basis). After these adjustments are made, the property's basis is called an **adjusted cost basis** (or "adjusted basis" or "tax basis").

Note:

> Most real estate acquisitions in which the buyer does not pay the full price in cash are financed with mortgages, loans secured by the acquired property, or deeds of trust through which the property is held by a third party as security for the lender. Basis in real property acquired by the taxpayer includes purchase-money mortgages given by the taxpayer and any debts assumed or to which the taxpayer takes subject. Basis does not include amounts payable only in the event of a contingency.

Example: Five years ago, X acquired a rental property for a purchase price of $66,000 plus basis closing costs of $2,000. In the following five years, X made capital improvements of $10,000, and deducted a total of $18,000 in depreciation. At the end of five years, X's adjusted basis is $60,000 as follows.

Start: Original purchase price	$66,000
Plus: Capitalized basis closing costs	+ 2,000
Plus: Capital improvements	+ 10,000
Minus: Depreciation deductions allowed or allowable	- 18,000
Equals: Adjusted cost basis	= $60,000

(ii) **Holding period** – For a purchase, the required long-term holding period is one year and one day, **not** just one year.[1] The holding period begins on the **day after the acquisition date** and ends on the date of disposition. Thus, the closing day of the purchase is excluded, while the closing day of the sale is included.[2] As a result, to attain long-term capital gain, the asset must be held one year and two days from the date of acquisition (closing date).[3]

Example: A $100,000 gain on an asset held for one year results in a top tax liability of $37,000 (37 percent). If the asset was held one year and one day, then the top tax liability is generally at 20 percent or $20,000. In this case, one day makes a difference of $17,000.[4]

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1 IRC §1222.
2 Rev. Rul. 70-598, 1970-2 C.B. 168.
3 Rev. Rul. 66-7, 1966-1 C.B. 188.
4 The disparity may be a little less if the $100,000 gain is ordinary income eligible for the §199A deduction. If not limited under the provisions of §199A, the tax would be $29,600 ($100,000 × .80 × .37%).

Note:

Holidays, Saturdays, or Sundays falling on the beginning or ending date of a holding period have no effect in determining the period. They are included.[5]

Planning point:

If one is selling real estate near the one-year-and-one-day holding period, schedule closing to meet this holding period in accordance with the above rules.

b. **The property is acquired in a tax-deferred transaction, such as a §1031 exchange.**[6]

(i) **Basis** – Generally, the basis of property acquired in a tax-deferred transaction is the basis of the property that was disposed of in the transaction, plus any recognized gain reported by the taxpayer. With a §1031 exchange, besides adding any recognized gain, there are a number of other plus or minus adjustments.[7] Similar rules apply to other tax-deferred transactions, such as a §1033 involuntary conversion.[8]

(ii) **Holding period** – The holding period of property acquired in a tax-deferred transaction includes the holding period of the property that was disposed of in the transaction, up to the basis of the property.[9]

Example: X Co. relinquishes property by a §1031 exchange. X has owned the property for six years and the property has a basis of $100,000. By reason of the exchange, X acquires replacement property. Up to the old property's basis of $100,000, the new replacement property includes the old property's holding period of six years.

Note:

In the case where the replacement property is higher-priced, the taxpayer will have to make an additional investment that represents an increase in basis. As to that increase there is a new holding period, beginning on the day following the date of the closing of the replacement property.[10] These same rules apply to other tax-deferred transactions, such as a §1033 involuntary conversion.[11]

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5 Rev. Rul. 70-598, 1970-2 C.B. 168.
6 TCJA of 2017 eliminated like-kind exchanges on property other than real property. (§1031(a)(1).
7 IRC §1031(d). Treas. Regs. §1.1031-(d).
8 IRC §1033(a)(2).
9 IRC §1223(1).
10 IRC §1223(1); IRC §1031(d).
11 IRC §1223(1)(A).

3. Other situations

Nonrecourse mortgages included as part of a property's initial basis – As noted above, a property's initial cost basis includes not only the cash down payment but also a mortgage on the property.[12] However, if the mortgage liabilities are too contingent or indefinite, they may not be included in basis, especially if such liabilities are nonrecourse. A nonrecourse mortgage is one in which the debtor is not personally liable on the debt, so that in the event of default, the lender can seek satisfaction only from the property and cannot sue the borrower personally. Nonrecourse purchase-money-mortgage debt is generally included in the basis of the property acquired by purchase unless the liabilities (together with any cash paid) exceed the fair market value of the property.

(i) In one case, the taxpayer purchased a property for a 3 percent down payment and the balance as an interest-only, nonrecourse loan with a 99-year term. The Tax Court ruled in favor of the taxpayer, stating that the parties intended a sale of the property and the **obligation was genuine.**[13] The IRS has acquiesced to this case, provided the selling price is at fair market value and the debt is bona fide.[14]

(ii) There are other similar cases where the courts have allowed full basis despite the existence of nonrecourse debt, low down payments, extended terms, etc.[15] However, where the purchase price is overinflated and/or the debt is not bona fide, the nonrecourse debt may be excluded from basis.[16]

Planning point:

Where there is nonrecourse debt, the purchase price should be at fair market value and the debt should be bona fide, indicating a genuine intention to pay. All of this should be evidenced by arm's-length documentation.

Effect of refinancing on a property's basis – A refinanced debt is generally not included in the basis of the property (except to the extent the refinanced loan was included in the property's basis before the refinancing) unless the proceeds are applied to the construction of capital improvements on the property. Consequently, a refinancing generally has no effect on the amount or method of depreciation.[17]

The holding period could begin on an earlier date before title passes – When a property is purchased, the holding period will generally begin the day title passes, i.e., the closing or settlement date.[18] However, the holding period could begin on an earlier date before title passes if the buyer becomes the owner of the property for tax purposes by acquiring the "burdens and benefits" of ownership.[19]

12 Treas. Regs. §1.1012-1(a).
13 *Mayerson v. Commissioner*, 47 T.C. 340 (1966), acq.
14 Rev. Rul. 69-77, 1969-1 C.B. 59, 1969-1 C.B. 59.
15 *Bolger v. Commissioner*, 59 T.C. 760 (1973), acq.
16 *Marcus v. Commissioner*, 30 T.C. Memo. 1971-299; *May v. Commissioner*; T.C. Memo. 1972-70.
17 *Woodsam Associates v. Commissioner*, 16 T.C. 649 (1960), aff'd 198 F.2d 455 (5th Cir. 1962).
18 *Segall v. Commissioner*, 114 F2d 705.
19 *White v. Commissioner*, T.C. Memo. 1974-69; *Union Pacific R.R. Co. v. Commissioner,* 86 F2d 637 (2nd Cir. 1936), *Merrill v. Commissioner*, 40 T.C. 66 (1963).

B. Applicable asset acquisitions

1. In general

In a case where the sale of the business is an applicable asset acquisition, the buyer is required to allocate basis among the assets in accordance with the residual system in the same manner the seller is required to allocate amounts of the consideration to the amount realized on the sale.

Note:

> For applicable asset acquisitions after March 15, 2001, under the §1060 residual method, consideration generally must be allocated to the same seven classes of assets, in descending order of priority, that were discussed in connection with the seller.[20]

2. What is an applicable asset acquisition?

An **applicable asset acquisition** is any transfer, whether direct or indirect, of a group of assets if the assets transferred constitute a trade or business in the hands of either the seller or the purchaser and, except as provided in nonrecognition exchanges, the purchaser's basis in the transferred assets is determined wholly by reference to the purchaser's consideration.[21] For further details, see the material concerning a seller's considerations in an applicable asset acquisition elsewhere in these materials.

II. Depreciation

A. Background

1. Defined

Depreciation is the annual deduction allowed to recover the cost or other basis of business or income-producing property with a determinable useful life of more than one year. However, land is not depreciable.

2. In general

Because depreciation deductions reduce taxable income without any current cash outlay, increasing depreciation deductions is an important method for enhancing after-tax income.

B. The allocation of basis among various components

1. Savings to clients

Obviously, paying back a long-term note (i.e., a mortgage) incurred regarding the purchase of a depreciable asset (e.g., a building) does not lead to an immediate tax deduction. Instead, the write-off for tax purposes is solely governed by the depreciation rules associated with the recovery class into which the asset is placed. Also, if we can maximize the amount of property that falls within either the five- or seven-year classes (e.g., fixtures), or even the 15-year class (e.g., for certain types of buildings and land improvements), the impact on the bottom line for a company can be dramatic.

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[20] Treas. Regs. §1.338-6(b).
[21] Treas. Regs. §1.1060-1(b)(1).

2. Timing versus permanent differences

Although one could argue that these savings merely represent timing differences (i.e., since any additional depreciation taken upfront will only serve to increase gain or decrease the loss when the property is ultimately disposed of), clients still tend to hold real property for longer periods of time (i.e., vis-à-vis most other types of assets). Therefore, these timing differences sometimes are considered as being just as valuable as more permanent tax deductions.

3. Commercial realty versus fixtures

For years, clients attempted to allocate as little as possible to land when purchasing a building, especially when the ACRS rules (i.e., 1981-1986) allowed a 15-, 18-, or 19-year recovery period with the 175 percent declining-balance method (i.e., regardless of whether the building was residential or commercial). Now, the issue is even more pronounced, given that we are left with a 39-year, straight-line method for commercial real estate. Buyers, rightfully so, are scrambling to find any justification to place property into either the five- or seven-year classifications (i.e., with the 200 percent declining-balance method).

4. Cost segregation studies

The first step in the computation of depreciation for a newly purchased property is the allocation of the total cost basis between depreciable property and nondepreciable property. When performing a cost segregation analysis, the use of qualified appraisers and qualified engineers to perform the study is recommended instead of just relying on the taxpayer's opinion (or his or her accountant) to break down these costs. It is much more likely that the Service would respect the results from an unrelated third-party professional.

Note:

> Component depreciation is not available. However, a similar but conceptually different method is a cost segregation that carves out with specificity the components of an entire property. It begins with five-year and seven-year property right through building improvements and land.

a. ADR 57.0 property (i.e., assets used in wholesale, retail, or rendering personal or professional services), or ADR .11 property (i.e., generic fixtures used in an office setting).

b. In addition, such property is reclassified as personal property in the shorter recovery periods and generally will become eligible for the §179 immediate-expensing election, which only applies to tangible[22] §1245 personal property acquired by purchase from an unrelated third party for use in the active conduct of a trade or business that is not:[23]
   - Used in residential rental operations (other than a hotel or motel operation housing "transient dwellers" whose average stay is 30 days or less);[24]
   - Property used predominantly outside of the United States (except for property described in §168(g)(4));
   - Property used by certain tax-exempt organizations;
   - Property used by governmental units; or
   - Property used by foreign persons or entities.

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22 Computer software is an exception.
23 IRS Publication 946, p. 45.
24 IRC §179(d)(1).

The Tax Cuts and Jobs Act of 2017 (TCJA) expanded the §179 expense provisions to include qualified improvement property, roofs, HVAC systems, fire protection systems, and security systems.[25] This makes the cost segregation study even more important. However, this could also be a trap. The TCJA expanded the §179 annual amount to $1,000,000. The amount for 2024 has been adjusted for inflation to $1,220,000.[26] However, the new law only raises the phaseout floor to $2,500,000 ($3,050,000 for 2024).[27] With larger amounts, the inclusion of more available property could backfire, putting the taxpayer over the limit and phasing out the §179 deduction.

c. The regulations note that in the case of the acquisition of a combination of depreciable and nondepreciable property for a lump sum, as for example, buildings and land, "the basis for depreciation cannot exceed an amount that bears the same proportion to the lump sum as the value of the depreciable property at the time of acquisition bears to the value of the entire property at that time."[28] The value of the land vis-à-vis the building, land improvements, and personal property is subject to different valuation techniques.

Note:

Many investors and tax preparers typically employ the "20-80" method, where they simply allocate 20 percent toward the land, and 80 percent toward the building, and nothing else.

d. Land can also be allocated basis using a residual method, which allocates basis first to the depreciable property before the nondepreciable land; instead, it starts with the depreciable components that have the lowest recovery periods, and therefore, yield the largest depreciation deductions and only the last (or residual) allocation with respect to nondepreciable land. The total property cost can be allocated into its four major components in this order: (i) five-year or seven-year personal property; (ii) 15-year land improvements; (iii) 27-1/2 or 39-year building (which, in turn, can be segmented into its structural components); and (iv) nondepreciable land.

e. **Personal property** – First, segregate personal property in and on the property. This serves a double-edged purpose: not only does it qualify such costs for faster depreciation than real estate, but it also qualifies the property in general for §179 expensing (subject to annual limitations and taxable income limitations) and the special 100 percent bonus depreciation[29] (which is not subject to limitations). Moreover, such segregated costs now have access to a double-declining accelerated method, unlike real property.

f. Qualified real property – TCJA of 2017 added five categories of qualified real property.[30]

- **Qualified improvement property:** Improvements to the inside of a commercial building after the building is first placed in service by any taxpayer that are not structural and are not elevators and escalators. This means that the purchaser of an existing building may use §179 to expense certain interior improvements.

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25 IRC §179(d)(1)(B)(ii), IRC §179(f).
26 Rev. Proc. 2023-34.
27 IRC §179(b)(1) and (2); Rev. Proc. 2023-34.
28 Treas. Regs. §1.167(a)-5.
29 Per the Tax Cuts and Jobs Act of 2017, the available bonus depreciation percentage for most assets reduces to 80 percent in 2023, 60 percent in 2024, 40 percent in 2025, 20 percent in 2026, and 0 percent in 2027 and beyond.
30 IRC §§179(d)(ii); 179(e).

- **Other:** The other four categories of qualified real property must be added to a commercial building:
  - Roofs;
  - HVAC systems;
  - Fire protection systems; and
  - Security systems.

Note:

Assets that do not fall into any specific asset class (or are otherwise not listed at all) are automatically placed into the seven-year MACRS class with a 12-year midpoint using the 200 percent declining-balance method. Examples had previously included appliances, rugs, etc. used in rental apartment buildings. The Service announced that, contrary to the Form 4562 instructions on depreciation, **personal property associated with real estate** should really be placed in ADR Asset Class 57.0, "Distributive Trades and Services," as five-year MACRS property rather than seven years.[31] Rental-unit owners who claimed seven years can apply for refunds on IRS Form 1040X, which goes back three years, or IRS Form 3115, "Application for Change in Accounting Method," which goes back to the purchase of the property, even if it is beyond three years.

Personal property associated with real estate includes furniture, carpets, appliances, cabinets, shelves, window treatments, and many other items (including certain fixtures). Allocations to personal property components may also save on state or local taxes, such as transfer taxes.

Planning point:

As to nonstructural components of a building, special care should be taken to break out these costs as well. A building and its structural components are deemed a single unit subject to a recovery period of either 27.5 or 39 years. However, any nonstructural components can be written off over the "normal" recovery period for that type of property (i.e., most likely as five- or seven-year fixtures). Rev. Proc. 87-56 identifies various asset classes for that purpose. Pursuant to the "old" investment tax credit (ITC) rules, removable and reusable partitions, carpeting, and removable solar heating equipment are also considered nonstructural components.

5. Hospital Corporation of America

The Tax Court's decision in ***Hospital Corporation of America***[32] (*HCA*) in 1997 was one of the first cases that examined the possibility for quicker write-offs by aggressively classifying a certain portion of the assets (i.e., fixtures) connected with developed real property as either five- or seven-year property. In siding with the taxpayer, the Tax Court determined that property qualifying as "tangible personal property" (i.e., versus real estate) under the former investment-tax-credit rules would also now qualify under **either** the ACRS or MACRS depreciation rules. As a result, practitioners should refer to these former ITC guidelines, developed and further refined by both the IRS and the courts (i.e., over the years leading up to 1981, when the investment credit was repealed), when ascertaining whether an asset is properly classified as "realty" (i.e., with a 39-year or 27.5-year recovery period) or "tangible personal property" (i.e., with a five- or seven-year recovery period).

a. The Service released **Chief Counsel Memorandum (CCM) 199921045**, which addressed the position that IRS examiners should take in light of the Tax Court's decision in *HCA*. One needs to keep in mind that even though it is not legally binding on the IRS, the discussion contained in the Service's memorandum does provide a good overview of what clients might do to enhance their chances of possibly obtaining faster write-offs for the various fixtures found in any developed real estate project.

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[31] Ann. 99-82, 1999-2 C.B. 244.

[32] *Hospital Corporation of America*, 109 T.C. 21 (1997).

b. The old ITC regulations[33] define "tangible personal property" to include "any tangible property except land and improvements thereto." For purposes of determining whether property is or is not "tangible" or "personal," local law does not control. Also, buildings and other inherently permanent structures (including structural components of such buildings and structures) are deemed to fit within the general definition of "improvements," and thus, are considered "real property." In making the determination as to whether an asset is inherently permanent or a structural component of a building as opposed to tangible personal property, even the Service admits in its memorandum that this issue is still "a highly factual one, with no bright-line tests."

c. **Inherently permanent** – Relying on its 1975 decision in ***Whiteco Industries,***[34] the Tax Court in *HCA* took note of the following factors when determining whether a particular piece of property is "inherently permanent":

   (i) Is the property capable of being moved?

   (ii) Has the property in fact been moved?

   (iii) Is the property designed to be moved or is it constructed to remain permanently in place?

   (iv) Are there circumstances that show the expected or intended length of affixation? Are there circumstances that show that the property may or will have to be moved?

   (v) How substantial a job is removal of the property and how time-consuming is it? Is it readily movable?

   (vi) How much damage will the property itself (i.e., not just the property that surrounds it, or to which it is attached) sustain upon its move?

   (vii) What is the manner of affixation to the land?

Comment:

"Movability" itself is not the controlling factor in deciding whether the property lacks permanence.[35]

Note:

The regulations make it clear, however, that the term "structural components" does not include machinery "the sole justification for the installation of which is the fact that such machinery is required to meet temperature or humidity requirements that are essential for the operation of other machinery or the processing of materials or foodstuffs." A good example we often see of this is the false flooring in a computer room where refrigeration and other cooling equipment, along with the necessary wiring, is run under the floorboards.

d. **Overall maintenance of the building** – Accordingly, an item constitutes a "structural component" of a building if the item "relates to the operation and maintenance of the building."[36] The "sole justification" test set forth in the regulations[37] excludes from the term "structural component" only machinery that is required to meet the temperature and humidity requirements of other machinery and not just to maintain the overall environment of a building.[38] However, such machinery would satisfy the "solely because"

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33 Treas. Regs. §1.48-1(c).

34 *Whiteco Industries, Inc. v. Commissioner*, 65 T.C. 664 (1975).

35 *Kramertown Co. v. Commissioner*, 488 F.2d 728, 731 (5th Cir. 1974), affg. T.C. Memo. 1972-239.

36 Treas. Regs. §1.48-1(e)(2).

37 Treas. Regs. §1.48-1(e)(1).

38 *Piggly Wiggly S., Inc. v. Commissioner*, 84 T.C. 739 (1985), affd. 803 F.2d 1572 (11th Cir. 1986); *Texas Instruments, Inc. v. Commissioner*, T.C. Memo. 1992-306.

requirement even if it "incidentally provides for the comfort of employees, or serves, to an insubstantial degree, an area where such temperature or humidity requirements are not critical."[39]

Practice point:

Here, we see that the Tax Court interprets as a "structural component" of a building those elements of the heating and cooling systems of the building, even if they are located outside (i.e., alongside an exterior wall, as are many compressor units for central air). Also, even though furnaces today are getting more compact, the Court makes it clear that these should also be treated as 27.5- or 39-year realty. Perhaps, though, items such as a water heater (e.g., for a rental unit) might still be distinguished as not being part of the property's "heating system." Especially where there are simply two lines (i.e., often connected with PVC, which can be easily moved, detached, or reconnected) for the water flow, along with a gas or electric line, one could make the argument that this should be instead treated as MACRS five-year property (and therefore, eligible for §179 immediate expensing).

e. **Wiring** – The Court in *HCA* summarized the regulation saying, "an item constitutes a structural component of a building if the item relates to the [overall] operation and maintenance of the building."[40] The Service went so far as to state emphatically "Be aware, however, that the list may be misleading." The *HCA* court followed an earlier case[41] in determining that even though wiring is an example under the regulations,[42] it is not a "structural component" unless it relates to the overall operation or maintenance of a building.[43] The focus instead, the Court found, should be on its "ultimate use,"[44] which is truly dependent on the facts and circumstances in each case. In addition, the Service has stated that it will not challenge the *Scott Paper* approach.[45]

6. Importance of cost segregation studies

As a practical matter, it should be noted that the use of cost segregation studies must be specifically developed by the taxpayer for the project at hand. In *HCA*, the Court sustained the Service's position that certain "allocated" equipment must be depreciated over the same period as the buildings to which they relate because the taxpayer's records did not provide any "logical and objective measure" in a number of instances to the equipment that was supposed to constitute §1245 property.[46] Furthermore, according to the IRS' memorandum, "an accurate cost segregation study may not be based on non-contemporaneous records, reconstructed data, or taxpayer's estimates or assumptions that have no supporting records."[47] Therefore, the Service warned that cost segregation studies should be closely scrutinized by the agents and auditors out in the field when these flaws become apparent.

39 Treas. Regs. §1.48-1(e)(2).
40 *HCA v. Commissioner*, supra.
41 *Scott Paper Co. v. Commissioner*, 74 T.C. 137 (1980).
42 Treas. Regs. §1.48-1(e)(2).
43 *HCA v. Commissioner*, supra, 109 T.C. at 92.
44 *HCA v. Commissioner*, supra, 109 T.C. at 92.
45 *Illinois Cereal Mills, Inc. v. Commissioner*, T.C. Memo. 1983-469, action on decision, 1991-019 (October 22, 1991).
46 *HCA v. Commissioner*, supra, 109 T.C. at 92.
47 *Boddie-Noell Enterprises, Inc. v. U.S.*, 36 Fed. Cl. 722 (1996), aff'd without op. 132 F.2d 54 (Fed. Cir. 1997).

Practice point:

> Even if a roof, for instance, is clearly part of a 39-year commercial building, its cost should still be segregated because when it has to be replaced after 10 or 15 years, the cost basis of the roof would be established to support taking a §1231 ordinary loss for the unrecovered basis at that point in time. Obviously, it is easier to more accurately break out the costs of a project when it is the taxpayer making the improvement as opposed to where the building is purchased in its finished state.

Planning point:

> Properly allocating costs between a client's real property and the fixtures (i.e., including perhaps the non-load-bearing walls) continues to be an overlooked tax-saving strategy. However, the Tax Court's *HCA* decision that the old ITC cases[48] are still relevant should be helpful in making this distinction, along with the release of the Service's legal memorandum discussed above, which concedes the merits of *HCA* while telling its auditors to abide by its findings. However, there is no question with regard to whether the Service feels a change in the taxpayer's overall method of accounting is involved when a taxpayer seeks to implement a change in depreciation methods, including recovery periods and conventions or the computation of depreciation allowances, because it affects the timing of a deduction involving a material item.

7. ADR Class 57.0

ADR Guideline Class 57.0 "Distributive trades and services" includes ***any*** asset (other than real property) used in a wholesale or retail business, or in rendering personal and professional services. Inclusion of an asset in this particular MACRS classification means a five-year write-off using the 200 percent declining-balance method. Therefore, outside of the actual "bricks and mortar" of a retail store, any and all other assets that constituted tangible personal property with regard to that retail outlet could be written off over this shorter period. Examples would include shelving, floor displays, movable fixtures (e.g., track lighting), carpeting, and display cases (e.g., such as refrigeration units for a market or convenience store, including the special 220-amp wiring required for its operation).

a. In a professional setting, this classification would affect a dentist, for instance, who had just spent $200-$300,000 for equipment to be used in the treatment of his or her patients, including that to be used by the dental hygienist and the necessary x-ray equipment. However, any other furniture or fixtures to be used in an "office setting" for the dentist, or other professionals (e.g., doctors, attorneys, accountants, engineers, etc.) would be under the **general ADR Guideline Classification of .11 (Office Furniture and Fixtures)**. This was the result from a case decided several years ago involving Norwest Bank.[49]

b. Other examples of this classification might be seen in a restaurant, which would have numerous fixtures, such as tables, chairs, utensils, wall decorations, along with a professional (e.g., stainless steel) kitchen. All of these items would be five-year property. Only the furniture and fixtures in the back offices (i.e., where the day's credit-card and cash receipts were processed) would be in the seven-year class.

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48 *Morrison, Inc., et al v. Commissioner*, 90-1 USTC 50034 (11th Cir. 1990); *Illinois Cereal Mills, Inc. v. Commissioner*, TC Memo 1983-469 (1983), Action on Decision, 1991-019 (October 22, 1991).

49 *Norwest Corp. v. Commissioner,* 111 T.C. 105 (1998).

Note:

> **Service rules signs to be 15-year land improvements** – The Tax Court determined that ADR Asset Class 57.0 (i.e., five-year property) was found to include restaurant decor items such as a decorative canopy system, along with its related concrete foundation, concrete piers, lumber, and attached signs.[50] However, in this field service advice, the Service ruled that outdoor signs must be written off as 15-year land improvements. Here, a casino constructed a large pylon sign on its property to draw attention to its gambling and hotel complex. The sign was not attached to the building. The casino had argued that the entire cost of the sign should be written off over five years (i.e., ADR Asset Class 57.0 Distributive Trades and Services). According to the Service's ruling, such treatment applies only to the sign's electronic circuitry.[51]

C. Final regulations concerning acquisition of a business, change in capital structure, and other transactions

1. Transactions covered

A taxpayer must capitalize an amount paid to facilitate each of the following transactions, without regard to whether the transaction is comprised of a single step or a series of steps carried out as part of a single plan and without regard to whether gain or loss is recognized in the transaction.

a. An acquisition of assets that constitute a trade or business (whether the taxpayer is the acquirer in the acquisition or the target of the acquisition).[52]

b. An acquisition by the taxpayer of an ownership interest in a business entity if, immediately after the acquisition, the taxpayer and the business entity are related within the meaning of §§267(b) or 707(b) (see §1.263(a)-4 for rules requiring capitalization of amounts paid by the taxpayer to acquire an ownership interest in a business entity, or to facilitate the acquisition of an ownership interest in a business entity, where the taxpayer and the business entity are not related within the meaning of §§267(b) or 707(b) immediately after the acquisition).[53]

c. An acquisition of an ownership interest in the taxpayer (other than an acquisition by the taxpayer of an ownership interest in the taxpayer, whether by redemption or otherwise).[54]

d. A restructuring, recapitalization, or reorganization of the capital structure of a business entity (including reorganizations described in §368 and distributions of stock by the taxpayer as described in §355).[55]

e. A transfer described in §§351 or 721 (whether the taxpayer is the transferor or transferee).[56]

f. A formation or organization of a disregarded entity.[57]

g. An acquisition of capital.[58]

h. A stock issuance.[59]

i. A borrowing. For purposes of this section, a borrowing means any issuance of debt, including an issuance of debt in an acquisition of capital or in a recapitalization. A borrowing also includes debt issued in a debt for debt exchange under §1.1001-3.[60]

j. Writing of an option.[61]

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50 *Walgreen Co. and Subsidiaries v. Commissioner*, T.C. Memo. 1996-374.
51 CCA 200203009.
52 Treas. Regs. §1.263(a)-5(a)(1).
53 Treas. Regs. §1.263(a)-5(a)(2).
54 Treas. Regs. §1.263(a)-5(a)(3).
55 Treas. Regs. §1.263(a)-5(a)(4).
56 Treas. Regs. §1.263(a)-5(a)(5).
57 Treas. Regs. §1.263(a)-5(a)(6).
58 Treas. Regs. §1.263(a)-5(a)(7).
59 Treas. Regs. §1.263(a)-5(a)(8).
60 Treas. Regs. §1.263(a)-5(a)(9).
61 Treas. Regs. §1.263(a)-5(a)(10).

2. Facilitate

In general, an amount is paid to facilitate a transaction if the amount is paid in the process of investigating or otherwise pursuing the transaction. Whether an amount is paid in the process of investigating or otherwise pursuing the transaction is determined based on all the facts and circumstances. In determining whether an amount is paid to facilitate a transaction, the fact that the amount would (or would not) have been paid but for the transaction is relevant but is not determinative. An amount paid to determine the value or price of a transaction is an amount paid in the process of investigating or otherwise pursuing the transaction. An amount paid to another party in exchange for tangible or intangible property is not an amount paid to facilitate the exchange. For example, the purchase price paid to the target of an asset acquisition in exchange for its assets is not an amount paid to facilitate the acquisition. Similarly, the purchase price paid by an acquirer to the target's shareholders in exchange for their stock in a stock acquisition is not an amount paid to facilitate the acquisition of the stock.[62]

Note:

An amount paid in the process of investigating or otherwise pursuing both a transaction described in the preceding paragraph and an acquisition or creation of an intangible described in the preceding section is subject to the rules contained in this section, and not to the rules contained in the preceding section. In addition, an amount required to be capitalized by §1.263(a)-1, §1.263(a)-2, or §1.263(a)-4 does not facilitate a transaction described in the preceding paragraph.[63]

3. Specific costs

There are some special rules for specific costs.

a. An amount paid to facilitate a borrowing does not facilitate another transaction (other than the borrowing) described in the transactions covered section.[64]

b. An amount paid by a taxpayer to facilitate a sale of its assets does not facilitate another transaction (other than the sale) described in the transactions covered section. For example, where a target corporation, in preparation for a merger with an acquiring corporation, sells assets that are not desired by the acquiring corporation, amounts paid to facilitate the sale of the unwanted assets are not required to be capitalized as amounts paid to facilitate the merger.[65]

c. An amount paid in the process of investigating or otherwise pursuing a distribution of stock by a taxpayer to its shareholders does not facilitate a transaction described in the transactions covered section if the divestiture of the stock (or of properties transferred to an entity whose stock is distributed) is required by law, regulatory mandate, or court order. A taxpayer is not required to capitalize (under this section or §1.263(a)-4) an amount paid to organize (or facilitate the organization of) an entity if the entity is organized solely to receive properties that the taxpayer is required to divest by law, regulatory mandate, or court order and if the taxpayer distributes the stock of the entity to its shareholders. A taxpayer also is not required to capitalize (under this section or §1.263(a)-4) an amount paid to transfer property to an entity if the taxpayer is required to divest itself of that property by law, regulatory mandate, or court order and if the stock of the recipient entity is distributed to the taxpayer's shareholders.[66]

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62 Treas. Regs. §1.263(a)-5(b)(1). See §1.263(a)-1, §1.263(a)-2, and §1.263(a)-4 for rules requiring capitalization of the purchase price paid to acquire property.
63 Treas. Regs. §1.263(a)-5(b)(2).
64 Treas. Regs. §1.263(a)-5(c)(1).
65 Treas. Regs. §1.263(a)-5(c)(2).
66 Treas. Regs. §1.263(a)-5(c)(3).

d. An amount paid to institute or administer a proceeding under Chapter 11 of the Bankruptcy Code by a taxpayer that is the debtor under the proceeding constitutes an amount paid to facilitate a reorganization within the meaning of paragraph (a)(4) of this section, regardless of the purpose for which the proceeding is instituted.

e. Amounts paid by an open-end regulated investment company to facilitate an issuance of its stock are treated as amounts that do not facilitate a transaction described in the transactions covered section unless the amounts are paid during the initial stock offering period.[67]

f. An amount paid to integrate the business operations of the taxpayer with the business operations of another does not facilitate a transaction described in the transactions covered section, regardless of when the integration activities occur.[68]

g. An amount paid by a taxpayer to a registrar or transfer agent in connection with the transfer of the taxpayer's capital stock does not facilitate a transaction described in the transactions covered section unless the amount is paid with respect to a specific transaction described in the transactions covered section.

h. An amount paid to terminate (or facilitate the termination of) an agreement to enter into a transaction described in the transactions covered section constitutes an amount paid to facilitate a second transaction described in the transactions covered section only if the transactions are mutually exclusive. An amount paid to facilitate a transaction described in the transactions covered section is treated as an amount paid to facilitate a second transaction described in the transactions covered section only if the transactions are mutually exclusive.[69]

4. Simplifying conventions

For these purposes, employee compensation, overhead, and de minimis costs are treated as amounts that do not facilitate a transaction described in the covered transactions section.[70]

The term de minimis costs means amounts (other than employee compensation and overhead) paid in the process of investigating or otherwise pursuing a transaction described in the covered transactions section if, in the aggregate, the amounts do not exceed $5,000 (or such greater amount as may be set forth in published guidance). If the amounts exceed $5,000 (or such greater amount as may be set forth in published guidance), none of the amounts are de minimis costs. For these purposes, an amount paid in the form of property is valued at its fair market value at the time of the payment.[71] The term "de minimis costs" does not include commissions paid to facilitate a transaction described in the covered transactions section.[72]

A taxpayer may elect to treat employee compensation, overhead, or de minimis costs paid in the process of investigating or otherwise pursuing a transaction described in the covered transaction section as amounts that facilitate the transaction. The election is made separately for each transaction and applies to employee compensation, overhead, or de minimis costs, or to any combination thereof.

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67 Treas. Regs. §1.263(a)-5(c)(5).
68 Treas. Regs. §1.263(a)-5(c)(6).
69 Treas. Regs. §1.263(a)-5(c)(8).
70 Treas. Regs. §1.263(a)-5(d)(1).
71 Treas. Regs. §1.263(a)-5(d)(3)(i).
72 Treas. Regs. §1.263(a)-5(d)(3)(ii).

5. Acquisitive transactions

In general, except for inherently facilitative amounts, an amount paid by the taxpayer in the process of investigating or otherwise pursuing a covered transaction facilitates the transaction only if the amount relates to activities performed on or after the earlier of:

(i) The date on which a letter of intent, exclusivity agreement, or similar written communication (other than a confidentiality agreement) is executed by representatives of the acquirer and the target;[73] or

(ii) The date on which the material terms of the transaction (as tentatively agreed to by representatives of the acquirer and the target) are authorized or approved by the taxpayer's board of directors (or committee of the board of directors) or, in the case of a taxpayer that is not a corporation, the date on which the material terms of the transaction (as tentatively agreed to by representatives of the acquirer and the target) are authorized or approved by the appropriate governing officials of the taxpayer. In the case of a transaction that does not require authorization or approval of the taxpayer's board of directors (or appropriate governing officials in the case of a taxpayer that is not a corporation) the date determined under this provision is the date on which the acquirer and the target execute a binding written contract reflecting the terms of the transaction.[74]

An amount paid in the process of investigating or otherwise pursuing a covered transaction facilitates that transaction if the amount is inherently facilitative, regardless of whether the amount is paid for activities performed prior to the date determined above. An amount is inherently facilitative if the amount is paid for:

(i) Securing an appraisal, formal written evaluation, or fairness opinion related to the transaction;[75]

(ii) Structuring the transaction, including negotiating the structure of the transaction and obtaining tax advice on the structure of the transaction (for example, obtaining tax advice on the application of §368);[76]

(iii) Preparing and reviewing the documents that effectuate the transaction (for example, a merger agreement or purchase agreement);[77]

(iv) Obtaining regulatory approval of the transaction, including preparing and reviewing regulatory filings;[78]

(v) Obtaining shareholder approval of the transaction (for example, proxy costs, solicitation costs, and costs to promote the transaction to shareholders);[79] or

(vi) Conveying property between the parties to the transaction (for example, transfer taxes and title registration costs).[80]

Solely for purposes of this paragraph, the term **covered transaction** means the following transactions:

(i) A taxable acquisition by the taxpayer of assets that constitute a trade or business;[81]

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73 Treas. Regs. §1.263(a)-5(e)(1)(i).
74 Treas. Regs. §1.263(a)-5(e)(1)(ii).
75 Treas. Regs. §1.263(a)-5(e)(2)(i).
76 Treas. Regs. §1.263(a)-5(e)(2)(ii).
77 Treas. Regs. §1.263(a)-5(e)(2)(iii).
78 Treas. Regs. §1.263(a)-5(e)(2)(iv).
79 Treas. Regs. §1.263(a)-5(e)(2)(v).
80 Treas. Regs. §1.263(a)-5(e)(2)(vi).
81 Treas. Regs. §1.263(a)-5(e)(3)(i).

(ii) A taxable acquisition of an ownership interest in a business entity (whether the taxpayer is the acquirer in the acquisition or the target of the acquisition) if, immediately after the acquisition, the acquirer and the target are related within the meaning of §267(b) or §707(b);[82] and

(iii) A reorganization described in §§368(a)(1)(A), (B), or (C) or a reorganization described in §368(a)(1)(D) in which stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under §354 or §356 (whether the taxpayer is the acquirer or the target in the reorganization).[83]

6. Success-based fees

An amount paid that is contingent on the successful closing of a transaction described in the covered transactions section is an amount paid to facilitate the transaction except to the extent the taxpayer maintains sufficient documentation to establish that a portion of the fee is allocable to activities that do not facilitate the transaction. This documentation must be completed on or before the due date of the taxpayer's timely filed original federal income tax return (including extensions) for the taxable year during which the transaction closes.[84] For these purposes, documentation must consist of more than merely an allocation between activities that facilitate the transaction and activities that do not facilitate the transaction, and must consist of supporting records (for example, time records, itemized invoices, or other records) that identify:

- The various activities performed by the service provider;
- The amount of the fee (or percentage of time) that is allocable to each of the various activities performed;
- Where the date the activity was performed is relevant to understanding whether the activity facilitated the transaction, the amount of the fee (or percentage of time) that is allocable to the performance of that activity before and after the relevant date; and
- The name, business address, and business telephone number of the service provider.

7. Success-based fees safe harbor: Revenue Procedure 2011-29

To help with the confusion of allocating success-based fees between facilitative expense that must be capitalized and non-facilitative costs that can be expensed in the current period, the IRS issued a safe harbor election in the form of Revenue Procedure 2011-29. It covers success-based fees paid in business acquisitions or reorganizations described in §1.263(a)-5(e)(3). The safe harbor election allows the taxpayer to treat 70 percent of the success-based fee as an amount that does not facilitate the transaction. The remaining 30 percent is capitalized as facilitative costs. In addition to the 70/30 allocation on the return, the taxpayer must attach an election to the original federal income tax return for the year that the fees are incurred stating that the taxpayer is electing the safe harbor, identifying the transaction, and detailing the success-based amounts that are deducted and capitalized. The election applies only to the transaction for which it is made and is irrevocable.

The safe harbor election is not considered an accounting method change. A §481(a) adjustment is not required or allowed.

The following are selected examples from Treasury Regulation §1.263(a)-5(l). The example numbers refer to the example numbers in the regulation.

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[82] Treas. Regs. §1.263(a)-5(e)(3)(ii).
[83] Treas. Regs. §1.263(a)-5(e)(3)(iii).
[84] Treas. Regs. §1.263(a)-5(f).

Example 1: Q corporation seeks to acquire all the outstanding stock of Y corporation. To finance the acquisition, Q must issue new debt. Q pays an investment banker $25,000 to market the debt to the public and pays its outside counsel $10,000 to prepare the offering documents for the debt. Q's payment of $35,000 facilitates a borrowing and must be capitalized. Q's payment does not facilitate the acquisition of Y, notwithstanding the fact that Q incurred the new debt to finance its acquisition of Y. See §1.446-5 for the treatment of Q's capitalized payment.

Example 2: Z agrees to pay investment banker B $1,000,000 for B's services in evaluating four alternative transactions ($250,000 for each alternative): an initial public offering; a borrowing of funds; an acquisition by Z of a competitor; and an acquisition of Z by a competitor. Z eventually decides to pursue a borrowing and abandons the other options.

The $250,000 payment to evaluate the possibility of a borrowing is an amount paid in the process of investigating or otherwise pursuing a transaction described in the covered transactions section. Accordingly, Z must capitalize that $250,000 payment to B. See §1.446-5 for the treatment of Z's capitalized payment.

The $250,000 payment to evaluate the possibility of an **initial public offering** is an amount paid in the process of investigating or otherwise pursuing a transaction described in the covered transaction section. Accordingly, Z must capitalize that $250,000 payment to B under this section. Because the borrowing and the initial public offering are not mutually exclusive transactions, the $250,000 is not treated as an amount paid to facilitate the borrowing. When Z abandons the initial public offering, Z may recover under §165 the $250,000 paid to facilitate the initial public offering.

The $500,000 paid by Z to evaluate the possibilities of an acquisition of Z by a competitor and an acquisition of a competitor by Z are amounts paid in the process of investigating or otherwise pursuing transactions described in the covered transactions section or certain acquisitive transactions. Accordingly, Z is only required to capitalize under this section the portion of the $500,000 payment that relates to inherently facilitative activities or to activities performed on or after the date determined for certain acquisitive transactions. Because the borrowing and the possible acquisitions are not mutually exclusive transactions, no portion of the $500,000 is treated as an amount paid to facilitate the borrowing. When Z abandons the acquisition transactions, Z may recover under §165 any portion of the $500,000 that was paid to facilitate the acquisitions.

Example 3: On February 1, 2024, R corporation decides to investigate the acquisition of three potential targets: T corporation, U corporation, and V corporation. R's consideration of T, U, and V represents the consideration of three distinct transactions, any or all of which R might consummate and has the financial ability to consummate. On March 1, 2024, R enters into an exclusivity agreement with T and stops pursuing U and V. On July 1, 2024, R acquires all of the stock of T in a transaction described in §368. R pays $1,000,000 to an investment banker and $50,000 to its outside counsel to conduct due diligence on T, U, and V; determine the value of T, U, and V; negotiate and structure the transaction with T; draft the merger agreement; secure shareholder approval; prepare SEC filings; and obtain the necessary regulatory approvals.

The amounts paid to conduct due diligence on T, U, and V prior to March 1, 2024 (the date of the exclusivity agreement) are not amounts paid to facilitate the acquisition of the stock of T, U, or V and are not required to be capitalized under this section. However, the amounts paid to conduct due diligence on T on and after March 1, 2024, are amounts paid to facilitate the **acquisition of the stock** of T and must be capitalized.

The amounts paid to determine the value of T, negotiate and structure the transaction with T, draft the merger agreement, secure shareholder approval, prepare SEC filings, and obtain necessary regulatory approvals are inherently facilitative amounts paid to facilitate the acquisition of the stock of T and must be capitalized, regardless of whether those activities occur prior to, on, or after March 1, 2024.

The amounts paid to determine the value of U and V are inherently facilitative amounts paid to facilitate the acquisition of U or V and must be capitalized. Because the acquisition of U, V, and T are not mutually exclusive transactions, the costs that facilitate the acquisition of U and V do not facilitate the acquisition of T. Accordingly, the amounts paid to determine the value of U and V may be recovered under §165 in the taxable year that R abandons the planned mergers with U and V.

III. Special problems

A. Asset acquisitions by S corporations

1. In general

An S corporation may acquire target assets directly in exchange for cash or promissory notes. Alternatively, the S corporation may acquire the target assets in a taxable merger.[85]

2. Subsidiary issue

In general, a purchase of assets by an S corporation should not result in the termination of the S election. Under the 1996 legislation, the election will not be terminated even if the acquired assets include **stock of a subsidiary**.[86] S corporations may own up to 100 percent of the stock of a C corporation without implicating its S election.

3. Allocation

The income or loss generated by the acquired assets will be blended in with other income of the S corporation and allocated to the S corporation's shareholders under the usual per-day per-share rule.[87]

4. Built-in gains tax

Because the acquired assets generally will have a cost basis, §1374 should not apply even if the assets are acquired from a C corporation.

B. Stock acquisitions by S corporations

1. In general

In many cases, the target shareholders will insist on selling their stock rather than the target's assets. A stock acquisition by an S corporation used to create **additional risks** not present in an asset acquisition. However, changes in the law in 1996 permit S corporations to make such acquisitions with fewer problems.

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85 See Rev. Rul. 69-6, 1969-1 C.B. 104.
86 IRC §1361(b)(3)(C).
87 IRC §1377(a)(1).

2. Immediate liquidation

An acquisition of stock by an S corporation generally does not terminate the S election even if the corporation acquires sufficient stock of the target to satisfy the §1504(a)(2) tests of affiliation. If the target is immediately liquidated into the acquiring S corporation, the transaction could be viewed as a purchase of assets.[88] In this case, the acquisition of stock and the liquidation of the target apparently would be ignored. However, even if this was not so viewed, then §§332 (tax-free liquidation of 80 percent owned subsidiary) and 337 (retention of *General Utilities* for §332 liquidation) are now available. It was feared that since §332 is available only to a corporate shareholder, the S corporation shareholder could not take advantage of it.[89]

Planning point:

> The immediate liquidation is generally not advised since, if §332 applies, there is a carryover basis in the acquired assets, while if it does not apply, §336 will apply causing the acquired corporation to recognize gain on the liquidation.

3. Section 338

Because an S corporation is now viewed as a corporation in its capacity as a shareholder, it can make an election to treat the target corporation as selling its assets at fair market value on the date of acquisition and having a new corporation acquire the assets on the following day allowing the corporate assets to be stepped up to the AGUB (adjusted grossed-up basis).

a. If the acquired corporation is a C corporation, the gain is taxable to the C corporation, so the purchase price should be adjusted to reflect this fact.

b. If the acquired corporation is an S corporation qualifying as a qualified Subchapter S subsidiary, the accountant must be aware that the gain on the deemed sale of assets will be allocated to the selling shareholders. This can convert a portion of the gain to ordinary income in respect of receivables, depreciation recapture, etc. The upward basis adjustment may result in a capital loss against which the pass-through of capital gain on the deemed sale may not be sufficient to offset. Because the “new” target is treated as a new corporation, none of its tax attributes carry over, including the pre-acquisition built-in gains of the acquired S corporation. Accordingly, none of the post-acquisition tax items of the subsidiary can be allocated to the selling shareholders of the subsidiary.

4. No §338 election

If the acquired corporation is a qualified Subchapter S subsidiary (QSub), the selling shareholders may elect to close the books[90] because the sale encompasses more than 50 percent of the share of stock outstanding. This will prevent the selling shareholders from being allocated a portion of the tax items of the corporation during the portion of the taxable year following the acquisition and the shareholders of the buying S corporation from being allocated a portion of the tax items of the subsidiary during the portion of the taxable year prior to the acquisition.

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88 See Rev. Rul. 76-123, 1976-1 C.B. 94. *Cf.* Rev. Rul. 67-274, 1967-2 C.B. 141.

89 But see GCM 39768, which affirms the right of the S corporation to participate in reorganizations.

90 IRC §1362(e)(6)(D).

a. According to the final regulations, if all the stock of a QSub is transferred to another S corporation, the S election of the QSub terminates at the time the deemed liquidation occurs, i.e., when the purchasing S corporation makes a valid QSub election.[91] Thus, the QSub is not treated as a C corporation for any period solely because of the transfer of the stock to the buyer.[92] In contrast, a sale of the stock of the QSub to a C corporation causes termination of the S election applicable to the QSub at the close of the day of the sale.[93]

b. When the QSub election terminates, the subsidiary is treated as forming a new corporation acquiring all of its assets (and assuming all of its liabilities) immediately before the termination from the S corporation parent in exchange for stock of the new corporation. The tax treatment of this transaction or of a larger transaction that includes this transaction will be determined under the Internal Revenue Code and general principles of tax law, including the step-transaction doctrine.[94]

Example: X, an S corporation, owns 100 percent of the stock of Y, a corporation for which a QSub election is in effect. X sells 100 percent of the Y stock to Z, an unrelated C corporation, for cash, thereby terminating the QSub election. Y is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) in exchange for Y stock immediately before the termination from the S corporation. The deemed exchange by X of assets for Y stock does not qualify under §351 because X is not in control of Y within the meaning of §368(c) immediately after the transfer as a result of the sale of stock to Z. Therefore, X must recognize gain, if any, on the assets transferred to Y in exchange for its stock. X's losses, if any, on the assets transferred are subject to the limitations of §267.[95]

Planning point:

The new corporation, in essence, buys the assets from the parent resulting in a basis step-up to the new corporation. Consequently, there is no need for an acquiring S corporation to resort to §338 in acquisitions of a QSub to obtain a basis step-up in assets.

c. The final regulations indicate that on the termination of the QSub election, the subsidiary may generally not make an S election for a period of five years without the consent of the Commissioner.[96] However, if the corporation's QSub election terminates by reason of a disposition of the corporation's stock, the corporation may, without requesting the Commissioner's consent, make an S election or have a QSub election made with respect to it before the expiration of the five-year period if and only if: (i) immediately following the disposition of its stock, the corporation (or its successor corporation) is otherwise eligible to make an S election or have a QSub election made for it (i.e., when the buyers are all individuals or the buyer is an S corporation); and (ii) the relevant election is made effective immediately following the disposition of the stock of the corporation.[97]

Example: X, an S corporation, owns Y, a QSub. X sells 100 percent of the stock of Y to Z, an unrelated S corporation. Z may elect to treat Y as a QSub effective on the date of purchase without requesting the Commissioner's consent.

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91 Treas. Regs. §1.1361-4(a)(2).
92 Treas. Regs. §1.1362-4(b)(3)(i).
93 Treas. Regs. §1.1361-5(a)(1)(iii).
94 Treas. Regs. §1.1361-5(b)(1)(i).
95 Based on Treas. Regs. §1.1361-5(b)(3), Example (1).
96 Treas. Regs. §1.1361-5(c)(1).
97 Treas. Regs. §1.1361-5(c)(2).

Caution:

> The example in the final regulations has several elements to it that tax advisors should consider. First, a subsequent sale of the stock of an erstwhile QSub involves two transactions: a deemed asset sale and then a real stock sale. In the asset sale to the new corporation, gain but not loss is recognized based on the character of such gain on the assets. If the QSub owns for state law purposes highly depreciated assets, a good portion of the gain recognized by the selling S parent will be ordinary in the form of depreciation recapture or §1231 recapture gain. The fair market value of the stock of the new corporation, the consideration received by the parent, must be allocated to the assets in accordance with §1060 and the regulations thereunder as well as the §338 regulations (the seven-tier asset class system). Second, even though the parent does not recognize the loss on the exchange of loss assets to the new corporation, it nevertheless obtains a fair market value basis in the new corporation. As a consequence, there is no remaining gain on the sale at fair market value that could be deferred by an installment sale of the QSub to the buyer. Third, because the deemed sale of loss assets is between members of a controlled group of corporations, the loss on the deemed sale of assets is merely deferred, and the loss is recognized, when the new corporation leaves the consolidated group on the real sale of stock.[98]

C. Section 338

Absent a §338 election, the target corporation's tax attributes generally remain intact and its basis and holding period for its assets do not change. On the other hand, assets treated as having been purchased because of a §338 election acquire a new basis and holding period. In addition, the amount of gain or loss realized and the character of such gain or loss may be different depending on whether stock or assets are considered to have been sold.

1. In general

Two elections are available when a **purchasing corporation** acquires the stock of another corporation (the **target**) in a **qualified stock purchase**. The first (§338(g)) is available to the purchasing corporation. The second (§338(h)(10)) is a joint election of the purchasing corporation and the shareholders of the target. In either case, the election treats the target as two separate corporations, old target and new target, even though target is, and remains, a single corporation under corporate law.[99]

a. The essence of the election is that although in fact the purchase takes the form of a stock sale, old target is treated as transferring all of its assets to an unrelated person in exchange for consideration that includes the assumption of, or taking subject to, liabilities, and new target is treated as acquiring all of its assets from an unrelated person in exchange for consideration that includes the assumption of or taking subject to liabilities. This transaction is, without regard to its characterization for federal income-tax purposes, referred to as the **deemed asset sale** and the income-tax consequences thereof as the **deemed sale gain**.

Note:

> The double tax reduces the desirability of making a §338 election in most cases. A §338 election may still be advantageous in certain circumstances; for example, when the target's basis in its assets exceeds its parent's basis in its stock, or when the target corporation has net operating loss carryovers that can be used to offset the gain recognized on the deemed sale. For these purposes, Section 382 does not limit the use of old target's net operating loss carryover against the gain on the §338 deemed sale.[100]

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98 IRC §267(f)(2).
99 Treas. Regs. §1.338-1(a)(1).
100 IRC §§382(h)(1)(c), 382(c)(2)(A)(ii).

b. If a §338(h)(10) election is made, old target is also deemed to liquidate following the deemed asset sale.

Note:

> Other rules of law apply to determine the tax consequences to the parties as if they had actually engaged in the transactions deemed to occur except to the extent otherwise provided in the regulations.[101] Other rules of law may characterize the transaction as something other than or in addition to a sale and purchase of assets; however, it must be a taxable transaction.

2. Treatment of target under other rules

In general, new target is treated as a new corporation that is unrelated to old target for most income-tax purposes, including the ability to make new elections in respect of depreciable property and a new taxable year and new method of accounting, except to the extent not permitted by law.[102]

In general, for all other purposes not involving the income tax, new target is treated as a continuation of old target.[103] For example:

- New target is liable for old target's federal income-tax liabilities, including the tax liability for the deemed sale gain and those tax liabilities of the other members of any consolidated group that included old target that are attributable to taxable years in which those corporations and old target joined in the same consolidated return;[104]
- Wages earned by the employees of old target are considered wages earned by such employees from new target for purposes of FICA and FUTA; and
- Old target and new target must use the same employer identification number.[105]

3. Qualification for the §338 election

The term "purchasing corporation" means any corporation that makes a qualified stock purchase of stock of another corporation.[106] An individual cannot make a **qualified stock purchase** of **target**. To qualify, the purchaser must purchase at least 80 percent of the stock over a twelve-month period.[107] If an individual forms a corporation (new P) to acquire target stock, new P can make a qualified stock purchase of target if new P is considered for tax purposes to purchase the target stock. Facts that may indicate that new P does not purchase the target stock include new P merging downstream into target, liquidating, or otherwise disposing of the target stock following the purported qualified stock purchase.[108]

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101 Treas. Regs. §1.338-1(a)(2).
102 Treas. Regs. §1.338-1(b)(1). Moreover, new target may adopt a taxable year on or before the last day for making the §338 election by filing its first return for the desired taxable year on or before that date.
103 Treas. Regs. §1.338-1(b)(3).
104 See Treas. Regs. §1.1502-6(a).
105 Treas. Regs. §1.338-1(b)(3)(iii).
106 IRC §338(d)(1).
107 IRC §338(d)(3).
108 Treas. Regs. §1.338-3(b)(1).

a. For these purposes, a purchase means a purchase of stock in which the basis of the stock in the hands of the purchasing corporation is not determined: (i) in whole or in part by reference to the adjusted basis of such stock in the hands of the person from whom acquired; or (ii) as property acquired from a decedent.[109] Nor does it include stock acquired in a corporate organization (§351) or reorganization (§§354, 355, or 356).[110] Moreover, it does not include any acquisition of stock from a person the ownership of whose stock would, under §318(a) (other than paragraph (4) thereof), be attributed to the person acquiring such stock; however, it may include an acquisition of stock from a related corporation if at least 50 percent in value of the stock of such related corporation was acquired by purchase.[111]

   (i) Stock acquired by a purchasing corporation from a related corporation is generally not considered acquired by purchase.[112] A purchasing corporation is treated as related to another person if the relationship exists: (a) in the case of a single transaction, immediately after the purchase of target stock; (b) in the case of a series of acquisitions otherwise constituting a qualified stock purchase, immediately after the last acquisition in such series; and (c) in the case of a series of transactions effected pursuant to an integrated plan to dispose of target stock, immediately after the last transaction in such series.[113]

   (ii) If the 50 percent rule applies and the purchasing corporation is treated as acquiring stock by purchase from the related corporation, solely for purposes of determining when the stock is considered acquired, target stock acquired from that corporation is considered to have been acquired by the purchasing corporation on the day on which the purchasing corporation is first considered to own that stock under §318(a) (other than §318(a)(4)).[114]

b. Stock in a target affiliate acquired by new target in the deemed asset sale of target's assets is considered purchased if, under general principles of tax law, new target is considered to own stock of the target affiliate meeting the requirements of §1504(a)(2), notwithstanding that no amount may be allocated to target's stock in the target affiliate.[115]

D. Section 338(h)(10) transactions involving S corporations

1. In general

A purchasing corporation wants the stepped-up basis in the assets of an S corporation but not the state transfer taxes that are involved in an acquisition of assets. Typical nontax reasons for a stock acquisition may involve the presence of nontransferable (or greatly difficult to transfer) assets, such as franchises and state licenses. The §338(h)(10) election can enable the purchasing corporation to get the legal benefits of a stock purchase and the income-tax benefits of an asset acquisition.

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109 IRC §338(h)(3)(A).
110 IRC §338(h)(3)(B).
111 IRC §338(h)(3)(C).
112 Treas. Regs. §1.338-3(b)(3)(i).
113 Treas. Regs. §1.338-3(b)(3)(ii).
114 Treas. Regs. §1.338-3(b)(3)(iii).
115 Treas. Regs. §1.338-3(b)(2).

2. Final regulations

The Service has issued final regulations to apply to any qualified stock purchase occurring after March 15, 2001.[116] Assuming the purchasing corporation can make a qualified stock purchase of the S corporation, an §338(h)(10) election can be made by the purchasing corporation and S corporation shareholders to treat the stock acquisition as an asset acquisition by a new corporation ("new target") of all the assets of the S corporation in a single transaction.

a. Rather than being viewed as a stock sale, the S corporation is treated as having sold its assets while still an S corporation in a single transaction at the close of the acquisition date.[117]

b. Old target is treated as transferring all of its assets to an unrelated person in exchange for consideration that includes the assumption of or taking subject to liabilities in a single transaction at the close of the acquisition date (but before the deemed liquidation). Old target realizes the deemed sale gain from the deemed asset sale before the close of the acquisition date while old T is a member of the selling consolidated group (**or owned by the selling affiliate or owned by the S corporation shareholders**). An S corporation target's S election continues in effect through the close of the acquisition date (including the time of the deemed asset sale and the deemed liquidation). Also, any direct and indirect subsidiaries of target that it has elected to treat as qualified Subchapter S subsidiaries remain qualified Subchapter S subsidiaries through the close of the acquisition date. No similar rule applies when a qualified Subchapter S subsidiary, as opposed to the S corporation that is its owner, is the target the stock of which is actually purchased.[118]

c. Old target is treated as if, before the close of the acquisition date, after the deemed asset sale, and while old target is owned by the S corporation shareholders, it transferred all of its assets to S corporation shareholders and ceased to exist. The transfer from old target is characterized for federal income-tax purposes in the same manner as if the parties had actually engaged in the transactions deemed to occur and taking into account other transactions that actually occurred or are deemed to occur. For example, the transfer may be treated as a distribution in pursuance of a plan of reorganization, a distribution in complete cancellation or redemption of all its stock, one of a series of distributions in complete cancellation or redemption of all its stock in accordance with a plan of liquidation, or part of a circular flow of cash. In most cases, the transfer will be treated as a distribution in complete liquidation to which §336 applies.[119]

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116 Treas. Regs. §1.338(i)-1.
117 Treas. Regs. §1.338(h)(10)-1(d).
118 Treas. Regs. §1.338(h)(10)-1(d)(4)(i).
119 Treas. Regs. §1.338(h)(10)-1(d)(3)(i).

3. Nonselling minority shareholders

If the S corporation has shareholders who do not sell their stock, any gain recognized by the S corporation target in the deemed asset sale to new target will be passed through and taxed to all shareholders (including the nonselling shareholders) pro rata and such gain will increase the nonselling shareholders' adjusted stock bases. S corporation shareholders are treated as if, after the deemed asset sale and before the close of the acquisition date, they received the assets transferred by old T in the deemed liquidation. In most cases, the transfer will be treated as a distribution in complete liquidation to which §331 applies.[120] An S corporation shareholder retaining stock is treated as acquiring the stock so retained on the day after the acquisition date for its fair market value. The holding period for the retained stock starts on the day after the acquisition date. For these purposes, the fair market value of all of the T stock equals the grossed-up amount realized on the sale to P of P's recently purchased target stock. S corporation shareholders recognize no gain or loss on the sale or exchange of T stock included in the qualified stock purchase (although they may recognize gain or loss on the T stock in the deemed liquidation).[121]

4. Consent

A §338(h)(10) election is made jointly by P and the S corporation shareholders on Form 8023 in accordance with the instructions to the form. Form 8883, "Asset Allocation Statement Under Section 338," is used for the applicable asset acquisition rather than Form 8594. **S corporation shareholders who do not sell their stock must also consent to the election**. The §338(h)(10) election must be made not later than the fifteenth day of the ninth month beginning after the month in which the acquisition date occurs.[122] A §338(h)(10) election is irrevocable.[123]

Planning point:

> While in theory minority shareholders could retain an interest in the corporation, the phantom income that is generated by the deemed sale will act as a major deterrent. Nevertheless, the requirement of unanimous consent of all the shareholders of an S corporation target provides a minority shareholder with considerable leverage. These may require a redemption of or a compensatory payment to the nonselling S shareholder if the corporate documents permit.

5. QSub target

What happens if a qualified Subchapter S subsidiary (QSub)[124] is involved in a §338(h)(10) transaction?

a. A QSub is a disregarded entity for federal income-tax purposes with all assets, liabilities, items of income, deduction, and credit being treated as the assets, liabilities, and items of income, deduction, and credit of the S corporation parent. The regulations provide that in the deemed asset segment of the transaction, the deemed asset sale of a parent corporation is considered to precede that of its subsidiary.[125] In contrast, the regulations provide that in the deemed liquidation segment of the transaction, the deemed liquidation of a subsidiary corporation is considered to precede the deemed liquidation of its parent.[126] Thus, if an S corporation target has a QSub and the S corporation shareholders and purchasing corporation make a §338(h)(10) election, the QSub remains a QSub

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120 Treas. Regs. §1.338(h)(10)-1(d)(5)(i).
121 Treas. Regs. §1.338(h)(10)-1(d)(5)(iii).
122 Treas. Regs. §1.338(h)(10)-1(c)(2).
123 Treas. Regs. §1.338(h)(10)-1(c)(3).
124 A QSub is a domestic corporation that is not an ineligible corporation, which is wholly owned by an S corporation that elects to treat such corporation as a QSub.
125 Treas. Regs. §1.338(h)(10)-1(d)(3)(ii).
126 Treas. Regs. §1.338(h)(10)-1 (d)(4)(ii).

through the close of the acquisition date. As a result, the sale of the QSub assets is treated as a sale of those assets by the S corporation. Without this rule, the QSub election would terminate and cause the assets of the QSub to be treated as contributed to a new corporation; although this appears to qualify as a §351 transaction, the immediate sale of the new corporation (as an asset of the S corporation parent) fails the required control of the corporation immediately after the contribution.

b. The regulations do not discuss what happens if the QSub is the target. It appears that a §338(h)(10) election should be available because a §338(h)(10) election may be made for a target corporation if the purchasing corporation makes a qualified stock purchase from a selling affiliate. The regulations define a **selling affiliate** as a domestic corporation that owns on the acquisition date an amount of stock in a domestic target, which amount of stock is described in §1504(a)(2) and does not join in filing a consolidated return with the target. In such case, the target is an **affiliated target.**[127] The S corporation parent meets the definition of a selling affiliate since the S corporation parent owns all the stock of the new corporation that was the QSub on the acquisition date. The S corporation is likely to recognize gain on the formation of the new corporation, since the formation of the new corporation and the sale of the new corporation's stock to the purchasing corporation will fail as a §351 transaction because it will not be in control of the new corporation immediately after the contribution. The new corporation's assets will have a fair market value basis, however; and thus, the new corporation has no further gain on the sale of its assets to new target in the §338(h)(10) transaction.

[127] Treas. Regs. §1.338(h)(10)-1(b)(3).

Planning point:

The §338(h)(10) election in connection with a stock purchase is treated as selling its assets to a new target followed by a deemed liquidation of the old target to its selling shareholders. In the case of an S corporation target, this has the effect of eliminating one-level of tax since the basis increase in the shareholders stock reflecting the gain recognized on the deem sale of assets will generally shield the distribution on the deemed liquidation from producing gain to the shareholders. However, the sale of assets may have the result of creating ordinary income in lieu of a corresponding capital gain on a stock sale, involve assets some or all whose gain (depreciation recapture) on sale is ineligible for deferral on the installment method of reporting, and may prove disadvantageous to non-selling shareholders.

In cases where the corporation's inside basis is higher than the shareholders' outside basis in the stock, a deemed asset sale results in less gain than the stock sale but may subject more of the deemed distribution to the shareholders to tax (but at capital gains rates). If the shareholders' outside basis in the stock is higher than the corporation's inside basis in its assets, the deemed asset sale may result in a larger gain (some of which may be at ordinary rates) than the stock sale unaccompanied by the election. For example, outside basis may exceed inside basis (thereby increasing the seller's cost of the election) if the seller purchased the target stock at a premium to the inside tax basis, and inside basis may exceed outside basis (thereby decreasing the cost of the election to the seller) if the seller acquired the target stock in a tax-free reorganization or §351 exchange.

Gain or loss from the deemed asset sale for an S corporation target is reported on a final return for the taxable year that ends on the acquisition date. An S corporation target for which a §338(h)(10) election is made files a final return for the entire short S corporation year, whereas an S corporation subject solely to a §338(g) election must file a one-day deemed asset sale return as a C corporation. The distinction between the two elections for an S corporation is necessary because a target's S corporation status terminates when its stock is acquired by a C corporation purchaser. The deemed asset sale, which occurs after the stock sale in the case of a §338(g) election, is reported on a one-day C corporation return. If, however, an S corporation target is subject to a §338(h)(10) election, the S election remains in effect through the end of the acquisition date, so the effects of the §338(h)(10) deemed asset sale are reported on a final S corporation return. An S corporation shareholder that retains target stock is treated as acquiring the retained stock on the day after the acquisition date for its fair market value and has a new holding period in the stock beginning on that day.

The asset mix of the target bears on the §338(h)(10) election. If the target's assets have relatively short recovery or it has self-created intangibles that by reason of the deemed sale transform into amortizable §197 intangibles, the buyer may obtain a sufficient write-off to justify paying a premium price to offset tax liability.

The marginal cost to sellers of the additional tax payable as a result of recapture income, the ordinary income/capital loss mismatch, and the built-in gains tax is often resolved by a gross-up in the purchase price that the purchaser pays to the S corporation shareholders. If the corporation has assets with high basis and built-in loss, the value of that loss in the future, coupled with depreciation deductions that are based on that historical basis may have a higher value to the purchaser than the reduced depreciation deductions following the deemed asset sale.

A purchaser usually benefits from the **asset basis step-up** that results from a §338(h)(10) election. The step-up increases depreciation and amortization of the target's assets, enhanced by §197.

Even though the target is deemed to have completely liquidated, a minority shareholder recognizes no gain or loss on shares of target stock that it retains, and the basis and holding period of target stock retained by a minority shareholder are unaffected by the §338(h)(10) election.

Planning point (continued):

> Purchasers may wish to finance the acquisition of the stock by installment payments. The sellers of the stock are modified because they must reflect an actual installment sale of the assets in the deemed asset sale and the deemed liquidation, the regulations modify the general tax consequences of a §338(h)(10) election. With respect to purchase money notes given in consideration of the recently purchased stock, the acquired corporation is treated as though it (not the shareholders) received the installment notes, then distributed those notes and all other consideration given to its shareholders in the deemed liquidation, with the shareholders adjusting such notes to reflect the adjusted sales price of the deemed sales.
>
> With respect to the deemed distribution of such installment obligations, the distribution of an installment obligation is not a taxable disposition to the distributing corporation where the liquidation is governed by §332 of an 80 percent or more subsidiary.[128] The distributee (parent) corporation steps into the shoes of the subsidiary corporation.[129]
>
> For an S corporation, the distribution of an installment obligation is not a taxable distribution to the distributing corporation if certain conditions are met. The S corporation must adopt a plan of liquidation before the acquisition date and the distribution is made in the 12 months following the adoption of such plan. Inventory may qualify for installment reporting.[130] It does not apply to such part of the realized gain on the deemed sale of assets corresponding to built-in gains (but the basis of such notes is adjusted accordingly.[131] S corporation shareholders generally are taxed as payments are made on the installment obligation and not on receipt of the obligation.

6. F reorganizations: An alternative to §368(h)(10)

An F reorganization is defined as "a mere change in identity, form, or place of organization of one corporation, however effected."[132] An F reorganization change of entity can be used as a substitute for a §338(h)(10) election and allow a purchaser of part or all of an S corporation to have a step-up in basis and continue the entity type.

Example 1: ABC wishes to buy 60 percent of XYZ, Inc., as S corporation. Because of licenses and franchises that are in place, ABC wishes to purchase the entity instead of the assets. However, the fair market value of XYZ's assets is much greater than the basis in the assets, so if ABC purchases the stock of XYZ, they will not be allowed to step up the basis of the assets for depreciation purposes. For tax purposes, as asset purchase would be better, but for other business reasons, they need to purchase the entity. If they purchase 60 percent, the transaction does not qualify for a §338(h)(10) election. An F reorganization can fix this situation.

Step 1: The shareholders of XYZ, inc. form a new S corporation, Parent, Inc.

Step 2: The shareholders contribute their shares of XYZ, Inc. to Parent, Inc. in exchange for stock. Now, XYZ, Inc. is a subsidiary of Parent, Inc.

Step 3: Parent makes a QSub election regarding XYZ so that XYZ becomes a qualified Subchapter S subsidiary of Parent, Inc. XYZ is now a disregarded entity.

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128 IRC §453B(d).
129 IRC §381(c)(8).
130 IRC §453(h).
131 Regarding certain liquidating distributions by S corporations, if: (i) an installment obligation is distributed by an S corporation in a complete liquidation; and (ii) receipt of the obligation is not treated as payment for the stock by reason of §453(h)(1), then, except for purposes of any tax imposed by Subchapter S, no gain or loss with respect to the distribution of the obligation shall be recognized by the distributing corporation. Under regulations prescribed by the Secretary, the character of the gain or loss to the shareholder shall be determined in accordance with the principles of §1366(b). IRC §453B(h).
132 IRC §368(a)(1)(F).

Step 4: Parent converts XYZ, Inc. to a single member LLC. This is allowed by most states because it is a conversion of one type of disregarded entity to another. It is therefore not a tax transaction.

Step 5: Now, ABC can purchase 60 percent of the LLC interest.

Step 6: According to IRS guidance, the sale is treated as Parent, Inc. selling 60 percent of the assets XYZ LLC, a disregarded entity, to ABC, followed by Parent Inc. contributing the remaining 40 percent of the assets to a new tax entity and ABC contributing their newly purchases 60 percent into the same entity. The basis in the assets of XYZ will be 40 percent of the basis before the transaction for the assets not sold to ABC and 60 percent at the new purchase price paid by ABC.

There is an issue with the example above. The steps in Example 1 work great for a 100 percent sale of the company. If ABC purchases 100 percent, they will have a step-up in basis for all of the assets while preserving the legal entity. Since they are purchasing only 60 percent, they will be left with the cumbersome allocations required under Section 704(c) when assets are contributed to a partnership. How can the plan be improved?

Example 2: Consider the same circumstances as Example 1 and add an extra step.

Step 1: The shareholders of XYZ, Inc. form a new S corporation, Parent, Inc.

Step 2: The shareholders contribute their shares of XYZ, Inc. to Parent, Inc. in exchange for stock. Now, XYZ, Inc. is a subsidiary of Parent, Inc.

Step 3: Parent makes a QSub election regarding XYZ so that XYZ becomes a qualified Subchapter S subsidiary of Parent, Inc. XYZ is now a disregarded entity.

Step 4: Parent converts XYZ, Inc. to a single-member LLC. This is allowed by most states because it is a conversion of one type of disregarded entity to another. It is therefore not a tax transaction.

Step 5: Parent distributes a small percentage of XYZ, LLC to one of the shareholders or to a non-owner manager as compensation. Now, XYZ, LLC is a multi-member LLC taxed as a partnership.

Step 6: Now, ABC can purchase 60 percent of the LLC interest as the purchase of an interest in a partnership.

Step 7: XYZ, LLC makes a §754 election and steps up the basis for the portion of assets related to the 60 percent purchaser. ABC, Inc. now owns 60 percent of XYZ, LLC, the legal entity is maintained, and ABC, Inc. can step up its portion of the inside basis of the assets to eliminate the difference between the inside basis and the outside basis and will be allocated the depreciation for the stepped-up basis.[133]

Question to ponder:

Your client owns 10 percent of an S corporation. Two brothers, unrelated to your client, own the other 90 percent. They want to sell to a larger company and retire. The purchaser wants to make a §338(h)(10) election. You are not excited about the potential sale, and you do not know what your future would be with the new company. How would you advise your client? What are his options? What factors should be considered? How might an F reorganization help?

133 §743(b).

IV. Intangibles regulations

A. Background

Note:

Since 1993, §197 has provided for the amortization of certain intangible property ratably over a 180-month period. The Service has issued final regulations relating to the special treatment accorded an amortizable §197 intangible.[134]

1. Service's approach

The Service placed all amortizable §197 intangibles **other than goodwill and going-concern value** in Class VI, together with certain nonamortizable §197 intangibles, some of which are amortizable by the buyer though they were not amortizable by the seller. Other §197 intangibles that are nonamortizable are those that are subject to the anti-churning rules. Accordingly, all §197 intangibles are placed in a class separate from the "other assets" category occupied by Class VI under the regulations.[135]

Note:

The amount required to be reported by the parties in an asset or deemed asset transaction is the amount of consideration received for the assets that is allocable to §197 intangibles. The term "**§197 intangibles**" is more inclusive than **amortizable §197 intangibles**. Accordingly, the regulations classify all §197 intangibles (other than goodwill and going-concern value) as Class VI assets.

2. Class VII

The final regulations take the position that the residual method of allocation for goodwill and going-concern value is achieved by dropping down goodwill and going-concern value to a "true" residual class, Class VII.[136] This permits the continuation of the policy of not valuing goodwill and going-concern value separately for purchase price allocation purposes. Allocating goodwill and going-concern value to Class VII avoids the need for determining the value of goodwill and going-concern value through a nonresidual method.

Planning point:

The practical significance of placing goodwill and going-concern value in Class VII is generally limited to circumstances in which fewer than all of the amortizable §197 intangibles acquired in a single transaction are subsequently disposed of at a gain. Those situations, in any case, require some method of allocation among the intangibles.

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134 Treas. Regs. §§1.167(a)-14 and 1.197-2, adopted by T.D. 8865, 65 Fed. Reg. 3820 (1/25/00).
135 Treas. Regs. §1.338-6(b)(2)(vi).
136 Treas. Regs. §1.338-6(b)(2)(vii).

B. Section 197

1. Overview

Section 197 does not apply to any amount paid or incurred for a §197 intangible if a deduction for the amount would be disallowed under any provision of the Code other than §263.[137]

a. Certain intangible property is not amortizable §197 property and is governed by §167(f).[138]

b. Generally, §197 does not apply to amounts that would be currently deductible without regard to §197.[139]

2. Section 197 intangibles

Generally, a §197 intangible is one of the following properties.[140]

a. **Goodwill** is the value of a trade or business attributable to the expectancy of continued customer patronage. This expectancy may be due to the name or reputation of a trade or business or any other factor.[141]

b. **Going-concern value** is the additional value that attaches to property by reason of its existence as an integral part of an ongoing business activity. Going-concern value includes the value attributable to the ability of a trade or business (or a part of a trade or business) to continue functioning or generating income without interruption notwithstanding a change in ownership but does not include any of the other intangibles. It also includes the value that is attributable to the immediate use or availability of an acquired trade or business, such as, for example, the use of the revenues or net earnings that otherwise would not be received during any period if the acquired trade or business were not available or operational.[142]

c. Section 197 intangibles include **workforce in place**. Workforce in place (sometimes referred to as agency force or assembled workforce) includes the composition of a workforce (for example, the experience, education, or training of a workforce), the terms and conditions of employment whether contractual or otherwise, and any other value placed on employees or any of their attributes.

d. Section 197 intangibles include business books and records, operating systems, and any other **information base**, including lists or other information of current or prospective customers (regardless of the method of recording the information). Thus, the amount paid or incurred for these items includes, for example, any portion of the purchase price of an acquired trade or business attributable to the intangible value of technical manuals, training manuals or programs, data files, and accounting or inventory control systems. Other examples include the cost of acquiring customer lists, subscription lists, insurance expirations, patient or client files, or lists of newspaper, magazine, radio, or television advertisers.[143]

e. Section 197 intangibles include any patent, copyright, formula, process, design, pattern, know-how, format, package design, computer software, or interest in a film, sound recording, videotape, book, or other similar property.[144]

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137 Treas. Regs. §1.197-2(a)(1).
138 Treas. Regs. §1.197-2(a)(2).
139 Treas. Regs. §1.197-2(a)(3).
140 Treas. Regs. §1.197-2(b).
141 Treas. Regs. §1.197-2(b)(1).
142 Treas. Regs. §1.197-2(b)(2).
143 Treas. Regs. §1.197-2(b)(4).
144 Treas. Regs. §1.197-2(b)(5).

f. Section 197 intangibles include any **customer-based intangible**. A customer-based intangible is any composition of market, market share, or other value resulting from the future provision of goods or services pursuant to contractual or other relationships in the ordinary course of business with customers. Thus, the amount paid or incurred for customer-based intangibles includes, for example, any portion of the purchase price of an acquired trade or business attributable to the existence of a customer base, a circulation base, an undeveloped market or market growth, insurance in force, the existence of a qualification to supply goods or services to a particular customer, a mortgage-servicing contract, an investment-management contract, or other relationship with customers involving the future provision of goods or services. In addition, customer-based intangibles include the deposit base and any similar asset of a financial institution.

g. Section 197 intangibles include any **supplier-based intangible**. A supplier-based intangible is the value resulting from the future acquisition, pursuant to contractual or other relationships with suppliers in the ordinary course of business, of goods or services that will be sold or used by the taxpayer.

h. Section 197 intangibles include any license, permit, or other right granted by a governmental unit (including, for purposes of §197, an agency or instrumentality thereof) even if the right is granted for an indefinite period or is reasonably expected to be renewed for an indefinite period. These rights include, for example, a liquor license, a taxicab medallion (or license), an airport landing or takeoff right (sometimes referred to as a slot), a regulated airline route, or a television or radio broadcasting license. The issuance or renewal of a license, permit, or other right granted by a governmental unit is considered an acquisition of the license, permit, or other right.[145]

i. A covenant not to compete includes any agreement having substantially the same effect, if entered into in connection with the direct or indirect acquisition of an interest in a trade or business or a substantial portion thereof.[146]

j. Section 197 intangibles include any right under a license, contract, or other arrangement providing for the use of property that would be a §197 intangible under any of the above definitions, unless excepted. Section 197 intangibles also include any term interest (whether outright or in trust) in such property.[147]

3. Exceptions

The term “§197 intangible” does not include certain listed property, and the following rules and definitions provide guidance concerning property to which the following exceptions apply.

a. Section 197 intangibles do not include an interest in a corporation, partnership, trust, or estate. Thus, for example, amortization under §197 is not available for the cost of acquiring stock, partnership interests, or interests in a trust or estate, whether or not the interests are regularly traded on an established market.[148] (See paragraph (g)(3) of §197 for special rules applicable to property of a partnership when a §754 election is in effect for the partnership.)

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145 Treas. Regs. §1.197-2(b)(8).
146 Treas. Regs. §1.197-2(b)(9).
147 Treas. Regs. §1.197-2(b)(11).
148 Treas. Regs. §1.197-2(c)(1).

b. Section 197 intangibles do not include an interest under an existing futures contract, foreign currency contract, notional principal contract, interest-rate swap, or other similar financial contract, whether or not the interest is regularly traded on an established market. However, this exception does not apply to an interest under a mortgage-servicing contract, credit-card servicing contract, or other contract to service another person's indebtedness, or an interest under an assumption reinsurance contract. [149]

c. Section 197 intangibles do not include any interest in land. For this purpose, an interest in land includes a fee interest, life estate, remainder, easement, mineral right, timber right, grazing right, riparian right, air right, zoning variance, and any other similar right, such as a farm allotment, quota for farm commodities, or crop acreage base. An interest in land does not include an airport landing or takeoff right, a regulated airline route, or a franchise to provide cable television service. The cost of acquiring a license, permit, or other land improvement right, such as a building construction or use permit, is taken into account in the same manner as the underlying improvement. [150]

d. Section 197 intangibles do not include any interest in certain kinds of software (discussed next in more detail).[151]

e. Section 197 intangibles do not include any interest (including an interest as a licensee) in a film, sound recording, videotape, book, or other similar property (such as the right to broadcast or transmit a live event) if the interest is not acquired as part of a purchase of a trade or business. A film, sound recording, videotape, book, or other similar property includes any incidental and ancillary rights (such as a trademark or trade name) that are necessary to effect the acquisition of title to, the ownership of, or the right to use the property and are used only in connection with that property. Such incidental and ancillary rights are not included in the definition of trademark or trade name. For these purposes, computer software is not treated as other property similar to a film, sound recording, videotape, or book.[152]

f. Section 197 intangibles do not include any right to receive tangible property or services under a contract or from a governmental unit if the right is not acquired as part of a purchase of a trade or business. Any such right is not treated as a §197 intangible even though the right is also certain governmental licenses, permits, and other rights and even though the right fails to meet one or more of the requirements relating to certain rights of fixed duration or amount.[153]

g. Section 197 intangibles do not include any interest (including an interest as a licensee) in a patent, patent application, or copyright that is not acquired as part of a purchase of a trade or business. A patent or copyright includes any incidental and ancillary rights (such as a trademark or trade name) that are necessary to effect the acquisition of title to, the ownership of, or the right to use the property and are used only in connection with that property. Such incidental and ancillary rights are not included in the definition of trademark or trade name.[154]

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149 Treas. Regs. §1.197-2(c)(2).
150 Treas. Regs. §1.197-2(c)(3).
151 Treas. Regs. §1.197-2(c)(4).
152 Treas. Regs. §1.197-2(c)(5).
153 Treas. Regs. §1.197-2(c)(6).
154 Treas. Regs. §1.197-2(c)(7).

h. Interests under leases of tangible property:

(i) Section 197 intangibles do not include any interest as a lessor under an existing lease or sublease of tangible real or personal property. In addition, the cost of acquiring an interest as a lessor in connection with the acquisition of tangible property is taken into account as part of the cost of the tangible property. For example, if a taxpayer acquires a shopping center that is leased to tenants operating retail stores, any portion of the purchase price attributable to favorable lease terms is taken into account as part of the basis of the shopping center and in determining the depreciation deduction allowed with respect to the shopping center.[155]

(ii) Section 197 intangibles do not include any interest as a lessee under an existing lease of tangible real or personal property. For this purpose, an airline lease of an airport passenger or cargo gate is a lease of tangible property. The cost of acquiring such an interest is taken into account under §178 and Treas. Regs. §1.162-11(a). If an interest as a lessee under a lease of tangible property is acquired in a transaction with any other intangible property, a portion of the total purchase price may be allocable to the interest as a lessee based on all of the relevant facts and circumstances.[156]

i. Section 197 intangibles do not include any interest (whether as a creditor or debtor) under an indebtedness in existence when the interest was acquired. Thus, for example, the value attributable to the assumption of an indebtedness with a below-market interest rate is not amortizable under §197. In addition, the premium paid for acquiring a debt instrument with an above-market interest rate is not amortizable under §197.[157] For these purposes, an interest under an existing indebtedness does not include the deposit base (and other similar items) of a financial institution. An interest under an existing indebtedness includes mortgage-servicing rights, however, to the extent the rights are stripped coupons under §1286.[158]

j. Section 197 intangibles do not include any franchise to engage in professional baseball, basketball, football, or any other professional sport, and any item (even though otherwise qualifying as a §197 intangible) acquired in connection with such a franchise.[159]

k. Section 197 intangibles do not include any right to service indebtedness secured by residential real property that are not acquired as part of a purchase of a trade or business.[160]

l. Section 197 intangibles do not include any fees for professional services and any transaction costs incurred by parties to a transaction in which all or any portion of the gain or loss is not recognized.[161]

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155 Treas. Regs. §1.197-2(c)(8)(i).
156 Treas. Regs. §1.197-2(c)(8)(ii).
157 Treas. Regs. §1.197-2(c)(9)(i).
158 Treas. Regs. §1.197-2(c)(9)(ii).
159 Treas. Regs. §1.197-2(c)(10).
160 Treas. Regs. §1.197-2(c)(11).
161 Treas. Regs. §1.197-2(c)(12).

m. Section 197 intangibles do not include any right under a contract or any license, permit, or other right granted by a governmental unit if the right:[162]

(i) Is acquired in the ordinary course of a trade or business (or an activity of the production of income) and not as part of a purchase of a trade or business;

(ii) Is not goodwill, going-concern value, covenant not to compete, or franchise, trademark, or trade name;

(iii) Is not a customer-based intangible, a customer-related information base, or any other similar item; and

(iv) Either:

- Has a fixed duration of less than 15 years; or
- Is fixed as to amount and the adjusted basis thereof that is properly recoverable (without regard to this section) under a method similar to the unit-of-production method.

Planning point:

This exception from §197 for separately acquired rights of fixed duration or amount applies to property acquired after August 10, 1993 (or July 25, 1991, if a valid retroactive election has been made under Temp. Regs. §1.197-1T).[163]

For the first taxable year ending after January 25, 2000, a taxpayer that has acquired property to which the exception applies is granted consent of the Commissioner to change its method of accounting for such property to comply with the provisions unless the proper treatment of such property is an issue under consideration in an examination, before an appeals office, or before a federal court.[164] A taxpayer changing its method of accounting must follow the automatic change in accounting method provisions.[165]

4. Computer software

Section 197 intangibles do not include any interest in computer software that is (or has been) **readily available to the general public** on similar terms, is subject to a **nonexclusive license**, and has **not been substantially modified for the user**.

(i) Computer software will not be considered to have been substantially modified if its cost does not exceed the greater of 125 percent of the price at which the unmodified version of the software is readily available to the general public or $2,000. For the purpose of determining whether computer software has been substantially modified:

- Integrated programs acquired in a package from a single source are treated as a single computer program; and
- Any cost incurred to install the computer software is not treated as a cost of the software.[166]

(ii) Computer software will be treated as readily available to the general public if the software may be obtained on substantially the same terms by a significant number of persons that would reasonably be expected to use the software. The requirements can be met even though the software is not available through a system of retail distribution.[167]

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162 Treas. Regs. §1.197-2(c)(13)(i).
163 Treas. Regs. §1.197-2(l)(1).
164 Treas. Regs. §1.197-2(l)(4)(i).
165 Treas. Regs. §1.197-2(l)(4)(iii). See Rev. Proc. 99-49, 1999-52 I.R.B. 725.
166 Treas. Regs. §1.197-2(c)(4)(i).
167 Treas. Regs. §1.197-2(c)(4)(v).

Section 197 intangibles do not include an interest in computer software that is not acquired as part of a purchase of a trade or business.[168]

Neither §197 nor §167(f) apply in the following cases:[169]

(i) Any amount of the cost of an interest in computer software that is included, without being separately stated, in the cost of the hardware or other tangible property will be treated as part of the cost of the hardware or other tangible property; and

(ii) Any amount of the cost of an interest in computer software that would be deductible under any provision other than §167(f) or §197 may be deducted and is not required to be capitalized.

Note:

The amount of the deduction for computer software is determined by amortizing the cost or other basis of the computer software using the straight-line method (except that its salvage value is treated as zero) and an amortization period of 36 months beginning on the first day of the month that the computer software is placed in service. If costs for developing computer software that the taxpayer properly elects to defer under §174(b) result in the development of property subject to the allowance for depreciation, these rules will apply to the unrecovered costs. In addition, this also applies to the cost of separately acquired computer software where these costs are separately stated and the costs are required to be capitalized under §263(a).[170]

However, this rule does not apply to the cost of computer software properly and consistently taken into account under Treas. Regs. §1.162-11 as a lease. The cost of acquiring an interest in computer software that is included, without being separately stated, in the cost of the hardware or other tangible property is treated as part of the cost of the hardware or other tangible property that is capitalized and depreciated under other applicable sections of the Internal Revenue Code.[171]

5. Self-created intangibles

An amortizable §197 intangible is any §197 intangible acquired after August 10, 1993 (or after July 25, 1991, if a valid retroactive election under Temp. Regs. §1.197-1T has been made), and held in connection with the conduct of a trade or business or an activity entered into for the production of income.[172]

a. Generally, amortizable §197 intangibles do not include any §197 intangible created by the taxpayer (a self-created intangible).[173] A §197 intangible is created by the taxpayer to the extent the taxpayer makes payments or otherwise incurs costs for its creation, production, development, or improvement, whether the actual work is performed by the taxpayer or by another person under a contract with the taxpayer entered into before the creation, production, development, or improvement occurs. For example, a technological process developed specifically for a taxpayer under an arrangement with another person pursuant to which the taxpayer retains all rights to the process is created by the taxpayer.[174]

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168 Treas. Regs. §1.197-2(c)(4)(ii).
169 Treas. Regs. §1.197-2(c)(4)(iii).
170 Treas. Regs. §167(a)-14(b)(1).
171 Treas. Regs. §167(a)-14(b)(2).
172 Treas. Regs. §1.197-2(d)(1).
173 Treas. Regs. §1.197-2(d)(2)(i).
174 Treas. Regs. §1.197-2(d)(2)(ii)(A).

(i) A §197 intangible is not created by the taxpayer to the extent that it results from the entry into (or renewal of) a contract for the use of an existing §197 intangible. Thus, for example, the exception for self-created intangibles does not apply to legal and other professional fees incurred by a licensee in connection with the entry into (or renewal of) a contract for the use of know-how or similar property.[175]

(ii) If an existing §197 intangible is improved or otherwise modified by the taxpayer or by another person under a contract with the taxpayer, the existing intangible and the improvements or other modifications are treated as separate §197 intangibles for these purposes.[176]

b. The exception for self-created intangibles does not apply to any §197 intangible relating to licenses, permits, or other rights granted by a governmental unit, to covenants not to compete, or to franchises, trademarks, and trade names. Thus, for example, capitalized costs incurred in the development, registration, or defense of a trademark or trade name do not qualify for the exception and are amortized over 15 years under §197.[177] The exception for self-created intangibles does not apply to any §197 intangible created in connection with the purchase of a trade or business.[178]

6. Calculating the deduction

Generally speaking, the amortization deduction allowable is computed by amortizing ratably the adjusted basis (for purposes of determining gain) of an amortizable §197 intangible over the 15-year period beginning on the later of the first day of the month in which the property is acquired; or, in the case of property held in connection with the conduct of a trade or business, the first day of the month in which the active conduct of the trade or business begins.[179] Generally, the adjusted basis is determined by disregarding salvage value.[180] Section 197 property is not eligible for amortization in the month of disposition.[181] In the case of a short taxable year, the amortization deduction is based on the number of months in the short taxable year.[182]

7. Loss disallowance rules

Generally, no loss is recognized on the disposition of an amortizable §197 intangible acquired in a transaction or series of related transactions in which the taxpayer acquired other amortizable §197 intangibles if, after the disposition, the taxpayer retains any of the other amortizable §197 intangibles, or the right to use, or an interest in, any of the other amortizable §197 intangibles (the retained intangibles).[183] Hence, as a general matter, the adjusted basis of each of the retained intangibles is increased by the product of the loss that is not recognized solely by reason of this rule and a fraction, the numerator of which is the adjusted basis of the retained intangible on the date of the disposition and the denominator of which is the total adjusted bases of all the retained intangibles on that date. The abandonment of an amortizable §197 intangible, or any other event rendering an amortizable §197 intangible worthless, is treated as a disposition of the intangible, and the abandoned or worthless intangible is disregarded (that is, it is not treated as a retained intangible) for purposes of the subsequent disposition of any other amortizable §197 intangible.

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175 Treas. Regs. §1.197-2(d)(2)(ii)(B).
176 Treas. Regs. §1.197-2(d)(2)(ii)(C).
177 Treas. Regs. §1.197-2(d)(2)(iii)(A).
178 Treas. Regs. §1.197-2(d)(2)(iii)(B).
179 Treas. Regs. §1.197-2(f)(1)(i).
180 Treas. Regs. §1.197-2(f)(1)(ii).
181 Treas. Regs. §1.197-2(f)(1)(iii).
182 Treas. Regs. §1.197-2(f)(1)(iv).
183 Treas. Regs. §1.197-2(g)(1)(i)(A).

Note:

> If the value of a self-created asset exceeds the cost of creation by a contributing partner, it appears that the excess may be an amortizable §197 intangible in the hands of the partnership even though the intangible is a nonamortizable §197 intangible in the hands of the partnership to the extent of the cost basis. By treating the two segments of the intangible as separate property, the partnership can use the remedial allocation method to create notional tax deduction and income items to take the book-tax disparity into account. Book amortization of the excess is based on the fair market value of the excess for new amortizable §197 intangible property.

8. Amounts paid or incurred for a franchise, trademark, or trade name

If an amount to which §1253(d) relating to the transfer, sale, or other disposition of a franchise, trademark, or trade name applies is one of a contingent serial payments, the amount is deductible under §1253(d)(1) and is not included in the adjusted basis of the intangible for purposes of §197. Any other amount, whether fixed or contingent, to which §1253(d) applies is chargeable to capital account under §1253(d)(2) and is amortizable only under §197.[184]

9. Amounts taken into account in determining the cost of a non-§197 intangible

Section 197 does not apply to an amount that is properly taken into account in determining the cost of property that is not a §197 intangible. The entire cost of acquiring the other property is included in its basis and recovered under other applicable provisions.[185]

10. Treatment as depreciable property

Generally, an amortizable §197 intangible is treated as property of a character subject to the allowance for depreciation. Thus, for example, an amortizable §197 intangible is not a capital asset for purposes of §1221, but if held for more than one year, it generally qualifies under §1231 as property used in a trade or business. Also, an amortizable §197 intangible is §1245 property and §1239 applies to any gain recognized upon its sale or exchange between related persons (as defined in §1239(b)).[186]

a. In the case of the acquisition of any amortizable §197 intangible in a transaction that would not be treated as the sale or exchange of property by the person from which the intangible was acquired, the above rule does not apply (and the amortizable §197 intangible shall not be treated as property) for purposes of applying the imputed interest rules or the original issue discount rules.[187]

b. No person shall be treated as having sold, exchanged, or otherwise disposed of property in a transaction for purposes of any provision of the Code solely by reason of the application of the general rule to any other party to the transaction.[188]

C. Summary of planning points

1. Structuring executive consulting contracts

Probably the best planning idea for buyers is the use of reasonable consulting arrangements or salary continuation agreements. Buyers can definitely lessen the impact of the acquired intangibles 15-year amortization provision by allocating some of the consideration to these agreements. The reason is simple – buyers obtain an immediate deduction for the payments rather than an asset amortizable over

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184 Treas. Regs. §1.197-2(g)(5).
185 Treas. Regs. §1.197-2(g)(6).
186 Treas. Regs. §1.197-2(g)(7)(i).
187 Treas. Regs. §1.197-2(g)(7)(ii)(A).
188 Treas. Regs. §1.197-2(g)(7)(ii)(B).

15 years. The key is that the arrangements must be reasonable under the facts and circumstances of that particular client. Reasonableness is crucial because the legislative history to the acquired intangibles provision warns that such an arrangement can be reclassified as a covenant not to compete (subject to 15-year amortization) if the amount paid to the former owner exceeds reasonable compensation for the services rendered.

a. Note that the former owner must provide real and substantial services to justify the arrangement. It is strongly recommended that the nature and extent of such services be documented in writing (e.g., through logs, diaries, written memorandum, etc.). Furthermore, the document that embodies this arrangement should require that the seller (former business owner) perform and document such services. It is also recommended that a cooperation clause be inserted in the agreement in the event that the IRS attacks the arrangement.

Example: Stephanie sells her New York-based maternity-clothing chain to Jennifer. A portion of the consideration is allocated to a consulting agreement between Jennifer's S corporation (Maternity Fashions Management, Inc.) and Stephanie (the former owner/seller). If Stephanie decides to retire to Florida to play golf, the IRS (upon examination) would mandate that Maternity treat the arrangement as a covenant not to compete rather than a consulting contract. Stephanie must provide real and substantial services to Maternity, which justified the consulting payments. Time logs, diaries, written memorandum to the company, and affidavits from company employees would be the best evidence that such services were being performed.

b. This may or may not be advantageous to the seller. The seller would benefit more for tax purposes from a noncompete, which is subject to ordinary income tax rates but not FICA, or from an allocation to goodwill, which may generate capital gains. Capital gains will benefit a pass-through owner, or the owner of a C corporation if the goodwill is purchased from the owner as "personal goodwill" and not from the C corporation.

c. However, sellers may want a consulting arrangement for a couple of key reasons. First, their retention as a consultant will likely aid the continued success of the business. Usually, the former owner is a key member of management and has knowledge and expertise that, in many cases, is invaluable to the new owner. The former owner normally takes back a substantial portion of the purchase price in the form of a promissory note. Therefore, the former owner may want to be retained as a consultant to ensure the continued success of the business and the payments under the promissory note. A second reason that the former owner may want to stay on as an employee/consultant relates to fringe benefits. The business may be providing its employees with key fringe benefits such as health insurance, group-term life insurance or other benefits that the former owner wants to retain. This is especially important in an early retirement situation where the former owner, for example, has many dependents to cover under the former owner's medical coverage.

d. Remember, even though the buyer and seller to a transaction are bound by a purchase allocation in their agreement, the IRS is free to challenge any such allocation. As a general rule, however, the IRS will respect an allocation arrived at by a buyer and seller as part of an arm's-length negotiation.

Planning point: Seller

A consulting agreement should be consideration paid for work performed. Therefore, the amount of the consulting agreement should be above and beyond the value of the company. For example, consider a proposal to buy a business that is worth $10,000,000. The buyer proposes to allocate $1,000,000 to a consulting agreement. The seller should resist that allocation unless there is enough benefit to the seller, such as fringe benefits, to justify the additional taxes paid. If the $1,000,000 is not allocated to a consulting agreement, it is likely to be allocated to goodwill, resulting in possible capital gains treatment for the owner of a pass-through, or personal goodwill taxed directly to the owner of a C corporation.

2. Buying covenants and selling goodwill

All asset acquisition and disposition planning must take into account the new rule that classifies all acquired §197 intangibles as §1231 assets subject to §1245 recapture. This is especially important because most sales are made on the installment basis and the installment sale rules mandate that all ordinary income recapture occur in the year of sale even if no cash is received in that year.[189] The identification of assets and allocation of basis to those assets is an important part of the business acquisition process. The rules of §1060 control the allocation of basis to classes of assets and then taxpayers must then allocate basis within each class of assets. This allocation process is crucial because the sale of all of the assets of the going trade or business is considered to be a sale of each individual asset rather than the sale of a single capital asset.[190]

The interaction of the separate asset approach and the new recapture problem with §197 intangibles requires careful planning on the front-end of an acquisition. The following example clarifies this issue.

Example: Focal Enterprises, Inc. (Focal) is going to acquire the assets of Optic Industries, Inc. (Optic), a manufacturer of well-known designer glass frames. It is very important that the former owners of Optic not enter into a competing business for a period of time after the acquisition. Thus, a covenant not to compete will be an important aspect of this acquisition. Let us say that the parties have all of the purchase-price allocation completed except $600,000 and the only assets remaining for allocation are goodwill and the noncompetition agreement. Focal intends to sell the business on the first day of the sixth year after the acquisition. The noncompetition agreement will last for five years (a reasonable period of time under the applicable state law) and will cover a reasonable geographic region. How much of the remaining $600,000 should be allocated to the noncompetition agreement and how much should be allocated to goodwill?

Many practitioners would answer that it does not matter how much you allocate to these two assets because you must amortize both of them over 15 years even though the economic life of the noncompetition agreement is five years. But is that the correct answer?

For example, if we allocate $300,000 to goodwill and $300,000 to the noncompetition agreement, what happens upon sale on day 1 of year 6? On day 1 of year 6, the noncompetition agreement has no economic value but still has a remaining adjusted basis of $200,000 ($300,000 – $100,000) and would generate a §1231 loss upon disposition of all of the acquired intangibles. On the other hand, the goodwill may have risen in value. Let us say that the goodwill is worth $700,000 on day 1 of year 6. The goodwill will also have an adjusted basis of $200,000 on day 1 of year 6 but the sale will generate ordinary income recapture of $100,000 in the year of sale and a §1231 gain of $400,000 (which will be netted against any

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189 IRC §453(i).

190 See *Williams v. McGowan*, 152 F.2d 570 (2d Cir. 1945).

§1231 losses like the one generated on the disposition of the noncompetition agreement). The ordinary income recapture will occur in the year of sale even if the transaction qualifies for installment sale treatment. Could the ordinary income recapture be lessened through a different allocation on the original acquisition? It appears so.

There is a conflict between the buyer and seller of a business regarding the allocation of the purchase price that exists because of the tax treatment of assets by the buyer and seller. The buyer often prefers, in order:

(1) Assets that can be expensed immediately, such as ordinary income assets (inventory) and assets that can be expensed under §179 or on which 100 percent bonus depreciation can be taken.
(2) Consulting agreements that can be immediately expensed.
(3) Assets with short depreciable lives (less than 15 years) that can be written off over the depreciable life.
(4) Noncompete agreements that can be amortized for 15 years but probably will not result in ordinary income recapture if the business is sold after the noncompete expires.
(5) Other 15-year assets such as goodwill.
(6) Assets with longer depreciable lives, such as real estate (however, much of the real estate can usually be converted to shorter lives with a cost segregation study).
(7) Capital assets that cannot be written off.

The seller, especially of a pass-through entity, generally prefers a different order of allocation for tax purposes:

(1) Assets that generate gains subject to normal capital gains rates and no ordinary income (buyer's (5) and (7) above).
(2) Assets that generate §1231 gain that may qualify for 25 percent capital gains rates under §1250 or normal capital gains rates (buyer's (6)).
(3) Items that generate ordinary income but no FICA tax such as noncompete agreements and §1245 recapture (buyer's (1), (3), and (4)).
(4) Consulting agreements (buyer's (2)).

If the seller is a C corporation, the order changes again:

(1) Personal goodwill;
(2) Noncompete;
(3) Consulting agreement; and
(4) Any asset purchased from the C corporation that results in double taxation.

The order for buyer and seller may change based on other factors, such as the seller's need to continue life and health insurance, etc., discussed above. These conflicts are the reason that a significant aspect of a business acquisition is the negotiation, not only of the purchase price, but of the allocation of the purchase price. The seller must always focus on after-tax dollars, not gross sales price.

Practice point:

> The CPA representing either side of the transaction will be called upon to continually update the tax results of different allocation strategies. This responsibility should be taken very seriously, as miscalculations could expose the CPA to liability.

3. Use of contingent payment franchise, trademark, and trade name agreements

As under pre-§197 law, payments that are contingent on the productivity, use, or disposition of a franchise, trademark, or trade name will be currently deductible if certain other requirements are met.[191] First, the contingent payments must be part of a series of payments that are payable at least annually throughout the term of the transfer agreement. Second, the payments must be substantially equal in amount or must be payable under a fixed formula (e.g., as a percentage of net sales).

a. This sort of arrangement also has nontax advantages. It allows the buyer to align the value of the applicable intangibles with the cash flow that they produce. Since most valuation models are based on future cash flows, this comports with the buyer's expectations. However, some sellers may be concerned with the successor's management capability, and thus, may be unwilling to tie the sales price to some productivity measure. Moreover, sellers may be uncomfortable with contingent payments just in case some unforeseen or catastrophic event occurs.

b. From a tax perspective, buyers will welcome the current deductions. Sellers, on the hand, will have to recognize ordinary income (rather than the capital gain, which could be realized and recognized on other intangibles sold). It will be difficult to get sellers to agree to these arrangements when you combine the tax/character disadvantage with the reliance on the buyers' future management performance, but buyers should certainly try to negotiate such an arrangement.

4. Asset acquisitions may make more sense today

In many situations, asset acquisitions make more sense than ever before. First, from the buyer's perspective, goodwill, and going-concern value as well as other previously nonamortizable assets are now amortizable over the prescribed 15-year amortization period. This means that in many cases the entire purchase price will be recovered over this 15-year period as compared with the past when a substantial portion of the purchase price came in the form of permanent capital items. Second, the buyer can generally avoid liabilities that may be contingent or "hidden."

a. Sellers may also be motivated to enter into an asset deal. For example, if the seller is an S corporation that is not subject to the built-in gains tax, there will basically be a single level of tax to pay on the transaction. Moreover, many pre-§197 intangibles (intangibles created prior to enactment) will continue to be capital in nature and thus, the sale of these assets will mirror the character of a stock sale. Therefore, if the seller can avoid the double tax impact imposed due to the repeal of the General Utilities doctrine (either because the seller was always an S corporation or because of the planning techniques in Chapter 1) and most of the assets being disposed of are capital in nature, it makes more sense to enter into asset deal rather than a stock deal.

5. When a stock acquisition makes sense

Most acquisitions are asset acquisitions because buyers are concerned about "hidden" or contingent liabilities. Also, buyers want a purchase-cost basis in the acquired depreciable and amortizable assets without the problems associated with a §338 election. However, in some situations, it may make more sense to enter into a stock acquisition. For example, if the selling corporation has a large unrecognized "inside" gain, it would be better for the seller to avoid the recognition of such gain through a stock sale or through a corporate reorganization provision.[192] If the seller does not recognize the corporate-level gain,

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191 These payments will be currently deductible as business expenses under IRC §1253(d)(1). This section also contains additional requirements that must be met to obtain a current deduction.

192 The corporate reorganization definitions are covered in IRC §368(a).

thereby avoids the corporate-level tax and passes a substantial portion of the tax savings onto the buyer in the form of a lower purchase price, the buyer should seriously consider a stock purchase if certain other factors are present. First, the buyer must be satisfied that there are no contingent liabilities. Also, the buyer must have an indemnity clause for such contingent liabilities and an "offset" provision that allows the buyer to deduct valid claims paid from the payments due under any purchase-money indebtedness. Additionally, it is preferable to have an escrow set up at the closing and held for a reasonable period of time to cover these contingent claims. Second, the buyer should have the intention of holding onto the corporation for many years. If the corporate-level tax is deferred for many years, the net present value of the obligation is minimized. Moreover, the buyer receives what equates to almost a double benefit – a purchase-price reduction for some portion (or the entire amount) of the corporate tax "saved" and a deferral of the corporate tax as long as the assets are retained in the same corporate form and no §338 election is made. A buyer may also be interested in a stock acquisition if the target corporation has valuable nonassignable agreements such as favorable supply contracts or leases.

Question to ponder:

> There is a possibility that business income tax rates will be lowered significantly in the near future. If that happens, how will that impact the current thinking about asset purchases vs. stock purchases?

V. Carryovers

A. NOL carryforwards

1. Section 172

Section 172 establishes a basic exception to the general principle that federal income tax is determined and assessed on an annual basis. It grants a taxpayer a measure of relief in certain circumstances where its profitability fluctuates. Net operating losses (NOLs) can benefit a buyer by allowing a §338(g) election with little or no tax. Also, an NOL can carry forward and offset future income of a target within limitations.

2. NOL limitations

Section 382 incorporates a single rule that limits the availability of NOL carryforwards in any case of a more-than-50 percent change in ownership of the loss corporation.

a. To ensure that after a change in ownership the loss corporation's NOL carryforward would be limited to the same use that would have been available to the loss corporation had no change in ownership occurred, the rate at which a typical loss corporation absorbs its NOL by offsetting it against taxable income is at the long-term federal rate established under §1274 provided an appropriate absorption rate. Thus, the annual limitation on NOL carryforwards generally is limited to an amount equal to the absorption rate (i.e., the **long-term tax-exempt rate**) times the **value** of the loss corporation at the time of the change in ownership.

Rev. Rul. 2024-04 Rates Under §382 for March 2024	
Adjusted federal long-term rate for the current month	3.33%
Long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months).	3.44%

b. In addition to the absorption limitation, there is a general disallowance of NOL carryforwards if a two-year **continuity of business enterprise** standard is not met.

c. Section 269 continues to be available to the Service as an independent means of challenging NOL carryforwards following corporate acquisitions. Further, the legislative history states that the SRLY and CRCO limitations will continue to apply notwithstanding the amendment to §382.

d. Section 382 applies in the event of an **ownership change** in a loss corporation. The Act provides that the determination of whether an ownership change has occurred must be made after:

   (i) An **owner shift** involving a **5 percent shareholder**; or

   (ii) An **equity-structure shift**.

e. An **ownership change** generally occurs when the percentage of stock (based on value) owned by one or more 5 percent shareholders in a **new loss corporation** increases by more than 50 percentage points over the lowest percentage of stock held by such stockholders, at any time during the **testing period**, in the **old loss corporation**.[193]

   (i) For these purposes, the **testing period** generally is the three-year period preceding the day on which any owner shift involving a 5 percent shareholder or any equity structure shift occurs.[194]

   (ii) Further, the Act defines a 5 percent shareholder as any person who holds 5 percent or more in value of the loss corporation's stock at any time during the testing period.[195]

   (iii) The Act also aggregates all less-than-5 percent shareholders and, effectively, treats them as one 5 percent shareholder.[196]

   (iv) An owner shift involving a 5 percent shareholder may arise in any number of ways including:

   - A taxable purchase of stock by a person who owns at least 5 percent of the corporation's stock either before or after the purchase;
   - A sale or other disposition of stock by a 5 percent shareholder;
   - An exchange of property for stock in a transaction that satisfies §351 and results in a change in the percentage ownership of a 5 percent shareholder;
   - A redemption that results in a change in the percentage ownership of a 5 percent shareholder; or
   - An exercise of a debt conversion privilege that results in a change in the percentage ownership of a 5 percent shareholder.

Example 1: A Corporation is owned equally by Jim, Jerry, Joe, and Jules. If Jules sells all of his stock to Jeffrey on January 1, 2024, there is an owner shift involving a 5 percent shareholder, although there is not then enough change in the ownership of A Corporation to trigger an ownership change for NOL carryover purposes.

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193 An "old" loss corporation refers to a corporation as to which there is an ownership change and which was a loss corporation before the change. A "new" loss corporation refers to a corporation that is a loss corporation after an ownership change. The same corporation may be treated as an old loss corporation and a new loss corporation (e.g., in the case of an owner shift involving a 5 percent shareholder). See IRC §§382(k)(2) and (3).

194 IRC §382(i)(1).

195 IRC §382(k)(7).

196 IRC §382(g)(4)(A).

Example 2: Jim and Jerry sell their stock to Jarred on August 1, 2024. Each sale involves an owner shift by a 5 percent shareholder, but by themselves they do not constitute a change in the ownership of 5 percent shareholders of more than 50 percent. However, using the three-year look-back rule, the owner shift involving Jules must also be taken into account. In the aggregate, these sales on August 1, 2024, constitute an ownership change (75 percent) causing the §382 limitations to come into effect if the corporation then had an unused and unexpired NOL.

Example 3: On January 1, 2027, Joe sells his stock (25 percent) to Jonah. Looking back three years to January 1, 2024, there would appear to be an ownership change of 100 percent. Is this another ownership change? No, because the ownership change on August 1, 2024, limits the next testing period to transactions beginning on August 2, 2024. As to this testing period, there is only a 25 percent change in ownership of 5 percent shareholders. Thus, no ownership change on Joe's sale.

B. Other carryforwards

1. Miscellaneous credits

The Treasury will issue regulations that will limit the ability of corporations to carry forward business credits, research credits, excess foreign tax credits, and capital losses in cases where ownership changes occur.[197]

2. Limitation

Capital loss carryforwards and the "deduction equivalent" of credit carryforwards available to a new loss corporation will be limited to an amount of income that does not exceed the §382 limitation for the taxable year in question.[198]

3. Section 163(j) business interest limitation

If the purchased company has unused §163(j) business interest expense carryforward amounts due to the limitation on interest expense, the amount is treated as a pre-acquisition loss and falls under the same §382 limitations as NOLs.[199]

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197 IRC §383.
198 IRC §383.
199 Proposed Reg. §1.382-2(a)(1)(i)(A) and §1.382-2(a)(7).

Learning Questions

1. Which of the following is NOT CORRECT?

   A. All §197 intangibles (other than goodwill and going-concern value) are classified as Class VI assets.
   B. Purchased goodwill is generally amortized ratably over 180 months beginning with the month of acquisition.
   C. In order to qualify for amortization, an intangible asset must be shown to have a limited useful life.

2. Which of the following assets is allocated purchase price last (relative to the other assets listed)?

   A. Certificates of deposit.
   B. Actively traded personal property.
   C. A covenant not to compete.

3. Which of the following statements concerning amortizable §197 assets is NOT CORRECT?

   A. The sale of such assets at a gain results in depreciation recapture to the extent the prior amortization does not exceed the realized gain.
   B. All gain other than recapture income is capital gain.
   C. Any loss on disposition may be ordinary.

4. With respect to the acquisition of an intangible, which of the following is NOT CORRECT?

   A. In general, a taxpayer must capitalize an amount paid to acquire an intangible.
   B. In order for a property interest to be a separate and distinct intangible asset, it must have ascertainable and measurable value in money's worth that is subject to protection under applicable state or federal law.
   C. Amounts paid to develop a package design must be capitalized under the uniform capitalization regulations.

5. Which of the following statements concerning the purchase of assets by an S corporation is CORRECT?

   A. In general, a purchase of assets by an S corporation should result in the termination of the S election.
   B. The income or loss generated by the acquired assets must be separately stated from the other income of the S corporation.
   C. The built-in gains tax could apply if the assets are acquired from a C corporation.

Learning Questions – Answers

1. A is **incorrect** because the class system adopts the residual method by which goodwill and going-concern value are allocated consideration in an applicable asset acquisition last (i.e., in the last class, Class VII). The Service placed all amortizable §197 intangibles other than goodwill and going-concern value in Class VI, together with certain nonamortizable §197 intangibles, some of which are amortizable by the buyer though they were not amortizable by the seller. The final regulations take the position that the residual method of allocation for goodwill and going-concern value is achieved by dropping down goodwill and going-concern value to a "true" residual class, Class VII.

   B is **incorrect** because goodwill is treated as an amortizable §197 intangible when it is acquired in an applicable asset acquisition. Since such an acquisition is defined in terms of one where goodwill could attach, any purchase of goodwill qualifies as an applicable asset acquisition. However, self-created (non-purchased) goodwill is not amortizable. The goodwill is treated as a Class VII asset and an amortizable §197 intangible that is amortized over 15 years (180 months). Such assets are depreciated beginning with the month they are placed in service.

   C is **correct**. While in general a useful life is necessary for amortization, the Code has eliminated this requirement in the case of an amortizable §197 intangible, which permits amortization as long as the asset fits certain defined categories and is acquired by purchase.

2. A is **incorrect** because it is and allocated to Class II and Class II is a higher class than Class VI. Class II assets include certificates of deposit and foreign currency even if they are not actively traded personal property.

   B is **incorrect** because it is allocated to Class II and Class II is a higher class than Class VI. Class II assets are actively traded personal property within the meaning of §1092(d)(1) and Treas. Regs. §1.1092(d)-1 [determined without regard to §1092(d)(3)].

   C is **correct**. A covenant-not-to compete is an amortizable §197 intangible that is generally not treated as goodwill or going-concern value. Accordingly, it is allocated to Class VI. Because it is allocated to the highest asset class, the purchase price is allocated to it last relative to other assets in lower-numbered asset classes.

3. A is an **incorrect** choice here; it is a correct statement because, as §1245 property, all prior deductions are recaptured to the extent of the realized gain.

   B is the **correct** choice here because it is not a correct statement. As §1245 property, gain from the sale beyond depreciation recapture is treated as §1231 gain, which may be treated as capital gain or ordinary income as §1231 recapture.

   C is an **incorrect** choice here; it is a correct statement because, as §1245 property, it is also §1231 property, the loss from which may be ordinary to the extent it exceeds other §1231 gains.

4. A is **incorrect** because in general, a taxpayer must capitalize the following: (i) an amount paid to acquire an *intangible*; (ii) an amount paid to create a *created intangible*; (iii) an amount paid to create or enhance a *separate and distinct intangible asset*; (iv) an amount paid to create or enhance a *future benefit* identified in published guidance in the Federal Register or in the Internal Revenue Bulletin as an intangible for which capitalization is required; and (v) an amount paid to facilitate an acquisition or creation of an intangible described in (i), (ii), (iii), or (iv).

   B is **incorrect** and in addition, its possession and control must be intrinsically capable of being sold, transferred, or pledged (ignoring any restrictions imposed on assignability) separate and apart from a trade or business.

   C is **correct**. Amounts paid to develop a package design are treated as amounts that do not create a separate and distinct intangible asset. However, nothing changes the treatment of an amount that is specifically provided for under any other provision of the Code [other than §162(a) or §212] or the regulations thereunder.

5. A is **incorrect** because it is the purchase of S stock that can cause a termination, not the sale of its assets.

   B is **incorrect** because the only items that are separately stated are items that can affect the tax liability of an individual shareholder.

   C is **correct**. The built-in gains tax may apply to assets acquired by an S corporation in exchange for built-in gains assets or built-in gains assets themselves that were acquired by the S corporation from a C corporation.

Financing the Sale

Financing the Sale

Learning objectives

Upon reviewing this chapter, the reader will be able to:

- Discuss the characterization of interest as business interest or investment interest and the deductibility of such interest;
- Identify the advantages and disadvantages of an installment sale of a business;
- Describe when a sale is eligible for installment sale accounting, what calculations are required to determine the timing of gain recognition, and the impact of liabilities assumed or taken subject to the timing of gain;
- Distinguish a wraparound mortgage from other financing arrangements;
- Explain how and when depreciation is recaptured in an installment sale;
- Identify pledging problems and the consequences of dispositions of an installment obligation;
- Discuss the fundamentals of original issue discount and imputed interest and how they apply in a business acquisition;
- Explain the problems associated with a redemption in the context of an acquisition and distinguish the consequences for a C corporation, S corporation, and partnership;
- Discuss the issues that should be considered in determining whether a business that sells its assets should liquidate or stay in existence; and
- Describe the general tax consequences of liquidation of a C corporation, S corporation, and a partnership.

I. Interest in general

A. Investment interest

1. In general

Generally, interest paid on loans to acquire stock of a C corporation is considered investment interest expense.

a. The deduction for investment interest expense is limited to **net investment income** for the taxable year, but any investment interest expense not deductible in the current year may be **carried forward** indefinitely.

b. The taxpayer can elect to include net long-term capital gains in the definition of **net investment income**, but only if the taxpayer agrees to forego the applicable maximum tax rate on such gains.

c. Investment income is defined as the sum of the gross income from property held for investment (other than gain from the sale of property held for investment and qualifying dividends) and the **excess**, if any, of the net gain attributable to the sale of property held for investment over the net capital gain[1] determined by only taking into account gains and losses from the dispositions of property held for investment, plus, **if elected**, the lesser of net gain or the net capital gain (as limited above) and, if separately elected, qualifying dividends.[2] The net long-term capital gain, if any, so elected is not eligible for the maximum capital gains tax rate of 28/25/20/15/10/0 percent.[3]

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1 IRC §1222(11) defines net capital gain as the excess of net long-term capital gains over net short-term capital losses. Net long-term capital gain is the excess of long-term capital gain over long-term capital loss. Net short-term capital loss is the excess of short-term capital loss over short-term capital gain.

2 IRC §163(d)(4).

3 IRC §1(h) (flush language).

Planning point:

> As a year-end planning tip, a taxpayer may desire to sell short-term capital gain property in order to increase net investment income for purposes of utilizing the excess investment interest at the end of a tax year, but a taxpayer should not sell long-term capital gain property for these purposes unless the taxpayer plans to make an election to include any net long-term capital gain in net investment income. In analyzing the usefulness of this tip, practitioners must balance the **temporary loss** of the investment interest deduction against the **permanent loss** of the maximum capital gains tax bracket on the gain that would otherwise have to be elected in order to obtain the current deduction. Investment interest expense that is not deductible on account of the investment interest limitation is carried over to later years and deducted when there is sufficient investment income.[4] In analyzing this strategy, practitioners must consider the time value of money during the deferral period, the length of the deferral period, and the tax brackets for the current year and the year to which the excess investment interest will be carried.
>
> The way in which losses are allocated also has an effect, since use of gains from a high-rate bracket will have the potential of reducing the net gain in lower rate brackets to the extent of capital losses. Accordingly, only where there are no capital losses or capital loss carryovers will it always make sense for the taxpayer who is in the 28 percent tax bracket currently and in all subsequent years to make the election to include net long-term capital gains in net investment income to the extent of the gains attributed to the 28 percent rate class.
>
> Beyond this, there will now be a rate differential that must be considered. In general, the election should not be made for lower rate bracket gains. The widening gap between the ordinary income rate and the maximum capital gains rate under the 1997 Taxpayer Relief Act extends the period in which the present value of a deferred investment interest expense exceeds the amount of a lower capital gains tax. In these cases, having the gain included in net capital gain rather than investment income with a deferred deduction results in a better cash flow for the taxpayer than a simple offset of the gain by the deductible amount in the current year.

d. Investment expenses are those expenses other than investment interest that are directly connected with the production of investment income. Thus, to the extent a capital gain is not included in the definition of investment income by reason of the definition and the failure to make the election, expenses directly connected with that gain are likewise not deductible as investment expenses. This has the effect of increasing net investment income for purposes of the investment interest limitation.

2. Business interest

Interest paid on debt to purchase stock may be business interest instead of investment interest in limited circumstances. In *Chester W. Schanhofer*,[5] the Tax Court carved out a very limited exception permitting the interest on a related loan used for the purchasing of stock in a closely held C corporation to be deducted as trade or business interest. In this case, a manager of a beer distributor was about to lose his job if the C corporation was sold to an outsider. The manager purchased all of the shares of stock. Based on the facts, the Tax Court ruled that he did not have an investment motive in buying the stock, particularly in view of the high price that he paid for the stock, its limited marketability, and other licensing restrictions. Rather, he was motivated to keep his job as manager and accordingly the interest paid was fully deductible business interest.

Beware of the new limitations on business interest expense imposed by the Tax Cuts and Jobs Act. This may apply if the buyer purchases a business in an asset acquisition with a significant portion of the purchase financed with debt. The amount of business interest expense that may be deducted cannot

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[4] IRC §163(d)(2).
[5] T. C. Memo 1986-166.

exceed the sum of business interest income plus certain floor plan financing interest expense plus 30 percent (50 percent for 2019 and 2020)[6] of adjusted taxable income. The disallowed portion may be carried over to subsequent years.[7]

Interest on qualified floor plan indebtedness is not subject to the limitation. The full deduction of floor plan interest expense is accomplished by the formula in the preceding paragraph. The total qualified floor plan financing interest expense is included in both the business interest expense amount and the limitation.

Qualified floor plan financing indebtedness is indebtedness used to the finance the acquisition of motor vehicles held for sale or lease and secured by the motor vehicles. For this purpose, a motor vehicle is defined as:

(i) Any self-propelled vehicle designed for transporting persons or property on a public street, highway, or road;

(ii) A boat; or

(iii) Farm machinery or equipment.[8]

Adjusted taxable income is the taxable income of the taxpayer computed without regard to:

(i) Any item of income, gain, deduction, or loss which is not properly allocable to a trade or business;

(ii) Any business interest expense or business interest income;

(iii) The amount of any net operating loss under §172;

(iv) The amount of any pass-through deduction allowed under §199A;

(v) For tax years beginning before January 1, 2022, any deduction allowable for depreciation, amortization, or depletion; and

(vi) Computed with such other adjustments as provided by the Secretary.[9]

Certain small businesses are exempt from the limitation. Most taxpayers who meet the gross receipts test of §448(c) for the year are not subject to the limitation.[10] The §448(c) limitation under the TJCA is $29,000,000 for 2023.[11]

3. Carryover of investment interest expense

To the extent investment interest is not currently deductible by reason of the investment interest limitation, such interest is treated as investment interest paid or accrued by the taxpayer in the succeeding taxable year.[12]

Example 1: ***Debt on C corporation stock***
Joe Smith has incurred large amounts of investment interest expense in connection with the purchase of common stock in a closely held C corporation. For 2024, Joe's tax practitioner projects that his investment interest expense of $30,000 will be deductible as follows.

6 Changed by the CARES Act of 2020.
7 IRC §163(j)(1) and (2).
8 IRC §163(j)(9).
9 IRC §163(j)(8).
10 IRC §163(j)(3).
11 Rev. Proc. 2021-45.
12 IRC §163(d)(2).

Investment interest expense		$30,000
Limitation:		
Interest and dividend income	$ 5,000	
Allowable interest expense		-$ 5,000
Carryover		$25,000

Of course, Joe also will have excess investment interest expense in the amount of $25,000, which carries forward to 2025 and future years. This interest will offset future net investment income or investment capital gains when such income or gains are eventually recognized.

Example 2: ***Debt on S corporation stock***

As a solution to Joe's investment interest expense restriction, the tax practitioner might recommend considering converting the corporation to S status. According to IRS Announcement 87-4,[13] and similar language in the General Explanation by the Joint Staff, interest on debt to purchase stock in an S corporation or an interest in a partnership is treated as deductible **business interest** under two conditions:

(i) The taxpayer **materially participates** in the operation of the business; and

(ii) The assets of the partnership or S corporation are used solely in the conduct of an **active trade or business** (as opposed to passive or portfolio activities).

If Joe did not materially participate in the business but the corporation operated under S status, the interest expense would be taken into account under the passive activity rules. Also, if the corporation operated under S status but some portion of the assets was held for investment, a portion of the interest expense would be treated as subject to the investment interest limitations. In effect, the interest would be allocated to the assets of the S corporation. A similar rule applies to partnership or LLC interest acquisitions.

4. C corporation acquirers

Investment interest expense limitations do not apply to C corporations, making corporations a tax-favored vehicle for the acquisition of businesses. However, be aware of the §382 limitation on the business interest deduction related to carryforward amounts of disallowed business interest expense from prior years of an acquired business.

B. Installment sales

1. Background

The use of an installment obligation to pay for the **stock or assets** of a company may meet the objectives of both the buyer and the seller. The seller of course will be able to **defer** all or a part of the gain on the sale and the buyer will be able to receive a step-up in basis in the assets purchased. An installment sale might meet other objectives:

- The use of an installment sale might be preferred over a reorganization since none of the consideration needs to be paid in stock;
- The buyer may prefer paying for a company with a note since any interest paid on that note may be deductible for tax purposes, while dividends paid on the stock will not; and

[13] Notice 88-37: IV. Interest Expense on Debt-Financed Acquisitions.

- The seller can convert interest income into capital gains by taking back an installment note with a maturity of six months or less with no stated interest. The buyer would not be entitled to an interest deduction but would get a higher basis in any assets purchased.

2. Definition

As long as one payment is to be received after the end of the taxable year of the sale, the sale is an installment sale for tax purposes.

a. The installment reporting rules for an installment sale are mandatory unless the seller affirmatively **elects out** of such rules.[14]

b. There are certain traps that still must be avoided. An otherwise proper installment note can be treated as a **payment** if it is **payable on demand** or is **readily tradable on an established market.**[15]

3. Guarantees

A note that otherwise qualifies as an installment note is not taxable solely because it is guaranteed by a third party or a "standby letter of credit." To be a "standby letter of credit," it must be drawable only upon default in payment of the installment note.[16]

4. Security and escrow account

Security arrangements are sometimes required by a seller in addition to the property purchased. If an **escrow account** is set up containing cash or cash equivalents, the escrow account may be considered a payment to the seller in the year of the sale. In addition, if the payments are made from the escrow account, there is a greater risk that the escrow account will be considered a payment for installment reporting. Practitioners can insure against this result by making the release of funds from the escrow account subject to substantial contingencies or restrictions. These restrictions must either be a real and definite restriction on the seller or give a specific economic benefit to the buyer. Examples of such restrictions would be covenants not to compete and customer's payments against accounts receivable, but not release of funds based on a payment schedule.

5. Contingent price and earnout arrangements

In a contingent price sale, such as an earnout, basis is generally recovered ratably over the period over which the contingent payments are to be received, rather than based on the gross profit percentage. This generally is disadvantageous to the seller because the payments under such price formulae tend to be more front-loaded (if for no other reason than for a cash down payment), resulting in an acceleration of income. However, the regulations permit the seller to adopt an alternative basis recovery if that method is both reasonable and is likely to provide the taxpayer with recovery of basis "at a rate twice as fast as the rate at which basis would have been recovered under the otherwise applicable normal basis recovery rule."[17] In a recent sale, the seller proposed as a basis-recovery fraction the ratio of the installment payment received in the year over the estimated amount of aggregate payments to be received, in essence the proportionate rule applicable to noncontingent installment sales. The Service permitted this as long as the estimates were based on past sales and profits rather than projections of future productivity, receipts, or profits.[18]

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14 IRC §453(d).
15 IRC §453(f)(4).
16 Temp. Regs. §§15A.453-1(b)(3)(iii).
17 Temp. Regs. §15A.453-1(c)(7)(ii).
18 PLR 200036014.

C. Recapture

1. Depreciation recapture

All **depreciation recapture** income under §1245 or §1250 is not subject to the installment payment rules and is therefore fully recognized in the year of sale.[19] As a result, a seller may have tax due on the depreciation recapture but receive no cash in the transaction to pay the taxes due.

2. Section 1231 gains

Once all depreciation recapture income is recognized in the year of sale, any remaining gain (§1231 gain) is reported using the normal installment sale rules. Thus, if any payments in excess of depreciation recapture are received in the year of sale, some capital gain will also be recognized.

a. In computing the **gross profit percentage** for the regular installment sale, the basis of the property must be increased for the depreciation recapture income recognized in the year of sale. Depreciation recapture recognized is added to the basis of the property in order to avoid double taxation of that gain.

Example 1: G sells a business machine for $200,000 in 2024, to be paid in five annual installments of $40,000 plus 12 percent interest on the unpaid balance, beginning with a $40,000 down payment upon closing. G had purchased the machine for $150,000 five years ago and had deducted a total of $90,000 depreciation. The total gain on the sale is $140,000 ($200,000 amount realized less $60,000 adjusted basis), of which $90,000 must be recaptured as ordinary income under §1245. The entire $90,000 of recapture income must be recognized immediately, even though only $40,000 cash is received in the year of sale. The $90,000 of recapture income is then added to G's adjusted basis in the property for purposes of the installment sale computations. Thus, G's new adjusted basis is $150,000 ($60,000 old basis plus $90,000 recapture income recognized), and the new gross profit ratio is 25 percent ($50,000 recomputed gross profit ($200,000 total contract price less $150,000 recomputed basis) divided by the $200,000 total contract price). G's gain is reported as follows (ignoring interest):

Year	Ordinary Income	Section 1231 Gain		
2024	$90,000	$40,000	.25	$10,000
2025	0	$40,000	.25	$10,000
2026	0	$40,000	.25	$10,000
2027	0	$40,000	.25	$10,000
2028	0	$40,000	.25	$10,000
Total	$90,000	$200,000		$50,000

b. **Recapture income** is the aggregate amount that would be treated as ordinary income under §§1245 or 1250. In addition, recapture income also includes any amount expensed under §179. Recapture income may also include any ordinary income recognized by corporate taxpayers under §291. Section 291 requires that 20 percent of the excess of what would have been depreciation recapture if the property were §1245 property over the §1250 depreciation recapture on the sale of §1250 property be recognized as ordinary income.

[19] IRC §453(i).

Note:

Real property expensed under §179 is subject to the recapture rules of §1245. When electing to treat qualifying real property as §179 property, the taxpayer is also electing to the ordinary income treatment of §1245 for that property.[20]

Planning point:

Practitioners must ensure that the taxpayer has sufficient liquid assets to pay any tax liability resulting from the recognition of recapture income under the installment rules.

Planning point:

A simple formula may be used to determine the amount of initial year payments necessary to pay the tax caused by the depreciation recapture:

$$C = (R \times TO_{oi}) + (GP \times C \times TO_{cg})$$

C = necessary break-even cash
R = total depreciation recapture
TO = marginal income-tax rate
GP = installment gross profit percentage

Example 4: If taxpayer G in **Example 1** had a 24 percent marginal ordinary income and 15 percent capital gains tax rate, the necessary break-even cash in the year of sale would be $22,442, computed as follows:

C = (90,000 x 0.24) + (0.25 x C x 0.15)
C = $21,600 + 0.0375C
0.9625C = $21,600
C = $22,442

For an individual in the highest tax bracket, the necessary break-even cash in the year of sale is computed as follows:

C = ($90,000 x 0.37) + (0.25 x C x 0.20)
C = $33,300 + 0.05C
0.95C = $33,300
C = $35,052

Note:

In the case of a noncorporate seller, if a portion of the capital gain from an installment sale is 25 percent gain and a portion is 20/15/0 percent gain, the taxpayer is required to take the 25 percent gain into account before the 20/15/0 percent gain, as payments are received.[21] (Because sales that result in 28 percent gain cannot also yield 25 percent gain or 20/15/0 percent gain, an allocation rule for 28 percent gain is unnecessary.) A front-loaded allocation method for 25 percent gain is generally consistent with the statute, under which 20/15/0 percent gain (that is, adjusted net capital gain) is defined as the residual category of capital gain not taxed at maximum rates of 28 percent or 25 percent. The front-loaded method precludes taxpayers from recognizing some 20/15/0 percent gain from an installment sale even when the amount ultimately recognized proves to be less than the amount subject to recapture at the 25 percent rate. Absent a front-loaded allocation method, this inappropriate result could arise (when a taxpayer later disposes of an installment obligation at a discounted price or the amount to be received is contingent.

[20] IRC §1245(a)(3)(C).
[21] Treas. Regs. §1.453-12(a).

D. Pledging problems

1. Real estate sales

Several modifications have been made to installment sale rules that apply to the sale of real estate used in a trade or business or that is held for the production of rental income where the selling price of such real property is greater than $150,000.

2. Payment

Congress repealed §453C, related to certain indebtedness treated as payment on installment obligations, by the Revenue Act of 1987, but did not abandon the concept of a pledge as payment on an installment obligation. The net proceeds of any indebtedness **secured directly** by an installment obligation to which §453A applies are treated as a payment on the obligation.[22] This rule applies to any installment obligation arising from the disposition of real property used in the taxpayer's trade or business or held for the production of rental income if the sales price exceeds $150,000.[23]

Note:

> Under the 1999 legislation, entering into any arrangement on or after December 17, 1999, that gives the taxpayer the right to satisfy an obligation with an installment note will be treated in the same manner as the direct pledge of the installment note, i.e., gain would be recognized under the anti-pledge rule.[24]

3. Timing

The payment is treated as occurring at the **later** of the time the taxpayer secures the indebtedness or the time the taxpayer receives the loan proceeds.[25] **Secured indebtedness** is defined as a debt under which the principal or interest payment is directly secured (under the terms of the indebtedness or any underlying agreement) by any interest in the installment obligation.[26] These rules apply for all taxable years ending after December 17, 1987, involving an installment obligation that is pledged after that date.

Example: On May 1, 2024, S (a nondealer) sold an office building to an unrelated party for $2.5 million. S received $250,000 cash and a 15-year, 12 percent, $2.25 million purchase-money note secured by a mortgage on the building. The note calls for monthly payments of $27,004 beginning on July 1, 2024. The building had an adjusted basis of $1.75 million.[27] On June 1, 2024, S obtained a 10-year, $1 million loan. The loan documents provide that the principal and interest payments are directly secured by an interest in the note. Of the $1 million made available to S, $100,000 could have been immediately withdrawn, and the remaining $900,000 may be withdrawn at the rate of $300,000 per year for 2025-2027.

Section 453A(b) applies to this sale. Section 453A(b)(1) states that the total sales price must exceed $150,000; presumably, §453A(b)(1) would apply even if the note were substantially less than $150,000 (as long as the total sales price exceeded that amount).

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22 IRC §453A(d).
23 IRC §453A(b).
24 IRC §453(a)(2), which denied installment sales treatment to an accrual method taxpayer, was repealed by the Installment Tax Correction Act of 2000.
25 IRC §453A(d)(1).
26 IRC §453A(d)(4).
27 It is assumed that the seller used straight-line depreciation, so that there is no IRC §1250 recapture and IRC §453(i) does not apply.

During 2024, S received $250,000 in cash (at closing) and $162,024 (6 x $27,004) in payments on the note, of which $27,707 was principal.[28] However, §453A(d) treats the $100,000 loan distribution to S as a payment on the note. S thus reports $350,000 ($250,000 + $100,000) of installment sale payments, generating an installment sale gain of $105,000.[29]

As for the $27,707 actually received as principal payments, to avoid taxing the installment sale gain twice (once when secured loan proceeds are received and again when installment payments are received), §453A(d)(3) provides that an installment payment is **not taxable** to the extent that the actual payment (here, $27,707) does not exceed the amount deemed received under §453A(d)(1) (i.e., on distribution of the secured loan proceeds) (here, $100,000).

In 2025, S receives $324,048 (12 × $27,004), of which $60,633 is principal. S also receives a $300,000 secured loan distribution from the bank. Section 453A(d)(1) treats the secured loan distribution as a payment on the installment obligation, generating an installment sale gain for 2025 of $90,000. Section 453A(d)(3) ignores the $60,633 principal payment actually received. By the end of 2027 (the final year of the secured loan distributions), S will have received $233,652 of principal on the note, but the pledging rules will have forced S to recognize and report $1 million of deemed payments for the same period. The effect of §453A(d) in this example is to accelerate recognition of $229,905 of the taxable gain inherent in the 15-year note into tax years 2024-2027.[30]

E. Interest charges

1. In general

If a nondealer sells **real or personal property** and receives an installment obligation to which §453A(b) applies, the nondealer **must pay interest on the deferred tax liability** attributable to the obligation if: (i) it was outstanding at the close of the taxable year; and (ii) the face amount of all installment obligations that arose during, and are outstanding at the close of, such taxable year exceeds $5 million.

2. Amount

The interest charge is: (i) the ratio of the aggregate face amount of the installment obligations outstanding in excess of $5 million to the aggregate face amount of all outstanding installment obligations (applicable percentage); multiplied by (ii) the unrecognized gain on the obligation at the close of the year; multiplied by (iii) the maximum tax rate in effect (under §1 or §11) for that year.[31] The result is then multiplied by the §6621(a)(2) underpayment rate for the last month of the taxable year.

Note:

> The preceding example was calculated using the §11 rate for a C corporation. If the property was sold by an individual or a pass-through, the appropriate rate would be the top individual rate of §1, which is currently 37 percent, or the maximum capital gains rate of §1(h), which is currently 20 percent.

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28 The principal of the note is reduced $27,707 in 2024; $60,633 in 2025; $68,323 in 2026; and $76,988 in 2027.

29 The §453(c) gross profit percentage (GPP) on the sale is 30 percent [($2,500,000 – $1,750,000)/$2,500,000]. The GPP is multiplied by the $350,000 of payments to arrive at $105,000 of gain.

30 If IRC §453A had not applied in the first example, S would have reported 30 percent of the $233,652 of principal received, or $70,096, over the period 2023-2026. Since IRC §453A applies, however, S must recognize and report 30 percent of the $1 million payment attributable to the secured loan distributions, or $300,000, as gain during that period.

31 IRC §§453A(c)(2), (3), and (4).

3. Deducting the interest

The interest charge is payable as **additional tax** for the relevant year. For deductibility purposes, however, the interest charge is treated as interest payable on an underpayment of tax. The interest charge is treated as personal interest and is thus nondeductible.

The Service is allowed to prescribe regulations providing for the application of the interest charge rules in the case of contingent payments, short taxable years, and pass-through entities (partnerships of S corporations).[32] This includes rules that will: (i) proportionately reduce the interest charge payable and the $5 million limitation for short years; (ii) address the $5 million limitation and the amount of year-end unrecognized gain in the case of contingent payments; and (iii) treat each partner or shareholder as owning a proportionate share of a partnership's installment obligations.

4. Scope of provision

Section 453A does **not apply solely** to installment obligations arising from the sale of real property. Instead, the pledging and interest charge rules now (retroactive to the effective date of the Revenue Act of 1987) apply to installment obligations arising from the nondealer disposition of **any property** if the sales price exceeds $150,000. The pledging and interest charge rules otherwise apply in the same manner (i.e., the aggregate of the face amounts of all such obligations arising in and outstanding at the end of the year exceed $5,000,000).

5. Investment property

The section also applies to any disposition of property under the installment method if the sales price exceeds $150,000, if that property is an investment-type property that is neither personal-use property nor held for the production of income.

6. Related parties

The Service can prescribe regulations disallowing the installment method for transactions that would otherwise avoid the pledging and interest-charge rules through the use of related persons, pass-through entities or intermediaries.[33] The regulations can also provide that the sale of an interest in either a partnership or a pass-through entity (S corporation) will be treated as a sale of the proportionate share of the assets owned by the partnership or the pass-through entity.[34] No regulations have yet been issued.

Caution:

> The sale of stock in an S corporation is, apart from §306 and the collapsible-corporation provisions, treated as the sale of a single asset. A similar rule applies to the sale of a partnership (other than the partner's proportionate share of partnership's hot assets). This means that the tax rate applicable to a stock sale of S stock may differ from that of a sale of assets. Not only is there no depreciation recapture with the concomitant acceleration of gain but also the shareholders can apparently use the 15 percent rate even though the corporation holds real estate with unrecaptured §1250 gain for which the 25 percent rate applies.

7. Use of the installment method for alternative minimum tax purposes

The installment method may be used in determining alternative minimum taxable income for all nondealer dispositions of property.

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32 IRC §453A(c)(5).
33 IRC §453A(e)(1).
34 IRC §453A(e)(2).

Questions to ponder:

Your clients, an elderly couple, come in to discuss selling their business to their son with a seller financed note. They tell you that they do not want to charge him interest.

Question 1: How do you respond?

Then the clients tell you that they are selling their business at a loss.

Question 2: How do you respond? What additional questions would you ask?

The AFR has been so low in recent times that inadequate interest has not been a great problem. A note that has any interest stated will usually be adequate. How will this change as interest rates rise?

F. Tax planning

1. Liquidation versus continued corporate existence

An installment sale of assets by an S corporation should not always be part of a §453B(h)[35] plan of liquidation. In some instances, tax benefits can be realized if the S corporation continues in existence, collects deferred payments on installment obligations, and distributes the payments to shareholders. Several factors should be considered prior to proceeding with a §453B(h) liquidation. Of paramount concern is maximizing basis recovery.

a. In most installment sales of assets by S corporations, cash or other property is paid by the purchaser in addition to the installment obligation. As a consequence, corporate-level gain is realized and passed through to shareholders, producing taxable gain and a corresponding increase in stock basis. In such an installment sale, when an S corporation retains the installment obligation, continues in existence, and distributes the cash or other property to its shareholders, the shareholders may use their entire stock basis, including basis produced by the recognition of pass-through gain, to offset gain on the distribution.[36] By contrast, when an S corporation distributes cash or other property and the installment obligation to its shareholders in a §453B(h) liquidation, the basis created from the recognition of pass-through gain must be recovered over the term of the installment note. Consequently, continued corporate existence under these circumstances can achieve an acceleration of basis recovery and deferral of gain.

(i) Continuing an S corporation's existence for the purpose of deferring gain recognition does have its shortcomings. As a practical matter, such a corporation will continue to be responsible for filing federal and state tax returns, complying with state law good-standing requirements, and maintaining its S corporation status, i.e., preventing transfers to ineligible shareholders. In addition, keeping the corporation in existence may not be a viable alternative for S corporations with Subchapter C earnings and profits. When an S corporation has Subchapter C earnings and profits and interest is more than 25 percent of gross receipts in any taxable year during the installment period, a corporate-level tax on excess net passive income will be imposed.[37] If the 25 percent threshold is exceeded for three consecutive tax years, the corporation's S status will be terminated.[38]

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35 Requires satisfaction of the conditions found in IRC §453(h).
36 See IRC §1368(b)(1).
37 IRC §1375.
38 See IRC §1362(d)(3).

(ii) For owners of S corporations that find continued corporate existence unpalatable, maximum gain deferral can be achieved in a liquidation. Prior to adoption of a one-year plan of liquidation, an S corporation can make distributions to eliminate shareholder stock basis, including basis resulting from corporate-level pass-through gain on the installment sale. If cash or other property is not available for these purposes, an S corporation can borrow the required amount. When an S corporation makes cash distributions equal to its shareholders' collective stock basis, stock basis is recovered in full in the taxable year of the distribution rather than offsetting gain on a pro rata basis over the term of the installment sale.

(iii) As the previous example illustrates, borrowing to eliminate basis prior to a §453B(h) liquidation can accelerate basis recovery and defer gain as effectively as continued corporate existence. The amount borrowed must be sufficient to eliminate presale basis and basis resulting from pass-through gain. In some instances, however, borrowing this entire amount may not be possible. Fortunately, approximately the same results can be attained by converting the sale into a 100 percent-financed transaction. By eliminating the cash payment at closing, S corporation shareholders avoid having to recognize corporate-level pass-through gain in full while the basis created from such gain must be recovered over the term of the installment note.

(iv) Another possible variation for the creation of debt is to sell the purchased assets subject to debt used to finance a distribution, or have the purchaser assume such debt as part of the purchase price. Generally, this approach would not be advisable. Debt will not be a qualifying indebtedness when it is incurred or assumed by the taxpayer or placed as an encumbrance on the property in contemplation of the disposition, and the arrangement results in acceleration of basis recovery.[39] Consequently, such debt would be a payment on the installment note in the taxable year it is assumed or taken subject to by the purchaser.

(v) There are several matters of interest with respect to installment sale tax planning.

- First, deferred payments in an installment sale cannot be secured either directly or indirectly by cash or its equivalent without being immediate, rather than deferred, payment.[40] When personal guarantees alone do not provide enough assurance, the regulations allow the deferred payments to be secured by a standby letter of credit from a financial institution.
- Second, an installment obligation will not qualify for installment method reporting if it is received in exchange for cash, in a transaction unrelated to a sale or exchange of noncash assets by the corporation, is not treated as qualifying for installment reporting.[41]

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39 See Temp. Regs. §15A.453-1(b)(2)(iv).
40 See Temp. Regs. §15A.453-1(b)(3)(i).
41 See Prop. Regs. §1.453-11(c)(2).

b. The advisability of liquidating pursuant to §453B(h) versus continuing corporate existence is affected by the relationship between internal and external gain. Where the internal pass-through gain that would be reported in connection with continued corporate existence exceeds the external installment gain that would be reported in connection with a §453B(h) liquidation, continued corporate existence could cause adverse tax consequences to the S corporation shareholder. This is especially detrimental when an S corporation sells ordinary income assets in an installment sale and the corporation's basis in its assets is less than the shareholders' collective stock basis. In this case, continued corporate existence may create phantom ordinary income that cannot be offset by capital losses on the disposition of the shareholders' stock.

c. A §453B(h) liquidation may not be desirable for a number of technical reasons. For example, the installment sale purchaser may not be related to the S corporation but may be related to a shareholder for purposes of §453(g) or §453(e). The installment method generally will not be available for the reporting of gain on the disposition of a shareholder's stock when the shareholder is related to the purchaser under §453(g). When the purchaser is related to an S corporation shareholder under §453(e) and the purchaser engages in a second disposition of the purchased assets within two years of the first disposition, gain recognition is accelerated on the installment obligation held by the shareholder.

    (i) Proceeding with a §453B(h) liquidation also may not be desirable where the assets sold are subject to the corporate-level tax on built-in gains. Acceleration of built-in gain could benefit shareholders, however, where Congress increases the highest rate of tax applicable to corporations and built-in gains are recognized prior to the effective date of the new rate.

    (ii) Finally, a shareholder who receives an installment obligation pursuant to a §453B(h) liquidation must recognize gain when the purchaser defaults on the installment obligation and the shareholder repossesses the property in partial or full satisfaction of the installment obligation. The Service has ruled that nonrecognition treatment for certain re-acquisitions of real property under §1038 did not apply when a shareholder received the installment obligation from a corporation in a §337 (prior to the Tax Reform Act of 1986) liquidation.[42]

2. Allocation of purchase price proceeds

The sale of the assets of a business is not a sale of a single asset but rather a sale of each individual asset in the business.[43] Accordingly, the amount and character of any gain or loss recognized on such a transaction must be determined on an asset-by-asset basis. Section 1060 requires that the purchase price in applicable asset acquisitions be allocated to most business assets on a pro rata basis based on the FMV of each asset. There is no requirement, however, that each type of consideration paid by the purchaser be allocated on a pro rata basis to each asset. Consequently, in an installment sale, where a portion of the purchase price is paid in cash and the remainder is paid with an installment note, a seller has some flexibility to allocate the cash payment entirely to certain assets to the exclusion of others.

a. In an installment sale of assets of a business, it generally is advisable to allocate cash payments first to property that does not qualify for installment method reporting. Since gain must be recognized immediately anyway on assets that do not qualify for installment method reporting, maximum gain deferral will result only where deferred payments are allocated to assets that qualify for installment method reporting.

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42 See Rev. Rul. 86-120, 1986-2 C.B. 145.

43 See Rev. Rul. 68-13, 1968-1 C.B. 195, and *Williams v. McGowan,* 152 F.2d 570 (2nd Cir. 1945).

b. If a §453(h) liquidation is contemplated, it generally will be advisable to allocate payments on a priority basis to broken lots of inventory that do not qualify for installment sale reporting. While the final regulations seem to achieve the preferred results by providing that cash payments are consideration for broken lots of inventory, remember that unsecured liabilities assumed by the purchaser or liabilities encumbering the inventory that the purchaser assumes or takes subject to are allocated to inventory prior to cash payments.[44] Since such liabilities generally would not trigger gain recognition if they were qualifying indebtedness and were allocated to noninventory assets, gain can be deferred when payments are allocated first to broken lots of inventory and nonqualifying indebtedness is allocated to noninventory assets. Although the regulations do seem to require the allocation of certain liabilities to nonqualifying sales of inventory on a priority basis, they also suggest that, to some degree, the seller's allocations of consideration may override these rules.[45]

c. The rules applicable to contingent payment sales tend to defer the recovery of basis in installment sales. Consequently, it ordinarily will be desirable to allocate contingent consideration to low-basis assets, so that basis recovery can be accelerated with respect to high-basis assets.

II. Redemptions

In some cases, a business will have assets that the buyer does not want. The problem of unwanted assets in an entity purchase (stock of partnership/LLC interest) can be alleviated by a redemption of the interest in conjunction with the purchase where the redeeming investor receives the unwanted assets. In an asset sale, the entity may retain these unwanted assets and continue as a business by purchasing additional assets with the proceeds of the asset sale to be added to the leftover unwanted assets.

A. Termination of interest

1. In general

A redemption occurs when a company acquires its stock in exchange for property including cash. The federal income-tax rules that apply to a corporation and to shareholders participating in a redemption are complex. We will concentrate on the applicable Code sections that will apply to redemptions in bootstrap acquisitions.

2. Complete termination of interest

Section 302(b)(3) provides that a redemption shall be treated as a sale if it "is in complete redemption of all of the stock of the corporation owned by the shareholders." To qualify for the treatment under §302(b)(3), the redemption must **completely terminate** the shareholder's **proprietary interest** in the corporation.

a. If the entire amount is paid to the shareholder in cash, the shareholder retains no proprietary interest on that account (but may have other concerns).

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44 Treas. Regs. §1.453-11(c)(4)(iii).
45 Treas. Regs. §1.453-11(c)(4)(iv), Example.

b. A corporation could redeem its shares with its debt obligation rather than money, thereby allowing the owner a fixed income. This, of course, improves the cash flow of the corporation. In this situation, the mere possibility that there could be a default on the corporate debt or the payout is unreasonably long has caused the Service to argue that there would not be a complete termination of a shareholder's proprietary interest. The courts have not agreed with the Service except where it was found that debt was a disguised equity interest in the corporation.

(i) If the shareholder takes back debt, the debt will not be treated as stock if:

- The ex-shareholder's rights are not greater than necessary for the enforcement of his claim;
- The debt is not subordinate to claims of general creditor; and
- Payments of principal are not contingent on earnings.[46]

(ii) Another important aspect of redemption is the application of the **family attribution** rules under §318. The family attribution rules would always apply to the complete redemption of one family member in a closely held corporation but the family attribution rules will be waived in a complete termination of interest[47] if:

- The shareholder retains no interest in the corporation after the redemption (including an interest as an officer, director, or employee) other than an interest as a creditor;
- The shareholder does not acquire any such interest (other than stock acquired by bequest or inheritance) within 10 years from the date of the distribution; and
- The shareholder agrees to notify the Commissioner of the acquisition of any forbidden interest within the 10-year period.[48]

3. Redemption

When the purchaser buys some shares of stock and the corporation redeems other shares as part of an integral plan, the purchaser will not be taxed on the acquisition of shares by the corporation. The purchaser will have a basis in the shares equal to the price paid.

a. If the purchaser buys the shares on credit but then has the corporation assume the liability to pay for these shares, the corporation will be considered to have made a **constructive dividend** to the purchaser at the time and in the amount of payments made by the corporation.

b. The same result would be true if the purchaser entered into a contract to buy all of the shares of stock from the seller on an installment payment plan and then caused the corporation to redeem the seller's shares.

c. The general rule is that when a corporation redeems stock from a seller and in doing so satisfies a buyer's contractual obligation to purchase the redeemed shares, there is no constructive dividend to the buyer provided:

- The buyer is not subject to an existing primary and unconditional obligation to perform the contract; and
- The corporation pays no more than fair market value for the stock redeemed.

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46 Treas. Regs. §§1.302-4(d) and 1.302-4(e).

47 IRC §302(c)(2)(A).

48 An interest in a parent, subsidiary, or successor corporation is equally fatal. Treas. Regs. §1.302-4(c).

B. Leverage

1. Leveraged buyout

The phrase **leveraged buyout** (**LBO**) refers to the use of borrowed money to buy a business with the business's assets and earnings being used to pay off the debt. The LBO principle is similar to the use of nonrecourse debt to buy real estate where the lender, in evaluating the credit risk, knows that it can look only to the property's value and earnings to pay off the debt and not to the general resources of the borrower. This has been the standard method for financing real estate purchases for years. In the corporate area, the typical LBO transaction was known as a **bootstrap acquisition** and has for many years been a common method of financing purchases of closely held corporations when the buyers were short of cash.

a. In the typical bootstrap acquisition, the buyers bought some of the stock of the target corporation from the selling shareholders and the target redeemed the rest, paying the price in cash, if the target had cash, or in installment notes, if the target did not. Although the selling shareholders might negotiate for personal guarantees by the new shareholders, typically they knew that they would have to look to the assets and earnings of the target corporation for the payment of their installment notes.

b. The modern LBO emphasizes the use of leverage to maximize returns even where the buyer does not have to borrow money to finance the transaction. Buyers deliberately have the target borrow almost all of the purchase price in order to **maximize the return on their equity investment**.

2. Leverage

The power of leverage can be illustrated by a simple example.

> ***Example:*** Assume that Corporation P buys all of the stock of Corporation T for $10 million. Two years later, it sells T's stock for $12 million. If P paid the entire purchase price of $10 million from available cash, its profit of $2 million would be 20 percent of its investment. If, instead, it used only $500,000 of its cash and borrowed the remaining $9.5 million of the purchase price, its $2 million profit would represent a 400 percent return on its investment. Even if one takes debt-service expenses into account, it is clear that leverage can produce extraordinary multiples on capital investment.

3. Acquisition debt

In the typical LBO involving a closely held corporation, all of the target shareholders sell their stock for cash and notes. A substantial part (in many cases, almost all) of the purchase price is paid with borrowed money. These days, borrowing the money from outside lenders may be difficult, although it can be borrowed from the target shareholders in an installment sale if the target's stock is not publicly traded. The acquisition debt becomes a primary obligation of the **target** after the acquisition. The target's assets secure the debt and a lender looks to the target's earnings to repay it. Given the risk, the selling shareholders may place a risk premium on the rate of interest they will require.

C. Partnerships

1. In general

Generally, a liquidation of a partner's partnership interest occurs when the partnership transfers consideration to the partner in exchange for the partner's relinquishment of the partnership interest.

Note:

> If the consideration flows indirectly from one or more existing or new partners to the partner who relinquishes the partnership interest, the transaction is a sale and is not subject to the liquidation rules.

2. Accounting issues

If the liquidation of a partner's interest occurs other than at the end of the partnership taxable year, the liquidated partner's distributive share of partnership items must be determined for the period beginning on the first day of the taxable year and ending on the day of the liquidation.

a. The partnership taxable year closes with respect to a partner whose partnership interest is liquidated. Thus, the partner's distributive share of the partnership items is included in the partner's taxable year in which the sale occurs.

b. The taxable year of a partnership must close with respect to a partner whose entire interest in the partnership terminates, whether by death, liquidation or otherwise.[49]

3. Treatment of contributed property

If the partner whose partnership interest is liquidated receives a distribution of property contributed to the partnership by **another** partner within the seven-year period preceding the liquidating distribution, that other partner must recognize gain or loss equal to the amount of gain or loss that would be allocated to that other partner under the §704(c) contributed property allocation rules had the partnership sold the contributed property for an amount equal to its fair market value at the time of the liquidating distribution.

If the partner whose partnership interest is liquidated contributed property to the partnership during the seven-year period preceding the liquidating distribution and did not receive that property back in that distribution, the liquidated partner must recognize the amount of gain (but not loss) that would have been allocated to the partner under the §704(c) contributed property allocation rules had the property been distributed to another partner. However, the partner is not required to recognize more than the amount of gain realized on the liquidating distribution, which is the excess of the fair market value of property received in the distribution, other than money, over the partner's adjusted basis in the partnership interest reduced by any money distributed.[50]

Comment:

> This rule prevents the partner who contributed the property from avoiding the §704(c) contributed property allocation rules by leaving the partnership before the partnership recognizes any gain or loss with respect to the property.

49 IRC §706(c)(2)(A).
50 IRC §737(a)(1).

4. Tax consequences of liquidating distributions

Gain/loss recognition – Generally, liquidating distributions, like current distributions, are tax-free to both the distributee partner and the distributing partnership.

(i) Section 731(a) provides that there is no gain recognized by the distributee partner except to the extent that an amount of money is distributed in excess of the distributee's basis in his partnership interest. A distributee partner may, however, recognize gain if §§737 or 751(b) (discussed later) apply. In addition, §731(a) provides that there is no loss recognized by the distributee partner except to the extent that the liquidating distribution consists solely of money, unrealized receivables (as defined in §751(c)), and inventory (as defined in §751(d)). Any loss recognized is equal to the amount by which the distributee's predistribution basis in the partnership interest exceeds the amount of money and the adjusted basis of the unrealized receivables and inventory items distributed.

Note:

In general, the partner will have sufficient basis because the gain on the disposition of assets will generate a basis increase.

(ii) Section 731(b) provides that the distributing partnership recognizes no gain or loss. However, the partnership may recognize income or gain if §751(b) applies to the distribution. In addition, if contributed property is distributed to a partner other than the contributing partner within seven years of the contribution, the distribution may trigger tax consequences to the contributing partner under §704(c)(1)(B).

Basis in distributed property – A distributee partner's basis in assets distributed in complete liquidation of the partner's partnership interest is equal to the partner's basis in the partnership interest immediately prior to the distribution reduced by the amount of any money received.[51] If the distributee partner's basis in the partner's interest, after reduction for any money received, is less than or equal to the partnership's basis in distributed unrealized receivables and inventory, the basis is allocated entirely to these assets as provided by the method of allocating decrease below. If, on the other hand, the distributee partner's basis in the partner's partnership interest exceeds the partnership's basis in distributed unrealized receivables and inventory, these assets are allocated basis equal to the partnership's basis in the assets and the remaining basis is allocated to the remaining distributed assets as follows.

(i) Allocation of basis in general – The basis of distributed properties to which §732(a)(2) [limitation on non-liquidating distribution] or (b) [liquidation] is applicable shall be allocated:

- First to any unrealized receivables (as defined in §751(c)) and inventory items (as defined in §751(d)) in an amount equal to the adjusted basis of each such property to the partnership; and, if the basis to be allocated is less than the sum of the adjusted bases of such properties to the partnership, then, to the extent any decrease is required in order to have the adjusted bases of such properties equal the basis to be allocated, in the manner provided by the method of allocating decrease below; and

51 IRC §732(b).

- To the extent of any basis remaining after the allocation under the above bullet, to other distributed properties:
  - First by assigning to each such other property such other property's adjusted basis to the partnership; and
  - Then, to the extent any increase or decrease in basis is required in order to have the adjusted bases of such other distributed properties equal such remaining basis, in the manner provided below for allocating increase or for allocating decrease, whichever is appropriate.

(ii) Method of allocating increase – Any increase required under the second bullet and sub-bullets under (i) above shall be allocated among the properties:

- First to properties with unrealized appreciation in proportion to their respective amounts of unrealized appreciation before such increase (but only to the extent of each property's unrealized appreciation); and
- Then, to the extent such increase is not allocated under the immediately preceding bullet above, in proportion to their respective fair market values.

(iii) Method of allocating decrease – Any decrease required under (i) above shall be allocated:

- First to properties with unrealized depreciation in proportion to their respective amounts of unrealized depreciation before such decrease (but only to the extent of each property's unrealized depreciation), and
- Then, to the extent such decrease is not allocated under the immediately preceding bullet, in proportion to their respective adjusted bases (as adjusted under the immediately preceding bullet).

Optional basis adjustment – If a **§754 election** is in effect, a basis adjustment is made to the partnership's adjusted basis in its undistributed assets under four distinct scenarios. If the distributee partner recognized capital gain under §731, the adjustment is an increase (or "upward") adjustment equal to the amount of the gain. If the distributee partner recognized capital loss under §731, the adjustment is a decrease (or "downward") adjustment equal to the amount of the loss. If the partner's aggregate adjusted bases in the distributed property are less than the partnership's adjusted bases (basis destruction) in that property, the adjustment is an increase (or "upward") adjustment equal to the difference. If the partner's aggregate adjusted bases in the distributed property are more than the partnership's adjusted bases in that property (basis creation), the adjustment is a decrease (or "downward") adjustment equal to the difference. An adjustment arising from the recognition of capital gain or loss under §731 is allocated to the capital/§1231 category of property. An adjustment arising from a difference between the partner's adjusted basis in an asset and the partnership's adjusted basis in that asset is allocated to the category to which that asset belongs. The portion of an upward basis adjustment allocated to a category is in turn allocated among the assets in that category with fair market value exceeding adjusted basis in proportion to each asset's excess of fair market value over adjusted basis. The portion of a downward basis adjustment allocated to a category is in turn allocated among the assets in that category with adjusted basis exceeding fair market value in proportion to each asset's excess of adjusted basis over fair market value.

5. Special rules – Sections 704(c)(1)(B) and 737

Under §704(c)(1)(B), a partner that contributes property with built-in gain or loss must recognize all or a portion of that gain or loss if the property is distributed to another partner within seven years of the contribution. Under §737, the contributing partner is also required to recognize all or a portion of the built-in gain (but not loss), if, instead, the partnership distributes other property directly to the contributing partner. The IRS has issued final regulations that describe the basis adjustments to the contributing partner's partnership interest that these transactions require.

a. For distributions of contributed property to another partner, the contributing partner's basis in the partnership interest is increased by the amount of gain or decreased by the amount of loss that the partner recognizes under §704(c)(1)(B).[52] This amount equals the amount of gain or loss the contributing partner would have been allocated under §704(c)(1)(A) if the partnership had sold the property for its fair market value at the time of the distribution. In addition, the partnership's adjusted tax basis in the distributed property is increased or decreased immediately before the distribution to reflect the amount of gain or loss recognized by the contributing partner.[53] This adjustment will therefore affect the determination of the distributee partner's basis in the distributed property under §732.

b. For distributions of other property to the contributing partner, the partner's basis in the partnership interest is increased by the amount of gain recognized under §737.[54] Under the regulations, this amount equals the lesser of the excess distribution or the net precontribution gain. The "excess distribution" is the amount by which the fair market value of the distributed property (other than money) exceeds the distributee partner's adjusted basis in the partnership interest. For this purpose, the partner's adjusted basis includes any other basis adjustment caused by the distribution (or a distribution that is part of the same plan), such as adjustments required under §752, except for: (i) the increase required under §737(c)(1) for the gain recognized by the partner; and (ii) the decrease required under §733(2) for any property distributed to the partner other than property previously contributed by the distributee partner.

III. Liquidations

Note:

In many cases following a sale of assets, the business will liquidate. As with redemptions, a liquidation may deal with unwanted assets.

A. Section 331 liquidations

1. In general

Amounts distributed in **complete liquidation** of a corporation shall be treated as full payment in **exchange** for the shareholder's stock.[55]

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52 Treas. Regs. §1.704-4(e)(1).
53 Treas. Regs. §1.704-4(e)(2).
54 Treas. Regs. §1.737-3(a).
55 IRC §331(a)(1).

a. The stock would normally be a capital asset in the hands of the shareholder and each shareholder would recognize gain or loss equal to the difference between the fair market value of the property received and the basis of the stock surrendered.[56]

b. The amount of the gain or loss, and its character as long-term or short-term capital gain or loss is dependent upon the shareholder's adjusted basis in the stock and holding period for his stock. If the stock was purchased at different times and for different amounts, the gain or loss is computed on each separate lot.[57]

2. Valuation issues

Since the shareholder will be receiving all of the assets of the corporation, a practical issue is the **valuation** of such assets if they consist of noncash items. Appraisals and estimates will likely be necessary to establish the fair market value of the property received. Gain or loss to the shareholders upon the liquidation of the corporation is the difference between the adjusted basis of the stock and the fair market value of the property received. While appraisals can readily be made for most tangible assets, there is often difficulty or impossibility in calculating goodwill, disputed claims, or contingent contract rights.

3. Amount realized

Gain must also be reported on the distribution of these assets. Note however that the amount received by the shareholder will be reduced by the tax the corporation must pay under §336.

4. Shareholder basis

When a shareholder uses the general rule of §331 to determine gain or loss on the liquidation, the **shareholder's basis** in the property received in the liquidation is its fair market value on the date of distribution.[58]

5. Liabilities

If the shareholder assumes or takes property subject to any liabilities, this will have an effect on the amount of gain or loss that must be reported by the shareholder.[59]

> ***Example:*** Suppose that corporation A holds, with a fair market value of $100,000, property subject to a liability of $40,000, and that the property is distributed under §331 and the liability is assumed by the shareholders. The shareholders basis in their stock is $50,000. The shareholders will have a gain of $10,000. The amount distributed is viewed as net of any liabilities.

6. Considerations

Only in rare circumstances will a transaction justify the tax cost of a step-up in basis. Except where the Old Target has an expiring NOL or an NOL can be effectively used against its gain on a deemed sale, it would seem that §338 would not be utilized to step up the basis of a target's assets.

7. Stock sales

To achieve a single-level shareholder tax, the transaction must be effected through a sale of stock. P must be willing to buy the X stock and with it all of the X liabilities that could remain with X if the

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56 IRC §1001.
57 Treas. Regs. §1.331-1(e).
58 IRC §334(a).
59 IRC §336(b).

transaction were structured as a direct purchase of assets from X, rather than a stock sale. P cannot buy the X assets with A achieving a single-level shareholder tax.

a. A corporation selling its assets is taxed on the gains from that sale whether it liquidates or not. Thus, it might be advisable for the corporation to pay any tax due on a sale of its assets but continue its existence as a corporation. This alternative avoids the capital gains tax of the shareholder on a liquidation.

b. The avoidance of the second capital gains tax could be substantial where stockholders have a very low basis in the stock. There have been a number of court cases that have determined that the value of the shareholders' stock is substantially less than the inside value of the cash and stock of the corporation for purposes of a liquidation after the death of a shareholder whose estate then has a basis adjusted to the fair market value as of the date of death.[60] The ability to escape the second income tax completely is one reason for keeping the corporation in existence following its complete disposition of assets.

c. The corporation would obviously be sitting with substantial cash and possibly some stock after the sale of its assets and would be able to freely invest such funds in either a new business or a wide portfolio of investments if it so wished.

B. Consequences for the S corporation

1. In general

The liquidating corporation recognizes gain or loss on a distribution of property in complete liquidation as if the corporation had sold the distributed property at its fair market value.[61] The character of the gain is determined by the underlying asset, subject to the mandatory ordinary income treatment for certain recaptures of previously expensed items.[62]

2. Effect of pass-through

The taxable gain generally passes through to the shareholders. The stock basis is increased by the shareholders' share of this gain.[63] This increase in stock basis should either decrease the gain recognized or increase the loss recognized on the liquidation by the shareholders.[64]

3. Built-in gains tax

When the built-in gains tax applies, that portion of the gain recognized on the distribution representing built-in gain is taxed to the corporation at the 21 percent rate. The total gain on the distribution, offset generally by the built-in gains tax, is taxed to the shareholders as pass-through.[65]

a. The distribution of certain installment obligations by an S corporation is generally not treated as a disposition of the obligation triggering gain.[66] This requires the shareholder to be entitled to report gain on the liquidation on the installment method. The shareholder will be entitled to report gain on the redemption on the installment method only on the receipt of an installment obligation obtained by the corporation during the 12-month period following adoption of a plan of liquidation in respect of its sale or exchange of

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60 IRC §1014(a).
61 IRC §336(a).
62 See IRC §§1245(a), 1250(a), 1254(a), and 617(d).
63 IRC §§1366(a)(1) and 1367(a)(1).
64 IRC §§331 and 1001.
65 IRC §1366(f)(2). Treas. Regs. §1.1366.
66 IRC §453B(h).

assets. Inventory-type assets are ineligible for this treatment unless they are sold to one person in one bulk transaction.[67]

b. The presence of a built-in gains tax renders the shareholders ineligible for reporting that portion of the gain on the installment basis. The corporation must recognize the gain on the distribution of the obligation to the shareholders.

Example: The corporation has a single asset worth $1,000 and an adjusted basis of $300. The asset is sold for an installment obligation, which it distributes to its sole shareholder. The shareholder has a stock basis of $500. The shareholder would report the $500 gain on the installment method.

If, instead, the sale of the asset is subject to the built-in gains tax, and the asset's built-in gain is $300, the distribution of the installment obligation would cause the corporation to recognize $300 of gain and incur a $63 tax. The shareholder will be taxed on the $237 net gain and the stock basis is increased to $737. Because the corporation has no cash, the shareholder will be making, in effect, an additional capital contribution in liquidation of $63, increasing the basis by a like amount. Thus, the shareholder's basis will be increased by $300 to $800. The shareholder's basis in the obligation is $800. The remaining $200 gain would be reported on the installment basis.

4. Passive investment income

During the course of a liquidation, the character of income is likely to change significantly from active-business income to passive investment income. For example, the interest on an installment obligation arising from the sale of the assets and the gain on the sale or distribution of stocks and securities are both investment income. This could subject the corporation to a corporate-level tax and, in some instances, loss of the S election. Timing may be important, since if the election is lost prior to the taxable year of final liquidating distribution, the gain will be taxed to the corporation without any corresponding basis adjustments to mollify the gain recognized by the shareholders on the distribution by the corporation.

C. Consequences for the shareholder

1. In general

The distribution is treated as a sale or exchange and an amount realized. Unlike nonliquidating distributions, no reference is made to the AAA or accumulated earnings and profits in determining the tax treatment.[68] The amount of the gain or loss is determined by the difference between the amount realized and the stockholders' basis.

2. Basis of property

The basis of property received in liquidation is its fair market value at that time, regardless of any liabilities.[69]

3. Unused losses

If a shareholder has losses suspended due to insufficient stock basis, the losses are lost on liquidation. The shareholder should either make additional capital contributions to increase basis or by lending money to the corporation (although repayment during liquidation then creates capital gain to the shareholder).

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67 IRC §453(h)(1)(B). See also the preceding footnote.
68 IRC §331.
69 IRC §334(a); Treas. Regs. §1.334-1(a).

4. *Characterization of gain*

The character of the gain to be reported in connection with a liquidating installment sale of assets by an S corporation (i.e., capital or ordinary income) is determined at the corporate level.[70] Thus, where an S corporation makes an installment sale of its assets, the character of the gain reported, whether corporate-level gain passed through to shareholders or shareholder-level gain on the disposition of stock, must reflect the character of the assets sold. The excess of the total recognized shareholder-level gain over the corporate-level gain is generally capital gain on the disposition of stock.[71]

D. Tax planning

1. *Liquidation versus continued corporate existence*

An installment sale of assets by an S corporation should not always be part of a §453B(h) plan of liquidation. In some instances, tax benefits can be realized if the S corporation continues in existence, collects deferred payments on installment obligations, and distributes the payments to shareholders. Several factors should be considered prior to proceeding with a §453B(h) liquidation. Of paramount concern is maximizing basis recovery.

a. In most installment sales of assets by S corporations, cash or other property is paid by the purchaser in addition to the installment obligation. As a consequence, corporate-level gain is realized and passed through to shareholders, producing taxable gain and a corresponding increase in stock basis. In such an installment sale, when an S corporation retains the installment obligation, continues in existence, and distributes the cash or other property to its shareholders, the shareholders may use their entire stock basis, including basis produced by the recognition of pass-through gain, to offset gain on the distribution.[72] By contrast, when an S corporation distributes cash or other property and the installment obligation to its shareholders in a §453B(h) liquidation, the basis created from the recognition of pass-through gain must be recovered over the term of the installment note. Consequently, continued corporate existence under these circumstances can achieve an acceleration of basis recovery and further deferral of gain.

Example 1: In 2024, Y Corp., a cash method S corporation, consummates an installment sale of all its assets to an unrelated purchaser. The purchase price of $1 million is to be paid with $400,000 in cash at closing and the delivery of a promissory note requiring two annual installments of $300,000 commencing on the one-year anniversary of the sale date. Y Corp. has a $500,000 basis in its assets, and its shareholders have a collective stock basis of $50,000. All of the assets sold qualify for installment method reporting. The tax consequences are as follows:

Corporate-Level Gain		
Cash payment		$400,000
Multiplied by gross-profit percentage		
Contract price Adjusted basis	$1,000,000 -$ 500,000	
Gross profit	$500,000	
Gross-profit percentage		x .50
Corporate-level gain passed through to shareholders		$200,000

70 IRC §§453B(h)(2) and 1366(b).
71 See IRC §1368(b)(2).
72 See IRC §1368(b)(1).

Shareholder-Level Gain in §453B(h) Liquidation			
Pass-through gain			$200,000
Liquidation gain			
Cash distribution Multiplied by gross-profit percentage		$400,000	
Contract price Adjusted basis	$1,000,000		
Presale basis Pass-through gain	-$ 50,000 -$ 200,000		
Gross profit	$ 750,000		
Gross-profit percentage		x .75	
Liquidation gain			$300,000
Total current gain			$500,000
Deferred gain			$450,000

Shareholder-Level Gain With Continued Corporate Existence			
Pass-through gain		$200,000	
Distribution gain			
Cash distribution Adjusted stock basis	$400,000		
Presale basis Pass-through gain	-$ 50,000 -$200,000		
Gross profit		$150,000	
Total current gain			$350,000
Deferred gain			$600,000

(i) Continuing an S corporation's existence for the purpose of deferring gain recognition does have its shortcomings. As a practical matter, such a corporation will continue to be responsible for filing federal and state tax returns, complying with state law good-standing requirements, and maintaining its S corporation status (i.e., preventing transfers to ineligible shareholders). In addition, keeping the corporation in existence may not be a viable alternative if the S corporation has Subchapter C earnings and profits. When an S corporation has Subchapter C earnings and profits and interest is more than 25 percent of gross receipts in any taxable year during the installment period, a corporate-level tax on excess net passive income will be imposed.[73] If the 25 percent threshold is exceeded for three consecutive tax years, the corporation's S status will be terminated.[74]

(ii) For owners of S corporations that find continued corporate existence unpalatable, maximum gain deferral can be achieved in a liquidation. Prior to the adoption of a one-year plan of liquidation, an S corporation can make distributions to eliminate shareholder stock basis, including basis resulting from corporate-level pass-through gain on the installment sale. If cash or other property is not available for these purposes, an S corporation can borrow the required amount. When an S corporation makes cash distributions equal to its shareholders' collective stock basis, stock basis is recovered in full in the taxable year of the distribution rather than offsetting gain on a pro rata basis over the term of the installment sale.

73 IRC §1375. Principal payments under the installment obligation should constitute gross receipts in most cases. See Treas. Regs. §§1.1362-3(d)(4)(i) and 1.1362-3(d)(6). Gains from the sale or exchange of stock or securities, however, constitute passive investment income. IRC §1362(d)(3)(D)(i). Only net capital gain from other capital assets is included in gross receipts. IRC §1362(d)(3)(C).

74 See IRC §1362(d)(3).

Example 2: Assume the same facts as **Example 1**, except Y Corp. borrows $250,000 and distributes the entire amount to its shareholders prior to adopting a plan of liquidation. The $250,000 borrowed is repaid after closing on the installment sale of assets which occurs in the same taxable year as that in which Y Corp. distributed the loan proceeds to its shareholders.

Shareholder-Level Gain (Borrowing)			
Pass-through gain			$ 200,000
Liquidation gain			
Cash payment	$ 400,000		
Repayment of debt	-$ 250,000		
Cash distribution		$ 150,000	
Multiplied by gross-profit percentage			
Contract price	$ 750,000		
Adjusted stock basis			
Presale basis	$ 0		
Pass-through gain	$ 0		
Gross profit	$ 750,000		
Gross-profit percentage		x 1.00	
Liquidation gain			$ 150,000
Total current gain			$ 350,000
Deferred gain			$ 600,000

(iii) As the previous example illustrates, borrowing to eliminate basis prior to a §453B(h) liquidation can accelerate basis recovery and defer gain as effectively as continued corporate existence. The amount borrowed must be sufficient to eliminate presale basis and the basis resulting from pass-through gain. In some instances, however, borrowing this entire amount may not be possible. Fortunately, approximately the same results can be attained by converting the sale into a 100 percent-financed transaction. By eliminating the cash payment at closing, S corporation shareholders avoid having to recognize corporate-level pass-through gain in full while the basis created from such gain must be recovered over the term of the installment note.

Example 3: Assume the same facts as the **Example 1**, except that the entire purchase price for the assets is paid by the delivery of an installment note requiring two annual installments of $300,000 commencing on the one-year anniversary of the closing and an initial installment of $400,000 payable the day after closing. The installment obligation is distributed immediately after closing and prior to payment of the first installment.

Shareholder-Level Gain in Section 453(h) Liquidation With 100% Financing			
Pass-through gain			$0
Liquidation gain			$0
Shareholder-level gain on first installment			
Cash received		$400,000	
Multiplied by gross-profit percentage			
Contract price	$ 1,000,000		
Less adjusted basis	-$50,000		
Gross profit	$ 950,000		
Gross-profit percentage		x 0.95	
		$380,000	
Total current gain			$380,000
Deferred gain			$570,000

(iv) Another possible variation for the creation of debt is to sell the purchased assets subject to debt used to finance a distribution, or have the purchaser assume the debt as part of the purchase price. Generally, this approach would not be advisable. Debt will not be a qualifying indebtedness when it is incurred or assumed by the taxpayer or placed as an encumbrance on the property in contemplation of the disposition, and the arrangement results in acceleration of basis recovery.[75] Consequently, the debt would be treated as a payment on the installment note in the taxable year it is assumed or taken subject to by the purchaser.

(v) There are several matters of general interest with respect to installment sale tax planning.

- First, deferred payments in an installment sale cannot be secured either directly or indirectly by cash or its equivalent without being immediate, rather than deferred, payment.[76] When personal guarantees alone do not provide enough assurance, the regulations allow the deferred payments to be secured by a standby letter of credit from a financial institution.[77]
- Second, an installment obligation will not qualify for installment method reporting if it is received in exchange for cash, in a transaction unrelated to a sale or exchange of noncash assets by the corporation.[78]

b. The advisability of liquidating pursuant to §453B(h) versus continuing corporate existence is affected by the relationship between internal and external gain. Where the internal pass-through gain that would be reported in connection with continued corporate existence exceeds the external-installment gain that would be reported in connection with a §453B(h) liquidation, continued corporate existence could cause adverse tax consequences to the S corporation shareholder. This is especially detrimental when an S corporation sells ordinary income assets in an installment sale and the corporation's basis in its assets is less than the shareholders' collective stock basis. In this case, continued corporate existence may create phantom ordinary income that cannot be offset by capital losses on the disposition of the shareholders' stock.

Example: The assets of Y Corp., an S corporation, consist of copyrights and compositions under §1221(3) and accounts receivable with a $1 million FMV and a $500,000 basis. Y Corp. sells its assets for a promissory note in the face amount of $1 million, which is due and payable in full on the one-year anniversary of the closing date. Y Corp.'s shareholders have a collective stock basis of $600,000.

Section 453B(h) Liquidation		
Pass-through gain		$ 0
Installment gain		
Contract price	$1,000,000	
Presale stock basis	-$ 600,000	
Gross profit		$400,000

75 See Treas. Regs. §15A.453-1(b)(2)(iv).
76 See Treas. Regs. §15A.453-1(b)(3)(i).
77 See Treas. Regs. §15A.453-1(b)(3)(iii) (defining "standby letter of credit" as a nonnegotiable, nontransferable letter of credit issued by a bank or other financial institution, which serves as a guarantee of the indebtedness secured by the letter of credit).
78 See the last sentence of Treas. Regs. §1.453-11(c)(2).

Continued Corporate Existence		
Pass-through gain		
Contract gain	$ 1,000,000	
Adjusted basis	$ 500,000	
		$500,000
Distribution gain		
Cash distribution	$ 1,000,000	
Less adjusted basis		
Presale basis	-$ 600,000	
Pass-through gain	-$ 500,000	
Deferred capital loss*		-$100,000

* It is assumed that some of the loss qualifies as ordinary under §1244.

As this example illustrates, an installment sale in which outside stock basis is greater than inside asset basis generally translates into less potential external gain than internal gain over the term of the installment note. Under these circumstances, a §453B(h) liquidation may be more appealing to S corporation shareholders. In many instances, however, stock basis is negligible, and asset basis, even after being adjusted for depreciation, will be greater. In addition, the $100,000 capital loss in this example generally will be fully deductible when the S corporation has disposed of §1231 or capital assets at a gain and installments are structured properly. If, in the example, all the assets sold were capital assets, the recognition of $100,000 capital loss in the same taxable year gain is reported on the installment note, producing a net capital gain of $400,000. As a result, internal gain and external loss are offset.

2. Allocation of purchase price proceeds

The sale of the assets of a business is not a sale of a single asset, but rather a sale of each individual asset in the business.[79] Accordingly, the amount and character of any gain or loss recognized on such a transaction must be determined on an asset-by-asset basis. Section 1060 requires that the purchase price in certain asset acquisitions be allocated to most business assets on a pro rata basis based on the FMV of each asset. There is no requirement, however, that each type of consideration paid by the purchaser be allocated on a pro rata basis to each asset. Consequently, in an installment sale, where a portion of the purchase price is paid in cash and the remainder is paid with an installment note, a seller has some flexibility to allocate the cash payment entirely to certain assets to the exclusion of others.

a. In an installment sale of assets of a business, it is generally advisable to allocate cash payments first to property that does not qualify for installment method reporting. Since gain must be recognized immediately anyway on assets that do not qualify for installment method reporting, maximum gain deferral will result only where deferred payments are allocated solely to assets that qualify for installment method reporting.

Example: Y Corp., a cash method S corporation, has assets consisting of real property with a $700,000 FMV and a $500,000 basis and publicly traded stock and securities with a $300,000 FMV and a $100,000 basis. In 2024, Y Corp. sells its assets for $1 million, consisting of $300,000 in cash at closing and a $700,000 installment note (including accrued interest) payable in full of the fifth anniversary of the closing date. The recognition of gain in 2024 would depend on the manner in which the cash payment is allocated:

[79] See Rev. Rul. 68-13, 1968-1 C.B. 195.

Pro Rata Allocation of Cash Payment			
Gain on stock and securities			
Amount realized		$300,000	
Adjusted basis		-$100,000	
			$200,000
Installment gain			
Cash payment allocated to real estate		$210,000	
Multiplied by gross-profit percentage			
Contract price	$700,000		
Adjusted basis	-$500,000		
Gross profit	$200,000		
Gross-profit percentage		x 0.286	
			$ 60,000
Total gain recognized in 2024			$260,000

Allocation of Cash First to Stock or Securities		
Gain on stock or securities		
Cash payment	$ 300,000	
Adjusted basis	-$ 100,000	
		$200,000
Installment gain		
Cash payment allocated to real estate	$ 0	
Gross-profit percentage	x 0.286	
		$ 0
Total gain recognized in 2024		$200,000

Accordingly, when the assets sold in an installment sale include assets that do not qualify for installment method reporting, such as publicly traded stock or securities, cash payments at closing should be allocated to those nonqualifying assets before qualifying assets. This same principle applies to installment sales involving a dealer disposition, depreciable property sold to a related party, property sold at a loss, and depreciable property subject to recapture.

b. If a §453B(h) liquidation is contemplated, it generally will be advisable to allocate payments on a priority basis to broken lots of inventory that do not qualify for installment sale reporting. While the final regulations seem to achieve the preferred results by providing that cash payments are consideration for broken lots of inventory, remember that unsecured liabilities assumed by the purchaser or liabilities encumbering the inventory that the purchaser assumes or takes subject to are allocated to inventory prior to cash payments.[80] Since such liabilities generally would not trigger gain recognition if they were qualifying indebtedness and were allocated to noninventory assets, gain can be deferred when payments are allocated first to broken lots of inventory and nonqualifying indebtedness is allocated to noninventory assets. Although the regulations do seem to require the allocation of certain liabilities to nonqualifying sales of inventory on a priority basis, they also suggest that, to some degree, the seller's allocations of consideration may override these rules.[81]

c. The rules applicable to contingent payment sales tend to defer the recovery of basis in installment sales. Consequently, it ordinarily will be desirable to allocate contingent consideration to low-basis assets, so that basis recovery can be accelerated with respect to high-basis assets.

80 Treas. Regs. §1.453-11(c)(4)(iii).
81 Treas. Regs. §1.453-11(c)(4)(iv), Example.

Question to ponder:

> A taxpayer is the sole owner of an S corporation who is considering selling the company to an interested buyer. The sale will be an asset sale. She is a new client. She has used a different tax preparer in the past but has been told she needs to see you about the sale. You review the prior year return and see that the incorporation date of the S corporation was April 11, 2014, and the S election was made effective January 1, 2020. What questions do you have and why? What are your concerns?

E. Partnership liquidations

1. In general

Liquidating distributions pursuant to a dissolution are subject to the rules set forth in §§731-735, 737 and 751(b). The rules for redemptions/liquidations of a single partner's interest generally apply.

2. Application of §751(b) to partnership dissolutions

Although it is arguable that §751(b) does not apply to the dissolution of a partnership (in contrast to the liquidation of one partner's interest) based on a literal reading of the statutory language, it is well settled that §751(b) does in fact apply in this context.[82] However, it is difficult to determine how §751(b) applies to a dissolution because the mechanics of the section assume that the partnership will be in existence after the distribution. The most rational approach to the application of §751(b) in the context of a complete dissolution appears to be the simultaneous withdrawal approach pursuant to which the partners are treated as withdrawing simultaneously. Under this approach, the §751(b) exchange with each partner is examined separately with respect to the consequences to the partnership and any income realized by the partnership is allocated to all of the partners, including the distributee partner. In addition, any adjustments to the bases of partnership assets or partnership interests are made. Next, the consequences to the partners under §751(b) and the general distribution provisions are computed giving effect to any adjustments determined in the first step.

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82 See, e.g., Rev. Rul. 77-412, 1977-2 C.B. 223: "Section 751(b) of the Code applies to a non-pro rata distribution of section 751 property in complete liquidation of a two person partnership so that, to the extent either partner receives section 751 property in exchange for other partnership property or receives other partnership property in exchange for section 751 property, the distribution is considered as a sale or exchange of property between the distributee partner and the partnership that consisted, after the distribution, of a single individual."

Learning Questions

1. With respect to the acquisition of a business, which of the following is NOT CORRECT?

   A. Generally, corporations are a more attractive vehicle for making acquisitions from a tax point of view.
   B. The use of an installment obligation to pay for the assets of a company may meet the objectives of the buyer and the seller.
   C. In a contingent price sale, such as an earnout, basis is generally recovered in accordance with the gross profit percentage.

2. In the case of the interest on an installment sale of a business, which of the following is TRUE?

   A. Interest expense paid by an individual buying S corporation stock must be capitalized as acquisition cost.
   B. Investment interest that is disallowed in the year it is incurred may be carried over indefinitely.
   C. All of the interest is deductible in the year of sale by an accrual method taxpayer.

3. With respect to the installment method of accounting, which of the following is TRUE?

   A. Section 179 expense taken on real property is subject to §1245 recapture as ordinary income and qualifies for the installment method of reporting income.
   B. Section 179 expense taken on real property is subject to §1250 recapture as ordinary income and is not eligible for the installment method of reporting income.
   C. Section 179 expense taken on real property is subject to §1245 recapture as ordinary income and is not eligible for the installment method of reporting income.

4. Which of the following statements concerning installment sales is CORRECT?

   A. In the year of the property's sale, the seller treats as a payment the unpaid principal of the mortgage against the property.
   B. The purchaser's note is treated as a payment in the year of sale if the individual purchaser's note is readily tradable, but not on an established market.
   C. The purchaser's note is treated as a payment in the year of sale if the individual purchaser's note is payable on demand.

5. Which of the following statements concerning §1231 property is CORRECT?

   A. Net losses are treated as capital losses to the extent of any §1231 net gains during the preceding five taxable years.
   B. The gain on such property is always capital gain.
   C. Property must generally be held for more than one year.

6. Which of the following statements describes depreciation recapture in an installment sale?

   A. Depreciation recapture increases the gross profit percentage on remaining payments.
   B. The depreciation recapture is recaptured ratably over the period payments are to be made.
   C. Depreciation recapture cannot exceed the total realized gain on the sale.

7. Which of the following statements concerning the installment sale of mortgaged property is CORRECT?

   A. The buyer's assumption of the mortgage is treated as a payment in the year of the sale.
   B. The seller must recognize in the year of sale the excess of the mortgage over the seller's basis in the mortgaged property.
   C. The contract price is the selling price increased by the excess of the mortgage over the seller's basis in the mortgaged property.

8. Which of the following statements concerning a corporate liquidation is NOT CORRECT?

   A. A shareholder generally recognizes capital gain/loss upon receipt of a liquidating distribution.
   B. A shareholder's amount realized on a liquidating distribution is reduced by liabilities assumed or taken subject to.
   C. The calculation of shareholder gain or loss on a complete liquidation is done on an aggregate basis.

9. In the case of an S corporation, which of the following is TRUE?

   A. An S corporation may avoid the built-in gains tax by liquidating during the recognition period.
   B. No gain or loss is recognized by an S corporation when that S corporation distributes appreciated property with respect to its stock.
   C. The Code sections that govern the liquidation of C corporations also apply to the liquidation of S corporations.

Learning Questions – Answers

1. A is **incorrect** because only a corporation may use §338 or the tax-free reorganization features. Investment interest expense limitations do not apply to C corporations, making corporations a tax-favored vehicle for the acquisition of businesses.

   B is **incorrect** because the seller will be able to defer all or part of the gain on the sale, and the buyer will be able to receive a step-up in basis in the assets purchased.

   C is **correct**. Basis must generally be recovered ratably over the period contingent payouts are to be received. This is an exception to the rule that gain is recovered in accordance with the gross-profit percentage. This generally is disadvantageous to the seller because the payments under such price formulae tend to be more front-loaded (if for no other reason than for a cash down payment), resulting in an acceleration of income. However, the regulations permit the seller to adopt an alternative basis recovery if that method is both reasonable and is likely to provide the taxpayer with recovery of basis "at a rate twice as fast as the rate at which basis would have been recovered under the otherwise applicable normal basis recovery rule."

2. A is **incorrect**. Interest expense paid by an individual buying S corporation stock is generally considered to be investment interest expense and is deductible to the extent of investment income. A rare exception is when an employee purchases the stock to protect his or her job.

   B is **correct** because to the extent investment interest is not currently deductible by reason of the investment interest limitation, such interest is treated as investment interest paid or accrued by the taxpayer in the succeeding taxable year; there is no limitation on the number of succeeding taxable years to which it may be carried.

   C is **incorrect** because the reporting of gain may be on the installment method and the interest accrues with the passage of time.

3. A is **incorrect**. Section 179 expense taken on real property is recaptured under §1245 as ordinary income, but the amount recaptured does not qualify for the installment method of accounting.

   B is **incorrect** because §179 expense taken on real property is recaptured under §1245, not §1250.

   C is **correct**. Section 179 expense taken on real property is subject to recapture as ordinary income under §1245. §453 disallows the installment method for §1245 recapture. Therefore, the §1245 recapture of §179 expense taken on real property is ineligible for the installment method of reporting income.

4. A is **incorrect** because in the year of the property's sale, the seller treats as a payment the excess of the unpaid principal of the mortgage against the property over the seller's adjusted basis in the property sold.

   B is **incorrect** because the purchaser's note is treated as a payment in the year of sale to the extent the note is payable on demand or is readily tradable on an established market.

   C is **correct**. One of the exceptions to the nonconstructive receipt of the purchaser's note as payment prior to actual payment is when the seller has the current right to demand payment but elects not to do so.

5. A is **incorrect** because if the gains from dealings in such property exceed any losses for the year, then the net §1231 gain is potentially treated as though it were derived from the sale of a long-term capital asset. This would normally yield capital gain. However, some or all of the gain will be treated as ordinary income to the extent of nonrecaptured net §1231 losses. Nonrecaptured §1231 losses are net §1231 losses in the prior five years that have not been recaptured against §1231 gain (i.e., converted the gain that would have been capital gain back to ordinary income).

   B is **incorrect** because part of the gain realized may be depreciation recapture or a recapture of nonrecaptured net §1231 losses.

   C is **correct**. The major categories of §1231 assets are as follows: (i) depreciable tangible personal property used in a trade or business and held for more than one year; (ii) real property used in a trade or business and held for more than one year; and (iii) trade or business property held for more than one year and involuntarily converted.

6. A is **incorrect** because in computing the gross profit percentage for the regular installment sale, the basis of the property must be increased for the depreciation recapture income recognized in the year of sale, thereby reducing the gross profit percentage.

   B is **incorrect** because no depreciation recapture income under §1245 or §1250 is subject to the installment payment rules and is therefore fully recognized in the year of sale.

   C is **correct**. By definition, depreciation recapture is the lesser of the gain realized or the depreciation taken subject to recapture.

7. A is **incorrect** because the buyer's assumption of the mortgage is treated as a payment in the year of the sale only to the extent it exceeds the seller's adjusted basis.

   B is **incorrect** because the excess of the mortgage over the seller's basis in the mortgaged property is only treated as a payment with respect to which the gain recognized is the gross profit percentage of the excess.

   C is **correct**. The installment sale provisions include many defined terms necessary to its application. Because the excess of the mortgage over the seller's basis is treated as a payment in the year of sale, without backing that amount out of contract price, the gross profit would be understated.

8. A is **incorrect** because, provided that the stock held by the shareholder is a capital asset, the receipt of a liquidating distribution generates capital gain or loss.

   B is **incorrect** because the amount realized by a shareholder on a liquidating distribution is equal to the fair market value of assets received (plus money received) minus liabilities assumed or taken subject to.

   C is **correct**. The calculation of shareholder gain or loss is done on a per-share basis; it is not done on an aggregate basis. Gain or loss is computed separately for each block of stock acquired at different prices and dates. For example, if A acquires 200 shares of stock in corporation X for $8,000 in year 1 and 160 shares of X stock in year 2 for $10,000, a liquidating distribution of $60 per share in June of year 2 would produce $4,000 of long-term capital gain on the year 1 block and $400 of short-term capital loss on the year 2 block.

9. A is **incorrect** because an S corporation is bound by the same rules that apply to a C corporation. A disposition of property triggers the realization and recognition of gain, which is the trigger, during the recognition period, of the recognition of built-in gain by an S corporation. The tax is applied to the asset appreciation (the excess of fair market value over basis) that took place prior to the S election and is imposed on gains recognized within a five-year period after conversion to an S corporation; there is no exception for disposition by liquidation.

   B is **incorrect** because the rules applicable to corporate distributions, other than ordinary dividends, made by a C corporation apply to distributions made by an S corporation. When an S corporation distributes appreciated property with respect to its stock, an S corporation is treated as though it sold the distributed property to its shareholders at fair market value. The gain recognized by an S corporation generally passes through to its shareholders, along with other items of income and loss, on a per-share, per-day basis and increases their bases in their stock. The character of the recognized gain is determined at the corporate level and depends upon the character of the asset distributed. If the gain is attributable to recapture items; however, it is ordinary. A distribution or sale of appreciated property in connection with a redemption also affects an S corporation's AAA and perhaps its accumulated earnings and profits.

   C is **correct**. The liquidating provisions that govern the liquidations of C corporations likewise apply to S corporations. All corporate provisions apply to S corporations except where specifically overridden, primarily by Subchapter S or a provision elsewhere in the Internal Revenue Code such as §453B(h).

GLOSSARY

Accumulated earnings tax is a 20 percent penalty tax on a corporation's accumulated taxable income that applies to any corporation formed or availed of for the purpose of avoiding the income tax on its shareholders.

Acquired MACRS property is MACRS property in the hands of the acquiring taxpayer that is acquired in a transaction described in a §1031 like-kind exchange for other MACRS property or that is acquired in connection with an involuntary conversion of other MACRS property in a transaction to which §1033 applies.

Adjusted depreciable basis is the unadjusted depreciable basis of the property, less the adjustments described in §§1016(a)(2) and (3).

Amount paid to facilitate the acquisition or creation of an intangible (the transaction) is an amount paid in the process of investigating or otherwise pursuing the transaction. Whether an amount is paid in the process of investigating or otherwise pursuing a transaction is determined based on all facts and circumstances. The fact that an amount would (or would not) have been paid but for the transaction is not relevant, but not determinative, in determining whether the amount is paid to facilitate the transaction. An amount paid to terminate (or facilitate the termination of) an existing agreement does not facilitate the acquisition or creation of another agreement. An amount paid to facilitate a borrowing does not facilitate an acquisition or creation of an intangible.

Applicable asset acquisition is any transfer, whether direct or indirect, of a group of assets if the assets transferred constitute a trade or business in the hands of either the seller or the purchaser and, except as provided in nonrecognition exchanges, the purchaser's basis in the transferred assets is determined wholly by reference to the purchaser's consideration. The allocation rules of §1060(a) apply. For these purposes, a group of assets constitutes a trade or business if the use of such assets would constitute an active trade or business under §355, or its character is such that goodwill or going-concern value could under any circumstances attach to such group.

Bootstrap acquisition is a leveraged buyout (LBO) in which the buyer purchases some of the stock of the target corporation from the selling shareholders and the target redeems the rest, paying the price in cash if the target has cash, or in installment notes if the target does not.

Built-in gains tax is a corporate-level 21 percent tax applied to the asset appreciation (the excess of fair market value over basis) that took place prior to the S election and is imposed on gains recognized within a five-year period after conversion to an S corporation.

Business income is income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations. Such income is generally apportioned to a state using the simple average of three measures (or factors) of economic activity within and without the state: property, payroll, and sales.

Business interest expense is interest expense allocable to the operation of a trade or business, such as interest expense on an equipment loan.

Business interest income is interest income that is allocable to the operation of a trade or business, such as interest income generated by accounts receivable.

Capital account is an account on an LLC's balance sheet that represents the members' equity in the LLC. The regulations include specific requirements under §§704(b) and 704(c) for maintenance of the capital accounts for LLC allocations to be respected.

Capitalization multiplier is the reciprocal of the capitalization rate and is used to multiply an assumed constant earnings stream to calculate the value of the business.

Capitalization rate is the rate of return for risk-free liquid investments (e.g., current Treasury bill yields) adjusted for the lack of liquidity and then increased for the economic risks associated with the business, including inflationary industry-dependent risks.

Capitalized earnings method for evaluating the worth of a company concentrates on potential net earnings. Starting with the income statement, the accountant should make adjustments that will help to identify the true earning power of the company.

COBRA benefit is the right of an employee or family member of that employee to elect to continue to be covered under the health care plan in certain circumstances in which the individual employee or family member of that employee would otherwise lose health care coverage.

Combined report is not a tax return but a worksheet used to determine that portion of the unitary business income attributable to sources within the state generated by members of the group that have tax nexus to the state. The combined reporting method generally treats an affiliated group of corporations conducting a unitary business both within and without the taxing state as a single entity, typically allocating the group's unitary income to the state by using a combined apportionment ratio. Intercompany transactions are eliminated (to a varying degree) from both the income base and the apportionment formula.

Computer is a programmable, electronically activated device that is capable of accepting information, applying prescribed processes to the information, and supplying the results of these processes with or without human intervention, and consists of a central processing unit containing extensive storage, logic, arithmetic, and control capabilities.

Computer software is any program or routine (that is, any sequence of machine-readable code) that is designed to cause a computer to perform a desired function or set of functions, and the documentation required to describe and maintain those programs.

Confidentiality statement is created for the protection of the potential seller and defines the kinds of inside information about the business that, until the business is sold to that buyer, the buyer is precluded from divulging to the public. To prevent the prospective buyer from breaching with impunity, the agreement should provide for a fixed dollar amount so that once the seller establishes the disclosure by the prospective buyer, the damages are fixed.

Covered transaction means the following transactions: (i) a taxable acquisition by the taxpayer of assets that constitute a trade or business; (ii) a taxable acquisition of an ownership interest in a business entity (whether the taxpayer is the acquirer in the acquisition or the target of the acquisition) if, immediately after the acquisition, the acquirer and the target are related within the meaning of §267(b) or §707(b); or (iii) a reorganization described in §§368(a)(1)(A), (B), or (C) or a reorganization described in §368(a)(1)(D) in which stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under §354 or §356 (whether the taxpayer is the acquirer or the target in the reorganization).

Customer-based intangible is any composition of market, market share, or other value resulting from the future provision of goods or services pursuant to contractual or other relationships in the ordinary course of business with customers.

Deemed asset sale is the transaction deemed to occur in a purchase that takes the form of a stock sale when the purchasing corporation makes a §338 election.

De minimis means that the aggregate of all amounts paid to that party (or those parties) with respect to an agreement does not exceed $5,000. De minimis amounts paid to another party (or parties) to create, originate, enter into, renew, or renegotiate with that party (or those parties) an agreement are excepted from capitalization. If the aggregate of all amounts paid to the other party (or parties) with respect to that agreement exceeds $5,000, then all amounts must be capitalized.

Depreciable excess basis is the excess basis reduced by: (i) the percentage of such basis attributable to the taxpayer's use of property for the taxable year other than in the taxpayer's trade or business (or for the production of income); (ii) any portion of the basis the taxpayer properly elects to treat as an expense under §179; and (iii) any adjustments to basis provided by other provisions of the Internal Revenue Code and the regulations under the Code [including §§1016(a)(2) and (3), for example, depreciation deductions in the year of replacement allowable under §§168(k) or 1400L(b)].

Depreciable exchanged basis is the exchanged basis reduced by: (i) the percentage of such basis attributable to the taxpayer's use of property for the taxable year other than in the taxpayer's trade or business (or for the production of income); and (ii) any adjustments to basis provided by other provisions of the Internal Revenue Code and the regulations under the Code [including §§1016(a)(2) and (3), for example, depreciation deductions in the year of replacement allowable under §§168(k) or 1400L(b)].

Depreciable property is property that is of a character subject to the allowance for depreciation as determined under §167.

Discounted cash flow method is a valuation method that focuses on the future cash flows of the business. Cash flow is the actual cash received by the business/business owner and is often not the same as net income. Adjustments to earnings must be made for depreciation, deferred taxes, and other items, in addition to all the other adjustments discussed in the capitalization of earnings method. Like earnings, cash flow is determined on an after-tax basis because this represents the net value to the business owner. With respect to the net cash flow for all subsequent years, the value of each future cash flow is determined by present-value techniques.

Estimated residual value corresponds to the cash flow that would arise at a point in the future if the business were sold for its then fair market value. To estimate this value, the capitalization of earnings method may be applied as if cash flow in the residual year were earnings. Typically, the accountant will use the projected net cash flow for the final year in which a future cash flow is determined. However, this estimated future cash flow must itself also be discounted back to a present value.

Excess basis is any excess of the basis in the acquired MACRS property or acquired computer software, as applicable and as determined under §1031(d) or §1033(b) and the regulations thereunder, over the carryover basis as defined in this glossary.

Exchanged basis is determined after the depreciation deductions for the year of disposition are determined and is the lesser of: (i) the basis in the replacement MACRS property, as determined under §1031(d) and the regulations under §1031(d) or §1033(b) and the regulations under §1033(b); or (ii) the adjusted depreciable basis [as defined in §1.168(b)-1T(a)(4)] of the relinquished MACRS property.

Exchanged or involuntarily converted computer software is computer software that is transferred by the taxpayer in a like-kind exchange under §1031 or that is converted as a result of an involuntary conversion under §1033.

Exchanged or involuntarily converted MACRS property is MACRS property that is transferred by the taxpayer in a like-kind exchange, or that is converted as a result of an involuntary conversion to which §1033 applies.

Floor amount is a minimum amount that something must exceed for a condition to apply, as opposed to a ceiling amount, which is a maximum amount for which a condition applies.

Going-concern value is the additional value that attaches to property by reason of its existence as an integral part of an ongoing business activity. Going-concern value includes the value attributable to the ability of a trade or business (or a part of a trade or business) to continue functioning or generating income without interruption notwithstanding a change in ownership, but it does not include any of the other intangibles. It also includes the value that is attributable to the immediate use or availability of an acquired trade or business, such as, for example, the use of the revenues or net earnings that otherwise would not be received during any period if the acquired trade or business were not available or operational.

Goodwill is the value of a trade or business attributable to the expectancy of continued customer patronage. This expectancy may be due to the name or reputation of a trade or business or any other factor.

Investment expenses are those expenses other than investment interest that are directly connected with the production of investment income.

Investment income is the sum of the gross income from property held for investment (other than gain from the sale of property held for investment and qualifying dividends) and the excess, if any, of the net gain attributable to the sale of property held for investment over the net capital gain determined by only taking into account gains and losses from the dispositions of property held for investment, plus, if elected, the lesser of net gain or the net capital gain (as limited above) and, if separately elected, qualifying dividends.

Inside basis is the LLC's basis in its assets, which is initially equal to the basis the contributing member had in the property.

Installment sale is any sale of property with respect to which at least one payment is to be received after the end of the taxable year of the sale.

Installment sale reporting is a method of tax accounting that applies to any installment sale for which the seller has not elected out. In this method, any depreciation recapture is recognized in the year of sale and any remaining gain is recognized as payments are received by multiplying the amount of the payment (not including interest or other amounts treated as interest) by the gross profit percentage.

Letter of intent or memorandum of understanding is a document that provides both the buyer and the seller assurances of the price and terms of a sale and normally gives the buyer the exclusive right to buy the business for a set period of time. This document precedes the signing of any final contract and lacks some of the other provisions of that agreement.

Leveraged buyout (**LBO**) refers to the use of borrowed money to buy a business with the business's assets and earnings being used to pay off the debt. The LBO principle is similar to the use of nonrecourse debt to buy real estate where the lender, in evaluating the credit risk, knows that it can look only to the property's value and earnings to pay off the debt and not to the general resources of the borrower.

Lien is a right of a creditor to force the sale of a specific asset if the creditor is not paid. While some liens are created by law, most are the result of a security agreement that, when duly recorded, perfects the ability of the creditor to take specific action with respect to such property even if the ownership of the property should later change hands.

Like-kind exchange is an exchange of property for other property (or money) in a transaction to which §§1031(a)(1), (b), or (c) applies.

Liquidation of a member's LLC interest occurs when the LLC transfers consideration to the member in exchange for the member's relinquishment of the LLC interest.

Liquidation refers to, under state law, the sale by the LLC of its assets and the distribution of the net cash proceeds to the members.

Liquidation value is the amount that would be available to the common shareholders in the event a business is liquidated. In a liquidation, time and outside pressure to sell are often factors to consider. Liquidation value normally represents the minimum asking price.

Liquidity discount is an additional multiplier of generally between 20 percent and 40 percent that adjusts the value of a business because of the absence of a ready market.

MACRS property is tangible, depreciable property that is placed in service generally after December 31, 1986, and subject to §168, except for property excluded from the application of §168 as a result of §168(f) or as a result of a transitional rule.

Negotiation in the context of this course is the process of a buyer and seller arriving at a value of a business that the purchaser is willing to pay and the buyer is willing to accept.

Net investment income is the excess, if any, of investment income over investment expenses.

Net precontribution gain is the net gain (if any) that would have been recognized by the distributee member under §704(c)(1)(B) if all property that had been contributed to the LLC by the distributee member within seven years of the distribution (five years in the case of a contribution made on or before June 8, 1997) and is held by the LLC immediately before the distribution had been distributed by the LLC to another member other than a member who owns, directly or indirectly, more than 50 percent of the capital or profits interest in the LLC.

Nonbusiness income generally includes the following: (i) rents and royalties from real and tangible personal property; (ii) capital gains and losses from sales of real and personal (tangible and intangible) property; (iii) interest and dividends; and (iv) patents and copyright royalties. Such income is allocated entirely to a particular state, usually on the basis of the type of income or the type of property.

Nonrecourse liability is an LLC debt where none of the members have any personal liability. Except for guaranteed debts, all LLC liabilities will be nonrecourse.

Original issue discount is unstated interest on a note that provides inadequate stated interest. This occurs when the note's stated principal amount exceeds the present value of all payments due on the note discounted at the *applicable federal rate (AFR)* compounded semiannually.

Outside basis is the member's basis in the LLC, which is initially equal to the sum of the money and the adjusted bases of property contributed to the LLC.

Pass-through deduction (PTD) is the common term used to refer to the new §199A deduction created by the Tax Cuts and Jobs Act of 2017.

Pass-through entity refers to a business operated as a partnership, S corporation, or proprietorship where the results of operations are passed through to the owner.

Pass-through losses are losses passed through to an owner by a pass-through entity.

Personal holding company is a corporation where: (i) five or fewer shareholders own more than 50 percent of the value of the corporate stock during the last half of the taxable year; and (ii) 60 percent of the adjusted ordinary gross income of the corporation consists of personal holding company income. Such companies must pay, in addition to the regular corporate tax, a penalty tax in the amount of 15 percent of the company's undistributed personal holding company income.

Present value of a future cash flow is that amount which, if invested today at a specified rate of return, would generate the future cash flow at that point in the future. The specified rate of return is called the "discount rate." Like other rates of return, it must include not only a return on the amount invested, but also a return on the risk incurred. The discount rate is expressed in after-tax terms.

Push-down accounting is the practice of attributing a corporate parent's item of income or expense (or asset, liability, or basis) to a subsidiary of that parent. The item is generally attributable to or related to the subsidiary, but was originally, and still might be legally, the parent's. Under the SEC Staff Accounting Bulletin No. 73, debt may be pushed down if the subsidiary assumes the debt of the parent either presently or in a planned transaction in the future, the proceeds of the debt incurred by the subsidiary will be used to retire all or a part of the parent's debt, or the subsidiary guarantees or pledges its assets as collateral for the parent's debt.

Qualified subchapter S subsidiary (QSub) is a domestic corporation that is: (i) 100 percent owned by an S corporation and that is not an ineligible corporation (i.e., a corporation that would be eligible to be an S corporation if the stock of the corporation were held directly by the shareholders of its parent S corporation) if 100 percent of the stock of the subsidiary were held by its S corporation parent; and (ii) the parent S corporation elects to treat the subsidiary as a QSub.

Qualifying disposition is a disposition of stock in an S corporation that permits the closing-of-the-books method of allocation of tax items for a taxable year. It must be one of three dispositions: (i) a disposition by a shareholder of 20 percent or more of the outstanding stock of the corporation in one or more transactions during any 30-day period during the corporation's taxable year; (ii) a redemption treated as an exchange of 20 percent or more of the outstanding stock of the corporation from a shareholder in one or more transactions during any 30-day period during the corporation's taxable year; or (iii) a disposition by a shareholder of 20 percent or more of the outstanding stock of the corporation in one or more transactions during any 30-day period during the corporation's taxable year.

Recapture income is the aggregate amount that would be treated as ordinary income under §§1245 or 1250. In addition, recapture income also includes any amount expensed under §179. Recapture income may also include any ordinary income recognized by corporate taxpayers under §291. Section 291 requires that 20 percent of what would otherwise be §1231 (capital) gain on the sale of §1250 property be recognized as ordinary income.

REIT income is income from a real estate investment trust. REIT income is qualified business income for §199A if it is not a capital gain distribution or a qualified dividend.

Relinquished MACRS property is MACRS property that is transferred by the taxpayer in a like-kind exchange, or in an involuntary conversion.

Remaining carryover basis is the carryover basis as defined in this glossary reduced by: (i) the percentage of the taxpayer's use of property for the taxable year other than in the taxpayer's trade or business (or for the production of income); and (ii) any adjustments to basis provided by other provisions of the Code and the regulations thereunder [including §1016(a)(2) and (3)] for periods prior to the disposition of the exchanged or involuntarily converted property.

Remaining excess basis is the excess basis as defined in this glossary reduced by: (i) the percentage of the taxpayer's use of property for the taxable year other than in the taxpayer's trade or business (or for the production of income); (ii) any portion of the basis the taxpayer properly elects to treat as an expense under §179; and (iii) any adjustments to basis provided by other provisions of the Code and the regulations thereunder.

Renegotiating a financial interest is any transaction in which the terms of the financial interest are modified. It also includes any situation in which the taxpayer enters into a new financial interest with the same party (or substantially the same parties) to a terminated financial interest, the taxpayer could not cancel the terminated financial interest without the consent of the other party (or parties), and the other party (or parties) would not have consented to the cancellation unless the taxpayer entered into the new financial interest. A taxpayer is treated as unable to cancel a financial interest without the consent of the other party (or parties) if, under the terms of the financial interest, the taxpayer is subject to a termination penalty and the other party (or parties) to the financial interest modifies the terms of the penalty.

Reproduction value is the cost of reproducing the assets of the business. In many businesses the cost of duplicating the assets would be higher than the amount shown on the balance sheet because of depreciation and inflation. A major disadvantage of reproduction value is that it tends to set a high asking price for a business.

Risk a buyer is willing to assume in purchasing a business is the percentage return the purchaser needs for his investment.

Section 199A pass-through deduction is a new deduction allowed to owners of pass-through businesses such as S corporations, partnerships and sole proprietorships. The deduction is 20 percent of the qualified business income of qualified trades or businesses.

Section 704(c) property is property contributed to an LLC, where, at the time of contribution, its book value differs from the contributing member's adjusted tax basis.

Section 732(d) basis adjustment is an adjustment under which a buying member who acquired an LLC interest by a transfer when there is no §754 election in effect may elect, with respect to distributions, within two years after the transfer, to adjust the bases of the LLC's assets as if a §743(b) adjustment had taken place. In addition, a member who acquired any part of a LLC interest in a transfer to which the election provided in §754 was not in effect, is required to apply the special basis rule contained in §732(d) to a distribution to the member, whether or not made within two years after the transfer, if at the time of his acquisition of the transferred interest the fair market value of all LLC property (other than money) exceeded 110 percent of its adjusted basis to the LLC.

Section 734(b) basis adjustment is an adjustment made following a distribution of property (including money) to a member, if an LLC has a §754 election in effect. The adjustment increases the inside basis of the LLC's assets by the amount of any §731(a)(1) gain recognized by the distributee member and, if the §732(a)(2) limitation applies, by the excess of the basis the distributed asset has to the LLC over the basis it had to the distributee member.

Section 743(b) basis adjustment is an adjustment made following a transfer (by sale, exchange, or death of a member) of an LLC interest if an LLC has a §754 election in effect. The adjustment increases or decreases the inside basis of the LLC's assets by the difference between the transferee's outside basis and the transferee's proportionate share of inside basis.

Section 751 property is a category of assets described in §751 that includes: (i) unrealized receivables (amounts received for the sale of goods or services, depreciation recapture under IRC §§1245 and 1250, and intangible drilling costs recapture under §1254); and (ii) inventory (inventory for this purpose includes any property not considered a capital asset or a §1231 asset). The transfer of an LLC interest holding §751 property may result in ordinary income instead of capital gain. A disproportionate distribution from an LLC with §751 assets can also result in the recognition of ordinary income. Section 751 assets are also sometimes referred to as "hot assets."

Section 754 election is an LLC election (revocable only with IRS approval) to adjust the inside basis of LLC assets with respect to a transferee member who has acquired a member interest from another member (the optional basis adjustment). The LLC's inside basis with respect to other members is not affected. The election also applies when certain property distributions to members result in basis discrepancies between the member and the LLC or result in taxable gain or loss to the distributee member. When the §754 election results from a transfer, it causes the transferee member's share of LLC assets' inside basis to reflect the outside basis of his or her LLC interest.

Self-created intangible is a §197 intangible and is an intangible created by the taxpayer to the extent the taxpayer makes payments or otherwise incurs costs for its creation, production, development, or improvement, whether the actual work is performed by the taxpayer or by another person under a contract with the taxpayer entered into before the creation, production, development, or improvement occurs.

Separate and distinct intangible asset means a property interest of ascertainable and measurable value in money's worth that is subject to protection under applicable state or federal law and the possession and control of which is intrinsically capable of being sold, transferred, or pledged (ignoring any restrictions imposed on assignability) separate and apart from a trade or business. In addition, a fund (or similar account) is treated as a separate and distinct asset of the taxpayer if amounts in the fund (or account) may revert to the taxpayer.

Superfund is the fund established to pay for the cleanup of sites where no responsible party can be found to pay for the cleanup. The law imposes strict joint and several liability for cleaning up sites that are releasing or threaten to release hazardous substances to the environment on anyone with certain specified connections to the site, unless the parties can prove a reasonable basis for apportioning that liability.

Supplier-based intangible is the value resulting from the future acquisition, pursuant to contractual or other relationships with suppliers in the ordinary course of business, of goods or services that will be sold or used by the taxpayer.

Target is the corporation the stock of which is acquired by another corporation in a qualified stock purchase.

Time of disposition is when the disposition of the exchanged or involuntarily converted MACRS property or the exchanged or involuntarily converted computer software, as applicable, takes place.

Time of replacement is the later of: (i) when the property received in the exchange or involuntary conversion is placed in service; or (ii) the time of disposition of involuntarily converted property.

Transaction means all of the factual elements comprising an acquisition or creation of an intangible and includes a series of steps carried out as part of a single plan. Thus, a transaction can involve more than one invoice and more than one intangible asset. For example, a purchase of intangibles under one purchase agreement may constitute a single transaction, notwithstanding the fact that the acquisition involves multiple intangibles and the amounts paid to facilitate the acquisition are capable of being allocated among the various intangibles acquired.

12-month rule refers to the exclusion from capitalization of amounts paid to create (or facilitate the creation of) any right or benefit for the taxpayer that extends beyond the earlier of: (i) 12 months after the first date on which the taxpayer realizes the right or benefit; or (ii) the end of the taxable year following the taxable year in which the payment is made.

Unadjusted depreciable basis is the basis of property for purposes of §1011 without regard to any adjustments described in §§1016(a)(2) and (3). This basis reflects the reduction in basis for the percentage of the taxpayer's use of property for the taxable year other than in the taxpayer's trade or business (or for the production of income), for any portion of the basis the taxpayer properly elects to treat as an expense under §179, and for any adjustments to basis provided by other provisions of the Internal Revenue Code [other than §1016(a)(2) and (3)] [for example, a reduction in basis by the amount of the disabled access credit pursuant to §44(d)(7)].

Unitary business is one in which: (i) all of its activities are in the same general line; (ii) its various divisions or segments are engaged in different steps in a large, vertically structured enterprise; or (iii) there is strong central management, coupled with the assistance of centralized departments for functions such as financing, advertising, research, or purchasing.

Workforce in place (sometimes referred to as "agency force" or "assembled workforce") includes the composition of a workforce (for example, the experience, education, or training of a workforce), the terms and conditions of employment whether contractual or otherwise, and any other value placed on employees or any of their attributes.

