Marquette Law Review

Volume 36
Issue 3 *Winter 1952-1953*

Article 4

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Joseph Berman

TAX CONSIDERATIONS IN PLANNING THE SALE OR PURCHASE OF A BUSINESS

JOSEPH BERMAN*

Heavy taxation in recent years has taught prospective sellers of any business or property to be wary of tax problems involved in every transaction and they now usually seek tax advice beforehand. Tax laws still afford some leeway in minimizing the tax burden, and if well-informed attorneys are consulted before the seller has entered into legally binding agreements they can render valuable services.

We shall consider here the more important tax considerations involved in the sale of property and show some of the advantages or disadvantages which result from adopting one method or another. We assume here that all transactions are bona fide arm's length sales between unrelated parties for cash or other consideration which do not involve the application of the reorganization provisions of the Internal Revenue Code.

We encounter the following problems: 1. Fixing the amount of the gain or loss involved; 2. determining whether the gain or loss is to be reflected at capital or ordinary tax rates; 3. determining when the gain or loss is realized; 4. determining whether the gain or loss will be recognized. The solution of these problems will depend equally upon the subject matter and the form of the transaction. We will deal first with the sale of a sole proprietorship, and then with the problems peculiar to the sale of a partnership.

In the sale of a sole proprietorship the seller has no choice but to treat it as a sale of the individual assets which comprise the business, with one exception. He can incorporate and sell the stock, thus converting any ordinary gain into capital gain.[1] It will not be necessary to hold the stock for six months in order to be able to take advantage of the long-term capital gain tax rate since under Section 117 (h) (1) of the Internal Revenue Code the holding period of the assets can be tacked onto the holding period of the stock. The obvious difficulty with this plan is that the costs of incorporation may so nearly equal the tax saving as to be impractical. Also, it should be pointed out that if the buyer liquidates the corporation soon after the purchase of the stock the gov-

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* Member of the New York Bar. The author wishes to express his thanks for editorial assistance to Lawrence Kaminski and Gaylord Henry, Student Editors of the Marquette Law Review.

[1] Gracey v. Commissioner of Internal Revenue, 159 F.2d 324 (5th Cir. 1947).

ernment may attempt to treat the transaction as a sale of assets by the corporation, although to date it has not had much success.[2]

The seller of a sole proprietorship should first determine the basis of his assets, and then adjust them. The attorney should be especially careful here to make all possible upward adjustments allowed under the Code and the Regulations. An excess of the amount realized over the adjusted basis will be gain, and an excess of adjusted basis over the amount realized will be loss. The gain or loss will have to be computed separately for each asset. Therefore it is apparent that there can be gain on some assets and loss on others, and both gains and losses may be subject to either capital or ordinary tax treatment. Due to the lower tax rates on long-term capital gains and the limited deductibility of capital losses it will be to the seller's advantage to attribute the gain, wherever possible, to the sale of the capital assets and the losses to the non-capital and short-term capital assets.

The Code[3] does not permit any choice in classifying assets as capital or non-capital. Bank accounts are capital assets, but there will usually be no gain or loss on them, except on accounts in closed banks.[4] Tangible fixed assets and stock in trade are non-capital assets. Attempts made to classify merchandise and inventory held for sale in the ordinary course of business as capital assets, on the theory that the intention to discontinue a business converts them from property held for sale in the course of business, were unsuccessful,[5] but in a proper case where the business had been discontinued for some length of time before the sale it might be considered meritorious. Some rather fine distinctions are drawn in determining whether or not property is used in the trade or business.[6]

Investments in securities and accounts receivable, if held for collection instead of for sale in the ordinary course of business, are capital assets.[7] But obligations of the United States are not capital assets.[8] It might be well to point out here the advisability of charging off uncollectible accounts as bad debts before the sale wherever possible; otherwise the loss will be treated as a capital loss and deductible only to the extent of capital gains.[9] Certain fixed assets, including machinery, equipment and real estate used in the trade or business, although not

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2 Steubenville Bridge Co., 11 T.C. 789 (1948); Armored Tank Corporation, 11 T.C. 644 (1948); Dallas Downtown Development Co., 12 T.C. 114 (1949); Bethlehem Steel Co., CCATCM. Rep. Dec. No. 17, 900(M) (1950).

3 INT. REV. CODE §§117(a), 117(j).

4 Ralph Perkins, 41 B.T.A. 1225 (1940).

5 Grace Bros., Inc., 10 T.C. 158 (1948).

6 Miller, *The "Capital Gain" Concept: A Critique of Capital Gains Taxation*, 59 YALE L. J. 837, 1057 (1950).

7 Graham Mill & Elevator Co. v. Thomas, 152 F.2d 564 (5th Cir. 1945).

8 INT. REV. CODE §117(a)(1)(A).

9 See note 7 *supra*.

capital assets, may receive capital gain treatment under Section 117 (j). Good will is a capital asset, but presents many peculiar problems of its own.

The next step is to allocate the purchase price among the assets, ascribing gains, as far as possible, to the capital assets and losses to the non-capital assets. Care should be taken, however, that the allocations are not too unrealistic. The Bureau of Internal Revenue has often questioned the taxpayer's allocations, and substituted allocations of the Bureau have been upheld by the courts in extreme cases.[10] The best proof in support of allocations is a contract of sale listing the prices for the various assets. In the absence of bad faith or unrealistic allocations not justified by actual value, such listings will be accepted.[11] It is advisable to have clients make allocations according to the actual relative worth of the assets. Also it is well to note that inconsistency of treatment on clients' books arouses the suspicions of the Bureau, and such inconsistencies have usually been corrected by the courts.[12]

The seller may encounter a good deal of resistance in allocation from the buyer, who has his own tax problems. The buyer usually desires a high basis for inventory and depreciable assets, and is opposed to a high price attributable to good will. Section 117 (j) of the Code has to a large degree removed this cause of friction, and in cases where a business has substantial fixed depreciable assets, enables both seller and buyer to be benefited taxwise by allocating a large part of the consideration to such assets. There remains a pronounced conflict of interests in cases of sales of businesses with few tangible assets. In these cases it is desirable to adjust the purchase price intead of leaving clients at the mercy of the Bureau.

The greatest source of trouble is the allocation of good will.[13] It is usually held to be a non-depreciable capital asset, and is of little tax benefit to the buyer but of great tax benefit to the seller.[14] The Bureau will usually oppose the taxpayer in these cases, whether he be the buyer or the seller. The usual argument would be that the seller had no good will to sell;[15] that if he had it, it was not sold;[16] if sold, it was not worth

[10] Constantine H. Kavalaris, 5 T.C.M. 18 (1946); Estate of John C. Burns, 6 T.C.M. 973 (1947); Violet Newton, 12 T.C. 204 (1949).

[11] Fraser v. Nants, 8 F.2d 106 (D.C. Ohio, 1925); Republic Steel Corporation v. United States, 40 F.Supp. 1017 (Ct. Cl. 1941).

[12] Toledo Newspaper Co., 2 T.C. 794 (1943); Mrs. Franklin Shops of Philadelphia, Inc., 3 T.C.M. 401 (1944); Ellen J. Franklin, 6 T.C.M. 1099 (1947); Toledo Blade Co. v. Commissioner, 180 F.2d 357 (6th Cir. 1950).

[13] Berman, *The Valuation of Property for Estate, Gift and Income Tax Purposes,* 29 CHI-KENT REV. 231; 5 LAW & L. NOTES 23 (1951); Davies, *The Valuation of Good Will,* etc., 31 NEB. L. REV. 559 (1952).

[14] INT. REV. CODE §117(a)(1).

[15] Fox River Paper Co. v. United States, 65 F.Supp. 605 (E.D. Wis. 1946).

[16] Stratton Grocery Co., 8 B.T.A. 317 (1927); Shilling Grain Co., 8 B.T.A. 1048 (1927); Grace Bros., Inc. v. Commissioner, *supra* note 5.

the amount allocated to it;[17] or that the amount allegedly paid for good will was instead the consideration for a contract to eliminate competition and therefore ordinary income.[18]

The taxpayer has the burden of proof as to the value of good will,[19] the question being one of fact.[20] The testimony of witnesses who are experts in that particular type of business is given great weight by the courts in fixing the value of good will.[21] Proper record should be made of good will by the seller if he intends to avail himself of it. Its existence can be proven by substantial earnings, a valuable trade repute, a good business location, and a sale at a price in excess of tangible assets.[22] It can also be proven by the transfer of the name of the business, customers lists, personnel, and seller's covenant restricting himself from competing with the buyer. If the covenant not to compete can be severed from the rest of the transaction for purposes of valuation, the consideration given for it will be ordinary income. But if it accompanies a transfer of good will and has the primary function of assuring to the buyer the enjoyment of the good will it is treated as non-severable and part of the good will.[23] In the sale of a professional or personal business there is usually few tangible assets, and most of the profits are attributed to good will.[24]

If the seller is a corporation, payments made to the officers for covenants to not compete are treated as ordinary income.[25] Where payment is made to the corporation, and not to its officers, in order to protect good will and not primarily to prevent competition it is treated as price paid for good will; not ordinary income of the seller nor deductible or depreciable by the buyer.[26] If its purpose was to eliminate the seller's competition the payment is treated as ordinary income.[27]

Apart from the taxes saved by properly allocating the purchase price among the various assets, further savings can be had by choosing the best method of handling the transaction. What method will be the best depends upon the particular circumstances of each transaction, consider-

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17 Estate of John C. Burns, *supra* note 10.
18 Constantine H. Kavalaris, *supra* note 10.
19 Schulz Baking Co., 3 B.T.A. 470 (1926).
20 Delaware Trucking Co., 3 B.T.A. 1211 (1926).
21 Howard B. Lawton, 6 T.C. 1093 (1946); Henry L. Watkins, 19 T.C. Mem. Dec. 407 (1950).
22 Dodge Bros., Inc., v. United States, 118 F.2d 95 (4th Cir. 1941); *cf.* Grace Bros., Inc., *supra* note 5 (for a list of the elements composing good will.)
23 Acme Palmers & DeMooy Foundry Co., 3 B.T.A. 1126 (1925); Aaron Michaels, 12 T.C. 17 (1949).
24 Rodney B. Horton, 13 T.C. 143 (1949).
25 Cox v. Helvering, 71 F.2d 987 (D.C. Cir. 1934); Salvage v. Commissioner, 76 F.2d 112 (2nd Cir. 1935); Beal's Estate v. Commissioner, 82 F.2d 268 (2nd Cir. 1936).
26 News Leader Co., 18 B.T.A. 1212 (1930).
27 Estate of Mildred K. Hyde, 42 B.T.A. 738 (1940).

ing the parties involved and their personal requirements, the subject matter of the sale, and the financial situation. All that can be done here is to point out the tax consequences of some of the various aspects of the sale.

When the sale is partly for cash and partly for other property realization of some of the gain can quite often be deferred until later years, thus reducing the taxes for the year in which the sale took place, and sometimes keeping the taxpayer out of a higher tax bracket. The amount realized in such a transaction will consist of the sum of the cash and the fair market value of the other property received.[28]

Usually the property received, other than cash, as part of the consideration consists of notes or some other type of security. Notes are usually included in the amount realized to the extent of their fair market value,[29] the burden of proof resting on the taxpayer, but negotiable promissory notes of a responsible and solvent maker have been held includible as cash at their face value.[30] Non-negotiable notes, payment of which was dependent upon a contingency, were held not the equivalent of cash.[31]

It has been held that a mere sales contract is not property other than money to its fair market value, and therefore not a part of the amount realized, as to a taxpayer who reports on the cash basis. The result would be different, however, if notes, mortgages or other evidences of indebtedness had been received.[32] Stock in a corporation received as part of the consideration was held to have a fair market value and includible to that extent in the amount realized, although it was not to be sold without the consent of the other stockholders.[33]

Sometimes the property received, other than money, has been held to have no determinable market value, although it definitely does have some value. This usually occurs only when the payment or amount of payment is dependent upon some contingency. In such cases the cash and other property with a determinable market value are considered merely as a return of capital, and there is no gain until an amount equal to the adjusted basis of the property sold has been received. After that any more payments received are taxed as gain, in the year in which received. So where stock was sold for cash and a share of the profits

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[28] INT. REV. CODE §111(b); Tex-Penn. Oil Co., 28 B.T.A. 917 (1933); Gould Securities Co., Inc. v. United States, 96 F.2d 780 (2nd Cir. 1938).

[29] A. & A. Tool & Supply Co. v. Commissioner, 182 F.2d 300 (10th Cir. 1950).

[30] Aaron W. Wolfsan, 1 B.T.A. 538 (1925); Liberty Agency Co., 5 B.T.A. 778 (1926).

[31] Mainard E. Crosby, 14 B.T.A. 980 (1929); Carling Dinkler, Executor, 22 B.T.A. 329 (1931); Edward J. Hudson, 11 T.C. 1042 (1948).

[32] Harold W. Johnson, 14 T.C. 560 (1950).

[33] Newman v. Commissioner, 40 F.2d 225 (10th Cir. 1930).

of future ore production, the contract right had no determinable market value and was not part of the amount realized.[34]

One of the most effective ways to spread the taxable gain over a period of more than one year is to report on the installment basis.[35] If the initial payment does not exceed thirty per cent of the total sales price, and the balance is paid with notes or other obligations of the buyer, the seller has the option of reporting it all as income in the year of sale to the sum of the cash and fair market value of the notes and other property, or to just report the cash and property as income in the year received and the obligations of the buyer as income when, and to the extent, they are paid. This method of reporting income, however, can only be used if the requirements of Section 44(b) can be met. If the subject of the sale is real property the initial payments must not exceed thirty per cent of the selling price. If the subject of the sale is personalty two further requirements must be met; it must be a "casual sale or other casual disposition," and the price must exceed one thousand dollars. Some initial payment must always be received in the year in which the sale is made, and the taxpayer must report the sale on the installment basis in his original return if he wishes to take advantage of this section. If the seller disposes of all the buyer's obligations at their face value in the same year as the sale he will have gain in the same amount as if he had sold only for cash.[36]

The regulations set up the method of reporting gain when the consideration received is partly in obligations of the buyer, and when the installment sales method cannot be used because the initial payment received exceeds thirty per cent of the sales price.[37] This method is called the deferred payment sale method. The notes or other obligations are treated as cash when received to the extent of their fair market value and included in the amount realized at the time of sale. In later years as the obligations are satisfied the percentage of each payment, equal to the percentage of the notes which was originally called their fair market value, is considered as a return of capital. The excess over that amount is considered as ordinary income, in the nature of interest on an investment, regardless of whether the original sale was of capital or noncapital assets.[38]

Since state property taxes are deductible,[39] but only by the person who has the liability of paying them, an adjustment of the sales price should be made in this respect. The Wisconsin Statutes provide that in

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[34] Burnet v. Logan, 283 U.S. 404, 51 S.Ct. 550, 74 L.Ed. 1143 (1931); *accord,* Westover v. Smith, 173 F.2d 90 (9th Cir. 1949).
[35] INT. REV. CODE §44.
[36] Miller Saw-Trimmer Co., 32 B.T.A. 931 (1935).
[37] U.S. Treas. Reg. 111, §29.44-4 (1943).
[38] A. B. Culbertson, 14 T.C. 1421 (1950).
[39] INT. REV. CODE §23(c).

the absence of any agreement concerning payment of real estate taxes, as between the grantor and grantee, the grantor shall pay to the grantee a proportionate amount of the taxes, based on the taxes of the preceeding calendar year.[40] This statute, however, does not appear to change the incidence of the taxes, as concerns their deductibility under the federal tax law, or even the duty to pay them under the state tax law.[41] Therefore it is still important to know whether the seller has the duty of paying the taxes, under federal tax law, at the time of the sale. Also, if the party who does not have the duty of paying the taxes does pay them, he is conferring a benefit on the other party which is taxable as income.[42] Thus, if at the time of the sale the seller has the duty of paying the taxes, but the buyer agrees to and does pay them, he cannot deduct them; they are considered as part of the price paid for the property.

For federal tax purposes the rule has been laid down that the party who owns the property at the time that the taxes become a lien has the duty of paying them.[43] This, however, has not solved the problem in Wisconsin. In 1933 the Bureau ruled that ownership as of May 1st, when the property was assessed, determined the incidence of Wisconsin taxes for federal tax purposes.[44] But in 1939 a federal court decided that the liability to pay taxes does not accrue in Wisconsin, for federal tax purposes, until the November levy, in accordance with Section 74.62 which at that time provided that the owner as of December 1st was liable for the taxes assessed for that year.[45] In 1942 the United States Supreme Court laid down the lien rule concerning the incidence of state taxes.[46] The next year Section 70.01 was amended to provide that real estate taxes became a lien on the property as of May 1st, but the levy was deemed to be made "when the tax roll on which they are extended has been delivered to the local treasurer with his warrant for collection." The latest ruling by the Bureau on the subject indicates that the controlling date for the incidence of Wisconsin taxes for federal tax purposes is the date on which the tax roll is delivered to the local treasurer with his warrant for collection.[47] To avoid difficulties with the Bureau this is probably the date which should be used.

One more problem should be pointed out before dealing with the problems peculiar to partnerships, and that is, that in some transactions

[40] WIS. STATS. (1951), sec. 74.62.
[41] No cases dealing with this problem were found.
[42] S.M. 4122, V-1 CUM. BULL. 55 (1926).
[43] Magruder v. Supplee, 316 U.S. 394, 62 S.Ct. 1162, 86 L.Ed. 1555 (1942).
[44] I.T. 2694 XII-1 CUM. BULL. 107 (1933).
[45] Commissioner v. Patrick Cudahy Family Company, 102 F.2d 930 (7th Cir. 1939).
[46] See note 43 *supra*.
[47] G.C.M. 24599, 1945 CUM. BULL. 110.

where property is exchanged, in whole or part, for other property of a like kind, no gain or loss is recognized, or no loss is recognized and gain recognized only to a limited extent.[49] Since these sections of the Code are not difficult no further treatment will be given them here.

The sale of a partnership or partnership interest presents a few new problems. Where the sale is considered as a sale of the partnership assets the above discussion concerning sale of a sole proprietorship is applicable. But a partner's interest in a partnership is now recognized as a capital asset, and sale of that interest results in capital gain or loss.[50] The only problem arises when all the partners sell. Then the question arises whether they are selling the partnership assets or their respective partnership interests. The tendency seems to be to decide that they are selling their partnership interests, but it would be well to handle the transaction carefully. In a fairly early case the Board of Tax Appeals held that there was only one sale of the entire business as a whole, although the partnership agreed to sell the entire business, all appurtenances and all the assets except a few specifically listed. The purchase price was allocated between good will and the assets, and the partnership remained in existence for a few years after the sale. The court decided that the matter of setting separate prices for good will and assets merely showed the manner of agreeing on the price and the payment thereof.[51] The most recent case on the subject seems to have gone the farthest, holding that it was a sale of partnership interests when all the partners sold, although the bill of sale listed the separate assets sold, several assets were retained, and the partnership continued in existence for several months after the sale.[52] Whether the sale is of partnership interests or partnership assets is to be determined by looking at the transaction as a whole, in substance and effect, as opposed to form and appearance. The sale will be more likely to be recognized by the Bureau as a sale of partnership interests if the contract of sale does not allocate any part of the price to specific assets.[53] The danger here, perhaps not

[48] INT. REV. CODE §112(b).
[49] INT. REV. CODE §112(c).
[50] G.C.M. 26379, 1950-1 CUM. BULL. 58; Commissioner v. Allan S. Lehman, 164 F.2d 383 (2nd Cir. 1948); United States v. Shapiro, 178 F.2d 459 (8th Cir. 1949). According to G.C.M. 26379 the recognition of a partner's interest as a capital asset is limited to transactions where in substance and effect, as distinguished from form and appearance, it is essentially the sale of a partnership interest. Payments made to a retiring partner which represent his distributive share of earnings for past services should be treated as ordinary income rather than the proceeds derived from a sale of his interest. *Contra:* Swiren v. Commissioner, 183 F.2d 656 (7th Cir. 1950), holding that attorney's fees billed but uncollected and potential fees for work in progress were part of the partnership interest, not distributive shares of partnership earnings.
[51] Henry F. McCreery, 4 B.T.A. 967 (1926).
[52] Hatch's Estate v. Commissioner, 198 F.2d 26 (9th Cir. 1952).
[53] Mignonette E. Luhrs, 9 T.C.M. 537 (1950).

too great, is that if the Bureau insists on applying the separate assets theory the taxpayer will have to go to court, or lose the advantages of being able to make his own allocations, to a degree, of the purchase price among capital and non-capital assets.