SALE OF A BUSINESS: ASSET SALE

A common structure for the sale of a business is an asset sale. common methods for structuring the sale of a business: (i) a taxable asset sale and (ii) a taxable stock sale. In a taxable asset sale of a business in which an individual has personal goodwill, there are three parties involved in the transaction: the selling corporation (the "Target"); the acquiring corporation (the "Acquiror"); and the person with goodwill (the "professional").[1] In this type of transaction, the Target sells some or all of its assets to the Acquiror in exchange for cash or other consideration. Simultaneously, the professional in his or her individual capacity sells his or her professional goodwill to the Acquiror. Following the acquisition, the Target holds, distributes, or reinvests the sales proceeds.

I. In General. A corporation that acquires (or is deemed to acquire) an ongoing business in a transaction structured as an asset acquisition typically acquires a number of different types of assets. In general, the character of gain or loss recognized by a selling corporation on the sale of its assets will be determined on an asset-by-asset basis in accordance with the character and holding period of the assets sold. It is possible (and common) for a sale to generate ordinary income with respect to some assets and capital gain with respect to others. Therefore, it is important to allocate the lump-sum purchase price among various assets. This process is further described below.

The Target will recognize gain or loss on each asset equal to the difference between the amount of cash (or other consideration) allocable to the asset and its basis in the asset if the Target sells its assets to Acquiror for cash, [2] The Acquiror will take the assets with an aggregate basis equal to the amount of cash (or other consideration) paid (including liabilities assumed),[3] and such aggregate basis will be allocated among the assets according to their relative fair market values.[4] Any tax attributes of the Target (e.g., net operating loss and capital loss carry forwards, earnings and profits, etc.) are not transferred to the Acquiror, but remain with the Target, and are extinguished upon its liquidation.

II. Williams v. McGowan and Section 1060: The Comminution Rule. In *Williams v. McGowan*,[5] the United States Court of Appeals for the Second Circuit established the comminution rule, which holds that the sale of an entire business by the owner, regardless of whether the owner is a sole proprietor, partnership, or a corporation, is not a unitary transaction permitting the classification of the business as a whole asset.[6] Rather, the purchase price must be

[1] Personal goodwill is generally applicable only in the sale of a professional practice. However, recent cases, such as *Bross Trucking, Inc. v. Cmm'r*, T.C. Memo 2014-107 (June 5, 2014), have found that personal goodwill existed with respect to a commercial business.
[2] I.R.C. § 1001.
[3] I.R.C. § 1012.
[4] I.R.C. § 1060. The treasury regulations provide a detailed explanation for the allocation of purchase price among the assets of a whole business. All of the assets must be identified and placed into one of seven classes before allocating any purchase price. *See* Treas. Reg. § 1.338-6(b).
[5] 152 F.2d 570 (2nd Cir. 1945).
[6] *Id.* at 571-73.

allocated among the various assets sold with the character of gain or loss recognized on the sale of the business determined by that allocation.

This rule was codified with the passage of Code Section 1060.[7] According to Code Section 1060, "the consideration received for [the sale of the] assets of a business shall be allocated among such assets acquired in such acquisition in the same manner as amounts are allocated to assets under Code Section 338(b)(5)."[8] Under Code Section 338(b)(5), the purchase of a whole business is treated as a "deemed asset sale," and applied when determining the purchasers' basis in the assets and the sellers' gain or loss with respect to the sale.[9] Under Treasury Regulation § 1.1060-1(a),[10] sellers and purchasers of an applicable asset acquisition must allocate the consideration "under the residual method as described in Treasury Regulations §§ 1.338-6 and 1.338-7 to determine, respectively, the amount realized from, and the basis in, each of the transferred assets."[11] An "applicable asset acquisition" for purposes of Treasury Regulation § 1.1060-1(a) 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, . . . the purchaser's basis in the transferred assets is determined wholly by reference to the purchaser's consideration."[12] A group of assets constitutes a trade or business if: "[t]he use of such assets would constitute an active trade or business under Code Section 355; or [i]ts character is such that goodwill or going concern value could under any circumstances attach to such group."[13] Hence, the individual assets of a purchased business can include goodwill and going concern value. The treasury regulations specifically define goodwill and going concern:

> 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. 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. [14]

If the assets transferred from a seller to the purchaser include more than one trade or business, then all of the assets transferred (whether or not transferred in one transaction or a

[7] I.R.C. § 1060 (1990).
[8] *Id.* § 1060(a) (referring to I.R.C. § 338(b)(5) (1984)).
[9] *Id.*
[10] Treas. Reg. § 1.1060-1 (2008).
[11] *Id.*
[12] *Id.* § 1.1060-1(b)(1)
[13] *Id.* § 1.1060-1(b)(2).
[14] *Id.* § 1.1060-1(b)(2)(i), (ii).

series of related transactions and whether or not part of a trade or business) are treated as a single trade or business for purposes of Code Section 1060.[15]

Before allocating the purchase price to the assets of the transferred business, the Target and the Acquiror must determine the consideration for the purchase. Under Treasury Regulation § 1.1060-1(c)(1),[16] the Acquiror's consideration is the amount, in the aggregate, realized from selling the assets in an acquisition, as defined under Code Section 1001(b).[17] Thus, the Acquiror's consideration is the amount, in the aggregate, of its cost of purchasing the assets in the sale that is properly taken into account in basis.[18]

<u>(i) Allocation of the Purchase Price: Treasury Regulation §§ 1.338-6 & -7</u>. The treasury regulations provide a detailed explanation for the allocation of purchase price among the assets of a whole business. All of the assets must be identified and placed into one of seven classes before allocating any purchase price.[19] The seven classes of assets are:

- Class I: Includes all cash and general deposit accounts, not including certificates of deposits held in banks, savings and loan associations, and other depository institutions;[20]
- Class II: Includes actively traded personal property, such as marketable stocks and securities, and certificates of deposits and foreign currency (but stock of a target corporation's affiliates is excluded);[21]
- Class III: Includes assets that a taxpayer marks-to-market annually for tax purposes, and debt instruments, including accounts receivable, mortgages, and credit card receivables which arise in an ordinary course of business;[22]
- Class IV: Includes stock in trade, inventory, and property held for sale to customers in the ordinary course of business;[23]
- Class V: Includes all assets not specifically assigned to the other classes (including stock of target affiliates);[24]
- Class VI: Includes all Code Section § 197 intangibles, except for goodwill and going concern value. The assets in this class include self-created customer lists, employment contracts, supply contracts, and covenants not to compete;[25]
- Class VII: (the "Residual Category") Includes goodwill and going concern value (regardless of whether amortizable under Code Section § 197). Any excess purchase price not allocated to the other classes is allocated to this residual class;[26]

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[15] *Id.* § 1.1060-1(b)(7).
[16] *Id.* § 1.1060-1(c).
[17] *Id.* (citing I.R.C. § 1001(b) (1954)).
[18] *Id.*
[19] Treas. Reg. § 1.338-6(b).
[20] *Id.* § 1.338-6(b)(1).
[21] *Id.* § 1.338-6(b)(2)(ii).
[22] *Id.* § 1.338-6(b)(2)(iii).
[23] *Id.* § 1.338-6(b)(2)(iv).
[24] *Id.* § 1.338-6(b)(2)(v).
[25] *Id.* § 1.338-6(b)(2)(vi).
[26] *Id.* § 1.338-6(b)(2)(vii).

Class V generally holds most tangible assets, including depreciable buildings and equipment, as well as land and some other depreciable intangible assets like computer software.[27] Class VI typically contains intangible assets, such as patents, copyrights, trademarks, trade names, franchises, customer lists, and covenants not to compete.[28] The assets in this class are amortizable over a fifteen (15) year period under Code Section 197.[29]

(ii) Allocation of Purchase Price to a Class. The purchase price of the business is first allocated to the Class I assets based on their aggregate fair market value, and then to other classes in seriatim.[30] The fair market value of an asset is defined as its gross fair market value (e.g., fair market value determined without regard to mortgages, liens, pledges, or other liabilities).[31] However, for purposes of determining the amount of a seller's deemed sale tax consequences, the fair market value of any property subject to a nonrecourse indebtedness will be treated as being not less than the amount of such indebtedness.[32] Transaction costs are not taken into account in allocating the purchase price in a deemed asset sale.[33]

(iii) Allocation of Purchase Price to the Individual Assets within the Class. Within each class, the amount of purchase price allocated to the class is then further allocated among the individual assets relative to their respective fair market values.[34] The amount allocated to an individual asset (other than Class VII assets) cannot exceed the fair market value of that individual asset at the beginning of the day after the acquisition date.[35] Moreover, the amount of the purchase price allocated to an individual asset is subject to other provisions of the Code or general principles of tax law in the same manner as if such asset were transferred to or acquired from an unrelated person in a sale or exchange.[36]

Since each asset in Classes I thru VI should be allocated a portion of the purchase price equal to its fair market value, any amount designated as paid for goodwill or going concern value, as well as the entire premium, if any, should be allocated to Class VII. However, if a business is purchased for less than its liquidation value, then the Class VI assets (and the Class V assets if the Class VI assets are insufficient enough or the discount is deep enough) are allocated an amount less than their fair market values.

An important aspect of Code Section 1060 is that the seller and the purchaser are not required by the Code to agree on the allocation of purchase price. However, the reporting requirements of Code Section 1060(e) prevent the potential for whipsaw.[37]

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[27] *See id.* § 1.338-6(b)(2)(v).
[28] *See id.* § 1.338-6(b)(2)(vi).
[29] *See generally* I.R.C. § 197(c) (2004).
[30] Treas. Reg. § 1.338-6(b).
[31] *Id.* § 1.338-6(a)(2)(i), (ii).
[32] *Id.*
[33] *Id.*
[34] *Id.* § 1.338-6(b)(2).
[35] *Id.* § 1.338-6(c)(1).
[36] *Id.* § 1.338-6(c)(3).
[37] I.R.C. § 1060(e) (1990). Generally, the seller and purchaser have competing interests in allocating purchase price to an asset. For example, a seller may want to allocate as little purchase price as possible to depreciable property in

(iv) Section 1060(e): Reporting Requirements. Under Treasury Regulation § 1.1060-1(e)(1),[38] both 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.[39] The information must be filed as an asset acquisition statement on Form 8594, *Asset Allocation Statement*, with each purchaser's and seller's income tax returns or returns of income for the taxable year that includes the first date that the assets were sold pursuant to an applicable asset acquisition.[40]

III. Goodwill. Generally, there are two types of goodwill: (1) business, enterprise, practice, or institutional goodwill and (2) personal, professional, or practitioner goodwill.[41] Business, enterprise, practice, or institutional goodwill is the intangible value and the nature of goodwill that is associated primarily with the practice of the business entity.[42] Personal goodwill is the intangible value that is associated primarily with the individual. Personal goodwill exists when the shareholder's reputation, expertise, or contacts gives the corporation value.[43] Ability, experience, or qualifications of individuals do not constitute goodwill because they are not assets that can be purchased and sold for income tax purposes. Thus, salable goodwill must be more than a nontransferable degree or qualification.[44]

The issue of personal goodwill arises often in the context of the professional practice. There is often substantial personal goodwill in a professional practice, particularly in one-owner practices. The existence of personal goodwill is especially relevant in a sale of assets by a corporation.

The Service can challenge an allocation to personal goodwill, or the amount of the allocations, based on the facts and circumstances of each asset sale. However, the courts and the Service have recognized the existence of personal goodwill under certain facts and circumstances.

From the seller's perspective, goodwill is a capital asset.[45] Likewise, personal goodwill is considered a capital asset. Code Section 1221(a) provides that the term capital asset means

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Class V, such as a building, so as to minimize the amount of depreciation recapture that garners ordinary income treatment. However, the purchaser will want to allocate as much purchase price as possible to a building so as to establish a high basis with the goal of taking as much depreciation as possible in the future. These competing interests can result in different allocations of purchase price, particularly since there is no requirement that the Seller and the Purchaser agree. The reporting requirements ostensibly prevent manipulation by parties.

[38] Treas. Reg. § 1.1060-1(e).

[39] *Id.*

[40] *Id.*

[41] *Schilbach v. Cmm'r*, T.C. Memo, 1991-556.

[42] S. Pratt, R. Reilly & R. Schweihs, *Valuing Small Businesses & Professional Practices*, p. 584 (3d ed. 1998).

[43] Darian M. Ibrahim, "*The Unique Benefits Of Treating Personal Goodwill As Property In Corporate Acquisitions*," 30 Delaware Journal of Corporate Law 1 (2005).

[44] *Wickes Boiler Co. v. Cmm'r*, 15 BTA 1118 (1929).

[45] *Michaels v. Cmm'r*, 12 T.C. 17 (1949) (acq.); *X-Pando Corp*. v. Cmm'r, 7 T.C. 48 (1946); *Rainier Brewing Co. v. CIR*, 7 T.C. 162 (1946); *Burns v. Cmm'r*, 6 TCM 973 (August 25, 1947); *Ensley Bank & Trust Co. v. United States*, 154 F.2d 968 (5th Cir. 1946).

property held by the taxpayer (whether or not connected with the taxpayer's trade or business), but does not include the exclusions specified in Code Sections 1221(a)(1)-(8). Code Section 1221(a)(2) excludes intangible property used in a trade or business, which is subject to the allowance for depreciation provided in Code Section 167. Self-created personal goodwill is a capital asset because Code Section 197(c)(2) provides that the term "amortizable section 197 intangible" shall not include any Code Section 197 intangible that is created (as opposed to purchased) by the taxpayer.[46] Although Code Section 1221(a)(2) renders depreciable *purchased* goodwill ineligible for capital asset status, Code Section 1231(a) characterizes any gain recognized upon the sale, exchange, or involuntary conversion of goodwill held for more than one (1) year as capital gain.

From the buyer's perspective, the purchase of goodwill and payments for a noncompete agreement may both be amortized over fifteen (15) years.[47]

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[46] *See* Priv. Ltr. Rul. 2002-43-002.
[47] I.R.C. § 197; Temp. Reg. § 1.197-1T.