Case Western Reserve Law Review

Volume 17 | Issue 3

1966

Problem Areas in Buying and Selling a Corporate Business

Wilton S. Sogg

II

Problem Areas in Buying and Selling a Corporate Business

Wilton S. Sogg

TRADITIONALLY, AN ANALYSIS of the problem of buying and selling a corporate business has involved a consideration of the alternatives of purchasing stock or purchasing assets.[1] Various forms of this transaction are available: (1) the purchaser may buy all of the stock of a corporation and then liquidate it, thereby gaining a stepped-up basis through the application of section 334(b)(2) of the Internal Revenue Code of 1954; or (2) the seller may adopt a twelve-month plan of liquidation and, under the provisions of section 337, sell the assets and then liquidate, thus avoiding taxation at the corporate level. The nontax considerations of the transaction must not be ignored.[2] Tax-free transactions offer another important alternative, although they are not within the scope of this article.[3] Recent changes in statutory law and current developments in case law suggest new problems which require reconsideration of traditional techniques in answering the stock versus assets question. It has been suggested that because of the additional complications in asset transactions, there will be an increase in stock transactions.[4] The purpose of this article is to con-

THE AUTHOR (A.B., Dartmouth College, LL.B., Harvard University) is a practicing attorney in Cleveland, Ohio, and is a member of the Associate Faculty of the Cleveland-Marshall Law School of Baldwin-Wallace College.

---

1 For general discussions of the problems involved and tax planning considerations, see *How to Buy and Sell a Business: A Functional Presentation*, N.Y.U. 17TH INST. ON FED. TAX 717 (1959) (comments of Mr. Silverstein); *The Sale of a Business: A Panel Discussion*, N.Y.U. 23D INST. ON FED. TAX 513 (1965) (comments of Mr. McDonald); *Sale of a Corporate Business: A Panel Discussion of the Issues, Including Valuation and Assets vs. Stock Techniques*, N.Y.U. 21ST INST. ON FED. TAX 1143 (1963) (comments of Mr. Anthoine).

2 See Colborn, Fleming, Katcher & Merritt, *Buying and Selling a Corporate Business: A Survey of Tax and Non-Tax Implications*, 10 W. RES. L. REV. 123, 152-59 (1959); Weithorn & Elder, *Buyer's and Seller's Points in sale of Corporate Business: An Outline-Checklist*, N.Y.U. 21ST INST. ON FED. TAX 1065 (1963).

3 See Colborn, Fleming, Katcher & Merritt, *supra* note 2, at 144-51.

4 See *The Sale of a Business: A Panel Discussion*, N.Y.U. 23D INST. ON FED. TAX 525 (1965) (comments of Mr. McDonald).

sider four significant problem areas in buying and selling a corporate business: (1) good will and covenants not to compete; (2) imputed interest; (3) recapture of depreciation and investment credit; and (4) twelve-month liquidations under section 337.

I. Good Will and Covenants Not To Compete

Good will is a capital asset, the cost of which is nondepreciable by the purchaser and the sale of which produces capital gain to the seller. By contrast, payments made for a covenant not to compete are ordinary income to the covenantor-seller and are deductible by the covenantee-buyer over the life of the agreement. The basic problem is whether good will and the covenant not to compete will each be given separate tax treatment, or whether the covenant will be grouped together with the good will, with the result that all consideration is treated as relating to the good will. Traditionally, whether the covenant not to compete is given separate tax treatment from the good will is determined by whether the covenant is severable from the good will.[5] An agreement for the purchase and sale of a corporate business should specify whether or not good will is included in the purchase price; if so, a specific portion of the consideration should be allocated to that asset. If no good will is specified, the Commissioner may nevertheless determine that it is present and make a disadvantageous allocation.[6] Even if a realistic allocation is made by the parties, the allocation may be reexamined.[7] In addition, special consideration must be given to section 483, which may impute interest into certain deferred or contingent payments with respect to the performance of the business subsequent to its sale.[8]

A covenant not to compete has been more readily separable from good will when the sale of assets has been made by the corporation, and the covenant has been granted independently by the shareholders. This has been viewed as a triumph of form over substance

---

[5] For a general discussion of this problem see Barnet, *Covenants Not to Compete: Their Effects Upon the Covenantor and Covenantee*, N.Y.U. 18TH INST. ON FED. TAX 861 (1960); Wolfen, *Tax Effects of Covenants Not to Compete*, 12 U. SO. CAL. 1960 TAX INST. 667.

[6] For a discussion of the government's position on this issue see Ruhe, *The IRS Position on Allocation of Intangibles in Business Acquisitions*, J. ACCOUNTANCY, Sept. 1965, p. 50.

[7] Compare Carl L. Danielson, 44 T.C. 549 (1965).

[8] See text accompanying notes 13-35 *infra*.

in the case of a close corporation.[9] To help insure separate treatment as a covenant, the agreement containing the covenant should be of specific duration and the payments with respect to it should be made periodic and dependent upon performance by the covenantor.

The tax consequences of a covenant not to compete may vary between the parties. All amounts received by the covenantor may be treated as income in the year received, although the term of the covenant may extend several years into the future. By contrast, the covenantee must amortize payments over the life of the agreement, and may not deduct greater amounts in earlier years. It is important that a specific portion of the total consideration be allocated to the covenant not to compete. Otherwise, it will be grouped together with good will and the buyer will not be able to treat it separately for tax purposes.

The severability test for separate tax treatment of a covenant not to compete has been viewed as conflicting both with state contract law, which generally holds that the covenant is enforceable only if it is ancillary to or entered into to protect good will, and with the basic business practice of obtaining the covenant to protect the good will which is being purchased. The issue of whether or not to grant separate tax treatment is now being viewed by some courts as a question of fact rather than of severability versus non-severability.[10] Factors such as the age of and potential competition from the covenantor have been considered relevant in making the determination as to the validity of the covenant. However, covenants with inactive shareholders have been accorded separate tax treatment. The parties, in their subsequent tax treatment of the transaction, should not deviate from their initial agreement or they may produce additional tax liabilities and be liable for damages to the other party to the contract.[11] In planning for the tax treatment of a proposed transaction, consideration must also be given to the fact that income derived by a selling corporation for a covenant not to compete is not exempt from taxation under section 337.

Several recommendations may help assure that the desired or agreed result is actually achieved. First, all aspects of the matter

---

[9] See 3B MERTENS, FEDERAL INCOME TAXATION § 22.33, at 152 (1958).

[10] See 4 MERTENS, *op. cit. supra* note 9, § 23.68, at 60 (Supp. 1965).

[11] See Stern & Co. v. State Loan & Fin. Corp., 238 F. Supp. 901 (D. Del. 1965); Carl L. Danielson, 44 T.C. 549 (1965).

should be thoroughly negotiated during the bargaining sessions. Second, the negotiations and bases for results should be documented contemporaneously with the negotiations. Third, specific amounts should be allocated to good will and specific computations provided as evidence of the manner in which specific amounts were derived. The Commissioner may not overturn these amounts unless strong evidence is adduced.[12] Finally, a specific term should be set for the covenant not to compete, and periodic payments made with respect to the covenant during its term.

II. Imputed Interest

Section 483, which creates imputed interest with respect to certain deferred payments, may contain traps for the unwary due to its wide and overriding application. Prior to the enactment of this section, the entire payment in the deferred transaction could be treated as sales proceeds by the recipient and as costs of assets by the payor. Conversely, the parties could agree that a portion of the proceeds in such a transaction was interest. Thus, basically identical transactions could receive differing tax results merely by alteration of the agreement by the parties. Congress has acknowledged that section 483 was enacted to eliminate such discrepancies and was not designed to raise substantial revenues.[13]

The basic effect of section 483 is to impute interest into certain payments due more than six months after a sale whenever it is determined that there is unstated interest and where payments in excess of 3,000 dollars are deferred for more than one year. In order to determine if unstated interest is present the treasury regulations prescribe that the rate of four per cent per annum should be used.[14] If it is determined that section 483, applies, unstated interest is computed at a rate of five per cent per annum, compounded semiannually. The full five per cent rate is applied even though there is stated interest which is less than four per cent per annum. Section 483 by its own terms does not apply: (1) if the sales price cannot exceed 3,000 dollars; (2) if the amount paid is treated as interest under section 163(b); (3) if the seller does not receive capital gain

---

[12] Ullman v. Commissioner, 264 F.2d 305 (2d Cir. 1959).

[13] See Branda, *Imputed Interest and Fictitious Sales Prices: The Unexpected Effects of Section 483*, 21 J. Taxation 194 (1964); Cohen, *Imputed Interest in the Sale of a Business*, N.Y.U. 23d Inst. on Fed. Tax 487 (1965); Hoffman, *Interest in Deferred Payments Under the Revenue Act of 1964*, N.Y.U. 23d Inst. on Fed. Tax 921 (1965); Murdoch, *Imputed Interest*, 42 Taxes 844 (1964).

[14] Treas. Reg. § 19.3-1(b) (1964); see text accompanying note 19 *infra*.

from the sale; (4) if the transfer is a patent transfer described in section 1235(a); or (5) if the amounts received are an annuity to which section 72 applies.[15]

The application of section 483 alters the result anticipated by the parties. A seller obtains less capital gain and receives some interest income instead. In the event of a loss on a sale, the seller will receive a greater loss and interest income as well. These may, however, be equal except if interest and loss fall in different years. The buyer receives a lower basis for his assets and an interest deduction. If he purchases a nondepreciable asset, such as good will, a tax benefit may inure to him. Similarly, the interest deduction may accrue faster than the depreciation deduction.

Payments which are contingent as to amount, or as to the actual fact of payment, are treated on a "wait-and-see" basis. Section 483 applies in the year of receipt, regardless of the earlier treatment of the balance of the consideration.

The readjustment in sales price and the portion of payment treated as interest may affect the qualification of a transaction as an installment sale under section 453.[16] However, the regulations have made certain provisions for such cases.[17]

Dispositions under section 337 may result in installment obligations which, when distributed, produce ordinary interest income to shareholders. Presently unresolved is the question as to whether interest income accrues to the corporation during the twelve-month liquidation period with respect to any such deferred payment or installment obligation, and if so, on what basis.

Section 483 applies in conjunction with sections 1245 and 1250 in a manner such that consideration received on disposition may be composed of four portions: (1) recovery of basis; (2) interest income under section 483; (3) ordinary gain through the recapture provisions of section 1245 and 1250;[18] and (4) capital gain under section 1231. Each asset in a transaction is treated separately; thus allocation of sales price among assets is essential.

Temporary Treasury Regulation section 19.3-1, which has been issued under section 483, provides that the rate for determining the applicability of that section shall be four per cent per annum simple interest. Sub-section 19.3-1(b) provides that section 483 will not

---

15 INT. REV. CODE OF 1954, § 483(f).

16 See Murdoch, *supra* note 13, at 84.

17 See text accompanying note 32 *infra*.

18 See text accompanying notes 36-39 *infra*.

apply if the stated interest payments are at least four per cent per annum, whether simple or compounded. The temporary regulations are applicable to payments made after December 31, 1963, in consideration for sales or exchanges of property occurring after June 30, 1963, unless the sale or exchange was made pursuant to a contract entered into before July 1, 1963. Many important questions are left unanswered by the temporary regulation, such as the rate of imputed interest to be imposed if section 483 does apply. In addition, the unexpected effects of this section are given no mention.[19]

Proposed regulations were issued under section 483 on April 20, 1965.[20] Subsection 1.483-1(a)[21] provides for the computation of the amount which will constitute interest. Interest is treated as a pro rata portion of each payment rather than as a declining amount in later years. Actual stated interest is taken into account in determining whether there is unstated interest and is added to the unstated interest with respect to each payment.

Subsection 1.483-1(b)[22] defines those payments to which section 483 applies. The subsection refers to the "sales price" which is used in determining the applicability of section 483 and includes any stated interest. Where section 483 sales are combined with those to which the section is inapplicable, the parties may allocate the consideration; in the absence of such allocation the District Director may do so. The proposed regulation directs that section 483 be applied to a transaction before any other applicable section.[23]

Like the temporary regulations, the proposed regulations are applicable to payments made after December 31, 1963, as consideration for sales or exchanges of property occurring after June 30, 1963, unless the sale or exchange was made pursuant to a contract entered into before July 1, 1963.[24] In addition, if substantial change is made in the contract after June 30, 1963, the section is applicable. However, mere prepayment or mechanical adjustment in sales price through a contract formula is not considered a substantial change. A payment, if no more than ninety days late, or a later payment with additional interest, is not a substantial change. Evidence of indebtedness is not treated as a payment.

---

19 See Branda, *supra* note 13, *passim*; Murdoch, *supra* note 13, at 849-53.

20 Proposed Treas. Reg. § 1.483, 30 Fed. Reg. 5584 (1965).

21 Proposed Treas. Reg. § 1.483-1(a), 30 Fed. Reg. 5585 (1965).

22 Proposed Treas. Reg. § 1.483-1(b), 30 Fed. Reg. 5585 (1965).

23 See text accompanying notes 36-39 *infra*.

24 Proposed Treas. Reg. § 1.483-1(b)(4), 30 Fed. Reg. 5586 (1965).

Subsection 1.483-1(c) sets the interest rate to be applied in computing unstated interest under section 483 at five per cent per annum, compounded semiannually.[25]

Subsection 1.483-1(d) sets forth a test to determine whether there is total unstated interest in a contract.[26] The four per cent per annum simple interest test set forth in the temporary regulations continues in effect. An alternative test is provided by sub-section 1.483-1(d)(2) for cases in which the contract contains stated interest of four per cent simple interest per annum, payable either annually or more frequently. It should be noted that a "balloon" payment of all interest for the entire contract in the final year is apparently not acceptable.[27]

Subsection 1.483-1(e) provides for payments which are indefinite as to time, liability, or amount.[28] Payments are considered indefinite if any of these three factors are incapable of determination at the time of the sale or exchange. Section 483 applies to all payments which are definite and applies to indefinite payments in the year of actual payment. It does not apply to indefinite payments if made less than one year after the date of the sale or exchange, even if other definite payments can be ascertained. The section applies notwithstanding the fact that the transaction is closed for purposes of determining gain or loss. Indefinite interest payments are not taken into account until paid.

Subsection 1.483-1(f) provides for treatment of changes in the terms of a contract.[29] Section 483 applies to a changed contract despite the fact that the original contract may have been outside the purview of the statute. A variation of ninety days from the original due date for payment is not considered a change; but a novation or default will operate to bring a contract within the scope of the statute. However, changes do not affect the characterization of payments made in earlier years.[30] The tax basis of the assets in the hands of the purchaser is recomputed as of the date of the change, but only if he has not disposed of the property. If recomputed total unstated interest is more than had been previously reported, it will be allocated pro rata among the remaining payments. If it is less

25 Proposed Treas. Reg. § 1.483-1(c), 30 Fed. Reg. 5586 (1965).

26 Proposed Treas. Reg. § 1.483-1(d), 30 Fed. Reg. 5587 (1965).

27 Compare Branda, *supra* note 13, at 199-200, which suggests this device.

28 Proposed Treas. Reg. § 1.483-1(e), 30 Fed. Reg. 5587 (1965).

29 Proposed Treas. Reg. § 1.483-1(f), 30 Fed. Reg. 5589 (1965).

30 See Branda, *supra* note 13, at 200, for possible retroactive effects on personal holding companies or Subchapter S corporations.

than the amount reported, the total difference is deducted from income in the year of the change in the contract.

Subsection 1.483-1(f) also provides rules for the transfer of deferred payment obligations.[31] If an obligation to make such payments is transferred, the right to receive the payment is unaltered. The transferor is not entitled to interest deductions after the transfer, and section 483 applies to the transferee in the same manner as it did to the transferor. In cases where the right to receive payments is transferred, the tax effect of the obligation to make payments is unaltered. The transferor treats payments as final and recomputes "total unstated interest," and the transferee treats the transaction as a sale or exchange on the date of transfer.

Of greatest importance, section 1.483-2 sets forth the rules relating section 483 to other sections of the Internal Revenue Code and answers some of the questions raised by section 483 and the temporary regulations.[32] Under this section, unstated interest is treated as interest for all purposes under the Code. Unstated interest is treated by both cash and accrual basis taxpayers in the manner ordinarily prescribed for each of these groups, even though this may result in different treatment for each group. Stated interest remains governed by the provisions of the Code. Application of section 483 may increase the amount of nondeductible loss, and a taxpayer may incur such a loss as well as interest income on a deferred sale. In addition, section 483 may alter the total selling price and the initial annual payment thereby, jeopardizing chances of receiving installment sale treatment under section 453. Application of section 483 to additional stock given in a reorganization will *not* disqualify a reorganization otherwise qualifying for favorable treatment under section 368(a)(1).

Fragmenting one sale in excess of 3,000 dollars into several sales of less than 3,000 dollars to avoid application of section 483 is subject to attack by the Internal Revenue Service. Section 483 will not apply if no part of the gain on the sale or exchange is considered as resulting from the sale of a capital asset. However, this determination is made without regard to whether the gain is actually recognized. Finally, section 1.483-2 of the Proposed Regulations recognizes that the buyer and seller may receive differing tax treatment on the same transaction.

---

[31] Proposed Treas. Reg. § 1.483-1(f), 30 Fed. Reg. 5589-90 (1965).

[32] Proposed Treas. Reg. § 1.483-2, 30 Fed. Reg. 5594 (1965).

The best current procedure, until the many uncertainties in the application of section 483 have been resolved, is to draft agreements with the four per cent minimum interest stated, so that section 483 does not apply. The proposed regulations require that the four per cent interest be "paid at least annually";[33] however, this requirement is not clear. Although a balloon payment of interest in the last year has been suggested,[34] even a four per cent rate may not qualify under the foregoing language. It has been suggested that the entire section 483 be repealed or that its application be suspended until its intricacies have been resolved, particularly in view of the acknowledged fact that the section is not primarily a revenue measure.[35]

III. Recapture of Depreciation and Investment Credit

Sections 1245 and 1250 of the Code operate to increase ordinary income for a seller and to reduce his capital gain by recapturing depreciation in certain dispositions of assets. Section 47, in the same situations, increases tax liability by recapturing investment credit. Sections 1245 and 1250 tax all or part of the gain on the disposition of certain property at ordinary income rates. "Section 1245 property" is primarily personal property, tangible and intangible, while "section 1250 property" is primarily real property. Section 47 provides for the recapture of one-third, two-thirds, or all of the investment credit allowable with respect to "section 38 property" which is disposed of prior to the end of the useful life upon which the credit was based.[36]

There are certain basic differences between the operations of section 1245 and section 1250. The first of these sections recaptures depreciation taken after 1961, regardless of the length of time the property was held or the method of depreciation. Section 1250 recaptures depreciation taken after 1963, only to the extent that this amount exceeds straight-line depreciation. The recapture is made in

33 Proposed Treas. Reg. § 1.483-1(f), 30 Fed. Reg. 5589 (1965).

34 Branda, *supra* note 13, at 199-200.

35 Murdoch, *supra* note 13, at 853.

36 For a general discussion of these sections see Branda, *Problems in Recapture of Depreciation*, N.Y.U. 23D INST. ON FED. TAX 449 (1965); Horvitz, *Sections 1250 and 1245: The Puddle and the Lake*, 20 TAX L. REV. 285 (1965); Kahn, *Recapture of Depreciation*, 42 TAXES 918 (1964); McAnallen, *The Recapture of Rules — §§ 47, 1245, 1250: How They Work, What They Mean, How to Play*, 21 J. TAXATION 272 (1964).

decreasing amounts at one per cent per month from the twentieth through the one hundred and twentieth month of the holding period. Because the length of the holding period may affect the amount of recapture, its measurement is of particular importance in the application of these sections. Since the extent of recapture varies with the holding period, the timing of a sale may have material tax implications. Finally, allocation of total consideration in a transaction is also of importance, since these sections apply on an asset-by-asset basis.

Sections 47, 1245, and 1250 apply notwithstanding any other provisions of the Internal Revenue Code. Section 337 dispositions may produce ordinary income because of the application of these sections.[37] This application may also impair the benefits of section 334(b)(2).[38] Finally, nonstatutory recapture of depreciation may be possible, even in situations where sections 1245 and 1250 do not apply.[39]

IV. Twelve-Month Dispositions Under Section 337

Various complications in the operation of section 337 make it mandatory that care be exercised in the utilization and application of this section, in order to avoid unwanted tax consequences.[40] Section 337 permits the disposition of corporate assets and subsequent liquidation of the corporation within a twelve-month period. Through the nonrecognition-of-gain provisions, the only tax imposed on such a transaction is at the shareholder level. In order to qualify, the liquidation must be completed within a twelve-month period. The nonrecognition provisions apply only to dispositions of such property as are defined in the section. Excluded from such property are certain installment obligations and inventory which is not sold in bulk to one purchaser.[41] Losses are not recognized nor is netting permitted. The application of sections 1245, 1250, 47,

---

[37] See text accompanying notes 40-47 *infra.*

[38] See Soter, *Section 334(b)(2) — Depreciation and Investment Credit Recapture,* Outline, 7th Annual Cleveland Regional Tax Inst. 21 (1964).

[39] See Branda, *supra* note 36, at 465-71; Smith and Wasserstrom, *Depreciation in the Year of Sale: An Analysis,* 9 Tax Counselor's Q. 123 (1965). *But cf.* Fribourg Nav. Co. v. Commissioner, 86 Sup. Ct. 862 (1966).

[40] For a discussion of Code § 337, see Boland, *A Review of Developments Under Section 337 of the Internal Revenue Code of 1954,* 42 Taxes 676 (1964).

[41] *But see* Pridemark, Inc. v. Commissioner, 345 F.2d 35 (4th Cir. 1965).

and perhaps 483 results in an alteration of the basic nonrecognition pattern of section 337. Thus, special care must be paid to transactions involving these sections. The timing requirements of section 337 create both planning and administrative problems. Losses may be recognized before a plan of liquidation is adopted; however, care must be exercised so that the Commissioner may not contend that there has been a *de facto* adoption of the plan. There has been considerable difficulty in some cases in determining the exact date of the adoption of the plan of liquidation.[42] Since the application of this section is non-elective, care must be taken to avoid an undesired result. Conversely, if recognition of the loss is desired, the twelve-month period can be avoided.

The corporation may retain sufficient assets to meet possible claims against it. There is, however, a question as to which assets may be retained and the amount that may be retained. The definition of "claim" is difficult, and the corporation may be required to take inconsistent positions in defending against the claims and defending the right to retain assets to meet them. As a corollary to this, all assets must be distributed, except as previously stated. Such a distribution is difficult when an intangible asset such as a tax refund claim is involved. The problem may be solved by the distribution of the intangible to an agent for the benefit of shareholders.

If there is continuity of ownership between the shareholders of the selling corporation and those of the acquiring corporation, the transaction may be held to be a reincorporation and the benefits of section 337 forfeited.[43]

Despite the basic rules of nonrecognition of gain at the corporate level, there are a variety of situations where the recognition of income to the corporation is a problem. Examples of problem areas include bad debt reserves, complete and incomplete contracts, unearned subscription income, and the confusion between earned income and the right to earn income in the future. In addition, the expenses of disposition are not deductible.[44]

The recent case of *Frank C. Verito*[45] suggests that there are planning opportunities and dangers in carrying out a twelve-month

---

[42] See, *e.g.*, Technical Information Release No. 755, Aug. 16, 1965.

[43] See, *e.g.*, *The Sale of a Business: A Panel Discussion*, N.Y.U. 23D INST. ON FED. TAX 513, 565-67 (1965).

[44] See text accompanying notes 5-12 *supra*.

[45] 43 T.C. 429 (1965). For a discussion of the case, see 22 J. TAXATION 154-55 (1965).

liquidation. In this case, forty-five corporations adopted plans of liquidation and disposed of their assets under section 337. After the sale of the assets, but before final distributions to shareholders, cash proceeds of the sale were invested in the stock market in numerous transactions which resulted in both long and short term capital gains. All of these gains were held to be non-recognizable under section 337 and shareholders were accorded complete capital-gain treatment on final distributions from the corporation.[46] This result converted the short term capital gains from the sales of securities into long term capital gains; it also avoided all tax at the corporate level. The court held that nonrecognition arising from the application of section 337 treatment applies "so long as a sale is not inconsistent nor incompatible with the pending liquidation, that is, as long as the corporation is, in fact, in the process of complete liquidation" and the other requirements of section 337 are met.[47] The result in this case allows the legitimate business practice of investing idle funds during a period of liquidation; however, the decision should not be relied upon with respect to other business activities during the twelve-month period.

---

[46] Frank C. Verito, 43 T.C. 429, 430 (1965).
[47] *Id.* at 431.