ENDING A BUSINESS

Wolters Kluwer

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Just as all "good" things must come to an end, a business—or an individual's relationship with it—may eventually come to an end. The end of your business generally either means the end of your ownership interest or it means your business totally goes out of existence.

Your business can end for any number of reasons including:

- Sale of the business;
- A key owner or employee dies; or
- The business fails.

By far the best way for your business to end is through a planned ending. That is an ending you have structured with your tax advisor. You will most likely receive something of value in return such as cash or non-cash consideration or the satisfaction that your family or other loved ones are taking over a successful enterprise as you let go of the reins.

When your business undergoes a forced ending, such as a bankruptcy or forced sale, it generally means that you may receive nothing for all your years of effort or you will receive far less than the value of the business when it was fully operational. For this reason it is far better to plan for the ending of your business in whatever manner will provide you with the greatest financial return.

This booklet reviews the various ways you can structure and plan for ending your small business. It covers issues related to sale of your business and its tax ramifications. Since the form in which you have chosen to do business controls a significant portion of how it will be taxed on its termination or transfer, we will examine the sale of a business based upon your business's tax structure, whether it is a sole proprietorship, a partnership, or a corporation (regular or "S" corporation). With this information, you will be able to discuss and plan with your business and tax advisors how to maximize the after-tax results you will receive when you finally want to call it quits.

> Comment. Of course, your interest in the business can end not only through a sale but as the result of transfers to family members who will continue the business. Estate and financial planning related to the transfer of a family business, however, is not the focus of this booklet.

OVERVIEW—SALE OF BUSINESS

In most cases, if you are ending or disposing of a business, it means that you will be selling the business. The two major ways that you can accomplish this sale is either through sale of your business assets or through the sale of your entire ownership interest in the entity which owns the business. For example, if you are operating your business as a corporation, following the latter alternative would mean that you would sell all of your stock in the corporation.

When you sell all the assets of your business, the transaction is treated as if you are selling each asset individually. When you sell all of your business' assets, generally you enter into an agreement with the buyer on how much of the total purchase price is allocated to each of the individual assets you are selling. This often includes "intangible" assets as well, such as a business name or goodwill. Making these allocations is important for you to calculate how much tax to report from the sale of each of the assets. The buyer of the assets also needs this allocation to be done to establish the cost basis of each asset purchased. You and the buyer must carefully identify the assets transferred to determine how best to allocate the purchase price. You might consider structuring the deal to report gain from selling assets under the installment method.

Sole proprietorships. If you operate your business as a sole proprietor, you recognize gain or loss on selling proprietorship assets, based on the amount by which the consideration allocated to the assets under the residual allocation method exceeds or is less than your basis, as proprietor, in the assets. A proprietor sometimes can gain some advantage by incorporating the proprietorship before selling the business. A seller and buyer generally prefer allocations that favor their respective tax positions. Since these positions are usually opposite one another, the IRS generally treats the transactions as the parties have arranged them for tax purposes.

Partners in a partnership. If you own a business interest as a partner in a partnership, you can sell your interest in the business by selling your partnership interests. Partners selling their partnership interests divide the gain or loss they recognize on the sale into two portions. As a general rule, a selling partner recognizes one portion of the gain or loss as ordinary income or loss and the other portion as either capital gain or loss (This is covered in more detail later in this booklet).

Shareholder in a corporation. A corporation can sell its business by selling its business assets. Generally, your corporation must recognize gain or loss on the sale, regardless of whether you have entered into a plan to liquidate the corporation. The corporation also must recognize gain or loss when it distributes its business assets to you and other shareholders as it is undergoing liquidation. You and other shareholders, as owners of the corporation, generally will also recognize gain or loss when your corporation liquidates.

You can also terminate your interest in a corporation by selling all of your stock. If you and any other shareholders sell your stock, you will realize capital gain (or loss) on the sale. Publicly traded stock is not eligible for installment sale treatment. However, the shareholders of a privately held corporation are allowed to sell their stock on the installment method, and should seriously consider that option. Better yet, if you and your fellow shareholders still want to keep an investment in your business while stepping back from day-to-day operations, you might consider disposing of your shares in a tax-free stock-for-stock reorganization with another corporation.

S corporation. An S corporation generally is not subject to tax. The S corporation shareholders pay tax on their share of the corporation's gain or other income for each year. Thus, S corporation shareholders generally can sell their corporation's business without concern over the two levels of tax that may apply to regular corporations and their shareholders.

There are three main exceptions to the absence of two levels of tax on S corporations, all applicable solely to former C corporations. Built-in gain from any corporate assets that had appreciated in value between the time the corporation acquired them may be subject to tax for a set period of years (generally, 10 or less) after the election has been made. The same tax may be applicable to depreciable assets whose tax depreciation had exceeded their actual decline in value at the time of the S election. An S corporation with undistributed earnings and profits from its C corporation years may be subject to tax on its passive income if this income exceeds 25 percent of its gross receipts. Finally, any distributions of earnings attributable to years in which the business was a C corporation are taxed as dividend income to the shareholders.

The S corporation shareholders can sell their stock in the corporation. They also generally can participate in tax-free reorganizations.

SALE OF YOUR SOLE PROPRIETORSHIP

Selling assets of a sole proprietorship

If you want to sell a business that you have been conducting as a sole proprietorship, the sale will almost always result in a taxable transaction since a sole proprietorship does not involve a legal entity separate and distinct from its owner (such as, in the case of a corporation or partnership). The owner generally must recognize gain on the sale regardless of how the purchaser pays for the business.

On the purchase and sale of a proprietorship's assets, the buyer and seller must enter into an agreement that allocates the purchase price to the assets being sold under the residual allocation method. When you are negotiating these allocations, you will generally seek to allocate the purchase price to assets differently if you are the seller, from the way you would choose to make the allocations as the buyer. Different allocations benefit the buyer than those that would benefit the seller of the business. A seller's preferences generally reflect variations in tax rates on ordinary income and capital gains, or a seller's tax position outside the proprietorship. A purchaser's preferences generally relate to how quickly the purchaser can recover the allocated tax cost.

SALE OF YOUR CORPORATION

Selling a corporate business by selling assets

If you conduct your business as a corporation, you can sell the business by selling the stock of the corporation or by having the corporation sell the assets comprising your business.

If your corporation sells the assets comprising the business and then distributes the proceeds to you or other shareholders, it generally results in the proceeds being taxed twice. First, your corporation is taxed when it receives the proceeds from selling the assets. The gain recognized by the corporation on the sale is taxed at either ordinary income or capital gains rates, as applicable.

The second tax is imposed on you and the other shareholders upon receipt of a distribution of the proceeds from the sale. This can occur either currently as a dividend or in liquidation. Distributions that meet the requirements for qualified dividend income are taxed at capital gains rates. Other dividend distributions are taxed at ordinary income rates.

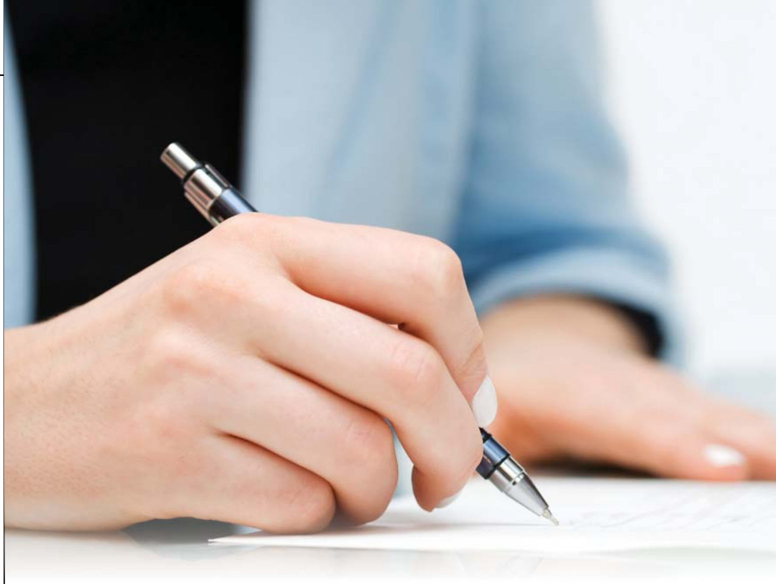
Two levels of tax can also occur if your corporation distributes its assets to its shareholders, either currently as a dividend or in liquidation.

Selling a corporate business by selling stock

When you operate your business as a corporation it can also be sold by you and the other shareholders selling your stock. Each shareholder who sells stock generally recognizes capital gain or loss with respect to the sale. An individual shareholder selling stock in a small business corporation at a loss can deduct the loss as an ordinary rather than a capital loss. A stockholder can report gain from selling stock under the installment method, unless the stock is publicly traded.

Installment reporting of stock sale. If you are a shareholder in a privately held corporation, you can elect to report gain from selling your shares under the installment method. The installment method would permit you to report gain from a stock sale over the course of more than one tax year as long as you are receiving at least one payment from the sale in a different year than the first payment you receive. For each year's payments, you would recognize as taxable gain during that year the amount of the payment that is multiplied by a fraction, the numerator of which is the gross profit to be realized from the sale and the denominator is the total contract price. However, the stockholders of a corporation whose stock is traded on an established securities market may not use the installment method to report gain from selling their stock or securities.

If you are a shareholder in a privately held corporation that sells stock on the installment method, you must charge no less than a minimum rate of interest on the portion of the sales proceeds that is deferred. Failure to do so will result in a portion of the deferred sales proceeds being recharacterized as interest by the



IRS. This recharacterization will affect the seller's gain or loss and the buyer's basis in the stock acquired.

Net operating losses. A corporation with large net operating losses (NOLs) is an attractive target for a profitable acquiring corporation. In an acquisitive reorganization, the acquiring corporation succeeds to the target corporation's NOLs and may use them against future earnings. Even without a merger, a corporation with NOLs is more valuable than a corporation without NOLs because its future tax liability is lower.

The Tax Code limits the use of NOLs following an ownership change. The Code Sec. 382 limitation is designed to prevent trafficking in NOLs.

SALE OF YOUR S CORPORATION

If you own a business conducted through an S corporation, you can sell the business either by causing the S corporation to sell the assets comprising the business, or by selling your S corporation stock. In an asset sale, the gain or loss on each asset would be passed through to the S corporation shareholders. Gains and losses can be taxed at capital or ordinary income rates

On a stock sale, the S corporation shareholders determine gain or loss by reference to their adjusted basis in the S corporation stock. Gain and losses from the sale of stock are typically capital gains and losses.

If you are a shareholder in an S corporation, taxable gain or loss the S corporation recognizes when it sells its assets passes through to you. Each shareholder includes a pro-rata share of the S corporation's gain, loss and other income items. Shareholders adjust the basis in their S corporation stock by the amount of any passed-through income, loss or deduction. Shareholders generally receive distributions tax free, with the exception for distributions of earnings from C corporation years noted above. If you sell your stock in an S corporation you recognize gain or loss on the sale.

Another manner in which you can terminate your interest in an S corporation is for you, other shareholders and the S corporation to participate in a tax-free asset or stock acquisition.

General rules for S corporation terminations

Once your corporation obtains S corporation status, it continues to be an S corporation for the tax years that follow until its status as an S corporation is terminated. Terminating S corporation status is generally undesirable, but in some cases it may be advantageous. For example, it may be desirable to terminate an S election if corporate income will be taxed to shareholders at high marginal tax rates, or if earnings must be retained in order to sustain corporate growth.

General termination rules. An S corporation election may be terminated in any one of the following ways:

(1) Shareholders holding more than one-half of the corporation's stock consent to revocation of the election;
(2) The corporation ceases to meet the qualifications of an S corporation; or
(3) The corporation's passive investment income exceeds 25 percent of its gross receipts for three consecutive tax years, and the corporation has accumulated earnings and profits.

Method 1 above is done on a voluntary basis by the shareholders. Methods 2 and 3 are usually involuntary, and you should attempt to avoid them if the buyers of your business want to continue the business as an S corporation.

Regardless of the circumstances that cause the termination of S corporation status, the result will be to convert the corporation to a C corporation subject to the tax rules that apply to regular corporations. Generally, once you terminate your business's S corporation, you must wait five years before you can reelect S corporation status, unless the IRS consents to an earlier reelection.

SALE OF YOUR PARTNERSHIP INTEREST

Selling a partnership business

The partners of a partnership generally can structure the sale of the partnership's business either by selling their partnership interests or by causing the partnership to sell the assets of the business. If a partnership sells the assets comprising its only business in what amounts to a liquidating sale, the partners may have to treat the transaction as a sale of their partnership interests.

Buying and selling a partnership interest

Selling your partnership interest will ordinarily result in a taxable gain or loss. If the selling partner is relieved of his or her obligation for partnership liabilities, he or she must include these amounts in the total proceeds received from the sale.

The sale of a partnership interest terminates the partnership tax year for the selling partner as of the date of sale. Consequently, he or she must take into

account the distributive share of partnership items for such tax year as of the date of the sale.

End of partnership

A partnership terminates for federal tax purposes only if either:

1. Its operations are discontinued and the business ceases to be carried on in the partnership form; or
2. At least 50 percent of the partnership's capital and profits interests are sold or exchanged within a 12-month period.

Consequently, a partnership may be able to continue despite the death or retirement of a partner or the entrance of a new partner.

Partnership distributions

Generally, when a partnership makes a distribution, an individual partner will not recognize any gain attributable to the distribution to the extent of the basis in its partnership interest. Since a partnership is a passthrough entity, if you are a partner, you must take into account your distributive share of the partnership income for the year on the last day of the partnership's tax year.

However, if as a partner you receive a distribution of money or marketable securities in excess of your basis in your partnership interest. A partner generally is not required to recognize gain with respect to a distribution of property other than money. Regardless of the form of the distribution, a partner cannot recognize a loss on a distribution unless the distribution is made in complete liquidation of his partnership interest.

Liquidating distributions

If you are ending your partnership interest, you will receive a liquidating distribution. A liquidating distribution is an actual or constructive distribution that terminates a partner's entire interest in a partnership. Your partnership will not recognize any taxable gain or loss when the partnership distributes money or other property to liquidate a partner's interest in the partnership. Generally if you are the partner receiving the liquidating distribution, you also would not recognize any taxable gain or loss. However, there are two important exceptions to this nonrecognition rule that may apply:

1. A partner recognizes gain to the extent that the amount of cash, marketable securities, unrealized receivables or inventory with fair market value 120 percent greater than its basis actually or constructively distributed to him or her exceeds the basis in the partnership interest.
2. A partner recognizes loss if no property other than money, marketable securities, unrealized receivables or inventory with fair market value 120 percent greater than its basis are distributed to him or her, and the basis in the partnership interest exceeds the amount of money plus the basis of the distributed receivables and inventory.

Basis in property received in liquidating distribution. The distributed property you receive will have the same basis as your partnership interest reduced by the amount of money received. This means that any built-in gain or loss in the distributed property will not be recognized until a former partner disposes of it in a taxable transaction.

The partner must also adjust the basis of any marketable securities treated as money to reflect the gain recognized on the distribution. A portion of the total basis is first allocated to any distributed unrealized receivables and inventory.

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The basis of this kind of property cannot exceed the partnership's basis at the time of the distribution. Any remaining basis is allocated among other distributed property in proportion to the bases of all assets in the partnership's hands. Special basis allocation rules apply when the distributed property is subject to an elective basis adjustment by the partnership. A partner is required to make a basis adjustment to prevent basis from being shifted from nondepreciable to depreciable property.

Distributions to a retiring partner or the successor-in-interest of a deceased partner. These distributions may not be treated as liquidating distributions and are subject to special rules. A disproportionate distribution of unrealized receivables and substantially appreciated inventory is treated as a partial sale between the partner and partnership.

> Caution: The IRS can recharacterize a payment in the form of a liquidating distribution as sale proceeds, compensation, or a loan if the IRS believes it is required to accurately reflect the substance of the transaction.

Character of property received in a liquidating distribution. The character of distributed property is determined by reference to its status in the hands of the partner receiving the distribution. This rule is subject to two exceptions. First, unrealized receivables are always ordinary income property to the partner. Second, inventory items are ordinary income property if the partner disposes of them within five years. If there is a potential for recapture inherent in distributed property, it carries over to the partner and results in ordinary income when the partner disposes of the property.

Other rules for tax impact on partnership of liquidating distribution. The partnership recognizes no gain or loss when it liquidates a partner's interest. However, the liquidation may trigger recapture of the investment tax credit or generate income under the tax benefit rule. If the partnership makes a disproportionate distribution of its unrealized receivables and inventory, the transaction is treated as a partial sale and gain or loss may be recognized. Since distributions to a retiring partner or the successor-in-interest of a deceased partner may not be treated as liquidating distributions, the partnership may be allowed to deduct these payments. The partnership may also recognize gain or loss if payments in the form of liquidating distributions are recharacterized (that is, as sales proceeds, compensation, or loans) to accurately reflect the substance of the transaction. A liquidating distribution may affect the partnership's basis in undistributed property.

Caution. The law provides certain limitations on the use of partnerships to shift or duplicate losses. For example, if a partnership has a built-in loss in property that was contributed when it had a lower basis value than fair market value, that partnership cannot take that built-in loss into account. It may only be taken into account by the contributing partner.

In general, for purposes of allocating items to other partners, the basis in such property is the fair market value of the property at the time the contributing partner made the transfer. Therefore, the special loss limitation rule states that if a contributing partner's interest in the partnership is transferred or liquidated, the partnership's adjusted basis in the contributed property will be its fair market value. This eliminates any benefit a built-in loss could have afforded the remaining partners. Such restrictions must be considered within the context of an overall tax planning strategy for liquidating distributions.

BUY-SELL AGREEMENT FOR CLOSELY HELD BUSINESSES

So far we have discussed a variety of ways to end your business or your interest in a business and the related tax impact. When you are ready to dispose of your interest in a business (or when you die and your estate must liquidate your interests), you will want to receive in return the amount of money or property that reflects the true value of the business. However, many times in the case of a small, closely held business it is difficult to find a buyer who has the amount of

money that your business is really worth.

For this reason, as well as others, many small business owners enter into a buy-sell agreement. Sometimes these agreements are made among the shareholders of a corporation or among the partners in a partnership. In the case of a business owned as a sole proprietor, a buy-sell agreement can also be entered into with a top employee or another individual who is interested in buying the business in the future.

A buy-sell agreement binds the other shareholders, partners, or an individual to buy your interest in a business. The agreement will:

- List certain events that will trigger the obligation for the other parties involved to buy out your business interest;
- Provide a definite amount or a formula for determining the amount that your interest in the business is worth (and how much you will

receive) when your business interest is bought out under the agreement;
- Identify the parties who are obligated to buy your business interest; and
- Identify a source of funds from which those obligated to buy your business interest will have the funds to pay (the funding is sometimes provided through life insurance policies the business buys on your life).

For these reasons, buy-sell agreements can provide for a smooth transition of ownership for small, closely held businesses.

There are several types of buy-sell agreements and many different factors that must be considered by business owners when initiating a buy-sell agreement. Buy-sell agreements should be reviewed at least every two years. This bi-annual review ensures that the agreement will reflect the current ownership of the business and the owner's objectives by incorporating any changes into the agreement. Buy-sell agreements often require tax planning to maximize the benefit to you and your business.

TAX-FREE REORGANIZATIONS

Another way a business interest can be disposed of or ended is through what is referred to as a "tax-free reorganization" under the Tax Code. As the name implies, a reorganization involves a reshuffling in the form of doing business rather than a complete end to the business itself. Sometimes, however, one party to a reorganization may qualify for tax-free treatment while the other side may be taxed, either partially or entirely. For example, if your business has become a "target" that a larger business wants to buy and fold into its operations, it may transfer cash and some of its stock to you as payment. Depending up the amount of stock that it exchanged, that portion may be tax free to you, to the purchaser, or to both.

Under the Tax Code, a qualified "reorganization" must involve corporate entities and must fall within one of seven categories:

(A) A statutory merger or consolidation (that is, a merger or consolidation under the corporation laws of any state in the United States or the District of Columbia);

(B) The acquisition by one corporation of stock of another corporation, in exchange solely for all or a part of its own or its parent's voting stock, if the acquiring corporation has control of the other immediately after the acquisition, whether or not it had control before the acquisition;

(C) The acquisition by one corporation of substantially all the assets of another corporation, in exchange solely for all or a part of its own or its controlling parent's voting stock;
(D) A transfer by a corporation of all or a part of its assets to another corporation if, immediately after the transfer, the transferor or one or more of its shareholders is in control of the corporation to which the assets are transferred;
(E) A recapitalization;
(F) A mere change in the identity, form, or place of organization of one corporation; or
(G) A transfer by a corporation in bankruptcy of all or part of its assets to another corporation, but only if stocks or securities of the transferee corporation are distributed to the shareholders tax free or partially tax free.

"Control," for purposes of the above requirements, generally means ownership of 80 percent of the stock of the corporation.

"Spin-off," "split-off," and "split-up" exchanges

One category of tax-free reorganizations for which gain is not recognized is when you receive stock in connection with corporate exchanges in distributions known as "spin-offs," "split-offs," or "split-ups." Modification of these alternatives is also useful in situations in which you may want to continue ownership of one line of operations within your business but want to sell off the rest, either for cash or return for stock in a potential purchaser.

Spin-off. A "spin-off" occurs when a corporation distributes stock or securities in another corporation controlled by it (through at least 80 percent stock ownership) without requiring shareholders to surrender any shares. The distribution is pro-rata. The recipients do not surrender any of their stock in the controlling corporation. A new or existing corporation may be used for the spin-off.

Split-off. A "split-off" is a type of corporate division in which a parent corporation distributes to some or all of its shareholders stock in a newly formed or pre-existing controlled corporation, under the same conditions as in a "spin-off," except that the shareholders surrender part of their stock in the parent corporation for the stock in the controlled corporation. The distribution may be pro-rata but usually is not.

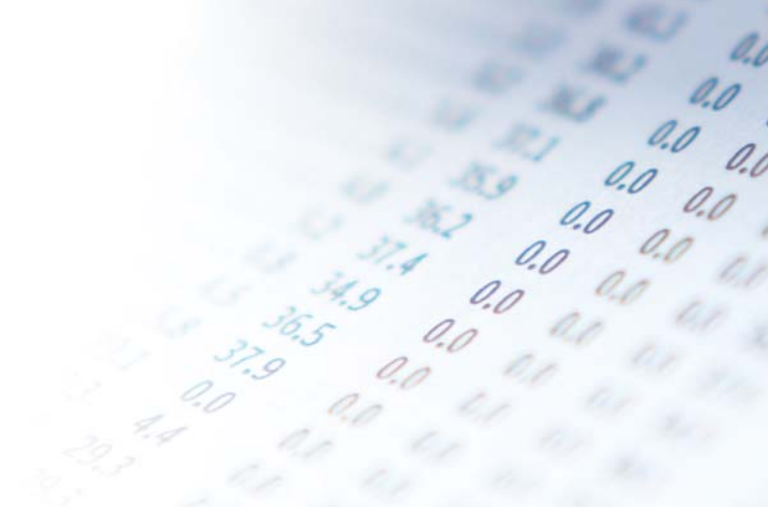
Split-up. In a "split-up," the distributing corporation's shareholders surrender all shares held in the distributing corporation and in return receive new shares in two or more controlled subsidiaries it controlled immediately before the distribution. The subsidiaries may be pre-existing or newly formed.

"Morris Trust" rules. Restrictions have been imposed on certain spin-offs that follow the structure of a case decided by the Tax Court called Morris Trust. If either the controlled or distributing corporation is acquired pursuant to a plan or arrangement in existence on the date of distribution, taxable gain is generally recognized by the distributing corporation as of the date of the distribution.

Tax can be avoided if more than 50 percent of the historical shareholders retain ownership in the distributing and acquiring corporations. Acquisitions occurring within the four-year period beginning two years before the date of distribution are presumed to have occurred pursuant to a plan or arrangement.

Gain or loss to shareholders

A corporation recognizes no gain or loss on the exchange of property solely for stock or securities of another corporation when the exchange is made pursuant to a plan of reorganization. Both sides of the exchange are eligible for nonrecognition. However, to achieve such a favorable tax outcome, transactions must satisfy strict statutory and nonstatutory requirements.



Although no gain or loss is generally recognized by a transferor on the transfer of property pursuant to a plan of reorganization, gain is recognized on any "boot" (property that does not qualify for nonrecognition treatment) as if it were sold to the recipient at its fair market value. In addition, a corporation recognizes no gain or loss on the disposition, pursuant to a plan of reorganization, of stock or securities that were received under the plan and are from another corporation that is a party to the reorganization.

There cannot be a tax-free "reorganization" unless there is an "exchange" of properties as distinguished from a "sale."

Delayed tax. Generally, the basis of stock and securities received by a corporation in a reorganization is the same as the basis of the property transferred to the acquiring corporation, adjusted for any gain or loss recognized on the exchange and the value of any money or other property ("boot") received. Boot received from the acquiring corporation generally takes a basis equal to its fair market value at the time of the transaction.

BANKRUPTCY

Sometimes, your business can end simply because it runs out of steam. If your business's liquid assets can't cover its liabilities, you should consider bankruptcy. Bankruptcy can have positive and negative implications, however, and it may not be the solution to your particular cash-flow problems. But it is important that you take the initiative whenever possible and plan the best course of action with your business and tax advisors. You can be placed in a distinct tax advantage if you can control the timing of a bankruptcy, rather than having your creditors take the initiative and force you into bankruptcy.

Individual debtors

When an individual files a petition in bankruptcy or is involuntarily placed in bankruptcy under Chapter 7 or Chapter 11 of the Bankruptcy Code, a new tax entity, the bankruptcy estate, is created. The bankruptcy estate is taxed in the same manner as an individual. The estate succeeds to the debtor's tax attributes, and it may also deduct administrative expenses connected with the bankruptcy proceedings. The trustee must file the estate's income tax returns and pay any tax due from the estate's assets. In the meantime, the debtor remains responsible for filing his individual tax returns and paying any taxes due for his or her items of income and deduction occurring after the bankruptcy petition is filed. Upon the conclusion of bankruptcy proceedings, the debtor succeeds to the tax attributes remaining from the estate. A separate taxable entity is not created for a partnership or corporation in bankruptcy proceedings.

Partnership debtors

Although the commencement of a bankruptcy proceeding by or against a partnership creates a bankruptcy estate under bankruptcy law, no separate taxable entity results from commencement of the case. As a result, a partnership cannot elect to terminate its tax year, or elect to apply the other tax rules applicable to individual debtors with respect to Chapter 7 and 11 bankruptcy cases.

The bankruptcy trustee of a partnership debtor must file an annual information return with the IRS for the partnership on IRS Form 1065, U.S. Partnership Return of Income. The IRS has ruled that the court appointment of a receiver does not create a separate taxable entity, and therefore the receiver must file an information return for the partnership on Form 1065 rather than a fiduciary return on Form 1041, U.S. Fiduciary Income Tax Return.

Corporate debtors

The commencement of a bankruptcy case by or against a corporation creates a bankruptcy estate, but no separate taxable entity. A debtor corporation that has commenced a bankruptcy case or had a bankruptcy case commenced against it has no right to elect to terminate its tax year, or to elect to apply the other rules available to an individual debtor. The bankruptcy trustee of a debtor corporation is therefore required to file annual income tax returns for the debtor corporation and to pay any corporate income tax due.

Tax protections

Filing a bankruptcy petition or beginning a receivership proceeding in federal or state court significantly affects the IRS's right to collect taxes, and can alter the amount that would otherwise be paid to the government. The bankruptcy or receivership proceeding may resolve contested tax liabilities and discharge the debtor's liability for taxes.

In a receivership proceeding, the IRS cannot collect taxes from, or enforce liens on, property under the control of the court. The filing of a bankruptcy petition triggers an automatic "stay," which prevents the government from taking or continuing action to collect taxes or enforce its liens. The automatic stay also prevents the filing of a petition with the Tax Court or the continuation of a Tax Court proceeding which began before the bankruptcy petition was filed. However, the automatic stay does not apply to an individual's post-petition taxes.

Once a bankruptcy petition is filed, the bankruptcy court may rule on any controversy concerning the amount of taxes due from the debtor. The bankruptcy court's determination of the amount of taxes owed is binding on the IRS and the bankruptcy estate, subject to appeal of that decision under bankruptcy rules. A decision by the Tax Court, if the stay is lifted, is binding on the IRS, the bankruptcy estate, and the debtor.

The distribution priority given to a tax claim in a bankruptcy proceeding depends on the nature of the proceeding and on whether the tax claim is secured. In a receivership proceeding, an unsecured tax claim has priority over all but two categories of other debts:

- Claims secured by liens perfected while the debtor was solvent;
- Administration expenses and debts incurred during the administration of the receivership estate; and
- Taxes incurred during the administration of the bankruptcy estate qualify for first priority.

Second priority taxes are those incurred in the period between the time an involuntary bankruptcy petition is filed and the time a trustee is appointed or the order for relief is entered. Taxes withheld on specified wages, salaries, or commissions qualify for a third priority.

Taxes qualifying for an eighth priority include income taxes incurred within three years of the filing of the bankruptcy petition, taxes required to be withheld from other persons and employment taxes on wages paid before the petition was filed.

A discharge, which is the legal right not to pay a debt, can be obtained only in a bankruptcy, not in a receivership or similar proceeding.

In a Chapter 7 liquidation proceeding, only individual debtors may be discharged. Subject to the overall exceptions to discharge for specified taxes, the debtor is discharged from all taxes that arose before the date of the order for relief.

In a Chapter 11 reorganization, any taxes entitled to a first or second priority must be paid. Likewise, taxes entitled to a third or eighth priority must be paid in full over a period not exceeding six years. Subject to the overall exceptions to discharge for specified taxes, all other taxes are discharged upon confirmation of the reorganization plan.

CONCLUSION

Ending a business, from a tax point of view, is similar in many ways to the situation you faced when you started your business. Your mind is on other things.

In starting your business, you first focused on how you were going to find your startup money, then on how you were going to make a profit, what employees were needed to do what tasks, and when. Taxes were not high on your list of immediate concerns. In ending a business, you also have other pressing needs. Once you make the decision to end it, you're usually anxious to get it over with. At the same time, there is a sentimental attachment to certain aspects of the business, which probably has been a big part of your life for many years. All the while, there is a business that still needs to be run—or to be wound down properly—before you close this chapter of your life. Again, taxes may seem secondary.

If you want to exit a business while preserving as much money as possible, however, tax planning should be a part of the process. Whether you are selling your business, passing it on to the next generation, or just closing its doors, the IRS wants to know the details. How you ran your business, and how you sell it, often makes a significant difference in the amount of taxes you and your business must pay when you end your financial relationship with your business.

Are you the sole owner, or only a part-owner of the business? Was it operated as a proprietorship, a partnership, or a corporation? What is your current tax basis in your business assets? What carryover tax losses are still on the books? Will you be going into another, similar business? Or do you want to continue one side of your larger business operations and sell off the rest? Do you need the money from the sale immediately, or can you wait and receive it in installments? The questions are varied, and the tax solutions often involve customizing certain tried-and-true planning strategies to fit your exact situation.

Once you meet with your tax advisor and customize the steps you will take in ending your business with the best possible consequences for you, you probably will find—as other clients have—a sense of organization and purpose … and a sense of satisfaction that the rewards from a business that you worked so hard to build are not being shared unnecessarily with Uncle Sam.