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USING NEGOTIATION EXERCISES TO BUILD A BETTER TAX FOUNDATION WHILE KEEPING STUDENTS ACTIVELY ENGAGED

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USING NEGOTIATION EXERCISES TO BUILD A BETTER TAX FOUNDATION WHILE KEEPING STUDENTS ACTIVELY ENGAGED

*Nathan L. Wadlinger**

I. INTRODUCTION

The difficulties in teaching tax have long been obvious to those faculty who are tasked with teaching this subject matter. The majority of students enter their first course in tax with the notion that tax law is intimidatingly complex and technical.¹ They believe that the course will require extensive memorization and difficult calculations.² They worry that tax law will not be clear in concepts and policies.³ Some of the most seasoned and renowned tax faculty have advised new educators in tax to think twice about teaching this subject, as tax law has grown increasingly complex and difficult to convey to students.⁴

Tax faculty have toiled over how to make the subject more approachable and more easily understood to both beginning and advanced students. Some academics have championed an “active approach” in which students grapple with the Internal Revenue Code and other regulations.⁵ Others have recommended a more “interdisciplinary, process-oriented approach” to tax courses in which tax issues are assessed from multiple perspectives, not just that of a tax professional.⁶ Still others have suggested that tax faculty should

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¹ Michael A. Oberst, *Teaching Tax Law: Developing Analytical Skills*, 46 J. LEGAL EDUC. 79, 80 (1996).

² *Id.*

³ *Id.*

⁴ See Paul L. Caron, *Tax Myopia, or Mamas Don't Let Your Babies Grow Up to Be Tax Lawyers*, 13 VA. TAX REV. 517, 521–22 (1994).

⁵ Oberst, *supra* note 1.

⁶ Michael A. Livingston, *Reinventing Tax Scholarship: Lawyers, Economists, and the Role of the Legal Academy*, 83 CORNELL L. REV. 365, 431 (1998).

“apply[] critical methods to teaching taxation,” meaning that they should delve into how social issues converge with tax law.⁷

In the law school setting there are additional issues, systemic in nature, that add to the difficulties in teaching tax courses. For hundreds of years, the study of law has been an institutionalized experience in which professors lead lectures from their podium and then employ the Socratic method to teach students to respond immediately to questions for which they have not had the chance to prepare.⁸ The Socratic method and court decision analysis, which has also been called “case method” or “case-dialogue method”⁹ have been the pedagogical tools of choice since 1870, employed to teach reasoning skills and intellectual process.¹⁰ However, research has shown that this teaching structure may not conform to adult learning methods for an array of students.¹¹ Over time, as this teaching structure has been challenged and criticized, law schools have begun to implement clinical and externship opportunities in litigation and transactional settings so that students can benefit from experiential learning.¹²

While law school does lend students the opportunity for hands-on learning in law clinics and externships, law schools have generally not managed to integrate hands-on learning with the formal lectures on doctrinal

⁷ Nancy E. Shurtz, *Critical Tax Theory: Still Not Taken Seriously*, 76 N.C. L. REV. 1837, 1886 (1998).

⁸ See, e.g., Christopher W. Holiman, *Leaving No Law Student Left Behind: Learning to Learn in the Age of No Child Left Behind*, 58 HOW. L.J. 195, 215–16 (2014); Jeffrey D. Jackson, *Socrates and Langdell in Legal Writing: Is the Socratic Method a Proper Tool for Legal Writing Courses?*, 43 CAL. W. L. REV. 267, 272–73 (2007).

⁹ See Phyllis Goldfarb, *Back to the Future of Clinical Legal Education*, 32 B.C. J.L. & SOC. JUST. 279, 285, 296 (2012).

¹⁰ See George S. Grossman, *Clinical Legal Education: History and Diagnosis*, 26 J. LEGAL EDUC. 162, 163 (1974).

¹¹ See MALCOLM KNOWLES, *THE ADULT LEARNER: A NEGLECTED SPECIES* 57–61 (1973); Fran Quigley, *Seizing the Disorienting Moment: Adult Learning Theory and the Teaching of Social Justice in Law School Clinics*, 2 CLINICAL L. REV. 37 (1995).

¹² See David I.C. Thomson, *Defining Experiential Legal Education*, 1 J. EXPERIENTIAL LEARNING 1, 1–4, 8, 10 (2015).

subjects.¹³ Instead, students usually take doctrinal classes in subjects like property, criminal law, and constitutional law, and complete their law clinics or externships separately. Currently, law schools provide little framework for integrating doctrinal knowledge with hands-on learning experiences.¹⁴ And there are very sparse examples of this kind of integration in the tax realm. Two excellent examples present in the literature involve negotiation-type exercises.

In the first example, Professor Yin teaches a Tax Policy seminar in which he assigns students a role to play as part of a simulation.¹⁵ These roles include congressional committee members, administration representatives, and lobbyists.¹⁶ In their roles, the students must reach a revenue goal set by Professor Yin by negotiating with each other and attempting to influence the committee.¹⁷ This simulation demonstrates that cooperative negotiating is imperative when attempting to achieve a specific goal.

In a second example, Professors Bartlett and Powell created a joint negotiation project where students from a doctrinal tax class and students from a pretrial litigation skills class came together to tackle a single negotiation project.¹⁸ This well-received project integrated doctrinal tax law with practical legal skills training, as the professors believed there can often be a gap between the two components of a legal education.¹⁹ The project involved “negotiating and drafting a settlement agreement incorporating specific tax implications,” as the professors believed that law schools can

¹³ See, e.g., Deborah Maranville & Cynthia Batt, *Pathways, Integration, and Sequencing the Curriculum*, in BUILDING ON BEST PRACTICES: TRANSFORMING LEGAL EDUCATION IN A CHANGING WORLD 53–58 (Deborah Maranville et al. eds., 2015).

¹⁴ Myra E. Berman, *Portal to Practice: A Multidimensional Approach to Integrating Experiential Education into the Traditional Law School Curriculum*, 1 J. EXPERIENTIAL LEARNING 157, 159 (2015).

¹⁵ George K. Yin, *Simulating the Tax Legislative Process in the Classroom*, 47 J. LEGAL EDUC. 104, 104–07 (1997).

¹⁶ *Id.* at 106–07.

¹⁷ *Id.* at 104–06.

¹⁸ Karen E. Powell & Lauren E. Bartlett, *Bridging the Gap: A Joint Negotiation Project Crossing Legal Disciplines*, 2 J. EXPERIENTIAL LEARNING 182, 184 (2018).

¹⁹ *Id.*

better prepare students for practice through the integration of experiential learning throughout the curriculum.²⁰

Students from a State and Local Tax course were required to investigate “the statutory and procedural requirements” pertaining to the tax liability of a spouse who claims to have been ignorant of the other spouse’s criminal financial dealings (i.e., an “innocent spouse claim”), while “students in the Civil Practice class studied the art of negotiation.”²¹ The students were then assigned to groups with others from a blend of the two classes.²² They received a fact pattern and met before the joint negotiation class to share what they had learned about the tax law and to prepare their negotiation strategy.²³ This joint negotiation project was designed to test the idea that joint projects across courses could help bridge the divide between doctrinal classes and practical legal skills training.²⁴ The professors envisioned merging these two sides of the divide through experiential problem solving in realistic scenarios using the full array of modern pedagogical tools.²⁵

Although there may be differences in the underlying pedagogical methodologies, these two innovative approaches involving the teaching of tax law generally address two key goals: (1) to engage students and (2) to emphasize the importance of tax in a well-rounded legal education, even for those students who intend to pursue other specialties. And while these two active negotiation exercises are excellent projects, they do have one limitation. They serve more advanced tax students rather than the introductory-level tax course. This is a critical point as the introductory-level tax course is where the students first encounter the intimidating nature of tax, as discussed earlier.

In this Article, I present an active negotiation exercise that focuses on these two keys goals and can be used in many different tax courses, including an introductory-level tax course. I have used this exercise in many of my courses including my Federal Income Tax course. The negotiation involves

²⁰ *Id.* at 183.

²¹ *Id.* at 184.

²² *Id.*

²³ *Id.*

²⁴ *Id.*

²⁵ *Id.*

the tax consequences of the purchase and sale of a sole proprietorship. Students are grouped into teams of buyers and sellers. Each buyer team negotiates with a seller team the purchase/sales price of the business and the fair market value of the assets of the business given a range of values from independent appraisers. After presenting the negotiation exercise fact pattern, I discuss how the exercise helps students understand important foundational tax rules, including the following: the calculation of realized and recognized gain/loss; the characterization of gain/loss; the benefit of preferential tax rates; determining how assets are depreciated or amortized; the effect of time value of money on tax benefit recovery; and allocation of purchase and sales price of a business using § 1060. I then discuss my experiences over many semesters of using the exercise. Finally, I discuss other tax topics that are well suited for negotiation exercises, and how I have integrated this negotiation exercise into my Corporate Tax, Partnership Tax, and Tax Research courses.

II. THE NEGOTIATION ASSIGNMENT

A. The Negotiation Case Information

This negotiation exercise should take place over multiple classes in an introductory-level Federal Income Tax course. At a minimum, three classes should be utilized in order for students to best learn from the case assignment.²⁶ The first of the three classes should include a discussion of the applicable tax law relevant to the assignment. The second class should entail the actual negotiation by the students. And the third class should be a postnegotiation discussion and feedback session. This Part of the Article will introduce the negotiation case information, discuss the tax consequences of buying and selling a business, consider unique consequences to both the seller and buyer in this negotiation, and discuss one successful approach that I have used in the first and second classes. The next Part of the Article will discuss the third class, along with additional insights. The remainder of this Part lays out the actual negotiation case information that students will use to conduct the negotiation.

²⁶ This assumes an introductory-level Federal Income Tax class that meets twice a week. If the class meets more frequently or less frequently per week, the number of classes may need to be adjusted.

Candy owns Candy's Candles, which makes scented candles, as a sole proprietorship. She started Candy's Candles from nothing ten years ago as simply a hobby and initially sold her products to just friends and family. Eventually, the business went viral thanks to lovely scented candles like Pumpkin Passion®. One day, Candy received an offer from Candle Conglomerate, a C corporation, to purchase her business for a \$2,000,000 lump-sum offer. Candy is very interested in selling her Candy's Candles business, as she would like to use this as seed money to invest in an art studio, art being her real passion. However, she feels a fair valuation of the business would be a \$2,500,000 lump-sum offer. A list of all assets (there are no liabilities) and the only possible range of values is as follows:

Asset	Adjusted Basis	Valuation Range (reasonable range)²⁷
Cash	\$10,000	\$10,000
Accounts receivable from local stores that buy Candy's candles (on Candy's books at \$100,000 before any reduction for bad debts)	\$0	\$80,000 to \$100,000
Inventory of existing candles	\$100,000	\$150,000 to \$200,000
Various machinery (purchased originally for \$80,000, and \$60,000 of depreciation has been taken over the years)	\$20,000	\$50,000 to \$120,000
A building on a small parcel of land owned by Candy and used as a business location to manufacture her candles. The purchase price of the property was \$450,000 with \$390,000 allocated to depreciable real estate and \$60,000 allocated to land. After approximately five years of straight-line depreciation, the tax basis is	Building: \$340,000 Land: \$60,000	Building: \$640,000 to \$700,000 Land: \$120,000 to \$180,000

²⁷ Assume that these valuation ranges are made from multiple independent appraisers.

Asset	Adjusted Basis	Valuation Range (reasonable range) ²⁷
now reduced to \$400,000 of which \$340,000 is allocated to depreciable real estate and \$60,000 to land.		
Trademarks and tradenames related to the Candy's Candles candle names (e.g., Pumpkin Passion®)	\$0	\$100,000 to \$150,000
Copyrights owned by Candy to various inspirational poems that she includes in the packages with her candles	\$0	\$50,000 to \$75,000
Various methods, techniques, know-how, and trade secrets that she has developed in making the candles	\$0	\$40,000 to \$60,000
A patent claiming rights in her special proprietary candle-making technology	\$0	\$200,000 to \$250,000
The goodwill of the business	\$0	\$460,000 to \$525,000
5,500 shares of Wax Candle Co. Inc. purchased 6 months ago by Candy's Candles. Assume for this assignment that Wax Candle Co. Inc. is a privately held corporation.	\$75,000	\$100,000 to \$130,000

Candy self-created all the intangible assets. Candy has no plans to work in the candle business going forward and will not need a covenant not to compete with respect to Candle Conglomerate. This asset acquisition will be one in which Candle Conglomerate pays cash for these assets of the business. Candle Conglomerate will use all assets acquired in its candle business except the Wax Candle stock, which it will hold as an investment. Further, Candle Conglomerate plans to hold and use all of these assets acquired for the duration of its candle business.

The aggregate (combined federal and state) tax bracket of Candy is forty percent for ordinary income and twenty percent for capital gains. Assume

that any discounting will take place at a six percent discount rate. All assets held by Candy's Candles have been held more than one year, if not specified. For purposes of cost recovery, Candle Conglomerate will not make any special cost recovery elections, including § 179 and bonus depreciation. The various machinery purchased by Candle Conglomerate will be considered five-year property for MACRS tax purposes.

The parties must come to an agreement on the purchase/sale as both parties want this event to occur. The agreed-on price must be a one-time, lump-sum amount that falls equal to or between \$2 million and \$2.5 million. No installment agreements can be considered. The parties must also agree on the valuation of each asset listed above for purposes of the sale. The value of each asset must fall within the reasonable range provided.

B. General Tax Consequences for Buying and Selling a Business

This negotiation revolves around a “sole proprietorship”; that is to say, a business owned by a single individual who reports all tax aspects of the business, including the sale transaction, on Schedule C to Form 1040. The sale of a sole proprietorship business is the “plain vanilla” fact pattern that involves tax issues that can be used to lay the foundation for understanding tax aspects of more complex asset sales by other business entities. A business is made up of many assets, usually including accounts receivable, inventory, equipment, land, buildings, and intellectual property. When determining the tax consequences of the sale of the assets of a business, the tax law applies the normal property transaction rules; specifically, the realized and recognized gain or loss will be the amount realized minus the adjusted basis.²⁸ However, a buyer usually pays a lump-sum price for all of the assets. So, is the recognized gain or loss based on the overall transaction or each specific asset? The tax law specifically looks at the amount realized minus adjusted basis of each asset sold in the sale of a business,²⁹ which will be discussed in more detail below. This rule breaks up characterization of the overall gain or loss based on the specific assets sold.³⁰ Unlike corporations,

²⁸ I.R.C. § 1001(a).

²⁹ *See id.* §§ 1060(a), 338(b)(5); Treas. Reg. § 1.338-6(a), (b), (d) (as amended in 2007).

³⁰ I.R.C. §§ 1060(a), 338(b)(5); Treas. Reg. § 1.338-6(a), (b), (d).

sole proprietors, because they are treated as individuals, benefit from a preferential tax rate on long-term capital gains.³¹ Therefore, the tax issues involved in the sale of a sole proprietorship generally pertain to the character of the assets being sold and, as a result, that of the income or gain recognized by the seller (e.g., ordinary income, ordinary loss, capital gain, and/or capital loss).

For purposes of determining the seller's amount realized for each of the assets sold in an applicable asset acquisition, the seller allocates consideration to all of the assets sold by using the residual method under § 1060 and Treasury Regulation section 1.338-6.³² This same residual method allocation is used to determine the purchaser's cost basis in each of the assets purchased in an applicable asset acquisition.³³ In general, the residual method allocates the purchase price paid in an applicable asset acquisition using fair market value of the assets.³⁴ The allocation of purchase price occurs in sequential order to seven classes of assets, designated as Classes 1 through 7.³⁵ The definition of each of the seven asset classes is as follows:

1. Class 1 assets are cash and cash equivalents.³⁶
2. "Class [2] assets are actively traded personal property."³⁷ "Examples of Class [2] assets include U.S. government securities and publicly traded stock."³⁸
3. Class 3 assets are other types of financial instruments not included in Class 2 and accounts/notes receivable.³⁹

³¹ I.R.C. §§ 1(h), 11.

³² See *id.* §§ 1060(a), 338(b)(5); Treas. Reg. § 1.338-6(a), (b), (d).

³³ See I.R.C. §§ 1060(a), 338(b)(5); Treas. Reg. § 1.338-6(a), (b), (d).

³⁴ Treas. Reg. § 1.338-6(b)(2)(i).

³⁵ *Id.* § 1.338-6(b).

³⁶ *Id.* § 1.338-6(b)(1).

³⁷ *Id.* § 1.338-6(b)(2)(ii).

³⁸ *Id.*

³⁹ *Id.* § 1.338-6(b)(2)(iii).

4. Class 4 assets are inventory.⁴⁰
5. “Class [5] assets are all assets other than Classes [1-4, 6 and 7].”⁴¹
Examples of Class 5 assets include furniture and fixtures, buildings, land, vehicles, and equipment.
6. Class 6 assets are all intangibles “except goodwill and going concern value.”⁴²
7. “Class [7] assets are goodwill and going concern value.”⁴³

The value allocated to assets in Classes 1 through 6 is capped at the fair market value of those assets on the purchase date.⁴⁴ Any excess should be assigned to Class 7.⁴⁵ Note that fair market value is the value upon which the buyer and seller agree under the tax law, as long as they are conducting business at arm’s length.⁴⁶

Considered another way, starting with the full purchase price consideration amount, the allocation process should proceed through three steps in order as follows:

1. Reduce the consideration “by the amount of Class 1 assets” transferred.⁴⁷
2. Allocate the remaining consideration to Class 2 assets, then to Class 3, 4, 5, and 6 assets in that order using the fair market value of each asset agreed to by the buyer and seller. If there is not enough consideration left to allocate within a class, allocate the

⁴⁰ *Id.* § 1.338-6(b)(2)(iv).

⁴¹ *Id.* § 1.338-6(b)(2)(v).

⁴² *Id.* § 1.338-6(b)(2)(vi).

⁴³ *Id.* § 1.338-6(b)(2)(vii).

⁴⁴ *Id.* § 1.338-6(c)(1).

⁴⁵ *Id.* § 1.338-6(b)(2)(i).

⁴⁶ *Id.* § 20.2031-1(b) (as amended in 1965).

⁴⁷ *Id.* § 1.338-6(b)(1).

remaining consideration to those class assets in proportion to their fair market values agreed upon by the buyer and seller.⁴⁸

3. Allocate the remaining consideration, if any, to Class 7 assets.⁴⁹

The residual method is simply a set of rules whereby the aggregate purchase price of a business is allocated in a logical economic progression, starting with the most easily valued assets (cash being the easiest-to-value asset), and descending in order of valuation ease until the remaining amount (the so-called “residual amount”) is allocated to the assets with the most difficult and imponderable value, namely business goodwill. If an asset in one of the classifications described above can be “includ[ed] in more than one class,” choose the lower numbered class (e.g., if an asset could be included in Class 3 or 4, choose Class 3).⁵⁰

One of the other requirements of § 1060 is that the parties to the transaction must negotiate the purchase price allocation and report it consistently on Form 8594.⁵¹ This requirement is designed to prevent the IRS from getting “whipsawed,” the term used to describe the practice where the buyer and the seller would allocate the same purchase price in very different ways, each to its own maximum advantage. The IRS imposed significant reporting requirements on an applicable asset acquisition for the very reason that there historically has been so much maneuvering and aggressive planning in the allocation of purchase price.

The buyer and the seller each must report information concerning the amount of consideration in the transaction and its allocation among the assets transferred, and they must also report information concerning subsequent adjustments to consideration.⁵²

[In particular, the buyer and seller] each must file asset acquisition statements on Form 8594, . . . with their income tax returns or returns of income for the tax[] year . . . includ[ing] the first date assets are sold pursuant to an applicable asset

⁴⁸ *Id.* § 1.338-6(b)(2)(i).

⁴⁹ *Id.*

⁵⁰ *Id.*

⁵¹ *Id.* § 1.1060-1(e)(1)(ii)(A) (as amended in 2008).

⁵² *Id.* § 1.1060-1(e)(1)(ii)(B).

acquisition. This reporting requirement applies to all applicable asset acquisitions.⁵³

C. The Seller's Tax Consequences and Strategy in the Negotiation

Because this negotiation case only considers the effects of gains, the discussion below assumes the sale of a business results in no losses to the seller, only gains.⁵⁴ A selling sole proprietor typically desires capital gains treatment on a sale of business asset, not ordinary income treatment.⁵⁵ Therefore, it pleases the seller to allot each marginal dollar of purchase price not to an ordinary asset, but rather to a capital asset or a § 1231 asset that generates capital gain.

For purposes of this negotiation, Candy's character consequences for the assets sold will be as follows:

- Cash: the transfer of cash has no character consequences to Candy since there is no gain or loss on the transfer.⁵⁶
- Accounts Receivable: accounts receivable and equivalent assets acquired by Candy in the ordinary course of business are not capital assets nor § 1231 assets.⁵⁷ Therefore, gain or loss on the sale of accounts receivable will be ordinary.
- Inventory: inventory and other property held for sale to customers by Candy in the ordinary course of business are not capital assets or § 1231 assets.⁵⁸ Therefore, gain or loss on the sale of inventory will be ordinary.

⁵³ *Id.* § 1.1060-1(e)(1)(ii)(A).

⁵⁴ Note that if losses are generated, the seller would prefer the opposite character treatment of gains. Therefore, the seller would prefer ordinary losses rather than capital losses.

⁵⁵ As discussed above, the seller is seeking the lowest tax rate possible on the gains recognized from the sale.

⁵⁶ This is because the amount realized and adjusted basis are equal. Note that for practical purposes, in almost every asset sale, the seller keeps the cash on hand. Therefore, this item is rare in practice, but used in this exercise to help understand how the residual method works with the Class 1 assets.

⁵⁷ I.R.C. § 1221(a)(4).

⁵⁸ *Id.* §§ 1221(a)(1), 1231(b)(1)(A)–(B).

- Machinery: depreciable tangible personal property used in business and held for more than one year by Candy is a § 1231 asset, subject to long-term capital gain/ordinary loss treatment.⁵⁹ However, this property is also subject to § 1245 ordinary income depreciation recapture on any resulting gain.⁶⁰ Because machinery of this type is rarely sold for an amount greater than its original purchase price, all of the amount allocated to the depreciable tangible property in excess of its tax basis will be ordinary recapture income. However, for the range in value, it is possible in this negotiation to have a portion of ordinary income recapture and a portion of § 1231 gain.
- Building: depreciable real property used in business and held for more than one year by Candy is a § 1231 asset, subject to long-term capital gain/ordinary loss treatment.⁶¹ It is also subject to special recapture rules under § 1250,⁶² and also the special twenty-five percent capital gains tax rate on unrecaptured § 1250 gain.⁶³ Because depreciable nonresidential real estate is currently depreciated on a straight-line basis over thirty-nine years, recapture under § 1250 will generally be zero,⁶⁴ but gain attributable to prior depreciation deductions will be subject to the special twenty-five percent tax rate, rather than the normal twenty percent long-term capital gain rate to which Candy is subject in this problem.⁶⁵
- Land: nondepreciable real property used in business and held for more than one year by Candy is a § 1231 asset, subject to long-term capital gain/ordinary loss treatment.⁶⁶

⁵⁹ *Id.* § 1231(a), (b).

⁶⁰ *Id.* § 1245.

⁶¹ *Id.* § 1231(a), (b).

⁶² *Id.* § 1250(a), (c).

⁶³ *Id.* § 1(h)(1)(E).

⁶⁴ *Id.* §§ 1250(b), 168(b)(3)(A), (c).

⁶⁵ *Id.* § 1(h)(1)(E).

⁶⁶ *See id.* § 1231(a), (b).

- Trademarks: trademarks used in business and held for more than one year by Candy are § 1231 assets or long-term capital assets.⁶⁷ Because this negotiation case only results in gains, either characterization results in long-term capital gain to Candy on the sale of the trademarks.
- Copyrights: self-created copyrights on poems held by Candy are considered ordinary assets.⁶⁸ Further, they are not considered § 1231 assets.⁶⁹ Therefore, gain or loss on the sale of the copyrights will be ordinary.
- Trade Secrets: the “various methods, techniques, know-how, and trade secrets” owned by Candy fit the category of trade secrets. These self-created trade secrets are considered ordinary assets.⁷⁰ Further, they are not considered § 1231 assets.⁷¹ Therefore, gain or loss on the sale of the trade secrets will be ordinary.
- Patents: due to the enactment of the Tax Cuts and Jobs Act of 2017 (TCJA), when a taxpayer who personally had a hand in creating a patent sells the patent, the gain or loss is generally ordinary in nature.⁷² However, according to the Bluebook to the TCJA, § 1235 and § 1221(a)(3) are intended to coexist.⁷³ The Bluebook also indicates that a patent is not to be treated as a capital asset when owned by a taxpayer whose personal efforts created the property, unless the specific requirements of § 1235 are met.⁷⁴ If these requirements are met, then the patent will be eligible to yield long-

⁶⁷ *See id.*

⁶⁸ *See id.* § 1221(a)(3).

⁶⁹ *Id.* § 1231(b)(1)(C).

⁷⁰ *See id.* § 1221(a)(3).

⁷¹ *See id.* § 1231(b)(1)(C).

⁷² *Id.* § 1221(a)(3).

⁷³ STAFF OF J. COMM. ON TAX'N, 115TH CONG., GENERAL EXPLANATION OF PUBLIC LAW 115-97, at 207 (Comm. Print 2018).

⁷⁴ *Id.*

term capital gain when sold.⁷⁵ Section 1235 requires an individual “holder” rather than a business entity.⁷⁶ Because the patent was self-created and sold by a sole proprietorship, it is considered sold by Candy, an individual. Therefore, § 1235 applies to the sale of the patent and characterizes the gain as long-term capital gain.⁷⁷

- **Goodwill:** the self-created goodwill of a business is conventionally a capital asset.⁷⁸ The goodwill of a company may or may not be separable from the goodwill belonging to one or more individual owners who participate in the business. It seems entirely possible to identify a goodwill component belonging to the business (e.g., a going concern value or going business value of the enterprise) and goodwill belonging to the individual owner (in this case, Candy’s right to use her own name as she chooses, exploit her business contacts, and so forth). Practically speaking, the separation of individual goodwill and business goodwill does not make much difference in the sale of an unincorporated business because, however allocated, the goodwill is a capital asset, subject to capital gains rates at the individual level.⁷⁹ Therefore, the sale of the goodwill by Candy will be considered long-term capital gain.
- **Wax Candle Stock:** because the Wax Candle stock has been held for only six months by Candy, the characterization of the sale is short-term capital gain.⁸⁰

D. The Buyer’s Tax Consequences and Strategy in the Negotiation

Generally, if the buyer is obtaining the assets to use in a similar business, which is typically the case, then the assets will be characterized in the same

⁷⁵ I.R.C. § 1235(a).

⁷⁶ *See id.* § 1235(b).

⁷⁷ *Id.* § 1235(a).

⁷⁸ *See Comm’r v. Killian*, 314 F.2d 852, 855 (5th Cir. 1963).

⁷⁹ This would make a difference for a C corporation seller, such as if Candle Conglomerate developed the goodwill and was selling this asset.

⁸⁰ I.R.C. §§ 1221, 1222.

way they were characterized in the hands of the seller, if later disposed.⁸¹ For example, § 1231 property owned by the seller will almost always remain § 1231 property once it changes hands to the buyer, as long as the assets are being used in a similar business as before and held for more than one year.⁸² So from this angle, the buyer does have a common interest with the seller. However, the buyer still has very different motives that often conflict with those of the seller. The major conflict is that the buyer desires to deduct or depreciate the purchase price as quickly as possible due to time value of money concepts. Therefore, the buyer would like to allocate purchase price to items like inventory, which can be deducted within one tax year,⁸³ or to tangible assets that can be depreciated over a short period of time rather than intangible assets that would be amortized over a lengthy time period.

In this case, the buyer's tax strategy involves time value of money concepts. While accounting and business school students have a good foundation regarding time value of money, many law school students in an introductory tax class will need an overview of the concepts. It is wise to do a brief discussion of time value of money with one's tax students. The way I summarize to my law students is as follows: a dollar received today is more beneficial than a dollar received in the future because it can be invested or spent immediately without the need to borrow. If that dollar is received in the future instead of today, it cannot be invested or spent immediately. The longer one waits to receive the dollar, the greater one's opportunity cost, also known as the time value of money. Adjusting dollar amounts to reflect the time value of money is referred to as discounting or taking the present value of the amount. This concept also applies in terms of tax benefits and savings. A dollar of tax savings today is more beneficial than a dollar of tax savings

⁸¹ Of course, there is a distinction in tax rates by Candy, an individual, versus Candle Conglomerate, a C corporation. The main distinction is that there is no preferential tax rate on capital gains for C corporations.

⁸² See I.R.C. § 1231(a), (b).

⁸³ See *id.* § 162(a); see also Treas. Reg. § 1.63-1(a) (as amended in 1979). Accounting Standards Codification 330 provides guidance on the accounting and reporting of inventory in the financial statements. FIN. ACCT. STANDARDS BD., ACCT. STANDARDS UPDATE: INVENTORY (TOPIC 330) (2015), <https://asc.fasb.org/imageRoot/22/66710722.pdf>. Accounting Standards Codification 330 specifically provides that inventory is a current asset as it can be sold or easily converted into cash within one year. Since inventory is a current asset under generally accepted accounting principles, assume that the inventory is reasonably expected to be collected within one year.

received in the future. While a six percent discount rate is provided in the negotiation case facts, students really do not need to do the specific present value calculation of the tax benefits of the buyer.⁸⁴ Rather they should understand the general idea of the benefit of accelerating deductions rather than deferring them.

For purposes of this negotiation, Candle Conglomerate's tax benefit recovery of the assets purchased will be as follows:

- Cash: the transfer of cash does not have basis tax benefit recovery consequences to Candle Conglomerate since the face value and basis always remain the same.
- Accounts Receivable: the tax basis for accounts receivable is essentially recovered on the collection of the accounts receivable.⁸⁵ Using the Generally Accepted Accounting Principles (GAAP) definition that accounts receivable is a current asset,⁸⁶ assume that the accounts receivable is reasonably expected to be collected within one year. Therefore, the tax basis of accounts receivable will be recovered by Candle Conglomerate within one tax year.
- Inventory: the tax basis for inventory is essentially recovered on the sale of the inventory.⁸⁷ Using the GAAP definition that inventory is a current asset,⁸⁸ assume that the inventory is

⁸⁴ If you do want to require students to do mathematical discounting, it is essential that you discuss the present value calculation, which is as follows: $PV = FV / (1 + i)^r$, where "FV" is the future value of the cash amount "r" periods in the future and "i" is the interest (i.e., discount) rate per period, "r" periods in the future. Although present value calculations can be performed with hand calculators, Excel or another spreadsheet program is usually the tax professional's tool of choice because it allows maximum flexibility.

⁸⁵ When the accounts receivable are collected by the buyer, the basis allocated when purchased will be used to offset the reported gross income. See I.R.C. § 1001(a) for a similar application to property dispositions.

⁸⁶ Accounting Standards Codification 310 provides guidance on the accounting and reporting of accounts receivable in the financial statements. FIN. ACCT. STANDARDS BD., ACCT. STANDARDS UPDATE: RECEIVABLES (TOPIC 310) (2010), <https://asc.fasb.org/imageRoot/61/6956161.pdf>. Accounting Standards Codification 310 specifically provides that accounts receivable is a current asset as it due within one year.

⁸⁷ I.R.C. §§ 263A, 471.

⁸⁸ Accounting Standards Codification 330 provides guidance on the accounting and reporting of inventory in the financial statements. Accounting Standards Codification 330 specifically provides that

reasonably expected to be collected within one year. Therefore the tax basis of inventory will be recovered by Candle Conglomerate within one tax year.

- Machinery: the machinery purchased by Candle Conglomerate as stated in the negotiation assignment facts is considered five-year property. The basis amount is recovered under the MACRS depreciation system over six actual years when considering the tax returns where the depreciation is taken.⁸⁹
- Building: the building purchased by Candle Conglomerate is considered nonresidential depreciable real property and will be depreciated straight-line over thirty-nine years.⁹⁰
- Land: the land purchased by Candle Conglomerate does not provide any cost recovery tax benefits while continuing to be used in its business.⁹¹
- Trademarks: the trademarks purchased by Candle Conglomerate will be § 197 assets and amortized straight-line over fifteen years.⁹²
- Copyrights: the copyrights purchased by Candle Conglomerate will be § 197 assets and amortized straight-line over fifteen years.⁹³
- Trade Secrets: the trade secrets purchased by Candle Conglomerate will be § 197 assets and amortized straight-line over fifteen years.⁹⁴

inventory is a current asset as it can be sold or easily converted into cash within one year. *See supra* note 83.

⁸⁹ Rev. Proc. 87-57, 1987-2 C.B. 687, 696.

⁹⁰ I.R.C. § 168(c).

⁹¹ Section 167(a) states that “there shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, [or] wear and tear . . . of property.” *Id.* § 167(a). Since land is neither subject to exhaustion or wear and tear, it is not subject to depreciation. Treas. Reg. § 1.167(a)-2 (1960). Therefore, land’s basis remains with it until it is sold or disposed.

⁹² *See* I.R.C. § 197(a), (d)(1)(F).

⁹³ *See id.* §§ 197(a), (d)(1)(C)(iii).

⁹⁴ *See id.*

- Patents: the patents purchased by Candle Conglomerate will be § 197 assets and amortized straight-line over fifteen years.⁹⁵
- Goodwill: the goodwill purchased by Candle Conglomerate will be a § 197 asset and amortized straight-line over fifteen years.⁹⁶
- Wax Candle Stock: the stock purchased by Candle Conglomerate does not provide any cost recovery tax benefits while continuing to be held as an investment.⁹⁷

E. The Tension Between the Candle Conglomerate's and Candy's Goals in the Negotiation

As discussed above, the goals of the buyer, Candle Conglomerate, and those of the seller, Candy, are, naturally, at odds. The selling sole proprietor, Candy, desires capital gains treatment on a sale of business assets, not ordinary income treatment. The buyer, Candle Conglomerate, desires to deduct or depreciate the purchase price as quickly as possible due to time value of money concepts. Therefore, Candle Conglomerate would like to allocate purchase price to items like inventory, which can be deducted within one tax year, or to tangible assets that can be depreciated over a short period of time rather than intangible assets that would be amortized over a lengthy time period. To better understand this tension between the parties in the negotiation, the following chart shows Candy's and Candle Conglomerate's preferences in valuation of the assets in the purchase/sale from highest (1) to lowest (5).

⁹⁵ *See id.*

⁹⁶ I.R.C. §§ 197(a), (d)(1)(A).

⁹⁷ Amortization does not apply to stock. *Id.* § 197(e)(1)(A).

Candy's and Candle Conglomerate's Valuation Preferences from Highest (1) to Lowest (5)		
Candy's Preference	Residual Method Classes with Candy's Assets Listed Below Each Asset Class	Candle Conglomerate's Preference
	1. Cash and Cash Equivalents	
N/A	Cash	N/A
	2. Actively Traded Securities	
	3. Receivables & Non-Actively Traded Securities	
5	Accounts Receivable	1
5	5,500 Shares of Wax Candle Co. Inc. Stock	5
	4. Inventory	
5	Inventory	1
	5. All Other Assets Not Listed in Other 6 Classes	
4	Machinery	2
3	Building	4
1	Land	5
	6. All Intellectual Property Other Than Class 7	
2	Trademarks and Tradenames	3
5	Copyrights	3
5	Trade Secrets	3
2	Patents	3
	7. Goodwill and Going Concern Value	
2	Goodwill	3

For Candy, an asset with a "1" through "5" means the following:

1. Section 1231 gain taxed at normal long-term capital gains rates.
2. Long-term capital gain taxed at normal long-term capital gains rates.

3. Section 1231 gain taxed at the special twenty-five percent rate for unrecaptured § 1250 gain.
4. Mixture of § 1231 gain and § 1245 ordinary gain.
5. Ordinary and short-term capital gain.

For Candle Conglomerate, an asset with a “1” through “5” means the following:

1. Asset with recovery of tax basis in one tax year.
2. Asset with recovery of tax basis over six tax years through MACRS depreciation.
3. Asset with recovery of tax basis over fifteen years through straight-line amortization.
4. Asset with recovery of tax basis over thirty-nine years through straight-line depreciation.
5. Asset with no recovery of tax basis until property is sold or disposed of.

F. The In-Class Negotiation Preparation and Role Play

As mentioned earlier, the negotiation case presented above should take place over at least three classes.⁹⁸ The first of the three classes should include a discussion of the applicable tax law relevant to the assignment, which was covered in the previous sections of this Part. The second class should entail the actual negotiation role play. And the third class should be a postnegotiation discussion and feedback session. The ideal placement of these three classes is toward the end of the semester after the instructor has discussed the characterization of property transactions rules. It is imperative to cover the calculation of gain or loss and the characterization of gain or loss under §§ 1221, 1231, 1245, and 1250 before working through this negotiation case. It is also imperative to cover cost recovery through depreciation and amortization under §§ 167 and 197 before working through this negotiation case.

⁹⁸ See *supra* Part II.A.

In the first class, which I refer to as the prenegotiation class, students are presented with the negotiation case information discussed above. Instructors should also go through the tax consequences of buying and selling a business, including the buyer's and seller's objectives, if this subject matter has not already been covered during the semester. Some instructors may even want to delve into the facts of the negotiation case as an illustration to discuss these concepts. I also recommend discussing the purpose for this case, which can be best derived in the next Part of this Article. Students should be instructed that in the next class (i.e., the second class) they will be negotiating in groups representing either the buyer or the seller. Before the second class, each student should review the facts of the negotiation and consider the tax consequences and strategy of both parties, as they will not know which party they will represent until the day of the negotiation.⁹⁹ Students should also be reminded that during the negotiation, the parties must come to an agreement on the following: (1) the purchase/sale price of the business and (2) the value of each asset being purchased/sold.

If you plan on making this a graded assignment, it is recommended to let students know what they need to complete during this negotiation case assignment. Below is an example of what I require my students to submit for a grade two weeks after their actual negotiation in class two:

Please prepare a four- to five-page written memo (single-spaced) specifying the following:

- *the agreed-on price (the price must fall between \$2 million and \$2.5 million),¹⁰⁰*
- *the agreed-on valuation of each asset (the value of each asset must fall within the reasonable range provided),*

⁹⁹ By not telling the students which side they will represent until immediately before the negotiation, this ensures students learn the tax consequences and strategy of both sides. This helps students better grasp the critical tax fundamentals, and it also teaches students when going into any negotiation they should consider the negotiation strategy of the other side.

¹⁰⁰ If you are grading this negotiation exercise, you may want to consider putting a small percentage of the grade on the actual negotiated outcome. I have put ten percent of the grade on the actual outcome. There are tradeoffs to doing this versus not doing this, so please consider this issue carefully.

- *the Section 1060 determination and result of Buyer's Adjusted Basis/Seller's Amount Realized using the residual method,*
- *the ultimate tax consequences with respect to both parties,*¹⁰¹
- *your team's strategy going into the negotiation, and*
- *anything learned in the overall negotiation process.*¹⁰²

I find it helpful to provide students with a sample solution to provide the format to best address the write-up portion of the case.

The second class is the actual negotiation. At the beginning of this class, students are assigned randomly to chronologically numbered groups. It is preferable to have three to five members per group. The number of groups is variable, but there should be an even number of groups. Odd-numbered groups take on the role of the tax professionals representing the seller, Candy. Even-numbered groups take on the role of the tax professionals representing the buyer, Candle Conglomerate. Once students know their group, they will meet with their group to discuss strategy and approach to the negotiation. I normally give thirty minutes for students to meet with their groups and discuss strategy. Remember that in the previous class, students were instructed that they would need to come to the second class prepared to take on the role of either party in the negotiation. This makes thirty minutes plenty of time for the group to meet and discuss strategy. It also provides time for the groups to discuss which group members should do most of the talking with the other side. I occasionally see some groups give each member a role including main negotiator, secondary negotiator, calculation analyzer, and even a member assigned the moral support role. During this group strategy session, I walk around the room to answer any general questions by the groups to ensure that they understand the tax consequences and the strategy going into the negotiation.

¹⁰¹ I usually require every team to complete the tax consequences of both sides out to be fair as many students perceive determining the tax consequences of the seller to be more of a challenge.

¹⁰² This category is meant to be very broad and allow students to discuss skills they acquired related to negotiation skills. Most groups tend to focus on soft skills items including the willingness of the other side to come to an agreement, the willingness of both parties to work together to minimize taxes on both sides, who made the first offer, how the parties were arranged at the negotiation table and any effects of the arrangement, etc.

The remainder of the second class should be allocated to the actual negotiation role play. Once time is up for the groups to meet, each buyer group will be paired with a seller group and perform the negotiation. In my experience, most groups take between thirty and forty-five minutes to complete the negotiation. After the student groups reach a negotiation agreement, they are instructed to write down the terms of the negotiation and fill out and turn in their Negotiation Assessment forms. The Negotiation Assessment forms ask for the group numbers, the agreed-on purchase/sales price, and the agreed-on value of each asset. Before I start the negotiation, I always remind the groups that they must come to an agreement on the purchase price and agreed value of each asset; “no agreement” is not an option as both parties want this transaction to occur. During the negotiation session, I walk around the room observing various negotiations. I tell the groups that I will not answer any questions unless something is very much hindering a negotiation agreement. I do listen in on each negotiation for a few minutes and take notes upon which to reflect in the postnegotiation feedback session. In the next Part of this Article, I discuss the postnegotiation takeaways, including some common patterns I see during the negotiations and feedback that I hear from students regarding this negotiation exercise.

III. POSTNEGOTIATION TAKEAWAYS AND ADDITIONAL INSIGHTS

A. *The Postnegotiation Discussion*

Completing this negotiation exercise over at least three classes provides the benefit of having the ability to dedicate at least one class to postnegotiation discussion and reflection. This time to reflect ensures that students understand not only the tax consequences and strategy specific to negotiation, but also other essential topics in income tax. This Part of the Article will discuss a recommended conversation with the class after the negotiations have concluded. It will also lay out how this negotiation can benefit a student’s understanding in other areas of an introductory income tax course. Finally, it will discuss how negotiations can be used in other tax courses to provide additional benefits.

Experiential learning theory served as the framework for developing this negotiation project that would allow students to experience, think, act, and reflect on the course material at hand and to integrate practical skills with doctrinal knowledge. Timely feedback on experiential learning projects is a critical component of this experiential learning project. The instructor may or may not debrief the student on the assessment or grading aspect of the

project, but he or she may determine whether the student grasps the essentials for the project and can understand and employ the tools given for the project. For this negotiation project, self-assessment and peer assessments may be just as effective and important as feedback from the instructor.

It is important that an in-class discussion be held once this case has been assigned in order to allow the faculty and students to talk about their viewpoints. Due to the somewhat open-ended nature of the negotiation, the in-class discussion also gives faculty the chance to provide timely answers to students' questions. It has been noted that students find it rewarding to be able to discuss potential solutions and share what their own solution ultimately turns out to be. The students are generally able to recognize the ways in which the motivations of the seller and the buyer differ. They tend to struggle most with the allocation of assets in situations in which neither the seller nor the buyer feel strongly about how to allocate those assets. For example, the buyer does not care about the allocation to certain intangible assets since all of the intangible assets the buyer acquires will be amortized over fifteen years.¹⁰³ And further, even if the amount is not reallocated to other Class 6 intangible assets, any residual amount left over to be allocated goes to Class 7 goodwill under the residual method.¹⁰⁴ And goodwill will also be amortized by the buyer over fifteen years.¹⁰⁵

On the other hand, the seller does care about the allocation to the intangible assets because certain intangible assets, like trademarks and patents, generate long-term capital gain, and other intangible assets, like copyrights and trade secrets, generate ordinary income.¹⁰⁶ This strategy can be used to the buyer's benefit in order to "give and take" by letting the seller maximize the value of the preferred intangible assets. And by allowing the seller to enjoy this benefit, the buyer can request a higher value in an asset favorable to the buyer, like inventory.

¹⁰³ As discussed above, all the intangible assets that the buyer acquires will be treated as § 197 intangibles. I.R.C. § 197(a), (d).

¹⁰⁴ Treas. Reg. § 1.338-6(b)(2)(i) (as amended in 2007).

¹⁰⁵ I.R.C. § 197(a), (d)(1)(A).

¹⁰⁶ *Id.* § 1221(a)(3).

In order to help students better understand this issue, I go through the following example with students during the postnegotiation class. Let's say the parties agreed to the following fair market values of the assets:

Cash	\$10,000
Accounts Receivable	\$100,000
Inventory	\$200,000
Machinery	\$100,000
Building	\$640,000
Land	\$180,000
Trademarks	\$125,000
Copyrights	\$65,000
Trade Secrets	\$50,000
Patent	\$225,000
Goodwill	\$525,000
Wax Candle Stock	\$100,000
TOTAL Fair Market Value	\$2,320,000

We will assume two different variations in which only the purchase price changes. The fair market values will remain the same in both variations.

In variation one, assume that the parties agree to a \$2.5 million purchase price. To determine the seller's amount realized and the buyer's adjusted basis for each asset from this transaction, we allocate using the residual method stopping at fair market value and going in sequential order of the seven classes.¹⁰⁷ Therefore, the \$2.5 million purchase price is allocated starting with Class 1 and then continuing using the fair market value determined by the parties for each asset.¹⁰⁸ For Classes 1 through 6, each asset gets the fair market value because there is enough to allocate. When we

¹⁰⁷ Treas. Reg. § 1.338-6(b)(2)(i).

¹⁰⁸ *Id.*

get to Class 7, the remaining portion left over, \$705,000, is allocated to Class 7. This is called the residual method because it is what is left.

Asset Class	Asset	Seller's Amount Realized	Buyer's Adjusted Basis
Class 1	Cash	\$10,000	\$10,000
Class 3	Wax Candle Stock	\$100,000	\$100,000
Class 3	Accounts Receivable	\$100,000	\$100,000
Class 4	Inventory	\$200,000	\$200,000
Class 5	Building	\$640,000	\$640,000
Class 5	Land	\$180,000	\$180,000
Class 5	Machinery	\$100,000	\$100,000
Class 6	Patent	\$225,000	\$225,000
Class 6	Copyright	\$65,000	\$65,000
Class 6	Trademarks	\$125,000	\$125,000
Class 6	Trade Secrets	\$50,000	\$50,000
Class 7	Goodwill	\$705,000	\$705,000
	TOTAL	\$2,500,000	\$2,500,000

In variation two, assume that the parties agree to a \$2 million purchase price. To determine the seller's amount realized and the buyer's adjusted basis for each asset from this transaction, we allocate using the residual method stopping at fair market value and going in sequential order of the

seven classes.¹⁰⁹ Therefore, the \$2 million purchase price is allocated starting with Class 1 and then continuing using the fair market value determined by the parties for each asset.¹¹⁰ For Classes 1 through 6, each asset gets the fair market value because there is enough to allocate. When we get to Class 7, the remaining portion left over, \$205,000, is allocated to Class 7.

Asset Class	Asset	Seller's Amount Realized	Buyer's Adjusted Basis
Class 1	Cash	\$10,000	\$10,000
Class 3	Wax Candle Stock	\$100,000	\$100,000
Class 3	Accounts Receivable	\$100,000	\$100,000
Class 4	Inventory	\$200,000	\$200,000
Class 5	Building	\$640,000	\$640,000
Class 5	Land	\$180,000	\$180,000
Class 5	Machinery	\$100,000	\$100,000
Class 6	Patent	\$225,000	\$225,000
Class 6	Copyright	\$65,000	\$65,000
Class 6	Trademarks	\$125,000	\$125,000
Class 6	Trade Secrets	\$50,000	\$50,000
Class 7	Goodwill	\$205,000	\$205,000
	TOTAL	\$2,000,000	\$2,000,000

¹⁰⁹ *Id.*

¹¹⁰ *Id.*

When comparing variation one and two, notice that the amount realized and adjusted bases stay equal for Classes 1 through 6. However, the amount realized and adjusted basis for Class 7 goodwill change. Therefore, any change in valuation of Classes 1 through 6 affects how much goes to Class 7 goodwill. This is because goodwill takes on the residual amount as shown above.

As discussed above, both the buyer and seller in the purchase/sale of a business have different tax strategies.¹¹¹ A selling sole proprietor generally seeks capital gains treatment on a sale of business assets and thus will be happy to allocate each marginal dollar of purchase price to a capital asset, or a § 1231 asset that generates long-term capital gain, rather than to an ordinary asset. The characterization of assets was discussed above and should be used to determine if a specific asset will generate ordinary, capital, § 1231, or other characterization issues. For purposes of the negotiation case, Candy's capital gains tax rate is twenty percent, while the maximum ordinary income rate is double that at forty percent. Thus, there is a huge benefit to generating capital gain rather than ordinary income on a sale of assets. Therefore, the strategy of the seller is to focus on allocating amount realized to certain characterizations.

As demonstrated above with variation one versus two, any lowering of the fair market value of an asset would affect goodwill by increasing or decreasing the amount allocated to it. Goodwill to the seller is going to be treated as generating long-term capital gain.¹¹² For example, in variation one, if inventory was valued at \$150,000 and the purchase price stayed the same, the goodwill would go up by \$50,000 to \$755,000. This \$50,000 moved from inventory to goodwill will create a twenty percent tax savings, forty percent from ordinary income on inventory versus twenty percent from long-term capital gain on the goodwill.

As discussed above, the buyer, on the other hand, would naturally like to deduct or depreciate the purchase price as rapidly as possible, and accordingly would prefer to allocate purchase price to items that can be deducted immediately, or in the alternative, to items that are deductible over shorter periods of time (such as five-year depreciation of tangible assets)

¹¹¹ See *supra* Part II.D.

¹¹² See *Comm'r v. Killian*, 314 F.2d 852, 855 (5th Cir. 1963).

rather than over longer periods of time (such as fifteen-year amortization of intangible assets). This is due to the time value of money, specifically a dollar of tax savings this year is worth more than a dollar of tax savings years from now.

As demonstrated above with variation one versus two, any lowering of the fair market value of an asset would affect goodwill by increasing or decreasing the amount allocated to it. Goodwill to the buyer is generally going to be treated as a fifteen-year recovery property.¹¹³ For example, in variation one, if inventory was valued at \$150,000 and the purchase price stayed the same, the goodwill would go up by \$50,000 to \$755,000. This \$50,000 moved from inventory to goodwill will create a lowering of incentive by the buyer, as the buyer can recover the \$50,000 allocated to inventory in one year rather than fifteen years.

When comparing the suggested analysis above with the \$50,000 moved from inventory to goodwill, one can see that the seller prefers the move, but the buyer does not. This difference in preference creates a tension on both sides. There are some assets that the buyer would prefer to value high. At the same time, the seller wants to value these assets as low as possible to give more to goodwill or other assets that generate § 1231 gain or long-term capital gain.

This is an extremely important area to review with students postnegotiation. The understanding of these tax consequences and strategies is crucial to understanding the assignment. But even beyond the assignment, the discussion helps students to solidify their understanding in other major topics in introductory income tax classes, especially property transaction topics like characterization. Before we discuss the benefits to the introductory income tax course, I wanted to mention an example of other small issues that students may ask questions about or at least want to discuss. During the postnegotiation discussion, you should set aside time for smaller topics that are still critical. The range of these smaller topics is very wide and can include team strategy and roles, general negotiation skills, and even contract drafting.

The contract drafting issue is an interesting topic that a student occasionally brings up in class. The students understand that the parties want

¹¹³ I.R.C. § 197(a), (d)(1)(A).

this negotiation to occur, and they want to ensure that their party is protected. Lots of questions and issues are raised regarding getting the values in writing and ensuring that the Form 8594 matches for both parties. Asset purchase agreements that are crafted well should contain clauses laying out how the purchase price will be allocated among the assets to be transferred. Frequently, these asset purchase agreements include a statement indicating that the buyer and seller should reach an agreement on the values to submit on Form 8594. The following is an example of the language that might be found in an actual asset purchase agreement:

Seller and buyer recognize that reporting requirements of § 1060(b) of the Code, and the regulations promulgated thereunder, may apply to the transaction contemplated by this Agreement. If so, seller and buyer agree that the Purchase Price shall be allocated among the Assets as mutually agreed by seller and buyer to comply with and satisfy the requirements of § 1060(b) and applicable regulations. Seller and buyer agree that no Asset shall be allocated a negative value.

This is just an example of how diverse the discussion can be in the postnegotiation session. The sky is the limit in terms of where you would like to go with your class. Some time should be saved in the postnegotiation discussion class to discuss how the assignment not only benefits a student's understanding of the income tax consequences of buying and selling a business, but also even broader topics in the introductory income tax class. This is especially the case in the characterization area of property transactions.

B. Benefits of Using This Negotiation Exercise in the Introductory Income Tax Course

While students find the negotiation exercise challenging, they also see its value. This negotiation exercise aims to improve students' analytical skills in a complex case involving numerous tax concepts and to reinforce their ability to apply what they learn to a realistic example. In order to be effective, a tax professional must think critically. Specifically, the tax professional must be able to synthesize critical data and information, understand the goals of each party to a negotiation, complete the appropriate financial and tax analyses, interpret and contextualize those analyses for proper application, and communicate effectively with other professionals as well as lay people.

The negotiation exercise also aims to enhance students' knowledge of the tax consequences of property transactions, particularly when it comes to the sale or exchange of property. They have provided positive feedback,

indicating that this negotiation improves their skills in analyzing not only the tax rules applicable to this acquisition, but also broader tax rules in their introductory income tax class. They are able to better understand the manner in which the pieces of the tax puzzle must come together. As specific examples, they list §§ 1221, 1231, 1245, and 1250 characterization issues addressing the treatment of gain on the sale of property. As tax faculty know, this portion of the introductory tax class is one that many students have tremendous difficulty understanding. This assignment solidifies their comprehension in this area by working through an example that uses dynamic parts rather than static elements in the problem. A student needs to understand all moving parts in the negotiation.

By preparing for the negotiation, which requires considering different alternatives by both the buyer and seller, students must consider different possibilities and scenarios with changing numbers. When numbers change, it shifts strategy and the end results to each party. The negotiation is very similar to a game of chess, in which a chess player must consider all moves the player can make as well as countermoves by the opposing player. And just as a chess player also needs to consider multiple moves ahead of the current move, the student needs to understand how to react during the negotiation when the other side responds to the student's move.

This dynamic environment in the negotiation exercise has helped students better understand the property transaction area of income taxation. The normal problem approach in introductory income tax classes provides static numbers. This normal static approach is an excellent way to teach income tax. And adding this negotiation assignment with a dynamic element provides an additional way for students to better understand this area of income tax.

Students have also indicated that this negotiation helps to illustrate how present-value concepts can be applied in tax. And as mentioned earlier in the Article, present value is a topic with which many law students have trouble. The positive student feedback indicates that the negotiation exercise effectively delivers in supporting the learning objectives traditionally found in an introductory income tax course.

C. Other Tax Courses Where Negotiations Can Benefit Students

The negotiation in this Article focuses on an exercise that can be best used in an introductory income tax course. The same rationale for designing this negotiation can be used in and provide benefit to advanced tax courses.

As mentioned earlier in the Article, there are two excellent tax negotiation assignments in advanced tax courses on tax policy and state and local taxation.¹¹⁴ While these are outstanding exercises, State and Local Tax and Tax Policy courses are not traditionally found in law schools or accounting programs. Beyond introductory income tax classes, many law schools and accounting programs do have business entity tax classes that involve corporations and partnerships. And while this Article stresses that the negotiation exercise is for an introductory income tax class, it can be tailored to fit many advanced tax classes. Since it involves a sole proprietorship, which sets the “plain vanilla” example as discussed above, tailoring is very easy. For example, in my Partnership Tax course, I have used a similar negotiation exercise. I began using the Candy’s Candles example. However, rather than the seller being a sole proprietor, the seller is changed to a multimember LLC taxed as a partnership. Further, the seller is in the software business. I also add into the assignment the issue of covenants not to compete and a potential consulting agreement between the buying C corporation and the majority member of the LLC. This creates issues of parallel payments and provides for creative structures to be considered during the negotiation. I like to think of the Partnership Tax course negotiation as Version 2 of the Candy’s Candles negotiation, because many concepts roll over from the original Candy’s Candles exercise discussed earlier.

I have even adjusted Candy’s Candles for a Corporate Tax course: picture Candy’s Candles as a C corporation with a much bigger business in terms of asset value and purchase price amount. This changed negotiation involves mergers and acquisitions considerations in which there could be a B reorganization, C reorganization, forward triangular merger, reverse triangular merger, etc. Professor Gore describes a very similar case that illustrates the push and pull between the buyer and the seller in the context of a C corporation stock acquisition relative to asset acquisition in a situation involving appreciated assets.¹¹⁵

The point is that the sky is the limit. You can use the negotiation in this Article to help spark many different negotiation possibilities in advanced tax classes. The example could even be altered to include trusts and potentially

¹¹⁴ See *supra* Part I.

¹¹⁵ Richard A. Gore, *Buyer and Seller at Odds: The Economic Consequences of Holding Appreciated Assets in a C Corporation*, 28 ISSUES ACCT. EDUC. 929, 929–34 (2013).

deal with estate and gift tax issues. These ideas will help you engage students and emphasize the importance of tax in a well-rounded legal education.

IV. CONCLUSION

This tax negotiation fulfills a need in legal education today for experiential learning at the introductory course level. The difficulties in teaching tax have long been obvious to those faculty who are tasked with teaching the subject matter. The majority of students enter their first course in tax with the notion that tax law is intimidatingly complex and technical.¹¹⁶ They believe that the course will require extensive memorization and difficult calculations.¹¹⁷ Meanwhile, law schools currently provide little framework for integrating doctrinal knowledge with hands-on learning experiences, making it difficult for many students to grasp tax law concepts.¹¹⁸

Various examples of negotiation-type exercises from the literature demonstrate how these types of assignments can address two key goals: (1) to engage students and (2) to emphasize the importance of tax in a well-rounded legal education, even for those students who intend to pursue other specialties.¹¹⁹ However, none of these tax negotiation examples in the literature are geared towards introductory-level students, the likes of whom experience the type of worries described above. Therefore, there is a need for the type of tax negotiation I describe in this Article.

The active negotiation exercise that I describe involves the tax consequences of the purchase and sale of a sole proprietorship. Students are grouped into teams of buyers and sellers. Each buyer team negotiates with a seller team the purchase/sales price of the business and the fair market value of the assets of the business given a range of values from independent appraisers. The exercise helps students understand important foundational tax rules, including the following: the calculation of realized and recognized gain/loss; the characterization of gain/loss; the benefit of preferential tax rates; determining how assets are depreciated or amortized; the effect of time

¹¹⁶ Oberst, *supra* note 1.

¹¹⁷ *Id.*

¹¹⁸ Maranville & Batt, *supra* note 13, at 54.

¹¹⁹ *See, e.g.*, Yin, *supra* note 15; Powell & Bartlett, *supra* note 18.

value of money on tax benefit recovery; and allocation of purchase and sales price of a business using § 1060.

This negotiation exercise should take place over multiple classes in an introductory-level federal income tax course. At a minimum, the exercises should take place over three classes. The first of the three classes should include a discussion of the applicable tax law relevant to the assignment. During the second class, the students carry out the negotiation. And the third class should be devoted to a postnegotiation discussion and feedback session, which ensures students understand not only the tax consequences and strategy important in the negotiation but also other essential topics in income tax.

This tax negotiation nicely supplements the basic tax income course, as it can be used to assuage beginning students' trepidations about the area of tax law and can show them that tax is dynamic. Further, it presents an opportunity for students to better understand the influence of competing incentives on the application of tax law as well as better reinforce fundamental income tax principles in the property transaction area. And it does so through experiential learning, which is becoming increasingly common in the university and college setting. At the same time, universities and colleges face pressure to keep costs from rising as well as to ensure their graduates are well prepared to practice. This tax negotiation project exemplifies how to combine both doctrinal and clinical teaching while keeping costs down and requiring relatively little faculty time. While there are many other possible ways to conserve resources while providing an opportunity for experiential learning, this Article should help faculty think of possible projects that can be small yet powerful.

