THEME: Liquidating a Sole Proprietorship

By John W. Day

ACCOUNTING TERM: Sole Proprietorship

A sole proprietorship is an unincorporated business with a single owner. It is a pass-through entity in that the profit or losses from the business are reported on the individual's personal Form 1040 tax return. Only the income and expenses are reported on Schedule C. No Balance Sheet is required on the tax return. From a legal standpoint, no differentiation is made between the business entity and the individual. This means that if you get sued over a business transaction, your personal assets are at risk.

FEATURE ARTICLE: Liquidating A Sole Proprietorship

Unfortunately, for some people the moment comes when there is no other reasonable opportunity other than to throw in the proverbial towel and close the sole proprietorship. This experience may be very different from one person to the next. Perhaps shutting down comes as a great relief from unrelenting pressure. Or, maybe it is a real heartbreaker having to give up the dream of independence and being your own boss. The decision could even come with a sense of failure and financial ruin. Whatever the reason, the books have to be closed, the assets liquidated and the liabilities paid off.

Over the years, I have watched a number of clients go through this process. I've yet to see a disposition that hasn't been difficult for the owner. This is especially true for owners who end up having business debt added to their personal debt. Sometimes, owners have invested their lifetime savings in the business never believing that their dream could turn into a nightmare.

You may want to read a short e-book I wrote called "**Dream or Nightmare: Four Must Do's Before Starting a Small Business**". You can find it by clicking this link http://www.reallifeaccounting.com/pubs/pub_dn.pdf. In the book I try to give the reader a heads up as to the pitfalls of starting a new business without adequate planning.

You may be wondering why anyone would simply liquidate the business instead of selling it. Good chance the owner has tried to sell the business but has no takers. It could be that there is no measurable "goodwill" to sell, or the assets are old and not worth much. More likely, there is a market for the assets but not the business. Disposing of the assets is fairly straightforward. It boils down to establishing the book value (if any) of each asset and then determining if there is a gain or loss on the sale or discard. It might be helpful to read or re-read my newsletter article "Disposing of Assets". Here is the link to my articles page:
http://www.reallifeaccounting.com/articles.asp

To get the idea of liquidating a sole proprietorship firmly in your head, let's set up a sample balance sheet and systematically dispose each item. Keep in mind that I am referring to U.S. taxpayers when tax issues are mentioned.

BALANCE SHEET

<u>ASSETS</u>			
Current Assets:			
Cash	**500**		
Accounts Receivable	**900**		
Inventory	**2,500**		
Fixed Assets:			
Furniture & Fixtures	**3,700**		
Office Equipment	**4,800**		
Leasehold Improvements	**1,650**		
Accumulated Depreciation	**<8.200>**		
Other Assets:			
Deposits	**<u>500</u>**		
Total Assets:			**6,350**
			=====
<u>LIABILITIES</u>			
Current Liabilities:			
Accounts Payable	**3,450**		
Sales Tax Payable	**875**		
Credit Card Payable	**5,900**		
Payroll Taxes Payable	**1,750**		
Long-Term Liabilities:			
Notes Payable	**<u>8,400</u>**		
Total Liabilities:		**20,375**	
<u>OWNER'S EQUITY</u>			
Capital Contributions	**3,000**		
Owner's Draw	**<1,500>**		
Prior Year Equity	**<8,675>**		
Net Loss for the year	**<u><6,850></u>**		
Total Owner's Equity		**<u><14,025></u>**	
Total Liabilities & Owner's Equity			**6350**
			=====

Starting from the top of the balance sheet:

Cash: Stick it in your wallet, it's yours! You have already paid taxes on it.

DESCRIPTION	DEBIT	CREDIT
Owner's Draw	500	
Cash		500

Accounts Receivable: If you are a cash basis taxpayer then you must report as income any cash you receive in the year you receive it. Assuming you received any payments in a year after you closed the business, you will have to report this as "miscellaneous self-employment income" on your 1040 tax return.

If you are an accrual basis taxpayer then don't worry if you receive payment in a later year because you will have already reported the income.

DESCRIPTION	DEBIT	CREDIT
Owner's Draw	900	
Accounts Receivable		900

Inventory: If you are fortunate enough to sell any remaining inventory before the year closes then that sale is recorded just like any other sale. Cost of goods sold is increased and the inventory asset account is decreased. However, if you are stuck with inventory you cannot sell then you will have to show a "write-down" of your inventory as a line item in the cost of goods sold section of your P&L Statement.

DESCRIPTION	DEBIT	CREDIT
Inventory Write-Down	2,500	
Inventory		2,500

Fixed Assets: If all your assets are fully depreciated and not worth anything to anybody then your accumulated depreciation account will equal your fixed assets accounts. A simple reversal is all that is necessary to clear the books:

DESCRIPTION	DEBIT	CREDIT
Accumulated Depre	5,000	
All Fixed Assets Accts		5,000

If, as in our example, there was a book value of $1,950 remaining and the total assets sold for $2,500 then there will be gain on the sale of $550. Hence, this journal entry:

DESCRIPTION	DEBIT	CREDIT
Accumulated Depre	8,200	
Cash	2,500	
Furniture & Fixtures		3,700
Office Equipment		4,800
Leasehold Improve		1,650
Gain on Sale		550

You pocket the cash 2,500:

DESCRIPTION	DEBIT	CREDIT
Owner’s Draw	2,500	
Cash		2,500

The only remaining asset is that deposit you have with the landlord. If you get it back you would record it as cash and then take it as another draw:

DESCRIPTION	DEBIT	CREDIT
Cash	500	
Deposits		500

DESCRIPTION	DEBIT	CREDIT
Owner’s Draw	500	
Cash		500

Realistically, you would more likely wait until all these transactions related to cash were complete and then use the money to pay off your liabilities. Let’s assume you have done that and you actually have $4,400 cash in the bank. The next decision would be to choose which liabilities needed to paid first with your limited amount of cash.

Obviously, it would be best to pay off the tax liabilities first since there can be some severe penalties for not paying. Sales tax is $875 and payroll tax is $1,750 for a total of $2,650. This leaves $1,775 to pay toward the remaining liabilities. Good chance you would want to pay vendors who have been loyal to you all these years (like your accountant).

DESCRIPTION	DEBIT	CREDIT
Sales Tax Payable	875	
Payroll Taxes Payable	1,750	
Accounts Payable	1,775	
Cash (or Owner’s Dr)		4,400

The only items left are:

Accounts Payable		1,675
Credit Card Payable		5,900
Notes Payable	8,400	
Total Liabilities		$15,975 a credit balance

In the equity section we started out with a net loss $6,850. We have to add the inventory write down of $2,500 and subtract the gain on the sale of $550 to arrive at a net loss for the year of $8,800. Now we are ready to close all the equity accounts into Prior Year Equity:

DESCRIPTION	DEBIT	CREDIT
Capital Contributions	3,000	
Prior Year Equity		3,000
Prior Year Equity	10,300	
Owner's Draw		1,500
Net Loss		8,800

The remaining amount left in Prior Year Equity is:

Beginning		<8,675>
Cap Cont		3,000
Owner's Draw	<1,500>	
Net Loss		<8,800>
Total Pr Yr Equity	<$15,975> a debit balance	

If we close the remaining liability accounts in to Prior Year Equity, then the two amounts of $15,975 cancel each other out and the final balance is ZERO. The books are closed and the business assets have been liquidated. Unfortunately, our owner is left with $15,975 of debt to settle personally. Ouch!

QUESTION: When is it Time to Liquidate?

It's an awful moment when you have to decide to shut the business down and cut your losses. Often, there are competing arguments on both sides. Small business owners are usually a hearty breed. They are tenacious and determined. It's not easy for the facts and circumstances to pry loose the tight grip they have on their dream. At this point, it's probably much more than the dream. It's the time, money and energy that have been invested that is being let go.

Regardless, the day of reckoning does arrive and a reality check has to be taken. Most likely, the business owner has been doing what is called, "betting on the come". This means going deeper in debt hoping that the situation will change for the better. Yet "the come" never seems to come. Hopefully, the decision to not throw any more good money after bad will occur before complete financial ruin occurs. Since the owner may not be objective enough to see the clear message, it is probably wise to bring in a consultant, friend, banker, accountant, or some other party to assess the situation.

There are no hard and fast rules to measure exactly when to call it quits. It's a judgment call based on trends. If a current negative trend continues, one can usually foresee events unfolding in an unacceptable manner. How much can one afford to lose? Will the losses of the business cause the loss of a personal residence? Is that acceptable? How will this affect the family? Will it mean bankruptcy? All these kinds of questions come into play. They are tough ones that must be met with honesty and courage.

TIP: Tax Forms Used to Report the Liquidation

When operating as a sole-proprietorship in the U.S., Internal Revenue Service (IRS) form Schedule C is used to report income and expense. No balance sheet is required to be filed with the tax return. In our example above, the inventory write down is included in the cost of goods sold and is part of the net profit or loss of the P&L Statement. Net profit or loss is what is reported on Schedule C.

A gain or loss resulting from the sale of depreciable fixed assets is reported on IRS form 4797. If the business sold a capital asset such as a client list or patent, it is reported on IRS form Schedule D.

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