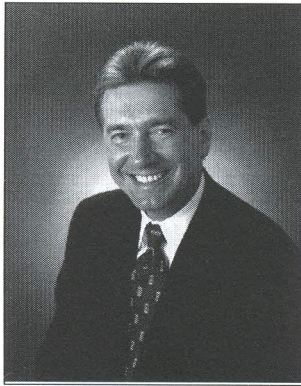
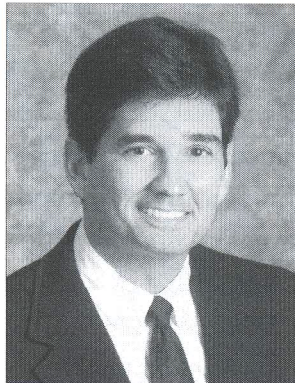


Current Developments In The Sale Of Personal Goodwill



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How goodwill can go from being personal to corporate—and what it can mean for your professional clients.

FOR THOSE DENTISTS, VETERINARIANS, AND OTHER PROFESSIONALS (“Professionals”) who practice through C-corporations, the sale of the corporation’s assets are double taxed: 35 percent at the corporate level and 15 percent at the individual level. Tax Reform Act of 1986, Pub. L. 99-514, 1986-3 C.B. (vol. 1) 1. Since 1998, advisors, relying on the *Martin Ice Cream* and *Norwalk* cases, in which the taxpayers won and goodwill was deemed personal, have minimized this double tax by taking the position that the Professional’s goodwill is personal and not corporate. *Martin Ice Cream Co. v. Commissioner*, 110 T.C. 189 (1998); *Norwalk v. Commissioner*, 76 T.C.M. (CCH) 208 (1998). To the extent that the Professional’s goodwill is personal, it is arguably taxed on one level at the favorable capital gains rate, currently 15 percent. Thus, a double tax is avoided on the largest part of the sale, the personal goodwill.

However, in the recent case of *Howard v. U.S.*, 2010 WL 3061626 (E.D. Wash. July 30, 2010), where a dentist sold the assets of his corporation (the “Corporation”) and his goodwill, the court held that the goodwill was corporate and not personal. The ruling resulted in a double tax on the sale of the Corporation’s assets. What made the difference in the rulings by the courts? In *Martin Ice Cream*

and *Norwalk*, the shareholder-employees did not have covenants not to compete with the corporations employing them. Unfortunately, Dr. Howard did, and the court ruled against him.

THE HOWARD CASE • Dr. Howard began practicing in 1972 and incorporated his dental practice as a C-corporation in 1980. Dr. Howard had also entered into a covenant not to compete with the Corporation, which was common at that time, to obtain favorable retirement plan contributions and fringe benefits. The restrictive covenant was in effect during Dr. Howard's employment with the Corporation and for a period of three years thereafter. The restrictive covenant had a radius of 50 miles from Spokane, Washington. In 2002, the Corporation sold its dental practice assets and Dr. Howard attempted to sell his personal goodwill. The purchase price allocation was \$47,100 to the Corporation's tangible assets, \$549,900 to Dr. Howard's personal goodwill, and \$16,000 to Dr. Howard's covenant not to compete with the purchaser. The IRS re-characterized the sale of personal goodwill as a corporate asset, which resulted in a tax deficiency and interest of \$74,921. The court did not accept the purchase price allocation, partly because of the purchasing dentist's testimony that (1) there was no negotiation of the allocation and (2) even if the 2002 Asset Purchase Agreement terminated the 1980 covenant not to compete, that would not have changed the characterization of the goodwill generated from 1980 through 2002.

The government argued that the goodwill was owned by the Corporation for three reasons. First, Dr. Howard was a Corporate employee with a covenant not to compete for three years after he no longer owned stock in the Corporation. Second, the Corporation earned the income and, correspondingly, earned the goodwill. Finally, attributing the goodwill to Dr. Howard was not consistent with the economic reality of Dr. Howard's relationship with the Corporation.

The government relied on three cases for its position that the goodwill was corporate rather than personal. First, in *Furrer v. Commissioner*, 566 F.2d 1115, 1117-1118 (9th Cir. 1977), *cert. denied*, 437 U.S. 903 (1978), the court divided an employee's goodwill as goodwill for his company and separately as goodwill for himself, "such as personal contacts." Second, in *Martin Ice Cream*, the court found that the goodwill of a corporation was an individual asset where the employer had not "obtained exclusive rights to either [the employee's] future services or a continuing call on the business generated by [the employee's] personal relationships." Finally, in the *Norwalk* case, the government relied on the proposition that if an employee works for a corporation under contract with a covenant not to compete, as Dr. Howard did, then the corporation and not the individual professional owns the goodwill.

The government also contended that the Corporation owned the goodwill generated by Dr. Howard's dental practice because the Corporation was the entity that earned the income. The government relied on *Johnson v. Commissioner*, 78 T.C. 882, 891 (1982), *aff'd without opinion*, 734 F.2d 20 (9th Cir. 1984), *cert. denied*, 469 U.S. 857 (1984), and stated that in a professional service corporation that employs a professional, such as Dr. Howard, a two-part test is used to determine whether the corporation or the employee is considered to be the controller of the income. The first prong is whether the professional is an employee of the corporation. The second prong is whether the professional has entered into an employment agreement with the corporation that recognizes its control. The court concluded that the Corporation earned the income and paid the taxes on the income from Dr. Howard's dental practice pursuant to the 1980 employment agreement (in effect through 2002) that established the Corporation as Dr. Howard's employer. The court further concluded that, because Dr. Howard was bound by the covenant not to compete for three years after he no longer owned stock in the

Corporation, Dr. Howard could not have earned income from a competitive dental practice within the 50-mile restricted radius. The court noted that even if the goodwill had belonged to Dr. Howard personally, it would likely have very little value because the 50-mile radius would discourage patients from following Dr. Howard to a new location.

LESSONS TO BE LEARNED • There are several lessons advisers of professionals should take away from the *Howard* case.

Plan For The Sale

The covenant not to compete in the *Howard* case should have been terminated before the practice sale. This leads to an interesting question: how long before the sale of the practice must the covenant be terminated? (Generally, the shareholder can terminate it at any time before the sale.) The court raised the point that the covenant not to compete was in effect from 1980 through 2002, and during that time, the goodwill was a corporate asset and not personal goodwill.

For example, assume the Professional has a covenant not to compete with the C-corporation for 25 years. It is terminated five years before the sale of the practice. The appraised value of the personal goodwill is \$500,000. Under this analysis, the value of the personal goodwill may be reduced by four-fifths: \$500,000 to \$100,000.

The Professional's legal counsel should review any and all corporate records to ensure that the goodwill belongs to the individual and not to the corporation. In addition to terminating any covenant not to compete with the corporation, the attorney should be authorized to review the corporation's proceedings of incorporation (which should be contained in the corporation's record book) to ensure that the goodwill was not transferred to the corporation at the time of its formation.

Lastly, in the *Howard* case the doctor's employment agreement with the Corporation did not

address whether the corporation or Dr. Howard owned the goodwill. Thus, it may be very helpful to have corporate minutes designating that the goodwill is owned by the Professional. Not bulletproof, but perhaps useful.

Consider Converting To An S-Corporation

Consider converting the professional's C-corporation to an S-corporation if the professional plans on practicing several more years; five years for sales in 2011. S-corporations that have never been C-corporations and C-corporations that have been converted within the applicable time period before the practice sale avoid the double tax problem. However, the conversions have complexities, particularly relating to avoiding a double tax on accounts receivable.

The Professional Should Authorize An Appraisal Of The Personal Goodwill Versus Any Corporate Goodwill

The *Howard* case was lost based on the covenant not to compete that Dr. Howard had with the Corporation. Any covenant not to compete with the Corporation must be distinguished from the covenant not to compete entered into with the purchaser of the professional practice. If Dr. Howard would not have had a covenant not to compete with the Corporation, the question probably would have been, "What is the value of the personal goodwill versus any corporate goodwill and why?" Without this specific type of appraisal, which is a separate appraisal from the appraisal of the practice, the professional loses.

Expect Increased Audits On The Sale Of Personal Goodwill

The IRS is well aware that professionals with goodwill are avoiding the double tax by structuring the sale of the practice primarily as the sale of personal and not corporate goodwill. Because Form 8594 must be filed with the IRS by all sellers (the

professional, the corporation and the purchaser), the IRS can determine whether personal goodwill was sold. The professional should authorize advisors to plan in advance to defend why the goodwill is personal and not corporate. A very significant factor in determining personal goodwill is the loyalty of one's patients. If the professional sells the practice without a covenant not to compete and establishes another practice near the former location, what percentage of the patients would follow the professional? Usually, all of them. However, under audit, the advisory team needs proof of that "loyalty" and an appraisal of the personal goodwill versus any corporate goodwill is essential.

Other factors indicating personal goodwill include efforts to transfer personal goodwill to the purchaser, continued limited employment with the purchaser, an introductory letter to patients (and referral sources if a specialty practice), personal introductions to patients (and any referral sources), and an allocation between payment methods of fee-for-service versus reduced-fee plans.

Personal Goodwill In Co-Ownership Buy-Outs

For shareholder buy-outs, sometimes the transaction is structured as the corporation's purchase of the professional's stock at a low value excluding goodwill, coupled with the corporation's purchase of the professional's personal goodwill. Under the *Howard*, *Martin Ice Cream*, and *Norwalk* cases, the professional cannot have personal goodwill if the professional has a covenant not to compete with the

professional corporation. However, would not the other shareholder(s) of the corporation's practice require a covenant not to compete from the departing or retiring owner? This point almost effectively eliminates the buy-out of personal goodwill in co-ownership. In co-ownership, this problem is also applicable to S-corporations because the buy-out of the professional's personal goodwill could either cause the termination of the S-election due to a disproportionate distribution or be considered as the S-corporation's redemption/purchase of the professional's stock. This would result in a double tax or purchase of the professional's practice interest in after-tax or non-deductible dollars to the purchaser. Another important deterrent to this method is that if the practice was formed before August 10, 1993, the anti-churning rules apply under Internal Revenue Code section 197(f)(9) and the goodwill is not amortizable.

CONCLUSION • Although the *Howard* case should come as no surprise, it teaches some important lessons. First, terminate any employment agreement that the professional has with the C-corporation and take steps to ensure that the professional's goodwill is personal. Second, consider converting to an S-corporation if the professional plans to practice several more years. Third, if the professional plans to sell the professional's practice as a C-corporation, obtain an appraisal of the personal goodwill. Fourth, expect increased audits of sales of personal goodwill. Finally, be cautious of the purchase and sale of personal goodwill in co-ownership.

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