Taxing Decisions

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More Current Developments In The Sale Of Personal Goodwill

In the Spring, 2011 issue, we wrote about *Howard v. U.S.*, 2010 WL 3061626 (E.D. Wash., July 30, 2010), in which the court held that when Dr. Howard sold the assets of his dental practice, a C-corporation (the Howard Corporation), the goodwill was a corporate asset because Dr. Howard had a covenant not to compete with the Howard Corporation, resulting in a double tax. The *Howard* case was appealed and argued on July 13, 2011 in Seattle, Washington. Dr. and Mrs. Howard (the Taxpayers) lost the appeal (the Appeal) based upon a Memorandum filed on August 29, 2011. United States Court of Appeals for the Ninth Circuit, No. 10-35768, D.C. 2:08-cv-00365-RMP.

For those professionals who practice through C-corporations, the sale of the corporation's assets, including goodwill, 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). Since 1998, advisors have attempted to minimize this double tax by taking the position that the goodwill is personal and not a corporate asset by relying on two favorable cases. *Martin Ice Cream Co. v. Commissioner,* 1998 WL 115614 (1998) (Martin); *Norwalk v. Commissioner,* T.C. Memo 1998-279, 76 TCM 208 (1998) (Norwalk). Based upon those cases, the goodwill that is characterized as personal is taxed only at one level at favorable capital gains rates and a double tax is avoided on the large part of the sale (roughly 85 percent plus), the personal goodwill. Unlike the *Howard* case, the shareholders in the favorable cases, *Martin* and *Norwalk*, did not have a covenant not to compete with the corporation employing them.

Court's Acknowledgement That Patient Relationships May Be Personal

The Taxpayers maintained that Dr. Howard's goodwill proceeds were personal assets of Dr. Howard, subject to capital gains treatment at one tax level. The court in the Appeal (the Court) noted that while Dr. Howard's patient relationships may be personal, Dr. Howard had transferred the economic value of the relationships to the Howard Corporation under his covenant not to compete with it.

No Corporate Goodwill Where No Covenant Not To Compete With the Professional's Corporation

The Court noted that under *Norwalk,* there is no corporate goodwill where "the business of the corporation is dependent upon its key employees, unless they enter into a covenant not to compete with the corporation or other agreement whereby the personal relationships with clients become property of the corporation…." The Court further noted that under *Martin,* "personal relationships… are not corporate assets when the employer has no employment agreement [or covenant not to compete] with the corporation…." Does this mean no allocation whatsoever to corporate goodwill that is double taxed? Advisors often recommend some allocation to corporate goodwill because the professional corporation is custodian of the patient records, employs the staff, and the like. For those advisors who recommend no allocation to corporate and all to personal goodwill, the Court's language is helpful. The argument from these advisors is that if there is any allocation to corporate goodwill whatsoever, the Internal Revenue Service can make an argument that the allocation is insufficient, thereby imposing an additional double tax on the corporate goodwill.

No Covenant Not To Compete Between The Professional's Corporation And The Purchaser

The Court noted that the purchase and sale agreements (the Agreements) in the *Howard* case provided that both Dr. Howard and the Howard Corporation agreed not to compete with the purchaser (the Purchaser). This point was part of the Court's analysis that the goodwill belonged to the Howard Corporation. The covenant not to compete with the Purchaser should have only been between Dr. Howard and the Purchaser.

No Independent Contractor Agreement For Post-Sale Services Between the Professional's Corporation And The Purchaser

The Purchaser and the Howard Corporation entered into an independent contractor agreement wherein Dr. Howard, through the Howard Corporation, would continue to render dental services to the Purchaser's patients for three years following the sale. The fact that the Howard Corporation entered into an independent contractor agreement with the Purchaser was also part of the Court's analysis that the goodwill belonged to the Howard Corporation. Dr. Howard should have worked for the Purchaser personally.

Terminating the Professional's Covenant Not To Compete

The Court implied that even if the Agreements had terminated Dr. Howard's covenant not to compete with the Howard Corporation, the release would have constituted a dividend payment (and double tax), equal to the value of the goodwill. This implication should be distinguished from the outcome in *Norwalk,* where the covenants not to compete for the shareholders in effect from October 1, 1985 through September 30, 1990 had expired prior to the date of asset distribution on June 30, 1992. In *Norwalk,* there was no reference

to any dividend or double tax for the five years the covenants were in effect. In following *Norwalk,* any covenant not to compete with the professional's C-corporation should be terminated, the earlier the better.

Further Lessons To Be Learned

1. Court's Acknowledgement That Patient Relationships May Be Personal. It is no longer only a question of whether the patients or referral relationships are personal to the professional, it is also a question of who owns the goodwill. Advisors should take this into account when completing the valuation that allocates the goodwill between personal and corporate.

2. No Corporate Goodwill Where No Covenant Not To Compete With the Professional's Corporation. Based upon the Court's analysis of *Norwalk* and *Martin,* there is an argument that all goodwill is personal. Advisors should also consider the Court's analysis of these cases when completing the valuation that allocates the goodwill between personal and corporate.

3. No Covenant Not To Compete Between the Professional's Corporation and the Purchaser. The selling shareholder should be subject to the covenant not to compete with the purchaser's practice entity, not the selling shareholder's C-corporation.

4. No Independent Contractor Agreement Between the Professional's Corporation and the Purchaser. Rendering post-sale services on behalf of the purchaser through the professional's C-corporation as an independent contractor makes it appear to the IRS that the professional's C-corporation owns the goodwill and not the professional personally. While these arrangements are common, the IRS also does not believe that the professional is an independent contractor when rendering post-retirement services for the purchaser, irrespective of whether it is through the professional's corporation.

5. Terminating the Professional's Covenant Not To Compete. Not that many C-corporation shareholders have a covenant not to compete with their own corporation. However, a buy-out of personal goodwill is a common business and tax structure in co-ownership. In co-ownership, it is very common for the shareholders to have covenants not to compete with their corporations. This can be a problem for both C and S corporations resulting in a double tax. See our Spring, 2011 article. Best to review these business and tax structures with your clients sooner rather than later. Then amend the buy-out agreements as appropriate.

The possible double tax involving personal goodwill on the largest part of a professional practice sale is a reality, but one that can be planned for.