

Quarterly Supplement To Business, Legal, And Tax Planning for the Dental Practice

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The purpose of the Quarterly Supplement is to continually update the material contained in **Business, Legal, And Tax Planning for the Dental Practice**, Second Edition, as "free-standing" articles relative to both current business, legal, tax and pending legislative matters that affect your practice and my ongoing experiences as an attorney representing dental and dental specialty practices. At times, articles will be written by my partners and friends who consist of tax attorneys, accountants, actuaries and dentists. The articles contained in the Quarterly Supplements all relate to material contained in my book, which I hope you will purchase after reading this Supplement if you haven't already.



William P. Prescott, M.B.A., J.D.
Attorney
Former Dental Equipment and Supply Salesman

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PERSONAL GOODWILL — MINIMIZING THE DOUBLE TAX

Since 1998, many advisors have advocated that C-corporation shareholders personally own the goodwill of their practices. Therefore, when the practice that operates as a C-corporation sells its assets, as is usually the case in a complete sale and acquisition, the shareholder-doctor simultaneously sells his or her personal goodwill. The personal goodwill is almost always coupled with the promise not to compete by the selling doctor with the purchasing doctor. It is argued that the personal goodwill is taxed at one level, rather than two as with corporate goodwill, and at favorable capital gain rates pursuant to a 1965 Revenue Ruling; 65-180. While this position is beneficial to the selling doctor, it is not without risk as each taxpayer involved in a sale and purchase of a business or practice must file a Form 8594 with its, his or her tax returns. So it is logical to think that the Internal Revenue Service (the "IRS") can "flag" those transactions involving personal goodwill.

As a result of this tax uncertainty for the selling doctor and as current Subcommittee Chair for Doctors, Lawyers and Other Professionals of the Closely-Held Business Committee of the American Bar Association Section of Taxation, I organized a program that took place on May 7, 2004, in Washington, D.C., on this topic. The program was presented in panel format. I was a moderator and the panel consisted of two tax attorneys and an IRS representative. The end result of our program was that: (a) the IRS, informally, reconfirmed the existence of personal goodwill pursuant to Technical Advice Memorandum ("TAM") 200244009; and (b) personal goodwill coupled with a non-severable covenant not to compete is taxed as ordinary income, as Revenue Ruling 65-180 should no longer be relied upon.

Background

The Tax Reform Act of 1986¹ repealed the "General Utilities Doctrine"² by amending certain tax sections of the Internal Revenue Code ("IRC") to require recognition of gain on a C-corporation's sale or distribution of appreciated property, including goodwill. Because professional service corporations operating as C-corporations ("PSC's") are separate taxpayers and are taxed at a 35% flat rate, the PSC will first pay any gain on the sale or distribution of assets. Then the shareholder(s) will pay a second tax, at capital gains rates, when the PSC liquidates and pays out the already taxed remaining proceeds. The net result approaches a 50% effective tax rate on the PSC's sale. Shareholder-doctors had the opportunity to avoid the double taxation problem prior to 1989 by making the switch to an S-corporation. While some PSC's did this, many did not because at that time C-corporations still provided greater fringe benefits than did S-corporations, e.g., 100% deductibility of health insurance premiums and certain retirement plan benefits. After 1989, S-corporation shareholders were required to wait ten years before such entity's assets could be sold without incurring the double tax.³

¹ Tax Reform Act ("TRA") of 1986, Pub. L. 99-514, 1986-3 C.B. (vol. 1) 1.

² *General Utilities and Operating Company v. Helvering*, 296 U.S. 200 (1935), was codified in Internal Revenue Code ("IRC") §§311, 336 and 337.

³ TRA 1986, Section 633(d)(8), as amended in 1988.

Tension Between Purchasers and Sellers of PSC's

In a complete sale and acquisition, a general or dental specialty practice is typically sold and purchased in an asset or stock transaction. Purchasers desire asset sales so that the purchase price can be amortized or written off. Stock purchases, on the other hand, are made in "after tax" dollars. Additionally, purchasing doctors do not desire to acquire stock because the purchaser will be subject to any unknown or contingent liabilities of the PSC.

Selling doctors desire to sell the stock of the PSC because all proceeds are taxed at capital gains rates so long as the stock has been owned for more than one year. The selling doctor would not desire to sell assets because an asset sale potentially subjects the shareholder(s) to double taxation. But if the purchasing doctor's advisor(s) do not allow the acquisition of stock, which is almost always the case, then the only alternative for the selling doctor(s) would be to sell assets and attempt to minimize the double tax.

After 1986, PSC asset sales were often structured as follows. The PSC would sell its tangible assets consisting of dental equipment, office equipment, furniture, dental supplies and dental instruments at fair market value. The PSC would also sell its corporate goodwill at a minimal amount. The remaining sum would be negotiated as a personal covenant not to compete by the selling doctor with the purchasing doctor. Covenants not to compete are taxed as ordinary income, but at least at one tax level and not two.

The Existence of Personal Goodwill

After 1998 and through the present date, advisors often advocate that the amount of the sale and purchase price of a practice above the fair market value of the tangible assets, and possibly a de minimis amount of corporate goodwill, is personal to the doctor. While personal goodwill was recognized in cases prior to 1998^{4,5,6,7,8}, it was made popular by the *Martin Ice Cream*⁹ ("Martin") and *Norwalk*¹⁰ ("Norwalk") v. *Commissioner* cases. By these two decisions, the Tax Court held that, under certain circumstances, the shareholder(s), not the PSC, is the owner(s) of the goodwill. To the extent that the goodwill is personal and not corporate, it is arguable that the personal goodwill is taxed at a single level. The questions prior to the May 7,

⁴ *Schilbach v. CIR*, T.C. Memo, 1991-556.

⁵ *D.K. MacDonald*, 3 T.C. 720 (1944).

⁶ *Stanton H. Bryden*, T.C. Memo 1959-184.

⁷ *Frank J. Longo*, T.C. Memo 1968-217.

⁸ *Arthur G. Rudd*, 79 T.C. 225 (1982).

⁹ *Martin Ice Cream Co. v. Commissioner*, 110 T.C. No. 18 (1998).

¹⁰ *Norwalk v. Commissioner*, T.C. Memo 1998-279.

2004 program were: (a) does personal goodwill exist in light of *Martin* and *Norwalk*; and (b) if it does, is it taxed as capital gains or ordinary income rates?

Martin

Martin involved an ice cream distribution business that split up under IRC Section 355 and, thereafter, sold distribution rights to Haagen-Dazs for \$1,500,000.00. The Tax Court held that there is no saleable goodwill in a corporation where its business depends on its key employees, unless they enter into a covenant not to compete with the corporation or other agreement whereby their personal relationship with the clients become property of the corporation.

Norwalk

Norwalk involved the liquidation and distribution of assets of an accounting firm that operated as a C-corporation. It is worth noting that Messrs. William Norwalk and Robert DeMarta had employment agreements with their accounting firm during their employment, but not thereafter. The IRS determined that the accounting firm, the C-corporation, realized a \$588,000 gain on liquidation of its goodwill and Messrs. Norwalk and DeMarta realized capital gains from the distribution of the goodwill from the accounting firm. However, the Tax Court ruled as follows. First, the liquidation was not taxable because the employment agreements had expired at the time the accounting firm liquidated. Because of this, the distribution of the client base to the respective shareholders did not result in a taxable event to either the corporation or the individuals. Second, the Tax Court found that client lists and goodwill have no "meaningful value" absent an effective non-compete agreement. "Because there was no enforceable contract which restricted the practice or any of its accountants at the time of the distribution, their personal goodwill did not attach to the corporation." Third, the Tax Court reasoned that, if the accountants left the firm, that person's clients could be expected to follow. It was the personal abilities and characteristics of the individual accountants that mattered to the client, not the characteristics of the corporation. Finally, the Tax Court said that without any employment or non-compete covenant, client goodwill attributable to the shareholder's personal characteristics is not a property right belonging to, or transferable by, a firm.

It is interesting to note that neither the split-up in *Martin* nor the liquidation in *Norwalk* involved a third-party sale and acquisition. Additionally, although both *Martin* and *Norwalk* recognized the existence of personal goodwill, neither case discussed how the personal goodwill was taxed, e.g., capital gains or ordinary income.

In light of the above, the IRS stated, informally at our program, that it recognizes the existence of personal goodwill pursuant to TAM 20024409 that cited *Martin*. This TAM involved a relatively complex case dealing with physician management companies. As a result of this TAM, it would seem difficult for the IRS to prevail in an argument that personal goodwill does not exist.

Personal Goodwill Coupled With A Covenant Not to Compete

While there are limited exceptions, e.g., a deceased practice owner, the purchaser will expect and demand a covenant not to compete from the selling doctor when acquiring a PSC's assets. However, the purchaser is not concerned whether the portion of the price above the amount paid for the tangible assets is allocated to goodwill or to a covenant not to compete because both are amortized over 15 years under IRC Section 197. However, the selling doctor cares very much about this distinction because goodwill is taxed at capital gains rates, assuming that the one-year holding period is met. The dollar amount of the covenant not to compete is taxed at higher ordinary income tax rates.

Revenue Ruling 65-180 from 1965 indicated that, if the facts can justify this treatment, it would be appropriate to allocate none of the intangible payments or goodwill to the seller's covenant not to compete and all of the value to the purchase of the seller's goodwill. However, the IRS took issue with Revenue Ruling 65-180 at out program. From a practical standpoint, some amount should be allocated to the covenant not to compete. The result of this allocation is that some portion of the intangibles should be subject to ordinary income rates, the covenant not to compete, and some portion should be subject to capital gains rates, the personal goodwill.

However, to further add to the uncertainty of personal goodwill versus ordinary income, some Courts have held that personal goodwill does not exist in the absence of a covenant not to compete.^{11,12,13} If personal goodwill cannot be transferred absent a covenant not to complete, it would then seem logical that the covenant not to compete should be non-severable with the personal goodwill and taxed at ordinary income rates. In other words, coupling a non-severable promise not to compete with the personal goodwill changes what may be capital gains to ordinary income, assuming that the covenant not to compete and the personal goodwill may be separately allocated. It should be noted that the selling doctor's promise not to compete with the purchasing doctor should be distinguished from any restrictive covenant that the selling doctor may have with his or her own PSC. Pursuant to *Martin* and *Norwalk*, if the PSC's shareholder(s) has a covenant not to compete with his or her PSC, then the goodwill is an asset of the PSC and not personal.

Allocating a small amount of the purchase price to a covenant not to compete and a large amount to personal goodwill presents a significant problem for the purchasing doctor. Purchasing doctors do not desire for a de minimis amount of the consideration to be allocated to a covenant not to compete, as the purchaser will think that selling that the selling doctor can tender the small dollar amount allocated to the covenant and actually compete. Thus, the purchasing doctor should insist that the covenant not to compete is equal to the entire value of the practice. However, the seller doctor desires capital gains treatment at one tax level. If Revenue Ruling 65-180 is no longer applicable, the selling doctor will desire that only a small amount be allocated to the covenant that is taxed as ordinary income. The personal goodwill not tied to the covenant

¹¹ *Flower v. Commissioner*, 61 T.C. 140 (1973)

¹² *Furrer v. Commissioner*, T.C. Memo 1976-331.

¹³ *Martin*.

should be taxed as capital gains, arguably at one tax rate. This interplay between ordinary income and capital gains will surely provide for interesting negotiations between shareholder-doctors selling assets and doctors purchasing assets of PSCs.

Planning Opportunities

Sale of PSC to Third Party

To the extent that personal goodwill exists in a PSC sale and acquisition, the shareholder-doctor will retain an additional \$0.30 for each \$1.00 allocated to the individual rather than the PSC. This is based on a 35% PSC tax rate and a current 15% capital gains rate. If the goodwill is owned by the PSC, the PSC will pay \$0.35 in corporate taxes; $\$1.00 \times 35\%$. The shareholder will then pay \$0.10 in capital gains taxes; $\$0.65 \times 15\%$. If the goodwill is owned by the shareholder-doctor, such doctor will either pay \$0.15 in taxes, $\$1.00 \times 15\%$, or ordinary income tax on the personal goodwill if coupled with a covenant not to compete.

The following example shows the possible planning opportunities available under *Martin* for shareholder-doctors to minimize the double taxation on a portion of the proceeds from the sale of the PSC's assets.

Example: The Smith PSC sells its dental practice for \$1,000,000 to Dr. Jones and liquidates, distributing the after-tax proceeds to Dr. Smith, the sole shareholder.

If all intangible assets belong to the Smith PSC, it will recognize gain of \$1,000,000 and pay income taxes of \$350,000; $35\% \times \$1,000,000$. Dr. Smith will pay income taxes of \$97,500; $15\% \times \$650,000$ or $\$1,000,000 - \$350,000$. Dr. Smith would have \$552,500 remaining after the payment of \$447,500 in taxes.

If instead, the Smith PSC sells its tangible assets and corporate goodwill for \$200,000 to Dr. Jones and Dr. Smith sells self-created intangible assets or personal goodwill for \$800,000 to Dr. Jones that Dr. Smith has not transferred to the Smith PSC, the Smith PSC will owe income taxes of \$70,000, $35\% \times \$200,000$, and Dr. Smith will owe income taxes of \$139,500; $15\% \times \$800,000$, plus $15\% \times \$130,000$, or $\$200,000 - \$70,000$. Dr. Smith will have \$790,500 remaining, for a tax savings of \$238,000 in this situation. Dr. Jones, the purchaser, will be able to amortize the self-created intangibles or personal goodwill over 15 years under under IRC Section 197 and will prefer this transaction to a stock purchase.

Liquidation or Conversion of a PSC to a Limited Liability Company

Norwalk provides the opportunity for shareholder-doctors to possibly reduce the double taxation on the liquidation of a practice or conversion to a limited liability company. The following example shows the opportunity for planning.

Example: Assume the same facts as the above example, except that the Smith PSC does not sell its practice and Dr. Smith does not sell his or her personal goodwill. Instead, the Smith PSC liquidates and distributes its assets to Dr. Smith or converts to a limited liability company.

If the Smith PSC owns all the intangible assets or goodwill, it will owe income taxes of \$350,000 and Dr. Smith will pay income taxes of \$97,500, as in the preceding example, for a total of \$447,500 in taxes. However, if Dr. Smith owns intangible assets or personal goodwill of \$800,000, the taxes will only be \$89,500. The Smith PSC will pay income taxes of \$70,000, based on 35% of the \$200,000 of tangible assets it owns. Dr. Smith will pay income taxes of \$19,500; $15\% \times \$130,000$ or $\$200,000 - \$70,000$.

Rewriting Buy-Sell Agreements

Some advisors are recommending that doctors who practice as co-owners should rewrite their buy-sell agreements to provide for the sale of personal goodwill rather than for the PSC's obligation to pay deferred compensation. This assumes that the stock is valued at a relatively low amount. Because personal goodwill coupled with a covenant not to compete will be taxed at ordinary income rates, this often makes rewriting the buy-sell agreements for group practice owners impractical, not to mention costly, as the remaining doctor(s) will always insist on the departing doctor being subject to a covenant not to compete if such departing doctor is being paid for his or her interest in the practice. But instead of the PSC receiving an immediate tax deduction for the payment of deferred compensation or continued compensation as income under IRC Section 162, notwithstanding the risks of an "unreasonable compensation" challenge,¹⁴ it will now have to amortize the payment of personal goodwill over 15 years. This will significantly increase the cost of a shareholder's buy-out to the PSC. In other words, not only do the buy-sell agreements have to be rewritten, but the practice also must be revalued in light of the tax consequences to the PSC to purchase a departing owner's personal goodwill in addition to his or her stock.

Bottom Line

The *Martin* and *Norwalk* decisions and TAM 20024409 are important for doctors who are shareholders of PSC's. Personal goodwill has again been recognized by the Tax Court and although the shareholder-doctor is taxed at ordinary income rates on the sale of personal goodwill coupled with a non-severable covenant not to compete under Revenue Ruling 65-180, at least the personal goodwill is taxable at one level, instead of two. If the covenant not to compete with the purchasing doctor is separate in dollar amount from the personal goodwill, arguably the personal goodwill will be taxed at one level as capital gains.

¹⁴ *Pediatric Surgical Associates, P.C.*, T.C. Memo, 2001-81 (April 2, 2001).