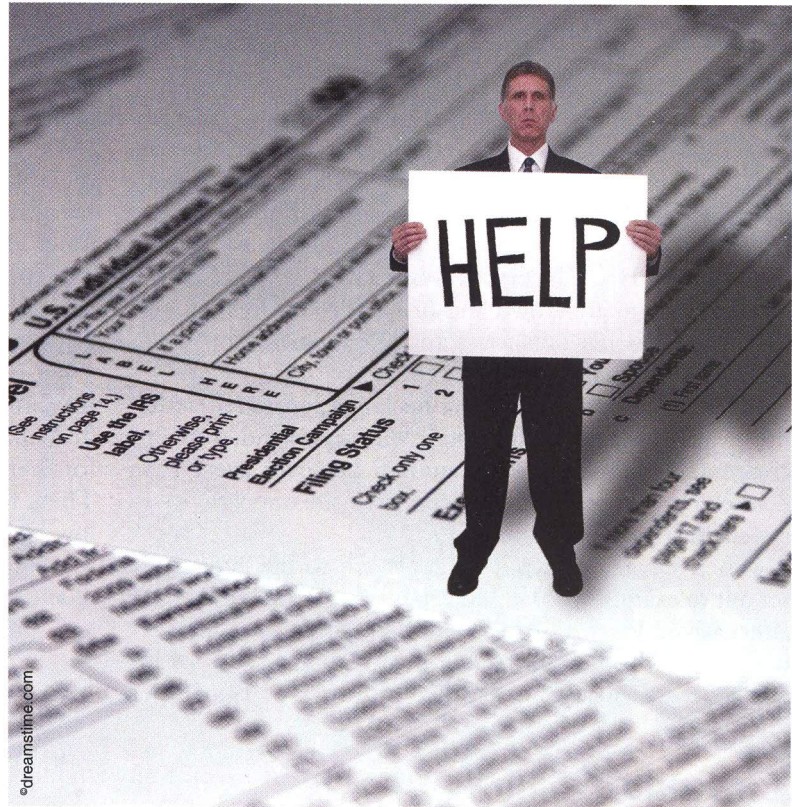


Perils for practice transition:

Double taxation of goodwill

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For most dental practices, goodwill constitutes the largest component of the practice's value. A mistake in handling goodwill could cost you thousands or even tens of thousands of dollars in unnecessary taxes when you sell your practice. Giving Uncle Sam your hard-earned money in the form of unnecessary taxes is a costly mistake at any time; but, it can be especially costly in today's difficult economic climate when more dentists than ever are relying on the proceeds from the sale of their practice as a substantial part of their retirement nest egg.

Navigating the IRS rules regarding goodwill has always been difficult. Recently, it has become even more difficult, especially for those dentists who formed a C corporation. Historically, many dentists were advised to organize their

practices as a C corporation due to favorable retirement plan and fringe benefit tax advantages.

Over the years, those benefits became available to all entities, causing C corporations to fall out of favor and S corporations to become the entity of choice. Although C corporations are used less frequently today, many dentists now reaching retirement age and considering selling their practice still operate as a C corporation.

For those of you who practice through C corporations, the sale of your corporation's assets are *double taxed* — 35% at the corporate level and 15% at the individual level. Since 1998, advisors have minimized this double tax by taking the position that your goodwill is a personal asset (personal goodwill) and not part of your practice's assets (corporate goodwill).

They did this by relying on two 1998 favorable tax court cases. Based on those cases, goodwill that is characterized as personal is taxed on only one level at the favorable capital gains rate — currently 15% — and a double tax is avoided on the largest part of the sale, the personal goodwill.

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However, this favorable case history is now under attack. In a recent case, the court held that when a dentist (a Dr. Howard) sold the assets of his C corporation practice, the goodwill was not personal, but rather a practice asset (corporate goodwill) resulting in a double tax.

What made the difference? In the two favorable cases, the shareholder-employees did not have a covenant-not-to-compete with the corporation employing them. Unfortunately, Dr. Howard did, and the court ruled against him.

The Howard case

Dr. Howard began practicing in 1972 and incorporated his practice as a C corporation in 1980. At that time, Dr. Howard also entered into an employment agreement and a covenant-not-to-compete with his corporation to obtain favorable retirement and fringe benefits. The restrictive covenant was in effect during Dr. Howard's employment with his corporation and for three years thereafter.

In 2002, Dr. Howard sold his practice, with his corporation selling the practice assets and Dr. Howard selling his personal goodwill. Of the total purchase price, small amounts were assigned to the tangible assets and Dr. Howard's covenant-not-to-compete with the purchaser, and the lion's share to Dr. Howard's personal goodwill. In challenging the allocation, the IRS recharacterized the sale of Dr. Howard's personal goodwill as a corporate asset, resulting in a tax deficiency and interest totaling almost \$75,000.

Ruling in favor of the IRS, the court concluded that the goodwill was not personal goodwill because Dr. Howard's corporation earned the income and paid the taxes based on the 1980 employment agreement.

The court also concluded that because Dr. Howard was bound by the covenant-not-to-compete after he sold his corporation, he could not have earned income from a competitive practice within the restricted area. The court noted that even if the goodwill had belonged to Dr. Howard personally, it would likely have very little value because the restrictive covenant radius would discourage patients from following Dr. Howard to a new location.

Lessons to be learned

1. Plan for the sale. Authorize your attorney to review

your corporate records to ensure that the goodwill belongs to you and not your corporation. If you currently have an employment agreement with your C corporation (irrespective of, but especially if it includes a covenant-not-to-compete), terminate it — and *the sooner, the better!*

The covenant-not-to-compete in the Howard case should have been terminated long before the practice sale. This leads to an interesting question: *How long before the sale of your practice must a covenant be terminated in light of the shareholder's ability to terminate it at any time prior to the sale?* The court raised the point that Dr. Howard's 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.

Applying the same concept to the sale of your practice, suppose you have a covenant-not-to-compete with your C

corporation for 20 years and you terminate it five years before the sale. If the value assigned to your personal goodwill is \$500,000, the value could be reduced by four-fifths: i.e., \$500,000 to \$100,000.

Authorize your attorney to review your corporation's proceedings of incorporator (which should be contained

in your corporation's record book) to ensure that your goodwill was not transferred to your corporation at the time of its formation. In addition, it may be very helpful to have corporate minutes designating that the goodwill is owned by you personally. This is not bulletproof, but perhaps useful in the event of an IRS challenge.

2. Consider converting to an S corporation. Consider converting your C corporation to an S corporation if you plan on practicing 10 or more years; seven years for practice sales in 2009 and 2010, and five years for sales in 2011. S corporations that have never been C corporations — and C corporations that have been converted to S corporations within the applicable time period prior to the practice sale — avoid the double taxation problem. However, the conversions have complexities, particularly relating to avoiding a double tax on accounts receivable.

3. Authorize an appraisal of your personal goodwill versus any corporate goodwill. The Howard case was lost based on the covenant-not-to-compete that Dr. Howard had with his corporation. Any covenant-not-to-compete you

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have with your corporation must be distinguished from the covenant-not-to-compete that you would enter into with a purchaser of your practice. If Dr. Howard would not have had a covenant-not-to-compete with his 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 your practice — you lose!

4. Expect increased audits on the sale of personal goodwill. The IRS is well aware that dentists are avoiding the double tax by structuring the sale of the practice primarily as the sale of personal and not corporate goodwill. Because Forms 8594 must be filed with the IRS by all parties to the sale (you, your corporation, and the purchaser), the IRS can determine whether you sold your personal goodwill. Authorize your advisors to plan in advance to defend why your goodwill is personal and not corporate.

Hypothetically, a very significant factor is: If you sell your practice without a covenant-not-to-compete and establish another practice near your former location, what percentage of your patients would follow you? Usually, all of them.

Factors indicating personal goodwill include your efforts to transfer your 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 a distinction between fee-for-service versus reduced-fee plan payment methods as an indicator of patient loyalty and personal goodwill.

5. Personal goodwill in co-ownership buy-outs. For shareholder buy-outs in multi-doctor/co-ownership practices, it is common to structure the transaction as the corporation's purchase of your stock at a low value excluding goodwill, coupled with the corporation's purchase of your personal goodwill. Under the Howard and the two 1998 favorable cases, you cannot have personal goodwill if you have a covenant-not-to-compete with your corporation. However, would not the other shareholder(s) of your corporation's dental practice require a covenant-not-to-compete from you? This point almost effectively eliminates the buy-out of personal goodwill in multi-doctor/co-ownership practices.

In co-ownership cases, this problem is also applicable to S corporations if the buy-out is deemed corporate goodwill and 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 your stock. This would result in a double tax or purchase of your practice interest in after-tax or nondeductible dollars to the purchaser.

Another important deterrent to this method is if your practice was formed prior to August 10, 1993, the anti-churning rules apply under Internal Revenue Code Section 197(f)(9) and the goodwill is not amortizable because you and the other shareholder owned the practice together.

Any covenant-not-to-compete you have with your corporation must be distinguished from the covenant-not-to-compete that you would enter into with a purchaser of your practice.

Final advice

While the Howard case should come as no surprise, it teaches us some important lessons.

First: Terminate any employment agreement and covenant-not-to-compete that you have with your C corporation and take steps to ensure that your goodwill is personal.

Second: Consider converting to an S corporation if you plan to practice several more years.

Third: If you plan to sell your practice and personal goodwill as a C corporation, obtain an appraisal of the personal goodwill.

Fourth: Expect increased audits of sales of personal goodwill.

Fifth: Be very cautious of the purchase and sale of personal goodwill in multi-doctor/co-ownership practices.

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Editor's Note: References available upon request.



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