

The current status of personal goodwill

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IN THE SALE AND PURCHASE OF ASSETS of a dental or dental specialty practice, goodwill represents 75% to 90% of the selling and purchase price and 10% to 25% of the tangible assets. Because goodwill is the largest part of the consideration or price, the character of its taxation is very important.

If you are practicing through a C-corporation, the sale of your corporation's assets will be double taxed, 35% at the corporate level and another 20% at the individual level.¹ The double-tax problem is applicable only to C-corporations, as well as S-corporations that were C-corporations within the last 10 years.²

Advisors have attempted to minimize or eliminate the double tax by taking the position that goodwill is personal and not a corporate asset. Since 1998, advisors have been relying on two favorable tax court cases *Martin Ice Cream* and *Norwalk*.³ Based on these cases, goodwill that is characterized as personal is taxed once at a favorable capital gains rate, which is currently 20%. To the extent that your goodwill is personal, the double tax is avoided.

As a result of *Martin Ice Cream* and *Norwalk*, there has been a trend in thinking that dentists can elect to sell personal goodwill rather than corporate goodwill and avoid a double tax.⁴ Either way, the purchaser is unaffected and will amortize or deduct goodwill, either personal or corporate, over 15 years. However, the purchaser's accountant should consider a downward adjustment based on a tax-neutral practice valuation due to the lengthy amortization period over 15 years. Depreciation recapture is an additional point to be considered by the purchaser's accountant because future practice sale proceeds are taxed at ordinary income rates rather than favorable capital gains.⁵ The depreciation recapture may result in yet another downward price adjustment to the tax-neutral purchase price.

FORMS 8594

Forms 8594 are required under the Tax Regulations in order to report the allocation of the purchase price in an asset sale in accordance with defined categories.⁶ Depending on the fair market value of the assets in each applicable cat-

egory, there will be an allocation to the sellers of ordinary income or capital gains. For the purchaser, the asset allocation will be deducted or amortized in accordance with the applicable time period for each category. Forms 8594 must be filed with the IRS by both seller (the C-corporation and the individual dentist) and purchaser with their respective federal income tax returns.

Some advisors take the position that the selling dentist should not file a Form 8594 because the sale of goodwill without any other asset does not constitute the sale of a "trade or business." However, the Tax Regulations provide that any sale of a group of assets constitutes a trade or business in the hands of either the seller or purchaser.⁷

In addition, some advisors take the position that the C-corporation has no goodwill, and they argue that the IRS cannot increase the corporate goodwill allocation, thereby imposing more of a double tax. This is a risky strategy, considering the C-corporation is the custodian of the patient records and employs a trained workforce.⁸ If the selling dentist does not file a Form 8594, the allocations won't match with the purchaser's allocations under the purchaser's Form 8594, which could trigger an audit. And there are penalties for not filing under the Tax Code.⁹

RESTRICTIVE COVENANT WITH YOUR CORPORATION

You cannot have a restrictive covenant with your existing corporation and sell personal goodwill. Under both the *Martin Ice Cream* and *Norwalk* cases, had the shareholders been subject to restrictive covenants with their respective C-corporations, there would not have been any personal goodwill. In one case involving a dentist, the dentist had a restrictive covenant with his corporation and lost both the case and the appeal.^{10,11,12,13}

NECESSITY OF EMPLOYMENT AGREEMENT WITH THE PURCHASER

In order to allocate goodwill as personal, you should have an employment agreement with the purchaser.¹⁴ In *Solomon*, the purchaser did not require postsale employment agreements

from the two shareholders,¹⁴ and the tax court recognized that the selling shareholder in *Martin Ice Cream* had a post-sale employment agreement with the purchaser.³

POST-SALE SERVICES AGREEMENT SHOULD BE WITH THE INDIVIDUAL

The *Howard* appeal noted that the post-sale services agreement with the purchaser was through the selling dentist's corporation and should have been with the dentist personally in order for personal goodwill to exist. It is very common for dentists to sell their practices and personal goodwill and continue to work for the purchasers' practices as independent contractors through the selling dentist's corporation.

APPRAISAL OF PERSONAL GOODWILL

It is important to authorize an appraisal of any personal goodwill. In *Kennedy*, the Court noted that the shareholder did not have an appraisal of the personal goodwill versus the corporate goodwill.¹⁵ The court further noted that the allocation to personal goodwill was an afterthought by Mr. Kennedy's accountant and was done to avoid taxes.¹⁴ Had Mr. Kennedy not showed evidence that he relied on the advice of his accountant, he would have incurred a 20% accuracy-related penalty.¹⁴ An appraisal of personal versus corporate goodwill should be distinguished from an appraisal of your dental practice, which does not consider whether your goodwill is personal or corporate.

S-CORPORATION SHAREHOLDERS SELLING PERSONAL GOODWILL

Advisors are increasingly advocating the sale and purchase of personal goodwill for their S-corporation shareholders who never practiced as a C-corporation. S-corporation shareholders have no need to sell personal goodwill because it could be characterized as covenant compensation and taxed at ordinary income rates under *Solomon*.¹⁴ Unless the S-corporation was previously a C-corporation within the last 10 years, the sale of personal goodwill is irrelevant.

STATE TAXATION OF S-CORPORATION GOODWILL

Some states tax S-corporation sales of goodwill. As a result, some advisors will take the position that the goodwill is personal. There might be an additional planning tool in these situations.

An appraisal of **personal versus corporate** goodwill should be distinguished from an appraisal of your dental practice, which does not consider whether your goodwill is personal or corporate.

If the S-corporation purchased the practice that is now being sold earlier, it is important to track and appraise the value of the purchasing shareholder's personal goodwill from the time of the initial practice purchase. To the extent that there is personal goodwill developed by the purchasing shareholder since the practice was purchased, any state tax may be minimized. Of course, an appraisal of the shareholder-developed personal goodwill is essential.

CLOSING THOUGHTS

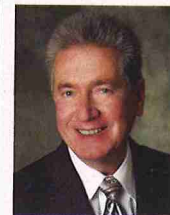
Here are the rules for characterizing personal goodwill in a practice sale and purchase:

- The purchaser's accountant should consider a downward adjustment to the tax-neutral purchase price due to a 15-year amortization period.
- Because of future depreciation recapture, the purchaser's accountant should consider an additional downward adjustment to the purchase price.
- Seller and purchaser should file Forms 8594.
- The seller should terminate any restrictive covenant with your C-corporation as early as possible prior to the sale.
- The seller should enter into a postclosing employment agreement with the purchaser to transfer the personal goodwill.
- The seller should ensure that the individual/selling dentist enters into the employment agreement with the purchaser rather than through the selling C-corporation.
- The seller should always authorize an appraisal of any personal goodwill versus corporate goodwill.
- S-corporation shareholders who have not practiced through a C-corporation within the last 10 years have no need to sell personal goodwill.
- If your state taxes S-corporation goodwill, authorize an appraisal to calculate the personal goodwill you developed from the time of purchase.

The use of personal goodwill is workable in certain situations but is much more limited than you might think. An appraisal of any personal goodwill versus corporate goodwill is essential, and the rules must be followed. **DE**

REFERENCES

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2. Internal Revenue Code (IRC) Section 1374.
3. *Martin Ice Cream Co. v. Commissioner*, 110 T.C. 189, 208 1998 WL 115614 (1998) ("Martin Ice Cream"); *Norwalk v. Commissioner*, T.C. Memo 1998-279, 76 TCM 208 (1998).
4. The Internal Revenue Service (IRS); American Bar Association, Section of Taxation Meeting, Closely Held Businesses Committee, May, 2009, Panel—Update on Personal Goodwill, Washington, D.C.
5. Internal Revenue Service Section 1245.
6. IRC Section 1060.
7. IRC Reg. Section 1.1060-1.
8. IRC Section 197.
9. IRC Section 6721(e)(2).
10. *Howard v. U.S.*, 2010 WL 3061626 (E.D. Wash.), 9th Cir 2010).
11. Prescott WP, Rang PD. Perils for Practice Transition: Double Taxation of Goodwill. *Dental Economics* website, 2010; 100(11); 90,92,94.
12. Prescott WP, Rang PD. Current Developments and Sale of Personal Goodwill. *The Practical Tax Lawyer*. 2011;25(3):47-50.
13. Prescott WP, Rang PD. Taxing Decisions: More Current Developments in the Sale of Personal Goodwill. *The Practical Tax Lawyer*. 2012;26(3):5-7.
14. *Solomon v. Commissioner*, T.C. Memo. 2008-102, (Solomon).
15. *Kennedy v. Commissioner*, T.C. Memo. 2010-206, (Kennedy).



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