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Who Sold That Goodwill – The Corporation or The Shareholder?

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Today most physicians, dentists, accountants and other professionals practice in entities established under state law as professional limited liability companies ("PLLCs"), limited liability partnerships ("LLPs") or professional corporations ("PCs"). PLLCs, LLPs and PCs that have elected S Corp status under the Internal Revenue Code generally enjoy pass-through tax status. This allows all profits and losses of the business entity to pass-through to the individual(s) owning the entity, i.e., a single tax is paid.

However, on occasion attorneys and accountants are in a position to represent physicians, dentists, accountants or other professionals who are selling their practices, which were established as a C Corp for tax purposes. This usually triggers a double tax that can consume well over 50 percent of the sale proceeds. Unless handled thoughtfully, the sale proceeds will first be taxed at the corporate level of 35 percent (federal)[1] and 8 percent (state)[2]. If the Corporation liquidates and distributes the remaining sale proceeds to the shareholder(s) of the C Corp, that distribution will be taxed at the personal level at about 15 percent (federal)[3] and 9 percent (state)[4].

Take the following simplified example ("Hypothetical #1") in which we have assumed a zero basis for all items: If the proceeds of the sale are $1 million, the federal and state tax at the corporate level would be about $430,000 and upon distribution of the remaining $570,000, there would be another $85,500 in federal tax and about $51,300 in state tax. Thus, there could be a whopping 56.7 percent tax bite of $566,800 with the owner keeping only about $433,200 out of the $1 million sale price.

A way to minimize the tax impact would be for the shareholder to sell his shares of the PC to the buyer.[5] Unfortunately, this is seldom acceptable to the buyer of a professional practice for two reasons. First, it subjects the buyer to all of the malpractice exposure of the seller, a risk buyers are generally unwilling to accept. Second, the buyer cannot depreciate any portion of the purchase price and the real cost of the deal to the buyer can become prohibitive.[6]

However, as discussed below, there is a history of federal tax litigation that takes into consideration the economic realities of a transaction and indicates that sometimes a different structure can result in more favorable tax treatment for both the buyer and seller. Where the shares of the C Corp are owned by one or more professionals who do not have contracts of employment or restrictive covenant agreements with the PC and the primary assets being sold are the name, reputation and customer and referral source loyalties, analysis of the economic realities may reveal that the goodwill actually resides in the licensed individual and not in the PC. Thus, a transaction can be structured in which the buyer (1) purchases from the PC equipment, furniture, a leasehold, leasehold improvements, phone numbers, and patient or client records and zero or a small amount of goodwill, (2) purchases from the licensed professional(s) individually his/their personal goodwill, name, reputation and patient and referral source loyalty, and (3) enters into an employment agreement or independent contractor agreement with the licensed professional(s) which contains a restrictive covenant and reasonably compensates the professional(s) for work to be provided after the Closing.[7]

When it comes to professionals, it has long been recognized that the guts of a purchase and sale deal is the ability of the buyer to secure the goodwill of the seller and have confidence that the seller's patients or clients will continue to patronize the buyer. It is manifest that if a buyer acquires all of the hard assets of a PC but does not acquire the personal goodwill of the PC's owner, the buyer will be left holding the bag if the owner opens a competing office across the street. The patients and referral sources of the owner will not patronize the buyer but will go to the owner's new practice across the street. The simple lesson is that the individual owns the most valuable asset, i.e., the patient and referral source loyalty and reputation that composes his personal goodwill.

Prior to 1986, utilizing what had become known as the *General Utilities* doctrine[8], a corporation could distribute its appreciated assets to its shareholder(s) without incurring a corporate tax. The shareholder(s) would pay tax and receive a stepped up basis to fair market value. The shareholder(s) could then sell the assets at fair market value with no additional tax impact. In this way, shareholder(s) benefited by the corporation not paying tax on the distribution to them of appreciated assets. Some considered this to be a "loophole" and the Tax Reform Act of 1986 repealed the *General Utilities* doctrine and required corporations to recognize gain on the distribution of appreciated assets while the shareholder(s) continued to be subject to tax upon receiving the assets distributed.

However, all was not lost for the shareholder(s) of certain PCs established as C Corps for tax purposes. In 1998 the Tax Court cases of *Martin Ice Cream Co. v. Commissioner*[9] and *William Norwalk, et al. v. Commissioner*[10] established the proposition that a Corporation has no saleable goodwill where its business is dependent upon its key employees, unless those employees entered into a covenant not to compete with the corporation or other agreement whereby the owner's personal relationships with clients and referral sources became the property of the corporation.[11]

The *Martin* and *Norwalk* cases seem to remain good law today and were cited by the Tax Court as recently as August 2010 in *Howard v. US*[12]. In this case, which held against the individual taxpayer, Dr. Howard was the sole owner of a PC but signed an employment agreement and a covenant not to compete with the PC in 1980. In 2002 the PC entered into an Asset Purchase Agreement in which about 90 percent of the purchase price was allocated to Dr. Howard's personal goodwill. The Tax Court rejected this position distinguishing the *Martin* and *Norwalk* cases and held that the goodwill belonged to the PC because of the existence of the employment agreement and the restrictive covenant agreement with Dr. Howard. The facts and economic realities in *Howard* did not support the taxpayer, but the case affirms the vitality of the tax doctrine established in *Martin* and *Norwalk*.

Consider the alternative tax implications as illustrated by following simplified example ("Hypothetical #2") and in light of the economic realities and the doctrine established by the *Martin* and *Norwalk* cases: The buyer executes an Asset Purchase Agreement with a PC to purchase the PC's assets for $60,000 comprised of $35,000 in furniture and equipment, $12,500 in phone and fax numbers, $12,500 in records and charts and zero goodwill because the PC does not have an employment agreement and restrictive covenant agreement with the PC's owner.[13] The buyer contracts with the individual professional for his professional services over a number of years (at a reasonable salary); the agreement includes the payment of $100,000 for a restrictive covenant. At the same time, the buyer purchases the most important asset, the individual's goodwill, for $840,000 pursuant to a clear and well-drafted sale of goodwill agreement. The tax consequences of these transactions should be along the following lines, assuming the tax basis of all items is zero: The PC will pay federal professional services corporate tax of 35 percent and ordinary state income tax of 8 percent on the full $60,000 of its sale proceeds.[14] The individual professional will pay ordinary income tax on the payments he receives for his work and on the $100,000 he receives for his restrictive covenant and will pay federal capital gains tax and ordinary state income tax on the proceeds of the sale of his personal goodwill.[15]

Based on the foregoing, the total tax bite will be approximately $278,600 (28%), determined roughly as follows: $25,800 paid by the PC for federal and state taxes on the $60,000 it receives for the sale of its assets, and $252,800 to be paid by the individual approximately as follows: $8,200 for federal[16] and state income taxes on the $34,200 distributed to him from the PC, $43,000 for federal and state taxes on the $100,000 paid to him by the buyer for his restrictive covenant and $126,000 for federal taxes and $75,600 for state taxes on the $840,000 paid to him to purchase his personal goodwill. The owner ends up keeping $721,400 out of the $1 million in total consideration.

Thus, one can readily see the $288,200 tax savings obtained from a properly structured transaction by comparing $566,800 in total tax payments in Hypothetical #1 above to $278,600 in total tax payments in Hypothetical #2 above. Accordingly, it is incumbent upon the attorney and accountant, prior to the commencement of negotiations, to identify "who owns what" in a sale transaction involving a professional corporation which has been structured as a C Corp for tax purposes. These professionals can provide value-added services to their clients by initially determining who actually owns the goodwill and then structuring the transaction in accordance with the economic realities and carefully drafting the deal documents in light of the principles discussed in this article.[17]

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[1] The federal corporate income tax rate is a flat 35% for personal service corporations. There is no preferential capital gains rate for a C corporation. While there may be a federal income tax deduction for state taxes paid (i.e., New York State corporate income tax), we have ignored that deduction for purposes of this article. This article also ignores sales tax issues on furniture, fixtures and equipment.

[2] The New York State corporate income tax rate is approximately 7% and in New York City, Nassau, Suffolk, Westchester, Dutchess, Orange, Putnam and Rockland counties, there is an additional approximate 1% surcharge. For purposes of this article, we use a state rate of 8%.

[3] The federal individual income tax rate for capital gains has been 15% under the Bush Tax Cuts which were recently extended through December 31, 2012.

[4] The New York State individual income tax rate is about 9%. For NYC transactions, an additional City tax of about 3.5% applies. For this article, we have used a state rate of 9%. While there may be a federal income tax deduction for state taxes paid (i.e., including New York State individual income tax), we have ignored that deduction for purposes of this article.

[5] Upon the sale of the stock, a seller likely would enjoy capital gain treatment (IRC §1(h)) on the net proceeds of the sale. Conversely, the buyer would receive the stock, which is not a depreciable asset.

[6] Of course, the C Corp could continue to depreciate or amortize its assets but the purchase price in excess of the tax basis of those assets would not be depreciable or amortizable.

[7] The buyer will get 15 year depreciation on his payments for goodwill and the restrictive covenant. See IRC §197.

[8] *General Utilities and Operating Company v. Helvering*, 296 US 200 (1935).

[9] *Martin Ice Cream Co. v. Commissioner*, 110 TC 189.

[10] *William Norwalk, et al. v. Commissioner*, TC Memo 1998-279.

[11] See *William Norwalk, et al. v. Commissioner*, citing *Martin Ice Cream Co. v. Commissioner* at page 207 ("personal relationships of a shareholder-employee are not corporate assets when the employee has no employment contract with the corporation"). See also *Goodwill and PSCs – Recent Cases Offer Planning Possibilities on Dissolution and Conversion*, Journal of Taxation, Volume 90, Number 3, March 1999; *Avoid Taxes in Liquidation – Proper planning requires CPAs to examine existing employment agreements with shareholder-employees*, Journal of Taxation, May 2001; and *Try to take it personally: revisiting the role of goodwill in the sale of a professional service corporation*, Practical Tax Lawyer, Spring 2006.

[12] *Howard v. U.S.*, 106 AFTR 2nd 2010-5533.

[13] Query whether the selling PC without an employment contract or restrictive covenant agreement with its owner professional(s) has zero goodwill or a small amount of goodwill. It is possible that some patients may call the purchased phone number and end up as patients or clients of the buyer. Practitioners should use their best judgment to assess the economic reality of the deal in which they are involved in order to determine whether any goodwill resides in the selling PC.

[14] See footnotes 1 and 2 above.

[15] Capital assets are defined in IRC §1221 and include goodwill.

[16] This distribution to the owner from the PC is treated as a sale of a capital asset under IRC §1221 and is taxed at the rate of 15%.

[17] This article is not intended to be and should not be treated as legal or tax advice. Readers should not rely upon the information in this article as a substitute for their own research or for obtaining specific legal and/or tax advice from their own counselors.