



# Practice Transitions Made Perfect™

## Newsletter Article Reprint

### a TAXing Decision

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For those of you who practice as C-corporations, the sale of your practice results in a double tax; 35% at the corporate level and 15% at the individual level. Since 1998, advisors have relied on several favorable tax court rulings to minimize this double tax by taking the position that your goodwill is personal to you (personal goodwill) and not part of your practice assets (corporate goodwill). To the extent that your goodwill is personal, it is arguably taxed on one level at the favorable capital gains rate, currently 15%, and the double tax is avoided on the largest part of the sale, the personal goodwill.

However, this favorable case history is now under attack. In a recent case, the court held that when Dr. Howard sold his dental practice (C-corporation), the goodwill was not personal, but rather a practice asset resulting in a double tax. What made the difference in the rulings by the courts? In the prior favorable cases, the employee-shareholder did not have a covenant not to compete with the corporation employing him. Unfortunately, Dr. Howard did have a covenant not to compete as part of his employment agreement with his own corporation, and the court ruled against him.

#### Lessons To Be Learned

##### 1. Plan for the Sale

If you currently have an employment agreement with your C-corporation which includes a covenant not to compete, consider revising the agreement to eliminate the covenant not to compete, and the sooner the better.

In addition to not having a covenant not to compete with your own C-corporation, authorize your legal counsel to review your corporate records to ensure that the goodwill belongs to you and not to your corporation. This includes reviewing the proceedings of incorporation to ensure that your goodwill was not transferred to your corporation at the time of its formation. Also, it may be helpful to have corporate minutes designating that the goodwill is owned by you personally. Not bulletproof, but perhaps useful in the event of an IRS challenge.

##### 2. 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 own corporation. Any covenant not to compete that 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. 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.

##### 3. 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 goodwill and not corporate goodwill. Because Form 8594 must be filed with the IRS by all parties to the sale (you individually, 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. Factors indicating personal goodwill include your efforts to transfer the personal goodwill to the purchaser, continued 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 payment methods of fee for service versus reduced fee plans.

##### 4. Personal Goodwill in Co-Ownership Buy-Outs

For shareholder buy-outs in co-ownership, it is common to structure the transaction as the corporation's purchase of your stock at a low value excluding goodwill, coupled with corporation's purchase of your personal goodwill. Based on the court cases, you

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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 co-ownership.

### Conclusion

While the recent Howard case should come as no surprise, it teaches some important lessons. First, if you operate as a C-corporation, consider converting to an S-corporation. C corporations that have been converted to S corporations for at least seven years for practice sales in 2009 and 2010, and for at least five years for practice sales in 2011, avoid the double tax problem. Second, Dr. Howard's covenant not to compete should have been terminated prior to the practice sale, although the question remains how long before the sale is sufficient? 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. Finally, be very cautious of the purchase and sale of personal goodwill in co ownership.

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1 Tax Reform Act of 1986, Pub. L. 99-514, 1986-3 C.B. (vol. 1) 1. 2 Martin Ice Cream Co. v. Commissioner., 110 T.C. 189, 208 1998 WL 115614 (1998); Norwalk v. Commissioner, T.C. Memo 1998-279, 76 TCM 208 (1998). 3 Howard v. U.S., 2010 WL 3061626 (E.D. Wash.), July 30, 2010.

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