Professional Service Goodwill: *Who Owns It?*

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For a number of years, when a small professional service corporation has been sold, many tax advisors have encouraged the shareholder-owners to have the payments for goodwill paid to the owners personally. They generally rely on *Martin Ice Cream Co. v. Comm'r*, 110 T.C. 189 (1998), and *Norwalk v. Comm'r*, T.C. Memo 1998-279 to mean that the owner's personal relationships and professional skill belong primarily to the owner, not the corporation. The recent Ninth Circuit Court of Appeals decision in *Howard v. U.S.*, 108 AFTR 2d 2011-5993, 08/29/2011, casts doubt on whether the *Martin Ice Cream* and *Norwalk* cases should continue to be relied on, or whether a safer course of action is to have an S Corporation election in place.

The Transaction at Issue

Dr. Howard sold his dental practice in 2002. The purchase agreement allocated almost all of the sale proceeds to goodwill. Dr. Howard reported on his personal return $320,358 as long-term capital gains from the sale of the goodwill. The IRS disagreed, arguing that Dr. Howard's employment agreement with his corporation converted the goodwill into a corporate asset because the agreement contained a covenant not to compete. On these grounds, the IRS recharacterized the income as a dividend from the corporation and assessed additional income taxes at the higher dividend rate then prevailing. The result was an increased tax bill to Dr. Howard of $74,921.

The District Court ruled for the IRS, holding that Dr. Howard transferred his goodwill to his corporation when he signed an employment agreement with the corporation despite the fact that the agreement contained no provision for a transfer of goodwill. Thus, the goodwill transferred as part of the sale of the business was owned by the corporation, not by Dr. Howard.

The Ninth Circuit upheld the District Court opinion despite Dr. Howard's arguments. First, he argued that language in the purchase agreement identifying the goodwill as a personal, non-corporate asset was dispositive to show that the goodwill was conveyed by Dr. Howard, not by the corporation. The Court rejected this argument, concluding that the "objective economic realities of a transaction" trump self-serving language in a purchase agreement.

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Second, Dr. Howard argued that the sale of his business effectively terminated the employment contract and non-competition agreement and transferred the goodwill back to Dr. Howard an instant before it was transferred to the buyer. The court rejected this argument on the grounds that Dr. Howard continued to work for the corporation for another three years after the sale of the business. The Court stated that even if the employment agreement had been terminated by the purchase agreement, that release "would constitute a dividend payment, the value of which would be equivalent to the price paid for the goodwill of the dental practice."

The *Martin Ice Cream* and *Norwalk* Decisions

Superficially, at least, the *Howard* courts followed the holdings in *Martin Ice Cream* and *Norwalk*. These are generally interpreted to mean that a key employee's personal relationships belong to the employee unless an employment agreement or covenant not to compete specifically converts those personal relationships into corporate assets. However, a close reading of the *Martin Ice Cream* and *Norwalk* decisions may leave open the question of whether the mere existence of an employment agreement or covenant not to compete converts goodwill into a corporate asset.

In Dr. Howard's case, the employment contract included a covenant not to compete but made no mention of goodwill. Even so, the Ninth Circuit found that a transfer had occurred.

What Does the *Howard* Decision Mean for Professional Service Corporations?

There are two main lessons here. First, sole shareholder professionals should not enter into a covenant not to compete with their corporations. These agreements almost guarantee that the IRS and the courts will find that goodwill has been converted into a corporate asset. Even a contract explicitly reserving goodwill to the professional may not prevent a court from deciding that such a transfer took place.

Second, professionals should elect S status for their corporations. Given the magnitude of the risk — goodwill generally constitutes the bulk of the value of the practice — the benefits of a professional service corporation may be outweighed by the risk that a large part of the value of the business will be subject to two levels of taxation when the business is sold. To compound the problem, the shareholder will pay tax on the proceeds as a dividend rather than as capital gain on the sale of the business. The best way to mitigate that risk is an S corporation election.

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