Sale Of A Business Or Practice &
Sale Of Personal Goodwill

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Sale Of A Business Or Practice: Sale Of Personal Goodwill

I. TYPES OF GOODWILL FOR INCOME TAX PURPOSES.

This outline focuses on the income tax existence of, and issues relating to, personal goodwill.

A. Goodwill Defined.

Goodwill may be owned by the business, the owners of the business, or both.

The Treasury Regulations distinguish between corporate goodwill and going concern value, although the distinction in cases and elsewhere is not clear – often these concepts are treated as one. Reg. 1.197-2(b)(1) provides: "*Goodwill* is the value of a trade or business attributable to the expectancy of continued customer patronage. This expectancy may be due to the name or reputation of a trade or business or any other factor." Reg. 1.197-2(b)(2) states: "*Going concern value* is the additional value that attaches to property by reason of its existence as an integral part of an ongoing business activity. Going concern value includes the value attributable to the ability of a trade or business (or a part of a trade or business) to continue functioning or generating income without interruption notwithstanding a change in ownership, but does not include any of the intangibles described in any other provision of this paragraph (b). It also includes the value that is attributable to the immediate use or availability of an acquired trade or business, such as, for example, the use of the revenues or net earnings that otherwise would not be received during any period if the acquired trade or business were not available or operational.

Rev. Rul. 59-60 defines goodwill as an expectation that investment in the assets of a business will yield profits in excess of the usual return on those assets because of characteristics peculiar to the business. These characteristics may include a competitive advantage of the business due to a special relationship with suppliers or special price advantages, location, the name of the firm, reputation, and well-known brand names owned by the company.

Like Rev. Rul. 59-60, appraisers define goodwill as "the ability to earn a rate of return in excess of a normal rate of return on the net assets of the business." S. Pratt, R. Reilly & R. Schweihs, *Valuing Small Businesses & Professional Practices*, p. 726 (3d ed. 1998). Normal earning power is what can be expected from the physical business assets; if the business has greater earnings than what is expected, then the business has goodwill. *Norwalk v. CIR*, T.C. Memo. 1998-279.

Even though a business operates at a profit, it may have no goodwill because of the highly competitive nature of the business or the turnover of customers,

necessitating constant solicitation. For example, a business that derives most of its profits from government contracts, awarded by competitive bids, has no goodwill except to the extent of any privately negotiated contracts. *Barber v CIR*, T.C. Memo. 1963-206. *Vamvaks v. CIR*, 4 TCM 733 (June 30, 1945). There can be many explanations for high profits other than goodwill. The taxpayer must prove that profits are attributable to goodwill. *Landesman, Hirschheimer Co. v. CIR*, 44 F.2d 521 (6th Cir. 1929).

In a professional practice: "Goodwill incorporates such subjective factors as the 'personality' of a practice, which evolves from the physician(s) running it, the office staff, the surroundings and the patients themselves. Goodwill is demonstrated by the fact that patients continue to seek the services of the physician(s) and that new patients are attracted as well." *Buying and Selling Medical Practices: A Valuation Guide*, p. 39 (American Medical Association 1990). The AMA identifies as factors generating goodwill the medical records, use of the seller's name, use of the seller's telephone number. See also S. Pratt, R. Reilly & R. Schweihs, *Valuing Small Businesses & Professional Practices*, p. 633 (3d ed. 1998).

B. Types of Goodwill.

There are generally two types of goodwill: (1) business, enterprise, practice, or institutional goodwill and (2) personal, professional, or practitioner goodwill. *Schilbach v. CIR*, T.C. Memo, 1991-556.

1. Business, Enterprise, Practice, Or Institutional Goodwill.

"Institutional goodwill consists of location, computer systems, operating procedures, trained and assembled staff, and a patient or client base." "These intangible elements (and others like them) can generate value over and above the entity's net asset value, thus producing goodwill value." S. Pratt, R. Reilly & R. Schweihs, *Valuing Small Businesses & Professional Practices*, p. 585 (3d ed. 1998).

Business, enterprise, practice, or institutional goodwill is the intangible value and the nature of goodwill that is associated primarily with the practice of the business entity. S. Pratt, R. Reilly & R. Schweihs, *Valuing Small Businesses & Professional Practices*, p. 584 (3d ed. 1998).

2. Personal, Professional, Or Practitioner Goodwill.

Personal, professional, or practitioner goodwill has value in many contexts. However, there is no universally accepted, clear-cut method for determining its value.

Personal goodwill is the intangible value that is associated primarily with the individual. S. Pratt, R. Reilly & R. Schweihs, *Valuing Small Businesses & Professional Practices*, p. 584 (3d ed. 1998). Personal

goodwill exists when the shareholder's reputation, expertise, or contacts gives the corporation value. Darian M. Ibrahim, "*The Unique Benefits Of Treating Personal Goodwill As Property In Corporate Acquisitions*," 30 Delaware Journal of Corporate Law 1 (2005). Ability, experience, or qualifications of individuals do not constitute goodwill because they are not assets that can be purchased and sold for income tax purposes. Thus, salable goodwill must be more than a nontransferable degree or qualification. *Wickes Boiler Co. v. CIR,* 15 BTA 1118 (1929). The line, if it exists at all, between expertise and ability is fuzzy at best.

Another critical fact for the existence of personal goodwill is the lack of a non-compete or non-solicitation contract with the selling business. Tax cases, discussed later in this outline, have found the existence of personal goodwill, despite IRS challenges. However, the IRS certainly can and does challenge the existence and the amount of allocations to personal goodwill.

C. Professional Service Organizations Versus Commercial Businesses.

The issue of personal goodwill arises often in the context of the professional practice. There is often substantial personal goodwill in a professional practice, particularly in one-owner or few-owner professional practices. The value can be more difficult to ascertain and value in a commercial business. Even if a commercial business has one owner, it may be more difficult to attribute much value to personal goodwill. In the case of a commercial business, there might be a lesser element of personal goodwill, or even a negative value that some have suggested might be measured by the imposition of a key person discount on the business. However, there are a number of cases holding that there can be personal goodwill in a commercial business.

In *Frazier v. Frazier*, 737 N.E.2d 1220 (Ind. App. 2000), the business being valued was a single location retail furniture store. While the propertied spouse's attorneys in a divorce claimed that most of the goodwill was personal, the facts were that very little of the value, if any, could be attributed to the owner. He did not have any special relationship with the customers (who came from the general public) and he had no special relationships with suppliers. While a buyer would insist on a noncompete agreement, it would really have value only to keep the owner from an attempt to compete in a nearby location. The court ruled that the most appropriate method of valuing personal goodwill in a commercial business is to value the "Key Person" element. See Pratt, Reilly, Schweihs, Valuing A Business; pp 601-602 (3d ed. 1998).

On the other hand, *Martin Ice Cream* and other cases discussed below are examples of a non-professional mercantile business where there was substantial personal goodwill.

D. Relevance Of Goodwill Decisions Outside The Income Tax Context.

The valuation of a business is at a particular point in time for a particular purpose. The purposes can vary, and the law can vary depending on the purpose. Issues regarding the existence and value of goodwill arise in a wide variety of contexts, including sales of businesses and professional practices, divorce, mergers and acquisitions, bankruptcy, liquidations, transfer pricing, income, estate and gift taxes, charitable deductions, and disputes involving the existence and impairment of goodwill. Thus, decisions about goodwill in other areas of law may not be relevant to income tax issues. See *Howard v. U.S.,* 106 AFTR 2d ¶ 2010-5140 (D.C. WA. 7/30/2010), following federal tax law and not state divorce law.

While cases may reach certain conclusions, it is important to view them in context, especially if they are not income tax cases. Indeed, even income tax cases can be misleading.[1]

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[1] . In *Muskat v. U.S.*, 101 AFTR 2d 2008-662 (D.C. NH. 4/2/2008), aff'd 554 F.3d 183 (1st Cir. 2009), the court, applying the strong proof rule, rejected the taxpayer's attempt to recharacterize payments for a noncompete as payments for personal goodwill. The trial court in dictum expressed doubt that an allocation to personal goodwill was appropriate in this case (without explaining why and without analysis). It stated: " Indeed, the concept of personal goodwill as an asset, separate from business goodwill and from the obligations imposed by the noncompetition agreement, in the context of the sale of a business . . . is unclear." The court cited Martin Ice Cream (for the holding that personal goodwill can exist – this case is discussed in detail hereafter) and three other cases, which the court described in parenthesis as follows: Matter of Prince, 85 F.3d 314, 320–23 (7th Cir. 1996) (discussing value of orthodontist's goodwill in his practice for purposes of bankruptcy valuation and attributing orthodontist's goodwill, his relationships with patients, as an asset of his practice); Bruss Co. v. K & S Brokerage, Inc., 1992 WL 25375 at 10 (N.D. Ill. 1992) (discussing personal goodwill of former sales contractor for purposes of determining whether nonsolicitation covenant was enforceable); In re Cooley, 87 B.R. 432, 443 (S.D. Tex. 1988) (goodwill of medical practice not separate from personal goodwill of physician and could not be sold separate from his services).

However, if the court thinks that these 3 cases stand for the proposition that there can be no personal goodwill in these circumstances, it is incorrect. In my opinion, the court misread each of these 3 cases. Prince is a Ch. 11 bankruptcy reorganization case, valuing the stock of an incorporated orthodontist practice based on a fairly contemporaneous price in a stock sale agreement of that same practice. There was no issue or discussion of personal versus corporate goodwill, only that the value of the ongoing practice was much more than the value of its equipment and business assets as separate assets.

Cooley is another Ch. 11 bankruptcy case, involving the famous heart surgeon, Denton Cooley. Cooley practiced as a sole proprietor with 5 employed surgeons, and the court recognized the distinction between practice versus personal goodwill. The issue was the extent to which profits generated post-petition from the sole proprietorship of an individual Chapter 11 debtor are excluded from property of the estate by the earnings exception of 11 U.S.C. § 541(a)(6), i.e., the post-petition income stream of an individual debtor's practice (part of the bankruptcy estate) versus profits from the debtor's services (excluded from the estate). Indeed, the court ruled that "personal goodwill is inextricably bound up with his personal services and is not by operation of the earnings exception property of the estate." The court concluded that while Cooley's personal services generated half of the practice gross income, he was entitled to 65% of the post bankruptcy petition income, clearly recognizing that he was entitled to retain income attributable to his personal goodwill. Indeed, since his personal return reported his income and the income of the five surgeons, less the expenses of their salaries, it can be read to mean that the entire goodwill value was allocated to Dr. Cooley and none to the practice.

II. EXISTENCE AND VALUE OF PERSONAL GOODWILL.

A. When Relevant.

The existence of personal goodwill is especially relevant in a sale of assets or liquidation by a C corporation or S corporation, where goodwill is a built-in gain item or the S corporation has earnings and profits. A valid allocation to personal goodwill in such situations eliminates taxation upon both sale and liquidation, including any built in gains tax that might otherwise apply to an S corporation or which could exist if the S corporation has earnings and profits.

B. Early Tax Cases Recognizing Personal Goodwill.

Many income tax cases recognize the existence of personal goodwill. They involve professional practices as well as other businesses. Initially, the Board of Tax Appeals indicated that personal services could not create goodwill.

An early case on the issue of goodwill in corporations is *Providence Mill Supply Company v. CIR*, 2 BTA 791 (1925). The Board of Tax Appeals had to decide whether goodwill could be allowed as invested capital in a corporation. The BTA rejected the corporation's claim that it received goodwill. It stated that the only benefit received by the corporation resembling goodwill was the services provided by one of its principal owners: "Ability, skill, experience, acquaintanceship, or other personal characteristics or qualifications do not constitute good will as an item of property; nor do they exist in such form as they could be the subject of transfer." The *Providence Mill Supply* case laid down the general principle that personal services were not the equivalent of goodwill. The practical effect of this holding would mean that the liquidation of a corporation

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Bruss is a case where a noncompete was successfully enforced in a preliminary injunction hearing against an individual (Mr. Silverman) previously employed (as an independent contractor through the Silverman's own corporation) by the plaintiff and then later by the individual's new employer. While the sale of assets fell through, and it was not clear whether the noncompete was ever signed, the court treated the plaintiff's purchase from the bankruptcy estate of the business it had previously contracted to buy (but never closed) as if it was in fact an asset purchase from the selling corporation with the noncompete in existence, thereby making the noncompete more enforceable than if it were in an employment agreement. The court held that since the parties followed the written noncompete, it was an enforceable contract. As to the possible existence of personal goodwill, the Bruss court states: "'Goodwill' is an abstraction. It means the reputation of a business in the eyes of those who deal with it. It is associated with trade names and trademarks, but it can also be embodied in the people with whom customers come in contact." Bruss does contain language that infers that the two owners' goodwill in the business sold was business goodwill, but distinguishing between business and personal goodwill was not important to its holding. Bruss simply holds that goodwill must exist for a noncompete to be enforced. Indeed, later in the opinion the court indicates that there was no business goodwill because the business was headed for bankruptcy, and Bruss, the buyer, had not contracted to buy its customer lists or trademarks. The court then stated: " Nevertheless, in a competitive business personal goodwill can be important. Knowing the customer may not permit you to charge a higher price, but if you meet your competitor's price it can get you the order. Silverman's relationship with customers permitted Bruss to break into the rib business, and that is what it paid for."

dependent on the services of its employees would be less likely to include goodwill as an item of distributable property. However, later decisions by the courts and IRS rulings reach a different result. However, a number of subsequent court decisions indicate that in appropriate factual circumstances a professional practice or other business may possess salable goodwill even though its success is solely attributable to the skill, integrity and other characteristics of the owner. See, for example, Brooks v. CIR, 36 T.C. 1128 (1961), acquiescence, C.B. 1962-2, 4; *Horton v. CIR*, 13 T.C. 143 (1949), acquiescence in result only, C.B. 1959-2, 5; and *Herndon, v. CIR*, T.C. Memo. 1962-184.

For an *auto dealer*, the ability to obtain the cars and hold the exclusive territory rested on the personal relations between the owner of the selling company and the managers of the manufacturing company. It was not corporate goodwill. *Noyes-Buick Co. v. Nichols*, 14 F.2d 548 (D.C. Mass. 1926)(an action to recover back excise taxes assessed on corporate goodwill under § 1000 of the Revenue Act of 1921).

O'Rear v. CIR, 80 F.2d 473 (6th Cir. 1935), stated that it was not ruling on whether a professional could ever sell personal goodwill but held in the facts of this case that an attorney did not do so. The Board of Tax Appeals had ruled that there was no sale of goodwill where an attorney who entered a partnership was paid $50,000 by the new partners. The BTA held that it was doubtful whether a professional person could dispose of any goodwill that attached to his practice "except perhaps by contracting to refrain from practicing," i.e., a covenant not to compete. The taxpayer's reputation had been built up through his own efforts and "attached to his person. He could not transfer it piecemeal to two others." 28 BTA 698 (1933).

In *Horton v. CIR*, 13 TC 143 (1949), the taxpayer sold his accounting practice and claimed that the selling price should be allocated to goodwill. The court rejected the Service's claim that all of the intangible value had to be allocated to a covenant not to compete. It allowed 50% to be allocated to goodwill, after looking at the right of the purchaser to continue using the firm name. The Tax Court stated that goodwill is "nothing more than the probability that the old customers will resort to the old place."

An *accountant*'s sale of practice to larger firm (Peat Marwick) involved sale of goodwill. The amount allocated to goodwill was not additional compensation for future services to buyer but rather was taxed as capital gain. The goodwill was the right to provide accounting services to the seller's customers. *Wyler v. CIR*, 14 TC 1251 (1950).

In *Watson v. CIR*, 35 TC 203 (1960), the taxpayer sold a portion of his unincorporated accounting practice with an agreement to transfer the remainder after a period of years for an amount to be based on future earnings. He allowed the acquirer to use his name, place of business, and working papers, and agreed to recommend his clients to it after he terminated his relationship with the acquiring

partnership. The Tax Court stated that goodwill, "viewed from a transferee's standpoint, is an opportunity to succeed to the advantageous position of his predecessor. Generally, attitudes of customers or others may be transferred from one proprietor to another (1) by furnishing the transferee with all the symbols and other transferable attractions which invoke a favorable response in the customers and (2) by removing the transferor as an alternative attraction."

The court distinguished Watson from the taxpayer in *O'Rear*, in that the latter did not prove that "he had any vendible goodwill since all he had was his own skill and ability which he could not transfer." Whether there was any substantive difference between the *Watson* and *O'Rear* taxpayers is very questionable. Here, the Tax Court had signaled a willingness to accept the concept of salable goodwill in a service business that was dependent on the skills of the taxpayers who owned them.

In *MacDonald v. CIR*, 3 T.C. 720 (1944), the taxpayer was the sole shareholder of an incorporated *insurance agency*. The corporation was liquidated, and the taxpayer received all of its assets in exchange for the outstanding stock. The value of the tangible assets received was $287,198. The Service determined that an additional amount of $99,635, representing the fair market value of the "MacDonald insurance agency accounts and business" should be added to the amount the taxpayer received. In *MacDonald*, the IRS took the position that "insurance agency accounts and business" included agency agreements between the corporation and insurers, insurance agreements between the corporation and customers, and other goodwill of the corporation.

The Tax Court disagreed and ruled that there was no goodwill distributed to Mr. MacDonald upon liquidation because the development of the business was primarily due to the taxpayer's personal business ability and personal relationship with clients. The court further found that value dependent merely upon the personal friendship or relationships between seller and customers, or personal abilities, does not constitute business goodwill. Finally, the court held that "we find no authority which holds that an individual's personal ability is part of the assets of a corporation by which he is employed where the corporation has no right to further services by that individual." *Id*. at 727.

In a second *insurance agency* liquidation case, *Bryden v. CIR*, T.C. Memo. 1959-184, the court found that the only intangible asset constituting goodwill was the agency customer list. The court found that this list had little or no value because all the accounts were acquired or retained through the personal abilities of certain individuals in the corporation. The court stated that unless those responsible for the accounts had a contract to remain with the corporation or a covenant not to compete, no significant corporate goodwill existed.

In a third *insurance agency* liquidation case, *Longo v. CIR*, T.C. Memo. 1968-217, the court determined that there is no salable business goodwill where the business of the corporation is substantially dependent on its personnel, unless the

key employees enter into a covenant not to compete with the selling or liquidating corporation. When this corporation liquidated and distributed a customer list to the two shareholders, who brought the customers to the corporation, the list only had value as long as the shareholders stayed with the corporation or entered into a covenant not to compete, even though the corporation had earlier paid the shareholders $20,000 for the customer list. Indeed, the court allowed an ordinary loss deduction for this customer list because it had no value to the corporation when its key employees abandoned the corporation.

Wilmot Fleming Engineering Co. v. CIR, 65 T.C. 847 (1976) held that there was no entity goodwill in a family-owned manufacturing machine shop business in which the owners had a dominating influence and overall importance to the success of the business.

C. More Recent Cases: *Martin Ice Cream & Norwalk*.

The teaching of the cases discussed below is that where employment agreements containing noncompete clauses are in place, or the facts are such that it is clear the employee/shareholders would never be in a position to compete with the corporation, then only business level goodwill may exist, but not personal goodwill. Absent binding noncompete agreements with the selling or liquidating business, where personal contacts and relationships are important to the business, personal goodwill can exist separate and apart from, or to the exclusion of, business goodwill.

1. <u>*Martin Ice Cream*</u>. In *Martin Ice Cream Co. v. CIR*, 110 T.C. 189 (1998), the Tax Court held that there is no salable goodwill in a corporation where the business of the corporation is dependent on its key employees, unless the key employee enters into a covenant not to compete with the employing corporation or agreement whereby their personal relationships with clients become property of the corporation. This case did not involve a sale but rather a failed attempted § 355 split up.

   In *Martin Ice Cream*, Arnold Strassberg (AS) developed a new packaging and sales campaign for ice cream that was very popular with the supermarkets. In 1971, Martin (MS), Arnold's son, incorporated Martin Ice Cream (MIC) and was its sole shareholder. *Id*. at 191. In 1974 AS began distributing Haagen-Dazs ice cream based upon an oral agreement with Ruben Mattus, the founder of Haagen-Dazs. *Id*. at 193. AS worked for MIC and focused on distribution to supermarkets while MS focused on distribution to small grocery stores and food service accounts.

   In 1979, AS became a 51% shareholder in MIC. However, no employment agreements or noncompetition agreements were executed. *Id*. at 192. In 1983 Pillsbury bought Haagen-Dazs and later approached AS and MS about Haagen-Dazs acquiring access to AS's relationships with supermarkets. MIC formed a subsidiary called SIC. *Id*. at 197. SIC

was split off from MIC in a transaction designed to be tax-free under § 355. AS exchanged his MIC stock for SIC stock, and MIC transferred its supermarket business to SIC. *Id*. at 200.

The Service attempted to assess a corporate level gain to MIC by asserting that the amount paid by Haagen-Dazs to SIC and AS measured the gain realized and recognized by MIC on an alleged redemption of AS's stock because MIC, not AS and SIC, owned the assets sold. *Id*. at 206. Thus, the Service sought to disregard both the § 355 split-off and the personal ownership by AS of goodwill.

The Tax Court, however, determined that the intangible assets embodied in AS's oral agreement with Mr. Mattus of Haagen-Dazs and his personal relationships with supermarket owners and managers were never MIC corporate assets. *Id*. at 206. Rather, AS was the owner of these intangible assets, and he merely made them available to MIC. AS, acting on his own behalf and as agent for SIC, of which he was the sole shareholder, entered into a contract to sell Haagen-Dazs two distinctly different types of assets: The first, and much more valuable, was the intangible assets of Arnold's rights under his oral agreement with Mr. Mattus and his relationships with the owners and managers of the supermarkets, which formed the basis of his ability to direct the wholesale distribution of super-premium ice cream to the supermarkets; the second, and much less valuable, was the business records that had been created by petitioner during Arnold's development of the supermarket business, and transferred by petitioner to SIC.

Importantly, AS never entered into an employment agreement or a covenant not to compete with MIC. *Id*. at 206. AS, as part of his sale, signed a "Consulting and Non-Competition Agreement" with Haagen-Dazs, the buyer, for which he was to be paid $150,000 annually for a period of 3 years.

While MIC in its documents purported to transfer certain supermarket rights to Haagen-Dazs, the tax court ruled that AS owned them: "What petitioner (MIC) did not own, petitioner could not transfer; these documents transferred only that which belonged to MIC — the business records generated by the supermarket business that were subsequently transferred by petitioner to SIC in exchange for its stock. Accordingly, we find that the sale to Haagen-Dazs of Arnold's supermarket relationships and distribution rights cannot be attributed to petitioner."

2. <u>Norwalk</u>. *Norwalk v. CIR*, TC Memo 1998-279 involved the liquidation of a 2-shareholder accounting corporation DeMarta & Norwalk, CPA's, Inc. realized a gain of $588,297 on the distribution of its goodwill to its shareholders in a liquidation in 1992. The corporation was formed by DeMarta and Norwalk in 1985. The business of the corporation was the

practice of public accounting. At all times, DeMarta and Norwalk were its only shareholders.

In 1985, DeMarta and Norwalk signed separate employment agreements with the corporation with a 5-year term. The agreements expired in 1990 and were not renewed. The employment agreements prohibited each shareholder-employee from competing with the corporation and provided that the client's were corporate assets, and that the shareholder-employees were not "entitled to keep or preserve records or charts of the Corporation as to any client unless a client specifically requests a different disposition of those records, and in no event shall Employee be entitled to the records of clients not served by him."

The court found that these obligations had expired after the 5-year term at the time of the 1992 liquidation and that DeMarta and Norwalk were not bound by any covenant not to compete on June 30, 1992. On June 30, 1992, the corporation's assets were distributed to its shareholders, and the business of the corporation ceased.

The directors' resolution provided that the corporation would cease practice as certified public accountants, distribute all available assets and liabilities to the shareholders, and each shareholder would then be able to pursue a professional practice on their own or as partners with other accountants.

On July 1, 1992, DeMarta and Norwalk became partners of the accounting firm Ireland, San Filippo (the partnership), and transferred assets, distributed to them by the corporation, to the partnership. The partnership did not use the corporation's name. The tangible assets distributed to the shareholders included all the corporation's furniture and equipment, which the corporation reported on its 1992 Federal income tax return at a value of $59,455. These assets were contributed to the partnership. The shareholders also transferred their share of the corporation's receivables to the partnership and the corporation's liabilities were assumed by the partnership in exchange for the DeMarta and Norwalk partnership interests. The partnership did not assume tax obligations of the corporation, nor did it assume the debts owed by the corporation to the shareholders.

DeMarta and Norwalk signed the partnership agreement, which restricted the partners' ability to compete with the partnership. The partnership assumed the corporation's lease and occupied its former offices from July 1, 1992, to April 25, 1994. After the liquidation of the corporation, many of its former employees were subsequently employed by the partnership. Five years following the liquidation of the corporation, only about 10 percent of the accounts serviced by the corporation remained with the partnership due to, in part, some of the former corporation CPAs leaving the partnership and their clients going with them.

The IRS argued that when the corporation was liquidated, it distributed to its shareholders "customer-based intangibles" in addition to tangible assets that included the corporation's client base, client records and workpapers, and goodwill (including going-concern-value). The taxpayers argued that the corporation did not own the intangibles. Rather, the accountants themselves owned the intangibles, and, thus, there was no transfer nor any corresponding taxable gain attributable to these intangibles.

The court noted that goodwill can be owned by and sold with a professional practice. The Tax Court cited *LaRue v. CIR*, 37 T.C. 39, 44 (1961); *Watson v. CIR*, 35 T.C. 203, 209 (1960); and *Rudd v. CIR*, 79 T.C. 225, 238 (1982), which stated:

> The goodwill of a public accounting firm can generally be described as the intangibles that attract new clients and induce existing clients to continue using the firm. These intangibles may include an established firm name, a general or specific location of the firm, client files and workpapers (including correspondence, audit information, financial statements, tax returns, etc.), a reputation for general or specialized services, an ongoing working relationship between the firm's personnel and clients, or accounting, auditing, and tax systems used by the firm.

The Tax Court also noted that in determining the value of goodwill, there is no specific rule, and each case must be considered and decided in light of its own particular facts, citing *MacDonald v. CIR*, 3 T.C. 720, 726 (1944). The court also noted that in determining such value it is well established that the earning power of the business is an important factor, citing *Estate of Krafft v. CIR*, T.C. Memo. 1961-305 and *Staab v. CIR*, 20 T.C. 834, 840 (1953), which stated:

> Goodwill, then, is an intangible consisting of the excess earning power of a business. A normal earning power is expected of the business assets, and if the business has greater earnings, then the business may be said to have goodwill. This excess in earning power may be due to any one or more of several reasons, and usually this extra value exists only because the business is a going concern, being successful and profitable. Goodwill may arise from: (1) the mere assembly of the various elements of a business, workers, customers, etc., (2) good reputation, customers' buying habits, (3) list of customers and their needs, (4) brand name, (5) secret processes, and (6) other intangibles affecting earnings.

The taxpayers' expert stated: "Intangible value within a company (or goodwill value) is based upon the existence of excess earnings." After

examining financial information from the corporation's Federal income tax returns, the pay history of Messrs. DeMarta and Norwalk, and Federal Government guidelines for an accountant's pay, he found that the corporation did not have excess earnings or earnings over and above a return on tangible assets. Consequently, petitioners' expert concluded that the corporation was worth the value of its tangible assets and that there was no intangible or goodwill value at the time of the distribution to the shareholders. He then addressed the valuation of the corporation's client list. Recognizing that in a service-related business the client relationship is normally between the client and the professional who services that client, petitioners' expert concluded that "Without an effective non-competition agreement, the clients have no meaningful value." Recognizing that there was no restriction on the ability of the individual accountants to compete with the corporation, he concluded that the client-related goodwill and intangibles belonged to the professional accountants individually who serviced the clients and that a list of these clients had no material value for the corporation.

The court stated: "We have no doubt that most, if not all, of the clients of the corporation would have 'followed' the accountant who serviced that client if the accountant would have left the corporation. For instance, when Mr. Tang and Ms. Hagan left the partnership shortly after the corporation was liquidated, at least 92 clients engaged these former employees to provide future services. On the record here, it is reasonable to assume that the personal ability, personality, and reputation of the individual accountants are what the clients sought. These characteristics did not belong to the corporation as intangible assets, since the accountants had no contractual obligation to continue their connection with it. There is no persuasive evidence that the name and location of the corporation had any value other than for their connection with the accountants themselves."

The Tax Court cited *MacDonald v. CIR, supra*, 3 T.C. at 727: "We find no authority which holds that an individual's personal ability is part of the assets of a corporation by which he is employed where, as in the instant cases, the corporation does not have a right by contract or otherwise to the future services of that individual. . . . Therefore, for the same reasons as given in MacDonald, we hold that at the time of the corporation's liquidation it had no goodwill, either in terms of a client list or in any other form, which could be distributed to the individual shareholders or sold to a third party. . . . Because there was no enforceable contract which restricted the practice of any of the accountants at the time of the distribution, their personal goodwill did not attach to the corporation. Any goodwill transferred to the partnership was that of the individual accountants, not the corporation."

Norwalk provides incorporated professional service practices and other closely held businesses that do not have noncompete agreements with their

key owners with authority to liquidate, accomplish an asset sale, or convert into operation as an LLC or other limited liability entity that is treated as a pass-through entity for tax purposes without incurring corporate-level gains with respect to the goodwill attributable to the professionals.

D. IRS Recognizes Personal Goodwill & Also Allows Partial Transfer.

The IRS can be expected to base its audit positions on the logic that raises the most revenue. The Service can challenge an allocation to personal goodwill, or the amount of the allocations, based on the facts of the case. However, as noted above, the courts and the IRS have recognized the existence of personal goodwill under certain facts and circumstances.

Originally, it was the position of the Service that personal characteristics or qualifications do not constitute goodwill as an item of property and do not exist in such form that they can be the subject of transfer. Consequently, if a business is dependent solely upon the personal characteristics and competence of the owner, no element of goodwill exists with respect thereto and no portion of the sale price of the business may be treated as proceeds from the sale of goodwill, irrespective of whether or not such sale comprehends a valid assignment of the right to the exclusive use of the firm name. See Rev. Rul. 60-301.

In TAM 200244009 (involving a complicated sale of medical practice assets to an unrelated physician practice management company through the use of several corporations and a transitory partnership), the Service ruled that "the goodwill associated with the AAs [shareholder-physicians of Corp 1] and their PM [practice of medicine] cannot be a corporate asset in the absence of an employment/noncompete agreement between the corporation and the shareholder." Corp 3, the physicians' original professional corporation, sold the bulk of its assets to an unrelated third party, Corp 2, and the physicians became employed by Corp 1, which agreed to pay a substantial management fee to Corp 2 for 40 years. The auditing agent sought to treat the goodwill as being constructively sold by Corp 1 to Corp 2 and then constructively distributed as a dividend to the physician-shareholders of Corp 1. The National Office, citing *Martin Ice Cream*, stated that no goodwill was transferred from Corp 1 to Corp 2 because the physicians had no noncompete agreement with Corp 2 but only with Corp 1. Therefore, the goodwill remained with Corp 1.

Rev. Rul. 70-45 held that a partial transfer of goodwill may be made by a professional upon admission of partners to his practice, modifying Rev. Rul. 64-235, which had held that a partial transfer of goodwill by a professional cannot be made when admitting partners to share in his practice. The Service ruled that whether there has been a partial transfer of goodwill or merely an anticipatory assignment of future earnings of the practice will be treated as a question of fact, citing *Rees v. United States*, 187 F. Supp. 924 (1960), affirmed per curiam 295 F. 2d 817 (1961); *Butler v. CIR*, 46 T.C. 280 (1966). However, transactions

purporting to make a partial transfer of goodwill will be carefully scrutinized to assure that goodwill in fact exists and that the consideration allocated to goodwill actually represents payment therefor.

In one audit in which the author has been involved, the Service at the audit level has attempted to limit the application of *Martin Ice Cream* to the personal goodwill the owner of the selling corporation had, if any, before the seller was incorporated. However, that position was not followed at appeals.

III. TAX RULES, PLANNING OPPORTUNITIES, & PITFALLS.

A. Sale Of Personal Goodwill.

1. Capital Asset Status Of Personal Goodwill.

From the seller's perspective, goodwill is a capital asset. *Michaels v. CIR*, 12 T.C. 17 (1949) (acq.); *X-Pando Corp*. v. CIR, 7 T.C. 48 (1946); *Rainier Brewing Co. v. CIR*, 7 T.C. 162 (1946); *Burns v. CIR,* 6 TCM 973 (August 25, 1947); *Ensley Bank & Trust Co. v. United States*, 154 F.2d 968 (5th Cir. 1946). This principal should also apply to personal goodwill, although there is no case expressly dealing with this issue, but not to the licensing of the use of a person's name, such as for endorsements, which is earned income.[2]

Section 1221(a) provides that the term capital asset means property held by the taxpayer (whether or not connected with the taxpayer's trade or business), but does not include the exclusions specified in §§1221(a)(1)-(8). Code §§1221(a)(2) excludes intangible property used in a trade or business, which is subject to the allowance for depreciation provided in section 167.

Self-created personal goodwill is a capital asset because § 197(c)(2) provides that the term "amortizable section 197 intangible" shall not include any section 197 intangible which is created (as opposed to purchased) by the taxpayer. See PLR 200243002.

Although IRC §1221(a)(2) renders depreciable *purchased* goodwill ineligible for capital asset status, IRC §1231(a) characterizes any gain recognized upon the sale, exchange, or involuntary conversion of goodwill held for more than one (1) year as capital gain.

2. Seller's Perspective.

[2] Code § 401(c)(2)(C) states that the term "earned income" includes gains (other than any gain which is treated as gain from the sale or exchange of a capital asset) and net earnings derived from the sale or other disposition of, the transfer of any interest in, or the licensing of the use of property (other than goodwill) by an individual whose personal efforts created such property.

a. C & S Corporation Asset Sale Double Tax Problem. This sale of assets by a C corporation, an S corporation with earnings and profits, and an S corporation subject to the built in gains tax, can all be subject to the double tax at the corporation and shareholder level when the assets are sold and then the proceeds are distributed to the shareholders. The usual methods of minimizing the double tax for an operating corporation will often be insufficient to eliminate the double tax in the year of the sale.

If the buyer will not agree to a stock purchase, the owner has a limited number of options to minimize the double tax. Some of the payments can be made directly to the owner as employment, consulting, or non-compete payments, but these will be subject to ordinary income tax rates and the first two are subject to employment taxes as well. Employment and consulting payments must also have economic substance with respect to actual employment or consulting services performed.

Where a corporate business is sold and in conjunction therewith an amount, separately negotiated for between the parties, is paid in consideration of the stockholders' agreeing to refrain from entering a competing business for a specified period, the amount so paid is ordinary income to the stockholders whether paid directly to them or paid to the corporation by which it is distributed to them. *Cox v. Helvering*, 71 F. 2d 987 (D.C. Cir. 1934); *Mathews v. CIR*, T.C. Memo 1961-304.

If the facts permit, an even more effective solution to the double tax problem than employment, consulting or noncompete payments is to allocate a portion of the purchase price to the personal goodwill of the shareholders. To the extent that goodwill exists in a corporate asset transaction, a shareholder will retain an additional $0.30 for each $1.00 of payment allocated to personal goodwill rather than the corporate goodwill (based on a 35% corporate tax rate and 15% personal capital gains tax rate):

- If the corporation owns the goodwill, the corporation will pay $0.35 in corporate taxes ($1.00 x 35%).[3] The shareholder will then pay roughly $0.10 in capital gain taxes ($0.65 x 15%) upon liquidation, an effective combined tax rate of 45%.

[3] Corporate taxpayers must fully include both long-term and short-term capital gains in gross income. All types of capital losses, long term and short term, are fully deductible from all types of capital gains, long term and short term. Code § 1211(a). Corporate capital gains are taxed at the same rate as ordinary income, unless the AMT applies. Personal Service Corporation rates are a flat 35%.

- Employment, consulting, or non-compete payments are taxed at the highest rate of 35%, plus employment taxes on the first two items.
- If the goodwill is owned by the individual shareholder, and has been owned at least 12 months, the individual will pay $0.15 in taxes ($1.00 x. 15%), one-third as much tax as corporate goodwill was sold and the corporation liquidated.

b. State Income Tax. If the seller of personal goodwill is a resident of state with no personal income tax, the sale may be income tax free even though the business or practice operates in many states.

3. Buyer's Perspective.

The buyer does not want to purchase stock because of liability risk and the inability to depreciate or expense any part of the purchase price (unless perhaps the buyer is a public company, where reported earnings may be more important than reducing taxes).

However, where the buyer does purchase stock, the buyer will benefit if part of the allocation is to the seller's owner's sale of personal goodwill, as it will be amortizable if not successfully challenged by the Service. In such a case, there must be some real personal goodwill and the seller's owner must do something to transfer it to expect the buyer to be able to amortize it.

From the buyer's perspective, for assets acquired after August 10, 1993, the purchase of goodwill and payments for a noncompete agreement may both be amortized (deducted) over 15 years, unless the anti-churning or anti-abuse rules apply, in which case the noncompete payments are preferable because the goodwill would then not be amortizable. Code § 197 and Temp. Reg. § 1.197-1T.

Payments for employment or consulting services actually rendered are, if reasonable, currently deductible, under § 162, and ordinary income to the recipient.

The useful life for depreciation purposes is 7 years for most furniture and equipment. 5-year property" includes (i) any automobile or light general purpose truck, (ii) any semi-conductor manufacturing equipment, (iii) any computer-based telephone central office switching equipment, (iv) any qualified technological equipment, and (v) any section 1245 property used in connection with research and experimentation, and. Property classified as real property is subject to relatively lengthy recovery periods and the straight-line method of depreciation (39 years for commercial buildings), while the cost of property in the building not classified as real

property may be recovered over a much shorter period using an accelerated method of depreciation. See Code §168.

4. Buyer's Goodwill Amortization.

Under I.R.C. § 197, purchased goodwill, like a covenant not to compete, is amortizable over fifteen years provided that it is (1) acquired after August 10, 1993 (the date of the statute's enactment); (2) held in connection with the business; and (3) is not "self-created." The first two requirements are clear. As to the third requirement, in the case of personal goodwill, the buyer is purchasing the goodwill created by the seller, so it is not "self-created" for this purpose. It does not matter, for buyer's purposes, whether the seller created the goodwill, acquired it from another, or some combination of the two. See Andrew F. Halaby, *Treatment of Goodwill By the Seller Under I.R.C. Section 197,* 43 U. Kan. L. Rev. 903, 917-43 (1995).

Reg. 1.1060-1(b)(2)(i)(B) provides that a group of assets constitutes a trade or business its character is such that goodwill or going concern value could under any circumstances attach to such group. Reg. 1.1060-1(b)(1) defines an "applicable asset acquisition" to be any transfer, whether direct or indirect, of a group of assets if the assets transferred constitute a trade or business in the hands of either the seller or the purchaser. Thus, even if the sale by the individual is viewed separately, from the purchaser's perspective, there are assets other than goodwill, which would include the sale of personal goodwill in an applicable asset acquisition and make it amortizable.

In addition, the anti-churning rules and anti-abuse rules must be met for the buyer to amortize the payments for income tax purposes. If they are not met, the buyer gets no deduction. These rules are discussed later in this outline.

5. Purchase Price Allocation In Asset Sale Not Necessarily Binding On IRS.

A statutory allocation of the purchase price is required in the income tax reporting of a sale of a going business. The modified residual allocation method apportions the purchase price among various classes of assets, including amortizable intangibles in the nature of goodwill and going concern value. Code § 1060; Reg. § 1.1060-1(b)(2)(ii).

When reviewing the parties' allocation agreement, the courts give deference to the parties if and when the parties have competing tax interests because competing tax interests deter allocations that lack economic reality. However, if the parties do not have competing tax interests, the allocation agreement is strictly scrutinized. *Langdon v. CIR*,

2003-1 USTC ¶50,244 (8th Cir. Feb. 14, 2003)(unpublished) aff'g T.C. Memo. 2001-260.

If the parties do not have competing tax interests in allocating an amount to a covenant not to compete, the courts look to see whether the allocation is grounded in economic reality. For cases rejecting an allocation even with an appraisal because it did not comport with economic reality in a reorganization context, see *South Tulsa Pathology Laboratory, Inc. v. CIR*, 118 T.C. 5 and 118 T.C. 84 (January 28, 2002). This same principle should apply to an allocation to personal goodwill. In *South Tulsa Pathology Laboratory, Inc.* v. CIR, 118 TC 84 (2002), a corporation contributed its clinical business to a newly formed subsidiary and distributed the subsidiary to its physician-shareholders in October 1993. The physician-shareholders immediately sold the subsidiary's stock for $5.53 million and received $70,000 for noncompete agreements. The Service assessed a deficiency against the company, claiming that the contribution/distribution was not tax-free. The Tax Court agreed that the distribution failed to qualify under section 355 and was taxable as a device to distribute the company's earnings and profits. As a result, the issue became the amount of gain taxable to the company on the distribution of the stock. The company argued that the value of the distributed stock was only $1 million, and that most of the $5.53 million paid by the purchaser was allocable to the physician-shareholders' personal goodwill. The court rejected this argument because it was not credible on the facts.

An allocation to a covenant not to compete lacks economic reality in the event that there is no showing that the seller by refraining from competition stands to lose earnings comparable to the amount supposedly paid for the covenant or that the buyer would lose such an amount if the seller were to compete against it. *Forward Communications Corp. v. United States,* 221 Ct. Cl. 582, 608 F.2d 485, 493-494 (Ct. Cl. 1979); *Lorvic Holdings Inc. v. CIR,* TC Memo 1998-281.

For example, the parties' allocation of $1 million of the $2 million sales price of a wholesale beer distributorship to a five-year covenant not to compete was reduced to $334,000 when challenged by the IRS. The parties' interests were not adverse. It was unreasonable to think that the buyer would lose $1 million if the seller were to compete against it. *Langdon v. CIR.*, 1 AFTR 2d 2003-912 (8th Cir. 2003), affirming TC Memo 2001-260.

No part of a sales price of a business is attributable to a covenant not to compete where it is shown that (1) goodwill is attached to the business, which is growing and prosperous, and (2) there is virtually no danger of competition by the seller. *Maryland National Bank v. CIR.*, 534 F.2d 328 (4th Cir. 1976).

B. Must Personal Goodwill Allocation Be Proportionate To Equity Ownership?

Sale Of Personal Goodwill May Be Disproportionate To Stock Ownership. Selling shareholders may use allocations to personal goodwill as a means to allocate purchase price disproportionately with share ownership to reflect contributions to the business or other basis. See Jerome M. Schwartzman, The Intangible Intangible: Increasing The Value Of A Deal Using Personal Goodwill, Journal of Corporate Taxation, pp 12-16 (Sep/Oct 2009) and Ginsburg and Levin, Mergers, Acquisitions and Buyouts, Para. 404.1.3 (Aspen Publishers, 2009) (suggesting that a pro rata allocation of personal goodwill among shareholders to circumvent corporate-level tax would likely not be respected). Some sellers may seek to allocate personal goodwill to key employees who own no stock in an attempt to provide capital gain to them. If they too are sellers, this could work, although one source indicates that the state of the law does not appear to support such an allocation. Jerome M. Schwartzman, The Intangible Intangible: Increasing The Value Of A Deal Using Personal Goodwill, Journal of Corporate Taxation, pp 12-16 (Sep/Oct 2009)

C. Form 8594; Reporting Issues.

Most asset sale agreements contain an allocation of the purchase price to the various categories of assets and also provide that the parties will each use that allocation for form 8594. Alternatively, the agreement may provide that the allocation selected by one party will be used by the other party. The seller and buyer filing inconsistent forms 8594 is something to be avoided, as it will likely trigger an IRS audit.

There is a dollar amount allocation required to seven categories of assets

I. Cash general deposit accounts (including savings and checking accounts) other than certificates of deposit
II. Actively traded securities certificates of deposit, and foreign currency
III. Accounts receivable, assets that the taxpayer marks to market at least annually for tax purposes, and debt instruments
IV. Stock in trade of the taxpayer "or other property of a kind that would properly be included in the inventory of taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business
V. Furniture and fixtures, equipment, land and all assets not in another category
VI. Covenant not to compete and other 197 intangibles except goodwill and going-concern value, such as patient records, trained workforce, franchise, trademark, trade name, operating systems, know-how (see form 8594 instructions)
VII. Goodwill and going-concern value

1. Is a Form 8594 required to be filed by an individual selling personal goodwill? The instructions to Form 8594 state that a seller of assets

should file Form 8594 for the sale of assets that make up a trade or business if there is goodwill or going concern value. However, the instructions also state the transfer of a section 197 intangible (which includes goodwill), without any other assets, is not the sale of a trade or business.

While the instructions are not clear, Reg. §1.1060-1 contains the rules for applicable asset acquisitions. It provides: "An applicable asset acquisition is any transfer, whether direct or indirect, of a *group of assets if the assets transferred constitute a trade or business in the hands of either the seller or the purchaser* . . ., and the purchaser's basis in the transferred assets is determined wholly by reference to the purchaser's consideration. Reg. §1.1060-1(b)(1). (Emphasis added)

Additionally, Reg. §1.1060-1(b)(4) deals with asymmetrical transfers of assets. It provides that a purchaser is subject to section 1060 if:

(i) Under general principles of tax law, the seller is not treated as transferring the same assets as the purchaser is treated as acquiring;
(ii) The assets acquired by the purchaser constitute a trade or business; and
(iii) The purchaser's basis in the transferred assets is determined wholly by reference to the purchaser's consideration (except for partial nonrecognition transactions).

Thus, both Reg. §1.1060-1(b)(1) and (4) indicate that the form 8594 should be filed as to the sale of personal goodwill by the seller. Therefore, here are the options, in what seems to the author the order of the most correct to lesser degrees of correctness.

a. The buyer files 2 forms 8594, one for the corporate seller's assets, and one for the shareholder's goodwill. Then the selling corporation and the individual seller of goodwill each file one 8594 form. The numbers will then match. However, this flags the personal goodwill.

b. The corporation and the shareholder are both listed as sellers on one form 8594, which matches the buyer's 8594.

c. The individual seller of the personal goodwill does not file an 8594 with his or her 1040, since that individual is not selling a "group of assets that makes up a trade or business" or even a "group of assets." Instead, the personal goodwill sale is reported at line 6 of the selling corporation's form 8594.

2. Penalties. The penalties for not filing form 8594, or for omitting information, are substantial. If one or more failures to file an information return described in subsection 6721(a)(2) (nonfiling) or 6721(a)(2)(B)

(any failure to include all of the information required to be shown on the return) are due to intentional disregard, then, with respect to each such failure, the penalty imposed under subsection (a) shall be $100, or, if greater, 10 percent of the aggregate amount of the items required to be reported correctly. Code 6721(e)(2); Reg. §301.6721-1(d)(4).

An exception to the penalty exists for a return other than a return required under section 6045(a), 6041A(b), 6050H, 6050I, 6050J, 6050K, or 6050L. Thus, since form 8594 is not in this list, if the form is required to be filed, and it isn't (or in the case of the seller and purchaser, it does not reflect the personal goodwill purchased) and if the failure to file this personal goodwill information was due to intentional disregard, then the nonfiling penalty is 10% of the amount that should have been reported.

3. Can Form 8594 Filing Be Avoided By The Individual By A Pre-Asset Sale Transfer Of The Personal Goodwill To The Selling Corporation?

Some have suggested that personal goodwill be sold by the shareholder to the corporation prior to the asset sale by the corporation. Then the corporation would be the only seller of the goodwill, and the personal goodwill would have been converted to business goodwill. To safeguard the existence of the personal goodwill, the seller should enter into a noncompete with the corporation of which he/she is a shareholder prior to the sale. Of course, this would raise the issue of whether the price paid by the selling corporation to the shareholder for the shareholder's personal goodwill could be recharacterized by the IRS as in whole or in part for the noncompete or a dividend.

D. Is Consistency Of Values Required For Assets Within A Class?

The allocation rules of IRC § 1060 require that the seller and the buyer be consistent between themselves as to the allocation of assets within an asset class under the applicable regulations. However, as to assets within that class, they could each report differently unless the parties agree to the specific asset values. Assume an asset that cost $2m, and was depreciated to $1.5m. Buyer values it at $1.9m and Seller values it at $1.7m. The recapture amount to Seller is different. The Seller would want put a higher value on assets that are newer and would have less recapture. IRC § 1060 states:

"In the case of any applicable asset acquisition, for purposes of determining both--
(1) the transferee's basis in such assets, and (2) the gain or loss of the transferor with respect to such acquisition, the consideration received for such assets shall be allocated among such assets acquired in such acquisition in the same manner as amounts are allocated to assets under section 338(b)(5). If in connection with an applicable asset acquisition, the

transferee and transferor agree in writing as to the allocation of any consideration, or as to the fair market value of any of the assets, such agreement shall be binding on both the transferee and transferor unless the Secretary determines that such allocation (or fair market value) is not appropriate."

IRC Section 1060 further requires reporting to the IRS with respect to an asset acquisition. The code and regulations require that Form 8594 be used to satisfy the required reporting. Treas. Reg. §1.1060-1(e) states in part:

"… the seller and the purchaser in an applicable asset acquisition each must report information concerning the amount of consideration in the transaction and its allocation among the assets transferred."

Form 8594, Part II, Question 5 asks if the purchaser and seller have provided for an allocation of the purchase price in a contract or agreement. It then asks if the "aggregate" fair market values listed for each of the asset Classes on Form 8594 are the amounts agreed upon by the parties. This seems to imply that the parties only have to agree upon and report consistently the aggregate or total fair market values for the asset Classes.

From BNA Portfolio #750:

"Although most buyers and sellers agree on the purchase price allocation, neither the regulations nor the Code explicitly require that their Forms 8594 agree. For the most part, corporate sellers may be indifferent to the capital versus ordinary treatment attached to the gain. They may, however, desire higher allocations to assets for which they have basis and lower allocations to those assets for which they have no basis, typically the Class VII intangibles, to minimize gain recognition. Buyers, however, benefit more from a higher allocation to depreciable and amortizable assets, as well as assets they intend to sell quickly, such as inventory."

Treas. Reg. §1.1060-1(c) states in part:

"(2) Allocation of consideration among assets.

For purposes of determining the seller's amount realized for each of the assets sold in an applicable asset acquisition, the seller allocates consideration to all the assets sold by using the residual method under Secs. 1.338-6 and 1.338-7."

The regs under IRC Section 338 state that the assets in a class are to be allocated among all of the assets in the class in proportion of fair market values. That certainly contemplates the same amounts by buyer and seller

since there should only be one "fair market value." They also state that an allocation to an asset cannot exceed its fair market value.

Treas. Reg. §1.1060-1(c) further states in part:

"(4) Effect of agreement between parties.

If, in connection with an applicable asset acquisition, the seller and purchaser agree in writing as to the allocation of any amount of consideration to, or as to the fair market value of, any of the assets, such agreement is binding on them to the extent provided in this paragraph (c)(4)."

This regulation would not be violated if only the aggregate fair market values are reported on Form 8594 so long as they were reported the same by the buyer and seller.

Conclusion. Neither the IRC nor the applicable regulations require that the buyer and seller agree on the fair market value of each asset, only the aggregates for each Class on From 8594 and only if there is an agreement between the buyer and seller in the written sales agreement or otherwise. However, the seller should have support for its allocation of fair market value to each asset in the event of audit. The IRS will also be able to obtain the determination of fair market value for each asset by the buyer. If there are differences and the determination by the buyer is better supported than the determination by the seller, or vice versa, the IRS would have support for reallocating the values.

E. Relation To Noncompete Agreements.

1. Personal Goodwill Does Not Exist Without A Covenant Not To Compete By The Selling Individual With The Buyer.

Bryden v. CIR, TC Memo 1959-184, a liquidation case, determined that the only intangible asset constituting goodwill was the agency customer list. The court found that this list had little or no value because all the accounts were acquired or retained through the personal abilities of certain individuals in the corporation. Unless those responsible for the accounts either had a contract to remain with the corporation or a covenant not to compete with the corporation, no significant corporate goodwill existed. Thus, for the buyer to be able to purchase personal goodwill, the buyer must have a noncompete or similar agreement with the individual seller.

Furrer v. CIR, T.C. Memo 1976-331: "The damages award did not represent the value of any goodwill, agency force, or records that petitioner transferred to IHA. Petitioner did not transfer any goodwill to IHA. Petitioner introduced no evidence indicating that he entered into a

covenant not to compete with IHA. Apparently, he was perfectly free to contact the agents that he had obtained for IHA and to enlist them as agents for his new employer, PHA, as soon as his contract with IHA was terminated."

"We have held that there is no salable goodwill where, as here, the business of a corporation is dependent upon its key employees, unless they enter into a covenant not to compete with the corporation or other agreement whereby their personal relationships with clients become property of the corporation." *Martin Ice Cream Co. v. CIR*, 110 T.C. 189, 207 (1998) ("personal relationships of a shareholder-employee are not corporate assets when the employee has no employment contract with the corporation")."

However, if the buyer does not enter into an employment or consulting agreement with the individual seller, the buyer is likely not purchasing personal goodwill but rather a noncompete. *Solomon v. CIR*, TC Memo 2008-102.

2. Personal Goodwill Can Exist Only If Selling Individual Has No Existing Noncompete With Corporate Seller.

a. General.

Martin Ice Cream at 207-208 stated: "Ownership of these intangible assets (of the individual employee and shareholder Arnold Strasburg) cannot be attributed to petitioner (the corporation) because Arnold never entered into a covenant not to compete with petitioner or any other agreement — not even an employment agreement — by which any of Arnold's distribution agreements . . . relationships . . . and ice cream distribution expertise became the property of petitioner. This Court has long recognized that personal relationships of a shareholder-employee are not corporate assets when the employee has no employment contract with the corporation. Those personal assets are entirely distinct from the intangible corporate asset of corporate goodwill. See, e.g., *Estate of Taracido v. Commissioner*, 72 T.C. 1014, 1023 (1979) (where sole shareholder was sine qua non of corporation's success, corporation's goodwill did not include the personal qualities of its sole shareholder); *Cullen v. Commissioner*, 14 T.C. 368, 372 (1950) (personal ability, personality, and reputation of sole active shareholder not a corporate intangible asset where there is no contractual obligation to continue shareholder's services. The taxpayer recognized capital gain on liquidation of corporation based on his 25% ownership. The court found that the goodwill of the business belonged solely to the 25% shareholder taxpayer based on his ability, personality, and reputation and that he had no contractual obligation to continue his connection with the corporation that manufactured, sold, and serviced orthopedic appliances and artificial limbs.); *MacDonald v. Commissioner*, 3 T.C.

720, 727 (1944) ("We find no authority which holds that an individual's personal ability is part of the assets of a corporation by which he is employed where *** the corporation does not have a right by contract or otherwise to the future services of that individual."); *Providence Mill Supply Co. v. Commissioner*, 2 B.T.A. 791, 793 (1925)(Providence Mill Supply Co. v. CIR, 2 BTA 791 , 793 (1925)(corporation did not own goodwill that was associated with a shareholder who had long experience and acquaintanceship in selling leather belting to cotton and wool factories.)

The IRS concluded in TAM 200244009 that no corporate goodwill was sold as part of the transaction and, citing *Martin Ice Cream*, stated that "the goodwill associated with [the professionals] cannot be a corporate asset in the absence of an employment/noncompete agreement between the corporation and the shareholder."

There no salable goodwill when the business is dependent on its key employees "unless they enter in a covenant not to compete with the corporation or other agreement whereby their personal relationships with clients become property of the corporation." *Norwalk v. CIR*, TC Memo 1998-279. In this case, they once had a noncompete but it had lapsed and was also terminable at will when it did exist.

In *Cullen v. CIR*, 14 T.C. 368 (1950), to support their argument that the corporation had no valuable intangible assets, the Cullens produced evidence that Charles Cullen, for all practical purposes, was Charles C. Cullen and Co. He procured most of the customers. He alone dealt with the orthopedists on behalf of the corporation. The court believed that most of the doctors who referred customers to the business would have followed Charles had he left the corporation. The court concluded that the name and location of the corporation had no value other than for their connection with Charles. His personal ability, personality, and reputation "did not belong to the corporation as intangible assets, since he had no contractual obligation to continue his connection with it." Likewise, the personal ability of the other employees could not be considered corporate assets since they were also free to leave.

b. <u>Personal Goodwill In Sale Of Professional Service Corporation Was Corporate Goodwill, Resulting In Double Taxation, Due To Noncompete With Selling Corporation; Termination Of Noncompete At Sale Would Have Made No Difference; Contract Purchase Price Allocation Not Binding</u>.

Howard v. U.S., 106 AFTR 2d ¶ 2010-5140 (D.C. WA. 7/30/2010) is a case reflecting a number of things discussed in various parts of this outline. It held that the amount received by a sole shareholder dentist on the sale of assets of his professional service corporation that was allocated

to personal goodwill was a corporate asset because of his noncompete with the selling corporation. As a result, the amount was recharacterized as a dividend to him from his corporation. The court did not discuss that fact that as sole shareholder, officer, and director, he could choose to ignore the noncompete.

Dr. Larry E. Howard incorporated his practice and was its sole shareholder, officer, and director. In 1980, Dr. Howard entered into an employment agreement and a covenant not to compete with Howard Corporation. The covenant lasted as long as he held any stock of the corporation plus three years thereafter.

In 2002, Dr. Howard and Howard Corporation sold the practice to Dr. Brian Finn and his personal service corporation, Brian K. Finn, D.D.S., P.S. (Finn Corporation). In that asset purchase agreement, Howard was allocated $549,900 for his personal goodwill and $16,000 for consideration for a covenant not to compete with Finn Corporation. Howard Corporation received $47,100 for its assets.

On audit, the IRS recharacterized the sale of the goodwill as a corporate asset and treated the amount received by the Howards from the sale to Finn Corporation as a $320,358 dividend from Dr. Howard's professional service corporation. IRS determined that there was a $60,129 deficiency and $14,792 interest owed based on the difference in long-term capital gain rates and dividend income rates. The Howards paid the amount, filed a refund claim, and eventually filed a refund suit with the court.

The IRS argued that the goodwill was Howard Corporation income for three reasons: (1) the goodwill was a corporate asset because Dr. Howard was a Howard Corporation employee with a covenant not to compete for 3 years after he no longer held Howard Corporation stock; (2) Howard Corporation earned the income, and correspondingly earned the goodwill; and (3) attributing the goodwill to Dr. Howard didn't comport with the economic reality of Dr. Howard's relationship with Howard Corporation.

<u>Howard's Noncompete With His Own Corporation</u>. Howard contended that the Asset Purchase Agreement terminated the covenant not to compete in the 1980 employment agreement. However, the court noted that there was no evidence that Dr. Howard ever modified or revoked the employment agreement or the covenant not to compete. Even if it had done so, the court stated in *dictum*, without citing authority, that the termination would not change the characterization of the goodwill that was generated from 1980 through 2002.

However, *Norwalk, supra*, ruled differently. In *Norwalk, t*he corporation existed for 5 years with noncompetes with its two shareholder-employees,

which noncompetes terminated by their own expiration two years prior to the corporation's liquidation. *Norwalk's* holding was that all of the goodwill belonged to the individual CPAs, and the corporation owned none, notwithstanding the earlier noncompete, focusing primarily on that fact the clients would likely go with the accounts who did their work.

Howard also argued that state divorce law indicated that professional goodwill was personal, citing *Matter of Marriage of Fleege*, 91 Wash.2d 324, 326 (1979) (a professional "can expect a large number, if not most, of these patients to accept as their dentist a person to whom he sells his practice.... a part of goodwill, and they have a real pecuniary value"). The court did not deal directly with this argument but rather focused on the noncompete, citing federal tax cases, stating that these decisions were based on facts and circumstances.

The court noted that goodwill can be personal or corporate, citing *Furrer v. CIR*, 566 F.2d 1115 (9th Cir. 1977). The court found that here the goodwill was a corporate asset because Dr. Howard had an ongoing employment contract and a covenant not to compete with the seller, citing *Martin Ice Cream Co*., 110 TC 189 (1998) and *Norwalk,* TC Memo 1998-279. Dr. Howard was an employee with a covenant not to compete with Howard Corporation from 1980 through 2003 plus three years until 2006. Therefore, the court ruled that any goodwill generated during that time was Howard Corporation goodwill due to the covenant not to compete.

The court also reasoned that the 2002 Asset Purchase Agreement was not dispositive as to whether the goodwill acquired was personal or corporate in nature. Dr. Finn testified that the price for the dental practice had been presented and accepted, without any negotiation, and that he did not recall any discussion as to the allocation of the proceeds.

3. <u>Goodwill Allocation With Covenant Not to Compete Does Not Require Allocation To Covenant If Incidental To Protect Goodwill; Allocation To Noncompete Not Incidental To Goodwill Is Ordinary Income to Recipient</u>.

Several cases have recognized that a covenant not to compete that is incidental to the purchase of goodwill need not be accorded separate value where the parties did not allocate value to the noncompete. Other cases hold to the contrary. They are very dependent on their facts. See *Karan v. CIR,* 319 F.2d 303, (7th Cir. 1963) (terms of the agreement respecting future competition were in the nature of precautionary provisions looking to the future, and were not severable from the sale of the goodwill, so that no part of the consideration can be attributed to those provisions). Accord, *Schultz v. C.I.R.*, 294 F.2d 52 (9th Cir. 1961).

Where the covenant not to compete is made in connection with the sale of a going business, and is primarily for the purpose of assuring to the

purchaser the beneficial enjoyment of the goodwill that he has acquired, several cases hold that the covenant is regarded as nonseverable and in effect merely a contributing element to the assets acquired. Most of the cases deal with the situation where the parties do not make an allocation and one of them attempts to put value on the covenant. The reported cases are generally old cases where (a) the buyer could not amortize goodwill because Section 197 did not exist and (b) the buyer was attempting to allocate an amount to the covenant when no amount was allocated in the sales agreement. There are also older pre-197 cases, discussed in the next section below, where there was no allocation and the buyer's allocation to the covenant was upheld. *Aaron Michaels*, 12 T.C. 17, 19 (1949) and cases there cited.

In *Aaron Michaels*, tightly controlled authority was exercised over the transfer of customers from one laundry company to another, and hence the purchase of goodwill and the right to service existing customers attained more than ordinary value. On the other hand, the ability of a new laundry to enter the field was apparently limited to newcomers arriving in the community--a factor tending to diminish not only the dollars and cents value of a covenant not to compete, but also its significance as an independent element of the sale of the business as a whole. The court stated it found as a fact, though the matter is not free from doubt, that the agreement to refrain from competition should be treated as a capital asset ancillary to the transfer of goodwill and customers. The consequence is that the entire proceeds of the sale, exclusive of that attributable to the linens, are taxable as a capital gain.

Kenney v. CIR, 37 T.C. 1161 (1962), acq., held that a covenant not to compete had no allocable value, stating that any value the covenant might represent to the buyer was too remote to be separable from the other property and rights acquired. In this case, an insurance agent, selling principally special risk insurance, entered into contract with insurance company to terminate his agency and sell his business, including all expiration records, goodwill, etc., to the insurance company for $35,000 and at the same time entered into employment contract with the company. The court held that the $35,000 was received from the sale of a capital asset, and the gain realized was capital gain. The covenant was an integral part of the sale agreement and gave the buyer some additional assurance that it would have the maximum opportunity to profit from the business it was acquiring. It was nonseverable from the goodwill transferred and no part of the amount paid was allocable to it.

Like *Aaron Michaels*, Rev. Rul. 65-180 states whether a severable covenant not to compete exists to which an independent value may attach is a factual question. In this ruling, the portion of the total sales price of a business received by the seller that was properly allocable to the sale of the insurance "expirations" was treated as the proceeds from the sale of an

asset in the nature of "goodwill." A covenant not to compete assured the buyer the beneficial enjoyment of the purchased goodwill, was nonseverable from the goodwill, and had no separate value.

4. Noncompete & Goodwill Allocations; Severability & Economic Reality Tests.

Prior to the enactment of IRC §197, the allocation between a covenant not to compete and goodwill gave rise to no fewer than 50 cases dealing with this issue. Under prior case law, the buyer was unable to deduct payments for goodwill but could take a current deduction for payments for a covenant not to compete. The seller, on the other hand, reported income for both types of payments with goodwill payments being treated as a capital asset. With the adoption of IRC §197, the buyer can now amortize goodwill and covenant not to compete payments over a 15-year period. Many, if not most of the reported cases, would not have been tried if IRC §197 had been in place from 1950 to 2000.

Factors used to evaluate the independent value of a covenant not to compete include:

- the seller's ability to compete;
- the seller's intent to compete;
- the seller's economic resources;
- the potential damage to the buyer posed by the seller's competition;
- the seller's business expertise in the industry;
- the seller's contacts and relationships with others in the business, for example, customers and suppliers;
- the buyer's interest in eliminating competition;
- the duration and geographic scope of the covenant; and
- the seller's intention to remain in the same geographic area. *Lorvic Holdings Inc. v CIR,* TC Memo 1998-281, where under Asset Purchase Agreement petitioner (buyer) entered into a 5-year noncompete agreement with seller and others. Buyer paid $2 million for the noncompete covenant, and $1 million for a secrecy agreement. The court discounted the values when the IRS challenged the buyer's ability to amortize. The court discounted the buyer's claimed value by 25 percent to (i) reflect the cost of enforcement and (ii) recognize the inherent going-concern value. Consequently, the fair market values of the covenant not to compete and the secrecy agreement were $1.5 million and $750,000, respectively.

Where the parties allocate value to the noncompete, they will generally lose any attempt to claim it has no value. *Mathews v. CIR*, T.C. Memo

1961-304: "Where a corporate business is sold and in conjunction therewith an amount, separately negotiated for between the parties, is paid in consideration of the stockholders' agreeing to refrain from entering a competing business for a specified period, the amount so paid is ordinary income to the stockholders whether paid directly to them or paid to the corporation by which it is distributed to them. *Cox v. Helvering*, 71 F. 2d 987 (D.C. Cir. 1934). In this case, the Court rejected the taxpayer's assertion that the covenant not to compete "was not severable from the sale of the corporate business."

Two closely related tests have been applied in determining whether a covenant not to compete has separate value and is depreciable: a severability test (also called the severable-non severable test) and an economic reality test. In both, the parties must allocate a portion of the sales price to the noncompete for there to be consideration allocated to it.

a. Severability Test.

The severability test has been used by the Second, Fifth, and Sixth Circuits. *Ullman v. CIR*, 59-1 264 F.2d 305 (2d Cir. 1959); *Barran v. CIR*, 334 F.2d 58 (5th Cir. 1964); *Theophelis v. US*, 751 F.2d 165 (6th Cir. 1985). Under this test, whether a portion of the sales price for a business is allocable to a covenant not to compete depends on whether the parties treated the covenant as a separate and distinct item. *Burke v. CIR*, 18 T.C. 77 (1952). The parties must show that the covenant was separately bargained for. This showing requires that the covenant be included as a separately stated item in any contract or purchase agreement. *Better Beverages, Inc. v. US*, 619 F.2d 424 (5th Cir. 1980), rehearing denied per curiam, 625 F.2d 1160 (5th Cir. 1980); *Shelby U.S. Distributors, Inc. v. CIR*, 71 T.C. 874 (1979) and that the parties specifically allocate a portion of the sales price to the covenant. *Schulz v. CIR*, 294 F.2d 52 (9th Cir. 1961).

Some decisions indicate that the severability test is no longer the preferred approach. *Rich Hill Insurance Agency, Inc. v. CIR*, 58 T.C. 610 (1972); *Perkins v. CIR*, T.C. Memo. 1979-356; *Krug v. CIR*, T.C. Memo. 1981-522, appeal dism'd (6th Cir. 1982). The severability test would reach the same result as the economic reality test where there is no specific allocation of any part of the sales price to the covenant not to compete.

b. Economic Reality Test.

The economic reality test depends upon whether (1) the parties to the agreement intended to allocate a portion of the purchase price to such covenant at the time they executed their formal sales agreement and (2) that the covenant "have some independent basis in fact or some arguable relationship with business reality such that reasonable men, genuinely

concerned with their economic future, might bargain for such an agreement. This two-part test is favored by the Tax Court, the Court of Claims as well as the First Third, Fourth and Ninth Circuits. *Perkins v. CIR*, T.C. Memo. 1979-356; *Goldstein v. CIR*, T.C. Memo. 1984-62; *Welch v. CIR*, T.C. Memo. 1997-120; *Thompson v. CIR*, T.C. Memo. 1997-287; *Forward Communications Corp. v. US*, 608 F.2d 485 (Ct. Cl. 1979); Harvey *Radio Laboratories, Inc. v. CIR*, 470 F.2d 118 (1st Cir. 1973); *Levine v. CIR*, 324 F.2d 298 (3d Cir. 1963); General *Insurance Agency, Inc. v. CIR*, 401 F.2d 324 (4th Cir. 1968); *Hardware Plus, Inc. v. CIR*, T.C. Memo. 1994-250; *Schulz v. CIR*, 294 F.2d 52 (9th Cir. 1961).

Courts applying this test first determine whether an agreement reflects the intent of the parties to allocate a certain value to the covenant and then determine whether the agreed-upon value has sufficient economic reality to support the allocation.

In addition, only the IRS can invoke the economic reality test to challenge an allocation of value. Taxpayers generally cannot prove the existence or value of a covenant not to compete by ignoring their own agreements that do not give value to a covenant and trying to show that the economic realities are otherwise. *Harvey Radio Laboratories, Inc. v. CIR*, 470 F.2d 118 (1st Cir. 1973); *Forward Communications Corp. v US*, 608 F.2d 485 (Ct. Cl. 1979).

Several courts before the enactment of section 197 stated that an amount a purchaser pays to a seller for a covenant not to compete in connection with a sale of a business is ordinary income to the seller and an amortizable item for the buyer unless the covenant is so closely related to a sale of goodwill that it fails to have any independent significance apart from merely assuring the effective transfer of that goodwill. This may be the same as the economic reality test, just stated slightly differently. *Wilson Athletic & Mfg. Co. v. CIR*, 222 F. 2d 355 (7th Cir. 1955)(where there was no allocation between goodwill and the noncompete, and based on the buyer's testimony, the court overruled the Tax Court and allowed most of the value to be allocated by the buyer to the noncompete, allowing the buyer to write it off over the 10 year noncompete term); *CIR v. Gazette Tel. Co.*, 209 F. 2d 926 (10th Cir. 1954)(upheld contract allocation of $750,000 to stock and $250,000 to noncompete); *Hamlin's Trust v. CIR*, 209 F.2d 761 (10th Cir. 1954)(each $200 received $50 would go to the agreement not to compete and $150 to the stock. The $50 allocable to each share for the covenant represented ordinary income and not capital gain from the sale of the stock. Since taxpayers acted at arm's length and understandingly in respect to the contract, they cannot be heard to say later that they overlooked possible tax consequences); *Toledo Blade Co. v. CIR.*, 180 F.2d 357 (6th Cir. 1950), cert. denied, 340 U. S. 811 (1950)(court would not allocate value to noncompete to allow buyer to

amortize where parties made no allocation between the goodwill asset and the noncompete). Rev. Rul. 65-180.

In the *Toledo Blade* case, the buyer could not take an amortization deduction where there was no allocation to the covenant. The parties allocated all value to linens and goodwill (customer lists). Since there was no allocation to the noncompete, that fact alone could have been the basis for this decision. The court stated that the evidence was that there was no transfer of customers from one laundry company to another, and hence the purchase of goodwill and the right to service existing customers attained more than ordinary value. The ability of a competitor to enter the field was limited to new residents in the community, which diminished not only the value of a covenant not to compete, but also its significance as an independent element of the sale of the business.

5. FICA & FUTA. Payments under a non-compete are not "wages" for purposes for FICA and FUTA.

F. Taxpayer's Ability To Recharacterize Noncompete & Severance Payments As Payments For Personal Goodwill.

While the IRS can argue substance over form, the taxpayer must generally live with the taxpayer's characterization of a transaction and cannot later alter it to the taxpayer's advantage, at least not without "strong proof" that the taxpayer's revised characterization is correct.

Taxpayers have little freedom to ignore the form of their own transactions and are ordinarily bound by the tax consequences that flow from the form of transactions they use. *Bolger v. CIR*, 59 TC 760, 767 n. 4 (1973). In appropriate circumstances, however, a taxpayer may argue that the substance of the transactions, rather than their form, should control the tax consequences of the transactions. *Glacier State Electric Supply Co. v. CIR*, 80 TC 1047 1053 (1983). Where as here, the taxpayers seek to avoid the tax consequences of the form of a transaction, they must present strong proof that the substance of the transaction was different from its form. *Landa v. CIR*, 206 F.2d 43 (D.C. Cir. 1953); *Coleman v. CIR,* 87 TC 178, 202 (1986), aff'd 833 F.2d 303 (3d Cir. 1987) (unpublished); *Georgia-Pacific Corp. v. CIR*, 63 TC 790, 795 (1975). The taxpayer's burden is far heavier when his tax reporting positions and other actions do not consistently reflect the substance that he later argues should control the form. *Illinois Power Co. v. CIR*, 87 TC 1417, 1430 (1986).

For example, in the third of a series of cases by he same taxpayer resulting from a sale of business in 1998, *Muskat v. U.S.*, 101 AFTR 2d 2008-662 (D.C. NH. Apr. 2, 2008), aff'd 554 F.3d 183 (1st Cir. 2009) held that a taxpayer failed to show that payments for a noncompetition agreement in the sale of his family business was actually intended to purchase his personal goodwill. Taxpayer sold the assets of his family corporation's business (Seller) to Manchester Acquisition

Corporation (Buyer). Taxpayer exercised operational control of Seller, maintained involvement in key accounts and had personal relationships with Seller's customers and suppliers.

The purchase agreement included an allocation for Seller's business goodwill and $3,955,599 for a noncompete agreement. All agreements were subject of negotiation. The noncompete prohibited Taxpayer from soliciting employees and from diverting business from the buyer for 13 years. The taxpayer himself signed the agreement, which was not ambiguous with respect to the allocation of the amount at issue.

Taxpayer reported the $1,000,000 down payment for the noncompete as ordinary income but later sought a refund of $203,434, based on the claim that the noncompete payment was really for his personal goodwill. The court held that to succeed in recharacterizing the noncompete payment, Taxpayer would have to show by "strong proof" that *both parties* intended the $1,000,000 payment to be compensation for his personal goodwill, despite the terms of the noncompete agreement.

The court ruled that Taxpayer failed to produce strong proof. The negotiation for the sale didn't include any discussion of Taxpayer's personal goodwill, and no agreement mentioned Taxpayer's personal goodwill. The express purpose of the noncompete agreement was to protect the selling corporation's business goodwill. The court rejected Taxpayer's argument that the long term (13 years) and continued payment should Taxpayer die before the end of the 13 years showed that it really was a sale of his personal goodwill. "[A] person who has the wherewithal (knowledge, contacts, and the like) to compete effectively is in a strong position to drive a hard bargain in exchange for his agreement to eschew competition. A survivability provision may be part of that hard bargain. Thus, courts frequently have classified agreements that contain survivability provisions as valid noncompetition agreements for tax purposes."

The court so ruled despite facts that would have supported an allocation to personal goodwill. Buyer valued Taxpayer's key relationships with Seller's customers, suppliers, and distributors. Although Buyer did not believe that it was likely that Taxpayer would leave and compete, Buyer included noncompetition agreements in such transactions because of the protection such agreements provide.

In *Flower v. CIR*, 61 T.C. 140 (1973), the court dealt with the tax treatment of termination payments by Rowell to petitioner, a salesman of Rowell's pharmaceutical products. It held the payments were ordinary income and not payments for personal goodwill. The court ruled that the salesman-petitioner was paid a commission on Rowell's entire product sold in his territory even though he had had no direct contact with the consumer-purchaser. Having been paid to build up goodwill for Rowell's products with physicians, the termination payment by Rowell to petitioner was ordinary income (as a substitute for the ordinary

commission-income petitioner would have received by continuing under the contract) and not for goodwill. Petitioner had already transferred whatever interest he may have had in the physicians' goodwill toward Rowell's products prior to termination of the contract. Further, the court ruled that petitioner transferred any personal goodwill he may have built up through his contacts with prescribing physicians. The termination agreement did not require petitioner to continue boosting Rowell's products with his physician friends, nor to introduce his successor to the physicians, nor did it contain a covenant not to compete.

Danielson Rule – More Stringent Version Of Strong Proof Rule. If a transferor and a transferee enter into a written agreement allocating the consideration or determining the fair market value of any asset in an applicable asset acquisition under Code § 1060, they are both bound by the allocation unless either: (a) IRS determines that the allocation or value determination is not appropriate (Code § 1060(a), or (b) the parties are able to refute the allocation or valuation due to mistake, undue influence, fraud, or duress. Reg. § 1.1060-1(c)(4); *Com. v. Danielson,* 378 F.2d 771 (3d Cir. 1967), vacg & revg, 44 T.C. 549 (1965), on remand, 50 T.C. 782 (1968), cert den. 389 US 858 (1967)(there was no substance at all to taxpayer-seller's agreement not to compete, which had been inserted at the buyer's request, yet the court nevertheless held seller to the tax consequences of the agreement and ruled that the amount paid to him for the noncompetition agreement was ordinary income).

Although the Ways and Means report (WMCP No. 101-37 (Leg. History of Ways & Means Democratic Alternative, PL 101-508) p. 81) refers to the "parties" being able to show fraud, etc., the *Danielson* rule only requires such a showing by one of the parties.

Where the IRS attacks a formal agreement between parties, the courts look at the substance and not merely the form of the transaction. *Guaderrama v. CIR*, 2001-2 USTC ¶50,714 (10th Cir. Oct. 31, 2001)(unpublished), aff'g T.C. Memo. 2000-104.

The *Danielson* rule doesn't apply:

- when it is IRS that seeks to upset an allocation, *Janus v. CIR*, TC Memo 1971-257;
- when there is no allocation in the agreement, *Fedders Corp. v. CIR*, TC Memo 1979-350 affd, 659 F.2d 1066 (3d Cir. 1981), cert den 454 US 862 (1981);
- where an agreement is permeated with ambiguity, *Smith v. CIR*, 82 T.C . 705 (1984); or

- where both parties are before the court and IRS does not object to the presentation of evidence varying the terms of the agreement. *Freeport Transport Inc. v. CIR,* 63 T.C. 107 (1974); *Wallach v. CIR*, TC Memo 1982-502.

Thus, while IRS can challenge the bona fides of a contract allocation, a party to the contract can challenge it only by proof that would be admissible in an action seeking to avoid enforcement of the contract by the other party because of mistake, undue influence, fraud, or duress.

G. Appraisal.

1. Advisability of Appraisal.

For income tax purposes, there is no arm's length allocation between buyer and seller to personal goodwill versus corporate goodwill or a noncompete. The buyer is unconcerned; all such payments are amortized by the buyer over 15 years. Thus, it is very useful to have a third-party appraisal support the allocation. In the author's experience, allocations to personal goodwill have ranged from 10% to 90% of the total purchase price, depending on the particular facts and circumstances of the transaction.

A good example of how not to do a sale of personal goodwill is illustrated by the case of *Solomon v. CIR*, T.C. Memo 2008-102, holding that sales by individuals of a customer list and personal goodwill were really payments for noncompete agreements. The parties and their attorneys made the various drafts of the agreement, all of which were found by the IRS and discussed by the Tax Court, including those that were supposed to be shredded. Before the seller got a counsel involved, term sheet was signed, which provided for sale by a corporation of a division that accounted for 7% of its revenue. The IRS recast the transaction as the company's partial distribution of the customer list to the shareholders, resulting in a taxable dividend to the shareholders, followed by the shareholders' and the company's sale of the customer list, as well as the execution of the noncompete agreements. The Tax Court concluded that the entire proceeds received by the shareholders were for the noncompete agreements and not for the sale of customer lists based on the agreements and the facts. The court rejected the shareholders' attempt to allocate a portion of the purchase price to the shareholders' personal goodwill under Martin Ice Cream because the shareholders did not provide the quality of service or develop customer relationships such that personal goodwill would attach. In addition, the shareholders were not named as sellers. Importantly, the buyer did not require a post-acquisition employment or consulting agreement from either shareholder but required only noncompete agreements.

2. Sample Letter to Client.

We have discussed the appraisal of your business since part of the proposed sale price allocation will be for personal goodwill. The reason for the appraisal is to

help to establish the value with the Internal Revenue Service. The IRS has the power to make its own determination of purchase price allocations and to propose revised allocations.

If the IRS successfully challenged the personal goodwill allocation, not only would additional income taxes be owed, which could be quite substantial, the IRS could also assert the negligence and substantial understatement penalties, which apply at the rate of 20% of the amount of underpayment. In addition, interest would be owed on the additional taxes, as well as the penalties. The penalties and interest could result in the tax bill being nearly twice as much as just the income tax deficiency in three years, and the increased amounts begin to run when the income tax return was filed, not when the audit or court decision occurs. Thus, for instance, instead of the federal income tax being about $150,000 on $1,000,000 of personal goodwill, three years later the tax, penalties and interest could be around six times that much! Not only does the appraisal make this result much less likely, it should help to remove the likelihood that penalties would apply because it is a defense to the penalty that there is substantial authority for the taxpayer's position, or the relevant facts are disclosed on the taxpayer's return and there is a reasonable basis for the position.

H. How To Transfer Personal Goodwill To The Buyer In Business Asset Sale.

1. Written agreement for sale by selling businesses owner with buyer. The means of making the transfer depends on the makeup of the personal goodwill. Personal goodwill can be divided into two types. One depends on contacts and relationships. The other depends on expertise, knowledge, and/or skill. Reputation could fall into either category.

    a. If the shareholder's contacts or relationships with customers or suppliers constitute the personal goodwill, the shareholder should be obligated to provide introductions and generally facilitate a smooth transition of these relationships to buyer.

    b. If, on the other hand, the shareholder's expertise, knowledge, or skills constitutes the personal goodwill, the acquisition documents should obligate the shareholder to educate buyer or teach him these skills. While the buyer cannot become the shareholder, the extent to which buyer can be taught the knowledge or skill of value depends on the facts. In the case of the widget maker with the secret process, a complete transfer should occur when the secret is shared with buyer. In the case of a highly skilled neurosurgeon, a lesser doctor may benefit from the neurosurgeon's training and reputation, but will never possess the same degree of skill.

    c. Although the transfer of professional goodwill is more difficult than the transfer of institutional goodwill, an individual can facilitate the transfer of personal goodwill. The shareholder should

be under contract for a sufficient period to accomplish a meaningful transfer of the goodwill to buyer. Buyers may further entice the shareholder to fulfill these obligations by conditioning payment of a portion of the purchase price on the future earnings of the business (commonly referred to as an "earn-out"). S. Pratt, R. Reilly & R. Schweihs, *Valuing Small Businesses & Professional Practices*, p. 585 (3d ed. 1998).

d. Announcement by Seller's owner to customers/patients/clients of qualifications and suitability of buyer. "[A] method for transferring goodwill is to advertise the successor of a firm. another way is for the seller of a professional practice to form a temporary partnership with the buyer, so that the seller can introduce the new practitioner to the patrons, inspire the patrons' confidence in the purchaser, and then leave the purchaser well-established in the practice." S. Pratt, R. Reilly & R. Schweihs, *Valuing Small Businesses & Professional Practices*, p. 585 (3d ed. 1998); Carmen Valle Patel, Note, *Treating Professional Goodwill as Marital Property in Equitable Distribution States*, 58 N.Y.U. L. Rev. 554, 566 (1983).

2. Seller's owner continuing with the buyer, through an employment or consulting agreement, for a transition period after the sale to introduce and transition customers/suppliers/patients/clients to buyer. If the buyer does not enter into an employment or consulting agreement with the individual seller, the buyer is likely not purchasing personal goodwill but rather a noncompete. See *Solomon v. CIR*, TC Memo 2008-102, so holding where there was no post-acquisition employment or consulting agreement..

3. Seller's owner not having noncompete with selling corporation and entering into noncompete with buyer. A non-compete obligation with buyer is necessary, but not alone sufficient, to transfer personal goodwill.

4. Seller entering into nonsolicitation/nondisclosure agreement with buyer as to seller's corporate employees, customers, and suppliers, and as to confidential information related to the acquired corporation. The latter is important where the selling shareholder possesses knowledge that gives the business its value. The other restrictions, however, are of less importance (at least for purposes associated with the transfer of personal goodwill) because it is the selling shareholder, and not employees, customers, and suppliers, who possesses the personal goodwill.

I. Does IRC § 1239 Convert Capital Gain To Ordinary Income On Sale Of Self-Created Goodwill To Related Party?

There is no clear answer to this question.

1. Why 1239 Applies. Sec. 1239(a) states: In the case of a sale or exchange of property, directly or indirectly, between related persons, any gain recognized to the transferor shall be treated as ordinary income if such property is, in the hands of the transferee, of a character which is subject to the allowance for depreciation provided in section 167.

   Section 197(f)(7) states: For purposes of this chapter (Code sections 1-1400) , any amortizable section 197 intangible shall be treated as property which is of a character subject to the allowance for depreciation provided in section 167. Doesn't this answer the question?

   For the term "subject to the allowance for depreciation provided in section 167," which is also used in § 1221(a)(2) (depreciable property not a capital asset) and § 1231(b)(1) (hotchpot for depreciable property used in the taxpayer's trade or business). See *Baker v. CIR*, 38 TC 9 (1962) (leaseholds subject to § 1239, even though regulations imply they are amortized under §§ 162 and 212 rather than depreciated under § 167); *McEnery v. CIR*, 26 TCM (CCH) 1060 (1967)(amount received by lessee from controlled corporation for cancellation of lease was ordinary income under § 1239

   Assuming it is amortizable to buyer, (the anti-churning rules do not apply) then this would prevent seller from getting capital gain and buyer getting deductions against ordinary income/

2. Why 1239 Does Not Apply. Section 1239 applies only to amortizable intangibles, and self-created goodwill is not "amortizable" until after the sale. Code § 197(f)(7), Reg. § 1.197-2(g)(8), and the legislative history use the prefix "amortizable." Code § 197 and Reg. § 1.197-2(g)(8) became law long after Code § 1239 was enacted and therefore would control in the event of a conflict with Code § 1239. The Regulation says that "an amortizable section 197 intangible is section 1245 property and section 1239 applies to any gain recognized upon its sale or exchange between related persons (as defined in section 1239(b))." The amortizable section 197 intangible must be such before the sale.

   The legislative history is even more helpful, as it replaces the pronoun: "As further examples, an amortizable section 197 intangible is to constitute section 1245 property, and section 1239 of the Code is to apply to any gain recognized upon the sale or exchange of an amortizable section 197 intangible, directly or indirectly, between related persons."

IV. BUYER AMORTIZATION OF GOODWILL; ANTI-CHURNING & ANTI-ABUSE RULES.

A. Personal Goodwill; Amortization By Buyer; Anti-Churning Rules.

Congress enacted Code Sec. 197 in 1993 to end litigation regarding the valuation and lives of acquired intangibles. Code Sec. 197 provides a mandatory 15-year amortization period for any "amortizable §197 intangible" and prohibits any other depreciation or amortization with respect to such property. Code Sec. 197 applies to goodwill, going concern value and workforce in place; business books, records, lists and other information-based intangibles; licenses, permits and other legal rights conferred by a governmental agency or instrumentality; covenants not to compete; franchises, trademarks and trade names; customer-based intangibles; and supplier-based intangibles, all of which are included in the term "section 197 intangible." Code Sec. 197(d)(1).

1. Pre-Aug. 10, 1993 Goodwill Subject To Anti-Churning Rules.

Section 197(a) provides that the basis of intangibles acquired after August 10, 1993, generally is amortizable on a straight-line basis over fifteen years. However, § 197(f)(9) provides anti-churning rules to prevent amortization of certain intangibles that existed before August 10, 1993, and were not amortizable under prior law.

Congress was concerned that taxpayers could change previously nonamortizable goodwill into an amortizable asset by transferring businesses to related parties. Therefore, Sec. 197(f)(9) provides anti-churning rules to prevent amortization in such related party situations. Code Sec. 197(f)(9) applies even to a taxable transaction. The purpose of the anti-churning rules of section 197(f)(9) is to prevent the amortization of section 197(f)(9) intangibles (goodwill and going concern value) created before August 11, 1993 unless they are transferred in a transaction giving rise to a significant change in ownership or use.

The final regulations identify three groups of intangible assets: Code Sec. 197 intangibles, items that are not Code Sec. 197 intangibles, and amortizable Code Sec. 197 intangibles. In general, a Code Sec. 197 intangible is an intangible asset acquired in conjunction with the acquisition of a trade or business and some separately acquired intangibles.

Self-created intangibles, namely intangible assets created by the taxpayer, such as goodwill and going concern value, are not amortizable by that creating taxpayer under Section 197. IRC § 197(c)(2). However, a self-created governmental license, permit or other right; a franchise, trademark or trade name; or a non-compete agreement in connection with acquiring a business is amortizable. If self-created, any of the following assets will be not be amortizable under IRC section 197: goodwill, going concern value, workforce in place, business books and records, patents, copyrights, formulas, processes, designs, patterns, know-how, format, customer-based intangibles, supplier-based intangibles, and other similar items.

2. Amortizable Code Sec. 197 Intangibles.

a. Include:

(1) Code Sec. 197 intangibles that are:

(a) Acquired after August 10, 1993 (or after July 25, 1991 if a retroactive election has been made), and

(b) Held in connection with the conduct of a trade or business or a Code Sec. 212 activity

(2) Self-created Code Sec. 197 intangibles that are:

(a) Licenses, permits or other rights granted by a governmental unit,

(b) Covenants not to compete,

(c) Franchises, trademarks and trade names, and

(d) Self-created intangibles that are disposed of and are subsequently reacquired in a transaction that is not part of a series of related transactions and that were amortizable Code Sec. 197 intangibles in the hands of the seller.

b. Do not include:

(1) Self-created Code Sec. 197 intangibles, other than those listed above, and

(2) Property subject to the anti-churning rules.

3. Application Of Anti-Churning Rules. The anti-churning rules apply to sales of amortizable 197 intangibles such as goodwill, going concern value and other Code §197 intangibles that existed before Aug. 11, 1993 where there is a continuing relationship (more than 20%) between buyer and seller or related parties.

The anti-churning rules apply in three situations for goodwill in existence during the "transition period" that begins July 25, 1991, and ends August 10, 1993. Reg. § 1.197-2(f)(4) provides that the transition period begins July 25, 1991 if the taxpayer made an election to apply § 197 to intangibles acquired after that date.

First, the rule applies if, at any time during the "transition period," the taxpayer or a related person owned the intangible (or any interest therein) or used the intangible. For example, the rule usually denies § 197 amortization for an intangible purchased after 1993 from an affiliated

corporation if the intangible was not amortizable in the affiliate's hands and was held by the affiliate during the transition period.

Second, the rule applies if the taxpayer acquired the intangible from a person who owned it during the transition period and the acquisition transaction did not effect a change in the user of the intangible. Reg. § 1.197-2(h)(2)(ii). For example, § 197 amortization is not allowed if the taxpayer purchases an intangible, not amortizable under prior law, from a person who owned it during the transition period and immediately grants to the seller an exclusive license to use the intangible.

Third, the rule applies if the taxpayer grants a right to use the intangible to a person who owned or used it during the transition period or is related to a person who owned or used the intangible during that period if the transactions in which the taxpayer acquired the intangible and grants the right "are part of a series of related transactions." Reg. § 1.197-2(h)(2)(iii).

For purposes of these rules, persons are generally considered related if they have a relationship described in § 267(b) , § 267(f) , or § 707(b) (applied reducing the more than 50 percent ownership thresholds to more than 20 percent) or if they are trades or businesses under common control. Reg. § 1.197-2(h)(6). Relatedness is tested both before and after the transaction in which the intangible is acquired or, in the case of a series of related transactions, before the first transaction and after the last one.

The rules do not apply to sales of goodwill coming into existence after August 10, 1993.

In PLR 200551018, an S corporation with two shareholders was entitled to amortize goodwill acquired when the business operated by the S corporation purchased another business for full fair market value. B is a 50% shareholder of Taxpayer, the seller, and will be a 90% shareholder of New Corp, the buyer. Thus, Taxpayer and New Corp are related parties for purposes of 197(f)(9). However, Taxpayer began operations during 1994. Furthermore, none of the assets used in the formation of Taxpayer constituted a previous trade or business. Thus, Taxpayer's goodwill asset did not exist during the 197(f)(9) transition period, and the anti-churning rules of section 197(f)(9) did not apply. Under 197, the goodwill acquired is amortized using the straight-line method over a 15-year recovery period.

Reg. § 1.179(k) contains 30 examples of the application of the anti-churning rules.

4. Amount Of Pre-Aug. 11, 1993 Goodwill Not Relevant. If $1 or more of goodwill existed before Aug. 10, 1993, it taints all goodwill, i.e., it is all treated as created or acquired before Aug. 10, 1993 if there is a related party transaction. See Martin D. Ginsburg & Jack S. Levin, Mergers,

Acquisitions, & Buyouts. Partnerships that receive goodwill and going concern value in connection with a transfer of a business from another partnership will find themselves subject to the Sec. 197 anti-churning rules if the same persons own more than 20% of the capital interests or profits interests in each partnership (when there was the requisite ownership or use on or before Aug. 10, 1993). In such a case, the transferee partnership generally will not be able to amortize the goodwill and going concern value under Sec. 197.

5. Related Persons. Under the Code § 197 anti-churning rules, a person is related to any person if the persons bear a relationship described in Code §§ 267(b) or 707(b)(1) (except that where the relationship concerns the relation of a person to an entity, the ownership of interests in the entity or entities involved is reduced from more than 50 percent to more than 20 percent) or such persons are engaged in trades or businesses under common control. Code § 197(f)(9)(C). Generally, however, overlapping ownership of more than 20% (immediately before *or* immediately after the transaction) will cause the anti-churning limitations to apply. *For example, if (i) a more than 20% shareholder/partner of the seller corporation or partnership or (ii) the seller of personal goodwill becomes a greater than 20% shareholder or partner of the purchaser, the value of the goodwill or the amount of the noncompete payments will not be entitled to be amortized by the purchaser under Code §197 unless it was all created after Aug. 10, 1993*.

- In general, persons are related within the meaning of Code §§ 267(b) and 707(b)(1) (as modified by Code §197) for the anti-churning rules if they are:
- An individual and his or her brothers, sisters, half-brothers, half-sisters, spouse, ancestors (parents, grandparents, etc.), and lineal descendants (children, grandchildren, etc.).
- A corporation and an individual who owns, directly or indirectly, more than 20% of the value of the corporation's outstanding stock.
- Two corporations that are members of the same controlled group as defined in section 1563(a) of the Internal Revenue Code, except that "more than 20%" is substituted for "at least 80%" in that definition and the determination is made without regard to subsections (a)(4) and (e)(3)(C) of section 1563. (For an exception, see section 1.197-2(h)(6)(iv) of the regulations.)
- A trust fiduciary and a corporation if more than 20% of the value of the corporation's outstanding stock is owned, directly or indirectly, by or for the trust or grantor of the trust.
- The grantor and fiduciary, and the fiduciary and beneficiary, of any trust.
- The fiduciaries of two different trusts, and the fiduciaries and beneficiaries of two different trusts, if the same person is the grantor of both trusts.
- The executor and beneficiary of an estate.

- A tax-exempt educational or charitable organization and a person who directly or indirectly controls the organization (or whose family members control it).
- A corporation and a partnership if the same persons own more than 20% of the value of the outstanding stock of the corporation and more than 20% of the capital or profits interest in the partnership.
- Two S corporations, and an S corporation and a regular corporation, if the same persons own more than 20% of the value of the outstanding stock of each corporation.
- Two partnerships if the same persons own, directly or indirectly, more than 20% of the capital or profits interests in both partnerships.
- A partnership and a person who owns, directly or indirectly, more than 20% of the capital or profits interests in the partnership.
- In determining whether an individual owns more than 20% by value of a corporation's stock immediately after the transaction, all of the corporation's outstanding stock, common and preferred, voting and nonvoting, is taken into account. Stock owned indirectly through another corporation, partnership or trust or by a member of the family or a partner is included. However, stock that is not issued and not outstanding and could be acquired through the exercise of an option, warrant, or convertible debt is not considered under the constructive ownership rules. Code §1563(e) *North American Industries, Inc. v. CIR,* 33 T.C.M. 1275, 1278 (1974).
- Two persons who are engaged in trades or businesses under common control (as described in section 41(f)(1) of the Internal Revenue Code).

a. When To Determine Relationship. Persons are treated as related if the relationship existed at the following time. In the case of a single transaction, immediately before or immediately after the transaction in which the intangible was acquired. In the case of a series of related transactions (or a series of transactions that comprise a qualified stock purchase under section 338(d)(3) of the Internal Revenue Code), immediately before the earliest transaction or immediately after the last transaction. Code Section 197(f)(9)(C)(ii); Reg. Section 1.197-2(h)(6)(ii).

b. Ownership Of Stock. In determining whether an individual directly or indirectly owns any of the outstanding stock of a corporation, the following rules apply.

Rule 1. Stock directly or indirectly owned by or for a corporation, partnership, estate, or trust is considered owned proportionately by or for its shareholders, partners, or beneficiaries.

Rule 2. An individual is considered to own the stock directly or indirectly owned by or for his or her family. Family includes only brothers and sisters, half-brothers and half-sisters, spouse, ancestors, and lineal descendants.

Rule 3. An individual owning (other than by applying Rule 2) any stock in a corporation is considered to own the stock directly or indirectly owned by or for his or her partner.

Rule 4. For purposes of applying Rule 1, 2, or 3, treat stock constructively owned by a person under Rule 1 as actually owned by that person. Do not treat stock constructively owned by an individual under Rule 2 or 3 as owned by the individual for reapplying Rule 2 or 3 to make another person the constructive owner of the stock.

c. Partnerships. The anti-churning rules may apply with respect to an increase in the basis of partnership property resulting from the application of Code §§ 732, 734, or 743. The determination of whether the anti-churning rules apply and whether a person is a related person is made at the partner level. Each partner is treated as having owned and used his proportionate share of the partnership property. Code §197(f)(9)(E); Reg. §1.197-2(h)(12). Basically, if the distributee partner was not related to the person who transferred the partnership interest with respect to which the distribution is being made, the anti-churning rules do not apply to an increase in basis of partnership property under Code § 732(d).

In the case of an adjustment to the common basis of partnership assets required under Code § 734(b) as a result of a partnership distribution that increases the basis of the partnership's goodwill or going concern value, the inquiry under the anti-churning rules generally is whether a partner is related to the distributee partner. Reg. §1.197-2(h)(12)(iv). Where a basis adjustment is required under Code §743(b) for the benefit of the transferee partner, the anti-churning rules will apply if the transferee partner is related to the transferor of the partnership interest. Reg. §1.197-2(h)(12)(v). If the person acquiring the partnership interest is not related to the person transferring the partnership interest, the anti-churning rules do not apply to an increase in the basis of partnership property under Code § 743(b).

In the case of a basis adjustment under Code 732(b), the anti-churning rules generally will apply to the portion of the unrealized appreciation in the partnership's goodwill or going concern value that is attributable to partners other than the distributee partner or persons related to the distributee partner. Reg. § 1.197-2(h)(12)(ii).

B. Exceptions To The Anti-Churning Rule.

1. Gain-Recognition Exception. Where the overlapping ownership is 20% or more but does not exceed 50%, an exception exists if an election to recognize gain made by the seller. An exception to the anti-churning rules

is provided if such rules would not apply but for the substitution of the more stringent 20 percent stock and partnership percentage ownership tests for the 50 percent tests under Code § 267(b) and Code § 707(b)(1). This exception applies if the person from whom the intangible is acquired elects to:(1) recognize gain on its disposition; and (2) pay a tax on the gain that, when added to any other federal income tax imposed on the gain, equals the product of the gain and the highest income tax rate applicable to such person. If the election is made, the anti-churning rules apply to the intangible only to the extent that the taxpayer's adjusted basis in the intangible exceeds the recognized gain. Code § 197(f)(9)(B).

2. Property Acquired From A Decedent. The anti-churning rules do not apply to a section 197 intangible acquired from a decedent if the basis of the intangible is stepped up to its fair market value under Code Sec. 1014(a). Code § 197(f)(9)(D).

3. Buyout Reduces Ownership To Seller To Less Than 20%. *Note that where there is, for example, a business owned by a parent and child and the child buys out the parent, ownership will be imputed from one to the other making this exception inapplicable.*

4. Seller Forms Partnership With Seller's Affiliate At Least 1 Year Before Sale. The regulations contain an example as to how to avoid the anti-churning rules. For example, A owns an intangible that A acquired or created in 1990 (prior to the March 10, 1993 date), such as self-created goodwill. Individual A wishes to enter into a partnership with Individual B using the intangible. If A sells an interest in the intangible to B, and A and B form a partnership to use the intangible, the entire basis of the intangible in the hands of the partnership will be subject to the anti-churning rules unless A has a 20 percent or less interest in the partnership. See Reg. § 1.197-2(k) Example (18). The result is the same if A sells the intangible to the partnership, either directly or in a disguised sale. See Reg. § 1.197-2(k) Example (17) (disguised sale).

As noted above, if A (not B) elects to recognize gain under paragraph (h)(9) on the transfer of the remaining one-half interest in the intangible to P, then the intangible would be amortizable by P to the extent provided in section 197(f)(9)(B). In this event, the transfers by A to B and P would both be taxed, not just the transfer to B.

Reg. § 1.197-2(k) Example (19) provides a method for A to avoid imposing the anti-churning rules on B, the new owner, if A forms a partnership with an affiliate of A at least one year before the sale to B. This partnership makes a § 754 election, and, at least one year later, A sells B an interest in the partnership. B 's § 754 basis increase in the intangible is amortizable in this example, which sets forth no business

purpose for the formation of the partnership with the affiliate and does not specify that the sale to B is unrelated to the prior formation of the partnership. The sale of a portion of A's partnership interest to B is a transaction to which § 743(b) applies. The anti-churning rules do not apply. It is not clear why. One possible explanation is that the 754/743 rules trump the anti-churning rules.

However, compare Reg. § 1.701-2(d) Example (8) (partnership by A with brother and brother's wife used to allow a loss to be taken twice, once A and once by partnership is not bona fide because the partnership was used with a principal purpose to reduce substantially the partners' tax liability in a manner inconsistent with the intent of subchapter K). This example 8 in the anti-abuse regulation says that any purported business purpose for the transaction is insignificant in comparison to the tax benefits that would result if the transaction were respected for federal tax purposes On these facts, partnership is not bona fide and the anti-abuse rule applies.

Nonetheless, the 197 regulations were published January 25, 2000, after the 701 anti-abuse regulations on January 3, 1995. Thus, one can infer that the anti-abuse regulation does not override example 19. However, example 19, as noted, is silent as to whether there is a business purpose to the formation of the partnership between A and A's affiliate. In addition, there is a separate 197 anti-abuse rule at Reg. §1.197-2(j), discussed below.

C. Expense Sharing Arrangement As A Solution To Anti-Churning Rules In Partial Practice Sale.

Where a professional intends to sell a 50% interest in a practice, including personal goodwill, and where some of that goodwill existed before Aug. 1993 (and does not qualify for an exception, which self-created goodwill does not), then the anti-churning rules would apply if the purchaser bought into the seller's practice. If instead, the seller sells 50% of his personal goodwill and assets to a purchaser, who commences his own practice, and if the parties only share expense, and not income, no controlled group or affiliated service group will exist. Thus, the anti-churning rules do not apply.

D. Anti-Abuse Rules.

The application of the anti-churning rules is complicated by anti-abuse rules set forth in Reg. §1.197-2(j). A taxpayer cannot amortize any section 197 intangible acquired in a transaction for which the principal purpose was either of the following.

- To avoid the requirement that the intangible be acquired after August 10, 1993.

- To avoid any of the anti-churning rules.

The regulations allow the Service to interpret and apply the rules as necessary and appropriate to prevent avoidance of the purposes of Code §197. If one of the principal purposes of a transaction is to achieve a tax result that is inconstant with the purposes of Code §197, the Service may recast the transaction as appropriate to achieve tax results that are consistent with the purposes of the section, in light of the applicable statutory and regulatory provisions and the pertinent facts and circumstances. Thus, for example, if the Code Section 197 intangibles are acquired in a transaction in which an option to acquire stock is issued to a party to the transaction, but the option is not treated as having been exercised in determining whether the parties are related, the anti-abuse rule may apply. Code Section 197(f)(9)(F); Reg. Section 1.197-2(h)(11).

E. Getting The Buyer The Deduction.

Where the buyer can amortize the goodwill, and stays in business with the seller, a partnership or LLC taxed as a partnership can allocate the deduction to the buyer. One of the biggest issues for an entity taxed as a partnership involves depreciation of appreciated contributed assets. Complicating this are the options the partnership has in allocating the depreciation in the new entity.

1. The ceiling method (Reg. § 1.704-3(b)(1)) is the default rule when the partnership agreement makes no provision for an allocation. Under this method, the gain is allocated to the contributing partner until the pre-recognition gain is fully recognized, then to the other partners in accordance with their agreement. This method works well as long as the gain recognized exceeds the pre-contribution gain.

2. Under the curative method (Reg. § 1.704-3(c)(1)), the partnership can allocate some other income or expense item as required to eliminate the discrepancy to noncontributing partners between the book and tax depreciation amounts. As long as the allocations are "reasonably" expected to have substantially the same effect as the gain or loss limited by the ceiling rule, the allocation is allowed.

3. Finally, the remedial allocation method (Reg. § 1.704-3(d)(1)) may be used. If the ceiling rule results in a book allocation to a noncontributing partner different from the corresponding tax allocation, the partnership makes a second "remedial" allocation of income, deduction, gain, or loss to the noncontributing partner equal to the full limitation created by the ceiling rule and a second offsetting remedial allocation of income, deduction, gain or loss to the contributing partner. The remedial allocation must be in full. No partial allocation is permitted; it is all or nothing. Remedial allocations of items must have the same tax attributes as items they replace. If the ceiling rule limits the allocation, the remedial

allocation must have the same effect on each partner's tax liability as is produced by the tax item limited by the ceiling rule.

What is the “right” allocation method? It depends on a variety of factors, including the difference between the book and tax basis of assets contributed, the complexity of the allocations, and the additional expense incurred by the partnership in determining the depreciation deduction.