

The Transfer of Professional Goodwill

By Phyllis Horn Epstein

A professional practice is identified with the professional who cleans your teeth, prepares your tax return, sues your tenant or checks your heartbeat. A professional practice is built upon these personal relationships and presents a unique question in determining value, and that is the issue of goodwill. Does it exist? Is it transferable? If so, what is it worth? The issue arises in many contexts: divorce, a death, a break up of owners, bankruptcy, a sale or gifts.

In divorce, the presence of marketable goodwill in a business contributes to value for purposes of property division between the spouses. In bankruptcy, marketable goodwill becomes an asset of the bankrupt estate. In a sale, transfer or liquidation of a business interest, marketable goodwill has a negotiable sale value. The attribution of all or a part of a transfer price to goodwill has certain tax implications for the seller and buyer of goodwill. At death, goodwill may increase the value of an estate resulting in the imposition of estate tax. Because professional goodwill, as opposed to business goodwill, has no value at death, the issue continues to be actively litigated under a variety of facts and situations.

What Is Goodwill?

The IRS has long established a list of factors to consider in the valuation of a business in the absence of a valid agreement and one of those important factors is goodwill. The IRS offers the following:

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In the final analysis, goodwill is based upon earning capacity. The presence of goodwill and its value, therefore, rests upon the excess of net earnings over and above a fair return over the net tangible assets. While the element of goodwill may be based primarily on earnings, such factors as the prestige and renown of the business, the ownership of a trade or brand name, and a record of successful operation over a prolonged period in a particular locality, also may furnish support for the inclusion of intangible value. In some instances it may not be possible to make a separate appraisal of the tangible and intangible assets of the business. The enterprise has a value as an entity. Whatever intangible value there is, which is supportable by the facts, may be measured by the amount by which the appraised value of the tangible assets exceeds the net book value of such assets.¹

Consider the following eight factors:

1. The nature of the business and its history
2. The economic outlook in general and the condition and outlook of the industry
3. The book value and financial condition of the company. Book value is generally a secondary consideration for an operating company as compared to its earning capacity unless the business is in difficulty and is looking for liquidation value, or unless the company has assets which are more valuable than their book value. An example is real estate that may have been depreciated from its purchase price but which has a fair market value far in excess of its book value.
4. The earning capacity of the company. This is generally determined by its EBITA (Earnings Before

Interest Taxes and Amortization) averaged over a period of three to five years and multiplied by anywhere from three to seven times. This method can be determined by reference to the selling price of listed stocks of companies in a similar industry.

5. The dividend paying capacity of the company. Most closely held companies rarely pay dividends, whether S corporations, partnerships or LLCs. Business appraisers will look to a fair return on capital invested to determine whether salaries of owners are excessive and actually represent dividends.
6. Whether the enterprise has goodwill or other intangible value, such as a recognized name in the industry or a location that creates a customer base. Goodwill may be a factor in valuing certain types of businesses but not others.
7. Recent sales of company stock, if any, may be relevant, but consider whether the sales are at arm's length (willing buyer and willing seller with neither under a compulsion to buy or sell) and whether the shares in question are control shares or a minority interest. The existence of an agreement between owners may also impact marketability and establish a price.
8. The market price of stock of companies in the same or similar industries which are actively traded

Many courts have defined goodwill in varying contexts. Considering the tax consequences from the liquidation of an accounting firm the U.S. Tax Court in *Norwalk* offers this concise definition:

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.²

The Seventh Circuit Court in considering the assets of a bankruptcy estate adopted a similar definition in the 1996 case of *In Re Prince*:

Goodwill is an intangible asset that represents the ability of a company to generate earnings over and above the operating value of the company's other tangible and intangible assets. It often includes the company's name recognition, consumer brand loyalty, or special relationships with suppliers or customers.³

In several Pennsylvania courts in the context of equitable distribution in a divorce, goodwill has been defined as "[t]he positive reputation that a particular business enjoys ..."⁴; and "the favor which management of a business has won from the public, and probability that old customers will continue their patronage."⁵ And by another Pennsylvania court, goodwill "represents a pre-existing relationship arising from a continuous course of business which is expected to continue indefinitely."⁶

The Ninth Circuit Court of Appeals defined goodwill as "the sum total of those imponderable qualities which attract the custom of the business—what brings patronage to the business."⁷ In another Tax Court opinion, goodwill is "the expectance of continued patronage, for whatever reason," and "the expectancy that old customers will resort to the old place" of business.⁸ The Eighth Circuit Court of Appeals defined goodwill as:

... the advantage or benefit, which is acquired by an establishment, beyond the mere value of the capital, stock, funds, or property employed therein, in consequence of the general public patronage and encouragement which it receives from constant or habitual customers, on account of its local position, or common celebrity, or reputation for skill or affluence, or punctuality, or from other accidental circumstances or necessity, or even from ancient partialities or prejudices.⁹

Ultimately, the presence of goodwill is a question of fact.

Professional or Business Goodwill?

Professional businesses may have goodwill, but very often that goodwill is related to the individual, and the individual cannot transferred that goodwill. Goodwill that is related to the business entity is referred to sometimes as "enterprise goodwill," "marketable goodwill," "vendible goodwill," or "going-concern"

value. Goodwill that is “marketable” or “vendible” can be valued and sold. Conversely, no value is assigned to goodwill that is purely personal or professional (see the Appendix, *infra*).

Divorce

The presence of goodwill in a business that is predominately a service practice is an issue that arises most frequently in the context of property division at the time of divorce. The best source for defining this valueless intangible can be found in the divorce dockets.

The debate between spouses rages first over whether a business has any goodwill at all, and then, if there is goodwill present, does it attach to the entire business (enterprise goodwill) or is it personal in nature, something that remains with the owner and cannot be sold, transferred or valued for sale. A professional enterprise, like accounting, the law or medicine, is more likely to have goodwill that is personal to the professional and therefore off the balance sheet when it comes to adding up its worth, leaving only office furniture and adding machines to divide with a disappointed spouse.

There are a number of cases that discuss whether goodwill should be included in the valuation of a personal business for equitable distribution purposes, but these are limited to situations where a husband (and in these cases it is always the husband) owns a business, which must be valued and a portion of that value distributed to his wife in cash at its present value. These cases arise most frequently with businesses that are by their nature professional occupations such as lawyer, dentist, doctor or architect. The husband usually takes the position that his efforts are indispensable to the business and if he left there would be nothing remaining. To this, he assigns a value representing goodwill that is personal in nature. To the extent that the facts and circumstances bear this out, the courts in my home state, Pennsylvania, have ruled that personal goodwill can be excluded from the value of a personal professional business for equitable distribution purposes.¹⁰ The Pennsylvania Supreme Court has held that goodwill is not a factor in the value of a business if the goodwill is “intrinsically tied to the attributes and or skills” of that certain individual.

There are many factors that are relevant to determining whether goodwill is professional or enterprise goodwill. It is significant that Pennsylvania courts have also held that “the mere fact that a party is a

professional is not necessarily sufficient to attribute the business’s goodwill to that individual.” Citing *In re Paolino*,¹¹ the U.S. Eastern District Court of Pennsylvania wrote:

Because all professionals do not necessarily engender professional goodwill and non-professionals can create professional goodwill, the key issue in determining the existence of professional goodwill is not whether the particular individual is a professional; instead, the proper focus in determining the existence of professional goodwill is whether the individual has established a reputation for specialized skill, experience and judgment.¹²

More specifically, on the question of “uniqueness” of skill, experience and judgment, the court offered the following:

Such skills include the ability to perform a certain life saving operation, win difficult trials, save money on taxes or design buildings that are characterized by a particular aesthetic quality.

Merely doing a job well isn’t sufficiently “unique” if it can be done well by others. The Pennsylvania Superior Court in the case of *Gaydos*¹³ determined that the goodwill in a husband’s dental practice was not purely professional:

Plainly, any long-standing business such as Husband’s dental practice has a going-concern value—*i.e.*, a value related to the business’s enhanced power to earn future revenues based on the fact that the business is already organized, rather than a start up.

In the Pennsylvania Superior Court Case of *Fexa*, the court again examined a dental practice and ruled that if patients were shared among doctors within the practice, the goodwill involved could *not* be purely personal. These factors were relevant to the Pennsylvania Superior Court in *DeMasi*¹⁴ involving valuation of a medical practice. The court also deemed it relevant to value a business based upon what it might bring if sold to another physician or if another physician was invited to buy into the practice on a bid in excess of simple book value.

In *Buckl*, the Pennsylvania Superior court examined an architectural partnership for its value with the result

that all of the goodwill of the practice was included in its value for equitable distribution purposes given that the business had an identity as an association, not just tied to an individual by name, and that much of the work could be performed by either partner in the firm. In *Butler*, involving an accounting practice, the court held that the source of the “client base” was relevant to categorizing goodwill.

Several other cases have focused on whether the “going concern” value of an enterprise could be “realized.” The husband who was a partner of a law firm in *McCabe*¹⁵ was restricted from realizing the full value of his interest because of a prior partnership agreement which limited the value to be placed upon that interest in equitable distribution. In other words, if the goodwill could be realized by a sale or buy-in, the goodwill would be subject to equitable distribution. The Pennsylvania Supreme Court sided with Husband and held that the partnership agreement is a “preeminent factor” in valuing his partnership interest. To ignore the limitations therein would be a “fiction.”

Subsequently, the Supreme Court of Pennsylvania revisited this issue in the case of *Butler*,¹⁶ holding that a partnership or shareholder agreement is a *factor* but not the only factor in determining value. The key to their analysis is whether the valuation of interest in the agreement closely represented present-day worth. Unlike the agreement in *McCabe*, which set forth a method of valuation, the agreement in *Butler* assigned a fixed value to a shareholder interest that was set years before and never re-evaluated. Accordingly, the agreement in *Butler* was set aside for equitable distribution purposes. Under today’s law, an agreement is something that the courts will look at first “to ascertain a present day monetary value.” The value assigned to an interest under an agreement is only “presumptively” correct and can be challenged on the basis that it fails to offer a method closely reflective of present day value. Such agreements will not be determinative per se of the value of an individual’s interest.

The Court of Appeals of New York held that the goodwill of a dental practice was entirely enterprise goodwill when it included the right to practice at a particular location.¹⁷ This opinion was subsequently shared by the Pennsylvania Superior Court in *Baker*¹⁸ where all of the goodwill from the husband’s veterinary practice was attributed to location and customer lists and was therefore deemed entirely enterprise goodwill.

In considering the matter, the Court of Appeals of Colorado held that all of the goodwill of a dental practice should be included in its value for divorce purposes finding that “the probability of continued patronage has a present market value to the purchaser of a professional practice.”¹⁹

The Alaska Supreme Court²⁰ in a 1989 decision in a domestic dispute excluded from the marital estate the goodwill of a husband’s law practice and coined the phrase “unmarketable goodwill.” Husband was the sole shareholder of his professional corporation law firm, although he employed other lawyers in his practice. Nevertheless, the court held that any goodwill the practice possessed was personal to him. They declined to extend their holding to a multi-lawyer firm intimating that other facts might offer different results.

In arguing vigorously for a different outcome, the dissent for the Alaska Supreme Court cited many of the Pennsylvania cases recounted above as ultimately causing confusion and injustice. The dissent argued, “If equitable distribution is to have vitality then such items must be included within its scope.” Furthermore the dissent argued, the line of cases to which Pennsylvania’s courts have contributed to inconsistent results dependent upon the form of the business alone, *i.e.*, sole practitioner versus corporation. In support of its position the dissent quotes one California case as holding the value of a professional business should be the same whether “a sole practitioner, a professional partnership or a professional corporation.”²¹ Notwithstanding the lack of marketability of a professional practice, the dissent notes the economic reality of a successful professional practice and in a divorce context argues for some inclusion of its value for the spouse who will no longer enjoy the benefits of that practice.

In the context of a divorce, unlike an estate or acquisition valuation, some jurisdictions require the parties use a business fair market value equal to liquidation value net of taxes. It is unlikely that an entire operating company will be transferred to a spouse as a going concern, but if so, the practitioner should consider alternative values as a going concern versus liquidation: One method calls for an earnings-based valuation while the other, an asset liquidation valuation.

Bankruptcy

Under our bankruptcy laws, the bankrupt estate consists of the debtor’s nonexempt assets that are

available to the creditors to satisfy outstanding debts.²² A debtor's business is included in the bankrupt estate. That business may include the value of goodwill. If goodwill is characterized as "personal" rather than "enterprise," it will reduce the value of the enterprise and therefore the size of the bankrupt estate.

The Seventh Circuit Court of Appeals addressed the issue of the value of an orthodontia practice conducted as a personal corporation in a Chapter 7 bankruptcy matter.²³ Dr. Prince and his wife filed for bankruptcy under Chapter 7 of the Bankruptcy Code and sought to pay into the bankruptcy court the value of his professional orthodontia practice. A dispute arose over the value of that practice. One of the issues was the value of Dr. Prince's professional goodwill. The Seventh Circuit acknowledged that personal goodwill belonging to Dr. Prince would be excluded from the bankruptcy estate:

Dr. Prince's services are valuable because of his various personal attributes, including his natural skills, his personality and demeanor, his extensive training and professional knowledge, and his license to practice dental medicine. By expending his labor in providing these services, Dr. Prince generated earnings for the practice, which resulted in profits flowing to the professional corporation's shares of stock. That portion of the stock's worth on the date of confirmation representing the value of Dr. Prince's future skilled labor is undisputedly excluded from the estate by virtue of the §541.

But then the court delivered a *Solomon*-like decision creating two subcategories of personal goodwill: human capital and goodwill. Human capital, it declared, cannot be transferred or valued. These are Dr. Prince's "innate physical ability, his personality, or his professional degree," "his skills, his schooling, his or his dental license," which cannot be transferred or sold. On the other hand, there is another dimension to his goodwill that can be transferred to another doctor: His "best efforts to transfer his patients' loyalties" to another doctor the court concluded was the same as transferring a trademark. This dimension of goodwill could be valued as part of the bankruptcy estate. The court explained:

The value of Dr. Prince's goodwill represents future cash flows not from earnings for future services actually performed by Dr. Prince, but

from return on an intangible capital asset that could be sold and transferred with the sale of the practice. The value of Dr. Prince's goodwill is therefore not excluded from the estate by virtue of §541(a)(6), and according to the plan of reorganization it must be paid by the Princes into the creditors fund.

The court was aided in valuing the doctor's orthodontia practice by the fact that shortly after confirmation of his bankruptcy, Dr. Prince negotiated the sale of the practice to another doctor. In addition to a fixed sale price, the agreement contained a covenant not to compete and an agreement on the part of Dr. Prince to aid in the transition of his practice. Although the sale was never consummated, the court relied upon the agreement as an indication of worth. The court may have required other indicators of value had there not been a negotiated sale so close in time to the confirmation of bankruptcy. Its ultimate goal was to find a present value for the business that would consider the probability of future events including the possibility that Dr. Prince may sell the practice and enter into competition or refrain from doing so.

The U.S. Bankruptcy Court for the Eastern District of New York²⁴ followed Prince's lead by referring to "human capital" in place of "professional goodwill" with similar results in the describing the accounting practice of Mr. Schulz. Even though the value of Mr. Schulz' accounting practice was largely attributable to his professional efforts, the court concluded that the goodwill in the practice was marketable.

... the value of a professional practiced owned by a debtor as of the commencement of a bankruptcy case is attributable to many different assets; e.g., some of its value flows from the practice's future cash flow may be attributable to the professional's human capital, such as his skills and labor; and some of its value may derive from the practice's intangible assets, such as good will. See *Prince*, 85 F.3d at 321. Goodwill includes the practice's name recognition, consumer brand loyalty, or special relationships with suppliers or clients. Additionally, it is settled law in New York that professional goodwill, which is comprised of other than personal attributes of a professional person, such as continuity of location and continuity of the name of a professional practice, is a saleable asset which attaches to the place, not the person, and survives even the death of that professional person.

For bankruptcy purposes, the court suggested the practice be valued at a rate that it could be sold if the accountant refused to enter into a noncompete agreement, a value that would presumably be much lower had the court assumed the accountant remained in practice albeit at another location.

The U.S. Bankruptcy Court for the Eastern District of Pennsylvania in a case involving the Chapter 13 bankruptcy filing by the owner of a special delivery service business confronted the issue of valuing of the sole proprietorship and in doing so relied upon the body of law developed by the courts dealing with equitable distribution in divorce cases when it came to deciding the presence of personal versus entity goodwill.²⁵ The case involved an application for Chapter 13 relief under the U.S. Bankruptcy Code filed by Mr. and Mrs. Thomas. Mr. Thomas was the sole shareholder of All American Couriers (“All American”), a corporation that elected subchapter S status after five years of operations. All American specialized in same-day deliveries. Mr. Thomas employed independent contractors on a commission basis to assist in making deliveries.

Mr. Thomas first argued that the present value of All American for bankruptcy purposes should be at liquidation value rather than its value as a going concern. In light of its finding that All American was going to continue operations, the court held that the appropriate valuation method for All American was as a going concern. Quoting from the Seventh Circuit’s *Prince* decision, the court concluded:

[W]here a business is expected to continue as a going concern, the company’s expected future earnings from operations often far exceed the liquidation value of the company’s physical assets. Thus, when valuing a business that is continuing to operate as a going concern, liquidation value is generally an inaccurate approximation of what shares are worth to shareholders.²⁶

Next, Mr. Thomas put forth the argument that, under Pennsylvania law, the court was bound to exclude from the value of his business professional goodwill. In consideration of Mr. Thomas’ position, the court considered the body of Pennsylvania law developed for equitable distribution principles noted that professional goodwill cannot be valued.

The court reflected upon other decisions where nonprofessional businesses had been found to have professional goodwill. One such case was *In re Rives*,²⁷

involving a queen bee business, and another was *In re Hargrave*,²⁸ involving a manufacturer’s representative. After a close examination of All American’s operations and Mr. Thomas’ role in it, the court concluded that Mr. Thomas did not exhibit special skill, experience and judgment, and that All American could continue to operate independent of Mr. Thomas. Echoing the Pennsylvania divorce case of *In re Paolino*, Mr. Thomas’ personal efforts, while sufficiently ambitious and remarkable, were not sufficiently “unique.” Therefore all of the goodwill of All American was “economic goodwill.” The result was a value for goodwill that was greater than zero and included in the bankrupt estate.

In another decision, the U.S. Bankruptcy Court for the Eastern District of Pennsylvania again concluded that the goodwill in a doctor’s practice was economic goodwill given the local nature of his practice and absence of outside professional referrals of patients.²⁹ The paramount impact of a business location upon its success compelled the result that all of the doctor’s goodwill was enterprise rather than personal.

Sales and Liquidations

In the context of a sale or liquidation of a business interest, the attribution of a portion of the purchase price to goodwill value is critical in determining the tax effect of the transaction. In these situations, the concern over whether there is goodwill and the type of goodwill (enterprise versus professional) has less to do with settling with creditors or a spouse than with future tax implications.

Ordinarily, when sold, goodwill is a capital asset.³⁰ A seller realizes capital gains rather than ordinary income and a buyer may treat the goodwill as an asset that can be amortized over 15 years but not deducted or depreciated.³¹ Often the disparate tax treatment places buyers and sellers at odds when negotiating a transfer of interest and becomes an issue for negotiation.

In very general terms, the value of a business interest is equal to what a willing buyer will pay to a willing seller. Our courts will first look to recent sales at arm’s-length of all or a portion of the enterprise.³² In the absence of any recent sales, the courts will try to determine what value a willing buyer and willing seller would agree upon if neither was under pressure to buy or sell and both had identical knowledge.³³ The method of valuation of any business interest will vary depending upon the nature of the business.³⁴ Without exploring in greater detail the many and various methods of valuation employed by experts, it is fair to state here that value is based gener-

ally on a fair return on tangible assets plus consideration of goodwill. Goodwill is indicated by the presence of earnings in excess of a fair return on the assets.³⁵ In most instances, the U.S. Tax Court will not overturn the value placed upon a business interest by a buyer and seller in an arm's-length transaction.³⁶ For closely held companies, in the absence of an actual sale, the value of all or part of the entity is determined by other factors among which are evidence of comparable sales of similar businesses or even a single prior sale of stock or the attachment of contingencies.³⁷ In the absence of an agreement, "relevant factors" include net worth, earning power, dividend paying capacity good will, industry outlook, management, control block, position in the industry, nonoperating assets and management and other factors listed in Rev. Rul. 59-60.

Even if an arm's-length agreement of sale exists, the value set by that agreement may not be accepted for all circumstances. In one such instance, the Tenth Circuit, in a decision affirming the Tax Court, held that a company's value that was set by a buy-sell agreement was not controlling for purposes of a gift of that stock (although the buy-sell value may be a *factor* in determining value for the purposes of a gift).³⁸

The value of goodwill is influenced by corporate earning capacity as exists when there are earnings that exceed the value of corporate assets. Under the residual method, applied when an entire business is transferred or sold, goodwill is valued by the excess of the purchase price over the aggregate fair market value of the tangible assets and the other identifiable intangible assets.³⁹ For a sale of a portion of the business, the value of intangibles is arrived at by capitalizing the earnings attributable to those assets.⁴⁰

Professional service partnerships are offered exceptional tax treatment because, unlike other businesses, their value is not reflected in the sum total of their fixed assets but rather the reputation of their professionals.⁴¹ Under some circumstances, professional service partners may treat the liquidation of their partnership interest as either a guaranteed payment or payment for a distributive share resulting in ordinary income treatment. In granting special tax treatment, Congress has identified professional service partnerships as those that charge "fees, commissions, or other compensation for personal services performed by an individual."⁴²

Liquidations

The U.S. Tax Court in *Norwalk*⁴³ considered the liquidation of an accounting CPA firm to determine gain or loss on the transaction. Generally, gain or loss on a complete

liquidation is recognized as if there were a sale at fair market value.⁴⁴ The corporation would ordinarily recognize gain (or loss) on the difference between the fair market value of the property distributed and its basis in the property. Payments received by shareholders in liquidation are in exchange for their stock, and shareholders recognize gain on the difference between the amount realized and their basis in the stock (less any obligations assumed).⁴⁵ However, when assets are distributed in kind, there may be ordinary income to the organization as a result of recapture of depreciable assets.⁴⁶

Goodwill is a component of fair market value and so the accountants in *Norwalk* argued that the fair market value of the accounting firm upon liquidation was without value since it was entirely professional goodwill. The IRS argued that the accountants had received customer-based intangibles upon liquidation that would have triggered gain had it been reported. The question before the Tax Court was whether the distribution of customer lists or files had a value that triggered gain on the liquidation.

The court stated that goodwill can be a "vendible asset" even in a professional practice⁴⁷ and so proceeded to examine the nature of this specific accounting practice. It concluded that the business of the firm was "dependent upon its key employees." The court was certain that if any of the accountants left the firm, their clients would follow since "the personal ability, personality, and reputation of the individual accountants are what the clients sought." Moreover, and perhaps controlling, was the fact that the accountants were not bound by a noncompete agreement or an employment agreement which would give ownership of the clients' accounts to the general firm. In fact, upon liquidation, many of the firms' clients followed the individual accountants to continue servicing their accounts. The court concluded that none of the customer-based intangibles received in liquidating transfers represented economic goodwill that had a value that could result in unreported gain.

In an earlier case, the Tax Court examined the practice of a doctor conducting a family medical practice as a professional corporation in Oregon.⁴⁸ Dr. Schillbach was the sole shareholder and physician in his corporation. In anticipation of retiring to Arizona, Dr. Schillbach first liquidated then sold his practice. The IRS raised the issue that the amount received by Dr. Schillbach in liquidation should have included a value for enterprise goodwill.

The good doctor had no contractual restrictions on his ability to continue practicing medicine at the time of liquidation. The doctor argued that his ongoing ability to compete with his former firm reduced to zero the

value of any goodwill that the corporation may have distributed in liquidation.

First, the Tax Court examined the nature of the medical practice and concluded that there existed enterprise goodwill separate from the doctor's abilities. That goodwill was based upon the "large patient base" that "was a result of the corporation's extended hours, range of services, billing practices, and general operating procedures." They next addressed the impact of the doctor's ability to compete with his former professional corporation upon the value of this enterprise goodwill. For this analysis, they looked at the terms of the sale, which had been negotiated before and after the liquidation. Inserted in the final draft of the sale agreement was a covenant not to compete which bound Dr. Schilbach. The court disregarded the impact of this provision on the worth of the practice sold for a number of reasons: First, the doctor was retiring to another state and had no intention of competing with the purchasers; second, the doctor was unable to continue practicing medicine because of his health and inability to secure insurance; and last, the doctor hadn't bargained for additional consideration for agreeing not to compete. Accordingly, the Tax Court determined the noncompete clause that was executed at a later date had no impact on reducing the value of the enterprise goodwill.

Sales

Charles Girt was an orthodontist in Pittsburgh who sold his Uniontown branch office to his assistant Herbert LaRue in an arrangement that involved LaRue sharing the profits with Girt for a certain future term. Appealing to the U.S. Tax Court, LaRue argued that the payments he made were a share of profits taxable to Girt and did not reflect a payment for the sale of the practice. The Tax Court disagreed.⁴⁹ The arrangement, the court concluded, "was more than that. It was primarily the opportunity of LaRue to acquire the established practice which had been built up by Girt over a period of 15 years." The Tax Court concluded that the sale of the Uniontown practice included goodwill and that LaRue had purchased a capital asset although he would not be permitted to amortize the orthodontia cases that had been pending at the time of purchase. The court held that LaRue had paid for more than just a few orthodontia cases that ultimately would be completed. LaRue had paid for a practice which had "a continuing value." Moreover, the court concluded that any profits received by LaRue from the practice, including any amounts he then tendered to Dr. Girt in exchange for the practice, were ordinary income to him.

In the same year the Tax Court examined the tax consequences in the sale of a clinic-type dental practice with three separate offices⁵⁰ by Dr. Brooks. Dr. Brooks sold one of his office locations and allocated a substantial portion of the sale proceeds to goodwill, which he maintained was entirely enterprise goodwill for the purpose of reporting the goodwill portion of the sale as capital gains on his income tax return.

The factual record showed that the patients of this clinic did not expect to have a personal relationship with one dentist; that the volume of patients meant that patients often were treated by different dentists; that Dr. Brooks himself rarely treated the patients at the sold location; that "the success of the business apparently lay in supplying satisfactory assembly line orthodontic work at lower prices which resulted from the high volume of patients which could be handled." The court concluded that goodwill of the practice was "salable" and was not personal to Dr. Brooks even though he was a professional.

The IRS argued that the payments to Dr. Brooks should be given ordinary income treatment since the agreement contained a covenant not to compete. The court disagreed, finding that the mere existence of a covenant not to compete does not mean that any portion of the sale price should be allocated to it if the bargain reflects otherwise; "it is necessary to look at the entire transaction to see what the parties bargained for." As the covenant itself was added on to the agreement by Dr. Brooks himself after the purchase price had been set, the court was able to conclude that none of the sales price should be allocated to the covenant and given ordinary income treatment. The covenant was "ancillary" to the transfer of goodwill.

Gifts and Estates

The valuation principles with respect to professional goodwill in the events of sales or liquidations are equally applicable to lifetime gifts or transfers at death.⁵¹ As with other transactions, prior sales are relevant in determining value: the value of a gift or date of death value.⁵²

As a general rule, property in the estate of a decedent is valued at its fair market value on the date of death.⁵³ In valuing a business for estate tax purposes, goodwill is a "relevant factor"⁵⁴; however, other relevant factors include net worth, earning power and dividend paying capacity. Goodwill of a business interest at time of death, if related to the business, and if it survives death, increases the value of the estate subject to tax.⁵⁵

The gift of a partnership interest will include goodwill in proportion to the interest granted⁵⁶; however,

upon gifts of a minority stock interest or partnership interests, courts have allowed a reduced value which was less than the proportionate share of the ownership because of minority discounts or lack of marketability discounts.⁵⁷ In the absence of an actual bid for an enterprise, the IRS may challenge a valuation taken for gift or estate tax purposes if it feels the business was valued too low for estate or gift tax purposes.

Conclusion

There are times when the owner of a professional practice will take the position that any goodwill is personal and has no value, and other times he or she will argue the opposite. Someone facing bankruptcy or divorce will argue that any goodwill in his or her business is personal and that the marital estate or bankrupt estate should not include a value for goodwill that may be distributed to a creditor or ex-spouse. Other times, to acquire favorable capital gains treatment, the same professional may take the opposite position that all of his or her goodwill is related to the business entity. The courts will have the task of closely examining the nature

of the practice and the secrets of its success when called upon to decide if goodwill is personal or enterprise.

In short, the factors most often considered by various jurisdictions in determining the presence of personal goodwill rather than economic goodwill follow:

- The uniqueness of tasks
- Start-up versus long-standing business
- The price the practice might bring in a sale to another professional
- The price the practice might command to another dentist to buy into the practice
- The identity of the practice as an association
- The interchangeability of tasks among practicing professionals
- Whether the sale price is realizable or restricted by a partnership agreement
- Whether there are referrals from other doctors
- Whether this is a purely local practice or if the practitioner has some renown within his professional community
- Source of client base
- Whether the value of the practice ties into a specific location or if it is portable

ENDNOTES

¹ Rev. Rul. 59-60, 1959-1 CB 237, and its progeny, applying factors for purposes of gift tax, estate tax or income tax.

² *W. Norwalk*, 76 TCM 208, Dec. 52,817(M), TC Memo. 1998-279.

³ *In re Prince*, CA-7, 85 F3d 314 (May 31, 1996).

⁴ *Solomon v. Solomon*, 531 Pa. 113, 611 A2d 686 (Pa.1992)

⁵ *Buckl v. Buckl*, 373 Pa. Super. 521, 530, 542 A2d 65, 69 (Pa. Super. 1988).

⁶ *Butler v. Butler*, 541 Pa. 364, at note 9, 663 A2d 148, at note 9 (1995).

⁷ *R.M. Boe*, CA-9, 62-2 USTC ¶9699, 307 F2d 339, *aff'g*, 35 TC 720, Dec. 24,641 (1961).

⁸ *C.D. Canterbury*, 99 TC 223, Dec. 48,420 (1992); *Houston Chronicle Publishing Co.*, CA-5, 73-2 USTC ¶9537, 481 F2d 1240; *M.L. Killian*, CA-5, 63-1 USTC ¶9347, 314 F2d 852, 855.

⁹ *Red Wing Malting Co. v. Willcuts*, CA-8, 15 F2d 626, SCt, *cert. denied*, 273 US 763.

¹⁰ *Beasley v. Beasley*, 359 Pa. Super. 20, 518 A.2d 545 (Pa. Super. 1986); *Fexa v. Fexa*, 396 Pa. Super. 481, 578 A.2d 1314 (Pa. Super 1990); and *Solomon supra* note 4.

¹¹ *In re Paolino*, 1991 Bankr. Lexis 2203, BANKR. L. REP. (CCH) ¶73,883 (US Bankr. Ct. ED PA 1991).

¹² *In re Thomas*, 246 BR 500, BANKR. L. REP. (CCH) ¶78,144 (US Bankr. Ct. ED PA 2000).

¹³ *Gaydos v. Gaydos*, 693 A2d 1368 (Pa. Super. 1997).

¹⁴ *DeMasi v. DeMasi*, 366 Pa. Super. 19, 530

A2d 871 (1987).

¹⁵ *McCabe v. McCabe*, 525 Pa. 25, 575 A2d 87 (1990).

¹⁶ *Butler v. Butler*, 541 Pa. 364, 663 A2d 148 (1995).

¹⁷ *Spaulding v. Benenati*, 57 NY2d 418, 442 NE2d 1244, 456 NYS2d 733 (1982).

¹⁸ *Baker v. Baker*, 2004 Pa. Super 413, 861 A.2d 298 (2004).

¹⁹ *In re Marriage of Nichols*, 42 Colo. App. 383, 606 P2d 1314 (1979).

²⁰ *Richmond v. Richmond*, 779 P2d 1211 (1989).

²¹ *In re Marriage of Lopez*, 38 Cal. App. 3d 93, 113 Cal Rptr. 58, 68 (1974).

²² 11 U.S.C.S. §§541, 542.

²³ *In re Prince*, *supra* note 3.

²⁴ *In re Schultz*, 250 BR 22, 2000 Bankr. Lexis 649, BANKR. L. REP. (CCH) ¶78,207 (2000).

²⁵ *In re Thomas*, 246 BR 500, 2000 U.S. Dist. Lexis 3706, BANKR. L. REP. (CCH) ¶78,144 (2000).

²⁶ *In re Thomas* quoting *In re Prince*, *supra* note 3, at 85 F3d 319.

²⁷ *In re Rives*, 130 Cal. App. 3d 138, 181 CAL. RPTR. 572 (1982).

²⁸ *In re Hargrave*, 163 Ca. App. 3d 346, 209 CAL. RPTR. 764 (1985).

²⁹ *In re Paolino*, *supra* note 11.

³⁰ It can never be transferred independent of the underlying business, but at least one court has held that it may be leased and the payment received accounted for as ordinary income. *International Multifoods Corp.*, 108 TC 25,

Dec. 52,100 (1997); *Metropolitan Bank v. St. Louis Dispatch Co.*, SCt, 149 US 436 (1893); *Grace Bros., Inc.*, CA-9, 49-1 USTC ¶9181, 173 F2d 170; *Chatsworth Stations, Inc.*, CA-2, 60-2 USTC ¶9627, 282 F2d 132, *rev'g & rem'g*, 20 TC 1150, Dec. 22,896 (1958).

³¹ Code Secs. 197 and 1060; Reg. §1.338-6(b).

³² *C.W. Ward*, 87 TC 78, 101, Dec. 43,178 (1986).

³³ *J. Hall Est.*, 92 TC 312, 335, Dec. 45,484 (1989).

³⁴ *Ushco Mfg. Co.*, CA-2, 45-2 USTC ¶9434; 151 F2d 821; *Nat'l Grocery Co.*, SCt, 38-2 USTC ¶9312, 304 US 282.

³⁵ Rev. Proc 59-60, 1959-1 CB 237, at §4.02(f). In at least one case it has been said that a business that has experienced multiple years of losses presumptively does not have goodwill. *Fox River Paper Corp.*, DC-WI, 46-2 USTC ¶9321, 65 FSupp 605, *aff'd*, CA-7, 48-1 USTC ¶9149, 165 F2d 639.

³⁶ At least one instance overlooked the agreed-upon price and chose to apply a liquidation value based upon expert testimony. *Continental Grain Co.*, 56 TCM 900, Dec. 45,229(M), TC Memo. 1988-577.

³⁷ *H.H. Spitzer*, CA-8, 46-1 USTC ¶10,258, 153 F2d 967; *compare H.K. McCann*, CA-2, 45-1 USTC ¶10,160, 146 F2d 385.

³⁸ *H.A. True, Jr., Est.*, CA-10, 2004-2 USTC ¶60,495, 390 F3d 1210.

³⁹ Reg. §1.338-6; Code Sec. 1060(a); CONF. REPT. No. 99-841, at 208.

⁴⁰ *F. Harvey*, 11 TCM 773, Dec. 19,120(M).

ENDNOTES

- ⁴¹ Revenue Reconciliation Act of 1993 (P.L. 103-66):
The practice of his or her profession by a doctor, dentist, lawyer, architect, or accountant will not, as such, be treated as a trade or business in which capital is material income-producing factor even though the practitioner may have a substantial capital investment in professional equipment or in the physical plant constituting the office from which such individual conducts his or her practice so long as such capital investment is merely incidental to such professional practice.
- ⁴² Revenue Reconciliation Act of 1993, COM. REPT. ¶ 7361.
- ⁴³ *W. Norwalk*, 76 TCM 208, Dec. 52,817(M), TC Memo. 1998-279.
- ⁴⁴ Code Sec. 336(a).
- ⁴⁵ Code Sec. 331(a).
- ⁴⁶ Code Sec. 1245.
- ⁴⁷ *H.M. LaRue*, 37 TC 39, 44, Dec. 25,078 (1961).
- ⁴⁸ *C.S. Schilbach*, 62 TCM 1201, Dec. 47,733(M), TC Memo. 1991-556.
- ⁴⁹ *LaRue*, *supra* note 47.
- ⁵⁰ *M.P. Brooks*, 36 TC 1128; 1961, Dec. 25,046 (1961).
- ⁵¹ Rev. Rul. 59-60, 1959-1 CB 237.
- ⁵² *Harvey*, *supra* note 40.
- ⁵³ Code Sec. 2031(a); Reg. §20.2031-1(b).
- ⁵⁴ Reg. §20.2031-2(f); Reg. §25.2512-2(f).
- ⁵⁵ *Danley v. Deal*, DC-AL, 54-1 USTC ¶10,936; *E.S. Donehoo, Exr.*, DC-PA, 68-1 USTC ¶12,519; *W.P. Blodgett, Exr.*, 18 BTA 1050, Dec. 5805 (1930); *A. Mandel*, DC-NY, 57-1 USTC ¶9668, 11,688, *rev'd and rem'd*, CA-2, 59-1 USTC ¶9443, 266 F2d 321.
- ⁵⁶ *E.P. Grimes, et. al.*, 13 TCM 1119, Dec. 20,707(M), TC Memo. 1954-219; *R.T. Barber*, 22 TCM 1025, Dec. 26,241(M), TC Memo. 1963-206.
- ⁵⁷ *H.J. Knott*, 55 TCM 424, Dec. 44,653(M), TC Memo. 1988-120.

Appendix

Take the Test: Does Your Business Have Enterprise Goodwill or Professional Goodwill?

- **Identity as an association.** Drive by the office building and look for outdoor signs promoting the business. Do you see the name of an individual or a company name? Is this a practice that promotes itself under a name like “Health Center” or “Accounting by the Numbers?” Check the name on the lobby or door registry, look in the telephone book, examine the stationery and other printed business records: What is the public identity for this enterprise?
- **Interchangeability of tasks among practicing professionals.** Do the professionals share clients or patients? To what extent are many performed tasks interchangeable? Is this a general practice or does the individual have a unique expertise or talent that attracts individuals? On the other hand, do the professionals work often as a team, sharing clients where their strengths can provide the better service?
- **Referrals and source of client base.** The source of a client base may be varied coming from drive-bys, client referrals, the yellow pages and insurance company referrals and other profession-
- als. The more anonymous the source of referrals, the more likely the value of this business includes a goodwill component that exists regardless of the professional performing the service.
- **Specific Location/ start-up versus long-standing business.** Does the practice enjoy a prime location with the potential for easy walk-in clients? Is there onsite parking and a variety of early, late and weekend hours? Would a potential purchaser of the business be most interested in retaining the location, and does the site require specialized rehabilitation such as specialized plumbing, fixtures and other equipment? Is this a business that is easily transported elsewhere without large start-up costs? The attractiveness of this business may be the fact that it has longevity at its site with a large existing client base with contacts in the area and elsewhere for referrals.
- **Uniqueness of talent.** Are the services provided unique in the professional community? While we all believe we are irreplaceable, the truth may be something else.
- **Realizeable/sale value.** Given the location, client base, modern equipped offices and ongoing business contacts, would the enterprise compel a sale value beyond that of its assets and receivables? That ultimately is the question.

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