Regulation of physician and dental practices is undergoing a sea change as the health care industry adapts to the new health care reform law. These practices are being buffeted by developments related to payments, electronic records requirements, and anti-kickback and Stark regulations, and continuing challenges by the IRS to compensation practices. Industry trends are also challenging physicians and dentists with the rise of ACOs and general consolidation, including sales of practices to hospitals. This program will provide you with a practical guide to legal developments impacting physician and dental practices, including health care reform, electronic records, compensation practices, sales of practices, anti-kickback and Stark rules, and much more.

**Day 1 – September 24, 2013:**

- Impact of new health care reform law on physician practices
- Update on electronic records and Accountable Care Organizations (ACOs)
- Fringe benefit changes under health care reform, including insurance, HRAs/MERPs
- Physician and dental practice valuation and sales, including sales to hospitals
- Developments in sales of personal goodwill

**Day 2 – September 25, 2013:**

- Update on the Stark anti-kickback rules and other regulatory developments
- Trends in organizing professional practices – regulatory and financial considerations
- Physician and dentist compensation issues, including “unreasonable compensation” developments and the impact of Section 409A
- Trends in drafting physician employment and buyout agreements

**Speakers:**

**James Egleston** is a partner in the Cleveland office of Waldheger Coyne, LPA, where he has a national practice representing physician practices, ambulatory surgery centers, and hospitals. His substantive experience includes a broad range of federal and state laws related to physician and dental practices, including the anti-kickback Law, the Stark Law, antitrust law, the myriad of billing rules and regulations as well as general business and tax planning and representation. Mr. Egleston earned his B.S. and M.S. from Akron College and his J.D., with distinction, from Ohio Northern University.

**Alson R. Martin** is a partner in the Overland Park, Kansas office of Lathrop and Gage, LLP, where he has a national practice focusing on business law, taxation, health care, and retirement plans. He is a Fellow of the American College of Tax Counsel and the American College of Employee Benefits Counsel. Mr. Martin is the author of "Limited Liability Companies and Partnerships" and the co-author of "Kansas Corporation Law & Practice (Including Tax
Aspects)." He is the president and a director of the Small Business Council of America. Mr. Martin received his B.A., with highest distinction, from the University of Kansas, and his J.D. and LL.M. from New York University School of Law.
VT Bar Association Continuing Legal Education Registration Form

Please complete all of the requested information and fax or email with credit card info or mail it with payment to: Vermont Bar Association, PO Box 100, Montpelier, VT 05601-0100. Fax: (802) 223-1573. PLEASE USE ONE REGISTRATION FORM PER PERSON.

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2013 Update on Advising Physician and Dental Practices, Part 1
Teleseminar
September 24, 2013
1:00PM - 2:00PM
1.0 GENERAL MCLE CREDIT

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2013 Update on Advising Physician and Dental Practices, Part 2
Teleseminar
September 25, 2013
1:00PM – 2:00PM
1.0 GENERAL MCLE CREDIT

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Sponsor: Vermont Bar Association

Date: September 25, 2013

Seminar Title: 2013 Update on Advising Physician and Dental Practices, Part 2

Location: Teleseminar

Credits: 1.0 General MCLE Credit

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PROFESSIONAL EDUCATION BROADCAST NETWORK

Speaker Contact Information

2013 UPDATE ON ADVISING PHYSICIAN AND DENTAL PRACTICES, PART 1 & PART 2

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Healthcare Reform Changes For Fringe Benefits

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I. HRAs/MERPs - 2014 PHSA § 2711 Prohibition On Annual/Lifetime Dollar Limits; 4 Exceptions.

PHSA § 2711, effective in 2014, prohibits annual and lifetime dollar limits by group health plans on essential health benefits by group health plans and individual insurance policies, including grandfathered plans and policies.¹ Annual or lifetime dollar limits can be imposed on benefits that are not essential health benefits.² Healthcare reform also adds new ERISA § 715 and new Code § 9815, which impose the PHSA mandates not only on group health plans but also on health insurance issuers. The penalty for violating PHSA § 2711 is an excise tax under IRC § 4980D of $100 per day ($36,500 per year) per affected individual (per participant) for violating the Chapter 100 requirements, including IRC § 9815, which incorporates the PHSA mandates.

Group Health Plan. ERISA and the PHSA define “group health plan” in virtually identical language, providing that the term means an employee welfare benefit plan to the extent that the plan provides medical care (including items and services paid for as medical care) to employees or their dependents directly or through insurance, reimbursement, or otherwise.³

HRA/MERP. IRS guidance specifically confirms that generally health reimbursement accounts (“HRAs”) and their close cousin, medical expense reimbursement accounts (“MERPs”), both of which are funded with employer contributions, are generally group health plans.⁴ Group health plans generally are subject to the PHSA § 2711 prohibition on annual/lifetime dollar limits in 2014 and thereafter. However, five types of HRAs and MERPs are exempt from PHSA and can continue in 2014 and thereafter:

- A stand alone HRA or MERP with no annual or lifetime dollar limits (a very risky thing from the employer’s point of view).
- A stand-alone HRA that is limited to one employee or retirees is not subject to the PHSA § 2711 annual/lifetime dollar limit restrictions.⁵ Such HRAs are not group health plans under ERISA § 607(1) because they are not employee welfare benefit plans.
- A plan is not an ERISA welfare benefit plan if it covers only individuals who own, or whose spouses own, an interest in an unincorporated business (as partner or proprietor) is not a plan subject to federal regulation, but ERISA does apply if one or more common

¹ PHSA § 2711(a)(1).
² PHSA § 2711(b).
³ ERISA § 733(a)(1); PHSA § 2791(a)(1). Under ERISA, group health plans are welfare benefit plans.
⁵ Preamble to TD 9491, 6/22/2010.
law employees is a participant.\textsuperscript{6} If a corporation is wholly owned by an individual (or by an individual and his or her spouse), a plan that does not cover any other employee is also exempt from ERISA.\textsuperscript{7} Accordingly, the incorporation of a sole proprietorship does not affect ERISA's coverage but the incorporation of a partnership usually does because there will be shareholders who are not spouses of one another.

- HRAs that are or provide for excepted benefits (vision and dental coverage) should also be exempt from the annual/lifetime dollar limit prohibition.\textsuperscript{8} The regulators have confirmed that the HIPAA excepted benefits provisions apply for the PHSA mandates, including those in the PHSA itself (applicable to insurers and governmental employers) and as incorporated into ERISA and the Code.\textsuperscript{9}

- Finally, HRAs that are integrated with other major medical coverage as part of a group health plan will not violate the annual limit rules so long as the other coverage on its own would comply “because the combined benefit satisfies the requirements.”\textsuperscript{10} While there is no clear definition of “integration” for this purpose, all individuals covered under the HRA must also be covered by the major medical coverage to be integrated.\textsuperscript{11}

Stand-alone HRAs/MERPs that do not satisfy the definition of “integrated” cannot continue beyond 2014 unless they are limited to excepted benefits, have no annual or lifetime dollar limit (which could expose an employer to substantial, perhaps devastating, liability), or otherwise exempt from the PHSA mandates. The agencies have provided limited transition relief for HRAs in existence prior to January 1, 2013 for amounts accrued prior to January 1, 2014. To qualify for the transition relief, the accrued amounts must be made pursuant to a formula established prior to January 1, 2013, or, if there is no formula, must be less than the amounts accrued in 2012.\textsuperscript{12}

There is very little guidance on what “integrated” means. “The Departments intend to issue guidance under PHS Act section 2711 providing that an employer-sponsored HRA may be treated as integrated with other coverage only if the employee receiving the HRA is actually enrolled in that coverage.”\textsuperscript{13} It is clear that employees must be participants in both plans for the

\textsuperscript{6} 29 C.F.R. § 2510.3-3(b), (c) (1997). To trigger ERISA the program must cover a common law employee who is not an owner's spouse.

\textsuperscript{7} Id. This rule applies even if the shareholder or spouse is also a common law employee of the corporation. It does not extend to cases where the corporation is closely held but not wholly owned by an individual or a married couple.

\textsuperscript{8} To be excepted benefits, limited-scope dental or vision benefits must be provided either under a separate policy, certificate, or contract of insurance, a condition generally not met by an HRA or must satisfy the conditions necessary for the benefits to be considered “not an integral part” of the employer's other group health plan(s).

\textsuperscript{9} Preamble to Grandfathered Health Plan Regulations, 75 Fed. Reg. 34537, 34539 (June 17, 2010) (confirming that the exceptions in the Code and ERISA still exist, and announcing an HHS nonenforcement policy with respect to the PHSA provisions); FAQs About the Affordable Care Act Implementation Part II, Q/A-6.

\textsuperscript{10} Preamble to Interim Final Rules Relating to Preexisting Condition Exclusions, Lifetime and Annual Limits, Rescissions, and Patient Protections Under PPACA, 75 Fed. Reg. 37188, 37190 (June 28, 2010).

\textsuperscript{11} Fees on Health Insurance Policies and Self-Insured Plans for the Patient-Centered Outcomes Research Trust Fund, 26 CFR Parts 40, 46, and 602, 77 Fed. Reg. 72721, 72725 (Dec. 6, 2012) (addressing an HRA combined with “a separate applicable self-insured health plan” or a separate fully insured plan, in context of determining amount of PCORI fee); and FAQs About the Affordable Care Act Implementation Part XI, Q/A-3 at http://www.dol.gov/ebsa/faqs/faq-aca11.html, stating: “Any HRA that credits additional amounts to an individual when the individual is not enrolled in primary coverage meeting the requirements of PHS Act section 2711 provided by the employer will fail to comply with PHS Act section 2711.”

\textsuperscript{12} See FAQs About the Affordable Care Act Implementation Part XI, Q/A-3

\textsuperscript{13} DOL FAQ Part IX, Q&A-3.
plans to be integrated. However, it is not clear whether an HRA or MERP could cover additional benefits not covered by the employer’s group health plan, such as vision or dental benefits when those are not covered by the employer’s main major medical plan. It seems likely that guidance will limit the reimbursement to the types of coverage provided by the major medical plan but which is not paid due to coinsurance, copay, or deductible provisions.

II. 2013 Fiscal Year Cafeteria Plan Elections To Purchase Health Insurance Can Be Changed Mid-Year To Purchase Insurance On Exchange Or In Plan For Plan Year Beginning In 2013.

If the plan is amended, fiscal year cafeteria plan elections to purchase health insurance can be changed mid-year to purchase insurance on exchange or in plan for plan year beginning in 2013 despite the fact that this is not a change in status, which is a normal prerequisite to change a cafeteria plan election. Employees may want to terminate their election to purchase health insurance through the employer’s cafeteria plan and go to the exchange if they eligible for health insurance exchange tax credits. Other employees may want to elect to purchase health insurance from the employer plan effective Jan. 1, 2014 to avoid the individual mandate penalty. If the cafeteria plan year is a fiscal year, employees wanting exchange insurance on Jan. 1, 2014 would have to terminate or change their elections mid-year. However, under current cafeteria plan regulations, these two elections are not a change in status allowing an election change mid-year. The proposed regulations allow an applicable large employer with a fiscal year cafeteria plan, at its election, to amend the plan any time during the year on a retroactive basis (by Dec. 31, 2014, retroactive to beginning of 2013 plan year) to permit either or both of the following changes in salary reduction elections:

1. An employee who elected to salary reduce through the fiscal year cafeteria plan for accident and health plan coverage beginning in 2013 is allowed to prospectively revoke or change his or her election with respect to the accident and health plan once, during that plan year, without regard to whether the employee experienced a change in status event described in Reg. § 1.125-4; and

2. An employee who failed to make a salary reduction election through his or her employer's fiscal year cafeteria plan beginning in 2013 for accident and health plan coverage before the deadline in proposed § 1.125-2 for making elections is allowed to make a prospective salary reduction election for accident and health coverage on or after the first day of the 2013 plan year of the cafeteria plan without regard to whether the employee experienced a change in status event described in Reg. § 1.125-4.

Some provisions of the transition relief refer to “applicable large employer members” (i.e., employers that are subject to healthcare reform’s employer mandate), raising questions as to whether the relief is available for all non-calendar-year cafeteria plans or only those that are sponsored by applicable large employer members.

III. Health Flexible Spending Account (FSA) Limited to $2,500 Per Year.

Applies to plan years beginning on and after January 1, 2013. Amend cafeteria plan (FSA) plan document if different limit applied in past. Consider whether $2500 limit automatically increases when IRS approves COLA or to adopt fixed amount and amend in the future. This dollar limit does not apply to dependent care FSAs nor to health insurance premium conversion options in a cafeteria plan. The health FSA limit applies employer by employer and each spouse may have their own $2500 limit.

IV. Employer Exchange Notice Due To Employees By October 1, 2013 & New Hires Thereafter; Sample Notice.

Fair Labor Standards Act (FLSA) § 18B requires that employers subject to the FLSA provide a notice to employees by October 1, 2013 and new hires thereafter. Most firms under $500,000 in annual dollars received from “sales made or business done” are exempt from the FLSA and thus exempt from the notice requirement other than those specifically included regardless of annual income, which are hospitals; institutions primarily engaged in the care of the sick, aged, mentally ill, or disabled who reside on the premises; schools for children who are mentally or physically disabled or gifted; preschools, elementary and secondary schools, and institutions of higher education; and federal, state, and local government agencies.

In addition, only employers with $500,000 more in annual dollars received from “sales made or business done” who are also engaged in interstate commerce are subject to the FLSA. Examples of engaging in interstate commerce include:

- An employee uses a telephone, facsimile machine, the U.S. mail, or a computer e-mail system to communicate with persons in another state for the business;
- An employee who drives or flies to another state while performing his or her job duties;
- The business uses goods from an out of state supplier; or
- The business uses an electronic device that authorizes a credit/debit card purchase.

The model DOL Exchange Notice for employers with a health plan is located at http://www.dol.gov/ebsa/pdf/FLSAwithplans.pdf. For employers with no health plan, the model notice is at http://www.dol.gov/ebsa/pdf/FLSAwithoutplans.pdf. Part B on the notice for employers with health plans is optional and complicated and many employers with health plans will not use it, preferring instead to customize the information on the Part B notice for employers with no health plans.

A simplified Sample Notice is attached below.

State Health Insurance Marketplace (Exchange) Health Insurance Coverage Options & Your Health Plan Coverage

PART A: General Information. When key parts of the health care reform law take effect in 2014, there will be a new way to buy health insurance - the Health Insurance Marketplace or Exchange that will exist in every state. To assist you evaluate options for you and your family, this notice provides basic information about the new state Marketplaces (Exchanges).

What is the Health Insurance Marketplace (Exchange)? Each state’s Marketplace (Exchange) is designed to help you find health insurance that meets your needs and fits your budget. The
Marketplace (Exchange) offers "one-stop shopping" to find and compare private health insurance options. You may also be eligible for a new kind of federal tax credit that lowers your monthly premium. Open enrollment for health insurance coverage through the Marketplace (Exchange) begins in October 2013 for coverage starting as early as January 1, 2014.

**Can I Save Money on my Health Insurance Premiums in the Marketplace (Exchange)?** You may qualify to save money and lower your monthly premium, but only if your employer does not offer coverage, or offers coverage that doesn't meet certain standards. The savings on your premium for which you may be eligible depends on your household income.

**Does Employer Health Coverage Affect Eligibility for Premium Savings through the Marketplace (Exchange)?** Yes. If you have an offer of health coverage from your employer that meets certain standards, you will not be eligible for a tax credit through the Marketplace (Exchange) and may therefore wish to enroll in your employer's health plan. However, you may be eligible for a federal income tax credit that lowers your monthly health insurance premium if your employer does not offer health plan coverage to you or does not offer coverage that meets affordability and minimum value standards. If the cost of a plan from your employer that would cover you (but not any other members of your family) is more than 9.5% of your household income for the year, or if the coverage your employer provides does not meet the "minimum value" standard set by the Affordable Care Act, you may be eligible for a tax credit.

**Note:** If you purchase a health plan through the Marketplace (Exchange) instead of accepting health coverage offered by your employer, then you may lose the employer contribution (if any) to any employer-offered coverage. Also, this employer contribution -as well as your employee contribution to employer-offered coverage- is generally excluded from income that is taxed for Federal and State purposes. Your payments for coverage through the Marketplace (Exchange) are made on an after-tax basis.

**How Can I Get More Information?** The Marketplace (Exchange) can help you evaluate your coverage options, including your eligibility for coverage through the Marketplace (Exchange) and its cost. Please visit [https://www.healthcare.gov](https://www.healthcare.gov) on the internet for more information, including an online application for health insurance coverage and contact information for a Health Insurance Marketplace (Exchange) in your state. There will also be “Navigators” who are person trained to help you use your exchange.

**PART B: Information About Your Employer.** If you decide to complete an application for health insurance in your state Marketplace (Exchange), you will be asked to provide this information below. *This information is numbered to correspond to the Marketplace (Exchange) health insurance application.*

3. Employer name _________________________________
4. Employer Identification Number (EIN)_______________
5. Employer address
6. Employer phone number
7. Employer’s City
8. Employer’s State
9. Employer’s ZIP code
10. Who can we contact at your job about information about the employer’s health plan, if any?
11. Phone number of employer contact person listed in #10 above (if different from above)
12. Email address of person listed in #10 above.
PHYSICIAN PRACTICE SALES TO HOSPITALS

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Reasons For Their Occurrence From Physicians’ Perspective.

Difficulty In Recruiting. Allows hospital to pay recruitment cost and subsidize new physicians during start-up phase.

Cost Of Equipment. Allows hospital to purchase expensive equipment.

Physical Plant. Allows hospital to bear costs to develop specialty centers, such as musculatal-skeletal center for orthopaedic surgeons, physical therapy, MRI, physiatrists, etc.

Running Scared. Some physicians are afraid that they’ll get left behind in health reforms emphasis on bundled payments and accountable care organizations.

Private Practice Compensation Less Than Employed Physician Compensation.

Stark Law Considerations.

The sale of practice safe harbor provides protection to a physician acquiring another physician’s practice if the sale is completed within one year and, after the sale, the selling physician will not be in a position to make referrals to the acquiring physician. The safe harbor also allows transactions involving a hospital’s purchase of a physician practice located in an HPSA as part of a practitioner recruitment program.

Pursuant to Stark, a physician may not make a referral to an entity for the furnishing of certain “designated health services” (“DHS”) if payment will be made by the Medicare or Medicaid program and the physician has a direct or indirect financial relationship with the entity. Direct and indirect financial relationships include both investment interests and compensation relationships. Indirect relationships may be found to exist between a physician and an entity furnishing the DHS if there is an unbroken chain of any number of persons or entities having financial relationships between them.

A practice sale will create a direct financial relationship. Thus, if DHS are being provided by the selling practice, the arrangement for the sale of a medical practice must comply with Stark. Unlike the Anti-Kickback Statute safe harbors, an arrangement is prohibited by Stark unless it fits within the applicable exception. The Stark law contains an exception for "isolated transactions," which encompasses the sale of a physician practice.
To satisfy the Stark isolated transaction exception, the arrangement must satisfy all of the following:

(i) the amount of remuneration must be consistent with fair market value; and
(ii) the amount of remuneration must not be determined in a manner that takes into account the volume or value of any referrals by the selling physician, another physician, or between the parties.
(iii) If payment is for more than six months, the note must be negotiable to come within the "isolated financial transaction" exception to the Stark Law in 411.357(f).
(iv) the amount of remuneration that is being provided under the agreement will be commercially reasonable even if the physician makes no referrals; and
(v) there are no additional transactions between the parties for six months after the isolated transaction, except for transactions that are specifically accepted under another provision of the Stark rules.

The Stark isolated transactions exception requires that the remuneration is not determined in a manner that takes into account volume or value of referrals or other business between the parties and only allows post closing adjustments that do not directly or indirectly take into account the volume or value of referrals or other business generated between the parties. The proposed financial arrangement (tying purchase price to later business whether or not the later business involves DHS) would not fit the exception, thus referrals of DHS to the hospital would not be permitted.

Anti-Kickback Considerations.

In order to satisfy the elements of the AKS Sale of Practice Safe Harbor, all of the following must be met:

(i) the period of time from the date of the first agreement pertaining to the sale of the physician practice to completion of the sale is not more than one year; and
(ii) the seller of the physician practice will not be in a professional position to refer to the purchaser after one year from the date of the agreement; and
(iii) the purchase price must be equal to fair market value.

Accordingly, to satisfy the Sale of Practice Safe Harbor, the selling physician must either move from the geographic area or retire within one year from the date of the agreement. Therefore, if the selling physician is going to continue to practice in the geographic area or continue to provide services for the acquiring group practice, the Sale of Practice Safe Harbor will not be met.

If the purchase price is tied to the RVUs that the physician produces post closing so that in order to get the higher purchase price, he has to make referrals post closing, that implicates the AKS. If the physician is just required to meet certain RVUs under the
employment agreement and there is no tie to the purchase agreement, the purchase price would not be an issue.

**Goodwill.** The IRS and other sources have commented regarding the value in the purchase price for intangibles. The majority view is that the purchase price should be first allocated to specific hard (tangible) assets. Any amount of the purchase price allocated to intangible assets (i.e., goodwill or covenants not to compete) must be independently justifiable in a manner that makes it clear that such “excess” payments are not being made in return for future referrals by the selling physician.

A widely cited publication regarding this topic was issued by D. McCarty Thornton, Associate General Counsel of the Office of Inspector General (“OIG”) on 12-22-1992 to the IRS. This letter from the OIG to the IRS addresses the potential liability associated with a scenario whereby a physician practice is acquired by a hospital or other entity and the selling physician(s) continues to treat patients and be affiliated (through an employment relationship or otherwise) with the acquiring hospital or entity. The letter appears below. Additionally, the IRS specifically stated that it would subject these types of acquisitions to critical scrutiny because of the ability to disguise payments (for intangibles) to the selling physician for future referrals.

The publication lists the following factors which the government "critically" evaluates when determining whether or not a portion of the sale price is being made for the value of a referral stream:

(i) payment for goodwill;
(ii) payment for value of the ongoing business unit;
(iii) payment for covenants not to compete;
(iv) payment for exclusive dealing arrangement;
(v) payment for patient lists; and
(vi) payment for patient records.

If the selling physician is going to continue to perform services for the acquiring entity and a portion of the purchase price entails intangibles, the transaction will be subject to heightened Anti-Kickback Statute scrutiny. To alleviate this concern, if the purchase price contains a component of intangibles, the parties must be able to objectively justify the value in a manner that makes it clear that the "excess" payments are not being made in return for future referral streams are part of the value of the practice. In practice, this would be done by an unrelated third party appraiser.

**Purchase Price.**

*Varies.* Will be based on appraisal so that payment is fair market value and not payment for referrals. Some valuations are based on value of hard assets only. Some include a goodwill component. Approach varies depending on leverage of parties. Many hospitals refuse to pay for personal or corporate goodwill on the basis that it is a payment for referrals.
However, it seems that some intangibles have value and do not deal with patient referrals. Items that should be able to be valued include:

- Noncompete
- Patient charts (recent sale valued at $100K based on $6/chart)
- Trained assembled staff (recent transaction valued at $100K) for 4 physician practice

One transaction that closed last year valued practice at $1.9 million even though hard assets valued at only $300K using a cost to replicate practice methodology. Goodwill was not mentioned.

**Accounts Receivable.** These can be purchased either for specific dollar amount or based on collections, but closing adjustments must be made after six months under the Stark "isolated transaction" exception. Important for hospital to use practice’s billing system and employees. Hospital less likely to send to collection or sue, so decision on these options should be addressed in contract. Alternatively, practice can collect and pay to physicians.

**Stock Sale; Benefit For Physicians; Tax Problem For Hospital.** If hospital is motivated purchaser, it may be willing to purchase the stock, which will save physicians $.20 or more on purchase price. Again, the payment for accounts receivables will need to be a specific dollar amount or subject to an adjustment within six months. If a stock sale, in most states hospital will not be a qualified shareholder of a PC and PC will need to be converted to general business corporation if permitted by state law.

Whether the physician corporation is a C corporation or an S corporation, it will become a C corporation after the sale because the hospital is not a qualifying S shareholder. Thus, the collection of the accounts receivable by the corporation or the liquidation of the physician corporation by the hospital will produce taxable income to the corporation or the hospital, respectively, even if the hospital is not for profit. The liquidation triggers income tax at the corporation level (the former PC) and again at the shareholder level.

**Installment Payments - Stark Isolated Transaction Exception.** A sale of assets by a physician or physician group may be negotiated in exchange for installment payments as long as (1) the total aggregate payment is set before the first payment is made; (2) the arrangement does not take into account, directly or indirectly, the volume or value of referrals or other business generated by the referring physician; (3) a fair market value interest rate is charged to the purchaser and the terms of the promissory note and ancillary documents are commercially reasonable; and (4) the outstanding balance is either guaranteed by a third party, secured by an appropriate amount of collateral, or is subject to a similar mechanism to assure payment even in the event of default of the purchaser, such as a negotiable promissory note.

**Noncompete.** May be separately paid for or part of employment contract. Physicians should bargain for termination of noncompete upon termination of initial term
of contract to minimize likelihood that hospital will have overwhelming leverage in terms of renewal contract. In some states, a noncompete is not enforceable, or enforceable only under specified circumstances.

**Productivity Payments.** Regardless of compensation method used, physicians can be paid a higher rate (since much overhead is fixed) for production in dollars or RVUs above a specified level each year.

**Signing & Retention Bonuses.** Bonuses can be paid at initial signing of the contract and upon renewal.

**Call Income.** Additional compensation for other functions may make sense, such as for neurosurgeons and orthopaedic surgeons’ trauma call.

**Practice Quality Bonus.** Physicians can be eligible for payment of a yearly bonus of up to but not exceeding specified dollar amount for actively working with hospital for achieving or establishing and implementing written guidelines, specific criteria and duties for a practice quality bonus.

**Research/Education Bonus.** Physicians can be eligible for payment of a yearly bonus for working with hospital for meeting or establishing and implementing written guidelines, criteria and duties for medical research.

**Program Development Bonus.** Physicians can be paid a specified amount for working with hospital to develop a specified program.

**HOPD Compensation Example.** Use the actual numbers from last year and actual types of cases done at the ASC. Now, using hospital outpatient rates (where the ASC is converted into a hospital outpatient department (HOPD), and assuming a maximum payment to the physicians of $360,000 for committee work, it has an NOI of almost $2.7 million. If that were the result in a first-year operation as an HOPD, there would be no bonus to the physicians. However, if the net operating income improves to $3.4 million, then there a potential bonus pool of $65,000. If NOI gets to $6,750,000, then a potential bonus pool of $650,000 is available to be divided among the eligible employed physicians. Once the bonus threshold is reached, 40% of it is eligible to be distributed because that part is based on meeting in net operating income threshold. For the remaining 60% to be distributed, then all of the efficiency indicators, customer satisfaction indicators, and quality indicators must be met. If the NOI is above the 10% threshold, then the amount of the potential bonus is prorated up to the $650,000 maximum amount. The factors comprising the 60% should be set up in such a way that it is almost impossible to meet all of them. In other words, the bonus should be paid for real achievement and not be a gimme.

**Other Issues.**

**Veto Over New Recruits In Specialty.** Physicians will want veto power over the recruitment of new specialists to prevent income dilution and to provide leverage if hospital wants additional physicians in their specialty.
Practice Governance. Physicians may want to bargain for their ability to govern their specialty's call schedule, allocation of compensation within those in their specialty, etc.

Prior Service Credit For Eligibility & Vesting For Benefits.

COBRA. If PC’s employees not immediately eligible for hospital’s health plan, COBRA will become an issue. If the practice is not continuing its plan for any remaining employees, and if the hospital as purchaser is buying the entire practice, it will be a successor employer and have COBRA responsibilities. One non-profit hospital advised me it had no COBRA responsibilities in this situation, but the first case involving the final regs held COBRA successor liability applied to a non-profit entity. *Risteen v. Youth for Understanding, Inc.*., 245 F. Supp. 2d 1 (D.D.C. 2002). Note that if hospital’s plan is self-insured, it cannot offer immediate coverage to physicians and subject staff to waiting period under IRC 105(h).

ASC or HOPD. In addition, contract could require hospital to provide ASC for physicians who are surgeons (or HOPD – Hospital Outpatient Surgery Department) and give physicians power to hire, schedule, and run operations, and perhaps receive a portion of net income as additional miscellaneous income for the ASC or a consulting fee for the HOPD. Amounts that can be billed for same procedures are dramatically higher for HOPD.

Option To Unwind & Repurchase Practice. The contract can give the physicians the option to repurchase their practice, which provides an exit strategy if things do not work out and also increases physician negotiating leverage at time of employment contract renewal.

Purchase Or Lease Of Real Estate. If physicians own their own practice building, they can bargain for hospital to purchase it. Ideally, they can negotiate for hospital lease during their employment contract initial term and the “put” option to sell the building to the hospital at that time. This would give them the ability to resume their private practice in their own building if things do not work out. Ditto with respect to leased space.

Medical Records & HIPAA. Under HIPAA Reg. § 164.502(a)(1)(ii), a covered entity is permitted to use or disclose protected health information for treatment, payment, or health care operations. Under Reg. § 164.501(6)(iv), "health care operations" includes the sale, transfer, merger, or consolidation of all or part of the covered entity with another covered entity, or an entity that following such activity will become a covered entity and due diligence related to such activity.

Other Options

Management Agreements. The deals I've seen between physicians and hospitals have included a Management Company (typically an LLC) formed when more than one service line is involved. Another document is the Co-Management Agreement. This document will usually include the compensation and payment details and can have a bonus payment. The bonus payment usually includes some aspect of payment for
reaching quality measures and may include “gain-sharing” (shared savings) payments, although the latter can only last a year or two. The arrangement may be based on a series of performance and quality metrics.

**Hospital Payment For Other Services.** This can include payments for an exclusive contract, at least for radiologists and other non-referring specialties, payments for call, committee work, or a contract with the group where the physicians remain employed by the group but the hospital does the billing.

**Compensation Methodology For Physicians Employed By Hospitals.**

**Required Referrals To Hospital Employer – OK – 3 Required Exceptions.** Under the Stark regulations, the existence of a bona fide employment relationship allows an employer to require its employed physicians to refer within the health system’s network for services such as hospital care and ancillary tests with three exceptions: the physician may not be required to make referrals to a particular provider, practitioner or supplier if (1) the patient expresses a preference for a different provider, practitioner or supplier; (2) the patient’s insurer determines the provider, practitioner or supplier; or (3) the referral is not in the patient’s best medical interests in the physician’s judgment. Other exceptions could be (4) Hospital-affiliated providers do not offer the needed services, (5) medical emergency requires otherwise, or (6) a referring physician from another system, or such system itself, desires patient referrals back to that system in order to coordinate the patient’s care.

**Minimum Compensation.** Regardless of compensation method used, due to physicians’ lesser control of their practice, they should bargain for this, especially where, after the sale, they will be unable to participate in certain MCOs in which they have patients pre-sale or at competing hospitals they work at pre-sale, or both. Hospital may agree but require RVUs to be equal to prior RVUs less the work for the insurer(s) with which hospital does not have contract.

**Net Collections Less Expenses.** This approach is like private practice model. If physicians in same specialty want same pay, can be applied to all physicians in specialty.

**RVU Compensation & Bonus Provisions.** Resource-Based Relative Value Scale (RBRVS) is the basis for the Medicare physician fee schedule. The Centers for Medicare & Medicaid Services (CMS) put the RBRVS into place in 1992. This has become commonplace.

If physicians in same specialty want the same pay, the formula can be applied to all physicians in the specialty. **Negotiation of the multiplier is critically important.** Often reference made to regional physician compensation in MGMA or other surveys, and percentile is based generally on physicians past practice production. That data is often used to determine the dollar multiplier, the conversion factor. A Hospital may need to help physicians determine their RVU numbers based on historical production. RVU compensation is not affected by payor mix or collections. Thus, it is advantageous for areas with large numbers of uninsured and Medicaid patients.
Where collected revenue-based systems—historically common in group practice, for example—reflect the individual physician’s underlying payor mix, RVU systems are payor-mix neutral. A RVU system is therefore attractive to a physician employed by a hospital that treats patients regardless of their ability to pay. However, RVU systems may be tainted by payor mix and other market conditions, requiring that the analyst understand and examine the effects of this issue when using compensation survey data to establish fair market value incentive compensation based on RVUs.
Sale Of A Business Or Practice &
Sale Of Personal Goodwill

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Table Of Contents

I. TYPES OF GOODWILL FOR INCOME TAX PURPOSES ........................................... 1
   A. Goodwill Defined ................................................................................................... 1
   B. Types of Goodwill ................................................................................................. 3
   C. Professional Service Organizations Versus Commercial Businesses ............... 3
   D. Relevance Of Goodwill Decisions Outside The Income Tax Context ............. 4
   E. Goodwill & Partnerships ....................................................................................... 6

II. EXISTENCE AND VALUE OF PERSONAL GOODWILL ........................................... 6
   A. When Relevant ....................................................................................................... 6
   B. Early Tax Cases Recognizing Personal Goodwill ............................................. 7
   C. More Recent Cases: Martin Ice Cream & Norwalk .......................................... 9
   D. IRS Recognizes Personal Goodwill & Also Allows Partial Transfer .............. 15

III. TAX RULES, PLANNING OPPORTUNITIES, & PITFALLS ..................................... 16
   A. Sale Of Personal Goodwill ................................................................................... 16
   B. Must Personal Goodwill Allocation Be Proportionate To Equity Ownership? ........... 23
   C. Form 8594; Reporting Issues ............................................................................... 24
   D. Is Consistency Of Values Required For Assets Within A Class? ...................... 26
   E. Relation To Noncompete Agreements ................................................................... 28
   F. Taxpayer's Ability To Re characterize Noncompete & Severance Payments As Payments For Personal Goodwill .................................................. 37
   G. Appraisal .............................................................................................................. 40
   H. How To Transfer Personal Goodwill To The Buyer In Business Asset Sale ...... 41
   I. Does IRC § 1239 Convert Capital Gain To Ordinary Income On Sale Of Self-Created Goodwill To Related Party? .................................................. 43
   J. Is 1031 An Option For A Professional Selling One Practice & Purchasing Another? ........................................................................................................ 44

IV. BUYER AMORTIZATION OF GOODWILL; ANTI-CHURNING & ANTI-ABUSE RULES .......................................................... 45
   A. Personal Goodwill: Amortization By Buyer; Anti-Churning Rules ................. 45
   B. Exceptions To The Anti-Churning Rule .............................................................. 52
   C. Expense Sharing Arrangement As A Solution To Anti-Churning Rules In Partial Practice Sale .................................................................................. 54

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D. Anti-Abuse Rules........................................................................................................... 54
E. Getting The Buyer The Deduction.................................................................................. 55
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.

Prior to 1986, there was little guidance concerning purchase price allocations in business acquisitions. Code § 1060 was enacted in 1986. The regulations concerning asset sale allocations reference section 197. See Reg. § 1.1060(b)(1). The purchase price allocation method employed by 1060 is a residual method whereby any premium paid in excess of the total fair market value of the purchased assets is treated as a payment for goodwill or going concern value. The preamble to the 1988 proposed regulations under 1060 provides: "The principles of section 1060 apply to any transfer of an interest in a partnership to which section 743(b) or section 732(d) applies, but only for the purpose of determining the amount of the transferee partner's basis adjustment that must be allocated to goodwill and going concern value (hereinafter referred to as “goodwill”) under section 755." Perhaps this comment reflects a view that goodwill and going concern value are synonymous, at least for all purposes of Subchapter K partnership taxation.
There is some support for treating going concern value as a separate intangible asset from goodwill. See Taylor, Professional Partner Expulsion: The Effects of RUPA and Section 736, Business Entities (May/Jun 2007). Prior to 1986, some courts distinguished the terms goodwill and going concern value. E.G., VGS Corp. v. CIR, 68 TC 563 (1977). Concord Control, Inc. v. CIR, TC Memo 1976-301, aff’d 615 F.2d 1153 (6th Cir. 1980). noted four elements that contribute to going concern value: (1) earning money, (2) a trained staff of employees, (3) a product line presently ready for sale, and (4) equipment ready for immediate use. However, accounting literature provides that goodwill and going concern value are largely interchangeable terms. See Business Combinations, Statement of Financial Accounting Standard No. 141, ¶102.

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. Schweihis, 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. Schweihis, 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. Schweis, *Valuing Small Businesses & Professional Practices*, p. 585 (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. Schweis, *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, Schweihls, 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.*, 2010-2 USTC ¶50,042, 106 AFTR 2d ¶ 2010-5140 (E.D. WA. 7/30/2010), aff'd 108 AFTR 2d ¶ 2011-5226 (9th Cir. Aug. 29, 2011)(unpublished) where the district court followed federal tax law and not the state divorce law that was argued by the taxpayer.

Over the years, there has been a great deal of debate within the business valuation and legal professions with respect to the treatment of personal goodwill in divorce. From state to state, there is no consensus as to the proper treatment of personal goodwill in divorce.
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. 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.

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
E. Goodwill & Partnerships.

In a service partnership, for income tax purposes under § 736, for any part of the payment to be goodwill, the agreement must so state and state how much of the payment is for goodwill. Otherwise, the entire 736 payment will be ordinary income. A second issue exists for LLCs. If a service business is taxed as a partnership, do the service partnership rules apply? While there is no authority on point, there are rulings in analogous areas applying partnership tax concepts to LLCs and LLPs. It seems the better answer is that 736 applies to those LLCs taxed as partnerships despite the fact that under state law, LLCs have members, not partners.

A question exists whether a payment for "going concern value," made pursuant to a partnership agreement or redemption agreement, is considered a payment "with respect to good will" under Section 736(b)(2)(B). It is not clear. Below is a summary of the issues at stake:

- If going concern value is synonymous with goodwill for purposes of Section 736(b)(2)(B), the partner's buyout payment should be taxed at capital gain rates.
- If going concern value is not synonymous with goodwill for purposes of Section 736(b)(2)(B), the tax consequences to the retiring partner will depend on whether going concern value constitutes a separate type of intangible partnership property for purposes of Section 736(b)(1).
- If going concern value constitutes a separate type of intangible partnership property apart from goodwill, a partner's buyout payment should be taxed at capital gain rates.
- If going concern value is not synonymous with goodwill and is not considered a separate type of intangible partnership property, the expelled partner's buyout payment should be taxed as ordinary income under Section 736(a).

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 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.  

2 In the event such a payment is treated as subject to Section 736(a), a determination must be made as to whether it is properly treated as a distributive share of the partnership income under Section 736(a)(1) or a guaranteed payment under Section 736(a)(2). In the context of a professional partnership, each type will likely be treated the same way (ordinary income).
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, acquaintance, 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 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. *Martin Ice Cream*. 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. *Norwalk.* Norwalk v. CIR, TC Memo 1998-279 involved the liquidation of a 2-shareholder accounting corporation DeMart & 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 DeMart and Norwalk in 1985. The business of the corporation was the practice of public accounting. At all times, DeMart and Norwalk were its only shareholders.

In 1985, DeMart 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 DeMart 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, DeMart 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 or 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
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.

3. **Sole Shareholder's Personal Goodwill Was not Corporate Asset Taken Into Account On Sale Of Business; Compensation Post Sale Not Part Of Sale Price.**

*H&M, Inc. v. CIR*, TC Memo 2012-290 ruled that where a corporation sold its insurance brokerage business and its sole shareholder, Schmeets, was employed by the buyer, the compensation under the employment agreement was not a disguised purchase price payment to the selling corporation for goodwill. The Court agreed that the payments were not simply the fair market value of his services. Schmeets not only brought his personal goodwill to the bank, he also signed a noncompete provision. However, Schmeets' individual tax liability was not before the Court, so it did not address the allocation between what he was paid for Schmeets' services to the agency, his personal goodwill, and his promise not to compete.

In reaching this conclusion, the Court determined that the shareholder's personal ability and other individualistic qualities was not a corporate asset (goodwill) that should be taken into account as part of the purchase price.
When people came to Harvey Insurance to buy insurance, they were buying it from Harold Schmeets. He had far more name recognition as an individual than Harvey Insurance did as a firm.

H&M argued that Schmeets' compensation under the agreement was reasonable because the bank needed him to keep the insurance business going, and he had significant responsibilities as the manager of the bank's agency. H&M further contended that any goodwill of the business was attributable to Schmeets personally. Neither party focused on the tax consequences of the transaction. Instead, both parties wanted to create an employment relationship and both consistently treated the deal as if they had.

The Tax Court found that the payments to Schmeets weren't disguised purchase price payments to H&M, the seller, in light of Schmeets's personal relationships, his experience in running all facets of an insurance agency and his responsibilities as manager of the bank's insurance agency. The compensation that the bank paid him was reasonable. The employment agreement contained an extensive list of duties that Schmeets was required to perform. Not only did Schmeets sell insurance, he also had significant management and bookkeeping responsibilities. He went from working around 40 hours per week before the sale to double that afterward. Additionally, the IRS failed to specify what other purchased intangible assets, other than the name Harvey Insurance, weren't accounted for in the purchase price. The Service provided little persuasive evidence that the name of the corporation had much value. The court found that Harold Schmeets had by far more name recognition than Harvey Insurance.

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.3

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.

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

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3 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.
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%).[^4] 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%.
- 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

[^4]: 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%.
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.


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.

A buyer does not care if it pays for corporate goodwill, personal goodwill or a noncompete agreement because the buyer has 15 year amortization in each case (assuming that the anti-churning rule does not apply). So the buyer and seller do not have competing tax interests in this situation. 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).

6. Payments Purportedly For Personal Goodwill Were Self-Employment Income Where There Was No Appraisal & No Factual Basis For Allocation Solely To Consulting & Personal Goodwill; Tax Court Used Its Own Analysis & Did Not Follow IRS Arguments.

*Kennedy v. CIR*, T.C. Memo. 2010-206 held that payments to an individual, characterized as proceeds of the sale of personal goodwill, were instead self-employment income. However, the taxpayer was not liable for the 6662 accuracy penalty because he reasonably relied on the advice of a competent CPA to prepare his return, acting in good faith, and providing the CPA with all relevant facts and documents.

Kennedy owned KCG, an employee benefits consulting firm, employing himself and another individual as the sole employees. Kennedy did not have an employment or noncompete agreement with KCG. KCG’s clients did business with KCG primarily because Kennedy worked for that company. Kennedy commanded loyalty among the clients. Kennedy attended all significant meetings with the clients.
Mack & Parker purchased the KCG business by buying Kennedy’s personal goodwill and for consulting by KCG, which included uncompensated work by Kennedy for the buyer Mack & Parker. The payments due to Kennedy under the Goodwill Agreement for the purported sale of his personal goodwill and to KCG under the Consulting Agreement were generally in the ratio of 75/25 and depended on the amounts Mack & Parker received from KCG’s former clients. Therefore, Kennedy had an incentive to work to ensure that KCG’s former clients continued to do business with Mack & Parker.

Kennedy devoted more time to Mack & Parker than he had expected. During the first year after the sale transaction, 46 percent of Mack & Parker’s revenue was traceable to time directly billed from Kennedy’s personal billable time. Kennedy did not receive any compensation from Mack & Parker other than the payments that Mack & Parker was required to make under the 2000 sale transaction. Kennedy did not receive any payments labeled as wages.

The IRS argued:

- The owner of the customer list was KCG, not Kennedy. Without the customer list, Kennedy could not transfer goodwill.

- Kennedy failed to prove that Kennedy owned a goodwill asset. Kennedy provided no appraisal of the goodwill asset. Kennedy personally did not have any contracts with any clients.

- Even if Kennedy owned the goodwill asset, this asset should was not a salable asset because its value would be based upon Kennedy’s relationships with his customers, which, had no value unless Kennedy continued to perform services for the clients.

- Kennedy could not have personally sold goodwill because he did not own the employee benefits consulting business. Rather, KCG was the owner. In support of its contention that Kennedy could not sell goodwill without owning the underlying business, the IRS cites Baker v. Commissioner, 338 F.3d 789 (7th Cir. 2003). That case held that payments by State Farm to a retiring agent were for a noncompete agreement, as the petitioner reported on his form 8594, and not for a sale of his agency’s “assets.” The only “assets” not already owned by State Farm were the retiring agent’s employees and phone number, and there was no indication that the payments were for the successor agent’s right to use these items.

- Finally, the IRS asserted that the substance-over-form doctrine requires that the payments from Mack & Parker were payments for Kennedy’s services, payments for Kennedy's promise not to compete, or both.
Kennedy failed to prove that the payments from Mack & Parker were payments for his goodwill asset. Section 7491(a) places the burden of proof on the IRS only if a taxpayer produces credible evidence with respect to a factual issue and meets other conditions. Among these conditions is that the taxpayer met all substantiation requirements. Second, the taxpayer must maintain all required records and comply with the IRS's requests for information. Kennedy did not contend that he meet these requirements.

The Tax Court did not follow the arguments of the IRS. It stated that a payment to someone who provides ongoing services for the buyer can be considered a payment for goodwill, citing three cases holding there was a sale of goodwill by a sole proprietor CPA: *Horton v. Commissioner*, 13 T.C. 143, 145, 149 (1949) (five years of payments promised to a solo practitioner CPA upon joining an accounting partnership—payments that were equal to 10 percent of the fees collected by the partnership from clients in the city of the CPA's former practice were considered to be half for the CPA's pre-existing goodwill and half for the CPA's covenant not to compete with the partnership), *Wyler v. Commissioner*, 14 T.C. 1251, 1260 (1950) ($50,000 lump-sum payment to solo practitioner CPA upon joining an accounting firm, a payment that was additional to yearly $10,000 salary, was considered a payment for goodwill), and *Watson v. Commissioner*, 35 T.C. 203, 208 (1960) (lump-sum payment equal to the gross annual receipts of selling CPA's practice who joined two new partners in an accounting partnership was payment for goodwill).

The Tax Court held that the allocation in Kennedy’s case was not based on economic reality. There was no appraisal and no factual basis for the allocation. Rather, it was done for tax savings. Although the allocation was in the contract, Kennedy agreed to work for Mack & Parker for five years until his retirement, he gave Mack & Parker a noncompete, and he worked for Mack & Parker for 18 months without compensation other than relatively meager amounts paid to KCG under the Consulting Agreement. “Under these circumstances, we find that the payments Kennedy received were not payments for goodwill” but instead were self-employment income.

**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 Form 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. 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.

Howard v. U.S., 2010-2 USTC ¶50,042, 106 AFTR 2d ¶ 2010-5140 (E.D. WA. 7/30/2010), aff'd 108 AFTR 2d ¶ 2011-5226 (9th Cir. Aug. 29, 2011)(unpublished) is a case reflecting a number of things discussed in various parts of this outline. It held on summary judgment 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.
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. The Ninth Circuit also noted that Dr. Howard's corporation, through Dr. Howard, continued to provide services to the buyer after the sale. To preserve the value of the goodwill, Dr. Howard entered into a restrictive covenant with the buyer.

Howard’s Noncompete With His Own Corporation. Howard contended that the Asset Purchase Agreement terminated the covenant not to compete in the 1980 employment agreement. However, there was no evidence that Dr. Howard ever modified or revoked the employment agreement or the covenant not to compete. Additionally, the Ninth Circuit noted that this argument was inconsistent with the agreement entered into between the Howard Corporation and the buyer by which the Howard Corporation arranged for Dr. Howard to provide dental treatment on the patients of the buyer. Dr. Even if the noncompete with the Howard Corporation had terminated, the trial 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. The Ninth Circuit took a different approach and ruled that any termination of the
noncompete would be a dividend from the corporation to Dr. Howard: "Nevertheless, even if we accept the premise that the purchase agreement terminated both the employment contract and the non-competition agreement, such a release would constitute a dividend payment, the value of which would be equivalent to the price paid for the goodwill of the dental practice. See 26 U.S.C. § 316(a) (a “dividend” is “any distribution of property made by a corporation to its shareholders”); 26 U.S.C. § 301(b)(1) (“the amount of any distribution shall be the amount of money received, plus the fair market value of . . . property received”); 26 U.S.C. § 301(c)(1) (“that portion of [a] distribution which is a dividend . . . shall be included in gross income”)."

The Ninth Circuit also noted that having then made himself available to the advantages of using the corporation, and having entered into the agreements that he did with the corporation, then why should we try then to allow him . . . out of what he got himself into.”

However, Norwalk, supra, ruled differently. In Norwalk, the 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 Ninth Circuit did not address this issue.

The trial 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 2002 plus three years until 2006 while working for the buyer. 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. The Ninth Circuit agreed, saying that all facts and circumstances were relevant.

3. 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.

Rev. Rul. 65-180 states whether a covenant not to compete has an independent value from purchased goodwill 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 goodwill. The covenant not to compete that assured the buyer the beneficial enjoyment of the purchased goodwill (the insurance expirations) was nonseverable from the goodwill and had no separate value.

Note: 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.

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 merely a contributing element to the goodwill asset that is 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-section 197 cases, discussed in the next section below, where there was no allocation and the buyer's allocation to the covenant was upheld.
In *Aaron Michaels*, 12 T.C. 17, 19 (1949) and cases therein cited 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., cited in Rev. Rul. 65-180, 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.

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.

See 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
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) (from 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 arms’ length and understandably 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 the 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. Schweih, *Valuing Small Businesses & Professional Practices*, p. 585 (3d ed. 1998), although special issues exist for physicians under the federal anti-kickback law, which prohibits payments to induce referrals of federal government paid healthcare.

   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. Schweih, *Valuing Small Businesses & Professional Practices*, p. 585 (3d ed. 1998); Carmen Valle Patel, Note, *Treating Professional Goodwill*

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 important to allow allocation to goodwill and not noncompete.** If the buyer does not enter into an employment or consulting agreement with the individual seller, the buyer is less likely purchasing personal goodwill and more likely a noncompete. See *Solomon v. CIR*, TC Memo 2008-102, so holding where there was no post-acquisition employment or consulting agreement. In one case, the seller stayed on with the buyer, and the IRS failed in its attempt to reclassify part of the compensation paid by the buyer to the seller as part of the purchase price for goodwill or the noncompete.5

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

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5 *H&M, Inc. v. CIR*, TC Memo 2012-290 ruled that where a corporation sold its insurance brokerage business and its sole shareholder, Schmeets, was employed by the buyer, the compensation under the employment agreement was not a disguised purchase price payment to the selling corporation for goodwill. The Court agreed that the payments were not simply the fair market value of his services. Schmeets not only brought his personal goodwill to the bank, he also signed a noncompete provision. However, Schmeets' individual tax liability was not before the Court, so it did not address the allocation between what he was paid for Schmeets’ services to the agency, his personal goodwill, and his promise not to compete. The Tax Court found entirely unbelievable the IRS's expert's report, which estimated the fair market value of Schmeets’ services to be $22,700 in '94 and '95, and $38,300 in '96, '97, and '98. The less experienced manager that replaced Schmeets was paid roughly $55,000 to $65,000 per year. Further, even after Schmeets’ six-year employment term was up, the bank still paid him around $30,000 per year for part-time work to train his replacement.
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.”

J. Is 1031 An Option For A Professional Selling One Practice & Purchasing Another?

CCA 200911006 addresses 1031 and states that mastheads, trade names, and customer based intangibles can be separate from goodwill and therefore part of a 1031 non-taxable exchange. In fact, the CCA says: “In our opinion, except in rare and unusual circumstances, intangibles such as trademarks, trade names,
mastheads, and customer-based intangibles can be separately described and valued apart from goodwill.” This seemingly would apply to a newspaper, for example, selling its subscriber list in an exchange. Perhaps under the CCA analysis the goodwill in, for instance, a solo dental practice is a “rare and unusual circumstance.” If an appraiser can put a significant number on customer based intangibles separate from goodwill or going concern value, there could be no tax instead of capital gain.

A CPA in a transaction once took the position that virtually everything in a dental practice except equipment is customer based intangibles under 197 instead of goodwill, so the practice can be exchanged in a sale and purchase under 1031. Before and after the CCA there are examples of situations in which “acquired” (purchased) customer based intangibles which had been amortized could be separated from later, self-generated customer based intangibles which could not be amortized and were “goodwill” (in those cases the taxpayer wanted this result to reduce the recapture tax).

Such a 1031 exchange, if possible, would likely have to be done through an intermediary where someone such as a dentist is selling one practice and buying another.

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.

Pre-Aug. 11, 1993 Goodwill Taints All Goodwill. Goodwill is treated as a unitary asset. 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, Donald E. Rocap, Mergers Acquisitions & Buyouts ¶403.4.1.4, pp. 4-166 to 167 (Feb. 22, 2012), which states:

"Accordingly the rules will continue to serve as a serious trap for the unwary far into the future, even if only a small portion of the value of the goodwill or goodwill-like intangible is attributable to the pre-8/11/93 period.

"EXAMPLE 20

"Because A owns more than 20% of both P and T-SCo immediately after the purchase, the transaction is covered by the Code §197 anti-churning rules. Only $1 of T-SCo's goodwill existed on the 8/10/93 effective date of Code §197. However, neither Code §197 nor the 1/00 Regulations bifurcates the goodwill P purchased from T-SCo into its pre-8/11/93 component ($1) and its post-8/10/93 component ($799). Instead, the entire $800 of goodwill existing when P purchases T-SCo's assets is disallowed under the anti-churning rules.

"We believe the result in the preceding example is inequitable and inconsistent with the stated Congressional purpose of Code §197(f)(9), which is "to prevent taxpayers from converting existing [i.e., pre-8/11/93]
goodwill, going concern value, or any other section 197 intangible for which a depreciation or amortization deduction would not have been allowable under [pre-8/11/93] law into amortizable property." This concern should not exist for goodwill created after 8/10/93, so that, logically, only the amortization deductions attributable to T-SCo’s $1 of goodwill existing on 8/10/93 in the example should be disallowed. To illustrate the capriciousness of the current rule, suppose in the preceding example T-SCo’s goodwill on 8/10/93 was $0 (rather than $1). As a result of this immaterial change in the facts, none of the goodwill existing when P purchases T-SCo’s assets would be subject to the anti-churning rules (in contrast to the entire $800 of goodwill in the example). To make the anti-churning rules more equitable and less arbitrary, Treasury should change the regulations so that the anti-churning rules apply to purchased goodwill only to the extent of the goodwill’s 8/10/93 FV [fair value].”

Separate Asset With Provable Value & Useful Life.
A taxpayer’s ability to treat one intangible asset as separate and distinct from another intangible asset was addressed in IRS Letter Ruling 201016053 (4/23/10) in the context of customer-based intangibles, which held that the taxpayer could treat a set of purchased customer relationships as a separate asset from other self-created customer relationships and from goodwill generally for purposes of the Code §1245 recapture rules only if the taxpayer could surmount the burden of proving that each group of customer relationships: (i) can be separately identified, (ii) has a reasonably ascertainable value, and (iii) has a reasonably determinable life.

The anti-churning rules do not apply, in any event, to such an asset because it would have been amortizable without regard to Code §197. See Code §197(f)(9)(A). See See Martin D. Ginsburg, Jack S. Levin, Donald E. Rocap, Mergers Acquisitions & Buyouts ¶403.4.1.4, pp. 4-167 (Feb. 22, 2012).

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.

4. Redemption Example. Is there pre 8/10/93 goodwill?

Corp. X (an S Corp) is owned 50/50 by individuals A and B. A and B are not related. The plan is for Corp. X to completely redeem B. B (who is not subject to any restrictive covenants) will sell his personal goodwill to Corp. X. Is there any reason why B would not be entitled to capital gains treatment on the sale of his personal goodwill to Corp. X, and is there any reason why Corp. X would not be entitled to 197 amortization on the purchased goodwill? This can be done but if there is any pre-8/10/93 goodwill, there is no amortization since the anti-churning rules apply to a sale by a more than 20% owner, which is tested immediately before and after the sale. That owner is a related person. See below.

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 tax 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. The 754/743 rules trump the anti-churning rules. SMLLC will not work. The key is you have to buy partnership interests.

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.
CHOICE OF ENTITY – A FRESH LOOK; TAX & NON-TAX CONSIDERATIONS

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I. INCOME TAX CONSIDERATIONS.  

A. Tax Rates. .......................................................................................................................... 1
   1. Personal Income Tax. ........................................................................................................ 1
   2. Corporate Income Tax. .................................................................................................... 1
   3. Capital Gains & Dividends Tax. ....................................................................................... 1
   4. Health Reform – New Medicare Taxes On High Income Taxpayers In 2013 ................. 1

B. Relative Rates. ..................................................................................................................... 3

C. Reasons Favoring C Corporation Status. ............................................................................. 4
   1. Public Company Or Company Planning To Go Public. .................................................. 4
   2. Existing C Corps; Problems With Changing Status. ....................................................... 4
   3. Section 1202 Small Business Stock Exclusion............................................................... 4
   4. No Medicare tax for owners on employer’s retirement plan contribution (applies to S corporation also) or employer’s payments for health, dental, vision or other types of insurance. .......................................................... 7
   5. Use Of Losses. ................................................................................................................. 7
   6. Accumulation At Lower Tax Rate. .................................................................................. 7
   7. Fringe Benefits For Owner-Employees. ......................................................................... 7
   8. Simple Cafeteria Plans Available In 2011; Owners Can Only Be Covered In C Corporations. .............................................................................................................. 8

D. Reasons Favoring Any Pass-Through (S Corporation, LLC, LLP, etc) Over C Corporation. .............................................................................................................................................. 11
   1. No double taxation upon an asset sale, unlike a C corporation. .................................... 11
   2. Losses flow through to owners annually (up to amount of basis). ................................. 11
   3. No risk of unreasonable compensation resulting in double taxation as in C corporation for compensation paid to owner-employee ................................................................. 11
   4. No accumulated Earnings Tax .................................................................................... 11
   5. Personal Holding Company Tax .................................................................................... 12

E. Reasons Favoring S Status Over C Corporation & Other Pass-through Entities. ............. 12
   1. Ability for high income shareholder employees, active in business, to receive dividends not subject to Medicare tax from distributions from business as opposed to investment income. Such distributions are exempt from the new Medicare tax after 2012 on business income paid as a distribution (dividend) but not on investment income paid as a distribution. .............................................................. 12
   2. No Medicare Tax For Owners On Employer’s Retirement Plan Contributions (applies for shareholder-employees of C corporations also) ...................................................................... 13

F. Reasons Favoring Partnerships & Entities Taxed As Partnerships. ............................... 13
   1. Ability to avoid application of 409A for retiring partners/members by use of 736 payments. ................................................................................................................................. 13
   2. Ability to avoid self-employment income tax to retiring general partners who are paid some amount until death under 1402(a)(10). ............................................................................................................. 13
   3. Opportunity for person buying in to obtain increased basis on entity assets through 754 election and re-depreciate them. ................................................................................................. 13
   4. Pass-Through Tax Desired & Owners Include Ineligible S Corporation Owner. ........ 13
   5. LLPs for multistate professional firms avoid state qualification and licensing issues
<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>6. Special allocations of income to owners desired.</td>
<td>13</td>
</tr>
<tr>
<td>7. Entity debt creates owner basis, unlike in S corporation.</td>
<td>13</td>
</tr>
<tr>
<td>8. Refinancing proceeds can be distributed income tax free.</td>
<td>13</td>
</tr>
<tr>
<td>9. Multiple classes of owners permitted (applicable also for C corporations)</td>
<td>13</td>
</tr>
<tr>
<td>G. 736 Payments &amp; Service Partnership Buyouts; Planning Important; Issue As To LLCs</td>
<td>15</td>
</tr>
<tr>
<td>H. Passive Losses, LLCs and LLPs Better Than LPs For Those Wanting Current Losses</td>
<td>19</td>
</tr>
<tr>
<td>I. Service Firms Practicing as LLLPs</td>
<td>21</td>
</tr>
<tr>
<td>1. Tax consequences of converting to an LLLP.</td>
<td>21</td>
</tr>
<tr>
<td>2. Tax Issues In Operating LLLP.</td>
<td>22</td>
</tr>
<tr>
<td>J. Reducing Self Employment (SECA) Tax</td>
<td>23</td>
</tr>
<tr>
<td>K. Conclusion</td>
<td>23</td>
</tr>
<tr>
<td>II. NON-TAX CONSIDERATIONS.</td>
<td>32</td>
</tr>
<tr>
<td>A. Sole Proprietorship</td>
<td>32</td>
</tr>
<tr>
<td>B. General Partnership</td>
<td>32</td>
</tr>
<tr>
<td>C. Corporation</td>
<td>33</td>
</tr>
<tr>
<td>D. Limited Liability Company</td>
<td>34</td>
</tr>
<tr>
<td>E. Limited Liability Partnership</td>
<td>34</td>
</tr>
<tr>
<td>F. Limited Partnership</td>
<td>35</td>
</tr>
<tr>
<td>G. Limited Liability Limited Partnership</td>
<td>36</td>
</tr>
<tr>
<td>1. General</td>
<td>36</td>
</tr>
<tr>
<td>2. Professional Firms</td>
<td>36</td>
</tr>
<tr>
<td>H. Other Issues</td>
<td>39</td>
</tr>
<tr>
<td>1. Foreign State Operations</td>
<td>39</td>
</tr>
<tr>
<td>2. State Law Merger and Conversion of Entities</td>
<td>39</td>
</tr>
<tr>
<td>3. Continuity of Life/Withdrawal/Right to Dissolve.</td>
<td>40</td>
</tr>
<tr>
<td>4. Claims of Outside Creditors</td>
<td>40</td>
</tr>
<tr>
<td>5. State Filing Fees &amp; Taxation</td>
<td>41</td>
</tr>
<tr>
<td>6. Fiduciary Duties</td>
<td>41</td>
</tr>
<tr>
<td>III. CHART COMPARING ENTITY CHARACTERISTICS.</td>
<td>44</td>
</tr>
</tbody>
</table>
CHOICE OF ENTITY – A FRESH LOOK;
TAX & NON-TAX CONSIDERATIONS

I. INCOME TAX CONSIDERATIONS.

A. Tax Rates.

1. Personal Income Tax.

The top individual rate initially was 7% for incomes in excess of $500,000. Revenue Act of 1913, § 2A, 38 Stat. 114, 166 (1913), which is over $10 million in today’s dollars. The top rate increased to 67% during World War I in 1917 and reached 94% during World War II.

The Economic Recovery Tax Act of 1981 (“ERTA”) reduced top individual rate to 50%. The Tax Reform Act of 1986 (“TRA”) reduced the maximum individual rate to 28%. The top rate was increased to 31% and then 39.6%, and then reduced to its current 35%. Assuming that the Bush tax cuts expire as scheduled, it will increase to 39.6% in 2011. The effective top marginal rate will then be 41% for taxpayers in states that impose state income taxes because the 3% reduction in itemized deductions will apply. I.R.C. § 68; Pub. L. No. 107-16, § 901.

2. Corporate Income Tax.

The corporate income tax originated in 1909, imposing a 1% tax on corporate income over $5,000. The tax rate rose to 12% by 1918, and remained at roughly that level until the late 1930’s, when a series of rate increases increased the top tax rate to 40% in 1942. The tax rate increased in 1951 to over 50%, and did not return to below 40% until 1988. The 34% top rate applicable in 1988 has remained consistent with only a one percent increase in 1993 to the current 35%.


Special treatment for capital gains began in 1922 with an alternative tax rate of 12.5% for assets held for at least two years and evolved into a 50% exclusion in 1942, and increased to 60% in 1978. The net capital gain was later eligible for a special top rate of 20%, which in turn was adjusted down to 15% with the Jobs and Growth Tax Relief Reconciliation Act in 2003. I.R.C. § 1(h)(1)(C).

The top tax rate for dividends paid by C corporations was reduced to the preferential rate for net capital gain of 15%. The top rates for net capital gain and C corporation dividends will increase in 2011 to 20% and 39.6%, respectively.


Under current law, wages are subject to a 2.9% Medicare tax. Workers and employers pay 1.45% each. Self-employed people pay both halves of the tax (but are allowed to deduct half of this amount for income tax purposes). Health Reform, The Patient Protection And Affordable Care Act (“PPACA”), adopts the Senate proposal to increase an employee’s share of Medicare from 1.45% by 0.9 percentage points, to a total 2.35 percent for high-income workers in 2013. The employer’s share remains at 1.45%, making the total tax paid for high-income individuals 3.8%. That would
be added to the worker’s top marginal rate, which will rise to as much as 39.6 percent in 2011 as the Bush tax cuts expire. The extra .9% tax is also added to the self-employment tax (SECA) and is not deductible, increasing that tax from 2.9% to 3.8%.

An increased 3.8% Medicare tax is imposed by IRC § 1411 on investment income of individuals, trusts, and estates. Beginning in 2013, it is supposed to generate an estimated $210 billion to help fund health care reform. This is the largest tax increase in the health reform law and raises over half of the new revenue. It would push tax rates on capital gains and dividends to 23.8 percent in 2013 for high-income people if Congress goes along with Obama’s proposal to let those rates rise to 20 percent in 2011 from the current 15 percent as the Bush cuts expire. This would be the highest rate for long-term capital gains since 1997. Overall tax rates on income from interest, annuities and royalties would rise to a maximum of 43.4 percent (39.6% + 3.8%).

The investment Medicare tax does not apply to trades or business income of a sole proprietor, partnership, or S corporation. In the case of the disposition of a partnership interest or stock in an S corporation, gain or loss is taken into account only to the extent gain or loss would be taken into account by the partner or shareholder if the entity had sold all its properties for fair market value immediately before the disposition. Thus, only net gain or loss attributable to property held by the entity that is not property attributable to an active trade or business is taken into account.

Income, gain, or loss on working capital is not treated as derived from a trade or business. However, distributions of S corporation income (dividends for state law purposes) will be subject to this tax to the extent from investment income. Income that could be paid as salary or a distribution by an S corporation to a high-income individual would be taxed at 3.8% in either case. If it is a dividend, it is subject to a 3.8% tax but only to the extent that it is from investment income. If it is compensation from a corporation, the corporation pays 1.45% and the individual pays 2.35%. If it is self-employed income, it is taxed at 3.8%. Previously, in an entity taxed as a partnership, if some of the income is self-employment income, then all of it is self-employment income. That apparently will now be different and like an S corporation. Previously, there was no bifurcation of active and investment income in a partnership as there can be for shareholder-employees.

Example. If in 2013 your share of an S corporation's profit is $100,000 and $80,000 of this $100,000 represents profits from the business operation, with $20,000 of profit coming from dividends, interest and capital gains on investments held by the S corporation, no matter whether you're a working shareholder or a passive shareholder, you'll pay the expanded Medicare tax on the $20,000 of investment income (but not the $80,000 business income) that flows through to you if your income exceeds the $200,000 or $250,000 threshold amounts.

In the case of an individual, the tax is the 3.8 percent of the lesser of net investment income (investment income less deductions allocated to producing it) or the excess of modified adjusted gross income over the threshold amount. The threshold amount is $250,000 in the case of a joint return or surviving spouse, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case.

Investment income is the sum of (i) gross income from interest, dividends, annuities, royalties, and rents (other than income derived from any trade or business to which the tax does not apply); (ii) other gross income derived from a trade or business is that is a passive activity (within the meaning of section 469 ) with respect to the taxpayer, or trading in financial instruments or commodities (as defined in section 475(e)(2) per IRC § 1411(c)(2); and business to which the tax applies, and (iii)
net gain (to the extent taken into account in computing taxable income) attributable to the
disposition of property other than property held in a trade or business to which the tax does not apply.

The term “net investment income” does not include any distribution from a retirement plan or
arrangement described in IRC § 401(a), 403(a), 403(b), 408, 408A, or 457(b). IRC § 1411(c)(5).

Gross income does not include items, such as interest on tax-exempt bonds, veterans’ benefits, and
excluded gain from the sale of a principal residence, which are excluded from gross income under
the income tax.

For purposes of computing net earnings from self-employment, taxpayers are permitted a deduction
equal to the product of the taxpayer’s earnings (determined without regard to this deduction) and
one-half of the sum of the rates for OASDI (12.4 percent) and HI (2.9 percent), i.e., 7.65 percent of
net earnings. This deduction reflects the fact that the FICA rates apply to an employee’s wages,
which do not include FICA taxes paid by the employer, whereas the self-employed individual’s net
earnings are economically equivalent to an employee’s wages plus the employer share of FICA
taxes. Thus, investment income does not include amounts subject to SECA tax. IRC § 1411(c)(6).

Modified adjusted gross income is adjusted gross income increased by the amount excluded from
income as foreign earned income under section 911(a)(1) (net of the deductions and exclusions
disallowed with respect to the foreign earned income). IRC § 1411(d).

In the case of an estate or trust, the tax is 3.8 percent of the lesser of undistributed net investment
income or the excess of adjusted gross income (as defined in section 67(e)) over the dollar amount
at which the highest income tax bracket applicable to an estate or trust begins.

The tax does not apply to a non-resident alien or to a trust all the unexpired interests in which are
devoted to charitable purposes. IRC §1411(e). The tax also does not apply to a trust that is exempt
from tax under section 501 or a charitable remainder trust exempt from tax under section 664.

The tax is subject to the individual estimated tax provisions. The tax is not deductible in computing
any income tax.

B. Relative Rates.

The relative rates are important for choosing among the various entity types that are available. The
basic choice for tax purposes is between the pass-through treatment for partnerships and S
corporations and the potential lower rates (except for personal service corporations) and double tax
of the C corporation. Prior to TRA 1986, most businesses, especially profitable ones, were
conducted through C corporations.

The primary reason for many closely-held businesses choosing this form of entity was that the C
corporation marginal rates were significantly lower than those for individuals. Prior to ERTA, The
Economic Recovery Tax Act of 1981, the top corporate and individual rates were 46% and 70%,
respectively; ERTA reduced the top individual rate to 50%. TRA 1986 lowered the top marginal
individual income tax rate to 28%, and the top corporate rate was 34%. For the first time since
1913, closely-held businesses electing pass-through status could pay less tax on income passed
through from an S corporation or partnership, as well as avoiding the potential second tax that
would have been triggered by the distribution of those earnings from the entity if it were a C
corporation.
The 1986 changes fueled the popularity of pass-through entities. As a result of the 1986 changes, the trend has been toward pass-through taxation, through the use of partnerships or entities taxed like partnerships or S corporations. In the former category are limited liability companies and actual partnerships (general partnerships, limited partnerships, limited liability partnerships, and in some states, limited liability limited partnerships) that have not elected to be taxed as corporations. In the S corporation category are state law corporations that have made the S election as well as limited liability companies and partnerships that have elected both to be treated as S corporations. S corporations have represented a majority of all corporate returns and remained very popular among the pass-through entities. One, reason has been the ability to make S distributions (state law dividends) without Medicare tax that would apply if the amounts were paid in addition to compensation over the Social Security Wage base. A second reason is the ability to avoid double taxation on the sale of assets.

C. Reasons Favoring C Corporation Status.

1. Public Company Or Company Planning To Go Public.

The largest category of entities that are taxed as C corporations is publicly-traded entities. Most of these entities have many more than the maximum 100 shareholders that are allowed for corporations to elect S status, and are per se corporations; therefore, they are not eligible to elect out of corporate status in order to achieve partnership treatment. Widely held partnerships (including limited liability companies not electing to be treated as corporations) have only slightly more flexibility. If any of their interests are “traded on an established securities market” or “readily tradable on a secondary market (or the substantial equivalent thereof),” then, with limited exceptions, they too will be taxed as corporations. I.R.C. § 7704(a) & (b). There are exceptions for partnerships whose gross income consists at least 90% of “qualifying income” (interest, excluding financial or insurance business interest, dividends, real property rents and gains, mineral or natural resource income and commodities income in certain circumstances). Id. There is also an exception for certain electing 1987 partnerships. I.R.C. § 7704(g).

2. Existing C Corps; Problems With Changing Status.

In addition, there are a number of corporations that had C status prior to TRA 1986, and have not converted to some form of pass-through entity because converting from corporate to partnership status will be treated as a liquidation and trigger two levels of taxation, one at the entity level and one at the individual level. See I.R.C. §§ 336(a), 331(a). Other C corporations that could qualify for S corporation status have in some cases not converted because of the built-in gains tax. This tax effectively imposes a double tax regime on all gain that is “built-in” as of the beginning of the corporation’s first taxable year as an S corporation. It only lasts for a period of 10 years (7 years for taxable years beginning in 2009 and 2010), and only applies to recognized built-in gains in excess of recognized built-in losses during that period. See I.R.C. § 1374(d)(2) & (7). There are circumstances, often involving accounts receivable for cash basis taxpayers and inventory, where the potential cost of converting to S status under the built-in gains tax is for some not worth the more uncertain benefits of the single-tax S corporation. There are also circumstances where the single class of stock, shareholder eligibility, and excluded corporation requirements of S corporation status prevent the conversion of C corporations. See I.R.C. §§ 1361(b)(1)(B)-(D), (2).

In order to qualify for the section 1202 exclusion, the entity issuing the stock must qualify as a C corporation “during substantially all of the taxpayer’s holding period for such stock.” See I.R.C. § 1202(c)(2)(A). Thus, an individual forming a business, or investing substantial funds in it, always needs to balance the somewhat more favorable combined income/self-employment top marginal tax rates for S corporations against the benefits of this exclusion, which is only available to C corporations.

There is a 5 year holding requirement.

Until February 18, 2009, the exclusion was 50% of any gain from the sale or exchange of qualified small business stock held for more than 5 years but that percentage was raised to 75% for stock acquired after February 17, 2009 and before January 1, 2011 For purposes of calculating eligible gain under this provision, pre-contribution gain on property used to acquire the qualified small business stock, or contributed to the capital of the C corporation, is excluded. See I.R.C. § 1202(i).

HR 4853, the “Middle Class Tax Relief Act of 2010” and “Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010” increased the exclusion to 100% for all qualified small business stock issued after September 27, 2010, and before January 1, 2012, which is held for a minimum of 5 years.

In order to qualify as “qualified small business stock,” stock must be issued after August 10, 1993 directly to the selling taxpayer at original issue in exchange for money or other property (other than stock) or services (other than as an underwriter of the qualified small business stock). See I.R.C. § 1202(c)(1). If a taxpayer is acquiring stock that would otherwise qualify, except for the fact that some of the consideration is ineligible stock or services, then the taxpayer should split the acquired stock into two blocks. If qualified small business stock is converted into other stock in the same corporation, the new stock shall be treated as such and as having been held during the period the converted stock was held. See I.R.C. §1202(f).

At issuance, the corporation itself must be a “qualified small business.” Thus, it must be a domestic corporation that has not had more than $50 million of aggregate gross assets since August 10, 1993 and will not surpass that amount “immediately after the issuance.” In addition, the corporation must agree to submit reports to the Secretary and shareholders as required. See I.R.C. § 1202(c)(1), (d).

“During substantially all of the taxpayer’s holding period for such stock,” the corporation must be actively engaged in the conduct of one or more qualified trades or businesses. This means that 80% (by value) of the assets of the corporation must have been used in such active conduct, though there are special rules for start-up activities, research and experimental expenditures, and in-house research expenses. See I.R.C. § 1202(e)(1).

Qualified trades or businesses exclude the following: (a) health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services or any other trade or business where the principal asset is the reputation or skill of one or more of its employees; (b) banking, insurance, financing, leasing, investing or similar businesses; (c) farming; (d) production or extraction of depletable resources and; (e) hotels, motels, restaurants and similar businesses. See I.R.C. § 1202(c)(3). Additionally, the corporation cannot be a DISC or former DISC, a possessions corporation (or the parent of one), a regulated investment company, a real estate investment trust, a REMIC or a cooperative. See I.R.C. § 1202(e)(4).
Not more than 10% of the value of the corporation’s net assets in excess of liabilities can consist of stock or securities of other non-subsidiary corporations. See I.R.C. § 1202(e)(5)(C). Presumably, bank accounts do not constitute “securities in other corporations,” and corporations with low net worth would be well advised to stay away from any investments in other corporations.

Not more than 10% of the corporation’s total assets, by value, can consist of real property not used in the active conduct of its business, which, in turn, cannot consist of “ownership of, dealing in, or renting of real property.” See I.R.C. § 1202(e)(7).

After an initial start-up period of two years, no more than 50% of the assets of the corporation can consist of cash. See I.R.C. § 1202(e)(6).

There are requirements relating to redemptions. First, during the four-year period surrounding the issuance of such stock (two years before and two years after), the corporation cannot have “directly or indirectly” redeemed more than $10,000 worth or 2% of the outstanding stock owned by the taxpayer and related persons. See I.R.C. § 1202(c)(3)(A); Treas. Reg. § 1.1202-2(a). Second, during the two-year period surrounding issuance (one year before and one year after), the corporation cannot have redeemed stock valued in excess of 5% of the aggregate value of all of the corporation’s stock as of the beginning of such two-year period. Note that this could be a problem if the value of the stock increases dramatically during that period. In addition, the rule could be violated even before the taxpayer purchases his or her stock. For purposes of both of the foregoing requirements, transfers of stock by shareholders to employees or independent contractors are ignored, notwithstanding the fact that they may be treated as the acquisition and reissuance of the stock by the corporation under section 83 of the Code. See Treas. Reg. § 1.1202-2(c).

In addition, there are exceptions for stock redeemed upon termination of employment, death, disability and divorce. See Treas. Reg. § 1.1202-

All of these requirements are apparently intended to prevent the indirect sale of stock by one shareholder to a new shareholder, thereby defeating the “original issuance” requirement described above. These rules require constant monitoring.

In addition to the C corporation and five-year holding period requirements, the section 1202 exclusion is also subject to some monetary limits. However, the limits are fairly generous. At a minimum, at least $10 million gain is eligible on a cumulative basis for each corporation in which the taxpayer invests.¹ Thus, taxpayers should be entitled to at least up to $7.5 million of exclusion for investments made in a qualified small business stock of any given corporation between now and January 1, 2011. Moreover, even this limit is increased so that the taxpayer’s entire gain will be eligible for the partial (or possibly complete) exclusion unless his or her return on investment is greater than 10 to 1. See I.R.C. § 1202(b)(1).

Although the current rule is that only 7% of the excluded gain will be treated as a tax preference for AMT purposes, this provision expires on December 31, 2010, at which point the preference will be increased to 28% for stock acquired after December 31, 2000, and to 42% for stock acquired before that. See I.R.C. § 57(a)(7); Pub. L. No. 108-27 § 303(b)(3)(A)-(B), as amended by Pub. L. No. 109-222 § 102. Here again, however, President Obama has proposed eliminating this preference entirely.

In conclusion, section 1202 stock is unlikely to offset the benefits of a single level of tax in a pass-

¹ There is parent-subsidiary but not brother-sister, aggregation. See I.R.C. § 1202(d)(3).
through entity upon sale unless (a) a stock sale or tax-free reorganization is the more likely form of disposition or (b) tax at the corporate level upon sale will not be a significant issue for some other reason (e.g., substantial net operating loss carryforwards). In those circumstances where coupling C corporation status with the section 1202 exclusion might be beneficial, an analysis of the after-tax results of ongoing operations as a C corporation vs. S corporation/partnership should be made, along with a careful determination of whether the technical requirements of small business stock qualification can be satisfied with a reasonable level of certainty.

4. **No Medicare tax for owners on employer’s retirement plan contribution (applies to S corporation also) or employer’s payments for health, dental, vision or other types of insurance.**

For married owner making $250,000 or more with a retirement plan contribution of $49,000, this will be an annual savings of $1,862 per owner [3.8% times $49,000] as opposed to any other entity.

5. **Use Of Losses.**

Owners may prefer to accumulate losses at the corporate level so that they can be used to shelter income at the entity level later.

6. **Accumulation At Lower Tax Rate.**

There are also small businesses (not, however, personal service corporations (“PSCs”), i.e., those engaged in health, law, engineering, etc. that are taxed at a flat 35% federal rate) that would prefer to accumulate up to $50,000 a year at the low 15% rate (I.R.C. § 11(b)(1)(A), (2) for use in the business, despite the fact that there may be an additional second tax sometime in the future on dividends or sale of assets. This may be easier to accomplish in settings where compensation is low enough so that it can be adjusted to prevent corporate income from hitting the 25% ($50,001-$75K), 34% ($75,001-$100K) and 39% ($100,001- $335K) rates.

This advantage must be weighed against the disadvantage of double tax on dividends or sale of assets and liquidation.

7. **Fringe Benefits For Owner-Employees.**

There are also other situations, including professional service corporations, where the majority of the available cash is paid out in taxable compensation, and the treatment of certain fringe benefits is available only for “employees” (e.g., medical reimbursement, cafeteria plan, disability insurance, group term life insurance) is still more favorable for C corporation shareholder-employees. See I.R.C. §§ 1372, 79, 105, 125.

Until the advent of PPACA, this differential between proprietors, partners, more than 2% shareholders of S corporations and C corporation shareholder-employees was no longer applicable with respect to health insurance. I.R.C. § 162(l). Under PPACA (ERISA 715; IRC 9815), there is a new nondiscrimination requirement for health insurance (the effective date will be announced by the IRS), although it does not apply to any group health plan in existence on March 23, 2010 that qualifies as a “grandfathered plan.” Where the new nondiscrimination requirement does apply, it can likely be avoided by the use of the new simple cafeteria plan that becomes available beginning in 2011 under Code § 125(j), thereby allowing shareholder-employees of regular C corporations (but not owners of other entities except 2% or less shareholder-employees of S corps) to continue to
enjoy preferential health insurance benefits. However, it may be necessary for a technical amendment to add new Code § 9815 to the list of nondiscrimination requirements that are deemed to be met.

8. Simple Cafeteria Plans Available In 2011; Owners Can Only Be Covered In C Corporations.

The health reform law includes a provision creating “simple cafeteria plans” under IRC § 125(j) for small businesses, effective for years beginning in 2011. Simple cafeteria plans automatically meet nondiscrimination requirements applicable to cafeteria plans if they meet minimum eligibility, participation, and contribution requirements. This safe harbor covers the regular cafeteria plan nondiscrimination requirement of section 125(b), the 25% concentration test, and the nondiscrimination requirements of 79(d), 105(h), and 129(d) applicable to group term life insurance, a self-insured health insurance or medical reimbursement plan, and dependent care assistance benefits (child care).

Where a business wants to avoid the 25% concentration test and contribute for owner-employees, only a regular C corporation can do so.

Under 125(h)(3), a “qualified benefit” does not include any qualified health plan as defined in section 1301(a) of the Patient Protection and Affordable Care Act or “PPACA”) offered through an Exchange unless the employer is a qualified employer under 1312(f)(2) of PPACA offering the employee the opportunity to enroll through such an Exchange in a qualified health plan in a group market.

Avoiding New Health Insurance Nondiscrimination Requirements. Simple cafeteria plans, available for plan years beginning in 2011, offer a work around to the new health insurance nondiscrimination rules applicable to all employer insured plans on and after Sept. 23, 2010 other than grandfathered plans. In addition, these plans allow shareholder-employees and other key employees to benefit under the plan and be exempt from the regular cafeteria plan rule that limits benefits for such individuals to 25% of the total nontaxable plan benefits – the so-called concentration test.

Until Sept. 23, 2010, a partnership or corporation can pay 100% of family coverage for partners or shareholder-employees, and 50% of single employee coverage for staff that are not insured through a spouse. The employer can pay for and deduct insurance only for owner-employees. Thereafter, such an employer can do so only with a grandfathered plan in existence on March 23, 2010. A simple cafeteria plan in 2011 and thereafter can get the same result if the employer is a regular C corporation, although will not be exactly equivalent, as formula for employer contribution will be 2% (or more if desired) with all eligible employees, including the shareholders, paying for whatever health insurance they select with pre-tax dollars.

The simple cafeteria plan eliminates the new health insurance nondiscrimination requirement because it automatically meets 125(b) and 105(h). Could the IRS argue that 105(h) only applies to self insured plans. Even though that new IRC 9815 incorporates 2716 of the PHSA, which in turn incorporates IRC 105(h), it does so for insured plans. So do we fail 9815 and thus simple cafeteria plan rules if the employer does not contribute same dollar amount for each eligible employee? Do we fail because the salary reduction contributions are treated as employer contributions where, for example, the same benefit options are available but all HCEs buy family coverage NHCEs buy only single coverage or nothing? The answer should be no to both questions, as the intent was to give a
pass to all nondiscrimination requirements, but a technical correction to include Code § 9815 is needed to make that clear. Alternatively, if the regulations under 125(j) or 9815 provide that the nondiscrimination requirement is met based on eligibility rather than use of benefits, as is the case under 105(h), then the nondiscrimination requirement should be easy to meet.

The simple 125(j) rules give a free pass on 79, and 105(h), 125(b), and 129 (and hopefully 9815) testing for nondiscrimination, even if most health insurance costs is paid by employees, if they so elect, by salary reduction. Therefore, the simple cafeteria plan should pass testing if it offers all participants eligibility under the simple rules and offers the same benefits to those similarly situated. Under 105(h), only the benefits offered are tested. All benefits provided for highly compensated employees and their dependents are also offered for all other participants and their dependents. Reg. §1.105-11(c)(3)(i) provides: “This test is applied to the benefits subject to reimbursement under the plan rather than the actual benefit payments or claims under the plan.” Similarly, Reg. §1.105-11(c)(3)(ii) states: “The determination of whether plan benefits discriminate in operation in favor of highly compensated individuals is made on the basis of the facts and circumstances of each case. A plan is not considered discriminatory merely because highly compensated individuals participating in the plan utilize a broad range of plan benefits to a greater extent than do other employees participating in the plan.”

Technique Only Available Practically For Smaller Employers Without Penalty. For businesses that have 50 or more FTE employees, if an employee voluntarily opts out of the employer's plan and goes to an exchange to obtain an individual subsidized health insurance plan (the subsidies go as high as income of $88,000 for a family of 4) then the employer has to pay a penalty for those who don't take the plan and get a government subsidy in connection with purchasing a plan from a state-exchange. However, the benefits of the simple cafeteria plan may outweigh any penalty in certain situations.

100 Or Fewer Employees. An employer is eligible to implement a simple cafeteria plan if, during either of the preceding two years, the business employed 100 or fewer employees on average (based on business days). For a new business, eligibility is based on the number of employees the business is reasonably expected to employ. Businesses maintaining a simple cafeteria plan that grow beyond 100 employees can continue to maintain the simple arrangement until they have exceeded an average of 200 or more employees during a preceding year. Employees include leased employees.

Controlled & Affiliated Service Groups One Employer. The employer aggregation rules under IRC Sections 52 (applying the rules of section 1563, except “more than 50 percent” is substituted for “at least 80 percent” in section 1563(a)(1), and subsections 1563(a)(4) and (e)(3)(C) are disregarded) and 414 (controlled and affiliated service groups) apply for purposes of determining an eligible employer. Additionally, an employer includes a “predecessor employer,” which term is undefined.

Simple Cafeteria Plan Eligible “Employees.” All non-excludable employees who had at least 1,000 hours of service during the preceding plan year must be eligible to participate in a simple cafeteria plan. The new rules continue the regular cafeteria plan requirement that to a participant can only be an “employee” and thus excludes partners, LLC members taxed as partners, 2% or more owners of S corporations, and sole proprietors.

Simple Cafeteria Plan Qualified Employees. The term “qualified employee” means any employee who is not a highly compensated employee under section 414(q) or key employee under section
416(i) and who is eligible to participate in the plan. This definition of qualified employee is relevant only to the two alternative minimum contribution requirements, discussed below, and that HCEs and key employees may participate like everyone else so long as they are “employees” and do not receive disproportionate employer regular or matching contributions.

Section 125(j)(3)(C) allows comparable contributions for HCEs and key employees, as it provides: Subject to subparagraph (B)(regarding matching contributions), nothing in this paragraph shall be treated as prohibiting an employer from making contributions to provide qualified benefits under the plan in addition to contributions required under subparagraph (A). The required contributions in (A) are for “qualified employees” but the employer contributions for at least 2% of pay are for all employees under (A)(i), not just qualified employees, and (B) indicates that matching contributions can be made for HCEs and key employees.

Simple Cafeteria Plan Excludable Employees. Excludable employees are those who:

- have not attained age 21 (or a younger age provided in the plan) before the end of the plan year;
- have less than one year of service as of any day during the plan year;
- are covered under a collective bargaining agreement; or
- are nonresident aliens.

An employer may have a shorter age and service requirement but only if such shorter service or younger age applies to all employees.

Employees who previously worked 1000 in a plan year but do not currently can be excluded, as employees who do not have a year of service in the current plan year can be excluded. However, since the rule is that they can be excluded if they do not have a year of service on any day in the year, they will have 1000 hours if they go from full time to part time at the beginning of the current year. This is an important point where the employee’s salary is less than the health benefits. They should be entitled to the entire maximum benefit if elected, even if greater than their compensation in order to safeguard simple status.

Benefit Nondiscrimination. Each eligible employee must be able to elect any benefit under the plan under the same terms and conditions as all other participants.

Minimum Contribution Requirement. The minimum must be available for application toward the cost of any qualified benefit (other than a taxable benefit) offered under the plan.

Employer contributions to a simple cafeteria plan must be sufficient to provide benefits to non-highly compensated employees (NHCEs) under 125(j)(3)(A) of at least either:

For 2010, an individual is an HCE if his or her compensation from the same employer in 2009 exceeded $110,000 or the person is an officer, more than 5% owner, a spouse or dependent working for the same employer. For 2010, an individual is a key employee if:

- An officer earning more than $160,000 in the 2009 plan year; or
- A more than a 5% owner; or
- A more than a 1% owner receiving compensation in excess of $150,000 in the prior plan year.

Government entities do not have Key Employees.
(i) A uniform percentage of at least two percent of compensation (defined as it is under 414(s) for retirement plan purposes, whether or not the employee makes salary reduction contributions to the plan; or

(ii) The lesser of a 200% matching contribution or six percent of the employee’s compensation. Under 125(j)(C), additional contributions can be made, but the rate of any matching contribution for HCEs or key employees cannot be greater than the rate of match for NHCEs under 125(j)(B). The same method must be used for calculating the minimum contribution for all NHCEs. The rate of contributions for key employees and HCEs cannot exceed that for NHCEs. Compensation for purposes of this minimum contribution requirement is compensation with the meaning of section 414(s).

Safe Harbor From Nondiscrimination Rules.

Simple cafeteria plans are treated as meeting the nondiscrimination requirements of IRC Section 125(b), including the concentration test that currently limits key employees’ benefits to 25% of the total of nontaxable benefits provided for all employees under the plan.

Nondiscrimination tests applicable to individual benefits are deemed to be satisfied, including the Section 79(d) rules for group-term life insurance, the Section 105(h) rules for self-insured medical expense reimbursement plans, and the dependent care rules of Section 129(d)(2),(3) and (8).

These nondiscrimination rules have discouraged utilization of cafeteria plans by small businesses. For example, if a small office with two key employees and two non-key employees provided identical dollar amounts of benefits to all employees under a cafeteria plan, the 25% concentration test would be failed because 50% of total benefits go to the key employees. The new simple cafeteria plan safe harbor addresses this problem but only for small employers organized as traditional C corporations since only common law “employees” and not the self employed are eligible. Multiple classes of owners permitted (applicable also for entities other than S corporations).

D. Reasons Favoring Any Pass-Through (S Corporation, LLC, LLP, etc) Over C Corporation.

1. No double taxation upon an asset sale, unlike a C corporation.

2. Losses flow through to owners annually (up to amount of basis).

3. No risk of unreasonable compensation resulting in double taxation as in C corporation for compensation paid to owner-employee.

4. No Accumulated Earnings Tax

For C corporations, IRC §§ 531-537 provide that from 2003 through 2010, the accumulated earnings tax is 15 percent on earnings a corporation accumulates above $250,000 without a valid business purpose. The limit is $150,000 for certain personal service corporations (i.e., corporations in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting, where the owners provide the services). In 2011, the tax rate reverts back to the highest individual rate, which will be 39.6 percent if the law does not change. This tax does not apply to LLCs or other entities not taxed as corporations.
This tax is designed to dissuade corporations from accumulating earnings just to avoid paying taxable dividends. However, this tax is usually easy to avoid, for three reasons:

- Earnings can be reduced to zero, through the withdrawal of earnings in deductible ways such as higher (reasonable) compensation for the owners.
- The corporation can accumulate earnings beyond these limits, provided it can prove it has a business need to do so, such as payment of anticipated future operating expenses, a planned business expansion, etc.
- The corporation can elect to be treated as a conduit for tax purposes, by making a subchapter S election, which eliminates this problem.

5. Personal Holding Company Tax

A regular C corporation is a Personal Holding Company (referred to as an “incorporated pocketbook”) if at any time during the last half of the taxable year more than 50% in value of its outstanding stock is owned, directly or indirectly, by no more than 5 individuals. In addition, at least 60% of the corporation’s "adjusted ordinary gross income" must consist of passive investment income (dividends, interest, annuities, rents, royalties (other than mineral, oil and gas, copyright, or computer software royalties), capital gains, etc) or from personal services performed by a major shareholder. I.R.C. §§ 542, 543. Real estate rents do not count if they are more than 50% of the adjusted ordinary gross income but any other passive income more than 10% of AOGI must be paid out. Banks and insurance companies are not subject to the PHC tax.

When computing the personal holding company's taxable income, several adjustments are made. Net long term capital gains are excluded, the "regular income tax paid" is deducted, and the 80% dividends-received deduction is added back. The tax is not imposed on dividends paid to shareholders.

The PHC tax is 39.6%. The penalty tax of 39.6% is applicable in addition to the corporate tax. This penalty tax is applied to the corporate taxable income, less distributions to shareholders, income taxes, and certain other adjustments. The tax applies to foreign and domestic companies alike, and is in addition to the regular corporate tax.

Adverse Impact On Tech Startup Licenses. This tax can apply to tech startups that license technology. For example, NewDrugCo decides to license its second patent to Big DrugCo for a large lump sum payment of $3,000,000 in hopes of using the money to develop its first patent over the next few years. This is particularly important because the founders will own only 60% of NewDrugCo after the angel funding and, thus, they want to avoid the need to seek venture capital investment at this stage. When NewDrugCo closes the license deal with Big DrugCo, NewDrugCo will be subjected to potential penalty tax liability for 15% of “undistributed personal holding company income.” The solution of course is not to use a C corporation.

E. Reasons Favoring S Status Over C Corporation & Other Pass-through Entities.

1. Ability for high income shareholder employees, active in business, to receive dividends not subject to Medicare tax from distributions from business as opposed to investment income. Such distributions are exempt from the new Medicare tax after
2012 on business income paid as a distribution (dividend) but not on investment income paid as a distribution.

2. No Medicare tax for owners on employer’s retirement plan contributions or health insurance (applies for shareholder-employees of C corporations also).

F. Reasons Favoring Partnerships & Entities Taxed As Partnerships.

1. Ability to avoid application of 409A for retiring partners/members by use of 736 payments.

2. Ability to avoid self-employment income tax to retiring general partners who are paid some amount until death under 1402(a)10).

3. Opportunity for person buying in to obtain increased basis on entity assets through 754 election and re-depreciate them.


5. LLPs for multistate professional firms avoid state qualification and licensing issues that may apply to PCs and LLCs.

6. Special allocations of income to owners desired.

7. Entity debt creates owner basis, unlike in S corporation.

8. Refinancing proceeds can be distributed income tax free.

9. Multiple classes of owners permitted (applicable also for C corporations).

This 1402(a)10) exclusion for lifetime payments to retired general partners (which also applies to LLC member-managers) is not available to severance payments to shareholder-employees of corporations. Under IRC § 1402(a)(10) and Reg. 1.1402(a)-17(c)(1), exclusion of payments to “general partners” from self-employment tax is an all-or-nothing proposition as to whether payments on account of retirement received by a retired partner during the tax year of the partnership are excluded. On retirement, a “general partner” can exclude from NEFSE (income subject to self-employment tax) amounts received if the requirements of IRC § 1402(a)(10) and Reg. 1.1402(a)-17 are met, namely:

(1) The payments must be received by the partner pursuant to a written plan of the partnership.

(2) The payments must be made on account of retirement, on a periodic basis, to partners generally or to a class or classes of partners, with the payments continuing at least until the partner’s death. These payments can be front loaded. See PLR 200403056, where most of the payments were made in the first 5 years after retirement and $100 a year thereafter.

(3) The partner must render no services with respect to any trade or business carried on by the partnership during the tax year of the partnership in which the amounts were received.

(4) No obligation may exist as of the close of the partnership’s tax year from the other partners to
(5) The partner's share, if any, of the capital of the partnership must have been repaid in full before
the close of the partnership's tax year in which such amounts were received.

(6) The retired partner must have no financial interest in the partnership except for the right to
retirement payments.

If payments are not made to the retired partner on a periodic basis that continue at least until the
partner's death (but rather terminate after a fixed number of years), the former general partner will
include the retirement payments in NEFSE. If the partner has a right to a fixed percentage of any
amounts collected by the partnership after the date of retirement that are attributable to services
rendered prior to her retirement to clients of the partnership, the payments received by her for that
tax year are not excluded from NEFSE since, as of the close of the partnership's tax year, an
obligation (other than an obligation with respect to retirement payments) exists from the other
partners to the retired partner. See Reg. 1.1402(a)-17(c)(2), Example (3).

PLR 9630012 ruled that an active member in an accounting firm LLP who carries management
rights and actively participates in the accounting business of the firm will have NEFSE on his entire
distributive share of income from the firm, and that none of his income will be excluded under
Section 1402(a)(13). This indicates that an active member of an LLP (which is treated as a general
partnership for state law purposes) is neither a limited partner nor treated as a limited partner for
purposes of Section 1402. See Shop Talk, "Are Retirement Payments to Limited Partners and LLC
Members Subject to Self-Employment Tax?", 86 JTAX 62 (January 1997).

LLP General Partner Qualifies. PLR 9630012 holds that payments made on account of a retired
partner of an LLP that meet the requirements of Section 1402(a)(10) will be excluded from NEFSE.

LLC Member Qualifies. PLR 200142004 ruled that Section 1402(a)(10) relief is available for
payments to an attorney who was a retired member of an LLC classified as a partnership for federal
income tax purposes. The LLC maintained a retirement benefit program for its members (treated as
partners for tax purposes) that provided for payments directly from the law firm to the retiree. On
retirement, the retired partner relinquishes her interest in the LLC, in exchange for the balance of
her capital account in the firm, the retirement benefits under the nonqualified retirement program,
and other benefits payable under the firm's benefit plans. The retired partner is entitled to a
retirement payment equal to the sum of the average of the partner's three highest distributions for
any previous calendar year. The amount is paid out, without interest, in a series of monthly
payments for a period of not less than 60 and not more than 120 months. Thereafter, the retired
partner is entitled to payments of no less than $100 per month for the rest of the partner's life.

After describing the requirements of Section 1402(a)(10) and Reg. 1.1402(a)-17, the letter ruling
concludes that the LLC's retirement program is a bona fide retirement plan within the meaning of
Section 1402(a)(10), and meets the other requirements of the statute and the Regulation. In
connection with the requirement that the payments by a partnership must continue at least until the
partner's death, the ruling observes that although the payments by the LLC are likely to be reduced
after the initial 60–120 month period, the monthly payments thereafter will never fall below $100
per month and will continue until the retired partner's death. The letter ruling is consistent with the
Service's position (in earlier letter rulings) involving redemptions of general partners in a general
partnership agreement in not requiring level, equal amounts of retirement benefit payments
throughout the retired partner's lifetime. A step-down in the amount is permissible as long as the
payments are retirement payments for at least the duration of the retired partner's life.

The ruling expresses no opinion as to the treatment of the payments to the retired partners under any provision of the Code other than Section 1402(a)(10).

Retirement Payments To Limited Partners. Limited partners may enjoy an exemption from NEFSE during the period they are limited partners. Section 1402(a)(13) provides that NEFSE does not include the distributive share of any item of income or loss of a limited partner, as such, other than guaranteed payments described in Section 707(c) to that partner for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services. Section 1402(a)(13) (then numbered (a)(12)) was added to the Code by P.L. 95-216, 12/20/77 (the Social Security Amendments of 1977); prior to that time, the distributive share of income or loss received by a limited partner from the trade or business of a limited partnership was included in NEFSE, and some limited partners made passive investments in limited partnerships solely to become insured for Social Security benefits by incurring NEFSE while performing no services for the partnership. See Banoff, "Tax Distinctions Between Limited and General Partners: An Operational Approach," 35 Tax Law Review 1 (Fall 1979), pages 76-77.

However, a limited partner who actively renders services (permitted in many states without serious risk of unlimited personal liability, pursuant to the Revised Uniform Limited Partnership Act) and receives Section 707(c) guaranteed payments for services determined without regard to partnership income will receive NEFSE. Any remaining share of income as a limited partner will not be NEFSE. Section 1402(a)(13); Reg. 1402(a)-1(b). Moreover, if the limited partner does not receive a Section 707(c) payment, i.e., does not receive compensation determined "without regard to partnership income," but rather merely receives her distributive share of income (e.g., a percentage of net profits) for services, no portion of her compensation constitutes NEFSE.

What is the treatment of retirement payments made to a limited partner who rendered services while a partner, but who had received an allocable share of partnership net income as remuneration for services and never received guaranteed payments for services under Section 707(c)? While a partner, such service provider would have no NEFSE pursuant to Section 1402(a)(13). Does the answer change with respect to payments made to the (former) limited partner on retirement? If the retirement payments meet all of the aforementioned requirements of Section 1402(a)(10) and Reg. 1.1402(a)-17, the payments clearly are not NEFSE. If, however, the retirement payments did not qualify for Section 1402(a)(10) treatment, the answer is less clear. Prop. Reg. 1.1402(a)-2 does not permit a service partner in a service partnership to be a "limited partner" for purposes of Section 1402(a)(13). See Prop. Reg. 1.1402(a)-2(h)(5). If this proposed rule were adopted and applicable, the pre-retirement payments to such a limited partner would be NEFSE.) No cases, rulings, or regulations under Section 1402(a)(13) deal with payments to retired limited partners.

G. 736 Payments & Service Partnership Buyouts; Planning Important; Issue As To LLCs.

Code § 736 applies to transactions treated as a liquidation (redemption) of a partner's interest in the partnership. If a written buyout agreement and the partnership agreement of a service partnership do not contain any purchase price allocation for the redemption (liquidation) of a retiring partner, the net fair market value of the equipment, furniture and other tangible assets is a capital gain payment. The partnership can make a 754 election and amortize those assets. The balance of the payments is ordinary income because they will be characterized as relating to accounts receivable or unstated goodwill. Moreover, they are deductible to the partnership.
IRC § 736 dictates how liquidating final payments to the retiring partner or estate are classified. For tax purposes, the payment, whether in the form of cash or property, is considered either a payment for the partner's share of partnership property or something other than his or her share of partnership property. The purpose of the section is to ensure that retiring partners correctly classify certain items as ordinary income.

In 1993, Congress enacted Section 736(b)(3), which curtailed the flexibility of capital partnerships to choose the tax consequences of payments made in redemption of a partner's interest in partnership goodwill. Prior to this legislation, Section 736(b)(2) allowed all partnerships a choice between treating payments for goodwill as capital or ordinary items by allowing the partnership agreement to control the outcome. Section 736(b)(3) eliminated this choice for partnerships other than service partnerships. The House Ways & Means Committee reasoned that “general partners in service partnerships do not ordinarily value goodwill in liquidating partners. Accordingly, such partners may continue to receive the special rule of present law.”

Service partnerships are those in which capital is not a material income producing factor. Sec. 736(b)(3)(A). For this purpose, capital is not a material income producing factor where substantially all the gross income of the business is derived from fees, commissions, or other compensation for personal services performed by individuals. Thus, a professional practice of a doctor, dentist, lawyer, architect, or accountant is not treated as a trade or business in which capital is a material income-producing factor, even though the practitioner has a substantial investment in professional equipment or in a physical plant constituting the professional office, so long as the capital investment is only incidental to the professional practice. H Rept No. 103-111 (PL 103-66) p. 783.

Code Sec. 736(b)(3) provides that if capital is not a material income-producing factor and the partner is a general partner, Code Sec. 736(b)(2) automatically applies ordinary income treatment to the unrealized receivables and unstated goodwill. Unstated goodwill is goodwill for which the partnership agreement contains no provision for payment.

All payments, fixed or contingent, are 736(b) payments to the extent of the value of the partner’s percentage share of the net fair market value of partnership assets. However, payments for receivables and unstated goodwill (where there is no dollar allocation to goodwill in the operating or purchase agreements) to a general partner in a service partnership with no allocation of value, which are treated as 736(a) payments.

Section 409A does not apply to an arrangement that provides for section 736 payments unless the arrangement provides for payments for life that qualify under 1402(a)(10), which are excluded from self-employment tax. See Notice 2005-1 Q&A-7.

Section 736(a)(1) payments reduce the total amount of partnership income that would otherwise have been allocated to the remaining partners while Section 736(a)(2) payments result in a partnership-level deduction. The partnership deducts the 736(a) payments when made, which may be before or after the income as collected by the partnership, which is when it is taxed. Payments for substantially appreciated inventory and recapture items are payments for property that are
736(b) payments but taxed under 751(b) as ordinary income.

736 & LLCs (Taxed As Partnerships). Where there is no contrary written agreement, the probable correct result for the treatment of a redemption of a personal service LLC member is that the redeemed member's share of the net fair market value of the LLC's assets is a capital gain payment under section 731 and 736(b) (and not deductible by the LLC), with the balance of the payment being a guaranteed payment under 736(a), which is ordinary income to the member bought out and deductible to the LLC.

Service LLC Members Should Not Be Treated As General Partners. The only basis for this proposition is that a member of an LLC is not treated as a general partner of a partnership because the member is not a "general partner" under state law. While the IRS has not ruled on this issue, a manager-member or a member of a member managed LLC should be treated as a general partner for this purpose, based on the purpose of the provision, IRS rulings in an analogous area, and four court cases, all discussed below.

Service LLC Members Should Be Treated As General Partners. "At least some LLC members, particularly managers and manager-managed LLCs and probably all members and member-managed LLCs should qualify, as should almost all partners and LLPs, since LLPs generally operate under the same partnership acts as general partnerships, with the only difference being limited liability obtained by filing an appropriate document." 811 BNA T. M. Portfolio A-120 (2009).

Second, 736(b) payments are by definition distributions made in exchange for the retiring member's interest in LLC assets, and, therefore, any payment in excess of a member's share of LLC assets cannot be treated as a Section 736(b) payment. Therefore, in the event that such a premium is paid for a member's interest in the LLC that exceeds the value of the member's share of the LLC's assets, that premium should be treated as a Section 736(a) deductible to the extent of the value of accounts receivable and the balance of the payment if there is no allocation in the operating agreement or a separate agreement to goodwill.

Third, the answer lies in whether the LLC member is more like a general partner or a limited partner for (purposes of) Section 736(b). Understanding that basically there are only two differences between a general and a limited partner—unlimited liability and the right to participate in management—and understanding that a member of an LLC may have the right to participate in the management and business of the company (like a general partner) and limited liability (like a limited partner), whether a member is treated as a general partner or as a limited partner in any given instance depends on which of these two characteristics is critical in treating general partners and limited partners differently in that case.

Fourth, the reason for the carve-out for general partners in Section 736(b)(3)(B) for Section 736(b)(3)(A) service organizations is the service element and not the liability element. Thus, the fact that a general partner has unlimited liability and that an LLC member has limited liability is irrelevant. Accordingly, there is no reason to treat LLC members any differently than general partners where the LLC members are entitled to provide services on behalf of the firm, as would a lawyer for a law firm. Therefore, it is my conclusion that professional LLCs may use Section 736
now as they have always, pursuant to Section 736(b)(3).”

Fifth, the IRS has treated an LLC member as a general partner in a similar context. On retirement, a general partner can exclude from self-employment tax amounts he receives if the requirements of Section 1402(a)(10) and Reg. 1.1402(a)-17 are met. In a private letter ruling, the IRS treated an LLC member as a general partner for this purpose. In Ltr. Rul. 200142004, Section 1402(a)(10) treatment was granted for payments to an attorney who was a retired member of an LLC classified as a partnership for federal income tax purposes. The retired partner is entitled to a retirement payment for life and the other requirements of Section 1402(a)(10) and Reg. 1.1402(a)-17 were met. The letter ruling concludes that the LLC’s retirement program is a bona fide retirement plan, within the meaning of Section 1402(a)(10), and meets the other requirements of the statute and the Regulation.

Sixth, while the IRS has not yet ruled on the characterization of an unallocated liquidation payment attributable to the self-created goodwill of an LLC, which is paid to a retiring LLC manager or actively participating LLC member. However, Treasury in the self-employment arena has in proposed regulations put LLCs and partnerships on equal footing, which indicates that the Code Sec. 736(b)(3) choice should be available to a “personal service” LLC.

Seventh, the courts have ruled that LLC members are not limited partners. Thus, if they are not limited partners, they are general partners, which is the only other choice. The basic reason for the courts’ holding is that unlike limited partners, LLC members can participate in the governance and operations of the LLC. In Garnett v. CIR, 132 TC No 19, 2009 WL 1883965 (2009), and Thompson v. CIR, 87 Fed Cl 728 (Fed. Cl. Ct., 2009), the Tax Court and the Court of Federal Claims rejected the Service’s attempt to treat both the members of LLCs and the partners in limited liability partnerships (LLPs) as limited partners for purposes of the passive loss rules. The courts concluded that, absent direct statutory or regulatory guidance, the taxpayers could not be treated as subject to the more restrictive rules applicable to limited partners under Section 469. This was also the result in Hegarty v. CIR, TC Summary Opinion 2009-153 and Gregg v. CIR, 186 F Supp 2d 1123 (DC Ore. 2000).

Service Partnerships-Capital Not Material Income Producing Factor. In the case of a retiring or deceased general partner of a service partnership, one in which capital is not a material income-producing factor, 736(b) payments do not include payments made for such partner's interest in the partnership's unrealized receivables (not including recapture items) under § 751 and goodwill unless there is a specific allocation to goodwill in the partnership agreement, in which case the goodwill payments are also § 736(b) payments. It is probably sufficient for the agreement to be in a separate redemption agreement as well. See CIR v. Jackson Investment Co., 346 F.2d 187 (9th Cir. 1965).

Section 736 gives the partners in service partnerships significant flexibility to determine whether distributions are deductible ordinary income payments under section 736(a) or payment for the withdrawing partner's interest in partnership property under 736(b).

Example. Unrealized Receivables. A service partnership has three equal partners and $90,000 cash, cash method receivables of $222,000, and supplies that were properly deducted when acquired and are worth $9,000. One partner is read deemed for a payment of $107,000 in cash. The
supplies are substantially appreciated inventory because their sale would produce ordinary income and their fair market value exceeds 120% of the zero adjusted basis. 751(b) treats the redeemed partner as having received $3000 for the supplies. The redeemed partner's outside basis is $30,000, so $30,000 of cash is tax-free. The remaining $74,000 of the payment is for the receivables and is treated as ordinary income under 736(a), a guaranteed payment, and not under 751(b). The partnership steps up its basis in the supplies by $3000 and can take a deduction for the "purchase" of those supplies. See BNA 811 T. M. Portfolio at pages A-119 – 120 (2009).

**Example. Receivables & Unspecified Goodwill.**

A service partnership with three equal partners redeems one partner for $150,000. The partnership has $90,000 cash and cash-method receivables worth $111,000 with a zero basis. The partnership determined the amount paid based on the redeemed partner's $30,000 capital account with the balance based on an earnings formula. There is goodwill because the amount paid is in excess of the redeemed partner's capital account plus the partner's $37,000 share of accounts receivable. No amount is allocated by the partnership agreement or separate agreement to the receivables or goodwill. The $30,000 payment allocable to the partner's capital account is a 736(b) liquidation distribution with a gain or loss determined by that amount less the partner's outside basis. The balance, $120,000, is a section 736(a)(2) guaranteed payment, taxed as ordinary income to the redeemed partner and deductible to the partnership. The receivables are not taxed under 751(b). If the agreement had specified an amount for goodwill, it would have been a 736(b) capital payment amortizable by the partnership over 15 years. Accounts payable and similar obligations of a cash-method partnership that have not been deducted are not liabilities. However, if they are not transferred to the partner (who could deduct them one the partner pays them) but are taken into account in determining the amount of the liquidating distribution, they reduce the ordinary income because 736(b) payments come first. See 811 BNA T. M. Portfolio A-121 (2009).

**Example. Service Partnership With Bank Debt**

A service partnership with three equal partners redeems one partner. Neither the partnership agreement nor any separate agreement makes any allocation of the purchase price. The partnership has cash and other assets look the value of $90,000, cash-method accounts receivable of $180,000, bank debt of $60,000, and accounts payable of $18,000 deductible only when paid. The redeemed partner's capital account is $30,000, and has outside basis in the partnership interest is $50,000. The partnership redeems his interest for $64,000 in cash and agrees to indemnify him for the bank debt and the payables. The taxable distribution is $64,000 plus $20,000 of debt relief (the payables are not debt for this purpose) for a total of $84,000. $30,000 of the payment is based on the value of assets and taxed under 736(b). The remaining $54,000 is 736(a)(2) guaranteed payment, taxed as ordinary income to the redeemed partner and deductible to the partnership. This is amount is less than is one-third share of receivables because his $6,000 share of the payables was netted against that value. See 811 BNA T. M. Portfolio A-121 (2009).

**H. Passive Losses, LLCs and LLPs Better Than LPs For Those Wanting Current Losses.**

Under Code Section 469, passive losses may offset only passive income. Unless a partner can demonstrate his material participation, his share of the partnership's loss a passive activity loss
rather than an ordinary loss. Section 469(c)(1)(B). In Garnett v. CIR, 132 TC No 19, 2009 WL 1883965 (2009), and Thompson v. CIR, 87 Fed Cl 728 (Fed. Cl. Ct., 2009), the Tax Court and the Court of Federal Claims rejected the Service's attempt to treat both the members of LLCs and the partners in limited liability partnerships (LLPs) as limited partners for purposes of the passive loss rules. The courts concluded that, absent direct statutory or regulatory guidance, the taxpayers could not be treated as subject to the more restrictive rules applicable to limited partners under Section 469. This was also the result earlier in Gregg v. CIR, 186 F Supp 2d 1123 (DC Ore. 2000). Members of LLCs and partners in LLPs are not "limited partners" under the passive activity rules of Section 469 based on recent cases. It is not clear how general partners of a limited liability limited partnership (LLLPLP) should be treated for purposes of 469.

Section 469(a) provides a limitation on the ability of certain taxpayers to use losses or credits from passive activities in determining their income. A passive activity is defined in Section 469(c) as any rental activity or any trade or business activity in which the taxpayer does not materially participate.

Section 469(h)(1) provides that a taxpayer materially participates in an activity only if he is involved in the activity's operations on a regular, continuous, and substantial basis. Section 469(h)(2) provides, however, that (except as provided in Regulations) "no interest in a limited partnership as a limited partner shall be treated as an interest with respect to which a taxpayer materially participates."

Losses from limited partnership interests are not available to offset positive income from other sources. The Senate committee incorrectly assumed that income allocable to a limited partner automatically was passive due to the nature of limited partnerships and the inability of limited partners to participate actively in an activity if they wish to maintain limited liability status. In many states, limited partners can now participate in management. S. Rep't No. 99-313, 99th Cong., 2d Sess. 716 (1986).

1988 Temporary Regulations are still the latest interpretation and define material participation. Temp. Reg. 1.469-5T(a) lists seven tests for determining whether an individual materially participates in an activity; a taxpayer must satisfy one of these tests. Specifically, an individual may establish his material participation in an activity for a given tax year by demonstrating any of the following:

(1) The individual participated in the activity for more than 500 hours during such year.

(2) The individual's participation in the activity for the tax year constituted substantially all of the participation in such activity of all individuals for that year.

(3) The individual participated in the activity for more than 100 hours during the tax year, and such individual's participation in the activity for the tax year was not less than the participation in the activity of any other individual for that year.

(4) The activity was a significant participation activity for the tax year, and the individual's aggregate participation in all significant participation activities during that year exceeded 500 hours.

(5) The individual materially participated in the activity for any five tax years during the ten tax years that immediately preceded the tax year.

(6) The activity was a personal service activity, and the individual materially participated in the
activity for any three tax years preceding the tax year.

(7) Based on all facts and circumstances, the individual participated in the activity on a regular, continuous, and substantial basis during that year.

On the other hand, if an individual is a limited partner in a partnership, Temp. Reg. 1.469-5T(e)(2) provides that the individual can materially participate in an activity only if the first, fifth, or sixth test above is met. Thus, an individual who participates for less than 500 hours in the tax year in an activity in which the taxpayer is a limited partner generally cannot materially participate in the activity (unless the taxpayer materially participated in the activity in prior years), whereas a taxpayer can establish material participation on several other bases if the individual is not a limited partner (e.g., is a general partner).

Temp. Reg. 1.469-5T(e)(3)(i) defines an interest in an entity taxed as a partnership as a "limited partnership interest" if either of the following conditions is met:

(1) The interest is designated as a limited partnership interest in the limited partnership agreement or the certificate of limited partnership, without regard to whether the liability of the holder of such interest for obligations of the partnership is limited under state law.

(2) The liability of the holder of such interest for obligations of the partnership is limited, under the law of the state in which the partnership is organized, to a determinable fixed amount (e.g., the sum of the holder's prior capital contributions and contractual obligations to make additional capital contributions to the partnership).

Temp. Reg. 1.469-5T(e)(3)(ii) provides that if a person is both a general partner and a limited partner in the same partnership, the limited partnership interest will not be treated as a limited partnership interest for these purposes.

**Newer Limited Partnerships**

Under subsequent revisions of the uniform limited partnership act, i.e., RULPA 1976, RULPA 1985, and ULPA 2001, limited partners in many states can now participate in significant activities of the limited partnership, without loss of limited liability.

**LLLPs**

An LLLP is a limited partnership whose general partners are also shielded from personal liability for some or all of the partnership's debts. The shield already exists with respect to the LLLP's limited partners, of course, although in some instances the vicarious liability protection afforded limited partners in an LLLP is thought to be slightly greater than under traditional limited partnership law.

I. Service Firms Practicing as LLLPs.

1. Tax consequences of converting to an LLLP.

Assume a professional services firm is already operating as a general partnership. What are the tax consequences of its decision to operate as an LLLP? Specifically, is the conversion of the general partnership into LLLP form a taxable event, and what are the collateral tax consequences?

**Tax-Free Conversion From Entity Taxed As Partnership.** Rev. Rul. 95-37 ruled that a conversion of a general partnership into an LLC was governed by Section 721 (providing neutral consequences
to the partners and the unincorporated entities), and determined that the particular form used to convert the general partnership into an LLC did not affect the tax consequences (effectively, permitting the substance of the conversion to control over the form). Similarly, in Rev. Rul. 95-55 ruled that the registration of a general partnership as an LLP pursuant to that state's law was a Section 721 transaction based on Rev. Rul. 84-52 and Rev. Rul. 95-37. No Revenue Rulings or letter rulings are known to have been issued to date with respect to changes of existing partnerships, LLCs, or LLPs into LLLP status. Nonetheless, there appears to be no reason why the IRS would not apply a similar favorable Section 721 analysis to conversions into LLPs.

The tax consequences of operation of a professional services firm in LLLP form remain unclear. While "partnership" and "partner" are defined for tax purposes, "general partner" and "limited partner" are not. "Partnerships" and "partners" are included in Section 761 and Reg. 1.761-1 by reference to the Regulations under Section 7701. Section 7701(a) defines "partner" to include a member in a syndicate, group, pool, joint venture or other unincorporated organization.

2. Tax Issues In Operating LLLP.

A professional firm considering operation as an LLLP must deal with the following tax and related issues:

State Law Status Of Limited Partners. Are the limited partners of the LLLP treated for tax purposes as "limited partners" because they are members of an entity organized under a state's limited partnership laws, even though the partners will actively provide services and may take part in the firm's management?

Tax Status Of General Partners. Are the general partners of an LLLP treated for tax purposes like "general partners" because of their title and managerial authority and powers or "limited partners" because of their limited liability under the LLLP shield?

Self Employment Income. Will the income of the limited partners in the LLLP constitute net earnings from self-employment (NEFSE)? Section 1402(a)(13) provides that the distributive share of any item of income or loss of a limited partner is excluded from the computation of NEFSE, other than guaranteed payments for services to the limited partner. If so, the professionals who are limited partners in an LLLP would not pay SE taxes on their distributive share of partnership income and those amounts would not be eligible for retirement plan contributions, eliminating social security and Medicare tax until the law changes in 2013 under the 2010 health reform legislation.

Liquidation Payments Upon Termination Repurchase Of LLLP Interest. The rule is that Section 736 payments to a partner are not deductible by the payor partnership pursuant to Section 736(b)(2). Section 736(b)(3), however, provides an exception for such payments to a “general partner” of a partnership for which capital is not a material income-producing factor. That qualification is important because the service firm typically is using operating revenues (ordinary income, taxable to the remaining partners) to pay the withdrawn partner. By qualifying under Section 736(b)(3), professional service partnerships generally structure payments to a retired or deceased partner in a manner that allows the partnership to have a deduction for the ordinary income paid to the exiting partner, with the remaining partners to obtain tax-advantaged treatment for the departed partner's share of payments for goodwill or unrealized receivables.

This same issue of 736 application has been cited by some general partnership service firms as a factor in their converting into LLP (rather than LLC) form, given the continuing uncertainty of
whether LLC members are "general partners" for this purpose. There is no clear resolution on this issue yet. There is a good case that 736 should be available to LLCs and LLLPs.

Cash Method Accounting. Section 448 permits qualified personal service corporations and partnerships to use the cash method. Professionals typically use this method because collections occur after the right to income is earned. Sections 446, 448, 461, 464, and 1256 provide that a partnership or other pass-through entity cannot use the cash method if more than 35% of the losses of such entity during the tax year are allocable to limited partners or limited entrepreneurs.

Temp. Reg. 1.448-1T(b)(3) provides that a partnership or other entity may fail this test only if more than 35% of the losses during the tax year are actually allocated to limited partners and limited entrepreneurs. Therefore, assuming the other requirements of Section 448 are met, an LLLP, like an LLC, arguably should not lose the cash method under Section 448 before the first year in which it incurs losses in excess of income and more than 35% of such losses are allocated to the limited partners. See PLRs 9321047 and 9415005.

Will The LLLP's Trade Or Business Be Imputed To Its Limited Partners? The question of whether a limited partnership's trade or business is imputed to "active" limited partners is not settled. Butler v. CIR, 36 TC 1097 (1961), acq., held that a lawyer who was an "active" limited partner in a business limited partnership could deduct his unpaid loan to the LP as a business bad debt. Imputation to "active" limited partners in a professional service LLLP would seem to be similarly appropriate.

However, TAM 9728002 held that the partnership's trade or business should not be imputed to limited partners, but only to general partners, in connection with the attempted deduction of legal fees incurred by a limited partner in a lawsuit against the general partner, thereby resulting in a Section 212 itemized deduction rather than a Section 162 above-the-line deduction. The Service limited Butler to its facts because Butler was more than a passive investor—he was a key member of the firm "and more like a general partner even though labeled a limited partner." Many if not all service LLP partners arguably will be as active as general partners in a service LLP, and thus imputation of trade or business status may be appropriate, even under TAM 9728002.

State Income Tax. Finally, for state and local tax purposes, will the LLLP be treated as a limited partnership, in those jurisdictions where entity-level taxes are applied to certain types of pass-through entities (e.g., LLCs) but not to limited or general partnerships? Moreover, in those jurisdictions where limited partnerships may be subject to entity-level taxes and withholding on distributions to limited partners (but the same rule does not apply to general partnerships), does operation as an LLLP provide a tax disadvantage?

Similarly, will those out-of-state individual service partners who are limited partners in the LLLP be less likely to have a nexus with other states, for purposes of multistate jurisdiction or taxation? In states where the service firm does business and that state's individual income tax rate is materially greater than the home state tax rate of the LLLP limited partner, can the latter validly avoid taxation or nexus on his allocable share of the LLLP's net income attributable to the high tax rate state?

J. Reducing Self Employment (SECA) Tax.

As noted above, payments to limited partners and perhaps to members of LLCs other than for management services may be exempt from self employment tax except to the extent that they are payments for services. This concept was attempted to be implemented in Robucci v. Cir, T.C.
Memo. 2011-19 (January 24, 2011) holds that (1) the new structure of a sole proprietor psychiatrist’s practice should be largely disregarded as without substance, (2) the taxpayer continues to be taxable as a sole proprietor, and (3) the 6662 substantial understatement penalty applies. This case follows a much different path than numerous earlier cases upholding conversions of sole proprietorships and partnerships into professional corporations. The entities involved were not implemented properly. The court notes that if they had been, the result might have been different. This reminds us of the early PC days, where the IRS was on the attack and successful taxpayers were careful to dot every “I” and cross every “T.”

Robucci P.C. was wholly owned by Dr. Robucci, and this PC was a co-member, along with Dr. Robucci personally, in Tony L. Robucci, M.D. LLC (Robucci LLC). Dr Robucci personally owned 95% of the LLC and his PC owned 5%. Dr. Robucci’s 95-percent interest in the LLC was divided between a 10-percent general partner interest and an 85-percent limited partner interest attributable to Dr. Robucci’s personal goodwill. Westsphere was a management corporation wholly owned by Dr. Robucci. The PC and Westsphere are referred to as the corporations.

The IRS argued and Tax Court Judge Halpern held that the corporations should be disregarded, leaving the Robucci LLC as a SMLLC owned solely by Dr. Robucci. Thus, as footnote 2 of the decision noted, the court did not need to deal with the two IRS alternative 482 and 269A arguments, both typically unsuccessful in prior litigated cases.

The Taxpayer’s Goal – Tax Reduction.

During his first meeting with Mr. Carson, an attorney and CPA, sole proprietor Dr. Robucci stated that he wanted to do what was best from the standpoint of his own personal tax planning and wanted to minimize the amount of taxes he was paying. Mr. Carson recommended the organizational structure described above. That discussion covered structuring Dr. Robucci’s practice so as to reduce self-employment tax while also minimizing other tax liabilities. Dr. Robucci did not seek a second opinion from any other C.P.A. or attorney, nor did Mr. Carson provide him with a written explanation of the need to form three separate entities. Carson explained orally to Dr. Robucci that the LLC would conduct the practice, that for reasons not made clear to Dr. Robucci, it needed to have two members (Dr. Robucci personally and Robucci P.C.), and that Westsphere would be a business management corporation and not involved in providing patient care.

Failure To Implement Mr. Carson’s Recommended Organizational Structure

Dr. Robucci was the sole shareholder of both corporations. During that same period, Robucci LLC was 95-percent owned by Dr. Robucci and 5-percent owned by Robucci P.C. The court says that Robucci P.C.’s interest was as a limited partner. This seems to be incorrect, as footnote 4 of the decision notes that Reg. § 301.7701-3(b)(1)(i) states that a multimember LLC that does not elect association status (which describes Robucci LLC) is treated, for Federal tax purposes, as a partnership. Thus, Robucci LLC’s members would most likely both constitute general partners for Federal tax purposes if it were respected as a two-member entity. Several court decisions hold that LLC members cannot be limited partners, even if they are merely members in a manager managed
LLC. However, the IRS has never issued final regulations on this issue. The court’s reasoning also makes this issue moot in this decision.

Dr. Robucci’s 95-percent ownership interest was reflected on Robucci LLC’s partnership returns as an 85-percent interest as a limited partner and a 10-percent interest as a general partner. While not noted by the court, many cases hold that LLC interests of members in a manager managed LLC are not limited partner interests but rather general partner interests. Carson based his determination of an 85-percent limited partner ownership interest for Dr. Robucci on the value of Dr. Robucci’s goodwill and what would be a reasonable rate of return on that goodwill at the time he formed Robucci LLC. Mr. Carson never discussed with Dr. Robucci the basis for the 85-percent-10 percent allocation between his limited and general partner interests in Robucci LLC. Dr. Robucci did understand that his 10-percent general partnership interest represented his interest as a provider of medical services and his 85-percent limited partnership interest represented his interest attributable to his capital contribution of intangibles.

Carson did not prepare a written valuation report to support his conclusions. Additionally, Dr. Robucci did not make any written assignment of the tangible or intangible assets of his practice to Robucci LLC.

Westsphere executed a loan agreement, whereby Dr. R as an "employee" was authorized to borrow money from Westsphere "from time to time" under specified terms and conditions.

Dr. Robucci executed an Employee Business Expense Reimbursement Plan, whereby Westsphere agreed to reimburse its employees for all employment related expenses upon submission of the proof of expenditure documentation specified in the plan. Westsphere also adopted a Medical Reimbursement Plan and a Diagnostic Medical Reimbursement Plan. The Operating Agreement of Robucci LLC designated Robucci P.C. as manager but it was not clear whether it was signed. Dr. Robucci had a limited understanding of the need for the entities formed and the agreements and other documents drafted by Mr. Carson.

Robucci LLC and Westsphere had bank accounts, while Robucci P.C. did not. Dr. Robucci did not have an employment agreement with any of those three entities, nor did any of them have employees during the years in issue. Neither Robucci P.C. nor Westsphere paid a salary to Dr. Robucci or to anyone else during those years. Dr. Robucci did not keep records of any time he might have spent working for Westsphere. Although Robucci LLC deducted "management fees" for each of the years in issue ($31,475, $25,500, and $38,385 for 2002, 2003, and 2004, respectively), its returns and bank records do not specify to whom they were paid or for what services. Dr. Robucci was aware that Westsphere charged management fees to Robucci LLC but he did not know the nature of those charges except that they related to non-patient care services.

Robucci LLC and the corporations used the same business address but there was no written lease agreement between Robucci LLC and either of the corporations.

The corporations did not (1) have separate Web sites or telephone listings, (2) pay rent to Dr. Robucci or Robucci LLC, (3) have customers other than Robucci LLC or contracts with any other third parties, or (4) advertise. Westsphere did not have separate dedicated space in Dr. Robucci's
office. Dr. Robucci continued to bill Medicare and Medicaid (a relatively small portion of his practice) as an individual practitioner and not through Robucci LLC.

During the years in issue, Robucci LLC was a calendar year taxpayer and the corporations reported on the basis of fiscal years ending November 30.

Dr. Robucci’s Self-Employment (SECA) Taxes

Dr. Robucci’s 2002, 2003, and 2004 Forms 1040, U.S. Individual Income Tax Return, show the following distributions to him of "passive" and "nonpassive" income from Robucci LLC:

<table>
<thead>
<tr>
<th>Year</th>
<th>Passive Income</th>
<th>Nonpassive Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>$48,153</td>
<td>$5,665</td>
</tr>
<tr>
<td>2003</td>
<td>57,446</td>
<td>6,851</td>
</tr>
<tr>
<td>2004</td>
<td>95,143 i</td>
<td>11,193</td>
</tr>
</tbody>
</table>

Dr. Robucci's 2004 return reported this $95,143 amount as nonpassive income on Schedule E, although the 2004 Schedule K-1 from Robucci LLC in connection with his 85% partnership interest lists $95,143 as the distribution attributable to that (passive) interest, and Dr. Robucci's 2004 Schedule SE, Self-Employment Tax, included only $11,193 as net earnings from self-employment.

Dr. Robucci’s Schedule SE filed for each of those years lists the 10% “general partner: nonpassive income as gross earnings from self-employment.

The Tax Court noted that the Supreme Court in Gregory v. Helvering, 293 U.S. 465, 469 (1935) stated: "The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted." Directly after that statement, however, the Court added the admonition: "But the question for determination is whether what was done, apart from tax motive, was the thing which the statute intended." Id.

In Chisholm v. Commissioner, 79 F.2d 14, 15 (2d Cir. 1935), Judge Learned Hand elaborated upon the Supreme Court's admonition in Gregory, stating: "The question always is whether the transaction under scrutiny is in fact what it appears to be in form".

The issue in these cases is whether the corporations, Robucci P.C. and Westsphere, are entitled to respect as viable business corporations or whether, as in Judge Hand's description of the facts in Gregory, the incorporator's "intent, or purpose, was merely to draught the papers, in fact not to create corporations as the court *** [understands] that word." Id. In other words, were Robucci P.C. and Westsphere corporations in fact as well as in form; i.e., were they "the thing which the statute intended" when referring to corporations?
A corporation will be recognized as a separate taxable entity if (1) the purpose for its formation is the equivalent of business activity or (2) the incorporation is followed by the carrying on of a business by the corporation. Moline Props., Inc. v. Commissioner, 319 U.S. 436, 438-439 (1943); Achiro v. Commissioner, 77 T.C. 881, 901 (1981). If neither of those requirements is satisfied, the corporation will be disregarded for Federal tax purposes, and all of its income will be attributed to the true earner. Shaw Constr. Co. v. Commissioner, 35 T.C. 1102, 1114-1117 (1961), affd. 323 F.2d 316 (9th Cir. 1963); Aldon Homes, Inc. v. Commissioner, 33 T.C. 582, 597-607 (1959).

The Tax Court held that it need not decide the burden of proof issue under section 7491(a) because a preponderance of the evidence supports the resolution of that issue. Therefore, resolution of that issue does not depend on which party bears the burden of proof. See, e.g., Estate of Bongard v. Commissioner, 124 T.C. 95, 111 (2005).

**Business Purpose Of The Structure.**

The taxpayers argue that as "managing member" of Robucci LLC, Robucci P.C. "performed oversight and management" services and that Westsphere was established to (1) "provide oversight, and to manage certain overheads and indirect expenses, including employee benefits such as health insurance", (2) "track business expenses and overheads", and (3) create a "group" for group sickness and accident insurance coverage under Colorado law. Taxpayers also argue that the formation of a multimember LLC, including a corporate member, afforded Dr. Robucci superior protection, under Colorado law, against personal liability for acts of Robucci LLC, and that Robucci P.C.'s interest in Robucci LLC was necessary to accomplish that goal.

The IRS argues that (1) the corporations "were created solely for the purpose of reducing . . . [Dr. Robucci's] tax liability" and to help him "avoid income and self-employment taxes"; (2) taxpayers "did not offer any credible explanation of the business purpose for forming the corporations"; and (3) taxpayers "did not demonstrate that either corporation engaged in any business activity after it was formed." The court agreed with the IRS.

Taxpayers state two reasons for the formation of Robucci P.C.: (1) Its role as the "managing member" of Robucci LLC, a role not reflected in Robucci P.C.'s articles of incorporation, which state that its "sole purpose" is to practice medicine "through persons licensed to practice medicine" and (2) the superior protection against personal liability that would be afforded to Dr. Robucci by the formation of a multimember LLC.

Assuming that Robucci P.C. was properly organized under Colorado law, that fact does not mean that it performed any function that would warrant its recognition as an entity for Federal tax purposes. E.g., Noonan v. Commissioner, 52 T.C. 907, 909 (1969), affd. 451 F.2d 992 (9th Cir. 1971). Although Robucci P.C. may have been a party to an "operating agreement" with Robucci LLC, whereby it was appointed Robucci LLC's "manager," there is no evidence that Robucci P.C. performed any management or other services for Robucci LLC. Robucci P.C. had no assets (other than its interest in Robucci LLC) or employees, it had no service contract with Robucci LLC, and it paid no salary to Dr. Robucci or anyone else during the years in issue. In fact, Robucci P.C. was not intended to perform management services or other business activities. Mr. Carson's handwritten
note states: "We need P.C. to be a partner in LLC only; Westsphere is the mgmt. corp. P.C. does nada [nothing]."

In support of the second reason of limiting Dr. Robucci’s liability, taxpayers cite In re Albright, 291 Bankr. 538 (Bankr. D. Colo. 2003), in which the court permitted the trustee in bankruptcy to liquidate all of the property of a single-member LLC on behalf of creditors. The Tax Court held that Taxpayers' reliance upon Albright is misplaced. That case does not involve a creditor’s right to hold the sole member of a single-member LLC personally liable for the LLC’s debts. Rather, it holds that all of the LLC’s assets are available to satisfy the claims of the sole member's creditors (and not that the sole member's assets are available to the LLC's creditors). The trustee in Albright did not attempt to pierce the "corporate" veil to reach the member's personal assets to satisfy the LLC's debts.

The court concluded that Robucci P.C. was not formed for a purpose that "is the equivalent of a business activity" within the meaning of Moline Props., Inc. v. Commissioner, 319 U.S. at 439.

Westsphere Management Corporation

Taxpayers list three purposes for the organization of Westsphere: management, the tracking of overhead and indirect expenses, and to form a group for insurance purposes. However, the evidence refutes the notion that those alleged purposes constituted bona fide nontax purposes. Although, Westsphere had a checking account, like Robucci P.C., it had no employment agreement with Dr. Robucci and no employees. Nor did it perform any management or other services for Robucci LLC in the person of Dr. Robucci.

Rather, Dr. Robucci continued to conduct his practice as he always had, including the retention of Ms. Williams as his billing assistant. Both before and after the formation of Robucci LLC, Ms. Williams was the billing assistant for Dr. Robucci’s practice. Although she received instructions from Dr. Robucci in letters with a letterhead "Tony L. Robucci, M.D., A Professional L.L.C.," she considered herself to be the employee of Dr. Robucci.

The only activity allegedly attributable to Westsphere during the audit years was its reimbursement of various expenses incurred by Dr. Robucci and Robucci LLC pursuant to the various plans. Dr. Robucci testified that that activity consisted of electronic transfers of funds between bank accounts. Thus, Dr. Robucci continued, as in prior years, to pay the expenses of his practice, but allegedly out of Robucci LLC's bank account. Westsphere's only alleged "service" was to reimburse those expenses by electronic transfers of funds from its account to Robucci LLC's account. The bank account statements in the record provide scant evidence that there were, in fact, regular interaccount transfers from Westsphere to Robucci LLC. For example, Westsphere's bank statement dated January 23, 2003, shows debits of $5,097.60 and $1,114.84 for a 2002 Medical Expenses Reimbursement and a Health Insurance Premium Reimbursement, but the absence of corresponding credits to Robucci LLC's account on the same date or thereafter indicates that the transfer of funds was to Dr. Robucci's personal account. In fact, the bank statements contained no correlation between debits to Westsphere's bank account and credits to Robucci LLC's bank account. Any interaccount transfers, to the extent they occurred, were the equivalent of taking money from one pocket and putting it into another because Dr. Robucci controlled both entities.
Such a procedure hardly qualifies as a "business activity" under Moline Props., Inc. v. Commissioner, supra at 439.

Taxpayers also argue that the organization of Westsphere was essential in order to create a "group" eligible for group sickness and accident insurance. Whatever the merits of taxpayers' concerns in that regard, it is not clear how the formation of Westsphere alleviated those concerns. The "groups" to be afforded coverage are "groups of persons," generally, under policies issued to an employer for the benefit of the employees, which include officers, managers, and other employees of the employer. See Colo. Rev. Stat. sec. 10-16214(1)(a). It is difficult to see how the organization of Westsphere, which neither is an employee of Robucci LLC nor has employees of its own, could serve to qualify for small group or small employer health insurance. More importantly, there is no evidence that Robucci LLC made any effort to obtain group health insurance for its sole operative, Dr. Robucci. Dr. Robucci or Robucci LLC continued to pay premiums for health insurance but it is not clear that the policy differed from the one Dr. Robucci had as a sole proprietor.

Taxpayers have not persuaded us that Westsphere was organized for a purpose that "is the equivalent of a business activity" under Moline Props., Inc. v. Commissioner, supra at 439.

Robucci P.C. and Westsphere were hollow corporate shells. The court ruled that neither carried on a business after incorporation, the second alternative prong for corporate viability under Moline Properties. Because Robucci P.C. and Westsphere served no significant purpose or function other than tax avoidance, they should be disregarded. What we said in Aldon Homes, Inc. v. Commissioner, 33 T.C. at 598, in disregarding 16 so-called alphabet corporations is equally applicable to this case:

The alleged business purposes impressed us simply as a lawyer's marshaling of possible business reasons that might conceivably have motivated the adoption of the forms here employed but which in fact played no part whatever in the utilization of the [structure employed]

Thus, Robucci LLC was a single-member LLC. The result is that Dr. Robucci is a sole proprietor for Federal tax purposes, which was his status before the formation of Robucci LLC and the corporations. It follows, and we hold, that the net income arising from his psychiatric practice during the years in issue, including any amounts paid to Robucci P.C. and Westsphere, was self-employment income of Dr. Robucci subject to self-employment tax under section 1401.

Imposition Of The 6662 Accuracy-Related Penalty

The IRS has established that Dr. Robucci's understatements of income tax for the years in issue are substantial as they exceed both 10 percent of the correct tax and $5,000. Therefore, there was no need to determine whether Dr. Robucci was negligent under section 6662(b)(1).

Section 6664(c)(1) provides that the penalty shall not be imposed with respect to any portion of an underpayment if a taxpayer shows that there was reasonable cause for, and that the taxpayer acted in good faith with respect to, that portion. The determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances. Circumstances that may indicate reasonable cause and good faith include
an honest misunderstanding of law that is reasonable in light of all of the facts and circumstances, including the experience, knowledge, and education of the taxpayer. Reliance on the advice of a professional tax advisor does not necessarily demonstrate reasonable cause and good faith. Reg. § 1.6664-4(b)(1).

Under section 7491(c), the IRS bears the burden of production, but not the overall burden of proof, with respect to Dr. Robucci's liability for the section 6662(a) penalty. By demonstrating that Dr. Robucci's understatements of income tax exceed the thresholds for a finding of "substantial understatement of income tax" under section 6662, the IRS has satisfied his burden of production.

CPA/Attorney As Promoter. The IRS argues that there was no reasonable cause for the positions taken by Dr. Robucci and that he did not act in good faith. In the IRS's view, "[p]etitioner should have requested a second opinion after getting advice that was clearly too good to be true". the IRS views Mr. Carson as "the promoter of the arrangement, who earned substantial fees for incorporating the various sham entities and preparing the tax returns at issue." Taxpayers deny that Mr. Carson was a promoter and argues that, in the light of Mr. Carson's status as an independent, experienced C.P.A., Dr. Robucci was under no obligation to obtain a second opinion before he could reasonably rely on Mr. Carson's advice.

Too Good To Be True. The court held that even if we were to agree with petitioner that Mr. Carson was not a promoter, we agree with the IRS that the tax result afforded by implementing Mr. Carson's suggestions, i.e., the dramatic reduction in Dr. Robucci's self-employment taxes, was "too good to be true." See, e.g., Neonatology Associate, P.A. v. Commissioner, 299 F.3d at 234 ("When * * * a taxpayer is presented with what would appear to be a fabulous opportunity to avoid tax obligations, he should recognize that he proceeds at his own peril."); McCravy v. Commissioner, 92 T.C. 827, 850 (1989) (stating that no reasonable person should have trusted the tax scheme in question to work).

Carson’s Structure Might Have Worked If Implemented Properly.

Somewhat contrary to its statement that the structure led to a tax result that was too good to be true, the court stated that Mr. Carson's goal of directing some of Dr. Robucci’s income to a third-party corporate management service provider and bifurcating Dr. Robucci's interest in Robucci LLC so that he would be separately compensated for the use of his intangibles was not unreasonable. On the contrary, had it been more carefully implemented, it well might have been realized, at least in part. In footnote 11, the court noted that although it is the IRS's position that profit distributions to service-providing members of a multimember, professional service LLC are never excepted from net earnings from self-employment by § 1402(a)(13), which excepts distributions to a limited partner other than sec. 707(c) guaranteed payments for services rendered, the Treasury has yet to issue definitive guidance with respect to that issue.

Although Robucci P.C. and Westsphere were properly formed under Colorado law to carry out legitimate corporate functions, the fact that they were nothing more than empty shells, devoid of property (Westsphere did have a bank account), personnel, or actual day-to-day activities, i.e., of substance, should have sent warning signals to Dr. Robucci that those corporations were not effecting any meaningful change in the prior conduct of his medical practice. There were also no
contracts between the entities or with Dr. Robucci and his PC. Additionally, the LLC paid Dr. Robucci for his "active services, not his PC, which did not have any activity or even a bank account.

While Dr. Robucci may have had some vague notion that he was acting on behalf of Westsphere when performing services other than actual patient care, there is little or no evidence as to the precise nature of those services, the time Dr. Robucci may have spent performing them, or their value. In short, there is no support for any charge from Westsphere to Robucci LLC for such services or for the claim that Dr. Robucci was wearing a Westsphere hat when he performed them.

For Dr. Robucci, aside from signing a raft of documents and shifting some money between two new bank accounts, it was business as usual. Although he might have been justified in relying upon Mr. Carson's expert valuation of his intangibles as the basis for the 85-10 split between his limited and general partnership interests in Robucci LLC, the lack of any formal transfer of those intangibles to Robucci LLC should have been cause for concern.

Under those circumstances, Dr. Robucci, even though he was not a tax professional, should have questioned the efficacy of the arrangement that purported to minimize his taxes while effecting virtually no change in the conduct of his medical practice. He should have sought a second opinion. By not doing so, Dr. Robucci failed to exercise the ordinary business care and prudence required of him under the circumstances. See United States v. Boyle, 469 U.S. at 251; Haywood Lumber & Mining Co. v. Commissioner, 178 F.2d 769, 770-771 (2d Cir. 1950), modifying 12 T.C. 735 (1949), which involve circumstances exemplifying the exercise of ordinary business care and prudence.

K. Conclusion.

The C corporation double tax would not be a major factor if the C corporation owners do not plan to pay dividends and if it is unlikely that the business will be sold or if the sale would be a sale of stock and not assets. Although the C corporation owners (unlike S corporation/partnership owners) do not get a basis step-up for earnings retained at the entity level, the low initial corporate income tax rate and the preferred capital gains tax rate would still likely combine to provide a lower overall present value effective tax rate for the purchase price attributable to these retained earnings if the owners sold their business in a stock sale. Nevertheless, most purchasers will want to “buy assets” in order to achieve a step-up in basis for the intangible assets represented by the portion of the purchase price in excess of the corporation’s internal basis in its assets, so that those amounts can be depreciated or amortized for tax purposes, and to avoid inheriting the sold entity’s liabilities. In general, this means a sale of assets at the entity level, either an actual sale of assets or a deemed sale of assets via a section 338(h)(10) election for an S corporation. The 34% initial tax and the 20% tax on liquidation combine for an effective rate of around 48% on $500,000 of proceeds. This compares with only a 20% single tax rate (plus applicable Medicare tax) applicable in the S corporation and partnership/sole proprietorship sale scenarios. This double-tax can be mitigated by non-compete payments directly to the individual owners, consulting and compensation payments, and sale of personal goodwill, where it exists. However, the marginal tax rate of around 46% will
apply to ordinary income payments for someone in the highest bracket subject to deduction phaseouts. Additionally social security and Medicare taxes would apply to any consulting or compensation payments.

II. NON-TAX CONSIDERATIONS.

In recent years, the number of business entity forms available has doubled, adding limited liability companies (“LLCs”), limited liability partnerships (“LLPs”) and limited liability limited partnerships (“LLLPs”), to general partnerships, limited partnerships and corporations.

The factors that differentiate these various types of business entities are:

- the extent to which the entity shields its owners from personal liability for the debts or obligations of the entity;
- the management structure of the organization and the extent to which management may be centralized among a group consisting of less than all the owners; and
- the income tax treatment of the organization and its owners.

As a result of changes in the statutes governing certain of these entities adding flexibility to their structure, business planners now consider many of the forms of business organization to be interchangeable except for the sole proprietorship and general partnership. Nonetheless, numerous issues exist as to the liability protection in operations outside the state of formation and operational income tax issues.

Terminology For Uniform Partnership Acts.

The correct name for the revised uniform partnership act is the Uniform Partnership Act (1997). In 1994, the “Revised” was dropped. Nonetheless, “Revised” and RUPA have become firmly fixed in common parlance as the name of the act.

The Uniform Limited Partnership Act (2001) is the successor to the Revised Uniform Limited Partnership Act (1976). The Uniform Limited Partnership Act (1976) is referred to as ULPA. With its 1985 Amendments, it was commonly referred to as the Revised Uniform Limited Partnership Act or RULPA. The uniform act approved in 2001 was through the drafting process called ReRULPA, the revision of RULPA, and that unofficial acronym is often used.

A. Sole Proprietorship.

A sole proprietor is a business owned by one individual that does not have limited liability. For income tax purposes, its activities are reflected on Schedule C of the personal form 1040 income tax return. The owner is personally liable for the liabilities of the proprietorship.

B. General Partnership.

The definition of a partnership is “an association of two or more persons to carry on, as co-owners, a business for profit.” The basic form of partnership is a general partnership (“GP”). No formal action, state filing, or written agreement is needed to form a general partnership. As a result, any
business (where profits are shared) involving two or more owners will be a general partnership unless the participants make a different agreement.

In a general partnership (i) each partner has an equal right to participate in management, (ii) each partner has the authority to make commitments or enter into binding agreements on behalf of the partnership, (iii) the death or withdrawal of one of the partners results in the dissolution of the partnership for income tax purposes, and (iv) a general partnership does not provide a liability shield for its partners, because each partner has complete joint and several liability for all debts and obligations of the partnership.

Under versions of the Uniform Partnership Act in many states, a general partnership can be created in which the first three characteristics described above are eliminated and are replaced with the corporate characteristics of centralized management and continuity of life. In other words, it is possible to have a general partnership in which certain partners do not have the ability to participate in management decisions relating to the business of the partnership or to enter into binding agreements on behalf of the partnership. It is also possible to structure a general partnership in such a way that the death or withdrawal of one of the partners does not cause the partnership to be dissolved.

The most significant disadvantage of a general partnership is that partners have joint and several personal liability for partnership debts and obligations.

C. Corporation.

Corporations are the most formal type of business entity. They provide a liability shield for their shareholders, have a centralized management group consisting of a board of directors elected by the shareholders (except for statutory close corporations managed by their shareholders), and they have perpetual existence. Corporations are the preferred form of business entity for organizations that have a large and diverse ownership group and for organizations that intend to make a public offering of their securities. Statutory close corporations are used when the owners want to vote on matters on which directors vote by number of shares rather than 1-director, 1-vote.

Unless a corporation and its shareholders make an affirmative election under Subchapter S of the Internal Revenue Code, the corporate entity is separated from its owners for tax purposes and is responsible for payment of its own income tax. All of the other forms of business organization mentioned above are generally intended to be pass-through entities for tax purposes, meaning that the entity itself does not pay income tax. Instead, the owners are responsible for payment of income taxes on their proportionate share of the entity’s income.

Professional corporations or associations are permitted for professionals in all states and have their own somewhat unique rules. Only licensed professionals can be owners. Where special statutory rules do not apply, the regular state corporation statute applies. Professional corporations can be “C” or “S” corporations for tax purposes, although 13 states do not recognize S corporations.

Additionally, in most states, there is a “corporate practice” doctrine in the statute or by case law that prevents the use of a general business corporation by a professional practice. Professionals subject to a state prohibition on the corporate practice of their profession may be legally precluded
from operating their professional medical practices through LPs (or LLLPs) and can only do so through GPs (or LLPs) if all partners thereof are either duly licensed individuals or PAs or PLLCs legally authorized to render the same professional medical services as the GPs are organized to provide.

Ancillary medical ventures (specialty hospitals, ambulatory surgery centers, imaging centers, etc) principally formed to offer the technical component of medical services and not any professional services cannot qualify for PA or PLLC status because they are not rendering a professional service, even if all shareholders or members thereof are duly licensed medical professionals legally authorized to offer such ancillary (technical) medical services as part of their professional medical practices. An exceptions to the general rule that PAs or PLLCs are not available for the operation of ancillary medical ventures may include the operation of diagnostic imaging facilities by duly licensed radiologists who offer the technical component of diagnostic imaging services through a PA or PLLC, as part of and ancillary to their provision of their professional interpretative services.

State nonprofit corporations are in a few cases used to run businesses that are taxed as for profit corporations for federal and state purposes.

D. Limited Liability Company.

In most states, LLCs are the most popular form of organization for new business entities because of the liability protection they provide to all owners and the flexibility they afford in defining the business relationship between the parties. An LLC is formed by filing articles of organization with the secretary of state. After filing the articles of organization, the basic business arrangement between the owners of the LLC (who are referred as to “members”) is set forth in a separate agreement usually called an operating agreement. The state statute provides default operating rules, most of which can be varied in the operating agreement, which is a contract among the members of the LLC. The LLC itself should also adopt the operating agreement.

One popular form of LLC is the single member entity. Both the IRS and the state law authorize the creation of a single member LLC. Such an entity is, in many ways, the equivalent of a sole proprietorship with limited liability protection or a division of a corporation or other entity that owns the SMLLC.

Another subset of LLC available in a few states is the series LLC. There are many uncertainties about its operation.

E. Limited Liability Partnership.

A limited liability partnership (“LLP”) is a general partnership that registers with the secretary of state as an LLP. The effect of registration is to limit the vicarious liability of each of the partners. The LLP arose in the early 1990s as a response to the malpractice joint and several liability sought to be imposed upon attorneys and accountants who were partners in general partnerships for the failures of the savings and loans associations, including partners who had no involvement with that work. The original statutes (Texas was the first) were partial shield statutes, providing limited liability against tort liabilities for members not involved in the work but not contract liabilities. Most states LLP statutes now provide protection from both types of liability except for the partners
involved in the work. The LLP is not itself a separate and distinct form of business organization. Rather, the LLP is a general partnership that files with the state to avoid the traditional rule of joint liability for claims arising in the course of the partnership's business.

Partners in an LLP in all states are liable for debts or obligations of the organization that arise as a result of their own negligence, wrongful acts, or improper conduct. In many states, this limited liability also extends to contract liabilities (these are called “full shield” states). Partial shield statutes include Ky. REV. STAT. ANN. § 362.220(2) (2002) prior to its revision; and TENN. CODE ANN. § 61-1-306 (2002); W. VA. CODE § 47B-3-6(c).

All general partnerships should consider whether registration as an LLP is appropriate if permitted by state law because the process of registration is simple. The form filed is a simple one-page form, and the partnership must change its name to include the words “Limited Liability Partnership” or the abbreviation “LLP.” Some states, such as New York and California, allow only certain professional service firms to elect LLP status, although most states allow any type of business general partnership to elect limited liability status.

At the time of registration, modification of provisions of the written partnership agreement dealing with indemnification and with the obligations of partners to make additional contributions to the partnership should be made to make those provisions consistent with limited liability. For example, if a partnership agreement has provisions that require a partner with a negative partnership capital account to make up such a deficit, such a provision in your LLP's operating agreement could open a back door of liability for partners, defeating the goal of having a limited liability legal entity, although the laws in some states now protect an LLP against such an oversight.

F. Limited Partnership.

A limited partnership (“LP”) is a partnership formed by two or more persons, in which at least one of the partners is a general partner and at least one of the partners is a limited partner. Generally, the general partners in a limited partnership have the same rights and responsibilities as general partners in a general partnership. As a result of amendments to the Uniform Partnership Act, it is now possible in many states to have a limited partnership in which certain of the general partners do not have the ability to participate in management decisions relating to the business of the partnership or to enter into binding agreements on behalf of the partnership. It is also possible to structure a limited partnership in such a way that the death or withdrawal of one of the general partners does not cause the partnership to be dissolved.

Limited partners are protected from liability for the debts and obligations of the partnership as long as they do not participate in control of the business of the partnership. Likewise, under current law in many states, limited partners may lose their limited liability protection if they participate in management in a manner that is inconsistent with their limited partner status. Under the Uniform Limited Partnership Act (2001), a limited partner is no longer statutorily constrained from participating in the management of the organization.

Family limited partnerships have become a popular vehicle to be used for estate planning and asset protection planning due to liability protection for the limited partners and ability to obtain discounts in the value of the LP’s assets for estate and gift tax purposes, as well as to pay unearned income to
lower bracket partners.

The advantage of a limited partnership, from the standpoint of a limited partner, is the limited liability protection that the entity affords. The disadvantage is that in order to obtain the limited liability protection, limited partners must refrain from participating in control of the business except in those states where it is permitted. The advantages and disadvantages from the standpoint of the general partner are that the general partner has sole responsibility for management of the partnership business and must accept personal liability for partnership debts and obligations. In situations in which a limited partnership seems to be the appropriate form of business organization but the prospective general partner(s) are unwilling to accept personal liability for partnership debts and obligations, the solution may be a limited liability limited partnership or to use a limited liability entity as the general partner(s).

G. Limited Liability Limited Partnership.

1. General.

A limited liability limited partnership ("LLLP") is a limited partnership that registers with the secretary of state as an LLLP, where permitted by statute. The effect of registration is to limit the vicarious liability of the general partners in the same fashion that registration as an LLP limits the liability of the general partners of a general partnership.

The earliest LLLPs were formed under both RULPA and UPA by having a RULPA limited partnership elect LLP status. Subsequently, certain RULPA statutes were amended to provide for the election of LLLP status by the limited partnership. LLLP status was made an elective status under ReRULPA.

Certain LLLP elections take the form of the limited partnership electing to be a limited liability partnership (for example, Delaware) while in other states the election is made in the certificate of limited partnership (Florida, Hawaii and Kentucky). Most states require that an LLLP identify itself in its name, but those requirements are not universal.

States permitting LLLPs include Alaska, Arizona, Arkansas, Colorado, Delaware, Florida, Georgia, Hawaii, Idaho, Iowa, Kentucky, Maryland, Minnesota, Missouri, Nevada, North Carolina, North Dakota, Pennsylvania, South Dakota, Texas, and Virginia.

The factors to consider in determining whether registration is appropriate include the impact which registration may have on the perceptions of the limited partners concerning the proper role of the general partners, and in partnerships in which there is more than one general partner, the interrelationship between the general partners with respect to their willingness and ability to contribute additional capital to the partnership when considered necessary for the furtherance of the partnership business.

2. Professional Firms.

The advantage of a limitation on personal liability co-existing with favorable pass-through tax treatment for unincorporated entities has encouraged many professional services firms to adopt the
LLP or LLC model. Which one was chosen often depended on state rules.

For example, California prohibits law, accounting, and other firms requiring a license from operating in LLC form. California law firms and multistate law firms having offices in California have embraced LLP status. Some firms operate in professional corporation form, as either S or C corporations, with the attendant applicable tax consequences to the corporations and shareholders.)

With a change in Illinois in July 2003, lawyers are now able to practice in LLPs in every state. The rules applicable to, and cost of, registration vary from state to state, and in some states the liability shield afforded LLPs may not be total. The rules applicable to other professionals also have become more flexible over recent years as laws and regulations have been changed to accommodate practice by LLCs and LLPs. Additionally, there are many domestic limited partnerships engaged in professional and business services.

(a) Practical reasons for—and against—LLLLPs.

A potential advantage of operating as an LLLP (compared with LLCs) is that the law involving the rights and relationships of general and limited partners is fairly well settled, and the general partner of the LLLP may obtain the same liability shield provided to LLC member-managers. The limited partners, for example, may require the general partner of the LLLP to have the high duties of loyalty and other fiduciary duties owed by general partners in a traditional state law limited partnership.

There are also disadvantages of operating as an LLLP rather than as an LLC:

(1) Not all states recognize LLLPs, and fewer have authorized practice of licensed professions in LLLPs. Additionally, the general partner of the LLLP may be personally liable for LLLP liabilities of the LLLP arising in non-LLLLP states.

(2) The general partner may have fiduciary duties owing to the limited partners as a matter of state partnership law that are not applicable to member-managers of LLCs, and under ULPA 2001 the limited partners do not have fiduciary duties, thereby distorting the duty structure within the partnership from that generally expected in a general partnership or LLP, whereby each partner owes similar duties to his or her partners and the partnership.

(3) The bulk of the management of the LLLP must be done by or under the supervision of a general partner whereas LLCs permit non-member managers, although this arrangement would be unavailable for professional service firms whose managers must be licensed.

(4) There is also the possible need to change the firm’s name when one of its general partners withdraws or becomes a limited partner. Some states' versions of the ULPA (Texas) provide that a limited partnership may not include in its name the name of the limited partner unless that name is also the name of a general partner. Since an LLLP is a limited partnership, presumably the firm must change its name to delete the name of a general partner when he or she become a limited partner. This generally would not be a problem if the firm operated as an LLP, LLC, or other limited liability entity.

The use of LLLPs by professional service firms raises the question of whether use of the LLLP is legal and ethical. This a question not only of state statute but the licensing rules. In the case of law firms, even if otherwise so permitted, would that practice be unethical in light of ABA and state bar association opinions?

(b) Is LLLP Legal?
As a matter of state statute, LLPs, where permitted, are organized and operating under the limited partnership acts. Under the statute, LLPs, where permitted, are permitted to operate all types of trades and businesses, although many limited partnership acts often proscribe engaging in certain activities such as banking and insurance.

In contrast, state rules generally permit professionals to practice in general partnership form and specified forms of limited liability entities, such as professional corporations, LLPs (under the general partnership act), and LLCs.

Delaware and Pennsylvania explicitly approve of law practice in limited partnership form (Del. S.Ct. Rule 67(a)(iii); Pa. S.Ct. Rule 5.4(d) and Comment (5)). See Donn, "Limited Liability Entities for Law Firms—Ten Years Later," 7 J. Passthrough Entities, July-August 2004, page 19. Indeed, one might conclude that when the supreme court rules of a state explicitly approve of professional corporations, LLCs, and LLPs by name, any other type of practice, such as business corporations (unless the state as no corporate practice prohibition by statute or case law), trusts, limited partnerships, and LLLPs may not be permissible, even if such entities can be validly formed under state statutes.

Connecticut’s bar association has opined that limited partnerships formed under the ULPA are permissible forms of organization. Conn. Bar Assn. Formal Opinion No. 43 (1994). New Mexico and Pennsylvania permit lawyers to practice law as members or owners of "any limited liability entity." In those states, since the state court rules permit limited liability entity practice, this would logically have to include limited partnerships and LLLPs. See Pa. S.Ct. Rule 5.4(d) and Comment (5); Rule 24-107 NMRA of the Rules Governing the New Mexico Bar (effective 3/28/05).

Even if a law firm is formed and successfully registers as an LLLP in its home state, there remains the question of whether it can validly operate as an LLLP in other jurisdictions that do not explicitly recognize the LLLP form for law practice. Similar questions as to multistate law practice by LLCs were faced when LLCs first gained popularity.

(c) Is LLLP Ethical?

It is now. Over forty years ago, in the ABA's Committee on Ethics and Professional Responsibility informally opined that law practice could not be conducted in limited partnership format. However, ABA Formal Opinion 96-401 (8/2/96) issued by the ABA's Ethics Committee reversed its 1965 position, and concluded that the Model Rules of Professional Conduct permit lawyers to practice in an LLP or LLLP if the applicable law provides that the lawyer rendering legal services remains personally liable to the client, the requirements of the law of the relevant jurisdiction are met, and the form of business organization is accurately described by the lawyers in their communications. The ABA Formal Opinion makes no reference to the Committee's prior informal opinions to the contrary prohibiting practice in limited partnership form.

Opinion 96-401 assumes there is compliance with applicable state statutes and other controlling law, and does not purport to indicate appropriate choice of law rules involving multi-jurisdictional

3 ABA Informal Opinion 865 (9/23/65). That opinion was based on provisions of the original Uniform Limited Partnership Act (particularly the effective prohibition on limited partners taking part in control of the partnership's business), and on restrictions on limitations of liability for personal malpractice. This was viewed as antithetical to the lawyer's duties to the client and preclude any meaningful participation with the lawyer's partners in the conduct of the firm's business. ABA Informal Opinion 1265 (2/21/73) and ABA Informal Opinion 85-1514 (4/27/85) prohibited use of a limited partnership for an impermissible division of fees among lawyers. If it is unethical to practice as a limited partnership, it would be unethical to practice in LLLP format.
law firms. The ABA Opinion states that a requirement of any ethically permissible business form for lawyers is that the lawyer rendering the legal services to the client must be personally responsible to the client. The Opinion states the understanding that all of the LLP and LLLP laws (then enacted) of the various states meet this requirement. The ABA Opinion concludes that lawyers can avail themselves of the LLP (or LLLP) business form without that constituting an agreement with a client prospectively limiting the lawyer's liability to a client for malpractice within the scope of Model Rule 1.8, because LLPs and LLLPs do not insulate a lawyer from liability for his own negligence. Rather, the limitation on vicarious liability created by LLPs and LLLPs derives solely from state law, not from an agreement between a lawyer and his client. Notwithstanding the green light given by the ABA Opinion, law firm and other professional LLLPs and limited partnerships are rare. There are, however, LLLP service providers in Arizona, Arkansas, Colorado, Delaware, Florida, Georgia, Hawai'i, Kentucky, Maryland, Massachusetts, Minnesota, Montana, Nevada, and Texas, based on an internet Google search in late 2011.

H. Other Issues.

1. Foreign State Operations.

A limited, unsettled and contradictory body of case law exists regarding how a business entity not formally recognized in a particular foreign jurisdiction will be treated in that jurisdiction. See Rutledge, “To Boldly Go Where You Have Not Been Told You May Go: LLCs, and LLLPs in Interstate Transactions,” 58:1 Baylor Law Review 205-242 (2006).

There is no such issue for corporations or LLCs operating in other states. The internal affairs rule, as embodied in both common law and corporate statutes, precludes any need to undertake a conflicts of law analysis with respect to internal corporate affairs. The law of the state of incorporation governs. However, whether shareholder liability to third parties for claims incurred by the corporation falls within internal affairs is not clear.

While the law is not clear for newer types of entities as to the effect of limited liability protection in other states outside the state of formation that do not recognize the entity in question, it is likely that courts would reach the following results:

(a) A foreign limited liability entity (“LLE”) doing a type of business in a state that the same domestic entity may not engage in will likely not afford its owners limited liability;
(b) A full shield LLP in a partial shield LLP jurisdiction likely will not afford its partners limited liability;
(c) A partial shield LLP operating in a full-shield jurisdiction likely will afford its partners only a partial liability shield;
(d) A LLE owner that is not listed as having liability under a state statute where it is operating (such as a state law mentioning only corporate officials but not LLC managers as being personally liable for unpaid wages) will be found liable if liable under the state of formation.
(e) A LLLP operating in a state that does not have an LLLP statute likely will not afford its general partners limited liability.

Although structural distinctions between the various forms of business entity have been minimized, there are certain situations in which business owners may consider one form of entity to be desirable over another. For example, business owners may wish to transform corporations into LLCs to obtain flexibility, or to transform an LLC or other form of unincorporated business into a corporation in the expectation of making a public offering of securities. Many states have adopted special statutory provisions in order to help to facilitate these type of transformations from one form of business entity to another. Under these provisions entities can easily convert from one form of entity in the same or another state. The statute permits these transformations to be completed administratively without the need to wind up the business affairs of the converting entity and pay its obligations or distribute its assets. As a result, the transformation is not deemed to be a dissolution of the converting entity and the entity that results from the transformation is deemed to be the same entity as the converting entity. However, for income tax purposes, conversion from a “C” or “S” corporation is treated as a liquidation followed by the formation of the new entity.

3. Continuity of Life/Withdrawal/Right to Dissolve.

Corporations and, unless otherwise specified in their respective operating or limited partnership agreements, LLCs and LPs (but not GPs) exist in perpetuity and, except as may be expressly granted by the terms of an applicable shareholders, operating or limited partnership agreement to which all shareholders, members or partners are parties, no shareholder, member or partner thereof has the unilateral right or power to dissolve or terminate any such legal entity.

Unless otherwise provided in a shareholders, operating or partnership agreement to which all shareholders, members or partners are parties, under state law, neither shareholders of corporations (including PAs), members of LLCs (including PLLCs) nor limited partners of LPs have the right to withdraw from their respective corporation, LLC or LP or otherwise force, by unilateral action, a mandatory purchase of their respective interests therein.

General partners of LPs subject to ReRULPA have the right to “dissociate” (or withdraw) from their LP as a “general partner” at any time, even if prohibited by the terms of the applicable limited partnership agreement. Such dissociation does not entitle the dissociated general partner to any distributions nor will such dissociation cause or result in a dissolution of the LP unless expressly required by the applicable limited partnership agreement or unless the dissociated general partner was the sole general partner of the LP and within 90 days from the date of dissociation, all remaining limited partners do not otherwise agree to continue the business of the LP or agree to admit and cause to be admitted at least one additional general partner.

By contrast, general partners of LPs not subject to ReRULPA, are entitled by statute to be paid the “fair market value” of their interest in such LPs upon their dissociation or withdrawal therefrom, if not otherwise provided by the terms of their applicable limited partnership agreement, even if they dissociate or withdraw from their LP in violation of the terms of their LP’s limited partnership agreement.

Shareholders in professional corporations, absent a buy-sell agreement, are often only entitled to be bought at their death.

Unlike judgment creditors of shareholders of corporations (except PCs or PAs in some states\(^4\) because owners must be licensed professionals), who are generally able to foreclose on a debtor-shareholder’s stock in a corporation in order to satisfy their judgments, judgment creditors of members of LLCs or partners (general or limited) of GPs or LPs are precluded from foreclosing on a debtor-member’s or debtor-partner’s equity interest and, instead, are limited to obtaining what is known as a “charging order” against the debtor-member’s or debtor-partner’s respective membership or partnership interest. If a judgment creditor of a member or partner obtains a charging order against the debtor-member’s or debtor-partner’s membership or partnership interest, then such creditor will only be entitled to receive whatever distributions, if any, the debtor-member or debtor-partner is otherwise entitled to receive from the LLC, GP or LP, at the time or times the debtor-member or debtor-partner would otherwise be entitled thereto, until such time such creditor’s judgment (secured by such charging order) is satisfied in full unless under state law that creditor could foreclose on the charging order and become an assignee.

5. **State Filing Fees & Taxation.**

In some cases, the use of one type of entity versus another may result in higher state filing or annual report fees or state taxes.

6. **Fiduciary Duties.**

There are differences in fiduciary duties and the ability to waive, limit or modify fiduciary duties between Delaware limited partnerships and Delaware LLCs. In Delaware LLCs, they may be eliminated. Outside of the Delaware context, there may be distinctions for a fiduciary duty analysis between limited partnerships and LLCs based on whether the limited partnership is organized in a jurisdiction that has not adopted RUPA. One would expect that this difference will recede as additional jurisdictions adopt RUPA. Limited partnerships have been around much longer than LLCs and have a “greater judicial track record” that might provide guidance to future courts and practitioners. However, with the development of non-corporate limited liability entities such as limited partnerships, limited liability partnerships, limited liability limited partnerships and LLCs, all designed in one form or another to insulate ownership from liabilities of the business enterprise, as a policy matter it appears there is no logical reason to distinguish among such forms of entity for fiduciary duties.

Neither RULPA nor DRULPA identifies the fiduciary duties of a general partner. Rather, to determine what fiduciary duties are owed in a limited partnership by the general partners, reference must be to the UPA or, in those jurisdictions that have adopted RUPA, to RUPA. See RULPA §404. See J. William Callison, “Blind Men and Elephants: Fiduciary Duties Under the Revised Uniform Partnership Act, Uniform Limited Liability Company Act, and Beyond”, 1 J. Small & Emerging Bus. L. 109, 161 (1997).

Case law under the RUPA identifies the fiduciary duties of general partners:
1. A duty of loyalty, defined as a duty not to appropriate partnership opportunities, a duty not to enter into competition with a partnership and a duty not to act adversely to the partnership’s

\(^4\) *Central State Bank v. Albright*, 12 Kan. App. 2d 175, 737 P.2d 65 (1987) holds that K.S.A. 17-2712 prohibits a professional from pledging his or her stock as collateral, where the lender is a bank or other non-permitted shareholder.
interests;
2. A duty of good faith and fair dealing;
3. A duty of care; and
4. A duty to disclose material information to the partnership.

ReRULPA takes a different approach than RUPA in that the fiduciary duties of a general partner are set forth within the text and without requiring a reference to UPA or RUPA for such purposes. ReRULPA sets forth the fiduciary duties of a general partner in a limited partnership in Section 408, “General Standards of General Partner’s Conduct.”

RULPA does not provide that a limited partner has fiduciary duties to the limited partnership or to the other partners in the limited partnership. However, in appropriate circumstances, limited partners have been held to have fiduciary duties. Tri-Growth Centre City, Ltd. v. Silldorf, Burdman, Duignan & Eisenberg, 216 Cal. App. 3d 1139, 265 Cal. Rptr. 330 (Ca. Ct. App. 1989). See In Re Villa West Associates, 193 B.R. 587 (D. Kan. 1996) (limited partner not liable for breach of fiduciary duty by acting to reduce liability under personal guaranty without advising other limited partners of the possibility). In Re Kids Creek Partners L.P., 212 B.R. 898 (Bankr. N.D. Ill. 1997) (limited partner not liable as fiduciary because it took no management role and did not act to interfere with or mislead other equity holders).

ReRULPA provides that a limited partner may be subject to fiduciary duties and is subject to an obligation of good faith and fair dealing.

RUPA sets forth certain statutory guidelines for limitations on fiduciary duty obligations, but does not provide that such fiduciary duties may be eliminated in their entirety.47/ Indeed, RUPA provides that the default rules of the statute that include fiduciary duties may be waived or varied with only 10 exceptions set forth in RUPA Section 103(b). Three of the 10 exceptions pertain to fiduciary duty and the duty of good faith and fair dealing. Although the duty of loyalty may not be eliminated, the partners are free to provide by agreement for the identification of specific types of activity that do not violate the duty of loyalty if not “manifestly unreasonable.” The partnership agreement may specify a mechanism for a consent by the partners after full disclosure of a specific act or transaction that might otherwise violate the fiduciary duty of loyalty. The partnership agreement may not unreasonably reduce the duty of care (which is limited by statute to grossly negligent or reckless conduct, intentional misconduct or knowing violation of law).

The non-fiduciary duty of good faith and fair dealing may be defined within the agreement but may not be manifestly unreasonable. The manifestly unreasonable test and the outer limits of specification for good faith and fair dealing are left to the courts. Of course, the partnership agreement may specify higher standards of care, loyalty and good faith. For example, partners with strong bargaining power may insist on a higher standard of care in managing the assets of the enterprise.

ULLCA’s recitation and identification of fiduciary duties is substantially similar to RUPA. Under Section 409 of ULLCA, fiduciary duties are limited only to the fiduciary duties of loyalty and care. The fiduciary duty of loyalty is limited to (a) accounting to the company and to hold as trustee any
property or profit derived from the member in winding up the business of the company or derived from the use of a member of company property, including appropriation of a company opportunity, (b) refraining from dealing with the company in the conduct or winding up of the company’s business in an adverse manner, and (c) competing with the company’s business before dissolution of the company. The duty of care is limited to refraining in engaging in grossly negligent or reckless conduct, intentional misconduct or a knowing violation of law. Like RUPA, the duty of good faith and fair dealing is imposed, but not as a fiduciary duty. Like RUPA, no violation of a fiduciary duty or the duty of good faith and fair dealing will occur when the action in question furthers the member’s own interest. Furthermore, as with RUPA, lending money or transacting business with the company is permitted. However, such transaction should generally be approved by the company or members either by reference to the specific transaction or by adherence to a procedure set forth in the operating agreement of the company.

There may be a difference between LLCs organized under ULLCA and limited partnerships organized under RULPA that remain bound up with UPA. Cases have held that fiduciary duties may be modified or actions otherwise a breach of a fiduciary duty may be consented to. The ULLCA provides specific statutory blessing for such matters. There appears to be little to distinguish ULLCA LLCs and limited partnerships with RUPA general partners (other than DRUPA) and, accordingly, fiduciary duty analysis would not be dispositive in considering the choice of entity between a LLC and a limited partnership.
### III. CHART COMPARING ENTITY CHARACTERISTICS

Comparison Chart: Regular and S Corporations, LLC, Limited Partnership (LP), Limited Liability Limited Partnership (LLLP), General Partnership (GP), and LLP

<table>
<thead>
<tr>
<th>Factor</th>
<th>C Corp</th>
<th>S Corp</th>
<th>LLC*</th>
<th>LP &amp; LLLP</th>
<th>GP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of Owners</td>
<td>No restrictions</td>
<td>No more than 100 shareholders</td>
<td>No restrictions, but need at least two members to be considered a partnership for tax purposes</td>
<td>Must have at least one general partner and at least one limited partner and they must be at least two different partners</td>
<td>Must have at least two partners</td>
</tr>
<tr>
<td>Type of Owners</td>
<td>No restrictions</td>
<td>May not have shareholders other than individuals, certain trusts, estates, and certain exempt organizations (including charitable organizations and qualified retirement trusts). May not include regular S corporations, (except for 100% owned S corporation subsidiaries), or nonresident aliens as shareholders</td>
<td>No restrictions</td>
<td>No restrictions</td>
<td>No restrictions</td>
</tr>
<tr>
<td>Classes of Ownership Interests</td>
<td>Permitted</td>
<td>One class only, but can have differences in voting rights</td>
<td>Permitted</td>
<td>Permitted</td>
<td>Permitted</td>
</tr>
<tr>
<td>Liability of Owners</td>
<td>Limited</td>
<td>Limited</td>
<td>Limited</td>
<td>General partners have joint and several liability except in LLLP; limited partners have limited liability except in unusual circumstances where they participate in management or are general partners have several liability</td>
<td>General partners have several liability</td>
</tr>
<tr>
<td></td>
<td>Professionals</td>
<td>Limited Partners</td>
<td>Owners Participation in Management</td>
<td>Permitted</td>
<td>Permitted by Limited Partners Generally Restricted</td>
</tr>
<tr>
<td>------------------------------</td>
<td>---------------</td>
<td>------------------</td>
<td>------------------------------------</td>
<td>-----------</td>
<td>----------------------------------------------------</td>
</tr>
<tr>
<td><strong>Organization Costs</strong></td>
<td>Filing fee</td>
<td>Filing fee</td>
<td>Filing fee</td>
<td>Filing fee</td>
<td>Filing fee</td>
</tr>
<tr>
<td><strong>Formation Requirements</strong></td>
<td>File articles of incorporation with state; adopt bylaws; initial minutes of organizers or directors</td>
<td>Same as for regular corporation; file S election with IRS</td>
<td>File articles of organization with state; adopt operating agreement</td>
<td>File certificate of limited partnership; adopt partnership agreement</td>
<td>None. Partnership may exist in the absence of any written agreement</td>
</tr>
<tr>
<td><strong>Conduct of Business in Other States</strong></td>
<td>Most states have foreign corporation qualification provisions</td>
<td>Same as for regular corporation</td>
<td>Most states have foreign LLC qualification provisions</td>
<td>Most states have foreign limited partnership qualification provisions; many do not for LLLPs</td>
<td>Typically no mechanism for qualification of foreign partnerships</td>
</tr>
<tr>
<td><strong>Name</strong></td>
<td>Must contain “corporation,” “limited,” “incorporated,” “company,” or an abbreviation thereof</td>
<td>Same as for regular corporation</td>
<td>Must contain “L.C.,” or “LLC” or words Limited Company or Limited Liability Company</td>
<td>Must contain Limited, Limited Partnership, Ltd., L.P., or LLLL or the full words</td>
<td>No requirements</td>
</tr>
<tr>
<td><strong>Interests Transferable As with Full Substitution of Transferee</strong></td>
<td>Yes, subject to agreements among shareholders</td>
<td>Same as for regular corporation</td>
<td>Only if permitted by articles of organization, regulations or operating agreement; possible tax issue if freely transferable</td>
<td>Only if permitted by partnership agreement; possible tax issue if freely transferable</td>
<td>permitted by partnership agreement</td>
</tr>
<tr>
<td><strong>Term</strong></td>
<td>Typically perpetual unless otherwise limited incorporation</td>
<td>Same as for regular corporation</td>
<td>May not exceed term specified in operating agreement</td>
<td>Typically limited by partnership agreement</td>
<td>Typically limited by partnership agreement</td>
</tr>
<tr>
<td><strong>Dissolution</strong></td>
<td>No</td>
<td>No</td>
<td>Determined by</td>
<td>No for limited</td>
<td>Yes</td>
</tr>
<tr>
<td>Section</td>
<td>Level of Income Taxes</td>
<td>Special Allocations of Tax Items</td>
<td>Contributions on Formation</td>
<td>Deductibility of losses by owners</td>
<td>At-Risk Limitations</td>
</tr>
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<td>----------------------------------------------</td>
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</tr>
<tr>
<td>Operating Agreement</td>
<td>Operating agreement unless state law requires</td>
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</tr>
<tr>
<td>partner(s); yes for general partners unless partnership agreement provides otherwise</td>
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</tr>
<tr>
<td>At corporate and shareholder level</td>
<td>At shareholding level only, except certain items can be taxed at corporate level</td>
<td>Permitted if provided as stock classes</td>
<td>Taxable, unless transferors meet 80% control test of §351 of IRC and adjusted basis of assets exceeds liabilities</td>
<td>No, except upon sale/exchange of stock if §1244 applies</td>
<td>Applicable, if closely held or PSC</td>
</tr>
<tr>
<td>At member level only, if structured to be taxed as partnership</td>
<td>At partner level only</td>
<td>Pro rata according to stock ownership</td>
<td>Same as regular corporation</td>
<td>Yes, subject to basis limitations; corporate debt not included in basis but shareholder debt to corporation is included</td>
<td>Applicable</td>
</tr>
<tr>
<td>At partner level only</td>
<td>At partner level only</td>
<td>Permitted</td>
<td>Nontaxable unless disguised sale or member is relieved from debt</td>
<td>Yes, subject to basis limitations; LLC debt included in basis if taxed as partnership</td>
<td>Applicable</td>
</tr>
<tr>
<td>Permitted</td>
<td>Permitted</td>
<td>Permitted</td>
<td>Nontaxable unless disguised sale or partner is relieved from debt</td>
<td>Same as LLC</td>
<td>Applicable</td>
</tr>
<tr>
<td>Permitted</td>
<td>Permitted</td>
<td>Permitted</td>
<td>Same as limited partnership</td>
<td>Same as limited partnership</td>
<td>Applicable</td>
</tr>
<tr>
<td>Liquidation</td>
<td>Taxable to both corporation and shareholders</td>
<td>Taxable at shareholder level via flow-through of corporate items</td>
<td>Nontaxable to extent of member's tax basis in LLC interest</td>
<td>Nontaxable to extent of partner's tax interest</td>
<td>Nontaxable to extent of partnership basis in partnership interest</td>
</tr>
<tr>
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<td>------------------------------------------------</td>
<td>---------------------------------------------------------------</td>
</tr>
<tr>
<td>“Employee” Fringe Benefits for Owners</td>
<td>Permitted</td>
<td>Not permitted if more than 2% shareholder</td>
<td>Not permitted</td>
<td>Not permitted</td>
<td>Not permitted</td>
</tr>
<tr>
<td>Medicare Tax on Retirement Plan for Owners’ Contributions</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>IRC § 409A</td>
<td>Applies</td>
<td>Applies</td>
<td>Not applicable to 736 payments if member is “general partner”</td>
<td>Not applicable to 736 payments</td>
<td>Not applicable to 736 payments</td>
</tr>
<tr>
<td>IRC § 1402(a)(10) – No payroll tax on retirement payments paid until death</td>
<td>No</td>
<td>No</td>
<td>Probably if member is “general partner” but no rulings</td>
<td>Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

Assumes LLC is a partnership for tax purposes.