AMERICAN BAR ASSOCIATION, 
SECTION OF TAXATION, 
CLOSELY HELD BUSINESSES COMMITTEE 
Washington, DC 
May 10, 2019 

SECTION 197 AND PERSONAL GOODWILL 
IN PROFESSIONAL PRACTICES
Goodwill: Context

Transaction:
- Sale
- Distribution

Tax at corporate level:
- C corporation
- S corporation with built-in gains during recognition period – now, 5 years
Goodwill: Transactional Impact

Scenario A

Shareholder

C Corporation

Personal Goodwill
$5 million

Enterprise Goodwill
$2 million

Scenario B

Shareholder

C Corporation

Enterprise Goodwill
$7 million

$1 million
$2 million
$5 million
$7 million
Goodwill: Transactional Impact

Scenario A

Shareholder

Personal Goodwill
$2 million

C Corporation

Enterprise Goodwill
$5 million

Scenario B

Shareholder

C Corporation

Enterprise Goodwill
$7 million
Goodwill: Personal and Enterprise

$1 million Tax on Distribution (20% x $5 million)

$0.74 million Tax on Personal Income (37% x $2 million)

$1 million Tax on Distribution (20% x $5 million)

$1.05 million Tax on Corporate Income (21% x $5 million)

Total Tax: $1.79 million
Goodwill: Enterprise Only

Scenario B

$1.4 million Tax on Distribution (20% x $7 million)

Shareholder

C Corporation

$1.47 million Tax on Corporate Income (21% x $7 million)

Buyer

Total Tax: $2.87 million

Enterprise Goodwill
$7 million
What is Goodwill?

U.S. Supreme Court:

Treasury Regulations:
• “[V]alue 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.” Treas. Reg. § 1.197-2(b)(1).
What is Goodwill?

IRS Guidance:


• Characteristics peculiar to the business, including the company’s reputation, ownership of well-known trade or brand names owned by the company, and track record of successful operations over a prolonged period in a particular locality. *See id.*
What is Enterprise Goodwill?

Secondary Source:

• Intangible value and nature of goodwill that is associated primarily with the practice or operations of the business entity. See Shannon Pratt, Robert Riley & Robert Schweihs, Valuing Small Businesses and Professional Practices, p. 584-85 (3d ed. 1998).

• Enterprise goodwill consists of location, computer systems, operating procedures, trained and assembled staff and a patient or client base. See id.
What is Personal Goodwill?

Secondary Source:

• Intangible asset associated primarily with an individual based on reputation, expertise or contacts which are of value to the business, but not transferred by the shareholder to the corporation. *Shannon Pratt, Robert Riley & Robert Schweihs, Valuing Small Businesses and Professional Practices*, p. 584 (3d ed. 1998).
Personal Goodwill Respected

Personal goodwill is separate from enterprise goodwill:

• Shareholder has not entered into employment agreement or covenant not compete
• Personal goodwill has not been transferred to Corporation
• Corporation has no enterprise goodwill

• Shareholder transferred customer relationships to newly formed Subsidiary.

• Subsidiary’s sole assets were these customer relationships developed solely by Shareholder.

• Goodwill was personal because Shareholder had no employment or noncompetition agreements.

• Personal goodwill is likely to be present when:
  • Business relationships are developed and maintained by a single proprietor,
  • Others do not develop business relationships, and
  • Nature of the relationships is personal to that individual.
Bross Trucking


• Dad’s OldCo ceased operations and Sons formed NewCo to operate new trucking business.

• IRS asserted distribution of appreciated intangible assets from OldCo to Dad and transfer to Sons.

• Goodwill was personal to Dad because:
  • Dad had no employment or noncompetition agreement with OldCo; and
  • OldCo had no goodwill because of regulatory infractions and impending suspension.
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The Anti Churning Rules

Example 1

Professional practice was formed prior to August 10, 1993. It has been proposed by counsel for the incoming owner that Dr. Junior form an S-corporation which will purchase an undivided interest in both the tangible assets and goodwill of the practice. Subsequent with the purchase, the doctors will form a limited liability company which will bill the patients, pay the operating expenses, employee the staff, sponsor the benefits plans, and distribute profits to the respective S corporations, which will then be distributed to Dr. Senior and Dr. Junior.

Dr. Junior's counsel has advised Dr. Junior that the goodwill can be deducted for both the buy-in and later buy-out of Dr. Senior, irrespective that the practice was formed before August 10, 1993.
The Anti Churning Rules

Example 2

Professional practice has two 50% shareholders who have practiced together for several years. The practice was formed prior to August 10, 1993. For Dr. Senior's buy-out, it has been proposed that Dr. Junior should purchase 60% of the remaining 50% of Dr. Senior's stock. Thereafter, the shareholders will practice as 80%/20% shareholders. Upon the retirement of Dr. Senior, it has been proposed that the corporation purchase the remaining 20% owned by Dr. Senior through the purchase of Dr. Senior's personal goodwill. The rationale is that Dr. Senior and Dr. Junior now do not own more than 20% of the stock, although they were previously 50% shareholders. The remaining tangible asset value would be paid through the purchase of Dr. Senior's stock by Dr. Junior.
The professional practice was formed prior to August 10, 1993. Dr. Senior and Dr. Junior practice through an S-corporation as more than 20% shareholders. Dr. Junior's counsel is proposing that upon the mandatory buy-out of Dr. Senior in roughly 10 years that Dr. Junior purchase a combination of stock at the pro-rata fair market value of tangible assets and the personal goodwill of Dr. Senior. Restrictive Covenants are in place and there has been no appraisal of any personal goodwill.
Query? What is the result when the doctors and/or advisors do not follow the rules?