Minimizing Tax Liability upon Sale of Your Accounting Practice

By Stuart M. Bordman

It was the 1970s and physicians, dentists, lawyers and CPAs were incorporating their practices. It seemed like a good idea and it was a good idea. You and your partner (now your fellow shareholder) incorporated your accounting practice and benefited from all of the tax benefits available and accumulated sizable account balances in your retirement plans. There was no reason to make an S election and your professional corporation ("PC") has always been a C corporation.

You incorporated in the 70s and now you are in your 70s and it is now time to think about selling the practice and enjoying the good life. You are in very preliminary discussions with a regional firm that desires to buy your practice and allow you to phase out on a mutually agreeable basis. You inform your corporate attorney of your preliminary discussions and he reminds you that substantial tax savings can be achieved by allocating a portion of the sale price to personal goodwill. You now remember reading about cases in which "personal goodwill" was sold by the individual shareholders and equipment, receivables, etc. were sold by the PC. If there is no allocation to personal goodwill sale proceeds will be subject to taxation twice: once at the corporate level and again at the shareholder level with respect to the distribution of the after-tax sale proceeds from the PC. If the personal goodwill is sold by the shareholder it will be taxed at capital gain rates.

You ask your attorney if you can allocate a portion of the purchase price to personal goodwill and he says he will take a look at the issue and get back to you.

A few days later, your attorney calls and reminds you that when the PC was formed, you and your fellow shareholder entered into employment agreements and a stock redemption agreement. He tells you the relevant provisions of each agreement regarding the allocation issue are as follows:

a. The employment agreement provides that if you separate during lifetime you receive a severance bonus, but no bonus will be paid if within two years after separation you perform services for any person or entity who was a client at any time while you were employed by the PC.

b. Under the stock redemption agreement, if you wish to sell during lifetime you must tender a written offer of your entire holding to the PC. The sale price would be accrual basis book value. However, if at any time within two years after separation from the PC you perform services for any person or entity who was a client at any time while you were employed by the PC, the purchase price for your shares will be $5,000.

Your attorney tells you about the leading case in the area, ***Norwalk v. Commissioner***, 76 TCM 208 (1998). Norwalk was an incorporated accounting practice with two shareholders who wanted to join a larger practice. In order to join the larger firm, the two Norwalk shareholders liquidated their corporation. The issues before the court were: (i) whether the corporation realized a gain on the distribution of its intangible assets to its shareholders in liquidation, and (ii) whether the shareholders realized a capital gain on receipt of property from the corporation in a liquidating distribution.

The IRS position in Norwalk is that when the corporation was liquidated, it distributed to its shareholders “customer based intangibles” in addition to tangible assets. Those intangibles include the client base, client records, work papers, goodwill and going-concern value. The taxpayers maintained that the corporation did not own the intangibles but rather the accountants themselves owned the intangibles, and thus, there was no distribution by the corporation of any “customer based intangibles”.

The expert retained by the taxpayers stated that “Without an effective noncompetition agreement, the clients have no meaningful value.” The court concluded that the “customer based intangibles” did not belong to Norwalk. “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.”

Accordingly, the crucial issue is whether, in your case, the goodwill of you and your fellow shareholder attached to the corporation at the time the corporation was organized.

Your attorney tells you that your agreements present a problem. In Norwalk there was an “in term” agreement not to compete, i.e., while employed, the CPA could not perform accounting services other than for his employer. However, there was no prohibition against competing after termination of employment. Your agreements prohibit you from competing during employment. However, you can compete after termination of employment, but your payout is reduced. Accordingly, it is unclear under Norwalk as to whether you transferred your goodwill to the PC.

After giving the matter thought for a day or two, you contact your attorney. You tell him that you and your fellow shareholder have been in practice for 40 years and you trust each other implicitly. Neither is worried about the other separating and competing. You ask him what the result would be the same if you eliminated those portions of the agreements that dealt with sale during lifetime. In other words, your agreements would only address death or disability. Your attorney tells you that there is no case like the one at hand of which he is aware. The best he can tell you is that if the lifetime sale provisions are eliminated before you sign a binding agreement to sell the practice and before there is even a letter of intent, there is a good chance an allocation to personal goodwill would survive an audit. He cautions you that both purchaser and seller must comply with IRC Section 1060 and complete a Form 8594, Asset Allocation Statement, for the year in which the sale occurs. As a result the tax return of the PC and your 1040 and your fellow shareholder's 1040 may be audited during which the allocation to personal goodwill would be scrutinized.

Practice Note: Now may be a good time to review those old employment agreements and buy-sell agreements not only for the issue at hand but to see if they currently reflect the value of the practice and your expectations.