The “Invisible” Asset: Tax Treatment of Goodwill in a Dental Practice

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The intangible asset, commonly known as goodwill, is also commonly misunderstood. Goodwill is generally the largest single component of practice value and its proper tax treatment is not only misunderstood by dentists; but by their lawyers and accountants as well. Let’s review the definition of goodwill and how it should be treated for transition purposes.

Definition: Goodwill is the common term for all of the intangible things that cause people to come into your practice for dentistry. It includes, among other things: office location, staff, reputation, doctor resume and CE, office environment, specialization, if any, etc.

In short, all of the little things that cause folks to know you and respect you are part of goodwill. When valuing a practice, you may think that all of your technology and furnishings and tenant improvements are the largest component of value. In fact, goodwill usually comprises 50-80% of practice value.

We will leave the science and theory of valuation for another article; but suffice it to say that when we value a practice, we are determining the value of both the goodwill and the tangible assets.

As mentioned above, goodwill is usually the most significant portion of the purchase. It is therefore essential that we know how to treat this component, for tax purposes.

As in most cases, the tax treatment depends on the nature or type of asset that is sold and whether the taxpayer is the buyer or seller.

Prior to the adoption of the new Internal Revenue Code of 1986, a buyer of goodwill, as part of a practice purchase, was not able to treat it as a depreciable asset; that is, to deduct the cost-basis over the useful life of the asset. In 1986 Section 197 was added to the Code and this section allows a buyer of goodwill to write off, or expense, the asset over a flat 15 years.

As to the seller, the goodwill is treated as a capital asset and the gain on the sale of this asset is capital gain. Capital gains are currently taxed at 20% for federal purposes. Things get a little tricky in determining who owns the goodwill; or who is the seller? In a situation where the doctor is operating his practice as a professional corporation (PC) and has not made an S Election, the corporation is a taxable entity (C Corp). We all know that when the doctor has a C Corp/PC and there are profits remaining in the corporation at the end of the year, the taxpayer will "bonus" those profits out to himself; in order to avoid the corporation being taxed on those profits. The so-called double taxation of a corporation can usually be avoided in this way.

The problem arises when a buying doctor buys the tangible (e.g. equipment) and intangible (e.g. goodwill) assets from that corporation. When these assets are sold by the corporation, it is deemed to have liquidated and distributed the assets to the practice owner; he is then deemed to have sold the assets to the buying doctor. This "deemed sale" treatment is a legal fiction; but it can be a very expensive one if the goodwill is carried on the corporate balance sheet.

The good news is that the goodwill is NOT a corporate asset; but a personal one! So it should not be carried on the corporate books. The personal nature of goodwill was determined, famously, in the *Norwalk* case. In this case the Tax Court logically ruled that if there was no non-compete in place when Mr. Norwalk sold his interest in his accounting firm, he could simply walk across the street and set up shop. In this event his clients would come right back to him. They would do this because of their personal relationship; not because of the existence of some legal entity called a corporation. Therefore, the court reasoned, the goodwill was personal to Mr. Norwalk. This case is frequently overlooked by professionals.

There was a more recent case which held that the goodwill in the seller's practice WAS a corporate asset and thus subject to taxation at the entity level. In this case, however, the doctor had a non-compete provision with his own corporation and the court held that, ill-advised or not, the non-compete with the corporation (thus preventing him from competing with the corporation) prevented him from characterizing it as personal.

This case, while holding against the taxpayer, was further evidence of the Tax Court's reasoning: that the goodwill attaches to the individual professional; unless (as in this case) the shareholder/doctor binds himself, by contract, to not compete with the corporation.

Remember that this asset, called goodwill, needs to be properly valued and properly treated for tax purposes.