

COVENANT NOT TO COMPETE DEFEATS PERSONAL GOODWILL CLAIM

Dr. Howard was the sole shareholder, officer, and director of his personal service corporation. Back in 1980, he entered into an employment agreement and a covenant not to compete with the corporation.

In 2002, the corporation sold the practice. In the sale, \$549,900 of the purchase price was paid to Dr. Howard as a sale of his personal goodwill in the practice (instead of such amount being paid to the corporation for its goodwill). Dr. Howard reported the sale of the goodwill on his individual return, as capital gain.

The IRS challenged the sale, claiming the goodwill belonged to the corporation.

The court acknowledged that the “essence of goodwill is the expectancy of continued patronage, for whatever reason...the probability that old customers will resort to the old place without contractual compulsion.” As such, the court also recognized that a professional that works for a personal service corporation can have personal goodwill. Unfortunately, in this circumstance, the goodwill that was sold was held to be corporate goodwill, and not goodwill belonging to Dr. Howard.

What did in Dr. Howard was the employment agreement and the covenant not to compete that he had with the corporation. Relying on prior case law, the court determined that the personal relationships with the patients became the property of the corporation by reason of those agreements. Absent such agreements, the court would likely have ruled differently.

The sad part of the case is that Dr. Howard really did not need an employment agreement nor a covenant not to compete, since he was the sole shareholder. Those items generally protect the corporation vis-a-vis its employees, but as a practical matter Dr. Howard was protecting himself (as shareholder) from himself (as employee).

A curious part of the case is that the IRS and the court converted the payment to Dr. Howard to a taxable dividend to him. One would think that the proper tax accounting would have been income to the corporation, followed by either a dividend (or liquidating distribution if applicable) to Dr. Howard.

Howard v. U.S., 106 AFTR2d 2010-xxxx (7/30/2010)

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