The ‘Quid’ and the ‘Quo’: Valuing Firm Goodwill and Executive Perks

As the headlines remind one from time to time, the U.S. tax system holds out its rewards for charitable contributions. The amount of the tax deduction, however, is limited to the net amount transferred to charity—the difference between the value of what the taxpayer parted with and the value of anything he or she received in return. If the return benefit is great enough, the deduction is disallowed entirely. Valuing such a benefit can be a tricky business, as the recent Tax Court decision in *Derby* illustrates.

**Background**

The taxpayers in *Derby* were a loosely knit group of Northern California physicians who, feeling the economic pressures arising out of the managed care revolution, decided it would be best to affiliate themselves in a more organized way with a large health care organization. To that end, they transferred all of the tangible and intangible assets of their medical practices to a nonprofit foundation, SMF, which was affiliated with such an organization. The doctors also agreed to provide services to SMF through their own recently formed medical group.

SMF paid the physicians immediate cash totalling about $1.2 million, representing the appraised values of the tangible assets of their practices. Over the ensuing years, it also paid the medical group personal service compensation, set at various percentages of different types of operating revenue from the acquired practices; and a one-time $35,000 “access bonus” for each physician, purportedly for the promise to keep accepting new patients. The physicians also became shareholders of SMF, and were entitled as a group to representation on the SMF board of directors and other internal governing bodies. They retained their own accounts receivable for services rendered prior to the deal.

The individual doctors simultaneously entered into employment agreements with their medical group, under which they were paid salaries out of the amounts that the group received from SMF for their work. The employment contracts required that the physicians refrain from rendering professional services for pay outside the group; upon leaving employment with the group, however, they were free to compete with the group, and with SMF, if they wished.

The various agreements surrounding the acquisition said nothing about any consideration being paid for intangible assets of the practices, such as goodwill. The doctors took the position with the IRS that they had made charitable contributions of valuable intangible assets to the foundation. They deducted a total of approximately $1.6 million in charitable contributions on their individual income tax returns. The $1.6 million figure was based on a professional appraisal, which valued the overall business enterprise of the group at $4 million; from this, the $1.2 million value of the hard assets and another $1.2 million amount for the accounts receivable were subtracted. All the rest of the enterprise value, the appraisal opined, was goodwill; this amount was, in turn, divvied up among the group members based on a formula devised by one of the group’s leading doctors.

**Issues**

The IRS challenged the taxpayers’ deductions, on the ground that they received sizeable benefits in return for the business intangibles that
they transferred. Under controlling Supreme Court precedent, a charitable contribution deduction is allowable only if the property is transferred without any expectation of a substantial benefit in return. In the words of the High Court, "Congress intended to differentiate between unrequited payments to qualified recipients and payments made to such recipients in return for goods and services." If a taxpayer transfers property to a charity that "is clearly out of proportion to the benefit received," a deduction is available for the excess of the value transferred over the value received. In contrast, if the benefit received by the taxpayer has a value "commensurate with" that of the benefit transferred, no deduction is allowed. The IRS argued that the taxpayers had not proved that the package of consideration they received had an overall value less than the overall value of their practices.

The taxpayers countered that federal Medicare and Medicaid laws forbade SMF from paying anything for intangibles such as goodwill. Therefore, they assigned no value to the various features of the consideration they received under the acquisition and employment agreements other than the cash paid for the hard assets. Moreover, when audited by the IRS, they commissioned a new valuation by another business appraiser, which set a value of about $2.5 million on various allegedly donated intangibles, including "assembled workforce, patient records, provider contracts, trademarks and trademark, and practice goodwill." This appraiser arrived at the value of the intangibles by subtracting from an overall enterprise value of about $41.1 million the $1.2 million value of the tangible assets and another $400,000 for working capital. The taxpayers relied on this second appraisal in the Tax Court case before Judge Joseph Gale.

Quid pro quo. The court agreed with the IRS that the physicians received a "quid pro quo" for the intangibles that they transferred to the foundation. Beyond the cash that they received for the hard assets of the practice, the court said, the taxpayers received "future employment with SMF on carefully delineated terms," and each of the various agreements was "part of an integrated transaction." The additional elements of consideration included above-median shares of practice revenue; the $35,000 bonuses; the freedom from noncompetition agreements; improved economic security (and diminished risk) as compared to their previous practice structure; greater professional autonomy than they would have enjoyed under other employers; and roles in the management of their practices.

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2 TCM 2008-45.
6 TCM 2008-45, at 255.
7 Id., at 258.
The court concluded that the transaction with SMF had an “inherently reciprocal nature,” coming as it did after long and sometimes heated negotiations in which the taxpayers “extracted from SMF all that SMF believed it could provide.” Although there may have been legal issues with paying the taxpayers for their goodwill directly, the court said, “we are persuaded that [the taxpayers’] intangible assets functioned as leverage in the negotiations and that their transfer to SMF resulted in an increase in the total consideration [the taxpayers] received in the transaction.”

Comparing values. Having found that the taxpayers received benefits in exchange for their transfers of intangibles, Judge Gale next turned to the question of whether the values of the return benefits and those of the transferred intangibles were commensurate. He concluded that the taxpayers had not carried their burden of proving that the intangibles were worth more than the benefits of the employment arrangements. Much of the court’s discussion was conceptual, rather than quantitative—it recounted the many noncash benefits that the taxpayers enjoyed under their new employer—but the court included several criticisms of the appraisal of the taxpayers’ professional practices performed by their expert witness.

The physicians argued that the employment benefits they received were already accounted for in the overall value that their appraiser had placed on their practices. Recall that the overall value was about $4.1 million; the taxpayers noted that this was based on future earnings, net of physician compensation expense and all other expenses that the practice would incur. Even with these expenses subtracted, the present value of the future net earnings was, according to the taxpayers, far in excess of the $1.2 million they received for the tangible assets and a reasonable amount of working capital. The difference, they reasoned, must have been a charitable donation.

This argument was rejected. The court noted that the appraiser assumed that the compensation to be paid to the physicians would equal the median level of compensation observed in the market for services in the group’s specialty areas, whereas the compensation actually payable to the taxpayers under the SMF contracts was higher—including the $35,000 bonuses, which the appraiser ignored. Moreover, the court observed, the appraisal took no account of the other intangible benefits (such as freedom to compete) that the actual deal bestowed on the taxpayers. Presumably, these would have depressed the earnings of the enterprise below the median level projected by the expert.

In a footnote, the court offered additional criticisms of the expert’s appraisal. One was of his failure to distinguish practice goodwill, which was transferred to SMF, from professional goodwill, which is personal to the individual owning it and cannot be transferred. The appraiser based his value of the company on “the distributable earnings stream” that the taxpayers would generate, but as the court noted, “those distributable earnings were undoubtedly generated in part by patients who continued to see a physician because of that physician’s charisma, skill, and/or reputation”—none of which could be transferred to SMF. Further, the court noted, the goodwill that was transferred was not backed up by covenants not to compete, without which the value of that intangible was greatly diminished.

Winding up the value comparison, the court noted that in a prior bid to acquire the taxpayers’ combined practices, another large health care organization had offered the group substantial outright cash payments for goodwill and other intangibles. The taxpayers had rejected this offer in favor of the transaction with SMF—a fact that convinced the court that the noncash perquisites that they eventually
received from SMF “were of substantial benefit to them.”

**Estoppel against IRS.** The taxpayers also argued that the IRS was prohibited by a “duty of consistency” from challenging the validity of their alleged charitable contributions. They cited both a determination letter issued in a previous, similar transaction in their area, and passages from a series of IRS exempt organization training manuals, which the taxpayers said conceded that charitable contribution deductions should be allowed in circumstances such as theirs.

The court agreed with the IRS that neither the prior determination letter nor the manual excerpts precluded the agency from challenging the claimed deductions. For one thing, the letter and the manuals dealt with the tax-exempt status of nonprofit organizations taking over medical practices; although charitable contributions by the transferors of the practices were mentioned, they were not the focus of the IRS documents. Further, the Tax Court noted, the facts in the prior ruling were distinguishable, in that the claimed charitable contribution was a mere 12% of the overall value of the assets transferred—a far cry from the 61.5% of the business enterprise value being claimed by the taxpayers in the present case.

Most significantly, though, the court held that regardless of whether the prior ruling and the manuals were on point, they did not estop the IRS because they were not public guidance, such as a revenue ruling. Therefore, the judge declared, they did not “constrain the position that [the IRS] may take in these cases.”

**Valuation penalties.** The IRS sought penalties from the taxpayers under Sections 6662(a) and 6662(h) for valuation misstatements. Because the value of the charitable contribution was zero, the IRS reasoned, the taxpayers had reported a value of 400% or more of the correct value, thus triggering those penalties. The court disagreed, ruling that its holding on the deduction was based on a ground other than valuation—namely, that the taxpayers “received a commensurate quid pro quo.” Thus, it refused to impose the penalties that the IRS sought.

**Analysis**

*Derby* teaches several lessons. Aside from reaffirming that charitable contributions must be truly donative to be deductible, the case illustrates that even intangible return benefits that are difficult to value with precision can diminish or defeat the deduction. Where the parties have a continuing relationship—such as where the donor is an employee of the donee—sorting out the proper matching of exchanged benefits could become quite uncertain.

The *Derby* court also reinforces a couple of valuation precepts that could be gleaned from a handful of prior cases. First, there is a difference between the goodwill of a firm and the personal goodwill of its workers, and only the former can be transferred. Second, without the protection of covenants not to compete, even the goodwill of the firm may be substantially diminished.

Additionally, Judge Gale looked askance at an allocation of value drawn up by one of the medical doctors, whose methodology differed from that suggested by the business valuation experts whom he and his colleagues had hired at the time. In so doing, the court illustrated the wisdom of the perception that taxpayers who act as their own appraisers have fools for clients. Physician, appraise thyself not.

The decision also shows once again that it is difficult, if not impossible, to establish estoppel against the IRS. The taxpayers asserted that the government owed them a “duty of consistency” with decisions that the IRS had made in another case, and reflected in a training manual. Those arguments went nowhere fast. Estate planners who spend hours parsing IRS appeals guideline memos and similar documents, such as the recent missive by the National Office to the field on family limited partnerships, take note.

Finally, the court’s narrow view of the valuation penalties is likely to be hailed by tax advisors. Although the charitable contribution deduction was denied entirely, the analysis presented by the taxpayers rested largely, if not solely, on valuation of their practices—they determined their deductions for goodwill by valuing that intangible asset under a residual approach. Despite the prominence of issues of value in the case, however, the court characterized the rationale behind its decision in purely conceptual terms, thus rendering the valuation penalties inapplicable.

Of course, if a similar case arises in the future, the IRS would be free to pursue a penalty for negligence, rather than for a valuation misstatement. But whereas the negligence penalty is 20% of the tax underpayment, the penalty for a “gross valuation misstatement,” which the IRS was asserting in *Derby*, is 40%. Moreover, nowadays the defenses to the valuation misstatement penalties are different from those applicable to the negligence penalty.
Postscript on Litman

In an earlier column, we discussed Litman, a decision from the Court of Federal Claims that considered, among other things, the proper discount for lack of marketability applicable to restricted stock in a company that was going public on the controlling valuation date. The case involved income taxes of both sides of the transaction: the issuer of the stock, which was setting the stock value high, to establish a high basis for amortization deductions; and the recipients—executives and owners of a company recently acquired by the issuer—who preferred a lower valuation to keep their taxable capital gain to a minimum. The court’s opinion provided some interesting insights into lack-of-marketableability discounts, with application across the federal tax system — beyond the income tax context implicated by the case.

On its tax return for the year of the public offering, the issuing company had used the initial public price for the stock, with no discount, arguing that the recipients had agreed in the acquisition contract to use that value for tax purposes. The court rejected that position. It adopted a middle-of-the-road valuation, applying a relatively moderate-sized discount (slightly closer to the trial position of the company than to that of the recipients of the stock). In its opinion, the court ruled out any penalties against the stock recipients, on the ground that they had relied reasonably and in good faith on professional advisors — two appraisers and a tax advisor — in setting the value on their returns. However, the IRS reserved the right to pursue the issuing corporation for penalties, and in supplemental proceedings it did just that, seeking penalties under two different penalty provisions: Section 6662(b)(2), applicable to “substantial understates” of income tax; and Section 6662(b)(1), applicable to negligence or disregard of rules and Regulations. In a supplemental opinion, the court has now denied these penalties as well.

The company first argued that the IRS had waived any right to impose penalties, because at trial the government had deviated from its position in the notice of deficiency it had originally sent to the company — a change in the company’s favor. In the original notice, the IRS had used the recipients’ low valuation against the company, just as it had wielded the company’s high valuation in deficiency notices sent to the recipients. The court held that the IRS had properly preserved the penalty issue against the company in its pre-trial brief, and that the government’s abandoning the notices “whipsaw” positions in favor of a consistent trial posture did not amount to a waiver of penalties.

However, the court further found that the company had “acted pursuant to reasonable cause and with good faith” when it filed its tax return for the year in which the stock was issued, valuing the stock at the initial public price. This was true even though the company used a lower value in computing its amortization deductions in later years, and even though it failed to file a required IRS form valuing and allocating the consideration paid for the acquired business whose goodwill it was amortizing.

According to the court, the company had “believed upon reasonable cause and in good faith” that the acquisition agreement constituted a binding contract with the stock recipients to use the public price for tax purposes — even though the court later held that it constituted no such thing. The fact that the company hedged its bet on this issue in later years by procuring an appraisal that arrived at a different value did not, the court said, negate the reasonableness of its tax return position for the year of the stock issuance. The court quoted with approval the company’s assertion that “there is no general requirement to file an amended return and, in any event, the failure to file an amended return cannot support a negligence penalty.” In the end, the court rejected all of the asserted penalties.

The supplemental opinion effectuated a subtle transformation of a key finding from the court’s original substantive opinion on valuation. In the earlier opinion, the court had found that the company had “intentions” that the acquisition agreement control the tax valuation, but that the “intentions” were not in fact “memorialized” in a binding agreement. By the time it came to ruling on penalties, those “intentions” were recharacterized as beliefs: The court declared that the company “believed upon reasonable cause and in good faith... that the [acquisition agreement] embodied a negotiated agreement with the [recipients] conclusive as to the fair market value of the restricted shares for tax reporting purposes.” Often in life, there is a sharp distinction between intent and belief; apparently, not so in this case.

19 78 Fed. Cl. 90 (Fed. Cl. 2007).
20 Litman, 78 Fed. Cl. 90 (Fed. Cl. 2007). The court later denied reconsideration of its original opinion, except to add a statement that the burden of proof did not affect its decision, which it said it made based on the preponderance of the evidence. Litman, 100 AFTR2d 2007-6733 (Fed. Cl. 2007).
21 See Section 6664(c)(1).
23 Id. at 101 AFTR2d at 2008-1400—2008-1401.
24 Form 8994, Asset Acquisition Statement.
26 Litman, 78 Fed. Cl. at 114.
27 101 AFTR2d at 2008-1399.
28 Cf. Luther, A Commentary on St. Paul’s Epistle to the Galatians, Chap. V (1531) (discussing distinctions between faith and hope).