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6 UNITED STATES DISTRICT COURT  
7 EASTERN DISTRICT OF WASHINGTON  
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9 LARRY E. HOWARD and JOAN M.  
10 HOWARD,

11 Plaintiffs,

12 v.

13 UNITED STATES OF AMERICA,

14 Defendant.  
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NO: CV-08-365-RMP

ORDER DENYING PLAINTIFFS'  
MOTION FOR SUMMARY  
JUDGMENT AND GRANTING  
DEFENDANT'S MOTION FOR  
SUMMARY JUDGMENT

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18 Plaintiffs are Dr. Larry Howard ("Dr. Howard") and Joan Howard ("Ms.  
19 Howard"), collectively ("the Howards"). Defendant is the United States of  
20 America. The Howards and the United States each have moved for summary  
21 judgment (Ct. Rec. 20; Ct. Rec. 25). Jurisdiction is conferred upon this Court by  
22 Title 28 U.S.C., § 1346(a)(1).  
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25 The central issue in dispute is the proper tax classification of goodwill  
26 during the sale of a dental practice. The first issue is whether a solely owned  
27 Washington corporation can own the goodwill generated by a dentist (see Ct. Rec.  
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1 30 at 2-3). The second issue is whether a covenant not to compete between the  
2 dentist and the corporation affects the ownership of the goodwill.

### 3 **I. BACKGROUND**

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5 Dr. Howard began practicing dentistry in 1972 (Ct. Rec. 21 at 2). In 1980 he  
6 incorporated his practice as the sole shareholder, officer, and director of the  
7 corporation Larry E. Howard, D.D.S. (“Howard Corporation”) (Ct. Rec. 21 at 2).

8  
9 Also in 1980, Dr. Howard entered into an employment agreement and a covenant  
10 not to compete with Howard Corporation (Ct. Rec. 28, Ex F). The covenant not to  
11 compete states that Dr. Howard, the employee, “so long as he holds any stock, and  
12 for a period of three (3) years thereafter, shall not engage, as principal, partner,  
13 agent, employee, shareholder, director, officer, or in any other manner or capacity,  
14 or have any financial interest, in any business which is competitive to that of the  
15 Company within fifty (50) miles of Spokane, Washington” (Ct. Rec. 28, Ex F,  
16 Paragraph 19). The agreement did not address whether the ownership of goodwill  
17 belonged to Howard Corporation or Dr. Howard (Ct. Rec. 23 at 2).  
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22 All parties acknowledge that as sole shareholder, director, and officer of the  
23 corporation, Dr. Howard had the ability to modify or cancel the 1980 employment  
24 agreement at anytime and that Dr. Howard was bound by the terms of the 1980  
25 employment agreement and covenant not to compete with Howard Corporation  
26 throughout the relevant time period of this case (Ct. Rec. 23 at 4; Ct. Rec. 32-2 at  
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1 3). Plaintiffs contend that the Asset Purchase Agreement terminated the covenant  
2 not to compete in the 1980 employment agreement, although there is no evidence  
3 that Dr. Howard ever did modify or revoke the 1980 employment agreement or the  
4 covenant not to compete.  
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6 In 2002, Dr. Howard and Howard Corporation sold the practice to Dr. Brian  
7 Finn and his personal service corporation, Brian K. Finn, D.D.S., P.S. (“Finn  
8 Corporation”). That agreement was entitled the Asset Purchase Agreement (Ct.  
9 Rec. 22-7 at 75). In the Asset Purchase Agreement, Dr. Howard was allocated  
10 \$549,900 for his personal goodwill and \$16,000 for consideration regarding a  
11 covenant not to compete with Finn Corporation (Ct. Rec. 22-7 at 76; Ct. Rec. 22-7  
12 at 95). Howard Corporation received \$47,100 for its assets (Ct. Rec. 27 at 5).  
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16 The Howards filed a 2002 federal income tax return and reported \$320,358  
17 as long-term capital gain income resulting from the sale of goodwill to Finn  
18 Corporation (Ct. Rec. 1 at 2). An Internal Revenue Service (“IRS”) audit of Dr.  
19 Howard's 2002 return resulted in the IRS recharacterizing the sale of the goodwill  
20 as a corporate asset and treating the amount received by Dr. and Ms. Howard from  
21 the sale to Finn Corporation as a dividend from Dr. Howard's professional service  
22 corporation in the amount of \$320,358 (Ct. Rec. 1 at 3). Because of the difference  
23 in long-term capital gain rates and dividend income rates, the Internal Revenue  
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1 Service charged Dr. and Ms. Howard with a deficiency of \$60,129, together with  
2 interest of \$14,792.17 (Ct. Rec. 1 at 3).

3  
4 The Howards paid the full amount that the IRS charged and then filed a  
5 claim for refund of that amount, together with statutory interest from the payment  
6 date (Ct. Rec. 1 at 3). When six months had passed after the claim was filed, the  
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8 Howards filed this lawsuit pursuant to 26 U.S.C. § 7422; *see also Thomas v.*  
9 *United States*, 755 F.2d 728, 729 (9th Cir. 1985).

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11 All parties agree that there are no material facts in dispute and that judgment  
12 as a matter of law is appropriate (Ct. Rec. 26 at 5; Ct. Rec. 30 at 3).

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14 The Howards argue that the goodwill was personal to Dr. Howard and that  
15 he was entitled to claim the proceeds from the goodwill as a long term capital gain.  
16 The government argues that the goodwill was Howard Corporation income for  
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18 three main reasons: first, the goodwill at issue was a corporate asset, because Dr.  
19 Howard was a Howard Corporation employee with a covenant not to compete for  
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21 three years after he no longer held Howard Corporation stock; second, Howard  
22 Corporation earned the income, and correspondingly earned the goodwill; and  
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24 third, attributing the goodwill to Dr. Howard does not comport with the economic  
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26 reality of Dr. Howard's relationship with Howard Corporation.  
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1 **II. APPLICABLE LAW**

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3 Summary judgment is appropriate “if the pleadings, depositions, answers to  
4 interrogatories, and admissions on file, together with the affidavits, if any, show  
5 that there is no genuine issue as to any material fact and that the moving party is  
6 entitled to a judgment as a matter of law.” Fed. R. Civ. P. 56(c). A key purpose of  
7 summary judgment “is to isolate and dispose of factually unsupported claims . . . .”  
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9 *Celotex Corp. v. Catrett*, 477 U.S. 317, 323-24, 106 S.Ct. 2548, 91 L.Ed.2d 265  
10 (1986).  
11

12  
13 The moving party bears the initial burden of demonstrating the absence of a  
14 genuine issue of material fact. *See Celotex*, 477 U.S. at 323. The moving party  
15 must demonstrate to the Court that there is an absence of evidence to support the  
16 non-moving party's case. *See Celotex Corp.*, 477 U.S. at 325. The burden then  
17 shifts to the non-moving party to “set out ‘specific facts showing a genuine issue  
18 for trial.’” *Celotex Corp.*, 477 U.S. at 324 (quoting Fed. R. Civ. P. 56(e)).  
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21 A genuine issue of material fact exists if sufficient evidence supports the  
22 claimed factual dispute, requiring “a jury or judge to resolve the parties' differing  
23 versions of the truth at trial.” *T.W. Elec. Service, Inc. v. Pacific Elec. Contractors*  
24 *Ass'n*, 809 F.2d 626, 630 (9th Cir.1987). At summary judgment, the court draws  
25 all reasonable inferences in favor of the nonmoving party. If the nonmoving party  
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1 produces direct evidence that contradicts direct evidence produced by the moving  
2 party, the court must assume the truth of the nonmoving party's direct evidence  
3 with respect to that fact. *T.W. Elec. Service, Inc.*, 809 F.2d at 631.  
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5 In order to resolve issues of tax liability arising from legal interests, the  
6 Court must look both to state law for the determination of the legal interest and  
7 federal law for the taxation of the interest. *See Drye v. United States*, 528 U.S. 49,  
8 58 (1999) (quoting *Morgan v. Commissioner*, 309 U.S. 78, 80 (1940) (state law  
9 creates legal interests and federal law designates what interests are taxed). “In a  
10 refund suit the taxpayer bears the burden of proving the amount he is entitled to  
11 recover. It is not enough for him to demonstrate that the assessment of the tax for  
12 which refund is sought was erroneous in some respects.” *United States v. Janis*,  
13 428 U.S. 433, 440 (1976) (cite omitted).  
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18 In this case, the issue is whether Dr. Howard or Howard Corporation owned  
19 the income from selling the goodwill. “[T]he essence of goodwill is the expectancy  
20 of continued patronage, for whatever reason. . . . the probability that old customers  
21 will resort to the old place without contractual compulsion.” *Comm’r v. Seaboard*  
22 *Finance Co.*, 367 F.2d 646, 649 (9th Cir. 1966). Accrued goodwill can be  
23 attributed to an individual employee or to a company, depending on the  
24 employment relationship between the two. *Martin Ice Cream Co. v. Comm’r*, 110  
25 T.C. 189, 207 (1998). Similarly, “there is no [corporate] goodwill where . . . the  
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1 business of a corporation is dependent upon its key employees, unless they enter  
2 into a covenant not to compete with the corporation or other agreement whereby  
3 their personal relationships with clients become property of the corporation.”  
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5 *Norwalk v. C.I.R.*, T.C. Memo. 1998-279, 1998 WL 430084 (U.S. Tax Ct. 1998).

### 6 III. DISCUSSION

7  
8 The Howards rely on Washington State dissolution case law to support the  
9 idea that professional goodwill in Washington is a community property right in  
10 dissolution cases: *Matter of Marriage of Fleege*, 91 Wash.2d 324, 326 (1979); *In*  
11 *re Marriage of Hall*, 103 Wash.2d 236 (1984); *In re Marriage of Lukens*, 16  
12 Wash.App. 481(1976). “[G]oodwill is indeed a factor which has value to a  
13 professional person and should be included among the assets distributed upon  
14 marriage dissolution.” *Matter of Marriage of Fleege*, 91 Wash.2d 324, 326 (1979).  
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16 The Howards argue that Washington State recognizes the personal nature of the  
17 classification of goodwill. *See, e.g., Matter of Marriage of Fleege*, 91 Wash.2d  
18 324, 326 (1979) (a professional “can expect a large number, if not most, of these  
19 patients to accept as their dentist a person to whom he sells his practice. . . . a part  
20 of goodwill, and they have a real pecuniary value”).  
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25 In addition, the Howards argue that it is dispositive in this case that the 2002  
26 Asset Purchase Agreement with Finn Corporation classified the Howard  
27 Corporation goodwill as a personal, non-corporate asset (Ct. Rec. 21 at 7; Ct. Rec.  
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1 23 at 3). The Government objects that allowing the terms of the Asset Purchase  
2 Agreement to control over the economic reality of Dr. Howard's relationship with  
3 Howard Corporation violates the common taxation rule of substance over form.  
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5 *See Frank Lyon Co. v. United States*, 435 U.S. 561, 573 (1978) (stating "the Court  
6 [looks] to the objective economic realities of a transaction rather than to the  
7 particular form the parties employed").  
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9         In this case, the 2002 Asset Purchase Agreement is nondispositive of  
10 whether the goodwill acquired from 1980 to 2002 was personal or corporate in  
11 nature. Dr. Finn testified that the price for the dental practice had been presented  
12 and accepted, without negotiation, and that he did not recall any discussion as to  
13 the allocation of the proceeds (Ct. Rec. 28, Ex. B). Therefore, the Court finds that  
14 the allocations presented in the 2002 Asset Purchase Agreement are not dispositive  
15 of the goodwill ownership issue, nor a valid reflection of the relationship between  
16 Dr. Howard and Howard Corporation.  
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20         The Howards' second argument is that Dr. Howard, as sole owner, officer,  
21 and director of his corporation, could modify the 1980 employment agreement  
22 with Howard Corporation and did so through the 2002 Asset Purchase Agreement  
23 with Finn Corporation. The Howards contend that the 2002 Asset Purchase  
24 Agreement terminated the 1980 covenant not to compete (Ct. Rec. 21 at 11).  
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28 However, as the government points out, even if the 2002 Asset Purchase

1 Agreement somehow terminated the 1980 covenant not to compete, that term  
2 would not change the characterization of the goodwill that was generated from  
3 1980 through 2002 (Ct. Rec. 30 at 7).  
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5 The government relies on three main cases for its position that the goodwill  
6 of Dr. Howard's dentist practice was corporate rather than personal: *Furrer v.*  
7 *Comm'r*, 566 F.2d 1115 (9th Cir. 1977); *Martin Ice Cream v. Comm'r*, 110 T.C.  
8 189 (1998); and *Norwalk v. Comm'r*, TC Memo 1998-279, 76 TCM 208 (1998).  
9  
10 In a professional corporation, like Dr. Howard's dental practice, employees can  
11 create goodwill that is either personal or corporate. See *Furrer v. Comm'r*, 566  
12 F.2d 1115, 1117-1118 (9th Cir. 1977). The *Furrer* court divided an employee's  
13 goodwill as goodwill for his company, and separately, goodwill for himself, "such  
14 as personal contacts . . . ." *Furrer v. Comm'r*, 566 F.2d 1115, 1117-1118 (9th Cir.  
15 1977). The *Martin* court "found goodwill of a corporation was an individual asset  
16 when the employer had not "obtained exclusive rights to either [the employee's]  
17 future services or a continuing call on the business generated by [the employee's]  
18 personal relationships." *Martin Ice Cream v. Comm'r*, 110 T.C. 189, 208 (1998).  
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23 In this case, it is undisputed that Dr. Howard had a contractual obligation  
24 under the 1980 employment agreement to continue working for and not to compete  
25 against Howard Corporation for the duration and for three years after his holding  
26 Howard Corporation stock (Ct. Rec. 28, Ex. F). It is also undisputed that Dr.  
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1 Howard held the stock until the Howard Corporation was dissolved at the end of  
2 2003. Therefore, Dr. Howard was bound by the terms of the 1980 employment  
3 agreement and covenant not to compete with Howard Corporation until the end of  
4 2003.  
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6         The Government primarily relies on *Norwalk v. C.I.R.*, T.C. Memo. 1998-  
7 279, 1998 WL 430084 (U.S. Tax Ct. 1998), and *MacDonald v. Comm’r*, 3 T.C.  
8 720, 726, 1944 WL 121 (1944), for the proposition that if an employee works for a  
9 corporation under contract and with a covenant not to compete with that  
10 corporation, as Dr. Howard did, then the corporation, and not the individual  
11 professional, owns the goodwill that is generated from the professional’s work.  
12 Even when a corporation is dependent upon a key employee, the employee may  
13 not own the goodwill if the employee enters into a covenant not to compete or  
14 similar agreement whereby the employee’s personal relationships with clients may  
15 become property of the corporation. *See Norwalk v. Comm’r*, TC Memo 1998-  
16 279, 76 TCM 208 (1998) at \*7. “In determining the value of goodwill, there is no  
17 specific rule, and each case must be considered and decided in light of its own  
18 particular facts. Moreover, in determining such value it is well established that the  
19 earning power of the business is an important factor” *Id.* at \*6 (citing *MacDonald*  
20 *v. Commissioner*, 3 T.C. 720, 726 (1944) and *Estate of Krafft v. Commissioner*,  
21 T.C. Memo. 1961-305 (1961)).  
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1 Courts have distinguished between personal and corporate ownership of  
2 goodwill depending on whether the employee had an ongoing employment  
3 contract and a covenant not to compete *Id.* at \*7 (citing *Martin Ice Cream Co. v.*  
4 *Commissioner*, 110 T.C. 189, 207, 1998 WL 115614 (1998)) (“personal  
5 relationships of a shareholder-employee are not corporate assets when the  
6 employee has no employment contract with the corporation”). Conversely, when  
7 there is no employment contract, then the goodwill may be personal. *See Martin*  
8 *Ice Cream Co. v. Commissioner*, 110 T.C. 189, 207, 1998 WL 115614 (1998).

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12 In this case, Dr. Howard was a Howard Corporation employee with a  
13 covenant not to compete with Howard Corporation from 1980 through 2003, plus  
14 three years, or 2006. Therefore, any goodwill generated during that time period  
15 was Howard Corporation goodwill. *See Norwalk; Martin Ice Cream Co.*

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18 The government also contends that Howard Corporation owns the goodwill  
19 generated by Dr. Howard’s dental practice because Howard Corporation was the  
20 entity to earn the income (Ct. Rec. 26 at 10). The Court has long held that the  
21 taxes are owed by the entity who earns the income. *See Lucas v. Earl*, 281 U.S.  
22 111, 114-15 (1930). In a professional services corporation that employs a service-  
23 providing employee, such as Dr. Howard, a two-part test is used to determine  
24 whether the corporation or the employee is considered to be the controller of the  
25 income. *Johnson v. Comm’r*, 78 T.C. 882, 891 (1982), *aff’d without op.* 734 F. 2d  
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1 20 (9<sup>th</sup> Cir. 1984). The first prong is whether the individual is an employee of the  
2 corporation; and the second prong is whether there is a contract showing that the  
3 individual recognizes the corporation's control. *Id.*  
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5 In this case, it is uncontested that Howard Corporation earned the income  
6 and paid the taxes on income from Dr. Howard's dental practice pursuant to the  
7 1980 employment agreement that established Howard Corporation's position as  
8 employer. The covenant not to compete in the 1980 employment agreement  
9 reinforces the conclusion that Howard Corporation controlled the assets, earned the  
10 income from Dr. Howard's services, and barred Dr. Howard from competing with  
11 Howard Corporation.  
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15 Bound by the covenant not to compete with Howard Corporation for a  
16 period of three years beyond when Dr. Howard no longer held Howard  
17 Corporation stock, which was until the dissolution of the Howard Corporation at  
18 the end of 2003 (*see* Ct. Rec. 28, Ex A at 28), Dr. Howard could not have earned  
19 income from a competitive dental practice within fifty miles of Spokane (Ct. Rec.  
20 28, Ex F). Therefore, even if the goodwill had belonged to Dr. Howard personally,  
21 it likely would have little value, because Dr. Howard could not have practiced  
22 within a fifty mile radius from his previous practice location for at least three years  
23 beyond the date of the Howard Corporation dissolution. Those prohibitions would  
24 likely discourage patients from following Dr. Howard to a new location.  
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