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Personal Goodwill and Loss Limitations Under §461(l) of the Tax Code are Likely to be Tested in Future Tax Appeals and Must be Considered in Structuring Business Sales

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An important tax code update that business owners in Ohio and across the country should take note of is part of the recent tax reforms concerning personal goodwill and its tax treatment in recent and future business transactions that largely became effective on January 1, 2018. The quick take-away is that personal goodwill limitations under § 461(l) of the new tax code are likely to be tested in future tax appeals and must be considered in structuring new sales of business interests and in determining tax treatment of completed transactions. If you or your business has an applicable transaction, you should further consider the provisions discussed below and confer with counsel.

Much has been written about the lack of clarity regarding the loss limitations under § 461(l) of the Internal Revenue Code. One way in which this new provision is likely to be tested by the Internal Revenue Service and U.S. Tax Court is regarding the treatment of gain on the sale of personal goodwill and its interplay with excess business losses. When structuring a transaction, your attorneys should keep an eye on the impact of the allocations.

Section 461(l) nets business income and losses and then limits the amount of net loss allowed to offset other income. For single filers, the limit is $250,000, and for joint filers, the limit is $500,000. Any unused loss will roll forward to the following year as a net operating loss. This provision raises an important question about future transactions for businesses and entrepreneurs, as well as tax planning, and even potential IRS audits regarding the issue. What happens when someone has enough business losses to offset the gains from the sale of business assets but some of the gain was treated as the sale of personal goodwill? Should gain from the sale of personal goodwill classify as business income and be offset by the business losses?

When practitioners started examining the impact of the Tax Cuts and Jobs Act (“TCJA”), § 461(l) was initially overlooked by many due to more prominent changes that rightfully drew attention. As the dust settles and we continue digging into the impact of the tax reform, this section certainly warrants discussion and careful planning. Understandably, the first questions arose as to what items of income/loss are encompassed by the section’s terminology of “attributable to such trades or business.” The initial analysis was this was an expansive term that would include most items of income/loss from one’s trade or business. Yet on January 2, 2019, Rep. Kevin Brady, the former Chairman of the Ways and Means Committee, proposed a draft of the anticipated technical corrections. In his draft, Brady specifically excluded wages from trades or business as being “attributable to trade or business.” To add further confusion, Form 461 Limitation on Business Losses and its instructions were less than clear on what was included and excluded.

Ever since the U.S. Tax Court ruling in *Martin Ice Cream Co. v Commissioner*, 110 T.C. 189, taxpayers have repeatedly argued with the IRS over the presence of personal goodwill. The Tax Court gave the

taxpayers what they wanted in *Martin Ice Cream Co*. when they held, “[w]here the success of the venture depends entirely upon the personal relationships of the practitioner, the practice does not generally accumulate goodwill.” Now we must ask, does that earlier taxpayer victory prevent a taxpayer today from attributing gains from the sale of personal goodwill to a trade or business for calculating § 461(l) limitations?

While there are arguments that the gain on the sale of personal goodwill should be attributable to business, taxpayers and tax preparers should be mindful of the “reasonable basis” standard for taking such a position on a return. This uncertainty on this issue will likely lead to tax controversy matters flowing through IRS Appeals and the U.S. Tax Court. There is similar concern in transactions involving Qualified Opportunity Zones (“QOZ”), where routine allocations in a transaction may trigger gain that delays the deployment of capital into a QOZ fund. Ultimately, the original structuring of the deal will be a central point of analysis of this issue by the IRS and the U.S. Tax Court.

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