Tax Court Denies Charitable Deduction Based on Faulty Premise of Value

***Derby v. Comm'r*, 2008 WL 540271 (U.S. Tax Ct.) (Feb. 28, 2008)**

The *Derby* case arose out of this consolidation of the healthcare industry more than a decade ago, when a group of Northern Californian physicians wanted to sell their practices to a non-profit medical foundation ("Sutter"). The negotiations were protracted and difficult, because the physicians refused to sign non-compete agreements and Sutter did not want to pay for the doctor's goodwill, in part to avoid potential violation of anti-kickback laws (42 U.S.C. Sec. 1320a-7b (b), which prohibit payments to doctors for Medicare/Medicaid patient referrals.

The doctors retained an attorney, who suggested transferring the intangible values of their practices to Sutter as charitable donations. Accordingly, the parties executed professional services agreements (PSAs), which entitled the physicians to certain benefits, including a 1) "free to compete" clause; 2) $35,000 access bonus; 3) guaranteed annual compensation; and 4) management representation. In return for shares in the new medical group, the physicians would donate their hard assets and a charitable contribution representing the difference between the purchase price of the assets and their "fair market value."

To obtain these values, the parties retained an independent appraiser to estimate the fair market value of the consolidated medical corporation's aggregate assets ($4 million), and a third party appraisal of the physicians' aggregate tangible ($1.16 million). To allocate the value of the physician intangible assets, one of the doctors arrived at a formula, which took the entire enterprise value ($4 million), less the amount paid for the tangible assets ($1.16 million), less the physicians' aggregate, collectible accounts receivable as of the transfer date ($1.21 million). The residual value of $1.63 million was divided among the 29 participating providers according to their prior gross revenues, years in practice, and share of aggregate fixed assets.

On their 1994 tax returns, the doctors used this formula to claim charitable deductions for their donation of goodwill. On its 1994 return, however, the new non-profit corporation did not report any of the intangibles as donations.

After an IRS audit, the taxpayers obtained a second appraisal of the intangible assets. Starting with a fair market value for the entire enterprise of $4.09 million, the appraiser subtracted "implied" working capital ($416,462) and fixed assets ($1.16 million) to value the aggregate intangible assets at just over $2.52 million. He then adopted the doctor's

formula for allocating the intangible value among the participating physicians with only slight adjustment.

At trial, the taxpayers argued that they transferred their medical practices to the new nonprofit in return for cash equal to the value of their tangible assets. Any payment for goodwill would have violated the federal anti-kickback laws, they said, so the taxpayers donated their intangible assets at a value equal to the sum of each taxpayer's allocable share, as determined by a reasonable formula, ratified by their expert.

The IRS disagreed, claiming that the value of the transferred assets, including intangibles, exceeded the consideration that the taxpayers received. Not only did the taxpayers obtain future employment with the new medical group, but they each got the benefit of bonuses, guaranteed compensation, and the "free to compete" provisions. Moreover, the taxpayers successfully transferred the risks arising from managed care to the consolidated medical group, by which they also secured greater leverage in negotiating with HMOs.

The Tax Court sided with the IRS. Even though the physicians did not specifically exchange the intangible assets for these benefits, the latter served "as leverage in the negotiations," the court said, and increased the total amounts received. The court also found a number of problems with the second appraisal, including its failure to allocate the intangible values between the doctor's professional goodwill (personal attributes) and practice goodwill (patient records, provider contracts, etc). The appraisal also failed to account for the "free to compete" agreements, and it adopted the doctor's allocation formula without any independent analysis. Finally, by ignoring the doctor's bonus payments, the appraisal overstated their earnings, resulting in an inflated value for the intangible assets as well.

Based on all these grounds and more, the court denied the taxpayers' charitable deductions in their entirety. Nevertheless, it refrained from assessing accuracy-related penalties under IRC Sec. 6662(a), because it had separate, independent grounds for disallowing the deductions, apart from their overvaluation of the assets.

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