Personal Goodwill: Practical Considerations

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A central consideration in planning for the sale of goodwill involves applicable income tax rates.

Goodwill is described as the expectation of continued patronage by existing customers[1] and is an important asset for many businesses. Unless purchased, goodwill is not generally reflected as a business asset, but goodwill nevertheless plays an important role in many transactions. In certain instances, goodwill is considered a personal asset of the employee or shareholder. The recent concept of personal goodwill has evolved from theory to practical application. By relying on the guidance presented in recent cases, considerable tax benefits may be obtained. A central consideration in planning for the sale of goodwill involves applicable income tax rates. The sale of personal goodwill will be taxed at favorable capital gains rates and may avoid C corporation taxation. Local tax benefits may also be enjoyed if the seller resides in a low (or no) tax jurisdiction. This article discusses the concept of personal goodwill and its applicability in various planning situations. Recognition of personal goodwill is important to CPAs in helping advise clients of favorable planning opportunities. CPAs conducting business as professional corporations must also pay close attention to these rules.[2]

Historical Evolution

Business valuation is an essential element of many diverse transactions including business sale, distribution, gift, and succession planning. Tax consequences are

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frequently based on the fair market value (FMV) of property exchanged. For example, a taxable gift may result from a transfer of shares to children as part of a succession plan. FMV is generally described as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."[3] Rev. Rul. 59-60[4] sets forth the applicable standards in establishing FMV. In general, this is a facts and circumstances approach considering all relevant items. There are various valuation methods including earnings capitalization, dividend paying capacity, and book value.[5]

Failure to properly assess ownership and valuation of intangible assets can result in substantial taxes and penalties. In *Cavallaro*,[6] a merger of two family companies, one owned by the parents and one by their sons, resulted in substantial gift taxes and penalties.[7] Technology owned by the parent's company was undervalued and, as a result, the parents received fewer shares of the merged entity. A substantial gift to the children ensued, resulting in unpaid gift taxes.

Martin Ice Cream Co.

Martin Ice Cream Co. involved a corporate division and spin-off of a Haagen-Dazs ice cream distribution business. The IRS asserted that the corporate valuation included valuable rights to distribute the premium brand ice cream. At issue were considerable corporate taxes applicable to the distribution of appreciated assets under Section 311(b) as well as the subsequent individual taxation with respect to the stock distributed in the spin-off.[8] The IRS asserted that the ice cream distribution rights were an extremely valuable asset of the Martin Ice Cream Company and the effective distribution to the shareholder resulted in substantial taxes; first, at the corporate level, and then as a dividend to the shareholder. The court found that the distribution rights were never corporate assets in that they resulted solely from the shareholder's personal relationships with various supermarket owners and managers. The shareholder created and nurtured those business relationships and was considered the sole owner; and therefore, no corporate distribution of such rights resulted. The shareholder built the wholesale distribution business of the Haagen-Dazs Ice Cream brand due to his personal relationships with supermarkets and managers over many years. There were no underlying corporate contracts with the Haagen-Dazs Corporation. The shareholder never signed a noncompete agreement with the corporation. The court discussed the history of the super-premium ice cream business, and the important role that the shareholder had in developing this business.

In supporting its findings, the Tax Court stated that the personal relationships of a shareholder-employee "are not corporate assets when the employee has no employment contract with corporation. Those personal assets are entirely distinct from the intangible corporate assets of corporate goodwill. See, e.g, *Estate of Taracido v. Commissioner*, 72 TC 1014, 1023 (1979)…."

The Martin Ice Cream decision seems to have awakened a new world of planning opportunities. These recent decisions help provide guidance in using the doctrine of personal goodwill and in creating planning opportunities.

Howard

In *Howard,*[9] a different result occurred due to the existence of a noncompete agreement. Dr. Howard sold his corporate dental practice but excluded the value of goodwill from the corporate sale. He maintained that he sold his personal goodwill in an attempt to avoid corporate taxes. The allocation to personal goodwill resulted in a single level tax at favorable capital gains rates. Unfortunately, Dr. Howard entered into a shareholder employment agreement with his corporation, which included a covenant not to compete. The court found that Dr. Howard was bound by the terms of his employment agreement. The covenant not to compete with the Howard Corporation was in full force and effect resulting in the loss of any allocation to personal goodwill. As sole shareholder and corporate officer, Dr. Howard had the ability to cancel the employment agreement but failed to do so. As a result, the corporation was responsible for the corporate level tax associated with the goodwill sale. The distribution to Dr. Howard resulted in a second level of tax at the individual level as a dividend. The court further stated that even if under state law the goodwill was owned by Dr. Howard, it would have very little value because the noncompete agreement did not expire until the end of a three year period and contained a fifty mile radius.[10]

Solomon Colors, Inc.[11]

Solomon Colors, Inc. sold one of its dye processing divisions to a competitor. The initial sale agreement did not include the individual sale of customer goodwill but did contain shareholder covenants not to compete with the purchaser. The sale agreement was later changed to include the sale of personal goodwill. In *Solomon*, the court distinguished *Martin Ice Cream* and held that, based on the facts presented, customer relation-

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1 See, e.g., *Howard,* 106 AFTR2d 2010-5533 (DC WA, 2010).

2 See, *Norwalk*, TCM 1998-279. In *Norwalk*, the taxpayer was a shareholder in a CPA firm operating as a PC. The corporation was liquidated and the IRS asserted that the corporation must pay tax on the distribution of customer goodwill. In the absence of an enforceable covenant not to compete, no corporate goodwill was distributed.

3 *Cartwright*,411 U.S. 546, 31 AFTR2d 73-1461 (1973); Reg. 20-2031-1(b).

4 1959-1 CB 237.

5 See discussion in *Martin Ice Cream Co.,* 110 TC 189 (1998).

6 *Cavallaro,* TCM 2014-189 (2014); *affd. in part* (CA-1, 2016).

7 The IRS initially instituted a tax fraud investigation.

8 Section 311(b) states that a corporation is taxed on the distribution of appreciated assets to a shareholder as if the assets were sold at FMV. The shareholder will then incur an individual tax based on the receipt of valuable consideration. This is referred to as the double tax associated with C corporations.

9 *Howard,* Note 1, *supra*.

10 It does not appear that Dr. Howard argued that such a long duration and extensive scope would not be enforceable under local law. If supported by local precedent, such assertion might have saved the day for Dr. Howard.

11 TCM 2008-102.

ships and personal goodwill were not a subject of the sale. Solomon Colors Inc. sold one of its divisions. The individual shareholders were not named in the initial contract drafts as sellers of any of the assets but were included only with respect to covenants not to compete. The IRS originally asserted that Section 301 applied to tax the distribution of the customer list to the individual shareholders as a dividend. Although the court did not find such to be the case, it reallocated the purchase payment to covenants not to compete that were important to the purchaser and were prominently included in the initial contract drafts. This allocation resulted in the shareholder recognition of ordinary income as opposed to capital gain.

Interestingly, the decision did not state that the customer relationships were owned by the corporation, but rather, due to the unusual facts surrounding the sale of this particular division, the customer list was not a significant part of the agreement and was not requested by the purchaser. Unlike Martin Ice Cream, Solomon Colors, Inc. was involved in the manufacture, processing, and selling of a particular dye. It was not a personal service business and did not depend on employee goodwill for its success. Moreover, the customer list was not important because the parties were aware of most of the customers and Solomon Colors was the only manufacturer of this particular dye. There were few customers involved and the two parties were aware of their identities. In contrast, the purchaser required noncompete agreements. The court found that the shareholders must recognize the payments allocated to the covenants not to compete resulting in the recognition of ordinary income.

Failure to properly assess ownership and valuation of intangible assets can result in substantial taxes and penalties.

Estate of Franklin Z. Adell[12]

Adell presents estate planning opportunities with respect to the allocation of personal goodwill. In *Adell*, the court agreed that the estate valuation of personal goodwill was correct and approved its application in a business succession context. The father's estate allocated substantial goodwill to the decedent's son resulting in a significantly lower estate tax valuation of the business. The son developed a new satellite uplinking business, which concentrated on religious programming. The goodwill with respect to this new business was developed and maintained solely by the son, thereby resulting in a smaller estate valuation. The court found that the expert valuation presented by the IRS was not persuasive because it did not appropriately take into consideration the son's efforts in developing personal relationships and goodwill. This personal goodwill was deducted from the business valuation.

Although the father created a successful satellite business, his son created the uplinking business and obtained the cooperation of several renowned ministers for program content. The son handled the day to day business affairs. This case presents an important lesson for business succession planning. When children are active in the family business, keeping an active record of their client relationships may assist in reducing the estate value of the business.

BrossTrucking, Inc.[13]

BrossTrucking similarly involved the ownership and valuation of goodwill. In *BrossTrucking,* the IRS determined a gift tax deficiency, contending that the father gifted appreciated intangible assets and goodwill to his three sons who organized a new trucking company.

Due to regulatory pressure Mr. Bross decided to close BrossTrucking, Inc. At the same time, his three sons established a new trucking company. The new corporation was a separate and distinct entity with similar but expanded business lines. There were some interrelationships in that the new business leased some of the original equipment and trucks used by the father. However, the new company masked the old name and logo on the trucks and equipment. Again, the IRS asserted Section 311(b)(1) to tax the corporation on the distribution of appreciated goodwill to the shareholder, and also asserted gift tax liability on the theory that the father gifted valuable goodwill to his children. In essence, the IRS was asserting that the corporation distributed appreciated goodwill to Mr. Bross who then gave the same to his sons resulting in both corporate level income recognition and the imposition of individual gift tax liability. In *BrossTrucking,* the court discussed and contrasted *Martin Ice Cream Co.* and *Solomon*, noting that in *Solomon,* the value of the corporate assets related to the processing and manufacturing of pigments and did not involve personal business relationships. "The goodwill of the pigment division was developed at the corporate level independent of the shareholders." Therefore, the sale did not include personal goodwill. The court stated that "[t]hese two cases suggest there are two regimes of goodwill: (1) Personal goodwill developed and owned by shareholders; and (2) Corporate goodwill developed and owned by the company." The court then stated that goodwill related to BrossTrucking was primarily generated by Mr. Bross and his personal relationships and therefore the company did not transfer corporate goodwill to Mr. Bross.

Mr. Bross was responsible for the development and maintenance of the crucial personal relationships underlying the customer base of the trucking company. These customers were developed by the personal abilities and reputation of Mr. Bross, both in the trucking industry and as a successful

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[12] TCM 2014-155.
[13] TCM 2014-107.
[14] TCM 2010-206.
[15] Section 7491.

construction businessman active in road construction since the 1960's. The court in *BrossTrucking* stated that, "[a] company does not have any corporate goodwill when all of the goodwill is attributable solely to the personal ability of an employee. See, *MacDonald v. Commissioner*, 3 TC 720, 727 (1944)… ". The trucking company did not contribute to developing goodwill and therefore, the corporation had no corporate goodwill. Mr. Bross did not have an employment contract or a covenant not to compete and therefore he did not transfer his personal goodwill to the corporation. Mr. Bross was under no obligation and was free to take his personal goodwill from the company. The decision did state that perhaps some negligible corporate goodwill, described as "workforce in place," had been distributed by BrossTrucking Co. However, this was later dismissed due to the fact that the employees in question did not have employment agreements or noncompete agreements and were free to accept or reject employment from the new corporation.

With respect to the gift, the court found that BrossTrucking's customers had a choice whether they wished to use the services of the new corporation established by the three sons. No such customer base was found to be transferred. At the time of these transactions, BrossTrucking was under considerable pressure with respect to safety and other road violations and their trucks were continually stopped for inspection. Thus, the court found that the customers would have a great incentive to choose a company with an untarnished reputation of service. Mr. Bross did not own any portion of the new entity and he was free to compete against the new company. There was no indication that the new trucking company used any relationship that Mr. Bross personally created. His sons had worked in the industry and they had close relationships with customers, which they had developed apart from Mr. Bross.

Kennedy[14]

James Kennedy provided employee benefits consulting services as a sole proprietorship. He later incorporated as a C corporation. Revenue consisted of consulting fees. Mr. Kennedy developed the client relationships, and customers looked to his knowledge and experience. Mr. Kennedy later sold the business; and after negotiations, 75% of the purchase price was allocated to personal goodwill to minimize the corporate level tax and apply the lower capital gains rate at the individual sale.

The IRS recast the goodwill payments as self-employment income. In *Kennedy*, the court held that the taxpayer did not meet the burden of proof that the payments were for goodwill. No qualified appraisal was obtained. The small allocation for consulting payments was an additional factor pointing to arbitrary tax structuring. The court found that the allocation to personal goodwill (75%) was "a tax-motivated afterthought that occurred late in the negotiations."

The taxpayer must produce credible evidence that the payments represent goodwill. The burden of proof may then shift to the IRS if the taxpayer maintains required records and complies with IRS requests for information.[15] The Kennedy's did not contend that they met these requirements. A qualified appraisal is essential.

Ten Lessons

The following guidance is summarized from the discussion above:

1. Document the importance and history of personal relationships.
2. Do not negotiate an entity sale with last minute changes and tax motivated allocations.
3. Consider a separate contract of sale for personal goodwill and intangibles owned by individual shareholders.
4. Properly structure corporate documents such as shareholder and employment agreements.
5. Obtain professional analysis and valuation and be careful to value consulting and employment services.
6. Obtain a qualified appraisal from a qualified appraiser.
7. Distinguish personal goodwill and intangibles from that owned by the entity and properly allocate sale proceeds to covenants not to compete.
8. Review all shareholder and confidentiality agreements including those signed by employees.
9. Address the sale of goodwill early in the negotiations of sale.
10. Make certain the economic substance is respected–not just the tax consequences.

All relevant facts and circumstances including business history and customer relationships must be considered. Rarely are the factors clear and professional guidance is essential. The recent cases help guide the analysis necessary to distinguish and value personal goodwill. Many CPA firms operate as professional corporations and these factors must be considered in structuring corporate transactions.