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An Updated Look at Personal Goodwill

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Introduction

First of all, personal goodwill is a relatively new concept that not every legal or tax practitioner has heard of. The phrase “personal goodwill” appears absolutely nowhere in the Internal Revenue Code, United States Code Annotated, or any state statute. It was given life in court cases over the past 20 years and is roughly defined as “the asset that generates cash profits of the enterprise that are attributed to the business generating characteristics of the individual, and may include any profits that would be lost if the individual were not present .” Quite simply, personal goodwill is the intangible value a person (usually the owner or CEO) brings to the company. It stands in contrast to traditional goodwill in that traditional goodwill is the value attributable to the company itself arising from intangible advantages such as location, customer quality, employees, etc.... While this dichotomy may seem insignificant, personal goodwill is an important concept to legal and tax practitioners for three reasons.

Federal Tax Ramifications

When selling any corporation, the buyer is always interested in purchasing the assets of a company to gain the advantage of lesser liability and the tax advantage of depreciating assets with a stepped up basis against income to reduce taxable income. While an asset sale gives rise to tax benefits to the buyer, the seller may suffer multiple tax detriments, especially in the case of selling assets of a C Corporation. With an almost certainty, in any sale, the seller

will face 1) Taxes arising from ordinary income, 2) Taxes arising from depreciation recapture (also at the ordinary income tax rate), 3) Taxes arising from capital gains, and 4) in the case of a C Corporations, double taxation when the proceeds are distributed to the owners.

When selling an S Corporation, partnership, sole proprietorship, or other pass through entity through an asset or stock sale, ordinary goodwill does not present any problems. The sale of the goodwill gets taxed once, at the seller's level as a capital asset. The tax rate on the gain is presently 15%.

However, the problems begin when selling a C Corporation through an asset sale. Ordinary goodwill creates a tremendous tax burden that is not present in the sale of a flow through entity. During the sale, ordinary goodwill is taxed at the corporate level. Since C corporations do not get the benefit of the lower capital gains tax rates, the capital gain is taxed at the corporation's ordinary rate. This federal tax rate can be as high as 39% at certain income levels. Once ordinary goodwill is taxed at the corporate level, it is given to the seller usually in the form of a dividend distribution. When given to the seller, it is taxed at the federal dividend rate of 15%. This means that of every \$100 given to the selling corporation as part of an asset sale, potentially \$48 of it will be paid to the federal government as taxes. In addition, we might have to deal with state taxes.

Along comes the concept of personal goodwill. As mentioned previously, the phrase "personal goodwill" does not appear anywhere in the Internal Revenue Code. Two tax cases gave rise to the concept of personal goodwill for

federal tax purposes and the two cases contain the definition for tax purposes in which we use. In the Martin Ice Cream Case (110 TC 189, (1998)), Arnold Strassberg was the co-owner of a company know as Martin Ice Cream Company. During his tenure with the company, he became a distributor of ice cream from Haagen-Dazs to multiple grocery stores under a non-written, “handshake” agreement. In the mid-1980’s, Pillsbury acquired Haagen-Dazs. Rather than allowing Arnold to continue in the distributorship, middle–man position, Pillsbury acquired Arnold’s company, the Martin Ice Cream Company. Forty-six percent of the purchase price was allocated to Arnold’s seller’s rights or what is now known as “Personal Goodwill”. When the case went to court, the Tax Court held that personal relationships of a shareholder-employee are not corporate assets when the employee has no employment contract with the company. This landmark tax case gave rise to personal goodwill.

Additionally, Norwalk (TCM 1998-279, 1989) found that the personal relationships of a group of accountants were the property of the individual owners and not the corporation itself. Hence, affirming the existence of personal goodwill.

When a seller is in a position similar to the facts above, it is most advantageous to split personal goodwill off from company goodwill. During the negotiation phase of the sale, the seller must create a separate personal goodwill contract stating that some of the goodwill being sold is personal goodwill. At the same time, the seller should not engage in an employment agreement. If an employment agreement is part of the deal, theoretically, the goodwill IS an asset

of the company being sold and is not personal goodwill. Practitioners have, in the past, sold 10%-90% of goodwill as personal goodwill in business sales. This amount should be based on a reasonable and objective estimation of the two values, while keeping in mind that more personal goodwill means less tax.

Personal goodwill is more likely to exist in smaller, service type companies. Characteristics of companies with personal goodwill include companies that are “relationship” dependent, no written contracts, no written property rights in the company, owner/employee controls the company, and the earnings do not support the transaction price. In companies which would be heavier on the traditional goodwill, characteristics such as “capital” dependence, written employment contracts, written property rights, no controlling owner, and business is where the business earnings support a transaction price, lend the characteristics to a business which would have more traditional, business owned goodwill. When valuing a company or working transaction allocation details, these factors can and should be considered to support a correct allocation.

Divorce – Equitable Division

Practitioners involved with divorce work routinely are unfamiliar with the general concepts of valuation when a business is present. Valuation specialists are sometimes not even used to appraise businesses. In these cases, the trier of facts will essentially make an educated guess as to the value of the business using rules-of-thumb which may be erroneous. Furthermore, and of even greater consequence in cases not retaining experts, company goodwill and personal

goodwill cannot be differentiated from one another, placing the business owner's case in jeopardy. Essentially, in any case involving a business interest, valuation specialists should be employed up front.

Proceeds derived from the sale of personal goodwill are not subject to a spouse's claim for equitable distribution. In Florida, the case of *Thompson v Thompson* (576 So. 2d. 267, 270 (1991)) an attorney divorced his wife. The wife claimed that the entire law practice was a marital asset subject to 50% division. The husband (attorney), on the other hand, argued part of the law practice's value was not merely "professional" or company goodwill, but also, the asset consisted of "personal goodwill". The court agreed with the personal goodwill concept and allowed personal goodwill to become a precedent at least in the state of Florida. The court defined "personal goodwill" as goodwill that depends on the continued presence of a particular individual that is not a marketable asset distinct from such individual. Although the personal goodwill was not an "asset" of the marriage, it could be used in determining alimony payable to the wife. Cases establishing personal goodwill in other states have been written as well. The cases are not always used as many practitioners do not know of the concept or even understand it.

Using the Corporate Veil Effectively

People incorporate their businesses to gain the effect, among other benefits, of limited liability. Generally, closely held and family owned businesses suffer a higher incidence of having their corporate veils pierced as opposed to

widely held, large corporations. Though corporate veils can be pierced, incorporating is still very effective in preventing personal losses in corporate situations.

Personal goodwill is an asset that creditor's of a corporation cannot attach to in a corporate lawsuit or collection proceeding. Because personal goodwill is outside the corporation, it is the personal property of the individual and therefore protected by the corporate veil.

While personal goodwill may seem worthless to those who own it at the time of a corporate proceeding, it does have a value when the owner wants to start up a business again. Since personal goodwill invokes personal relationships, it survives any proceeding to benefit the owner another day. This benefit is marketable and therefore valuable to those trying to obtain a recovery based on the full goodwill of the company and owners.

C Corporation Conversion

Under the Internal Revenue Code, when a C Corporation converts to a flow through entity, the value of the company at conversion must declare built-in gains i.e. the difference between the fair market value of their assets and the book value. If a corporation has goodwill and no basis, the result is a larger amount of tax due the federal government upon conversion. Under the doctrine of "personal goodwill", part of the total goodwill does not belong to the corporation itself, but to the executive. As it is not a corporate asset, it is not

subject to the built-in gains rules. The personal goodwill will continue to be an asset of the owner/CEO of the company.

In conversion situations, it is certain that a valuation of the company is necessary. Valuing the goodwill and separating the personal goodwill which is attributable to the owner is necessary to gain the best tax position. In doing so, the company and owner can expect to pay less taxes to the government.

Most Recent Case Updates

There are three recent cases of interest affecting personal goodwill. The first case is Solomon. In the Solomon decision, the fact pattern is overwhelmingly adverse to the interest of the business person. Unlike Martin Ice Cream, Solomon was an iron ore processor that did not largely depend on personal relationships to sell his commodity in the open market (after all, iron ore is iron ore). At one point in the case, his own accountant testified that the goodwill belonged to the company itself and not the owner of the business. In the ruling against the taxpayer, the IRS cited that nothing in the agreement cited personal goodwill, the role of the owner was not personal relationships like in Martin Ice Cream, and further there was no further evidence the seller intended to sell personal goodwill in ANY document.

The second decision is that of Muskat. In this decision the taxpayer and counsel listed all goodwill contained in the company and essentially elsewhere on the asset purchase agreement. Further, the covenant not to compete was relied on as evidence of personal goodwill by the taxpayer. The Court did not, by

any means repudiate the existence of goodwill, but cited no communication, nor document selling personal goodwill anywhere to justify taxpayer claims.

Last, but not of least importance, is Kennedy v. Commissioner. In this decision, the taxpayer did not have his personal goodwill valued. Instead an unsupported, arbitrary value of 75% was assigned to personal goodwill. The court cited lack of support as the reason to rule against the taxpayer. Once again, the court did not dismiss the concept of goodwill, but rather implied that valuations had better not be sloppy or arbitrary in their results.

Lessons Learned

Personal Goodwill, while enduring a string of defeats is alive and well! With that, the following conclusions from the cases should be observed and followed: 1) The value of personal goodwill should be supported within the formal valuation by the facts and numbers making the valuation, 2) certain documents must be created selling personal goodwill at the time of sale, not after the fact to create a scenario to support your argument, 3) Use competent counsel throughout the course of action during a business sale. One impression a reader of these cases gains is that it is never a good thing to lump documents together in a willy-nilly style at the last minute. Had these attorneys realized the proper method of establishing personal goodwill in the legal documents, they would have known at least enough to examine the facts, run the numbers under a formal process, and create the proper legal documents.

Conclusion

When appropriate, personal goodwill can provide large tax savings to taxpayers. Being a relatively new concept, it is important that the allocations to personal goodwill be reasonable and objective as there is only so much guidance through cases and decisions at this point. The Center specializes in reducing tax burdens upon disposition of assets and liquidations of companies through the use of personal goodwill and other leading edge techniques. Call the professionals at the Center for help with the sale of your business if you are concerned about taxes. Remember, it is critical that the documents be properly drafted and not by a general practitioner, but by someone who specializes in the area and knows the law regarding “personal goodwill”.