

PERSONAL GOODWILL IN ASSET SALE OF “C” CORPORATIONS



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This article discusses a somewhat aggressive but potentially valuable tax technique to enable a shareholder or shareholders of a closely held “C” corporation to

manage tax consequences upon an asset sale by distinguishing personal goodwill from enterprise goodwill. Prior to repeal of the General Utilities doctrine in 1986, upon the sale of assets, a “C” corporation, by complying with the election procedures of Internal Revenue Code § 337 could, within twelve months of a sale of assets, liquidate and avoid tax at the corporate level. This change in regime had a major impact on “C” corporations. Since the repeal of the General Utilities doctrine, the sale of assets of a “C” corporation will result in double tier taxation, i.e. tax on the sale of assets at the corporate level and tax on the stock redemption by a shareholder upon dissolution. The double tier taxation on “C” corporations has created a significant tension between potential buyers and sellers. Buyers prefer not to purchase stock due to the inherent liability risk

and inability to depreciate or amortize the purchase price and favor an asset purchase in which they receive a step up in basis and generally assume only those liabilities specified in the asset purchase agreement. On the other hand, sellers prefer a stock purchase transaction to avoid a double tier taxation, have the purchase price taxed at a capital gains rate and, except as provided by law or in the stock purchase agreement, not be obligated for liabilities of the corporation. The use of personal goodwill in an asset purchase transaction has to some degree enabled a compromise between buyers and sellers. If all or a portion of the goodwill can be characterized as personal goodwill owned by the shareholder and transferred outside of the corporation, the selling shareholder will avoid double tier taxation and the personal goodwill will be characterized as a capital gain at the shareholder level. Additionally, the personal goodwill acquired by the buyer from the selling shareholder may be amortized over fifteen (15) years under Section 197 of the Internal Revenue Code. Finally, the buyer will receive a step up in basis to the

extent of the consideration paid for corporate assets for depreciation and amortization purposes.

GOODWILL DEFINED

Goodwill is often defined as the expectation of continued patronage by existing customers. *Network Morning Ledger Co. v. U.S.*, 507 U.S. 546, 572-73 (1993). The Treasury Regulations define goodwill as “[T]he value of a trade or business attributable to the expectancy of continued customer patronage. This expectancy may be due to the name or reputation of a trade or business or any other factor.” *Treas. Reg. § 1.197-2(b) (1)*. Goodwill has also been defined as “the advantage or benefit, which is acquired by an establishment, beyond the mere value of the capital, stock, funds, or property employed therein, in consequence of the general public patronage and encouragement which it receives from constant or habitual customers, on account of its local position, or common celebrity, or reputation for skill or affluence, or punctuality, or from other accidental circumstances or necessity, or even from ancient partialities, or prejudices.” *Metropolitan Bank v. St. Louis Dispatch Co.*, 149 U.S. 436, 446 (1893) (internal quotations omitted). In Revenue Ruling 59-60, the Internal Revenue Service (“IRS”) defined goodwill as an expectation that investment in the assets of a business will yield profits in excess of the usual return on the assets because of characteristics peculiar to the business. The characteristics may include a competitive advantage of the business due to a special relationship with suppliers or special price advantage, location, the name of the firm, reputation, and well-known brand names owned by the company. *Rev. Rul. 59-60, 1959-1 C.B. 237*.

There are two types of goodwill: personal goodwill and enterprise goodwill, also referred to as business, practice or institutional goodwill. Enterprise goodwill is the intangible value and nature of goodwill that is associated primarily with the practice or operations of the business entity; it consists of location, computer systems, operating procedures, trained and assembled staff and a patient or client base. Shannon Pratt, Robert Riley & Robert Schweihs, *Valuing Small Businesses & Professional Practices*, p. 584-85 (3d e. 1998). Personal goodwill is the intangible asset associated primarily with an individual based on reputation, expertise or contacts which are of value to the business but not transferred by the shareholder to the corporation. Pratt et al, *supra*, at 584. Characteristics of personal goodwill

include individual skill, knowledge, and reputation. *Schilbach v. Commissioner*, T.C. Memo. 1991-556 (1991). It is considered personal, rather than enterprise, goodwill when an owner’s name is recognized and a company’s is not. *H&M, Inc. v. Commissioner*, T.C. Memo. 2012-290 (2012). Personal goodwill is likely to be present when business relationships are developed and maintained by a single proprietor, when others do not develop business relationships, and the nature of the relationships is personal to that individual. *Martin Ice Cream Co. v. Commissioner*, 110 T.C. 189 (1998). See also *Cullen v. Commissioner*, 14 T.C. 368 (1950); *MacDonald v. Commissioner*, 3 T.C. 720 (1944). The personal nature of the relationship is a stronger indicator of the existence of personal goodwill in services than in manufacturing companies. *Solomon v. Commissioner*, T.C. Memo. 2008-102 (2008).

Personal goodwill is more likely to be found in smaller firms than larger firms, such as a closely held business. The shareholder or shareholders must be intimately involved in the business, otherwise the goodwill is due to the work of others. Additionally, personal goodwill is likely to be found in technical, specialized or professional businesses and in businesses with customers or suppliers.

RECOMMENDATIONS

To effectuate use of personal goodwill to attempt to avoid double tier taxation in an asset sale of a “C” corporation, it is recommended that a seller consider the following:

- Identify personal goodwill as a specific asset class from the initial conversation in any verbal and written communications regarding a proposed transaction, including a letter of intent, term sheet and emails. This should be included as a caution even if a stock sale may be contemplated;
- If a letter of intent or term sheet is used in early negotiations or deal documentation, the intention to allocate a value to the personal goodwill to be determined should be stated. Failure to do so may lend ultimate support to an IRS claim that such allocation in a definitive agreement was merely a tax-savings afterthought to the transaction;
- Engage a professional appraiser to prepare to an independent valuation report of all assets, including personal goodwill. Personal goodwill should

be differentiated from enterprise goodwill in the valuation;

- Based on the appraisal, allocate a portion of the price in the asset purchase agreement to personal goodwill and identify the individual or individuals to whom it is attributable as the seller or sellers of the personal goodwill;
- The independent appraisal should separately value the non-competition covenant required of the selling shareholder to rebut a potential IRS contention that all of the consideration paid was for the non-compete agreement, and should therefore be treated as ordinary income, rather than for personal goodwill which would be treated as a capital gain;
- It is helpful, although not imperative, to use two agreements (i.e. (i) an asset purchase agreement for the sale of corporate assets including enterprise goodwill and (ii) an agreement by the shareholder to sell personal goodwill);
- Personal goodwill generally will not exist if a shareholder has a non-competition agreement with the target corporation at the time of the sale. Various courts have held that a non-competition agreement in existence at the time of the sale between a shareholder and selling corporation is evidence of an intention to transfer personal goodwill to the corporation. Practitioners should advise their clients of this risk if a shareholder-seller has an existing non-competition agreement in place and is contemplating an asset purchase agreement;
- On the other hand, it is essential that a shareholder-seller enter into a non-competition agreement with the acquiring company (and/or an employment agreement or consulting agreement) and the non-competition agreement should reference personal goodwill. It is imperative that valuation of the personal goodwill reflect reality to rebut an IRS claim that it is unreasonable and all or a portion of the personal goodwill should be allocated to the non-competition or employment agreement as ordinary income; and
- Finally, pushing the envelope, a practitioner may consider seeking tax indemnification from the buyer. The position is that the buyer is obtaining a step-up in basis through an asset purchase transaction rather than structuring the transaction as a

stock purchase and therefore, should share in the allocation of risk if the IRS is successful in disallowing the personal goodwill treatment.

RELEVANT CASE LAW

While personal goodwill received recognition prior to 1986, the seminal case of *Martin Ice Cream Co. v. Commissioner*, 110 T.C. 189 (1998) decided by the Tax Court in 1998, elevated its prominence and authority in asset transactions. In *Martin*, the Tax Court held that, when a corporation did not have an employment contract or non-competition agreement with an employee, the employee's personal relationships were not corporate assets. By way of background, Arnold Strassberg ("Arnold") and his son, Martin Strassberg ("Martin"), owned all of the stock of Martin Ice Cream Co. ("Martin Ice Cream"), an ice cream distributor. Prior to going into business with his son, Arnold worked for more than a decade in his own wholesale ice cream business in which he developed strong relationships with managers and owners of supermarket chains. Martin expanded the distribution side of the business after developing an innovative packaging and slogan campaign, introducing bright colors and catchy slogans, to market ice cream products in supermarkets for resale to consumers. In 1974, Arnold was approached by the founder of Haagen-Dazs, Ruben Mattus ("Mr. Mattus"), who had been unsuccessful in selling his product to supermarkets due to price points. Mr. Mattus asked Arnold to use his marketing expertise and relationships with supermarket owners to introduce Haagen-Dazs into supermarkets. On a handshake agreement with Mr. Mattus, Arnold quickly established distribution relationships with four major chains for Haagen-Dazs using his packaging and marketing techniques, and Haagen-Dazs flourished. Neither Arnold nor Martin Ice Cream ever entered into a written agreement with Haagen-Dazs.

In the mid-1980s, Pillsbury acquired Haagen-Dazs and approached Arnold about acquiring his relationships with supermarkets. Pillsbury had no interest in purchasing Martin Ice Cream as an ongoing distributor or in acquiring its physical assets; it was only interested in Arnold's personal relationships. Arnold eventually decided to sell his relationships to Pillsbury. To do so he created Strassberg Ice Cream Distributors ("SIC"), a new subsidiary corporation of Martin Ice Cream. All of the supermarket relationships of Martin Ice Cream were transferred to SIC and held as the subsidiary's

only assets. Martin Ice Cream transferred all of the SIC shares of stock to Arnold in exchange for his interest in Martin Ice Cream. SIC then sold the relationship assets to Pillsbury for \$1,400,000 without specific allocation between the consideration paid to SIC and to Arnold. As part of the sale, Arnold signed a bill of sale and an assignment of rights, and both Arnold and Martin signed non-compete agreements with Pillsbury. The Tax Court held that the intangible assets embodied in Arnold's agreement with Haagen-Dazs, and the personal relationships with supermarket owners and managers, were never corporate assets and were owned at all times by Arnold individually. The Court determined that Arnold built the distribution business based on years of personal relationships, the success of which depended entirely on Arnold. The ownership of the intangible asset could not be attributed to the corporation because Arnold never entered into a non-competition agreement, or even an employment agreement, to transfer the asset to the corporation. The Tax Court stated that it has long recognized that personal relationships of a shareholder-employee are not corporate assets when that employee has no employment contract with the corporation, and that those personal assets are entirely distinct from the intangible corporate asset of corporate goodwill.

In *Norwalk v. Commissioner*, the corporation, DeMarta & Norwalk, CPA's, Inc. ("DeMarta & Norwalk"), a CPA firm with two shareholders, Robert DeMarta ("DeMarta") and William Norwalk ("Norwalk"), each of whom signed a five-year employment agreement with non-competition and non-disclosure covenants to apply during the term of the agreement. *Norwalk v. Commissioner*, T.C. Memo. 1998-279 (1998). The contracts and covenants expired and no further employment agreements were signed. In 1992, DeMarta and Norwalk liquidated the corporation and distributed all assets to themselves. The IRS argued that the "customer-based intangibles," including client records and goodwill, were assets of the corporation that triggered a taxable gain to both the corporation and shareholders upon distribution to the shareholders. DeMarta and Norwalk argued that the corporation did not own the intangibles in question, and there was never a transfer of the intangibles to trigger the taxable gain. The Tax Court held that the "customer-based intangibles" belonged to the shareholders because neither DeMarta nor Norwalk had a contractual obligation in place at the time of the liquidation; therefore, the intangible assets did not belong

to the corporation, but instead to DeMarta and Norwalk individually.

Noting the lack of discussion of personal goodwill during negotiations, the Court in *Muskat v. U.S.* disallowed a refund claim when the Taxpayer tried to claim that payment was consideration for personal goodwill and should be characterized as a capital gain. *Muskat v. U.S.*, 554 F.3d 183 (1st Cir. 2009). The Taxpayer, Irwin Muskat ("Irwin"), was the CEO of Jac Pac Foods, Ltd. ("Jac Pac"), and owned 37% of the shares of stock. For thirty (30) years Irwin had developed valuable relationships with customers, suppliers and distributors, resulting in soaring increases in revenue. Manchester Acquisition Corporation ("MAC"), a subsidiary of Corporate Brand Foods America, Inc. ("CBFA"), approached Irwin about an acquisition of Jac Pac. A significant component of the negotiations involved discussions of the value of Irwin to the business and his expectation to receive payments in addition to the payment for corporate assets, and the parties agreed that after CBFA acquired Jac Pac's assets, Irwin would continue to run the business and would receive incremental payments under both an employment and non-competition agreement. CBFA and Jac Pac eventually entered into an asset purchase agreement and Irwin entered into an employment agreement and non-competition agreement with CBFA. Irwin listed the initial payment as ordinary income on his 1998 tax return, and later filed an amended return claiming a refund on the basis that the payment should be characterized as capital gain because it was consideration for personal goodwill. The District Court disallowed the refund claim and the First Circuit Court later affirmed. The Court held that the non-competition agreement expressly stated that the sums would be paid to Irwin in order to protect Jac Pac's goodwill and in consideration of Irwin's promises not to compete, not to solicit CBFA employees and not to divert business opportunities from CBFA. The Court emphasized that during negotiations there had been no discussion that any payment was to be considered for the Irwin's personal goodwill and there had been no mention of personal goodwill.

In *Solomon v. Commissioner*, the taxpayers, Robert and Richard Solomon ("Robert" and "Richard," respectively) were shareholders of a corporation, Solomon Colors, Inc. ("Solomon Colors"), which consisted of packaging and the sale of Mather ore, a red ironed oxide mined in the Upper Peninsula of Michigan. *Solomon v. Commissioner*, T.C. Memo. 2008-102 (2008). Neither Robert nor

Richard had an employment agreement with Solomon Colors. In August 2000, Solomon Colors sold its Mather ore division to Prince Manufacturing Co. ("Prince"). Robert and Richard argued that they sold a "Customer List/Goodwill" directly to Prince and were entitled to treat the purchase price allocated to the customer list as long-term capital gain on the transfer of the goodwill. They further argued that the customer list represented the customer relationships and goodwill that they owned personally, and that Prince was mainly interested in the assurances that Robert and Richard would maintain the customer base of the ore division after Prince acquired it. The Court analyzed the negotiation process of the acquisition, including the initial offer, term sheet, draft agreements, purchase price allocation and definitive agreement and noted that preliminary negotiations involved a \$1,500,000 offer for the ore business and did not mention the customer lists. This continued through the negotiations and initial drafts of the proposed purchase agreement. Eventually, Prince stated that non-competition agreements would be required. Solomon Colors' accountant was consulted, resulting in a discussion relating to the allocation of a portion of the purchase price to Robert and Richard. The Court held that the taxpayers received payments for the non-competition agreements and did not receive payments in exchange for the sale of the customer list and emphasized the lateness of consideration of the customer list/goodwill being incorporated into negotiations. The Court observed that the agreement referenced a customer list alone, and did not reference Robert and Richard's relationships independent of their obligations with Solomon Colors. Robert and Richard were not named as individual sellers of any assets, but were parties to the purchase agreement only to guarantee they would not compete with the buyer through the non-competition agreements.

In *Howard v. Commissioner*, the taxpayer, Dr. Larry E. Howard ("Dr. Howard"), was a dentist who practiced through a single shareholder "C" corporation, the Howard Corporation. *Howard v. Commissioner*, 448 Fed. Appx. 752 (2011). Dr. Howard had a written employment agreement, which included a non-competition agreement, restricting him from competing with the corporation while a shareholder and for three (3) years after termination of his shareholder relationship. Even though Dr. Howard had developed personal relationships with his patients, with the non-competition

agreement in place, the economic value of the relationships belonged to the corporation, rather than Dr. Howard individually. Dr. Howard sold the Howard Corporation and entered into a non-competition agreement with the buyer to preserve the value of the goodwill. Dr. Howard allocated the bulk of the purchase price to personal goodwill on his tax return, arguing that the goodwill proceeds from the sale were personal assets subject to taxation as long-term capital gains. The IRS argued that the goodwill proceeds belonged to the Howard Corporation, and recharacterized the proceeds as a dividend payment. The Court rejected the allocation, holding that the non-competition agreement provisions transferred all of the goodwill to the corporation.

In *Bross Trucking v. Commissioner*, the Tax Court held that the shareholder, Chester Bross ("Bross") retained his personal goodwill as a personal asset and did not transfer any goodwill to the corporation. *Bross Trucking v. Commissioner*, T.C. Memo. 2014-107 (2014). Bross entered into the road construction industry in 1966, eventually organizing Bross Trucking in 1982. Bross personally developed relationships with the necessary entities in the industry and was responsible for fostering these relationships to ensure that projects were successfully completed. Bross did not have an employment agreement or non-competition agreement with Bross Trucking. In the late 1990s Bross Trucking was the subject of a series of audits and investigations for regulatory violations, resulting in the closing of Bross Trucking due to negative publicity. Subsequently, Bross helped his sons, who had not been involved with Bross Trucking, open LWK Trucking ("LWK") as a separate entity. LWK adopted Bross Trucking's business model and hired half of its workers, but expanded into other service lines. In 2001, Bross and his wife, along with their three sons, organized Bross Holding Group ("BHG"). In 2006, Bross and his wife gave portions of BHG to their three sons, resulting in an issued deficiency from the IRS. The issue before the Court was whether Bross Trucking distributed appreciated intangible assets to Bross, and whether Bross then gave those assets to his sons as a taxable gift. The Court held that no gift tax was due, as Bross Trucking's goodwill was owned by Bross personally. Bross did not transfer any goodwill to Bross Trucking through an employment agreement or non-competition agreement and any corporate goodwill that Bross Trucking had was lost due to negative publicity.

Bottom line! Follow the guidance from the cases, and expect/require your client to authorize a legitimate appraisal of any personal versus corporate or enterprise goodwill. 🍀



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