

Personal Goodwill: Opportunities for Buyers and Sellers

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If goodwill is personal to a shareholder of a C corporation (or an S corporation with built-in gain), in the context of a sale of the corporation's assets to a buyer, the shareholder may be able to sell the goodwill separately from the assets at capital gains rates and without corporate-level tax. The buyer will be able to amortize the personal goodwill for tax purposes in the same manner as if the goodwill belonged to the corporation. This approach is subject to significant factual development and legal analysis, as described below.

The Personal Goodwill Advantage

The buyer of a corporate target often will prefer acquiring the corporation's assets instead of its stock. From an income tax perspective, an asset acquisition generally is favorable for a buyer compared to a stock acquisition because it can provide an increase, or step-up, in the tax basis of the assets acquired based on the purchase price. For certain assets, this increased tax basis may be depreciated or amortized, providing tax benefits to the buyer. Acquired goodwill is one such asset: Its tax basis may be amortized over 15 years. In contrast, a step-up in the corporate stock tax basis resulting from a stock acquisition (that is not treated as a deemed asset acquisition under the tax laws) does not result in increased depreciation or amortization, because stock is not an amortizable asset.

A selling shareholder, on the other hand, often will prefer a stock sale over an asset sale. Provided that the shareholder has held its stock for more than a year, gain on the stock disposition generally will be taxed only once (at the shareholder level) at the long-term capital gains rate. If the target corporation is a C corporation or an S corporation subject to entity-level tax on built-in gain (because, for example, it had converted from a C corporation to an S corporation within the last five years), an asset sale, in contrast, generally would result in two levels of tax — once at the corporate level on gain in the asset sale and a second time on the distribution of the net proceeds to the selling shareholder.¹

In instances in which goodwill is a significant asset, the parties' ability to structure the sale in part as a sale by the shareholder of personal goodwill and in part as a sale by the corporation of its assets may provide desired results to both parties. The buyer will obtain a stepped-up tax basis in all the assets acquired, including the amortizable personal goodwill. The shareholder will incur two levels of tax only on assets sold by the corporation; the personal goodwill sold directly by the shareholder will be subject to only individual taxation at the long-term capital gains rate, provided it has been held for more than one year.

The following examples demonstrate the potential effectiveness of this planning:

Example 1: Corporate Asset Sale

In this case, the target C corporation, Target Corp, sells its assets to Buyer Corp for \$1 million cash. Target Corp's basis in its assets is \$0, and thus the corporate-level taxable gain is \$1 million. At a 21 percent federal rate, the corporate tax is \$210,000.²

Target Corp, after paying \$210,000 to the federal government, distributes the remaining \$790,000 in liquidation to Shareholder, who is assumed to have a basis of \$100,000 in its Target Corp stock. Shareholder's gain, therefore, is \$690,000 and attracts tax at a 23.8 percent rate (combined capital gains rate, Medicare surcharge, and net investment income tax rate), resulting in a tax of \$164,220. The total tax paid on the transaction, therefore, is \$374,220, leaving Shareholder with \$625,780 from the transaction.

Example 2: Corporate Asset Sale With Sale of Personal Goodwill

In this example, Target Corp sells its assets while Shareholder simultaneously sells personal goodwill to which a value of \$250,000 has been ascribed. As before, Target Corp pays corporate tax on its sale of assets, but since they are worth less than in the prior case — only \$750,000 — there is less corporate tax to pay (\$157,500). After Target Corp pays \$157,500 of tax, it distributes \$592,500 of proceeds to Shareholder. Its gain on this distribution is \$492,500 (after reduction for the \$100,000 stock basis). Shareholder also pays tax on the sale of the personal goodwill; the goodwill produces \$250,000 of gain (personal goodwill, being self-generated, has \$0 basis). The gain on the distribution (\$492,500) plus the gain on the sale of personal goodwill (\$250,000) together are taxed at a 23.8 percent rate, resulting in a total tax to Shareholder of \$176,715 and a total tax on the transaction of \$334,215. This is \$40,005 (approximately 11 percent) less total tax than in Example 1 and provides \$40,005 more in after-tax proceeds to Shareholder.

Substance Must Support Form

The significant advantages, described above, to be gained from the proper allocation of consideration to personal goodwill of the shareholders of a corporation should not lure taxpayers to overly aggressive tax planning. A number of factors must be taken into account in determining whether consideration can be allocated properly to personal goodwill and the amount of such allocation. We describe many of these factors below. Certain fact patterns may raise “red flags” that require extra analysis before allocating consideration to goodwill. Examples include:

a proposed allocation of purchase price to the “goodwill” of shareholders proportionately according to shareholdings, regardless of the shareholders' involvement in the business or the extent of the shareholders' knowledge and relationships and their benefit to the business, does not support a claim that goodwill is being sold

the lack of any (or any significant) allocation of consideration to the assets of the target corporation (which value

may include corporate goodwill, going concern value and workforce in place)

late-in-the-negotiations reallocations of consideration to personal goodwill without a significant nontax business reason for the change

payments of monies to nonowner employees that the employees seek to have treated as payments for personal goodwill rather than transaction bonuses generally will not work.

In what cases, then, does personal goodwill exist, and how does one substantiate and document the sale of such an asset?

Personal Goodwill Must Be Personal

The goodwill must be personal to the selling shareholder and must exist separately from corporate goodwill. Determining whether certain skills, experience, knowledge or personal relationships possessed by shareholders constitute personal goodwill is a fact-intensive inquiry.

In the seminal *Martin Ice Cream* decision, a father and son operated an ice cream distribution business through Martin Ice Cream Company.³ Mr. Arnold, the controlling shareholder, exchanged his stock for ownership of a subsidiary called Strassberg Ice Cream Company. Martin Ice Cream then transferred its distribution business to Strassberg, which then sold Mr. Arnold's personal goodwill related to his relationships with customers to another company. The Tax Court held that the goodwill related to Mr. Arnold's relationships with customers belonged to Mr. Arnold, not the corporation, because Strassberg's distribution business depended on Mr. Arnold's relationships. The court further reasoned that Mr. Arnold did not transfer personal goodwill to Strassberg because he never entered into a noncompetition or employment agreement.

More recently, in *Bross Trucking*, the IRS argued that Bross Trucking Inc. distributed intangible assets to its sole shareholder, Chester Bross, who then transferred those assets to a trucking corporation his sons owned.⁴ The Tax Court held that there was no distribution of intangible assets from Bross Trucking to Mr. Bross because the personal goodwill already belonged to Mr. Bross. The court explained that, after a government-imposed suspension of Bross Trucking's operations due to regulatory infractions, any remaining goodwill was a result of Mr. Bross's personal relationships with Bross Trucking customers. The court then ruled that Mr. Bross never transferred any of his personal goodwill to Bross Trucking because neither Mr. Bross nor his sons signed employment or noncompete agreements.

Subsequently, in *Estate of Adell*, the Tax Court addressed the impact of personal goodwill in an estate tax valuation concerning the value of the decedent's stock in a corporation.⁵ The Tax Court found that the corporation's success was due to the personal goodwill of the decedent's son, reasoning that the decedent's son's personal relationships with customers as well as technical expertise were critical to the success of the corporation. The court also recognized that the decedent's son did not transfer his goodwill to the company through a noncompetition agreement, but instead was free to use his relationships to directly compete against the corporation.

A Noncompete Kills Personal Goodwill

Courts consistently have held that personal goodwill exists when an individual possesses the right to sell his or her personal goodwill. Conversely, personal goodwill is transferred to a corporation and, thus, does not exist when noncompetition or employment contracts are in force. These agreements demonstrate an intent to transfer personal goodwill and grant exclusive rights to the corporation, ensuring that the individual cannot benefit from personal goodwill without working for the corporation.

For instance, a dentist was unable to allocate any consideration to personal goodwill upon the sale of his wholly owned corporation in a case where he entered into a covenant not to compete when he incorporated his sole proprietorship.⁶ The court held that the goodwill the dentist generated in his sole proprietorship was corporate goodwill

because “the economic value of” the dentist’s relationships with customers “did not belong to him” because “he had conveyed control of them” through the noncompetition agreement.

On the other hand, personal goodwill existed when shareholders’ noncompetition agreements expired before they sought to liquidate a corporation and distribute its intangible assets among themselves.⁷ The Tax Court reasoned that, although the shareholders previously signed noncompetition agreements transferring any goodwill they possessed to the corporation, no such contracts existed at the time of the corporation’s dissolution and any personal goodwill of the shareholders did not belong to the corporation.

Transferring Personal Goodwill

To reap the benefits of personal goodwill in an asset sale of a corporation, a seller should document its intention to allocate a value to personal goodwill early in negotiations.⁸ Ideally, the portion of the purchase price of an asset sale related to personal goodwill should be supported by an independent valuation.

To ensure the proper transfer of personal goodwill, a seller typically will enter into a separate agreement to transfer the goodwill as well as a noncompetition agreement (and/or an employment agreement) supporting the goodwill transfer. Generally, in connection with a corporate asset transaction, an amount separately paid in consideration of a noncompetition agreement is taxed to the seller at ordinary income rates. On the other hand, if the noncompetition agreement is made primarily to ensure the buyer has the exclusive right to use the acquired personal goodwill, allocation of consideration may be able to be made away from the noncompetition agreement and to the personal goodwill transfer, resulting in taxation to the seller at capital gain rates.

Notably, a noncompetition agreement may be insufficient to meaningfully support a transfer of personal goodwill from seller to buyer. If personal goodwill represents a seller’s relationships with customers, the buyer should ensure that the seller is contractually obligated to provide introductions and facilitate a smooth transition of these relationships. On the other hand, if personal goodwill represents the seller’s knowledge, skills or experience, the buyer should ensure that the seller is contractually obligated to teach the buyer these skills or knowledge.

Pepper Perspective

As noted above, tax planning with respect to transactions involving the potential sale of personal goodwill depends on all the facts and circumstances of the relevant business and various agreements between the seller (personal

goodwill owner) and the corporation. Specifically, the seller may be precluded from selling its goodwill separate from the sale of the corporation's assets if, for example, a noncompete between the seller and the corporation is in place at the time of the sale. Given the potential significance of the tax consequences to a seller who does have valuable personal goodwill, a review of the relevant agreements, facts and documentation of this type of asset is advisable well in advance of preparing for a sale transaction.

Endnotes

¹ The multiple-level tax issue typically is not present for federal tax purposes if the target is an S corporation not subject to the built-in gains tax. Thus, personal goodwill generally is not used as part of an acquisition strategy in this context. Personal goodwill also generally is not used in the partnership acquisition context for a similar reason (*i.e.*, only one level of tax on partnership flow-through income).

² The examples do not include the effect of state income taxation.

³ *Martin Ice Cream Co. v. Comm'r*, 110 T.C. 189, 207-09 (1998).

⁴ *Bross Trucking, Inc. v. Comm'r*, T.C. Memo. 2014-107, 24-25 (2014).

⁵ *Estate of Adell v. Comm'r*, T.C. Memo. 2014-155, 52-54 (2014).

⁶ *Howard v. U.S.*, 448 Fed. App'x 752, 753-54 (9th Cir. 2011).

⁷ *Norwalk v. Comm'r*, 1998 Tax Ct. Memo. LEXIS 281, at *25-26, T.C. Memo 1998-279 (July 30, 1998).

⁸ *Kennedy v. Comm'r*, 2010 Tax Ct. Memo LEXIS 241, T.C. Memo 2010-206 (Sept. 22, 2010).

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