



# **Business Law Section Newsletter**

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## **Business Sales and Personal Goodwill**

*by Gerald A. Shanker*

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When purchasing or selling a business, a key consideration for both sides is the appropriate structure of the transaction. The structure of a transaction is influenced by many factors, including the potential tax consequences to both buyer and seller. This article discusses the tax aspects of both a stock sale and an asset sale, and when it is appropriate to allocate some of the purchase price to personal goodwill.

## Overview of a Stock Sale vs. an Asset Sale

In the sale of a C corporation (or an S corporation subject to the built-in gains tax provisions of Internal Revenue Code Section 1374), a stock sale generates the lowest tax for the seller because the gain on the stock sale is taxed to the shareholders as capital gain at a 23.8 percent maximum federal tax rate. In an asset sale, a C corporation is subject to double taxation—first the corporation pays taxes on the sale of its assets and then the shareholders pay taxes on the sale proceeds distributed to them as a dividend.

Although an asset sale may not be as tax advantageous for sellers, buyers typically prefer an asset sale for a variety of reasons. In an asset sale, for instance, the entire purchase price is allocated to the tangible and intangible assets purchased, providing current tax deductions to the buyer for the entire purchase price.

The following example compares the federal income tax on a stock sale to that on an asset sale, assuming a \$1.0 million purchase price, zero basis in the assets of the corporation, zero basis in the corporate stock, a 35 percent corporation tax rate and a 23.8 percent capital gain and dividend tax rate.

	<b>Stock</b>	<b>Asset</b>
Sale Price	\$ 1,000,000	\$ 2,000,000
Basis	-	-
Gain	1,000,000	1,000,000
Corporation Tax 35%	350,000	350,000
Amount Remaining for Distribution	1,000,000	1,000,000
Shareholder Tax 23.80%	238,000	154,700
Net After Tax	\$ 762,00	\$ 495,300
<b>Difference</b>	<b>\$ 266,700</b>	

Because the asset sale is subject to both corporate and shareholder-level income taxes, the tax on a \$1 million gain is approximately \$267,000 greater on an asset sale than the tax on a stock sale.<sup>1</sup>

Depending on the circumstances, an asset-based transaction may accomplish the seller's goal of avoiding double taxation while also accommodating the buyer's desire to purchase assets of a corporation (rather than stock). A seller may avoid double tax on assets sales by allocating a portion of the sale proceeds to a covenant not to compete, a consulting agreement, or other assets transferred in the sale that are not owned by the corporation, such as shareholder goodwill. Although the sale of a covenant not to compete results in ordinary income to the seller (and, thus, may not be the best alternative), a sale of goodwill is taxed at favorable capital gain tax rates. Purchasers of shareholder goodwill may amortize and deduct the purchase price of these assets over 15 years. This allocation creates a tax win for both buyer and seller.

Due to the favorable tax treatment upon the sale of personal goodwill, many sales transactions include an allocation to shareholder goodwill. These allocations are frequently challenged by the Internal Revenue Service (IRS). Self-serving language in a purchase agreement notwithstanding, the IRS looks behind the form of a transaction to the substance itself to determine if, in fact, the shareholders own personal goodwill.

## Personal Goodwill: What is it and When is it Present?

The IRS defines goodwill as “the 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”<sup>2</sup> and “[i]n the final analysis, goodwill is based upon earning capacity. The presence of goodwill and its value, therefore, rests upon the excess of net earnings over and above a fair return on the net tangible assets.”<sup>3</sup>

Personal goodwill is present when the unique expertise, reputation, or relationship of an individual gives

a business its intrinsic value. For example, consider a mom and pop grocery store. Customers would likely find better selection and prices at the new Wal-Mart in town. Customers, however, may continue to shop at the grocery because they are loyal to mom and pop. If mom and pop retired, the business would lose its customers, and thus much of its value. In essence, mom and pop *are* the business, and the business derives its intrinsic value from them. Mom and pop possess personal goodwill.<sup>4</sup>

Personal goodwill is typically found in three types of businesses: 1) closely held businesses, 2) highly technical, specialized or professional businesses, and 3) businesses with few customers or suppliers.<sup>5</sup> In a closely held business, a shareholder is intimately involved in the business and frequently plays multiple roles. In essence, the shareholder is, in every way, the corporation (recall mom and pop).

In a highly technical, specialized, or professional business, personal goodwill may be found if the shareholders possess unique characteristics that give the business its intrinsic value. Personal goodwill may be easier to detect in professional businesses, but non-professionals also may acquire special knowledge or skills that are invaluable to their businesses.

In businesses with few customers or suppliers, close relationships may develop between the shareholders and the customers or suppliers. If a business is highly dependent on a small number of customers or suppliers, it is crucial to the business's survival that the owners cultivate relationships (or goodwill) with customers or suppliers.

### ***Martin Ice Cream Company***

In the seminal case, *Martin Ice Cream Company v. Commissioner*,<sup>6</sup> Arnold and Martin Strassberg were the sole shareholders of Martin Ice Cream, an S corporation. Neither Arnold nor Martin had a noncompetition agreement or an employment contract with the corporation. Having worked in the ice cream distribution business for many years, Arnold had ice cream marketing expertise and relationships with supermarket owners and managers. In 1974, he was approached by Ruben Mattus, the owner of Haagen-Daz, to introduce Haagen-Daz products into supermarkets. Haagen-Daz manufactured an entirely new range of super-premium ice cream products that were differentiated from the competition by both higher quality and higher price. Mattus asked for Arnold's help because he had been unable to convince supermarkets to carry his products.

Arnold, as the first distributor of Haagen-Daz ice cream to supermarkets, sparked a revolution in the retail sale of ice cream. Arnold and Haagen-Daz tapped into a hidden demand for a super-premium ice cream in supermarkets by consumers who were willing to pay higher prices for higher quality. By the late 1970s, Martin Ice Cream was distributing ice cream products, including Haagen-Daz ice cream, to four major supermarket chains in New York, New Jersey, Pennsylvania and Connecticut. Neither Arnold nor Martin Ice Cream ever entered into a written distribution agreement with Haagen-Daz or Mattus.

In 1988, after Haagen-Daz was acquired by Pillsbury, Arnold agreed to sell the supermarket distribution business to Haagen-Daz. Upon the sale of this business, the entire gain was allocated to Arnold and reported on his 1988 personal income tax return on the basis that the supermarket relationships were the property of Arnold, not Martin Ice Cream. The IRS contested this treatment on the grounds that the consideration received was gain realized and recognized by Martin Ice Cream because Arnold negotiated the sale on the corporation's behalf.

Rejecting the government's position, the tax court found that the most valuable assets sold were the intangible assets of Arnold, namely his rights under his oral agreement with Mattus and his relationships with the owners and managers of the supermarkets.

The court stated:

Arnold built the business of wholesale distribution of super-premium ice cream to supermarkets on the twin foundations of his personal relationships with the supermarket owners, the development of which preceded the creation of petitioner by some years, and his personal, handshake understanding with Mr. Mattus, which continued with Haagen-Daz after its sale to Pillsbury. In developing his supermarket distribution business, Arnold changed the way ice cream was marketed to customers in supermarkets. The success of the venture depended entirely upon Arnold.<sup>7</sup>

Referring to the intangible assets, the court stated

[o]wnership of these intangible assets cannot be attributed to [the corporation] because Arnold never entered into a covenant

not to compete with [the corporation] or any other agreement—not even an employment agreement—by which any of Arnold’s distribution agreements with Mr. Mattus, Arnold’s relationships with the supermarkets, and Arnold’s ice cream distribution expertise became the property of [the corporation]. This court has long recognized that personal relationships of a shareholder-employee are not corporate assets when the employee has no employment contract with the corporation. These personal assets are entirely distinct from the intangible corporate asset of corporate goodwill.<sup>8</sup>

### **Key Factor: Lack of an Employment Agreement or Noncompetition Agreement**

An important factor in determining whether personal goodwill exists is whether the shareholder has an employment agreement or a noncompetition agreement. The lack of such an agreement was crucial to the government’s loss in *Bross Trucking, Inc. v. Commissioner*.<sup>9</sup> In that case, the IRS assessed an \$883,800 corporate income tax deficiency and a \$176,760 accuracy-related penalty against Bross Trucking. It was the government’s contention that Bross Trucking distributed appreciated intangible assets to its sole shareholder, Chester Bross, who then gifted these intangible assets to his three sons, who had formed their own trucking company independent of their father.

Bross organized Bross Trucking in 1982. He did not have an employment contract with Bross Trucking and never signed a noncompete agreement that would prohibit him from competing against Bross Trucking if he dissociated from the company. None of Bross Trucking’s employees signed noncompete agreements with the company. None of the three Bross sons ever worked for Bross Trucking.

Internal Revenue Code (IRC) Section 311(b) provides that if a corporation distributes appreciated assets to a shareholder, the corporation recognizes gain as if the property were sold to the shareholder at its fair market value. The IRS took the position that Bross Trucking distributed the company’s operations to Bross. In other words, the income tax deficiency was based on the distributed intangible assets.

Citing *Martin Ice Cream*, the tax court found that “[a] business can distribute only corporate assets and cannot

distribute assets that it does not own”<sup>10</sup> and, other than the workforce in place, all remaining intangible assets were owned by Chester Bross. The court concluded that “Bross Trucking’s customers chose to patronize the company solely because of the relationships that Mr. Bross personally forged” and his “experience and relationships with other businesses were valuable assets, but assets that he owned personally.”<sup>11</sup>

In its analysis, the court 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,” and concluded that Bross did not transfer any goodwill to Bross Trucking through an employment contract or noncompete agreement.<sup>12</sup> A key employee who develops relationships for his or her employer may transfer goodwill to the employer through an employment contract or noncompete agreement. The transfer is evidenced by the employee’s covenant not to use his or her goodwill to compete against the employer. An employer has not received personal goodwill from an employee where an employer does not have a right, by contract or otherwise, to the future services of the employee.

Likewise, the lack of a covenant not to compete or an employment agreement transferring a key employee’s relationships to the corporation was a key factor in the court’s decision in the 2014 case of *Estate of Adell v. Commissioner*.<sup>13</sup> That case involved the valuation of STN.com (a corporation that provides satellite uplinking services for television programs) following the death of one of its shareholders, and the economic charge for the personal goodwill of its key employee, Kevin Adell, in valuing the corporation. Adell served as STN.com’s president, but never had an employment agreement or noncompete agreement with STN.com. STN.com’s sole business purpose was to broadcast an urban religious program channel that Adell named “The Word Network.”

Attached to the estate tax return was a valuation report of STN.com with a date of death value of \$9.3 million. In its notice of deficiency, the IRS determined that the date of death value of STN.com actually was significantly higher. The primary difference between the values were the deductions for Adell’s compensation and charges for his personal goodwill.

The estate’s valuation expert made adjustments to reduce officers’ salaries and to include an economic charge for Adell’s personal goodwill.<sup>14</sup> He explained that the charge for personal goodwill was necessary

because the success of STN.com depended heavily on his personal relationships. Since Adell did not have a noncompete agreement with STN.com, a potential buyer could acquire STN.com only to the extent that the company retained Adell. The expert determined the fair market value of the STN.com stock was \$9.3 million as of the date of Adell's death.

The government's valuation expert also recognized Adell's importance, concluding that a hypothetical investor would anticipate retaining him as an officer of STN.com and would compensate him at a rate of 8.1 percent of sales. Using a discounted cash flow and applying a 20 percent discount for lack of marketability, this expert concluded that the fair market value of STN.com stock on the date of Adell's death was \$26.3 million.

In concluding that \$9.3 million was the correct value of Adell's stock, and citing *Martin Ice Cream*, the court recognized that Adell's personally developed goodwill was not a corporate asset, and absent a covenant not to compete or other agreement that transfers the relationships to the employer, the employer cannot freely use the asset and the value of the goodwill should not be attributed to the corporation. In the instant case, Adell was free to leave STN.com and use his relationships to directly compete against his previous employer. If he quit, STN.com could not exclusively use the relationships that Adell cultivated; thus, the value of those relationships (his personal goodwill) should not be attributed to STN.com.

Unlike the above cases, in *Solomon v. Commissioner*<sup>15</sup> the tax court held no personal goodwill existed. The taxpayers were shareholders in Solomon Colors, Inc. Upon the company's sale of its Mather ore division to Prince Manufacturing Company, the IRS took the position that the fair market value of a partial interest in the company's customer list was distributed to the company's shareholders simultaneously with the sale of the business and was, therefore, taxable to them as a dividend. As part of the sale transaction, each of the Solomon shareholders signed a covenant not to compete with Prince Manufacturing, in his or her individual capacity.

At the time of the sale, Solomon Colors and Prince Manufacturing were the sole processors of Mather ore in the United States and Canada. After the sale, Prince was the only remaining processor of Mather ore.

In the sale transaction, Solomon Colors received \$550,000 in exchange for the company's customer list and \$150,000 for the company's covenant not to

compete. Shareholders Robert and Richard Solomon received \$525,000 and \$165,000, respectively, in exchange for their covenants not to compete with Prince.

In ruling that the shareholders did not receive anything for the customer list but were paid for their covenants not to compete, the court considered that the sale agreement made no specific reference to any customer list belonging to Robert or Richard Solomon. Also, a side agreement stated that Solomon Colors and Prince would work together after the sale of the Mather ore division to form a plan for smooth transition of production. The side agreement required nothing of Robert or Richard Solomon in their personal capacities independent of their duties as officers of Solomon Colors.

After Prince acquired the Mather ore division from Solomon Colors, Prince was left as the sole business in the industry.<sup>16</sup> Prince did not need the goodwill of Solomon Colors or any of its key employees to succeed. Prince continued to do business in its own name; not under the name of Solomon Colors.

As noted by the court, the *Martin Ice Cream* case is distinguishable from this case because the value of Solomon Colors in the market was not attributable to the quality of service and customer relationships developed by Robert or Richard Solomon. Solomon Colors, as a business of processing, manufacturing, and sales, rather than one of personal services, did not depend entirely on the goodwill of employees for its success.

The court also noted that Robert and Richard Solomon were not named as sellers of any assets but were included in the sale in their individual capacities solely to guarantee they would not compete with Prince. Also, unlike the above cases, the fact that Prince required noncompete agreements, but not employment or consulting agreements of Robert and Richard Solomon makes it unlikely that Prince was purchasing the personal goodwill of these individuals.<sup>17</sup>

### Personal Goodwill in Professional Businesses

*Howard v. United States of America*<sup>18</sup> is the first of two cases of particular interest to professional practices. In that case, the goodwill generated by a dentist while he was employed by his solely owned professional corporation was owned by the corporation, and the amount he received from the sale was a dividend, not capital gain from the sale of a personal asset. Dr. Howard worked for the corporation under an employment agreement with a covenant not to compete. The corporation retained

complete control over the individual's clients and any relationships the individual had with his clients and, therefore, the corporation, not the individual, owned the goodwill. Further, the court found it significant that the purchase agreement did not terminate the dentist's employment contract or the noncompete agreement, and actually arranged for Howard to provide dental treatment on the patients of the buyer.

In the consolidated case of *Norwalk v. Commissioner*,<sup>19</sup> the IRS asserted that a certified public accounting firm realized a gain of \$588,297 on the distribution of intangible assets to its shareholders, and the shareholders realized a capital gain of approximately \$572,000 on receipt of property from the firm in a liquidating distribution. The tax court held that the firm made no distribution of intangibles to its shareholders that would result in the realization of taxable gain. There was no transferable goodwill belonging to the firm, independent of the abilities, skills and reputations of the individual accountants. The firm had no goodwill that could be distributed to its shareholders or sold to a third party. Since there was no enforceable contract that restricted the practice of any of the accountants at the time of the distribution,<sup>20</sup> their personal goodwill did not attach to the firm.

Citing *Martin Ice Cream*, the court stated, "We have held that there is no salable goodwill where, as here, the business of a corporation is dependent upon its

key employees, unless they enter into a covenant not to compete with the corporation or other agreement whereby their personal relationships with clients become property of the corporation."<sup>21</sup>

## Conclusion

Planning the sale of a corporation should begin long before commencement of negotiations. The assets to be sold and the ownership of such assets should be identified and documented. When the company is sold and personal goodwill exists, the sale should include two separate agreements—the first between the corporation and the buyer identifying and transferring the corporate assets, and the second between the shareholder and the buyer, transferring the personal goodwill. The seller would be well advised to engage a valuation professional to analyze and document the value of the respective assets.

If a noncompetition or employment agreement exists, consideration should be given to terminating such agreements. Even an employment agreement without a noncompetition agreement may be sufficient to transfer personal goodwill to the corporation, because if the shareholder employee is prohibited from working anywhere else, he or she most likely cannot use personal goodwill to the detriment of the corporation. ■

*Gerald A. Shanker, CPA/AVB, is a member of Kreinces Rollins & Shanker, LLC in Paramus.*

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## Endnotes

1. This example does not consider New Jersey income taxes, which generally tax corporations and individual taxpayers at a nine percent rate, but are deductible for federal income tax purposes.
2. Treas. Reg. §1.197-2(b)(1).
3. Rev. Rul. 59-60, 1959-1 CB 237.
4. Darian M. Ibrahim, The Unique Benefits of Treating Personal Goodwill as Property in Corporate Acquisitions, *Delaware Journal of Corporate Law*, Vol. 30, No. 1, Winter 2005, Page 9.
5. *Id.* at 16-18.
6. 110 T.C. No. 18 (1998).
7. *Id.* at 207.
8. *Id.*
9. T.C. Memo 2014-107 (June 5, 2014).
10. *Id.* at 7.
11. *Id.* at 9.
12. *Id.*
13. T.C. Memo 2014-155 (Aug. 4, 2014).

14. Employing the discounted cash flow method, the expert added the economic charge to STN.com's projected operating expenses, thereby increasing expenses by this charge, which ranged from 37.2 to 43.4 percent of sales over the historical period and 43.7 to 44.1 percent of sales over the projection period.
15. T.C. Memo 2008-102 (April 16, 2008).
16. *Id.* at 9. As part of the purchase, Prince required the promises of Solomon Colors and each of the four Solomons that they would not compete with Prince in the Mather ore industry for a desired period of time.
17. *Id.* at 11. *See also Kennedy v. Commissioner*, T.C. Memo 2010-2006 (Sept. 22, 2010) (finding payments to Kennedy were consideration for services rather than goodwill and citing, in part, the noncompete Kennedy signed).
18. U.S. Court of Appeals, Ninth Circuit; 10-36768 (Aug. 29, 2011) affirming 2010-2 USTC.
19. T.C. Memo. 1998-279.
20. Although the shareholders had signed employment and noncompetition agreements in Sept. 1985, the term of the agreements was five years. Upon expiration, these agreements were not renewed and no subsequent agreements were entered into with the shareholders.
21. T.C. Memo. 1998-279 at 7.