Distinguishing Personal and Business Goodwill: Planning Strategies to Minimize Tax Liability

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Personal vs. Enterprise Goodwill

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Why Is the Distinction Important?

- It has tax implications when a business is sold.
- It has valuation implications:
  - in divorce settlements,
  - in shareholder disputes, and
  - in determining what someone is willing to pay for a business.

Definitions of Goodwill

IRS definitions:

- Treasury Reg. §1.197-2(b)(1) – "*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.*"
- Revenue Ruling 59-60 – States that goodwill is based upon earning capacity, and the value of goodwill *"rests upon the excess of net earnings over and above a fair return on the net tangible assets."*

Definitions of Goodwill

"The sum total of those imponderable qualities which attract the customer of a business, - what brings patronage to the business…"

Definitions of Goodwill

Applying Revenue Ruling 59-60

Example:

Excel Corp. has net tangible assets worth $16,000,000 (market value, not book) and companies with comparable sales in the same industry are determined to have a fair return of 12% on net tangible assets. That would mean that any earning capacity over $1,920,000 ($16,000,000 x 12%) would be attributed to goodwill. However, any intangible assets with separate value such as patents, trademarks, and copyrights would have to be taken into consideration in arriving at the correct value of goodwill.

Definitions of Goodwill

Applying Revenue Ruling 59-60

Example – cont'd:

Let's say Excel Corp. earns $3,200,000 and thus, has exceeded the return it should expect on its net tangible assets (NTA). It also has a patent and a trademark.

Earnings	*$3,200,000*
Less: Return on NTA	*(1,920,000)*
Excess amount	*$1,280,000*

The IRS considers this excess amount to be attributable to goodwill, but since there are other intangible assets besides goodwill, the amount attributed to goodwill alone will need to be determined.

Professions Typically Associated with Personal Goodwill

- Doctors
- Attorneys
- Accountants
- Hair stylists
- Personal trainers
- Other personal services providers

But there is also usually an element of personal goodwill in any closely held business. Indications may include:

- technical or specialized services provided, and/or
- a relatively small number of customers and/or suppliers, which indicates the owner(s) may have close personal relationships with these customers and suppliers.

Attributes of Enterprise Goodwill

Enterprise goodwill exists regardless of who owns or operates the business and derives from characteristics of the business itself. Things like:

- Brand name (Nike, Apple, Tesla)
- Logo
- Website
- Specialized phone number (1-800-GOT-JUNK)
- Location
- Specialty technology
- Secret recipes (Coca Cola, Mrs. Fields, KFC)

Attributes of Personal Goodwill

Personal goodwill exists because of characteristics specific to a particular person. Things like:

- Reputation
- Professional knowledge and skills
- Contacts
- Relationships
- Craftsmanship
- Unique designs or styles
- Unique methods

Actual Applications

A colleague of mine had a divorce case that involved a busy dental practice with only three dentists. One might rationally conclude that a small dental practice would certainly involve personal goodwill, but they would be wrong in this case. WHY?

Because in this case, the practice was located near a large air base and nearly all the patients were military personnel on short-term assignments. The patients were there because of location and NOT because of the personal reputation, knowledge, or skills of the individual dentists.

Actual Applications

Conversely, there is the famous tax court case *Martin Ice Cream Company v. Commissioner.* Martin Ice Cream Company was an S corporation owned by two brothers. One of the brothers, Arnold Strassberg, had worked in the ice cream distribution business for a long time and had close relationships with supermarket owners, managers, and buyers. In 1974, he used those relationships to get Haagen-Daz ice cream introduced into supermarkets. Fast forward to 1988 when Haagen-Daz is acquired by Pillsbury and Arnold and his brother sell Martin Ice Cream Company to Pillsbury.

Actual Applications

The genesis of the case was Arnold Strassberg filing his 1988 personal income tax return and including the entire gain from the sale of the business. The IRS contested this treatment on the grounds that the gain belonged to Martin Ice Cream Company because Arnold had negotiated the sale on behalf of Martin Ice Cream Company, and Martin Ice Cream Company owned the relationships, not Arnold. The court concluded that Arnold did, in fact, own those relationships.

How did the court reach that conclusion? The key was the absence of any employment or non-compete agreement. The court stated its long-held position that *"personal relationships of a shareholder-employee are not corporate assets when the employee has no employment contract with the corporation."*

Categorizing Goodwill

In order to correctly determine how much goodwill belongs to a business and how much to an individual, it is vitally important to establish if a non-compete or employment agreement exists and if one does exist, to what extent does it transfer the personal goodwill to the business?

It is also important to recognize the difference between transferable and non-transferable goodwill because no rational buyer would willingly pay for goodwill that will depart along with the person to whom it is attached.

Transferability of Goodwill

If personal goodwill is only attributable to a person, how can any part of it be considered transferable in the absence of a non-compete or employment agreement?

Some goodwill may never be transferable, such as highly specialized and difficult-to-replicate skills or knowledge, or certain long-term personal relationships. However, with a long enough time frame and a well-planned transition to a new owner, it is possible to transfer some of the required knowledge, and for the seller to help the new owner build relationships with important clients and suppliers.

Categorizing Goodwill – Factors to Consider

	Enterprise Goodwill	Personal Goodwill
Customer loyalty	Patronage is based on company-specific factors such as pricing, value, reputation, quality, location, convenience, and unique product or service offerings; relationships may be contractual	Patronage is based on personal relationships with owners or key employees; few or no contracts with key customers; customers may have many other options for similar goods or services
Employment agreements	Owners and key employees have signed non-compete or other employment agreements with the business	No non-compete or other employment agreements exist between the business and its owners or key employees
Location	Location can be a significant factor in attracting customers	Not a significant factor in obtaining customers or patients

Categorizing Goodwill – Factors to Consider

	Enterprise Goodwill	Personal Goodwill
Management structure	Professional management that does not rely heavily on the existing ownership	Existing owners or key employees are crucial to the continued functioning of the business
Marketing	Based on factors integral to the business and individuals are not specifically identified; the business name is separate from its owners; strong brand recognition with the logo prominently featured	Focuses on the owner or a key employee's reputation, skills, knowledge, contacts or relationships; business name same as the owner(s); marketing features individual's names and/or photos
Profit allocation	Based on an equitable division of profits or losses	Based on each individual's production of business income

Categorizing Goodwill – Factors to Consider

	Enterprise Goodwill	Personal Goodwill
Reputation and referrals	Reputation is based on the business as a whole; referrals are to the business and not specific individuals; formal referral arrangements may exist	Reputation is based on the owner's or key employee's personal reputation and not that of the business; referrals are to a specific individual rather than to the business
Sales	Sales are generated by multiple individuals; sales would not drop significantly if any one individual left the business	Highly reliant on the efforts and relationships of an individual; revenue would drop significantly if this individual left the business

Categorizing Goodwill – Factors to Consider

	Enterprise Goodwill	Personal Goodwill
Size of the business	Tends to be larger with professional and diverse management; knowledge is institutionalized; there are written policies and procedures	Tends to be smaller with the owner or key individual being integral to the management of the business; knowledge largely resides with a key individual; no or few written policies and procedures
Suppliers	No significant reliance on any one supplier; no one individual handles all transactions with any supplier; relationships may be contractual	Limited number of suppliers and the owner or key employee has personal relationships with the suppliers

Goodwill from a Tax Perspective

- Despite what you may have heard, personal goodwill is not the silver bullet to eliminate the General Utilities repeal for all C corp service businesses
  - Potentially over-utilized
  - Often not documented or supported but simply claimed
- As discussed earlier, the judicial position has been that an individual's valuable attributes, abilities, and relationships may constitute goodwill, and that if such goodwill has not been transferred to the corporation, it is the individual's personal goodwill.

- and -

- Case law has established that when an individual does not have an employment/non-compete, the individual's personal relationships and other assets constituting goodwill are distinct assets from corporate goodwill.

Goodwill Case Law

Martin Ice Cream Co.

The shareholder employee's intangibles were "entirely distinct from the intangible corporate asset of corporate goodwill," and that the personal abilities, qualities, reputation, and personality of the sole active shareholder are not assets of the corporation where there is no contractual obligation to continue with the corporation.

Goodwill Case Law

Schilbach, T.C. Memo. 1991-556 at 8

The court stated as fact that a professional practice can generate two types of goodwill:

- Personal goodwill – "attributable to the individual skill, knowledge, and reputation of the professional" and
- Business goodwill – "intangible assets inherent in the practice itself, including, among other things, patient lists and records, trained employees, and leases in place."

Tax Perspective – Critical Factors

- Does the acquirer intend to utilize the individual's personal goodwill?
  - If there is no intent for the individual to continue on with the company following the acquisition, there is little support for the acquisition of personal goodwill. Covenant and employment agreements post-transaction are key.

Tax Perspective – Critical Factors

- Individual must not have previously transferred his or her personal goodwill to the company
  - Is there currently an employment contract or non-compete agreement in place?
  - Existence of such agreements may not be fatal but makes the argument more complex
    - Is the agreement a condition of employment or a transfer?
    - How restrictive is the covenant/agreement?

Tax Perspective – Critical Factors

- Existence of goodwill in a service or distribution business is NOT by default personal goodwill
- Must have factors such as:
  - Significant personal relationships with customers
  - Alter ego of the business
  - Been with the business since inception or close to it
  - Survival of the business is questionable without the individual
  - Employees and customers would follow

Tax Perspective – Critical Factors

- Factors indicating enterprise or business goodwill
  - Wider range of services than competitors
  - Trade name and trademarks
  - Valuable contracts (i.e., government contracts, long-term contracts, and other customer-based intangibles)
  - Operational efficiencies
  - Nature of the business would lead to continued customer patronage despite a change in service provider

Documenting the Sale

- Threshold question: ***Who is at risk?***
- Asset acquisition with an allocation to personal goodwill
  - Seller bears the primary risk
    - Potential corporate-level asset gain
    - Potential compensatory transfer
  - Buyer is simply buying assets and entering into a non-compete with the Seller
    - Re-characterization still results in a 15-year asset

Documenting the Sale

- Threshold question: ***Who is at risk?***
- Acquisition of stock with an allocation to personal goodwill
  - Buyer risks losing step-up in basis if allocation is not respected
    - Remains 15-year asset if non-compete is re-characterized
  - Seller bears compensatory risk on non-compete and employment agreement

Documenting the Sale

Representing a seller:

- Purchase agreement(s) should clearly show that personal goodwill is being acquired separately from the stock or business assets
  - Most recent IRS victories classified purported goodwill as compensation
  - Documentation in the sale agreements did not support the personal goodwill claim

Documenting the Sale

Representing a seller:

- Covenant not to compete and employment agreement should incorporate the personal goodwill acquisition and transfer
  - To establish that agreements are to guarantee the purchaser's ability to recover the value of the goodwill rather than being compensatory
- Agreement with purchaser as to the allocation of the value of personal goodwill sold/acquired
  - *Danielson* Rule (however, IRS is not tied to allocation)

Documenting the Sale

Representing a buyer – asset transaction

- Generally no problem with agreeing to language in the agreement that establishes a dual acquisition
- May wish to avoid agreeing upon a specific allocation of the proceeds
  - No real benefit to the buyer, and there is the potential that the seller somehow brings the buyer into the argument with the IRS because the buyer agreed to a value

Documenting the Sale

Representing a buyer – stock transaction

- Follow the guidelines that you would for supporting a seller in a sale of goodwill in an asset transaction

Documenting the Sale

Representing a buyer or seller:

- Obtain a valuation of the personal goodwill
  - Enterprise value and with/without valuations (next topic)
  - Many valuation specialists struggle with the concept and may need to be walked through the issue carefully
- Strongly urge the party you are representing to obtain a tax opinion
- Form considerations
  - Multiple forms 8594?
  - Single form 8594 listing both?
  - No form 8594 by selling shareholder?

Valuing Goodwill

If you have established that a non-compete or employment agreement does not exist or does not transfer the personal goodwill, you have several options with respect to valuing the personal goodwill.

- **Income approach using discounted cash flow (DCF): With and without method** – This method involves estimating the cash flow if the key individual remains vs. if they leave.

  Caveats:

  - Even with the best transitional planning, some loss of business occurs if a large amount of personal goodwill is involved.
  - Some loss of business may occur simply due to changes made by the new owner.
  - Consider using different discount rates between the two scenarios. The company-specific component of the discount rate considers the degree of reliance on a key person, and that can be lessened with a good transition plan.

Valuing Goodwill

- **Income approach using discounted cash flow (DCF): Multi-attribute utility model (MUM) method** – This method requires identifying the various attributes of personal goodwill, which are then weighted based on two measures:
  - the importance of the attribute to generating cash flow, and
  - the degree to which that factor exists.

A detailed discussion of this method is beyond the scope of this presentation but here is a link to a PDF PowerPoint presentation that explains the method in detail:

https://www.berrydunn.com/uploads/1088/doc/Allocating_Goodwill_Multi_Attribute_Utitlity_Model.pdf

Valuing Goodwill

- **Market approach: Comparable transactions** – This method involves searching proprietary databases for sales of similar businesses within the same industry, keeping in mind the subject business may have more or less reliance on an owner or key individual than the comparable company.

  Look for transactions that provide details for the amounts paid for employment, consulting, and non-compete agreements. These data points can assist with determining the value of transferable personal goodwill based on the theory that the buyer is compensating the seller for the transferable goodwill.

Valuing Goodwill

Caveats for the Market Approach:

- These data points should not be the sole point of reference because the amounts may be based more on tax strategies than on the actual estimated value of the transferable personal goodwill.
- Furthermore, the sales transaction may include additional compensation that is not captured in the transaction details, such as:
  - the previous owner being retained as an employee for a specified period of time (this is uncommon), or
  - certain personal expenses of the former owner may be paid by the business (much more common): professional memberships and subscriptions, country club dues, gym memberships, and provision of a company car or use of a vacation home .
- Therefore, it is wise to compare the values from this approach with those generated using one of the income approaches.

Personal Goodwill and Divorce

- In the most recent summary I could find, 28 states exclude personal goodwill from marital assets while 12 include it.
- Mississippi was the only state to exclude all goodwill.
- Alabama had made no decision either way.
- The remaining 8 states were either categorized as "complicated" or they based the inclusion of personal goodwill on the marketability of the personal goodwill.
- For the states that focus on the marketability of personal goodwill, the transferable portion of personal goodwill must be segregated and valued separately.
- Therefore, to advise a client correctly, you should be aware of the law as it applies to your client's venue.

Personal Goodwill and Business Sales

- It is obviously very important to be aware of all of the tax implications posed by how much value is assigned to each sale component and what is considered enterprise goodwill vs. personal goodwill.
- Consideration should be given to ways to make personal goodwill more transferable. This is where you can add value for your clients by guiding them through the process of planning the transition. This is especially important for professional practices and why I have advised clients to work out a transition plan that allows the seller to work beside the buyer for a long enough period of time to allow the buyer time to acquire any specialized knowledge about the business, and more importantly, allow the seller to introduce the buyer to important clients and suppliers.

Final Thoughts

- There are no hard and fast rules for establishing the value of goodwill, but a thorough analysis of the factors listed in the chart will help in defining what is and is not personal goodwill.
- My recommendation is to use one of the income approaches previously discussed and then use the market approach as a reasonableness check.

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