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Goodwill in Corporate Asset Sales: Tax Planning, Personal vs. Corporate Goodwill, Allocation and Valuation Rules

THURSDAY, JANUARY 23, 2020

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Today's faculty features:

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PERSONAL GOODWILL IN CORPORATE ASSET SALES

A Strafford Webinar

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Goodwill Defined

- The value of a trade or business attributable to expectancy of continued patronage. This expectancy may be due to the name or reputation of a trade or business or any other factor. *Treasury Regulation Section 1.197-2(b)(i).*
- In 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. While the element of goodwill may be based primarily on earnings, such factors as the prestige and renown of the business, the ownership of a trade or brand name, and a record of successful operation over a prolonged period in a particular locality, also may furnish support for the inclusion of intangible value. *Revenue Ruling 59-60.*
- Goodwill is an intangible asset consisting of the excess earning power of a business. *Stabb, 20 T.C. 834 (1953)*.
- Goodwill is "an asset representing the future economic benefits arising from other assets acquired in a business combination … that are not individually identified and separately recognized." *FASB ASC Paragraph 805-30-20*.

Asset Allocation Rules

- Applicable asset acquisition = residual method of allocation
  - Applies to transfer of assets constitution trade or business
  - Trade or business – goodwill or going concern could under any circumstances attach to assets
- Residual Method
  - Class I – Cash and deposits (not CDs)
  - Class II – Actively traded personal property, CDs, foreign currency (not stock of affiliates)
  - Class III – Assets that are marked to market at least annually, A/R, debt instruments (excluding related party debt, convertible debt and contingent debt)
  - Class IV - Inventory

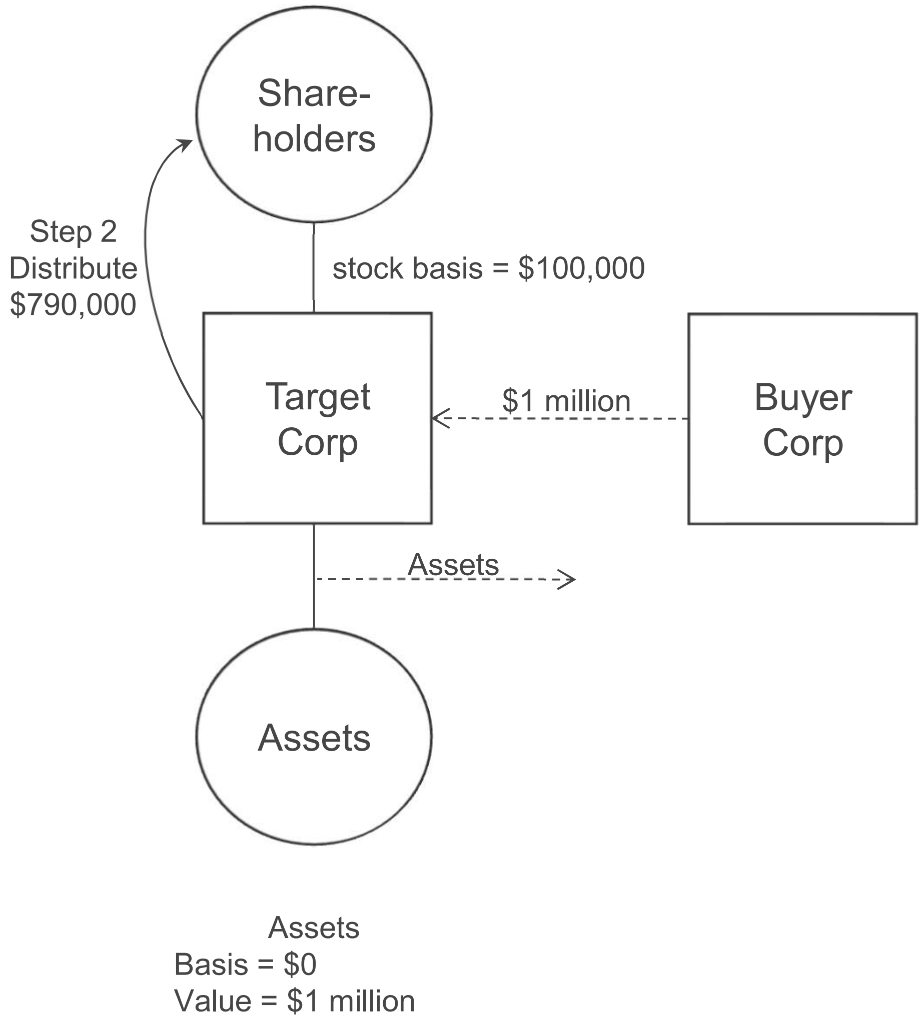
Asset Allocation Rules

  - Class V – Everything but I, II, III, IV, VI and VII
  - Class VI – Section 197 intangibles <u>other</u> than goodwill and going concern value
  - Class VII – Goodwill and going concern value
- IRS Form 8594
  - Form combines Class VI and VII assets

Business vs. Personal Goodwill

- Business – GW of business enterprise, practice or institution
- Personal – personal, professional or practice goodwill

Corporate Asset Sale



Tax Impact

Corporate tax	
Sales price	$1,000,000
Less basis	($ 0)
Gain	$1,000,000
Tax rate	21%
Corporate tax	210,000
Shareholder tax	
Distribution proceeds	790,000
Less basis	(100,000)
Gain	690,000
Tax rate	23.8%
Shareholder tax	164,220
Total tax	374,220
Remaining Proceeds	$ 625,780

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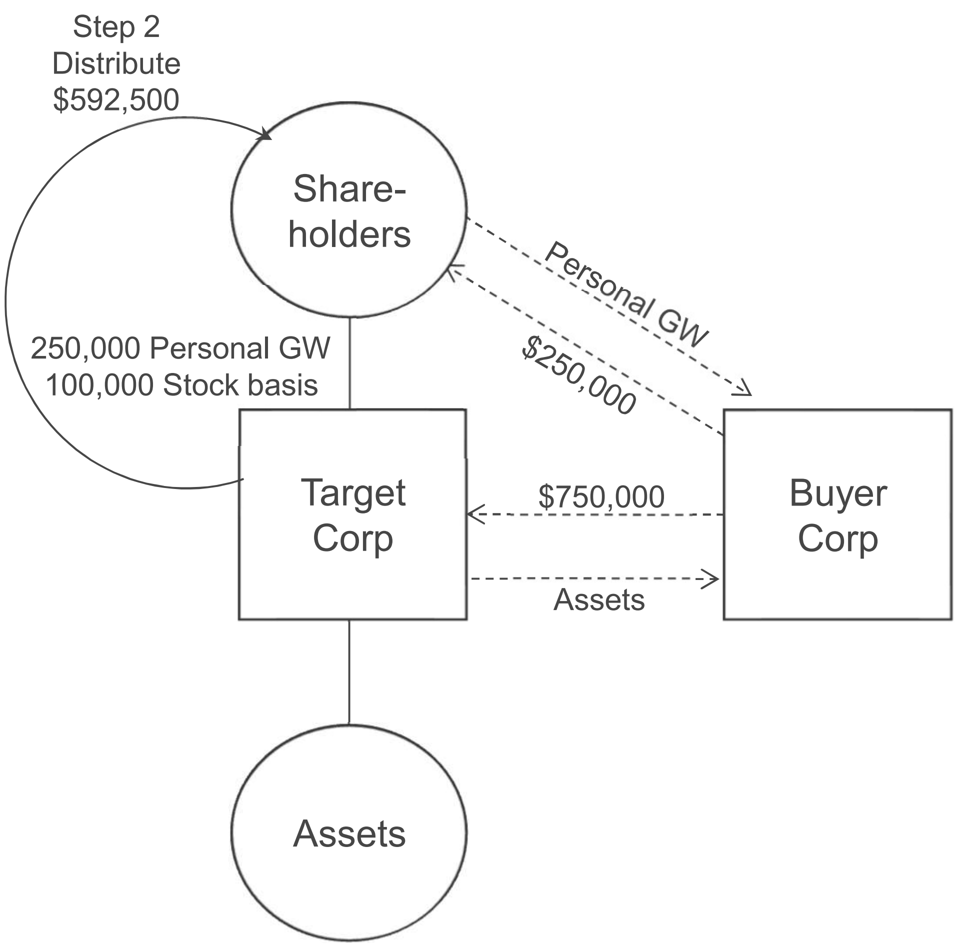
Do S Corp Sales Present Same Issue?

- Dividend if S Corp was a C Corp and has E&P (distribution not in liquidation)
- Corporate tax on net built in gain
  - BIG = FMV of assets at beginning of 1st S year over adjusted basis of assets
  - 5-year recognition period

So Just Sell Stock

- Take on liabilities
- No basis step up
- No immediate depreciation
- No asset selection

Corporate Asset Sale Plus Sale of Personal Goodwill



Tax Impact

Corporate tax	
Sales price	$750,000
Less basis	($ 0)
Gain	$750,000
Tax rate	21%
Corporate tax	157,500
Shareholder tax	
Sales price for GW	$250,000
Less basis	($ 0)
Gain	250,000
Distribution	$592,500
Less stock basis	($100,000)
Gain	$492,500
Total gain	$742,500
Tax rate	23.8%
Shareholder tax	$176,715
Total tax	$334,215
Remaining Proceeds	$ 665,785

Comparison

	Corporate Asset Sale	Corporate Asset Sale with Personal GW
Corporate tax	$210,000	$157,500
Personal tax	$164,220	$176,715
Total tax	$374,220	$334,215
Tax Savings		$ 40,005
Percentage tax savings		10.69%

*Ignores State Tax

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Other Strategies

	Seller	Buyer
Non-compete	ordinary	15 yr. amort.
Employment Agreement	ordinary	comp. deductions*
Goodwill	capital	15 yr. amort.

*IRS will scrutinize

Code Section 1060(e) – If 10% shareholder enters into CNTC, employment contract, royalty, lease, other agreement, then owner and buyer must disclose to IRS.

Impact of Tax Reform

- Corporate rate lower, but individual long-term capital gain and dividend rates are the same.
- Still substantial savings to be had.
- Loss of immediate depreciation?
  - Tangible capital assets now immediately depreciable
  - Pressure in asset deals to allocate to immediately depreciable assets
  - Law does not extend to goodwill or going concern value
- Must differentiate from self-created inventions, etc., which no longer are capital assets

Liquidation and Re-formation

- Business operated as corporation
- Wish to conduct as sole proprietorship or partnership
- Tax concerns
  - Deemed distribution of intangibles
    - Corporate tax on distribution
    - SH tax on liquidation
      - Dividend if corporation (dividend to full extent of E+P)

Liquidation and Re-formation

- MacDonald – Taxpayer favorable
  - Liquidation of insurance brokerage corporation and conduct of business outside corporation
  - All goodwill considered personal to shareholder
    - SH experienced in the business
    - Development of business attributable to personal ability and customer relationships
    - No contract or other agreement between shareholder and corporation for future services or covenant not to compete

Distribution and Gift

- Bross Trucking (2014) – IRS asserted that Bross Trucking transferred goodwill to shareholder and shareholder transferred to 3 children as taxable gift
- Trucking company operated from April 1982 to December 2003
- 90-95% of business from Bross family entities
- Bross Trucking in jeopardy of being shut down due to regulatory violations
- October 2003, LWK Trucking formed – 98.2% owned by Bross sons (remainder by 3rd party)

Bross Trucking

- No Distribution or gift
  - LWK independently satisfied all regulatory requirements rather than transferring insurance and licenses
  - Bross remained in existence with licenses and insurance
  - Most goodwill lost due to regulatory infractions – customers seeking new providers (but doesn't address fact that continued to perform services for family businesses)
  - Expansion of services offered (with new employees)
  - Only 50% of LWK employees formerly worked at Bross Trucking. Most work done by independent contractors who were not bound to any company.
  - Not impressed that leased equipment from same related company
  - Limited barriers to entry into business
  - No indicatiion that LWK benefited from supplier relationships
  - Bross never transferred his goodwill to company – no contract

Emphasis – Lack of Contract with Corporation

- MacDonald – No value beyond tangible assets since TP had no contract with corporation for future services
- Martin Ice Cream – Personal relationships of shareholder-employee not corporate assets when employee has no employee's contract with corporation
- Norwalk – (liquidation of accounting firm) – employees' contract/CNTC terminated at liquidation and personal abilities, personality and reputation of accountants is what clients sought.
  - Termination of contract means shareholder had no obligation to continue connection to corporation
- Compare Howard case – Sale of dentistry practice. Amounts treated as personal goodwill recast as dividend – CNTC – patients would not follow dentist 50 miles. GW = corporate goodwill
- Potential issue if general transfer from sole proprietorship to corporation

Reduce Estate Tax – Estate of Adell (2014)

- Adell owned 100% of stock of STN.Com
  - Sole purpose was to broadcast urban religious program called The Word
- The Word was a religious organization (501(c)(3))
  - Adell president and director. Son was treasurer.
- The Word paid over 95% of its programming revenue to STN.Com. The Word was sole customer of STN.Com
- On death, appraiser, discounted cash flow analysis added expense item to compensate son for personal goodwill. Expenses ranged from 37.2% to 43.4% of sales over historic period.
- Court found reduction to value of stock equal to $8 million to $12 million appropriate. Reported $9.3 million value on estate tax return, and court found total value to be $9.3 million

Adell Continued

- Son's goodwill was personally owned and independent of STN.Com
- Success heavily dependent on The Word (sole customer)
- Son had relationships with religious leaders
- Through son's relationships people contributed to the Word when they found out that it was a 501(c)(3)
- Son operated both companies
- Religious leaders trusted son and didn't realize he was employee of STN.Com
- Son had no employment contract or covenant not to compete with STN.Com

How to Transfer

- Pepper uses a Personal Goodwill Transfer Agreement
- Enter into covenant not to compete with transferee
  - Must be primarily to support GW (else all ordinary)
- Transfer
  - Provide introductions
  - Facilitate smooth transition of relationships
  - Teach knowledge, skills, experience
- Valuation essential. Must support consideration allocable to goodwill and NOT to covenant
  - May make sense to allocate some to covenant
- Helpful to address sale of personal goodwill early in transaction (letter of intent)

Allocation of Goodwill

- Residual method not applicable – shareholder only selling GW
- Should obtain qualified business valuation

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- Steven D. Bortnick is a partner in the Tax Practice Group of Pepper Hamilton LLP, resident in the Princeton and New York offices. Mr. Bortnick focuses his practice on domestic and international tax and private equity matters.
- Mr. Bortnick handles a broad range of transactions, including asset, stock, cross-border and domestic acquisitions, recapitalizations and reorganizations. He is experienced in, and a significant portion of his practice is devoted to, the structuring of domestic and international transactions. He advises business organizations on a variety of tax issues, and he is involved in the formation of private equity and hedge funds.
- An active speaker and author, Mr. Bortnick has written materials and spoken for several major private equity tax conferences. Topics of his presentations include private equity, venture capital, cross-border investing, venture capital operating company issues, and merger and acquisition tax issues.
- Before joining Pepper in 2007, he practiced in the New York office of Dechert LLP.

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- Howard Goldberg is a partner with Pepper Hamilton LLP in the firm's Tax Group. Mr. Goldberg focuses on tax planning for domestic and international transactions. His practice includes advising on mergers, acquisitions, reorganizations, dispositions, private equity transactions, capital markets transactions and restructurings in and out of bankruptcy.
- Mr. Goldberg is a frequent speaker on a variety of transactional tax matters. His recent programs include "Tax Structuring of Acquisitions and Dispositions of Portfolio Companies," "Mergers and Acquisitions Involving Partnerships and LLCs," "Tax-Free Reorganizations: the Old and the New," "Structuring for Your Exit at the Time of Investment," and "Consolidated Return Issues Affecting the Use of Favorable Tax Attributes."
- Mr. Goldberg is a former member of Pepper's Associates Committee. He also served as an elected official on his local school board.
- Prior to attending law school, Mr. Goldberg was an investment banker in the Mergers and Acquisitions Group of Salomon Brothers in New York.

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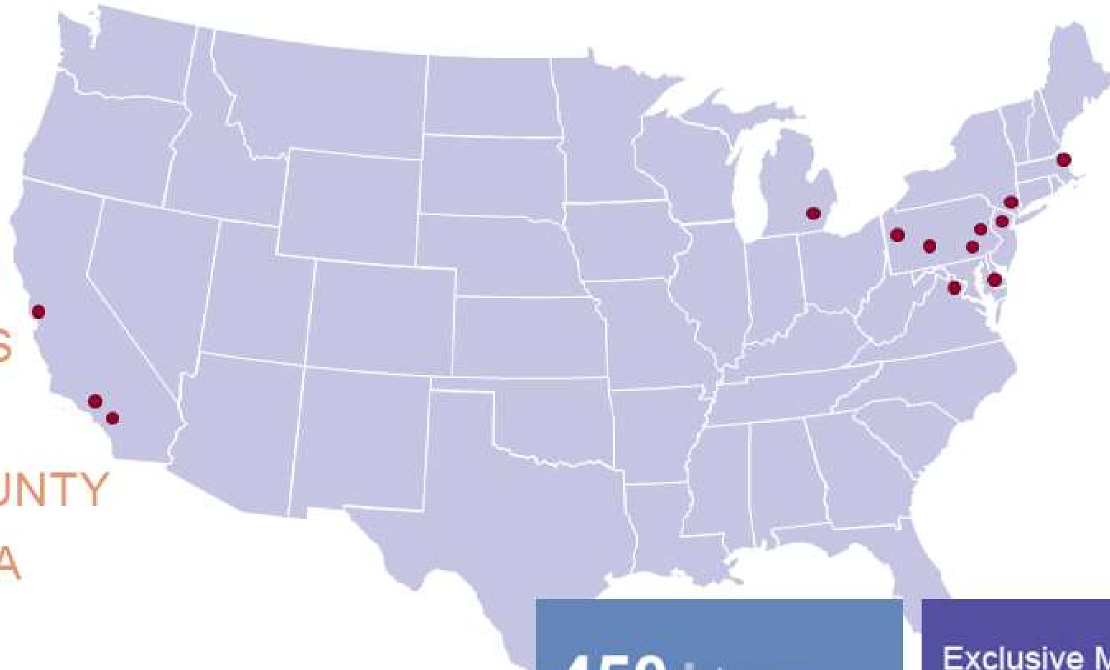

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