Sale of Personal Goodwill

By Jim Afinowich

One of the roadblocks that commonly arises in structuring the sale of a business has to do with the competing tax consequences for the buyer and seller. From a tax standpoint, what is good for the seller is often bad for the buyer, and vice versa.

However, one important tax strategy for sellers generally has no impact on buyers: the allocation of company assets as "personal good_will" of the company's owner (or executives). In this strategy, the seller's personal reputation, expertise and relationships are segregated from the assets of the company being sold. The good_will that otherwise would be attributed to the company is shifted to the seller.

If the subject company is being sold for $10 million, and the tangible assets are worth $8 million, the remaining $2 million would normally be classified as good_will. If that good_will is assigned to a C corporation, it will be taxed at the 34% rate and then taxed again, at 15%, when it (the proceeds are) is distributed to the shareholders.

If, on the other hand, it can be shown that the good_will is attributable not to the corporation but to the owner personally, then the $2 million would be paid directly to him and taxed as long-term capital gains (not as ordinary income). In addition, the proceeds are paid directly by the buyer to the seller personally, thereby keeping them out of reach of the (subject) company's creditors. Finally, as we mentioned above, the tax treatment to the buyer is the same regardless of whether the executive/owner recognizes long-term capital gain from the sale of personal goodwill or ordinary income for a non-compete payment.

(Also, for some (sellers) taxpayers, creating personal goodwill helps (avoid) minimize corporate income tax when the (selling) corporation liquidates, ie. converts to an LLC that is taxable either as a partnership or as a disregarded single-member entity.) The use of this technique can also minimize potential future Built-In Gain taxes if the corporation desires to make a Subchapter S election.)

The purposeful creation of personal goodwill first gained notoriety a decade ago in what has become a famous U.S. Tax Court case, *Martin Ice Cream Co. v. Commissioner,* 110 T.C. 189 (1998). In that decision, the Tax Court reaffirmed that, when a corporation has no employment contract with an employee (in this case, the owner), the employee's personal relationships are not corporate assets.

Here are the particulars:

Arnold Strassberg and his son, Martin, owned all of the stock of Martin Ice Cream Co., an ice cream distributor. Before going into business with his son, Arnold had worked for more than a decade in his own wholesale ice cream distribution business, where he developed strong business relationships with the managers and owners of a number of supermarket chains.

Shortly after launching Martin Ice Cream, Arnold was approached by the founder of Häagen-Dazs to introduce its ice cream to supermarkets. On a handshake agreement (which was never reduced to writing), he quickly established distribution relationships with four chains.

In the mid-1980s, Pillsbury acquired Häagen-Dazs and eventually approached Arnold about acquiring his relationships with the supermarkets so that Pillsbury could sell Häagen-Dazs products to them directly. Pillsbury was willing to pay for Arnold's connections, but it had no interest in a relationship with Martin Ice Cream or in acquiring any of its physical assets.

Ultimately, Arnold decided to sell his relationships to Pillsbury. Then:

- Arnold created a new corporation, Strassberg Ice Cream Distributors, as a subsidiary of Martin Ice Cream.
- All of the supermarket relationships of Martin Ice Cream Co. were transferred to Strassberg Ice Cream Distributors and held as the subsidiary's only assets.
- Martin Ice Cream conveyed all of the subsidiary's stock to Arnold in exchange for his interest in Martin Ice Cream.
- Strassberg Ice Cream Distributors then sold the relationship assets to Pillsbury for $1.4 million.
- 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 attributed the $1.4 million purchase value primarily to two assets: (1) Arnold's personal relationship with the supermarkets, and (2) Arnold's handshake agreement with the founder of Häagen-Dazs. The court determined that these assets could not be attributed to Martin Ice Cream Co. or its subsidiary because Arnold never had a covenant not to compete or any employment agreement with such entities.

Creating and Transferring Personal Goodwill

As recognized in Martin Ice Cream, personal goodwill may be unique and is present only if supported by particular facts. For example, the seller should not be subject to a contractual non-compete provision in favor of his former company. Further, the seller should not be subject to any non-solicitation provision that prohibits him from contacting and trying to sell to his former company's customers, suppliers or service providers.

Personal goodwill should be transferred pursuant to an asset purchase agreement executed by the buyer and seller. The agreement should describe the personal goodwill being transferred and include representations by the (seller) selling individual as to ownership of such assets and that such assets do not exist separate and distinct for the (seller) selling corporation. The agreement should also include exhibits such as a bill of sale and an assignment of rights (as suggested by the *Martin Ice Cream* case). The buyer may want to include any non-compete provision within the asset purchase agreement to obtain a lengthier presumption of reasonability for the restrictive time period. The parties may then allocate the purchase price between assets comprising the personal goodwill and the covenant not to compete.

Benefits of Creating and Selling Personal Goodwill

As was stated earlier, the proceeds received by the seller from the sale of personal goodwill are subject to long-term capital gain treatment rather than as ordinary income. (The maximum federal income tax rate for long-term capital gains is 15%, versus 35% for ordinary income.) In addition, long-term capital gains can be offset by capital losses, whereas only $3,000 of capital losses may offset ordinary income each year. Note that in *Martin Ice Cream* the seller signed a non-compete agreement; the existence of this non-compete agreement did not cause the seller's sale of personal goodwill to be subject to taxation as ordinary income. The non-compete agreement was seen by the Tax Court as necessary by the buyer to protect its purchase of the seller's personal goodwill.

Tax Treatment to Buyer

Under IRC § 197, the buyer is entitled to deduct the amount paid in connection with goodwill (whether it is personal or corporate) over 15 years. The tax treatment to the buyer would be the same if the buyer purchased corporate or personal goodwill or if the buyer made covenant-not-to-compete payments to the seller in connection with the acquisition of a trade or business. Each such asset is considered a "§ 197 intangible." Section 197 intangibles also include goodwill, going concern value, workforce in place, information-based intangibles (including customer-related information such as customer lists and patient or client files), know-how, customer-based intangibles, supplier-based intangibles, licenses, permits, covenants not to compete, franchises, trademarks, and trade names.

Summary

A seller who has unique skills, a strong relationship with customers and an excellent industry reputation and is not bound by a covenant not-to-compete should consider structuring a transaction as a sale of personal goodwill. This structure provides a seller with a beneficial parachute because the payments are treated as long-term capital gain, not subject to equitable distribution and not subject to the claims of the employer's creditors. This structure can also be (used to convert) during the conversion of a corporation to an LLC or limited partnership taxable, respectively, as a disregarded entity or partnership for federal income tax purposes.

If structured properly, the seller receives significant benefits with no adverse tax consequences to the buyer.