PERSONAL GOODWILL –

TAX ISSUES AND OPPORTUNITIES

Presented to the Princeton Chapter of the American Society of Appraisers on January 20, 2015
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 undue 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 other 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

Shareholders

Target Corp

Assets

Stock basis = $100,000

$1 million

Buyer Corp

Assets

Basis = $0

Values = $1 million

Step 2
Distribute $650,000

Corporate Asset Sale

Tax Impact

Corporate tax

Sales price

$1,000,000

Less basis

($0)

Gain

$1,000,000

Tax rate

35%

Corporate tax

350,000

Shareholder tax

Distribution proceeds

650,000

Less basis

(100,000)

Gain

550,000

Tax rate

23.8%

Shareholder tax

130,900

Total tax

480,900

Remaining Proceeds

$519,100
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
  - 10-year recognition period
    - 2012 and 2013 – 5 year
    - 2014 – 5 year (extenders bill)
So Just Sell Stock

- Liabilities
- Basis step up
- Assets selection
Corporate Asset Sale Plus Sale of Personal Goodwill

Step 2
Distribute $487,500

Shareholders

Target Corp

Assets

Personal GW
$250,000

$750,000

250,000 Personal GW
100,000 Stock basis

$250,000

Buyer Corp

Assets

Corporate tax
Sales price $750,000
Less basis ( $ 0 )
Gain $750,000
Tax rate 35%
Corporate tax $262,500

Shareholder tax
Sales price for GW $250,000
Less basis ( $ 0 )
Gain $250,000
Distribution $487,500
Less stock basis ($ 100,000)
Gain $387,500
Total gain $637,500
Tax rate 23.8%
Shareholder tax $107,725
Total tax $414,225
Remaining Proceeds $ 585,775
## Comparison

<table>
<thead>
<tr>
<th>Corporate Asset Sale</th>
<th>Corporate Asset Sale with Personal GW</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate tax</td>
<td>$350,000</td>
</tr>
<tr>
<td>Personal tax</td>
<td>$130,900</td>
</tr>
<tr>
<td>Total tax</td>
<td>$480,900</td>
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<tr>
<td><strong>Tax Savings</strong></td>
<td><strong>$66,675</strong></td>
</tr>
<tr>
<td>Percentage tax savings</td>
<td>13.86%</td>
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</tbody>
</table>

*Ignores State Tax*
Other Strategies

<table>
<thead>
<tr>
<th></th>
<th>Seller</th>
<th>Buyer</th>
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</thead>
<tbody>
<tr>
<td>Non-compete</td>
<td>ordinary</td>
<td>15 yr. amort.</td>
</tr>
<tr>
<td>Employment Agreement</td>
<td>ordinary</td>
<td>comp. deductions*</td>
</tr>
<tr>
<td>Goodwill</td>
<td>capital</td>
<td>15 yr. amort.</td>
</tr>
</tbody>
</table>

*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.
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
• **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 indication 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 employees’ 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
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
Allocation of Goodwill

- Residual method not applicable – shareholder only selling GW
- Should obtain qualified business valuation
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 $9.2 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