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Personal Goodwill: A Rare Relief for Some

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Profits of a C corporation are subject to taxation at the entity-level. If distributed, they are again subject to taxation in the hands of the shareholders. In other words, the profits are subject to two levels of federal income tax.

A small C corporation is particularly sensitive to this issue in the context of sale of the business, a scenario many of the businesses engaged in professional services routinely face as owners age and seek to retire. Often, the owner has no ready, willing and able successor to continue the business. Sale of the business, then, is often the best avenue for an exit.

Sale may be structured as a stock purchase transaction, where the shareholder sells her shares of capital stock to the buyer, or as an asset purchase transaction, where the assets of the corporation are sold. Shareholders prefer selling stock: it is generally quicker because it avoids the tedium of itemizing and valuing individual assets and isolating liabilities, and, from a tax perspective, avoids entity-level taxation.

Buyers, however, generally prefer an asset purchase transaction because it lets them avoid liabilities they do not wish to assume, gives them a chance to cherry-pick assets they wish to acquire, and from a tax perspective, gives them a tax basis in acquired assets equal to the purchase price (a "step-up" in basis).[1] In other words, an asset sale is generally more advantageous to a buyer and disadvantageous to a selling shareholder, particularly from a tax perspective.

In this context, an avenue for the selling shareholder to avoid entity-level taxation in certain asset-sale transactions concerns how goodwill sold in the transaction is characterized. If all or part of the goodwill sold can properly be characterized as owned personally by the shareholder of the selling C corporation, it may be possible for the selling corporation to completely avoid entity-level taxation with respect to that asset.

Since goodwill is often the largest asset of an established small business, its characterization could be a significant planning tool for business lawyers. A string of court decisions point to continued use and viability of the tool.

Transferable Personal Asset

Goodwill means "the value of a trade or business attributable to the expectancy of continued customer patronage" and "may be due to the name or reputation of a trade or business or any other factor." Treas. Reg. §1.197-2(b)(1).

For an unincorporated solo professional or other solo businessperson engaged in a practice or business in her own name, any goodwill created by her is arguably an individual asset. Could the same be applicable in a corporate setting? For nearly 100 years, taxpayers have sought to argue, often successfully, that an individual could own and transfer professional goodwill in a corporate setting.[2]

The most cited case for the position that a shareholder may own personal goodwill independent of the corporation even when the goodwill was created while she was a shareholder and employee of the corporation, and that she, as distinguished from the corporation, could sell it as an asset in the event of the sale of the corporation is *Martin Ice Cream v. Commissioner,* 1110 T.C. 189 (1998).

In *Martin*, the Tax Court held that the goodwill earned by the shareholder and rainmaker of an ice cream distribution business through his personal relationships belonged to him personally. The court held that because the corporation never entered into an employment agreement or covenant not to compete with Arnold Strassberg, the rainmaker, his relationships with the supermarkets and his ice cream distribution expertise never became the property of the corporation. The court held: "…personal relationships of a shareholder-employee are not corporate assets when the employee

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has no employment contract with the corporation. Those personal assets are entirely distinct from the intangible corporate asset of corporate goodwill." *Martin*, at 207.

'Norwalk' Reaffirms 'Martin'

Martin was soon followed by *William Norwalk v. Commissioner*, T.C. Memo 1998-279. *Norwalk* involved two accountants who, as shareholders of a corporation formed in 1985, engaged in providing public accounting services. After seven years, the corporation liquidated and distributed its assets, including "customer-based intangibles," to the shareholders. "Customer-based intangibles," according to the IRS, comprised the corporation's client base, client records, work papers, and goodwill. The IRS contended that these intangibles were corporate assets and that their distribution to the shareholders upon liquidation of the corporation triggered taxable gain. Shareholders William Norwalk and Robert DeMarta contended that they personally owned the intangibles.

In hopes of distinguishing the case from *Martin*, the IRS focused on the employment agreement each shareholder entered into with the corporation. The agreements contained provisions relating to ownership of confidential information and restrictions against engaging in competition with the corporation during the term of the agreement. Each of the agreements had a five-year term, and at the time of the liquidation of the corporation, in 1992, the term had already expired.

The *Norwalk* court sided with the shareholder-employees and held: "…there were no transferable 'customer-based intangibles' belonging to the corporation independent of the abilities, skills, and reputation of the individual accountants… Because there was no enforceable contract which restricted the practice of any of the accountants at the time of the distribution, their personal goodwill did not attach to the corporation. Any goodwill… was that of the individual accountants, not the corporation." *Norwalk*, at 28.

Reaffirming *Martin*, the *Norwalk* court said: "…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." *Norwalk*, at 21. The *Norwalk* court gave little weight to the expired employment and restrictive covenant agreements.

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'Kennedy' Adds a Nuance

Martin and *Norwalk* firmly established the unique status of personal goodwill as an asset separate from and independent of the business in which it is created. That is, until the Tax Court added a subtle nuance to the tax treatment of personal goodwill in *Kennedy v. Commissioner*, T.C. Memo 2010-206.

In that case, the court found that James Kennedy's decision to allocate 75 percent of the purchase consideration for the sale of his corporation to personal goodwill was not grounded in business reality. Instead, it was a tax-motivated afterthought. A key factor in reaching the decision was that Kennedy performed full-time work for the buyer of his business for 18 months without commensurate compensation. As a result, the court concluded that the payment made to Kennedy was consideration for services, subject to ordinary income tax, and not for the purchase of goodwill.[3] The Kennedy decision demonstrates the need for careful structuring of acquisition transactions involving personal goodwill.

Careful Structuring

Another case involving an employment agreement, *Howard v. United States*, 2010 U.S. Dist. Lexis 77251 (D. Wash. 2010), is further illustrative of the need for careful planning by the business lawyer.

In 1980, Larry Howard formed a corporation to practice dentistry (Howard Corporation). In 2002, he sold the practice. The sale agreement allocated $549,900 to Howard for his personal goodwill and $16,000 for a covenant not to compete that he entered into with the buyer. Howard Corporation received $47,100 for the assets it sold. In his tax returns, Howard reported $320,358 as long-term capital gain income resulting from the sale of goodwill. After an audit, the IRS recharacterized the goodwill as a corporate asset and treated the amount received by Howard from that sale as a dividend from Howard Corporation to him.

In a lawsuit against the IRS, Howard argued that the goodwill was personal to him and that he was entitled to claim the proceeds from the sale of goodwill as a long-term capital gain. The IRS disagreed. The Eastern District of Washington in *Howard* noted that because Howard had entered into an employment agreement that included a covenant not to compete which was subsisting at the time of the purchase transaction, the goodwill generated by Howard belonged to Howard Corporation rather than him personally. Howard appealed and the U.S. Court of Appeals for the Ninth Circuit affirmed. *Howard v. United States*, 448 Fed. Appx. 752 (9th Cir. 2011).

Nonetheless, the circuit court noted: "Where the success of the venture depends entirely upon the personal relationships of the practitioner, the practice generally does not accumulate goodwill. The professional may, however, transfer his or her goodwill to the practice by entering into an employment contract or covenant not to compete with the business."[4] The Howard case, in effect, reaffirmed *Martin*.

Personal to Shareholder

The most recent case on the issue, *H&M v. Commissioner*, T.C. Memo. 2012-290 (2012), reaffirms the continued availability of characterizing certain goodwill as personal to the professional shareholder of a corporation in a sale transaction.

In *H&M*, Harold Schmeets, an insurance salesman, sold his business, Harvey Insurance, to the National Bank of North Dakota in an asset transaction. As part of the sale, Schmeets entered into a lucrative employment agreement with a covenant not to compete with the bank. In a subsequent audit, the IRS characterized the large compensation Schmeets received under his employment agreement as disguised consideration for sale of the insurance business and allocated part of that to the sale of goodwill by Harvey Insurance to National Bank. Schmeets petitioned the Tax Court for redetermination of income-tax deficiencies arising from sale of the business to National Bank and argued that the goodwill was personal to him and did not belong to the corporation.

The U.S. Tax Court noted that Schmeets was locally called the "King of Insurance" because "no one knew insurance better than Schmeets" and "when people came to Harvey Insurance to buy insurance, they were buying it from Harold Schmeets, and that he had far more name recognition as an individual than Harvey Insurance did as a firm." *H&M*, at 3. It said: "Time hasn't seen much change in this part of the law…we held [in *Martin Ice Cream*] that a corporation could not be taxed on the payments made to its controlling shareholder for his customer relationships." 110 T.C. at 209.

It went on to note: "…we specifically find that when customers came to his [Schmeets'] agency, they came to buy from him—it was his name and his reputation that brought them there. We also find that he had no agreement with H&M at the time of its sale that prevented him from taking his relationships, reputation, and skill elsewhere, which was precisely what he did when he began working for the bank's renamed insurance agency." *H&M*, at 8. *H&M* is a ringing assurance that personal goodwill can be sold by a shareholder of a small corporation separate and independent of the corporation's assets.

A business lawyer representing the seller must investigate the nature of the goodwill being sold well before the transaction is memorialized. As the court in 'Howard' noted: "By now, it is well settled that the incidence of taxation depends upon the substance, not the form of a transaction."

Take-Away for Lawyers

The foregoing cases illustrate the role of the business lawyer in structuring an asset sale transaction of a C corporation whose principal shareholder is the rainmaker.

The cases highlight that while personal goodwill is alive and well, courts carefully scrutinize the facts. The Ninth Circuit in *Howard*, for instance, noted: "In determining whether goodwill has been transferred to a professional practice, we are especially mindful that each case depends on particular facts. And in arriving at a particular conclusion, we take into consideration all of the circumstances of the case and draw from them such legitimate inferences as the occasion warrants." *H&M*, at 5 (quoting *Grace Brothers v. Comm'r*, 173 F.2d 170, 176 (9th Cir. 1949)).

A business lawyer representing the seller must investigate the nature of the goodwill being sold well before the transaction is memorialized. As the court in *Howard* noted: "By now, it is well settled that the incidence of taxation depends upon the substance, not the form of a transaction. As a result, we look to the objective economic realities of a transaction rather than to the particular form the parties employed." *H&M*, at 6.

In other words, any attempt to cloak a transaction with the appearance of a transfer of personal goodwill when facts do not support that position will be rejected by the courts. Where facts warrant characterizing goodwill as personal to the shareholder, a business lawyer who negotiates and documents the sale transaction has an excellent opportunity to save her client some taxes.

1. Step-up in basis implies a basis that is higher than the transferor's basis. For example, a buyer often receives a stepped-up basis in assets acquired in a transaction structured as an asset acquisition under the IRC §1014(a).

2. *Providence Mill Supply v. Commissioner*, 2 B.T.A. 791 (1925), is often cited as the first expression of the premise.

3. The court noted that the *Martin* court "had no occasion to address how the shareholder should be taxed on the payments, inasmuch the shareholder had no case before the court. Therefore that court was not called upon to opine on whether the payments should be treated as payments for services or payments for a capital asset." T.C. Memo 2010-206, at 33.

4. *Howard v. United States*, 448 Fed. Appx. 752, 753 (9th Cir. 2011) (internal quotes omitted). Tellingly, the court also noted that Howard had knowingly formed a C corporation and now wanted to be "let out of the corporate structure he chose for his dental practice." Id., at 755.