

Allocating the Sale of a Business to Personal Goodwill

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Introduction

- In the sale of a corporation, sellers generally seek favorable capital gains tax rates and deferred gain recognition while buyers seek early tax deductions for what they pay.
- Sellers demanding a stock sale will often be forced to discount the price of the stock to compensate the buyer for the loss of higher depreciation deductions.
- Buyers who demand an asset purchase will likely pay a premium to sellers because of the double tax sellers will pay (the tax at the entity level on the gain resulting from the sale and the tax at the shareholder level when the entity is liquidated or the sales proceeds are distributed).
- One way sellers avoid the double tax and buyers can amortize some of the cost is by negotiating a portion of the purchase price to goodwill (which happens to be a capital asset).
 - To the extent part of the purchase price is allocated to an individual shareholder instead of a corporation, the amount realized at the corporate level is reduced, thereby reducing the gain subject to corporate level tax.
- This technique may apply in the sale of a C corporation's assets or in the sale of an S corporation subject to the §1374 tax on built-in-gain, for which corporate goodwill is part of the S corporation's net unrealized built-in-gain.

Authority for Position

The Tax Court addressed the issue of allocating goodwill in two important cases:

1. *Martin Ice Cream Co. v. Commissioner*, 110 T.C. 189, (1998).

- A dispute between the father and son owners prompted one part of the business to be dropped down into a new subsidiary.
- That subsidiary was distributed to a 51% shareholder in redemption of his stock of the distributing corporation.
- The distribution was meant to qualify as tax free under §355 of the Code but did not.
- The value had to be determined to ascertain gain to the distributing corporation.
- The IRS argued that the value of the distributed corporation was high, because of certain intangible assets, mainly the shareholder's personal relationships with supermarket owners and with the founder of Haagen-Dazs Ice Cream.
- The Tax Court found against the IRS and held that those intangible assets were not assets of the corporation but of the shareholder. Thus, the value of those assets was not included in the value of the distributed corporation and consequently did not give rise to any related gain to the distributing corporation (or a gain or ordinary dividends to the shareholder).

Authority for Position, cont.

2. *Norwalk v. Commissioner*, T.C.M. (RIA) 1998-279, (1998)

- The CPA corporation owned by two shareholders was liquidated.
- The IRS argued that the value of the corporation included “customer based intangibles,” i.e., the clients.
- The accountants argued that because they were not restricted from leaving the corporation and serving the same clients elsewhere, the clients had “no meaningful value.”
- The Tax Court ultimately agreed with the taxpayers, stating that the “personal ability, personality and reputation of the individual accountants is what the clients sought. These characteristics did not belong to the corporation as intangible assets since the accountants had no contractual obligation to continue their connection with it.”

Authority for Position, cont.

- In both cases, *Martin Ice Cream Co.* and *Norwalk*, the Tax Court stressed that there were no covenants not to compete or employment agreements that would have caused the shareholders personal goodwill to be owned by the corporations rather than the shareholders.
- The Tax Court provided that if such agreements were in place, the shareholder would be treated as having transferred ownership of the goodwill to the corporation.

Goodwill Ownership Guidelines

Who owns the goodwill – the corporation or the individual owners of the corporation? Guidelines:

The Corporation (Business Goodwill)

1. “Capital” dependent
2. Written employment or noncompete agreement
3. No controlling/participating owner
4. Business earnings support transaction price
5. e.g., Manufacturer

The Owner (Personal Goodwill)

1. “Relationship” dependent
2. No written employment or noncompete agreement
3. Owners participate in and control business
4. Business earnings do not support transaction price
5. e.g., Personal Service Corporation

Other Suggestions

- The corporation should have minutes to document that the shareholders own the goodwill separate from the corporation in order to establish intention.
- The selling shareholder should obtain a bona fide appraisal of the personal goodwill to substantiate the amount that can be allocated directly to the shareholder.
 - This will help to justify the allocation in the event of an audit by the IRS.
- The appraisal should not be prepared by the corporation's regular accountant.