

It's not business, it's personal

Personal goodwill offers opportunities for M&A planning

Parties to merger and acquisition (M&A) transactions involving closely held corporations may enjoy certain tax benefits if they can allocate a portion of the purchase price to individual shareholders' personal goodwill. Although the IRS doesn't much like personal goodwill, one Tax Court case confirms that it remains a viable tax-planning tool under the right circumstances.

Personal vs. business goodwill

The *International Glossary of Business Valuation Terms* defines goodwill as "that intangible asset arising as a result of name, reputation, customer loyalty, location, products and similar factors not separately identified." The value of goodwill is usually expressed as the excess of a business's fair market value over the value of its net tangible assets and its identifiable intangible assets (such as patents, trademarks and other intellectual property).

Personal goodwill is derived from an individual owner's reputation, training, skills, experience and relationships. In contrast, **business** goodwill is associated with characteristics of the business itself. In theory, these characteristics — such as company name, reputation, location, products and workforce in place — remain with the business even if key owners or employees leave the company.

Tax benefits

When a C corporation sells its assets, the sale proceeds are subject to double taxation. They're taxed once at the corporate level and again when they're distributed to shareholders. An S corporation generally isn't subject to corporate-level taxes when sold, but if it started out as a C corporation it may be exposed to double taxation on certain "built-in gains" — that is, unrealized appreciation on assets it owned at the time it converted to S status.

Selling shareholders may reduce the impact of double taxation to the extent the purchase price can be allocated to personal goodwill. Because personal goodwill belongs to the individual shareholders, and *not* the company, that portion of the purchase price bypasses the corporation, avoiding corporate taxes. In addition, payments that shareholders receive for their personal goodwill generally are taxed at lower capital gains rates, as opposed to payments for employment or noncompete agreements, which generally are considered ordinary compensation income.

If the transaction is structured as a stock sale, double taxation isn't an issue. But allocating a portion of the purchase price to personal goodwill still offers significant benefits. The selling shareholders enjoy capital gains treatment of those amounts and the buyer acquires an amortizable asset. (Goodwill is amortizable over 15 years.) Buyers usually prefer asset sales, in part because amounts paid for assets generate significant depreciation and amortization deductions. Amounts paid for stock, on the other hand, are capitalized and can't be deducted or amortized. The ability to allocate a portion of the purchase price to amortizable personal goodwill may make a stock transaction more palatable to a buyer.

Supporting the allocation

To support a purchase price allocation to personal goodwill, it's important to involve an experienced business valuation professional early in the process. He or she can help determine and document the extent to which the business relies on the individual owners' talents and connections, and

estimate the portion of the business's earning capacity that's attributable to those talents and connections.

However, keep in mind that, to treat personal goodwill separately from corporate assets, it must continue to be the shareholders' property. If the owners have pre-existing employment, noncompete or nonsolicitation agreements, they may be deemed to have transferred their personal goodwill to the company, thereby converting it to business goodwill.

Also, it's critical for selling shareholders to take steps to transfer their personal goodwill to the buyer. This may include signing employment or consulting agreements that set forth the selling shareholders' responsibilities for helping ensure that the buyer retains the benefits of their business attraction and retention power.

Personal goodwill is alive and well

Despite several successful IRS challenges in recent years, a Tax Court case — *Bross Trucking v. Commissioner* — confirms that personal goodwill, under the right circumstances, can be the personal property of a corporation's owners separate from any business goodwill.

In the case, the taxpayer owned several family businesses, including a road construction business and a trucking company that hauled materials for the construction business. The company's reputation with regulators had suffered due to safety issues and it was facing possible suspension. To avoid harming the other family businesses, the family formed a new trucking company owned by the taxpayer's sons.

The IRS argued, among other things, that the original company had distributed goodwill to the taxpayer, triggering income taxes. The Tax Court disagreed, noting that the company's declining reputation and imminent suspension was "the antithesis of goodwill." The court found that most of the goodwill that did exist was the taxpayer's personal goodwill, which was his separate property and couldn't be distributed by the company. The court also found that he hadn't transferred any goodwill to the company through an employment contract or a noncompete agreement.

Get personal

If your corporation is contemplating a sale, it's worth investigating whether a portion of the purchase price can be allocated to the shareholders' personal goodwill. If significant personal goodwill exists, and you can value and document it, you may enjoy substantial tax savings.

The Law Office of Eugene Gorrin, LLC

17 Watchung Avenue, Suite 204

Chatham, NJ 07928

973.701.9300

egorrin@gorrinlaw.com

www.gorrinlaw.com