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Personal goodwill can work in the right situation

TAXING MATTERS
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Who owns the customer and supplier relationships of a closely held business—the owner or the company?

The answer to this question may have very significant tax consequences on a sale of the business.

This article will address the tax issues associated with the ownership of goodwill, including planning opportunities created by "personal goodwill," as shown in two intriguing recent cases.

When the assets of a C corporation are sold, the applicable tax rate is over 50 percent. First, the corporation pays corporate tax on the asset sale. Then, when the proceeds are distributed, the shareholders pay tax on the distributions. The taxes are enormous, much greater than those due in connection with sales of other types of business entities.

Personal goodwill provides a way around some of these taxes in the right situation. In some cases, part of a closely held business' goodwill may have been developed by—and consequently be owned directly by—one or more key shareholders, rather than by the corporation. The tax rate on the shareholder's sale of that personal goodwill (concurrently with an asset sale by the corporation) is only about 25 percent.

The leading case involved Martin Ice Cream, the first distributor of Haagen Dazs ice cream to supermarkets. The company operated a lucrative distribution business, which it effectively sold.

The key shareholder argued that the relationships he had developed with the supermarket chains and his oral agreement with the founder of Haagen Dazs were not assets of the company—sale of which would be subject to double tax. Instead, he took the position that he owned the relationships directly as personal goodwill, which reduced taxes. Based on the facts of the case, including the individual nature of the relationships and the absence of a non-compete agreement, the court agreed, reducing the shareholder's overall tax burden.

Following the issuance of the Martin Ice Cream case in 1998, allocating a portion of the purchase price to personal goodwill in corporate acquisitions became almost commonplace.

While the strategy tends to be overused, it can work if there are relationships that are truly personal to the shareholder and developed independently of corporate assets. The shareholder must not be subject to a noncompete or an agreement assigning these assets to the corporation. These criteria are likely to be met in businesses dependent on reputation, such as professional services, or businesses like Martin Ice Cream with a few key customers or suppliers.

Personal goodwill does exist, but taxpayers tend to see it more often than the Internal Revenue Service does. This is illustrated by the string of taxpayer losses that followed Martin, largely in cases where the taxpayers' positions were aggressive and expanded beyond the narrow Martin facts.

The latest tax court case on personal goodwill, released last month, is actually an estate tax case. The deceased, an associate of the Rev. Jesse Jackson Sr., was the founder of a 24-hour African American religious television channel known as The Word, which is broadcast nationwide.

At issue was the valuation of his ownership interest in the closely held company that effectively operates the network. The estate argued that the value of the decedent's interest was reduced as a result of the fact that the business relationships developed by his son, a co-owner of the company without a noncompete, were not a corporate asset.

After hearing expert testimony, the tax court accepted his argument, finding that the company's value could be adjusted for the value of the son's personal goodwill. As in the sale context, this case illustrates that in the right situation, personal goodwill is respected for tax purposes. There has been so much discussion about this case in the estate tax community that at this point it only presents an estate planning opportunity for persons with a high risk tolerance.

The other recent tax court case, issued earlier this summer, involved a company with a terrible reputation. To use the court's words, "its customers did not trust it and did not want to continue doing business with it."

In order to obtain a clean slate, the sons of the family patriarch started a new company to take over the activities of the original business, which was owned by the father. The IRS took the view that the original company distributed its goodwill to the father in a taxable transaction and the father then made a gift of the goodwill to his sons.

The patriarch successfully challenged this determination in tax court on the grounds that all of his goodwill was personal to him. The tax court agreed with this theory, determining that the patriarch owned the goodwill and holding and, moreover, the old company did not have any goodwill to transfer—its poor reputation was "the antithesis of goodwill."

These two cases show that despite a string of IRS victories, the concept of personal goodwill can still work in the right case.

Owners of C corporations who are contemplating an exit transaction should evaluate whether a personal goodwill theory can apply based on the facts. If the theory seems to be applicable, try to plan ahead and build a documentary record that shows the value of the goodwill and its importance to the operation of the business.

A personal goodwill theory can provide a significant planning opportunity, but it presents a strong risk of IRS challenge.

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