Distinguishing Personal Goodwill from Entity Goodwill in the Valuation of a Closely Held Corporation

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The valuation of a closely held corporation often has gift tax, estate tax, and generation-skipping transfer tax implications. In addition, the valuation of a closely held corporation often has income tax implications. In these tax-related instances, it is often important for the business owners (and for their professional advisers) to allocate the total enterprise value (or the total transaction consideration) between (1) the company-owned entity goodwill and (2) the individual shareholder/employee-owned personal goodwill. This discussion summarizes the valuation analyst considerations with regard to the elements of, the separability of, and the documentation of a shareholder/employee's personal goodwill.

Introduction

This discussion focuses primarily on the valuation of the closely held (or family-owned) company. Primarily, but not exclusively, this discussion focuses on the valuation of a closely held C corporation that is managed by its shareholder/employees.

In particular, this discussion focuses on the question of how much of the total business enterprise value relates to the personal goodwill of the company shareholder/employees.

There are numerous gift tax, estate tax, generation-skipping transfer tax, and income tax reasons why valuation analysts may be asked to allocate the subject business enterprise total intangible asset value between (1) the company's entity goodwill and (2) the individual shareholder/employee's personal goodwill.

This discussion is informed by the recent U.S. Tax Court decision in *Bross Trucking, Inc., et al. v. Commissioner of Internal Revenue*[1] (the "*Bross Trucking* decision").

There are several instances when it is important for a closely held corporation (and for its owners) to distinguish between:

1. the personal goodwill (owned by the individual shareholder/employees) and
2. the entity goodwill (owned by the company itself).

The first instance typically relates to the formation of the closely held company. In many closely held corporation formations, individual shareholder/employees transfer their personal goodwill to the newly formed corporation in exchange for newly issued shares of the corporation stock.

Those transfers of personal goodwill may qualify as a tax-deferred exchange (of personal goodwill for corporation stock) under Internal Revenue Code Section 351.

The alternative tax treatment (when personal goodwill is not transferred) is to treat the issuance of the corporation stock as taxable equity-based compensation for the shareholder/employee's "sweat equity" in the newly formed company.

The second instance may involve the conversion of the closely held C corporation to a closely held S corporation. In such a tax status conversion transaction, the C corporation assets are valued on the date of the tax status conversion.

If the S corporation is then sold during the term of the Section 1374 built-in gain recognition period, that corporation would have to pay tax on any gain (i.e., the amount of the sale price over the tax basis of the company assets).

However, any assets that are owned outside of the C corporation (such as the shareholder/employee's personal goodwill) would not be part of the corporation's tax status conversion.

Therefore, the amount of any personal goodwill that would be transferred along with the sale of the (now) S corporation would not be subject to the Section 1374 built-in gain recognition. Of course, the individual shareholder/employee would still recognize one level of tax on the sale of his or her personal goodwill.

The third instance is the most common instance, and it relates to the sale (structured as an asset sale) of the closely held corporation. In such a sale, the business sale transaction would be structured as (and the deal documents should reflect) two separate transfers:

1. The sale of the closely held corporation assets
2. The sale of the shareholder/employee's personal goodwill

The sale of the assets of the C corporation will likely be subject to two levels of taxation: (1) once at the corporation level for the sale of any appreciated (sale price in excess of tax basis) assets and (2) again at the shareholder level related to the distribution of the after-corporate-tax sale proceeds to the individual shareholders.

However, the shareholder's sale of any personal goodwill should be subject to only one level of taxation. This is because the individual shareholder is selling his or her personal goodwill directly to the business acquirer.

In addition, any gain on the sale of the shareholder/employee's personal goodwill would typically be considered a capital gain, subject to preferential capital gains tax treatment. The capital gain treatment assumes that the personal goodwill was owned by the individual shareholder/employee for more than 12 months.

The fourth instance relates to other transfers of the closely held corporation stock or of the personal goodwill.

Such transfers could occur in a gift tax, estate tax, or generation-skipping transfer tax situation. Such situations depend on:

1. which assets (personal goodwill, entity goodwill, or other assets) were transferred,
2. who transferred and who received the transferred assets, and
3. the valuation of the transferred assets.

The *Bross Trucking* decision relates to such a set of circumstances. The Internal Revenue Service (the "Service") claimed that the owner of Bross Trucking Company, Inc. ("Bross Trucking") made a gift of transferred goodwill to a new company formed by his three sons.

Based on the Tax Court's judicial guidance provided in the *Bross Trucking* decision, this discussion considers:

1. the elements that demonstrate the existence of an individual shareholder/employee's personal goodwill,
2. the factors that differentiate the existence (and transfer) of personal goodwill from the existence (and transfer) of entity goodwill, and
3. the components of the transaction (and of the deal documentation) that indicate the transfer of personal goodwill as part of the overall closely held business sale transaction.

The *Bross Trucking* Decision

In the *Bross Trucking* decision, the Tax Court concluded that a trucking company owned by Chester Bross ("Chester") did not distribute goodwill to Chester who, in turn, did not transfer the goodwill to a newly formed trucking company owned by Chester's three sons.

The name of the sons' trucking company was LWK Trucking Co., Inc. (LWK).

Therefore, the Tax Court determined that Chester owed no gift tax with regard to any transfers to LWK or to his three sons.

In the *Bross Trucking* decision, Chester owned a road construction company. Chester also organized several other companies to provide services and equipment to his construction company. Chester was knowledgeable about the construction industry, and he had developed important relationships with government entities and other customers.

Chester created Bross Trucking, a wholly owned company, to haul construction-related materials and equipment for road construction projects. It is important to note that Chester did not have an employment contract with—and he never signed a noncompete agreement with—Bross Trucking.

About 90 to 95 percent of the Bross Trucking primary customers were companies owned by Bross family members. However, Bross Trucking did not have any formal written service agreements with any of its customers.

After facing a series of audits and investigations, Bross Trucking received an unsatisfactory safety rating. Bross Trucking had experienced extensive investigations from both:

1. the United States Department of Transportation and
2. the Missouri Division of Motor Carrier and Railroad Safety.

Bross Trucking was in jeopardy because of heightened scrutiny from both federal and state safety inspectors. The company faced the possibility of having its hauling authority revoked.

In response to this negative attention and a possible company shutdown, Bross Trucking ceased its ongoing business operations. Nonetheless, Bross Trucking remained as a legal entity to address any potential regulatory claims and obligations.

To ensure continued trucking services to the Bross family businesses, Chester's three sons created LWK. Chester did not own any interest in LWK. And, Chester was not involved in managing LWK.

No assets were transferred from Bross Trucking to LWK. LWK met all regulatory requirements on its own. However, about 50 percent of the LWK employees previously worked for Bross Trucking.

LWK leased its equipment (primarily its trucks) from the same family-owned leasing business as Bross Trucking had. While LWK operated under a similar business model as Bross Trucking, it expanded into several other service lines.

Initially, some of the LWK trucks still displayed the Bross Trucking logos. However, these Bross Trucking logos attracted heightened scrutiny from the safety inspectors that had investigated Bross Trucking. Therefore, LWK used magnetic signs to cover up the Bross Trucking logos until it could afford to have the trucks repainted.

Chester and his wife did not report any gifts for the year in which LWK began operations. The Service issued a notice of deficiency to Mr. and Mrs. Bross, determining:

1. a distribution of corporate intangible assets to Chester and
2. a subsequent transfer of these intangible assets to the Bross sons.

The Service's notice of deficiency described the allegedly transferred intangible assets as the following intangible "attributes":

1. Goodwill
2. Established revenue stream
3. Developed customer base
4. Transparency of the continuing operations between entities
5. Established workforce including independent contractors
6. Continuing supplier relationships

The Service's notice of deficiency was unclear as to (1) whether each intangible "attribute" was supposed to be a separate intangible asset or (2) whether the "attributes" were supposed to be aggregated into goodwill as a whole.

The principal issues presented before the Tax Court in this matter were whether:

1. any appreciated intangible assets were distributed by Bross Trucking to Chester and
2. Chester made a gift of these distributed intangible assets to his sons.

The Tax Court initially determined that the intangible asset that was being transferred was goodwill. Goodwill is often defined as the expectation of continued patronage. The competitive advantage that constitutes goodwill may be represented by a number of property rights or legal interests.

Accordingly, the Tax Court concluded that the intangible "attributes" listed in the notice of deficiency were separate interests or legal rights that the Service alleged to have made up the Bross Trucking goodwill.

After reaching this initial conclusion, the Tax Court concluded that there was no corporate distribution of goodwill from Bross Trucking to Chester.

The Tax Court reached this conclusion because it determined that a business can only distribute corporate assets, not assets that it does not own. Specifically, a corporation cannot distribute intangible assets owned individually by its shareholders—in this case, Chester.

The Tax Court cited three reasons for this determination.

First, the Bross Trucking goodwill was limited to a workforce in place. At the time, Bross Trucking had lost most of its goodwill and reputation with its customers because of:

1. its unsatisfactory safety rating,

2. the heightened regulatory scrutiny from safety inspectors, and
3. the possibility of a shutdown of business operations.

The Tax Court classified these three circumstances as "the antithesis of goodwill." This antithesis of goodwill was demonstrated by the LWK need to hide the Bross Trucking name and logo on the LWK trucks.

At the time of the alleged transfer of goodwill, Bross Trucking could not expect any continued patronage. This was because its customers did not trust it and did not want to continue doing business with it.

The Tax Court recognized that Bross Trucking employed several mechanics and administrative staff. Bross Trucking may have used this assembled workforce in the corporation and transferred that assembled workforce to Chester.

However, the Tax Court indicated that the record was unclear as to whether its independent contractor drivers could be counted as part of the Bross Trucking assembled workforce.

Second, nearly all the goodwill used by Bross Trucking was part of Chester's personal assets. The Bross Trucking established revenue stream, its developed customer base, and the "transparency of the continuing operations" were all a result of Chester's work in the road construction industry and the personal relationships that he had developed.

The Tax Court concluded that a company does not have any entity goodwill when all of the goodwill is attributable solely to an individual shareholder/employee's personal ability.

Third, Chester did not transfer his personal goodwill to Bross Trucking partly because he did not have an employment contract or a noncompete agreement with the company. The Tax Court noted that an employer has not received personal goodwill from an employee where that employer does not have a right to the employee's future services.

Therefore, Chester's personal goodwill remained a personal asset, separate from the Bross Trucking corporate assets.

The Tax Court concluded that because Chester did not gift the intangible assets to his three sons, he was not required to file a gift tax return. Because Bross Trucking did not distribute intangible assets to Chester, the Tax Court determined that any remaining issues were moot.

The Tax Court also determined that Bross Trucking did not transfer intangible assets. This is because the intangible assets that the Service alleged to be transferred, Bross Trucking never owned. Rather, these intangible assets were personally owned by Chester.

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The Elements of the Personal Goodwill

The primary requirement related to personal goodwill is for the business owner to establish that his or her personal goodwill exists separate from any closely held corporation's entity goodwill. Personal goodwill is property with a value dependent solely on the personal characteristics of the individual business owner.

Although very fact specific, these personal characteristics can include the personal relationships, ability, personality, and reputation of the individual shareholder where the company does not have a right by contract or otherwise to that individual's future services.

Judicial guidance with regard to this particular element of personal goodwill is provided in several Tax Court decisions, including *Martin Ice Cream Co.*,[2] *Norwalk*,[3] and *Schilbach*.[4]

In the *Bross Trucking* decision, Chester, a successful construction businessman, had established close, personal relationships with his primary customers. Additionally, Chester was extremely knowledgeable about the trucking industry because of his many years of experience. To that end, customers sought these personal traits through their relationships with Chester, which led directly to business for Bross Trucking.

As a result, the Tax Court concluded that Chester's personal goodwill existed through these relationships.

The Tax Court noted that the facts in the *Bross Trucking* case were analogous to the facts in the *Martin Ice Cream* case. In the *Martin Ice Cream* decision, the corporation's success was attributed to the individual shareholder's personal relationships with his retail customers. These personal relationships constituted an intangible asset used to establish a revenue stream and to develop a customer base.

However, because these personal relationships—and the corresponding intangible assets—were

never transferred to the corporation, the Tax Court held that the intangible assets were the shareholder's personal property.

Similarly, the Tax Court in the *Bross Trucking* decision held that any existing goodwill from Chester's personal relationships was his personal goodwill.

One factor in the *Bross Trucking* decision supporting the position that it was Chester's personal goodwill was that Bross Trucking clearly lacked its own entity goodwill. Bross Trucking had an impending suspension from various regulatory infractions, causing it to face bankruptcy. Further, the impending suspension caused customer uncertainty and business interruptions that impaired the business.

Unlike many situations involving claims of personal goodwill, the nonexistence of entity goodwill was clear in the *Bross Trucking* decision.

In addition, the Tax Court distinguished the *Bross Trucking* decision from the *Solomon* decision.[5] In *Solomon*, the corporation's success occurred because of the company's products and not because of any relationships that the shareholders formed.

In the *Solomon* decision, the taxpayers failed to convince the Tax Court that their personal abilities in developing an iron ore processing business were of any value.

The Tax Court concluded that the acquiring party

> did not need the goodwill of Solomon Colors or any of its key employees to succeed; in fact, after the acquisition [the acquiring party] continued to do business under its own name, not under the name of Solomon Colors.

Also, in the *Solomon* decision, the selling shareholders effectively ended their involvement in the business following the company sale, further indicating that their personal abilities were dispensable.

The Separability of the Personal Goodwill

A second requirement for the existence of personal goodwill is that the individual shareholder possess the right to sell his or her goodwill. To avoid corporate-level income tax, the personal goodwill must be the shareholder's individual asset. And, the shareholder cannot have previously transferred that personal goodwill to the corporation.

Tax Court precedent establishes that personal goodwill is transferred to a corporation when the individual shareholder/employee cannot personally benefit from it without the employer corporation. This issue is discussed in such Tax Court decisions as *Martin Ice Cream Co.*[6] *Norwalk*,[7] *H&M, Inc.*,[8] and *Bross Trucking, Inc.*[9]

Personal goodwill is often transferred through shareholder or employment agreements, such as an employment contract or a noncompete agreement. In general, once such an agreement is in existence, any current goodwill (or goodwill created thereafter) will likely belong to the corporation.

In the *Bross Trucking* decision, Chester never entered into an employment contract or a noncompete agreement with the company. Chester was free to leave the company and take his relationships with him if he decided to compete against the business.

The Tax Court stated "[a]n employer has not received personal goodwill from an employee where an employer does not have a right, by contract or otherwise, to the future services of the employee."

As a result, the lack of such agreements allowed the Tax Court to conclude that Chester did not transfer his personal goodwill to the corporate entity.

The favorable facts in the *Bross Trucking* decision may be contrasted with the facts in *Howard*.[10] In that Appeals Court decision, Larry Howard, a practicing dentist, incorporated his sole proprietorship and entered into an employment agreement and a noncompetition agreement with the corporation. Later, Larry decided to sell his practice.

Larry argued that the sale included the sale of his personal goodwill. The Service, however, recharacterized the payment that Larry received. Larry claimed the payment to be for the sale of personal goodwill. The Service classified the payment as a dividend payment from the corporation.

The Ninth Circuit concluded that Larry's personal goodwill did not exist separately from the corporate assets. Specifically, the Appeals Court noted that, although Larry possessed some personal goodwill through his patient relationships, "the economic value of those relationships did not belong to him, because he had conveyed control of them to [his business]."

As a result, the Ninth Circuit upheld the Service's recharacterization of the transaction payment as a dividend.

The Documentation of the Personal Goodwill

While not an issue in the *Bross Trucking* decision, it is noteworthy that certain formalities and documentation will help support the taxpayer positions taken with respect to personal goodwill. Personal goodwill should be:

1. valued by an independent valuation analyst,
2. clearly identifiable in the purchase agreements, and
3. agreed to by the acquiring party.

In the *Kennedy* decision,[11] James Kennedy, the sole shareholder of KCG International, sold his consulting business corporation. Late in the negotiation process, the transaction parties agreed that:

1. 25 percent of the purchase price should be designated as a payment for consulting services and
2. the remaining 75 percent should be designated as a payment for James' personal goodwill.

To effectuate the sale of James' personal goodwill, the parties entered into three separate agreements, one of which was for the sale of James' personal goodwill and customer lists. In a separate agreement, James agreed to continue to service his former clients as an employee of the acquirer.

While the Tax Court found that James did own personal goodwill, it held that the identification of personal goodwill is not enough to conclude that the personal goodwill had been sold. The Tax Court stated that "[e]ven though a payment to a service provider can be considered a payment for goodwill in certain circumstances, we are convinced that the payments to Kennedy were consideration for services rather than goodwill."

The Tax Court went on to state that it found

> it significant that there is a lack of economic reality to the contractual allocation of the payments to goodwill. In other cases, the contractual allocation of a portion of a payment to goodwill has been important in determining that the payment was indeed for goodwill. In those other cases, the contractual allocation appeared to genuinely reflect the relative value of the seller's customer relationships compared to the value of the seller's ongoing personal services.[12]

The Tax Court's decision was based on the lack of an independent valuation or any other meaningful attempt to allocate the transaction sales proceeds. Accordingly, the *Kennedy* decision illustrates the importance of formal documentation regarding the value of personal goodwill—with an independent valuation to support the contractual sale price allocation.

The Tax Court also looked to the actual language of the purchase agreements in the *Solomon* decision. In the *Solomon* decision, the taxpayers (i.e., father and son shareholders) argued that the acquiring party purchased the shareholders' personal goodwill. The taxpayers argued that such personal goodwill represented value generated from their customer relationships.

In its decision, the Tax Court concluded three reasons why the taxpayers did not sell personal goodwill.

First, the Tax Court concluded that nothing in the transaction agreement between the parties referred to the sale of personal goodwill or customer lists personally owned by the taxpayers.

Second, unlike the facts in the *Martin Ice Cream* decision, the Tax Court concluded that the facts did not support that the value of the business was attributable to the taxpayers' personal attributes and relationships.

Third, although the taxpayers entered into noncompete agreements, the Tax Court concluded that the lack of employment or consulting agreements arguably demonstrated that the intent was not the purchase of personal goodwill.

As a result of these three factors, the Tax Court attributed the transaction payments to the taxpayers' covenants not to compete in the *Solomon* decision.

Summary and Conclusion

Based on the above-described judicial guidance, it is clear that the lack of supporting contractual documentation and the lack of an independent valuation may damage an otherwise strong case for the sale of personal goodwill.

In general, the sale of a C corporation through an asset sale structure will result in two levels of income tax:

1. A taxable gain to the corporation
2. A taxable distribution to the shareholders

One strategy for closely held corporation shareholders to avoid this double taxation involves the assertion that a portion of the business sale relates to the sale of the personal goodwill of the shareholder/employee. Therefore, a portion of the total purchase consideration should only be taxed once—as a capital gain to the shareholder/employee directly.

The concept of personal goodwill is well-established, dating back to the above-mentioned Tax Court decision in *Martin Ice Cream Co*. The *Martin Ice Cream* decision involved a father and son who operated an ice cream distribution business through a corporation.

The Tax Court concluded that the success of the business depended entirely on the father, who had personal relationships with supermarket owners and an oral agreement with the founder of Häagen-Dazs to distribute a line of super-premium ice cream to supermarkets.

At no time did the father have an employment agreement with Martin Ice Cream. Following the purchase of Häagen-Dazs by Pillsbury, negotiations between Martin Ice Cream and Häagen-Dazs ensued for the acquisition of the Martin Ice Cream ice cream distribution business.

The father and son disagreed on the future of the business, and they decided to split the assets of the corporation in what was meant to be a tax-free split-off under Section 355.

The Tax Court concluded that the transaction failed the requirements of Section 355. Therefore, Martin Ice Cream was subject to tax on the distribution of appreciated property under Section 311.

In determining the income tax impact to Martin Ice Cream, the Tax Court analyzed whether the father had (1) transferred certain intangible assets to the corporation or (2) retained these intangible assets personally.

The Tax Court concluded that the success of the business depended entirely on:

1. the father's relationships in the marketplace and
2. the father's oral agreement with the founder of Häagen-Dazs.

The Tax Court concluded that these assets represented personal intangible assets.

The Tax Court concluded that these assets could not be owned by Martin Ice Cream. This was because the father never entered into a covenant not to compete or any other agreement with Martin Ice Cream that would result in the transfer of rights in those assets to Martin Ice Cream.

The recent Tax Court decision in *Bross Trucking* illustrates that, with the right set of facts, the sale of personal goodwill, as an asset separate from corporate-owned goodwill, should withstand a challenge from the Service.

For an individual shareholder/employee to sell his or her personal goodwill, that intangible asset must:

1. meet the definition of goodwill from a tax perspective and
2. be owned by the individual outside of the legal business entity.

The main issue in the *Bross Trucking* decision was the Service's contention that Bross Trucking distributed appreciated intangible assets (including goodwill) to its sole shareholder, Chester Bross.

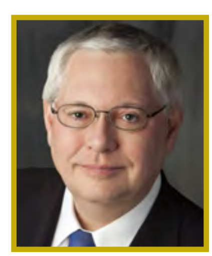
The Service alleged that Chester then transferred those intangible assets to a newly created trucking entity that his three sons owned.

In holding for Chester, the Tax Court concluded the following:

1. Bross Trucking had no corporate goodwill at the time of the alleged distribution.
2. Chester's personal goodwill constituted all of the Bross Trucking goodwill.
3. Chester did not transfer any of this personal goodwill to the company that he had owned and operated.

Notes:

1. Bross Trucking, Inc. v. Commissioner, T.C. Memo 2014-107 (June 5, 2014).
2. Martin Ice Cream Company v. Commissioner, 110 T.C. 189 (1998).
3. Norwalk v. Commissioner, T.C. Memo 1998-279 (July 30, 1998).
4. Christhart S. and June Schilbach v. Commissioner, T.C. Memo 1991-556 (Nov. 6, 1991).
5. Solomon v. Commissioner, T.C. Memo 2008-102 (Apr. 16, 2008).
6. Martin Ice Cream Co., 110 T.C. 198.
7. Norwalk, T.C. Memo. 1998-279.
8. H&M, Inc. v. Commissioner, T.C. Memo 2012-290 (Oct. 15, 2012).
9. Bross Trucking, Inc., T.C. Memo 2014-107.
10. Howard v. U.S., 448 Fed.Appx. 752 (9th Cir. 2011).
11. Kennedy v. Commissioner, T.C. Memo 2010-206 (Sept. 22, 2010).
12. Id., at *23.



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