More than Good Manners – Personal Goodwill May Reduce Taxes

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Imagine a small business owner who is the only shareholder of an incorporated service business taxed as a C corporation by the IRS. Let's call the shareholder "Jane" and the company "SmallCo." Through years of hard work and dedication, Jane has built a reputation for excellent service. Furthermore, the relationships that she has forged with her customers are the reason that her company has had such success. Because it's her company, she has never had, nor needed, an employment agreement with SmallCo.

Now imagine that all of Jane's hard work paid off; a large corporation, "MegaCo," wants to acquire all of the assets of SmallCo. The purchase price will be $1 million, with half of the purchase price allocated to SmallCo's tangible assets and the other half allocated to SmallCo's goodwill and intangible assets. In addition, MegaCo wants to retain Jane's services after the transaction and asks Jane to sign a consulting and non-compete agreement. Jane, as sole shareholder, agrees to these terms. MegaCo pays SmallCo $1 million in exchange for all of SmallCo's assets, and, after satisfying its liabilities, SmallCo liquidates and distributes all of its remaining cash to Jane.

As the transaction is presently structured, the sale proceeds would be subject to double taxation. First, the proceeds would be taxed at the corporate level (the difference between the $1 million received and the tax basis of the assets sold), and, second, the amount paid to Jane in the liquidation of SmallCo, less Jane's basis in her SmallCo stock, would also be subject to tax.

Restructuring the transaction to account for Jane's personal goodwill may reduce that double taxation burden. The Treasury Regulations define goodwill as the value of a business that is attributable to the expectancy of continued customer patronage. Generally, goodwill is an asset of the business, as reflected in the transaction structure above. Courts have recognized, however, that in certain situations the goodwill properly belongs, in whole or in part, to certain key employees of the company. This "personal goodwill" is generated by, and is directly linked to, the relationships and interactions those key employees have with the company's customers.

Consider Jane and SmallCo again. Imagine that SmallCo's assets consist of a small office with a nicely appointed lobby, enough office furniture to fill a couple of rooms, some computer equipment, and, perhaps, a company car. Did any of those assets generate $500,000 of goodwill? The likelihood is that the vast majority, if not all, of the goodwill that MegaCo is buying is a direct result of Jane's personal relationships with her customers.

Jane should have structured the transaction as two separate sales: a sale by SmallCo of its assets; and a separate sale by Jane of her personal goodwill. Under that structure, MegaCo would have paid SmallCo $500,000 for the assets of the company. Those proceeds would still have been subject to double taxation. MegaCo would have paid the other $500,000 directly to Jane in exchange for her personal goodwill. That second $500,000 would have only been subject to taxation at the shareholder level. As a result, Jane could have realized a substantial tax savings.Personal goodwill is only available in select situations. Courts generally find personal goodwill in smaller, service-oriented businesses with few shareholders. The shareholder claiming personal goodwill must have created the goodwill personally through the unique relationships that he or she forged with customers. It is important that those relationships between the customers and the shareholder are "portable." In cases where shareholders or employees were prevented from taking customers from, or competing with, the company by an employment agreement or covenant not to compete, courts have found that the goodwill belongs to the business because the shareholders or employees could not have "taken it with them" when they left. Finally, it is important that the negotiations between the parties and the documents memorializing the transaction reflect the existence and acquisition of personal goodwill. Recent tax court opinions have disallowed claims based on personal goodwill where the transaction documents did not mention an allocation for *personal* goodwill; without such documentation, the courts typically view these positions as after-the-fact tax planning.

If you are considering a sale of your company and the scenario laid out above sounds more than a little familiar, we can assist you in evaluating whether to structure your transaction to include a sale of personal goodwill.