Larry's Tax Law

Personal Goodwill Appears to be Alive and Well

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In the circumstance where substantially all of the assets of a closely-held C corporation are being sold, the shareholder of the seller may desire to receive part of the purchase price directly from the buyer for his or her personal goodwill. The result is beneficial to both the buyer and the selling shareholder. The buyer gets to amortize the amount paid for the goodwill ratably over fifteen (15) years, and the shareholder enjoys two tax advantages, namely he or she gets capital gain treatment on the amount received for the goodwill and he or she avoids the corporate level tax. This approach works provided certain facts exist:

- The selling shareholder has created personal goodwill;
- The selling shareholder has the ability to take the personal goodwill with him or her to another company and has the ability to compete with the corporation;
- There is no contractual arrangement limiting the selling shareholder's ability to use the personal goodwill in the pursuit of work for a business competitor or the ability to sell it to a business competitor; and
- The amount of the sale proceeds allocated to the personal goodwill is reasonable.

The leading cases on personal goodwill include: ***Martin Ice Cream v. Commissioner***, 110 TC 189 (1998), and ***Norwalk v. Commissioner***, 76 TCM 208 (1998). Commentators often refer to these cases as foundational in this area of tax law.

In 2011, it appeared using personal goodwill as an asset in the sale of a business may have been curtailed a bit. In ***Howard v. US***, 108 AFTR.2d 2011-5993 (Ninth Cir., August 29, 2011), affg 106 AFTR.2d 2010-5533 (DC Wash., July 30, 2010), the court was presented with a case involving a dentist from Spokane, Washington. Dr. Howard began practicing dentistry in 1972. In 1980, he incorporated his dental practice and it remained a C corporation for its duration. Dr. Howard was the only shareholder, director and officer of the corporation. His attorney prepared, along with the basic incorporation documents, an employment agreement between Dr. Howard and the corporation. In that agreement, it provided that Dr. Howard could not, during his employment with the corporation and for a period of three (3) years thereafter, compete with it in the practice of dentistry.

Twenty-two (22) years later, Dr. Howard decided to sell the assets of the corporation. Once he learned about the tax consequences of selling the assets of a C corporation, his accountant likely suggested an allocation of some of the purchase price to personal goodwill would be beneficial. It appears that nobody

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remembered the non-competition provision contained in the employment agreement or considered that it may have an impact on the sale of personal goodwill. The purchase price for the business assets was $613,000. It was allocated as follows:

$549,900 Personal Goodwill

$16,000 Dr. Howard's Non-Compete Covenant

$47,100 The Assets of the Corporation

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$613,000 **TOTAL**

On audit, the Service re-characterized the amount allocated to personal goodwill as corporate goodwill. Consequently, the corporation had income from the sale of the goodwill, and Dr. Howard had dividend income resulting from the distribution of the sale proceeds he received from the corporation. Dr. Howard paid the deficiency, and filed a claim with the IRS for refund. When his claim for refund proved to be unsuccessful, he sued for refund in the Federal District Court for the Eastern District of Washington. Dr. Howard argued that the purchase and sale agreement was dispositive of the issue - the parties, acting at arms length, allocated $549,900 of the sale proceeds to personal goodwill. The Service, of course, responded by displaying for the judge's eyes the non-competition provision that was contained in Dr. Howard's employment agreement, and argued it voided the parties attempt to buy and sell personal goodwill.

Dr. Howard then got quite creative. He asserted that, as the sole shareholder, officer and director of the corporation, he terminated the non-competition provision by entering into the purchase and sale agreement. **Good try!** The astute attorney for the government pointed out that, even if Dr. Howard's assertion was correct, termination of the non-competition provision did not change the character of the goodwill generated for the twenty-two (22) years before the termination - it was and still is corporate goodwill.

Further, the government asserted that there was no factual evidence that Dr. Howard actually terminated the employment agreement. The three-year post employment non-competition provision continued to bind Dr. Howard following the sale of the corporation's assets. So, the government argued, even if personal goodwill existed, it had little value, because the non-competition arrangement prohibited Dr. Howard from competing for three (3) years post employment. The government relied upon the **Norwalk** case for this proposition.

The court concluded the only goodwill that existed in Dr. Howard's case, because of the non-competition provision in his employment agreement, was corporate goodwill. The government prevailed.

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Dr. Howard appealed to the Ninth Circuit Court of Appeals. The Ninth Circuit affirmed the Federal District Court for the Eastern District of Washington. In the court's opinion, Judge Korman said:

"Dr. Howard has offered no compelling reason why he should be let out of the corporate structure he chose for his dental practice."

Bad facts bring bad results. **Howard v. US** did cause tax practitioners to pause for cause when suggesting part of the purchase price in an asset deal be allocated to personal goodwill. Practitioners need to be careful. Allocating part of the purchase price to personal goodwill is not appropriate in all cases. Also, an issue not raised in **Howard v. US** is the amount allocated to personal goodwill. It must be reasonable under the facts and circumstances. To assist in determining what amount is reasonable, obtaining a qualified appraisal may be desirable.

In **H&M, Inc. v. Commissioner**, TC Memo 2012-290 (October 15, 2012), the court was presented with a matter involving the sale of personal goodwill. This case had a strange twist.

In the late 1960s, in Harvey, North Dakota, Harold Schmeets went to work selling life insurance for a local bank's wholly-owned insurance agency. Mr. Schmeets had greater aspirations. He wanted to own the insurance agency. During the mid-1970s, Mr. Schmeets started buying small amounts of the stock of the insurance agency from the bank. By the 1980s, he was the sole shareholder of the agency. He eventually changed its name to The Harvey Insurance Agency. It operated in the bank's own building.

In 1983, the bank decided to get back into the insurance business. It started another insurance agency inside the same building where Mr. Schmeets operated The Harvey Insurance Agency. Not wanting to operate in the same building as a rival, he moved the business down the street to separate quarters.

The insurance market in Harvey was extremely competitive, but Mr. Schmeets, through hard work, knowledge and a good gift of gab, gained the reputation as one of the best insurance people around. In fact, he became known in the community, even among competitors, as the "King of Insurance."

Unfortunately for the bank, its new insurance agency did not fare well. In 1992, the bank approached Mr. Schmeets about combining forces. Discussions continued for a long period of time; they eventually made a deal whereby the bank bought the assets of Mr. Schmeets' corporation.

The bank's attorney drew up the deal which consisted of a Purchase Agreement and an Employment Agreement.

1. Under the Employment Agreement, Mr. Schmeets was made the manager of the agency. The Employment Agreement had a term of six (6) years. He was paid a base salary each year of $38,936. In addition to the base salary, he received each year the greater of $50,000 or 45% of the net adjusted gross income of the agency. Last, Mr. Schmeets was entitled to receive a lump sum payment of $74,000 at the end of the term of the Employment Agreement. If he died, the bank was still required to pay his heirs the annual base pay and the lump sum payment. The Employment Agreement contained a 15-year

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non-competition agreement.

2. Under the Purchase Agreement, Mr. Schmeets' corporation agreed to sell the bank all of its hard assets, name and goodwill. The purchase price was $20,000, payable, with interest, over a period of years. The purchase was conditioned upon Mr. Schmeets executing the Employment Agreement.

A year after entering into these agreements, the parties amended the deal. They agreed to defer payment of part of Mr. Schmeets' compensation for six (6) years and then pay it over a period of seven (7) years with interest. This occurred before Section 409A was introduced to the Code.

After the Employment Agreement ended, the bank asked Mr. Schmeets to stay on to help transition his work to a replacement manager. Interestingly, the replacement manager was being paid $55,000 – $65,000 each year, while he received around $30,000 each year during the transition period.

Instead of liquidating the old corporation after its name and assets were sold to the bank, Mr. Schmeets kept it alive. The board of directors, which was comprised of Mr. Schmeets and his immediate family, decided he had been undercompensated in prior years. So, in 1992, it issued a promissory note to him in the amount of $120,000, plus interest at the rate of 10% per annum. The note did not contain any payment terms. No independent analysis was conducted to confirm Mr. Schmeets was undercompensated in prior years. Further, no corporate minutes were created to document the theory that Mr. Schmeets had been underpaid in prior years or the amount of such underpayment.

The corporation treated the note as accrued compensation. At the time the note was created, the corporation had retained earnings of over $270,000 and cash of a little bit less than $200,000. Its payments on the note, which commenced in 1999, were sporadic. Finally, about ten (10) years later, the corporation paid the note in full.

The Service audited the corporation for tax years 2001-2005. Ultimately, the Service issued a Notice of Deficiency to Mr. Schmeets' corporation in the amount of $70,000, including taxes and penalties.

The Service raised many issues, including excessive retained earnings, the personal holding company tax, and that the deferred compensation was a disguised dividend. The biggest issue, however, was whether the income received by Mr. Schmeets from the bank relating to the Employment Agreement was really disguised purchase price, which should have been paid to the corporation and subject to a double tax.

Mr. Schmeets argued the bulk of the sale proceeds were paid to him directly for his personal goodwill. The business was built on relationships between Mr. Schmeets, his customers and the community. Mr. Schmeets argued that these relationships were what he really transferred to the bank.

Citing ***Norwalk*** and ***Martin Ice Cream***, the court was quick to note that personal goodwill does exist and it is transferred to another entity when the individual enters into a non-competition arrangement with that entity, which Mr. Schmeets did as part of the Employment Agreement he entered into upon the sale of his agency.

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However, as illustrated by ***Howard v. US***, if the taxpayer enters into a non-competition agreement with his own corporation before the sale, he or she no longer possesses goodwill which he or she may sell to a buyer. But, as in this case, where the taxpayer had no previous non-competition arrangement with his corporation, and entered into a non-competition agreement with the buyer as part of a sale, personal goodwill, if it exists, may be transferred to the buyer.

The tax court looked at the services Mr. Schmeets actually performed for the bank following the sale, and all of the aspects of personal goodwill, including his customer relationships, and his knowledge of the community and the industry, which he transferred to the bank during the employment period.

The court ultimately concluded personal goodwill did exist and it was transferred by Mr. Schmeets to the bank as part of the sale of the agency's assets. Consequently, the amounts paid to Mr. Schmeets under his Employment Agreement were not disguised sales price for the assets of the agency.

Unfortunately for Mr. Schmeets, he lost the battle on several other issues and his corporation got hit with a Section 6662 accuracy-related penalty.

The moral to the story is: personal goodwill is alive and well. It is interesting to note that Mr. Schmeets and the bank did not specifically allocate a portion of the purchase price to personal goodwill. When the IRS attacked the consideration being paid to Mr. Schmeets under the employment agreement as disguised purchase price for the assets of the corporation, Mr. Schmeets raised the personal goodwill argument.

This is not a good approach. It may have worked for Mr. Schmeets, but an allocation of purchase price to personal goodwill should be well thought out; it should not be an after thought. You need to:

- Consider all of the facts to determine if personal goodwill exists;
- Determine whether the shareholder has been prohibited from competing with the corporation prior to the sale or after the sale as the result of a pre-existing agreement;
- Determine whether the shareholder can actually compete with the corporation based on non-contractual facts (e.g. medical conditions or age);
- Determine a reasonable allocation of the purchase price to personal goodwill (a qualified appraisal is warranted); and
- Properly document the sale of personal goodwill in the purchase and sale agreement, including an actual allocation of purchase price to it.

An allocation of the purchase price to personal goodwill may be appropriate in some cases where the assets of a C corporation are being sold, but this approach should be carefully reviewed and scrutinized before it is implemented. These days, the risk of the imposition of a Section 6662 penalty exists.

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