MERCER CAPITAL

# VALUE MATTERS™

The Complimentary Electronic Newsletter for Attorneys and Other Professional Advisors to Business

**Volume 2005 -11 • December 5, 2005**
**www.mercercapital.com**
**mcm@mercercapital.com**

# An Overview of Personal Goodwill

Wendy S. Ingalls, CPA/ABV, CBA, ASA & Lucas M. Parris

In the world of FASB, goodwill is not delineated into personal goodwill and corporate or enterprise goodwill. However, in the tax world, this distinction can be of critical importance and can create significant savings to a taxpayer involved in the sale of a C corporation business.

Many sellers prefer that a transaction be structured as a stock asset sale, rather than an asset sale, thereby avoiding a built-in gains issue and its related tax liability. Buyers want to do the opposite for a variety of reasons. When a C corporation's assets are sold, the shareholders must realize the gain and face the issue of double taxation whereby the gain is taxed at the corporate level, and taxed again at the individual level when proceeds are distributed to the shareholders. Proceeds that can be allocated to the sale of a personal asset, such as personal goodwill, avoid the double taxation issue.

The Internal Revenue Service defines goodwill as "the value of a trade or business based on expected continued customer patronage due to its name, reputation, or any other factor."[1] Recent Tax Court decisions have recognized a distinction between the goodwill of a business itself and the goodwill attributable to the owners/professionals of that business. This second type is typically referred to as personal (or professional) goodwill (a term used interchangeably in tax cases).

Personal goodwill differs from enterprise goodwill in that personal goodwill represents the value stemming from an individual's personal service to that business, and is an asset owned by the individual, not the business itself. This value would encompass an individual's professional reputation, personal relationships with customers or suppliers, technical expertise, or other distinctly personal abilities which provide economic benefit to a business. This economic benefit is in excess of any normal return earned on other tangible or intangible assets of the company.



[1] IRS Publication 535: *Business Expenses*, Ch. 9, Cat. No. 15065Z

In *Martin Ice Cream Co. v. Commissioner* ("Martin")[2], the Tax Court ruled that intangible assets embodied in the shareholder's personal relationships with key suppliers and customers were not assets of the shareholder's corporation because there was no employment contract or non-competition agreement between the shareholder and the corporation. In this case, the shareholder/owner, Arnold Strassberg, had developed personal relationships with his customers over a period of approximately 25 years. During this time, Mr. Strassberg was instrumental in the design of new ice cream packaging and marketing techniques. In 1974, the founder of Haagen-Dazs (a large ice cream manufacturer) asked Mr. Strassberg "to use his ice cream marketing expertise and relationships with supermarket owners and managers to introduce Haagen-Dazs ice cream products into supermarkets."[3]



The underlying question in the *Martin* case involved the tax treatment of a 1988 split-off of Mr. Strassberg's portion of the business from the rest of the company. Arnold Strassberg had an oral agreement to distribute Haagen-Dazs products, and his portion of the business focused on the large supermarket customers, with whom he had developed personal relationships throughout his career. Arnold Strassberg's son Martin, the other shareholder of Martin Ice Cream Co. ("MIC"), preferred instead to focus on the small store business. Strassberg Ice Cream Distributors, Inc. ("SIC"), a subsidiary entirely related to Arnold Strassberg's side of the business that serviced the large supermarkets, was split-off from the rest of the company. Arnold Strassberg became the sole shareholder of SIC, and the assets of SIC were subsequently sold to Haagen-Dazs.[4]

The Tax Court held that Arnold Strassberg's oral agreement for distribution with Haagen-Dazs and his personal relationships with customers were never corporate assets of MIC, and therefore could not have been transferred to SIC in the split-off. Prior to the sale to Haagen-Dazs, Arnold Strassberg was the sole owner of those intangible assets because he had never entered into an employment or non-competition agreement. The Tax Court concluded,

> "Accordingly, neither any transfer of rights in those assets to SIC or other disposition to Haagen-Dazs is attributed to petitioner [Martin Ice Cream Co.]"[5]

While the Martin case does not provide specific methodology for valuing personal goodwill, it does lend guidance to the issue of identification of personal goodwill apart from corporate goodwill. Following the Tax Court's approach, the process of recognizing personal goodwill would consider the following issues:

- Do personal relationship exist between customers or suppliers and the owner/manager of the business?
- Do these relationships (customer or supplier) persist in the absence of formal contractual obligations?
- Does the owner/manager's personal reputation and/or perception in the industry provide an intangible benefit to his business?

2 *Martin Ice Cream Co. v. Commissioner*, 110 T.C. 189 (1998).
3 Ibid.
4 Ibid.
5 Ibid.

- Are the practices of the owner/manager innovative or distinguishable in his or her industry, such that the owner/manager is regarded as having added value to that particular industry?
- With respect to the above factors, is the owner/manager currently under any employment agreement or covenant not to compete with the business?

The existence of personal goodwill apart from corporate goodwill was also recognized in ***Norwalk v. Commissioner*** ("Norwalk").[6] The Norwalk case centered on the tax implications of the liquidation and distribution of assets of an accounting firm (C corporation). The two shareholders of the firm elected to terminate the company and to distribute its assets because the business was not profitable. The IRS maintained that the firm had realized a gain on the liquidation of its goodwill, and that the shareholders had realized a capital gain from the distribution of goodwill from their accounting firm to them. Although the shareholders had employment agreements with the firm prior to its dissolution, these agreements expired at the time of the liquidation.[7]

The Tax Court found that the liquidation was not taxable because the employment agreements with the shareholders had expired. With no enforceable contract in place to restrict the activities of the accountants, any personal goodwill of the shareholders was not an asset belonging to the corporation. Therefore the distribution of the client base to the shareholders did not result in a taxable event to either the firm or the shareholders.

Citing ***MacDonald v. Commissioner***[8], the Tax Court in Norwalk stated:

> "We find no authority which holds that an individual's personal ability is part of the assets of a corporation by which he is employed where, as in the instant case, the corporation does not have a right by contract or otherwise to the future services of the individual."[9]

Although both Norwalk and Martin clearly recognize the concept of personal goodwill, neither provides a definitive answer as to its quantification. Because personal goodwill is considered to be the value of the services of a particular individual to a firm, the issue often arises in the context of professional practices. With respect to professional practices, ***Lopez v. Lopez***[10] suggests several factors that should be considered in the valuation of professional (personal) goodwill:

- The age and health of the individual;
- The individual's demonstrated earning power;
- The individual's reputation in the community for judgment, skill, and knowledge;
- The individual's comparative professional success
- The nature and duration of the professional's practice as a sole proprietor or as a contributing member of a partnership or professional corporation.

Should a seller be contemplating an asset sale of his or her C Corporation, and there is an embedded gain involved, the possibility of allocating a portion of the purchase price to personal goodwill should be considered. However, the idea must have a basis in reality. The best case scenario is when the shareholder/manager has an excellent professional reputation and close contact with customers and suppliers.

While the transaction price, including any intangible assets, is often negotiated between the buyer and seller, it is highly recommended that a professional appraisal be obtained to allocate the appropriate portion of the transaction to personal goodwill.

Wendy S. Ingalls

Lucas Parris

**Wendy Ingalls, CPA/ABV, CBA, ASA**
ingallsw@mercercapital.com

**Lucas M. Parris**
parrisl@mercercapital.com

6 *Norwalk v. Commissioner*, T.C. Memo 1998-279.
7 Ibid.
8 *MacDonald v. Commissioner*, T.C. 720,727 (1944).
9 *Norwalk v. Commissioner*, T.C. Memo 1998-279.
10 In re *Marriage of Lopez,* 113 Cal. Rptr. 58 (38 Cal. App. 3d 1044 (1974).

## COMING SOON

### Buy - Sell Agreements: The Do's and Don'ts

*A New Book from Mercer Capital, Coming in the First Quarter of 2006*

Mercer Capital has reviewed hundreds of buy-sell and other shareholder agreements, and we want to share our "lessons learned" with you. We do not offer legal opinions or guidance, but instead provide a list of things to watch out for and why they are important. Written for business owners, attorneys, CPAs, insurance providers, as well as other business appraisers, the book powerfully illustrates the valuation consequences of badly-drafted agreements.

To be notified of the publication date and qualify for the special pre-publication discount, email Barbara Price at priceb@mercercapital.com. Please type "Buy - Sell" in the subject line, and be sure to provide your name and address in the message.

## ANNOUNCING MERCER CAPITAL'S E-BOOK LIBRARY

| Title | Description | Investment | Release Date |
|---|---|---|---|
| **Valuing Shareholder Cash Flows: Quantifying Marketability Discounts** | *Quantifying Marketability Discounts* has been updated and is now offered as an e-book. Titled *Verifying Shareholder Cash Flows: Quantifying Marketability Discounts - 2005 E-Book,* this edition provides a brand new chapter which discusses each of the five assumptions of the QMDM in depth. As a bonus, when you purchase the e-book, you will also receive the *QMDM Companion,* the latest edition of the Quantitative Marketability Discount Model in spreadsheet format. We plan to continually add content to this e-book, and as a purchaser, you will receive this content free-of-charge when it becomes available. | **$95.00** | *Currently Available* |
| **Valuing Financial Institutions** | We are responding to requests to put this book back into print and we are doing so as an e-book | **$65.00** | *Currently Available* |
| **Valuation for Impairment Testing** | The first SFAS 142 valuation resource for CFOs and auditors. Also available in printed form at www.mercercapital.com | **$45.00** | *Currently Available* |
| **Are S Corporations Worth More Than C Corporations?** | An e-booklet that adds to the S Corp vs. C Corp. debate | **Complimentary** | *Currently Available* |
| **Embedded Capital Gains** | Mercer Capital's latest publication | **$19.95** | *Currently Available* |

**Visit our website at www.mercercapital.com for more information or to download an e-book.**

## MERCER CAPITAL ON THE ROAD

The professionals of Mercer Capital have a great deal of experience speaking to industry and professional groups across the nation on topics such as:

- Buy-Sell Agreements
- The Integrated Theory of Business Valuation
- Is Your Business Ready for Sale?™
- Purchase Price Allocation
- Valuation of Employee Stock Options
- Litigation Support and Expert Testimony
- Valuation of Privately Held Businesses, Partnerships, or LLCs
- Financial Institution Valuation
- ESOP Valuation

**To book a Mercer Capital professional as a speaker at your next conference or CLE/CPE meeting, please contact Barbara Walters Price at priceb@mercercapital.com.**

## A GENTLE PLUG FOR OUR FIRM

**MERCER CAPITAL** is a business valuation and investment banking firm serving a national and international clientele. Our reputation for excellence is based on an ability to solve complex financial problems expeditiously. We convert over 20 years of experience, including thousands of assignments, into solutions for the issues of today.

Mercer Capital provides a broad range of independent valuation and financial advisory services, including:

- Dispute Analysis Services and Expert Testimony
- Valuation for Corporate Tax Matters
- Valuation for Corporate Income Tax Issues
- Corporate Litigation Support
- Purchase Price Allocations
- Valuation of Employee Options
- Goodwill Impairment Testing
- Valuation of Intangible Assets
- Fairness Opinions

**MERCER CAPITAL ADVISORS** is the investment banking division of Mercer Capital and specializes in providing merger and acquisition services to sellers or buyers of private businesses or public companies divesting divisions and subsidiaries. In addition, Mercer Capital Advisors assists clients in industry consolidations, roll ups, and refinancings.

## INTERNET COMMERCE: OBTAIN PROPOSALS TO VALUE YOUR COMPANY, BANK, FLP OR LLC VIA OUR WEBSITE

The cost of your time and delays in obtaining proposals has just gone down. Use one of the PROPOSAL REQUEST FORMS on our website.

Many of your colleagues have already used our PROPOSAL REQUEST FORMS and are impressed by the decrease in transactional overhead and the increased ease in obtaining actionable proposals for their clients. We are pleased to be doing business with them. Try it yourself! Visit our website and provide us with the pertinent information via this form, and we'll prepare a proposal and deliver it to you via e-mail, fax or USPS. Complete confidentiality is assured.

## UNSUBSCRIBE

We will continue to send the newsletter as published at no cost unless you notify us that you wish to be removed from the distribution list. To REMOVE yourself from this list, send an e-mail to: mercer-owner@mercercapital.com and type the words "Unsubscribe – Value Matters" in the subject line (without the quotation marks).


MERCER CAPITAL

Business Valuation • Investment Banking

Headquarters:
5860 Ridgeway Center Parkway, Suite 400
Memphis, Tennessee 38120
901.685.2120 • Fax 901.685.2199

Midwest Office:
511 South 5th Street, Suite 206
Louisville, Kentucky 40202
502.585.6340 • Fax 502.585.6345

www.mercercapital.com


**DISCLAIMER.** This publication does not constitute legal, valuation, tax, or financial consulting advice. It is offered as an information service to our clients and friends. Those interested in specific guidance for legal and accounting matters should seek competent professional advice. Inquiries to discuss specific valuation or corporate finance matters are welcomed. Permission is specifically granted to send copies of this ***Value Matters***™ to others who might have an interest in its contents. Permission is also granted to quote portions of this newsletter with proper attribution.

**Mercer Capital's**
**Complimentary Teleseminar Series**

# Is Your Business Ready for Sale?™

Presented by Z. Christopher Mercer, ASA, CFA

*Two Sessions Remaining*

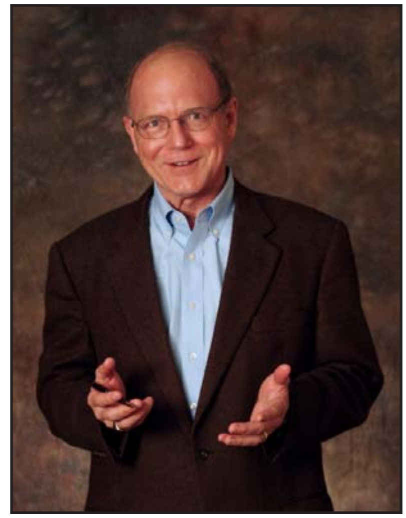
**December 14, 2005** Noon - 1:00pm (Central Standard Time)
**January 18, 2006** Noon - 1:00pm (Central Standard Time)

***If you missed the first session on November 2, you can purchase it on CD for only $49 , or you can purchase the entire teleseminar series on CD for only $99. The CDs will be mailed to you shortly after each teleseminar.***

"Is your business ready for sale?" is a question that might seem to have a simple answer: "yes" or "no." But the answer truly has many nuances. There are many aspects of readiness for sale, some of which are more important than others. But *any* aspect of a business that is not "ready for sale" can create issues, slow down the process of an actual sale *when desired*, and cause prospective buyers to write smaller checks - none of which are attractive results.

If your business is not ready for sale, you are leaving in place costly impediments to orderly transfers, opportunity costs of unknown and potentially huge proportions, and the comfort and satisfaction of a job well done - in taking care of your business, your customers, your employees, and your family.

It is time to take control of your future. Do not let another day pass without paying attention to **your most important asset - your business** (or your client's business if you are a business adviser).



Z. Christopher Mercer, ASA, CFA

**A Personal Note from Chris**

I have enjoyed looking at the world from the perspective of one who values businesses for many years now. That perspective has evolved into one causing me to examine much of what I see and hear based on implications related to value – and values – as both pertain to businesses, projects, strategies or whatever. Through this teleseminar series, I want to speak directly to the needs of business owners and their advisers. You can't work with business owners for over twenty years without learning a thing or two. I will be honored to share what I've learned with you.

**Registration information on page 11 of this newsletter.**

## *SESSION DETAIL*

### SESSION ONE: NOVEMBER 2, 2005 -- "A CALL TO ACTION"

Session One is a call to action. After listening to this session, business owners interested in selling their business now or in the future as well as their professional advisers will understand:

- Why the topic, Is Your Business Ready for Sale?™, is so important today
- Your business will sell, one way or another, and why you should plan for that transaction
- Your business is an investment and should be thought of as an investment, not a paycheck
- The dynamics of business value and growth
- The financial, operational and leadership characteristics of a business that is ready for sale

And, for those business owners who are buyers of businesses, we ask the question: "Is this business ready to buy?"

## SESSION TWO: DECEMBER 14, 2005 -- "FOCUS ON READY"

While Session One is a call to action, Session Two focuses on "READY." Are you ready personally? Is your business ready? In the second session of this teleseminar series, we discuss the key areas you, as a business owner, should focus your time and energy on every day to move you and your business to a "ready for sale" mindset:

**R** Risk
**E** EBITDA
**A** Ability, Agility, and Attitude (for both you and your people)
**D** Driving Growth
**Y** Year-to-Year Comparisons

## SESSION THREE: JANUARY 18, 2006 -- "PATHWAYS TO LIQUIDITY"

Session Three discusses your pathways to liquidity or an overview of the markets for privately held businesses:

- Who are the buyers for businesses of various sizes?
- What are they looking for, particularly in the context of Is Your Business Ready for Sale?TM
- Why are private equity groups so important to you?
- Why do so many buyers focus on EBITDA?
- Why do multiples paid tend to congregate in certain ranges for certain industries?

---

**What is the focus of this teleseminar series?** This teleseminar series focuses on **value** - **understanding, building, and realizing** the value of and in your or your client's business.

**Is the content of each session different?** **Each of the three sessions addresses a different set of topics important to business owners and their advisers**. Attending just one session means that you hear only one-third of the total content.

**What this teleseminar series IS.** This teleseminar series IS **an unabashed effort to convince you to begin the process of getting your business ready for sale** - so that when you are ready - or an unexpected and extravagant offer comes along - you and your company are ready.

**What this teleseminar series is NOT.** This teleseminar series is NOT a come-on to try to convince you to sell your business now.

**Who should attend?** If you are a business owner or a professional adviser to businesses, you should not miss this opportunity to share in the knowledge learned from working with thousands of clients representing hundreds of industries. Chris Mercer has taken this knowledge and encapsulated it to a few hard truths about value and what business owners and their advisers must be focused on every day.

**Is this just more theory?** No. We share numerous true stories of business owners who operated their business in a "ready for sale" mode and reaped the benefits. We also share stories of business owners who essentially had their heads in the sand and missed once-in-a-lifetime opportunities! **Business owners will learn from the successes and mistakes of others.**

And, if you are a professional adviser to businesses, we'll be providing actionable information you can use to communicate with your clients in these important and sometimes delicate conversations. **If your clients don't see you as a trusted adviser now, after this teleseminar series, they will**.

**Qualifications of the speaker.** **Chris Mercer has been valuing businesses for more than 25 years**. During those years, he has consulted with hundreds of companies and financial institutions about business planning and business strategy. He has also been an advisor to numerous boards, and have served on the boards of several private companies and one public company. **And, given his wealth of experience acting as a sell-side M&A adviser for numerous companies and financial institutions, he knows when a business is ready for sale — or not**. He shares this wealth of knowledge with the registrants.

**How much does it cost?** There is no such thing as a free lunch, but when you dial into the sessions, our teleseminars are **complimentary**! The only cost you incur is the cost of the phone call. The value of the information you receive, however, is priceless.

If your schedule doesn't permit you to join us on December 14 and January 18, you can purchase recordings of the individual sessions for only $49 each, or you can purchase the entire teleseminar series on CD for only $99. The CDs will be mailed to you shortly after each teleseminar. (See **Registration Information** below)

---

## Don't Think It Can Happen To You? A True Story ...

He stared into his morning cup of coffee trying to fathom how he could have walked away from $25 million.

That's the story of an owner/operator of a manufacturing company located in a small southern town. The business had been in the family for three generations. In the late 1980s, it had revenues of about $30 million per year with a hefty 20% pre-tax margin. The industry was a niche industry and highly competitive so growth was hard to come by but the family ran the business exceptionally well. So well that they were able to increase market share and sales while generating excellent margins. At this point, the company was worth about $35 million or 6x pre-tax earnings. It was a prime time to sell, but the family enjoyed not only the income from the business but the social status of owning this business which was so important to the community.

Fast forward to the late 1990s. The general business climate was excellent, the economy was in the midst of a length expansion, and the acquisition market was dynamic. The stock market was booming and interest rates continued to decline. Revenues at the business were $28 million and the pre-tax margins were still in the range of 20%. However, potential trouble was brewing. Domestic competitors were moving their operations off-shore. Yet, there were still numerous potential acquirers for the business and the company was worth a multiple between 5x and 6x pre-tax earnings – or about $30 million. Still, the family was comfortable and complacent. They could never imagine that this business that had been such a part of their family and their community for so long could ever go away.

It is early 2005 and revenues are approximately $20 million and pre-tax margins have slipped to 12% and the downward trend appears to show no signs of stopping. The company is now worth about $10 million, lay-offs have become the norm, and there are no buyers in sight.

The owner/operator now spends many mornings staring into his coffee before he faces another day at work – looking back with regret. He knows he should have sold and knows now that the same opportunity likely won't come his way again.

## Sign-Up Bonus #1

For signing up for this teleseminar series, you will receive a **special pre-publication notice and discount off the purchase price of Chris Mercer's soon-to-be-published book** entitled (not so strangely) "Is Your Business Ready for Sale?"TM

**You will also be eligible for discounts on future teleseminar series and products from those series!**

## Sign-Up Bonus #2

You will receive a **complimentary E-Booklet** containing over fifteen recent articles dealing directly with the issues that will be addressed in this teleseminar series.

Determining the Value of Your Business: Art or Science?

Private Initial Offerings (PIOs), IPOs or "Back Door IPOs"

The TR Factor — Business Planning or Not?

Six Ways to Look at Your Business

Get Rid of That Crazy Stuff on Your Balance Sheet

"Tiredness" and Business Value

Your Buy-Sell Agreement: Ticking Time-Bomb or Reasonable Resolution?

Investors Paying Attention to Dividends?

Cash is Good, Right?

Too Much Cash?

Why Do Private Businesses Retain Earnings?

Sprint Nextel and Nextel Partners — What is Fair Market Value?

Nextel Partners' Put to Sprint Nextel Advances

Nextel Partners Hires an Appraiser

Sprint Nextel Provides Valuation Lessons for Appraisers

A Wally Lowenbaum Story

These articles were originally published as posts on Chris Mercer's blog, **Mercer on Value**.

## Sign-Up Bonus #3

**Complimentary sign-up** for notification of new posts to Chris Mercer's blog, **Mercer on Value**. Many of the posts on this blog deal directly with the issues we are addressing in this teleseminar series.

# Is Your Business Ready for Sale?™
# Teleseminar Registration Information

Register Today for this **complimentary teleseminar series** and/or purchase the entire series on CD using our secure ordering system at **www.mercercapital.com/readyforsale.html**.

If you are unable to attend the teleseminars or wish to have the information available to you at any time, you can purchase the teleseminar series on CD for only $99. Shortly after each teleseminar, a CD will be mailed to you.

If you would like to send copies of this teleseminar series on CD to clients and/or friends, contact Barbara Walters Price at priceb@mercercapital.com for information on volume discounts.

You will receive a confirmation after your order. And, if attending the teleseminars, you will receive dial-in instructions several days before the scheduled teleseminar. Also, handout material will be e-mailed to you directly prior to the teleseminars.

And don't forget the three sign-up bonuses available with any registration and/or order.

**Also, remember that each of the three sessions addresses a different set of topics important to business owners and their advisers. Attending just one of the sessions means that you will only hear one-third of the content.**

---

**SESSION ONE: NOVEMBER 2, 2005 -- "A CALL TO ACTION"**

**SESSION TWO: DECEMBER 14, 2005 -- "FOCUS ON READY"**

**SESSION THREE: JANUARY 18, 2006 -- "PATHWAYS TO LIQUIDITY"**

---

**Register today via the web at**
**www.mercercapital.com/readyforsale.html**

**or by calling**
**Barbara Price or Matt Washburn at 901.685.2120**