An Overview of Personal Goodwill

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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.” 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. 15085Z

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In *Martin Ice Cream Co. v. Commissioner* (“Martin”), 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.”

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.

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.]”

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?

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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"). 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.

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*, 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."

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* 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.

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7 Ibid.
10 In re Marriage of Lopez, 113 Cal. Rptr. 58 (38 Cal. App. 3d 1044 (1974)).
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Presented by Z. Christopher Mercer, ASA, CFA

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er checks - none of which are attractive results.

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your customers, your employees, and your family.

It is time to take control of your future. Do not let another day pass without paying
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you are a business adviser).

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?”

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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.

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- Get Rid of That Crazy Stuff on Your Balance Sheet
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These articles were originally published as posts on Chris Mercer’s blog, Mercer on Value.

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Is Your Business Ready for Sale?™

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