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Insights

Three Minute Update – Doing a Deal: Benefits from Selling Personal Goodwill

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When selling a business, careful planning of the structure of a transaction can result in significant tax savings for the seller without increasing the costs to the buyer. As one option, owners of a closely held business should explore the potential of selling the goodwill attributed to them personally, as a stand-alone part of the transaction separate from the sale of the company's other assets, including its enterprise goodwill. This approach can be beneficial in most transactions, but its impact will be maximized in transactions involving the sale of assets by a "C" corporation.

Asset Sales by "C" Corporations – Overview

As a separate taxpayer, a "C" corporation will likely experience a taxable transaction when selling its assets to another party. The applicable tax rate will vary based on whether the asset is considered a capital asset subject to capital gains rates or an ordinary asset subject to ordinary tax rates. Then, after the sale, when the proceeds are distributed to the company's owners, another taxable event occurs, resulting in the well-known and universally disliked "double taxation" characteristic attributable to "C" corporations. These elements provide planning opportunities that can help achieve higher after-tax proceeds to the sellers without unduly burdening the buyer.

When sold as part of a business, goodwill typically will be treated as a capital asset. With further planning and documentation, as we explain below, allocating that goodwill to certain individual owners and away from the company might avoid the "double taxation" on the personal goodwill proceeds typically experienced in an asset sale transaction by a "C" corporation. If done correctly, and assuming current tax rates, a seller could save nearly half of the taxes that might otherwise be payable with respect to goodwill if both of these components are satisfied.

Company Goodwill Compared to Personal Goodwill

Goodwill generally refers to the market value of the business in excess of the market value of the assets carried on the books of that business. Most valuation methodologies for a business will measure the recurring business expected from that business. By building a loyal customer base, the business will develop a reasonable expectation of continued revenues on which the parties to the deal will be able to negotiate a value. Often, this value bears little relationship to the market value of the assets used to generate those revenues.

In addition to business goodwill, individual participants in the business (including the owners) will have opportunities to develop relationships with those outside the business that help the business flourish. This "personal goodwill" typically includes a combination of special relationships of those individuals with customers and suppliers, personal knowledge or expertise in a particular industry, and strong reputation and personal brand in the community.[1] If clients return to a business because of the owner, the owner may be able to establish that this goodwill – or some portion of it – was created by the owner as a personal asset compared to the goodwill attributed to the business as a company asset.

Benefits of Selling Personal Goodwill

Owners of a business can realize significant tax benefits if they are able to sell goodwill as a personal asset. Specifically, doing so allows the seller to avoid double taxation on that portion of the purchase price attributed to personal goodwill. This contrasts with the tax at the company level on that portion of the goodwill attributed to the business itself and then a second tax when the proceeds attributed to the corporate goodwill are distributed to the owner.

By selling goodwill as a personal asset, the seller-shareholder only pays tax at the shareholder level on the proceeds from the sale of the personal goodwill because the transaction is directly between the seller-shareholder and the buyer. The sale of personal goodwill will almost always be taxed at the long-term capital gain rate.

From the flip side of the coin perspective, the buyer should be neutral on whether to accept recognizing personal goodwill as part of the deal, as it typically does not impact the overall purchase price, the buyer's tax burden or any of the components of the transaction. The buyer still acquires the goodwill that made the target an attractive acquisition candidate and will be able to amortize the personal goodwill just as it would if the goodwill is included in the corporate assets. (Typically, this amortization will be spread over 15 years.) This classic "win-win" scenario should always be explored in these situations.

Keep It "Personal"

For the benefits of this scenario to be realized, an individual owner of a business will need to carefully distinguish his or her personal goodwill from corporate goodwill. Consideration of this element should come early in the planning stages for an exit and could even be part of the planning at the formation of the business.

Determining whether personal goodwill exists will require a fact-sensitive analysis. For example, courts have been clear that a business owner does not develop personal goodwill if a non-compete or employment agreement exists between the owner and the business. Those arrangements effectively transfer to the business the relationships from which goodwill develops.

Other cases have found that personal goodwill develops where a customer believes that their dealings are with the individual, and not the business. In some situations, a company may lose goodwill that might have been the company's but migrates to the individuals involved, such as the loss of goodwill by the company when a business becomes insolvent but where the individuals still have relationships with the customers and suppliers of the business.

The selling owner must be able to demonstrate that he or she has developed personal goodwill and to quantify the value of that personal goodwill. A seller should approach the subject of personal goodwill early in the sale negotiations. Additionally, demonstrating the existence of personal goodwill can be done more effectively with a third-party appraisal that determines the value associated with the goodwill in comparison to other assets. A valuation will also help the parties appropriately allocate the purchase price between the assets of the corporation (including corporate goodwill) and the personal goodwill of the seller-shareholder. Reallocating proceeds among shareholders without a proper valuation or significant nontax reason has persuaded courts to conclude that the corporation, instead of the individual, was the seller of the goodwill.

The parties should also separately document the transfer of the personal goodwill. A separate agreement demonstrates that the transaction is directly between the seller-shareholder and buyer, though separate provisions in the primary purchase agreement should be effective as well.

Planning opportunities exist at the outset of a business as well. The founders can document their intent either to include all goodwill in the business by using appropriate agreements, such as employment and restrictive covenant agreements, or to allow personal goodwill to be built up by the individuals.

Cautions

The handling of personal goodwill as described in this alert works well with a single "working" owner pursuing a sale of the business in an asset structure. When other owners become involved, additional considerations come into play to avoid claims that value in the deal that should have been associated with the business has been diverted to individuals in a disproportionate manner. Also, passive owners will be less likely to develop the type of personal goodwill that the courts have recognized.

Using a stock structure typically minimizes the benefit of allocating value to personal goodwill. This structure usually avoids the “double taxation” cost, thus negating or minimizing the need to allocate value to personal goodwill.

For “S” corporations, special care will be needed to evaluate how effective allocations to personal goodwill will be. Those with “built in” gains will be better able to achieve these benefits as some “double taxation” will likely be involved in those situations.

For LLCs taxed as a pass-through entity, “double taxation” avoidance will not be a driver for planning an exit structure. However, some of the other benefits of selling personal goodwill may still lead to adapting this structure to those circumstances.

The parties may find the need to negotiate allocations of transaction proceeds among restrictive covenant payments separately from those for the goodwill and other business assets. A buyer may prefer allocation to items that allow a current deduction rather than a longer term amortization, while the sellers will prefer allocations to capital items that can be taxed at long-term capital gains rates rather than ordinary income rates.

Summary

Owners of “C” corporations can achieve tax and financial benefits by selling personal goodwill as a separate asset compared to the goodwill owned by the business itself. These benefits come mostly from avoiding “double taxation.”

Whether an individual or the business owns the goodwill will be a fact-sensitive inquiry. A court will look for the existence of a non-compete agreement to help determine whether an owner’s relationships, knowledge, and reputation are personal or part of the business.

A personal goodwill allocation approach should be raised early in the negotiation process. This will safeguard against a challenge that allocation of personal goodwill was an afterthought, with the value negotiated by the parties assuming the goodwill was part of the business.

The seller should obtain a third-party appraisal to establish the existence and the value of the personal goodwill. A separate agreement or, at a minimum, separate provisions of a purchase agreement should be used to evidence the sale of the personal goodwill separately from the corporate goodwill of the business.

Could a personal goodwill allocation be right for your sale? Ultimately, answering this fact sensitive question will benefit from the help of experienced professionals. With careful planning, documentation, and consideration, selling personal goodwill just might be a way to help offset the double-tax consequence of selling your “C” corporation’s assets and achieve other objectives.

If you have any questions regarding the information in this article or with asset acquisitions generally, contact **Robert A. Greising**, **Travis D. Lovett**, or any member of our **Business, Acquisitions, & Securities Practice**.

[1] See, e.g., Bross Trucking, Inc. v. C.I.R., 107 T.C.M. (CCH) 1528 (T.C. 2014) (relying on Martin Ice Cream Co. v. C.I.R., 110 T.C. 189 (1998)).