PERSPECTIVE

7 Los Angeles | Daily Journal THURSDAY, NOVEMBER 1, 2012

'Goodwill' ownership has tax implications

By Robert W. Wood

If you run a small business — or a small law firm — you know that what belongs to you and what belongs to the company can seem to merge. The "company" may be a corporation, partnership, LLC or LLP. If it is a corporation, it may be a C or an S corporation. Most corporations are C corporations, but some corporations with 100 or fewer shareholders can elect S status to be taxed more like a partnership.

But whatever the type of entity, what the entity owns matters, as does the type of entity it is. Big or small, business owners don't always distinguish between personal assets and those owned by their business. That can be a mistake, especially when it comes to taxes. Consider this example.

Sam owns 100 percent of SamCo. He works 80 hours a week, as he has for the last 30 years. Sam sells his company to BigBuy. It might be a stock or an assets deal, but the buyer signs agreements with SamCo and Sam. BigBuy wants everything, of course, in order to take over the business.

BigBuy may not care too much precisely what it is acquiring from SamCo and what it is acquiring from Sam personally. BigBuy just wants it all, which may include real estate (or at least leased premises), equipment and machinery, inventory, accounts receivable, etc.

But what about the *goodwill* of Sam's business? Goodwill is generally defined as the expectation that customers will continue to patronize the business. There is almost always goodwill in a business sale. If Sam sells a business with hard assets worth $100 but the buyer pays $150, the extra $50 is probably for goodwill.

Personal relationships of a shareholder-employee were not corporate assets where the employee had no employment contract with the corporation.

Invariably, Sam will be expected not to compete with BigBuy, and that can complicate this issue. Whether Sam or SamCo owns the goodwill (or each owns some of it) can be complex. Local law is important, as are the agreements Sam has signed.

For example, if Sam signed an employment agreement with SamCo, SamCo probably owns all of the goodwill. Similarly, if Sam previously transferred all of his business assets to SamCo when he incorporated it, that too may mean SamCo owns all of the goodwill.

But what if Sam never signed anything and has been the driving personality and bedrock of the business? BigBuy is buying all of the business, of course, including any and all goodwill, *whoever* owns it. Yet BigBuy may not care if the goodwill belongs to Sam or to SamCo as long as BigBuy acquires it all.

You may not think this point matters until you consider taxes. In the leading case of *Martin Ice Cream Co*, 110 TC 189 (1998), the Tax Court held that personal relationships of a shareholder-employee were not corporate assets where the employee had no employment contract with the corporation. In our example, that may mean that Sam could receive the portion of the purchase price paid for goodwill himself, without passing it through SamCo with its corporate tax.

This is where the particular type of business entity that is being sold is key. If SamCo is a partnership, LLC or S corporation, Sam may not be too worried about corporate tax (If it is an S corporation, it is best if it was always an S corporation or converted more than 10 years before). But if SamCo is a C corporation or an S corporation that recently converted from C status, the tax difference can be huge. That's why Sam should think this through carefully before he signs sale documents with BigBuy.

A recent tax case, *H&M, Inc. v. Commissioner,* T.C. Memo 2012-290 (Oct. 15, 2012), re-invigorates the *Martin Ice Cream* principle. Harold Schmeets sold his insurance brokerage business to its competitor. The buyer hired Schmeets individually, but the IRS claimed that his pay was disguised purchase price that should have gone to his selling corporation. Rejecting the IRS' claims, the Tax Court ruled that Schmeets' personal ability was goodwill that did not belong to the company.

Schmeets was the sole shareholder of Harvey Insurance Agency, Inc. and stood out among local insurance agents. Customers asked for Schmeets and wanted him, not the company. In fact, Schmeets had far more name recognition than the "Harvey Insurance" name.

So when Harvey Insurance sold the business to a local bank, the bank wanted Schmeets' services too. Harvey Insurance sold its files, customer lists, insurance agency or brokerage contracts, the name Harvey Insurance, and all its goodwill to the bank for $20,000, payable in six annual installments plus interest. However, that was conditioned on Schmeets signing an employment agreement and noncompetition agreement.

The bank paid Schmeets base pay of $38,936, a bonus of $50,000 or 45 percent of net income (whichever was greater), plus deferred compensation of $74,000 at the end of the six-year term. If Schmeets died, the bank still had to pay. Noting that his total compensation was over $600,000 for six years, the IRS claimed it was disguised purchase price. Under the IRS' theory it should be taxed to the company and then to Schmeets individually.

The IRS even said Schmeets arranged the deal in this way to avoid being taxed twice, once through the corporation and once individually. However, Schmeets and his company argued that the buyer needed him and that the pay was reasonable. Besides, the goodwill of the business really belonged to Schmeets *personally*, not the company. The Tax Court agreed, satisfied that Schmeets and the bank were not just creating paperwork to produce the tax consequences they wanted.

Bottom line? Schmeets' personal relationships, experience and responsibilities made all of this reasonable. Schmeets had more name recognition in the community than Harvey Insurance did. The amount the bank paid him was not a disguised payment for goodwill. Quite properly, Schmeets had avoided the corporate tax.

There is plenty that can go wrong in a business sale. The topic discussed here is usually referred to as "personal goodwill." Plainly, the IRS is no fan of this line of authority. Still, given the right facts and with the right documents, it can be a home run.

Robert W. Wood *is a tax lawyer with a nationwide practice (www.WoodLLP.com). The author of more than 30 books including "Taxation of Damage Awards & Settlement Payments" (4th Ed. 2009 With 2012 Supplement www.taxinstitute.com), he can be reached at Wood@WoodLLP.com. This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.*