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Personal Goodwill and the Emperor of Ice Cream

By Robert W. Wood • Wood & Porter • San Francisco

Old-timer tax lawyers like me like to trot out the illustrious case of *Martin Ice Cream Co.*, 110 TC 189, Dec. 52.624 (1998). It is not an *old* case by old lawyers' standards, yet it represents the linchpin of the argument that personal goodwill can be sold *outside* a business sale, thus obviating corporate-level tax. That is no small feat.

The poet Wallace Stevens penned *The Emperor of Ice Cream,* a title that could aptly be applied to *Martin Ice Co.* as the emperor of personal goodwill.

Not So Fast …

Before we admire the flavor and toppings of *Martin Ice Co.*, however, let's see how one dentist recently learned that ice cream didn't help his teeth or his taxes. In *L.E. Howard,* DC-WA, 2010-2 USTC ¶50,542 (2010), an incorporated dentist sold his dental practice. On the side, he received a payment for his personal goodwill. Our story starts in 1980, when Dr. Larry Howard incorporated his dental practice.

Dr. Larry executed an employment agreement and covenant not to compete with his corporation. He drilled merrily away as his corporation's sole shareholder, officer and director. Twenty-two years later, in 2002, he sold his practice to Dr. Finn and Dr. Finn's professional corporation. An asset purchase agreement was drawn up between the two dentists and their two dental corporations, and here is where the numbers start to get interesting.

Under the agreement, Dr. Larry (outside his professional corporation) received $549,900 for his personal goodwill, while his corporation received only $47,100 for its assets. Dr. Larry also received $16,000 personally for entering into a new covenant not to compete with the buyer. Dr. Larry reported $320,358 as long-term capital gain from the sale of goodwill.

On audit, viewing the goodwill as a corporate asset, the IRS treated the cash Dr. Larry received as a dividend from the

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professional corporation. Accordingly, the IRS assessed a $60,129 deficiency (plus $14,792 in interest). Dr. Larry paid the tax, filed a refund claim and eventually filed suit for a refund in district court.

Dr. Larry argued in his refund suit that the goodwill was personal to him, entitling him to claim the proceeds from its sale as long-term capital gain. After all, he said, in *Martin Ice Cream Co.*, the Tax Court had famously concluded that the personal relationships of a shareholder-employee are *not* corporate assets, at least where the employee has no employment contract with the corporation. Without an employment contract, the Tax Court had reasoned, the goodwill may be personal.

Dr. Larry's case was similar he argued. Nevertheless, in *W. Norwalk*, 76 TCM 208, Dec. 52,817(M), TC Memo. 1998-279, the Tax Court concluded that even when a corporation is dependent upon a key employee, the employee cannot own the goodwill if the employee has entered into a covenant not to compete (or similar agreement) under which the employees' personal relationships with clients may become the property of the corporation.

Given Dr. Larry's fatally thorough corporate documentation, the IRS arguments were strong and predictable:

- The goodwill here was a corporate asset. Dr. Larry was a corporate employee with a covenant not to compete that extended throughout his employment, and even for three years after he no longer held any corporate stock.
- The corporation *earned* the income, and correspondingly *earned* the goodwill.
- Attributing the goodwill to Dr. Larry did not comport with economic reality (given Dr. Larry's relationship with his professional corporation).

The court seemed to have no choice in this case, concluding that Dr. Larry was a corporate employee with a covenant not to compete. The covenant applied from 1980 through 2003, plus an additional three years after the stock sale! Any goodwill generated during that period was corporate goodwill, not Dr. Larry's individually.

After all, where an employee works for a corporation under a contract including an agreement not to compete, the corporation—not the individual—owns the goodwill. The fact that the goodwill may be generated from the professional's work does not make this goodwill personal goodwill within the meaning of *Martin Ice Cream Co.* The court went on to note that it was uncontested that the corporation had earned the income and paid the taxes on the income from Dr. Larry's dental practice.

The covenant not to compete reinforced that notion that the company controlled the assets, earned the income, and was entitled to enforce the noncompetition provision. Was the 2002 asset purchase agreement helpful here? Not really.

The court said that the agreement was not dispositive as to whether the goodwill was personal or corporate in nature. The buyer, Dr. Finn, testified that the price for the dental

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practice had been presented and accepted without negotiation. He did not recall any discussion as to the allocation of proceeds.

Ice Cream Lessons

Even casual readers of the lore of personal goodwill could have told Dr. Larry not to sue. Indeed, the *Martin Ice Cream* case teaches that the documents matter. The presence of an employment agreement with an enforceable covenant not to compete (that extended for another three years beyond the close of the deal) seemed fatal. But there is a much more practical point here.

Was it reasonable for Dr. Larry to allocate virtually *all* of the consideration being paid by Dr. Finn to him personally? Clearly not. Of the total consideration of $702,000, Dr. Larry's professional corporation received only $47,100. It is hard to see how this was a Solomonic approach. In ice cream parlor parlance, Dr. Larry ate it all, gorging until he was ice cream-fed veal (or pork). Pigs, as the adage portends, do get slaughtered.

Despite Dr. Larry's recent debacle, it's useful to reflect on just why *Martin Ice Cream* remains a rich and satisfying decision. Arnold Strassberg and his son Martin owned all of the stock of Martin Ice Cream Co. Previously, the father had worked for more than a decade in his own wholesale ice cream distribution business. He developed strong business relationships with supermarket chains, and they were purely his contacts and his relationships long before Martin Ice Cream Co.

The founder of Haagen Dazs—truly an emperor of ice cream—approached the father about distributing Haagen Dazs ice cream in supermarkets. Based on a handshake agreement—that was never even memorialized in writing—Arnold Strassberg made hay (or sundaes?) with this deal. By the 1980's, Pillsbury had acquired Haagen Dazs and approached Arnold Strassberg about acquiring his relationships so Pillsbury could sell Haagen Dazs directly to the stores.

This was an unusual deal. Pillsbury was willing to pay for Arnold's connections, but had no interest in buying Martin Ice Cream company assets. As a result, Arnold Strassberg created Strassberg Ice Cream Distributers, a new subsidiary of Martin Ice Cream. Arnold transferred all his supermarket relationships to the new company, and they became the only assets of Strassberg Ice Cream Distributers.

In a non–*pro rata* exchange, Arnold Strassberg then surrendered his shares in Martin Ice Cream in exchange for all of the stock of Strassberg Ice Cream Distributers. Strassberg Ice Cream Distributers then sold its assets to Pillsbury for $1.4 million. As part of the deal, Arnold Strassberg signed a bill of sale and an assignment of rights. Both Arnold and Martin Strassberg signed non-compete agreements with Pillsbury.

The Best Ingredients

There are several striking facts about *Martin Ice Cream*. One of them was the lack of a written agreement between Arnold Strassberg and the corporation. Family companies are often informal, but it was clear that the company would have had a hard time enforcing the notion that all of the goodwill belonged to the company and not to Arnold.

In fact, there seemed virtually no chance of that. It was Arnold individually who developed these contacts and relationships before joining Martin Ice Cream Co. That was a good fact. The lack of any written agreement made it even better.

A second notable point relates to Pillsbury's lack of interest in acquiring the assets of Martin Ice Cream Co. All Pillsbury wanted was Arnold Strassberg's contacts. For that reason, one simply did not face allocation questions.

The normal context in which *Martin Ice Cream* arises, of course, is where a buyer wants to purchase a business and its relationships, lock, stock and barrel. The buyer may not care how the purchase price is allocated and precisely to whom it is paid. In a closely held business, after all, the company and owner will both be signatories on various documents. The precise allocation of consideration may not be too important.

Most of the time *Martin Ice Cream* Co. is invoked it will be in the sale of an integrated business. Yet it bears remembering that a far better fact pattern is where the goodwill alone is being sold.

Conclusion

A sale of personal goodwill can provide a seller with a huge benefit: a payment outside

the company reported by the individual as long-term capital gain. That may sound like ice cream that will never melt, one more tax canard pitched by people who should know better. However, the personal goodwill idea isn't a canard, although it is often misinterpreted and misapplied, as it clearly was by Dr. Larry.

Where a seller has unique skills and a strong relationship with customers, it is worth considering. But be sure to assess whether the individual is bound by a covenant not-to-compete! Finally, if your sale of personal goodwill occurs at the same time as the company's sale (as it usually will), don't be greedy. One wonders whether Dr. Larry's situation would have boiled over (even considering his employment contract and covenant not to compete) if he had been a bit more reasonable in divvying up the money. Don't eat the whole carton of ice cream when one scoop will taste plenty good.

Howard should rekindle our memories of *Martin Ice Cream*, wistful thinking on a lazy summer afternoon, the sounds of a Good Humor truck in the distance. Yet ultimately it doesn't help or hurt the personal goodwill authorities. There was little chance Dr. Larry would prevail, and his defeat does not mean *Martin Ice Cream* is not still rich and enticing.