

State Law and Tax Treatment Of Personal Goodwill, Part 2

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In the second of a two-part article on personal goodwill, Wood and Beck address the developing history of personal goodwill, with emphasis on ownership and transferability under state law. They concluded that state property law is key to the federal income tax treatment of personal goodwill. Part 1 of this article appeared in *Tax Notes*, Jan. 14, 2013, p. 231.

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Personal Goodwill

Of all the varieties of goodwill, personal goodwill is the most nebulous, even being referred to by different names.¹ However it is labeled, its substantive

¹See Darian M. Ibrahim, "The Unique Benefits of Treating Personal Goodwill as Property in Corporate Acquisitions," 30 *Del. J. Corp. L.* 1, at 10-11 (2005) ("Personal goodwill may be mistaken for business goodwill, and vice versa") (citation omitted).

rights are significant.² This goodwill is personal because it accrues to an individual rather than a business.

Moreover, it has more personal content than standard business goodwill. At its root are the skill, talent, and relationships of an individual. Even Justice Joseph Story 130 years ago acknowledged that something in the nature of goodwill could accrue to partners independently of the partnership.³

In his treatise on partnership law, Story discussed goodwill as "a part of the partnership property."⁴ Nevertheless, he also mentioned the goodwill of an individual, noting that a partnership could acquire goodwill from the departure of a partner.⁵ That asset, he wrote, represented the advantage arising from the exclusion of the former partner from the same line of business.⁶ That goodwill could be valued and assigned.⁷

Story went as far as to describe particular instances when goodwill accrues to individuals. A partnership has goodwill when it is a "mere commercial business," and a partnership does *not* accrue goodwill when it is a professional business "connected with the personal skill and confidence in the particular partner."⁸ Professional or service partnerships may be less likely to develop goodwill, but goodwill may accrue to the partners, he said.

It has long been understood that goodwill could accrue to the owner of a business when the owner was primarily responsible for its success.⁹ Some

²*Cf. Frank Lyon Co. v. United States*, 435 U.S. 561, 572 (1978) ("Taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed — the actual benefit for which the tax is paid"). In *Morgan v. Commissioner*, 309 U.S. 78, 80-81 (1940), the Supreme Court disregarded the naming of a special power of appointment under local law.

³See Joseph Story, *Commentaries on the Law of Partnership as a Branch of Commercial and Maritime Jurisprudence*, section 99, at 157 (1881).

⁴*Id.* (the section was concerned with goodwill "in some sort a part of the partnership property").

⁵*Id.* at 159.

⁶*Id.* at 161 ("and, in the latter sense, as an advantage arising from the fact of excluding the retiring partner from the same trade or business, as a rival").

⁷*Id.* at 159.

⁸*Id.* at 161.

⁹See, e.g., *Noyes-Buick Co. v. Nichols*, 14 F.2d 548 (D. Mass. 1926) ("I should hesitate before agreeing to certain basic assumptions in the Commissioner's letter of June 13, 1925; e.g.,

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courts have refrained from calling it goodwill or valuing it¹⁰ because business goodwill and its accounting definition appear inapplicable to individuals.¹¹ However, in *MacDonald v. Commissioner*,¹² the Tax Court recognized that goodwill could belong to an individual rather than the corporation.

D.K. MacDonald was the sole owner of an insurance brokerage, Carter MacDonald & Co. (CMC). When CMC liquidated, MacDonald treated the goodwill as his, not CMC's. The IRS argued that the goodwill should be included in CMC's liquidating distribution.

Over the IRS's objections, the Tax Court held that the goodwill belonged to MacDonald. Given his role in the company and the nature of the business, MacDonald "was the company."¹³ He was active in the key social clubs and was personally involved in the business, which depended on his "aggressiveness and business ability."¹⁴

Moreover, the type of insurance sold had "greater and more specialized risks" than was typical.¹⁵ His sales accounts were terminable on 30 days' notice and required active servicing.¹⁶ The quality of his accounts and his level of service "represented a high class business."¹⁷

that a selling agent's capital account should be surcharged with a good will item in order to bring it to a predetermined proportion of the earnings. This is analogous to valuing a broker's office furniture, or a lawyer's law books, according to his income. Doubtless an average ratio could be worked out between the earnings and the furniture, or law books, but there is no causal connection between them. I think that the Commissioner failed to appreciate the extraordinary character of the business with which he was dealing, and in the surcharges which he imposed for good will made a decision which cannot be supported").

¹⁰See, e.g., *Sommers v. Commissioner*, 22 B.T.A. 1241, 1244 (1935) ("It may be conceded that the petitioner had built up a considerable clientele and business acquaintanceship, and that this clientele followed him to a large extent, during his various business enterprises. But this personal following does not constitute good will within the generally accepted meaning of the term").

¹¹See Mary Kay Kisthardt, "Professional Goodwill in Marital Dissolution Cases: The State of the Law," in Ronald L. Brown, *Valuing Professional Practices and Licenses: A Guide for the Matrimonial Practitioner*, para. 2.01 (1996) ("Both the accounting and economic concepts of goodwill are based on the principle that goodwill is an asset of a business not an individual").

¹²3 T.C. 720 (1944).

¹³*Id.* at 727.

¹⁴*Id.* at 723 ("He kept in touch with as much of the corporation's clientele as was possible and personally solicited larger accounts and handled existing accounts that developed problems which might affect the financial status of the corporation. The business of the corporation was personal in its nature and depended largely on the relation between D.K. MacDonald and the corporation's customers").

¹⁵*Id.* at 724.

¹⁶*Id.* at 724-725.

¹⁷*Id.* at 725.

In short, the goodwill was the result of MacDonald's "personal ability, business acquaintanceship, and other individualistic qualities."¹⁸ The Tax Court recognized his personal goodwill as a valuable asset.¹⁹ Because there was no employment contract or covenant not to compete, MacDonald never transferred his goodwill to CMC. That meant its value could not be attributed to CMC.²⁰

Similarly, in *H&M Inc. v. Commissioner*,²¹ Harold Schmeets, like MacDonald, was the owner and sole shareholder of an insurance company, H&M Inc. Schmeets was widely regarded in North Dakota for his personal ability and experience selling insurance. He was known as the "King of Insurance," and people came to H&M specifically to buy insurance from him.

In 1992 H&M sold its assets to a competitor, the National Bank of Harvey. As part of the deal, Schmeets became an employee of National Bank. H&M entered into a purchase agreement for its asset sale, and Schmeets signed an employment agreement.

Part of Schmeets's compensation was deferred and paid between 2001 and 2005. The IRS asserted that those and other payments from National Bank to Schmeets should be recharacterized as payments from National Bank to H&M relating to the asset sale, and then as distributions from H&M to Schmeets. Although the Tax Court adjusted Schmeets's wages, it disagreed with the IRS about the appropriateness of allocating monies to Schmeets's personal goodwill.

The Tax Court's definition of goodwill is reminiscent of Justice Story: "Goodwill is often defined as the expectation of continued patronage by existing customers."²² Story found that goodwill accrued to partners in a service business in which success depended on the individual partner.²³ Noting that selling insurance is a service business, the Tax Court compared Schmeets with MacDonald and with Arnold Strassberg of *Martin Ice Cream v.*

¹⁸*Id.* at 724-725.

¹⁹*Id.* at 728 ("Nothing in this opinion is inconsistent with the authorities cited by respondent to show that good will is an intangible asset having value under certain circumstances or that a list of customers may, under particular conditions, also possess value").

²⁰*Id.* ("there existed no contract... with respect to future services").

²¹T.C. Memo. 2012-290 at *3-4, *Doc 2012-21314*, 2012 TNT 200-8; *id.* at *21 (comparing Schmeets with MacDonald). H&M was originally named Harvey Insurance Agency Inc. but sold the rights to its name.

²²*Id.* at *19 (citation omitted).

²³Story, *supra* note 3, at 161.

Commissioner.²⁴ To the Tax Court, selling insurance is “extremely personal,”²⁵ and patrons came to buy insurance from Schmeets.

The case law recognizes goodwill as an asset belonging to individuals and having a variety of state law consequences.²⁶ California has been a leader in recognizing goodwill as a distinct, valuable asset capable of being transferred by an individual. In the landmark case of *Mueller v. Mueller*,²⁷ a California appellate court held that it was a question of fact whether a business that “was dependent solely upon the personal skill and ability” accrued value in goodwill.²⁸

Shortly thereafter, in *Burton v. Burton*,²⁹ the court attributed goodwill to the personality and characteristics of one man.³⁰ Other states followed California in recognizing personal goodwill, including Washington, New Mexico, and New Jersey.³¹ Many states have not directly confronted the personal goodwill question. Some states have rejected the identification of personal goodwill as an asset that can accrue to the owner of a business.³² Still others recognize that goodwill can accrue to an individual but only in a more limited form.³³

²⁴110 T.C. 189 (1998), *Doc 98-9572*, 98 TNT 52-8; see *H&M*, T.C. Memo. 2012-290, at *21 (“This case is like *MacDonald* and *Martin Ice Cream Co.*”).

²⁵*Id.* (internal quotations omitted).

²⁶See, e.g., *Lawton v. Commissioner*, 6 T.C. 1093 (1950); *Stillwagon v. Commissioner*, 8 T.C.M. (CCH) 644 (1949); *Horton v. Commissioner*, 13 T.C. 143 (1949); *Akers v. Commissioner*, 6 T.C. 693 (1946).

²⁷144 Cal. App. 2d 245 (1956).

²⁸*Id.* at 251-252.

²⁹161 Cal. App. 2d 572 (1958).

³⁰*Id.* at 576 (the value of the goodwill of a business “depend[s] very much upon the personality of the [owner]; that one man by his personality, his adroitness in conducting his business, his geniality in attracting customers, and his wide acquaintance with his customers, may be capable of doing a profitable business where another, lacking some or all of these qualities may fail, or at least not succeed to the extent his predecessor had attained”).

³¹See Allen M. Parkman, “A Systematic Approach to Valuing the Goodwill of Professional Practices,” in Brown, *supra* note 11, at 3-5; see also *In re Marriage of Lukens*, 16 Wash. App. 481 (1976); *Hurley v. Hurley*, 94 N.M. 641 (1980); and *Dugan v. Dugan*, 92 N.J. 423 (1983).

³²See, e.g., *Nail v. Nail*, 486 S.W.2d 761, 764 (Tex. 1972) (The goodwill “did not possess value or constitute an asset separate and apart from his person, or from his individual ability to practice his profession. It would be extinguished in event of his death, or retirement, or disablement, as well as in event of the sale of his practice or the loss of his patients, whatever the cause”).

³³See, e.g., *Taylor v. Taylor*, 386 N.W.2d 851 (Neb. 1986); *Hanson v. Hanson*, 738 S.W.2d 429 (Mo. 1987); see also Kisthardt, *supra* note 11, at para. 2.01.

Personal Goodwill in California

California pioneered the recognition of personal goodwill as a valuable asset that is held and transferable by an individual.³⁴ Of course, California also recognizes business goodwill as distinct and owned by business entities. However, more so under California law than in most other states, the goodwill associated with a service or professional business accrues to the owner rather than the business entity. Unless the owner has transferred the goodwill through a contract such as an employment or noncompete agreement, it remains his.

California Business Goodwill

Business goodwill in California has elements of broader customer goodwill. California Business and Professional Code section 14100 limits the goodwill of a business to “the expectation of continued public patronage.”³⁵ California has long held that customer lists and access to customers are included in the goodwill of a business.³⁶

Indeed, the sale of California business goodwill implies a covenant not to directly solicit former customers even under a separate name.³⁷ California courts limit this customer goodwill to “patronage which has become an asset of that business.”³⁸

For example, to prevent damage to a launderer’s goodwill, one California court required striking laundry workers to return customer lists.³⁹ In another case, a salvager claimed loss of goodwill when a retailer sold damaged goods and harmed the salvager’s relationship with its chief supplier.⁴⁰ A coupon distributor claimed damage to goodwill when a former employee “learned the names, addresses, and requirements of plaintiff’s customers” and interfered with customer relationships.⁴¹

³⁴See *Mueller*, 144 Cal. App. 2d 245; *Burton*, 161 Cal. App. 2d 572; *Parkman*, *supra* note 31, at 8.

³⁵Cal. Bus. & Prof. Code section 14100 (“The ‘good will’ of a business is the expectation of continued public patronage”); see *Story*, *supra* note 3, at 157 (using similar “public patronage” language).

³⁶See, e.g., *George v. Burdusis*, 21 Cal. 2d 153 (1942); *New Method Laundry Co. v. MacCann*, 174 Cal. 26 (1916); *Cornish v. Dickey*, 172 Cal. 120 (1916); *Empire Steam Laundry v. Lozier*, 165 Cal. 95 (1913).

³⁷*Bergum v. Weber*, 136 Cal. App. 2d 389, 392 (1955).

³⁸*Id.*; see also *Smith v. Bull*, 50 Cal. 2d 294, 303 (1958).

³⁹*Hunt v. Phinney*, 177 Cal. App. 2d 212, 216 (1960) (“The retention of the lists of customers or records thereof will tend to depreciate or destroy the goodwill of the business by preventing access to those customers”).

⁴⁰*Nadell & Co. v. Grasso*, 175 Cal. App. 2d 420, 431 (1959) (“In the present case there was indirect, if not direct, evidence that respondent would be irreparably injured in ‘the expectation of continued public patronage.’ (Bus. & Prof. Code section 14100), specifically as it concerned [the supplier], if the restriction was not enforced”) (citation in original).

⁴¹*Reid v. Mass Co.*, 155 Cal. App. 2d 293, 305 (1957).

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California is particularly restrictive of the goodwill that accrues to wholesale distributors organized as corporations.⁴² In distribution arrangements, a relationship with a supplier is a prerequisite. A distributor simply cannot have an expectation of future patronage for the supplier's product when a supplier terminates the distributor.

In *California Beverage & Supply Co. v. Distillers Distributing Corp.*,⁴³ a distributor (California Beverage) sued for loss of goodwill when its distribution agreement was terminated. Because California Beverage lost its distribution rights, the court held that it had no goodwill. Citing California's definition of goodwill as the "expectation of continued public patronage,"⁴⁴ the court reasoned that because it was no longer a distributor, California Beverage had no expectation of continued public patronage.

California Personal Goodwill

California Beverage suggests that the express terms of a distribution contract define the extent of a distributor's corporate goodwill. Nevertheless, California law has consistently recognized personal goodwill. There is value in an individual's know-how, personal relationships, and ability, and it does not accrue to the business entity unless it is assigned. Moreover, given the limitations of business goodwill in California, personal goodwill can be especially valuable.

California was the first state to give strong legal imprimatur to personal goodwill as a transferable asset.⁴⁵ Since *In re Marriage of Lopez*,⁴⁶ California courts have referred to personal characteristics of an individual such as age, demonstrated earning power, professional reputation, and skill in ascribing and valuing personal goodwill. Those factors are exemplary rather than all-inclusive.⁴⁷

⁴²See *California Beverage & Supply Co. v. Distillers Distributing Corp.*, 158 Cal. App. 2d 758 (1958).

⁴³*Id.*

⁴⁴Cal. Bus. & Prof. Code section 14100.

⁴⁵*Burton*, 161 Cal. App. 2d at 576 (citation omitted) (This goodwill depends "very much upon the personality of the [owner]; that one man by his personality, his adroitness in conducting his business, his geniality in attracting customers, and his wide acquaintance with his customers, may be capable of doing a profitable business where another, lacking some or all of these qualities may fail, or at least not succeed to the extent his predecessor had attained"); see also *Mueller*, 144 Cal. App. 2d 245; Ibrahim, *supra* note 1, at 9 (As it is commonly understood, personal goodwill "attaches to an individual rather than a business" and "is present when the unique expertise, reputation, or relationships of an individual give a business its intrinsic value").

⁴⁶38 Cal. App. 3d 93 (1974).

⁴⁷*Id.* at 109 ("factors, assuredly not all inclusive, which may tend to provide the trial court with broad latitude in resolving these questions, with one objective being the determination of the fair economic value").

California statutes also explicitly address the sale of goodwill, noting an important exception to the state's generally applicable prohibition on non-compete agreements.⁴⁸ Section 16601 of the California Business and Professions Code applies to "any person who sells . . . goodwill,"⁴⁹ making a transfer of goodwill a prerequisite for the applicability of the exception. California law is also explicit that goodwill is transferable.⁵⁰ State law defines a transfer as the conveyance of title,⁵¹ and California takes the broad view that "property of any kind may be transferred."⁵²

In addition to allowing goodwill to be transferred by express contract, California courts have routinely implied a sale of goodwill. If an asset sale is paired with a covenant not to compete, the seller transfers a substantial interest, and if the seller actively participates in the company, the goodwill goes, too.⁵³ Those cases generally have the following elements:

1. an individual transferor⁵⁴ who appears to transfer goodwill in connection with the sale of his business, whether or not the conveyance of the goodwill is explicit⁵⁵;
2. the act of transfer is a simple conveyance,⁵⁶ so that after the sale the buyer owns the goodwill and the seller does not⁵⁷; and

⁴⁸See Cal. Bus. & Prof. Code section 16601.

⁴⁹*Id.* (discussing the enforceability of covenants not to compete).

⁵⁰Cal. Bus. & Prof. Code section 14102.

⁵¹Cal. Civ. Code section 1039 ("Transfer is an act of the parties, or of the law, by which the title to property is conveyed from one living person to another").

⁵²Cal. Civ. Code section 1044.

⁵³*Hill Med. Corp. v. Wycoff*, 86 Cal. App. 4th 895, 906 (2001) (seller must sell a "substantial interest such that it could be said that the transfer of goodwill was considered").

⁵⁴See, e.g., *George v. Burdusis*, 21 Cal. 2d 153 (1942); *Handyspot Co. of N. Cal. v. Buegeleisen*, 128 Cal. App. 2d 191 (1954); *General Paint Corp. v. Seymour*, 124 Cal. App. 611, 612 (1932) (explicitly referring to sellers as the individual "owners of . . . a paint and varnish business"); *Martinez v. Martinez*, 41 Cal. 2d 704 (1953).

⁵⁵*George*, 21 Cal. 2d at 155 (The seller sold "good will and all of the property of the business"); *Handyspot*, 128 Cal. App. 2d at 195 ("In addition to the sale of stock of merchandise . . . [the seller] expressly agreed 'to use its best efforts to transfer all of its customers'" (emphasis in original)); *Martinez*, 41 Cal. 2d at 705 (the seller had a written agreement to sell his business "including the good will").

⁵⁶*George*, 21 Cal. 2d at 155 (evidence of the transfer was "a bill of sale"); *Handyspot*, 128 Cal. App. 2d at 195 ("while 'good will' is not susceptible of manual delivery, it is transferrable").

⁵⁷*George*, 21 Cal. 2d at 155 (The seller also was to "deliver up the route book in his possession"); *Martinez*, 41 Cal. 2d at 706 (after the sale, the buyer "deriv[ed] title to the good will from him").

3. the buyer can enjoin the seller from behaving inconsistently with the sale of goodwill.⁵⁸

An example of this common fact pattern appears in *Mahlstedt v. Fugit*,⁵⁹ in which an individual sold his business but the agreement did not identify goodwill as one of the assets sold. There was, however, a noncompete agreement.⁶⁰ When the seller claimed that the noncompete agreement was void because no goodwill was sold, the court easily held for the buyer.⁶¹

Similarly, in *Monogram Industries Inc. v. Sar Industries Inc.*,⁶² there was a covenant not to compete but no explicit agreement to sell goodwill. The owner of Sar Industries claimed that a noncompete agreement made in conjunction with his sale of the company was void because he sold no goodwill. Nevertheless, when the seller sold similar products to the same customers, the buyer successfully enjoined the former owner. The court held that the covenant implied that the business had goodwill and had transferred it.

Yet another case is *Bosley Medical Group v. Abramson*,⁶³ in which the seller of a corporation was held to have transferred goodwill despite omitting explicit reference to it in the sale agreement.⁶⁴ The California case law on these and similar points is consistent and voluminous.

Moreover, the pertinent California statute on goodwill and covenants not to compete is long-standing. It was enacted in 1872 and amended in 1945, 1963, 2002, and 2006.⁶⁵ The successive amendments clarified and enhanced the treatment of goodwill, particularly for sole owners providing personal services.⁶⁶ As a matter of California law, the ownership and legal validity of personal goodwill is clear.

⁵⁸*George*, 21 Cal. 2d at 163 (The Supreme Court of California held that the seller should be enjoined from the solicitation of his former customers and that the seller's new employer should be prohibited from obtaining the benefits "of the seller's goodwill that had been sold"); *General Paint*, 124 Cal. App. at 616.

⁵⁹79 Cal. App. 2d 562 (1947).

⁶⁰*Id.* at 564 ("Seller agrees to refrain from entering into the orchard heater business as a manufacturer or owner in whole or in part, for a period of ten years or to act as a salesman or representative of any orchard heater company other than the California Orchard Heater Co.').

⁶¹*Id.* at 565 ("Appellant further contends that since the goodwill . . . was not mentioned in the agreement it was not transferred and that appellant is entitled to continue in the business").

⁶²64 Cal. App. 3d 692 (1976).

⁶³161 Cal. App. 3d 284 (1984).

⁶⁴*Id.* at 290 (citing Cal. Bus. & Prof. Code section 16601).

⁶⁵See Cal. Bus. & Prof. Code section 16601 (2006) (amending Cal. Bus. & Prof. Code section 16601 (2002)).

⁶⁶See *Bosley Medical Group*, 161 Cal. App. 3d at 289 ("the benefits of the amendment to section 16601 would flow most

(Footnote continued in next column.)

Conclusion

Martin Ice Cream has come to be viewed as a leading case. There, the Tax Court held that Strassberg possessed, controlled, and sold his personal goodwill. New Jersey state law governed, and like California, it recognizes personal goodwill.⁶⁷ Strassberg's ability to segregate and sell his personal goodwill distinct from the assets of a business was enabled by New Jersey's legal recognition of these rights.

The result on similar facts is even clearer in California. The state law's limitation of business goodwill to broad customer goodwill and its explicit recognition of personal goodwill across a variety of legal matters make California even more receptive than New Jersey to the ownership and disposition of personal goodwill.⁶⁸ In the absence of explicit transfer documents (employment agreements or covenants not to compete) that assign goodwill to a business entity, goodwill attributable to an individual remains his property under California law.

As a result, goodwill can be transferred outside the business entity that may own the remaining business assets and conduct the business. However, as many federal tax cases reveal, the seller of goodwill must actually own it. He cannot have transferred it back to the corporation through a noncompete agreement or covenant not to compete. Many cases that invoke the personal goodwill moniker simply cannot support those claims on the facts.

Conversely, the fact that many cases lack the right facts does not mean that *all* cases do. Some states recognize personal goodwill, some may not, and some have not considered the issue in this context. Disposing of personal goodwill requires both favorable state law and a solid set of facts. Ultimately, though, *Martin Ice Cream* and its progeny are merely a proper reflection of state property law (and the governing documents) determining who should be taxed on what.

conspicuously to the stockholder in relatively small corporations . . . where the customers or clients have become used to and appreciate the personal service of the vendor stockholder") (citations omitted).

⁶⁷*Dugan v. Dugan*, 92 N.J. 423 (1983).

⁶⁸*Cf. Norwalk v. Commissioner*, T.C. Memo. 1998-279, Doc 98-24175, 98 TNT 147-5 (California accountants found to have goodwill).