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Unending Interest in Personal Goodwill

By Robert W. Wood

In *Martin Ice Cream Co.*, 110 TC 189, Dec. 52,624 (1998), the Tax Court famously held that personal goodwill can be sold outside of a business sale and obviate corporate-level tax. The case is of little interest to large public companies or their advisors. But if you represent entrepreneurs and their companies, it never seems to go out of style. For recent discussion, *see* Robert W. Wood, *Personal Goodwill and the Emperor of Ice Cream*, M&A TAX REP., October 2010, at 1.

Under arguably unique facts, the Tax Court ruled that intangible assets embodied in a founder's oral agreements were not corporate assets of his company. The Tax Court also found that the transfer of those goodwill assets to a buyer and their eventual sale to someone else could not be attributed to the company. That truly made the personal goodwill sale, well, *personal*.

Martin Ice Cream is usually invoked in the context of the sale of an integrated business. The buyer may or may not care how the purchase price is allocated and precisely to whom it is paid. In the acquisition of a closely held business, the company and the owner will both be signatories to various documents. That can make this issue seem deceptively simple.

Plainly, the allocation of consideration is important. However, it may be less important than other aspects of the deal. However, taxpayers often seem to want to make *Martin Ice Cream* into something it is not.

Case in Point

In *J.P. Kennedy*, 100 TCM 268, Dec. 58,339(M), TC Memo. 2010-206 (2010), Kennedy formed a sole proprietorship to engage in employee benefits consulting. Five years later, he incorporated KCG International, Inc. as a C corporation. For the next 10 years,

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Kennedy was KCG's sole shareholder and president as it continued to provide employee benefits consulting.

Employers who retained KCG did not execute contracts either with KCG or with Kennedy. KCG had two full-time employees, Kennedy and an unrelated person named Dolatowski. Notably, Kennedy did not have an employment or noncompetition agreement with his corporation.

Kennedy was approached by M&P, a potential buyer. Early on, it appeared that M&P would pay 150 percent of the predicted annual income from KCG clients, subject to various adjustments. Based on the formula, the expected sale price was $660,000. It was to be paid 40 percent at closing and 60 percent over five years.

One More Thing …

Later, there was discussion that 25 percent should be treated as payment for consulting, with 75 percent of the consideration allocated to Kennedy's personal goodwill. The concern, of course, was that payments would be taxed twice, first to KCG, and then to Kennedy. One advisor suggested that perhaps Kennedy could sell the customer list and goodwill himself. They drafted documents allocating 75 percent of the purchase price to Kennedy's goodwill, with the remaining 25 percent allocated to consulting services.

The transaction closed shortly thereafter. The asset purchase agreement required the target to convey its relationship with 46 clients. The goodwill agreement required Kennedy to convey his personal relationships with the same 46. Almost all of them had been long-time clients of Kennedy even before he incorporated.

The agreements prevented Kennedy from competing in employee benefits consulting. Post-closing, Kennedy began work with M&P, as did the other former KCG employee, Dolatowski. However, the latter quit after only two months. Kennedy then devoted far more time to his new role than he had anticipated.

In fact, during the first year after the transaction, 46 percent of M&P's revenue was traceable to time billed personally by Kennedy. Nevertheless, Kennedy did not receive *any* wages or fees from M&P other than payments under the sale documents. Approximately a year after closing, Kennedy worked out a new agreement and began receiving wages as well as the continuing payments under the goodwill agreement.

Paying the Piper

The central issue in the case was just what these payments were. Were the payments Kennedy received proceeds from the sale of personal goodwill and therefore taxable as capital gain? Alternatively, were they payments for services and therefore taxed as ordinary income?

The IRS argued that KCG, not Kennedy, owned the customer list. Kennedy had no contracts with any clients, and had no proof of the existence of *any* goodwill asset. Predictably, Kennedy relied on *Martin Ice Cream.*

Whether goodwill exists as a capital asset of a sole proprietor and whether the goodwill was transferred are questions of fact. The Tax Court acknowledged that a payment to a service provider *can* in some circumstances

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be considered a payment for goodwill. Yet it was convinced the payment to Kennedy was for services.

Timing and Intent

It plainly did not help matters that the 75 percent allocated to goodwill was a tax-motivated afterthought lacking economic reality. Initial negotiations had resolved the purchase price at $660,000 minus Dolatowski's base salary. In fact, this payment was to be adjusted over five years to reflect Kennedy's success in integrating KCG clients into M&P.

The 75/25 allocation did not reflect the value of goodwill in relation to other aspects of the transaction. Kennedy undertook M&P work for five years. He gave a valuable noncompete. He even worked for 18 months post-closing without compensation.

These facts made it clear that the payments were really not for goodwill. Kennedy's payments represented ordinary income either for services or for a promise not to compete. Furthermore, they were subject to self-employment taxes. But at least the court held accuracy related penalties should not be imposed—Kennedy had reasonable cause and acted in good faith.

Conclusion

Why did Kennedy's *Martin Ice Cream* position fail? The answer lies in the belated nature of his personal goodwill allocation and its richness. It can also be explained by the fact that his personal services were putatively receiving no compensation whatsoever.

A sale of personal goodwill can sometimes provide a seller with a huge benefit: a payment outside the company reported by the individual as long-term capital gain. Where a seller has unique skills and a strong personal relationship with customers distinct from the corporate goodwill, the personal goodwill possibility can be worth considering. But be sure to assess whether the individual is bound by a covenant not to compete.

Furthermore, if the sale of personal goodwill occurs at the same time as the company's sale (as it usually will), don't be greedy. That may well count as universal advice.