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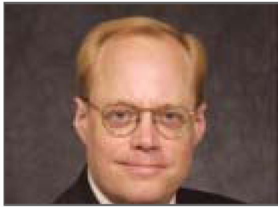

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When Selling A Business, It Matters Who Owns What

In business–especially small business–the owners may not always distinguish between personal and business assets. The company may be a partnership, LLC, C or S corporation (for the difference, see C or S Corporation Choice is Critical for Small Business). Who owns what may not matter until time to sell.

This year our 15% capital gain rate soars to ***23.8%*** in 2013. See No Matter Who Wins The Election, Higher Taxes Are Certain. That's one reason this year-end will be a busy one. See Looming Tax Hike Motivates Owners to Sell. And some sellers may wonder who owns–and who has to pay tax on–what.

Suppose Sam owns 100% of SamCo and works 80 hours a week for 30 years. Sam sells it to BigBuy, which signs agreements with SamCo and Sam. BigBuy wants all assets but is unlikely to care whether SamCo or Sam sells them. In addition to equipment, inventory, and accounts receivable, the ***goodwill*** of Sam's business is the expectation customers will continue to patronize it.

If the hard assets are worth $100 but Sam sells for $150, the extra $50 is probably for goodwill. Invariably, Sam will be expected not to compete with BigBuy. But whether Sam or SamCo owns the goodwill (or each owns some) may hinge on local law and the agreements.

For example, if Sam signed an employment agreement with SamCo, SamCo probably owns it all. Similarly, if Sam transferred all his business assets to SamCo when he incorporated it, that too may mean SamCo owns it all. But what if Sam never signed anything and has been the driving personality of the business?

In *Martin Ice Cream Co. v. Commissioner*, the Tax Court held that personal relationships of a shareholder-employee aren't corporate assets where the employee has no employment contract with the corporation. See Personal Goodwill and the Emperor of Ice Cream. If Sam owns the goodwill, that part of the purchase price should not pass through SamCo with its corporate tax. That may mean a 15% tax rather than more than double it.

In *H&M, Inc. v. Commissioner*, the Tax Court re-invigorated this principle. Harold Schmeets sold his insurance brokerage to a competitor, and the buyer hired Schmeets individually. The IRS claimed his pay was disguised purchase price that ***should have*** been paid—and taxed to—his corporation. Ruling against the IRS, the Tax Court held that Schmeets' personal goodwill ***didn't*** belong to the company.

Schmeets stood out among local insurance agents. Buyers wanted him personally, not the company. The goodwill was his ***personally***, and the amounts the bank paid him were not disguised purchase price.

These "personal goodwill" cases require unique facts. Where they fit, though, the tax benefits can be significant. Whether you are selling this year or next, look before you leap.

Robert W. Wood practices law with Wood LLP, in San Francisco. The author of more than 30 books, including Taxation of Damage Awards & Settlement Payments (4th Ed. 2009 with 2012 Supplement, Tax Institute), 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.