

PURCHASE PRICE ALLOCATION

Personal Goodwill – An Opportunity to Recognize LTCCG and Avoid Double Taxation

I. Context and Overview

The sale of a C corporation's¹ assets generally results in double taxation on the sale proceeds, first, at the corporate level, and then upon distribution of proceeds to its shareholders, at the personal level. However, individual business owners of C corporations who can establish that their personal goodwill is integral to the business and is not an asset of the corporation have an opportunity to improve their tax position upon the sale of the corporation. Such owners may (i) avoid the double taxation on a portion of the sales proceeds by allocating a portion of the sales price to personal goodwill as an asset owned by the business owner, and not the corporation; and (ii) recognize long term capital gain (LTCCG) on the portion of the sales price allocated to personal goodwill, instead of ordinary income which the business owner would recognize for payments related to other intangible assets (i.e. covenants not to compete).

II. Benefits of Allocating a Portion of Sale Proceeds to Personal Goodwill

- Avoids triggering corporate level tax for that portion of the proceeds
- Individual shareholders who possess the personal goodwill of the selling corporation recognize LTCCG on that portion
- Purchaser can amortize the value allocated to personal goodwill as a IRC Section 197 intangible asset over a 15 year period

III. Comparison to Allocating to other Intangible Assets, such as Non-Compete Covenants or Consulting/Employment Services

- Disadvantage - Individual shareholder who receives payment allocated to non-compete covenants recognizes payments as ordinary income instead of LTCCG
- Neutral - Avoids corporate level tax
- Neutral – Purchaser receives amortizable IRC 197 asset

IV. Applicability

The opportunity for a shareholder to recognize LTCCG and avoid double taxation applies in fact specific situations. The most common scenario involves a shareholder who has strong personal relationships with the selling corporation's customers, key suppliers, joint venture parties, etc... and does not have pre-existing non-compete covenants or employment contracts with the selling corporation restricting the shareholder from transferring those relationships to a third party.

¹ This concept also applies to an S corporation that converted from a C corporation to an S corporation within 10 years prior to a sale transaction (IRC Section 1374).

While the circumstances in which a shareholder may avail him or herself of this opportunity are limited, recognizing the opportunity exists and analyzing its usefulness and value is imperative to address early on in representing a closely held C corporation. The importance of establishing restrictions and otherwise affecting relationships that support personal goodwill must be weighed against the value of preserving the possibility of selling the personal goodwill in a future transaction.

V. Factors - To effectively invoke the benefits of allocating a portion of the sales price to personal goodwill, in addition to the premise of a sale of assets (not stock) by a selling entity that is a C corporation, the Tax Court² and certain federal courts have established several criteria, or factors, that they consider when determining if personal goodwill exists and the allocation of value to personal goodwill:

- The owner(s) of the selling business is integrally involved in the business operations
- The business is primarily built on the strength of the owner's personal relationships, reputation, skills, and know-how
- No employment agreement or non-competition agreement exists between the selling entity and the owner(s) (if in existence, it will be deemed to have transferred the asset of personal goodwill to the selling entity)
- The success of the business is based on few, high volume customers
- The contracts with these customer and other relationships are terminable at will
- The allocation of the portion of the purchase price to the personal goodwill as compared to other assets of the selling business must be reasonable; obtaining a an independent appraisal is preferred
- The loss of the individual(s) would negatively impact the revenue and profitability of the business
- The owner(s) enter into a consulting or employment agreement with the purchaser

The existence of all or a portion of these factors will generally support a determination that (i) an individual possess personal goodwill; and (ii) a higher allocation of value to that personal goodwill.

VI. Transaction Tips

- Discuss possible personal goodwill allocation in a sale event early on in representing a C corporation. Decisions whether to enter into an employment agreement with restrictions or a separate non-compete covenant for the benefit of the corporation, which could be deemed to transfer the asset of personal goodwill to the company may be driven by this allocation issue.

² Martin Ice Cream Co. v. Commissioner, 110 T.C. 189 (1998); William Norwalk, et al. v. Commissioner, TC Memo 1998-279. .

- Upon entering into initial discussions related to the sale of the C corporation's assets, analyze the benefit of asserting the position of allocating a portion of the sales price to personal goodwill
- Document the sale of the personal goodwill as an asset sold separate from the assets of the selling corporation
- Consider obtaining an appraisal of the value of the personal goodwill to support the allocation