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The Tax Benefits and Challenges of Allocating Total Business Goodwill to Personal Goodwill in a Transaction

By **Lisa Tran** | Vice President, Portland

Introduction

Several potential benefits entice stockholders to convert their S corporation to a limited liability company ("LLC"). In most states, the members of an LLC are protected from creditors by the "charging order" statutes. A charging order issued by a court allows a creditor to receive any profits the LLC member earns from his or her investment in the LLC. However, creditors with a charging order cannot assume ownership of an LLC member's interest or attain any management or voting rights in an LLC. The protection offered to the LLC member by the charging order statute varies state by state.

Shareholders also may wish to convert an S corporation to an LLC to reduce potential tax liabilities. A potential capital gain occurs when the value of an S corporation increases from the date it is formed to the date it is converted to an LLC. If there is a capital gain, the corporation's shareholders will pay taxes on the gain (i.e., the difference between the fair market value of the property distributed to the shareholders and its basis in the corporate stock). Therefore, the sooner the conversion occurs, the less significant the tax liability likely will be on the liquidation or conversion.

In the transfer of assets from one enterprise to another, for tax purposes, closely held business owners are faced with the challenge of allocating portions of the total enterprise value between (1) company-owned entity goodwill and (2) individual shareholder/employee-owned personal goodwill. If a selling shareholder can classify the transferred assets as personal goodwill, these assets may qualify as a tax-deferred exchange (of personal goodwill for corporation stock) under Section 351 of the Internal Revenue Code. This rule states that no gain or loss shall be recognized (1) if a property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and (2) if immediately after the exchange, the transferor(s) are in control of the corporation.

When personal goodwill is not transferred in a transaction, the issuance of new shares by the acquiring corporation is treated as taxable, equity-based compensation in exchange for the shareholder/employee's "sweat equity" in the newly formed company. The S corporation shareholder will recognize a gain on the surrender of his or her stock equal to the difference between the fair market value of the property distributed after liquidation and the book basis in the corporate stock. The gain is determined as though the corporation sold the asset(s) at their full fair market value.

A shareholder's sale of personal goodwill could result in the selling shareholder being subject to capital gains taxes on any capital gains resulting from the sale, at a federal rate up to 23.8 percent (i.e., maximum capital gains tax rate of 20 percent, plus 3.8 percent net investment income tax).

The potential significant tax savings that could be achieved by selling shareholders from the transfer of assets from one enterprise to another motivates closely held business owners to allocate as much of the total enterprise value as possible to individual shareholder/employee-owned personal goodwill rather than company-owned entity goodwill.

What is Goodwill?

There are three divisions of goodwill: (1) entity or enterprise goodwill, (2) transferrable (salable) personal goodwill, and (3) "pure," personal goodwill.

Enterprise goodwill is the value of earnings or cash flow directly attributable to the enterprise's characteristics or attributes. Enterprise goodwill, sometimes referred to as practice goodwill, is a function of the earnings from repeat business that will patronize the business as opposed to the individual, new consumers who will seek out the business, and new referrals that will be made to the business.[1]

PERSONAL GOODWILL IS THE VALUE OF EARNINGS OR CASH FLOW DIRECTLY ATTRIBUTABLE TO AN INDIVIDUAL'S CHARACTERISTICS OR ATTRIBUTES

Entity goodwill is attached to the entity or enterprise and belongs to the enterprise. Entity goodwill includes: (1) the company name, (2) the company phone number, (3) the company location, (4) special attributes (e.g., special menus or recipes at a restaurant), and (5) the company's trained and assembled workforce. Entity goodwill can exist when no shareholder or employee is critical to the success of the company.

Personal goodwill is the value of earnings or cash flow directly attributable to an individual's characteristics or attributes. Personal goodwill, sometimes referred to as professional goodwill, is a function of the earnings from repeat business that will patronize the individual as opposed to the business, new consumers who will seek out the individual, and new referrals that will be made to the individual.[2]

"PURE" GOODWILL IS UNIQUE TO THE INDIVIDUAL AND CANNOT BE TRANSFERRED TO ANOTHER

Within personal goodwill, transferrable (salable) goodwill has been developed and nurtured by the individual possessing it. However, transferrable personal goodwill may be deemed an asset of a corporation if the shareholder can transfer the goodwill to the corporation through a noncompetition, employment, or other agreement.

Also within personal goodwill, "pure" goodwill is unique to the individual and cannot be transferred to another. Pure personal goodwill can relate to specialized skills that cannot be transferred, such as the skills of a surgeon. Pure personal goodwill is not included in a company's value that is determined under the fair market value standard because it cannot be transferred or sold. Personal goodwill also exists when the shareholders of a company are critical to its success and the loss of such shareholders can detrimentally affect the company's value.

Personal goodwill often exists for highly technical, specialized, or professional services corporations. In addition, shareholders of companies that have few customers or suppliers may own personal goodwill as the success of the company is dependent on these shareholders maintaining these relationships.

Personal Goodwill Recognized by the Court

Since 1944, the courts (tax and family) have concluded that goodwill is personal and separate from the company if the owner(s)/shareholder(s) have established contacts and relationships with customers that are critical to the success of the business.

To prove the existence of personal goodwill, the business owner must establish first that the personal goodwill exists separately from the corporation's entity goodwill. Personal goodwill has a property value that is dependent solely on the personal characteristics of the individual business owner. The personal characteristics can include the personal relationships, ability, personality, and reputation of the individual shareholder; specifically, when the company does not have a right by contract or other means to that individual's future services.

Second, to prove the existence of personal goodwill, the individual shareholder must possess the right to sell his or her goodwill. The personal goodwill must be the shareholder's asset, and the shareholder cannot have previously transferred the asset to the corporation.

TAX COURT RULED THAT PERSONAL GOODWILL CAN BE SOLD SEPARATELY FROM A BUSINESS SALE

Martin Ice Cream Company v. Commissioner (1998)[3] is a case frequently cited for the purpose of addressing the concept of personal goodwill. In this case, the Tax Court ruled that personal goodwill can be sold separately from a business sale, thereby enabling the selling shareholder to avoid, legitimately, corporate-level taxes.

Martin Ice Cream Company ("MIC") was incorporated in 1971 by Martin Strassberg, its sole shareholder at the time, as a wholesale ice cream distributor to small grocery stores and food service accounts. Martin's father, Arnold Strassberg, had developed relationships with the owners and managers of several supermarket chains through the ownership of Arnold's Ice Cream, to distribute ice cream to supermarkets to sell under their private labels. In the late 1960s, Arnold's Ice Cream filed for bankruptcy due to the loss of a major supplier. In 1979, Arnold became a 51 percent shareholder of MIC.

In 1974, Arnold partnered with Haagen-Dazs through a verbal agreement with Haagen-Dazs founder, Ruben Mattus, to introduce and distribute Haagen-Dazs ice cream to supermarket chains, which sparked a revolution in the retail sale of premium ice cream in supermarkets. While Arnold was successful in expanding the distribution of ice cream to supermarket chains, Martin did not agree with his father's strategy to expand the supermarket business.

A PRIMARY REQUIREMENT REGARDING THE EXISTENCE OF PERSONAL GOODWILL IS FOR THE BUSINESS OWNER TO ESTABLISH THAT HIS OR HER PERSONAL GOODWILL EXISTS SEPARATELY FROM THE CORPORATION'S ENTITY GOODWILL

In May 1988, the MIC board of directors formed a subsidiary, called Strassberg Ice Cream Distributors, Inc. ("SIC"). In June 1988, MIC transferred its interest in the supermarket business (i.e., the Haagen-Dazs Ice Cream distribution rights to supermarkets chains) to SIC, and Arnold exchanged his stock in MIC for stock in SIC, thereby separating the operating businesses of Martin and Arnold. Martin operated the business of distributing ice cream to small independent grocery stores, while Arnold operated the business of delivering ice cream to supermarket chains.

In July 1988, Arnold, as president of SIC, solely negotiated and entered into a purchase and sale of assets agreement to sell the supermarket distribution rights to Haagen-Dazs for $1.5 million. In April 1989, SIC filed Form 1120S for tax year 1988. SIC reported its sale of the assets, including the SIC business records valued at $286,068 and goodwill (i.e., the "right to distribute" Haagen-Dazs ice cream) valued at $1,144,272. Arnold, as the sole stockholder of SIC, reported the gain from the sale on his personal income tax return for tax year 1988. In July 1989, Arnold dissolved SIC.

A primary requirement regarding the existence of personal goodwill is for the business owner to establish that his or her personal goodwill exists separately from the corporation's entity goodwill. The Tax Court found that Arnold's personal relationships with the supermarket owners and Mattus enabled him to successfully build the wholesale distribution of superpremium ice cream to supermarkets.

The second requirement for the existence of personal goodwill is that the individual shareholder possesses the right to sell his or her personal goodwill. The Tax Court found that Arnold was the sole owner of the assets sold to Haagen-Dazs. Arnold, as the sole shareholder and president of SIC, entered into a contract to sell to Haagen-Dazs two distinct assets: (1) Arnold's rights under his oral agreements with Mattus and his relationships with the owners and managers of the supermarkets, and (2) the business records generated by Arnold during his development of the supermarket business, which were transferred by MIC to SIC in 1988.

THE TAX COURT RECOGNIZED THAT THE PERSONAL RELATIONSHIPS OF A SHAREHOLDER-EMPLOYEE ARE NOT CORPORATE ASSETS WHEN THE EMPLOYEE HAS NO EMPLOYMENT CONTRACT WITH THE CORPORATION

The Tax Court also noted that MIC did not own the Haagen-Dazs distribution rights because Arnold never entered into a convent not to compete with MIC or any other agreement (i.e., an employment agreement) that would have transferred to MIC (1) the ownership of Arnold's distribution agreement with Mattus, (2) Arnold's relationships with key supermarket owners and managers, and (3) Arnold's expertise in distributing ice cream to supermarkets. The Tax Court recognized that the personal relationships of a shareholder-employee are not corporate assets when the employee has no employment contract with the corporation.

A Method for Determining Personal Goodwill

Once personal goodwill is proven to exist, separating a corporation's personal goodwill and entity goodwill can be a challenging task. To distinguish enterprise goodwill from personal goodwill, David Wood developed the multi-attribute utility model ("MUM"), which was validated by the court in *Lieberman v. Lieberman*.[4] The MUM first divides certain attributes into two groups, one for enterprise goodwill and one for personal goodwill, and then applies relative weights to confirm the conclusions.

The MUM steps are:

1. Define the objective, which is to determine the allocation of total goodwill between personal goodwill and enterprise goodwill.

2. Establish alternatives for the possible outcomes that the MUM will produce. Each alternative represents a range of personal goodwill percentages. The ranges for enterprise goodwill are the reciprocal percentages. The outcome for each alternative is a specific percentage within the range.

   An example of potential alternatives is presented below.

	Personal Goodwill			Enterprise Goodwill		
Alternatives	From	To	Outcome	From	To	Outcome
1	0%	20%	10%	80%	100%	90%
2	20%	40%	30%	60%	80%	70%
3	40%	60%	50%	40%	60%	50%
4	**60%**	**80%**	**70%**	**20%**	**40%**	**30%**
5	80%	100%	90%	0%	20%	10%

3. Define the attributes and divide them between the two categories of goodwill. To select the attributes, the analyst must assess each attribute's potential contribution toward the earnings of the business. Examples of goodwill attributes include (1) ability, skills, and judgment; (2) age and health of the owner; (3) closeness of contact with clients or patients; (4) comparative personal success in the subject industry; (5) marketing and branding associated with the individual; (6) marketing and branding associated with the subject company; (7) personal in-bound referrals; (8) personal reputation; (9) personal staff; (10) work habits; (11) ancillary services; (12) assets in use; (13) business name; (14) business reputation; (15) repeating revenue streams; (16) systems and organizational structure; (17) workforce in place; (18) business location; and (19) barriers to entry.[5]

   Examples of personal and enterprise goodwill attributes are presented below.

Goodwill Attributes[6]

Personal Goodwill	Enterprise Goodwill
Nontransferable	Number of offices
Specialized knowledge	Business location
Personalized name	Multiple service providers
In-bound referrals	Enterprise staff
Personal reputation	Systems
Personal staff	Years in business
Age, health, and work habits	Outbound referrals
Knowledge of end user	Marketing

4. Measure the utility of each attribute, which is a two-step process.

   First, assess the attribute's importance utility ("IU"). What is the attribute's effect on company earnings? The greater the effect, the greater the importance. An example of IU weights: weight of 1 (least important), weight of 3 (moderately important), and weight of 5 (most important).

   Second, the analyst assesses the attribute's existence utility ("EU") or how strong the presence is of the attribute. Does the presence of the attribute add to the earnings of the business? An example of EU weights: weight of 0 (weak presence), weight of 1 (below average), weight of 2 (moderate presence), weight of 3 (above average), and weight of 4 (strong presence).

5. Aggregate the results (i.e., perform the math). Below is an example of a MUM calculation.

MUM Goodwill Allocation Example				
Personal Goodwill Attributes (PGA)	Importance Utility (IU)	Existence Utility (EU)	Multiplicative Utility (MU)	
1. Nontransferable	5	3	15	
2. Specialized knowledge	5	4	20	
3. Personalized name (of the individual)	5	3	15	
4. Personal in-bound referrals	5	3	15	
5. Personal reputation of the individual	5	3	15	
6. Personal staff	1	3	3	
7. Age, health, and work habits of the individual	5	4	20	
8. Knowledge of enduser	1	3	3	
Total Utilities	**32**	**26**		
Total Multiplicative (PGA) Utility			**106**	**76%[A]**
Enterprise Goodwill Attributes (EGA)	Importance Utility (IU)	Existence Utility (EU)	Multiplicative Utility (MU)	
1. Number of offices	1	1	1	
2. Business location	3	1	3	
3. Multiple service providers	1	2	2	
4. Enterprise staff	1	1	1	
5. Systems and organization *(i.e, policies, manuals)*	3	3	9	
6. Years in business	5	2	10	
7. Outbound referrals	5	1	5	
8. Marketing and branding	3	1	3	
Total Utilities	**22**	**12**		
Total Multiplicative (EGA) Utility			**34**	**24%[B]**
Total Multiplicative Goodwill Utility (PGA+EGA)			**140**	

A) Total PGA multiplicative utility divided by total multiplicaitive goodwill utility.
B) Total EGA multiplicative utility divided by total multiplicaitive goodwill utility.

6. Evaluate the alternatives. In the example presented above, the total multiplicative utility for the personal goodwill is 76 percent, which falls into alternative 4 (60 percent to 80 percent). Therefore, the outcome is 70 percent allocated to personal goodwill.

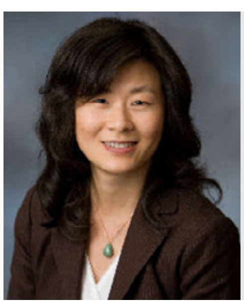
7. Express an opinion based on the MUM result. If total goodwill is estimated at $1.0 million, then based on the MUM example, $700,000 would be allocated to personal goodwill, and $300,000 would be allocated to enterprise goodwill.

Conclusion

In transferring assets from one enterprise to another, it may be important to distinguish between personal goodwill and entity goodwill for tax reasons. Closely held business owners can realize potentially significant tax savings if they are able to allocate portions of the total transferred enterprise value between (1) company-owned entity goodwill and (2) individual shareholder/employee-owned personal goodwill. If a selling shareholder can prove that personal goodwill exists separate from entity goodwill, the selling shareholder (i.e., taxpayer) can defer paying taxes on the related sale proceeds or pay taxes at a lower rate.

Over the years, courts have followed the *Martin Ice Cream* decision in recognizing that the portion of goodwill value attributable to the personal abilities and relationships of the shareholders/employees of a corporation is not the property of the corporation unless there is an employment agreement or noncompetition agreement that transfers these intangible assets to the corporation.

If both personal goodwill and business goodwill exist in a company, determining the allocable share of a transaction price to personal and business goodwill in a sale of the company requires (1) assessment and analysis of the company and identified intangible asset value by a qualified, independent business appraiser, (2) clearly identified assets in related purchase price agreements, and (3) agreement regarding the transferred assets between the selling and the acquiring parties. Proving the existence of personal goodwill includes documenting the traits and characteristics of personal goodwill used in the business operation and documenting evidence supporting the ownership of that goodwill by the selling shareholder (i.e., absent an employment contract or noncompete agreement before any sale or transfer of the goodwill).



About the Author

Lisa Tran is a vice president of our firm. She can be reached at (503)-243-7510 or at lhtran@willamette.com.

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