How Personal Is Goodwill?

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Readers of the M&A TAX REPORT may have a love-hate relationship with goodwill. Historically, allocations to goodwill were undesirable if you were a buyer, and often undesirable if you were a seller too. In the wake of the enactment of Code Sec. 197, some buyers aren't quite so upset at goodwill allocations as they used to be. If sellers are receiving capital gain treatment, they are doubtless not upset at all, at least if there is only a single layer of tax on the gain.

Indeed, perhaps the greatest bonanza of all in the realm of goodwill relates to the highly personal topic of personal goodwill. If you get it, it has nothing to do (the theory goes) with the business entity. If you have a C corporation, and you as, a key owner. enter into a separate personal goodwill agreement, some of what might in other circumstances be viewed as a part of the purchase price for the company can be paid to you personally. But hold on, I'm getting ahead of myself.

What got me thinking about personal goodwill was the recent case of *I. Muskat*, DC NH, 2008-1 USTC ¶50,283 (Apr. 2, 2008). This was a tax refund suit arising out of a sale of a business. Muskat sold his business in 1998, and reported a $1 million payment as ordinary income.

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He later filed an amended return seeking a tax refund, arguing that the $1 million actually represented a sale of personal goodwill, thus taxable (to him personally) at capital gain rates. Muskat lost out on this argument, but it is worth examining why he failed, and what he might have done differently to prevail.

A Rose Is a Rose?

Lawyers are wordsmiths. Documents are important. What they say is important. If they do not say what you want them to say, it is often hard to later argue that they said something else.

I admit that these aphorisms sound a little like a Robert Fulgham book, the ubiquitous author of ALL I REALLY NEEDED TO KNOW I LEARNED IN KINDERGARTEN (Dramatic Publishing 1989). Still, that doesn't make these observations less true.

Muskat owned a meatpacking company in New Hampshire and Massachusetts and cultivated many personal relationships with customers and suppliers over a lifetime. By 1987, he owned 37 percent of this family corporation and had many personal relationships with customers and suppliers of a business that produced $130 million in annual revenues.

In 1998, after protracted negotiations, Muskat sold his company *via* an asset sale. Significantly, there were separate agreements covering noncompetition, employment, *etc.* After much negotiation, an asset purchase agreement was eventually signed March 31, 1998.

Among the consideration was a nearly $16 million payment for the company's goodwill. An employment agreement required Muskat to work personally for the company for 13 years, although it appears this was largely a noncompete agreement. It called for a $1 million payment on the date of the agreement, and several additional payments over ensuing the years.

On his 1998 tax return, Muskat reported the $1 million payment he received under the noncompete agreement as ordinary income, paying his income tax and self-employment tax on that amount. Several years later, Muskat filed an amended return claiming that the $1 million was attributable to a sale of his personal goodwill in the company. That meant capital gain. The IRS denied the claim, and the matter went to district court.

Personal Goodwill Cases

Perhaps the most famous personal goodwill case is *Martin Ice Cream Co.,* 110 TC 189, Dec. Dec. 52,624 (1998). In that case, a family member operated without an employment agreement or noncompetition agreement and had many oral agreements with customers and extensive personal contacts. Those were viewed as his own assets, and not as an asset of the business. In the post–*General Utilities* world, that can be a quite momentous advantage.

The personal goodwill theory pops up in other contexts too. Thus, *Matter of Prince*, CA-7, 85 F3d 314 (1996), involved an orthodontist's goodwill in his own practice for purposes of bankruptcy valuation. Like so much else in the tax laws, much of this area involves shadings of all the facts and circumstances. The district court in *Muskat* relied upon *Harvey Radio Labs, Inc.*, CA-1, 73-1 USTC ¶9121, 470 F2d 118 (1972). That case is limiting.

Indeed, as noted by the *Muskat* court, the *Harvey Radio* case suggests that there must be strong proof of the parties' intentions when they entered into the noncompetition agreement. To prevail on a personal goodwill claim, one must show strong proof that, despite the express terms of the agreement, the parties intended a particular payment to be compensation for personal goodwill. Ultimately, Muskat simply couldn't meet that standard.

This seems a shame, for the background and facts of the case suggest that Muskat probably could have had a pretty decent personal goodwill argument. Despite all the negotiation, which had been considerable, this point apparently never got made. It certainly wasn't made in the documents. Going back several years later, it was a near Herculean task to prove it.

Rewriting History

Muskat argued (with considerable force) that the provisions in his noncompetition agreement—including the long term of the agreement and a survivability provision which guaranteed future payments even on his death—were unusual. Those provisions showed, he argued, that the agreement really amounted to a sale of his personal goodwill. Indeed, his age, his lack of interest in competing with the new buyer, his employment and his investment in the acquiring company (which had been required) all made it clear that there was no real practical need for a noncompetition agreement.

Arguing that a noncompetition agreement was not necessary, Muskat contended that the amounts paid under that agreement therefore had to be regarded as paid instead for his personal goodwill. Those are all persuasive points.

Why, then, did Muskat fail?

It is an *awfully* tall order to convince a court (or anyone else) that a document labeled a noncompetition agreement, which expressly says that it prohibits competition and provides payment for same, is really a payment for something else. An attempted clarification of the parties' intentions after the fact—particularly a one-sided clarification—just doesn't ring quite true. Sometimes, after all, things are just what you call them.