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Who Controls Goodwill?

By Robert W. Wood and Dashiell C. Shapiro • Wood LLP • San Francisco

When selling a business, the nature of what is sold, and who is selling it, has a big impact on taxes at the end of the year. If a key individual (say a star CFO) sells his own goodwill in connection with a sale of a business, it may be possible to avoid corporate taxes. But if the goodwill belongs to the company, it is the company's gain.

Whose Goodwill?

"Goodwill" is generally defined as the expectation that customers will continue to patronize a business. There is almost always goodwill in a business sale. If John sells a business with hard assets worth \$50 but the buyer pays \$150, the extra \$100 is probably for goodwill. And if these numbers are in the millions, that can mean considerable tax savings are at stake. So it's important to determine whether John owns the goodwill, and whether he transfers it in connection with any sale of the business.

Personal goodwill may be referred to by different names, but it is personal because it accrues to an individual rather than a business. It has personal content, being rooted in the skill, talent and relationships of an individual.

In *Martin Ice Cream Co.*, 110 TC 189, Dec. 52,624 (1998), the seminal case on personal goodwill, the company's owner was Mr. Strassberg. He owned assets underlying the business. More importantly, he owned the goodwill because he had control over the economic benefits of the business. His company only benefitted from the business as long as Mr. Strassberg chose to remain associated with the corporation.

Although *Martin Ice Cream* is well known, it wasn't the first case regarding personal goodwill. In *D.K. MacDonald*, 3 TC 720, Dec. 13,898 (1944), the Tax Court recognized that goodwill can belong to an individual. D.K. MacDonald was the sole owner of insurance seller

Carter MacDonald & Co. When the company liquidated, MacDonald treated the goodwill as his own, not treating it as a corporate asset. It's clear that personal goodwill is a concept accepted by courts.

Let's say John's business is selling balloons, which he does through his corporate vehicle, Balloon Lovers Up North, Inc. ("BLUN"). John started his business from scratch, controls 100 percent of the voting shares and, over the years, has built up relationships with all the key balloon suppliers and distributors in his area. He knows absolutely everything about the balloon business.

What happens when the well-known multinational BigBalloon Inc. wants to buy out John's business? Whose goodwill are they buying? Depending on the facts, they might be buying John's goodwill.

To puzzle through this, a key question to

ask is this: *Does the buyer need to control BLUN in order to benefit from the business?* Maybe not. Maybe what they really need to buy is *John*, meaning both his personal business relationships and know-how.

Suppose they only buy BLUN and don't properly arrange for John to exit the business. They might end up with a corporate entity that is worthless. Indeed, John may simply set up shop with a new corporate vehicle and continue to work his balloon business magic. If BigBalloon has any hope of entering and *controlling* the market John once dominated, they may need to buy his personal goodwill *and* ensure that he won't compete with them in the future.


While personal goodwill is an accepted concept, identifying where it exists is trickier. Once one determines that there is goodwill in a business, *who owns it?* The individual that runs the business, or the company itself?

Contracts Count

A corporation does not control the *goodwill* of a business if its distribution agreements are not assignable and can be terminated with no action by the corporation. The owner must be able to exclude others from using or taking the property. As the Supreme Court stated, "The right to exclude others is generally one of the most essential sticks in the bundle of rights that are commonly characterized as property." [*Ruckelshaus v. Monsanto Co.*, SCT, 467 US 986, 1011 (1984).]

In *S.L. Savidge, Inc.*, 4 TCM 545, Dec. 14,578(M) (1945), S.L. Savidge, Inc. distributed automobile parts. The corporation's principal asset was a dealer agreement to distribute Dodge parts. The owners/operators of S.L. Savidge, Inc. were the Savidges, a husband-and-wife team. They decided to liquidate the corporation and continue the business through a partnership.

The question was whether the corporation owned any goodwill at the time of the liquidation. The Tax Court said no. After all, the dealer agreement was not assignable and terminated on liquidation of the corporation. Because of this, the Savidges had to rely on their own personal relationships with Dodge to obtain a new dealer agreement after the liquidation.



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In John's balloon business, we should look to the legal agreements with distributors. Can John terminate these agreements, liquidate BLUN and set up shop under a new entity (with a snazzier name)? If so, BigBalloon may need to tie up John and not merely acquire his corporate vehicle. If John can liquidate BLUN and easily set up new agreements with a new corporate entity, John may control the goodwill in the business.

Another issue is whether BLUN can control its own employees. In *Savidge*, the Tax Court concluded that the corporation did not own goodwill through its employees. None of the employees were bound by an employment agreement or an agreement that restricted their ability to compete with the corporation.

Just as the owners could (and did) walk away from the corporate entity, so could the employees. When this is true, the corporate entity may have very little control over the goodwill. As long as the corporation can reasonably expect its employees to continue to work, it can expect to continue to enjoy the benefits of the business.

But where the corporation lacks this control over its employees, it may not control the goodwill. If BLUN's employees are not working under an employment contract or noncompete agreement, perhaps John rather than BLUN controls the goodwill, especially if the employees are loyal to John.

Dominant Presence

If BLUN doesn't control the goodwill, how can one be sure that John does? Let's look at control over the future benefits of the business. An individual may have control over the goodwill associated with a business by being the dominant presence in the business or having key relationships. This can make the individual a significant barrier to a competitor entering the market. Here, John may have both aspects of control.

In *J.A. Patterson, CA-6, 87-1 USTC ¶9168, 810 F2d 562 (1987)*, James Patterson was a minority shareholder in Long John Silvers, Inc., a fast-food chain. Patterson owned 40 percent, with 60 percent owned by unrelated Jerrico, Inc. Despite his minority interest, the court found that Patterson controlled Long John Silvers. He was the dominant reason behind the success of the business.

The court noted that the business Patterson built was not merely successful. It was a "dramatic success ... with profits margin[s] higher than that of other well managed fast food operations, such as McDonald's." [*Id.*, at 574.] The court said, "Realistically, Patterson's dominant presence in the operations of Long John Silver from its inception and his role in its rise to profitability are clearly aspects of the business which were transferred" [*Id.*] Plus, "[i]f there is reason to believe that the business has prospered because of the character or the reputation of the proprietor or partner ... such reputation or character would also form part of the goodwill." [*R.H. Shulz, CA-9, 61-2 USTC ¶9648, 294 F2d 52, 55 (1961).*]

Noncompete

A key factor in the transfer of personal goodwill is a binding noncompete agreement. In the balloon example, BigBalloon will surely make John sign a noncompete so he doesn't interfere with its new balloon business. Otherwise, he could fly off with their balloon distribution agreements.

In *Patterson*, Patterson agreed not to compete with the business he once dominated. This removed Patterson as an "alternative attraction" in the market, and effectuated the transfer of his personal goodwill.

Similarly, in *J.W. Edelberg*, the Tax Court expressly found that Edelberg's noncompete agreement transferred her goodwill to the purchaser (GFS, a competitor). [70 TCM 393, Dec. 50,829(M), TC Memo. 1995-386.] Edelberg had incorporated Datamed to provide billing and collection services to groups of physicians. Although Datamed had multiple clients, it had one principal client, EPI. GFS purchased Datamed's assets including Datamed's "relationship with EPI." Significantly, however, Edelberg—not Datamed—signed an agreement not to compete in connection with this sale.

Edelberg began to receive payments for the noncompete agreement and claimed the payments were passive in nature (to offset passive losses). But the Tax Court held the income was active in character because the payments purchased Edelberg's personal goodwill. Even though the contract with the principal client was in the corporation's

name, Edelberg was the key service provider. As the public face of the business, Edelberg alone could exclude Datamed from the future benefits of the business. As a result, in order for Datamed's competitor, GFS, to enter the market, it had to purchase control from Edelberg, not from her corporate vehicle. And to do this, it needed Edelberg to sign a noncompete agreement.

Just how important a noncompete can be is clear from *Forward Communications Corp.*, FedCl, 608 F2d 485 (1979). Although the Federal Claims Court held that the noncompete agreement had minimal value, the court said that it was of *pivotal* significance to the transfer of goodwill.

Consulting

Does John need to consult with BigBalloon following the sale in order to transfer his goodwill? Not necessarily. John may agree to consult following the sale and to transfer some of his know-how to the buyer. But if he chooses not to, he still may have sold his personal goodwill.

In *K.M. Davee*, CtCls, 71-1 USTC ¶9479, 444 F2d 557 (1971), a noncompete agreement transferred the goodwill controlled by an individual. The seller, Ken Davee, and the buyer, Lea Associates, Inc., were competitors. Their customers were pharmaceutical companies in a limited market and Davee's business had more customers. Lea purchased Davee's business and Davee signed a noncompete agreement, but *Davee did not agree to perform any services for Lea whatsoever after the sale.*

Lea even stated that the corporation "genuinely had little or no use for Mr. Davee's services or his back records." [*Id.*, at 564.] Lea merely wanted Davee out of the way and didn't want his help going forward. Nevertheless, the noncompete agreement *transferred* Davee's personal goodwill.

Transfer of Intangibles

When selling personal goodwill in a business, there may often be a transfer of intangibles and know-how. *Davee* shows that all that is needed is a noncompete agreement, and that consulting after the sale is not necessary. But it often occurs, and it is another method by which personal goodwill is transferred to the

buyer. These intangibles include any additional benefit which may help the buyer obtain the benefits of the business relationships that have been nurtured over time.

One way to assist the buyer in obtaining these benefits is for the transferor to notify customers and suppliers of the buy-out. John can call his suppliers and let them know he is walking away from BLUN in favor of BigBalloon. The case law recognizes this as a transfer of personal business relationships.

For example, in *Edelberg, supra*, a competitor bought out Datamed, Edelberg's medical billing and collections business. The Tax Court concluded that the purchaser acquired Edelberg's personal goodwill through a noncompete agreement. However, Edelberg also transferred her personal relationship-based intangibles through notices to his customers and suppliers.

Edelberg contacted her customers and suppliers to inform them that her corporation intended to discontinue business and that her competitor, GFS, would be taking over the business. The customers and suppliers were not obligated to continue business with the buyer. But, after the notice, they separately agreed to continue the business relationship (vacated by Edelberg) with the buyer. Indeed, the Tax Court stated:

[Edelberg] contacted each of the emergency room doctors that were affiliated with EPI to inform them that [his corporation] was discontinuing its billing and collection services for EPI and that GFS was taking over these services. EPI, familiar with GFS' business reputation and its billing collection services, agreed to have billing and collection services regarding its patients transferred to GFS.

Transfer of Know-How

John has a wealth of knowledge about the balloon business that he has acquired over the years. These informational advantages relate to pricing, quantities for ordering, where to position balloons at retailer locations and other gems of balloon wisdom. How can he transfer this know-how to the buyer?

John can transfer these intangibles to BigBalloon by consulting after the sale, or simply by allowing

the employees he trained and supervised to remain on and advise the new owners. This latter method is apparent in *Patterson*.

Patterson was instrumental in developing every aspect of his seafood restaurant business, Long John Silvers. In addition to obtaining control from Patterson, however, the buyer also necessarily gained the benefit of the informational intangibles he had developed over the years. To transfer this benefit, the employees that Patterson trained helped pass the information on to the new buyer after they bought the business. Indeed, the Tax Court noted that Patterson left behind a legacy to follow and a successful template for the new owners. Patterson did not need to consult.

It did not matter that employees were the vehicle in transferring the informational intangibles. The essence of a transfer, as respects taxation, is the passage of control over the economic benefits of property rather than any technical changes in title.

After Patterson was bought out, the employees that he supervised and trained remained. The benefits of what he created remained as well. The buyer did not have to start over from scratch.

What's Mine Is Yours?

In the hurly-burly world of the closely held business, it is not always easy to even define goodwill. Finding the dividing line between goodwill that a corporation controls and goodwill that a key individual controls is often more difficult. However, the case law distills some important principles.

First, if the corporation can't control the future benefits of the business, it may not

control the goodwill. If BigBalloon needs to tie up John (and his balloons) to successfully enter the market, BLUN probably doesn't control (and isn't selling) goodwill in connection with this purchase. This is especially true where BLUN does not control its own distribution agreements or employees.

If BLUN doesn't control the goodwill, there's a decent chance John does. If John controls the agreements with distributors as a legal matter (and as a result of his winning personality and long history in the business), he may control the goodwill in the business. That means he—not the company—is in a position to sell it to BigBalloon. What if BLUN doesn't have control over employees? That's another indication that John may control the benefits of the business, especially if the employees are loyal to him.

As a final matter, it's worth noting that *Patterson* involved a fast-food chain with 434 restaurants and many thousands of employees. Many assume—incorrectly—that personal goodwill is *only* present in a small operation with a few employees. *Patterson* proves otherwise. Patterson was not a doctor or lawyer and the business employed thousands of workers. But he still owned the goodwill.

Personal goodwill may be present even in the sale of a large business with thousands of employees. It can also be present when no allocation of the purchase price is made to the noncompete agreement. And it even may be present when the seller does not agree to consult following the sale. Rather, the key issue to consider is whether the corporation being sold controls the goodwill. If it doesn't, and if the buyer needs to obtain a noncompete agreement from whoever does control the goodwill, the goodwill for sale is arguably personal.