C Corporations, Family Companies and Personal Goodwill

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Doesn't *everyone* like ice cream? Perhaps not the IRS, at least not *Martin Ice Cream*. That tax case involved creamy Haagen-Dazs and the prickly legal question of who owned the goodwill associated with an ice cream distribution business. The case is of continuing interest, not in the least because it seems to annoy the IRS.

Ever since *General Utilities* was repealed in 1986, the corporate and personal tax on selling a business has caused many to elect S status or otherwise to reform their business structures so they do not put all their eggs in one C corporation basket. Some closely held businesses remain as C corporations, of course. One reason may be easier accounting and tax compliance.

Another reason may simply be the lack of perceived need for an alternative to C corporations. After all, many a closely held business pays out most of its income as reasonable compensation to employees, including shareholders. In this situation, there may be the perception that double taxation is not a problem. In an operational sense, it may not be.

In contrast, selling out is a different matter. One reason that the IRS may have a particular dislike for *Martin Ice Cream* is the IRS's perception that large numbers of the ice-cream eating public continue to have C corporations. Not only that, some people may unreasonably rely on *Martin Ice Cream*.

That may explain the IRS's latest unsuccessful attempt to limit *Martin Ice Cream* in *Bross Trucking* [107 TCM 1528, Dec. 59,928(M), TC Memo 2014-107]. Rather than helping the IRS stamp out the offending personal goodwill doctrine, *Bross Trucking* did the reverse, as we shall see.

Original Flavor

In *Martin Ice Cream* [110 TC 189, Dec. 52,624 (1998)], Arnold Strassberg sold the assets of Strassberg Ice Cream Distributors, Inc. along with his personal goodwill to Haagen-Dazs. The Tax Court recognized that Strassberg's personal goodwill was a transferrable, intangible asset that he alone owned and sold. And that meant one level of tax.

Mr. Strassberg had worked for over a decade in his own wholesale ice cream distribution business. He developed strong business relationships with supermarket chains, which were his personal contacts and relationships. The founder of Haagen-Dazs had approached him about distributing Haagen-Dazs in supermarkets.

It was a handshake deal, and both parties did well. But by the 1980s, Pillsbury had acquired Haagen-Dazs and approached Strassberg about acquiring his relationships with the supermarket chains. Pillsbury needed the contacts so it could sell Haagen-Dazs to the stores directly. Pillsbury was willing to pay for Strassberg's connections, but it had no interest in buying Martin Ice Cream Co. assets.

As a result, Strassberg created Strassberg Ice Cream Distributors, a new subsidiary of Martin Ice Cream. Strassberg transferred all his supermarket relationships to the new company, and they became the only assets of Strassberg Ice Cream Distributors. In a non-*pro-rata* exchange transaction, Strassberg then tendered his shares in Martin Ice Cream Co. in exchange for all of the stock of Strassberg Ice Cream Distributors.

Strassberg Ice Cream Distributors then sold its assets to Pillsbury for $1.4 million. The IRS said two levels of tax were payable and found this to be an inappropriate end run. However, the Tax Court ruled that intangible assets embodied in Strassberg's oral agreements were not corporate assets of Martin Ice Cream Co.

No transfer of those goodwill assets to Strassberg Ice Cream Distributors could be attributed to Martin Ice Cream. The deal was simply outside the corporation. And ever since then, the IRS has done whatever it can to limit the holding in the case.

No Agreement?

There are several striking facts about *Martin Ice Cream*. A big one is the lack of a written agreement between Strassberg and the corporation. Of course, family-owned companies are often informal. Yet, it was clear that the company would have had a hard time enforcing any argument that the goodwill belonged to the company.

It was Strassberg individually who developed the contacts and relationships. Without an employment agreement or noncompete agreement to which the company could point for legal rights, the company simply had none. This ownership feature of the case is at its root. The company cannot sell what it does not own.

In fact, a 2012 case, *H&M, Inc.* [104 TCM 452, Dec. 59,225(M), TC Memo 2012-290 (2012)] shows the continuing vitality and influence of *Martin Ice Cream*. Moreover, although tax cases come and go, *Bross Trucking* represents another important development that should help convince the IRS that personal goodwill is here to stay.

Who's the Bross?

Did Bross Trucking distribute appreciated intangible assets to its sole shareholder, Mr. Bross? Did Mr. Bross then give the assets to his sons, and if so, should they have been reported as gifts made in 2004? These may not sound like personal goodwill questions, but the first one turns out to be the only important question in the case.

Goodwill is an intangible asset. To address the tax issues, one must begin with the facts to discern who owned it and why. Mr. Bross founded Bross Construction in 1972, working for highway departments in Missouri, Illinois and Arkansas. Mr. Bross was extremely knowledgeable about the road construction industry, personally developed relationships in it and was responsible for completing all projects his company undertook.

This responsibility and control led him to found other businesses for his family. He had the same patriarch's approach to fostering and maintaining relationships for other Bross family businesses. In 1982, he organized Bross Trucking.

Mr. Bross did not have an employment contract with Bross Trucking and never signed a noncompete agreement. For that matter, none of Bross Trucking's employees signed noncompete agreements either. None of Mr. Bross' three sons ever worked for Bross Trucking.

Bross Trucking engaged in hauling construction-related materials and equipment for road construction projects. However, it went beyond handling solely family company projects. Bross Trucking also hauled coal in the winter for other customers.

Its operation was streamlined. Bross Trucking leased most of its equipment from another wholly owned Bross entity, CB Equipment. Bross Trucking paid for all the fuel and maintenance for the leased trucks. Bross Trucking used independent contract drivers to provide the hauling services, not employees.

Relationships and Customers

When Mr. Bross started, trucking was highly regulated. In fact, Bross Trucking operated under Missouri's highly regulated rules for almost 30 years, something that grew to be increasingly problematic as the company faced fines and regulatory compliance problems. Throughout, however, as sole owner of Bross Trucking, Mr. Bross arranged the services for its principal customers.

These principal customers were Bross Construction, CB Asphalt and Mark Twain Redi-Mix, Inc. The latter was owned by Mrs. Bross and two of the Bross sons. In fact, Bross Construction, CB Asphalt and Mark Twain Redi-Mix were *all* owned by Bross family members.

Bross Trucking, however, did not have any formal written service agreements with Bross Construction, CB Asphalt or Mark Twain Redi-Mix. Because of continuing regulatory problems, Mr. Bross decided to cease Bross Trucking operations. In July 2003, Mr. Bross and his three sons met with an attorney to discuss the best way to ensure that the Bross family businesses had a suitable trucking provider.

The attorney recommended that the Bross sons start a new trucking business. Accordingly, the three Bross sons—although not previously involved in Bross Trucking—created LWK Trucking. It would prove to be a different type of trucking company that provided a broader assortment of services than Bross Trucking.

New Dawn

The Bross sons used a different attorney experienced in the transportation industry to acquire the requisite authority, insurance and safety inspections. LWK Trucking was organized on October 1, 2003, with class A voting stock and class B nonvoting stock. Class A stock represented a 98.2-percent interest in LWK Trucking, and class B stock represented the remaining 1.8 percent.

In December of 2003, each of the three Bross sons established a self-directed Roth IRA. Each son directed his Roth IRA to acquire 2,000 class A shares in LWK Trucking. Together, the 6,000 shares acquired by the three Roth IRAs represented all of the class A shares in LWK Trucking, giving the three sons 98.2 percent. The remaining class B shares were acquired by an unrelated third party.

Mr. Bross was not an owner of LWK and was not involved in it. LWK met all of regulatory requirements on its own, and nothing was transferred from Bross Trucking. However, LWK Trucking did hire several Bross Trucking employees; in 2004 about 50 percent of LWK Trucking's employees had worked for Bross Trucking.

LWK Trucking executed a new master lease with CB Equipment after Bross Trucking's lease terminated. At first, some of the trucks still displayed Bross Trucking logos, but regulatory scrutiny of the Bross trucks made it clear that LWK was facing heightened scrutiny. LWK quickly covered the old Bross name with magnetic signs until the new company could have the trucks repainted.

LWK Trucking started with a similar business model to Bross Trucking, but then expanded into other service lines. In 2004, LWK Trucking started and retained a controlling interest in One Star Midwest, LLC, which provides GPS products to construction contractors. LWK Trucking also began employing 11 mechanics to provide repair services to third parties. In contrast, Bross Trucking had used mechanics only to serve its rental fleet.

Corporate Distribution?

The IRS assessed a deficiency against Bross Trucking, claiming that it distributed intangibles to Mr. Bross. The IRS listed goodwill and suggested that it included: established revenue stream; developed customer base; transparency of the continuing operations between the entities; established workforce, including independent contractors; and continuing supplier relationships. The IRS claimed that Bross Trucking distributed the goodwill to Mr. Bross, who gave it to his sons.

Of course, as the Tax Court noted, a corporation cannot distribute intangible assets that are actually owned by its shareholders. Thus, a key question was what Bross Trucking owned. In *Martin Ice Cream Co.*, when the ice cream entrepreneur sold distribution rights and goodwill, the IRS claimed they were company assets. The Tax Court disagreed, holding that without an employment or noncompete agreement, the company did not own the goodwill.

Besides, it was clear that Mr. Strassberg's personal goodwill and relationships were what counted. The Tax Court in *Bross Trucking* found *Martin Ice Cream* analogous and contrasted it with *Solomon v. Commissioner* [95 TCM 1389, Dec. 57,407(M), TC Memo. 2008-102]. In that case, the goodwill was developed and owned at the corporate level.

The Tax Court said the case law showed two regimes of goodwill: (1) personal goodwill developed and owned by shareholders; and (2) corporate goodwill developed and owned by the company. Bross Trucking's goodwill was primarily owned by Mr. Bross, so the company could not transfer it.

Corporate Goodwill

The Tax Court noted that Bross Trucking did have *some* corporate goodwill. However, it was clear that regulatory problems, fines and violations made it of dubious value. In fact, Bross Trucking could not expect continued patronage because customers did not want to continue doing business with it.

Indeed, LWK Trucking had needed to cover over the Bross name to avoid the increasingly bad association. To the Tax Court, this proved that any transferred corporate goodwill was more a liability than an asset. Nevertheless, the Tax Court went on to consider some of the other earmarks of goodwill.

For example, the Tax Court noted that Mr. Bross credibly testified that Bross Trucking had relationships with several national suppliers for fuel and parts. Even so, said the court, no evidence showed that LWK Trucking benefited from any transferred supplier relationships. There was a workforce in place and some independent contract drivers, and this was the only attribute that the Tax Court found that the corporation could have distributed to Mr. Bross.

It's Personal

According to the court, the remaining attributes that the IRS claimed belonged to Bross Trucking were *really* attributable to Mr. Bross' personal relationships. Bross Trucking's revenue stream, customer base and continuing operations were all spawned from Mr. Bross' work in the road construction industry. Mr. Bross developed the crucial relationships with the businesses' customers.

The court was convinced that the company's customers chose to patronize it solely because of the relationships Mr. Bross personally forged. Bross Trucking's developed customer base was also a product of Mr. Bross' relationships. Mr. Bross was the primary impetus behind the Bross family construction businesses.

In fact, rather than the web of Bross family businesses being a negative, it was clearly a positive. The court found that the transparency of the continuing operations among the entities was Mr. Bross' personal handiwork. His experience and relationships with other businesses were valuable assets, but assets that he owned personally.

A company does not have any corporate goodwill when all of the goodwill is attributable solely to the personal ability of an employee. None of the Bross sons contributed to Bross Trucking's goodwill because they were not employees of Bross Trucking, nor were any of them involved in operating it.

No Transfer of Personal Goodwill

When one reviews the case law in which personal goodwill is discussed, there is no more pivotal point than the presence or absence of an employment agreement or covenant not to compete. Many taxpayers have claimed that they personally owned goodwill, but have found such an argument thwarted by the presence of a binding employment contract or a noncompete agreement. In some cases, they face both.

Mr. Bross did not sign an employment contract or a noncompete agreement. That was key. After all, a key employee who develops relationships for his or her employer may transfer goodwill to the employer through employment contracts or noncompete agreements.

The Tax Court in *Bross Trucking* noted that an employer has not received personal goodwill from an employee where an employer does not have a right, by contract or otherwise, to the future services of the employee. Mr. Bross did not have an employment contract with Bross Trucking and was under no obligation to continue working for it. A contractual duty to continue to use his assets for the benefit of the company may show that an employee transferred personal goodwill to an employer for the length of the obligation.

Did that happen here? No. Mr. Bross was free to leave the company and to take his personal assets with him. Similarly, the lack of an employment contract showed that there was not an initial obligation for Mr. Bross to transfer any of his personal assets to Bross Trucking.

Bross Trucking did not take an ownership interest in Mr. Bross' goodwill from the beginning because Mr. Bross never agreed to transfer those rights. According to the court, the lack of an employment contract proved that Bross Trucking did not expect to—and did not—receive personal goodwill from him. It was a personal asset separate from Bross Trucking's assets.

Similarly, Mr. Bross never transferred any personal goodwill to Bross Trucking by signing a noncompete agreement. Mr. Bross was free to use his personal goodwill in direct competition with Bross Trucking if he stopped working for the company. That proved that he did not transfer it to Bross Trucking.

An employee may transfer personal goodwill to an employer through a covenant not to compete, but that did not happen here. The presence of an employment agreement with an enforceable covenant not to compete can be fatal. Consider *Howard v. United States* [106 AFTR 2d 2010-5140, 2010 U.S. Dist. LEXIS 77251 (E.D. Wa., July 30, 2010), Doc 2010-17126, 2010 TNT 148-15], and *Kennedy v. Commissioner* [100 TCM 268, Dec. 58,339(M), TC Memo. 2010-206].

Asset Transfer?

One must begin with the platitude that a business cannot distribute assets personally owned by shareholders. Bross Trucking did not own and could not transfer Mr. Bross' goodwill and did not transfer a workforce in place. In fact, the Tax Court found there to be no evidence that Bross Trucking transferred any other intangible assets to Mr. Bross.

The Tax Court recognized that there was one aspect of corporate goodwill that Bross Trucking displayed, and that was workforce in place. However, only about 50 percent of LWK Trucking's employees formerly worked at Bross Trucking. That did not seem to be a transfer of workforce in place to the court.

Instead, the court said that it appeared that LWK Trucking had assembled a workforce of its own, independent of Bross Trucking. The court found this to be demonstrated by the new key employees and services offered by LWK Trucking. LWK Trucking started One Star Midwest, which sold GPS services.

Moreover, LWK Trucking later started performing truck maintenance for third parties. Besides, these were just independent contractors choosing to accept work from a different business. That is not a transfer of workers.

The court went on to analyze other badges of goodwill. It noted that Bross Trucking did not transfer a developed customer base or revenue stream to LWK Trucking. Instead, Bross Trucking's customers had a choice of trucking options and chose to switch from Bross Trucking to LWK Trucking.

The Tax Court noted that the IRS argued that Bross Trucking's existing customer base was transferred to LWK Trucking. However, the court found that Bross Trucking's customers were interested in changing trucking providers because of the impending suspension. This interpretation was quite telling.

Customer Choice

This was not at all a transfer of intangibles at the service provider level. Rather, it was a business choice made at the customer level. Forming LWK Trucking gave Mark Twain Redi-Mix the option to use a trucking company with an untarnished reputation and clean service record.

Mark Twain Redi-Mix shared ownership with LWK Trucking and was one of Bross Trucking's primary customers. The court was convinced that Bross Trucking did not transfer its customers. Instead, the customers chose to use a new company because of Bross Trucking's troubled past. Bross Trucking did not distribute any cash assets and retained all the necessary licenses and insurance to continue business.

In fact, Mr. Bross remained associated with Bross Trucking and was not involved in operating or owning LWK Trucking. He was free to compete against LWK Trucking. The fact that Bross Trucking could have resumed its hauling business supports the view that it retained its corporate intangibles, if any.

Accordingly, there was no transfer of intangible assets. Bross Trucking's customers chose to use a different company, and Bross Trucking remained a going concern. The court also found that LWK Trucking did not benefit from any of Bross Trucking's assets or relationships.

At the end of the day, LWK Trucking was independently licensed and developed a wholly new trucking operation. LWK Trucking did not take a transferred basis in any assets such as property or purchased authority. There is no indication that LWK Trucking used any relationship that Mr. Bross personally forged. The Bross sons were in a similarly close capacity to Bross Trucking's customers to develop relationships apart from Mr. Bross.

Cultivating and profiting from independently created relationships are not, however, the same as receiving transferred goodwill. Sure, LWK Trucking's and Bross Trucking's customers were similar. However, that did not mean that Bross Trucking transferred goodwill.

Instead, the record shows that LWK Trucking's employees created their own goodwill. The Tax Court found that Bross Trucking did not distribute assets to Mr. Bross. That meant that he did not give his sons the assets, and there was no gift that could be taxed either. Mr. Bross eventually closed up Bross Trucking. His sons started a new trucking business.

In short, the IRS was wrong. There was no gimmick in ownership. With no noncompete or employment agreement, the company did not own the goodwill. Mr. Bross did.

Conclusion

A sale of personal goodwill can sometimes provide a seller with a huge benefit: a payment outside the company reported by the individual as long-term capital gain. That may sound like ice cream that will never melt. But it can seem like one more aggressive tax idea that can get people into trouble.

True, the personal goodwill idea is often misinterpreted and misapplied. Where it is clear that the company owns the goodwill, as it will be where an employment or noncompete agreement makes this conclusion inevitable, there is little to discuss. That is one reason why *Martin Ice Cream* has been so widely misunderstood.

When a seller has unique skills and a strong personal relationship with customers distinct from the corporate goodwill, it is worth considering. But a threshold question is whether the individual is bound by a covenant not to compete or employment agreement that gives some or all rights to the company. If so, the case is basically closed.

Conversely, where the facts and the documents line up, whatever the IRS may say, the courts correctly uphold the sale of personal goodwill. *Martin Ice Cream* is here to stay.

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