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Goodwill, Personal Goodwill and the Importance of State Law

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Who owns the goodwill associated with a business? In the vast majority of cases, the business clearly owns it, whether by purchasing or creating it. Goodwill can come in two forms: Acquired and developed, or self-created.

Developed goodwill is usually owned by the business whose employees labored to create and cultivate it. Often there are explicit employment and noncompetition agreements to make that eminently clear. Sometimes, without such agreements, state law may serve to clarify the ownership in question.

Any business purchase usually includes all goodwill. Otherwise, it seems hard to contemplate a sale. In the case of private companies dominated by a single individual, though, it may be less clear who owns what. In some cases, a founding individual attributes goodwill to himself or herself.

Yet he or she may have signed an employment agreement years before, transferring any goodwill he or she creates or develops to the company. Plainly, such a person no longer owns personal goodwill (if he or she ever did). In some cases, the selling individual signs an employment agreement and a covenant not to compete with the buying entity, which is also relevant.

An example shows why this issue comes up again and again.

Example:

Dr. Smith has long engaged in a medical practice through a C corporation, ServiceCo, which he wishes to sell. The price is $10 million for everything, including the goodwill Dr. Smith claims to own personally. Two $5 million agreements are negotiated: An asset purchase agreement between the buyer and ServiceCo, and a personal goodwill agreement between the buyer and Dr. Smith. Dr. Smith sells his personal goodwill with one tax, while the payment to ServiceCo is subject to two. The obvious tax incentives explain

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some of the confused—if not downright bad—case law.

In *Martin Ice Cream*, 110 TC 189, Dec. 52,654 (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. *Martin Ice Cream* seems unassailable on its facts.

In fact, the recent case of *H & M, Inc.*, TC Memo 2012-290, Dec. 59,225(M) (2012), shows its continuing vitality and influence on the landscape of the sale of service businesses. Yet for all the continued debates about the many personal goodwill cases that have succeeded and those that have failed, an often overlooked aspect is the role of state law. Although states have taken different positions concerning the content of goodwill, state law determines the underlying property rights.

State vs. Federal Law

The Internal Revenue Code (the "Code") imposes taxes by reference to property rights and the ownership of assets and income. These underlying property rights are generally established by *state* rather than by federal law. The Code taxes property transactions, but local laws regulate and define them.

For example, the Code allows a taxpayer to deduct a bad debt. However, local commercial laws determine when a debt becomes worthless. In the seminal case of *J.E. Morgan, Exr.*, SCt, 40-1 USTC ¶9210, 309 US 78, 60 SCt 424, the Supreme Court considered state law to determine property rights, and then applied federal tax law on that basis.

Of course, no section of the Code defines goodwill—although the Code does refer to it and provides some boundaries. For example, Code Sec. 197 controls amortization of certain intangibles, including goodwill. Federal tax law recognizes that goodwill *can* accrue to an individual rather than a business.

Indeed, personal goodwill has been claimed by businesspeople in varied contexts. Yet courts have acknowledged that, even when an individual *creates* it, he or she may transfer it to the business through an employment contract or covenant not to compete. This seems simple, yet has caused considerable confusion.

In *Martin Ice Cream*, Strassberg sold his intangible assets to Haagen-Dazs, including his personal relationships with supermarket owners and managers. This bundle of intangibles was personal to Strassberg; it did not belong to any corporate entity. In addition, Strassberg had never entered into a covenant not to compete or employment agreement. These were key facts in determining how the goodwill was to be handled.

Similarly, in *H & M, Inc.*, the owner had no agreement with his corporation prior to its sale to prevent him from taking his relationships, reputation, and skill elsewhere. The Tax Court therefore found that a portion of the sale price was allocable to his personal goodwill. Where the facts support it, the result is clear.

In contrast, the cases in which the facts do not support the personal goodwill claim are

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legion. Thus, in *Howard v. United States*, 448 Fed. Appx. 752 (CA-9 2011) (unpublished), the taxpayer transferred his goodwill to his corporation *via* an employment agreement and covenant not to compete. Plainly, he could not sell his personal goodwill, as it belonged to the corporation.

Many of these cases should never have been litigated. Perhaps there is genuine confusion over who owns what, occasionally clouded even further by the attractiveness of the tax benefits. But some taxpayers attempt to ram their facts into the personal goodwill mold like a square peg into a round hole.

In the face of a failure to own any personal goodwill under state law, some taxpayers claim that they did so regardless and that they rightfully sold it. Unfortunately, some of such claims are preposterous. A preexisting employment agreement and covenant not to compete will often make the state law and the tax result crystal clear.

These cases are unfortunate, tainting the entire field and making cases of *bona fide* personal goodwill appear suspect.

Definitions

Goodwill is a broad concept, and is often defined loosely as the additional consideration paid for a company beyond the aggregate value of its assets. Yet within or in addition to this business goodwill concept, goodwill can be more particularized. Customer goodwill is an asset representing the preference of customers. Personal goodwill, on the other hand, represents the personal skill, reputation and relationships that accrue to an individual.

Regardless of tax and accounting concepts, goodwill represents value from a customer base. More broadly, goodwill includes the reputation and other qualities that attract new as well as old customers. Narrow customer goodwill generally represents the quality of carrying on a specific business and retaining its historical customers.

In a sale, the buyer can, and inevitably does, prevent the seller from continuing the same business. However, without specific covenants, the act of selling a business generally cannot prevent the seller's practice of a trade. The seller may even be able to solicit the *same* customers *via* a *new* business

Of course, the buyer of customer goodwill will almost invariably obtain a noncompetition agreement to restrain the seller's trade. The average businessperson understands customer goodwill to include all reputation and advantages among both customers and potential customers. The seller of a business can thus endeavor to transfer the loyalty and business relationships of all the former customers to the buyer.

Personal Goodwill

Personal goodwill may be referred to by different names, but 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. *Martin Ice Cream* was not the first case to discuss it.

In *D.K. MacDonald*, 3 TC 720, Dec. 13,898 (1944), the Tax Court recognized that goodwill can belong to an individual rather than the corporation. 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.

The IRS argued that this goodwill should be included in the corporation's liquidating distribution. Despite the IRS' objections, though, the Tax Court ruled that the goodwill was MacDonald's alone. Given his role in the company and the nature of the business, the court found that MacDonald *was* the company.

That made sense. After all, he was involved in the key social clubs and was personally involved in the business. It depended on his aggressiveness and business ability.

Moreover, the type of insurance he and the company sold involved greater and more specialized risks than was typical. MacDonald's sales accounts were terminable upon 30 days' notice and required active servicing. The court found his accounts and his level of service exemplary.

In short, the goodwill was due to MacDonald's personal ability, business acquaintanceship and other individualistic qualities. Because there was no employment contract or covenant not to compete, MacDonald never transferred goodwill to the business. Therefore, its value could not be attributed to the company. The Tax Court recognized this personal goodwill as a valuable asset.

H & M, Inc.

Nearly 70 years after *MacDonald*, the Tax Court faced similar facts in *H & M, Inc.* In this case, Harold Schmeets was also the owner of an insurance company, H & M, Inc. Schmeets had been the sole shareholder of H & M since 1980 and was widely regarded in North Dakota for his personal ability and experience selling insurance. He was called the "King of Insurance," and people came to H & M to buy insurance from him in particular.

In 1992, H & M sold its assets to a competitor, the National Bank of Harvey. As part of the sale, Schmeets became an employee of the bank. There were two agreements to effect this transaction. H & M entered into a purchase agreement for its asset sale, and Schmeets entered into an employment agreement with the bank.

Part of the compensation to Schmeets from National Bank was deferred, and paid between 2001 and 2005. The IRS claimed that these and other payments from the bank to Schmeets should be re-characterized first as payments from the bank to H & M (relating to the asset sale), and then as a distributions from H & M to Schmeets.

However, the Tax Court disagreed with the IRS, quibbling with them over the precise size of Schmeets' wages. The court found that his wages should have been higher than the IRS allowed, although not as high as Schmeets, H & M and National Bank had reported.

Nevertheless, the court found that the difference between Schmeets' reported wages and actual wages was still income to Schmeets. Part of the difference was payment to Schmeets for a noncompetition agreement with National Bank. The remaining portion should have been directed to Schmeets as compensation for his personal goodwill. The Tax Court refused to attribute the value to the corporation.

In *H & M*, the Tax Court employed a classic definition of personal goodwill: The expectation of continued patronage by existing customers. Schmeets ran a service business selling insurance.

Indeed, the Tax Court compared him to MacDonald and Strassberg. The Tax Court noted that the business of selling insurance was extremely personal. Patrons came to buy insurance from Schmeets, not a company.

Ownership Counts

The case law recognizes goodwill as an asset of the individual for various state law purposes. California has been a leader in recognizing it as a distinct, valuable, intangible asset capable of being transferred by an individual. In *Mueller v. Mueller*, 144 Cal. App. 2d 245 (1956), a California appellate court held that it was a question of fact whether a business that was dependent solely upon the personal skill and ability of an individual accrued value in goodwill.

Shortly thereafter, in *Burton v. Burton*, 161 Cal. App. 2d 572 (1958), goodwill was attributed to the personality of one man. Other states have followed California, including Washington, New Mexico and New Jersey, all having recognized personal goodwill. Some states have rejected identifying personal goodwill as an asset of the owner of a business. Still other states recognize that goodwill can accrue to an individual, but only in a more limited form.

It is thus critical to assess the applicable state law and the extent to which it recognizes that there is value in an individual's know-how, personal relationships and ability. Assuming that the documents do not transfer these assets, it remains personal—it does not accrue to the business entity unless it is assigned. Moreover, in states such as California that have often limited and litigated the bounds of *business* goodwill, *personal* goodwill can be especially valuable.

Personal Goodwill and Transferability

California has consistently recognized personal goodwill as a transferrable asset. *See In re Marriage of Lopez*, 38 Cal. App. 3d 93 (1974). California courts have used age, demonstrated earning power, professional reputation, skill and more in valuing the personal goodwill of an individual. However, these factors are illustrative, not all-inclusive.

Mechanics are another matter. California statutes explicitly address the sale of goodwill, noting an exception to the general prohibition on the enforceability of noncompetition agreements. In fact, noncompetition agreements are not favored in California, and often not enforceable. A key and well-known exception to this broad rule relates to sales of business interests. And the goodwill concept comes up there too.

Section 16601 of the California Business and Professions Code includes the sale of business exception and makes the transfer of goodwill a *prerequisite* for the exception's applicability. California law is also explicit that goodwill is transferable. In fact, California law takes the broad view that property of any kind may be transferred.

California's dislike for noncompete agreements, coupled with its key sale of business exception, has a long history. The pertinent California statute was enacted in 1872 and was amended in 1945, 1963, 2002 and 2006. The amendments clarified and enhanced the treatment of goodwill, especially for sole owners providing personal services.

For a noncompetition agreement to be permitted and enforced, the seller must have transferred a substantial interest in the business. More than simply *allowing* goodwill to be transferred, California courts have routinely implied that there has been a sale of goodwill when an asset sale is paired with a covenant not to compete. These cases generally have the following elements:

1. An individual transferor who appears to transfer goodwill in connection with the sale of a business, even if the conveyance of goodwill is not explicit;
2. The act of transfer is a simple conveyance, so that after the sale, the buyer has the goodwill and the seller does not; and
3. The buyer can enjoin the seller from behaving inconsistently with the sale of goodwill.

For example, in *Mahlstedt v. Fugit*, 79 Cal. App. 2d 562 (1947), an individual sold his business. Unfortunately, the agreement did not identify goodwill as one of the assets that was sold. There was, however, a noncompetition agreement. When the seller claimed that the noncompetition agreement was void because no goodwill was sold, the court found this argument to be preposterous.

Similarly, in *Monogram Industries, Inc. v. Sar Industries, Inc.*, 64 Cal. App. 3d 692 (1976), a covenant not to compete was executed in connection with a sale. However, there was no *explicit* agreement to sell goodwill. The owner of Sar Industries claimed that a noncompetition agreement made in conjunction with its sale was void because he sold no goodwill.

When the seller sold similar products to the same customers, the buyer successfully enjoined the former owner. The court held that the covenant implied that the business had goodwill and had transferred it. The California case law for this proposition is consistent and voluminous.

For example, in *Bosley Medical Group v. Abramson*, 161 Cal. App. 3d 284 (1984), the seller of a corporation was held to have transferred the goodwill despite omitting explicit terms in the sale agreement.

Conclusion

Advisers who confine their activities to public companies may have little interest in or sympathy for the cadre of advisers and business owners who seem to be enchanted with the personal goodwill concept. Clearly, you need the right fact pattern and the right documentation. But if you have it, it is hard not to find the results of a personal goodwill allocation impressive.

In the modern classic case of *Martin Ice Cream*, Strassberg was well-situated to possess, control and sell his personal goodwill. State law was, and still is, important. Strassberg was based in New Jersey, which like California, recognizes personal goodwill. Strassberg's ability to segregate and sell his personal goodwill was buttressed by New Jersey's legal recognition of those rights and by documentation that supported them.

A California business that is particularly dependent on the services, personal relationships and ability of a key individual should be treated similarly. In fact, California law has particularly strong authorities on the concept of broad customer goodwill. Given California's case law litigating business sales, litigating competitive and anti-competitive practices, litigating divorces and many other types of disputes, the state allows considerable room for personal goodwill.

Of course, as *Martin Ice Cream* and other federal tax cases show, the seller of goodwill must actually *own* the goodwill. Moreover, he cannot have transferred it *back* to the corporation through a noncompetition agreement or covenant not to compete. These are fundamental rules, yet bear frequent repeating.