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IRS Backs Itself into a Corner in Goodwill Allocations

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When a business is sold, negotiating a fair price and getting to closing is often only the beginning of the story. What happens later, when the sale documents are parsed for tax purposes, can be where the real drama occurs. One of the most difficult battles taxpayers and the IRS fight is how much of a sale's purchase price should be allocated to goodwill.

Goodwill is generally defined as the expectation that customers will continue to patronize a business, but valuing it can be a challenge. The IRS and taxpayers often disagree over how much goodwill is present. The IRS achieved one victory in 1986, when it convinced Congress to lay out specific rules for allocations.

Of course, as with many tax fights, when the IRS wins one battle, it may lose another. As a case in point, some practitioners may remember the 1995 Seagram redemption of Du Pont shares. Du Pont had issued warrants to Seagram that were mostly worthless for practical purposes, but nevertheless allowed Seagram to qualify for an intercompany dividend deduction in connection with an $8.2 billion share reduction.

How was this possible? To qualify for the intercompany dividend provision, Seagram had to retain a 20-percent interest in Du Pont both before and after the transaction. Seagram certainly owned a sufficient percentage of Du Pont shares before the redemption, but after the redemption, it arguably did not own any.

How did it work, then? The warrants Seagram received were the key even though they were of minimal real value. The IRS had issued rulings confirming that similar warrants were valid in establishing constructive ownership, as it did not want taxpayers to be able to strategically avoid the constructive ownership rules. Therefore, the IRS did not challenge Seagram's claim that the warrants gave it constructive ownership of Du Pont, and the redemption was allowed

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to qualify as an intercompany dividend. As the Seagram deal shows, the IRS may often be hoist by its own petard. The same may be true in the goodwill allocation war.

Pre-1986 Allocations

Before 1986, purchasers and sellers often had competing interests regarding allocations to goodwill. A purchaser would generally want to avoid allocations to goodwill and would instead try to allocate as much of the consideration as possible to a covenant not to compete. This is because a covenant not to compete often had a short depreciable or amortizable life.

A seller, on the other hand, would not care about future amortization or depreciation. Rather a seller would generally prefer to take advantage of lower capital gain rates and would therefore prefer allocations to goodwill. Allocations to covenants not to compete generally give rise to ordinary income.

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The controversy was rooted in the fact that the IRS took the position that goodwill and other intangible assets were so connected to the “expectancy of continued patronage” that they did not have an ascertainable and limited useful life and therefore could not be amortized. [See *Houston Chronicle Publishing Co.*, CA-5 73-2 USTC ¶9537, 481 F2d 1240.] According to the Fifth Circuit, goodwill was “not a depreciable asset since it is self-regenerating and its benefits extend over a substantial period of time which cannot be estimated with reasonable accuracy.”

Because of this, purchasers often tried to use a second-tier allocation method, which made it easier to allocate more to depreciable or amortizable assets. This method provided that any consideration in excess of the appraised value of all acquired assets, including goodwill, would be allocated among the assets (other than cash) in proportion to their appraised value.

The IRS, on the other hand, generally argued for the residual method. Under this method, any consideration in excess of the value of separately identifiable assets would be allocated to goodwill. After all the specific assets are valued, the remainder, or residual, would be allocated to goodwill. In *Banc One Corp.* [84 TC 476, Dec. 41,985 (1985)], the Tax Court rejected the second-tier allocation method in favor of the residual method, as the IRS had urged.

The IRS often ended up fighting taxpayers in court about proper allocations because purchasers and sellers sometimes took inconsistent positions. Even so, taxpayers won some of these fights, and courts allowed taxpayers to disregard allocations in the contract if they offered proof that the parties intended to allocate differently.

For example, in *G.L. Krieder* [CA-7, 85-1 USTC ¶9427, 762 F2d 580], the court allowed the taxpayer to allocate to the covenant not to compete even though the agreement of sale contained no such specific allocation. The court noted that a preponderance of evidence showed that the covenant was bargained-for consideration. Moreover, the covenant had independent economic substance because of the grantor’s long experience and competitive force in the industry. This result understandably perturbed the IRS.

Residual Method Codified

To respond to the IRS's concern about allocations, Congress added Code Sec. 1060 to the Tax Code in 1986. This Code Section specifically required buyers and sellers in an asset acquisition to use the residual method for tax purposes, regardless of the allocation made in their purchase agreement. This was a victory for the IRS, preventing purchasers from allocating too little to goodwill. It also made it more difficult for parties to take inconsistent positions.

Code Sec. 1060 imposed new reporting rules requiring both the buyer and seller to report how the total consideration was allocated. These requirements made it easier for the IRS to identify inconsistent positions. Congress also reasoned that with the elimination of favorable tax treatment of capital gains and the new disallowance of nonrecognition of corporate-level gain in liquidating sales or distributions, the purchaser and seller may be less likely to have competing tax interests. [H. Rept. 99-841, pt. II, at 208 (1986).]

Danielson Rule

In 1990, Congress amended Code Sec. 1060 to codify the *Danielson* rule that a buyer and seller to an asset allocation are bound to the agreement unless the IRS determined that the allocation was not appropriate. The rule stemmed from the case *C.L. Danielson* [CA-3, 67-1 USTC ¶9423, 378 F2d 771], where the court held that a taxpayer can challenge the tax consequences of a written agreement only by showing proof that would be admissible to alter the IRS's construction of the agreement, or to show its unenforceability because of defects such as mistake, undue influence, fraud or duress.

The House report explained that Congress deemed it "appropriate to bind the parties ... to any written agreement they reach regarding the allocation of the consideration to, or fair market value of, any of the specific assets ... transferred." [H. Rept. 101-881, at 351 (1990).] The changes to Code Sec. 1060 made it even harder for taxpayers to stray from express allocations in the agreement and were designed to allow the IRS to rely on the parties' written agreement regarding how to allocate the purchase price to various assets. Of course, the IRS could still challenge the allocation if it chose to do so.

Code Sec. 197 Too

With the enactment of Code Sec. 197 in 1993, purchasers could amortize the cost of certain intangible assets, including goodwill, over 15 years. [26 U.S.C. § 197.] Much of the litigation that led to the enactment of Code Sec. 1060 was rooted in the disconnect between goodwill and other items, such as covenants not to compete. Code Sec. 197 caused a further reduction in this litigation, with less of an incentive for taxpayers to try to allocate to or from goodwill.

The backdrop for Code Sec. 197 was that Congress felt that taxpayers were becoming increasingly creative in finding intangibles other than goodwill. The Government Accounting Office identified more than 100 different intangibles it had seen, including $9 billion of deductions relating to customer lists, pizza recipes, a company's shrinking market and a business's nonunion status. In large part, Code Sec. 197 put an end to the fight over allocations to goodwill as opposed to other intangibles. Still, as with many tax disputes, the battles over goodwill did not end there.

Personal Goodwill in Business Sales

Code Sec. 1060 was enacted to address raging controversies regarding corporate goodwill. However, where a key individual (say a star CFO) is responsible for much of a business's success, that individual, rather than the company, may control the goodwill. In these cases, it may be possible to avoid corporate-level taxes on that personal goodwill upon a sale of the company because it is a personal, not corporate, asset.

Plainly, this poses a problem for the IRS. Code Sec. 1060 may have helped the IRS in fights with taxpayers that try to allocate away from goodwill. Yet it did not contemplate battles with corporate taxpayers that *do not own their own goodwill*. Code Sec. 1060 may come back to haunt the IRS in allocation disputes regarding the size of goodwill, where that goodwill is wholly or mostly owned personally by a company's shareholder.

The IRS appears to have assumed that it would never have to worry about personal goodwill. The IRS has repeatedly taken questionable legal positions on the subject, such as by denying the existence of personal goodwill or claiming that it cannot be transferred in a manner that avoids corporate-level taxes. Nevertheless, it has consistently lost these cases.

One notable case, *J.A. Patterson* [CA-6, 87-1 USTC ¶9168, 810 F2d 562, 574], was decided in 1987, only a year after Congress tried to resolve the allocation fight by enacting Code Sec. 1060. Mr. Patterson was only the minority owner of Long John Silvers, but a dominant reason behind the success of the business. The IRS argued that no allocation should be made to a noncompete agreement, but the Tax Court disagreed because of Mr. Patterson's personal goodwill.

Patterson appears to have not made a lasting impression on the government because the IRS continued to misunderstand the nature and effect of personal goodwill in litigation. For example, in 1995, the Tax Court sided with the taxpayer and held that payments for a noncompete agreement in connection with a sale purchased the taxpayer's personal goodwill. [*J.W. Edelberg*, 70 TCM 393, Dec. 50,829(M), TC Memo. 1995-386.]

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, the Tax Court held that he owned the goodwill personally 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.

Finally, the IRS took a knockout blow in June 2014 when the Tax Court ruled for the taxpayer regarding personal goodwill in *Bross Trucking, Inc., et al.* [107 TCM 1528, Dec. 59,928(M), TC Memo. 2014-107]. The Tax Court noted that Mr. Bross was the "primary impetus" behind a family-owned trucking business, and that he controlled its goodwill, not the company. The Tax Court even devoted an entire section of its opinion to its finding that "Nearly all of the goodwill used by Bross Trucking was part of Mr. Bross' personal assets."

In August 2014, the Tax Court delivered yet another blow to the IRS in *F.Z. Adell* [108 TCM 107, Dec, 59,981(M), TC Memo. 2014-155]. In this case, the IRS engaged in a battle of experts over the value of a family-owned religious broadcasting company. The taxpayers argued that the son personally owned the goodwill of the business, as he maintained the personal relationships that kept the business going. The IRS attempted to sidestep the goodwill issue by arguing that a prospective buyer would simply acquire any goodwill by paying the son a higher salary. The Tax Court, ultimately siding with the taxpayers, rejected the IRS's valuation for failing to account for the personal goodwill that had not been assigned to the company.

Conclusion

The courts have consistently rejected the IRS's positions on personal goodwill. As a result, the IRS might now regret pushing for the enactment of Code Sec. 1060. Plainly, it once made sense for the IRS to argue for allocations that gave short shrift to goodwill. Today, however, the IRS seems to favor trying to deny the very existence of goodwill, or at least to be selective about where it believes the goodwill is housed.

No longer able to deny the reality and extent of personal goodwill, the IRS may try to argue for smaller allocations to goodwill. As a result, the IRS may be forced to argue against the very residual method it has touted for more than 30 years and which was codified in Code Sec. 1060.

The IRS may not be technically bound by the residual method, but it will be hard-pressed to argue against it. Code Sec. 1060 is not fully reciprocal. It binds taxpayers to the residual method, while the IRS is free to use other methods. Nonetheless, the assumption is that the IRS may need to combat taxpayer abuse where parties to a sale take inconsistent positions and one taxpayer argues for too much allocation to goodwill as opposed to other intangibles.

With disputes over personal goodwill, the IRS's complaint is not that there is *too much* goodwill, but that it should not be considered to be owned personally by the shareholder. In many cases, that is a factual question, overlayed with legal questions, regarding whether the shareholder has signed over his or her goodwill *via* an employment or noncompete agreement. In any case, this "who owns the goodwill?" query is entirely different from the fight that led to the enactment of Code Sec. 1060.

Moreover, as we have seen, the courts have repeatedly rejected the IRS's positions on personal goodwill. The courts recognize that personal goodwill exists and can be transferred through a noncompete agreement even when there is a related corporate sale. Thus, the IRS may find itself arguing against the residual method. In the language of politics, one can truly say that the IRS was for the residual method, until it was against it.