The Emperor of Ice Cream, Dentists, and Personal Goodwill

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Martin Ice Cream v. Commissioner is a classic treat. But this rich and satisfying case is often misinterpreted. That occurred in two recent cases, *Kennedy v. Commissioner* and *Howard v. United States*.

Some case names are worth remembering, and *Martin Ice Cream Co. v. Commissioner*[1] is one of them. It may not be old, but it is a classic, for it represents the linchpin of the argument that personal goodwill can be sold outside a business sale, obviating corporate-level tax. Avoiding double tax is no small feat.

Perhaps for that reason, there is often misinformation about the case. Also, the benefits and opportunities that its holding provides are often overstated and misapplied. For that reason, it's useful to reflect on why *Martin Ice Cream* is satisfying, rich, and creamy without toppings or embellishments.

Emperor of Ice Cream

A Wallace Stevens poem glorifies the muscled server scooping ice cream as its emperor.[2] In the tax world, *Martin Ice Cream* is the emperor of personal goodwill. The case concerned Arnold Strassberg and his son Martin, who eventually owned all of the stock of Martin Ice Cream Co.

The father had worked for more than a decade in his own wholesale ice cream distribution business. In that capacity, he developed strong business relationships with supermarket chains, and they were purely his contacts and relationships long before Martin Ice Cream Co. was formed. The founder of Haagen Dazs approached the father about distributing Haagen Dazs in supermarkets. Based on a handshake agreement that was never put into writing, Strassberg made hay with this deal.

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 turned in 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. As part of the deal, Strassberg signed a bill of sale and an assignment of rights. (Both Strassberg and Martin signed non-competes with Pillsbury.)

The Tax Court ruled that intangible assets embodied in Strassberg's oral agreements were not corporate assets of Martin Ice Cream Co. Moreover, no transfer of those goodwill assets to Strassberg Ice Cream Distributors could be attributed to Martin Ice Cream. This deal was simply outside the corporation.

There are several striking facts about *Martin Ice Cream*. One of them is the lack of a written agreement between Strassberg and the corporation. Family-owned companies are often informal, but it was clear that the company would have had a hard time enforcing the notion that all of the goodwill belonged to the company and not to Strassberg.

In fact, there seemed to be virtually no chance of that. It was Strassberg individually who developed those contacts and relationships before joining Martin Ice Cream Co. He did so without any written agreements.

A second notable point relates to Pillsbury's lack of interest in acquiring the assets of Martin Ice

[1] 110 T.C. 189 (1998), *Doc 98-9572*, *98 TNT 52-8*.

[2] Wallace Stevens, "The Emperor of Ice Cream," originally published July 1922.

Cream Co. All it wanted was Strassberg's contacts. For that reason there were no allocation questions.

Business as Usual

The normal context in which a *Martin Ice Cream* issue arises, of course, is when a buyer wants to purchase a business and its relationships. The buyer may or may not care how the purchase price is allocated and precisely to whom it is paid. After all, in an acquisition of a closely held business, the company and the owner will both be signatories to various documents. The precise allocation of consideration is important, but it may be less important than other aspects of the deal.

Most of the time *Martin Ice Cream* is invoked it will be in the sale of an integrated business. Yet it bears remembering that a more appropriate fact pattern is when goodwill *alone* is being sold. Sometimes those who invoke *Martin Ice Cream* expect more than they should from this venerable case. Two recent cases must be added to the ice cream literature and both contain lessons about the dangers it presents.

The Kennedys

In *Kennedy v. Commissioner*,[3] Kennedy formed a sole proprietorship in 1990 to engage in employee benefits consulting. In 1995 Kennedy incorporated KCG International Inc. as a C corporation. From 1995-2006, Kennedy was KCG's sole shareholder and president, providing employee benefits consulting.

Employers who retained KCG did not execute contracts either with KCG or with Kennedy. KCG had two full-time employees, Kennedy and an unrelated person named Dolatowski. Notably, Kennedy did not have an employment or noncompetition agreement with his corporation.

In 2000 Kennedy was approached by Mack & Parker (M&P), a potential buyer. Early on, it appeared that M&P would pay 150 percent of the predicted annual income from KCG clients, subject to various adjustments. Based on the formula, the expected price was $660,000, to be paid 40 percent at closing and 60 percent over five years.

Later, there was discussion that 25 percent should be treated as payment for consulting, with 75 percent as a payment for Kennedy's personal goodwill. The personal goodwill discussion was prompted by outside legal and accounting advice. Interestingly, the Tax Court opinion contains references to many of the communiqués between the various parties and advisers.

For example, in 2000 Jerry Roberts, the lawyer representing M&P, e-mailed his client with concerns about taxes. If M&P bought the assets of KCG rather than its stock, Roberts warned, the payments would be taxed twice, first to KCG, and then to Kennedy when KCG distributed the proceeds. A purchase of stock would incur only one level of tax, a capital gain to Kennedy. The disadvantage of a stock sale, said Roberts, was that M&P would not be able to claim amortization deductions. A local accountant had suggested — and here the Tax Court is quoting:

> M&P could take the position that Kennedy owns KCG's customer list and the goodwill with the customers and hence could sell them directly to M&P.[4]

Roberts commented that this structure — a variation of an asset purchase — would involve Kennedy being taxed only once and at capital gain rates. Nevertheless, M&P would be able to amortize the assets over 15 years. Thereafter, Roberts drafted documents allocating 75 percent of the purchase price to Kennedy's goodwill. The remaining 25 percent was for consulting services. That was the first document reflecting the 75/25 percent split, and the transaction was consummated shortly thereafter.

The Tax Court spent considerable time describing the agreement for assignment of know-how and goodwill, the asset purchase agreement, and the consulting agreement. The asset purchase agreement required KCG to convey its relationship with 46 clients; the goodwill agreement required Kennedy to convey his personal relationships with the same 46 clients. Almost all had been clients of Kennedy before 1995 when he incorporated.

The Tax Court summarized the transaction documents as calling for three types of payments:

- a flat $10,000 to KCG required by the asset purchase agreement;
- payments to KCG that were required by and allocated to the consulting agreements; and
- payments to Kennedy that were required by and allocated to the goodwill agreement.

The last two payments were $58,700 and $176,100, respectively, or 25 percent and 75 percent.

All three agreements prevented Kennedy from competing in employee benefits consulting. Post-closing, Kennedy began work with M&P. The other former KCG employee, Dolatowski, did too, but quit after only two months. Kennedy then devoted far more time to his new role than he had anticipated. In fact, during the first year after the transaction, 46 percent of M&P's revenue was traceable to time billed personally by Kennedy.

[3]T.C. Memo. 2010-206, *Doc 2010-20736*, *2010 TNT 184-13*.

[4]*Id.* at *6.

Nevertheless, Kennedy did not receive any wages or fees from M&P other than payments under the sale documents. Approximately a year after the closing, Kennedy informed M&P he had been working full-time and would quit unless his compensation was increased. They worked out a new agreement, and Kennedy began receiving wages as well as payments under the goodwill agreement. Kennedy was still an M&P employee when his case came to trial in the Tax Court.

The central issue in the case was whether the payments Kennedy received were proceeds from the sale of personal goodwill and therefore taxable as capital gain, or payments for services, taxed as ordinary income. The IRS argued that KCG, not Kennedy, owned the list. Kennedy had no contracts with any clients, and had no proof of the existence of *any* goodwill asset. Even if Kennedy owned something, the IRS said, it was not transferable.

After all, any goodwill was based on the value of Kennedy's relationships, which had no value unless Kennedy continued to perform services. The IRS even argued that the business was owned by KCG, which in turn employed Kennedy. Finally, the IRS argued substance over form, that payments from M&P must be considered payments for Kennedy's services or payments for Kennedy's promise not to compete.

Predictably, Kennedy sought sweet sustenance in *Martin Ice Cream*. The Tax Court disagreed, noting that whether goodwill exists as a capital asset of a sole proprietor and whether the goodwill was transferred are questions of fact.[5] The Tax Court acknowledged that a payment to a service provider can in some circumstances be considered a payment for goodwill. Yet it was convinced the payment to Kennedy was for services. The 75 percent allocated to goodwill was a tax-motivated afterthought lacking economic reality.

Initial negotiations had established the purchase price at $660,000 minus Dolatowski's base salary. In fact, this payment was to be adjusted over five years to reflect Kennedy's success in integrating KCG clients into M&P. The Tax court found that the 75/25 allocation did not reflect the value of goodwill in relation to other aspects of the transaction, such as the services to be performed by Kennedy for M&P. The Tax Court went on to note that Kennedy undertook M&P work for five years until the end of 2005, gave a valuable non-compete, and worked for 18 months post-closing without compensation.

That made it clear the payments were not for goodwill. After a thorough exposition of the facts and reasoning in *Martin Ice Cream*, the Tax Court found it inapplicable. Kennedy's payments represented ordinary income either for services or for a promise not to compete. Further, they were subject to self-employment taxes. Turning to penalties, the court held that accuracy-related penalties should not be imposed because the Kennedys had reasonable cause for the tax treatment and acted in good faith. The court was convinced there was reasonable reliance on the advice of a professional.

Tooth Decay

Another double scoop of *Martin Ice Cream* came in *Howard v. United States*.[6] Our story starts in 1980, when Dr. Larry Howard incorporated his dental practice. Howard had an employment agreement and covenant not to compete with his corporation, and continued as its sole shareholder, officer, and director.

Twenty-two years later, in 2002, he sold his practice to another dentist. An asset purchase agreement was drawn up between the two dentists and their two dental corporations. Under the agreement, Howard (outside his professional corporation) received $549,900 for his personal goodwill, while his corporation received $47,100 for its assets. Howard also received $16,000 personally for entering into a new covenant not to compete with the buyer.

Howard reported $320,358 as long-term capital gain from the sale of goodwill. On audit, the IRS viewed the goodwill as a corporate asset, and treated the cash Howard received as a dividend. Accordingly, the IRS assessed a $60,129 deficiency (plus $14,792 in interest). Howard paid the tax, filed a refund claim, and filed suit in district court.

Howard argued that the goodwill was personal and that he was entitled to claim the proceeds from its sale as long-term capital gain. After all, in *Martin Ice Cream*, the Tax Court concluded that personal relationships of a shareholder-employee are not corporate assets, at least when the employee has no employment contract with the corporation. Howard argued that his case was similar.

Citing *Norwalk v. Commissioner*,[7] the Tax Court pointed out that even when a corporation is dependent on a key employee, the employee cannot own the goodwill if the employee has entered into a covenant not to compete (or similar agreement) under which the employee's personal relationships with clients may become property of the corporation. Howard had a covenant not to compete.

[5]*See Butler v. Commissioner*, 46 T.C. 280, 287 (1966).

[6]106 AFTR 2d 2010-5140, 2010 U.S. Dist. LEXIS 77251 (E.D. Wa., July 30, 2010), *Doc 2010-17126*, *2010 TNT 148-15*.

[7]T.C. Memo. 1998-279, *Doc 98-24175*, *98 TNT 147-5*.

The IRS arguments were strong and predictable:

- the goodwill here was a corporate asset, since Howard was a corporate employee with a covenant not to compete extending throughout his employment and even for three years after he no longer held any corporate stock;
- the corporation earned the income, and correspondingly earned the goodwill; and
- attributing the goodwill to Howard did not comport with economic reality (given his relationship with his professional corporation).

The court seemed to have no choice in this case, concluding that Howard was a corporate employee with a covenant not to compete from 1980 through 2003, plus three more years after the stock sale! Any goodwill generated during that period was corporate goodwill, not Howard's individually. After all, when an employee works for a corporation under a contract with an agreement not to compete, the corporation — not the individual — owns the goodwill. That the goodwill may be generated from the professional's work does not make this goodwill personal goodwill within the meaning of *Martin Ice Cream*.

The corporation had earned the income and paid the taxes on the income from Howard's dental practice. The employment agreement was entered into in 1980. The company controlled the assets, earned the income, and was entitled to enforce the non-competition provision.

Was the 2002 asset purchase agreement helpful? Not really. The court said it was not dispositive whether the goodwill was personal or corporate in nature. The buyer testified that the price for the dental practice had been presented and accepted without negotiation and that he did not recall any discussion about the allocation of proceeds.

Ice Cream Lessons

Even casual readers of the history of personal goodwill probably could have told Howard not to sue for a refund. After all, *Martin Ice Cream* teaches that the documents matter. The presence of an employment agreement with an enforceable covenant not to compete (that extended for three years beyond the close of the deal) seemed fatal. But there is a much more practical point here.

Kennedy is a far closer case, in which the personal goodwill argument was more credible. Why, then, did Kennedy suffer the same fate as the dentist? The answer lies in the belated nature of the personal goodwill allocation and the richness of the allocation, coupled with uncompensated personal services. The analysis is far more nuanced than it was for Dr. Howard, but the conclusion is still predictable.

For each, the thumbnail description of the personal goodwill argument seemed to fit just fine. But the ice cream turned out to be imitation. Was it reasonable for Howard to allocate virtually all of the consideration to him personally? Clearly not. Of the $702,000, Howard's corporation received only $47,100. It is hard to see this as Solomonic.

Was it reasonable for Kennedy to allocate 75 percent of the consideration to his goodwill? The answer is less obvious, but still no. Kennedy had stacked against him the dual bad facts of belated tax-driven negotiations and personal services that seemed entirely gratis. That made the 75/25 split, which already seemed aggressive, way over the top, well beyond the cherry.

Digestif

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, one more tax canard pitched by people who should know better. True, the personal goodwill idea is often misinterpreted and misapplied, as it was by Howard and perhaps less obviously by Kennedy. But it isn't a canard.

When a seller has unique skills and a strong personal relationship with customers distinct from the corporate goodwill, it is worth considering. But be sure to assess whether the individual is bound by a covenant not to compete! Further, if your sale of personal goodwill occurs at the same time as the company's sale (as it usually will), don't be greedy.

This point is nearly universal. One wonders whether Howard's position would not have been challenged (even considering his employment contract and covenant not to compete) if he had been a bit more reasonable in divvying up the money. In *Kennedy*, would a 50/50 split have been better? How about 75/25 the other way?

Both *Howard* and *Kennedy* should serve as a pleasantly iced reminder of *Martin Ice Cream*. Yet ultimately neither case helps nor hurts the personal goodwill authorities. There was relatively little chance either taxpayer would prevail. And their defeat does not mean *Martin Ice Cream* is not still alive and well.