

## Who Owns Goodwill?

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Practicing Law Institute (PLI) is supposed to be practical. What is more practical than acquiring or selling privately held companies? They come in all shapes and sizes and range from stock to assets to tax-free. There are earn-outs, bankruptcy deals and staged buys.

A good way to stay current is *via* thematic updates such as PLI's *Acquiring or Selling the Privately Held Company 2013*. PLI's recent coverage focused on the client rather than any specific type of transaction or area of law. Accordingly, a wide range of legal issues was addressed, including patent infringement concerns, employment contracts, indemnification provisions and corporate fiduciary duties.

With a closely held C corporation, it is important for the controlling shareholder to keep his or her role as investor separate from roles as board member and manager. One reason is to be sensitive to fiduciary duties to minority owners. Another is to respect the sometimes dual-pronged nature of goodwill.

When a business is conducted through a closely held C corporation, who owns the goodwill? Usually, that will be the corporation, but in some cases, goodwill, sometimes called personal goodwill, is owned by the controlling shareholder. Such a person may lead the board and manage the business.

There are usually significant tax consequences when assets of the business (including goodwill) are sold. Buyers may not be concerned precisely who they are paying because they get the step-up in basis in the assets regardless of the identity of the seller. But the buyer must make sure it acquires the assets from the proper owner in order to protect the purchase. Generally, all goodwill and assets are owned by the company. In the case of goodwill, the purchase will normally be accompanied by one or more covenants not to compete.

### Tax and Ownership

The sellers of the business, however, will be mindful that a corporate tax is applied on the asset sale followed by the shareholder-level tax on the distribution. What if an intangible asset

such as goodwill is *actually* owned directly by a patriarch and not through the corporation? How do you determine who owns goodwill?

Usually, the owner of the goodwill, like all other assets, will be the corporation. Yet, if the corporation depends on the owner to perform all of the critical functions of the business, and no employee is legally obligated to continue working for the corporation, it is worth considering whether the corporation actually owns it. Goodwill is generally defined as the reasonable *expectation* for *future* profits.

If the corporation is highly dependent on an individual who could depart at any moment, can the corporation reasonably expect future profits? The case law suggests that the key test for who owns goodwill is determining who controls the business. The indicator for control is whether one can exclude others from the benefits of the business.

Under common law, to be able to exclude others is the best indicator of ownership. As the Supreme Court said in *Ruckelshaus v. Monsanto Co.*, S Ct, 467 US 986 (1984), "the right to exclude others is generally one of the most essential sticks in the bundle of rights that are commonly characterized as property."

### *Martin Ice Cream*

It is impossible to talk about the concept of personal ownership and control of intangible assets (evidenced by the ability to exclude others) without giving a nod to the seminal case of *Martin Ice Cream Co.*, 110 TC 189, Dec. 52,624 (1998). There, the Tax Court held that the goodwill of the business was not a corporate asset. Even though the employee-shareholder ran the business through the corporation, he had all of the necessary skills and relationships to operate the business *without* the corporation.

In addition, the employee-shareholder had the right to exclude others—including his own corporation—from the business. It was key that he was *not* obligated to remain with the corporation. Indeed, he had not signed an employment or noncompete agreement.

Because of this, the Tax Court found that the corporation could only enjoy the benefits of the

business as long as the employee-shareholder chose to be associated with the company. Not having assigned any of his key personal goodwill to the company *via* an employment or noncompete agreement, he still owned it. And that meant he could sell it too.

### Statutory Analysis

A comparison of the tax code sections that define intangible assets also suggests that control over the business is the key to owning and selling goodwill. For a sale of assets of a business to an unrelated party, Internal Revenue Code Section (“Code Sec.”) 197 defines “intangible assets” with a list of specific categories of intangibles (*i.e.*, trademarks, franchise, know-how, *etc.*), *including goodwill*. For transfer pricing purposes, the Treasury regulations under Code Sec. 482 also define intangible assets with a similar list of intangible categories—*excluding, however, goodwill*. [See Reg. §1.482-4(b).]

The transfer pricing exclusion of goodwill appears to be consistent with attributing ownership of goodwill to control of the related business. Transfer pricing is intended to police transactions between related parties under *common* control. Because all of the assets are considered to remain under the same control before and after the transaction, no business (and thus no goodwill) can be transferred.

In contrast, Code Sec. 197 applies to a sale of assets of a business between unrelated parties. The seller of the goodwill may be an individual owner or (in the vast majority of cases) the corporation. They are surely related parties. But the buyer is an unrelated third party. Thus, goodwill can be transferred with the transfer of the business. This distinction between Code Sec. 482 and Code Sec. 197 reinforces the notion that ownership and transferability of goodwill is closely tied to control over the business.

### Limited Planning

Legal theories aside, it must be recognized that there are very few situations in which a business owner can be said to actually own goodwill. Of course, the need for even discussing this possibility does not exist if the business was originally structured as an S corporation, partnership, LLC or LLP. But that does not help a current

operating C corporation, nor does it help one that may have already converted to an S corporation but did so recently. The built-in gain gauntlet of Code Sec. 1374 is, after all, a long 10 years.

In a majority of cases, there will be employment or noncompete agreements between employees and the corporation. Either one will generally preclude any discussion of personal goodwill. Such agreements are desirable to increase the corporation’s control over the business, yet they also foreclose the possibility that a primary owner might personally have goodwill associated with the business.

Of course, as contracts in the corporation’s name with key customers and suppliers expire or are renewed, the terms of those contracts may change. Such terms can affect the corporation’s control of the overall business. Provisions that terminate the contract in situations without corporate action likely limit any control value the corporation may have through the contract. One example is if the contract is terminated upon liquidation, which is an act controlled by shareholders. This is also relevant to the ownership of goodwill, at least where that ownership is not made clear by an employment agreement or covenant not to compete.

### Conclusion

For many small business owners, selling their business may be a once-in-a-lifetime experience. After a career of building a company, what belongs to the owner or the company can seem to merge. Whatever type of entity the company is, however, what the company owns and what the individual owns matters. Not only should structural issues be examined and reexamined every few years, but so too should questions of control and ownership. In taxes, as in all else, they matter.

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