Separating Personal and Business Goodwill

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In a variety of transactions, tax savings are available if goodwill can be allocated to the business owner, rather than the business entity. This article identifies such tax savings situations, as well as the judicial factors and methods used to support an allocation to personal goodwill.

A tax adviser faces a variety of situations in which a client's interests are best served by minimizing the value of business assets. For example, when a C corporation sells its assets and distributes the proceeds to its shareholders, the overall tax liability can be reduced if some portion of the proceeds are allocated to the shareholders, rather than to the corporation. To the extent that goodwill exists in a corporate asset acquisition, a C shareholder may expect to retain an additional 27 cents for every dollar of goodwill allocated to the individual rather than to the corporation.[1]

Although it is not possible to simply assign consideration received in exchange for tangible and intangible assets titled in the corporate name, some flexibility may exist to characterize consideration paid for intangibles (such as goodwill, going concern value and a covenant not to compete (CNTC)) as payments to the shareholder.

This article identifies situations in which a tax adviser may need to assess whether intangible assets (such as goodwill) belong to the business entity or the business owner. It also discusses court decisions on personal versus business goodwill, the factors generally used in classifying goodwill as personal and methods involved in making an allocation to business and personal goodwill.

Need for a Goodwill Allocation

The determination of whether goodwill exists and, if so, whether it belongs to the business entity or to the individual, is relevant whenever tax or economic benefits may be realized by minimizing the business entity's valuation. There may be many such situations, including the six transactions discussed below.

Corporate Asset Sale

If a corporation sells its assets, the gain or loss at the entity level is the difference between the amount realized and each asset's basis. If the entity thereafter liquidates, with the after-tax consideration distributed to shareholders, Sec.331 requires them to recognize gain or loss measured by the difference between the amount realized and their stock basis. To the extent that goodwill exists in the business, its allocation to the shareholder (rather than

[1] This estimate assumes a 34%, corporate tax rate and a 20% capital gain tax. Avoiding one dollar of gain at the corporate level will save 34 cents in corporate taxes; the shareholder will then pay a 20% capital gain tax on an additional

to the corporation) will reduce the amount realized at the corporate level, thereby reducing any gain subject to corporate-level tax. This tax may apply to (1) a C corporation or (2) an S corporation subject to the Sec.1374 tax on built-in gain (BIG), for which corporate goodwill is part of the entity's net unrealized BIG.

Installment Sale

When all or a portion of the purchase consideration is a note issued by the purchaser, a distribution of that note in liquidation of a C corporation (or an S corporation subject to BIG tax on the goodwill) will cause corporate tax to be paid on the final return under Sec.45313.[2] However, to the extent that consideration for goodwill is allocable to a shareholder, any deferred payment for that goodwill would be eligible for installment reporting by the shareholder.

Sec.453(h)(1) allows an S shareholder to defer gain attributable to the receipt of certain installment obligations received in a liquidation. However, if a portion of the installment note is in payment for corporate goodwill, the corporate tax imposed on it is not eligible for deferral, creating an incentive to allocate consideration for goodwill directly to the shareholder. This installment reporting issue should not arise for asset dispositions of an S corporation not subject to the BIG tax, because Sec.453B(h) permits a distribution of the qualified installment obligation without accelerating gain recognition on the final Form 1120S.

Deemed Asset Sale

In addition to an actual sale of its assets, a corporation may be deemed to have sold its assets. Commonly encountered deemed sale transactions that may raise a goodwill issue include a (1) liquidation of an operating business, including a conversion of A corporate entity to a proprietorship, partnership or limited liability company (LLC); and (2) qualified stock purchase (QSP) treated as an asset acquisition via a Sec.338 election.

If a corporation distributes assets in complete liquidation, Sec.336 provides that the corporation will recognize gain or loss as if the assets were sold to the shareholder who receives the distribution.[3] Such a deemed asset sale may create particularly troublesome goodwill issues, because there is no aggregate sale price to allocate among the seven Sec.1060 asset categories. In an actual asset sale, there is a fixed pie to divide among all asset categories, including the Sec.1060 residual goodwill category. In a deemed sale, the IRS and the taxpayer may dispute the total size of the pie, as well as how to allocate it among the seven categories.

A taxpayer who liquidates a corporation (be it an S or a C corporation) should carefully evaluate the factors used to determine the existence of goodwill and whether it belongs to the entity or to the owner. A C liquidation can require payment of a corporate and a shareholder tax; an S liquidation may involve only one level of tax, but the asset distribution will accelerate gain attributable to corporate assets.[4] Taxpayers often ask a tax adviser about the wisdom of converting a corporation to an LLC; the toll charge, if any, imposed on such a conversion depends on the disparity between the value and basis of corporate assets, including goodwill.

A Sec.338 election allows a QSP of a corporate entity to be treated as if the corporate purchaser first established a new subsidiary that then purchased the business's assets. This election has two forms. Sec. 338(g) respects the seller as having sold stock, but allows the buyer to elect to treat the transaction as an asset purchase.

EXECUTIVE SUMMARY

- **Whether goodwill exists, and whether it belongs to the business or the individual, is relevant whenever tax or economic benefits may be realized by minimizing a business's value.**
- **Goodwill does not attach to a business that depends on the owner's skill, ability, integrity or personal characteristics, unless the business has a future claim to that owner's services.**
- **Distinctions between goodwill and going-concern value and between personal and business goodwill are not required by the Sec. 1060 residual-allocation methods, but are essential to support allocations to personal goodwill.**

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[2] Sec. 453B(d) provides that this provision does notapply to subsidiary liquidations governed by Sec.337(a).

[3] Sec.336(d) limits loss recognition in certain anti-abuse situations.

[4] Of course, the shareholder's basis in distributed assets will be adjusted to fair market value (FMV) under Sec.334(a) if the distribution is taxable to the shareholder.

Because the election affects only the buyer's treatment of the transaction, the buyer alone makes the election and bears any tax cost. Sec.338(h)(10), available when a target is a member of an affiliated group or is an S corporation, results in the seller and buyer treating the transaction as a sale and asset purchase.[5]

One difference between a deemed sale created by a Sec. 338 election and a Sec. 336 liquidation distribution, is that, with the former, the aggregate deemed purchase price is set using the amount paid to purchase the stock, avoiding uncertainty about the total size of the asset pie. A Sec. 338(8) election is rarely advisable when C corporation stock is purchased; the existence of corporate goodwill is one of several factors that would weigh against such an election by the purchaser. Similarly, the net cost (and benefit) of a Sec. 338(h)(10) election can be affected by the existence of corporate goodwill.

C-to-S Conversion

The conversion of a C corporation to an S corporation may also be adversely affected by the existence and value of corporate goodwill. Sec. 1374 imposes a BIG tax on such a corporation, at the maximum 35% rate, if such gains are recognized within 120 months of the conversion. This tax is subject to certain limits; the overall limit equals the net unrealized built-in gain (NUBIG) at the date of conversion.6 During the recognition period, any S income is subject to the tax, unless the taxpayer can prove otherwise. As BIGs are realized, the NUBIG decreases and reduces the potential for future assessment of the tax. The existence of corporate goodwill will increase the initial NUBIG determination and raise the potential cost of making a C-to-S conversion.

Transfer Taxes and Charitable Gifts

Value is often important for transfer tax purposes (estate or gift) or for determining the amount of a charitable deduction. Under Regs. Secs. 20.2031-1(b) and 25.2512-1, value is measured using a hypothetical willing buyer and willing seller, with both parties being reasonably informed of the relevant facts and neither being under a compulsion to buy or sell (i.e., the FMV standard). Because the taxpayer typically desires a low valuation for transfer tax purposes, it would be desirable to avoid any goodwill allocation to the entity, if possible. Conversely, corporate goodwill may be beneficial if a charitable gift is made of stock held for more than one year.

Stock Purchaser

A buyer of stock may also prefer to attribute some portion of the purchase price to the shareholder's personal goodwill. The buyer will obtain a cost basis in the stock, but stock is not a Sec.197 asset eligible for amortization. In contrast, to the extent the buyer has paid for shareholder goodwill, Sec.197 would allow 15-year amortization of the consideration allocable to it.

Court Decisions

The status of goodwill as personal or business received significant attention following the Tax Court's decision in *Martin Ice Cream Co.,*[7] in which goodwill was traced to the value of special personal relationships developed by a shareholder. However, the principles underlying that decision were first established over 50 years earlier in *MacDonald,*[8] the first of many cases involving service-oriented businesses. These cases established a rule that goodwill does not attach to a business that depends on the owner's skill, ability, integrity or personal characteristics, unless by contract or otherwise, the business has a future claim to that owner's services.

MacDonald

In MacDonald, a taxpayer owned all of the stock of a corporation that earned virtually all its income from an insurance brokerage business. The corporation liquidated to convert to a proprietorship. Because the insurance business depended mostly on the personal relationships between the taxpayer and his customers, the court held that the taxpayer did not realize income from the transfer of goodwill in the liquidation. MacDonald established the principle that value associated with the business owner's personal relationships or efforts are not corporate assets if the corporation does not have a right, by contract or otherwise, to that individual's future services.

Bryden

This principle was used to separate personal from business goodwill in two later decisions also involving insurance businesses. In *Bryden,*[9] a corporation operating an insurance business liquidated and converted to a partnership. At the time of the liquidation, the facts supported the owner's contention that any value associated with goodwill recorded on the purchase of the assets of another insurance agency had been eliminated, because the former agency owners no longer had personal relationships with the clients. The Tax Court concluded that a purchaser of the agency would not pay for goodwill in the absence of the owner's contractual agreement to continue with the corporation or to refrain from competing with it.

A similar result was reached in Longo,[10] in which an insurance business liquidated and distributed specific client accounts to the owners. The Tax Court cited MacDonald and stated there is no saleable goodwill when- a corporation's business is so dependent on its

[5] Both the buyer and seller must consent to a Sec. 338(h)(10) election, as both will be affected by it.

[6] Under Sec.137(d)(1), NUBIG is the excess of the FMV of all corporate assets over the basis of such assets, determined as of the first day of S status.

[7] *Martin Ice Cream Co*., 110 TC 189 (1998).

[8] *D.K. MacDonald*, 3 TC 720 (1944).

[9] *Stanton H. Bryden*, TC Memo 1959-184.

[10] *Frank J. Longo*, TC Memo 1968-217.

personnel, unless these key employees enter into a CNTC with the corpora-tion. *MacDonald's* principles were extended to goodwill arising in CPA practices in *Rudd'* [11] and *Norwalk*[12]

Martin Ice Cream Co.

Martin Ice Cream Co. was also decided on *MacDonald's* principles, but nonetheless received attention because its owner had sparked a revolution in the retail sale of ice cream. The IRS found that the individual owner's corporation was taxable on the sale of intangible rights, such as the owner's personal relationships with supermarkets, an oral distribution agreement and distributorship expertise. However, because the corporation did not have a CNTC or employment agreement with the owner, the Tax Court con-cluded that the corporation could not transfer what it did not own.

Appraisal Methods

The *International Glossary of Business Valuation Terms*[13] defines goodwill as "that intangible asset arising as a result of name, reputation, customer loyalty, location, products, and similar factors not separately identified." Regs. Sec. 1.197-2(b)(1) defines it as "the value of a trade or business attributable to the expectancy of future patronage. This expectancy may be due to the name or reputation of a trade or business or any other factor." Financial accounting stand-ards define it as "the excess of the cost of an acquired entity over the net of the amounts assigned to assets acquired and liabilities assumed."[14]

The existence and amount o£ any goodwill is a factual question that, using any of the definitions noted above, requires the expertise of a qualified business appraiser. A distinction exists between valuing goodwill when it is *not sold*, versus goodwill that is allocated in a transaction when a business is *sold*.

When the business is not sold (e.g., estate, gift, divorce situations), the standard of value is generally the FMV. A business appraiser defines FMV using the "willing buyer-willing seller" standard that tax advisers recognize as the transfer tax valuation standard. In contrast, the standard of value in a negotiated business sale is investment value, defined as "the value to a particular investor based on individual investment Requirements and expectations."[15] In this article, the terms investment value, transaction value[16] and purchase price are used interchangeably.

Exhibit 1 below depicts the differ-ence between FMV and purchase price (investment value). In a negotiated transaction, the price may be higher or lower than FMV, depending on various factors influencing the buyer and seller. Exhibit 1 illustrates the factors.

Exhibit 1: Value vs. price

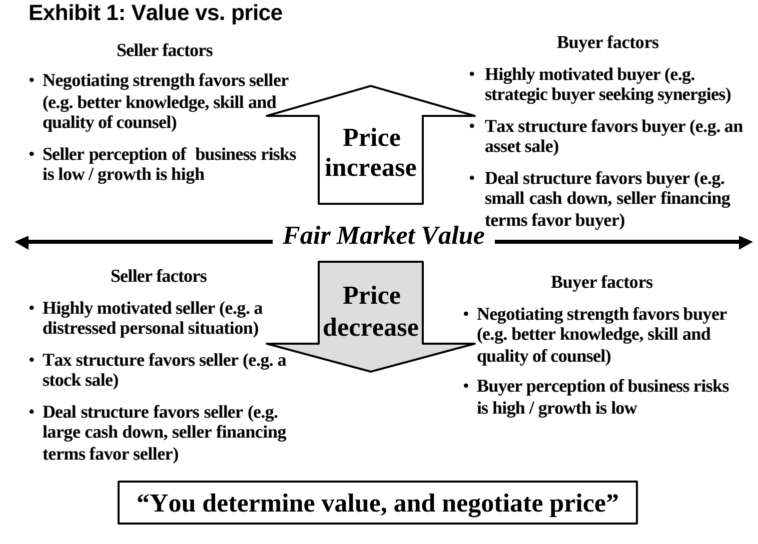
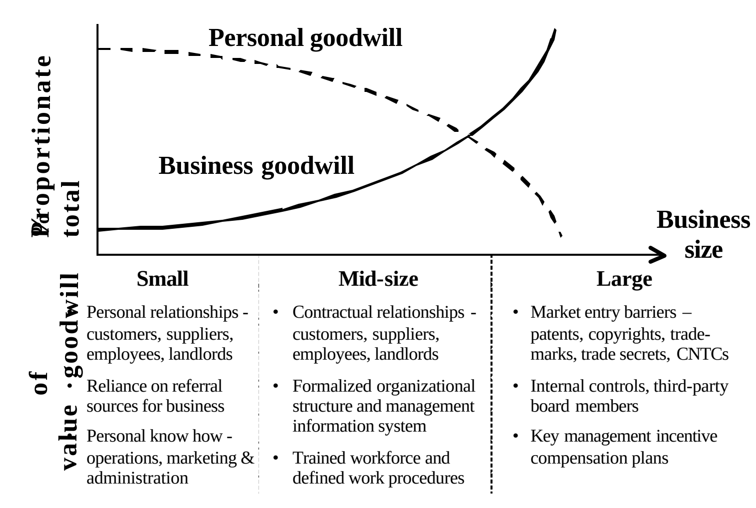


Exhibit 2: Goodwill transition: personal to business



[11] Arthur G. Rudd, 79 TC 225 (1982).
[12] William Norwalk, TC Memo 1998-279.
[13] See the International Glossary of Business Valuation Terms, at www.bvappraisers.org/glossary/glossary.pdf.
[14] Financial Accounting Standards Board, Statement of Financial Accounting Standards (SFAS) No. 141.Business Combinations (June 2001), Appendix F – Glossary.
[15] See note 13, supra.
[16] "Transaction value" is the sum of all consideration paid by a buyer, including that portion related to tangible business asets, CNTCs, employment and consultation arrangements, franchise fees, earn-outs, etc.

Exhibit 3: Purchase-price allocations

Book SFAS No. 141	(buyer's view in an asset purchase)	**Tax** Sec. 1060
	Business allocations	
Financial/tangible assets	Current assets	Class I–IV
Tangible assets	Fixed assets	Class V
Recognized intangibles: • Contractual-legal criterion • Separability criterion	•Identifiable intangibles	Class VI
Goodwill (residual)	**•Business goodwill**	Class VII (residual)
	Personal allocations	
Intangible - contractual	Employment agreements	Expense – Sec. 162
Intangible - contractual	CNTCs	Class VI
Goodwill (residual)	**Personal goodwill**	Class VII (residual)
Expense	Transaction costs	Capitalize – Sec.263

Transaction

the parties may use to determine overall value, including any value assignable to goodwill.

Exhibit 2 on p.349 provides reasons why the goodwill in many small businesses is largely personal. The common factors distinguishing personal from business goodwill are the business's nature, size and sophistication. As a business increases in size and complexity, goodwill slowly transitions from personal to business, for the reasons shown.

Exhibit 3 above illustrates how the transaction value in a business acquisition is allocated for both book and tax purposes. SFAS No. 141, *Business Combinations*,[17] requires that business acquisitions be reported only under the "purchase method"; this applies to both asset and stock purchases.

The method to arrive at goodwill under SFAS No. 141 is similar to the way the purchase price in a business acquisition is allocated among seven asset classes for tax purposes under Sec.1060 and Regs. Sec.1.1060-1(c)(2); both use a *residual method* to arrive at (total) goodwill. Sec. 1060(a) provides that, if the buyer and seller agree to the purchase-price allocation in writing, or agree as to any asset's FMV, that agreement is binding on both parties. [18]

However, the IRS may still challenge the allocation under Sec.1060 and Regs. Sec. 1.338-6(a)(2)(iii) by taking into consideration all factors, including any lack of adverse tax interests between the parties.

As Exhibit 1 shows, purchase price generally increases when the tax structure favors the buyer, to the detriment of the seller, and vice versa. Generally, sellers of businesses try to achieve capital gain treatment to reduce their tax cost. Buyers generally seek to maximize write-offs to reduce their tax costs. The Service is more likely to respect contractual purchase-price allocations when the buyer and seller have adverse tax interests, as shown below.

Five-Step Allocation Method

For Federal income tax purposes, purchase-price allocations have to follow the Sec.1060 residual method. Sec.1060 allocates consideration first to Classes I-VI in amounts not in excess of the FMV of assets within those classes, with any residual (Class VII) classified as goodwill or going-concern value. Here, a five-step method is proposed to allocate the purchase price among the assets in a business acquisition. This method follows the Sec.1060 principles and also considers distinctions both between goodwill and going-concern value, and between personal and business goodwill.

These Class VII distinctions are not required by Sec.1060 and are not separately reported on Form 8594, Asset Acquisition Statement Under Section 1060, but they are an essential aspect of a business appraisal designed to provide the taxpayer with support for an allocation of transaction value to personal goodwill. Although this article focuses on step five below (the allocation of goodwill between personal and business), steps one through four must be followed to provide support for the ultimate allocation to goodwill (both business and personal).

Step One-Determine the Purchase Price

Before any allocation takes place in a business acquisition, the purchase

Adverse tax interests

Price Allocation	Favorable to:	Unfavorable to:
Inventory	Buyer:deducted when sold	Seller: ordinary income above basis
Equipment	Buyer:depreciated, generally over 5-7 years	Seller: depreciation recapture is ordinary income
Land	Seller: capital gain above tax basis	Buyer: nondepreciable
Business goodwill	Seller: capital gain*	Buyer: 15-year amortization

*Preferential tax rates for net capital gain apply only to individual owners of businesses organized as passthrough entities; there is no preferential capital gain rate for C corporations (although they may prefer capital gains if needed to offset capital losses).

[17] See SFAS No. 141 supra.

[18] Reg. Sec.1.1060-1(c)(4) states that parties to the written agreement may ignore it only if the agreement's enforceability may be challenged by mistake, undue influence, fraud, duress and similar factors, under *Carl L. Danielson*, 378 F2d771 (3d Cir. 1967)

Exhibit 4: Intangible assets – apart from goodwill (Source: SFAS No. 141 – Appendix A)

A. Marketin-related intangible assets:
  (1) Trademarks, tradenames†
  (2) Service marks, collective marks, certification marks†
  (3) Tradedress (unique color, shape or package design†
  (4) Newspaper mastheads†
  (5) Internet domain names†
  (6) Noncomopetition agreements†

b. Customer-related intangible assets:
  (1) Customer lists*
  (2) Order or production backlog†
  (3) Customer contracts & related customer relationships†
  (4) Noncontractual customer relationships

c. Artistic-related intangible assets:
  (1) Plays, operas, ballets†
  (2) Books, magazines, newspapers, other literary works†
  (3) Musical works, such as compositions, song lyrics, advertising jingle†.
  (4) Pictures, photographs†
  (5) Video & audiovisual material, including motion pictures, music videos, television programs

d. Contract-based intangible assets:
  (1) Licensing, royalty, standstill agreements
  (2) Advertising, construction, management, service or supply contracts†
  (3) Lease agreements†
  (4) Construction permits†
  (5) Franchise agreements†
  (6) Operating & broadcast rights†
  (7) Use rights, such as drilling, water ,air, mineral, timber cutting & route authorities†
  (8) Servicing contracts, such as mortgage servicing contracts†
  (9) Employment contracts†

e. Technology-based intangible assets:
  (1) Patented technology†
  (2) Computer software and mask works†
  (3) Unpatented technology*
  (4) Databases, including title plants*
  (5) Trade secrets, such as secret formulas, processes & recipes†

† Contractual-legal criterion: Intangible assets apart from goodwill arising from contractual or other legal rights.

* Separability criterion: Intangible assets apart from goodwill that are capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged

Note: SFAS No. 141, p. 12,¶39: "For purposes of this Statement, an assembled workforce shall not be recognized as an intangible asset apart from goodwill."

price must be established. SFAS No. 141 describes this as the initial measurement, and states "in exchange transactions, the fair values of the net assets and the consideration paid are assumed to be equal, absent evidence to the contrary." Fair value of assets for SFAS No. 141 and Sec.1060 purposes is generally the same. The following are common forms of consideration used in business acquisitions:

• Cash,
• Assumed liabilities,
• Seller financing,
• Buyer's stock,
• Escrowed funds,
• Earnouts,
• CNTCs,
• Employment/consulting agreements,
• Lease and royalty agreements and
• Debt conversion agreements.

The aggregate purchase consideration, as determined in step one, has to be allocated among specific tangible and intangible assets acquired.

Step Two-Asset Allocations: Other Than Intangibles

The first purchase-price allocations are to the acquired business's financial assets[19] and tangible assets. Typically, these are the current and fixed assets of most business enterprises. Under Sec. 1060, they would be those assets in Classes I-V Of course, Sec.1060 requires that the consideration be allocated sequentially among the first five asset categories specified by Regs. Secs.1.1060-1(c)(2) and 1.338-6(b)(2),limited by the FMV of each asset category. However, because this article focuses on the residual intangible classification, step two consolidates the consideration allocable to the first five asset classes.

Step Three-Asset Allocations: Identifiable Intangibles

The next allocations are to specifically identifiable intangible assets.[20] SFAS No. 141 classifies these intangibles as those meeting the contractual-legal and/or separability criterion. Exhibit 4 above is an excerpt from SFAS No. 141 that lists identifiable intangible assets under these two criteria. Under the Sec. 1060 regulations, identifiable intangible assets are Class VI assets (see Exhibit 3).

Traditional valuation approaches (i.e., asset-based, income and market) are used to determine the FMVs of identifiable intangible assets. Except for "workforce in place" and a CNTC, valuation approaches and methods for identifiable intangible assets are beyond the scope of this article and would be addressed by a business appraiser.

[19]SFAS No. 141, note 14 supra, defines a financial asset to include cash, evidence of an ownership interest in an entity or a contract that conveys to a second entity a contractual right (1) to receive cash or another financial instrument from a first entity; or (2) to exchange other financial instruments on potentially favorable terms with the first entity.

[20]SFAS No. 141, note supra, defines intangible assets as assets (not including financial assets) that lack physical substance.

Under Sec. 1060, a workforce in place is deemed a Class VI asset, apart from going-concern value, a Class VII asset. However, for accounting purposes under SFAS No. 141 (see Exhibit 4 Note), an assembled workforce is deemed part of residual goodwill. For purposes of this article, an assembled workforce will be deemed an identifiable intangible asset separate from goodwill and going-concern value. An asset-based (cost) approach is commonly used to value a workforce in place; for example, that value would equal the cost to hire and train an assembled workforce.

CNTC: During the negotiations for the purchase of a business, a buyer may insist that the seller (either the business or personally) enter into a CNTC. These agreements provide protection for the buyer, by preventing the seller from operating a competing business within a specified territory, for a specified time. A personal CNTC is often included in the purchase-price allocation involving personal service businesses or professional practices, largely because the most significant asset purchased is personal good-will.The CNTC would be respected as a separate asset if it has economic reality. The first decision[21] requiring a CNTC to meet the economic reality test stated "the covenant must have some independent basis in fact or some arguable relationship with business reality such that reasonable men, genuinely concerned with their economic future, might bargain for such an agreement." In a subsequent case,[22] the Tax Court cited 11 factors to consider in applying the economic reality test.

In a CNTC valuation, the income approach is most commonly used. An IRS Market Segment Specialty Program release[23] identifies two methods to value a CNTC: the present value of the (1) seller's compensation over the life of the covenant and (2) economic loss to the buyer on the assumption that the seller re-enters the market.

Buyers should be indifferent to an allocation between goodwill and a CNTC, because Sec. 197 allows a buyer to amortize goodwill or a CNTC over the same 15-year period. Sellers, however, prefer goodwill allocations (capital gain treatment) over a CNTC (ordinary income treatment). Although C corporations have no preference for capital gains other than to offset capital losses, sellers nonetheless want support for allocations to potential personal assets (i.e., goodwill) to avoid the double tax. Because there is lack of adverse tax interests between buyers and sellers when allocating between goodwill and a CNTC, the Service will scrutinize these allocations closely.

Step Four-Residual Allocation: Going-Concern Value

The allocations of purchase price in steps two and three were based on the FMV of Sec. 1060 Class I-VI assets. What remains is simply a residual (if any), representing the difference between the purchase price and Class I-VI allocations. This residual amount is the going-concern value of the business plus goodwill (if any, be it business or personal). If there is a Class VII residual amount in a purchase-price allocation, often at least some amount is allocated to going-concern value (even when there is no business goodwill).[24]

The business appraiser's efforts in steps four and five are directed to an allocation between goodwill and going-concern value in a manner that best resembles economic reality, consistent with the facts and circumstances surrounding the business acquisition (including how the deal structure is negotiated). Because of the dynamics of a negotiated transaction and how the residual is affected, traditional business valuation approaches (particularly income and market) are less meaningful at this stage.

Goodwill and going-concern value are separate and distinct assets. Regs. Sec. 1.197-2(b) defines goodwill as "the value of a trade or business attributable to the expectancy of continued patronage. This expectancy may be due to the name or reputation of a trade or business or any other factor." Going-concern value is defined as "the additional value that attaches to property because of its existence as an integral part of an ongoing business activity" The residual method (for tax purposes) combines these assets as a single class. However, the business appraiser has to separate going-concern value from the total goodwill to support an allocation of any transaction value outside the business entity.

Going-concern value (excluding a workforce in place, which is not a residual-class asset under the Sec.1060 classification scheme) may include value attributable to the following other assets in place: (1) location, (2) operational plant and equipment, (3) records and accounting systems, (4) advertising programs and (5) licenses and permits. As with the valuation of an assembled workforce, a reproduction cost method would be appropriate to value other assets in place. In *Concord Control, Inc.*,[25] the Tax Court determined going-concern value by taking a percentage of the FMVs of various property and equipment categories (now Class V assets).

Buyers are indifferent as to an allocation between going-concern value and goodwill. However, sellers would prefer a goodwill allocation to enhance the ability to allocate transaction value outside of the business entity. This lack of adverse tax interest is again likely to heighten the IRS's level of scrutiny, suggesting the need for a qualified appraisal that supports the personal-business allocation.

Step Five-Residual Allocations: Personal and Business Goodwill

Once the purchase-price allocations are made under steps two through four, what remains is residual goodwill,

[21] *Ray H. Schulz*, 34 TC 235 (1960, aff'd, 294 F2d 52 (9th Cir.1961).
[22] *Charles B. Thompson*, TC Memo 1997-287.
[23] Internal Revenue Service, ISP-MSSP, IRPO ¶80,245, "Covenants Not To Compete" (2/19/96).
[24] In *Martin Ice Cream Co.*, note 7 supra, the facts did not support the existence of business goodwill, but an amount was still allocated to going-concern value. The amount allocated is again affected by the facts and circumstances of the business acquisition.
[25] *Concord Control, Inc.*, TC Memo 1976-301.

Exhibit 5: Personal vs. business goodwill allocation checklist

Facts and circumstances surrounding the business

Personal goodwill indicators	Business goodwill indicators
▪ Small entrepreneurial business highly dependent on employee-owner's personal skills and relationships.	▪ Larger business, which has formalized its organizational structures and institutionalized its systems and controls.
▪ No pre-existing CNTC and/or employment agreement between selling company and employee-owner.	▪ Owner-employee has pre-existing CNTC and/or employment agreement with selling company.
▪ Personal service is an important selling feature in the company's product or services.	▪ The business is not heavily dependent on personal services.
▪ No significant capital investment in either tangible or identifiable intangible assets.	▪ The business has significant capital investments in either tangible or identifiable intangible assets.
▪ Only employee-owners own the company.	▪ The company has more than one owner, some of whom are not employees.
▪ Sales largely depend on the employee-owner's personal relationships with customers.	▪ Company sales result from name recognition, sales force, sales contracts and other company-owned intangibles.
▪ Product and/or services know how, and supplier relationships, rest primarily with the employee-owner.	▪ Company has supplier contracts and formalized production methods, patents, copyrights, business systems, etc.

Deal Structure

Personal goodwill indicators	Business goodwill indicators
▪ Buyer has insisted on, and bargained for, a separate personal CNTC and/or employment agreement.	▪ Buyer has not insisted on, and bargained for, a separate personal CNTC and/or employment agreement.
▪ There is a separately bargained for agreement to purchase personal goodwill.	▪ There is no separately bargained for agreement to purchase personal goodwill.
▪ Personal seller financing is part of the consideration, with right of offset (e.g. loss of existing customers).	▪ Seller financing is with the company, with no right of offset.
▪ An earnout is part of the consideration; payout depends on future company sales and/or earnings.	▪ An earnout is not a significant part of the consideration.
▪ A strategic buyer's acquisition premium can be traced to attributes found in personal goodwill.	▪ A strategic buyer's acquisition premium can be traced to attributes found in business goodwill.

without regard to its status as business or personal. The following small-business characteristics support the characterization of goodwill in smaller businesses (i.e., those with revenues under $5 million) as largely personal:[26]

• The owners are directly associated with the firm, typically as full-time employees.

• Employee-owners generally make all significant management decisions and are involved in company matters on a day-to-day basis.

• The business operations are inseparable from the employee-owners; the business's stability (financial and otherwise) depends on the stability (financial and otherwise) of the individual equity owners.

• The business may not survive beyond the tenure of the current equity owners; it may not have created institutional attributes that allow it to transcend the departure of the individual equity owners. One way to assess personal goodwill is to examine the overall influence an employee-owner has on the small business's future success and viability. Based on the specific facts and circumstances, the more the business depends on the employee-owner's personal relationships, knowledge and skills, the greater is the personal goodwill. How the parties negotiate the deal is also important in determining the allocation between personal and business goodwill. There should be separate purchase agreements for business assets and separate agreements with individuals for personal assets. When personal goodwill is purchased, it makes sense for buyers to ask for an employment or consulting contract and a CNTC (including contingent payments) to ensure transferability.

Exhibit 5 above presents a checklist of factors to distinguish personal from business goodwill.

Conclusion

The issue of how to distinguish between personal and business goodwill has drawn significant attention ever since the Tax Court's decision in *Martin Ice Cream Co.* Tax savings are available in a variety of transactions if goodwill can be shifted away from the business entity. Although the Tax Court has followed a well-reasoned and consistent approach to this issue for more than 50 years, the classification of goodwill depends on the facts and circumstances. Knowledge of the judicial factors and appraisal methods can assist tax advisers in supporting a case for an allocation to personal goodwill.

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[26]See Pratt, Reilly and Schweihs, *Valuing Small Businesses and Professional Practices* (McGraw-Hill, 3d ed., 1998, p.69.