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Personal Goodwill (PGW) Revisited

This issue is devoted to personal goodwill (PGW) – first discussed in the April 2007 issue of *Business Transaction Marketplace*SM. Let's review. When the transaction price in a business acquisition is looked at closely, at times, there may actually be two sellers: 1) the business entity selling its Enterprise Value consisting of working capital, fixed assets, going concern value and business goodwill, and 2) an individual selling his or her PGW.

Allocation of the purchase price to PGW may reduce the overall tax cost, particularly when there is an asset sale involving a C Corp; that's because of the double tax situation in C Corps. A price allocation away from a C Corp – to the individual seller – eliminates this dreaded double tax. Thus, sellers have an interest in finding a PGW component as part of a business transaction – should it exit.

In 1998, there were two tax cases that dealt with the issue of PGW. The *Norwalk* case dealt with the liquidation of a CPA firm; and, the *Martin Ice Cream* (MIC) case which dealt with the sale of an ice cream distributor. The MIC case gained national attention because it dealt with PGW involving a company other than a personal service business (as in *Norwalk*).

Now, over ten years later, tax cases are being tried that mention the MIC case and the propriety of PGW allocations. In this issue, we will revisit the MIC case and the guidance it provided on PGW. We'll then summarize four (4) recent tax cases that challenged PGW allocations, and the lessons they provide.

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The Martin Ice Cream Case

Martin Ice Cream Co. v. Commissioner, 110 TC 189 (March 17, 1998). The case involved Arnold Strassberg (Arnold) who developed a unique way of packaging and marketing ice cream products to large supermarkets along the Jersey Shore during the 1960's – all done based on Arnold's personal relationships with customers and suppliers. When Arnold's former company went bankrupt, it reformed as Martin Ice Cream Co. (MIC) when his son Martin was brought in as another owner.

In 1974, the founder of Haagen-Dazs (HD) entered into an oral agreement with Arnold to distribute HD ice cream to supermarkets. It sparked a revolution in the retail sale of high quality, higher priced ice cream. Pillsbury Co. bought out HD in 1983 and began consolidating its distribution channels – thereby eliminating middlemen like MIC. The company was sold to Pillsbury for $2.46 million, nearly half the price being allocated to Arnold's PGW. Prior to the sale, MIC made a failed attempt at a non-taxable split-off of its large supermarket accounts into a new subsidiary – SIC – which was the only asset Pillsbury wanted to purchase. From the IRS's viewpoint, the split-off was taxable, thus becoming the underlying issue behind the tax case.

The Court's Ruling: "The benefits of personal relationships developed by (A) (Arnold Strassberg) with supermarket chains and (A)'s oral agreement with the founder of HD (Ruben Mattus) were not assets of MIC that were transferred by MIC to SIC (the split-off), and therefore sold by SIC to HD (Pillsbury). (A) was the owner and seller of those assets."

Facts of the MIC case provide guidance on what factors might indicate the existence of PGW, such as:

- The business is relationship dependent vs. capital dependent
- The employee-owner(s) have no written employment or non-compete agreements with their company
- There are no written customer or supplier agreements documenting property rights

Four Cases Challenge PGW Allocations

1. *Soloman v. Commissioner*, TC Memo 2008-12 (April 16, 2008). The case involved the sale of a manufacturing line to a competitor. The employee-shareholders entered into non-compete agreements with the buyer. Conflicting provisions within the Asset Purchase Agreement made it unclear whether payments to shareholder-employees were for customer lists (later argued as PGW) or non-compete payments.

   Court's Ruling. The court ruled that since it was a manufacturing business, the assets of the business did not depend upon the employee-owners for its success. Furthermore, the Asset Purchase Agreement indicated that the shareholders were not sellers of the assets, but only acting in their individual capacities as parties to a non-compete. In addition, the shareholders were not required to enter into employment or consulting agreements which made it unlikely that the buyer was purchasing PGW.

2. *Irwin Muskat v. U.S.*, No. 08-1513, 1st Cir, (January 29, 2009). Irwin Muskat, the controlling shareholder in Jac Pac Foods, sold his family business to Manchester Acquisition Corp. The purchase agreement included $15 million allocation to Jac Pac's business goodwill, and required Muskat to execute a 13-year non-compete agreement. Manchester's obligation to make payments on the non-compete would survive Muskat's death or disability. Initially, Muskat reported payments under the non-compete as ordinary income, but later claimed the payments were for his PGW.

   Court's Ruling. The court ruled that negotiations between Muskat and Manchester made no mention of Muskat's PGW, and the consideration paid under the non-compete agreement was bargained for as a covenant not to compete. Muskat did not show by "strong proof" that the contracting parties intended the payments to compensate for something other than what was bargained for at the time the agreement was written.

3. *Howard v. U.S.*, 106 AFTR 2d. 2010-5140 (July 30, 2010). The case involved a solely-owned dental practice formed as a C-Corp in 1980 by Dr. Larry Howard as Howard Corporation. At that time, Dr. Howard entered into an employment contract with his Corporation, which included a non-compete agreement. In 2002, Howard Corporation sold its assets to a buyer, under an Asset Purchase Agreement where Dr. Howard received $550,000 for his PGW; Howard Corporation received $47,000 for its assets.

   Court's Ruling. The court ruled that since Dr. Howard had a non-compete agreement with Howard Corporation, any goodwill created during the period from 1980-2002 belonged to Howard Corporation, and therefore no portion of the goodwill payments were be deemed to be PGW.

4. Kennedy v. Commissioner, TC Memo 2010-206 (September 22, 2010). Beginning in 1990, James Kennedy was engaged in an employee-benefits consulting business. The sole proprietorship was incorporated in 1995 as KCG International, a C Corp. In 2000, the business was sold, and the price allocated as follows: a) $10,000 for KCG's assets, b) 75% of a predetermined formula for Kennedy's PGW, and c) 25% for Kennedy's consulting services. Kennedy would only be paid for post transaction PGW upon the retention of clients he continued to service. Kennedy stayed on to work for the buyer for five (5) years after the sale receiving only compensation under the PGW agreement.

   Court's Ruling. The court ruled that the payments Kennedy received for his alleged PGW were really consideration for his post-sale services and his promise not-to-compete. Thus, the payments were re-characterized from capital gain to ordinary income.

PGW Lessons from the Courts

- It's much harder to argue PGW when the company is in the manufacturing business
- Employment and non-compete agreements support the allocation to PGW
- Employee-owner's non-compete agreement with his/her company transfers PGW to business goodwill
- Early negotiations should mention that PGW is being acquired; final documents should clearly state it
- What the seller's duties are post-transaction are critical: a) to transfer PGW? b) to provide services?

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