

2020 BENCH-BAR CONFERENCE

A METHOD of GOODWILL ANALYSIS

Sample

The viewpoint of Thomas Gillmore, CPA/ABV

Moderator, Honorable Donald Myers

Note: This method of goodwill analysis is provided by the appraiser for educational and discussion purposes only and does not reflect the opinion of the Florida Judiciary, the legal position of an attorney, nor the currently accepted method of goodwill appraisal in marital dissolution cases in Florida.



Table of Contents

Engagement Overview	6	Taxation Strategies	20
Company Overview	6	Asset Allocation – IRC 1060	21
Industry Outlook	7	Summary and Results	21
Valuation of the Company	8	Appendix A – Industry Overview	23
Goodwill	8	Appendix B – Economic Outlook	24
Personal Goodwill - Identification	9	Appendix C – Valuation Analyst’s Representations	28
Enterprise Goodwill	13	Appendix D – Assumptions & Limiting Conditions	29
Case Law - Personal Goodwill	16	Appendix E – Appraisal Certification	31
Case Law – Non-Compete Agreements	17	Appendix F - Sources of Information.....	32
Case Law – Economic Reality	19		
Case Law – IRS Guidance	20		

October 2, 2020

Dear Conference Attendee:

In this sample, the appraiser analyzes the attributes of (1) corporate goodwill and (2) personal goodwill. The purpose of the original engagement was to report taxes on the sale of a C Corporation, where IRS fights back against the tax-favored personal goodwill allocation. The purpose of showing you this analysis is to open a conversation on behalf of the monied spouse (business owner) who would likely make arguments similar to those made by the taxpayer.

Note #1: This method of goodwill analysis provided by the appraiser is for educational and discussion purposes only and does not reflect the opinion of the Florida Judiciary, the legal position of an attorney, nor the currently accepted method of goodwill appraisal in marital dissolution cases in Florida.

Note #2: The methods and results of this business valuation sample are provided by the appraiser for educational and discussion purposes only and do not reflect the opinion of the Judiciary or legal position of an attorney.

Mrs. Jacqueline Best and Mr. Franklin Best
Bug Bite, Inc.
PO Box 8798
Ocoee, FL 34761

Re: Appraisal of Goodwill Component of Bug Bite, Inc.

Dear Jacqueline and Franklin,

At your request and pursuant to our engagement letter, we have prepared and enclosed herewith our appraisal report of Bug Bite Exterminating Company Incorporated (Bug Bite, Inc.) As of August 31, 2020 (the Valuation Date). The purpose of this valuation is to determine the value of the personal goodwill of Franklin Best, CEO, as of the valuation date for tax filing and reporting under generally accepted accounting principles. This valuation opinion may be used for compliance purposes in conjunction with Internal

Revenue Code Section 1060 and IRS form 8594, Asset Acquisition Statement. We anticipate that this valuation will be used in the asset allocation process to reflect the terms and amounts described in a letter of intent from Arrow to purchase the business.

The standard of value for this engagement is “fair market value.” Fair market value is defined by IRS Revenue Ruling 59-60, 1959-1 C.B. 237 as “the Price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge have relevant facts.” RR 59-60 also states that “in addition, the hypothetical buyer and seller are assumed to be able, as well as willing, to trade and to be well informed about the property and the market for such property.”

For the purpose of this engagement, The Appraiser has assumed that fair market value is equivalent to the current purchase price agreed to between Bug Bite, Inc. and Arrow Exterminators.

The value of personal goodwill subject to a non-compete agreement derives from the avoidance of loss as a result of:

- Reduction in revenue
- Increase in expenses
- Deferral of development
- Change in working capital needs
- Anything that could otherwise reduce the cash flows of the acquired business

The purpose of this valuation is to identify and quantify, in monetary terms, the potential impact on cash flows stemming from Mr. Best’s personal goodwill to be protected by a non-compete agreement. In this body of work, we have concluded that personal goodwill does exist, and is both salable and transferable to a buyer. We understand that a covenant not to compete will be entered into as an assurance to the buyer of its continued economic and monetary benefit from Mr. Best’s personal goodwill.

Our analysis of these separate components: (1) enterprise and (2) personal goodwill; included consideration of specific industry-recognized attributes that we evaluated to determine whether each or any of those attributes were significant enough to warrant a purchase price allocation, whether to enterprise goodwill or to personal goodwill. The quantification of such personal and enterprise goodwill attributes is both an art and a science, requiring thoughtful contemplation and discussion. This quantification process assists the buyer and the Seller in determining whether the identified goodwill attribute is both salable and transferrable.

A critical lynchpin to our analysis is the confirmation from Mr. Best that no prior non-compete agreement has been executed between himself and Bug Bite, Inc. In other words, Mr. Best remains the sole owner of his personal goodwill, and he intends to sell such goodwill to Arrow Exterminators.

If a non-compete and a consulting agreement are contemplated, each must be distinguishable from the other to avoid recharacterization upon audit by the IRS. As such, we recommend using a separate Purchase and Sale Agreement for the Personal Goodwill of Franklin Best.

- We recommend that all parties clearly understand the language of IRC 1060 (a) (2), which states, “If in connection with applicable asset acquisition, the transferee and transferor agree in writing as to the allocation of any consideration, or as to the fair market value of any of the assets, such agreement shall be binding on both the transferee and transferor unless the Secretary determines that such allocation (or fair market value) is not appropriate.” Similarly, the IRS may be more likely to audit the tax forms 8594 that do not match.
- To recognize the quantified economic value of Mr. Best’s personal goodwill, we recommend using a non-compete agreement reflecting the following personal goodwill value:
- **\$800,000 Personal Goodwill of Franklin Best, President**

We appreciate the opportunity to provide valuation services to Bug Bite, Inc. Our valuation is subject to the attached statement of assumptions and limiting conditions.

Engagement Overview

The appraiser has been retained by Bug Bite, Inc. and has prepared this report for the purpose of expressing its opinion as to the fair market value of Mr. Franklin Best’s personal goodwill relative to the overall value of the Bug Bite, Inc. enterprise. This report is intended to present an objective, unbiased opinion of value for the exclusive purpose mentioned previously.

Company Overview

Company Background

Bug Bite is a well known and highly respected name throughout the state of Florida. This company is almost entirely a pest control and termite control business with very little lawn and fumigation. The company has a rich history in the industry. Bug Bite was originally incorporated in the state of Florida in 1946 as Rattler Exterminating company. In 1978 the company reorganized and was renamed Bug Bite exterminating company incorporated. The company moved to its current location in 1982.

Grandpa Best served in the Florida House of Representatives representing Orange County from 1963 to 1975; he was a silent partner in the business until this passing in 1984. Dick Best managed the business and was actively involved in both the national and Florida pest management associations. He was president of the Florida pest Management Association in 2009.

Following the passing of Dick Best in 1975, company ownership passed to his wife, Carolyn Best. Carolyn was one of the first women to become certified in pest control in the state of Florida. Her certificate number was 1170. In addition to being actively involved in the daily activities of the business, she was elected to and served on the board of directors for the Florida Pest Management Association. Richard “Rick” Best Began managing the company operations in 1975 and was succeeded by his son Franklin Best in 1985.

Company Personnel

The company employs nine pest and termite technicians, three office personnel, seven management-level personnel, and a general manager. Eight personnel are certified pest control operators.

Information Technology

WorkWave/ PestPac network structure is cloud-based, used for customer management. QuickBooks is used for financial record-keeping and payroll.

Sales Process

Inbound sales leads are entered in PestPac/WorkWave. They are then distributed to the appropriate Account Manager (territory based on zip code). The Account Manager then calls the potential customer to discuss the nature of the pest problem. At this time, the appointment is set for the inspection to identify the pest problem, measure the property & draw a graph of the home and property. The Account Manager explains the service, the price, and payment information. If the potential customer requests a quote for pest control services over the phone and refuses to book an appointment for the inspection, the Account Manager ascertains, through a series of questions, what the pest problems are, i.e., roaches, ants, or fleas. The size of the home or property is also determined at this time. In this case, the rest of the steps to the proposal are also completed over the phone by the Account Manager. The disposition of all leads is reviewed the following day at morning check-in by the General Manager. Sales coaching and assistance is also done during morning check-in.

Internet Marketing

The Bug Bite’s marketing strategy is to grow market share in the greater Orlando area through its presence on the Internet. Search engine optimization, pay per click, and Google AdWords are utilized to drive potential customers to its website. Once at the site, potential customers are provided information to contact Bug Bite, Inc. for a solution to their pest problem period. Also, the company uses high-resolution pictures, digital copies of all marketing material, and point-of-sale material.

Industry Outlook

While the rise of bedbugs across the United States has left homeowners and business owners frustrated, it has been a boon for the Pest Control industry. As a result of heightened demand for extermination and prevention services, industry revenue is expected to grow an annualized 4.3% to \$16.2 billion over the five years to 2019, including an expected increase of 1% in 2019 alone. While bedbugs were typically confined to hotels and few residences in the past, the creatures have begun to pop up in more unlikely spots, including movie theaters, offices, and even clothing stores. The increased occurrence of these pests has led to substantial demand for pest exterminators and rising service prices.

Weather changes have a significant effect on rodent and insect swarm development. When annual rainfall rises, pests are more likely to move indoors, boosting demand for pest control services. The average annual precipitation is expected to decrease in 2019, posing a potential threat to the industry.

Pest extermination services are considered a necessary service for most consumers. However, when per capita disposable income falls, consumers will be more likely to use general pest control products from home and garden stores instead of more expensive industry services. Improving employment will lead to an increase in per capita disposable income in 2019, representing a potential opportunity for the industry.

Valuation of the Company

For this engagement, The Appraiser has assumed that fair market value is equivalent to the current purchase price agreed to between Bug Bite, Inc. and Arrow Exterminators. Specifically, Arrow is buying \$400,000 worth of equipment, consisting of fifteen vehicles, office furniture, and fixtures, plus contracted recurring revenues of one million nine hundred forty-seven thousand, one-hundred forty-two dollars.

Goodwill

26 US Code Section 1.197-2(b)(1) defines goodwill as “the value of a trade or business attributable to the expectancy of continued customer patronage,” and that “[t]his expectancy may be due to the name or reputation of a trade or business or any other factor.” In Rev. Rul. 59-60, the IRS describes goodwill as being based on earning capacity. “The presence of goodwill and its value, therefore, rests upon the excess of net earnings over and above a fair return on the net tangible assets. While the element of goodwill may be based primarily on earnings, such factors as the prestige and renown of the business, the ownership of a trade or brand name, and a record of successful operation over a prolonged period in a particular locality, also may furnish support for the inclusion of intangible value.”

Personal Goodwill - Identification

Personal goodwill is owned by the shareholders and can be present when the owner's reputation, expertise, skill, knowledge, and relationships with customers are critical to its success and value.

We identified and analyzed the following personal goodwill attributes marking (+) for the attributes which indicate personal goodwill sufficient enough affect the future earnings of the company for which a non-compete agreement is required to protect the buyer's interest in those cash flows. The (-) sign indicates an immaterial impact on the future cash flows of the company.

1. **Ability, Skills, Judgment (+)**

Mr. Best's expertise, skills, and judgment are superior compared to an equally trained and dedicated Chief Executive Officer, earning a similar salary based on his years of experience and dedication to Bug Bite, Inc. Mr. Best has been employed at Bug Bite for 48 years and has been actively involved in all areas of the business. He was a service technician and then a supervisor in pest control, termite, fumigation, and lawn care. Mr. Best also worked in the office in an administrative function doing payroll and accounts receivable and has been president of Bug Bite since 1986.

Since 1983, he has been licensed by the Florida Department of Agriculture and Consumer Services in General Household Pest and Rodent, Termite and Other Wood-Destroying Organisms Control, Lawn and Ornamental Pest Control, and Fumigation. As such, Mr. Best encountered countless numbers of pest control related problems and successfully provided solutions to customers.

Bug Bite, Inc. has been a full-service pest control business for over 70 years. Mr. Best grew up in the family business and started on a part-time basis during summers and became a full-time employee in 1972. His core values of hard work, dedication, honesty, and integrity have been honed by years of service at Bug Bite. Mr. Best cares deeply for the employees and providing excellent customer service as the cornerstone of his career.

Mr. Best was on the board and served as chairman of the Florida Pest Control Association Property and Casualty Trust. Additionally, he served on the Florida Pest Control Association. First of all, Mr. Best's leadership involvement in the industry and 28 years of experience uniquely differentiate him from his competitors and is a strong indicator of personal goodwill. Secondly, there are sufficient factors in this category upon which Mr. Best could rely to circumvent a non-compete agreement if he chose to do so. Therefore, value allocation is appropriate.

2. Age & Health of Owner (-)

There is likely less personal goodwill in an older or unhealthy practitioner since expected future earnings are not expected to continue for an extended time. The age and health of the individual are considered when weighing the likely longevity of the continuing goodwill. This could be particularly important if the individual's health is poor and or the age is advanced. First of all, there are insufficient factors to distinguish Mr. Best from the competition in this industry. Secondly, having entered into retirement age, Mr. Best is less likely to thwart the intent of a non-compete agreement. Therefore, value allocation is not appropriate.

3. Proximity of Contact (-)

When the individual performs a service or offers a product, the proximity of contact generally increases the likelihood that the goodwill generated will be personal. For example, an anesthesiologist may have little or no personal contact with a patient, whereas an ophthalmologist must have substantial personal contact. Mr. Best is involved daily with all aspects of the business. Bug Bite, Inc. is a small business, and as such, Mr. Best deals directly with customers to resolve problem situations. However, in our opinion, there are insufficient factors in this category to distinguish Mr. Best from the competition in this industry. Therefore, value allocation is not appropriate.

4. Comparative Professional Success (-)

Mr. Best is a fully certified owner-operator, which is not always the case in some other pest control companies. Also, his length of service in the Florida Pest Control Association does distinguish him from his competition and industry. However, in our opinion, there are insufficient factors in this category to distinguish Mr. Best from the competition in this industry. Therefore, value allocation is not appropriate.

5. Marketing, Branding of Person (-)

Name recognition for the individual, as opposed to the product or service established through marketing efforts to tie the individual's name to the business, may indicate a higher level of personal goodwill. This might involve the individual's direct involvement in media advertisements and other marketing efforts. Bug Bite, Inc. does not market Franklin Best personally or individually. Therefore, value allocation is not appropriate.

6. Personal Referrals (+)

A personal in-bound referral is defined as a referral from an outside source, such as a customer or a referring competitor made to the owner-operator. The person making the referral is aware of some trait that makes this particular owner-operator an appropriate referral. Typically, referrals are made because an individual has a specialized skill, talent, or reputation and has inspired confidence in the referral source. In terms of word-of-mouth recommendations from satisfied customers, it is most appropriate in this situation. Bug Bite, Inc. does not have a large advertising budget, and so word-of-mouth based on reputation is a large part of how new business is created. We recognize that Mr. Best very likely receives many personal referrals, for which the well-trained workforce performs the actual service. We also recognize that it has become (over many decades) the reputation of the company itself, critical in customer confidence.

In our opinion, there are sufficient factors in this category to distinguish Mr. Best's referrals from company referrals, so that he could, in fact, successfully thwart the intent of a non-compete agreement if he chose to do so. Therefore, value allocation is appropriate.

7. Personal Reputation Among Peers (-)

If the reputation of the individual whose personal goodwill is being assessed is positive and stable, then the likelihood increases that the resulting goodwill is personal. For example, the best surgeons (of any type) who are internationally renowned in their field can attract patients from around the world. On a smaller scale, word-of-mouth recommendations from satisfied clients go a long way toward drawing new business. In our opinion, the word-of-mouth referrals to Mr. Best personally are somewhat indistinguishable from referrals to the company itself, i.e., the trained and established workforce-in-place. There are insufficient factors in this category to distinguish Mr. Best from the competition in this industry. Therefore, value allocation is not appropriate.

8. Personalized Staff (-)

The owner's reputation or knowledge may draw personnel who specifically want to work for that individual. If employees of business chose to work for the company specifically to have the opportunity of working with and learning from this individual, they are more inclined to leave if this individual is no longer associated with the business. There are insufficient

factors in this category to distinguish Mr. Best from the competition in this industry. Therefore, value allocation is not appropriate.

9. Personalized Business Name (-)

If the name of the business carries the name of the individual, a higher level of personal goodwill may be present. The goodwill may be more challenging to transfer, particularly if a name change is anticipated. Bug Bite, Inc. is not a personalized business name. Therefore, value allocation is not appropriate.

10. Work Habits (+)

When comparing two business owners working the same number of hours in the same specialty, the business that works more efficiently is expected to have more personal goodwill. Increased time spent per-customer is also likely an indicator of personal goodwill. Mr. Best states that he is actively involved in the management of Bug Bite, Inc. on a day-to-day basis, and he plays a critical role in human resource decisions and customer relationships. Therefore, value allocation is appropriate.

Enterprise Goodwill

Business goodwill is an intangible asset owned by and associated with the operation of the business entity. A company owns business goodwill where owners have relinquished managerial control and have become passive investors, its corporate interests and identity are separate from those of its shareholders, none of its shareholders are critical to its success, and the loss of any key employees would not significantly reduce its value. Other facts demonstrating business goodwill include the business's locations, a loyal customer base, unique operating systems and procedures, and a well-trained workforce, together with its reputation for excellence, product brands and name, and a record of successful operation over a prolonged period.

We identified and analyzed the following enterprise goodwill attributes:

1. Assemblage of Assets (+)

We considered the following premises of value when contemplating whether the assemblage of assets can be differentiated from the mere fact that certain assets exist.

Premise 1: Value in continued use as part of a going-concern business enterprise;

Premise 2: Value in Place, but not in current use in the production of income;

Premise 3: Value in exchange, as part of an orderly disposition;

Premise 4: Value in exchange as part of voluntary liquidation; and

Premise 5: Value in exchange, as part of involuntary liquidation.

The assemblage of assets of Bug Bite, Inc. is in place and is used to generate revenue, as described in Premise 1. Therefore, a value allocation is appropriate.

2. Barriers to Entry (+)

Depending on the subject enterprise specialty and location, it can be difficult and or may take a considerable time for new entrants in this industry to establish a referral base and other relationships with families, businesses, and the local community at large. Bug Bite, Inc. has firmly established its presence in this regard. Therefore, a value allocation is appropriate.

3. Business Location (+)

A business that is easily accessible and ideally located may have more enterprise goodwill. Convenience and recognition may be important factors in a particular business. Alternatively, a hard-to-find location may indicate that consumers return for other reasons, such as personal attention, price, or customer support.

The Bug Bite, Inc. physical business location is easy to find and accessible to the public. Therefore, a value allocation is appropriate.

4. Business Locations (Multiple) (+)

If a business has multiple locations, it may mean that goodwill is more associated with the enterprise and less with the individual, i.e., an individual cannot be in all locations simultaneously, and a costumer's satisfaction is likely to be associated with factors other than personal. The Bug Bite, Inc.'s business location is well-known throughout the operating region. With nineteen vehicles on the road, the public is "notified" of the company's presence on a continual daily basis. Therefore, a value allocation is appropriate.

5. Business Name (+)

If the name of the business carries the name of the individual, a greater level of personal goodwill may be present, which may be more difficult to transfer. Bug Bite, Inc. is not a "personal" name per se, i.e., it does not say, "Franklin Best' Pest Control." Therefore, a value allocation is appropriate.

6. Business Reputation (+)

Business reputation is frequently a factor in determining the attraction of new business and a consumer's likelihood to return for future business. If the reputation is more directly related to the business in general, as opposed to the individual providing the service, the goodwill is more likely enterprise goodwill. Bug Bite, Inc. has been family owned and operated since 1958 with nearly identical versions of its name throughout this time. The company's business reputation is well known and respected in the operating region. Therefore, a value allocation is appropriate.

7. Customer List (+)

An entity has a large, established customer base that requires recurring service; the greater business value is likely to exist. Bug Bite, Inc. has a deep, well-established customer list. Therefore, a value allocation is appropriate.

8. Repeating Revenue Stream (+)

The nature of the pest control business is that the customer finds a need for the service on a regular or even scheduled basis. A consumer relationship that generates revenues through the year or years, although not necessarily on a scheduled basis, could also generate repeat business. Most, if not all, Bug Bite, Inc. customers meet the criteria for repeating revenue streams. Therefore, a value allocation is appropriate.

9. Systems and Organization (+)

The systems and organization attributes refer to all of the decisions management makes that create the structure of the business. It is broader than computer systems and encompasses policies, manuals, procedures, methodology, and forms and documents developed to support the operations.

The transferrable value of necessary systems and Organizations exists with the Bug Bite, Inc. organization structure, with the fulcrum being the processes, systems, and procedures to develop and service a large, established customer base. Therefore, value allocation is appropriate.

10. Workforce in place (+)

Based on the economic principle of substitution, i.e., the cost to create a substitute workforce. The following aspects of workforce cost should be considered:

- Replacement cost new—the cost to create the ideal workforce;
- Reproduction cost new—the cost to re-create the actual current workforce;
- Four cost components:
 - Direct costs—recruitment/relocation fees;
 - Indirect costs—interview/hiring/training time;
 - Developer’s profit—return on direct and indirect costs;
 - Entrepreneurial incentive—lost income during the workforce assemblage period (i.e., an opportunity cost).

Bug Bite, Inc. has a long-standing and well-trained workforce in place that is transferrable to a buyer. Therefore, value allocation is appropriate.

Case Law - Personal Goodwill

We relied upon prior tax court case law addressing personal goodwill where it was found that in the absence of non-compete agreements, personal contacts and relationships important to the business can exist separate and apart from, or to the exclusion of, enterprise goodwill. Specifically, we considered the following cases:

MacDonald – 3 T.C. 720 (1944)

The Tax Court held, however, that no goodwill passed to the taxpayers since any goodwill of the business “was due to the personal ability, business acquaintanceship, and other individualistic qualities of [the husband],” and found that the corporation did not have any value beyond its tangible assets since the husband’s personal ability was not a corporate asset and there was not a contract or other agreement between the husband and the corporation for his future services.

Martin Ice Cream – 110 T.C. 189 (1998)

The tax court stated, “personal relationships of a shareholder-employee are not corporate assets when the employee has no employment contract with the corporation.” The corporation’s success was attributed to a shareholder’s relationships with his customers, which constituted an asset used to establish revenue streams and develop a customer base.

Norwalk - T.C. Memo (1998-279)

In this case, involving the sale of a CPA firm, the tax court stated the goodwill of a professional service corporation belongs to the employees unless the employees “enter into a covenant not to compete with the corporation or other agreement whereby their personal relationships with clients become the property of the corporation.”

The court stated that it did not doubt that most, if not all, of the clients of the corporation would have followed the accountant who serviced them if the accountant left the corporation, and therefore it was “reasonable to assume that the personal ability, personality, and reputation of the individual accountants are what the clients sought.

Muskat v. the United States, 2009 WL 211067 (1st Cir. 2009)

In this case, the trial testimony revealed no discussion of muscat’s personal goodwill during the negotiations. By the same token, none of the transaction documents, including the early drafts of those documents, mentioned Muscat personal goodwill. Muscat had ample opportunity to introduce the concept of personal goodwill into the non-competition agreement, but he did not do so. And although there is a reference to goodwill in the preamble to the non-competition agreement, its purpose was to protect corporate goodwill.

“In our judgment, the absence of any reference to Muscat separate goodwill combined with this expressed reference to corporate goodwill makes it extremely unlikely that the contracting parties intended the payments in a non-competition agreement to serve as de facto compensation for muscats personal goodwill.

Case Law – Non-Compete Agreements

As evidenced by a non-compete agreement, a shareholder’s contacts or relationships with customers or suppliers will transfer to the buyer by introductions and follow-on communications, comfort, and guidance from the Seller to promote a smooth transition of these relationships to the buyer. Similarly, if the shareholder is selling their expertise, knowledge, and skill, they will teach the buyer these skills or expertise. In both cases, the shareholder should be under contract for a sufficient period to accomplish a meaningful transfer of the personal goodwill to the buyer.

Where the owner enters into a compensatory non-compete covenant, the consideration received is taxed to the owner at ordinary income tax rates whether the transaction is structured as a stock or asset sale. However, where the covenant is entered into simply to effectuate the transfer of the business goodwill, the agreement does not necessarily result in ordinary income to the recipient, but rather may be considered part and parcel with the purchase of the business. As such, the value attributable to the covenant may result in capital gain treatment.

The following case law shows an evolution toward recognition of personal goodwill separate and apart from business goodwill.

Allison, No. 9633 (E.D. Cal. 1970)

Despite the lack of agreement between the parties as to the value of the covenant, the court considered not whether the covenant was severable from the purchase of goodwill, but instead if the covenant comprised independent significance separate from the acquisition of goodwill. The IRS and the U.S. Tax Court (in a separate proceeding against the buyer) previously determined that the covenant represented “a surrender of [the taxpayer’s] future income rather than the sale of goodwill.” Based on the acquirer’s testimony, the court agreed with the tax court and the IRS by holding that the covenant was not a transfer of property; instead, the agreement held independent significance apart from the purchase of goodwill and was, in fact, a surrender of future income—i.e., compensation not to compete during the term of the agreement.

Under different facts, however, courts have treated the covenant as capital in nature. In Ullman, the court stated that where a “covenant is so closely related to a sale of goodwill that it fails to have any independent significance apart from merely assuring the

effective transfer of that goodwill,” the covenant is not separate from the asset acquired (264 F.2d at 307–308). Similarly, “[i]f an agreement not to compete is necessary to effectuate a transfer of goodwill, then the payments made under it may be treated as if made for the sale of a capital asset.”[5] Citing Schultz, the court in Allison, stated:

In Schultz, both the commissioner and tax court found that the covenant not to compete, although stated separately as to value, was essential to the sale of the goodwill of the business and had no real economic value of its own. The court was unable to find that the covenant had an independent basis in fact to the extent that reasonable men, genuinely concerned with their economic future, might bargain for such an agreement.” 294 F. 2d at 55. In other words, for the covenant to be treated as a surrender of future income, it must appear that the potential competition of the Seller would pose a substantial economic threat to the buyer such that the covenant was not appended as a mere tax gimmick. *Source: The Tax Advisor; April 1, 2011; Nick Gruidl, CPA*

Schilbach, T.C. Memo. 1991-556

Addressing a transfer of personal goodwill, the court looked to the intent of the agreement. In that case, the taxpayer lost his malpractice insurance, was physically and emotionally exhausted, and intended to leave his practice and enter a new field of medical practice. Upon the sale of his business, the taxpayer signed a covenant not to compete; however, due to the taxpayer’s intentions and his physical and emotional condition, it was clear that even without the agreement, the taxpayer never intended to and was unable to compete with the buyer. Therefore, the covenant was not meant to compensate the Seller for the surrendering of future income. Accordingly, the tax court held that the medical practice had goodwill equal to the value established by the taxpayer as of the date of liquidation. *Source: The Tax Advisor; April 1, 2011; Nick Gruidl, CPA*

Bross Trucking, T.C. Memo 2014-107

In Bross Trucking, Bross, a successful construction businessman, had established close, personal relationships with his primary customers. Additionally, Bross was extremely knowledgeable about the trucking industry because of his many years of experience. To that end, customers sought these personal traits through their relationships with him, which led directly to business for Bross Trucking. As a result, the Tax Court determined that personal goodwill existed through these relationships. *Source: The Tax Advisor; April 1, 2015; Nick Gruidl, CPA*

Case Law – Economic Reality

The parties need to have competing interests to support a non-compete agreement. Furthermore, the non-compete agreement needs to be realistic. It is difficult to argue that a seller will compete if he or she does not have the financial ability, is in poor health, or spends much of his or her time after the sale vacationing. In our opinion, Mr. Best meets the criteria of a person capable of competing as defined by the following tax-court memorandums:

Beaver Bolt v. Commissioner (TDM 1995-549)

Nine-factor economic reality test for NCA, which considers:

1. The Seller's (covenanter's) ability to compete
2. Seller's intent to compete
3. Seller's economic resources
4. The potential damage to the buyer posed by the Seller's competition
5. Seller's business expertise in the industry
6. The Seller's (covenanter's) ability to compete
7. Seller's intent to compete
8. Seller's economic resources
9. The potential damage to the buyer posed by the Seller's competition
10. Seller's business expertise in the industry

Thompson v. Commissioner (TDM 1997-287)

Cites the Beaver Bolt Factors, plus five more:

1. The age and health of the grantor
2. The enforceability of the covenant under State law
3. Whether payments for the covenant are pro-rata to the grantor's stock ownership in the company being sold (relates to economic substance)
4. Whether the payments under the covenant cease upon breach of the covenant or the death of the grantor
5. The existence of active negotiations over the terms and value of the covenant (other than tax-motivated)

Case Law – IRS Guidance

Revenue Ruling 77-403 identifies the following relevant factors on non-compete agreements:

- Whether in the absence of the NCA, the covenantor would desire to compete.
- The ability of the covenantor to compete effectively with the covenantee in the activity in question
- The feasibility, because of the activity and market in question, of effective competition by the covenantor within the time and area specified in the covenant

Taxation Strategies

Non-compete covenants are created to protect the buyer's interest in the newly acquired business so that the Seller does not re-establish himself or herself in the geographical area or compete with the buyer, and are amortized over fifteen years.

Consulting agreements are created when the buyer wishes to retain the expertise of the Seller for some time. The buyer has a preference to allocate more of the purchase price to the consulting agreement, which would result in a current deduction, as opposed to the non-compete agreement, which must be amortized over 15 years.

From the Seller's perspective, a non-compete agreement is generally preferable to a consulting agreement from a tax standpoint because payments under a consulting agreement will be subject to self-employment tax. Self-employment income, however, does afford the individual taxpayer the ability to establish a variety of tax-saving vehicles, including retirement plans and medical reimbursement plans. These tax-saving vehicles generally need to be established within certain time limits and cannot be established after the fact.

Personal goodwill must be the shareholder's asset, and the shareholder cannot have previously transferred the asset to the corporation. Tax Court precedent establishes that personal goodwill is transferred to the corporation when the individual cannot personally benefit from it without the employer (see, e.g., *Martin Ice Cream Co.*, 110 T.C. 189 (1998); *Norwalk*, 76 T.C. Memo. 1998-279; *H & M, Inc.*, T.C. Memo. 2012-290; and *Bross Trucking, Inc.*, T.C. Memo. 2014-107). Personal goodwill is often transferred through agreements such as employment contracts or non-compete agreements. In general, once such an agreement is in place, any existing goodwill (or goodwill generated after) likely belongs to the corporation. *Source: The Tax Advisor; April 1, 2015; Nick Gruidl, CPA*

Asset Allocation – IRC 1060

To the extent business goodwill exists, Internal Revenue Code 1060 mandates the allocation in Step VII of the residual method and to report such allocation on IRS form 8594. Personal goodwill is not included in the asset allocation method under Section 1060 because it is owned by the shareholder, separate and apart from company assets. As such, personal goodwill is transferred in the form of a non-compete agreement or a similar device.

Summary and Results

Goodwill Allocation Table (Simplified MUM Model)

<i>Enterprise Attributes</i>	Add to Scale (0,1)	<i>Personal Attributes</i>	Add to Scale (0,1)
Assemblage of Assets	1	Ability, Skills, Judgment	1
Barriers to Entry	1	Age & Health of Owner	0
Business Location	1	Closeness of Contact	0
Business Locations (Multiple)	1	Comparative Professional Success	0
Business Name	1	Marketing, Branding of Person	0
Business Reputation	1	Personal Referrals	1
Marketing, Branding of Company	1	Personal Reputation Among Peers	0
Repeating Revenue Stream	1	Personalized Staff Recruit	0
Systems and Organization	1	Personalized Business Name	0
Workforce in Place	1	Work Habits	1
Total Enterprise Attributes	10	Total Personal Attributes	3
Ratio of Enterprise	77%	Ratio of Personal	23%

Purchase Price Allocation

Goodwill Analysis			
	Purchase Price	3,850,000	
	Less Equipment	-400,000	
	Goodwill (All Inclusive)	3,450,000	
	Personal Goodwill	-796,154	23%
	Business Goodwill	-2,653,846	77%
IRC 1060 Classification			
Class 1	Cash	0	
Class 2	Securities & Bonds	0	
Class 3	Accounts Receivable	0	
Class 4	Inventory	0	
Class 5	Asset Value	400,000	
Class 6	Non-Competes	0	
Class 7	Business Goodwill	2,653,846	
	Section 1060	3,053,846	

Appendix A – Industry Overview

NAICS Code 561710

Exterminating and Pest Control Services

Industry Regulation – Federal

In the United States, the Environmental Protection Agency (EPA) regulates pesticides at the national level. Congress gives the EPA this authority through several federal laws, including the Federal Insecticide, Fungicide, and Rodenticide Act (FIFRA). By regulating pesticides, the EPA works to protect human health and the environment.

The EPA works cooperatively with state agencies to review pesticide safety data, register pesticide products, educate professional applicators, monitor compliance, and investigate pesticide problems. Other areas of focus include pesticide and agricultural worker safety, endangered species and pollinator protection, reducing pesticide drift, and reporting pesticide incidents. Regional EPA offices can guide on importing and exporting pesticides to and from the United States.

Industry Regulation – Florida

For structural pest control (pest control provided to homes or other structures), Florida law requires that each pest control business location must meet the following criteria:

- Be licensed by the Florida Department of Agriculture and Consumer Services (FDACS)
- Carry the required insurance coverage (\$250,000 per person and \$500,000 per occurrence for bodily injury and \$250,000 per occurrence and \$500,000 in the aggregate for property damage, or combined single limit coverage of \$500,000 in the aggregate), and Employ full-time a Florida-certified operator in charge of the pest control operations of the business location.

Industry Certifications

- The operator must be certified in the categories in which the business operates:
 - General Household Pest and Rodent Control,
 - Termite and Other Wood-Destroying Organisms Control,
 - Lawn and Ornamental Pest Control and Fumigation.

Appendix B – Economic Outlook

In the valuation of any business interest, the general economic outlook as of the valuation date should be considered, since the national economic outlook influences how investors perceive alternative investment opportunities at any given time. In our analysis, we discussed the general economic climate that prevailed as of the valuation date.

Inflation – United States

The participants in the June Livingston Survey predict slightly higher output growth for the first half of 2019 than they did in the December survey. The forecasters, who are surveyed by the Federal Reserve Bank of Philadelphia twice a year, project that the economy's output (real GDP) will rise at an annual rate of 2.5 percent during the first half of 2019, an upward revision from the prediction of 2.4 percent in the December 2018 survey. Growth in the second half of 2019 is expected to fall to an annual rate of 2.3 percent, unchanged from the previous survey. Growth will fall further to an annual rate of 1.9 percent in the first half of 2020.

World Economic Outlook

International Monetary Fund - July 18, 2019: A Survey by the IMF staff is usually published twice a year. It presents IMF staff economists' analyses of global economic developments during the near and medium-term. Chapters give an overview as well as more detailed analysis of the world economy; consider issues affecting industrial countries, developing countries, and economies in transition to market; and address topics of pressing current interest:

Global growth remains subdued. Global growth is forecast at 3.2 percent in 2019, picking up to 3.5 percent in 2020 (0.1 percentage point lower than in the April WEO projections for both years). GDP releases so far this year, together with generally softening inflation, point to weaker-than-anticipated global activity

U.S. Economic Forecast

The following are excerpts from the Federal Reserve Bank's National Summary report of economic conditions based on information collected on or about the valuation date.

- Most of the twelve Federal Reserve Districts reported that their economies expanded at a modest or moderate pace from mid-October through late November, though both Dallas and Philadelphia noted slower growth than the prior Beige Book period. St. Louis and Kansas City noted just slight growth. On balance, consumer spending held steady.

- Most of the twelve Federal Reserve Districts reported that their economies expanded at a modest or moderate pace from mid-October through late November, though both Dallas and Philadelphia noted slower growth than the prior Beige Book period. St. Louis and Kansas City noted just slight growth. On balance, consumer spending held steady.
- Non-auto retail sales appeared somewhat weaker while auto sales tended to improve, particularly for used cars.
- Tourism reports varied but generally kept pace with the economy.
- Tariffs remained a concern for manufacturers, but a majority of Districts continued to report moderate growth in the sector.
- All Districts reported growth in nonfinancial services – ranging from slight to vigorous.
- New home construction and existing home sales tended to decline or hold steady, while the construction and leasing of nonresidential structures tended to rise or remain flat.
- Overall, lending volumes grew modestly, although a few Districts noted some slowing.
- Agricultural conditions and farm incomes were mixed; some Districts noted impacts from excessive rainfall and from tariffs, which have constrained demand.
- Most energy sectors saw little change or modest growth.
- Most Districts reported that firms remained positive; however, optimism has waned in some as contacts cited increased uncertainty from impacts of tariffs, rising interest rates, and labor market constraints.

Florida Economic Forecast

Dr. Sean Snaith and the University of Central Florida Institute for Economic Competitiveness prepares a comprehensive, quarterly forecast of the Florida economy and 12 metropolitan areas, as well as a comprehensive, quarterly forecast of the U.S. economy. Dr. Smith et al. provide a comprehensive, quarterly forecast of the Florida economy and 12 metropolitan areas. Metropolitan areas covered by the forecast include Pensacola, Tallahassee, Jacksonville, Gainesville, Ocala, Deltona-Daytona Beach, Tampa-St. Petersburg, Lakeland, Orlando-Kissimmee, Palm Bay-Melbourne, Naples-Marco Island, and Miami-Fort Lauderdale.

Dr. Snaith is a national expert in economics, forecasting, market sizing, and economic analysis who authors quarterly reports about the state of the economy. Bloomberg News has named Snaith as one of the country's most accurate forecasters for his predictions about the Federal Reserve's benchmark interest rate, the Federal Funds rate.

Snaith also is a member of multiple national forecasting panels, including The Wall Street Journal Economic Forecasting Survey, CNNMoney.com's survey of leading economists, the Associated Press Economy Survey, the National Association of Business Economics Quarterly Outlook Survey Panel, the Federal Reserve Bank of Philadelphia's Survey of Professional Forecasters, the Livingston Survey, Bloomberg U.S. Economic Indicator Survey, Reuters U.S. Economy Survey, and USA Today Economic Survey Panel.

Florida Economy (2018 - 2021)

Dr. Snaith et al. provided the following outlook for 2018-2021:

- <https://business.ucf.edu/florida-metro-forecast-robust-state-economy-remain-ahead-u-s-outlook/>
- While the Florida labor market should maintain its lead over national statistics, the difference will become less pronounced as state job growth is expected to slow down by 2019.
- "Our outlook for Florida is this outpacing will narrow as higher levels of job growth are expected nationally, and Florida's job growth decelerates somewhat," Snaith said. "However, Florida will still outpace national job growth through 2021."
- In the latest Florida & Metro Forecast from the UCF Institute for Economic Competitiveness, Snaith predicts year-over-year job growth will average 2.5 percent in 2018, 2.4 percent in 2019, 1.6 percent in 2020, and 1.3 percent in 2021. As consistently strong payroll job creation has strengthened Florida's labor market, the state is projected to outpace the national economy by 0.6 percentage points in overall job growth through 2021.
- Changes in economic policy driven by the federal government should continue to benefit Florida's economy over the next four years, Snaith said. The state economy, as measured by Real Gross State Product, will expand by 3.5 percent this year and 4.3 percent in 2019 before easing to 2.9 percent in 2020 and then 2.4 percent in 2021.
- "Through 2019, growth will accelerate as the Trump administration's economic policy helps to boost Florida's economy," Snaith said. "This faster economic growth will also generate a more rapidly growing labor force."

- Labor force growth in Florida will average 1.5 percent from 2018 to 2021, according to the forecast. The sectors expected to experience the most robust job growth are Construction (6.6 percent), Professional & Business Services (4.6 percent), Financial (2.1 percent), Leisure & Hospitality (1.4 percent), Education & Health Services (1.3 percent), and Trade, Transportation & Utilities (1.1 percent).
- Single-family housing availability will remain in short supply, despite housing starts accelerating in the short term, Snaith said. Total starts are expected to hit 133,656 in 2018, 148,610 in 2019, 154,958 in 2020 and 156,376 in 2021.
- “Low inventories of existing homes for sale and lagging housing starts growth contribute to an environment where home prices continue to rise at a rapid pace,” Snaith said. “The shortage will be resolved as the pace of single-family housing starts ramping up over the next several years.”
- According to Snaith, retail sales will grow at an average pace of over 4.5 percent from 2018 to 2021, encouraged by a stronger national economy, continued stability in Florida’s labor market, larger paychecks, and increasing household wealth.

Economic Outlook – Summary

Empowered by a robust and post-recession job market recovery, continued salary growth, and increased retail spending, Florida’s economy is expected to outperform the national forecast for four straight years, according to the latest projection from UCF economist Sean Snaith.

Appendix C – Valuation Analyst’s Representations

The analyses, opinions, and conclusions of value included in this valuation report are subject to specified assumptions and limiting conditions (see Appendix E), and they are the personal analyses, opinions, and conclusions of the analyst.

The economic and industry data included in this report were obtained from various printed or electronic sources that the valuation analyst believes to be reliable. I have not performed any corroborating procedures to substantiate that data.

This valuation engagement was performed in accordance with the American Institute of Certified Public Accountants’ Statement on Standards for Valuation Services.

The parties to which the information is given are specifically identified, and the use of this valuation report is restricted to those persons; the valuation report is not intended to be and should not be used by anyone other than such parties.

The analyst’s compensation is fee-based and is not contingent upon the development or reporting of a predetermined value or direction in value that favors the cause of the client, the amount of the estimate of value, or the attainment of a stipulated result. The valuation analyst has no obligation to update the report or the opinion of value for information that comes to his attention after the date of the report.

Appendix D – Assumptions & Limiting Conditions

1. The conclusion of value arrived at herein is valid only for the stated purpose as of the date of the valuation.
2. Financial statements and other related information provided by Bug Bite, Inc. Or its representatives, in the course of this engagement, have been accepted without any verification as fully and correctly reflecting the enterprise's business conditions and operating results for the respective periods under analysis, except as expressly noted herein. I have not audited, reviewed, or compiled the financial information provided, and, accordingly, I express no audit opinion or any other form of assurance on this information.
3. Public information and industry and statistical information were obtained from sources I believe to be reliable. However, I make no representation of the accuracy or completeness of such information and have performed no procedures to corroborate that information.
4. I do not assure the achievability of results forecasted (if any) because events and circumstances frequently do not occur as expected; differences between actual and expected results may be material; and achievement of the forecasted results is dependent on actions, plans, and assumptions of management.
5. The conclusion of value arrived at herein is based on the assumption that the current level of management expertise and effectiveness would continue to be maintained, and that the character and integrity of the enterprise through any sale, reorganization, exchange, or diminution of the owners' participation would not be materially or significantly changed.
6. This report and the conclusion of value arrived at herein are for the exclusive use of the requesting party for the sole and specific purposes as noted herein. They may not be used for any other purpose or by any other party for any purpose.
7. Furthermore, the report and conclusion of value are not intended by the author and should not be construed by the reader to be investment advice in any manner whatsoever. The conclusion of value represents the considered opinion of The Appraiser, based on information furnished by Bug Bite and other sources.
8. Neither all nor any part of the contents of this report (especially the conclusion of value, the identity of any valuation specialist(s), or Bug Bite, Inc. with which such valuation specialists are connected or any reference to any of their professional designations) shall be disseminated to the public through advertising media, public relations, news media, sales media, mail, direct transmittal, or any other means of communication without the prior written consent and approval of The Appraiser

9. Future services regarding the subject matter of this report, including, but not limited to testimony or attendance in court, shall not be required of The Appraiser unless previous arrangements have been made in writing.
10. I have not made a specific compliance survey or analysis of the subject property to determine whether it is subject to or in compliance with the American Disabilities Act of 1990, and this valuation does not consider the effect, if any, of noncompliance.
11. No change of any item in this appraisal report shall be made by anyone other than The Appraiser, and we shall have no responsibility for any such unauthorized change.
12. Unless otherwise stated, no effort has been made to determine the possible effect, if any, on the subject business due to future Federal, state, or local legislation, including any environmental or ecological matters or interpretations thereof.
13. If prospective financial information approved by management has been used in this work, we have not examined or compiled the prospective financial information and, therefore, do not express an audit opinion or any other form of assurance on the prospective financial information or the related assumptions. Events and circumstances frequently do not occur as expected, and there will usually be differences between prospective financial information and actual results, and those differences may be material.
14. I interviewed the current management of Bug Bite, Inc. Concerning past, present, and prospective operating results of the subject company.
15. Except as noted, I have relied on the representations of the owners, management, and other third parties concerning the value and useful condition of all equipment, real estate, investments used in the business, and any other assets or liabilities, except as specifically stated to the contrary in this report.
16. I have not attempted to determine whether or not all assets of the business are free and clear of liens and encumbrances or that the entity has a good title to all assets.
17. I have performed no services as an appraiser or in any other capacity, regarding the property that is the subject of this report within the three years immediately preceding acceptance of this assignment

Appendix E – Appraisal Certification

We now certify the following statements regarding this appraisal:

1. The appraiser personally inspected the subject business interests encompassed by this appraisal.
2. The appraiser has no present or prospective future interest in the business interests that are the subject of this appraisal report.
3. The appraiser has no personal interest or bias concerning the subject matter of this report or the parties involved.
4. The appraiser's compensation for making the appraisal is in no way contingent upon the value reported or upon any predetermined value.
5. To the best of the appraiser's knowledge and belief, the statements of facts contained in this report, upon which the analyses, conclusions, and opinions expressed herein are based, are true and correct.
6. The appraiser's analyses, opinions, and conclusions were developed, and this appraisal report has been prepared, in conformity with the Uniform Standards of Professional Appraisal Practice, as promulgated by The Appraisal Foundation.
7. No persons other than the individuals whose qualifications are included herein have provided significant professional assistance regarding the analyses, opinions, and conclusions outlined in this report.
8. The reported analyses, opinions, and conclusions are limited only by the reported contingent and limiting conditions, and they represent our unbiased professional analyses, opinions, and conclusions.
9. The reported analyses, opinions, and conclusions were developed, and this appraisal report has been prepared, in conformity with the requirements of the Principles of Appraisal Practice and Code of Ethics of the American Society of Appraisers, and of the other professional organizations of which we are members.
10. Disclosure of the contents of this report is subject to the requirements of the American Society of Appraisers, and the other professional organizations of which we are members related to review by their duly authorized representatives.

Appendix F - Sources of Information

- 1. Regulatory Guidelines – Federal**
 - a. US Code of Federal Regulations

- 2. Regulatory Agencies – Florida**
 - a. Florida Department of Agriculture and Consumer Services

- 3. Inflation Study**
 - a. Livingston Survey, June 7, 2019
 - b. <https://www.philadelphiafed.org/-/media/research-and-data/real-time-center/livingston-survey/2019/livjun19.pdf?la=en>

- 4. Central Florida Economic Forecast**
 - a. Dr. Snaithe et al. provided the Central Florida outlook for 2018:
 - b. http://business.ucf.edu/wp-content/uploads/sites/4/2018/04/WEB_FL-Metro-Forecast-March-2018.pdf

- 5. U.S. Economic Forecast**
 - a. Federal Reserve Bank of San Francisco’s National Summary report of economic conditions on or before July 8, 2019.
 - b. <https://www.federalreserve.gov/monetarypolicy/beigebook201907.htm>

- 6. World Economic Forecast**
 - a. International Monetary Fund, World Economic Outlook; July 2019.
 - b. <https://www.imf.org/en/Publications/WEO>

- 7. IRS form 1120 (page 1)**
 - a. 2018, 2017, 2016