Sale of Personal Goodwill— The Executive's Parachute

by Thomas O. Wells and Daniel Lampert

The sale of personal goodwill is desirable by an executive because a) proceeds are generally taxable to the executive as long-term capital gains and not as ordinary income; b) funds are transferred directly from the buyer to the executive (and not through the executive's company subject to the company's creditors); and c) personal goodwill is not subject to equitable distribution in connection with an executive's divorce. Under §197 of the Internal Revenue Code of 1986, as amended (the "Code"), the tax treatment to the buyer is the same regardless of whether the executive recognizes long-term capital gain from the sale of personal goodwill or ordinary income for a noncompete payment. Therefore, you have the rare occurrence in federal income tax law in which there is no friction between the buyer and executive. Finally, the creation of personal goodwill for the executive-shareholder is critical to avoid a corporate income tax under Code §311 or §336 when a corporation attempts to convert to a limited liability company that is taxable either as a partnership or as a disregarded single-member entity. This article examines the sale of personal goodwill by defining it, reviewing pretransaction methods to create and transfer it, analyzing the benefits of selling it, and explaining the tax treatment to the buyer in purchasing it.

> An executive with unique skills, a strong relationship with its customers, an excellent industry reputation, and no covenant not-to-compete should consider structuring a transaction with an acquirer as a sale of personal goodwill.

Defining Personal Goodwill

1) *Definition for equitable distribution.* The Florida Supreme Court in *Thompson v. Thompson*, 576 So. 2d 267, 270 (1991), defined "personal goodwill" as goodwill that depends on the continued presence of a particular individual that is not a marketable asset distinct from such individual. In *Thompson*, an attorney was divorcing his spouse and his spouse was claiming equitable distribution in his law practice. Equitable distribution entitles each spouse to a presumption of 50 percent equal ownership in all marital assets pursuant to F.S. §61.075. The Florida Supreme Court determined that the spouse was entitled to equitable distribution in the "professional goodwill" of the law practice provided that such goodwill must be a business asset having value that is separate and distinct from the presence and reputation of the individual attorney. The court further stated that any value that attaches to an entity solely as a result of personal goodwill represents nothing more than probable future earning capacity that, although relevant in determining alimony, is not a proper consideration in dividing marital property in a dissolution proceeding.

2) *Definition for tax law.* The tax definition of personal goodwill is derived primarily from two Tax Court cases in 1998: *Martin Ice Cream Co. v. Commissioner*, 110 T.C. 189 (1998); and *William Norwalk, Transferee, et al. v. Commissioner*, TCM 1998-279 (1998).

In *Martin Ice Cream*, the Tax Court held that the personal relationships of a shareholder-employee are not corporate assets when the employee has no employment contract with the corporation. Arnold Strassberg was a major distributor of ice cream in the northeast U.S. who had started distributing ice cream in 1960, taking over a business that his father had started soon after World War II. In 1974, the founder of Häagen-Dazs approached Arnold to sell and distribute the "super-premium" ice cream, and Arnold became Häagen-Dazs' first distributor to supermarkets. By the late 1970s, Martin Ice Cream Co., which was owned solely by Arnold's son, Martin, was distributing Häagen-Dazs ice cream to four major supermarket chains in

the Northeast. However, neither Arnold nor Martin Ice Cream Co. had any written distribution agreement with Häagen-Dazs. Martin preferred the wholesale distribution of ice cream to small independent grocery stores and food service accounts rather than Arnold's focus of distribution to supermarkets.

In the mid-1980s, Pillsbury acquired Häagen-Dazs and was seeking to sell directly to retail supermarkets and eliminate its distributor network. In 1988, Häagen-Dazs sought to acquire and terminate its distribution agreement with Arnold and Martin Ice Cream Co. Martin Ice Cream Co. created a wholly owned subsidiary with the goal of spinning off the supermarket ice cream sale business to the new subsidiary with the distribution ice cream to small independent grocery stores and food service accounts to be retained by Martin Ice Cream Co. Arnold was named sole shareholder of the subsidiary in exchange for stock that was granted to him in Martin Ice Cream Co. Pillsbury executed an agreement with Arnold and the new subsidiary to acquire the rights to the supermarket ice cream sale business in exchange for $1,430,340. Arnold also signed a bill of sale and an assignment of rights. To protect its rights, Pillsbury requested that Arnold and Martin both sign noncompete agreements.

The Tax Court attributed the purchase value primarily to two assets: Arnold's personal relationship with the supermarkets and Arnold's personal, handshake agreement with the founder of Häagen-Dazs. The court determined that these assets could not be attributed to Martin Ice Cream Co. or its subsidiary because Arnold never had a covenant not to compete or any employment agreement with such entities. The Tax Court has long recognized that personal relationships of shareholder-employees are not corporate assets when the employee has no employment agreement with the corporation.

In *Norwalk*, a two-shareholder professional service corporation rendering accounting services elected to liquidate. Although each shareholder had an employment agreement that contained noncompete provisions, such agreement had expired as of the date of liquidation on June 30, 1992. The corporation had eight other employees, including four accountants, but none of the employees had signed any employment agreement with the corporation. On July 1, 1992, the two shareholders became partners in another accounting practice and transferred assets distributed to them by the corporation to the new practice. The new practice also employed many of the corporation's other employees. Several of such employees left the new practice in October 1992 to create their own firm and took many of the corporation's former clients (and the new practice's existing clients) away to their new firm. By 1997, only about 10 percent of the accounts serviced by the corporation remained with the new practice. The IRS alleged that the corporation distributed "customer-based intangibles" to its shareholders and imposed a double level tax (once at the corporate level under Code §336 and again at the shareholder level under Code §331) with respect to an unreported gain of $870,000. The taxpayer countered that the client-related goodwill and intangibles belonged to the professional accountants who serviced the clients. The Tax Court concluded that without an effective noncompete agreement, the clients have no meaningful value for the corporation. The court referred to "personal goodwill" as the personality, personal ability and reputation of the individual accountants and does not belong to the corporation.[1]

There are tax cases that have found the existence of corporate goodwill. For example, in *Schilbach v. Commissioner*, T.C. Memo 1991-556, the court held that a corporate medical practice had goodwill despite the lack of a covenant not to compete with its sole shareholder and only physician-employee. Dr. Schilbach had a patient base of between 8,000 and 10,000 due to making services available on the patient's schedule, requiring employees to show an interest in the patients and their families, providing X-ray, laboratory and other services at the office rather than referring patients to others, accepting Medicare payments, billing patient's insurance company directly, and arranging payment plans for those patients who were unable to pay. In 1986, Dr. Schilbach decided to sell his practice due to personal medical problems and the termination of his medical malpractice insurance. Dr. Schilbach followed advice to liquidate the corporate medical practice prior to the end of 1986 due to tax law changes (the repeal of the *General Utilities* doctrine) and sold his practice in 1987. The court defined personal goodwill as attributable to the individual skill, knowledge, and reputation of the professional and practice or business goodwill to include patient lists and records, trained employees, and leases in place. The court then found some of the goodwill associated in the operating entity based on the factors set forth above. Accordingly, the analysis of and allocation between personal goodwill vs. corporate goodwill relies upon the particular facts of each case.

3) *Definition for fraudulent conveyance analysis.* Although there is not much case law examining personal goodwill and the rights of a corporate creditor in connection with the sale of a company, in *Corrugated Paper Corp. v. Eastern Container Corp.*, 185 B.R. 667 (Bankr. D. Mass. 1995), personal goodwill consisting of the salesmen's ability to transfer customer patronage to a new employer is not a corporate asset subject to the claims of creditors. The court determined that no fraudulent transfer of goodwill occurs when the debtor's salesmen acquire new jobs and the debtor's customers follow the salesmen to the new employer. This case is different when the employees (*e.g.*, guards for a service company) constitute a product and do not have a personal selling relationship with the customer.[2]

When a corporation is insolvent, it owes a fiduciary duty to its creditors to maximize payments to the creditors. Recently, the Bankruptcy Court suggested that this duty exists in the sale of a business in *In re W.R. Grace & Co.*, 281 B.R. 852 (Bankr. D. Del. 2002). The Bankruptcy Court held that W.R. Grace should have sold the assets to Sealed Air in a $4.9 billion disposition of its Cryovac business rather than structuring it as a "Morris trust" transaction in which a majority of the consideration was paid directly to the W.R. Grace shareholders (approximately $3.7 billion). Pursuant to the transaction, W.R. Grace spun off its specialty chemical business together with its significant asbestos liability to a newly formed corporation ("New Grace") that was owned by the W.R. Grace shareholders. W.R. Grace ("Old Grace") retained its only business that was the Cryovac operations and proposed to sell the stock in Old Grace to Sealed Air in exchange for $3.7 billion of Sealed Air stock paid to its shareholders. Sealed Air and Old Grace also paid $1.2 billion in cash to New Grace subject to an indemnification by New Grace of any asbestos liability made against Old Grace. If W.R. Grace had sold assets to Sealed Air, the $3.7 billion in Sealed Air stock plus the $1.2 billion in cash would have been available to the asbestos creditors prior to being distributed to the W.R. Grace shareholders. As structured, the asbestos creditors only had access to $1.2 billion in cash.

Although the Bankruptcy Court never ultimately decided whether the Morris trust transaction resulted in a fraudulent conveyance, Sealed Air elected to settle the matter in November 2002, with an additional payment of $853 million to

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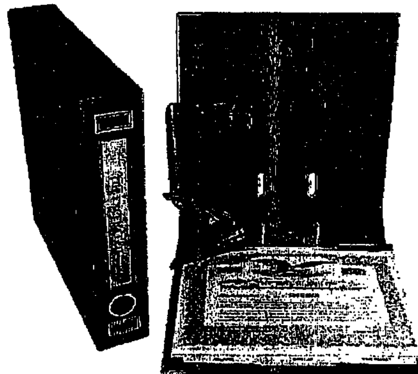

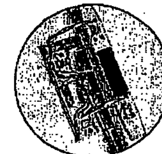
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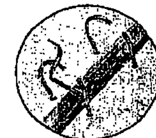
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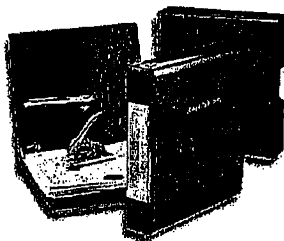

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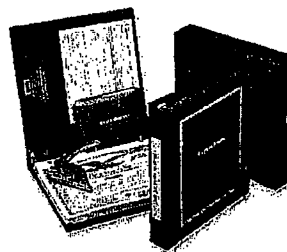

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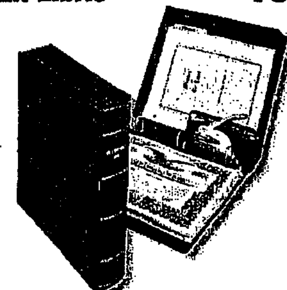

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the New Grace creditors. The significant difference between the direct payment to individuals for personal goodwill and the *W.R. Grace* bankruptcy is that personal goodwill is not an entity asset and therefore is not subject to claims by the entity's creditors. Further, if an entity is insolvent, the entity's creditors have a claim that has priority over the claim of the shareholders as to the transaction proceeds. Funds paid directly to individuals in exchange for personal goodwill avoid the claims of the entity's creditors and also avoid any potential breach of a fiduciary duty to the creditors because the entity does not own the personal goodwill nor is it allowing the proceeds from the sale of the personal goodwill to be diverted away from its creditors.

Creating and Transferring Personal Goodwill

As recognized in *Martin Ice Cream*, personal goodwill may be unique and is present only if supported by particular facts. For example, the executive should not be subject to a contractual noncompete provision in favor of his current employer. Further, the executive should not be subject to any nonsolicitation provision that prohibits the executive's contact and solicitation of his employer's customers, suppliers, or service providers. Such noncompete provision is tantamount to the employer owning the goodwill of the executive. The executive should have unique qualifications such as a license to practice law, medicine, accounting, or other profession, related professional licenses, industry awards recognizing the executive's unique abilities, and/or a history of outstanding sales, management, or leadership ability.

If the executive is subject to a noncompete or nonsolicitation provision or lacks certain licenses to replicate his business with another employer, the executive should consider terminating such noncompete and nonsolicitation provisions and obtain such licenses. The termination of a noncompete that results in the transfer of goodwill from corporate ownership to personal ownership could be construed as a fraudulent transfer if the entity is insolvent at the time of the termination of the noncompete agreement. This process should be done several years prior to a transaction with the buyer to avoid any "step-transaction" doctrine. This process also reduces the valuation of the employer if the executive is doing estate planning and transferring interest in the employer to his family or is concerned with an excessive valuation for equitable distribution.

If the corporation has accumulated a proprietary list of customers, a certain value should be attributed to such list if the executive intends to use such list at his new employer. Courts vary in valuing such list. In the *Corrugated Paper Corp.* case, the Bankruptcy Court did not attribute significant value to such list. However, in the *Schilbach* case, the Tax Court associated value to the corporate goodwill associated with the patient list. To avoid issues of reapportionment of value by the IRS or a court, the executive and/or corporation could obtain a valuation or fairness opinion with respect to the transaction.

Personal goodwill should be transferred pursuant to an asset purchase agreement executed by the purchaser and the executive. Such agreement should describe the personal goodwill being transferred and include representations by the executive as to ownership of such assets and that such assets do not exist separate and distinct for the executive (as described in the *Thompson* case). Such agreement should also include exhibits such as a bill of sale and an assignment of rights (as suggested by the *Martin Ice Cream* case). The purchaser may want to include any noncompete provision within the asset purchase agreement to obtain a lengthier presumption of reasonability for the restrictive time period pursuant to F.S. §542.335(d)(3)(a) and (e). The parties may allocate the purchase price between assets comprising the personal goodwill and the covenant not to compete.

Benefits of Creating and Selling Personal Goodwill

There are four significant benefits in the executive's creation and sale of personal goodwill. The first benefit is that the proceeds received by the executive from the sale of personal goodwill are subject to long-term capital gain treatment rather than as ordinary income pursuant to *Martin Ice Cream* and *Norwalk*. The maximum federal income tax rate for long-term capital gains is 15 percent compared to 35 percent for ordinary income. In addition, long-term capital gains can be offset by capital losses (subject to any alternative minimum tax limitations) whereas only $3,000 of capital losses may offset ordinary income each year. Note that the buyer in *Martin Ice Cream* required the executive to sign a noncompete agreement. The existence of this noncompete agreement did not cause the executive's sale of personal goodwill to be subject to taxation as ordinary income. The noncompete agreement was seen by the Tax Court as necessary by the buyer to protect its purchase of the executive's personal goodwill.

The second benefit is that the proceeds received by the executive from the sale of personal goodwill are not subject to the claims of the employer's creditors because the executive's employer does not own the personal goodwill. In *Corrugated Paper Corp.*, the Bankruptcy Court determined that no fraudulent transfer of corporate goodwill occurs when the debtor's salespersons change employment and the debtor's former customers follow the salespersons to the new employer.

The third benefit is that the proceeds derived from the sale of personal goodwill are not subject to a spouse's claim for equitable distribution pursuant to the *Thompson* case. However, such proceeds may be considered in determining alimony.

The fourth benefit is applicable in connection with the conversion of a corporation to a limited liability com-

pany or partnership taxable as a disregarded entity or a partnership for federal income tax purposes. Under Code §311, a corporation must recognize income equal to the difference between the fair market value of an asset and its adjusted tax basis upon the distribution of such asset to its shareholder. The corporation must recognize the same income upon liquidation under Code §336. If a corporation has corporate goodwill with no corresponding adjusted tax basis, the "deemed" distribution of such goodwill causes the distributing corporation to recognize income equal to the value of such goodwill. If the distributing corporation is taxable as a C corporation, the shareholders will have a second tax under Code §301 or 331. However, if the personal goodwill belonged to the executive, the corporation would not have to recognize any tax attributable to such goodwill on the conversion from a corporation to a limited liability company or partnership. Accordingly, a converting corporation wants to ensure that any goodwill is personal and not corporate prior to such conversion.

Tax Treatment to Buyer

Under Code §197, the buyer is entitled to deduct the amount paid in connection with goodwill (whether it is personal or corporate) ratably over 15 years. The tax treatment to the buyer would be the same if the buyer purchased corporate or personal goodwill or if the buyer made covenant not to compete payments to the executive in connection with the acquisition of a trade or business. Each such asset is considered a "§197 intangible." Section 197 intangibles also include goodwill, going concern value, workforce in place, information-based intangibles (including customer-related information such as customer lists and patient or client files), know-how, customer-based intangibles, supplier-based intangibles, licenses, permits, covenants not to compete, franchises, trademarks, and trade names.

Buyers seeking a faster deduction may attempt to characterize payments made in connection with a covenant not to compete as paid in connection with an employment arrangement and deduct the payments under Code §162. A covenant not to compete is a "§197 intangible" if it is entered into in connection with an acquisition (directly or indirectly) of an interest in a trade or business. Treasury Regulation §1.197-2(b)(9) provides that an agreement requiring the performance of services for the acquiring taxpayer does not have substantially the same effect as a covenant not to compete to the extent that the amount paid under the employment agreement represents a reasonable compensation for the services actually rendered. If the buyer is purchasing personal goodwill from an executive, the amount paid for such goodwill is amortizable over 15 years under Code §197 and cannot be characterized as compensation by the buyer. Accordingly, the buyer may sacrifice some flexibility by purchasing personal goodwill from the executive rather than including a noncompete payment within a reasonable compensation package pursuant to an employment agreement.

Summary

An executive with unique skills, a strong relationship with its customers, an excellent industry reputation, and no covenant not-to-compete should consider structuring a transaction with an acquirer as a sale of personal goodwill. The executive can make such sale in conjunction with a sale of other assets by the executive's employer. This structure provides an executive with a beneficial parachute because the payments are treated as long-term capital gain, not subject to equitable distribution and not subject to the claims of the employer's creditors. This structure can also be used to convert a corporation to a limited liability company or limited partnership taxable, respectively, as a disregarded entity or partnership for federal income tax purposes and minimize any gain such corporation would otherwise have under Code §311 or 336 with the distribution of such goodwill to its shareholders.

To properly structure this transaction, the executive needs to plan early by eliminating any covenants not to compete agreements. If the executive implements this strategy at a time when his employer is insolvent, such termination could be a breach of the employer's fiduciary duty to its creditors and a possible fraudulent conveyance to the executive. However, if structured properly, the executive receives significant benefits with no adverse tax consequences to the buyer. ❑

[1] Other tax cases have found the existence of personal goodwill, including *MacDonald v. Commissioner*, 3 T.C. 720 (1944) (holding that goodwill was attributable solely to an insurance agent-shareholder's personal ability, business acquaintances, and other individualistic qualities and that no tax was applicable in the liquidation of his corporation where there was no noncompete agreement); *Longo v. Commissioner*, T.C. Memo 1986-217 (holding that a corporate automobile and casualty insurance agency had no intangible value with a fair market value that could be distributed upon liquidation if it was completely dependent upon its key employees who had no noncompete agreements); and *Wilmot Fleming Engineering Co. v. Commissioner*, 65 T.C. 847 (1976) (holding that there was no entity goodwill in a family-owned manufacturing machine shop business in which the owners had a dominating influence and overall importance to the success of the business).

[2] *See Robinson v. Watts Detective Agency*, 685 F. 2d 727 (1982).

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