# What's in a Name? Personal Goodwill in a Company Sale

by Sonia K. Kothari

Sonia K. Kothari

Sonia K. Kothari is a senior counsel in the tax group of Foley & Lardner LLP. She thanks Lisa K. Kothari for her helpful suggestions on this article.

In this article, Kothari surveys relevant cases in the area of personal goodwill and provides practical guidelines for sellers.

With careful planning and the right set of facts, the separate sales of a company owner's personal goodwill[1] and a company's enterprise value can significantly reduce the overall tax burden from the sale of the business. Both the seller and the buyer can benefit from this arrangement. The selling shareholder can avoid corporate-level tax on the amount attributable to personal goodwill, and the gain from the sale generally will be treated as long-term capital gain subject to favorable individual tax rates. The buyer will have amortizable asset basis upon the acquisition of the individual seller's personal goodwill that would not be available if the buyer solely acquired the stock of the company.

Part I of this article provides background on asset sales versus stock sales and an overview of asset allocation rules. Part II defines personal goodwill and surveys relevant cases. Part III provides practical guidelines for sellers.

[1]As discussed in Part II, personal goodwill generally refers to the value of an owner's reputation, expertise, skill, knowledge, ability, personality, or relationships with customers that is separate from the value of the other assets of the business, including any enterprise goodwill.

## I. Where Do I Begin?

### A. Asset Sale vs. Stock Sale

#### 1. Asset sale.

In an asset sale, a buyer acquires all or some of the individual assets and liabilities of a target company. This allows the parties to cherry pick which assets and liabilities to include in the sale. However, transferring assets may be more complicated than selling equity interests for nontax reasons, such as transferring legal title of assets and changing the party to government contracts, leases, and other commercial agreements.

For tax purposes, the seller (in this case, the target company) is treated as selling individual assets at their respective fair market values and recognizes gain equal to the difference between the company's adjusted tax basis in the disposed assets and their FMVs. If/when the proceeds from the sale are distributed to the owners, the owners will be subject to a second level of tax on the distribution, generally at ordinary income tax rates. The tax basis of each acquired asset in the hands of the buyer is its FMV, and the buyer will be able to depreciate or amortize the full value of the acquired assets, including any acquired goodwill.

#### 2. Stock sale.

In a stock sale, the buyer acquires the equity interests of the target company from the seller (in this case, the owner(s) of the target company), including all the company's underlying assets, liabilities, and rights (including unknown liabilities). Compared with an asset sale, this is a more straightforward structure for corporate law purposes because the target company continues to own its assets, liabilities, and business relationships.

For tax purposes, each owner is treated as selling their equity interests in the company and recognizes gain (generally capital) equal to the

difference between their adjusted tax basis in the equity interests and the proceeds from the sale. This allows the selling individual to avoid the two levels of taxation inherent in an asset sale. However, the tax bases of the underlying assets are not stepped up to their FMVs at the time of the sale, so the buyer does not get the full benefit of deductions for depreciation and amortization of these assets.

### B. Purchase Price Allocation

Section 1060 requires parties in an "applicable asset acquisition"[2] to use the residual method to allocate the purchase price among the transferred assets for purposes of determining the buyer's basis and the seller's gain or loss in each transferred asset. Under this method, assets are grouped into seven classes (that is, cash, securities, receivables, equipment, intangibles, etc.) and the purchase price is allocated in descending order of priority.[3] The parties' preferences regarding the purchase price allocation tend to be at odds. Sellers prefer to allocate purchase price toward capital assets. Conversely, buyers prefer to allocate purchase price to assets that can be depreciated quickly. The value of any goodwill (Class VII) is the amount left after allocating the purchase price to classes I-VI. If a company sale is structured as two separate sales, one as a sale solely of the personal goodwill and another as a sale of the remaining assets (including any company goodwill), the gain from the sale of the personal goodwill will be capital gain to the individual owner of the personal goodwill (and will not be subject to two levels of taxation) and the full value will be available for the buyer's amortization.

## II. What Can One Person Do?

### A. Definition of Personal Goodwill

Personal goodwill is goodwill that is directly owned by an individual — quite literally, "goodwill" that is "personal." Treasury regulations define goodwill as "the value of a trade or business attributable to the expectancy of continued customer patronage . . . due to the name or reputation of a trade or business or any other factor."[4] This is consistent with numerous court decisions that provide that goodwill represents the intangible qualities that bring with them continued patronage.[5] Several courts have recognized that goodwill is an asset that can be sold with a professional practice.[6] In order for goodwill to be "personal," the expectation of continued patronage must belong to the individual, rather than the company. That is, if the individual abandoned the company, including all its tangible assets (buildings, equipment, inventory, customer lists) and other intangible assets (trademarks, intellectual property, company goodwill), their name, personal relationships, skills, and reputation would have a separate ascertainable value.

### B. Personal Goodwill in the Courts

#### 1. *Martin Ice Cream Co.*

*Martin Ice Cream Co.*[7] is the most cited and influential case involving a successful finding that personal goodwill existed. The taxpayer was a wholesale ice cream distributor, the shareholder of which had relationships with the owners and managers of several supermarket chains. The IRS asserted that the ice cream distribution rights were valuable assets of the company and that the distribution of the rights to the shareholder resulted in corporate-level tax under section 311(b) and shareholder-level tax as a dividend. The Tax Court disagreed — the benefits of the personal relationships developed by the

[2] Under section 1060, "applicable asset acquisition" includes a transaction structured as a stock sale that is treated as an asset sale for U.S. federal tax purposes, such as a merger treated as an asset acquisition, a transaction for which an election under section 338(h)(10) is made, and an acquisition of partnership or S corporation interests.

[3] *See* section 338(b)(5) and reg. section 1.338-6(b).

[4] Reg. section 1.197-2(b)(1).

[5] *See, e.g.*, *Metropolitan Bank v. St. Louis Dispatch Co.*, 149 U.S. 436, 446 (1893) (defining goodwill as "the advantage or benefit which is acquired by an establishment, beyond the mere value of the capital, stock, funds, or property employed therein, in consequence of the general public patronage and encouragement which it receives from constant or habitual customers on account of its local position, or common celebrity, or reputation for skill or affluence or punctuality, or from other accidental circumstances or necessity, or even from ancient partialities or prejudices"), and *Newark Morning Ledger Co. v. United States*, 507 U.S. 546, 556 (1993) (defining goodwill as the expectation of continued patronage by existing customers).

[6] *See, e.g.*, *LaRue v. Commissioner*, 37 T.C. 39, 44 (1961).

[7] *Martin Ice Cream Co. v. Commissioner*, 110 T.C. 189 (1998).

shareholder were not assets of the company; the shareholder was the owner and seller of these assets, and thus the company could not be taxed on payments to the shareholder. In so finding, the Tax Court noted that the shareholder never entered into an employment agreement or a covenant not to compete with the company and there were no underlying corporate contracts with the ice cream suppliers.[8]

**2. *Norwalk*.**

In another often-cited case[9] in which the taxpayer prevailed, the Tax Court found "customer-based intangibles" including the client base, client records, and workpapers to belong to selling owner-accountants, not to the accounting firm. As a result, the accounting firm could not have made a distribution of the customer-based intangibles to the accountants and there could be no corporate tax liability at the accounting firm level. In reaching this conclusion, the Tax Court found the following facts compelling: (i) there was no restriction on the ability of the individual accountants to compete with the corporation, (ii) clients of the accounting firm would have followed the accountants, and (iii) an expert concluded that the corporation was worth the value of its tangible assets. The takeaway is that not only must the personal goodwill have an ascertainable value but it also must clearly be transferred to the buyer. If the individual can compete with the buyer, the personal goodwill has not been transferred.

**3. *Solomon*.**

In a part-win for the taxpayers and part-win for the IRS, the Tax Court determined that proceeds allocated to taxpayer-shareholders from the sale of their mining corporation's ore business were a payment for a covenant not to compete.[10] The proceeds were not a payment for personal goodwill (as asserted by the taxpayers) or a dividend from the corporation (as asserted by the IRS). Distinguishing *Martin Ice Cream Co.*, the Tax Court noted the following: (i) the value of the corporation was not attributable to the quality of service and customer relationships developed by the shareholders, (ii) the shareholders were not included in the initial purchase agreement as the sellers of any asset but rather were included in their individual capacities solely to guarantee that they would not compete with the buyer, and (iii) the fact that the buyer required noncompete agreements, but not employment or consulting agreements, made it unlikely that the buyer was purchasing the goodwill of the individuals. Moreover, the buyer was the only business in the industry after the transaction and did not need the taxpayers or the corporation's goodwill to succeed. In fact, the buyer did not continue the business in the name of the corporation. The decision resulted in a part-win for the IRS (the taxpayers did not get capital gains treatment because a payment for a covenant not to compete is ordinary in character) and a part-win for the taxpayers (there was no corporate tax assessable because the covenant not to compete was not a corporate asset). This was simply a case of not having the right facts to support an allocation to personal goodwill.

**4. *Muskat*.**

In a win for the IRS, the First Circuit Court rejected the taxpayer's attempt to recharacterize a payment received under a noncompete agreement as capital gain.[11] The taxpayer entered into an asset purchase agreement and a separate noncompete agreement with the buyer. The noncompete agreement provided for installment payments in consideration for a covenant not to compete over a 13-year period. The taxpayer reported the first installment payment as ordinary income and paid income and self-employment taxes, consistent with the agreements. He subsequently filed an amended return

[8] The court cited the following cases for the proposition that an individual's personal relationships and other assets are not corporate assets when the person does not have an employment contract or restrictive covenant with the corporation: *Estate of Taracido v. Commissioner*, 72 T.C. 1014, 1023 (1979) (finding that the value of a corporation did not include the "personal ability, business acquaintanceship, and other individualistic characteristics" of the sole shareholder); *Cullen v. Commissioner*, 14 T.C. 368, 372 (1950) (noting that the personal ability, personality, and reputation of the sole active shareholder of a corporation did not belong to the corporation where he had no contractual obligation to continue his connection with the corporation); and *MacDonald v. Commissioner*, 3 T.C. 720, 728 (1944) ("the sale of goodwill of a business carries with it, even in the absence of a restrictive covenant, the implied obligation that the seller will not solicit his old customers").

[9] *Norwalk v. Commissioner*, T.C. Memo. 1998-279.

[10] *Solomon v. Commissioner*, T.C. Memo. 2008-102.

[11] *Muskat v. United States*, 554 F.3d 183 (1st Cir. 2009).

recharacterizing the payment as capital gain, alleging that the payment was compensation for the transfer of his personal goodwill. Nothing in the agreements between the parties supported the taxpayer's claim: (i) there were no references to personal goodwill during negotiations, and (ii) the asset purchase agreement allocated a substantial amount of the sale price to the company's goodwill. The First Circuit held that the taxpayer's assertions were not "strong proof" sufficient to overcome the unambiguous written allocation in the agreements between the parties. Unlike in *Solomon*, the facts in this case supported a finding of personal goodwill. The taxpayer may have prevailed if the parties had documented a payment for personal goodwill.

### 5. *Howard*.

In another win for the IRS, a district court found that the goodwill of a dental practice was a corporate asset rather than a personal asset.[12] Consequently, the dental practice was subject to corporate tax on the sale of the company goodwill, and the proceeds of the sale constituted a taxable dividend distribution to the dentist-shareholder. At the time of incorporation of his dental practice, the dentist-shareholder entered into an employment agreement and a covenant not to compete with the business of the corporation for three years and within a 50-mile radius. This agreement was never terminated. Distinguishing *Norwalk*, the court stated that "even when a corporation is dependent upon a key employee, the employee may not own the goodwill if the employee enters into a covenant not to compete or similar agreement whereby the employee's personal relationships with clients may become the property of the corporation."[13] The combination of the employment agreement (which caused the goodwill generated over the years to be owned by the corporation) and the time and distance components of the covenant not to compete (which meant that patients likely would not follow the dentist to a new location) ultimately led to the taxpayer's loss.

### 6. *Kennedy*.

The Tax Court recharacterized payments for the sale of the personal goodwill of a consulting services business as ordinary income for either services to be performed or a promise not to compete with the buyer.[14] The parties entered into three separate agreements: one for the sale of personal goodwill and customer lists (reflecting 75 percent of the purchase price), another for the sale of the business's assets (reflecting 25 percent of the purchase price), and finally an employment agreement between the taxpayer and the buyer entity. The court noted "a lack of economic reality to the contractual allocation of the payments to goodwill" and characterized the allocations as "a tax-motivated afterthought that occurred late in the negotiations."[15] There was no third-party appraisal or other attempt to value the personal goodwill relative to the other assets of the business. Furthermore, the taxpayer gave the buyer a promise not to compete before his retirement and worked for the buyer for 18 months without compensation. This case has some key takeaways: (i) it is important to obtain a third-party appraisal and have credible evidence that the allocation to personal goodwill genuinely reflects its value, (ii) services provided to the buyer post-transaction should be adequately compensated, and (iii) last-minute tax planning will not be looked upon favorably.

### 7. *H&M Inc.*

Ending the string of taxpayer losses, the Tax Court held that the taxpayer, a corporation, was not required to recognize additional capital gain from the sale of its insurance business to a competitor bank because compensation under an employment agreement between the shareholder and the bank was not disguised purchase price attributable to the sale of corporate assets.[16] The corporation sold all its files, customer lists, and contracts, its corporate name, and its enterprise goodwill. The sale was contingent on the execution of an employment agreement with the shareholder and a noncompete provision. In reaching its conclusion, the court, citing *Martin Ice*

[12] *Howard v. United States*, 106 A.F.T.R.2d 2010-5533 (E.D. Wash. 2010).

[13] *Id.* at 2010-5536.

[14] *Kennedy v. Commissioner*, T.C. Memo. 2010-206.

[15] *Id.* at 1269.

[16] *H&M Inc. v. Commissioner*, T.C. Memo. 2012-290.

*Cream Co.* and *Norwalk*, stated that "there will be no saleable [corporate] goodwill . . . where the business of a corporation depends on the personal relationships of a key individual . . . unless he transfers his goodwill to the corporation by entering into a covenant not to compete or other agreement so that his relationships become property of the corporation."[17] Here, the shareholder's relationships, reputation, and skill were not corporate assets that should have or could have been taken into account as part of the purchase price of the corporation because he had no agreement with the corporation that prevented him from taking his relationships, reputation, and skill elsewhere, which he ultimately did. The court also found that the compensation under the employment agreement with the buyer was reasonable. Because the individual's tax liability was not before the Tax Court, there was no determination of whether and what amount of the payments to the individual should have been characterized as a payment for personal goodwill or the covenant not to compete.

**8. *Bross Trucking Inc.***

In holding for the taxpayer, the Tax Court found that a road construction corporation had no corporate goodwill to distribute at the time of its alleged distribution to the sole shareholder.[18] The shareholder had established close personal relationships with his primary customers and was extremely knowledgeable about the road construction industry due to his many years of experience. The IRS sought to attribute the shareholder's established revenue stream, developed customer base, and transparency of the continuing operations to the corporation. However, the Tax Court found them to be direct results of the shareholder's personal efforts and relationships. The expectation of continuing patronage was a result of the unique relationships between the shareholder and the customers, so any goodwill that existed was the personal goodwill of the shareholder, and this goodwill had never been transferred to the corporation through an employment agreement or a noncompete agreement.

**9. *Estate of Adell.***

In the estate valuation context, the Tax Court held that the personal goodwill of the decedent's son had substantial value that should have been excluded from the value of the corporation for purposes of determining the value of the decedent's estate.[19] The decedent was the sole owner of the corporation, and his son helped him build the business. The court noted that the son, who was the president of the corporation at the time of his father's death, did not transfer his goodwill to the company through a covenant not to compete or other agreement and was free to leave the company and use his relationships to directly complete against the company. Moreover, if he quit working for the company, the company could not use his personal relationships to further its business. Thus, the value of the relationships could not be attributed to the company and should not have been included in the value of the company.

**10. *Huffman.***

In a recent win for personal goodwill, the Tax Court determined that an individual, in his role as the CEO of a company, created personal goodwill through his relationships with key employees and customers.[20] The court noted that during his time working for the company, the individual did not have an employment contract and was not subject to a noncompete agreement. The court also found that the personal goodwill was never otherwise transferred to the company. At the time of the asset sale, the individual entered into a noncompete agreement with the purchaser. During the course of negotiations, the parties engaged an independent valuation expert to prepare an allocation between the enterprise goodwill and the personal goodwill and formalized the allocation in the purchase agreement. Although the court determined that the parties overstated the value of the personal goodwill, this case had the right set of facts for a finding of a separate sale of personal goodwill: (i) personal goodwill that existed apart from the company, (ii) that was transferred by the individual to the buyer through a noncompete

[17] *Id.* at 2043.

[18] *Bross Trucking Inc. v. Commissioner*, T.C. Memo. 2014-107.

[19] *Estate of Adell v. Commissioner*, T.C. Memo. 2014-155.

[20] *Huffman v. Commissioner*, T.C. Memo. 2024-12.

agreement, and (iii) an independent valuation and formal allocation of that value memorialized in an agreement between the parties.

### III. Where Do We Go From Here?

The case law collectively establishes that it is possible to prove that personal goodwill exists as a separate capital asset owned by the individual shareholder. However, it also shows that this is difficult to prove and that all the facts and circumstances must line up favorably. Applying the lessons learned from the cases, the list below describes circumstances that should weigh in favor of an individual seller who wishes to demonstrate that personal goodwill existed, was transferrable, and was in fact transferred:

1. To begin, a company should be a closely held business that is highly dependent on the skills, personal relationships with customers/suppliers, technical expertise, and/or reputation of the individual seller. The individual seller should be significantly involved in the operations of the company. This is the type of company that is a good candidate for the separate sale of personal goodwill.
2. It is important that the individual seller does not currently have, and ideally has never had, an employment agreement with the company. When an individual has an employment contract, the individual's reputation, know-how, and personal relationships with customers will belong to the company. Even if there was no employment agreement to start, upon entering into an employment agreement, any personal goodwill will be transferred to the company, and any accretion to the value of that personal goodwill will be enterprise goodwill.
3. When discussions with potential buyers begin, the individual seller should clearly document the intention to separately sell the personal goodwill. The letter of intent between the parties relating to the company sale should identify the existence of personal goodwill. The buyer should indicate in writing that it desires to continue to use the personal goodwill.
4. The individual seller should obtain an independent third-party appraisal early in the process and enter into an agreement with the buyer that the parties will respect the expert valuation. This can be in the letter of intent or in the purchase agreement.
5. The separate sales of the personal goodwill and the equity or assets of the company should be documented in two separate purchase agreements. The purchase agreement for the personal goodwill should contain representations from the individual seller that the personal goodwill exists and is owned by the individual, that the individual has the right to transfer the personal goodwill, and that there are no employment agreements or other contracts that could restrict the buyer's use of the personal goodwill.
6. The individual seller should enter into a covenant not to compete with the buyer for a sufficient period of time and/or within a reasonable distance to demonstrate that the personal goodwill has been transferred to the buyer. Adequate consideration should be allocated to the covenant not to compete.
7. The individual seller should enter into an employment agreement with the company/buyer for a sufficient period of time to teach the buyer/buyer's employees the individual's skills and knowledge. If the personal goodwill is tied to the skills of the individual and the individual does not impart these skills and knowledge, there could be an argument that the personal goodwill was not transferred. The employment agreement should have reasonable compensation.

An individual seller with the right set of facts and circumstances, adequate documentation, and a cooperative buyer can benefit from selling their personal goodwill as an asset separate from the enterprise. Pay attention to the economics of the deal. If the economic substance of the agreement between the parties does not correspond with the intended tax treatment, there is greater risk of recharacterization. ■