Goodwill in Corporate Asset Sales: Maximizing Tax Planning Opportunities

Valuation and Negotiation of Seller's Personal Goodwill

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Valuation and Negotiation of Seller's Personal Goodwill

1. Types of business seller's personal assets
   – Seller's personal goodwill (incorporated in total business value)
   – Seller's personally owned identifiable intangible assets (used in the company business operations)
2. Common instances where we find seller's personal goodwill in the sale of a closely held business
3. Components of seller's personal goodwill
4. Generally accepted intangible asset valuation approaches and methods
5. Application of income approach to value seller's goodwill
6. Application of market approach to value seller's goodwill

Valuation and Negotiation
Seller's Personal Goodwill (cont.)

7. Application of cost approach to value seller's goodwill
8. Negotiation of the allocation of total business value between company assets and seller's goodwill
9. Explanation of the sale price allocation to buyer stockholders, other seller stockholders, and taxing authorities
10. Summary and discussion

Types of Business Seller's Personal Assets

1. Seller's personal goodwill
   – This is often considered to be the excess earnings that the individual owner contributes to the business—and that the individual owner can take away from the business
2. Sellers may also individually own identifiable intangible assets that are used by the company
   – Common examples of identifiable intangible assets include:
     - Marketing-related intangible assets
     - Customer-related intangible assets
     - Artistic intangible assets
     - Contract-related intangible assets
     - Technology-related intangible assets

Types of Business Seller’s Personal Assets (cont.)

3. The sale of the seller’s personally owned intangible assets is a different issue than the seller entering into either an employment agreement or a noncompete agreement with the buyer
   - The employment agreement ensures that the seller will continue to work for the buyer for a stated time period.
   - The noncompete agreement ensures that the seller will not compete against the buyer for a stated time period.
   - With regard to seller-owned intangible assets, the seller is first selling the stock of (or the assets owned by) the company to the buyer. Concurrently, but separately, the seller is selling his/her personally owned intangible assets to the buyer.

Types of Business Seller's Personal Assets (cont.)

4. The analogy for the sale of seller's personal goodwill (or other intangible assets) is the case where the company uses an office, a warehouse, a truck fleet, etc., that is personally owned by the seller. In that case, the buyer would buy the stock (or other assets) of the company. And, the buyer would separately buy the real estate or trucks directly from the seller.

5. In the tangible asset situation, the seller typically leases the personally owned real estate or equipment to the company. So, the value of the company is already reduced due to the expense of the real estate or equipment lease.

Types of Business Seller’s Personal Assets (cont.)

6. In the intangible asset situation, the seller typically allows the company to use his/her goodwill or other intangible assets without charge. In this case, the value of the company is not reduced by the expense of the goodwill use. So, the valuation analyst has to allocate the total business purchase price between the company assets and the seller's assets.

7. The allocation of the purchase price to seller assets is not a payment for the seller’s previous or expected future services—or for any of the company’s assets—or for the seller’s ownership of the company stock. The purchase price allocation is to pay the seller for personally owned intangible assets separately sold to the buyer (at the same time that the company is sold to the buyer).

Types of Business Seller's Personal Assets (cont.)

8. With regard to an allocation to the seller's goodwill, the seller should not have a preexisting employment agreement or noncompete agreement with the company.
   - Goodwill is the value of the income the seller can take with him/her to another (start-up, competitor, etc.) company.
   - If the seller is bound to the company with an employment agreement or noncompete, he/she can't transfer that income—and the seller's personal goodwill has no value.

Situations Where Seller's Goodwill is Transferred

1. Valuation analysts typically look for personal goodwill to be transferred in the following type of business sale transactions:
   - Professional practices
   - Professional services companies
   - Personal services companies
   - Any industrial or commercial business where the owner is:
     - a creative or innovative force
     - actively involved in the marketing function
     - a visionary as to company strategy
     - closely identified with the company operations
     - a charismatic individual who attracts employees, joint venturers, investors, etc.

Situations Where Seller's Goodwill is Transferred (cont.)

2. Valuation analysts typically look for personal goodwill when the seller is one of the company founders or a principal creator of the company products or services.
3. Valuation analysts typically look for personal goodwill when the owner transfers the use of—but not the ownership of—his/her intangible assets to a start-up company.

Elements of Goodwill

1. Valuation analysts typically consider the following elements or components of goodwill:
   - Excess purchase price: the excess of the total business value (or business purchase price) over the value of the company tangible assets and identifiable intangible assets
   - Going concern value: the value of all company assets (tangible and intangible) being in place and ready to use
   - Capitalized excess earnings: the present value of expected future income above a benchmark (or required) income level (usually a fair return on the company tangible and intangible assets)

Elements of Goodwill

2. Valuation analysts typically consider the following components or indications of seller's personal goodwill:
   - Excess purchase price
     - Some of the excess is business/institutional goodwill
     - Some of the excess may be personal goodwill
   - Going concern value
     - This is probably all business/institutional goodwill
   - Capitalized excess earnings
     - Some of the excess is business/institutional goodwill
     - Some of the excess may be personal goodwill

Intangible Asset Valuation Approaches

1. Valuation analysts use generally accepted valuation approaches and methods to value all intangible assets, including seller's personal goodwill.
2. The generally accepted intangible asset valuation approaches are:
   – the income approach,
   – the market approach, and
   – the cost approach.
3. In the income approach, value is based on the present value of that portion of the future business income that is specifically identified with the subject intangible asset (over that asset's remaining useful life—or RUL).

Intangible Asset Valuation Approaches (cont.)

4. In the market approach, value is based on pricing metrics extracted from either:
   - sales of guideline intangible assets,
   - licenses of guideline intangible assets, or
   - profit margins of guideline companies.
5. In the cost approach, value is based on the time, effort, and cost associated with creating a replacement intangible asset (with characteristics that are similar to the subject intangible asset).

Intangible Asset Valuation Approaches and Methods

1. Valuation analysts use these generally accepted methods to value all intangible assets, including the seller's identifiable intangible assets.
2. The income approach methods include:
   - incremental earnings (with v. without) method
   - differential earnings (before v. after) method
   - profit split (or residual profit split) method
   - excess earnings method
     - multiperiod excess earnings method
     - capitalized excess earnings method
3. The market approach methods include:
   - comparable uncontrolled transactions (CUT) method
   - relief from royalty (RFR) method
   - comparable profit margin (CPM) method

Intangible Asset Valuation Approaches and Methods (cont.)

4. The cost approach methods include:
   - replacement cost new less depreciation method
   - reproduction cost new less depreciation method
   - trended historical cost less depreciation method

Seller's Goodwill
Income Approach Methods

1. With versus without the seller valuation method
   - Value of the sellers' goodwill =

     present value of future business income with the seller in place
     minus present value of future business income without the seller in place
   - Typically measured over the expected work life of the seller
   - Assumes the seller retires; does not assume the seller competes with buyer; that is the value of the noncompete
2. Excess future income valuation method
   - Value of the seller's goodwill =

     present value of expected excess earnings related to seller's customer/client relationships, product or formula, innovation, etc.
   - Typically, excess earnings are measured after a fair return on all other assets
   - Projected over the RUL of the seller's intangible asset

Seller's Goodwill Income Approach Methods (cont.)

3. Residual from business value method
   – Value of seller's goodwill =
     value of the total business
     minus value of the company's tangible assets
     minus value of the company's identifiable intangible assets
     minus value of the company's goodwill (using CEEM)
   – Represents the portion of the business purchase price that cannot be allocated to any of the company's tangible assets or intangible assets (including the business goodwill)

Seller's Goodwill
Market Approach Methods

1. Excess pricing multiples method
   - Identify sales of guideline companies where the seller/founder stays with the company
   - Identify sales of guideline companies where the seller/founder doesn't stay with the company
   - Quantify the difference (if any) in the pricing multiples of seller-stay deals versus seller-leave deals
   - Value of seller's goodwill=

     income of subject company
     multiplied by pricing multiple increase in seller-stay deals

Seller's Goodwill Cost Approach Methods

1. Replacement cost new less depreciation (RCNLD) method
   - Identify seller-owned identifiable intangible assets—e.g., patents, designs and formulas, software, distribution routes, copyrights, trade secrets, customer/client relationships, etc.
   - Calculate the RCNLD for each seller-owned intangible asset
   - The RCN includes four cost components
     - direct costs
     - indirect costs
     - developer's profit
     - entrepreneurial incentive (opportunity cost)
   - The LD include three obsolescence components
     - physical depreciation
     - functional obsolescence
     - economic obsolescence

Negotiation of Price Allocation to Seller’s Goodwill

1. Emphasize that the seller’s goodwill does not increase the business purchase price
2. The seller's goodwill represents an allocation of the business purchase price (or total business value) between:
   - the assets owned directly by the company
   - the assets owned directly by the seller
3. The purchase price is <u>not</u> (a) the business value plus (b) the seller’s goodwill value
4. Rather, the seller’s goodwill is based on an allocation of the total business value to the parties that contributed to that total value

Negotiation of Price Allocation to Seller's Goodwill (cont.)

5. Total business purchase price equals:
   - the value of the business without the seller's assets plus
   - the value of the seller's assets (goodwill)
6. The buyer wants to buy a total operating business that includes the seller's assets (whether those seller assets are intangible assets or real estate)
7. The price negotiation can be based on a residual analysis

	total business value
minus	seller's goodwill
equals	residual business value

Negotiation of Price Allocation to Seller's Goodwill (cont.)

8. Or, the price negotiation can be based on a contributory income analysis

	present value of business enterprise income
minus	present value of income from seller's goodwill
equals	present value of business equity income

9. Note that the negotiation of the price allocation to the seller's goodwill should be separate from the negotiation of any seller employment agreement payments or noncompete agreement payments.

Explanation of Price Allocation to Other Interested Parties

1. May have to explain price allocation to company's auditors
   - Purchase price for company stock or assets is allocated on the company's balance sheet
   - Purchase price for seller's goodwill is not allocated on the company's balance sheet
2. May have to explain price allocation to other seller company stockholders
   - All seller stockholders (who may all be company founders) received the same purchase price per share
   - However, one seller may receive an additional payment for that seller's goodwill
   - Other selling stockholders often question the price allocation (particularly if the other stockholder is the seller's ex-spouse)

Explanation of Price Allocation to Other Interested Parties (cont.)

3. May have to explain price allocation to Internal Revenue Service
   - Seller only has to pay one level of income tax on the sale of personal intangible assets (compared to two levels of income tax on the sale of company goodwill)
   - If the buyer buys stock, it may have no step-up in the depreciable asset basis of acquired company; if the buyer buys seller’s goodwill, it has depreciable asset basis in the acquired intangible asset

Summary and Discussion

1. The seller may have personal goodwill or personally owned identifiable intangible assets
2. There are many instances when valuation analysts identify seller goodwill in the purchase of a closely held company
3. There are generally accepted intangible asset valuation approaches and methods
4. These valuation approaches and methods can be used to assign a value to the seller's intangible assets
5. The transaction participants typically negotiate an overall deal price and then negotiate the allocation of the total deal price between the company's assets and the seller's assets
6. Both the buyer and the seller may have to explain the total transaction price allocation to other selling shareholders, to the company auditors, or to the IRS