Intangible Asset Valuation Insights

Personal Intangible Assets and the Sale of the Closely Held C Corporation

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When many service-oriented businesses are sold, two "bundles" of intangible assets are often included in the transfer. The first bundle includes company-owned commercial intangible assets (e.g., contracts, patents, trademarks). The second bundle includes individually owned personal intangible assets (e.g., the business owners' customer/client relationships, personal goodwill and reputation). If the subject business is structured as a C corporation, the gain on the sale of the company intangible assets (and tangible assets) is typically taxed twice. First, the gain is taxed on the C corporation when the assets are sold to the business acquiror. Second, the gain is taxed again when it is distributed from the corporation to the individual owner/operator(s). However, typically, the gain on the sale of separately transferred personal intangible assets is only taxed once—to the individual business/owner operator(s). This discussion summarizes what business owners should consider regarding the identification and the documentation of personal intangible assets with respect to structuring the sale of the closely held C corporation.

Introduction

When the business owner/operator sells the closely held C corporation, any gain on the sale of the corporation assets (both tangible and intangible assets) is typically taxed twice. The gain is first taxed when the corporation sells the assets to the business buyer—such as a corporate acquiror. Then the gain is taxed again when the after-tax net proceeds are distributed from the company to the individual owner/operator(s).

Many closely held businesses are organized as an S corporation, a limited liability company (LLC), a limited partnership (LP), or some other type of pass-through entity for federal income tax purposes. This type of business structure is favorable to the business owners from an income tax perspective.

That is, the business income is generally not subject to federal income tax at the entity level. Rather, the business income is passed through from the company to the business owners and is taxed at the individual shareholder/member/partner level.

Alternatively, some closely held businesses (and most larger business entities) are organized as a C corporation for federal income tax purposes. With this type of company structure, the business income earned by the C corporation is first taxed at the entity level, at the corporation income tax rates.

To the extent that the after-tax company profits are then distributed to the individual shareholders (typically as dividends), the profit distributions are taxed again to the individual business owners. These business profit distributions are taxed at the individual shareholder income tax rates.

For this reason, C corporation business profits are sometimes said to be subject to double taxation—that is, once at the corporation level and once again at the individual shareholder level.

Owners of tax pass-through entities are also advantaged (compared to C corporation shareholders) when the closely held business is sold. This statement is particularly true in the case of a business sale that is structured as a sale of the company assets.

Let's assume that the closely held business owners (e.g., who may be planning to retire) sell all of the company assets (tangible and intangible) to a competitor. If the company is a tax pass-through entity, then the gain on the sale

of the company assets is typically taxed once—at the business owner level. If the closely held company sells its assets at a gain, then that gain is typically not taxed at the entity level. Rather, the amount of the gain on the company asset sale (including the sale of the business goodwill) is taxed once—at the individual business owner level.

In contrast, let's assume that the selling company is a C corporation. Again, let's assume that the closely held corporation owners decide to sell all of the company assets (tangible and intangible) to a competitor. To the extent that there is a gain on the sale of the company assets (including the sale of the business goodwill), that gain will first be taxed at the C corporation level. When these after-tax gains are then distributed to the company shareholders, these distributions are then taxed again, at the individual shareholder level.

This so-called double taxation occurs because a C corporation is a separate taxable entity from its individual shareholders. So, if the C corporation company sells business assets (tangible or intangible) that are owned by the corporation, then the corporation has to pay tax on any gain associated with that asset sale.

Therefore, in the case of the sale of a closely held C corporation, it is important for the business owner/operator(s) to distinguish between (1) the sale of any commercial intangible assets (including business owner/operator(s) that are owned by the company itself and (2) the sale of any commercial intangible assets (including personal goodwill) that are owned by—and may be sold by—the individual shareholders.

In the closely held business sale, it is likely that all of the tangible assets (e.g., real estate, machinery, equipment) are owned by—and are sold by—the company. However, in the closely held business sale, it is also possible that some of the commercial intangible assets related to the business operations may be owned by the individual shareholders.

Such individually owned commercial intangible assets may include customer/client relationships, trade secrets, proprietary food recipes or other product formulations, business systems and procedures, copyrights on product or process drawings, and so forth. Such individually owned intangible assets are more likely to exist in professional practices, professional service firms and other service companies, product distribution companies, and similar companies.

And, such individually owned intangible assets are more likely to exist when the individual shareholder is actively involved in the subject closely held company business operations and business management.

Typically, these individual intangible assets are created or developed by the individual business owner/operator(s). The business owner/operator(s) then allows his/her company to use the intangible assets in its regular business operations. However, when the company is ultimately sold (say to a competitor or any other business acquiror), two bundles of assets may be transferred.

Two Bundles of Assets Transferred in the Company Sale Transaction

The first bundle of transferred assets are the company-owned assets. These company-owned assets may be either (1) tangible assets or (2) intangible assets. These company-owned assets may include accounts receivable, inventory, buildings, machinery, equipment, patents, trademarks, licenses, computer software, an assembled workforce, and business goodwill.

The second bundle of transferred assets are the individually owned assets. These individually owned assets are typically intangible assets. These intangible assets may include the company owner's customer relationships, supplier relationships, business methods and procedures, designs and drawings (related to products or processes), and personal goodwill and reputation.

Tax Considerations in the Sale of the Closely Held Business

In the asset sale of the closely held C corporation, it is important for the business owner/operator(s)—and for their legal counsel and other professional advisers—to properly structure and document the company sale transaction. This is because the gain on the sale of the first bundle of transferred asses will typically be subject to the above-described double taxation.

In contrast, the gain on the sale of the second bundle of transferred assets will typically be taxed once—at the individual owner/operator level. Therefore, it is important for the parties involved in the sale of the C corporation business to document:

1. the transfer and sale price related to the company-owned intangible assets versus
2. the transfer and sale price related to the individually owned intangible assets.

In the federal income tax jargon, these business owner/operator–owned intangible assets are called "personal intangible assets." The following discussion summarizes the business owner/operator considerations related to the transfer of personal intangible assets within the context of a sale of a closely held C corporation.

Personal Intangible Assets and the *Martin Ice Cream Co.* Decision

Personal intangible assets consist of intangible assets:

1. that are developed and owned by an individual company owner and
2. that are held separately from the corporation business enterprise.

The individual owner/operator's ability to sell these separate intangible assets was addressed in the U.S. Tax Court decision *Martin Ice Cream Co*.[1] In this 1998 judicial decision, the Tax Court ruled that, at the time of the closely held company sale, the corporation's sole shareholder separately owned (1) product distribution agreements, (2) personal relationships with supermarket customers, and (3) ice cream distribution expertise. The Tax Court concluded that, at the time of the closely held company sale, these personal intangible assets were transferred apart from the tangible assets and intangible assets that were owned by the shareholder's wholly owned corporation.

In the *Martin* decision, these personal intangible assets were considered to be individually owned intangible assets by the Tax Court. As a result of this 1998 Tax Court ruling, at the time when both the assets of the corporation and the personal intangible assets were sold, the individual shareholder was able to individually report the gain on the sale of the personal intangible assets—outside of the corporation income tax return.

Therefore, by selling his personal intangible assets, the *Martin* business owner avoided the double taxation that would relate to the sale of C corporation–owned commercial intangible assets.

It is noteworthy that in the *Martin Ice Cream Co.* decision, the Tax Court specifically commented that there was no agreement between the corporation and the individual owner/operator that "would have caused those relationships to become the corporation's property." This factor should be an important issue in documenting the existence (and ownership) of personal intangible assets.

Business Sale Transaction Structuring Considerations

The sale of personal intangible assets is generally not a consideration in a transaction that is structured as the sale of the stock of a closely held C corporation. In addition, the selling business owner/operator should be careful not to transfer his or her personal intangible assets to the closely held corporation just prior to the contemplated business sale. This business owner/operator caution is applicable whether the business sale transaction is structured as a sale of the corporation stock or as a sale of the corporation assets.

This is because once the personal intangible assets are transferred to the closely held corporation, they lose their characteristics as personal intangible assets. That is, after such a transfer, the business buyer is actually buying these (previously personal) intangible assets as part of the stock or the assets of the C corporation. After such a transfer, the business buyer is no longer buying these (previously personal) intangible assets directly from the selling business owner/operator(s).

Obviously, the business sale transaction documentation should match the characteristics of the transferred assets. In the asset purchase agreement, the business acquiror should clearly indicate:

1. which tangible assets and intangible assets are being purchased directly from the C corporation and
2. which intangible assets are being purchased directly from the selling business owner/operator(s).

Ideally, the transaction asset purchase agreement will also allocate the total amount of the business purchase price between:

1. the corporation-owned tangible assets and intangible assets and
2. the individually owned personal intangible assets.

Other Transaction Planning Considerations

In the asset sale of the closely held C corporation, the Internal Revenue Service may challenge whether some of the transferred intangible assets are, in fact, personal intangible assets. And, the Internal Revenue Service may also challenge the allocation of the total business sale price consideration between:

1. the corporation-owned tangible and intangible assets and
2. the individually owned personal intangible assets.

In order to more effectively respond to such an audit challenge, it would be preferable for the closely held corporation owner/operator to document the existence of personal intangible assets prior to the subject business sale transaction. A periodic inventory of such personal

intangible assets may help convince the Service (and the business acquiror) that:

1. such personal intangible assets did exist over a long period of time and
2. such personal intangible assets were developed and owned by the owner/operator over a long period of time.

In addition, periodic appraisals of the personal intangible assets may convince the Service (and the business acquiror) that these personal intangible assets have a significant economic value. With such periodic documentation, it is less likely to appear (as the Service may allege) that the business owner/operator(s) simply "invented" these personal intangible assets at the time of the business transaction. In fact, the Service will often allege that the selling owner/operator(s) invented the whole idea of personal intangible assets just to engineer a favorable income tax treatment related to the sale of the closely held corporation.

Summary and Conclusion

Most closely held companies (of any organization structure) own and operate some commercial intangible assets. Typically, these commercial intangible assets are registered (or otherwise documented) in the name of the company. Such commercial intangible assets may include patents, trademarks, licenses or permits, contracts, franchise agreements, computer software, an assembled workforce, and business goodwill.

Usually, it is obvious that the subject business "owns" these commercial intangible assets. This is because the company name is recorded on the contract, the license, the software registration, the employee payroll information, the company financial statements, and so on.

For some closely held companies (regardless of tax structure or organization structure), the company owner/operators may have also created commercial intangible assets. This is particularly true in the case of professional practices or other service businesses. However, these personal intangible assets are individually owned by the company owner/operators.

Such personal intangible assets may include the business owner's: relationships with customers/clients, relationships with suppliers or subcontractors, personal goodwill and reputation, individual experience and expertise, designs or formulas for products, drawings or other documentation of processes or distribution routes, or other proprietary trade secrets.

Many of these personal intangible assets may not be registered or otherwise recorded in any set of books and records.

When the business owner/operators sell the closely held tax pass-through entity (e.g., S corporation, LLC, LLP), it does not matter how the buyers and sellers allocate the business sale proceeds for federal income tax purposes. This is because any gain on the sale of all tangible and intangible assets (whether company-owned or personally owned) is only taxed once—at the individual business owner level.

However, when the business owner/operators sell the closely held C corporation, it does matter how the business sale proceeds are allocated by the buyers and sellers. The gain from the sale of company-owned assets (both tangible and intangible) may be taxed twice—first to the corporation and second to the individual shareholder(s). However, the gain from the sale of individually owned personal intangible assets may be taxed only once—at the individual selling shareholder(s) level.

Accordingly, it is important for business owner/operators to properly structure—and to properly document—the sale of the C corporation closely held business. It also is important for such business owner/operators to document the fact that two different bundles of assets (particularly the intangible assets) are being transferred in the closely held business sale transaction.

And, it is particularly important for such owner/operators to properly allocate the business sale transaction proceeds between the two different bundles of transferred assets.

An inventory and appraisal of the owner/operator(s) personal intangible assets should help the selling business owner(s) to:

1. structure the closely held corporation business sale transaction,
2. document the existence of—and the value of—the personal intangible assets involved in the business sale transaction, and
3. allocate the sale transaction proceeds between (a) the personal intangible assets and (b) the corporation-owned tangible/intangible assets.

Note

1. *Martin Ice Cream Co.*, 110 T.C. 189 (1998).

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