Personal Goodwill

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National Association of Certified Valuators and Analysts

The Value of a Business is Not Always What it Seems (Part I of II)

Personal goodwill is taxed at the individual capital gains tax rate, not the higher corporate income tax rate. Therefore, a credible personal goodwill calculation can amount to significant tax savings. One that is not adequately defensible invites risk of an audit. Every personal goodwill calculation is unique to each business, and the management interview is crucial. In this first of a two-part article, the author discusses when goodwill may need to be calculated and answers whether goodwill is only present if a key employee is irreplaceable and/or a revenue generator.

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Personal Goodwill—Professional, Legal, and Academic Recognition

Personal goodwill is an intangible asset that a company does not own, or have the right to by contract, and is therefore not included as an asset for tax purposes in an acquisition by sale of assets, or property split in a marital divorce settlement. As implied by the word “personal,” this intangible asset is the capitalized income stream or cost savings generated by a key person(s) employed by a company who lack an employment contract and/or noncompete agreement. Personal goodwill will exist if the loss of that key person(s) would reduce the future income of the business for some period of time. If the individual who is not bound by contract could defect to compete against the target and successfully poach customers, the size of the personal goodwill would be accentuated.

If personal goodwill is found to exist, its value is excluded from the corporate-level built-in capital gains tax upon a

deemed asset sale by conversion from a C corporation to a pass-through entity. For this or any other type of transaction, the value of personal goodwill is taxed at the lower personal capital gains tax rate, and the buyer would amortize and deduct the amount from income over 15 years.[1] As a word to the wise when planning and documenting each step of the process, if the acquirer is paying separately for a noncompete agreement as part of the transaction, and the transaction documents do not specifically enumerate any value of personal goodwill, the seller may wind up paying at the personal income tax rate for the present value of the future income stream of the noncompete agreement. In *Muskat v. United States, 554 F.3d*, in a pretrial ruling, the district court declared that the taxpayer defendant would have to show by "strong proof that he and CBFA intended the payment to be compensation for personal goodwill."[2] If there is a lack of such proof, the seller would pay tax at the ordinary income tax rate for the amortized value of the noncompete agreement, rather than the capital gains tax rate.

Personal goodwill has been recognized by numerous state and U.S. Tax Court rulings,[3] and many professional publications and textbooks have recognized and explained personal goodwill. According to *BVR's Guide to Personal v. Enterprise Goodwill*, because the entity neither owns nor has rights to this intangible asset that is responsible for generating a portion of the entity's revenue and cash flow, the value of personal goodwill should be excluded from the fair market value of the entity.[4] The BVR textbook explains regarding the specific value of personal goodwill: "the allocation of goodwill between personal and enterprise is driven by the degree to which the success or failure of the business depends upon the individual's personal services."[5] Dr. Shannon Pratt states the importance of separating revenue attributable to the company itself and its assets, including intangibles like reputation, from revenue attributable to one or more key persons: "the separation of personal versus enterprise goodwill depends on whether (or the extent to which) the customer returns because of the individual, or because of an element or elements that belong to the enterprise."[6]

The Internal Revenue Service (IRS) posts on its web site the items it recognizes as intangible assets:

1. Goodwill
2. Going concern value
3. Workforce in place
4. Business books and records, operating systems, or any other information base, including lists or other information concerning current or prospective customers
5. A patent, copyright, formula, process, design, pattern, know-how, format, or similar item
6. A customer-based intangible
7. A supplier-based intangible
8. Any item similar to items three through seven
9. A license, permit, or other right granted by a governmental unit or agency (including issuances and renewals)
10. A covenant not to compete entered into in connection with the acquisition of an interest in a trade or business
11. Any franchise, trademark, or trade name
12. A contract for the use of, or a term interest in, any item in this list

Goodwill is defined as "the value of a trade or business based on expected continued customer patronage due to its name, reputation, or any other factor." Although the treatment of personal goodwill is not specifically encoded, the IRS seems to implicitly recognize that it exists—the IRS does recognize that a noncompete covenant is an intangible asset that has value. It should stand to reason that the absence of a noncompete covenant can reduce the value of a business.

It is not surprising that the concept of personal goodwill is accepted when you consider that enterprise goodwill can become impaired and written down. When goodwill that arose from an acquisition is deemed partly impaired, the

auditors have determined that the acquirer overpaid. The expected future returns generated by the amount of the purchase price in excess of book value no longer jibes with what should have been a fair transaction price—the acquirer will not realize the returns it hoped to achieve from the purchase of all tangible and intangible assets. Personal goodwill essentially rests on the premise that an acquirer will not pay for a past income stream that stands a high risk of ceasing.

Transactions That May Require a Personal Goodwill Calculation

If personal goodwill exists in a business, the personal goodwill calculation may be warranted under the following circumstances: 1) a corporate transaction by sale of assets to new ownership; 2) a corporate transaction for the conversion from a C corporation to a pass-through entity; 3) a corporate transaction for the conversion from one type of pass-through entity to another, such as from a corporation electing to be taxed as an S corporation to a limited liability company (LLC) taxed as a partnership; or 4) a divorce settlement that includes ownership of a business, whereby the personal goodwill component of the business valuation is not part of the asset split, but may be considered for determining alimony. When personal goodwill exists under either of these circumstances, it is because one or more individuals responsible for part of the income stream are not actually assets that are owned by the company and are not readily transferable, absent an employment contract and noncompete agreements. In other words, there is an intangible item that the entity has used to generate cash flow for the entity, but the entity either does not own the intangible item or does not have the right to its use by contract. Under this circumstance, a post transaction capital account, such as for a conversion to an LLC, should exclude the value of this intangible item.

For Personal Goodwill to Exist, Must the Person be Irreplaceable?

The more irreplaceable a key person is to a business, the larger the personal goodwill will be, assuming the absence of an employment contract and noncompete agreement. Absolute irreplaceability, however, is a strong word more likely to exist when a key person holds all the customer relationships in a service business. Personal goodwill can still exist when a key person can be replaced (including the revenue generated by that key person) but it would take some time. The personal goodwill calculation in this case, using the Income Approach, would involve incorporating the loss of business in the financial projections over some finite number of years rather than indefinitely. The forecast should consider the extent to which customers are recurring (if there are a lot of repeat customers, the revenue stream generated from those customers that the key person poached upon resignation are gone perhaps forever).

A single person having staunch ties with customers responsible for most of a company's revenue does not necessarily lead to any amount of personal goodwill. Large investment banks with wealth management divisions are often able to retain most of the clients of a departing employee due mainly to its reputation and sales tactics of the one charged with the responsibility of making those phone calls to clients the day after the resignation. At the big city branch offices of the wealth management divisions of bulge bracket investment banks, the mail carrier knows that every Friday of the year he can expect to pick up, for expedited delivery, a bag containing correspondence to clients of resigning wealth advisors. The Friday afternoon phone calls to try to retain as many of the clients as possible are often made by either the office manager or a portfolio manager. It is not a difficult sales pitch to retain the clients when the firm has a solid reputation, and the clients are averse to having to fill out paperwork to transfer accounts to another firm. Therefore, another consideration that should be heeded is the reputation and branding of the business, and the capabilities of other employees as compared to the departing employee. They may have never spoken once to the clients of the departing employee but may be able to retain them. Determining the stickiness of the client also depends on the type of services performed. Just as substitute goods is a consideration in the elasticity of demand, the existence of substitute employees is a consideration in personal goodwill.

For Personal Goodwill to Exist, Must the Person be a Revenue Generator?

Personal goodwill does not necessarily have to derive from a revenue-generating employee, at least not directly. Consider the example of a manufacturer that operates on high volume, decent margins during upcycles and razor

thin margins during downcycles. The manufacturing plant has a large amount of customized, automated equipment and systems that were developed over twenty years. The head of operations is the only employee who knows how to operate the plant holistically, and because of the level of customization, finding a replacement would be difficult, and it would take three years to both find a replacement and have them learn the systems. Over the course of those three years, the mostly likely scenario is that other operational employees would be able to run operations sufficiently to maintain production to some extent, but the throughput rate would decline (learning curve effect), there would be stock-out costs from not having product available, or customer defections by those who did not receive their product on time.

Although the operations manager did not work in sales or marketing, their departure would have an impact on sales. Creating a financial forecast for this scenario may not be so difficult if the company could cite a recent time when that operations manager was on vacation for two weeks and had documented the unit decline in the production throughput rate. If there were no decline, then perhaps as important as this operations manager may seem, there is no personal goodwill. Evidence may also be found from comparing operational efficiency before this key person became employed by the company to how it was during employment. This form of evidence must be placed into context with myriad other elements of macroeconomic and sector conditions before and after employment.

In the second part of this two-part article, the author discusses issues that arise valuing identifiable intangible assets if goodwill is derived by first valuing personal goodwill, questions to ask management, and factors to consider using the “with or without” method.

[1] Steven B. Gorin, “Structuring Ownership of Privately-Owned Businesses: Tax and Estate Planning Implications” (Thompson Coburn LLP): 489. Steven B. Gorin further cites the following in a footnote: “Horton v. Commissioner, 13 T.C. 143 (1949) (income from the sale of goodwill is capital gain, whereas income from a noncompete agreement is ordinary income); Code § 197(a), (d)(1)(A) (deduction for amortizing goodwill). Although Reg. § 1.197-2(d)(2) disallows amortization deductions for self-created goodwill, it allows amortization when the taxpayer buys the goodwill (including from someone who bought it from the taxpayer). *Fitch v. Commissioner*, T.C. Memo. 2012-358 rebuffed an IRS attack on repurchased goodwill using a very simple contract. But for Code § 197, goodwill is not amortizable. Reg. § 1.167(a)-3(a).”

[2] *Muskat v. United States*, 554 F.3d 183 (1st. Cir. 2009); Kinney, fn. 1726.

[3] There are too many cases to cite. One may refer to the list of cases in *BVR’s Guide to Personal v. Enterprise Goodwill*, Chapter 6. Adam Manson and David Wood, *BVR’s Guide to Personal v. Enterprise Goodwill* (Portland, Oregon: Business Valuation Resources, LLC, 2011), p. 543–557.

[4] Adam Manson and David Wood, *BVR’s Guide to Personal v. Enterprise Goodwill* (Portland, Oregon: Business Valuation Resources, LLC, 2011), p. 5.

[5] *Ibid*, p. 25. Also, see *Martin Ice Cream Company v. Commissioner*, 110 T.C. 189 (1998).

[6] *Ibid*, p. 37.

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