



Selling A Business? Consider Personal Goodwill

As a business owner, it's all about you. Or is it?

This is the question at hand when it comes to the issue of goodwill and who owns it — the individual or the corporation? The answer is important because of the significant tax consequences associated with selling a business.

At issue is a double tax involved in the sale of assets of a company. When selling an entity that is a "C" corporation (or a "C" converted to an "S" corporation within the last 10 years), gains are taxed at the corporate level — an average tax rate of 35 percent. These assets are then taxed again at the shareholder level, typically at the capital gains rate of 15 percent.

However, if a portion of the corporate assets — in this case, personal goodwill — can be carved out of the deal and attributed to the business owner himself or herself, the gains from the sale of a personal asset are only taxed once — at the shareholder's capital gains rate. The result? Major tax savings.

One important note: In most cases, personal goodwill indeed belongs to an individual person. But if the individual has signed a non-compete or other contractual employment agreement, his or her personal goodwill may actually be considered an asset of the business.

The Martin Ice Cream Case

The court decision giving authority to the separate treatment of personal and business goodwill is the 1998 case of *Martin Ice Cream v. Commissioner*. In this case, a wholesale ice cream company was jointly owned by Arnold Strassberg — an ice cream industry veteran — and his son, Martin. The two disagreed about how the business should be run, so they divided the company in two by forming a wholly owned subsidiary.

Arnold decided to sell his side of the business to Haagen-Dazs for \$1.5 million. Relative to the taxes associated with the sale, Martin Ice Cream contended that the majority of the value was actually the personal goodwill Arthur had built over a long career in the industry. As personal goodwill, the gains would be taxed at Arthur's capital gains rate. The IRS contended that the sale proceeds actually should be attributed to Martin Ice Cream and taxed at the corporate rate.

In the end, the tax court ruled against the IRS, agreeing that these intangible assets were property of the shareholder. Thus, the value of those assets was not included in the value of the corporate sale.

Opportunities for Savings

The Martin Ice Cream case underscores the opportunities available for significant tax savings in a business sale. A thoughtful valuation of corporate and personal assets can help avoid a major tax burden under the right circumstances.

If you would like to find out more about personal and business goodwill and how they are valued, please contact us.

What's the Difference?

Personal goodwill is generally defined as the goodwill associated with an individual. It is based on the premise that clients patronize the business based on the owner's talent, reputation, personality and relationships. Business goodwill is defined as the goodwill associated with the entity itself. Business goodwill is generated by such characteristics as location, facilities and products.