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The Unique Benefits of Treating Personal Goodwill as Property in Corporate Acquisitions

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THE UNIQUE BENEFITS OF TREATING PERSONAL GOODWILL AS PROPERTY IN CORPORATE ACQUISITIONS

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ABSTRACT

Corporate acquisition talks may not get far if buyer and seller disagree over transaction structure, which can have significant after-tax effects. But the parties may have overlooked an item that, due to its potential tax treatment, could be the key to facilitating the acquisition. That item is the selling shareholder's "personal goodwill."

Personal goodwill exists when the shareholder's reputation, expertise, or contacts gives the corporation its intrinsic value. It is most likely to be found in closely held businesses, especially those that are technical, specialized, or professional in nature or have few customers and suppliers. If personal goodwill is treated as property that can be sold ancillary to the sale of the corporation's assets or stock, it can produce a more favorable after-tax result for both buyer and seller. An effective transfer of personal goodwill is also necessary to give buyer the benefit of its bargain.

This author adopts the view that personal goodwill, like business goodwill, should be deemed marketable property. Under this view, buyers receive a step-up in basis in the goodwill and can amortize it for tax purposes. C corporation sellers can sell the goodwill ancillary to the sale of their corporations and avoid double taxation. All sellers may receive favorable capital gains treatment on the sale.

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I. INTRODUCTION

Corporate acquisition talks may not get far if buyer and seller disagree over transaction structure, which can have significant after-tax effects.[1] Buyers may prefer to purchase assets; sellers usually prefer to sell stock. This is especially true of sellers that operate as "C" corporations.[2] Perhaps contrary to common opinion, many small businesses—the focus of this article—may still operate as C corporations, thus exacerbating this problem.[3]

Consider why buyer and seller might prefer a different structure. In an asset sale, buyer receives a basis in the acquired assets equal to their purchase price (commonly referred to as a "step-up" in basis).[4] Buyer can

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[1]*See, e.g.*, Matthew A. Melone, *Taxable Corporate Acquisitions, A Primer for Business and the Non-Specialist*, 25 U. TOL. L. REV. 673, 674 (1994) (opining that "buyer and seller will have relatively strong preferences [on corporate structure] early in the acquisition process, probably well before due diligence procedures are undertaken").

[2]A "C" corporation is generally a corporation or association that is subject to taxation under Subchapter C of Chapter 1 of the Internal Revenue Code of 1986, as amended. *See also* Treas. Reg. § 301.7701-2(b) (2004) (defining the "check the box" entity classification regulations).

[3]*See* John W. Lee, *A Populist Political Perspective of the Business Tax Entities Universe: "Hey the Stars Might Lie But the Numbers Never Do,"* 78 TEX. L. REV. 885, 887 (2000) (stating that the "reality in taxland is that either the Subchapter C corporation . . . or the Subchapter S corporation . . . tends in most market segments to be the tax entity of choice for small businesses conducted in an entity form rather than as a sole proprietorship"); *see also infra* notes 170-72 and accompanying text.

[4]I.R.C. § 1012 (2003) ("The basis of property shall be the cost of such property . . . ."); THEODORE NESS & EUGENE L. VOGEL, TAXATION OF THE CLOSELY HELD CORPORATION 13-39 (5th ed. 1991) ("The purchaser's tax basis in property acquired in a taxable transaction is cost.").

then depreciate[5] or amortize[6] the assets, resulting in valuable tax deductions. If these tax benefits trump accounting considerations,[7] buyer may agree to pay seller's desired price using an asset structure. But a C corporation seller would face double taxation on the sale: first, the corporation would be taxed upon receipt of the acquisition proceeds; second, the shareholder would be taxed upon distribution of the proceeds.[8] The dividend tax rates were recently reduced to a maximum of fifteen percent through 2008.[9] But there are no guarantees beyond then. Moreover, even at fifteen percent, this second level of taxation is an expense sellers would rather avoid.

To avoid double taxation, seller may insist on a stock sale. Because the selling shareholder owns the stock personally, the acquisition proceeds are paid directly to the shareholder, thus bypassing the corporate tax.[10] But a stock sale will draw a lower offering price from buyer because the corporation's assets retain their lower basis post-acquisition.[11]

A difference in structure can make a real difference to a party's bottom line. Therefore, negotiations can end at an impasse over deal structure. But buyer and seller may have overlooked an item that, due to its potential tax treatment, may be the key to facilitating the acquisition.

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[5]I.R.C. § 168 (2004).

[6]*Id.* § 197. "Depreciation" is the term used when referring to tax deductions over the useful lives of tangible assets, whereas "amortization" denotes deductions on intangible assets. *See* WILLIAM A. KLEIN ET AL., FEDERAL INCOME TAXATION 36 (12th ed. 2000) (mentioning that "in the case of an intangible asset the process of spreading deductions over time is called *amortization* (as compared with depreciation, the term used for tangible assets)").

[7]*See infra* note 148 and accompanying text.

[8]*See, e.g.*, MICHAEL J. GRAETZ & DEBORAH H. SCHENK, FEDERAL INCOME TAXATION: PRINCIPLES AND POLICIES 514 (3d ed. 1995). For commentary on the wisdom of double taxation, see Jeffrey L. Kwall, *The Uncertain Case Against the Double Taxation of Corporate Income*, 68 N.C. L. REV. 613 (1990) (suggesting that the case against double taxation is not as persuasive as is generally thought); Lee, *supra* note 3, at 903-22 (describing how small business C corporations avoid double taxation). For possible reasons double taxation came into being and persists, see Steven A. Bank, *Corporate Managers, Agency Costs, and the Rise of Double Taxation*, 44 WM. & MARY L. REV. 167 (2002).

[9]26 U.S.C. §§ 1(h)(1), (11) (2004).

[10]*See, e.g.*, Joseph R. Gomez, *Tax Aspects of Mergers and Acquisitions for the Corporate Lawyer*, 5 J. SMALL & EMERGING BUS. L. 321, 329 (2001) (recognizing that "individual owners of a C corporation prefer a stock sale to an asset sale because a stock sale will produce only one level of tax (shareholder), not two levels of tax (corporation and shareholder)").

[11]Byron F. Egan et al., *Asset Acquisitions: A Colloquy*, 10 U. MIAMI BUS. L. REV. 145, 155 (2002).

> [A] buyer purchasing stock of a C corporation will obtain a stepped up basis only in the stock, which is not an asset it would be able to amoritize or depreciate for tax purposes, and the buyer generally would not want to succeed to the seller's presumably low tax basis in the acquired assets.

That item is the selling shareholder's "personal goodwill."[12] In short, this is goodwill that is owned by the selling shareholder personally instead of by the corporation as an entity (i.e., business goodwill).

Buyers frequently pay more for a business than its book value.[13] The premium paid by buyers represents goodwill.[14] Goodwill usually attaches to a business, but it can instead attach to a business owner when the corporation's intrinsic value is derived from the owner's individual reputation, expertise, or contacts.[15] This is "personal goodwill."

Assuming that personal goodwill gives a business its intrinsic value, a buyer of that business, by paying a premium, manifests an intention to purchase the personal goodwill. This assumes that personal goodwill is treated the same as business goodwill—as property that can be bought and sold. But how to characterize personal goodwill is the subject of much dispute. This article explores the two predominant lines of thought on the subject.[16] One contends that personal goodwill—or at least the subset of professional goodwill[17]— is property, and as such can be bought and sold. The other contends that personal goodwill merely represents the present value of future earnings potential, and is inextricably attached to the individual. This article attempts to show that the property approach is the better approach.

Characterizing personal goodwill as property produces two main benefits in corporate acquisitions. First, it reflects reality. As mentioned above, buyers pay for this goodwill. Therefore, the law should allow its benefits to inure to buyers. A common argument against the property view is that what is personal to an individual cannot be transferred to another. This article seeks to dispose of this argument by enumerating practical steps that can be taken to effectively transfer personal goodwill to a buyer.

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[12]*See* Hughlene A. Burton & Stewart S. Karlinsky, *Personal Goodwill Proves a Useful Strategy in Reducing Selling Shareholder's Tax Liability*, 4 VALST 14, 19 (2001), *available at* 2001 WL 1994660 (recognizing personal goodwill "may create the optional situation for both the buyer and the seller").

[13]Rev. Rul. 59-60, 1959–1 C.B. 237.

[14]*See, e.g.*, Andrew F. Halaby, *Treatment of Goodwill By the Seller Under I.R.C. Section 197*, 43 U. KAN. L. REV. 903, 905-06 (1995).

> [A]n operating business with an existing customer base is worth more than the mere aggregate value of its tangible and identifiable intangible assets because the purchaser may expect customers of the purchased business to continue their patronage. Upon sale, the difference in value between the business as a whole and this aggregate value comprises goodwill's value.

Id. at 905 (citations omitted).

[15]*See infra* Part II.A.

[16]*See infra* Part III.A.

[17]*See infra* Part II.A.2.

Second, personal goodwill as property can provide significant tax benefits to buyers and sellers, and can therefore be the catalyst for facilitating a stalled acquisition. The sale of personal goodwill creates an ancillary transaction to the sale of the corporation's assets or stock. C corporation sellers who own personal goodwill benefit because its sale is not double taxed.[18] Buyers receive a cost basis in personal goodwill, and the corresponding amortization tax deductions.[19] Accordingly, the sale of personal goodwill, as an ancillary transaction, can result in a more favorable after-tax result for buyer and seller who are forced to structure the primary corporate acquisition in their non-preferred manner.

This article has four main focuses. First, for personal goodwill to be useful, buyers and sellers must know what it is and how to identify it. To this end, Part II initially discusses the differences between personal goodwill and business goodwill. Next, it analyzes three illustrative cases on the subject. Finally, it extrapolates from these cases how to identify personal goodwill during a buyer's due diligence.

Second, Part III examines the two predominant lines of thought on how to properly characterize personal goodwill. The first is as property; the second is as future earnings potential. For the reasons discussed in Part III, treating personal goodwill as property is the better approach.

Third, Part IV discusses the implications of treating personal goodwill as property in corporate acquisitions. It first argues that this view allows a buyer to receive the benefits of its bargain. It then discusses the resulting tax benefits to buyers and sellers that can be the catalyst for facilitating a stalled acquisition.

Finally, because personal goodwill may be deemed future earnings potential rather than marketable property, Part V offers practical advice on protecting buyers of personal goodwill in the event of a successful challenge and reallocation by the Internal Revenue Service (IRS).

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[18]*See infra* Part IV.B.2 (discussing the tax treatment to sellers on the sale of personal goodwill).

[19]*See infra* Part IV.B.1 (discussing the tax treatment to buyers on the purchase of personal goodwill).

II. DEFINING AND IDENTIFYING PERSONAL GOODWILL

A. *Types of Goodwill*

Goodwill is a familiar concept to transactional lawyers, tax lawyers, and accountants. Defining it, however, is a difficult task.[20] At least one commentator has noted that goodwill is defined differently in law, accounting, and economics.[21] A common legal definition, penned by Justice Story and often cited by courts,[22] is:

> 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 necessities, or even from ancient partialities, or prejudices.[23]

The accounting definition focuses more on the value of goodwill than on its nature. That definition— that goodwill represents the premium paid for a business[24]—identifies goodwill in connection with its sale. Likewise, the economic definition—that goodwill is "excess earnings power"[25]—implicates its value rather than its character.

For purposes of this article, both goodwill's nature and its value are important. "Business" and "personal" goodwill will now be discussed, with emphasis on distinguishing between them.

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[20] *See, e.g.*, Bryan Mauldin, *Identifying, Valuing, and Dividing Professional Goodwill as Community Property at Dissolution of the Marital Community*, 56 TUL. L. REV. 313, 313-14 (1981) ("Goodwill has long been an elusive concept. Defining an intangible frequently results in vagueness. Definitions of goodwill are not only imprecise, but they vary according to the circumstances of their application and are frequently confused with methods of valuation.").

[21] Alicia Brokars Kelly, *Sharing a Piece of the Future Post-Divorce: Toward a More Equitable Distribution of Professional Goodwill*, 51 RUTGERS L. REV. 569, 577-82 (1999).

[22] *See* Carmen Valle Patel, Note, *Treating Professional Goodwill as Marital Property in Equitable Distribution States*, 58 N.Y.U. L. REV. 554, 561 n.44 (1983).

[23] JOSEPH STORY, COMMENTARIES ON THE LAW OF PARTNERSHIP AS A BRANCH OF COMMERCIAL AND MARITIME JURISPRUDENCE § 99, at 139 (Boston 1841).

[24] Kelly, *supra* note 21, at 578-79.

[25] *Id.* at 579.

1. Business Goodwill

The most prevalent type of goodwill is business, or "enterprise," goodwill.[26] Its prevalence (and the relative obscurity of personal goodwill) is revealed by the tendency of legal writers to refer to business goodwill as simply "goodwill."[27] For example, *Black's Law Dictionary* defines "goodwill" as "[a] *business's* reputation, patronage, and other intangible assets that are considered when appraising the business, esp. for purchase; the ability to earn income in excess of the income that would be expected from the business viewed as a mere collection of assets."[28] This definition clearly only refers to business goodwill.

Stock traders nearly always value a company at more than its book value. For example, it is well known that for many years the company amazon.com had never turned a profit. Yet its stock traded at high prices. Traders paid a premium for brand name and the expectation that it would lead to profits—classic indicia of business goodwill. Large, well-known law firms also possess business goodwill. Clients often seek the services of such firms not because of the skills of any particular lawyer, but because these firms, as entities, have reputations for employing fine lawyers.[29] (Indeed, the lawyers that perform services for any given client will change routinely.) Of course, not all clients who hire such a firm are comfortable working with any of its lawyers. Individual lawyers have qualities that may have influenced the client's choice of firm. But as a general rule, clients hire these firms despite high turnover among their individual lawyers.[30] These firms have, over the years, acquired business goodwill.

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[26]A closely related concept is "going concern value," which the Treasury Regulations define as "the additional value that attaches to property by reason of its existence as an integral part of an ongoing business activity." Treas. Reg. § 1.197-2(b)(2) (2004).

[27]*See, e.g., id.* § 1.197-2(b)(1) (defining "goodwill" as "the value of a *trade or business* attributable to the expectancy of continued customer patronage. This expectancy may be due to the name or reputation of a trade or business or any other factor") (emphasis added).

[28]BLACK'S LAW DICTIONARY 703 (7th ed. 1999) (emphasis added).

[29]*See* Patel, *supra* note 22, at 565 (suggesting that "the goodwill in a large commercial enterprise is like that in many large professional practices where numerous practitioners serve each client, for such goodwill depends less on a particular individual's talents and personality than on the firm's overall work product").

[30]*See* Courtney E. Beebe, *The Object of My Appraisal: Idaho's Approach to Valuing Goodwill as Community Property in* Chandler v. Chandler, 39 IDAHO L. REV. 77, 86 (2002) (presenting a similar hypothetical and reaching the same conclusion).

2. Personal and Professional Goodwill

Personal goodwill, on the other hand, attaches to an individual rather than a business. Personal goodwill is present when the unique expertise, reputation, or relationships of an individual give a business its intrinsic value. For example, consider a mom and pop grocery store. Customers would likely find better selection and prices at the new Wal-Mart in town. Customers, however, may continue to shop at the grocery because they are loyal to mom and pop. If mom and pop were to retire, the business would lose its customers, and thus much of its value. In essence, mom and pop *are* the business, and the business derives its intrinsic value from them. Mom and pop possess personal goodwill.

Personal goodwill is often found in professional businesses.[31] These businesses are able to offer unique services due to the advanced education and special skills of their owners.[32] In this context, personal goodwill is often referred to as "professional goodwill."

To illustrate, consider a hypothetical small town divorce law firm. Assume one of the firm's lawyers is reputed to be the best custody lawyer in the area. Unlike a client's choice to hire a large, well-known firm, a client's choice to hire the divorce firm may be conditioned upon the reputed lawyer handling the case. If this lawyer left the firm to start her own practice, her clients would most likely follow. In this scenario, the law firm itself does not possess the goodwill—the reputed lawyer does.[33] One commentator gives a similar example in the medical context:

> [I]f a doctor was a neurosurgeon with extensive experience, an excellent reputation for successfully treating highly complex and difficult neurological problems, and a good bedside manner, it is likely that patients would come to see the doctor not because of an established practice with a solid reputation in a particular locale, but because of the surgeon's

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[31]Kelly, *supra* note 21, at 580 (concluding that "the success of professional services businesses, such as that of lawyers, accountants, and doctors, appears to be tied directly to the individual providing the service rather than to the organizational entity").

[32]Patel, *supra* note 22, at 564 ("Professional goodwill has been viewed as inhering more in the individual than in the business, since it is the individual's service which is the 'product' offered to customers.").

[33]*See* Beebe, *supra* note 30, at 86. *But see* Helga White, Comment, *Professional Goodwill: Is it a Settled Question or Is There "Value" in Discussing It?*, 15 J. AM. ACAD. MATRIMONIAL LAW 495, 512 (1998) ("Law practices represent a somewhat unique situation due to ethical prohibitions against covenants not to compete, prohibitions on selling goodwill, and prohibitions on establishing a partnership with any non-attorney.").

> unique skills, abilities, and reputation. In such a case, the doctor's reputation does not constitute classic goodwill because no excess value attaches to the practice entity as an organization. Instead, goodwill is connected to and inseparable from the doctor himself. If the doctor leaves the practice, he takes his reputation with him, leaving no goodwill from his reputation remaining with the enterprise. While the doctor's reputation, no doubt, is a valuable thing, it is not classic goodwill.[34]

Most published cases involving personal goodwill address the subset of professional goodwill. In this article, conclusions are drawn from these cases about both professional and non-professional personal goodwill. This is a distinction without a difference. Both professionals and non-professionals can give businesses their intrinsic values. For example, the owner of a manufacturing company who has developed a novel method for making widgets is just as valuable to his company, if not more so, than the typical lawyer or accountant is to his firm. This has been recognized by courts.[35]

Courts have likely been more open to recognizing personal goodwill in a professional setting because it is easier to see how a professional, such as the lawyer or neurosurgeon, gives a business its intrinsic value. This, however, does not mean that the law should afford different treatment to non-professionals, such as mom and pop or the widget-maker, provided that they too are shown to own personal goodwill. Instead, the fundamental inquiry is whether a business or its owner, professional or non-professional, possesses the value sought after by a buyer.

B. *When Does Personal Goodwill Exist? A Sampling of Case Law*

Distinguishing personal goodwill from business goodwill is often difficult and always fact-specific.[36] Personal goodwill may be mistaken for

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[34]Kelly, *supra* note 21, at 581-82 (citation omitted).

[35]*See, e.g.*, Piscopo v. Piscopo, 557 A.2d 1040 (N.J. Super. Ct. App. Div. 1989) (opining the celebrity goodwill is marital asset subject to equitable distribution); *see also* discussion of *Martin Ice Cream Co. v. Comm'r*, 110 T.C. 189 (1998), *infra* Part II.B.2 (identifying that business relationships of an ice cream distributor constitute personal goodwill).

[36]*See, e.g.*, Beebe, *supra* note 30, at 85 ("Courts most often fail to distinguish whether the goodwill of a business is attributable to the individual owners or the business itself."); Kelly, *supra* note 21, at 573 ("Notwithstanding the rhetoric of judicial opinions that relies on classic goodwill theory, the notion of 'personal' goodwill transforms the concept.") (citations omitted).

business goodwill, and vice versa.[37] In addition, goodwill may belong to both a business and its owner, making valuation problematic.[38] There is also a danger, due to the prevalence of business goodwill as a legal concept and the relative obscurity of personal goodwill as a legal concept, that buyers and sellers—not to mention the courts and the IRS—will routinely treat all goodwill as business goodwill.[39] Three representative cases on the subject of personal goodwill will now be discussed. The first case is discussed only briefly to show the difficulty courts have had in distinguishing personal goodwill from business goodwill. The second and third cases are recent and significant decisions from the tax courts that are discussed in detail.

1. *Bateman v. United States*

A telling example of the confusing interplay between business goodwill and personal goodwill is the Ninth Circuit's decision in *Bateman v. United States*.[40] *Bateman* involved a transfer of partnership interests and its tax effects. One question before the court was whether the goodwill at issue belonged to the partnership or its partners. The majority held that all goodwill belonged to the partnership (i.e., was business goodwill). In support, the majority pointed out that third parties had paid premiums for these partnership interests in the past.[41] Presumably, under the majority's rationale, these third parties would not have paid premiums for the interests absent goodwill. The majority, however, failed to recognize that the goodwill could have belonged to the partners personally, and not the partnership.

The dissent correctly opined that the majority had not adequately distinguished between goodwill "associated with the business itself and [that belonging to] particular partners individually."[42] Accordingly, the dissent attempted to differentiate personal goodwill and business goodwill by asking "whether the good will would remain with the business or follow the individual partner if the partner withdrew from the business and competed with it."[43]

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[37] *See* discussion of *Bateman v. United States*, *infra* Part II.B.1.

[38] *See, e.g.*, *infra* note 59 (discussing relative allocation between personal intangibles and business intangibles in the *Martin Ice Cream* case).

[39] *See supra* notes 26-28 and accompanying text.

[40] 490 F.2d 549 (9th Cir. 1973).

[41] *See id.* at 552 & n.4.

[42] *Id.* at 554.

[43] *Id.*

2. *Martin Ice Cream Co. v. Commissioner*

Martin Ice Cream Co. v. Commissioner[44] involved the sale of an ice cream distribution business. This business, Martin Ice Cream Co. (MIC), was organized in 1971 by Martin Strassberg and his son, Arnold Strassberg. MIC began as a small wholesale ice cream distributor in New Jersey, but steadily grew. In particular, Arnold developed innovative packaging for ice cream that won him favor with supermarket owners.[45] As a result, Ruben Mattus, the founder of Häagen-Dazs ice cream, asked Arnold to convince supermarket owners to carry Häagen-Dazs (which Mattus had been unsuccessful in doing).[46] "Arnold . . . sparked a revolution in the retail sale of ice cream"[47] by introducing premium ice cream to supermarkets that had previously only sold lower end brands at cheaper prices.

Over the next decade, MIC continued to prosper, but Martin and Arnold never agreed on the future of the business. Martin wanted to focus on sales to small grocery stores and food service accounts, whereas Arnold wanted to focus on sales to supermarkets.[48] Martin disliked the social aspects of maintaining relationships with supermarket owners, whereas Arnold thrived upon them.[49]

In the mid-1990s, after being acquired by the Pillsbury Corp., Häagen-Dazs sought to acquire "direct access to Arnold's relationships with the supermarkets and [to remove] him as a middleman in the chain of distribution."[50] Stated differently, "Häagen-Dazs believed that these various relationships [with supermarket owners], *personal to Arnold*, had value for which it was willing to pay."[51] Häagen-Dazs was not interested in the distribution rights to small grocers—Martin's "side" of the business.[52]

The parties could not initially reach an agreement for the sale, however. Martin and Arnold continued to disagree over the future of MIC, and eventually agreed to split MIC into two companies. Martin became the sole owner of MIC, focusing on small grocers, and Arnold became the sole

[44]110 T.C. 189 (1998).
[45]*See id.* at 192.
[46]*See id.* at 192-93.
[47]*Id.* at 193.
[48]*See Martin*, 110 T.C. at 193-94.
[49]*See id.*
[50]*Id.* at 195.
[51]*Id.* at 195-96 (emphasis added).
[52]*Martin*, 110 T.C. at 196.

owner of a new corporation, Strassberg Ice Cream Distributors, Inc. (SIC), focusing on distribution to supermarkets.[53]

After the split, Häagen-Dazs resumed discussions with Arnold over purchasing his rights to distribute Häagen-Dazs to supermarket owners. The parties eventually agreed on a purchase price of $1.5 million.[54] Arnold executed a bill of sale and an assignment of rights in favor of Häagen-Dazs, both in his individual capacity and as sole shareholder of SIC, which transferred to Häagen-Dazs "all existing customer lists, price lists, historical sales records, promotional allowance and rebate records, 'and other business records as requested by Buyer, and the goodwill associated therewith.'"[55] This case arose because the IRS claimed that MIC was the true owner of the assets sold to Häagen-Dazs, and therefore was required to recognize a gain on the sale.[56]

The tax court ruled for Arnold, holding that he, personally, owned the intangible relationships with Mattus and with the supermarket owners that were sought after and acquired by Häagen-Dazs.[57] The court stated that "Arnold changed the way ice cream was marketed to customers in supermarkets. The success of the venture depended *entirely upon Arnold*."[58] Because MIC was not the owner of the assets sold, it could not have transferred them, and therefore properly recognized no gain on the sale. The primary asset sold to Häagen-Dazs was Arnold's personal goodwill.[59] The key to the court's holding was that Arnold never entered into a non-compete or employment agreement with MIC or SIC.[60] In the court's view, the absence of such agreements indicated that Arnold had

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[53] *See id.* at 200-01.

[54] *See id.* at 202.

[55] *Id.* at 204.

[56] *Martin*, 110 T.C. at 206.

[57] *See id.* at 206-07.

[58] *Id.* at 207 (emphasis added).

[59] The court also found that the business records of SIC had value, but much less than Arnold's personal goodwill. Of the $1.5 million purchase price, the parties allocated $1.2 million to "Seller's Rights" and only $300,000 to "Records," though the opinion does not divulge how the parties arrived at this allocation. *See id.* at 202.

[60] *Martin*, 110 T.C. at 207.

> Ownership of these intangibles cannot be attributed to [MIC] because Arnold never entered into a covenant not to compete with [MIC] or any other agreement— not even an employment agreement— by which any of Arnold's distribution agreements with Mr. Mattus, Arnold's relationships with the supermarkets, and Arnold's ice cream distribution expertise became the property of [MIC].

Id.

never transferred his relationships or expertise to either corporation, and therefore they remained his personal assets.[61]

3. *Norwalk v. Commissioner*

In *Norwalk v. Commissioner*,[62] the tax court recognized a shareholder's personal goodwill in connection with a corporate liquidation. William Norwalk and Robert DeMarta were the sole shareholders of DeMarta & Norwalk, CPA's, Inc., an accounting practice founded in 1985. Both Norwalk and DeMarta entered into employment agreements with the corporation that contained covenants not to compete.[63] After seven years, Norwalk and DeMarta voted to cease operations due to a lack of profitability.[64] The court found that the employment agreements expired at such time, and therefore Norwalk and DeMarta were no longer bound by the covenants not to compete.[65]

The IRS argued that, upon liquidation, the corporation distributed both tangible assets and customer-based intangible assets to Norwalk and DeMarta.[66] Norwalk and DeMarta countered that the intangibles at issue—"the corporation's client base, client records and workpapers, and goodwill (including going-concern-value)"—belonged to them personally.[67] As in *Martin Ice Cream*, if the corporation owned the intangibles and distributed them to the shareholders, then the shareholders would be forced to recognize a gain on the distribution.[68] If, on the other hand, the shareholders owned the intangibles personally, then no transfer had occurred and therefore no tax would be due.[69]

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[61]The court also rejected the IRS's argument that MIC was the true seller of the assets because the negotiations were initiated between Häagen-Dazs and MIC. The IRS contended that Arnold and SIC were only substituted as the sellers at the "last minute," citing several cases that characterized such last minute changes in a seller's identity as "form over substance." *Id.* at 212-15. The *Martin Ice Cream* court, however, held that the sale to Häagen-Dazs was entirely "transformed" after the formation of SIC. *Id.* at 215. Moreover, as discussed above, Arnold had never transferred the assets to MIC; therefore, they were not MIC's to sell. *Id.* at 209 ("What [MIC] did not own, [MIC] could not transfer.").

[62]76 T.C.M. (CCH) 208 (1998).

[63]*See* Norwalk v. Comm'r, 1998-279 T.C.M. 1, 5 (1989), *available at* http://www.ustaxcourt.gov/InOpHistoric/Norwalk.TCM.WPD.pdf.

[64]*See id.*

[65]*See id.*

[66]*See id.* at 12.

[67]*See Norwalk*, 1998-279 T.C.M. at 12.

[68]*Id.*

[69]*Id.*

The court held in favor of the shareholders, stating that it was "reasonable to assume that the personal ability, personality, and reputation of the individual accountants are what the clients sought."[70] Three findings of fact were central to the court's decision. First, the court found that the termination of the employment agreements with DeMarta and Norwalk, CPA's, Inc., meant that the shareholders had no obligation to continue their connection with this corporation.[71] Second, the court found that if the shareholders left the corporation, their clients would have followed.[72] Third, the court attributed no value to the corporation independent of the accountants themselves.[73]

C. *Identifying Personal Goodwill During Due Diligence*

Lawyers and accountants for corporate buyers understand the importance of thoroughly investigating acquisition targets before consummating any acquisition.[74] In conducting this due diligence, lawyers must identify the assets that their clients will be purchasing and the liabilities that they will be assuming. One fundamental part of this diligence is determining precisely who owns the assets that buyer intends to purchase—is it the target corporation, an affiliate or subsidiary of the corporation, or the corporation's shareholder(s)?[75]

As we have seen, goodwill can be owned by a shareholder personally. Therefore, when the acquisition target is a closely held

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[70]*Id.* at 17.

[71]*See Norwalk*, 1998-279 T.C.M. at 22 ("Because there was no enforceable contract which restricted the practice of any of the accountants at the time of distribution, their personal goodwill did not attach to the corporation.").

[72]*Id. See also supra* text accompanying note 43.

[73]For example, the court found that "no persuasive evidence that the name and location of the corporation had any value other than for their connection with the accountants themselves." *Norwalk*, 1998-279 T.C.M. at 18. *See also* Benjamin Aaron & Matthew Finkin, *The Law of Employee Loyalty in the United States*, 20 COMP. LAB. L. & POL'Y J. 321, 327 (1999).

> When people leave a business to work for another or to open a firm of their own, many are capable of taking with them a sizeable number of the clients whom they had served at their previous place of employment. If they were not in possession of some type of personal magnetism or personal goodwill, they would be incapable of retaining those clients or customers.

Id.

[74]*See generally* Melone, *supra* note 1, at 681-91 (outlining general due diligence procedures); Ram Sundar & Bea Grossman, *The Importance of Due Diligence in Commercial Transactions: Avoiding CERCLA Liability*, 7 FORDHAM ENVTL. L.J. 351 (1996) (describing the statutory scheme relating to environmental liability and discussing the allocation of environmental risk and the due diligence process in a commercial transaction).

[75]If the transaction is a stock sale, the relevant inquiry becomes what assets the corporation owns since they are transferred via transfer of the corporation's stock.

business,[76] and thus heavily dependent on the services of its owner, a buyer's lawyers should not merely assume that all goodwill is owned by the target corporation. *Martin Ice Cream* and *Norwalk* reveal that a shareholder may own goodwill if the shareholder's expertise or reputation attracts and keeps customers and generates revenue for the corporation.[77] The three general categories of businesses where personal goodwill is most likely to be found will be examined next.

1. Types of Businesses Where Personal Goodwill Most Likely to be Found

a. *Closely Held Businesses*

To own personal goodwill, a shareholder must be intimately involved in a business.[78] If not, any goodwill acquired by the business would be largely due to the work of others. Therefore, it is almost a prerequisite that the target business is closely held.[79] In closely held businesses, shareholders typically play the multiple roles of owner, director, officer, and employee.[80] In essence, the shareholder is, in every way, the corporation (recall mom and pop). It is this substantial intertwining of

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[76]*See infra* note 79.

[77]*See supra* Parts II.B.2-3.

[78]*See* Patel, *supra* note 22, at 564-65 ("Many individual owned and highly localized commercial businesses greatly depend on individual skills and personalities.").

[79]There is no precise definition of a closely held business. The term is used to refer to those corporations, partnerships, limited liability companies, and other non-publicly traded entities with a small number of owners who are also the entity's managers. *See* MICHAEL P. DOOLEY, FUNDAMENTALS OF CORPORATION LAW 1011 (1995) (defining such entities by their "[d]istinguishing characteristic . . . that management and shareholding are *not* separated functions"); Galler v. Galler, 203 N.E.2d 577, 583 (Ill. 1964) ("[A] close corporation is one in which the stock is held in a few hands, or in a few families, and wherein it is not at all, or only rarely, dealt in by buying or selling."); Lawrence E. Mitchell, *Professional Responsibility and the Close Corporation: Toward a Realistic Ethic*, 74 CORNELL L. REV. 466, 477 (1989) ("The most significant characteristics . . . [of a closely held business are] the substantial investment by participants, the illiquidity of ownership interests, and the substantial identity of ownership and management.").

[80]*See* William H. Simon, *Whom (or What) Does the Organization's Lawyer Represent? An Anatomy of Intraclient Conflict*, 91 CALIF. L. REV. 57, 67 (2003) (theorizing that shareholders of closely-held corporations "may think of incorporation primarily as a means of limiting liability or gaining tax advantage, and they may not think of it as affecting internal relationships at all"); Robert W. Tuttle, *The Fiduciary's Fiduciary: Legal Ethics in Fiduciary Representation*, 1994 U. ILL. L. REV. 889, 917 n.18 (1994) ("The close corporation . . . presents a far more complicated picture due to the difficulty of separating the entity's interest from the individual shareholders'.").

interests and identities between owner and business that creates the potential for the goodwill to belong to the owner rather than the business.[81]

On the other end of the spectrum, large, publicly traded companies have interests and identities clearly separate from those of their owners.[82] Owners of these companies have relinquished managerial control and become passive investors. Public shareholders, therefore, typically will not have personal goodwill.

Management has the skills, expertise, contacts, and relationships that are valuable to the business. It is unlikely, however, for management of public companies to have personal goodwill. Because a public company usually prospers despite high turnover among management, it is difficult to contend that any one manager is essential to the business.[83] In other words, when customers of a company would likely remain customers despite a change in CEO, the CEO cannot be said to have personal goodwill that detracts from the company's business goodwill.[84] Moreover, unlike in closely held businesses, key employees for large companies typically enter into employment and non-compete agreements. As will be discussed,[85] these agreements probably transfer any goodwill owned by an individual to the business.

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[81]An interesting question, beyond the scope of this article, is whether the presence of personal goodwill could affect piercing of the corporate veil. At least one pair of commentators has suggested that "[b]ecause the goodwill is owned individually, creditors of the corporation may not look to the shareholders' or employees' personal goodwill to satisfy the debts of the corporation." Burton & Karlinsky, *supra* note 12, at 19.

[82]The traditional corporation has been described as "an economic institution in which (i) management and shareholding are separable and separated functions; (ii) shares are held by a number of persons; and (iii) shares are freely transferrable [sic] and neither entry to nor exit from the firm is restricted." DOOLEY, *supra* note 79, at 1010.

[83]This seems likely even if one individual founded the company and was integral to its initial success. Consider, for example, Bill Gates of Microsoft. He founded the company and has been in large part responsible for its success. But if he resigned today, no one would expect the value of Microsoft's stock to take a serious and sustained hit.

[84]This example reveals an important point. That is, virtually all owners and employees of a business have "personal goodwill" in the sense that they bring certain skills, experience, and/or knowledge to the business. (If not, why were they hired?) And there is no doubt that they would retain these "assets" upon their departure from the business. But "personal goodwill" as a legal concept means goodwill that belongs to an individual *rather than* his business—it must take away from the goodwill that would otherwise belong to the business.

[85]*See infra* Part II.C.2.

b. *Technical, Specialized, or Professional Businesses*

Because a shareholder's knowledge, education, and experience can constitute personal goodwill, it may be found in highly technical, specialized, or professional businesses.[86] The shareholders of such businesses possess unique characteristics, often acquired through years of education or experience, which give businesses their intrinsic values.[87]

As discussed earlier,[88] personal goodwill may be easier to detect in professional businesses. As one commentator noted, "[T]he expertise and reputation developed by a professional over time is inextricably connected to the individual."[89] But non-professionals may also acquire special knowledge or skills that are invaluable to their businesses.[90]

c. *Businesses with Few Customers or Suppliers*

Shareholders of businesses with few customers or suppliers may be found to own personal goodwill due to the probability that close relationships are developed. If a business is highly dependent on a small number of customers or suppliers, then its owner must cultivate these relationships to ensure the business's survival. These relationships may give the business its intrinsic value. Consider, for example, the owner of a small construction firm who can underbid competitors due to favorable vendor deals he obtained through personal relationships. Without the shareholder, these relationships do not exist. Without the relationships, the business cannot underbid competitors, and thus cannot remain competitive.

Relatedly, personal goodwill is also more likely to be found if a corporation's contracts are terminable at will or do not contain automatic renewal provisions.[91] Such informal arrangements are often the course of dealing in smaller businesses. Under those circumstances, maintaining

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[86]*See* Scott E. Grimes et al., *Tangible Tax Savings from Shareholder Owning Intangibles*, 61 PRAC. TAX STRATEGIES 260, 266 (1998) ("The issue of who owns the intangible asset is very important in companies that are specialized, highly technical, or dependent on a few customers.").

[87]*See* Alicia Brokars Kelly, *The Martial Partnership Pretense and Career Assets: The Ascendancy of Self Over the Marital Community*, 81 B.U. L. REV. 59, 79 (2001) ("Over time, due to investments of time, labor and, often, additional education, an individual enjoys an increased earning capacity.").

[88]*See supra* text accompanying notes 35-36.

[89]Kelly, *supra* note 21, at 586.

[90]*See supra* note 35 and accompanying text.

[91]*See* MacDonald v. Commissioner, 3 T.C. 720, 724 (1944) (finding that corporation's contracts had no value since most were either terminable at will or upon thirty days' notice).

customers and suppliers, whether many or few, is dependent on the shareholder's abilities.[92]

2. The Importance of Pre-Acquisition Covenants Not to Compete

A business must seemingly be closely held for its owner to have personal goodwill.[93] There is also another prerequisite—that the shareholder has not transferred his personal goodwill to the business by a non-compete agreement.

Recall that *Martin Ice Cream* relied on the fact that Arnold had never transferred his personal rights or relationships to MIC or SIC by entering into a non-compete agreement.[94] The shareholders in *Norwalk*, on the other hand, were bound by employment agreements containing non-compete provisions, although those agreements terminated when their accounting practice ceased operations.[95] *Norwalk*, therefore, suggests that non-compete provisions will not preclude a finding of personal goodwill provided that they have terminated before the sale to buyer.

Support for this position can also be found in the *Martin Ice Cream* opinion, where the court stated that "[e]ven if there had been such an agreement [to transfer the shareholder's personal relationships and rights to the corporation] . . . the value of these relationships and rights would not have become [the corporation's] property in toto."[96] Query whether this means that shareholders would still possess some personal goodwill *while* a non-compete covenant is in effect, or whether it means that all such personal goodwill is "on loan" to the corporation while the covenant is in effect, but is returned fully to the shareholders upon its expiration. Without more guidance from the courts, it is difficult to say, although *Norwalk* suggests the latter.

It is also important not to assume, based on *Martin Ice Cream* and *Norwalk*, that the absence of a formal non-compete agreement will necessitate a finding of personal goodwill. In *Schilbach v. Commissioner*,[97] the tax court held that a *de facto* covenant not to compete negated personal goodwill. Although Schilbach never entered into a non-compete agreement, the court "found it doubtful that [Schilbach] would have

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[92]*See id.* at 726 (finding that corporation's contracts "depended for renewal to a large extent upon the personal efforts of [shareholder]").

[93]*See supra* text accompanying notes 78-81.

[94]*See supra* notes 60-61 and accompanying text.

[95]*See supra* text accompanying notes 63-65, 71.

[96]*Martin*, 110 T.C. at 208.

[97]62 T.C.M. (CCH) 1201, 1203-04 (1991).

competed with the medical practice due to his inability to obtain malpractice insurance and his physical and mental condition."[98] Therefore, during due diligence, lawyers must elicit information regarding both formal non-compete agreements binding the business owners and information that would implicate the *Schilbach* decision.

3. The Need for an Appraisal

If buyer detects the likelihood of personal goodwill during due diligence, it should obtain an appraisal to determine its value.[99] The appraisal is an essential part of due diligence—it will often dictate the portion of the purchase price that should be allocated to the sale of the personal goodwill.[100] This can have important tax consequences for buyer and seller.[101]

III. CHARACTERIZING PERSONAL GOODWILL: PROPERTY OR FUTURE EARNINGS POTENTIAL?

A. *Two Lines of Thought*

As mentioned earlier,[102] the law is inconsistent in its characterization of personal goodwill. Two main lines of thought have emerged. The first is that personal goodwill should be treated the same as business goodwill—as property that can be bought and sold.[103] The second is that personal goodwill is not property, but merely future earnings potential.

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[98]*Norwalk*, 1998-279 T.C.M. at 17.

[99]*See, e.g.*, Beebe, *supra* note 30, at 86-87 (summarizing various methods used to value goodwill); Grimes et al., *supra* note 86, at 266 ("The identification of an intangible asset is separate from the key person discount that the courts have allowed for companies that are heavily dependent on an individual."); Mauldin, *supra* note 20, at 330-48 (providing the general discussion of challenges associated with valuing professional goodwill); Rev. Rul. 59-60, 1959–1 C.B. 237 (discussing valuation of closely held corporation stock for estate and gift tax purposes).

[100]*See* Grimes et al., *supra* note 86, at 266.

> A valuation professional must determine who owns the asset that is generating income and how much income that particular asset generates. This can be done only through detailed discussions with management and a review of key documents. This due diligence is very important to conduct before any mathematical calculations are performed.

Id.

[101]*See infra* Part IV.B.

[102]*See supra* text accompanying notes 16-17.

[103]*See, e.g.*, Patel, *supra* note 22, at 561-62 (concluding that business "[g]oodwill is an accountable asset that can be sold or damaged with the enterprise").

These two lines of thought, and the rationales behind them, are explored below. This Part concludes by arguing that policy considerations support the property approach.

1. Personal Goodwill as Property

Courts have held that personal goodwill—or at least professional goodwill—is property that can be bought and sold. The two cases focused on thus far, *Martin Ice Cream* and *Norwalk*, both implicitly adopted a view of personal goodwill as property that can be transferred. Both of these cases found that the shareholders owned personal goodwill, and this goodwill was intangible property. They also found that personal goodwill could be transferred to a business via a non-compete agreement (although it was not under the facts of those cases).

Courts have also held that professional goodwill is property that can be sold to a third party. In *Rees v. United States*,[104] for example, an Oregon district court held that, based on Oregon precedent,[105] "professional good will may be bought and sold."[106] The Fifth Circuit held likewise in *Estate of Masquelette v. Commissioner*.[107] Tax courts have agreed.[108] In *Wyler v. Commisioner*,[109] for example, the tax court stated:

> Where a person acquires a reputation for skill and learning in a particular profession, as, for instance, in that of a lawyer, a physician, or an editor, he often creates an intangible but valuable property by winning the confidence of his patrons and securing immunity from successful competition for their business, and it would seem to be well settled that this is a species of good will which may be the subject of transfer.[110]

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[104] 187 F. Supp. 924 (Or. 1960).

[105] *Id.* at 926 ("Oregon has recognized the sale of good will by physicians, surgeons, lawyers and dentists.").

[106] *Id.* at 927.

[107] 239 F.2d 322, 327 (5th Cir. 1956).

[108] *See, e.g.*, Charleston v. Commissioner, 52 T.C.M. (CCH) 174, 176 (1986) ("The general rule is that acquisition of a professional practice is the acquisition of an intangible capital asset in the nature of goodwill."); Horton v. Commissioner, 13 T.C. 143, 149 (1949) (upholding that goodwill associated with accounting practice is a capital asset and a gain from the sale of that asset is a capital gain).

[109] 14 T.C. 1251 (1950).

[110] *Id.* at 1260.

In advocating transfers of professional goodwill, one commentator has attempted to characterize it as being similar to business goodwill and dissimilar to personal goodwill.[111] This commentator has the right idea—that it is incongruous for courts to allow transfer of business goodwill but prohibit transfers of professional goodwill. But to distance professional goodwill from personal goodwill goes about fixing the problem in the wrong way. This article has attempted to show that professional goodwill is a subset of personal goodwill, and that a distinction based on an individual's status as a professional is not meaningful.[112] We should embrace professional goodwill for its personal nature and recognize that it, like business goodwill, can be transferred.

2. Personal Goodwill as Future Earnings Potential

The other line of thought is that personal goodwill, professional or non-professional, is germane to the individual that owns it, and therefore cannot be transferred to another. The rationales for this position vary,[113] but the most common among them is that personal goodwill merely represents the future earnings potential of the holder.[114]

Two cases in the post-divorce, equitable distribution of property context have adopted this view.[115] In *Taylor v. Taylor*,[116] the Nebraska Supreme Court stated that "[a]ny value which attaches to the entity solely as a result of personal goodwill represents nothing more than probable

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[111]Patel, *supra* note 22, at 564 ("Any clear cut line drawn between professional goodwill and commercial goodwill on the basis of its personal nature will be arbitrary.").

[112]*See supra* note 35 and accompanying text.

[113]These rationales include: that personal goodwill (1) is not separable from the goodwill of the firm; see Hall v. Commissioner, 19 T.C. 445, 460 (1952) (concluding that goodwill was "inextricably associated with the firm name and not transferable otherwise"); (2) that is has little or no saleable value; see Coates v. Commissioner, 7 T.C. 125, 134 (1946) ("Ordinarily no value, or nominal value, will be given to good will attaching to a personal service partnership such as one composed of physicians, attorneys, or accountants."); or (3) based on precedent, it is simply not transferable; see Powell v. Powell, 648 P.2d 218, 223-24 (Kan. 1982). *See also* Joseph M. Dodge, *Taxes and Torts*, 77 CORNELL L. REV. 143, 178-79 (1993) ("The essential distinction, for example, between 'business' and 'personal' goodwill, or capital, is that the former is transferable and the latter is not."). Professor Dodge's sole support for this contention, however, is the previously discussed case of *Bateman v. United States*, 490 F.2d 549 (9th Cir. 1973). Whether this case supports Professor's Dodge's stand-alone statement, and whether this case is even correctly decided, are shaky propositions. *See supra* Part II.B.1.

[114]*See, e.g.*, Patel, *supra* note 22, at 569 (explaining that some "courts argue that professional goodwill is valuable only to the extent it assures future earnings, and that as an expectation of future income it is too tenuous to be a property right").

[115]Much has been written on personal and professional goodwill in this context. *See infra* note 122 and accompanying text.

[116]386 N.W.2d 851 (Neb. 1986).

future earning capacity."[117] In *Holbrook v. Holbrook*,[118] the Wisconsin Court of Appeals stated:

> The concept of professional goodwill evanesces when one attempts to distinguish it from future earning capacity. Although a professional business' [sic] good reputation, which is essentially what its goodwill consists of, is certainly a thing of value, we do not believe that it bestows on those who have an ownership interest in the business, an actual, separate property interest. The reputation of a law firm or some other professional business is valuable to its individual owners to the extent that it assures continued substantial earnings in the future. It cannot be separately sold or pledged by the individual owners. The goodwill or reputation of such a business accrues to the benefit of the owners only through increased salary.[119]

Cases involving the sale of a business have held likewise.[120] Although there are decisions supporting both sides of the property/future earnings capacity debate, it appears that when the personal nature of professional goodwill is emphasized by a court, the court will often find that it cannot be transferred.

B. *Policy Considerations Dictate a Property View*

Scholars have argued for the recognition of personal goodwill as property.[121] Much of the pertinent commentary is in the context of treating

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[117]*Id.* at 858; *see also* Clukey v. Clukey, No. 391,871, 1998 Conn. Super. LEXIS 2260 (Conn. Super. Ct. Aug. 12, 1998) (citing Taylor v. Taylor, 386 N.W.2d 851 (Neb. 1986); Beebe, *supra* note 30, at 84).

> [P]ersonal goodwill is associated directly with the individual owner's reputation, knowledge and skills. 'This [source of goodwill reflects the assumption that he [success] of a professional practice or highly skilled personal service business is part of the individual's future earning capacity and will not transfer upon sale' of the businesses, but will remain with the individual.

Id. at *18 (citations omitted).

[118]309 N.W.2d 343 (Wis. Ct. App. 1981).

[119]*Id.* at 354.

[120]*See, e.g.*, E.C. O'Rear v. Commissioner, 80 F.2d 473, 474-75 (6th Cir. 1935) (discussing sale of partial interest in law practice).

[121]*See, e.g.*, Kelly, *supra* note 21, at 573 ("This Article assumes that the classification of personal goodwill as property upon divorce is appropriate."); Mauldin, *supra* note 20, at 323 (noting that "the fact that goodwill arises and may be valued partially on the basis of an expectation of future earnings does not mean that there is no valuable current asset or that the

personal goodwill as marital property subject to equitable distribution upon divorce.[122] This section offers some thoughts, in conjunction with the thoughts of other commentators, on why personal goodwill should be recognized as marketable property rather than merely future earnings potential.

1. Personal Goodwill Should Not Receive Disparate Treatment

As discussed in the Introduction, buyers typically pay more for a business than its book value.[123] This is true whether the target business is an accounting practice, a small widget manufacturing business, or a publicly traded corporation. By paying a premium, buyer is manifesting an intent to purchase goodwill. We have also seen that in the accounting practice or widget manufacturing business, the goodwill could be of the personal variety. In the public corporation, it is of the business variety. In Part III.A above, it was shown that the law always recognizes a transfer of business goodwill, but only sometimes recognizes a transfer of personal goodwill.

How can the law allow a buyer to acquire the goodwill of a public corporation, but not of a closely held corporation, when buyer pays a premium for both?[124] There may be a rather simple explanation for this perverse result. *The authorities that prohibit the transfer of personal goodwill do so because they do not understand how it can be transferred.* Stated differently, some courts may wonder—quite understandably—how

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assets are the same"); Patel, *supra* note 22, at 574 ("Since professional goodwill, like commercial goodwill, is a valuable business asset, courts should include it in marital property.").

[122] *See, e.g.*, Lawrence J. Cutler & Samuel V. Schoonmaker, IV, *Division and Valuation of Speculative Assets: Reasoned Adjudications or Courthouse Confusion?*, 15 J. AM. ACAD. MATRIMONIAL LAW. 257, 309-10 (1998) (stating that personal goodwill is too speculative for valuation but that business goodwill is more predictable); Milton C. Regan, Jr., *Spouses and Strangers: Divorce Obligations and Property Rhetoric*, 82 GEO. L.J. 2303, 2365 nn.307-08 (1994) (discussing the difficulty in separating personal goodwill from future earning capacity); Sebastian Weiss, *Preventing Inequities in Divorce and Education: The Equitable Distribution of a Career Absent an Advanced Degree or License*, 9 CARDOZO WOMEN'S L.J. 133, 136-41 (2002) (observing that only three cases have deemed a celebrity career as personal goodwill subject to equitable distribution).

Intellectual property commentators have also at least tangentially addressed the issue. *See, e.g.*, J. THOMAS MCCARTHY, TRADEMARKS AND UNFAIR COMPETITION § 10:14(C), at 361 (2d ed. 1984) (noting that goodwill relating to a group may inhere to an individual member of the group); Jane C. Ginsburg, *Creation and Commercial Value: Copyright Protection of Works of Information*, 90 COLUM. L. REV. 1865, 1938 (1990) (opining that copyrights should only be sought to "safeguard personal goodwill" when a work shows "authorial personality").

[123] *See supra* notes 13-14 and accompanying text.

[124] *See* Mauldin, *supra* note 20, at 319 (stating that "professional goodwill is regularly bought and sold among professional practitioners").

an individual's personal reputation, education, or contacts can be transferred to another. A prime example of this is the previously mentioned case of *Taylor v. Taylor.*[125] In *Taylor*, the court held that "if goodwill *depends on the continued presence of a particular individual*, such goodwill, by definition, is not a marketable asset distinct from the individual."[126]

So what do these courts do? They create a fiction. They find that either seller is being paid a premium for future earnings potential, which he foregoes upon a sale of the business, or that there is goodwill, but it belongs to the business rather than the individual. Later, this article shows that courts need not create this fiction because an individual's expertise and relationships can be transferred.[127]

2. Deficiencies in Future Earnings Capacity Argument

Although there is overlap between goodwill and future earnings potential, there is a difference between the two concepts. Just as it will be argued that a non-compete agreement is a necessary, but not sufficient, means of transferring personal goodwill to a buyer,[128] future earnings potential is an essential part of personal goodwill, but not its whole.[129] Equating the two concepts ignores the fact that a business dependent on its owner is worth more than its book value on the day of the owner's retirement or death. This is because the owner has laid a foundation that has present value, even if its future value is diminished due to the owner's retirement or death.[130]

Other commentators have argued this point. As one commentator stated: "The personal goodwill approach insists that goodwill is distinguishable because it represents not just future earnings, but future earnings that have been enhanced by the professional's reputation and expertise, which, in turn, leads to a probability of future business."[131] Another commentator opined:

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[125]386 N.W.2d 851 (Neb. 1986).

[126]*Id.* at 858 (emphasis added).

[127]*See infra* Part IV.A.

[128]*See infra* Part IV.A.3.

[129]*See, e.g.*, Dugan v. Dugan, 457 A.2d 1, 6 (N.J. 1983) (stating that "future earning capacity per se is not goodwill").

[130]*See* Patel, *supra* note 22, at 568 (arguing that personal goodwill has present value "even though that value may later decline").

[131]Kelly, *supra* note 21, at 590.

> Although its present value is attributable to the expectation that the practice and its patronage will continue in the future, *it is possible to view professional goodwill as a vested, possessory interest with present value* . . . . [T]he probability of continued patrongage . . . has value to the petitioner even thought that value may later decline.[132]

Another commentator draws a good analogy by stating that "[m]any assets, such as rented property and dividend stocks, have a present value attributable in part to the expectation of future earnings, yet no one contends that when the present market value of rental property is divided in a divorce settlement, that allocation includes an award of future rental income."[133]

There is a practical reason why the IRS seeks to characterize personal goodwill as future earnings potential—it is taxed as ordinary income, and thus at a much higher rate than the capital gains treatment that would likely result under the property view. Shortly after the *Rees* decision discussed in Part III.A.1, the IRS issued Revenue Ruling 62-114[134] to announce that it would not follow *Rees*, but would instead follow the Sixth Circuit's decision in another case, *E.C. O'Rear v. Commissioner*.[135] *O'Rear* held that a lawyer did not sell personal goodwill,[136] but "anticipated future income reduced to present worth, [which] is taxable as income when received."[137] *Rees*, on the other hand, held that the personal goodwill at issue was a capital asset, and thus subject to capital gains tax when sold.[138]

The IRS endorsed *O'Rear* because, in its view, "a taxpayer may not escape tax on his earnings as ordinary income by an agreement which is in effect an anticipatory assignment of future income."[139] The IRS's position is understandable—it does not want to lose revenue. Many individuals who sell personal goodwill are high income individuals, and therefore taxed on their ordinary income at the maximum individual tax rate of thirty-five

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[132]*See* Patel, *supra* note 22, at 567-68 (emphasis added); Mauldin, *supra* note 20, at 319-22 (discussing how the concept of vesting factors into the property view of goodwill).

[133]Mauldin, *supra* note 20, at 323-24.

[134]Rev. Rul. 62-114, 1962-2 C.B. 15.

[135]80 F.2d 473 (6th Cir. 1935).

[136]The court in *O'Rear* abstained, however, from deciding whether personal goodwill could ever be a saleable asset, finding precedent supporting both outcomes. *Id.* at 474.

[137]*Id.* at 475. *See also* Kelly, *supra* note 87, at 79 ("At its core, personal goodwill is almost indistinguishable from the potential enhanced earnings that give value to a professional license or degree or a developed 'non-professional' career.").

[138]*Rees*, 187 F. Supp. at 926.

[139]Rev. Rul. 62-114, 1962-2 C.B. 15.

percent.[140] The capital gains rate on individuals, on the other hand, is generally a maximum of fifteen percent, at least through 2008.[141]

3. Additional Reasons to Adopt the Property View

There are additional reasons to treat personal goodwill as property. First, the law recognizes that a business's owners have value independent of the business's value, and that this value can be the subject of contractual bargaining. A prime example is that the law permits non-compete agreements. These agreements recognize that a shareholder's ability, expertise, or reputation has value that buyer is willing to pay to neutralize so that it cannot be used against him. Although non-compete agreements are often harshly construed against their beneficiaries, they are viewed more favorably when ancillary to a corporate acquisition.[142] As is implicit from the discussion of *Martin Ice Cream* and *Norwalk*,[143] there can be considerable overlap between non-compete agreements and transferring personal goodwill. The law, accordingly, should recognize both concepts.

Second, allowing transfers of business goodwill, but not personal goodwill, is an arbitrary distinction that does not reflect reality.[144] The distinction is often made because courts do not conceive of the ways in which personal goodwill can be transferred. But if a shareholder possessing personal goodwill effectively transfers it to a buyer through education, advertising, introductions, or otherwise,[145] the law should recognize this transfer.

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[140] 26 U.S.C. § 1 (2004).

[141] 26 U.S.C. § 1(h)(1)(C) (2004).

[142] *See, e.g.*, Gary P. Kohn, Comment, *A Fresh Look: Lowering the Mortality Rate of Covenants Not to Compete Ancillary to Employment Contracts and to Sale of Business Contracts in Georgia*, 31 EMORY L.J. 635, 646 (1982) ("When courts have analyzed covenants not to compete ancillary to employment contracts, they have focused on whether the territorial, activity, and time restrictions are reasonable. Conversely, when courts scrutinize covenants not to compete ancillary to sales of businesses, they evaluate only the reasonableness of the territorial restrictions.") (citations omitted); Steve D. Shadowen & Kenneth Voytek, *Economic and Critical Analyses of the Law of Covenants Not to Compete*, 72 GEO. L.J. 1425, 1427 n.14 (1984) ("Most courts scrutinize the reasonableness of employee covenants not to compete more stringently than the reasonableness of covenants not to compete incident to the sale of a business.").

[143] *See supra* Parts II.B.2.-3.

[144] *See* Patel, *supra* note 22, at 564 (asserting that courts "have exaggerated the differences between commercial and professional goodwill in holding that professional goodwill, unlike commercial goodwill, cannot be a business asset"); Mauldin, *supra* note 20, at 319 (observing that "subject to possible ethical restrictions, professional goodwill is regularly bought and sold among professional practitioners").

[145] *See infra* Part IV.A.3.

IV. THE UNIQUE BENEFITS OF RECOGNIZING PERSONAL GOODWILL AS PROPERTY

If personal goodwill should be treated as marketable property, as already argued, the implications for corporate buyers and sellers must be addressed. The asset of personal goodwill offers two distinct advantages in corporate acquisitions. First, it allows buyers to receive the property they have bargained for. We have seen that buyers pay a premium for goodwill, whether it is business or personal goodwill.[146] But buyers must understand the nature of this asset to benefit from it.

Part IV.A discusses the procedures necessary to transfer personal goodwill to a buyer.[147] In doing so, this article seeks to counter the claim that such a transfer is not possible. Second, personal goodwill, the asset, can yield potentially significant tax advantages. These advantages can facilitate a corporate acquisition stalled over transaction structure. Of course, accounting treatment of goodwill is now different, but accounting considerations are generally less important to closely held businesses than tax considerations.[148] Part IV.B elaborates these tax advantages.

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[146]*See supra* text accompanying notes 15-16.

[147]Although this article is not meant to provide practical advice to attorneys drafting acquisition documents, it does suggest that simply enumerating personal goodwill among the assets to be transferred in the acquisition is an insufficient method of transfer—as is simply restricting the selling shareholder's ability to compete with buyer post-acquisition.

[148]Accounting considerations are generally less important to closely held businesses because their financial statements are not continuously monitored by analysts, and may not be examined at all until such a business becomes an acquisition target. Accordingly, the accounting treatment of personal goodwill transfers is generally a secondary concern, and therefore will not be discussed in detail. But it is important to note that goodwill receives different treatment under tax and accounting rules. As discussed below, for tax purposes, goodwill is amortized over fifteen years. *See infra* note 178. In the past, goodwill also was amortized for accounting purposes. On July 21, 2001, however, the Financial Accounting Standards Board (FASB) issued Statements of Financial Accounting Standards No. 141 (SFAS No. 141) "Business Combinations" and SFAS No. 142 "Goodwill and Other Intangible Assets," which changed the treatment of goodwill for accounting purposes. In particular, SFAS No. 141 established specific criteria for the recognition of intangible assets subsequent to their acquisition, including goodwill. Further, under SFAS No. 142, companies no longer amortize goodwill for accounting purposes. Instead, a company must test goodwill for impairment annually or more frequently if events occur which indicate a potential reduction in the fair value of a reporting unit's net assets below its carrying value. An impairment is deemed to exist if the net book value of a reporting unit exceeds its estimated fair value. If an impairment exists, a company must record a loss on the impairment to reduce the carrying value of the goodwill on the company's balance sheet. *See generally* WILLIAM J. CARNEY, MERGERS AND ACQUISITIONS: CASES AND MATERIALS (2001 & Supp.2004).

A. *Giving Buyer the Benefit of Its Bargain*

1. Recognizing the Shareholder as the Owner of Personal Goodwill

One of the first jobs of the transactional lawyer drafting the acquisition agreement is to determine the proper parties to the agreement. If the transaction is a straight stock sale, the shareholder will be the selling party. If the transaction is an asset sale, the selling party may be only the corporation, or it may be both the corporation and the shareholder. This depends on whether all assets being sold are owned by the corporation.[149] In larger companies (especially those that are publicly-held), the corporation will likely own all business assets. But in closely held businesses, the shareholder may personally own certain assets used in the business.

Consider, for example, a transaction where the acquisition target is a manufacturing corporation owned by one shareholder. The parties intend a transfer of the business as a going concern, as well as the business's assets, including the manufacturing facility and the real estate on which it sits. Buyer should also consider that the shareholder may have acquired certain assets personally prior to incorporation. For example, if the shareholder owns the real estate on which the manufacturing facility is located (and leases it to the corporation),[150] the acquisition documents must reflect the shareholder as the seller of the real estate in order to convey it to buyer.[151] Providing only for the transfer of the stock or assets *of the corporation* will not transfer the real estate to buyer.

Likewise, if the goodwill is of the personal, rather than business, variety, the acquisition documents must be drafted to reflect the shareholder, and not the corporation, as the seller of this goodwill. But because of the unique nature of personal goodwill, simply enumerating it as an asset to be transferred in an asset sale, or providing that "seller hereby

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[149]Even if the corporation is the only selling party, the shareholder should be a party to the agreement for the purpose of making representations and warranties about the business, and for indemnifying buyer in the event of any breach of these provisions.

[150]Personal ownership of real estate is more likely if the shareholder is conducting business in the corporate form because holding real estate in a corporation can have negative tax consequences. *See* Burton & Karlinsky, *supra* note 12, at 17 ("[T]angible and intangible assets that are appreciated or appreciating in value need to be kept out of the corporate solution. Historically, many companies have accomplished this goal relative to tangible assets by, e.g., having the shareholder own real estate individually and leasing it to the corporation."); Lee, *supra* note 3, at 923-24.

[151]In addition, because the transferred asset is real estate, a deed is necessary to convey it to buyer.

transfers his personal goodwill related to the corporation" in a stock sale, does not seem sufficient for an effective transfer.[152] Two general steps are necessary to effectively transfer personal goodwill.

2. Neutralizing Personal Goodwill for Buyer's Protection

The first step in transferring personal goodwill to a buyer is to prevent the shareholder from continuing to use it or transferring it to anyone else. If the shareholder is free to compete with buyer immediately after the acquisition, either on his own or in connection with a third party, why would the customers who have existing relationships with the shareholder choose to hire buyer instead?[153] Accordingly, personal goodwill may not be transferred at all absent a restriction on seller's ability to compete with buyer post-acquisition.[154] Therefore, any buyer acquiring personal goodwill should insist on a non-compete provision in the acquisition agreement.[155] (This should not be confused with a *pre*-acquisition non-compete agreement between a shareholder and the corporation that employs him. The absence of such an agreement is necessary for the shareholder to have personal goodwill that can be

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[152]*But see Rees*, 187 F. Supp. at 926, 928 (finding a sale of personal goodwill even when contract merely provided for sale of "good will of the practice").

[153]*See* Aaron & Finkin, *supra* note 73, at 327 (covenant not to compete neutralizes employee's goodwill).

[154]Because non-compete agreements for lawyers are typically void as a matter of public policy, it may be difficult for lawyers to transfer personal goodwill in connection with the acquisition of a law firm. *See O'Rear*, 80 F.2d at 474. Buyers would presumably pay less for law firms whose reputations were tied to the reputations of their individual lawyers unless these lawyers stayed on in some capacity after the acquisition. *See* 17-6 BARRIAN C. EATON, PROFESSIONAL CORPORATIONS AND ASSOCIATIONS § 6.08, *Other Tax Problems Characteristic of Closely Held Corporations Rendering Personal Services* (2004).

> Although lawyers are not ethically free to sell their client relationships and files, some established firms have goodwill in the sense of going-concern value of the firm name. Additionally, although there may be no saleable client goodwill on retirement or dissolution, such goodwill can exist in determining what amount to charge an incoming partner. Some lawyers, however, might regard this as an inconsistency.

Id. at 6-135 n.138.

[155]*See* Patel, *supra* note 22, at 565 ("There are several way of insuring the successful sale or transfer of [professional] goodwill. One way is through a restrictive covenant not to compete made by the professional when he leaves."); Aaron & Finkin, *supra* note 73, at 327.

> Shrewd employers and franchisers . . . seek to deprive the employee/franchisee of the fruits of his [personal] goodwill by requiring that he enter into an agreement containing a restrictive covenant. The covenant is generally unfair to the employee/franchisee, for when that person is placed in the position of being unable to compete . . . his personal goodwill is effectively neutralized.

Id.

transferred to buyer.[156] The "new" non-compete obligation, entered into by the shareholder in favor of buyer at closing, will prevent competition with buyer post-acquisition, and therefore is a means of transferring personal goodwill.)

Likewise, buyers should contractually prevent the selling shareholder from soliciting corporate employees, customers, and suppliers, and from disclosing confidential information related to the acquired corporation. The latter is obviously important in the case of the selling shareholder who possesses knowledge that gives the business its value. The other restrictions, however, are of less importance (at least for purposes associated with the transfer of personal goodwill) because it is the selling shareholder, and not employees, customers, and suppliers, who possesses the personal goodwill.

3. Making Personal Goodwill Work for Buyer

The second step in a personal goodwill transfer ensures that buyer gets the benefit of its bargain. That is, buyer must not only prevent the selling shareholder from using the personal goodwill competitively (which step one accomplishes), but also ensure that the personal goodwill works *for* buyer. Buyers may be tempted to think that a post-acquisition covenant not to compete accomplishes this goal.[157] This, however, is not the case.

A non-compete obligation is necessary, but not sufficient, to transfer personal goodwill.[158] Something more is required to actually vest buyer with the benefits of the personal goodwill. Equating the two concepts is like stating that the destruction of a valuable software program is the same as delivering it to a buyer and teaching him how to use it. Destroying the program would mean that neither seller, nor any third party, could use the program to harm buyer. This is, likewise, the function of a non-compete agreement. If buyer, however, believes that the program has value, he will not want it destroyed—he will want to use it to his own advantage. This is analogous to a personal goodwill transfer.

The precise means of completing the transfer depends on the makeup of the personal goodwill. Personal goodwill can be roughly divided into

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[156]*See supra* Part II.C.2.

[157]*See, e.g.*, Todd Wight, *Determination of Goodwill in Dissolution Proceedings: A Hypothetical*, 11 J. CONTEMP. LEGAL ISSUES 298, 298 n.1 (2000) ("Personal goodwill is sold when an individual covenants not to act in a prescribed manner during some future time.").

[158]*See, e.g.*, *Masquelette*, 239 F.2d at 326 ("We think it clear that the agreement not to compete here was *one of the means* used by petitioners to assure the purchasers that the entire good will of the petitioners . . . would be effectively conveyed to their successors . . . .") (emphasis added).

two types. One depends on contacts and relationships. The other depends on expertise, knowledge, or skill. (Reputation, it seems, could fall into either category.)

If the shareholder's contacts or relationships with customers or suppliers constitutes the personal goodwill, the shareholder should be obligated to provide introductions and generally facilitate a smooth transition of these relationships to buyer. As one commentator suggests:

> [A] method for transferring goodwill is to advertise as the successor of a firm. Another way is for the seller of a professional practice to form a temporary partnership with the buyer, so that the seller can introduce the new practitioner to the patrons, inspire the patrons' confidence in the purchaser, and then leave the purchaser well-established in the practice.[159]

If certain customers only shop at the small grocery because of mom and pop, for example, mom and pop can work side-by-side with buyer until these customers become loyal to buyer. Naturally, buyer may still lose some customers despite mom's and pop's efforts. But this should affect valuation of the personal goodwill, not its existence.

If, on the other hand, the shareholder's expertise, knowledge, or skills constitutes the personal goodwill, the acquisition documents should obligate the shareholders to educate buyer or teach him these skills. Again, buyer cannot "become" the shareholder. The extent to which buyer can be taught the knowledge or skill of value depends on the facts. In the case of the widget maker with the secret process,[160] a complete transfer should occur when the secret is shared with buyer. In the case of the neurosurgeon who finished first in his class, however, a lesser doctor may only benefit from the neurosurgeon's training and reputation, but will never possess the same skill.

Implicit in these conditions is that the shareholder will perform services for buyer post-acquisition. The shareholder should be under contract for a sufficient period of time to effect a meaningful transfer of the goodwill to buyer. Buyers may further entice the shareholder to fulfill these obligations by conditioning payment of a portion of the purchase price on the future earnings of the business (commonly referred to as an "earn-out").

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[159]Patel, *supra* note 22, at 566.

[160]*See supra* text accompanying note 35.

B. *Potential Tax Benefits for Buyers and Sellers*

In addition to ensuring that buyer gets the benefit of its bargain, recognizing a shareholder's personal goodwill can have important tax consequences for both buyers and sellers.[161] In the initial stages of any proposed acquisition, buyer and seller must agree on structuring the transaction as an asset sale or a stock sale.[162] Factors influencing this decision include the target corporation's basis in its assets (i.e., "inside basis"), the corporate shareholder's basis in stock or personal goodwill (i.e., "outside basis"), the fair market value of the assets or stock being sold, and the gain or loss to be incurred in the proposed acquisition (including depreciation recapture gains).[163]

Buyers may prefer to buy assets of both C and S corporations[164] because they receive a step-up in basis, can depreciate or amortize the value of the assets, and can pick and choose which of the corporation's liabilities to accept.[165] If a buyer instead acquires the target corporation's stock, then it acquires risks both known and unknown, fixed and contingent.[166] Moreover, there are adverse tax consequences because buyer must retain

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[161] This article discusses only the most basic tax treatment that results from recognizing personal goodwill as a separate and distinct asset. It is primarily meant to apprise corporate lawyers of this important concept and to urge them to involve tax attorneys and accountants when the presence of personal goodwill is detected.

[162] *See supra* note 1 and accompanying text. For the sake of simplicity, this discussion excludes other possible transaction structures, such as the cash merger.

[163] *See, e.g.*, Egan et al., *supra* note 11, at 155.

> The tax treatment to the seller and its shareholders in an S corporation's sale of assets will depend on the form of consideration, the relationship of the tax basis in the seller's assets (the inside basis) to the tax basis of its shareholders in their stock (the outside basis), whether there is built in gain (i.e., the fair market value of assets in excess of tax basis at the effective date of the S corporation election), and whether the seller's S status will terminate.

Harold S. Peckron, *Watchdogs That Failed to Bark: Standards of Tax Review After Enron*, 5 FLA. TAX REV. 851, 880 n.166 (2002) ("A partnership technically has two bases in relation to a partner, i.e., the partner's basis in the partnership interest (outside basis) and the partnership's basis in the partnership property (inside basis).").

[164] An "S" corporation is generally a corporation or association that has elected under Section 1362 of the Internal Revenue Code of 1986, as amended, to be taxed pursuant to Subchapter S of Chapter 1 of the Code.

[165] *But see* NESS & VOGEL, *supra* note 4, at 13-38 to 13-39 (noting that although buyers prefer asset purchases, it may be difficult to acquire an ongoing business as a going concern by this method because most contracts, leases, etc. will require third party consent to assignment). Of course, if these agreements contain change-in-control provisions, consent is also required in a stock sale.

[166] *See id.* at 13-33.

the lower basis of the corporation's assets[167] and may be limited in its ability to use the corporation's net operating losses.[168]

Sellers of C corporations, however, prefer stock sales. These sellers do not wish to incur the double taxation that accompanies an asset sale.[169] Hypothesizing about small businesses operating as C corporations is not merely an academic exercise. As mentioned in the Introduction,[170] the number of small businesses operating as C corporations may be greater than is generally thought. There may be good reasons why this is so.[171] For one, the effects of double taxation *pre-sale* may be overstated due a sophisticated shareholder's ability to avoid it.[172] A C corporation seller, however, cannot avoid double taxation on the sale of its assets. Sellers of S corporations (and other pass through entities) will not face double taxation,[173] but they may wish to sell stock for a "clean" transfer of the corporation (i.e., a transfer of all assets and liabilities).[174] There are also other reasons why both buyers and sellers may prefer a stock sale to an asset sale.[175]

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[167]*See id.* at 13-35.

[168]*See id.*at 13-35 to 13-36.

[169]*See supra* note 8 and accompanying text.

[170]*See supra* note 3 and accompanying text.

[171]*See* Lee, *supra* note 3, at 916-21.

[172]*See id.* at 907.

> A private C corporation paying out all of its business income either as compensation or deductible fringe benefits may be utilized to obtain deductions for certain fringe benefits, including premiums paid for health and accident insurance and group-term life insurance, which are paid on behalf of its shareholder-employees, received tax free by such shareholder-employees, and then deducted by the corporation.

Id. *But see* FRANKLIN A.GEVURTZ, BUSINESS PLANNING 73 (3d ed. 2001) ("Depending on the type of business involved, the reasonableness of compensation paid to employee-shareholders (and its corollary, the lack of dividend distributions) could be called into question.").

[173]*See, e.g.*, Gomez, *supra* note 10, at 327 ("If [seller] is an S corporation, the sale of assets will usually generate collateral tax adjustments mitigating the double tax. Any gain on the sale of assets will increase shareholders' basis in their stock. This increase in stock basis acts to mitigate the effect of the double tax.").

[174]*See* NESS & VOGEL, *supra* note 4, at 13-33 (opining that a stock sale is the "simplest form of transaction" for sellers); Gomez, *supra* note 10, at 329 ("Sellers usually prefer to sell stock rather than assets. One main non-tax reason is that in a stock sale all limitations of [seller], including contingent liabilities, pass to the buyer."). If there is more than one shareholder, however, each shareholder must agree to sell his interests for a complete transfer. A majority of shareholders, on the other hand, can typically decide to sell all of the corporation's assets (with the dissenting shareholders having dissenters' rights).

[175]*See* Melone, *supra* note 1, at 675-77 (discussing that the sheer number of assets may make asset sale unduly cumbersome, obtaining numerous consents to assignment may be impractical, and stock sale may avoid state transfer taxes and dissenters' rights).

1. Tax Treatment to Personal Goodwill Buyers

If a shareholder owns personal goodwill, buyer can purchase both the corporation's assets and the shareholder's personal goodwill.[176] Buyer receives a step-up in basis and depreciation/amortization deductions on the corporation's assets.[177] If the personal goodwill is viewed as property, buyer also receives a step-up in basis and amortization tax deductions on the personal goodwill.[178]

Also consider the reverse situation. For the reasons given above,[179] shareholder desires to sell his stock in the corporation. The proposed purchase price is unacceptable because buyer takes the assets subject to their lower basis.[180] If the parties recognize the shareholder's personal goodwill, however, buyer can purchase both the corporation's stock and the shareholder's personal goodwill.[181] Although buyer would not receive a step-up in basis nor be able to take any deductions on the stock purchase, buyer would receive a step-up in basis and could amortize the personal goodwill for tax purposes.[182]

Allocating a portion of the purchase price to personal goodwill can also reduce a buyer's potential exposure to the "built-in gains" tax. If buyer acquires a C corporation, converts it to an S corporation, and then sells its assets within ten years, that sale is subject to double taxation.[183] This adverse tax potential limits a buyer's flexibility post-acquisition, but may

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[176] *See* Burton & Karlinsky, *supra* note 12 (suggesting that some accountants have begun marketing personal goodwill to their clients).

[177] *See supra* notes 5-6 and accompanying text.

[178] Under I.R.C. § 197 (2004), goodwill is amortizable over fifteen years provided that it is (1) acquired after August 10, 1993 (the date of the statute's enactment); (2) held in connection with the business; and (3) not "self-created." The first two requirements are easily satisfied. *See* Halaby, *supra* note 14, at 911-12. As to the third requirement, buyer is purchasing the goodwill created by another—the seller. It does not matter, for buyer's purposes, whether seller created the goodwill, acquired it from another, or some combination of the two. *See id.* at 917-43 (presenting hypotheticals where seller both created goodwill and acquired it). *See also* Burton & Karlinsky, *supra* note 12, at 19 ("The amount paid for [personal] goodwill allows the purchaser a step-up in basis and an amortization deduction over 15 years under Section 197.").

[179] *See supra* notes 169, 174-75 and accompanying text.

[180] *See supra* note 11 and accompanying text.

[181] Buyers may also choose to undertake a stock purchase followed by an election under I.R.C. § 338 (2004). Essentially, this election allows buyer to treat, for tax purposes, the purchase of stock as the purchase of assets. *See* THEODORE NESS & WILLIAM F. INDOE, TAX PLANNING FOR DISPOSITIONS OF BUSINESS INTERESTS 2-42 to 2-46 (2d ed. 1990). The election does not effect seller. At least one commentator, however, suggests that very few corporate buyers actually make such an election because electing buyers will face double taxation (in place of seller) in exchange for the step-up in basis. *See* Gomez, *supra* note 10, at 329-30.

[182] *See supra* note 178 and accompanying text.

[183] I.R.C. § 1374 (2004).

be mitigated through the purchase of personal goodwill. Acquiring personal goodwill reduces the amount paid for the corporation, and thus the amount subject to the built-in-gains tax.[184]

2. Tax Treatment to Personal Goodwill Sellers

As discussed above,[185] C corporation sellers prefer to sell stock to avoid double taxation. A sale of personal goodwill likewise avoids double taxation, even if the corporate sale is structured as an asset acquisition.[186] This is the primary benefit personal goodwill offers sellers in corporate acquisitions. As an added bonus, the one level of taxation incurred may be capital gains tax.[187] Such treatment is preferable to high income sellers whose ordinary incomes (e.g., on allocations to non-compete agreements) are taxed at higher rates.[188]

The future earnings potential view of personal goodwill dictates taxing it as ordinary income.[189] Although this article has attempted to reveal the deficiencies in this position,[190] it is the position adopted by many courts. Whether personal goodwill is subject to capital gains or ordinary income treatment is, however, of lesser importance, at least to C corporation sellers. The main problem—double taxation—has been eliminated by the recognition of personal goodwill.

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[184]*See* Burton & Karlinsky, *supra* note 12. These commentators also suggest that "the separation into two transactions can provide a second benefit if the purchaser buys assets and the amount allocated to land and buildings under [I.R.C.] Section 1060 is reduced and reallocated to goodwill." *Id.* at 19.

[185]*See supra* note 169 and accompanying text.

[186]*See* Burton & Karlinsky, *supra* note 12, at 19 (noting that a benefit of recognizing personal goodwill is that "the owner or employee can sell the goodwill outside of the corporation and avoid the double tax imposed on the sale of corporate assets").

[187]*See Rees*, 187 F. Supp. at 926; Halaby, *supra* note 14, at 912 ("Because goodwill has traditionally received capital asset treatment, goodwill not qualifying as an amortizable section 197 intangible may apparently continue to be so treated.") (citations omitted). Self-created goodwill, which typically includes personal goodwill, is not a section 197 intangible. *See supra* note 178.

[188]*See supra* note 140 and accompanying text.

[189]*See supra* text accompanying note 138.

[190]*See supra* Part III.B.

3. Tax Effects of Relative Allocation to Personal Goodwill, Post-Acquisition Non-Compete

We have seen the interplay between personal goodwill and covenants not to compete (both pre- and post-acquisition).[191] Determining the allocation of purchase price between personal goodwill and a post-acquisition covenant not to compete can be difficult. Some sources suggest that a covenant not to compete may be an inseparable part of personal goodwill (though I have argued there is a difference).[192] Others have suggested that where buyers and sellers make a relative allocation, it will be respected.[193] It seems that the facts will control in each situation.[194]

The relative allocation between personal goodwill and a covenant not to compete will not matter to buyer for tax purposes—both are amortizable over fifteen years.[195] But buyer may have non-tax reasons for preferring a greater or lesser allocation to the non-compete obligation. On the one hand, a greater non-compete allocation could disadvantage buyers worried about accounting treatment. Recall that goodwill is tested for impairment under new accounting rules.[196] Covenants not to compete, however, are amortized over the life of the covenant (usually three to five years).[197] Therefore they typically disappear from buyer's books much sooner than goodwill, which

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[191] *See supra* Parts II.C.2, IV.A.

[192] *See Masquelette*, 239 F. 2d at 326 (stating that "if the agreement not to compete is a non-severable part of the conveyance of good will, then the entire purchase price is to be treated as having been paid for goodwill").

[193] *See* Allen Walburn, Comment, *Depreciation of Intangibles, An Area of the Tax Law in Need of Change*, 30 SAN DIEGO L. REV. 453, 464 (1993).

> A purchaser paying a premium for goodwill in the acquisition of an ongoing business will typically demand a covenant not to compete from the seller so that he can be assured of obtaining the benefits of that goodwill. Courts have generally allowed taxpayers to allocate part of the purchase price of a business to an amortizable noncompete covenant if the parties to the purchase and sale agreed upon the amount allocated and the allocation reflected economic reality.

Id. (citations omitted).

[194] *See, e.g.*, Toledo Blade Co. v. Commisisoner(A), 11 T.C. 1079, 1085-86 (1948); Toledo Newspaper Co. v. Commissioner, 2 T.C. 794, 804-06 (1943).

[195] I.R.C. § 197. *See also* Catherine L. Hammond, Note & Comment: *The Amortization of Intangible Assets, Section 197 of the Internal Revenue Code Settles the Confusion*, 27 CONN. L. REV. 915, 940 (1995) (noting that "[p]rior to the enactment of section 197, buyers preferred to allocate the purchase price of a business or trade to a non-competition covenant which was usually amortizable over a three to five year period").

[196] *See supra* note 148.

[197] *See* Melone, *supra* note 1, at 706 (for accounting purposes, allocation to goodwill may be preferable as "greatly reducing the annual charge against net income compared to the charge against earnings resulting from assets assigned a shorter life—particularly covenants not to compete").

reduces earnings. (It has been argued, though, that accounting considerations are less important to closely held businesses.)[198]

On the other hand, some transactional lawyers may fear that by allocating a certain amount to a non-compete provision, they are in effect telling a court how much it is worth to buyer. These lawyers think that since such obligations are generally disfavored by courts,[199] a court will release a selling shareholder from such an obligation provided he pays buyer the allocated amount. If a court were to take this approach, obviously, buyer would prefer that it cost the shareholder more to be relieved from the obligation.

Sellers have the potential for different tax treatment based on the relative allocation to personal goodwill and a covenant not to compete. Compensation received for a non-compete obligation is taxed as ordinary income.[200] Personal goodwill, on the other hand, may be taxable to seller as either a capital gain or as ordinary income, depending on whether it is characterized as a saleable asset or as future earnings potential.[201] This suggests that sellers would prefer a greater allocation to personal goodwill. This would also make it less costly for sellers to be relieved of their non-compete obligation under the theory set forth in the preceding paragraph.

V. PROTECTING BUYERS IN THE EVENT OF REALLOCATION

Because we have seen that courts may not recognize personal goodwill as property, buyers who purchase personal goodwill ancillary to a corporate acquisition should protect themselves in the event that the IRS or a tax court later characterizes it as future earnings potential. Also, because distinguishing personal goodwill from business goodwill can be tricky even for those cognizant of the difference,[202] buyers should protect themselves in the event that the IRS or a tax court later determines that the goodwill is all, or in part, of the business variety. For example, buyer and seller may allocate part of the acquisition price to personal goodwill and part to business goodwill (e.g., firm name, books, and records). If it is later determined that no personal goodwill existed, or that it did exist, but that the parties' allocation did not reflect economic reality, the parties will have tax consequences related to the reallocation.

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[198] *See supra* note 148.

[199] *See supra* note 142 and accompanying text.

[200] *See, e.g.*, *Ballentine*, 46 T.C. at 276 ("It is well settled that payments received by a taxpayer for his covenant not to compete are taxable as ordinary income.").

[201] *See supra* notes 134-41 and accompanying text.

[202] *See supra* notes 26-28, 40-43 and accompanying text.

Sellers may resist offering buyers any protections because buyers also benefit from a personal goodwill allocation.[203] As we have seen, however, buyers may actually prefer a greater allocation to a non-compete obligation.[204] High income sellers, on the other hand, will not favor such an allocation.[205] Thus, savvy buyers should have the bargaining power to exact one or more of the protections discussed below.

A. *Seller Representations and Warranties*

There are several ways for corporate buyers to protect themselves in the event that a personal goodwill allocation is successfully challenged. First, buyers should have selling shareholders represent and warrant that they own personal goodwill, that it has not been transferred to the corporation, and that it is property that can be transferred to buyer.[206] A corresponding indemnity provision should provide that the shareholder will defend and hold buyer harmless for any breach of the personal goodwill representation.[207]

Buyer's attorney should draft the personal goodwill representation to "survive" until the applicable statute of limitations expires, and to be excluded from the negotiated "cap" and "basket" dollar amounts on the selling shareholder's liability.[208] The shareholder, on the other hand, should argue that the personal goodwill representation should be treated the same as all other representations and warranties for survival and cap and basket

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[203]*See supra* Part IV.B.1.

[204]*See supra* note 199 and accompanying text.

[205]*See supra* text accompanying notes 200-01.

[206]*See, e.g.*, Reid Breitman, *Equating California Foreclosure Sales with Ordinary Residential Sales*, 68 S. CAL. L. REV. 947, 957 (1995) (discussing "seller representations and warranties that protect the buyer" in real estate transfers).

[207]*See* Colleen E. Healy & Mark S. Hacker, *The Importance of Identifying and Allocating Environmental Liabilities in the Sale or Purchase of Assets*, 10 VILL. ENVTL. L.J. 91, 111-12 (1998) ("While representations and warranties provide the groundwork for allocating environmental liability between the buyer and seller, it is the indemnification provisions that usually become the focus of the negotiations among the parties.").

[208]*See* Peter V. Letsou, *The Scope of Section 12(2) of the Securities Act of 1933: A Legal and Economic Analysis*, 45 EMORY L.J. 95, 130 (1996).

> [I]ndemnity provisions are frequently subject to the following: "baskets," which prevent buyers from recovery for certain de minimus violations; "caps," which limit the buyer's total recovery to an amount specified in the contract; and "survivability" provisions, which prevent buyers from recovering at all after a specified period of time from the closing has passed.

Id. (citations omitted).

purposes.[209] There is no right or wrong argument here—the end result will be the product of negotiations.

B. *Hold Back or Escrow Arrangements*

Buyers know that indemnities are only as good as the collateral backing them.[210] Without security, a selling shareholder can take all proceeds from the sale and squander them. If the shareholder later owes under an indemnity, there would be no assets from which buyer could collect.[211] Therefore, even if a buyer is successful in obtaining a representation and warranty regarding the shareholder's personal goodwill, buyer must still ensure that it can collect in the event of a breach of that provision.

A common way for buyers to ensure adequate security is to hold back or escrow part of the purchase price.[212] A hold back is when buyer withholds part of the purchase price at the closing but pays it at a later date provided that buyer has not suffered an indemnifiable loss.[213] If buyer suffers a loss, it is entitled to retain a portion of the hold back equal to its loss (rather than pay it to seller). More common is the escrow, which is the same concept as a hold back except that instead of buyer holding the funds, they are deposited with an escrow agent, usually a neutral third party (e.g., a bank).[214] The escrow agent releases the escrowed funds to the

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[209]*See* Michael A. Rossi, *Insuring Representations and Warranties in Mergers and Acquisitions*, 22 RISK REPORT No. 8 (Apr. 2000) (suggesting, as a compromise, that transaction insurance can effectively extend the survival period while relieving seller of his direct payment obligations). *See infra* Part V.C for a discussion of the transaction insurance alternative.

[210]*See* Howard L. Shecter, *Selected Risk Issues in Merger and Acquisition Transactions*, 51 U. MIAMI L. REV. 719, 757 (1997) ("The value of an indemnity . . . from the seller relates directly to the availability of the assets backing the promise at the time the claim may be asserted."); Rossi, *supra* note 209 (stating that "an indemnity is only as good as the financial solvency of the indemnitor").

[211]The seller would, in effect, be judgment-proof.

[212]*See* Lou R. Kling et al., *Summary of Acquisition Agreements*, 51 U. MIAMI L REV. 779, 780 (1997) (noting that "unless an escrow or similar holdback device is established, there is no way for the purchaser to obtain indemnification").

[213]*See* Jeanne L. Schroeder, *Three's A Crowd: A Feminist Critique of Calabresi and Melamel's One View of the Cathedral*, 84 CORNELL L. REV. 394, 485 (1999) ("In corporate acquisitions, it is common for buyers to 'hold back' or escrow part of the purchase price for a negotiated period . . . ."). Another option, less common in small business acquisitions due to transaction costs, is obtaining a bank letter of credit. *See generally* Henry D. Gabriel, *Standby Letters of Credit: Does the Risk Outweigh the Benefits?*, 1988 COLUM. BUS. L. REV. 705 (1998).

[214]*See* Egan et al., *supra* note 11, at 165 ("As a practical matter, probably the most effective protection of a buyer against successor liability is comprehensive indemnification by the seller, particularly if the indemnification is backstopped by a portion of the purchase price held in escrow.").

shareholder per an agreed upon timetable provided buyer suffers no indemnifiable loss.[215]

Sometimes, however, shareholders will not agree to a hold back or escrow. Shareholders in closely held corporations,[216] perhaps lacking sophistication in corporate acquisitions,[217] are particularly concerned about such provisions. These shareholders may not be used to such lawyerly demands, and may deem it inequitable for buyers to acquire all rights to "their" business on the closing date without full payment.

C. *Transaction Insurance*

Another way to protect buyers, and to pay shareholders in full on the closing date, is to obtain transaction insurance.[218] The market for transaction insurance has grown in recent years.[219] Major insurance companies including American Insurance Group,[220] Chubb,[221] and Professional Insurance Associates[222] have developed new financial insurance products specifically tailored to mergers and acquisitions. These policies include representations and warranties insurance and contingent

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[215] *See generally* Howard L. Weinreich, *Contract of Sale*, *in* 1 BUSINESS ACQUISITIONS 5, 191-94 (John W. Herz & Charles H. Baller 2d ed. 1981).

[216] *See supra* note 79.

[217] *See* Note, *Toward Greater Equality in Business Transactions: A Proposal to Extend the Little FTC Act to Small Businesses*, 96 HARV. L. REV. 1621, 1629 (1983) (proposing that small businesses "are typically run by inexperienced entrepreneurs who may be little more sophisticated than individuals in the consumer marketplace").

[218] *See* Rossi, *supra* note 209 ("M&A insurance . . . can serve as the entirety of the financial guaranty for the seller's indemnity obligations, thereby eliminating the need for an escrow account, letter of credit, or security."); Jill Swaim et al., Using Insurance to Ensure the Smooth Sale of Your Business, (unpublished manuscript, on file with the author) (describing a hypothetical transaction where representations and warranties insurance enabled buyer and seller to reach an agreement).

[219] *See* Joseph P. Monteleone, *Financial Insurance Solutions to Exposures Arising From Merger, Acquisition and Related Transaction*, 1199 PLI/Corp 479, 484 (2000) ("Until very recently, there was a dearth of insurance products designed specifically with [mergers and acquisitions] in mind and responsive to the needs of the insurance purchaser.").

[220] AIG offers this insurance product through their related company American International Companies. *See* http://www.aig.com/gateway/asset/1/70/420/3068/United+States_Business_Mergers+%26amp%3B+Acquisitions.htm (last visited Dec. 15, 2004) (sample representations and warranties insurance application and policies on file with author).

[221] *See* http://csi.chubb.com/products/reps.asp (last visited Dec. 15, 2004).

[222] *See* http://www.piainc.com/repswarrinfo.htm (last visited Dec. 15, 2004).

tax liability insurance.[223] These products can be purchased for the benefit of either party,[224] and one or both may pay the premium.[225]

These insurance products may be desirable because seller's current insurance policies will neither apply to buyer post-acquisition, nor cover the specific risks of concern to buyer.[226] Before purchasing such products, however, buyers and sellers must be comfortable that personal goodwill is a covered item. In addition, procuring such insurance, if not considered until after an impasse occurs, can slow the momentum of a deal. Naturally, insurers will want to conduct their own due diligence on seller prior to issuing a policy.

Transaction insurance policies may become more prevalent in the future due to FASB's recent publication of Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (FIN 45). FIN 45 requires disclosure of any guarantees made by a company, no matter how remote the possibility that the guarantor's payment obligations will be triggered. Indemnification obligations are included in the definition of a guarantee,[227] which makes FIN 45 a potentially sweeping change for corporate sellers subject to FASB reporting requirements.[228] Therefore, all sellers who agree to indemnify buyers—which includes almost all corporate sellers—must record the fair value of the idemnities at the time they are made.[229]

How does a seller measure the "fair value" of an indemnity obligation? FIN 45 advises that one method of measurement is the

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[223]*See generally* John F. McCarrick et al., *Recent Developments in Directors' and Officers' Liability Insurance: Current Trends, New Financial Products and Y2-K Related Litigation*, 1136 PLI/Corp 507, 517-22 (1999); Rossi, *supra* note 209.

[224]*See* Rossi, *supra* note 209 (noting the differences between buyer's and seller's policies).

[225]In the author's experience, the premiums on such policies may be relatively high, probably due to their newness and the insurer's resulting uncertainty regarding the likelihood of payouts. The premiums may still pale in comparison to the amount at risk, and therefore be a wise investment.

[226]*See* Rossi, *supra* note 209.

[227]This was a major concern prior to the publication of FIN 45. The Accounting Standards Executive Committee (AsSEC) of the American Institute of Certified Public Accountants commented: "AsSEC observes that most every kind of representation and warranty could be considered an indemnification agreement." http:www.aicpa.org/members/div/acctstnd/comltrs (last visited Feb. 22, 2004).

[228]This generally means all sellers who prepare financial statements in accordance with generally accepted accounting principles (GAAP).

[229]Sellers must also disclose the maximum potential amount of future payments under the indemnity, which will usually be the seller's cap on liability. If there is no cap, or if certain representations and warranties are excluded from the cap, sellers should disclose this fact.

"premium received or receivable."[230] The premium paid to insure such an indemnity should suffice as a measurement of fair value. This may, in turn, lead more sellers to inquire about obtaining transaction insurance. And once buyers and sellers become more aware of this option, it may be considered a viable alternative to traditional buyer protections.

VI. CONCLUSION

Many transactional lawyers, and even tax lawyers, may be unaware that personal goodwill can exist separate from business goodwill and that courts may recognize this personal goodwill as marketable property. Consequently, they do not use personal goodwill to their clients' advantage. Whether a shareholder has personal goodwill, and the value of that goodwill, will vary with each set of facts, but the potential significance of personal goodwill over and above that of similar mechanisms (such as non-compete agreements) should not be underestimated.

Buyers receive less than they have bargained for if the acquisition documents do not provide for an effective transfer of personal goodwill. Of course, to transfer personal goodwill, buyers must know it exists; therefore, identifying personal goodwill during due diligence is critical. Personal goodwill exists when a shareholder's reputation, expertise, or contacts gives the corporation its intrinsic value. Personal goodwill is most likely to be found in closely held businesses, especially those that are technical, specialized, or professional in nature or have few customers and suppliers.

Buyers and sellers often prefer to structure deals differently for tax and other reasons, which may lead to an impasse during negotiations. Recognizing the existence of personal goodwill can be the catalyst for facilitating an acquisition that is stalled over the tax consequences of structuring. Regardless of how a deal is structured, allocating the appropriate consideration to personal goodwill can yield tax benefits for both buyers and sellers. Provided that personal goodwill is treated as a saleable asset, buyers receive a step-up in basis and can amortize the goodwill over fifteen years for tax purposes. C corporation sellers, meanwhile, can sell personal goodwill ancillary to the sale of their corporations and avoid double taxation. All sellers may receive favorable capital gains treatment on the sale.

A court may characterize personal goodwill as future earnings potential, rather than marketable property. Accordingly, a buyer should

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[230]FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (2002).

seek to obtain legal assurances that the selling shareholder owns personal goodwill and that it is property that can be transferred to buyer. Buyer should seek to hold back or escrow part of the purchase price, or should obtain transaction insurance, to compensate for any subsequent recharacterization of the personal goodwill.