

TRANSACTIONAL TEAM ALERT

SALE OF PERSONAL GOODWILL – THE EXECUTIVE’S PARACHUTE

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and Daniel Lampert, Esq.

Executives should sell personal goodwill when selling a business because (a) the executive achieves long-term capital gains treatment; (b) the executive receives the funds directly from the buyer; (c) personal goodwill is exempt from equitable distribution in the executive’s divorce. Section 197 of the Internal Revenue Code of 1986, as amended (the “Code”), gives the buyer the same tax treatment for the purchase of personal goodwill as for payments under a noncompete payment. Therefore, personal goodwill avoids the usual tax friction between the buyer and the executive. This Corporate Alert examines the sale of personal goodwill by defining it, reviewing pre-transaction methods to create it, analyzing the benefits of selling it, and explaining the tax treatment to the buyer purchasing it.

EQUITABLE DISTRIBUTION

The Florida Supreme Court in *Thompson v. Thompson*, 576 So.2d 267, 270 (1991), defined “personal goodwill” as value resulting from the continued presence of a particular individual that only such individual can transfer. *Thompson* denied a spouse’s equitable distribution claim to receive 50% of her husband’s law practice’s value. The Florida Supreme Court distinguished the portion of the law firm’s value that constituted “personal goodwill” from that which consisted of “professional goodwill” and gave the spouse half of the latter and none of the former.

TAX LAW

Tax Court cases in 1998 – *Martin Ice Cream Co. v. Commissioner*, 110 T.C. 189 (1998), and *Norwalk v. Commissioner*, TCM 1998-279 (1998), define personal goodwill for tax purposes. The Tax Court in *Martin* held that because of the absence of an employment agreement, the personal relationships of a shareholder-employee constitute personal goodwill and not corporate assets. The Tax Court in

Norwalk considered the liquidation of a two-shareholder accounting firm. The IRS asserted that the liquidation caused a double level tax on \$870,000 of unreported gain from “customer-based intangibles”. The taxpayer countered that

“An executive selling his personal goodwill receives capital gains (and not ordinary income) for a noncompete.”

accountants always owned this value, and the Tax Court agreed because absent an effective non-compete agreement, the firm has no value in the client relationships.

BANKRUPTCY

Few bankruptcy cases examine a creditor’s rights in a sale of personal goodwill as part of a business sale. The executive’s fiduciary duty, while in the zone of insolvency, to maximize payments to the creditors complicates this analysis. Further, creditors’ priority over shareholders’ claims to proceeds of an insolvent business sale also complicates this issue. Although the law is not settled, an executive could argue that proceeds from selling personal goodwill of an insolvent business avoid the creditors’ claims because the entity does not own the personal goodwill.

CREATION AND TRANSFER

Facts allowing personal goodwill to exist include the lack of a non-compete or non-solicitation contract. Other helpful facts include an executive’s qualifications such as a professional license, industry awards and/or a history of outstanding performance. An executive should terminate any non-compete or non-solicitation agreements, preferably several years prior to selling the business. Creating personal goodwill also reduces (a) the employer’s value for estate planning purposes and (b) marital assets subject to equitable distribution in a divorce.

Allocating goodwill between personal and corporate goodwill can be difficult. A business’ customer list, for instance, counts as corporate and not personal goodwill, and Courts vary in valuing such list. Obtaining an independent valuation may address the risks of re-apportionment of value by the IRS or a court.

An executive should transfer personal goodwill to the buyer pursuant to an Asset Purchase Agreement. The purchaser may include any noncompete provision within this Asset Purchase Agreement to support a longer non-compete period under Sections 542.335(d)(3)(a) and (e), Florida Statutes, and may allocate the purchase price between the personal goodwill and the noncompete covenant.

BENEFITS

An executive’s creation and sale of personal goodwill creates significant benefits. Selling personal goodwill creates long-term capital gain (taxable at 15%) rather than ordinary income (taxable at 35%). Long-term capital losses offset long-term capital gains without limit (subject to any alternative minimum tax limitations) but only offset ordinary income at \$3,000 per year. The buyer in *Martin Ice Cream* required the executive to sign a non-compete agreement, but the Tax Court ruled that this non-compete agreement did not subject the executive’s sale of personal goodwill to ordinary income tax rates.

Moreover, the *Thompson* case exempts proceeds from the sale of personal goodwill from a spouse’s claim for equitable distribution. However, a divorce court may consider these proceeds in setting alimony. Further, the sale of personal goodwill relating to an insolvent business may protect payments to the executive against creditors’ attacks. Finally, personal goodwill sales create certain tax advantages in connection with converting a corporation to a limited liability company or partnership.

BUYER’S TAX TREATMENT

Under Code Section 197, the buyer may deduct payments for goodwill (whether it is personal or corporate) ratably over 15 years. The buyer’s tax treatment for payments in connection with the acquisition of a business for goodwill (personal or corporate) is identical to the treatment of non-compete payments to the executive. Each such asset is considered a “section 197 intangible.” Section 197 intangibles also include goodwill, going concern value, workforce in place, information-based intangibles (including customer-related information such as customer lists and patient or client files), know-how, franchises and trade names.

SUMMARY

An executive with unusual skills, strong customer relationships, an excellent industry reputation and no noncompete covenant should consider including a sale of personal goodwill as a part of the sale of the business. The executive should plan early for this transaction by eliminating any noncompete agreements. In particular, the executive should terminate a non-compete before his employer becomes insolvent. However, if structured and timed properly, the executive receives significant benefits from creating and selling personal goodwill, with relatively few adverse tax consequences to the buyer. ■

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Thomas O. Wells, a shareholder in the Miami office of Berger Singerman, is dedicated to helping protect the businesses and money of entrepreneurs. As a former entrepreneur, he created, capitalized, built and managed b4bpartner Inc., an electronic signature and Internet document management software company that he sold in 2001. A recipient of the highest rating (AV) from Martindale-Hubbell, Mr. Wells is a Board Certified Tax Lawyer with The Florida Bar; a former Certified Public Accountant in

Florida; and a former Adjunct Professor in the Graduate Estate Tax Program at The University of Miami School of Law. He was named Outstanding CPA of the Year for 1999 in Business and Industry by the Florida Institute of Certified Public Accountants and was included in the list of top attorneys in South Florida by The South Florida Legal Guide and in Florida by Florida Trends. He has written and lectured frequently on issues affecting entrepreneurs and their businesses. Mr. Wells received his LL.M. in

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Daniel Lampert's practice centers on financing, securities, business, domestic and international transactions, including mergers and acquisitions, and aviation transactions. Mr. Lampert has also practiced extensively in bankruptcy matters, including his present work in assisting the Firm's Business Reorganization Team in transactional matters. Prior to joining

Berger Singerman, Daniel headed the corporate and securities department of the Miami office of a major national law firm. Mr. Lampert received his law degree from New York University School of Law in 1979, after graduating from Cornell University, finishing his undergraduate work in three years. He has practiced law for 24 years and is rated AV by Martindale-Hubbell.

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