

**GOODWILL:
PERSONAL or BUSINESS
WHY DOES IT MATTER?**

A Presentation By
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Alan Zipp, Speaker Bio



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Alan Zipp, Speaker Bio



- Masters Degree in Taxation
- Author of RIA's "Divorce: Valuation, Tax, and Financial Strategies"
- Bar Association of Montgomery County, Maryland, served as: Treasurer, Executive Committee member, and Chair of the Taxation Section.

DISTRIBUTIONS OF PROPERTY TAX TO SHAREHOLDERS

- **Section 301 General Rule:**
- Shareholder receives property from corporation;
- Corporation has earnings and profits;
- Classified as a dividend under sec 316;
- Taxable income to Shareholder.

DISTRIBUTIONS OF PROPERTY DIVIDEND TO SHAREHOLDER

- **Section 316 General Rule:**
- Dividend is any distribution from Corp.
- Deemed made from Earnings & Profits.
- Not a dividend if no Earnings & Profits.
- If no E&P, distribution under section 301.
- Reduce basis to zero; not taxable to basis.
- Excess over basis is capital gain.

DISTRIBUTIONS OF PROPERTY TAX TO CORPORATION

- **Section 311 General Rule:**
- Corporation recognizes gain on distribution of property to the extent fair market value exceeds its adjusted basis.
- Gain is recognized as if such property were sold at its fair market value.

DISTRIBUTIONS OF PROPERTY TAX TO SHAREHOLDERS

- **Section 331 Liquidation General Rule:**
- Shareholder receives property in exchange for stock.
- Not treated as a dividend under sec. 301.
- Shareholder gain is excess of fair market value of property over his basis of stock; taxed as capital gain.

DISTRIBUTIONS OF PROPERTY TAX TO CORPORATION

- **Section 336 Liquidation General Rule:**
- Gain or loss shall be recognized to a liquidating corporation on the distribution of property in complete liquidation as if such property were sold to the distributee at its fair market value.

EXAMPLE OF TAX ISSUES

SALE OF ASSETS AND LIQUIDATION

- Facts:
- FMV of tangible assets - \$1,500,000
- Basis in assets - \$300,000
- Intangible goodwill value - \$8,500,000
- Sale proceeds to Corp - \$10,000,000

EXAMPLE OF TAX ISSUES

SALE OF ASSETS AND LIQUIDATION

- Facts:
- Sale proceeds to Corp - \$10,000,000
- Corp basis in assets - \$300,000
- Corp gain - \$9,700,000
- Corporate 21% tax paid - \$2,037,000
- Cash to distribute - \$7,963,000

EXAMPLE OF TAX ISSUES SALE OF ASSETS AND LIQUIDATION

- Facts:
- Cash to Shareholder - \$7,963,000
- Basis in stock - \$100,000
- Gain on liquidation - \$7,863,000
- Capital gain 20% tax paid - \$1,572,600
- Cash after tax - \$6,390,400

WHAT IF: PERSONAL GOODWILL \$4 MILLION

- **Allocation of Goodwill:**
- Total goodwill - \$ 8,500,000
- Allocate to personal goodwill - \$4,000,000
- Allocate to business goodwill - \$4,500,000
- Sale proceeds to Corp - \$6,000,000
- Sale proceeds to shareholder \$4,000,000

WHAT IF: ALLOCATION OF GOODWILL

- Sale proceeds to Corp - \$6,000,000
- Corp basis in assets - \$300,000
- Corp gain - \$5,700,000
- Corporate 21% tax paid - \$1,197,000
- Cash to distribute - \$4,803,000

WHAT IF: PERSONAL GOODWILL \$4 MILLION

- Cash to Shareholder - \$4,803,000
- Basis in stock - \$100,000
- Gain on liquidation - \$4,703,000
- Capital gain 20% tax paid - \$940,600
- Cash after tax - \$3,862,400

WHAT IF: PERSONAL GOODWILL \$4 MILLION

- Goodwill sale proceeds - \$4,000,000
- Basis in goodwill - \$ -0-
- Gain on goodwill sale - \$4,000,000
- Capital gain 20% tax paid - \$800,000
- Cash after tax - \$3,200,000

NET CASH INCREASE IF PERSONAL GOODWILL \$4 MILLION

- Net cash from corporation - \$3,862,400
- Net cash from goodwill - \$3,200,000
- Total cash to shareholder - \$7,062,400

- Total cash without goodwill allocation:
- Corporate liquidation cash - \$6,390,400

- **Net additional cash - \$672,000**

DEFINITION

- The Value of a Business:
 - 1. Tangible Assets
 - 2. Intangible Assets
- **Intangible Assets = Goodwill**
- The price paid for a business in excess of the value of its tangible assets.

• *UFE, Inc. v. Comm'r.*, 92 T.C. 88 (1989)

GOODWILL EXAMPLES

- Going concern value
- Workforce in place
- Knowhow
- Customer-based intangibles
- Supplier-based intangibles
- Business books and records
- Patents, copyrights, formulas, processes, trademarks, covenants not to compete, etc

GOODWILL

- For many practical purposes, including family law involving business valuations, goodwill is divided into two parts:
 - 1. Enterprise (Business) Goodwill
 - 2. Personal Goodwill

BUSINESS GOODWILL

- Also called Enterprise Goodwill.
- The intangible value of a business that would continue to inure to the business without the presence of a specific individual.
- The earning capacity of a business transferable to the buyer in a sale, regardless of who owns the business.

PERSONAL GOODWILL

- The intangible value of a business attributable solely to the personal attributes of a specific person, including personal relationships, skill, reputation, and similar personal factors.

NO UNIFORM DEFINITION OF PERSONAL GOODWILL

“There is no specific consensus as to:
-- a definition of professional goodwill;
-- whether a sole practitioner of any profession can have goodwill; or
-- what method or methods should be used to value professional goodwill.”

- Thomson v. Thomson, 576 So.2d 267 (Fla. 1991)

PERSONAL GOODWILL

“Professional goodwill is that which: attaches to the person as a result of the clients’ confidence in professional skill or ability; does not possess value separate from the professional; and is extinguishable at death, retirement or disablement.”

- *Rathmell v. Morrison*, 732 S.W.2d 6 (Tex. 1987)

PERSONAL GOODWILL IS NOT A CORPORATE ASSET

Finding “... no authority which holds that an individual’s personal ability is part of the assets of a corporation ... where ... the corporation does not have a right by contract or otherwise to the future services of that individual.”

- Macdonald v. Comm’r., 3 T.C. 720, 727 (1944)

PERSONAL GOODWILL IS NOT A CORPORATE ASSET

“This Court has long recognized that personal relationships of a shareholder-employee are not corporate assets when the employee has no employment contract with the corporation. Those personal assets are entirely distinct from the intangible corporate assets of corporate goodwill.”

- *Martin Ice Cream Co. v. Comm’r.*, 110 T.C. Memo. 1998-279

PERSONAL GOODWILL IS NOT A CORPORATE ASSET

Where sole shareholder was *sine qua non* of corporation's success, corporation's goodwill did not include the personal qualities of its sole shareholder.

- *Estate of Taracido v. Comm'r.*, 72 T.C. 1014, 1023 (1979)

PERSONAL GOODWILL IS NOT A CORPORATE ASSET

“He cultivated personal goodwill with these professionals and he independently owned the asset of personal goodwill, not STN.com. ... Further, Kevin did not transfer goodwill to STN.com through a covenant not to compete or other agreement.”

- *Estate of Adell v. Comm’r.*, T.C. Memo. 2014-155

PERSONAL GOODWILL IS NOT A CORPORATE ASSET

“It is at least doubtful whether a professional man can sell or dispose of any goodwill which may attach to his practice except perhaps by contracting to refrain from practicing.”

- O'Rear v. Comm'r., 28 B.T.A. 698, 799 (1933), aff'd, 80 F.2d 473 (6th Cir. 1935)

PERSONAL GOODWILL IS NOT A CORPORATE ASSET

“Mr. Bross did not transfer any goodwill to Bross Trucking through an employment contract or a noncompete agreement. ... Accordingly, Mr. Bross’ personal goodwill remained a personal asset separate from Bross Trucking’s assets.”

Bross Trucking, Inc. v. Comm’r., T.C.Memo. 2014-107

PERSONAL GOODWILL

“Assets that are uniquely personal to the holder cannot, by their very nature, be held jointly with another person and consequently, cannot be classified as marital property.”

- *Unkle v. Unkle*, 505 A.2d 849 (Md. App. 1986)

PERSONAL GOODWILL IS NOT A CORPORATE ASSET

The Tax Court held that the clients were not assets of the corporation and could not be a taxable distribution to the CPA-shareholders because the clients were property constituting the personal goodwill of the CPA-shareholders.

William Norwalk, et al. v. Comm'r., T.C.Memo. 1998-279

GOODWILL IS PROPERTY

“Only those economic advantages which have the law back of them are property rights.”

United States v. Willow River Power Co., 324 U.S. 499 (1945)

The Supreme Court classified business goodwill as property and defined it as the expectation of continued patronage.

- *Newark Morning Ledger Co. v. United States, 507 U.S. 546, 555 (1993)*

GOODWILL IS PROPERTY

Goodwill has been defined by Federal courts as “the sum total of those imponderable qualities which attract the customer of a business, -- what brings patronage to the business. The competitive advantage which constitutes goodwill is represented by a number of property rights or interests.”

- Philip Morris Inc. & Consol. Subs. V. Comm’r., 96 T.C. 606,634 (1991);
 - Boe v. Comm’r., 307 F.2d 339, 343 (9th Cir. 1962)

GOODWILL IS NOT CORPORATE PROPERTY

“A business can distribute only corporate assets and cannot distribute assets that it does not own. Specifically, a corporation cannot distribute intangible assets that are individually owned by its shareholders.”

- *Bross Trucking, Inc. v. Comm’r.*, T.C. Memo .2014-107

HOW PERSONAL IS PERSONAL GOODWILL?

- Kansas statute defines marital property to include “professional goodwill to the extent that it is marketable for that particular professional.”
- Hence, if personal goodwill is transferable it is marital property subject to valuation and equitable distribution.

• Statute: K.S.A. 23-2801

GOODWILL IS NOT CORPORATE PROPERTY

- If marital property includes a corporation and the value of the corporation includes both business goodwill and personal goodwill,
- Does the marital property value of the corporation include the personal goodwill?

DIFFERENT VIEWS AMONG THE STATES

- 1. Enterprise goodwill is marital property; personal goodwill is not marital property. (31 States)
- 2. Both enterprise goodwill and personal goodwill are marital property. (14 States)
- 3. Personal goodwill may be marital property. (4 States)
- 4. Neither personal goodwill nor enterprise goodwill is marital property. (1 State – MS)

• Source: BVR Charting Goodwill Jurisprudence (As of April 2019)

DIFFERENT VIEWS AMONG THE STATES

- Enterprise goodwill is marital property; personal goodwill is not marital property.
- 31 States follow this view:
- AK, AR, CT, DE, DC, FL, GA, HI, IL, IN, KY, LA, ME, MD, MA, MN, MO, NE, NH, OK, OR, PA, RI, SC, TN, TX, UT, VT, VA, WV, WY.

• Source: BVR Charting Goodwill Jurisprudence (As of April 2019)

DIFFERENT VIEWS AMONG THE STATES

- No distinction – Both enterprise goodwill and personal goodwill are marital
- 14 States follow this view:
- AZ, CA, CO, ID, MI, MT, NV, NJ, NM, NY, NC, ND, OH, WA

• Source: BVR Charting Goodwill Jurisprudence (As of April 2019)

DIFFERENT VIEWS AMONG THE STATES

- Personal goodwill may be marital property
- 4 States follow this view:
- Iowa, Kansas, South Dakota, and Wisconsin

- Source: BVR Charting Goodwill Jurisprudence (As of April 2019)

DIFFERENT VIEWS AMONG THE STATES

- Neither personal goodwill nor enterprise goodwill is marital property
- 1 State follows this view:
- Mississippi

• Source: BVR Charting Goodwill Jurisprudence (As of April 2019)

LOUISIANA

Rao v. Rao, 927 So.2d 356 (La. App. 2005)

- The court held that it was not only inappropriate to include the personal goodwill of the divorcing spouse in the valuation of a professional practice, but that “it is likewise inappropriate to incorporate goodwill attributable to the personal and professional qualities of the other physician stockholders in such valuation.”

INDIANA

Yoon v. Yoon, 711 N.E.2d 1365 (Ind. 1999)

- “The goodwill that depends on the continued presence of a particular individual is a personal asset, and any value that attaches to a business as a result of this ‘personal goodwill’ represents nothing more than the future earning capacity of the individual and is not divisible.”

MARYLAND

Archer v. Archer, 493 A.2d 1074 (Md. 1985)

- “Assets that are ‘uniquely personal’ to the holder cannot, by their very nature, be held jointly with another person and, consequently, cannot be classified as marital property.”

NEW YORK

O'Brien v. O'Brien, 489 N.E.2d 712 (1985)

- The New York Court of Appeals ruled that a husband's license to practice medicine was marital property and subject to distribution.
- The court interpreted New York's domestic relations law [section 236(b)] as requiring that all property irrespective of the form of title be considered in the distributable estate.

NEW JERSEY

Dugan v. Dugan, 457 A.2d 1 (1983)

- New Jersey recognizes goodwill of a law practice as marital property subject to distribution.

PENNSYLVANIA

Beasley v. Beasley, 518 A.2d 545 (1986)

- Pennsylvania holds that professional goodwill of a law practice operated as a sole proprietorship is **not** marital property.

WASHINGTON

In re Hall, 692 P.2d 175 (1984)

- In Washington, two spouses have identical educations as doctors. One owned a practice and one worked as a salaried teacher. The court found that although both doctors may have equal earning capacities, only the practicing doctor had goodwill, and the goodwill needed to adhere to an entity and not to a person.

WISCONSIN

Holbrook v. Holbrook, 309 N.W.2d 343 (Wis. 1981)

- “The concept of professional goodwill evanesces when one attempts to distinguish it from future earning capacity.”
- “We do not believe that it bestows on those who have an ownership interest in the business an actual separate property interest.”
- “The goodwill or reputation of such a business accrues to the benefit of the owners only through increased salary.”

ATTRIBUTES OF PERSONAL GOODWILL

- Expertise, skill, ability, and reputation
- Personal attributes of the individual
- Academic credentials, licensure, experience
- Clients' confidence in the individual's skill
- Personal relationship with clients, patients...
- Nature of personal services provided
- Individual's relationship to business profits
- Analysis of business without the individual

IDENTIFYING PERSONAL GOODWILL

- The valuation of a business involving personal goodwill requires the identification of the existence of personal goodwill.
- Articulate specific examples showing how the key employee is responsible for the production of business profitability.
- Identify and measure business profitability dependent on the specific individual, not just the job of the individual.

VALUING PERSONAL GOODWILL IN DIVORCE

- “When performing a goodwill valuation analysis, one should ascertain first, whether in the particular case there exists a personal component, and secondly, if it does exist, determine the value of the personal component in the initial computation so that it can subsequently be excluded from the total valuation for purposes of fashioning an appropriate award.”

- *Strauss v. Strauss*, 647 A.2d 818 (Md. App. 1984)

HOW TO VALUE PERSONAL GOODWILL

- The New Jersey Supreme Court method:
 - 1. Determine what a professional of comparable experience would earn as an employee in the local area. (Normal Local Earnings)
 - 2. Determine the individual's actual average net earnings for a period of years, preferably five years.
 - 3. Subtract the normal local earnings from the actual average earnings of the party.
 - 4. Multiply the excess by a capitalization factor.
 - Dugan v. Dugan, 457 A.2d 1 (1983)

HOW TO VALUE PERSONAL GOODWILL

- Determine business profitability both with and without the specific individual.
- The difference in profitability identifies the existence of personal goodwill.
- Value the business based on profitability under each assumption
- The difference in business value is the value of the personal goodwill.

PREMISE OF VALUE MAY DETERMINE GOODWILL

- The premise of value may determine whether personal goodwill is included as a marital asset.
- Two generally-accepted premises of value
 - 1. Value in Exchange
 - 2. Value to the Holder

PREMISE OF VALUE

- Value in Exchange –
- The value of the business changing hands in a real or hypothetical sale. Commonly referred to as fair market value.

PREMISE OF VALUE

- Value to the Holder –
- The value of the business that is not being sold but instead is being maintained in its present form by its present owner. Often referred to as “intrinsic value” to the current owner, or “fair value”.

PREMISE OF VALUE VARIES AMONG STATES

- Fair Market Value – Maryland

- Rosenberg v. Rosenberg, 497 A.2d 485 (1985)

- Fair Value – New Jersey

- Brown v. Brown, 792 A.2d 463 (2002)

- Intrinsic Value – Virginia

- Howell v. Howell, 523 S.E.2d 514 (2000)

PREMISE OF VALUE

- Fair Market Value – Does not include nontransferable personal goodwill. Value is based on a sale of property to a willing buyer.
- Fair Value, Intrinsic Value, Investment Value – Includes all value to the holder, including personal goodwill.

MARITAL PROPERTY LAW

- Marital property law may exclude personal goodwill by statute or case law.
- In such states, personal goodwill must be excluded from the value of a business in a divorce valuation.

STATE MARITAL PROPERTY LAW

- Where state law does not specifically address whether personal goodwill is a marital asset, Federal property case law may answer the question in valuing a business for family law purposes.
- Federal case law holds that corporate assets do not include personal goodwill.

CORPORATE VALUE DOES NOT INCLUDE ANOTHER'S ASSETS

- A corporation that leases its office building would not include the value of the real estate in its valuation because it does not own the real estate, even though it uses it in its operations.
- When valuing a corporation, only the assets belonging to the corporation should be included in the valuation. Under Federal case law, personal goodwill is not an asset belonging to the corporation.

CORPORATE VALUE DOES NOT INCLUDE PERSONAL GOODWILL

- In making a valuation of a corporation for family law purposes in a fair market value state, personal goodwill should be excluded from the valuation, absent a state law provision to the contrary.
- Where personal goodwill is not transferable, it cannot be sold to a willing buyer and therefore has no market value.

PERSONAL GOODWILL AND VALUE TO THE HOLDER

- In a state using the value to the holder premise, absent a state law provision to exclude personal goodwill, personal goodwill will be included in the valuation.
-
- This may be the case even though the corporation does not own the personal goodwill of the individual.

A QUESTION TO PONDER

- If the marital property value of a business is based on a capitalization of earnings;
- And if the earnings include profits generated through the personal goodwill of all shareholder-employees;
- Will the marital property include value not owned by the corporation?



A QUESTION TO PONDER

- If personal goodwill belongs to the individual and not to the corporation;
- And if a corporation does not own the personal goodwill of its shareholder-employees;
- Does a shareholder have any ownership interest in the goodwill of his partners by virtue of his ownership interest in the corporation?

A QUESTION TO PONDER

- If the corporation is marital property because the spouse has an ownership interest in the corporation;
- And the value is determined by capitalizing the earnings of the corporation;
- Does the marital property value include an interest in property in which the spouse has no legal interest, i.e., the personal goodwill of his partners?

A QUESTION TO PONDER

- Can the value of marital property be greater than the value of property legally owned by a spouse?
- Unless personal goodwill is excluded from the valuation of a business, the marital property value may include value not owned by the corporation.

A QUESTION TO PONDER

- Can a spouse have a marital property interest in personal goodwill in which the shareholder has no legal interest?
- If State law defines marital property as all property acquired during the marriage and the spouse has no legal interest in his partner's personal goodwill then marital property should not include such goodwill.

CONCLUSION

- In divorce, marital property derives its very existence and value from property legally owned by one of the divorcing parties.
- If a divorcing party does not legally own a property right, the spouse should have no claim to that as marital property.

THE END

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