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Personal Goodwill Tax Cases

Taxation Section of the State Bar of Michigan
Estates and Trusts Committee

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Estate and Gift Valuation

- Rev. Rul. 59-60, 1959-1 C.B. 237, sets forth factors to determine valuation of a business interest (modified by Rev Rul 65-193, 1965-2 CB 370, and amplified by Rev Rul 77-287, 1977-2 CB 319, Rev Rul 80-213, 1980-2 CB 101 and Rev Rul 83-120, 1983-2 CB 170)
- Contemporaneous valuation by a certified valuation expert is the best defense to a challenge
- Consideration of discounts: marketability, minority, and goodwill

Estate and Gift Valuation: Personal Goodwill

- Personal Goodwill is a concept that assigns value to relationships held by an individual separate from the business
- In 1998, the courts again began to recognize the merits of allocating sales proceeds to an owner in a sale of assets by the company (there were cases dating back to the 1940s)
- Why do we care? Double taxation of C corporations (and some S corporations); Special allocations of dollars to specific indivduals; Capital gain treatment

Where it began (again): Martin Ice Cream (1998)

- Arnold Strassberg started in the ice cream business after WWII in which he developed relationships with various retail food distributors
- Arnold's business went into bankruptcy due to a dispute with its major supplier
- Martin Strassberg, Arnold's son, formed Martin Ice Cream Company (MIC) in 1971 because Arnold was concerned with creditor claims
- In 1974, MIC began distributing Haagen Daz (HD) ice cream pursuant to an oral agreement entered into between Arnold and the owner of HD
- In 1979, the ownership of MIC was reconfigured with Arnold owning 51% and Martin 49%
- Neither Arnold nor Martin had an employment agreement with MIC

Martin Ice Cream (1998): Pre-Transaction Developments

- Arnold focused on expanding distribution to supermarkets
- Martin managed day-to-day operations and sought to continue independent store distribution
- Arnold, individually, acted as agent to Borden – HD did not object but did object when Ben & Jerry's approached Arnold
- Pillsbury bought HD and sought to consolidate and self distribute
- Arnold and Martin had disagreements about the future direction of MIC

Martin Ice Cream (1998): The Transactions

- In 1987/1988 HD began discussions to acquire MIC's supermarket distribution business
- In preparation of a sale to HD, MIC contributed all of its assets relating to the business to a subsidiary, Strassberg Ice Cream Distributors (SIC)
- MIC distributed all of the SIC stock to Arnold in exchange for his MIC stock (split-off transaction)
- HD entered into a sale agreement with SIC and Arnold which included a PP for the business of about $1.4m, a 3 year employment agreement with Arnold ($150k/year) and non-compete payments to Arnold for 5 years ($50k/year)

Martin Ice Cream (1998): Court Findings of Fact

- The court held as a finding of fact that Arnold held the goodwill of the relationships with the supermarket chains and the original owner of HD
- The court also held as a finding of fact, a specific value to the stock of SIC ($141,000)
- SIC ceased operations after the transaction with HD

Martin Ice Cream (1998): IRS Position

- MIC should have reported $1.4m of consideration
  - Theory 1: Arnold negotiated the deal with HD on behalf of MIC and MIC constructively received the proceeds from HD and then constructively paid them to Arnold for his MIC stock
  - Theory 2: MIC recognized gain on the distribution of SIC to Arnold in a failed tax free split off. IRS did not present a valuation of the SIC because it did not think it was a valuation case.

Martin Ice Cream (1998): Court Opinion

- Arnold owned goodwill and never transferred it to MIC and thus MIC could not transfer what it does not own (to HD constructively or to SIC as part of the split off)
  - Response to Theory 1: During the early drafts of the agreements, seller's counsel told HD to remove Martin and MIC from the deal. This change had nothing to do with tax consequences. The form was consistent with the substance and the change in the deal occurred early in the deal and there was no evidence that it was to accommodate favorable tax consequences.
  - Response to Theory 2: The Court agreed that the split off was not a tax free transaction. MIC recognized gain on the distribution of SIC to Arnold in a failed tax free split off. MIC presented a valuation report setting the value of the SIC stock at in excess of $141k and even though the report was flawed, it effectively rebutted the IRS determination made without a valuation report.

William Norwalk, Transferee, et al. (1998): The Facts

- Robert DeMarta and William Norwalk were CPAs who decided to form a firm together in 1985
- Formed DeMarta & Norwalk, CPA's, Inc. and each entered into an employment agreement with contain a restrictive covenant and confidentiality provision with a 5 year term
- No evidence that the agreements were renewed or extended
- As a result of a lack of profitability, DeMarta and Norwalk decided to liquidate the company in 1992
- DeMarta and Norwalk joined another partnership contributing the practice assets received in the liquidation and received a capital account of $39k and $28k respectively

William Norwalk, Transferee, et al. (1998): IRS Position

- IRS contended that “customer-based intangibles” such as client base, client records and workpapers and goodwill were distributed to DeMarta and Norwalk
- IRS valuation report placed a value of $266k on the client lists and $369k on the goodwill

William Norwalk, Transferee, et al. (1998): Court Opinion

- Citing Martin Ice Cream, there is no salable goodwill where the business of a corporation is dependent uon its key employees unless there is a covenant non-compete or an agreement recognizing that the relationships of the employees belong to the corporation
- The IRS valuation, in addition to flaws based on using industry cost assumptions, assumed that the covenant was in force but by the terms of the agreements, there were no such agreements in effect
- Customer list alone could only have contingency value

Solomon (2008): The Facts

- In 1982, Robert Solomon and his son, Richard Solomon along with their spouses formed Solomon Colors, a successor to a partnership by the same name in existence since 1927
- Solomon Colors had one competitor, Prince, in the industry of using Mather Ore product and the customers of Mather Ore were well known in the industry
- Robert Solomon and Richard Solomon developed close relationships with its customers and did not hire or use a separate sales force
- Prince approached Solomon Colors about selling the Mather Ore business

Solomon (2008): The Transaction

- Agreements were between Solomon Colors, the Four Solomons and Prince for the sale of the business and covenants not to compete
- Evidence showed that there were many communications regarding the allocation of the purchase price with some allocated to Robert and Richard for the customer list including the phrase “creative tax planning”
- The allocation schedule listed $210k total for covenant not to compete and $1,190k for the customer list of Solomon Colors but some of this was allocated to Robert ($500k) and Richard ($140k)

Solomon (2008): The Case

- Robert and Richard reported the sale of the customer lists as a manifestation of their personal goodwill characterized as capital gain
- The IRS argued that the customer list was owned by Solomon Colors and if Robert and Richard sold a part of it, Solomon Colors paid them a taxable dividend to them prior to the transaction

Solomon (2008): The Decision

- The Court set aside both treatments and instead classified the payments to Robert and Richard as payments to not compete)
  - Agreements listed customer list as property of Solomon Colors
  - Court emphasized the importance of the covenant in the agreement
  - Side letter was with Solomon Colors
  - Prince did not use the name of Solomon Colors
  - Identity of customers was not a mystery
  - Key for Prince was to keep Robert and Richard from competing
- Lessons:
  - Importance of Drafting
  - Look at the overall facts such as industry and objectively ask what are the parties seeking

Irwin Muskat (2008): The Facts

- Jac Pac Foods, Ltd was a family business in which Irwin Muskat worked and gained operational control in 1968 and grew the business significantly
- Jac Pac processed and distributed meat products to restaurant chains and other commercial entities
- In 1998, Irwin owned 37% of Jac Pac Foods, Ltd (a family business) and served as its CEO
- Corporate Brand Foods America approached Irwin to buy the Jac Pac business and the parties entered into a deal for $34m for the business and a $4m non-compete agreement directly with Irwin that would continue after his death

Irwin Muskat (2008): The Opinion

- Irwin first reported the non-compete payments as ordinary income but before the expiration of the statute of limitations, filed for a refund claiming that he sold personal goodwill
- The Court of Appeals affirming the lower court decision held that Irwin could not present “strong proof” to overcome the designation of the payments as for a covenant not to compete in the agreements
- The Court pointed out that it is not uncommon for an executive to negotiate compensation payments extending beyond ones life and that there was no evidence that Irwin was not in good health

James P. and Joan E. Kennedy (2010): The Facts

- James Kennedy started an employee benefits consulting practice as a sole proprietor in 1990
- Kennedy incorporated the business in 1995 under the name KCG International, Inc.
- Kennedy developed the clients and maintained close relationship
- KCG employed Kennedy and one other person who also served the clients of KCG but no written employment or covenant not to compete

James P. and Joan E. Kennedy (2010): The Transaction

- Mack & Parker Inc. approached Kennedy about selling the business in 2000 and the parties negotiated a formula price to be paid
- Later after consultation with tax counsel, 75% was allocated to the personal goodwill of Kennedy
- In evidence was an email that the structuring was to “enhance the tax benefits”
- Mack and Kennedy entered into an Assignment of Know-How and Goodwill
- Mack and KCG entered into a Consulting Agreement and an Asset Purchase Agreement for the customer relationships
- The dollar amounts under the Assignment and Consulting Agreement were based on the future profitability of the business
- Kennedy was subjected to a restrictive covenant
- According to the Court, Kennedy had an incentive to continue working

James P. and Joan E. Kennedy (2010): The Transaction

- According to the Court, Kennedy had an incentive to continue working
- After the transaction, Kennedy sent a letter announcing the transaction and that this was part of his plan to retire in 5 years
- The other KCG employee left Mack after 2 months (who was making much less than Kennedy)
- Kennedy worked for Mack for several years and initially, was not paid for services provided
- Kennedy complained about not being paid enough because he had to work because his former employee abandoned him and Mack in 2002 started receiving a salary in addition to the payment for the personal goodwill
- Kennedy had significant capital losses from another unrelated transaction

James P. and Joan E. Kennedy (2010): IRS Position

- Payments to Kennedy were not for personal goodwill
  - KCG owned the customer list and thus owned the goodwill
  - Kennedy failed to prove he owned a goodwill asset because for instance, he did not produce a valuation report of the goodwill
  - Goodwill not a vendible asset because Kennedy had to continue to work to maintain

James P. and Joan E. Kennedy (2010): Court Opinion

- Held that the payments to Kennedy were not for personal goodwill but upon other reasoning
  - Even though a payment to a service provider can be goodwill, the Court did not believe that to be the case in this situation
  - Allocation was an after thought and tax motivated
  - The 75% was not based on any business reality
- Distinguished Martin Ice Cream
  - Stassberg was paid a separate consulting agreement at the start
  - The Martin Case was whether MIC was the true owner of goodwill distinguished from the character of the payment received by the seller of the alleged goodwill

James P. and Joan E. Kennedy (2010): Lessons

- After the fact planning even before the agreements are signed can taint the position
- Determine who is the owner of the goodwill and have that party and only that party sell the goodwill attributable to the business
- Emails are discoverable
- Post transaction facts will be looked at
- Address consideration for all items and services provided
- Do not assume all owners of a business by the mere ownership have goodwill to sell

Larry E. and Joan M. Howard (2011): The Facts

- Dr. Larry Howard started a dental practice as a sole proprietor in 1972
- Dr. Howard incorporated the practice in 1980 under the name Howard Corporation
- Dr. Howard developed the clients and maintained close relationships
- Howard Corp employed Dr. Howard pursuant to a written employment or covenant not to compete which applied while Dr. Howard owned stock and for 3 years thereafter
- Brian K. Finn, D.D.S., P.S. bought Dr. Howard's practice pursuant to an asset purchase agreement that paid Dr. Howard almost $550k for goodwill and $16k for a restrictive covenant

Larry E. and Joan M. Howard (2011): The Court Opinion

- The goodwill belonged to Howard Corporation upholding the IRS treatment of a dividend to Dr. Howard for the value of the goodwill prior to the sale to Finn
- Dr. Howard had the power to terminate the employment agreement and restrictive covenant but he did not
- The transaction was not some type of implicit termination of the employment agreement and restrictive covenant
- Statement in purchase agreement did not grant Dr. Howard ownership of the goodwill - substance over form
- One who avails oneself to the benefits of a corporation can't set aside the burdens of such an arrangement

H&M, Inc. (2012): The Facts

- Harold Schmeets began purchasing stock of National Bank of Harvey (NBH) insurance agency an insurance agency affiliated with a bank and by 1980 was the sole shareholder and renamed the corporation to Harvey Insurance Agency, Inc. (HIA)
- In the rural North Dakota community, personal relationships with customers were vital
- HIA was a dominant agency in that area however Harold earned modest compensation
- In 1983, NBH started a new insurance agency
- Due to competitive pressures and difficulty of smaller agencies to place insurance with larger insurance companies, NBH in 1992 approached Harold about combining the agencies

H&M, Inc. (2012): The Transaction

- Harold wanted a stable employment situation in the combined agencies and NBH needed him to run the business and train a successor
- NBH agreed to employ Harold and pay him about $600k over a 6 year period plus a deferred compensation to be paid at retirement
- NBH's successor was paid $55k-$65k while in training
- NBH bought the hard assets and goodwill from HIA for $20k
- No valuation reports were prepared
- IRS alleged that the payments to Harold should have been paid to HIA

H&M, Inc. (2012): The Opinion

- Emphasized importance of personal relationships and Harold's personal name recognition
- Harold's compensation was reasonable based on his duties, experience, goodwill and restrictive covenant, and in light of the compensation earned by his understudy
- The allocation of Harold's compensation among components was not before the court

Bross Trucking Inc. (2014): The Facts

- Chester Bross owned all of Bross Trucking, Inc. which was formed in 1982
- Chester did not have an employment agreement or a restrictive covenant
- Primary customers were Bross Construction, CB Asphalt and Mark Twain Redi-Mix, Inc. all owned by Bross family members either directly or through Bross Holding Group
- The trucks were owned by a separate entity controlled by the family called CB Equipment
- Bross that was under scrutiny by state DOT for years and in 1998 received an unsatisfactory rating

Bross Trucking Inc. (2014): The "Transaction"

- The primary customers were concerned with the continued viability of Bross
- Chester decided to close down Bross
- Sons started their own trucking company (LWK Trucking) in 2003 and obtained its own licensing and insurance
- LWK leased the same trucks previously leased by Bross but changed the logo on the trucks

Bross Trucking Inc. (2014): The Opinion

- IRS asserted a deemed distribution of the goodwill by Bross to Chester and a gift of the trucking business from Chester to his sons and assessed over $2m in taxes
- Court held that personal goodwill was held by Chester and not the Company so there was no distribution to him from the Company citing *Martin Ice Cream*, and that Chester did not transfer his personal goodwill to the sons
- Distinguished *Solomon* stating that customers of Solomon Colors continued based on the products produced and not the relationships with the owners
- Bross lost the faith of its customers due to the potential of being shut down
- No evidence that any goodwill based on vendor relationships developed by Chester were used by LWK
- “Work force” was not transferred; only 50% of the former Bross employees were hired by LWK

Estate of Franklin Z. Adell (2014): The Facts

- Franklin Z. Adell owned STN, Inc., a cable uplinking broadcast company formed in 1994
- Kevin Adell was President of STN and developed and maintained relationships with church leaders such as Rev. Jesse Jackson and Bishop Charles Haywood Ellis, and church organizations that wanted to broadcast but insisted that a 501(c)(3) organized be used
- The Word was formed as a 501(c)(3) and the board included Franklin and Kevin who were also officers of The Word
- The Word and STN entered into a Services and Facilities Agreement
- STN's gross revenue from 2002-2006 ranged between $7.6m and $15.9m
- Franklin died in 2006

Estate of Franklin Z. Adell (2014): The Valuation

- The value of STN on Franklin's estate tax return was reported at about $9.3m pursuant to a valuation report prepared by SRR (originally reported as $0)
- IRS initially assessed tax on a value of $93m (reduced to $27m during the trial)
- SRR submitted a second valuation based on the fact that the contract between STN and The Word was supposed to limit the earnings by STN and thus the value should have been $4.3m
- The initial SRR ($9.3m) and the second IRS valuation report ($27m) were similar except for the charge against the value for the personal goodwill owned by Kevin

Estate of Franklin Z. Adell (2014): The Opinion

- Court held that STN's value was $9.3m
- Goodwill was developed by Kevin (and not Franklin)
- Franklin had little involvement with the operations of STN or The Word
- Kevin had the education and background having developed WADL for his father

IRS Victories

- *Solomon v. Commissioner*, TC Memo 2008-102
  - Comments: sale of product; communications regarding “tax planning”; customers known (small market); some drafting mishaps
- *Muskat v. United States*, 554 F.3d 183 (1st Cir 2009) affm’g 2008-1 USTC P50,283
  - Comments: documents did not support goodwill treatment; meat packing (non-service)
- *Kennedy v. Commissioner*, TC Memo 2010-206
  - Comments: communications regarding tax planning; arbitrary allocation; personal service business did not save case
- *Howard v. United States*, 448 Fed.Appx. 752 affm’g 2010-2 USTC P50,542
  - Comments: employment contract and restrictive covenant and post-transaction rewriting of history; profession did not save the case

Taxpayer Victories

- *Martin Ice Cream Co. v. Commissioner*, 110 TC 189 (1998)
  - Comments: Good facts and well documented; personal services of a salesman; no pre-existing employment or restrictive covenant; no evidence of changing the deal
- *Norwalk v. Commissioner*, TC Memo 1998-279
  - Comments: Good facts with some luck; profession; pre-existing employment or restrictive covenant had terminated; prior 1998 case support for goodwill in the CPA profession; no evidence of changing the deal
- *H&M, Inc. v. Commissioner*, TC Memo 2012-290
  - Comments: Good facts; prior 1998 case support for goodwill in the insurance industry; no pre-existing employment or restrictive covenant; modest amounts; reporting payments as ordinary income; no evidence of changes

Taxpayer Victories

- *Bross Trucking, Inc.,* TC Memo 2014-107
  - Comments: Good facts or great planning; no pre-existing employment or restrictive covenant; no connection between transactions; form was proper; no evidence of improper tax planning
- *Estate of Franklin Z. Adell,* TC Memo 2014-155
  - Comments: Good facts or great planning; no pre-existing employment or restrictive covenant; no evidence of improper tax planning and the event was death

Some Pre-1998 Cases

- *Macdonald v. Commissioner*, 3 TC 720 (1944)
- *Horton v. Commissioner*, 13 TC 143 (1949)
- *Wyler v. Commissioner*, 14 TC 1251 (1950)
- *Watson v. Commissioner*, *35* TC 203 (1960)
- *LaRue v. Commissioner*, 37 TC 39 (1961)
- *Schilbach v. Commissioner*, TC Memo 1991-556

Questions & Answers

Thank you!

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