PERSONAL GOODWILL

If personal goodwill is not a property right of the enterprise, its value is not includable in the assets of the business. Thus, it is separable from business goodwill.

What is personal goodwill? It is that portion of total goodwill that is directly attributable to key employee functions in the business. Critical to this separation from business goodwill is the ability of the evaluator to articulate specific examples that quantify how the key employee is responsible for producing business profitability. These examples can explain how a portion of the profits are solely attributable to him or her. It is more than merely showing that any competent, qualified employee could perform in the same position. The analysis must be specific to the key employee.

Possible Splitting of Goodwill

The determination to split business and personal goodwill arises whenever tax consequences or economic benefits result from a specific transaction. These include:

1. **Corporate Asset Sale** – IRC Section 331 requires a recognition of gain or loss from an entity liquidation. To the extent that goodwill exists, the amount attributed to the shareholder (versus the company) reduces any gain subject to corporate level tax.

2. **Installment Sale** – For a C corporation liquidation, Section 453B allows for shareholder goodwill to be deferred and reported by the shareholder as received.

3. **Deemed Asset Sale** – Includes a conversion of an operating corporate entity into a proprietorship, partnership or LLC; and a qualified stock purchase treated as an asset acquisition via a Sec. 338 election. In a 338, the seller has sold stock but the buyer may elect an asset purchase.

4. **C to S Conversion** – May create corporate goodwill. Overall limit of the tax is the net unrealized built-in gain (NUBIG) at date of conversion.

C Corporation Sale of Assets followed by Liquidation of Corporation

The importance of separating personal from corporate goodwill is especially apparent in a C corporation sale of assets. The first level of tax occurs at the corporate level when the assets are sold for cash and the sales proceeds, after tax, are distributed to shareholders in exchange for their shares. Once the proceeds are distributed, the shareholders also incur a tax on their gain measured by the difference between the distributed proceeds and the tax basis in their stock. The importance of placing value on personal goodwill ("p.g.") as an asset sold is to remove this amount from the sales proceeds paid to the corporation and instead have that sum paid to the shareholder-key employee directly. By doing so, the p.g. sales proceeds received by the shareholder is not taxed at the corporate level.

Considerations for Personal Goodwill

Quantifying the proportion of personal versus business goodwill is based on these factors for the individuals:

1. Age and health
2. Demonstrated earning power
3. Community reputation for judgment, skill and knowledge
4. Comparative industry success
5. Nature and duration of person's role in creating company profits

Traditional indicators of personal goodwill are the following:

1. Personal relationship with customers
2. Importance to developing new business
3. Personal involvement in solving client problems
4. Critical role in financial/operational decisions
5. Direct impact on profitability
6. Personal knowledge, experience, known-how and abilities
7. Person not under contract to perform the services exclusively for company

The landscape of court cases is favorable to the taxpayers taking advantage of the separation of personal from business goodwill. At the same time, the analysis supporting personal goodwill must withstand both intense IRS and Tax Court scrutiny.

Generally, there are three approaches for estimating personal goodwill: "bottom-up", "top-down," and "with and without".

The "bottom-up" approach values the intangible elements, like workforce in place, customer list, patents, and business goodwill. After subtracting the value of these assets, the remaining value is attributable to the personal goodwill.

The "top-down" approach values the total enterprise and then separates personal goodwill through a Multi-Attribute Utility Model (MUM). The Multi-Attribute Utility Model uses a "point-scoring" method that distinguishes personal goodwill from enterprise goodwill.

The "with and without" approach values the enterprise twice – once with the efforts of the personal goodwill subject and once without this person. The difference is the personal goodwill.