Sale Of Personal Goodwill As Tax Savings Opportunity In Business Transactions

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Generally, in a sale of a closely-held business, a buyer who desires to acquire a regular or "C" corporation, which is taxed separately from its shareholders, will prefer to purchase the assets of the C corporation rather than the stock from the individual shareholders in order to avoid any hidden or contingent liabilities associated with the corporation and to get a "step-up" in basis for the acquired assets. In such an asset sale to a third party buyer, the selling C corporation must recognize gain on the sale of those assets and pay corporate income tax on any such gain. In addition, if the C corporation liquidates and makes a final distribution of assets to its shareholders proportionately in cancellation of their stock, the shareholders must pay capital gains tax (20%) and net investment income tax (3.8%) (NIIT) on the amount of the liquidating distribution, minus their respective bases in their stock. Thus, the proceeds from the sale of the corporate assets will be subject to two levels of taxation: first, a tax at the 35% corporate rate on the C corporation's gain on the sale of the assets, and second, a tax at the shareholder level on the liquidating distribution to the shareholders at the 20% capital gain rate plus the 3.8% NIIT.

In certain limited circumstances, the shareholders of the C corporation may be able to obtain long-term capital gain treatment for payments received by the shareholders directly from the buyer as a sale of shareholders' personal goodwill without such amount being taxed at the C corporation level. The amount paid by the buyer for the personal goodwill would be amortizable over 15 years as a Section 197 intangible. The sale of personal goodwill has been recognized and approved by the federal courts in those limited instances where the shareholders selling their personal goodwill (1) have strong personal ties and relationships to the corporation's customers and (2) have no pre-existing employment agreement or covenant not-to-compete with the corporation prohibiting them from transferring their strong personal contacts to any third party.

For example, suppose Acme Corporation, a C corporation for federal income tax purposes, sells its assets to Buyer for $1,000,0000 cash. Acme Corporation has been in the engineering consulting business for 15 years and is owned by two shareholders who have built strong personal relationships with their customers over the last 15 years. Neither shareholder has an employment agreement or a covenant not-to-compete with Acme. Acme's assets consist of equipment valued at $200,000, a patent valued at $100,000, and customer lists. The parties agree to an asset purchase agreement that includes a two-year covenant not-to-compete between Buyer and the two shareholders. During negotiations for allocation of the purchase price of $1,000,000 to the purchased assets, the parties allocate $300,000 to the assets and the patent, $200,000 to the covenant not-to-compete, and the balance of $500,000 to the personal goodwill of the two shareholders. The two shareholders and the Buyer separately enter into an Agreement to Sell Personal Goodwill and a separate Bill of Sale for Personal Goodwill for $500,000. Based on the applicable case law, the $500,000 for the sale of the personal goodwill avoids the 35% corporate level tax because it is paid directly to the shareholders, and is taxed to them at the maximum long-term capital gains rate of 20% plus 3.8% NIIT.

In short, the sale of the corporate shareholder's personal goodwill can result in long-term capital gain treatment for part of the purchase price paid directly to the shareholders and avoids the corporate level tax while entitling the buyer to amortization deductions under Section 197.