



Brentmore Valuation Advisors LLC

It's Personal!

**An Advisors Guide to Understanding
and Valuing Personal Goodwill**

June 26, 2015

EXIT PLANNING FOR ADVISORS

ATTRACT, ENGAGE AND PERMANENTLY REPRESENT SUCCESSFUL OWNERS

Presenter

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Of Exit Planning Professionals™



Objectives

- **What is Personal Goodwill & Why is it Important?**
- **What is the Difference Between Enterprise Goodwill, Personal Goodwill & Key Person Risk**
- **Determining the Existence & Value of Personal Goodwill**

Goodwill

- **Entity Goodwill** – often referred to as **enterprise goodwill**, is that goodwill that strictly attaches to the entity; assets such as name, phone number, location, assembled work force and going concern value for example.
- **“Pure” Personal Goodwill** – this can be best described as goodwill such as specialized skills or relationships that **cannot be transferred** under any conditions, including a covenant not to compete.
- **Transferable Personal Goodwill** – this represents goodwill that is personal in nature but can or might be transferred to another entity or person.
- How to Determine, Support, and Testify on Personal Goodwill in Divorce” webinar presented by Jim Alerding, CPA/ABA, ASA, CVA and Harold G. Martin, Jr., CPA/ABV/CFF, ASA, CFE in the VPS Straight Talk Series, January 31, 2012, pp. 29 of presentation materials

Enterprise Goodwill Components

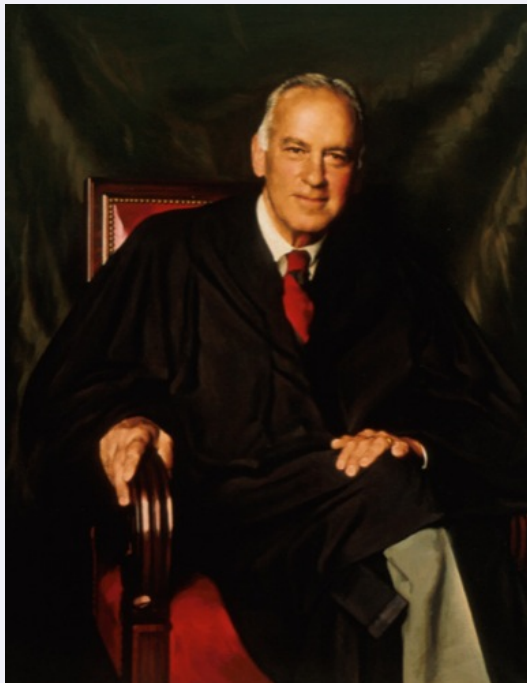
- **Company Name**
- **Reputation of Company or Brand**
- **Location**
- **Facility**
- **Phone Number**
- **Customer List**
- **Workforce in Place**

Enterprise Goodwill Components

- **Company Name**
- **Reputation of Company or Brand**
- **Location**
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- **Customer List**
- **Workforce in Place**

Query: Are any of these intangible assets “personal” in nature?

What is Personal Goodwill?



Justice Potter Stewart

“I know when I see it”

What is Personal Goodwill?

“...personal goodwill is owned by the shareholders of the target corporation and exists when a **shareholder’s reputation, expertise, skill and knowledge**, as well as the **shareholder’s contacts and relationships with customers and suppliers**, give a business its intrinsic value”.

“Goodwill as Part of a Corporate Asset Sale” by Jackson M. Payne, JD, The Tax Adviser (AICPA) May 2014

Query: What if reputation, skill, etc. rest with an employee?

Answer: Key Person Discount?

Does the type of the transaction change your answer?

Does the existence of a Non-Compete have an impact?

Key Person Risk

“An amount or percentage deducted from the value of an ownership interest to reflect the reduction in value resulting from the actual or potential loss of a key person in a business enterprise:

The International Glossary of Business Valuation Terms, American Society of Appraisers, 2009

How Do We Quantify Key Person Risk?

- **Estate of Renier – T.C. Memo 2000-298 – no factual support for 10% discount**
- **Estate of Paul Mitchell – T.C. Memo 1997-461 – 10% discount granted**
- **Estate of Furman – T.C. Memo 1998-157 – 10% discount granted**

Why is The Determination of Personal Goodwill Important?

- **Income Tax – Bateman, Martin Ice Cream, Norwalk,**
- **Estate & Gift Tax – Estate of Adell, Bross Trucking**
- **Marital Dissolution – Jurisdiction & Case Law Specific**

Bateman v. United States

- **Case involving sale of an interest in a personal service partnership**
- **Majority opinion ignores the personal service attributes and attributes any goodwill to be entity**
- **The dissenting opinion notes that the “material income-producing factor” is client relationships and that the Court fails to make a distinction between EG and PG**

Martin Ice Cream

- **Involves a Split-off of a subsidiary**
- **Arnold Strassberg has nurtured personal relationships with his customers over 25 years**
- **Oral agreement between Arnold and Haagen-Dazs of distribution rights**

Martin Ice Cream

- **Assets of subsidiary were sold to Haagen-Dazs**
- **Oral contract and relationships were never assets of subsidiary**
- **Upon sale of these assets Strassberg received capital gains treatment**

Martin Ice Cream – Sale Proceeds

<u>Allocation Table</u>	<u>\$(Millions)</u>
Personal Goodwill	1.14
Consulting/CNTC	0.45
Earn-out	0.33
Business Goodwill	0.29
Martin Strassberg CNTC	0.25
	<hr/>
	\$ 2.46

Norwalk v. Commissioner

- **An accounting firm is liquidated**
- **IRS asserts that Goodwill was distributed from corporation on liquidation**
- **With no CNTC and clients forming the overwhelming component of goodwill, Court finds any goodwill is personal**

Asset Allocation Process Under IRC 1060

Four Step Process:

- **Determine Purchase Price**
- **Allocate Value to Classes I-V**
- **Allocate Value to Identifiable Intangible Assets – Class VI**
- **Allocate Residual Value to Going Concern Value and Goodwill – Class VII**

Asset Allocation Process Under IRC 1060

Five Step Process:

- Determine Purchase Price
- Allocate Value to Classes I-V
- Allocate Value to Identifiable Intangible Assets – Class VI
- Allocate Residual Value to Going Concern Value and Goodwill – Class VII
- Determine Allocation Between Personal and Entity Goodwill?

Asset Allocation Process Under IRC 1060

Four Step Process:

- **Goodwill** defined as “the value of a trade or business attributable to the expectancy of continued customer patronage”.
- **Going Concern** defined as “the additional value that attaches to property because of its existence as an integral part of an ongoing business activity”.

Asset Allocation Process Under IRC 1060

- **Identifiable Intangible Assets** include workforce in place, non-compete agreement, know-how intangibles, **customer based intangibles, franchise agreements**, etc.
- **Going Concern Value** may include value attributable to location, operations, systems and procedures, accounting records and licenses and permits.

Asset Allocation Process Under IRC 1060

Sec. 1060(a) provides that:

“(i)f in connection with an applicable assets acquisition, the transferee and transferor agree in writing as to the allocation of any consideration, or as to the fair market value of any of the assets, such agreement shall be binding on both the transferee and the transferor unless the Secretary determines that such allocation (or fair market value) is not appropriate”

Personal Goodwill in Income Tax

Under what circumstances would an allocation of goodwill between enterprise and personal goodwill be appropriate?

Personal Goodwill in Income Tax: Auto Dealers

- **Noyes-Buick Co. v. Nichols, Internal Revenue Collector 1926 – personal relations between owner & manufacturer (excise tax)**
- **Akers v. CIR, 6 T.C. 693 1946 – franchises granted were personal service contracts...(liquidation)**
- **Zorninger v. Commissioner, 62 T.C. 435 (1974), United States Tax Court, Filed June 27, 1974 (gift tax)**

Personal Goodwill in Income Tax: Insurance Agency

- D.K. MacDonald, 3 T.C. 720 1944 – liquidation of agency, no transfer of goodwill ...personal relationships with customers...
- Stanton H. Bryden v. Commissioner, T.C. Memo 1959-184 – similar fact pattern to MacDonald, personal relationships with customers
- Frank J. Longo, T.C. Memo 1968-217 – again similar fact pattern in a liquidation, Court indicates that there is **no saleable goodwill when a corporation's business is so dependent on its personnel, unless a CNTC has been entered into with the corporation.**

Personal Goodwill in Income Tax

- **Martin Ice Cream Co., - 110 TC 189 (1998)**
- **Arthur G. Rudd, - 79 TC 225 (1982)**
- **William Norwalk, - T.C. Memo 1998-279**
- **Cascades Design, Inc. v. CIR - T.C. Memo. 2000-58
(February 23, 2000)**
- **Solomon v. CIR – T.C. Memo 2008-102 (April 16, 2008)**
- **Kennedy v. CIR – T.C. Memo 2010-206 (September 22, 2010)**

Personal Goodwill in Estate & Gift Tax Situations

Estate of Adell – T.C. Memo 2014-155

- Involves STN.com – owner and operator of equipment to link The Word to satellites
- The Word – an urban religious ministries programmer
- Decedent – Franklin Adell
- Kevin Adell – son and key person
- Valuation of STN.com

Personal Goodwill in Estate & Gift Tax Situations

Estate of Adell – T.C. Memo 2014-155

- Estate presents 3 different appraisals
- Values from \$9.3 M, \$4.3M and Net Asset Value
- IRS expert + \$26.3M

Personal Goodwill in Estate & Gift Tax Situations

Estate of Adell – T.C. Memo 2014-155

Court finds \$9.3M value appropriate – as it considers Kevin’s personal goodwill noting that he does not have a CNTC or employment agreement

Personal Goodwill in Estate & Gift Tax Situations

Bross Trucking v. Commissioner – T.C. Memo 2014-107, 2014

Gift tax case – IRS contends that Chester Bross distributed intangible assets to his three sons

Gift of Bross Trucking Inc.:

- Goodwill
- Established revenue streams
- Customer base
- Workforce
- Supplier relationships

Personal Goodwill in Estate & Gift Tax Situations

Fact Pattern:

- **Chester owns 100% of Bross Trucking**
- **Bross Trucking obtains almost 95% of revenues from other Bross entities**
- **Because of stepped up enforcement action by the State – Bross is forced to reconsider operations of Bross**
- **Sons establish LWK Trucking**
- **LTW obtains all Bross entity business**

Personal Goodwill in Estate & Gift Tax Situations

Fact Pattern:

- **No employment agreement or CNTC** with Bross Trucking
- No physical assets transferred
- Sons did not work at Bross
- Chester did not work at LWK
- LWK expands service offering

Personal Goodwill in Estate & Gift Tax Situations

Court findings:

- **Because of impending suspension of operations by authorities, Chester sought an alternative solution to ensure service to customers**
- **“Bross Trucking could not expect continued patronage because its customers did not want to continue doing business with it”.**
- **No goodwill transferred**

Indications of Personal Goodwill

- *Small entrepreneurial business highly dependent on employee-owner's personal skills and relationships*
- *No pre-existing covenant not to compete (CNTC) and/or employment agreement between the selling company and employee-owner*
- *Personal service is an important selling feature in the company's product or services.*
- *Only employee-owners own the company*

Indications of Personal Goodwill

- **Sales largely depend on the employee-owner's personal relationships with customers**
- **Product and/or services knowhow, and supplier relationships, rest primarily with the employee-owner**
- **Buyer has insisted on, and bargained for, a separate personal CNTC and/or employment agreement (Flower v. CIR, 61 T.C. 140 1973)**
- **There is a separately bargained for agreement to purchase personal goodwill**

Indications of Personal Goodwill

- **Personal seller financing is part of the consideration, with right of offset (loss of existing customers)**
- **An earn-out is part of the consideration; payout depends on future company sales and/or earnings**
- **A strategic buyer's acquisition premium can be traced to attributes found in personal goodwill (Martin Ice Cream)**
- **A Non-compete Agreement does not exist between shareholder and entity (Howard v. U.S., No. CV-08-365-RMP)**

Valuation of Personal Goodwill

“With or Without Method”

Personal Goodwill = Present value of future business income with seller in place minus the present value of future business income without seller in place.

- **Usually measured over the expected work life of seller**
- **Assumes that seller retires and does not compete (hence a non-compete agreement)**

Valuation of Personal Goodwill

“Residual or Indirect Method”

Personal Goodwill =

- **Value of total business**
- **Minus value of tangible assets**
- **Minus value of identifiable intangible assets**
- **Minus value of business goodwill**

Valuation of Personal Goodwill

“Residual or Indirect Method”

Personal Goodwill =

- Value of total business
- Minus value of tangible assets
- Minus value of identifiable intangible assets
- Minus value of business goodwill

**Does this method provide
the right answer?**

Valuation of Personal Goodwill

Excess Future Income Method

Personal Goodwill = present value of expected excess earnings related to seller's personal goodwill attributes

An excess earnings method after a reasonable return on all other assets

Valuation of Personal Goodwill

Multiattribute Utility Method (MUM)

- Define objectives – personal vs enterprise goodwill
- Establish alternative outcomes in %
- Define attributes
- Determine importance and existence utility
- Aggregate the results

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Valuation of Personal Goodwill

		Importance Utility (IU)	Existence Utility (EU)
Personal	Ability, Skills, and Judgment	Most Important	Strong Presence
	Work Habits	Moderately Important	Moderate Presence
	Age and Health	Moderately Important	Moderate Presence
Number of Personal Attributes		3	
Business	Personal Reputation	Moderately Important	Strong Presence
	Personal Staff	Most Important	Strong Presence
	Personalized Name	Moderately Important	Strong Presence
	Marketing and Branding	Most Important	Strong Presence
Number of Business Attributes		4	
Industry	In-bound Personal Referrals	Least Important	Below Average
	Closeness of Contact	Most Important	Below Average
	Important Personal Nature	Most Important	Strong Presence
Number of Industry Attributes		3	



EXIT PLANNING FOR ADVISORS

ATTRACT, ENGAGE AND PERMANENTLY REPRESENT SUCCESSFUL OWNERS

Valuation of Personal Goodwill

		Importance Utility (IU)	Existence Utility (EU)
Business Attributes			
Business	Business Reputation	<i>Most Important</i>	<i>Strong Presence</i>
	Business Staff	<i>Most Important</i>	<i>Strong Presence</i>
	Business Name	<i>Most Important</i>	<i>Above Average</i>
	Business Location	<i>Most Important</i>	<i>Strong Presence</i>
	Number of Business Locations	<i>Least Important</i>	<i>Moderate Presence</i>
	Marketing and Branding	<i>Most Important</i>	<i>Strong Presence</i>
	Systems and Organization	<i>Most Important</i>	<i>Strong Presence</i>
Number of Business Attributes		7	
Industry Attributes			
Industry	In-bound Referrals	<i>Most Important</i>	<i>Strong Presence</i>
	Repeating Revenue Stream	<i>Most Important</i>	<i>Strong Presence</i>
	Copyrights, Patents, Etc...	<i>Most Important</i>	<i>Strong Presence</i>
Number of Industry Attributes		3	



Valuation of Personal Goodwill

MUM Input Sheet for Goodwill Allocation

Step Six

Enter Total Goodwill to be Allocated

Instructions:

You must enter the total amount of goodwill that you wish to allocate between personal and enterprise.

	Amount	Percentage
Total Goodwill to Be Allocated by MUM	\$ 15,400,000	<u>100%</u>
Personal Goodwill	\$ <u>7,700,000</u>	<u>50%</u>
Enterprise Goodwill	\$ <u>7,700,000</u>	<u>50%</u>



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- **What is Personal Goodwill & Why is it Important?**
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Thank You!

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