

# GOODWILL SPLIT EQUALS TAX SAVINGS

by Mark E. Battersby



**G**oodwill is one of those intangible business assets that usually has little or no impact on a pressure cleaning operation's tax bill—until least expected. Determining who 'owns' that goodwill now can often avoid expensive surprises and reap substantial tax savings somewhere down the road.

Blackstone Group, the private equity buyout firm, devised a way for its partners to effectively avoid paying taxes on \$3.7 billion, the bulk of what it raised from selling shares to the public. Blackstone's tax strategy hinged on its goodwill, that same goodwill found in every pressure cleaning-related business.

While it is unlikely that a pressure cleaner, equipment dealer, or supplier can legitimately reap similar savings, the often-unrecognized goodwill built-up in their businesses can produce tax savings. If ignored, that same goodwill can also work against the owner in a sale of the pressure cleaning business, in a divorce, or during that inevitable transfer to the owner's heirs. If goodwill can be allocated to the business owner, rather than to the business entity, tax savings often result.

#### **Goodwill and More Goodwill**

Goodwill is an accounting term for the value of an all-too-real, but intangible business asset, such as the value of a brand name, built by a pressure cleaning business over time. Individuals who create goodwill through their skill at running a pressure cleaning business cannot, of course, claim a tax deduction for it. When goodwill is sold to someone else, however, the buyer gets to deduct it because its value is assumed to erode.

Unfortunately, the 'goodwill' of a pressure cleaning business is among the most difficult assets to place a value on. After all, goodwill usually does not have an original purchase price and cannot be seen. Yet, goodwill is one of the most valuable assets in every pressure cleaning operation.

All too frequently, a pressure cleaning business may have goodwill but

that goodwill may be related to the individual, and the individual cannot transfer that goodwill. Goodwill that is related to the business entity is referred to as "enterprise goodwill" or "going-concern" value. Goodwill that is marketable or vendible can be valued and sold. Conversely, no value is assigned to goodwill that is purely personal or professional.

There are a number of transactions where tax savings may result if goodwill can be allocated to the business owner rather than the business



entity. When an incorporated pressure cleaning business sells its assets and distributes the proceeds to its shareholders, the overall tax liability can often be reduced if a portion of the proceeds can be allocated to the shareholders rather than to the corporation.

Obviously, it is not possible to simply assign consideration received in exchange for tangible and intangible assets titled in the corporate name. Some flexibility may exist, however, to characterize consideration paid for intangibles (such as goodwill, going-concern value and a covenant not to compete) as payments to the shareholder.

#### **Separations and Transfers**

A common tax dilemma arises whenever an owner attempts to sell his or her business only to discover the

net after-tax proceeds will be substantially reduced by the dreaded double tax (once at the corporate tax rate and again when those non-deductible distributions are added to the shareholder's tax return). One well-known tax strategy involves allocating goodwill to the pressure cleaning business's owner rather than to the business entity.

The root of this dilemma lies with the fact that the earnings of an incorporated pressure cleaning business are taxed at the corporate level and again when

they are distributed to shareholders. Many businesses reduce corporate-level taxes by paying deductible bonuses, royalties, etc. to the owners to keep corporate profits—and tax bills—low. The problem often reappears when the owner sells the business.

Most buyers will not (or, in the case of many professional practices, cannot) purchase the stock for licensing, liability, and/or tax reasons. This often results in an asset sale. Unfortunately, sales of this nature will be subject to the double tax and the usual methods of minimizing the double tax will be insufficient to eliminate the double tax in the year of the sale.

Among the limited options available to the seller are having payment made directly to the seller as employment,

consulting, or non-compete payments. These payments, however, are subject to ordinary income tax rates and possibly employment taxes as well. These payments must also have 'economic substance' with respect to actual employment or consulting services performed in order to withstand the scrutiny of the IRS. The most effective solution may be to allocate a portion of the purchase price to the personal goodwill of the shareholders.

## The time to think about the value of the pressure cleaning operation's goodwill and ownership of that goodwill is now, not later.

### A Legitimate Loophole

In a 1998 decision known as *Martin Ice Cream*, a creative taxpayer successfully argued that the goodwill of a business can be bifurcated into goodwill owned by the corporation and goodwill owned by the owner. The taxpayer convinced the Tax Court the corporation's success was largely based on the personal reputation and industry contacts of one of the owners and that most of the goodwill was personal to the owner and had not been transferred to the corporation. Based on this bifurcation of goodwill, the owner's personal goodwill is a separately saleable asset that avoids the double tax and is subject to favorable capital gains rates.

The determination of whether goodwill exists in your pressure cleaning business and, if so, whether it belongs to the business entity or to the individual is relevant whenever tax or economic benefits may be realized by minimizing the business entity's valuation. There may be many such situations including:

- Corporate asset sales
- Divorce
- Bankruptcy

- Sales and liquidations
- Gifts and estates

### Tax Rules for "Acquired" Goodwill

According to the tax rules, the capitalized cost of goodwill and most other intangible assets acquired after August 10, 1993 and used in a trade or business or for the production of income are ratably amortized or written-off over a 15-year period generally beginning in the month of acquisition. Intangibles amortized under this

provision are referred to as "Section 197 intangibles."

Generally, self-created intangibles are not amortized under Code Section 197 unless created in connection with the acquisition of a trade or business. Exceptions are provided

for government-granted licenses, permits and rights, covenants not to compete entered into in connection with the purchase of a business, and franchises, trademarks, and trade names. However, certain self-created intangibles without an ascertainable useful life may be amortized over 15 years.

### Goodwill

Goodwill is an intangible but recognized business asset that is the result of such features as the production or sale of reputable brand-name products, a good relationship with customers and suppliers, and the standing of a business in the community. Another view holds that goodwill is merely an overall measure of unrecorded assets such as a favorable line of credit, dependable suppliers, a stable workforce, and loyal customers.

For both, the goodwill aspect arises from a difference between the accounting value attached to an asset and its economic value. Unfortunately, there seems to be no measurable way of distinguishing the two broad constitutive concepts of goodwill.

### Splitting the Goodwill

Regardless of the reason why an allocation of goodwill value may be

desirable, the primary issues involve determining just what are the intangible assets of a pressure cleaning business and what is their value? The asset is generally viewed as some combination of the reputation, personal relationships with customers and suppliers, and the expertise of the shareholder.

The best case is one where customers and suppliers perceive themselves as dealing with the individual shareholder rather than with the legal entity. A service business is most likely to support this position, although *Martin Ice Cream* itself demonstrates it can apply to other types of businesses.

### A Goodwill Strategy

There are times when the owner of a pressure cleaning business will take the position that any goodwill is personal and has no value, and other times he or she will argue the opposite. Someone facing bankruptcy or divorce will argue that any goodwill in his or her business is personal and that the marital estate or bankruptcy estate should not include a value for goodwill that may be distributed to a creditor or ex-spouse. Other times, to acquire favorable capital gains treatment, the same pressure cleaner, dealer, or supplier may take the opposite position that all of his or her goodwill is related to the business entity.

At its most basic, tax savings can be achieved by shifting value allocations from business goodwill to personal goodwill. Since the classification of goodwill depends largely on the facts and circumstances of each case, properly supporting the value allocations requires expertise in all business valuation methodologies. Knowledgeable, independent business appraisers understand the impact of these factors and can assist any pressure cleaning business or its owners in determining the proper allocation.

However, the time to think about the value of the pressure cleaning operation's goodwill and ownership of that goodwill is now, not later. *CT*