


**Personal Goodwill: A Case Study in Effective
Tax Planning for the Business Sale**

Presented to:
Pittsburgh Planned Giving Council

RANDY FOX, CFP®, AEP®




© STONE LAW OFFICES, LTD. & TWO HAWKS CONSULTING, LLC

1

A Few Tax Quotes

- ❖ "In this world nothing can be said to be certain, except death and taxes" – Benjamin Franklin
- ❖ "The only difference between death and taxes is that death doesn't get worse every time Congress meets." – Will Rogers
- ❖ "The reward of energy, enterprise and thrift is taxes." – William Feather
- ❖ "Anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes." – Judge Learned Hand




© STONE LAW OFFICES, LTD. & TWO HAWKS CONSULTING, LLC

2

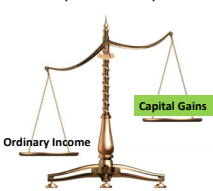
Primary Types of Business Owner Taxes

INCOME VS. ESTATE
(Federal & State)



Income Taxes **Estate / Gift Taxes**

ORDINARY VS. CAPITAL GAINS
(Federal & State)



Ordinary Income **Capital Gains**

© STONE LAW OFFICES, LTD. & TWO HAWKS CONSULTING, LLC

3

Tax Planning Methodology

Tax Deferral

- Deferral of the Tax Recognition Event until later tax years
- I.e., Installment Sales, 1031 Exchange, Rollover Equity

Tax Mitigation

- Reduction of the Tax Liability via shifting from ordinary to capital gains, basis management, or deductions
- I.e., Structured Stock Redemption, Charitable Deductions

Tax Elimination

- Elimination of Tax Liability via exemptions, jurisdiction selection, structure
- I.e., Sec. 1202 stock, NING Trusts

© STONE LAW OFFICES, LTD. & TWO HAWKS CONSULTING, LLC 4

4

Timeline for Liquidity Event Tax Planning

The diagram shows a sequence of stages: Thinking About It, Active Search, Negotiations, Non-Binding LOI, Binding LOI / Purchase Agreement, CLOSING, Pre-Distribution, and End of Tax Year. Below this, a yellow arrow points left labeled 'MORE TAX OPTIONS' and 'Mostly Structural Planning'. A blue arrow points right labeled 'LIMITED OPTIONS' and 'Mostly Proceeds Planning'.

© STONE LAW OFFICES, LTD. & TWO HAWKS CONSULTING, LLC 5

5

Our Role as Trusted Advisors

“Begin with the end in mind.”

7 Habits of Highly Effective People

– Dr. Stephen R. Covey

© STONE LAW OFFICES, LTD. & TWO HAWKS CONSULTING, LLC 6

6

What is Goodwill?

❖ **Technical Definition** – “A collection of intangible assets that generate earning power superior to that which would be generated by a business’ tangible and separately identifiable intangible assets.”
 – *What Creates Personal Goodwill?* by Christopher P. Casey and Brian R. Potter.

❖ **Practical Definition** – Anything that creates a market advantage or “excess earnings” over the normal return of a business’ operating assets.

© STONE LAW OFFICES, LTD. & TWO HAWKS CONSULTING, LLC 7

7

Types of Goodwill

<p style="text-align: center;">ENTERPRISE</p> <p>An asset attributed to the <u>business</u> by virtue of its existing arrangements with suppliers, customers, or others, and its anticipated future customer base due to the business operations.</p>	<p style="text-align: center;">PERSONAL</p> <p>A <u>personal</u> asset that depends on the continued presence of a particular individual and may be attributed to the individual’s personal skill, training or reputation.</p>
--	---

© STONE LAW OFFICES, LTD. & TWO HAWKS CONSULTING, LLC 8

8

Examples of Goodwill

<p style="text-align: center;">ENTERPRISE</p> <ul style="list-style-type: none"> ❖ Overall business reputation ❖ Effective workforce in place ❖ Business wide marketing ❖ Referrals to business (vs. individual) ❖ Repeating, systemized revenue (vs. one-time revenue) ❖ Business owned Intellectual Property 	<p style="text-align: center;">PERSONAL</p> <ul style="list-style-type: none"> ❖ Use of individual’s name in business name ❖ Personal name recognition in area or industry ❖ Referrals to specific individual ❖ Relationship of business contacts with individual ❖ Importance of individual’s personal service
---	---

© STONE LAW OFFICES, LTD. & TWO HAWKS CONSULTING, LLC 9

9

Why Do We Care About Personal Goodwill?

- ❖ **General:**
 - ❖ The sale of goodwill is taxed at capital gains rates
 - ❖ Buyers typically prefer an asset sale over stock sale (step-up basis, liability issues, etc.)
 - ❖ Buyers can amortize purchases of goodwill under IRC Section 197
- ❖ **Specific:**
 - ❖ For C Corp asset sales, personal goodwill sales are not subject to double taxation like enterprise goodwill sales
 - ❖ For S Corp asset sales, personal goodwill proceeds can be allocated differently than the pro rata distribution of business asset proceeds
 - ❖ No business entity-level gain on sale of personal goodwill
 - ❖ Opportunity to do individual-level tax planning with discrete asset transaction

10

How to Identify Personal Goodwill

- No Non-Compete Agreements exist between the Shareholder and the Business
- Business is highly dependent on the Shareholder's personal relationships, reputation, skills, know-how, etc.
- Shareholder's ongoing service and contribution is critical to the business sale process
- Shareholder is highly involved in the business' day-to-day operations
- Business is in a regulated, highly technical, or specialized industry (i.e., professional services)
- Business contracts are terminable at will or tied to Shareholder
- Loss of the Shareholder will have a substantial negative impact on the business revenue and/or profitability

11

Characteristics of Enterprise Goodwill

- Non-Compete or Employment Agreements that effectively prevent a Shareholder from competing or that converts all "intangible" efforts to a "work for hire" status.
- Business is highly systemized, with formal organizational structures, processes and controls
- Revenue is generated by business brand name, company sales team, etc.
- Business has a diversified customer and revenue base
- Shareholder is "passive" in day-to-day operations or has a strong management team
- Business contracts are not tied to an individual Shareholder
- Shareholder could effectively "retire" without any negative impact on business revenue or profitability

12

How to Value Personal Goodwill

- ❖ Key factors to be considered:
 - ❖ Age and health of Shareholder
 - ❖ Shareholder's earning power within the business
 - ❖ Shareholder's reputation in area and industry, i.e., judgment, skill, knowledge
 - ❖ Shareholder's comparative success to others in same business
 - ❖ Nature and duration of Shareholder's involvement in the business operations
 - ❖ Shareholder's vendor and customer relationships

© STONE LAW OFFICES, LTD. & TWO HAWKS CONSULTING, LLC 13

13

How to Value Personal Goodwill

- ❖ Valuation Methodologies
 - ❖ With and Without Method (i.e., impact of Shareholder revenue generation)
 - ❖ Top-Down Method (i.e., residual of Purchase Price Allocation)
 - ❖ Bottom-Up Method (i.e., business assets vs. personal assets)
 - ❖ Excess Earnings / Compensation Analysis (i.e., capitalized amount of Shareholder's actual earning capacity over FMV of compensation of person with similar skills)

© STONE LAW OFFICES, LTD. & TWO HAWKS CONSULTING, LLC 14

14

How to Value Personal Goodwill

- ❖ IRS default argument – goodwill gain occurred at the business entity level, and then distributions were made by business entity to the Shareholder, subject to all tax effects (i.e., double taxation, pro rata distribution, etc.)
- ❖ Taxpayer has initial burden of proof; however, if present credible evidence and meet other criteria, burden shifts to IRS
- ❖ Strongly recommend obtaining a valuation from a qualified appraiser and not simply relying on "stated value"
 - ❖ Possible taxpayer argument of arms-length negotiation with Buyer is indicative of Personal Goodwill value

© STONE LAW OFFICES, LTD. & TWO HAWKS CONSULTING, LLC 15

15

Best Practices Before the Sale

- ❑ Document the importance and history of the Shareholder’s personal relationships
 - Be realistic – don’t create something that is not there
- ❑ Carefully structure pre-sale corporate documents, i.e., shareholder, confidentiality, and employment contracts
 - “Founder’s rights” clauses
- ❑ Obtain a professional valuation from a qualified appraiser or professional using objective methodologies
- ❑ Disclose intent to allocate a portion of the total purchase price to Personal Goodwill *as early in the negotiations* with the Buyer as possible
 - If possible, put intent in the initial Letter of Intent; Personal Goodwill should not be a “tax afterthought;” demonstrate that this is a material term that is important to the Shareholder

© STONE LAW OFFICES, LTD. & TWO HAWKS CONSULTING, LLC 16

16

Best Practices Before the Sale

- ❑ Deal Structure Documents
 - Either separate Personal Goodwill Sale Agreement, or identified as separate asset sale in Asset Purchase Agreement
 - Enter into a Non-Compete Agreement between the individual Shareholder and the Buyer
 - If individual Shareholder is continuing in business, enter into an Employment Agreement with the Buyer (i.e., convert Personal Goodwill to Enterprise Goodwill for benefit of Buyer)
- ❑ Purchase Price Allocation
 - Inventory the Personal assets separate from the Business assets
 - Value the Personal Goodwill separately from the Enterprise Goodwill and other business assets
 - Agree to Personal Goodwill value and Purchase Price Allocation Schedule in advance of closing
- ❑ Follow the Money – make sure the economic substance of the transaction matches the tax effects

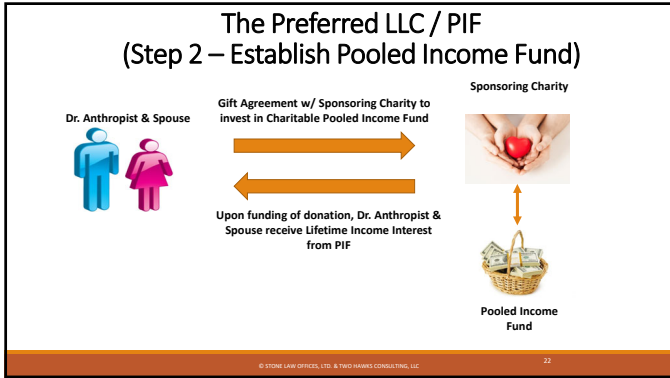
© STONE LAW OFFICES, LTD. & TWO HAWKS CONSULTING, LLC 17

17

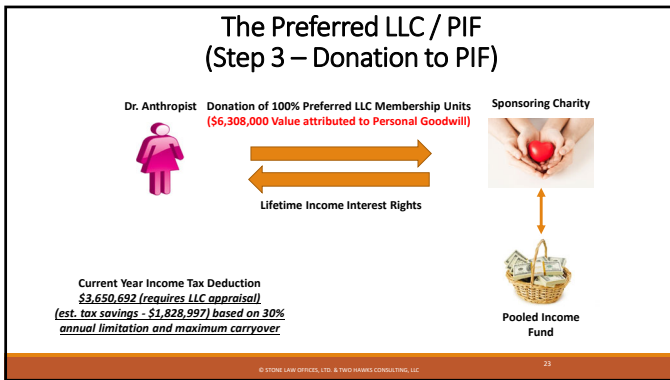
The Preferred Pooled Income Fund Case Study (Pre-Closing Tax Mitigation / Elimination Using Personal Goodwill)

© STONE LAW OFFICES, LTD. & TWO HAWKS CONSULTING, LLC 18

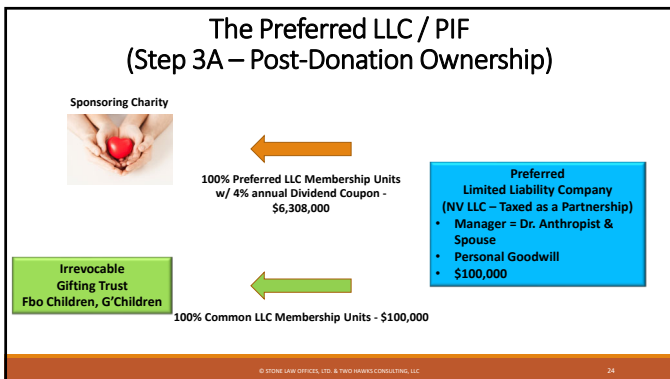
18



22



23



24

The Preferred LLC / PIF (Step 4 – Sale of Personal Goodwill)

Preferred
Limited Liability Company
(NV LLC – Taxed as a Partnership)

- Manager = Dr. Anthropist & Spouse
- Personal Goodwill
- \$100,000

Dr. Anthropist's Personal Goodwill

\$6,308,000

Buyer

- Preferred LLC and Buyer enter into contract for the sale of Dr. Anthropist's Personal Goodwill related to the Seller Entities in exchange for negotiated payment of cash proceeds. Can be integrated into existing Purchase Agreements or as a separate Personal Goodwill Purchase / Sale Agreement.
- Under Partnership Tax Law provisions, capital gains from sale of Personal Goodwill will be allocated pro rata to the Preferred LLC Members, of which the Sponsoring Charity / PIF owns 98% of the Preferred LLC contributed capital accounts; as such, a substantial portion of the capital gains taxes associated with the sale of the Personal Goodwill will be effectively eliminated as the Sponsoring Charity is a Sec. 501(c)(3) tax exempt organization

© STONE LAW OFFICES, LTD. & TWO HAWKS CONSULTING, LLC 25

25

The Preferred LLC / PIF (Step 4A – Post-Sale Results)

Preferred
Limited Liability Company
(NV LLC – Taxed as a Partnership)

- Manager = Dr. Anthropist & Spouse
- \$6,408,000 Cash

Buyer

- Personal Goodwill

- Dr. Anthropist effectively sells Personal Goodwill in a tax efficient manner, and receives a substantial charitable income tax deduction to mitigate the taxes associated with the sale of the Seller Entities.
- Buyer effectively receives the exact same assets, for the same purchase price, with the same representations, warranties, and indemnifications.

© STONE LAW OFFICES, LTD. & TWO HAWKS CONSULTING, LLC 26

26

The Preferred LLC / PIF (Step 5 – Investment of Proceeds)

Preferred
Limited Liability Company
(NV LLC – Taxed as a Partnership)

- Manager = Dr. Anthropist & Spouse
- \$6,408,000 Cash

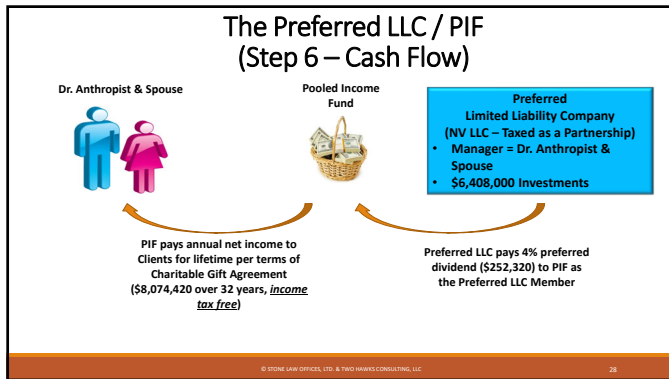
Preferred LLC uses cash from sale to pay premium for Private Placement Life Insurance Policy

PPLI pays 4% preferred dividends from loans and death benefit (income tax free)

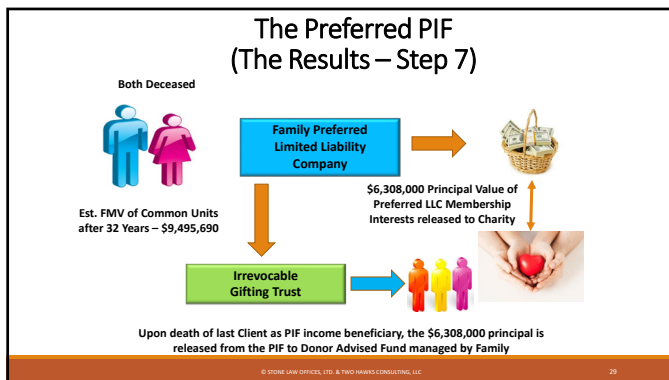
Private Placement Life Insurance Policy (PPLI)

© STONE LAW OFFICES, LTD. & TWO HAWKS CONSULTING, LLC 27

27



28



29

- ### The Preferred PIF (The Results)
- ❖ Amount of Planning Capital - \$6,308,000
 - ❖ Tax Savings - \$4,169,265
 - ❖ Personal Goodwill - \$2,340,268
 - ❖ Charitable Deduction Tax Savings - \$1,828,997
 - ❖ Lifetime tax-free income - \$8,074,420
 - ❖ Estate tax-free gift to children - \$9,495,690
 - ❖ Family Charitable Fund - \$6,308,000
- © STONE LAW OFFICES, LTD. & TWO HAWKS CONSULTING, LLC 30

30

Q & A / Open Discussion

Randy Fox, CFP®, AEP®
Two Hawks Consulting, LLC
randy@twohawksconsulting.com
704-698-4055




© STONE LAW OFFICES, LTD. & TWO HAWKS CONSULTING, LLC

31

Thank You!!
Contact Us to Continue the Conversation

Randy Fox, CFP®, AEP®
Two Hawks Consulting, LLC
randy@twohawksconsulting.com
704-698-4055



© STONE LAW OFFICES, LTD. & TWO HAWKS CONSULTING, LLC

32
