

SELLING YOUR BUSINESS???
BUSINESS GOODWILL / PERSONAL GOODWILL

An Article by
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After all these many years, you are selling off some percentage of your business – even up to 100% of your share (if you are in a partnership). You believed The Business Lawyer when he said that IF no one wants to buy your business, you have a job with a glorified title: “owner.” You’ve tested the water and someone wants to give you money for what you created over lo these many years. You’ve entered into a contract for an asset sale of your business.

How much of the purchase price should be allocated to “goodwill”? How much of that goodwill should be allocated to (and paid directly to) you as your personal asset, separate and distinct from the goodwill that is an asset of your corporate or LLC business?

Personal Goodwill In accounting and tax law, there exists a very real concept called “personal goodwill.” It exists because of the training and experience of the owner of the business. The intangible qualities that spring from such backgrounds are the personal ability (the expertise) of the owner, the contacts and the reputation of the owner, which added together give the business its value; they cause the telephone to ring; all together, they draw people and companies in the door, people and companies who write checks – that don’t bounce.

Business Goodwill Contrasted with personal goodwill is business goodwill, which might be comprised of the business records and customer/client files, a location (location, location, location) and a trained staff fully in place – all of which are important. Comparatively, however, business goodwill is usually less valuable than personal goodwill.

Capital Gains Treatment From an income tax perspective, the planning for the sale of personal goodwill gets convoluted by the variable ways in which people do business: C corporations, S corporations, partnerships and LLCs. Basically, however, the sale of goodwill will be taxed at low capital gain tax rates; that is a good thing, as my good friend, Martha Stewart, used to say. And, because goodwill normally has very little or absolutely no tax basis (you normally can’t attach a dollar figure to the acquisition of the elements of goodwill; therefore, for tax law, those elements have no basis), you will need all of the tax help you can get (capital gains rates) after subtracting your zero basis from the figure allocated for goodwill.

Covenant to Not Compete It is possible to mess up the sale of personal goodwill by the owner maintaining a covenant to not compete with the corporation or LLC whose assets are being sold. To avoid even a whiff of taint, that a step transaction took place by the cancellation of a covenant to not compete just before entering the sale transaction, the covenant should be dispensed with months, years before the planned sale. The problem to be avoided is that the existence of such a covenant is considered to have transferred the owner’s goodwill to his or her corporation or LLC.

Of course, as part of the owner’s sale of personal goodwill, the buyer will demand that the seller enter into a covenant to not compete with the buyer; that is to be expected – and will not

negatively affect the seller's tax treatment. Such a covenant is usually valued at less than the valuation for goodwill. Its tax treatment to the seller is as ordinary income (no Martha Stewart capital gains). In that case, it helps that the covenant is valued less than the goodwill. It is best if that covenant to not compete is a contract separate from the asset purchase agreement.

Contract for the Sale of Personal Goodwill A contract that is a separate document from the business' asset purchase agreement will be needed for the owner's sale of personal goodwill. Such a document will be the tangible vehicle for transferring the personal goodwill. From the buyer's standpoint (which will also help the seller prove the validity of the dollar figure allocated for personal goodwill), the contract for the sale of personal goodwill should at least require the seller to make introductions, mentor and train the staff of the buyer (a consulting contract for pay will facilitate the enforcement of the mentoring sessions), make endorsements of the buyer and advertise to the business' clients/customers that a new sheriff is town.

The consulting contract for pay, which should be separate from the contract for the sale of personal goodwill, can have a significantly beneficial effect for the buyer. That (essentially employment) contract converts goodwill (which the buyer must amortize over 15 years) into a current business expense (like payroll), which the buyer can deduct immediately as paid.

Summary A seller of some or all of a small business is in a good position to allocate a significant portion of the purchase price to be received to a category called "personal goodwill." To effectuate the transaction, there should be prepared the normal asset purchase agreement (where business goodwill is allocated), a contract for the sale of personal goodwill, a covenant to not compete and a consulting contract (for pay). Good tax treatment and retirement bliss are just around the corner.

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