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tax savings when selling a corporation or company.

Jan. 22, 2024



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Most people, including many experienced attorneys and CPAs, are surprised to learn that an individual owner, shareholder or member can individually own a corporation's or limited liability company's bundle of rights commonly known as goodwill.

The same corporation or company may have both enterprise goodwill and personal

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as a separate asset or property right. This goodwill property right provides some unique planning alternatives to minimize income tax related to a corporate or company acquisition. This article illustrates how planning with personal goodwill can be used to minimize tax arising from the sale of a corporation or company.

The importance of state law

Our analysis begins with state law. The Internal Revenue Code (IRC) assesses taxes by the ownership of property rights to both assets and income. However, those property rights are actually determined by the applicable state law. While the IRC taxes transactions, the applicable state law defines and regulates those property rights.

While there is no actual definition of goodwill in the IRC, it does refer to it. [IRC Section 197](#) provides for and controls the amortization of intangibles including goodwill. State laws recognize goodwill of a corporate or company business may accrue to an individual rather than simply to the business. State law further recognizes that goodwill is a property right or asset that is transferable in the same manner as equipment or other assets. Some of the cases define and describe goodwill as a property right are found in divorce cases where a spouse seeks compensation for the property right.

Since the individual state law recognizes goodwill as a transferable property right to one degree or another, the IRC uses this state law to define the tax attributes of goodwill. The reference to “company or enterprise goodwill” typically refers to the goodwill of the business or enterprise. Personal goodwill typically refers to the goodwill that accrues to the business owner or another individual. More specifically, personal goodwill generally reflects the personal skills, reputation and personal customer, vendor and referral relationships attributable to the business owner or other individual.

The unique tax advantages

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sale. Second, to obtain a basis step-up through the allocation of the purchase price to depreciable or amortizable assets. The depreciation or amortization can provide a substantial tax benefit for the buyer. Note that this can result in higher tax for the seller due to [depreciation recapture](#).

For example, the asset sale of a \$6 million C corporation might have the following tax consequences. Tax at the corporate level of \$2.058 million for federal and state purposes. When income is distributed to the shareholders or individual, tax of \$1.971 million. The combined corporate and individual tax rate could exceed 70% for federal and state tax.

If \$2 million is instead allocated to personal goodwill, then this amount is taxed to the business owner as a capital gain, resulting in a savings of over \$1 million because the personal goodwill is not subject to the corporate tax rate of over 30% and is taxed at the individual level only as a capital gain.

A lesser-known application

A lesser-known application is for the sale of a subchapter S corporation. An S corporation is taxed pursuant to subchapter S of the IRC. A subchapter S corporation does not pay federal tax at the corporate level. The income is taxed in a manner similar to a partnership. (There are a few differences, such as the inability to make a [754 election](#) for a basis step-up on the death of a partner.) The taxation of goodwill is not subject to a second level of tax and is already characterized as a capital asset taxed at the more favorable capital gains tax rate.

However, some of the best tax minimization strategies involve the transfer of part of the asset to be sold to a charitable entity prior to the sale. (Please see my article [A Tax Planning Cautionary Tale: Timing and Formalities Are Critical](#) to learn how *not* to do this.) This will provide that the portion contributed to the charity is *not* subject to

tax *and* provides a charitable contribution deduction to minimize tax on the

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This lifetime income charitable pooled trust can provide a substantial increase in a family's wealth over simply paying the tax. If we simply paid the tax, then the family would net \$2.25 million after paying federal and state (estimated) tax of 25%, or \$750,000. If invested at 7%, then that would provide income of \$157,000 per year. That provides a value of \$1,668,557. When added to the \$2.25 million, that provides a total increase in wealth at \$3,918,557. If we avoid tax on that same \$3 million, we save tax of \$750,000 and invest the entire \$3 million to receive safe, predictable income of \$210,000 every year. If invested for 20 years, that equals a value of \$8,609,053. The preset value of that is \$2,224,743. When added to the \$3 million net proceeds from the sale, that provides a preset value of \$5,224,743. This is an increase in wealth of over 33%.

In addition, the client received an income tax deduction to avoid tax on other income in the amount of \$2,202,641. The total tax savings was \$1,564,977, representing the tax savings from the deduction and the charitable portion of the sale not subject to tax. This provides a substantial benefit to the family particularly when added to the investment income described above.

The tax cases

One of the leading cases on the tax advantage and treatment of personal goodwill is *Martin Ice Cream Co. v. Commissioner*, in which Arnold Strassberg sold the assets of Strassberg Ice Cream Distributors Inc. to Häagen-Dazs. Included in these assets were intangible assets, including his personal relationships with supermarket owners and managers. The Tax Court recognized that these intangible assets were personal goodwill owned individually by Strassberg and not the corporation or enterprise. Key factors cited by the Tax Court was that Strassberg never entered into a covenant not to compete or even an employment agreement with his own company, Strassberg Ice Cream.

A similar result was found in [H&M Inc., TC Memo 2012-290](#), where the individual

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agreement or restrictive covenant with the corporation or company being sold *prior* to the sale.

The buyer and seller should negotiate and establish the amount or purchase price allocable to the goodwill being transferred. Consider using a separate purchase agreement between the buyer and the business owner selling his or her own personal goodwill.

The personal goodwill should be contributed to a separate LLC prior to the sale. If a contribution is to be made to a charitable organization, that must be done before there is a binding agreement between the buyer and seller.

Perhaps the best determination of value is the amount established by an unrelated buyer and seller. Nevertheless, the contribution is reported on [IRS Form 8283](#). That form requires an appraisal for all contributions of property.

As indicated above, a little planning can provide a substantial tax savings and increase the wealth retained upon the sale of the family business.

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John M. Goralka is founder of [The Goralka Law Firm](#).

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