Allocating Transaction Value Between Personal and Corporate Goodwill and Minimizing Pushback from the IRS

Remember, improperly allocating a transaction value to personal goodwill is a RED FLAG for the IRS.

AXIOM VALUATION

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About Axiom Valuation Solutions

Axiom Valuation Solutions is a nationally recognized financial security and business valuation firm. We have conducted valuation assignments for clients throughout the U.S., Europe and Asia. We regularly conduct fair value assignments for financial institutions in terms of fair valuing portfolio assets and liabilities as well as acting as an advisor and assessing whether internal transfers between funds meet the fair value standard. Our Co-founder and Chairman, Dr. Stanley Jay Feldman, was a member FASB's Valuation Resource Group, an advisory group to FASB on fair value issues. AIRAS is currently used by institutional investors to both validate self-reported returns and fair values of alternative investment managers.

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Today's Webinar Will Answer the Following Questions

How is Personal Goodwill Defined?

1. The asset personal goodwill must meet the definition of goodwill from a tax perspective, and must be owned by an individual. Personal goodwill is associated with the attributes of its owner.

2. Goodwill is defined in legislative history, regulations and numerous court decisions.

3. The consensus is that goodwill represents the intangible qualities that bring continued patronage from both customers and suppliers.

How is Personal Goodwill Defined (Continued)?

1. The attributes of the owner create an attachment to customers and/or suppliers so that the owner's presence is a necessary condition for an exchange between the company and a third party to take place. Examples are:

   a) Medical practice where patients routinely request a certain doctor.
   b) Supplier network: Owner created a network of window replacement operators. Retail stores would call and he would price the job and assign a local operator to do the work.   There are two intangibles assets: the network list and personal goodwill.

2. Tax court precedent establishes that when an individual does not have an employment contract, the individual's personal relationships and other assets constituting goodwill are assets **distinct from corporate goodwill**. (See, Tax Court cases: e.g., Norwalk, Martin Ice Cream, Schilbach, Estate of Taracido)

Minimizing IRS Pushback on the Transfer of Personal Goodwill

1. Demonstrate that personal goodwill exists.

2. Demonstrate that personal goodwill is owned by the transferee:
   - Necessary and sufficient condition: No non-compete in place with the acquired firm

3. Purchase and sale agreement separate from the sale of corporate assets.

4. Separate non-compete in place with the buyer.

5. Consulting agreement in place with acquiring firm for a period no shorter than the expected time it takes to transfer the personal goodwill.

The Difference Between Personal and Corporate Goodwill

Selling Corporation

Selling Owner

Acquirer:

Tangible Assets
- Current Assets
- Fixed Assets

Intangible Assets
- Customer Relationships
- Trademark

- Personal Goodwill
- Non-compete with seller (must be in place to protect the personal goodwill purchased by the buyer)

- Corporate Goodwill: purchase price less the fair value of the aggregation of assets purchased

What are the Benefits of Personal Goodwill to the Seller?

1. Tax benefit: Since personal goodwill belongs to the seller and not the corporation, its sale is only taxed once at the individual capital gains rate.
   a) If the asset belonged to the corporation, then it would be subject to a double tax: once at the corporate capital gains rate and again when the proceeds of the sale are distributed.

2. Marital dissolution: although personal goodwill belongs to the individual it still may be subject to matrimonial division
   a) 24 states and the District of Columbia exclude personal goodwill from the marital estate; 19 states (Arizona among them) include personal goodwill in the marital estate, and eight states have no formal precedent.

3. Personal goodwill is not subject to the selling corporation's creditors.

Effective Tax Rate for a Stock Sale

Stock Sale	
In a stock sales, sellers pay one layer of taxation - capital gains tax	
Stock Sale Proceeds to Sharholder	$10,000
Shareholder Basis	$0
Shareholder Gain	$10,000
Federal Capital Gain Tax Rate	15%
Federal Capital Gain Tax Liability	$1,500
After-Tax Net Proceeds	$8,500
Effective Tax Rate	15.0%

Effective Tax Rate for an Asset Sale

Asset Sale

In an asset sale, sellers pay two layers of tax - corporate income tax

Transaction Price	$10,000
Tax Basis of Assets	$0
Gain on Sale of Assets	$10,000
Federal Corporate Income Tax Rate	35%
Federal Capital Gain Tax Liability	$3,500
Asset Sale Proceeds to Shareholder	$6,500
Shareholder Basis	$0
Shareholder Gain	$6,500
Federal Dividend Tax Rate	15%
Federal Dividend Tax Liability	$975
Total Federal Tax Liability	$4,475
After-Tax Net Proceeds	$5,525
Effective Tax Rate	44.8%

Asset Sale with Allocation to Personal Goodwill

Gain from the sale of personal goodwill is taxed at capital gain rates

Transaction Price			$10,000
Amount Allocable to Corporate Assets	$5,000	n/a	
Amount Allocable to Personal Goodwill	n/a	$5,000	
Tax Basis of Assets	$0	$0	
Gain on Sale of Assets	$5,000	$5,000	
Federal Corporate Income Tax Rate	35%	n/a	
Federal Dividend Tax Liability	$1,750	n/a	
Asset Sale Proceeds to Shareholder	$3,250	$5,000	
Shareholder Basis	$0	0	
Shareholder Gain	$3,250	5000	
Federal Dividend Tax Rate	15%	n/a	
Federal Dividend Tax Liability	$488	n/a	
Federal Capital Gain Tax Rate	n/a	15%	
Federal Capital Gain Tax Liability	n/a	$750	
Total Federal Tax Liability	$2,238	$750	$2,988
After-Tax Net Proceeds			$7,013
Effective Tax Rate			29.9%

What are the Benefits of Personal Goodwill to the Acquirer?

1. Tax benefit: The acquirer can amortize the fair value of all intangible assets purchased including personal goodwill over 15 years.

2. It is not necessary for the parties to a transaction to make a 338 election, treatment of a stock deal as if it were an asset sale, to take advantage of the tax benefits of personal goodwill.

3. In a stock transaction where an owner purchases the stock of the company and then purchases the personal goodwill of one or more of the key sellers, this personal goodwill is an intangible asset and hence can be amortized over 15 years.
4. Personal goodwill is property, belongs to a person and can be acquired.

Criteria for Minimizing IRS Pushback on the Value of Personal Goodwill

1. Personal goodwill must be fair valued along with other purchased assets.

2. Cash flows used to value all intangible assets, including personal goodwill, should be those the acquirer used to price the transaction.

3. The fair values of purchased assets, including personal goodwill, should not exceed the transaction price. In other words, corporate goodwill should be 0 or positive; no bargain purchase- IRS RED FLAG.

4. If the analysis gives rise to corporate goodwill, then the implied rate of return on it should be larger than the returns on other assets including personal goodwill.

5. The IRR on the transaction should be equal to or greater than the weighted average cost of capital.

6. The value of personal goodwill should reflect the difference between the value of recognized intangible assets with and without the presence of the person to which the attributes are attached.

Case Study:

Calculating Personal Goodwill for the Seller of a Consulting Practice

Case Study: Facts and Circumstances

1. The founder started the consulting practice (C corporation) 20 years ago.

2. The practice has two streams of revenue
   - Traditional consulting
   - Research-based consulting

3. The customer base for each business segment is slightly different.

4. Customers are located all over the world and are well known and predominately public firms.

5. Over the years the founder has been contacted numerous times about potentially selling the business but for a variety of reasons decided not to sell.

6. The acquirer purchased the assets of the corporation and the personal goodwill of the founder.

Case Study: Establishing Personal Goodwill

Personal goodwill needs to be established before it can be calculated. The table below reviews the criteria for establishing personal goodwill.

Facts and Circumstances Surrounding the Business				
	Personal Goodwill Indicators			**Business Goodwill Indicators**
x	Small entrepreneurial business highly dependent on employee-owner's personal skills and relationships			Larger business, which has formalized its organizational structures and institutionalized its systems and controls
x	No pre-existing CNTC and/or employment agreement between selling company and employee-owner			Owner-employee has pre-existing CNTC and/or employment agreement with selling company
x	Personal service is an important selling feature in the company's product or services			The business is not heavily dependent on personal services
	No significant capital investment in either tangible or identifiable intangible assets		x	The business has significant capital investments in intangible but not tangible assets
x	Only employee-owners own the company			The company has more than one owner, some of whom are not employees
x	Sales largely depend on the employee-owner's personal relationships with customers			Company sales result from name recognitions, sales force, sales contracts, and other company-owned intangibles
x	Product and/or services knowhow, and supplier relationships, rest primarily with the employee-owner			Company has supplier contracts and formalized production methods, patents, copyrights, business systems, etc.
Deal Structure				
	Personal Goodwill Indicators			**Business Goodwill Indicators**
x	Buyer has insisted on, and bargained for, a separate personal CNTC and/or employment agreement			Buyer has not insisted on, and bargained for, a separate personal CNTC and/or employment agreement
x	There is a separately bargained-for agreement to purchase personal goodwill.			There is no separately bargained-for agreement to purchase personal goodwill
	Personal seller financing is part of the consideration, with right of offset (e.g., loss of existing customers)			Seller financing is with the company, with no right of offset
	An earnout is part of the consideration; payout depends on future company sales and/or earnings		x	An earnout is not a significant part of the consideration
x	A strategic buyer's acquisition premium can be traced to attributes found in personal goodwill			A strategic buyer's acquisition premium can be traced to attributes found in business goodwill

Case Study: Fair Value of Assets Acquired

Row		Fair Value	Useful Life
	Tangible Assets		
1	Current Assets excluding cash	$1,595,977	
2	Cash & Marketable securities	$1,043,164	
3	Net Fixed Assets	$58,438	
4	**Total Tangible (R1 + R2 + R3)**	$2,697,579	
	Intangible Assets		
5	**Total Value of Brand Names**	$450,820	Indefinite
6	**Total Value of Report Library**	$537,838	5 Years
7	**Total Value of Non-Competes**	$297,890	5 Years
8	Consulting Customer Relationships	$140,931	3 Years
9	Research Customer Relationships	$1,112,907	4 Years
10	**Customer Relationships Total (R8 + R9)**	$1,253,838	
11	**Workforce**	$395,778	
12	**Total Value of Intangible Assets Excluding Workforce (R5 + R6 + R7 + R10)**	$2,540,386	
13	**Tangible + Intangible Assets (R4 + R12)**	$5,237,965	
14	**Personal Goodwill**	$1,424,448	
15	**Purchase Price**	$5,633,108	
16	**Corporate Goodwill (R15 - R1 - R3 - R12 - R14)**	$13,860	
17	**Enterprise Value**	$6,485,640	
18	**Tax Amortization Benefit**	$585,366	
19	**Enterprise Value Including Intangibles' Tax Amortization Benefit (R17 + R18)**	**$7,071,006**	

Case Study: Personal Goodwill Calculation

Step 1: Calculate loss rates for consulting & research customers

	Loss rate with owner	Loss rate without owner
Consulting	31%	31%
Research	7.75%	25%

In this case, personal goodwill is derived from the differences in customer retention for research customers, when the owner is active in the business

Step 2: Create two scenarios for the value of the research customer list. One using the loss rate with the owner and the other using the loss rate without the owner

		Value after Amortization Benefit	Value Before Amortization benefit
1	Value of research customer relationships with Owner	$2,537,355	$2,200,174
2	Value of research customer relationships without Owner	$1,112,907	$975,895
3	**Personal goodwill**	**$1,424,448**	**$1,224,280**

Conclusion: the difference of the two values is attributed to personal goodwill

Case Study: Economic Balance Sheet

		A	B	C	D	E
Row	**Economic Balance Sheet**	**Fair Value at the Valuation Date**	**Rate of Return**	**Source**	**Weight (W)**	**Weighted Rate (R_W)**
1	Working Capital	$200,000	2.17%	(1-YR Yield Spread + 3-Month LIBOR)*(1-Tax Rate)	3.57%	0.077%
2	Net Fixed Capital	$60,000	7.50%	Risk Free Rate+Unlevered Market Risk Premium	1.07%	0.080%
3	Total Value of Brand Names	$450,000	22.93%	Cost of Equity	8.04%	1.843%
4	Total Value of Report Library	$540,000	15.00%	Assigned	9.64%	1.446%
5	Total Value of Non-Competes	$300,000	22.93%	Cost of Equity	5.36%	1.228%
6	Customer List: Consulting	$140,000	22.93%	Cost of Equity	2.50%	0.573%
7	Customer List: Research	$1,100,000	22.93%	Cost of Equity	19.64%	4.504%
8	Personal Goodwill	$1,400,000	20.75%	WACC	25.00%	5.187%
9	Purchase Price	$5,600,000			Sum	14.939%
10	Total Tangible Capital (A1+A2)	$260,000				
11	Total Intangible Assets (Sum of A3:A8)	$3,930,000				
12	Residual Goodwill (A9-A10-A11)	$1,410,000	23.07%	(WACC - E8) / D12	25.18%	5.807%
				WARA		20.75%
				WACC		20.75%

The rate of return on residual goodwill is higher than the rates applied to the other assets. This reflects the extra risk that is inherent in goodwill.

The weighted average return on assets should equal the weighted average cost of capital. If it does not, then this is indication that an error has occurred.

Case Study: Internal Rate of Return

In this case, the IRR was higher than the WACC . Thus the transaction was a good deal for the buyer.

ABC Corporation	Year 0
	Purchased Enterprise Value[1]
Free Cash Flows	-$5,000,000.00
NPV	$0
IRR	26.45%
WACC	20.75%
1. Purchase Price net of current operating liabilities and total tax amortization benefit.	

Case Study: Cost of Capital

Cost of Capital			
			Source
	Valuation Date	10/1/2012	
	Cost of Common Equity		
1	Risk Free Rate(1)	2.41%	20 Year T-Bond Federal Reserve
2	Beta	0.6209	Average Unlevered Beta for Public Finance Comps
3	D/E Ratio	0.1258	Median D/E Ratio for Public Market Research Comps
4	Levered Beta	0.668	Row 2 * (1 + (Row 3) * (1 - Row 11))
5	Market Risk Premium	6.62%	Morningstar: 2012 Valuation Edition Table 5-6
6	Size Premium	6.10%	Morningstar: 2012 Valuation Edition Table 7-7
7	Firm Specific Risk Premium	10.00%	Axiom
8	Weight of Equity	88.83%	1 / (1+ Row 3)
9	**Cost of Common Equity(2)**	**22.93%**	Row 1 + (Row 4 * Row 5) + Row 6 + Row 7
10	Cost of Debt	5.65%	Axiom Credit Rating Model
11	Tax Rate	40.00%	Axiom
12	Weight of Debt	11.17%	Axiom
13	**After Tax Cost of Debt(3)**	**3.39%**	Row 10 * (1- Row 11)
14	**Weighted Average Cost of Capital(4)**	**20.75%**	(Row 8 * Row 9) + (Row 12 * Row 13)

(1) 20 Year Treasury Bond rate at valuation date

(2) Cost of Equity=Risk Free Rate + (Beta * Market Risk Premium) + Size Premium + Firm Specific Risk Premium

(3) After Tax Cost of Debt= Cost of Debt*(1-Tax Rate)

(4) Weighted Average Cost of Capital= (Weight of Debt*After Tax Cost of Debt)+(Weight of Equity*Cost of Equity)

Some Final Thoughts

1. Personal goodwill cannot be calculated separately from the value of the other assets purchased.

2. There will be IRS pushback if the split between personal and corporate goodwill is seen as arbitrary.
   - Why? Because the buyer has no skin in the game.

3. Personal goodwill typically emanates from one of three sources:
   - Customer relationships
   - Supplier relationships
   - Special skills or talents of the person or persons in question

Some Final Thoughts Continued

1. Personal goodwill share of transaction value: No hard and fast rules but if there are other intangible assets, including corporate goodwill, then the allocation to personal goodwill is necessarily bounded at less than 100% of the transaction price less the fair value of intangible assets. The boundary is defined in terms of the following:
   - Number and value of other intangible assets
   - Does the economic balance sheet make sense? Are the returns assigned to each asset including personal goodwill consistent with the implied return to residual goodwill. Is the calculated return on residual goodwill greater than the assigned returns on other assets.
   - Is the IRR on the transaction equal to or greater than the WACC?

2. Personal goodwill is an asset that is embedded in the value of one or more of the assets of the selling business. Its value needs to be separated from these assets so it can standalone for transaction purposes.