From Double Tax to Ice Cream

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Mr. Merric presents nationwide more than a dozen annually. He is honored to have spoken at:

- Regis Campfield's Notre Dame Tax and Estate Planning Institute (2007) & (2009);
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- Chicago Bar Association (2004), (2007-2010).

Mark Merric has had three, four, and five part series published in Estate Planning Magazine, Journal of Practical Estate Planning, and Leimberg LISI. He is also a co-author of the following three treatises:

- The Asset Protection Planning Guide: A State-of-the-Art Approach to Integrated Estate Planning, Commerce Clearing House (CCH) treatise, first edition;
- Asset Protection Strategies, American Bar Association (two chapters); and
- Asset Protection Strategies Volume II, American Bar Association published Apr. 2005 (MM responsible for 1/5 of the text).

收购者通常更愿意购买资产

Purchaser Will Want to Buy Assets

1. 因为资产可以折旧
   Depreciate the purchase price
2. 并且，不会涉及不明确的债务
   Does not buy unknown liabilities
3. 再者，20%的所得税问题
   Income Tax Problem 20% to 30% of the sales price

A. Purchaser Will Want to Buy Assets

A purchaser will almost always prefer to purchase assets, rather than owning the stock. First, under U.S. law, the purchaser may almost always depreciate the purchase price. Even goodwill may be written off over fifteen years under IRC § 197.

Second, many times a corporation has some unknown liabilities. If assets are purchased, these liabilities generally stay with the corporation and do not flow to the purchaser. A major exception to this general rule is environmental liabilities. Under U.S. law, any purchaser of real property that has an environmental issue is also liable for the cleaning up the property.

Third, whoever purchases the stock also purchases the tax problems when they go to sell the C corporation's assets in the future. With many corporation interests, this tax problem may be as high as 20% to 30% of the sales price. This forces the seller to reduce their sales price by this 20% to 30% if they insist that the purchaser purchase stock.

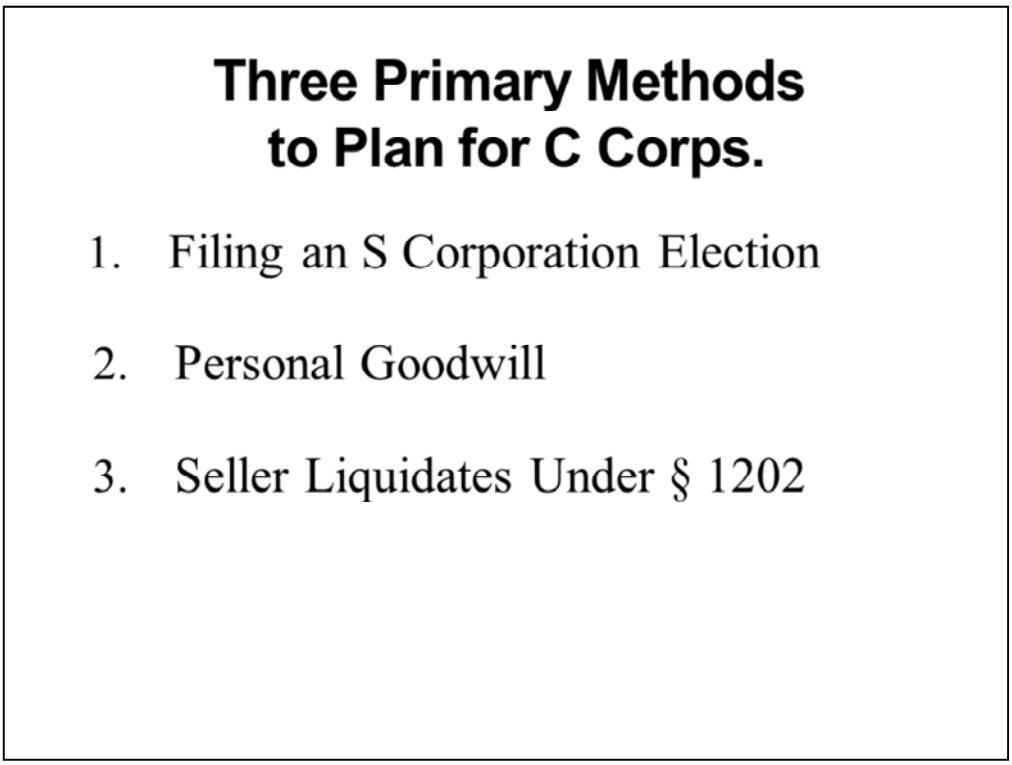
c. 购买资产

相比于购买股权，购买者通常更愿意购买资产本身。

主要有三个理由，首先，按照美国现行法律，资产购买者可以以购买价格来折旧资产，即使是商誉也能购折旧 15 年。

其次，大部分的股份公司都有一些不明确的债务，如果购买资产的话，这些债务不会从出售资产的公司转移到购买者身上。但由一个例外是在环境保护责任方面，房地产的购买者将负有责任清理资产。

第三，购买股票的人同时也会面临将来他们出售资产时的税务问题。对于大部分的矿产权益，该税收问题通常会高达销售价格的 25%到 30%，这将迫使出售者降低销售价格 25%到 30%来出售股权而非资产本身。

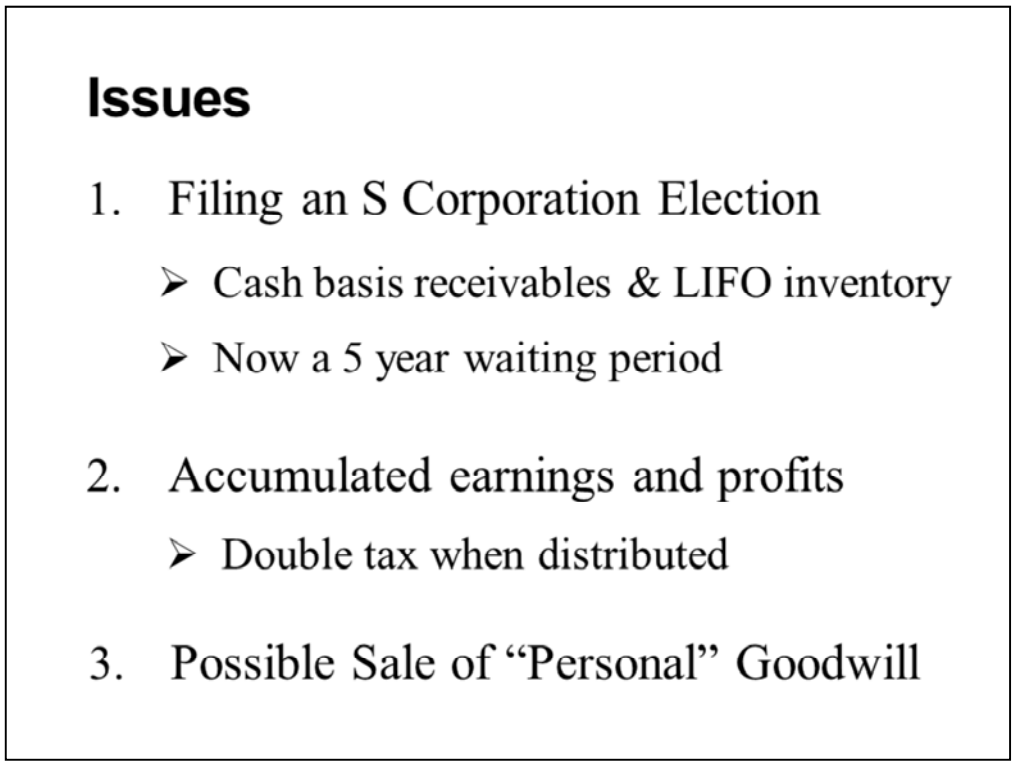


B. Three Planning Methods

Naturally, the simplest way to avoid the triple tax on sale issue is to have elected S corporation in the first place. However, the purpose of this outline is discuss situations where we have a C corporation, and methods to mitigate the triple tax on sale. These methods are ranked from least aggressive to most aggressive.

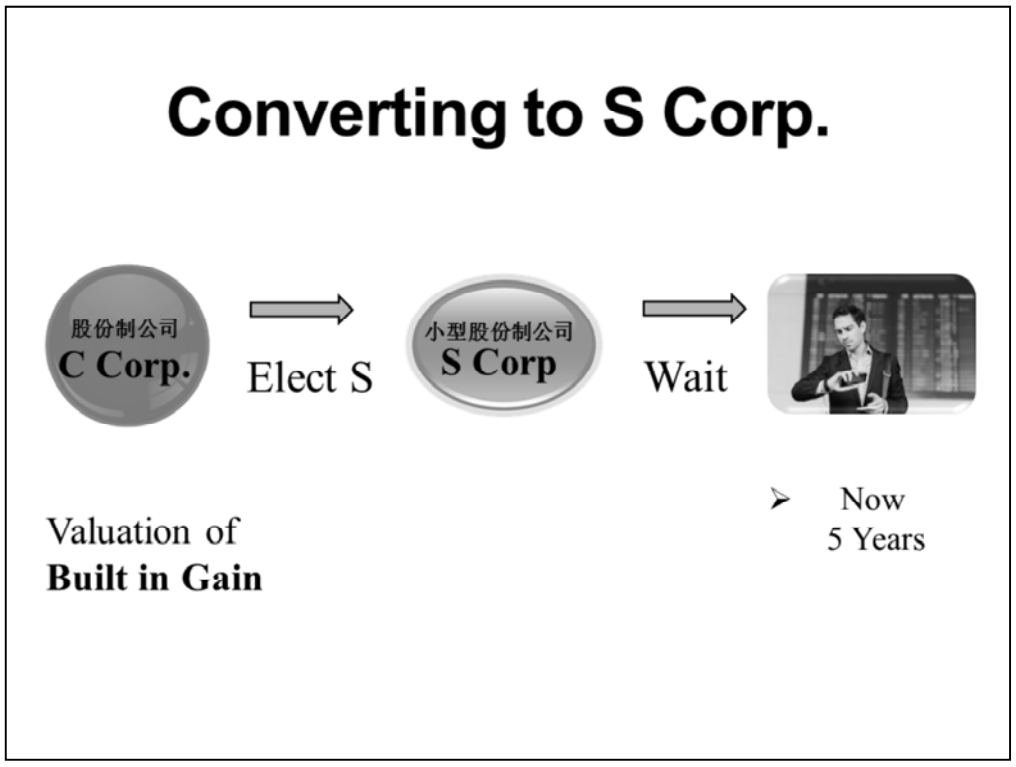
First, the C corporation may file an S election and wait 5 years for the built in gain tax to evaporate. However, as discussed in the following slides, there may be tax issues when electing S corporation status for a C corporation with cash basis receivables or LIFO inventory. In the event the client cannot wait five years, with the right fact pattern, the client may take the position that the goodwill is owned by the client, not the company. The sale of the goodwill at the personal level would be a capital gain.

The third method is for the seller to liquidate the corporation under § 1202 and then sell the assets. This is the most aggressive of the methods because there is not much authority that a liquidation will qualify under § 1202.



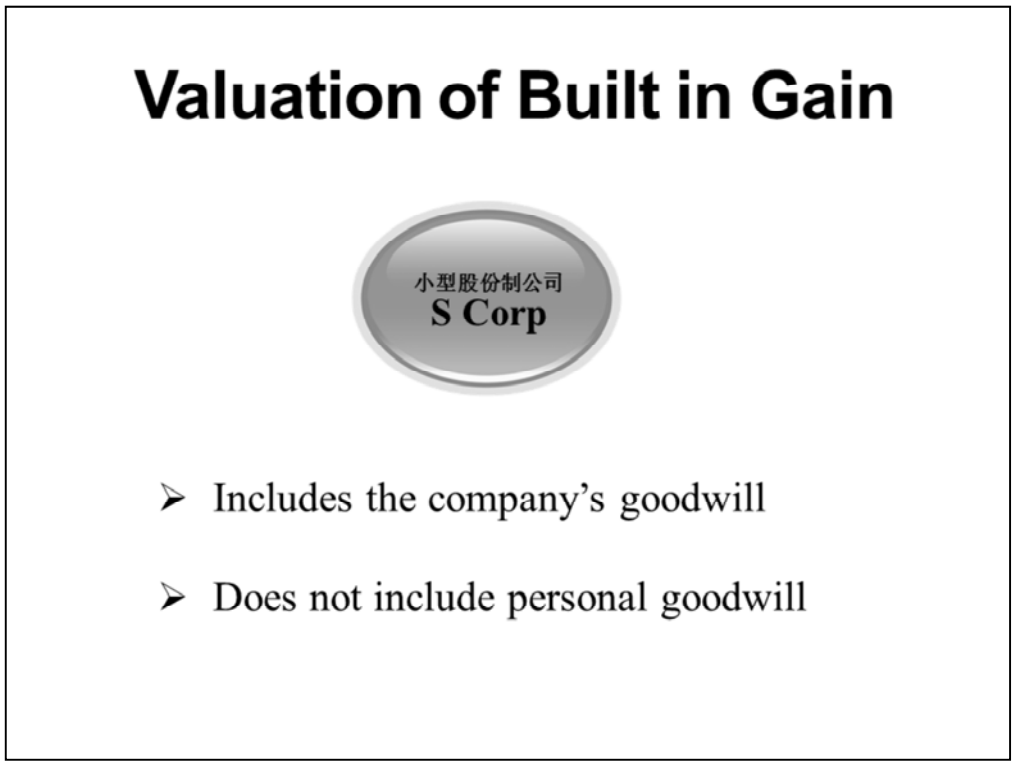
C. S Corporation Election

There are two issues when making the S corporation. First, waiting the applicable period of time, which is now 5 years; and second, whether the C corporation earnings and profits should be paid out before the election.



1. S Corporation Election

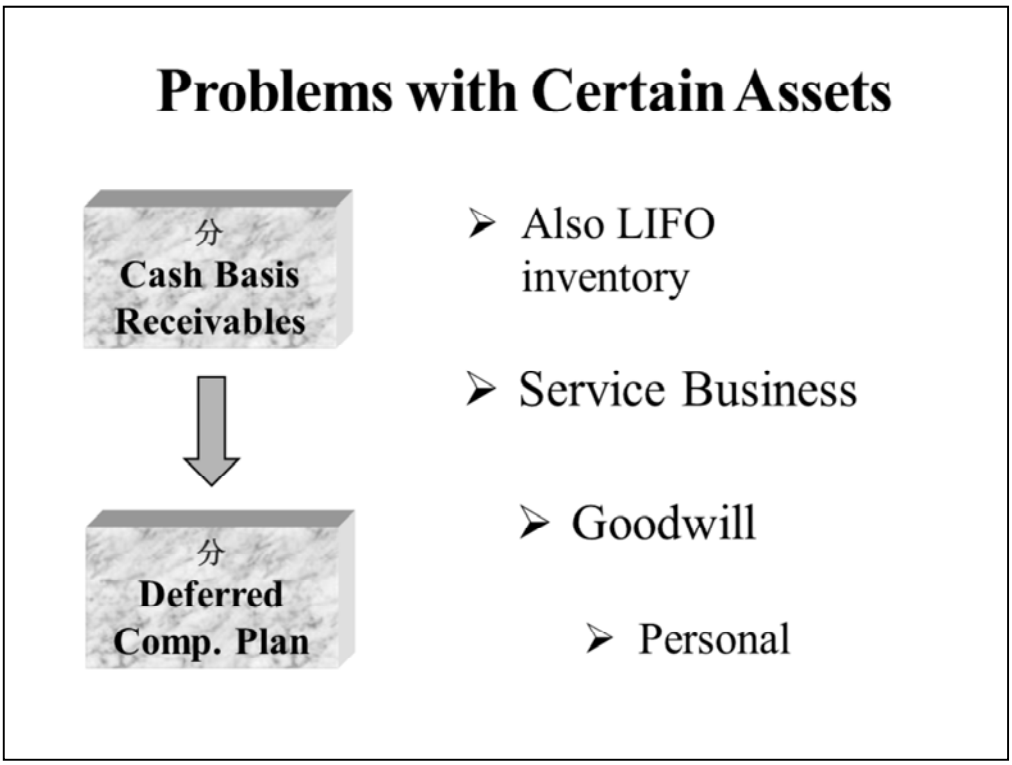
Subject to the accumulated earnings and profits issue discussed in the next few pages, the simplest method to eliminate the double tax on sale of assets issue is for the C corporation to make an S election and wait out the built in holding period. The built in gain holding period has changed with certain tax acts from initially a ten year period from the date of election, to selling the assets of the corporation in certain tax years seven or five years after the election. Now the look back period has been changed to five years. This is not an extender provision.



a. Valuation of Built in Gain

Another key aspect is a business valuation of the built in gain should generally be performed when the S election is made. The built in gain amount is required to be reported on form 1120S. If no built in gain valuation is made at the time of the S election, one made five years later may well not support the amount claimed on the initial 1120S. Naturally, the Service will have its own valuation of what it considers is the correct amount.

Also, when valuing the built in gain, the valuation person should look at whether the goodwill should be attributable to the owner. If so, this would reduce the amount of the built in gain. Please see discussion of personal goodwill in the pages that follow.

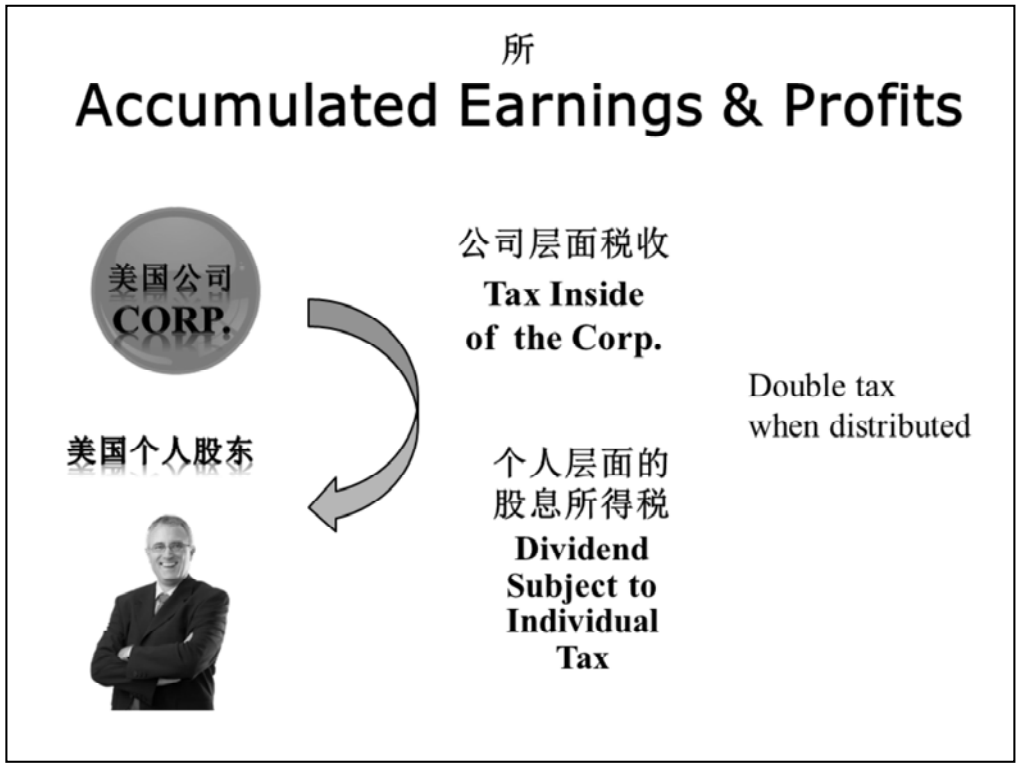


b. Problems With Certain Assets

There are primarily two types of businesses that have problems with simply making an S election and waiting for the built in gain period to pass: (1) service businesses with cash basis receivables; and (2) businesses with LIFO basis inventories.

In general terms, to the extent of the difference between receivables and payables, built in gain will be recognized in the year following the S election. In the Built in Gain Planning outline, we discussed accruing a bonus or creating a deferred compensation plan to eliminate the gain. As discussed in that outline, any bonus or deferred compensation is limited to reasonable compensation as discussed in the Reasonable Compensation Outline. This then begs the question whether the entire built in gain including the goodwill value of the business may be eliminated by accruing a bonus or adopting a deferred compensation plan?

For most service businesses, one may well take the position that the goodwill is something referred to as "personal" goodwill, not goodwill of the business. If the goodwill is personal goodwill attributable directly to the owner, then this value would not be part of the built in gain computation and the accrued bonus or deferred compensation plan may well solve the built in gain issue. The concept of personal goodwill will be discussed in detail in the following pages.

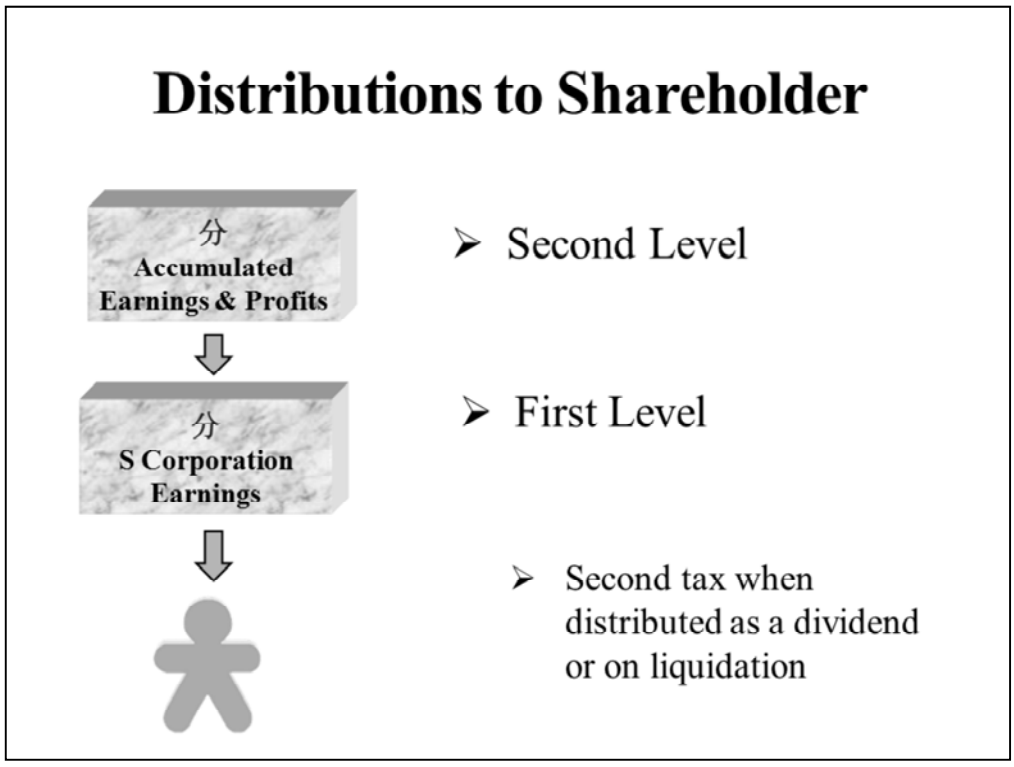


2. Accumulated Earnings and Profits

When a corporation makes a payment to a shareholder, the income will be taxed twice. First, the income is taxed at the corporate level. Second, when the shareholder receives a dividend it is taxed at the individual level. This second tax is because a dividend is not a deductible expense. These two levels of tax are commonly referred to as a "double tax on dividend income." When a C corporation with accumulated earnings and profits makes an S election, there will be a second tax if the accumulated earnings and profits are distributed as a dividend or when the corporation sells its assets and distributes the after tax proceeds.

2. 公司所得税的两个征收层面

当公司分配收益给股东时，这些收益将会被两次征税。首先，收益将在公司层面被征税。其次，当股东收到这些股息时将再次被征收个人所得税。会产生这两次征税是因为这些股息在付给股东时公司不被允许抵扣税前收入。这两个层面的税收一般被称为"股息收入的双重税收"。

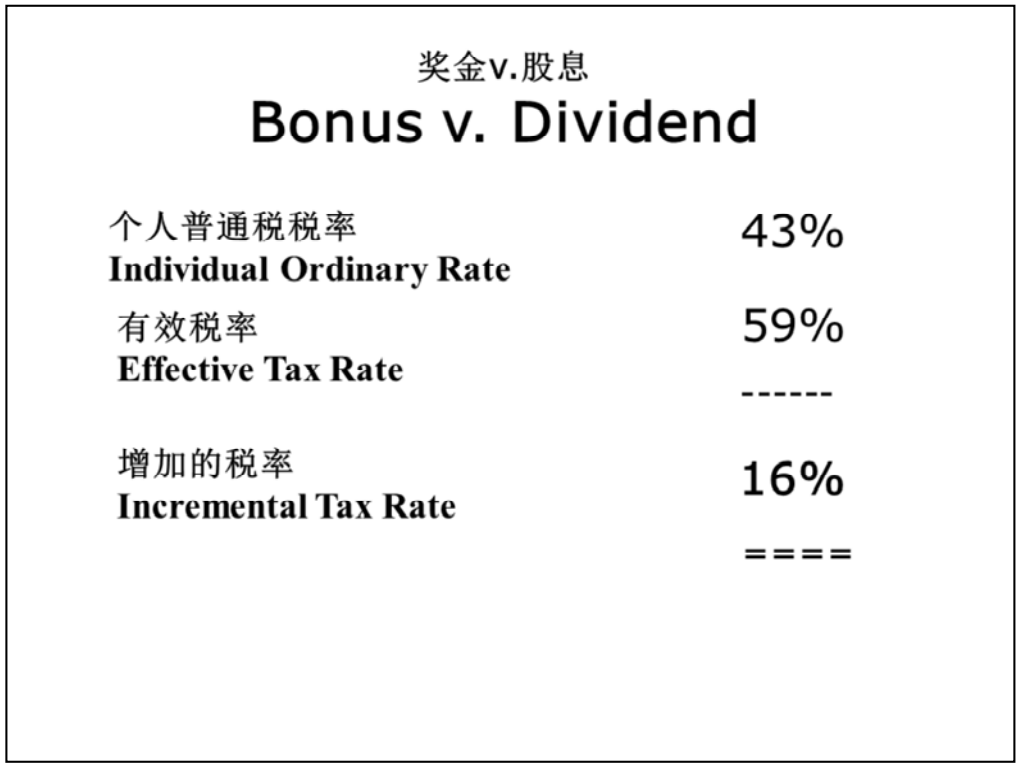


a. Taxation of Distributions

With a C corporation, dividends first come out of earnings and profits, second as a return of capital, and third as a capital gain. Conversely, with an S corporation, distributions come out of the following categories:

1. S corporation earnings;
2. earnings and profits;
3. shareholder basis; and then
4. a return of capital. IRC § 1368.

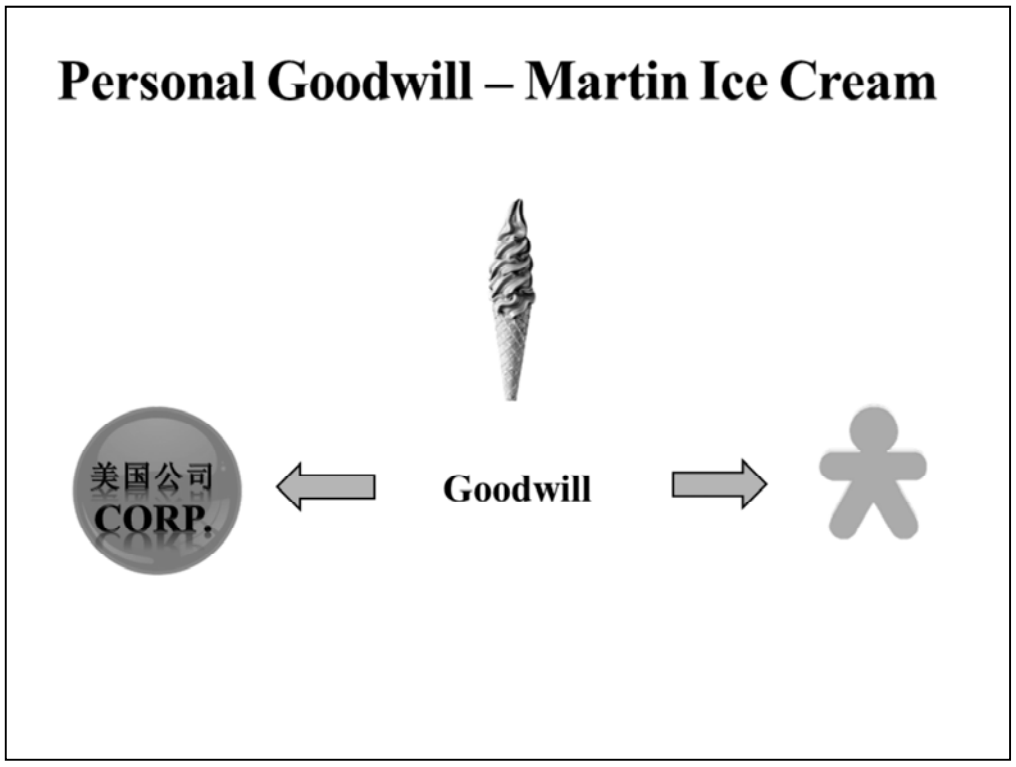
When a C corporation with accumulated earnings and profits makes an S election, there will be a second tax if the accumulated earnings and profits are distributed as a dividend or when the corporation sells its assets and distributes the after tax proceeds.



b. Bonus of Accumulated Earnings and Profits

If the accumulated earnings and profits of a corporation may be reduced to zero by paying the individual shareholder a bonus, then the effective income tax rate on the transaction is 43%. Conversely, if the amount is paid as a dividend, the effective income tax rate is 59%. Therefore, the bonus strategy saves approximately 16% on the double tax issue. Whether it will be possible to bonus out the accumulated earnings and profits depends on whether such compensation will be reasonable.

从前面的分析可以看到，如果公司利用支付股东奖金来降低公司的应纳税收入，那么总的有效税率将变成 43%，但如果使用支付股东股息的方式来降低公司的应纳税收入，那么有效税率为 59%，因此支付奖金的方式比支付股息的方式节省一笔收益 16%的所得税。



D. Personal Goodwill and Martin Ice Cream

In layperson's terms, goodwill may generally be defined as the value of the business over the fair market value of its assets. In tax terms, goodwill is the intangible value of the continued patronage. (Omnibus Budget Reconciliation Act of 1993, H.R. Rept 103-111, 103d Congress, 1st Session, House Committee Report, PL 103-66; § 1.197-2(b)(1); *Houston Chronicle Pub. Co.,* 481 F.2d 1240 (5th Cir. 1973); *Nelson Weaver Realty Co.,* 307 F.2d 897 (5th Cir. 1962). When defining and distinguishing personal goodwill from corporate goodwill, the Tax Court stated, "goodwill does not adhere to a business or profession solely on the personal ability, skill, integrity or other personal characteristics of the owner." *Macdonald,* 3 T.C. 720 (1944). Stated a little more clearly, good will does not become corporate goodwill if such goodwill is based on the personal ability, skill, integrity of the owner." Valuation experts typically use concepts such as earnings before interest, depreciation, taxes, and amortization (EBITA) divided by a capitalization rate (or multiplied by a multiplier) to begin to determine the fair market value of the business. From this the fair market value of the tangible assets as well as liabilities are deducted to estimate the goodwill of a business.

Generally, the goodwill of the business lies with the business because it is the team effort of the employees that generated the income stream. However, in many personal service businesses, it is actually the personal relationships of the owner with the clients that generates the goodwill. When the goodwill is attributable primarily to the owner, this is what is referred to as personal goodwill.

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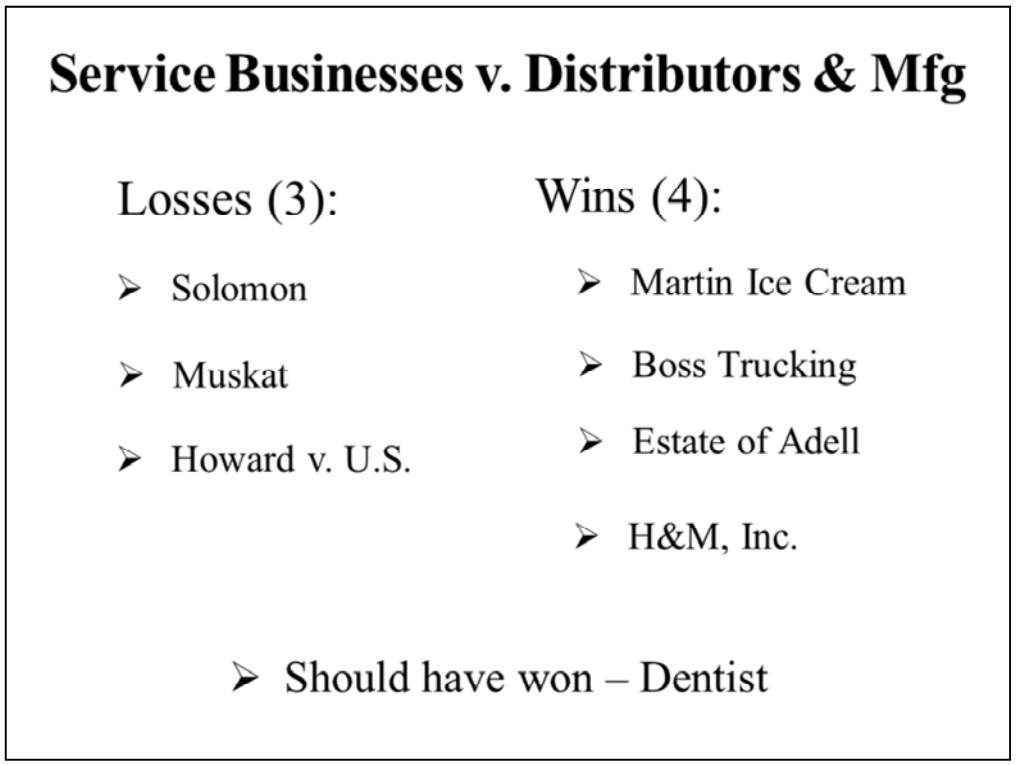


When reviewing earlier personal goodwill cases, one might conclude that most taxpayers lost when asserting the position. In this respect, some practitioners concluded that *Martin Ice Cream* was an abnormal case. However, further analysis supports that personal goodwill will be upheld when the proper form is followed as well as a fact pattern that supports the goodwill is attributable to the owner. Therefore, the outline will first look the pitfalls of the three loss cases.

5 Keys to Personal Goodwill

1. From the first correspondence negotiate personal goodwill
2. Form over substance
3. No non-compete with the corporation
4. Nature of Client Relations
5. Business Valuation

There are the following five keys to supporting the taxpayer's position that he or she is selling personal goodwill: (1) The initial negotiations need to discuss the sale of the personal goodwill; (2) the form of the transaction needs to be respected, (3) the owner cannot have a preexisting noncompete agreement with the corporation (or possibly an employment contract); (4) the client relations must be attributable to the personal skills of the owner; and (5) the allocation to the personal goodwill should be supported by a business valuation.

Negotiate Personal Goodwill at the Beginning

- Solomon T.C. Memo 2008-102; Mfg iron ore
  - Manufactures Iron Ore – selling a product line
  - All negotiation drafts entered as evidence
  - Seller accountant e-mails – client list; tax plan
  - Client list / good will allocation
    - Corporate distribution

1. Negotiate Personal Goodwill From the Beginning

In Solomon, T.C. Memo 2008-102, the seller originally set out to sell the assets of the business and $16 million of goodwill held by the corporation. The buyer naturally also wanted a non-compete agreement. This gives us the standard three elements of an asset sale: (1) tangible assets; (2) intangible assets which is usually goodwill; and (3) a non-compete agreement.

In *Solomon*, all of the negotiations and drafts were entered into as evidence. The Tax Court noted that the "initial discussions did not address the price and terms of the sale, any noncompete agreements for any of the family members, or a customer list."

In addition to mentioning the terms of each draft, the e-mails of the Solomon's independent accountant were entered as evidence against personal goodwill. One e-mail from the Seller's (Solomon's) accountant stated, "Solomon was currently in the process of reengineering their process. At this point in time, the only property available to purchase is their customer list, because the process is worthless given the raw materials are not available." Naturally, the customer list was owned by the corporation.

A second e-mail from the accountant argued the tax strategy that the client list should be deemed owned ½ by the corporation and ½ by its owner. Further, it stated that if the IRS was successful in calling the ½ list owned by the client as a dividend distribution, the company would treat this as a bonus to the owner. Here, the accountant appears confused. The company had never transferred ½ the client list to the owner. Further, if it had, it would be a dividend, the courts very seldom allow a taxpayer to change the form of the transaction at a later time.

The result was the Tax Court held that there was no personal goodwill, the value of the company was in the client lists that were owned by the corporation.

Form Over Substance

- Muskat (5th Cir. 2009)
  - Processing meat & distribution
  - Amended return
    - Noncompete should be personal goodwill
  - Strong proof rule
    - One party seeks to alter for tax purposes
  - $59 M purchase; $16 M allocated to goodwill
  - Purchaser testified the $16 million was only goodwill

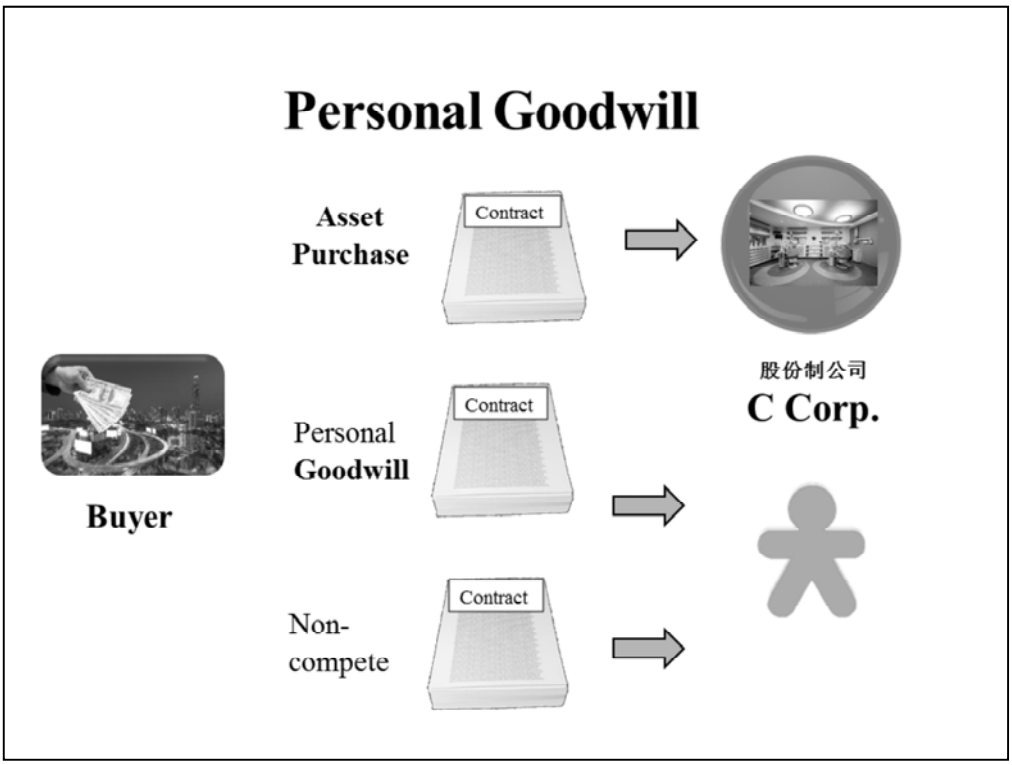
2. Form Over Substance

Substance over form is a doctrine the Service uses to reclassify a taxpayer's transaction to reflect the true nature of the transaction. While the doctrine is frequently asserted by the Service, it is a Catch 22 type of argument when the taxpayer attempts to assert that such taxpayer inadvertently cast the original transaction incorrectly. In this respect, the general rule is that as applied to taxpayers, form over substance governs. *Chisholm v. Commr.,* 79 F. 2d (2d Cir. 1935); *Estate of Maniglia,* T.C. Memo. 2005-247.

In addition to reluctance of the courts to allow taxpayers to use a substance over form argument to recast the transaction, there is the "strong proof rule," when one party seeks to change the allocations in a transaction for tax purposes. *Webb v. IRS,* 15 F. 3d 203 (1st Cir. 1994). Under this doctrine, the taxpayer has an elevated level of proof to recast a transaction.

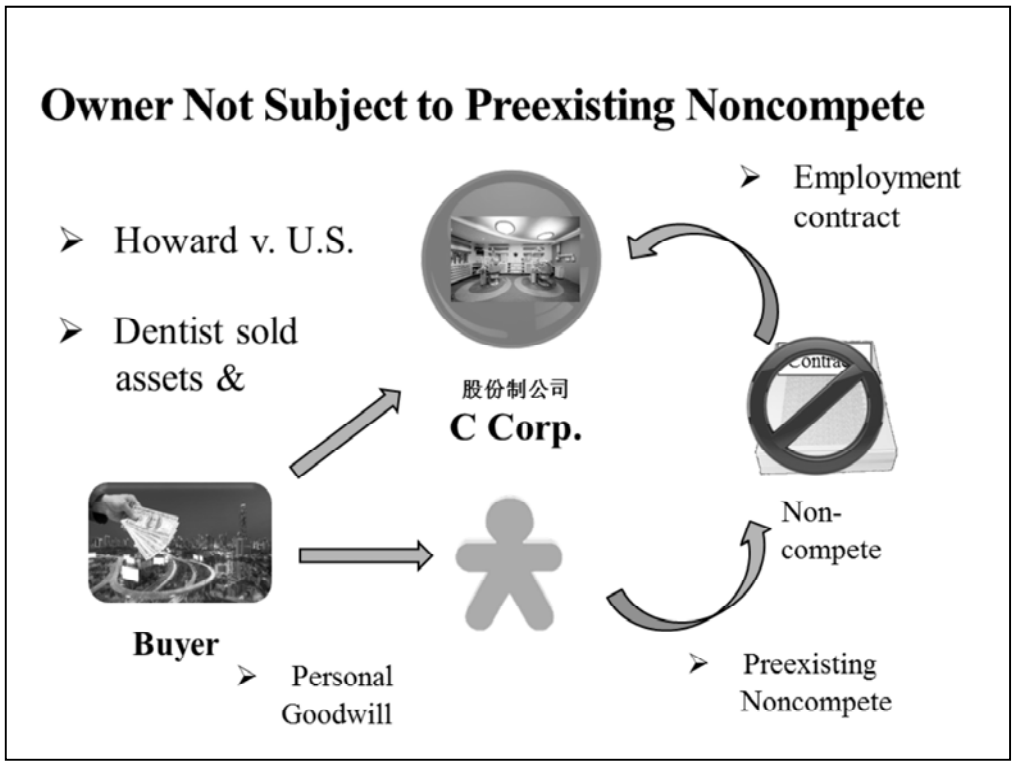
In this case, the parties allocated no amount to personal goodwill, nor was it even discussed. The $59 million sales price included $16 million for the corporate goodwill, and an additional $4 million was paid for a noncompete agreement. The taxpayer attempted to amend his personal tax return and reclassify the noncompete amount as personal goodwill.

At trial, the purchaser testified that he could not imagine that there was any other goodwill (i.e. personal goodwill). Therefore, the under the strong proof rule, the transaction as originally written was upheld.



There are three parts to the purchase of the assets of a business or there are three separate contracts. The seller will want the buyer to purchase (1) the assets and (2) the personal goodwill. The buyer will almost always want a non-compete agreement.

If one contract with three parts is used, both the corporation selling the assets as well as the owner(s) who are selling goodwill and are subject to a noncompete agreement must sign the agreement. If three contracts are used, the corporation executes the contract selling the assets. The owner executes both the non-compete and personal goodwill contracts. When three contracts are used, they typically reference the other contracts as part of the entire transaction.



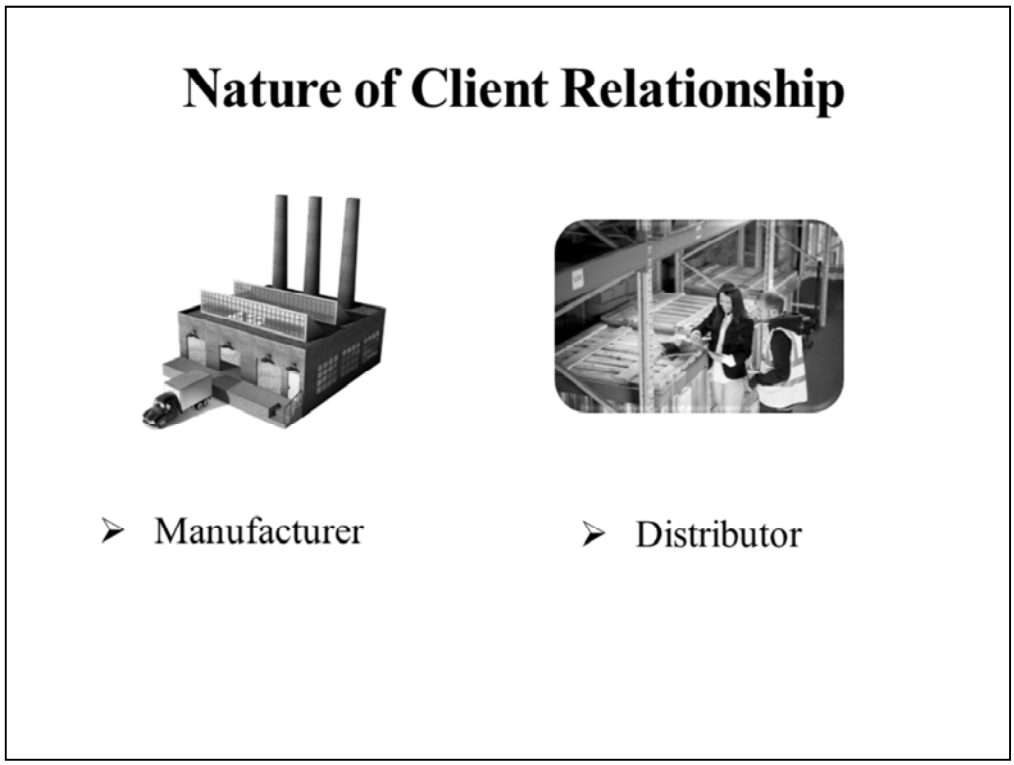
3. No Noncompete Agreement With Your Corporation

Howard is a case that the taxpayer should have one, if it had been well planned. Here, the taxpayer was a dentist who sold his practice. Naturally, as a dentist, the client relationship is primarily with the taxpayer. Therefore, there should have been goodwill.

Unfortunately, way back in the 1980's, the attorney who formed the corporation for the dentist advised him he needed an employment contract as well as a noncompete agreement. Attorneys frequently did this in the 1980's because the Service was attacking personal service corporations under the theory that they lacked substance. While the Service lost this argument, many businesses still have these employment agreements with its closely held owner. Dr. Howard was one of them.

The effect of the noncompete agreement between the closely held owner and his or her corporation is that it transfers the personal goodwill to the corporation. The result is that there is no personal goodwill. *Howard v. U.S.,* 2010 WL 3061626 (E.D. Wash. July 30, 2010); *affd* 108 AFTR 2d ¶ 2011-5993 (9th Cir. 2011).

While the cases have specifically mentioned noncompete agreements transferring any personal goodwill to the corporation, some authors have also voiced concerns with an employment contract that the owner may have with the corporation. Therefore, conservative planners may seek to make sure that the client selling the personal goodwill has neither a noncompete agreement with their corporation or an employment contract.



4. Nature of Client relationship

Some authors have mentioned that a manufacturer or distributor would not qualify for personal goodwill, because of the nature of the business. This view has some support from the dictum in *Solomon*, T.C. Memo 2008-12. Here, the Tax Court stated, "When we look at Solomon, a manufacturer of products, our fact pattern changes drastically and as a practical matter, the "goodwill" that is created is arguably more at the entity level, not so much at the individual shareholder/employee level.

The author thinks that the Tax Court needed to develop this statement a bit further. The question regarding personal goodwill is whether there is goodwill that is attributable to the owner's personal skill, ability, or integrity of the owner. *Macdonald*, 3 T.C. 720 (1944). In other words, it is the owner's relationship with the clients that determines whether there is personal goodwill.

With a larger manufacturer or distributor, the general rule may well be that there is a sales force. The sales force has the primary relationship with the client, and typically the sales force is subject to a noncompete agreement with the company. The result is that similar to *Howard,* the goodwill belongs to the company.

Conversely, if the primary sales efforts and client relationships are with the owner, then it is possible for both a manufacturer and a distributor to have personal goodwill. For example, *Martin Icecream* is a distributor case.

Relationship with the Clients

➢ Norwalk	Accountants
➢ Boss Trucking	Trucking Firm
➢ H & M, Inc.	Insurance Broker
➢ Estate of Adell	Television Station
➢ Martin Ice Cream	Distributorship

Reviewing the cases that have won, the client relationship was primarily with the owner selling the business. In *Norwalk*, T.C. 1998-279, the Service made the argument that when two CPAs liquidated their CPA practice and went their separate ways, there was a distribution of the goodwill to the CPAs. Remember, as a rule of thumb, CPA firms frequently sell for $1+ per annual revenues. Naturally, the Service position, would create an incredible tax to the CPA owners. However, the Tax Court stated that the goodwill was in the client relationships that were personal to the CPAs.

In *Bross Trucking,* T.C. Memo 2014-107, the Tax Court found that the client relationships as well as the owner's expertise in the trucking business is what created the relationships. Therefore, the goodwill was personal to the owner.

In H & M, Inc., the owner was insurance broker who sold his business to a bank. He continued to work for the bank during the transition. Again, the client relationships were with the owner, not the C corporation. H & M, Inc., TC Memo 2012-290.

In *Estate of Adell,* T.C. Memo. 2014-155, the father Franklin Adell owned a television station. However, it was his son, Kevin Adell that had all the key contacts and relationships with the customers. Therefore, when Franklin, the father, passed away, the Tax Court held that the personal goodwill was owned by Franklin, the son.

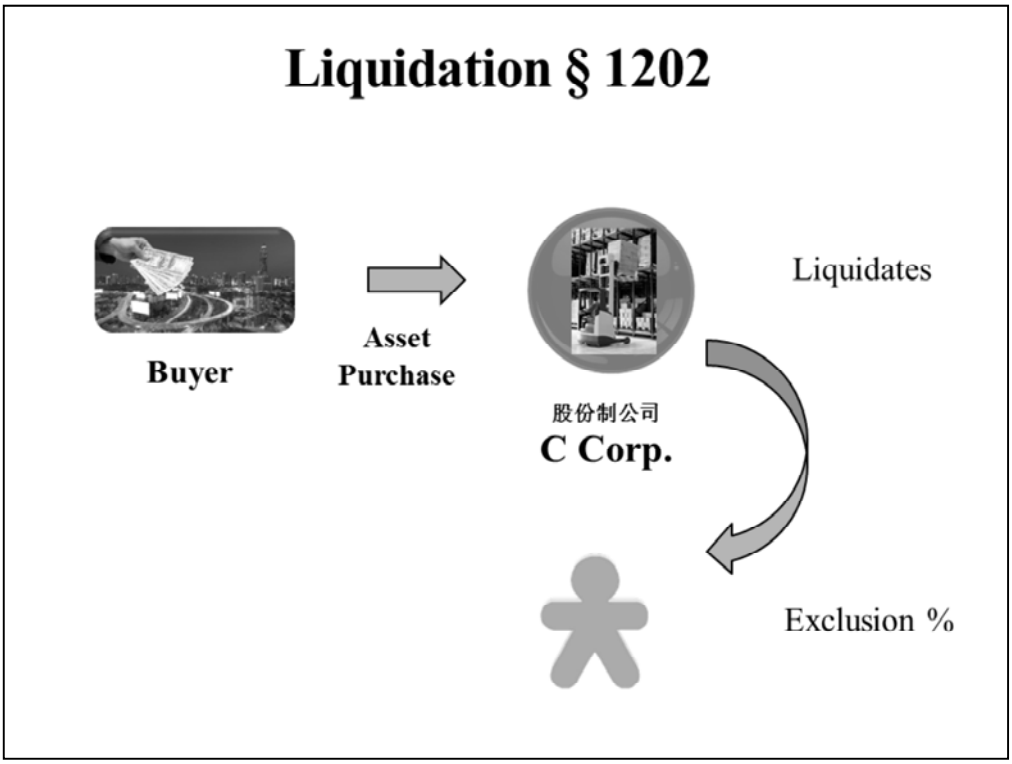
In *Martin Icecream,* Arnold Strassberg sold the assets of Strassberg Ice Cream distributors and his personal goodwill to Haagen-Dazs. Again, the key client relationships were with Arnold. Therefore, he owned the personal goodwill. *Martin Ice Cream,* 110 TC 189 (1989).

Business Valuation

1. Who are the client relationships with?
2. What are the special skills of the owner?

5. Business Valuation

As noted in the previous discussion, documenting the form of the transaction is one of the most important aspects to succeed with a case of personal goodwill. Part of this documentation a client should consider is a formal business valuation detailing the client relationships as well as the owner's expertise.



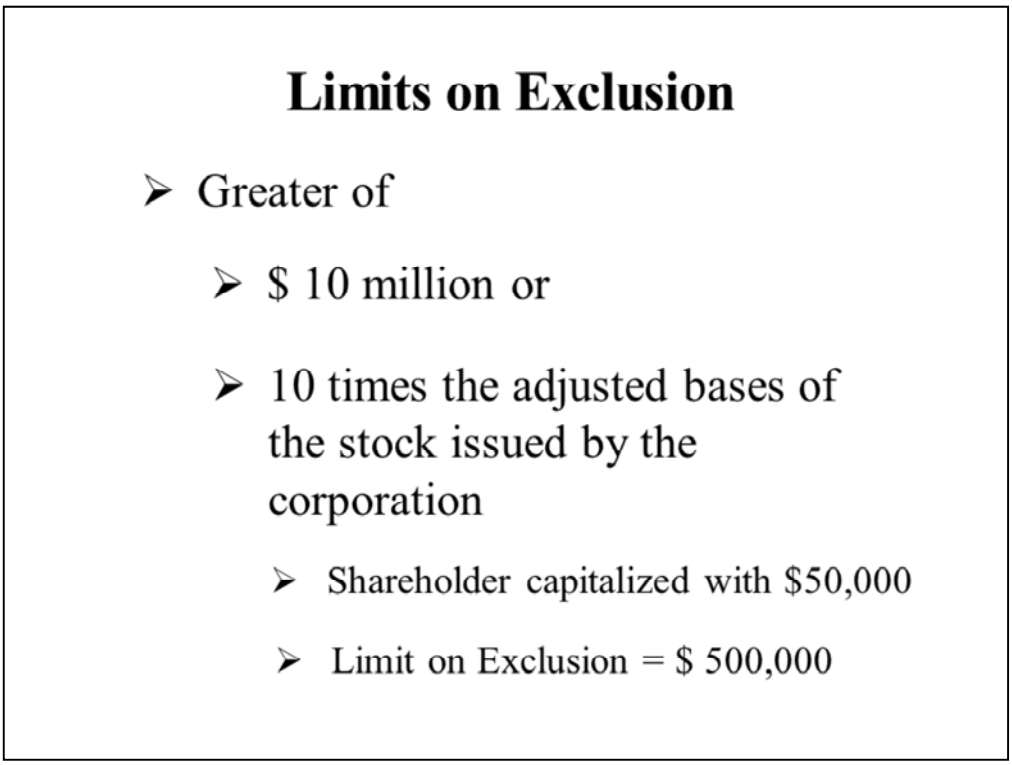
E. Liquidated Under IRC § 1202

One of the planning strategies on the triple tax on the sale of C corporation stock outline was to have the buyer purchase the stock and immediately liquidated the C corporation. Naturally, this would be a very hard negotiation to accept these terms.

Under the § 1202 liquidation strategy, the buyer purchases the assets, and the seller liquidates the company. If a liquidation, which is a big "if", and the owner meets the requirements of § 1202, then there would a certain percentage exclusion of the gain on the liquidation of the company. Unfortunately, the only authority the author has found that a liquidation may be included with § 1202 is paragraph 205 of the Small Business Jobs Act of 2010 Law and Explanation Analysis, which states that the exclusion not only applies to the sale of qualified business stock, but to the disposition transactions that are treated as sales or exchanges. If this is the case, § 331 liquidations would qualify for § 1202.

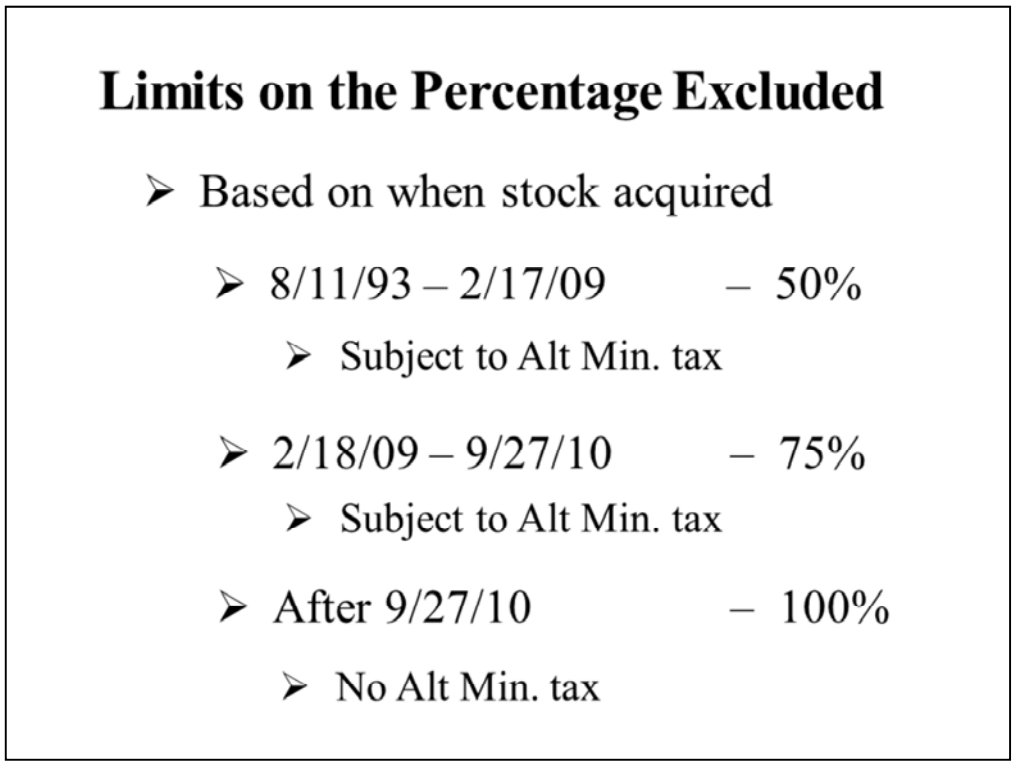
1. 5 Major Requirements

There are five major requirements to qualify for the benefits of § 1202. First, the stock must have been acquired after August 10, 1993. Second, the stock must be acquired by being issued from the corporation for money, property or services. It cannot be purchased from a preexisting owner, and it cannot be acquired by inheritance. Third, it must be a qualified subchapter business that generally means that the aggregate gross assets do no exceed $50 million and it is a C corporation. Pass through entities, including S corporations, do not qualify for the IRC § 1202 exclusion. Fourth, at least 80% of the corporations assets must be used for the active conduct of a trade or business and such corporation is not a DISC, RIC (regulated investment company) or a cooperative. Fifth, the stock must be owned by the taxpayer for at least five years. IRC § 1202(c).



2. Limits on the Exclusion

The amount of the exclusion is limited to the greater of $10 million or ten times the adjusted bases of the stock issued by the corporation. In the above example, if the owner capitalized the corporation with $50,000, the maximum amount that could be excluded would be $ 500,000.



3. Limits on the Percentage Exclusion

In addition to the limitation on the amount of the exclusion, there are limitations on the percentage exclusion based on when the stock was acquired. For stock that was acquired from August 11, 1993 through February 17, 2009, the exclusion amount is 50%. However, the taxpayer is subject to the alternative minimum tax on the amount excluded. For stock that was acquired from February 18, 2009 through September 27, 2010, the exclusion is 75%. However, this is also subject to the alternative minimum tax. Finally, stock acquired after September 27, 2010, the exclusion is 100%. However, this stock is not subject to the alternative minimum tax.