

Allocation of Bluesky / Goodwill in an Automobile Dealership Sale

By: John J. Pico, BA, JD

Automobile, dealership, sale, bluesky, goodwill, allocation, personal, enterprise, income, tax,

Goodwill, or blue sky, can be separated into personal and business (enterprise) goodwill. The distinction is important insofar as: (a) saving taxes in the sale of businesses; and (b) dividing assets in a marriage. In divorces, enterprise goodwill is considered marital property and can be divided, while personal goodwill is the sole property of the individual. Here we are interested in car dealership sales and are looking at assigning a portion of the sale proceeds to personal goodwill to save taxes.

The IRS defines goodwill as “the value of a trade or business based on expected continued customer patronage due to its name, reputation, or any other factor.” IRS Publication 535: Business Expenses, Ch. 9, Cat. No.15065Z.

The American Society of Appraisers defines goodwill as: “that intangible asset arising as a result of name, reputation, customer loyalty, location, products, and similar factors not separately identified.” And as “that intangible asset arising as a result of elements such as name, reputation, customer loyalty, location, products, and related factors not separately identified and quantified.”

Goodwill, however, can be separated into personal and business (enterprise) goodwill. Unlike enterprise goodwill, personal goodwill is the intrinsic value of services of a specific and identifiable person to a business.

The distinction between personal and enterprise goodwill is important insofar as: (a) saving taxes in the sale of businesses; and (b) dividing assets in a marriage.

In divorces, enterprise goodwill is considered marital property and can be divided, while personal goodwill is the sole property of the

individual. See: *May v. May*, 589 S.E.2d 536 (W. Va. 2003) and *Ledwith v. Ledwith*, 2004 Va. App. LEXIS 488 (October 12, 2004).

When a C Corporation is sold the enterprise goodwill is taxed at the corporate rate (which could be as high as 35%), and then again as a dividend (another 5 – 15%) when it is distributed. Excluding any state taxes, a \$3,000,000 gain could result in only \$1,500,000 after-tax dollars to a shareholder.

With some exceptions, sales involving S corporations, partnerships, sole proprietorships or other pass through entities, blue sky gets taxed only once as a capital asset. Note: One can also incur C Corp. tax with an S Corp, if the S Corp. is not at least ten years old and does not have, for example, adequate built in gains. (Visit your accountant for the fine details).

In this article we are interested in car dealership sales and are looking at assigning a portion of the sale proceeds to personal goodwill because, as CPA Carl Woodward, notes in the Spring 2006 publication of The AutoCPA Group's "Headlights": "For some dealerships, much of the total blue sky value is due to this personal goodwill."

The concept of separating goodwill with personal and enterprise distinctions first appeared in the 1986 Nebraska case of *Taylor v. Taylor* 386 N.W.2d 851 and then spread to other states. See: *Beasley v. Beasley*, 518 A.2d 545 (Pa. Super. Ct. 1986); *Hanson v. Hanson*, 738 S.W.2d 429, 434 (Mo. 1987); *Prahinski v Prahinski*, 75 Md App 113, 540 A2d 833 (1988); *In Re Marriage of Talty* 166 Ill 2d 232, 652 NE2d 330 (1995) and *Martin Ice Cream Co v. Commissioner* (110 T.C. 189 1998).

In 1998, *Norwalk v. Commissioner* TC memo 1998-279 held personal goodwill stems from an intangible asset that is the property of the individual, not the corporation, and that personal goodwill could be paid to owners because the employment contracts of the individuals expired when the corporation was sold.

(Some courts suggest a seller enter into a Non-competition Agreement to protect the value of personal goodwill, however, if the

personal goodwill portion of a purchase price was paid for a Non-competition Agreement, it would create ordinary income rather than capital gain.

Also, while Norwalk held personal goodwill is not transferable without a covenant not to compete, in most states and the Restatement of Contracts Non-competition Agreements are controlled by, among other things, standards of "reasonableness." And, in some states, enforceability is questionable.

Personal goodwill allocations have ranged between 10% and 90% of the total purchase price. In sale of Tresco Dealerships, Inc., roughly 40% of the goodwill was allocated to the dealer principal as "personal goodwill," resulting in a tax savings of approximately 27 cents on the dollar.

In on case a medical practice had a total appraised value of approximately \$600,000, with hard assets of \$165,000. The appraiser then allocated \$165,000 to the equipment and supplies, \$35,000 to corporate goodwill, and \$400,000 to the personal goodwill of the doctor.

When structuring asset sales of "C" corporations, buyers are usually agreeable to such allocations because it does not produce adverse tax consequences to them.

The IRS' evaluates personal goodwill in the context of the facts revolving around each sale and the selling corporation's contracts, articles, minutes, and such. Did the shareholder, for example, have a non-competition agreement with the corporation? Was there an employment contract that gave the corporation the benefit of the shareholder's personal goodwill? Did the buyer think he was purchasing personal goodwill? Did the seller think he was selling it? (See: Private Letter Ruling 9621002).

This article is limited to discussing "personal goodwill" and is not intended to cover all of the tax-saving methods available in the sale of a dealership. Talk to your accountant and tax attorney about other options, such as installment sales and such.