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PERSONAL GOODWILL AND THE FRANKLIN Z. ADELL CASE - AN UPDATE ON AN AWESOME CONCEPT

Introduction

To begin with, the phrase "personal goodwill" appears absolutely no where in the Internal Revenue Code, United States Code Annotated, or any state statute. Personal goodwill is a relatively new concept that not every legal or tax practitioner has heard of. It was given life in court cases over the past 20 years and is roughly defined as "the asset that generates cash profits of the enterprise that are attributed to the business generating characteristics of the individual, and may include any profits that would be lost if the individual were not present." Quite simply, personal goodwill is the intangible value a person (usually the owner or CEO) brings to the company. It stands in contrast to traditional goodwill in that traditional goodwill is the value attributable to the company itself arising from intangible advantages such as location, customer quality, employees, etc... While this dichotomy may seem insignificant, personal goodwill is an important concept to legal and tax practitioners for three reasons.

Federal Tax Ramifications

When selling any corporation, the buyer is always interested in purchasing the assets of a company to gain the advantage of lesser liability and the tax advantage of depreciating assets with a stepped up basis against income to reduce taxable income. While an asset sale gives rise to tax benefits to the buyer, the seller may suffer multiple tax detriments, especially in the case of selling assets of a C Corporation. With an almost certainty, in any sale, the seller will face 1) Taxes arising from ordinary income, 2) Taxes arising from depreciation recapture (also at the ordinary income tax rate), 3) Taxes arising from capital gains, and 4) in the case of a C Corporations, double taxation when the proceeds are distributed to the owners.

When selling an S Corporation, partnership, sole proprietorship, or other pass through entity through an asset or stock sale, ordinary goodwill does not present any problems. The sale of the goodwill gets taxed once, at the seller's level as a capital asset.

However, the problems begin when selling a C Corporation through an asset sale. Ordinary goodwill creates a tremendous tax burden that is not present in the sale of a flow through entity. During the sale, ordinary goodwill is taxed at the corporate level. Since C corporations do not get the benefit of the lower capital gains tax rates, the capital gain is taxed at the corporation's ordinary rate.

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