The background of the slide is a photograph of a rugged, snow-capped mountain range. The image is dark and moody, with the snow appearing as bright white patches against the dark, rocky terrain. The mountain peaks are jagged and steep, with snow clinging to the slopes and filling the valleys. The overall tone is professional and serious.

# PERSONAL GOODWILL VS. ENTERPRISE GOODWILL: WHAT'S THE DIFFERENCE?



Our team brings more than 90 collective years of experience with driving positive lasting outcomes for executives, attorneys, and accountants within privately held and publicly traded companies. We are familiar with questions about enterprise value when the enterprise may be entirely dependent on a single person for continued success.

The need to segregate the value of a company between personal and enterprise goodwill is incredibly relevant in today's valuation landscape. How the two are distinguished can have meaningful financial consequences and benefits for business owners and their stakeholders.

# WHAT YOU'LL LEARN

This eBook will help you assess the difference between personal goodwill and enterprise goodwill. You will gain an understanding of how to segregate value between a person and an enterprise, helping you to make confident decisions.

- The Distinctions Between Personal Goodwill and Enterprise Goodwill
- Attributes of Personal Goodwill
- Attributes of Enterprise Goodwill
- Use Cases for Personal Goodwill and Enterprise Goodwill
- Situational Applications
- Setting Precedent for Personal Goodwill
- Deciphering the Tax Court Rules



## The Distinctions Between Personal Goodwill and Enterprise Goodwill

The Internal Revenue Service 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.” The Tax Court recognizes a distinction between the goodwill of a business and the goodwill attributable to the owners of the business.

*Understanding these differences can empower you during valuation engagements and other legal matters.*



**Enterprise goodwill** (or “business goodwill”) is directly associated with the business. Consumers seek out the enterprise, are referred to the enterprise, or repeat patronage due to the enterprise.



**Personal goodwill** (or “professional goodwill”) is directly associated with an individual. Consumers seek out the individual, are referred to the individual, or repeat patronage due to the individual.

## Attributes of Personal Goodwill and Enterprise Goodwill

Many factors shape the distinction and use of personal goodwill and enterprise goodwill. Some attributes are clearly more personal or enterprise in nature, while others are more nuanced.

### Personal Goodwill

- Ability, Skill, and Judgment
- Work Habits
- Age and Health
- Personal Reputation
- Personal Staff
- Personalized Name
- Marketing and Branding
- Inbound Referrals
- Closeness of Contact
- Important Personal Nature


### Enterprise Goodwill

- Business Reputation
- Business Staff
- Business Name
- Business Location
- Multiple Locations
- Marketing and Branding
- Systems and Organization
- Inbound Referrals
- Recurring Revenue Stream
- Copyrights, Patents, Processes, Etc.



## Use Cases for Personal Goodwill and Enterprise Goodwill

Once you have a categorical sense of Personal Goodwill versus Enterprise Goodwill, you can begin to understand what specific characteristics that would segregate value to one or the other.

ATTRIBUTE	 PERSONAL GOODWILL	 ENTERPRISE GOODWILL
ADVERTISING	<ul style="list-style-type: none"> <li>• Person's name sells - reputation, experience, and skills</li> <li>• The business name is the name of the person</li> <li>• Photos of person</li> </ul>	<ul style="list-style-type: none"> <li>• Enterprise name sells without mentioning the person</li> <li>• Enterprise name different from person's name</li> <li>• Corporate logo</li> </ul>
REPEAT CUSTOMERS	<ul style="list-style-type: none"> <li>• Customers return due to a relationship with the person</li> <li>• Many other options for similar goods or services in the area</li> </ul>	<ul style="list-style-type: none"> <li>• Customers return due to location, convenience, price, or other enterprise-specific factors</li> <li>• Goods or services are unique to a particular area</li> </ul>
SALES	<ul style="list-style-type: none"> <li>• Sales based upon skills and reputation of the person</li> <li>• Many similar providers in the area</li> <li>• No formal referral contracts</li> </ul>	<ul style="list-style-type: none"> <li>• Sales based on proximity or enterprise affiliation</li> <li>• Referral relationships are contractually defined and transferable</li> </ul>
ORGANIZATIONAL STRUCTURE	<ul style="list-style-type: none"> <li>• New customers arrive seeking a particular person</li> <li>• Profits allocated on income production</li> </ul>	<ul style="list-style-type: none"> <li>• New customers arrive seeking a general service from the enterprise</li> <li>• Profits allocated equally among owners</li> </ul>
MANAGEMENT DEPTH	<ul style="list-style-type: none"> <li>• The business is either completely or mostly reliant on one person for income generation</li> <li>• Income associated with ownership interest would disappear if that person left the business</li> </ul>	<ul style="list-style-type: none"> <li>• The enterprise generates income from multiple producers</li> <li>• Income associated with ownership interest would not disappear if that owner left</li> </ul>
EMPLOYMENT AND NON-COMPETE AGREEMENTS	<ul style="list-style-type: none"> <li>• Employment or non-compete agreements do not exist</li> <li>• The key person is not secured by employment or non-compete agreements with the business</li> </ul>	<ul style="list-style-type: none"> <li>• Employment or non-compete agreements exist between person and business</li> <li>• Key employees are secured by employment or non-compete agreements with the business</li> </ul>



## Situational Applications

There are a number of situations where it can be beneficial to distinguish between personal goodwill and enterprise goodwill. Most commonly, we see the distinction between personal and enterprise goodwill being useful to achieve income tax savings at the time of the sale of a C corporation. Other examples include:

- Formation of closely held companies
- Conversion of a closely held C corporation to a closely held S corporation
- Sale of a closely held corporation
- Transfer of personal goodwill or closely held corporation stock
- Segregation of marital assets in the event of a divorce

The valuation of a closely held corporation can come with tax implications such as gift tax, estate tax, generation-skipping transfer tax, and income tax. Business owners and their advisors must be able to allocate the total enterprise value between the company's entity goodwill and the individual shareholder or personal goodwill.



## Setting Precedent for Personal Goodwill

*Martin Ice Cream Co. v Commissioner, 110 T.C. 189*

Arnold Strassberg and his son, Martin, owned all of the stock of ice cream distributor Martin Ice Cream Co. Arnold had worked in his own wholesale ice cream distribution business for more than a decade before going into business with his son. Shortly after launching Martin Ice Cream, Arnold was approached by the founder of Häagen-Dazs, who wanted Arnold to introduce that company's ice cream to supermarkets. The two had a handshake agreement and Arnold quickly established distribution relationships with four chains.

When Pillsbury acquired Häagen-Dazs (in the mid-1990s), the company approached Arnold about acquiring his relationships so Pillsbury could sell Häagen-Dazs products directly into supermarkets. Pillsbury had no interest in a relationship with Martin Ice Cream or in acquiring its physical assets.

When Arnold sold his relationships to Pillsbury, the transaction launched a series of events:

- Arnold created a new subsidiary corporation, Strassberg Ice Cream Distributors

- Strassberg Ice Cream Distributors gained all of the supermarket relationships of Martin Ice Cream, which were held as the subsidiary's only assets
- Martin Ice Cream conveyed all of the subsidiary's stock to Arnold in exchange for his interest in Martin Ice Cream
- Strassberg Ice Cream Distributors sold the relationship assets to Pillsbury for \$1.4 million
- As part of the sale, Arnold signed a bill of sale and an assignment of rights, and both Arnold and Martin signed non-compete agreements with Pillsbury

The Strassbergs and the IRS disagreed over how the proceeds of the sale should be taxed, which ultimately led the parties to court, where the Tax Court attributed the \$1.4 million purchase value primarily to two assets:

- Arnold's personal relationship with the supermarkets
- Arnold's handshake agreement with the founder of Häagen-Dazs

The court determined that these assets could not be attributed to Martin Ice Cream Co. or its subsidiary because Arnold never had a covenant not to compete or any employment agreement with such entities.

The case stands an example of why it is vital to separate personal goodwill and business goodwill. In the instance that a corporation does not have an employment contract with an employee, the employee's personal relationships are not corporate assets.



## Deciphering the Tax Court Rules

To identify any attribute as personal goodwill, the business owner must establish that his or her personal goodwill exists separate from the business goodwill. This process is not always straightforward. Fortunately, the Tax Court has considered personal and enterprise goodwill in a number of cases, and we can turn to it for judicial guidance.

The 1998 case of *Martin Ice Cream Co. v. Commissioner*, 110 T.C. 189<sup>1</sup> illustrates the issue of personal goodwill identification. While the case did not provide a specific methodology for valuing personal goodwill, it does offer guidance on the process of identifying goodwill.

*When evaluating whether personal goodwill exists, The Tax Court approach considers the following:*

- Describe the relationship between customers or suppliers and the person.
- Do these relationships persist without a formal contract?
- Does the personal reputation and industry perception provide a benefit to the business?
- Are the practices of the person innovative or distinguishable and regarded as adding value to the industry?
- Is the person under any employment agreement or covenant not to compete with the business?

Because personal goodwill deals with the value of the services of a particular individual to a firm, the issue of personal goodwill also often arises in professional practices. *Lopez v. Lopez*<sup>2</sup> suggests several factors that should be considered in the valuation of personal goodwill with respect to professional practices, including the person's:

- Age and health
- Demonstrated earning power
- Reputation in the community for judgment, skill, and knowledge
- Comparative professional success
- Nature and duration of practice as a sole proprietor or as a contributing member of a partnership or professional corporation

It is important to understand that accounting and tax rules follow cash and do not segregate value except for compensation. Explore whether compensation alone is sufficient to retain and motivate or if the person is also relying on “equity” returns for retention and motivation.

### *The Bottom Line*

Distinguishing between personal goodwill and enterprise goodwill is subjective and comes with few definitive answers. Every situation is unique and requires deep investigation and analysis. Before moving forward with any transaction where personal goodwill is involved, it is highly recommended that you obtain a professional appraisal by a valuation expert.

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<sup>1</sup> *Martin Ice Cream Co. v. Commissioner*, 110 T.C. 189 (1998).

<sup>2</sup> *Marriage of Lopez*, 113 Cal. Rptr. 58 (38 Cal. App. 3d 1044 (1974).



# WHAT ARE YOU WORKING TOWARD?

There are situations when figuring out your own way makes sense. Protecting the financial value of your business and positioning your company and its people for a secure, productive future is not one of those situations.

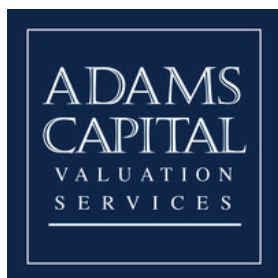
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We are a leading third-party independent business valuation firm with 90 years of experience driving positive lasting outcomes for executives, attorneys, and accountants within privately held and publicly traded companies.

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