

Martin Ice Cream Co. vs. Commissioner: A Case for *Personal Goodwill*



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As business brokers and intermediaries, our goal is to get the best deal for our clients. What is the best deal? It's getting the best price and terms (financial) along with achieving the non-financial goals of the business owner and other stakeholders.

Best terms include how a business transfer is structured for tax purposes. Saving taxes for our clients plays a large part in the value-added benefits we offer.

Table 1 is a summary of four general tax-saving strategies. *Paying taxes at lower rates* and *paying taxes later or never* are common tax-saving strategies in business transactions. This article deals primarily with *paying taxes at lower rates*. First, some groundwork concerning tax rates for individuals and C corporations.

Table 1 **Four General Tax Saving Strategies**

- 1. Choosing the Entity Form that Saves Taxes**
- 2. Pay Taxes at Lower Rates**
- 3. Pay Taxes Later or Never**
- 4. Take Advantage of IRS "Freebies":
Exclusions - Deductions - Credits**

Ordinary income tax rates for individuals range from 15% to 39.6%, whereas capital gain rates range from 10% to 20%. C Corporation rates range from 15% to 34% - with no special capital gain rate benefit. Obviously, the character of the income is critical to saving taxes at lower rates. When saving taxes, the following questions need to be answered:

- What is income?
- Who is taxed?
- When is it income?
- How is it taxed?

Table 2 is a listing of ordinary assets and capital assets that trigger the recognition of ordinary gains (losses), and capital gains (losses) in business transactions.

<u>Table 2</u>	
Two Types of Income (Losses) Common in Business Transactions	
I. Ordinary <ul style="list-style-type: none"> • Income (Gains) • Deductions (Losses) 	<div style="border: 1px solid black; padding: 5px; width: fit-content; margin: auto;"> <u>Ordinary Asset:</u> • Inventory • Equipment • Employment Contracts • Covenants (CNTC) </div>
II. Capital <ul style="list-style-type: none"> • Gains • Losses 	<div style="border: 1px solid black; padding: 5px; width: fit-content; margin: auto;"> <u>Capital Asset:</u> • Capital Stock • Goodwill • Going Concern Value </div>

C Corporations pose special problems for their owners because of the double tax in an asset sale. First, the corporation is taxed on the gain realized upon sale. The next tax (double tax) occurs when the remaining assets are distributed to the shareholders upon liquidation.

For example, assume a C Corporation has assets with a zero tax basis worth \$1,000,000, and the Company is debt free. The shareholders' basis in their stock is also assumed to be zero. Upon sale, the Company would realize a \$1,000,000 gain; at the 34% marginal rate for corporations, it would pay \$340,000 in Federal income tax. The remaining \$660,000 is distributed to the shareholders who would pay Federal capital gains tax at 20% or \$132,000. On the \$1 million sale, the shareholders end up with after-tax proceeds of \$528,000 – a 47% tax bite! However, had the shareholders sold their stock, there

would only be one tax of \$200,000, with \$800,000 in after-tax proceeds to the shareholders. Obviously, stock sales involving C corporations are often more favorable to sellers when there are built-in gains. Not so for buyers, however, who do not receive a step-up in the basis of assets in stock sales.

General Rule: In business transactions, sellers seek favorable tax rates and deferred gain recognition; buyers seek early tax deductions for what they pay.

Sellers of C corporations demanding a stock sale will often be forced to discount the price to compensate the loss of deductions for buyers. Correspondingly, buyers who demand an asset purchase will likely pay a premium to sellers of C corporations because of the double tax sellers will pay.

If buyers demand an asset purchase, sometimes buyers and sellers will seek ways to allocate the purchase price around a C Corporation in the form of non-compete agreements, and employment/consulting agreements. Sellers avoid the double tax, and buyers get at least a 15 yr. write off (e.g. non-compete agreement). Income from non-compete agreements, and employment/consulting agreements, are ordinary in the hands of the individual seller – again taxed at higher ordinary income tax rates.

But then there's the *goodwill*. What if the goodwill (a capital asset) is deemed “personal” to the business owner – and not attached to the business enterprise? The buyer still gets a 15-year write-off (same as a non-compete agreement), but the seller gets taxed at a lower capital gains rate. The buyer is in a no worse position; the seller pays tax at capital gains rates - about one-half ordinary income tax rates!

The key question then becomes: who owns the goodwill – the company, or the individual owner of the company? This brings us to the landmark tax court case titled: *Martin Ice Cream Company vs. Commissioner of Internal Revenue*; 110 TC 189 (1998). This case provides some guidance in answering the question of - who owns the goodwill?

To understand the factors that determine goodwill ownership, we need to review the factual background of this case. Pay attention to the information in italics.

Soon after World War II, Arnold Strassberg (Arnold) began selling wholesale ice cream products on a part-time basis to grocery stores in Newark, NJ and along the Jersey Shore. Arnold incorporated the business as Arnold's Ice Cream in 1960, and became a full time wholesale ice cream distributor during the 1960's. Arnold developed a unique packaging and sales campaign to market ice cream to supermarkets, and in doing so, formed *close personal relationships with supermarket owners and managers*.

In the late 1960's, because of a falling out with a major supplier, Arnold's Ice Cream went into bankruptcy. In 1971, a new company was formed as Martin Ice Cream Company (MIC), again a wholesale ice cream distributor; Martin Strassberg (Martin), Arnold's son, was the sole shareholder (but not an employee). Arnold had no ownership at that time because of potential creditor claims arising out of the prior bankruptcy. Martin began working in the business (after a career as a statistician) in 1975. In 1979, Arnold regained a 51% ownership in MIC; Martin's ownership was reduced to 49%. *At no time during Arnold and Martin's employment at MIC did they have employment agreements.*

In 1974, Ruben Mattus, founder of Haagen-Dazs (HD), approached Arnold to use his ice cream marketing expertise, and *relationships with supermarket owners and managers*, to introduce HD to large supermarkets. HD had only been marketed to smaller stores in single servings – unable to penetrate the large supermarkets.

Arnold, as the first distributor of HD ice cream to supermarkets, sparked a revolution in the retail sale of ice cream – tapping a hidden demand for higher quality, higher priced ice cream. By the late 1970's, MIC was distributing HD to four major supermarket chains on the East Coast. *At no time did Arnold or MIC enter into a written distribution agreement with HD or Ruben Mattus.*

Because of the success of HD, Mattus asked Arnold to become partners in marketing HD on the West coast – Arnold declined. All during this expansion phase, Martin did not participate in the marketing efforts of HD, disliking the social activities necessary to sustain the *personal relationships* with supermarket owners and managers – activities Arnold thrived on. Martin preferred the “inside” day-to-day operations of the business, and the development of ice cream distribution to small grocery stores and food service accounts; Arnold’s focus remained with the large supermarket chains.

In the mid 1980’s, Ben and Jerry’s (an HD competitor) asked Arnold to distribute their ice cream; HD objected saying Arnold could not be a distributor for both companies. All contact Arnold and MIC had with Ben & Jerry’s terminated. In 1983, Pillsbury Co. purchased HD from Mattus, and began consolidating the distribution of HD into its own distribution centers, following a corporate strategy of delivering directly to large supermarket chains (no middleman). Pillsbury (HD) corporate strategy was to enter into short-term written distribution contracts with independent distributors not yet bought out. *Since 1974, Arnold and MIC had only been under an oral distribution agreement with HD and Mattus.*

In the 1985-86 time period, Pillsbury (HD) approached Arnold about acquiring direct access to *Arnold’s relationships with supermarkets*, and removing him as a middleman. They believed that these various relationships (*personal to Arnold*) had value for which they were willing to pay. They also wanted to keep competitors like Ben & Jerry’s from gaining access to Arnold’s contacts. In addition, Pillsbury (HD) wanted to reward Arnold for the role he played with Mattus bringing HD into prominence. Pillsbury (HD) did not want to alienate Arnold and risk having him stir up other independent distributors; also, they wanted to terminate any *residual rights* to distribute HD ice cream that Arnold and MIC might have acquired over the years.

By 1988, Arnold and Martin were at odds over the operation of MIC, causing them to be receptive to buy out overtures by Pillsbury (HD). In mid 1988, the Board of Directors approved the formation of MIC’s 100% owned subsidiary - called SIC.

The SIC subsidiary was split-off from MIC with Arnold becoming the sole owner of SIC, which included all of the large supermarket business. Martin then became MIC’s sole shareholder, retaining the smaller grocery store accounts.

Note: The underlying issue in this case was to determine if the split-off was taxable or non-taxable; this led into what assets were owned by SIC, and what assets personally by Arnold.

<u>Allocation</u>	<u>\$(Millions)</u>
1. Arnold Strassberg:	
Sellers Rights (<i>Personal Goodwill</i>)	\$ 1.14
Consulting/CNTC	.45
Earn out	.33
2. SIC – Business Goodwill & Records	
	.29
3. Martin Strassberg – Consulting/CNTC	
	.25
Total Transaction Price	\$ 2.46

In July 1988, Arnold and SIC (sellers) entered into an asset purchase agreement with Pillsbury (HD). The total \$2.46 million transaction price (no evidence of how allocation was determined) was allocated to SIC (the Company) and to Arnold and Martin (personally) as shown on Table 3.

“Sellers rights” (*personal goodwill*) allocated to Arnold represented 46% of the total transaction price, with only 12% of the price allocated to the Company (SIC).

Court’s Final Ruling: *The benefits of the personal relationships developed by A (Arnold Strassberg) with supermarket chains and A’s oral agreement with the founder of HD (Ruben Mattus) were not assets of MIC that were transferred by MIC to SIC (split-off), and therefore sold by SIC to HD (Pillsbury). A was the owner and seller of those assets.*

The Martin Ice Cream Case offers guidance on the identification (unfortunately, no quantification methodology) of *personal goodwill* apart from *business goodwill*. Using the facts in this Case, Table 4 lists some factors to consider when answering the question – who owns the goodwill?

<u>Table 4</u>	
Goodwill Ownership Guidelines	
<u>The Company</u>	<u>The Employee/Owner</u>
<i>Business Goodwill Factors</i>	<i>Personal Goodwill Factors</i>
<ul style="list-style-type: none"> • “Capital” dependent • Written employment or CNTC agreements • Written property rights • No controlling owner • Business earnings support transaction price • e.g. Manufacturer 	<ul style="list-style-type: none"> • “Relationship” dependent • No written employment or CNTC agreements • No written property rights • Owner/Employee controls • Business earnings do <u>not</u> support transaction price • e.g. Personal Service Corp

Personal goodwill offers three significant tax-saving benefits for sellers in business transactions:

- Price allocation away from C corps (avoids the double tax)
- Price allocation away from accrual basis tax entities to cash basis owners (availability of the installment sale method)
- Goodwill allocation to individuals (lower capital gains rates)

Subject to the particular *facts and circumstances* in a business transaction, a *personal goodwill* allocation may be possible. The seller and his/her business broker/intermediary should always seek competent tax and valuation advice in these situations.