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tax IMPACT

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It's not business, it's personal

Personal goodwill offers opportunities for M&A planning

Parties to merger and acquisition (M&A) transactions involving closely held corporations may enjoy certain tax benefits if they can allocate a portion of the purchase price to individual shareholders' personal goodwill. Although the IRS doesn't much like personal goodwill, a recent Tax Court case (see "Personal goodwill is alive and well" on page 3) confirms that it remains a viable tax-planning tool under the right circumstances.

Personal vs. business goodwill

The *International Glossary of Business Valuation Terms* defines goodwill as "that intangible asset arising as a result of name, reputation, customer loyalty, location, products and similar factors not separately identified." The value of goodwill is usually expressed as the excess of a business's fair market value over the value of its net tangible assets and its identifiable intangible assets (such as patents, trademarks and other intellectual property).

Personal goodwill is derived from an individual owner's reputation, training, skills, experience and relationships. In contrast, *business* goodwill is associated with characteristics of the business itself. In theory, these characteristics — such as company name, reputation, location, products and workforce in place — remain with the business even if key owners or employees leave the company.

Tax benefits

When a C corporation sells its assets, the sale proceeds are subject to double taxation. They're taxed once at the corporate level and again when they're distributed to shareholders. An S corporation generally isn't subject to corporate-level taxes when sold, but if it started out as a C corporation it may be exposed to double taxation on certain "built-in gains" — that is, unrealized appreciation on assets it owned at the time it converted to S status.

Selling shareholders may reduce the impact of double taxation to the extent the purchase price can be allocated to personal goodwill. Because personal goodwill belongs to the individual shareholders, and *not* the company, that portion of the purchase price bypasses the corporation, avoiding corporate taxes. In addition, payments that shareholders receive for their personal goodwill generally are taxed at lower capital gains rates, as opposed to payments for employment or noncompete agreements, which generally are considered ordinary compensation income.

If the transaction is structured as a stock sale, double taxation isn't an issue. But allocating a portion of the purchase price to personal goodwill

Personal goodwill is alive and well

Despite several successful IRS challenges in recent years, a recent case — *Bross Trucking v. Commissioner* — confirms that personal goodwill, under the right circumstances, can be the personal property of a corporation's owners separate from any business goodwill.

In the case, the taxpayer owned several family businesses, including a road construction business and a trucking company that hauled materials for the construction business. The company's reputation with regulators had suffered due to safety issues and it was facing possible suspension. To avoid harming the other family businesses, the family formed a new trucking company owned by the taxpayer's sons.

The IRS argued, among other things, that the original company had distributed goodwill to the taxpayer, triggering income taxes. The Tax Court disagreed, noting that the company's declining reputation and imminent suspension was "the antithesis of goodwill." The court found that most of the goodwill that did exist was the taxpayer's personal goodwill, which was his separate property and couldn't be distributed by the company. The court also found that he hadn't transferred any goodwill to the company through an employment contract or a noncompete agreement.

still offers significant benefits. The selling shareholders enjoy capital gains treatment of those amounts and the buyer acquires an amortizable asset. (Goodwill is amortizable over 15 years.) Buyers usually prefer asset sales, in part because amounts paid for assets generate significant depreciation and amortization deductions. Amounts paid for stock, on the other hand, are capitalized and can't be deducted or amortized. The ability to allocate a portion of the purchase price to amortizable personal goodwill may make a stock transaction more palatable to a buyer.

Supporting the allocation

To support a purchase price allocation to personal goodwill, it's important to involve an experienced business valuation professional early in the process. He or she can help determine and document the extent to which the business relies on the individual owners' talents and connections, and estimate the portion of the business's earning capacity that's attributable to those talents and connections.

However, keep in mind that, to treat personal goodwill separately from corporate assets, it must continue to be the shareholders' property. If the owners have pre-existing employment, noncompete or nonsolicitation agreements, they may be deemed to have transferred their personal goodwill to the company, thereby converting it to business goodwill.

If the transaction is structured as a stock sale, double taxation isn't an issue. But allocating a portion of the purchase price to personal goodwill still offers significant benefits.

Also, it's critical for selling shareholders to take steps to transfer their personal goodwill to the buyer. This may include signing employment or consulting agreements that set forth the selling shareholders' responsibilities for helping ensure that the buyer retains the benefits of their business attraction and retention power.

Get personal

If your corporation is contemplating a sale, it's worth investigating whether a portion of the purchase price can be allocated to the shareholders' personal goodwill. If significant personal goodwill exists, and you can value and document it, you may enjoy substantial tax savings.

International estate planning: Handle with care

If you or your spouse is a non-U.S. citizen, different rules apply to your estate plan. One misstep can lead to unpleasant tax surprises, so make sure you understand the differences.

Rules for citizens: Worldwide taxation

U.S. citizens are subject to federal gift and estate taxes on all of their worldwide assets, with an exemption for gifts and bequests up to an inflation-adjusted $5.34 million (in 2014). They're also entitled to an annual gift tax exclusion (which is currently $14,000 per recipient; $28,000 for married couples who "split" gifts). Married couples enjoy an unlimited marital deduction, which allows them to freely transfer property to each other without triggering gift or estate taxes.

Rules for noncitizens: Domicile matters

The tax treatment of noncitizens depends on whether they're "domiciled" in the United States. Your country of domicile depends on your particular facts and circumstances. In general, however, the IRS views you as a U.S. domiciliary if you live in the United States — even briefly — with no present intention of moving.

Although transfers to a noncitizen spouse that are in excess of your exemption amount are taxable, you can obtain some of the benefits of the marital deduction by leaving assets in a QDOT.

Noncitizen U.S. domiciliaries enjoy many of the same advantages as citizens, including the $5.34 million exemption, the $14,000 annual

gift tax exclusion, and gift splitting (with a spouse who's a U.S. citizen or domiciliary). But the marital deduction is *not* available for transfers to a noncitizen spouse, regardless of whether he or she is domiciled in the United States.

That doesn't necessarily mean that transfers to a noncitizen spouse are taxable. You can still use your exemption amount to shield up to $5.34 million from taxation, and there's a "super" annual exclusion for gifts to a noncitizen spouse (currently, $145,000).

Although transfers to a noncitizen spouse that are in excess of your exemption amount are taxable, you can obtain some of the benefits of the marital deduction by leaving assets in a qualified domestic trust (QDOT). QDOTs must meet certain requirements designed to ensure that the assets stay in the United States and ultimately are subject to estate taxes. Unfortunately, they don't quite duplicate the marital deduction.

For example, if you leave an inheritance to a citizen spouse, he or she can avoid estate taxes by spending the money or giving it away (using his or her own exemption or annual exclusion). But when a noncitizen spouse withdraws principal from a

QDOT, the general rule is that it's immediately subject to estate taxes as part of *your* estate. There are, however, exceptions that may exempt the withdrawal from the estate tax.

Rules for nonresident aliens

What if you're a "nonresident alien" — that is, neither a U.S. citizen nor a U.S. domiciliary? In that case, you're subject to U.S. gift and estate taxes *only* on property "situated" in the United States. But if you do own property in the United States — for example, real estate or personal property, such as cars, boats, collectibles, and certain interests in U.S. companies — be aware that the exemption amount for nonresident aliens plummets from $5.34 million to a paltry $60,000.

In some cases, it may be possible to avoid U.S. transfer taxes by setting up a foreign corporation to hold U.S. property.

Have a plan

If you or your spouse is a noncitizen, consult your advisors to evaluate the potential impact on your estate plan and to discuss strategies for avoiding unintended tax consequences. ◎

Why substantiating your charitable gifts is so important

The United States tax code recognizes the need for qualified organizations to reach out to taxpayers to help fund their nonprofit activities. And in return, these patrons receive the right to deduct such charitable gifts on their tax returns.

But, the tax code also has very strict rules regarding charitable deductions. So, to ensure you don't lose any deductions, adhere to IRS guidelines and tax law requirements.

Substantiating gifts of cash

You can substantiate cash donations of less than $250 with a canceled check, a receipt from the charity or another reliable written record that shows the name of the charity and the date and amount of your contribution. Separate contributions of less than $250 to a single charity aren't combined in determining whether you exceeded the $250 threshold. So, for example, if you donate $200 a month to a charitable organization, you can substantiate each donation with a canceled check.

Donations of $250 or more require a contemporaneous written acknowledgment from the charity describing the amount of your contribution and any goods or services you received from the charity in exchange for the donation.

An acknowledgment is contemporaneous if you receive it on or before the earlier of either your tax return due date, including extensions, for the tax year the contribution is made or the date you actually file your return. It's critical to make

sure you obtain all necessary acknowledgments before you file your return. If you don't, you could lose the deduction, even if you receive a valid acknowledgment later.

How the IRS treats noncash gifts

For noncash gifts under $250, obtain a receipt that shows the charity's name, the date and location of the contribution, and a description of the property. Although the property's fair market value should be considered in determining the amount of detail included in the receipt, that value need not be stated on the receipt.

Noncash gifts of $250 or more require a contemporaneous written acknowledgment from the charity containing the information described above for cash gifts as well as a description (but not necessarily the value) of the property.

If you donate noncash property worth more than $500, then, in addition to the substantiation requirements described above, you also must maintain written records that document:

- The date (approximate is permissible) you acquired the property,
- The manner in which you acquired the property (for example, via purchase, gift or inheritance), and
- Your adjusted basis in the property. (There is an exception for property you've held for at least 12 months, and for publicly traded securities.)

If your noncash gifts for the taxable year exceed $500, you also must prepare and file IRS Form 8283 ("Noncash Charitable Contributions"). Note that the $500 threshold is an aggregate of all noncash contributions; it's not an entity-by-entity calculation.

Rules for large noncash gifts

If you donate property valued at more than $5,000 ($10,000 for closely held stock), you must acquire a qualified appraisal and include an appraisal summary, signed by the appraiser and the charity, on Form 8283. You can meet the $5,000 threshold by donating a single item or a group of similar items, even if you give them to different charities.

You don't need an appraisal for publicly traded securities. For closely held stock worth more than $5,000 but less than $10,000, an appraisal isn't required, but you need to complete a portion of the appraisal summary form.

For noncash contributions exceeding $500,000 or gifts of art worth $20,000 or more, include a copy of the signed appraisal — not simply the summary — with your return. Note that there are limited exceptions for certain items, even if they exceed the $500,000 threshold.

Your appraisal must be prepared, signed and dated by a qualified appraiser, as defined by IRS regulations, and must include specific information required by the regulations. The appraisal can't involve a prohibited appraisal fee and has to be prepared no earlier than 60 days before the property is contributed and no later than the tax return due date, including extensions.

Your tax advisor can help

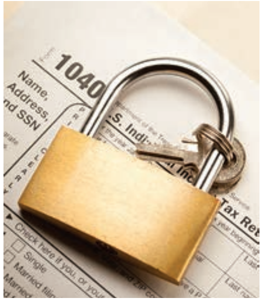
The IRS keeps a wary eye on taxpayers' charitable cash and noncash donations to ensure they're abiding by the rules. That's why it's critical to work with your tax advisor. He or she can help ensure your donations are in line with the United States tax code.

tax **TIPS**

Watch out for tax scams

As tax season approaches, be on the alert for tax fraud. Every year, the IRS publishes its list of "Dirty Dozen" tax scams. Here are two of the most common:

Identity theft. An identity thief uses your identity to file an illegal tax return and claim a refund. To avoid this scam, file your return as early as possible. If you receive any suspicious tax-related notices or any of your personal information is lost or stolen, contact the IRS right away to secure your tax account.



Telephone scams. A caller pretending to be with the IRS claims you owe money and threatens you with loss of your driver's license or even arrest if you don't pay. Remember, the IRS *always* initiates contact by mail, not by phone, so if a claimed tax liability is news to you, it's probably not legitimate. If you're uncertain whether you owe taxes, call the IRS at 800-829-1040. And if you're *certain* that you don't, call the Treasury Inspector General for Tax Administration at 800-366-4484 to report the incident.

Have you researched the research credit?

Claiming traditional research credits requires a company to compile and analyze years of histori-cal data, a process that can be time-consuming and expensive. The alternative simplified credit (ASC) is easier to calculate and document, but until recently, it could only be claimed on a timely filed, original tax return (including extensions).

In June 2014, the IRS issued new regulations that allow companies, with certain exceptions, to claim research credits for open tax years using the ASC method on an amended return. If you missed the opportunity to claim the ASC in prior years, consult with your tax advisor to see if you're eligible.

Mandatory accrual accounting for personal service firms?

Under current law, personal service businesses — such as law, accounting, architecture, engineering and consulting firms — are allowed to use the cash method of accounting for tax purposes, regardless of size (unless they have inventory). But this may change if certain lawmakers have their way. Two bills pending in Congress would require these companies to use the accrual method if their annual gross receipts exceed $10 million (using a three-year average gross receipts test).

If this proposal becomes law, many personal ser-vice firms will find themselves with accelerated tax liabilities for work-in-process and receivables that haven't yet been billed or collected. Firms should have a plan for financing these liabilities in the event they're required to switch from the cash method to the accrual method.

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Card, Palmer, Sibbison & Co. has been serving as a trusted advisor and management consultant to owners and businesses in Northeast Ohio since 1920. We have expertise in both the privately held company and not-for-profit area. As certified public accountants we perform the traditional financial and tax services but also provide a wide array of other business services.

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