HANTZMON WIEBEL LLP
Certified Public Accountants
for over 85 years

Valuation Report

Business Valuation Trends and Strategies

Summer 2015

Personal or Corporate?

Bross Trucking Case Illuminates the Nature of Goodwill

The concept of personal goodwill is alive and well — and it has been reinforced by a recent court case, *Bross Trucking, Inc. v. Commissioner of Internal Revenue*.

To briefly review, personal goodwill is goodwill that an employee or shareholder of a corporation owns separately from the goodwill of the company. For example, a business owner may have personal goodwill related to his or her reputation, specific skills, knowledge, personal relationships, judgment, expertise, personality or management style.

These are all qualities that customers value deeply — and often consider the center of their commercial relationship with the corporation. These intangible characteristics translate into an intangible asset that is generally considered to be inseparable from the individual.

In a valuation related to a transaction, there's an important reason to assess the value of personal goodwill: avoiding double taxation. When a C corporation is sold, the gains are taxed at the corporate level — up to a 35 percent effective tax rate — and then again at the shareholder level.

However, if personal goodwill can be properly allocated from the sale price and attributed to the owner, gains from the sale of personal goodwill are only taxed at the shareholder's capital gains tax rate. Thus, the IRS's concern for the proper existence and treatment of personal goodwill.

Damaged Reputation Leads to Shut Down

In the case of Bross Trucking, determining which entity — the company or the shareholder — owned the goodwill became a $2.7 million question.

Chester Bross founded Bross Trucking in 1982 and owned 100 percent of the company. In the late 1990s, the company was cited by the Department of Transportation (DOT) for some safety problems, and regulatory scrutiny of the company's operations increased in the form of audits and investigations.

Eventually Mr. Bross decided to close Bross Trucking because its reputation was severely damaged. He feared that the government would possibly shut down the business and believed that continuing to operate might impact the success of other companies he owned. However, in 2003 Bross' three sons founded a new company, LWK Trucking, and employed about half of Bross Trucking's former employees.

In 2011, the IRS demanded $2.7 million in corporate income tax and gift tax from Mr. Bross and his wife. According to the agency, an appreciated intangible asset in the form of goodwill was transferred from Bross Trucking to Chester Bross, who then made a gift of the goodwill to his sons. The IRS contended that the company should have recognized a gain as if the goodwill were sold to Mr. Bross at fair market value, and Mr. and Mrs. Bross should have paid tax on their "gift" to their sons. Team Bross strongly disagreed

Continued on page 3

2 Case Study: Subsequent Events
3 More Details on Bross Trucking
4 Valuation Analyst Credentials

Subsequent Events

What Did the Analyst Know — and When Did He Know It?

A business valuation is an assessment of a company at a specific point in time. It reflects the circumstances and prospects of the company at a certain date.

So what happens when those circumstances change, either for the better or worse, and the value of the company is altered due to an event subsequent to the valuation date?

Generally, the rule is that subsequent events are ignored unless they were "known or knowable" at the time of the valuation. Valuation professionals must carefully distinguish between the facts that could be foreseen at the valuation date and those that could not have been foreseen at the time.

For example, a pending lawsuit (which might impact value negatively) or a signed contract for more work (which might impact value positively) would likely be known or knowable if they existed at the valuation date. However, a fire that destroys the business two weeks after the valuation date would not have been known or knowable. But it's not always that simple.

Estate of Helen M. Noble

Several court cases relevant to subsequent events have attracted a lot of attention. For example, *Estate of Noble v. Commissioner* involves the relevance of post-valuation date transactions relative to the value of privately held bank stock in the estate of Mrs. Noble.

At the valuation date, the estate's analyst presented an appraisal concluding that the fair market value of Mrs. Noble's minority interest in the bank was $841,000, or $7,250 per share. The IRS challenged that figure, its valuation analyst concluding that the interest was worth $1.1 million, or $9,483 per share.

It's important to note that the estate sold some of its bank stock twice before the valuation date. The first time, 15 months prior to the valuation date, it sold the stock for $1,000 per share, and the second time, two months prior to the valuation date, it sold it for $1,500 per share.

Of particular note, however, is that 14 months *after* the valuation date, the estate sold the rest of its bank stock — 116 shares — for the precise amount of the IRS valuation: $1.1 million, or $9,483 per share.

Why the difference in the price before and after the valuation? One factor is that after the valuation date, the bank decided to pay dividends for the first time, which substantially raised the price of the stock. Did the estate's valuation analyst know this would happen at the time of the valuation? Was the bank's intention knowable to him?

Despite the fact that the bank didn't reveal its plans to issue dividends to the estate's valuation analyst, the court suggested that the third transaction was relevant because, among other factors, it happened within a "reasonable time" of the valuation date. The court's eventual conclusion of value was $1.067 million, or $9,276 per share — close to the IRS valuation.

Impact on Valuation

So does the rule hold? Should subsequent events be ignored? Like Noble, several court cases have muddied the waters.

But despite the gray areas, the general rule is that subsequent events that were not known or knowable should not figure into the valuation. It goes without saying that good documentation is essential to defending this position. ■

Interested in further discussion of subsequent events or other valuation issues? Contact us today.

The Nature of Goodwill

Continued from page 1

Who Owns the Goodwill?

The Bross Trucking case hinged on the question of who owned the goodwill — the company or Mr. Bross? That's because in 1998, a pivotal goodwill case, *Martin Ice Cream v. Commissioner*, established that "a business can only distribute corporate assets and cannot distribute assets that it does not own." The Martin Ice Cream case also established that without an employment contract or a non-compete agreement, the company couldn't own an intangible asset — like personal goodwill — that belonged to an employee or shareholder.

It's important to work with an experienced valuation analyst in cases where goodwill is a factor.

In the Bross case, the IRS contended that the goodwill owned by Bross Trucking and distributed to Mr. Bross and then given to LWK included an established revenue stream, a developed customer base, transparency of the continuing operations between the entities, an established workforce, and continuing supplier relationships.

The tax court disagreed, ruling that the goodwill was primarily owned by Mr. Bross and that the company therefore couldn't transfer it. As the court considered the elements of goodwill in question, it noted that:

- Mr. Bross didn't have an employment contract or a non-compete agreement with Bross Trucking. Without this type of agreement, the company had no right to Mr. Bross's future services or his personal goodwill.

- The Bross sons never worked at Bross Trucking and Mr. Bross never worked at LWK Trucking. The court believed that customers of Bross Trucking chose to work with the company because of their relationship with Mr. Bross. The sons didn't contribute to the goodwill of Bross Trucking.

- No tangible assets were transferred from Bross Trucking to LWK Trucking. In fact, although Bross Trucking ceased operations, it retained all of the licenses and insurance required to continue in business.

The court said the only element of goodwill that possibly was transferred was a "workforce in place." But since only 50 percent of the Bross Trucking workforce moved to LWK Trucking, the court found that half a workforce didn't meet the definition of a workforce in place.

The court also noted that while Bross Trucking did have some corporate goodwill in the form of its name and reputation, the company's regulatory problems actually created a negative association with the company and that "continuing supplier relationships" were not a given. In other words, the Bross name was actually a liability, not an asset.

In fact, the court found that customers wanted to move their business from Bross Trucking because they were afraid the company was going to be suspended by the DOT due to regulatory problems. The court ruled that the company didn't own the goodwill and that Mr. Bross did. Therefore, there was no transfer of intangible assets and no taxable event.

The Taxpayer Wins

Some consider *Bross Trucking v. Commissioner* to be a case of IRS overreaching. But others were delighted to have another "good case" regarding personal goodwill, with clear facts and circumstances for the court to discuss and discern. The good news for taxpayers is that the case clearly underscores the outcome of the *Martin Ice Cream v. Commissioner* case and establishes more precedent for taxpayers and their attorneys in cases where personal goodwill is involved.

Of course, every case is different and goodwill is a complicated concept. For this reason, it's important to work with an experienced valuation analyst in cases where goodwill is a factor. ■

Have questions about goodwill or valuation? Our firm can answer them. Please call on us to assist you.

Different Credentials = Different Standards

Perhaps you've noticed the initials after the names of the valuation analysts with whom you work: ABV, CVA, CBA, MCBA, ASA and others. These letters represent credentials that the analyst has earned, proving his or her proficiency and competence in business valuation.

The credentials are offered by different organizations and each has slightly different requirements. Notably, each organization also has different valuation standards that it requires its members to follow.

For example, the American Institute of CPAs (AICPA) issues the Accredited in Business Valuation (ABV) credential. This requires all CPAs to adhere to the AICPA's Statement on Standards for Valuation Services No.1 (SSVS1).

The American Society of Appraisers (ASA) issues the Accredited Senior Appraiser (ASA) credential. This requires adherence to the Uniform Standards of Professional Appraisal Practice (USPAP).

The National Association of Certified Valuators and Analysts (NACVA) issues the Certified Valuation Analyst (CVA) credential. Meanwhile, the Institute of Business Appraisers (IBA) issues the Certified Business Appraisers (CBA) and Master Certified Business Appraiser (MCBA) credentials. Both NACVA and IBA have their own business valuation standards.

Each organization requires specific education and relevant experience on the part of valuation analysts and administers a lengthy, rigorous exam. Each also requires continuing professional education to ensure that members stay current in valuation trends and topics.

As someone who works with valuation professionals, what should you make of all of these acronyms? The organizations' standards are different, but not vastly so. Some organizations permit certain types of reports, while some use different nomenclature. Most financial professionals would agree that the various credentials all show a clear dedication to the practice of business valuation, and indicate a high level of professional competence and conduct.

Generally, the differences matter because, as they do their valuation work, credentialed professionals must apply the standards of the organization by which they've been accredited. ■