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VALUATION OF GOOD WILL

Howard M. Kohn

The question of whether there is good will, and the value which will be ascribed to good will, may arise in a variety of contexts. The approach to that question will frequently be colored by the result which will flow from the existence or non-existence of good will in the particular situation. By way of example, the purchaser of assets of a business will ordinarily not wish to have any portion of the purchase price allocable to good will, because the cost of good will cannot be written off through charges against income.[1]

WHAT IS GOOD WILL?

Before turning to a discussion of particular situations, consideration should be given to the question: What is good will?

Good will is an intangible asset which is difficult to define. There is no single definition that is adequate or accurately descriptive.[2] The Tax Court has stated that, in essence, good will is "the probability that the old customers will resort to the old place."[3]

One important test of the existence of good will is whether the business has an expectancy of earnings in excess of a normal return on tangible assets. If the business does not, it does not have good will.[4] If it does have such excess earnings, it may have good will.[5]

Another *sine qua non* of the existence of good will is the requirement that the expectancy of earnings in excess of a normal return on tangible assets be transferable.[6] If the expectancy of excess earnings depends upon the personal services or other personal characteristics of the present owner, it may not be transferable.[7] If it is dependent upon a nontrans-

1. Treas. Reg. § 1.167(a)-3 (1956), as amended, T.D. 6452, 1960-1 CUM. BULL. 127 [hereinafter cited as Reg. §].

2. See Mossman, Yarnelle & Co., 9 B.T.A. 45 (1927).

3. Malcolm J. Watson, 35 T.C. 203 (1960); Erwin D. Friedlaender, 26 T.C. 1005 (1956), *acq.*, 1957-1 CUM. BULL. 4.

4. See Fox River Paper Corp. v. United States, 65 F. Supp. 605 (E.D. Wis. 1946), *aff'd.*, 165 F.2d 639 (7th Cir. 1948); George J. Staab, 20 T.C. 834 (1953), *acq.*, 1953-2 CUM. BULL. 6; A.R.M. 34, 2 CUM. BULL. 31.

5. *Cf.* Copperhead Coal Co., Inc. v. Commissioner, 272 F.2d 45 (6th Cir. 1959), where the court of appeals affirmed the Tax Court's finding of good will or "going value." Neither court referred to earnings, but the Tax Court had predicated its finding on various factors all of which could be expected to enhance earnings.

6. Estate of A. Bluestein, 15 T.C. 770 (1950).

7. See The Danco Co., 14 T.C. 276 (1950).

ferable franchise, obviously it is not a transferable asset.[8] On the other hand, as in one case, the expectancy of excess earnings may depend upon business made available to the corporation by its shareholders and therefore may not be transferable.[9] Thus, where the touchstone of the business' success is not transferable, it does not indicate the existence of good will.

The mere fact, however, that the business is a personal service business does not preclude the existence of good will. In a number of cases involving the sale of an interest in a going professional practice, where an amount was paid for neither tangible assets nor an assignment of earned income, the Tax Court and the Court of Appeals for the Ninth Circuit have held that the payment was for good will.[10] These courts have held that there can be good will in a professional practice. The Commissioner does not yet agree with this conclusion,[11] but the trend of the cases is against him.

Thus, a key question is: Is there an intangible asset that is transferable? If there is, there may be good will. If the expectancy of excess earnings is attributable to a lease, a patent, or another particular asset, it may be merely a factor in the valuation of such other asset.[12] If, however, it is attributable to the name, reputation, customers lists, or other intangibles, then it will probably be classified as good will.

VALUATION OF GOOD WILL

Assuming that good will exists, the next question that arises is: How is it valued? If there has been a purchase and sale transaction at arm's length, in which the parties have placed a value on good will, that allocation will ordinarily be given great weight. For example, in one case[13] involving a sale of a lumber business, the sale contract allocated $100,000 of the selling price to good will, while allocating to inventory an amount less than the inventory was worth. The court sustained the allocation, stating that the taxpayer was justified in placing an inadequate price on inventory as an inducement to obtain a buyer for his less salable good will. In another case[14] a corporation purchased newspaper assets from a partnership for a price equal to the fair market value of the tangible assets. The purchaser also took over and used subscription lists and other

8. S. Leigh Savidge, 4 CCH Tax Ct. Mem. 545 (1945).

9. Donal A. Carty, 38 T.C. No. 7 (April 16, 1962).

10. United States v. Rees, 295 F.2d 817 (9th Cir. 1961), *affirming*, 187 F. Supp. 924 (D. Ore. 1960); Merle P. Brooks, 36 T.C. 1128 (1961); Malcolm J. Watson, 35 T.C. 203 (1960); Estate of Leo Melnick, 21 CCH Tax Ct. Mem. 671 (1962).

11. See Rev. Rul. 62-114, 1962 INT. REV. BULL. No. 32.

12. *Cf.* Michael Berbiglia, 10 CCH Tax Ct. Mem. 413 (1951).

13. Fraser v. Nauts, 8 F.2d 106 (N.D. Ohio 1925).

14. Seaton Publishing Co., 13 CCH Tax Ct. Mem. 303 (1954).

earmarks of good will which were not mentioned in the contract. The Commissioner sought to compel an allocation of part of the purchase price to good will. The Tax Court refused to make such an allocation on the ground that good will was not handled in the sale agreement and was not sold under the agreement.

Such cases cannot be relied upon entirely, however, because the courts have repeatedly stated that they are not bound to accept the parties' allocation of the purchase price among various assets purchased and sold.[15] However, the cases do justify the conclusion that if the parties to a purchase and sale transaction do have a meeting of the minds as to the allocation of the purchase price, their allocation will be entitled to great weight.

A second group of cases valuing good will are those where there has been a sale of assets for a lump sum which must then be allocated among the various assets. In such cases the courts have tended to marshal the price first against inventory and other tangible assets, the value of which can be established.[16] Where the allocation is between good will and a covenant not to compete, however, the courts have in some cases made the allocation by analogy to the *Cohan* rule.[17]

A third group of cases involves those situations where there has been no purchase and sale transaction, but there is extrinsic evidence of value. Thus, where stock of a corporation must be valued for estate tax purposes, and where there have been sales of stock in the corporation near in point of time to the date of death which indicate the existence or absence of good will, such evidence will be given considerable weight.[18]

Finally, there is the situation where there has been no purchase and sale transaction and there is no other extrinsic evidence of the presence or absence of good will. In those cases, either the taxpayer or the Internal Revenue Service may fall back upon the capitalization of earnings formula set forth in A.R.M. 34.[19] This formula of A.R.M. 34 is not difficult to state. An amount representing a normal return on the tangible assets used in the business is subtracted from average annual net earnings; and the difference, representing return on intangibles, is then capitalized at an appropriate rate. For example, if (1) the average tangible assets used in the business during the most recent five-year period is $200,000,

15. See Meister v. Commissioner, 302 F.2d 54 (2d Cir. 1962); Copperhead Coal Co. v. Commissioner, 272 F.2d 45 (6th Cir. 1959).

16. See Cohen v. Kelm, 119 F. Supp. 376 (D. Minn. 1953); George J. Staab, 20 T.C. 834 (1953), *acq.*, 1953-2 CUM. BULL. 6; Copperhead Coal Co. v. Commissioner, 272 F.2d 45 (6th Cir. 1959).

17. See United Fin. & Thrift Corp. v. Commissioner, 282 F.2d 919 (4th Cir. 1960), *cert. denied*, 366 U.S. 902 (1961); James M. Herndon, 21 CCH Tax Ct. Mem. 1013 (1962).

18. See Estate of Ben R. Henderson, 11 CCH Tax Ct. Mem. 1014 (1952).

19. 2 CUM. BULL. 31 (1920).

(2) ten per cent or $20,000, would be a normal return on the tangible assets, and (3) earnings during the past five years have actually averaged $50,000 each year; then the $20,000 normal return would be subtracted from the $50,000 average annual earnings experienced, leaving $30,000 as representing earnings in excess of the normal return on tangibles. If the $30,000 excess earnings are then capitalized at a rate of twenty per cent, the result is a figure of $150,000, ostensibly representing the value of good will.

Any attempt to apply that formula, however, presents a host of questions to be resolved.[20] First, in computing average annual earnings, how many years should be included in the average? What adjustment may be made for an abnormal year?[21] What effect should be given to a trend in earnings? What if the earnings have been increasing each year? What if, conversely, they have been decreasing each year? Adjustment must be made for abnormally low or abnormally high expenses. For example, if compensation deducted has been less than reasonable, an adjustment is necessary.[22] Should income taxes be deducted?[23] Thus, it is obvious that one of the very first steps in the application of the formula, namely, the computation of average annual earnings, presents a number of troublesome questions.

Second, in computing average tangible assets used in the business, what effect should be given to the fact that some of the assets (perhaps a large cash balance) may exceed what is needed and used in the business?

Third, what rate of return is to be used to compute normal earnings attributable to the tangible property? This will turn on the industry involved, the degree of risk involved, and, perhaps, the quality of the management. The question of what is a normal rate of return will be largely a matter of opinion, but will require the production of some evidence.

Fourth, after the amount representing normal earnings has been subtracted from average annual earnings, and a difference is arrived at representing earnings on the intangible called good will, at what rate should that difference be capitalized? In essence, the question here is: What multiple of the excess earnings would a buyer pay? Five times? Three times? Again the answer is in the realm of opinion, but some evidence will be needed.

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20. See Charles F. Hubbs & Co., 8 CCH Tax Ct. Mem. 903 (1949).

21. See Plaut v. Munford, 188 F.2d 543 (2d Cir. 1951), in which an adjustment was allowed for an abnormal year.

22. See Charles F. Hubbs & Co., 8 CCH Tax Ct. Mem. 903 (1949).

23. *Compare* A.R.M. 145, I-1 CUM. BULL. 24 (1922), *with* A.R.R. 2954, II-2 CUM. BULL. 202 (1923).

Thus, any attempt to apply the formula of A.R.M. 34 raises numerous debatable questions. The formula is difficult to apply. It is not controlled by hard and fast rules, but instead involves many variables; and accordingly, it is ordinarily no more than a guide or a method, which may be adjusted or disregarded entirely by a court in arriving at what the court deems a proper result.[24]

Nevertheless, the theory of the formula has been approved by the courts. Accordingly, account must be taken of it in valuing good will, where more direct evidence of the value is not available.

TYPICAL GOOD WILL VALUATION SITUATIONS

Valuation of Property for Estate or Gift Tax Purposes Where Business Interest Involved

One of the most common situations where the question of the existence and the value of good will may arise is the valuation of property for estate or gift tax purposes, where a business interest is involved.

Purchase or Sale of Business Assets

A second common situation is the case of the purchase or sale of business assets. The purchaser will have in mind that any portion of the purchase price allocable to good will must be capitalized and may not be recovered through charges against income.[25] On the other hand, if a covenant not to compete is severable from the good will of the business, and is separately bargained for, the amount paid for the covenant may be amortized over the period of the covenant;[26] the cost of inventory will be deducted as cost of goods sold; and the purchase price allocable to depreciable tangible assets, a leasehold, or other property having a limited life will likewise be written off through charges against income. Thus, the purchaser will normally prefer not to have any of the purchase price allocated to good will.

On the seller's side, if he must allocate part of the sale price to a covenant not to compete, that amount will be ordinary income.[27] In addition, any sale price allocated to inventory which is more than the cost of the inventory will result in ordinary income.

Therefore, in the purchase and sale situation, the interests of the parties, so far as obtaining the best tax result is concerned, may be in direct conflict. If one party is alert to the problems, while the other is

24. See, *e.g.*, Estate of A. Bluestein, 15 T.C. 770 (1950).
25. Reg. § 1.167(a)-3 (1956), as amended, T.D. 6452, 1960-1 CUM. BULL. 127.
26. James M. Herndon, 21 CCH Tax Ct. Mem. 1013 (1962).
27. Estate of Thomas F. Remington, 9 T.C. 99 (1947).

not, then the one may have a distinct advantage.[28] On the other hand, if both parties are alert to the problems, then through bargaining they will find a common meeting ground.

Ordinary Liquidation of Corporation

Another situation where good will may have to be valued is the ordinary liquidation of a corporation. The shareholders will realize gain measured by the difference between the basis of their shares and the value of the assets received in the liquidation.[29] If, in valuing those assets, good will is present, it will have to be valued.[30]

Business Assets Transferred into Corporation

Another situation where the existence of good will may be equally important, but where it may be overlooked by the parties, is the case where business assets are being transferred into, rather than out of, a corporation. This situation usually arises upon incorporation. Suppose, for example, that a partnership business is about to be incorporated and the book value of the tangible assets of the business is $200,000. Suppose further that the business in fact has substantial good will, worth at least $150,000, so that the value of the business in an arm's length sale transaction would be at least $350,000. If it is desired to transfer the partnership business to a corporation in a tax-free incorporation[31] and to have the corporation issue debt as well as stock for the assets in a ratio of three or four of debt to one of stock,[32] then it will be clear that the corporation can issue more debt if good will is taken into account as an asset than if it is ignored. If only the $200,000 of book value of tangible assets is considered, then the corporation might issue only $150,000 of debt. On the other hand, if good will is considered and the assets are valued at $350,000, consideration might be given to issuing debt of at least $250,000. Thus, in computing the value of assets for the purpose of determining the corporation's capital structure and the amount of debt and stock to be issued, good will is one of the important factors.

Similarly, if the incorporation of the business is one in which gain will be recognized (for example, if it does not qualify as a tax-free incorporation because the debt issued by the corporation does not qualify as a security),[33] it may be even more important to know whether the

28. *E.g.*, see Hamlin's Trust v. Commissioner, 209 F.2d 761 (10th Cir. 1954).

29. INT. REV. CODE OF 1954 §§ 331, 1001 [hereinafter cited as CODE §].

30. Henry L. Watkins, 9 CCH Tax. Ct. Mem. 448 (1950).

31. See generally, *Tax Problems of Close Corporations: A Survey*, 10 W. RES. L. REV. 9, 19 (1959).

32. *Id.* at 32-38.

33. *Cf.* Harrison v. Commissioner, 235 F.2d 587 (8th Cir. 1956).

assets included good will. Assume that the above-mentioned partnership business having tangible assets with a book value (and a basis to the partnership) of $200,000 was transferred to a corporation in exchange for $40,000 par value of common stock plus $160,000 of one-year notes. This incorporation would not qualify as wholly tax-free because the assets were not transferred solely for stock or securities (the one-year notes would not qualify as securities).[34] Accordingly, any gains realized on the incorporation would be taxable to the extent of the value of the property other than stock or securities received in the exchange. If in fact there was $150,000 of good will in the business, so that the business as a whole had a value of $350,000, the stock and debt received by the partnership would have a value aggregating $350,000. The partnership or the partners would have a $150,000 realized gain, and that gain would all be recognized and taxable because the shareholders received more than $150,000 of one-year notes. Thus, the presence or absence of good will may be extremely important, whether the transfer be out of or into a corporation.

Partners and Partnerships

Finally, there is one particular area in Subchapter K of the Code relating to partners and partnerships where good will may be a factor. If payments are made by a partnership upon the retirement or death of a partner in liquidation of his interest, then to the extent that such payments are for the interest of such partner in partnership assets (other than unrealized receivables), the payments will, in effect, be treated as the purchase price for his interest in those assets, not deductible by the partnership, and not ordinary income to the recipient (except in certain cases where there is inventory which has substantially appreciated in value).[36] If, however, the payments exceed the value of the retiring or deceased partner's interest in such partnership assets, then, even though such excess payments are in fact for good will, if the partnership agreement does not specify that such excess payments are for good will, those excess payments are deductible by the partnership and are ordinary income to the recipient. On the other hand, if the partnership agreement provides that such excess payments are for good will, such payments will be treated as part of the purchase price of good will, not deductible by the paying partnership and not income to the recipient.[37] Thus, here is one area where the parties have considerable control over the tax treatment of a payment for good will.

34. Rev. Rul. 56-303, 1956-2 CUM. BULL. 193.
35. CODE § 736.
36. See CODE §§ 736(b), 731, 751.
37. CODE § 736; Reg. § 1.736-1 (1956).