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Upcoming Free Events

6th Annual Introduction to New Jersey Tax Controversy

January 17 RSVP: goo.gl/7obOi0
Newark, NJ

8th Annual Criminal Tax Enforcement Forum

January 23 RSVP: goo.gl/WIVcaQ
Paramus, NJ

DOING BUSINESS IN NEW JERSEY: COLLATERAL CONSEQUENCES FOR FOREIGN BUSINESSES THAT FAIL TO REGISTER

**By Frank Agostino, Esq.
Jairo G. Cano, Esq.¹**

Under certain circumstances, foreign corporations with a “nexus” to New Jersey are required to register their business activities with the State. This requirement has increased in scope. As the definition of “nexus” expands, states, including New Jersey, are moving the needle on registration requirements in a manner that encompasses more activities.² Since the penalties and collateral consequences for noncompliance are significant, it is important that foreign companies with activities in New Jersey understand these obligations. This article explains the registration obligations and discusses the collateral consequences for a company that fails to comply.

Who is Required to Register?

A foreign company carrying on an activity or owning or maintaining property in New Jersey must file an annual Notice of Business Activities Report (“Notice”). The Notice is not required if the company received a Certificate of Authority to do business in New Jersey or filed a timely New Jersey income tax return. The Notice must be filed by the 15th day of

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the fourth month after the close of the company's calendar or fiscal year.

The obligation to file a Notice is triggered when:

1. The company maintains an office or other place of business in New Jersey;
2. The company maintains employees, agents, representatives, or independent contractors in New Jersey;
3. The company owns or maintains real or tangible personal property in New Jersey and that property is used in the state;
4. The company owns or maintains tangible or intangible property in New Jersey which is used by others in the state;
5. The company receives payments from New Jersey persons or businesses located in the state which aggregate to more than \$25,000;
6. The company derives income from any source within New Jersey; or
7. The company engages in any other activity in, has property in, or an interrelationship with New Jersey as designated by the Director.

Failure to comply with the Notice requirement can have significant consequences for the company.

Tax Requirements

A foreign company operating in New Jersey must comply with the State's tax obligations, including income and sales & use taxes. For example, the corporation business tax applies to any foreign corporation if such foreign corporation enjoys the privilege of deriving receipts from sources within New Jersey, or the privilege of engaging in contacts within the state, or the privilege of doing business, employing or owning capital or property, or maintaining an office, in the State. Be-

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cause the requirement to pay the corporation business tax is substantially similar to the requirement to file the Notice, a company that is required to file the Notice will likely be required to file a corporation business tax return.

In addition to the corporation business tax, a foreign company that sells goods or services that are subject to New Jersey sales tax must collect and pay over such sales taxes. A failure to comply with the sales tax obligation can result in an assessment of sales tax against the company. Furthermore, a foreign company that brings property into the State for use in New Jersey may have an obligation to pay use tax for the use of such property. The calculation of the use tax allows a credit for foreign sales taxes paid and is based on a pro rata formula that takes into account the time period that the property is used in New Jersey.

Restricted Access to New Jersey Courts

An unanticipated consequence for a company failing to register is the restriction of access to any State or Federal Court located in New Jersey. The company will not be able to commence a case for any cause of action that accrued prior to the last date of the year in which the company failed to file the timely notice. The restriction on access to the courts was established to encourage foreign corporations that conduct business in New Jersey to register so that their presence is formally known to the State, including the Division of Taxation.

The logical question that may come up in these cases is whether the company can cure the registration defect after a case is commenced in the State. The New Jersey Appellate Division concluded that the registration requirement is jurisdictional.³ In other words, a company that does not cure the defect prior to filing a complaint may be precluded from maintaining the cause of action until the defect is cured. The ability to proceed with the matter must be authorized by the Court which has the discretion to make such a determination.

Generally, a foreign company has an opportunity to cure the defect if it can demonstrate that the failure to file the Notice was due to ignorance of the law and such ignorance was reasonable under the circumstances. In addition, the company must demonstrate that all taxes, penalties and interest due for all periods during which the company operated in New Jersey are paid.

Jeopardy Tax Assessments

In addition to the restriction on court access, the Division of Taxation ("Division") is authorized to assess tax against foreign companies who fail to properly file a Notice and/or business tax return. The Division implemented a program where investigators are authorized to check license plates for out-of-state commercial vehicles at truck weigh stations and to conduct on-site investigations

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of construction sites and warehouses. The purpose of these investigations is to determine if there are any unregistered companies operating within the State.

When an investigation commences, a company is well advised to retain a tax professional who can manage the investigation process. A company that ignores the Division has significant exposure to a jeopardy assessment. The amount of the jeopardy assessment can be high as it is based on estimates from the information collected by the investigator. Typically, the Division initiates contact with the foreign company and requests that the company register and file all necessary tax returns. If the company fails to respond, the Division will move quickly to protect its interests. First, the Division can file a Certificate of Debt against the company which has the force and effect of a judgment against the company in New Jersey. After the Certificate of Debt has been filed, the Division will proceed with a jeopardy assessment and Warrant of Execution to seize any property located in the State, including any receivables that are due to the company from New Jersey persons.

The foreign company can file a protest to request Conference & Appeals review of the case. However, unlike other tax deficiency cases, these cases require the company to post an acceptable bond with the Division. Until the bond is accepted, the Division is authorized to proceed with enforced collection activities against the company.

A practitioner who is brought into the case after the jeopardy assessment is made must move quickly to protect his client. First, the unfiled returns must be prepared and filed with the Division. Second, the practitioner should file the protest as soon as possible. The jeopardy assessment notice provides the foreign company with 90 days to file a protest. However, because enforced collection activity can proceed until the bond is paid and accepted, an aggressive investigator may issue a levy against the taxpayer before the conclusion of the 90 day protest period. The quick filing of a protest places the Division on notice that the company wants to resolve the dispute, and can facilitate negotiating a suspension on collection activity until Conference & Appeals reviews the case and sets the bond payment amount.

In cases where the Division is less inclined to work with the company and insists on proceeding with enforced collection, the company should consider filing a request for New Jersey Taxpayer Advocate to review the case and evaluate whether it is appropriate to suspend enforced collection actions..

Best Practices

Practitioners who work with out-of-state clients should be aware of the registration and tax obliga-

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tions in New Jersey to ensure compliance with those requirements. In addition, an attorney who represents an out-of-state company that intends to file suit in a New Jersey court should ensure that the client is in compliance with the state's tax and registration requirements before the suit is filed.

If the company is not compliant, the practitioner should consider filing a voluntary disclosure or requesting a closing agreement with the Division to come into compliance with the state's tax obligations. The Division implemented a voluntary disclosure program focused on compliance by out-of-state businesses. Generally, a business must:

1. Have no previous contact with the Division or any of its agents;
2. Not be registered for the taxes that it wants to disclose;
3. Not be under current criminal investigation; and
4. Be willing to pay outstanding tax liabilities and file outstanding tax returns within a reasonable period of time.

For sales tax disclosures, the look-back period is four years (16 quarters) and for other business taxes, the look-back period is also four years. In addition to a written proposal for a voluntary disclosure, the submission must include the Division's "New Jersey Voluntary Disclosure Fact Pattern Form." If the taxpayer's request for a disclosure is accepted, the company will be required to pay the outstanding taxes, interest, the 5% amnesty penalty for amnesty years and a 5% trust fund tax penalty for any trust fund taxes that were collected but not previously remitted to the Division.

Similarly, if the company is not compliant with its registration obligations, the company should cure the defect by filing the appropriate application with the State and paying the required filing fees and penalties. The application for reinstatement is located on the New Jersey Division of Revenue and Enterprise Services website. In order to reinstate the business, the company must obtain a Certificate of Tax Clearance from the Division.

Footnotes:

1. Frank Agostino is the principal of, and Jairo G. Cano is an associate at, Agostino & Associates, P.C.
2. In 2014, the New Jersey legislature enacted P.L. 2014, c. 13 which adopted "click through" nexus sales tax provisions, broadens the definition of operational income and requires certain nonresident partners to file a tax return in the state in order to receive certain credits and refunds related to a partnership.
3. Bonnier Corp. v. Jersey Cape Yacht Sales, Inc., 416 N.J. Super. 436, 440 (App. Div. 2010).

PERSONAL GOODWILL— TRANSACTIONS, BANKRUPTCY AND ESTATE AND GIFT ISSUES

By Frank Agostino, Esq.
Jeffrey Dirmann, Esq.¹

I. Introduction

Often referred to as "the most 'intangible' of the intangibles," goodwill reflects the value of "the probability that customers will return to the old stand" or more precisely "the value of a trade or business attributable to the expectancy of continued customer patronage." When discussing goodwill it is important to differentiate between two components. The first component of goodwill is "business goodwill," also known as enterprise or commercial goodwill. Business goodwill represents the income stream associated with strong management, a trained workforce, and contracts with suppliers and customers. The second aspect of goodwill is known as "personal goodwill" or professional goodwill; personal goodwill refers to the income stream resulting from an individual's relationships with clients and suppliers, skill, knowledge, and reputation. The allocation of income streams between those attributable to business goodwill and those generated by personal goodwill reflects economic reality. In tax cases, an allocation between business and personal goodwill is required by the rule announced in *Lucas v. Earl*, i.e., that income is taxed to the party who earns it. The goal of this article is to provide an overview of the transfer and valuation of personal goodwill in connection with corporate transactions, bankruptcies distributions, estate and gift tax computation, and equitable distribution incident to divorce.

II. How Personal Goodwill is Transferred

Goodwill is property.² Justice Cardozo summarily explained the concept of goodwill when he wrote:

Men will pay for any privilege that gives a reasonable expectancy of preference in the race of competition. Such expectancy may come from succession in place or name or otherwise to a business that has won the favor of its customers. It is then known as good will.³

In 1998, the Tax Court issued its seminal opinion on the topic.⁴ In *Martin Ice Cream v. Commissioner*, Martin's majority shareholder personally developed valuable relationships with the supermarkets to distribute ice cream products, including Häagen-Dazs, with which the shareholder had an oral distributorship agreement.

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Martin Ice Cream stands for the proposition that a key employee who develops income-generating relationships may only share his or her personal goodwill with an employer through an employment contract.⁵ Consequently, the Tax Court held that the shareholder's lack of an employment agreement or covenant not to compete with the corporation resulted in the good will at issue belonging to the shareholder, not the corporation. In other words, a corporation may capitalize on an individual's personal goodwill only when that individual works for the entity. A corporation does not own personal goodwill, and it is not a corporate asset.⁶ In order to transfer personal goodwill to an entity, an employee must covenant not to use his or her personal goodwill to compete against the employer.⁷ The rationale is that when an employee enters into a covenant not to compete, the individual can no longer benefit from his or her personal relationships or reputation except where for the benefit of the employer. In fact, courts have speculated that "it is at least doubtful whether a professional man can sell or dispose of any good will which may attach to his practice except perhaps by contracting to refrain from practicing."⁸

A non-compete agreement between the individual owner of personal goodwill and a purchasing company demonstrates goodwill has been transferred and increases the chance of favorable tax treatment. The non-compete agreement must be legitimate, not a token agreement. Signs of a token non-compete may include the situation where the individual owner of personal goodwill moves to a different state following an acquisition, has a physical or mental condition that would prevent competition irrespective of any non-compete agreement,⁹ or where drafts of a purchase agreement that do not contain the non-compete language provide the same purchase price as a final agreement containing the non-compete language.¹⁰

A non-compete agreement is not always enough to demonstrate the transfer of personal goodwill. For example, a court may characterize it as protecting the goodwill of the purchased company, as opposed to transferring personal goodwill.¹¹ Personal goodwill should be specifically mentioned in the non-compete agreement. The individual owner of goodwill should also have an employment and consulting agreement with the purchaser.¹²

Theoretically, the scope of a non-compete agreement, its duration, and any state law limitations on unlimited non-compete agreements should be analyzed, so that some personal goodwill should survive even broad non-compete agreements. To date, however, courts have refrained from engaging in this sort of thorough analysis of non-compete agreements in personal goodwill cases. One thing is clear; expired non-compete agreements do not transfer personal goodwill to a corporate entity.¹³ It is imperative to include personal goodwill as a specific asset class from the commencement of discussions of the proposed transaction. This applies to any verbal discussions and all written exchanges, including pre-purchase negotiations.¹⁴ A professional appraiser should prepare a report that includes the value of all assets, including goodwill, and should further differentiate between business and personal goodwill. The amounts in the purchase agreement

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should be allocated based on the appraiser's report, and personal goodwill should be associated with the name(s) of its creator(s). To overcome allocation in a purchase agreement, courts may

require a showing of personal goodwill by strong proof. The creator of personal goodwill should ideally sell it in a separate agreement.

A. Transactions Involving Goodwill

Because goodwill is an asset, the final structure of any deal involving goodwill should account for the significant tax effects on the parties. Buyers tend to prefer to buy assets, while some sellers prefer to sell stock. Of importance to sellers is the double layer of taxation for C corporation sellers that results in the recognition of gain by the corporation and the subsequent distribution of the sale proceeds to the shareholders.

To illustrate the point, take, for example, a C corporation that owns assets with a basis of \$50 and a fair market value of \$100. If the corporation sells the assets, it recognizes a taxable gain of \$50. That gain is taxed at the 35% corporate tax rate resulting in \$17.50 of tax. When the corporation distributes the remaining \$32.50 to the shareholders, the shareholders would be taxed at the dividend rate of 15% resulting in a tax due of \$4.88. The total tax due as a result of the transaction is \$22.38, or almost 45%. In this example, if there is goodwill that can be allocated to the shareholder, it would reduce the amount of gain recognized by the corporation and thereby reduce the corporate level tax. Similarly, in a corporate liquidation, section 331 of the Internal Revenue Code (the "Code") requires the shareholders to recognize any amount realized with respect to their shares.

While it appears that a stock sale would eliminate this problem, it must be kept in mind that (1) sellers are less likely to want to assume the potential liabilities associated with stock transfers, and (2) assets inside a corporation are less valuable to a buyer because they cannot be depreciated and do not receive a step-up in basis. In other words, a seller is likely to receive a lower price for the shares than the assets. In an asset acquisition, the buyer is entitled to depreciate¹⁵ or amortize the assets.¹⁶ Thus, buyers will also have to factor in the book cost of amortizing goodwill.¹⁷

In addition to the potential tax savings, sellers may prefer a stock sale to be able to transfer built-in taxable gains to the buyer.¹⁸ Sellers may also have fixed assets whose fair market value exceeds their basis.

Though the buyer in a typical stock purchase is not entitled to a step-up in basis of the assets of the corporation, Code section 338 allows the buyer to treat a stock purchase as a hypothetical asset sale and therefore be entitled to a stepped up basis.¹⁹ In that case, the buyer would be enti-

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tled to depreciate and amortize the deemed acquired assets, including intangibles like goodwill that were identified in the purchase price allocation. Although not likely to be a significant benefit to buyers because the deemed asset sale triggers an additional taxable gain, if the present value of the future tax savings from depreciation and amortization exceeds the current additional tax, then there is a benefit to the buyer.

B. Disposing of Goodwill

Gain or loss realized on the sale or exchange of property is determined by the difference between the amount realized and the adjusted basis of the property sold²⁰ unless a non-recognition provision, such as Code sections 351, 721, 1031, or 1033, is applicable.²¹ When trade or business assets are sold, the purchase price of the trade or business is allocated among all tangible and intangible assets of the business in accordance with the terms of Code section 1060,²² with each asset analyzed based on the amount of consideration allocated to each asset and its corresponding adjusted basis.²³

Assets are first allocated to Classes I through VI, which include financial and tangible current assets. Next, assets are allocated to tangible fixed assets. Assets are then allocated to specific identifiable intangible assets, including contract-based intangibles, marketing-related intangibles, customer-related intangibles, or artistic-related intangibles. The remaining portion of the purchase price, also referred to as the residual value, is allocated to Class VII assets, including the value of the business and goodwill (whether business or personal).²⁴ Self-created goodwill will have a zero basis if the costs incurred in creating it were currently deductible.²⁵ Consequently, gain will be realized to the extent that any portion of the purchase price is allocable to these assets.

When negotiating a deal, allocations to personal goodwill must reflect reality. Consider the case of *Kennedy v. Commissioner*,²⁶ in which documentary evidence created during sale negotiations showed that allocations to personal goodwill were motivated by tax considerations and mere afterthoughts. The result was that the Tax Court agreed with the IRS that the amounts received by the shareholders should be re-characterized as ordinary income, and not gains from the sale of a capital asset, i.e. goodwill.

C. Contribution to a Corporation

A controlling shareholder recognizes neither gain nor loss if “property” is contributed to a corporation solely for stock of the corporation.²⁷ Code section §351. According to Code section 197, bona fide intangible assets, including goodwill, constitute “property” for purposes of section 351.²⁸

The basis of property contributed to a corporation by a controlling shareholder is equal to the basis of the asset in the hands of the shareholder at the time of the contribution, increased by any

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gain recognized by the shareholder on the transfer.²⁹ Consequently, the corporation will obtain a carryover basis in any goodwill contributed to it by a controlling shareholder exclusively in return for stock.³⁰ Where the shareholder receives money or property in addition to stock, gain must be recognized to the extent of any money received plus the fair market value of any property received.³¹ In that case, the basis of the goodwill in the hands of the corporation will be the same as in the hands of the shareholder, increased by the amount of any gain recognized.³²

D. Distribution by a Partnership

A partnership does not recognize gain or loss on the distribution of property to its partners.³³ The adjusted basis of the property, including goodwill, is the adjusted basis in the hands of the partnership immediately prior to the distribution.³⁴ As a result, partners will often receive a carryover basis in any goodwill distributed to them from a partnership. The non-recognition treatment is important because section 197 requires that the transferee of goodwill acquired in a carryover basis transaction under Code section 732 (distributed property other than money) step into the shoes of the distributing partnership with respect to the basis and amortization period applicable to the goodwill.

E. Anti-Churning Rules – Preventing Abusive Amortization of Goodwill

Generally, a taxpayer can amortize intangible assets over 15 years. The anti-churning rules prevent taxpayers from amortizing intangibles acquired in transactions that did not result in a significant change in ownership or use.³⁵ Under section 197(f)(9)(A), the anti-churning rules are specifically applicable to goodwill.³⁶ The anti-churning rules prohibit amortization of section 197 intangibles acquired after August 10, 1993 if (1) the intangible was held or used at any time on or after July 25, 1991, and on or before August 10, 1993 by the taxpayer or a related person; (2) the intangible was acquired from a person who held such intangible at any time on or after July 25, 1991, and on or before August 10, 1993, and, as part of the transaction, the user of such intangible does not change, or (3) the taxpayer grants the right to use such intangible to a person (or a person related to such person) who held or used such intangible at any time on or after July 25, 1991, and on or before August 10, 1993.

Parties are “related” if they are members of an individual’s family (brothers, sisters, spouse, ancestors, lineal descendants);³⁷ if the parties are a partnership and a person, or two partnerships owned by the same persons, who own, directly or indirectly, more than 20 percent of the capital interest or profits interest in a partnership;³⁸ or the parties are engaged in trades or businesses under common control.³⁹ Parties are to be treated as related if the relationship exists immediately before or after the acquisition of the intangible asset. As a result, the sale of non-amortizable

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goodwill to a corporation or a partnership by a shareholder or partner with a 20 percent or greater interest in the entity may be subject to the anti-churning rules.⁴⁰

Consider the following examples:

- Attorney One sells her successful practice, including goodwill, with a covenant not to compete, to unrelated Attorney Two. Attorney Two is permitted to amortize the intangible goodwill over 15 years.
- Instead of selling her successful practice, Attorney One contributes the assets of the practice, including her personal goodwill, to a corporation ("Attorney One, Inc.") in which she owns 100 percent of the shares via a tax free section 351 contribution. Attorney One, Inc. will not be permitted to amortize the goodwill because it was not amortizable in the hands of Attorney One.
- If Attorney One chose to sell her practice to her son (Attorney Three), Attorney Three would not be permitted to amortize goodwill due to the related party rules. The related party rules would also apply if Attorney Three acquired the assets of the practice through a wholly owned corporation.

A partial exception from the anti-churning rules is available to a transferor with less than a 50 percent interest in the entity to which the goodwill is contributed. This exception is only available if the seller recognizes gain on contribution of the goodwill and agrees to pay a tax on that gain computed at the highest rate imposed under sections 1 and 11 of the Code.⁴¹ The anti-churning rules will continue to apply to the excess of the transferee's basis in the asset over the gain recognized by the transferor.

F. Can I Exchange My Goodwill for Someone Else's Goodwill?

The simple answer is no. Code section 1031 provides that gain or loss realized on the transfer of property held for productive use in a trade or business or for investment will not be recognized if the property is exchanged solely for property that is like kind and held for productive use in a trade or business or for investment. If the taxpayer receives cash or non-like-kind property in addition to like-kind property as part of the exchange, the taxpayer will recognize gain but only to the extent of the cash plus the fair market value of the non-like-kind property received (the "boot"). In no event will the taxpayer recognize loss with respect to any like-kind property on such an exchange. When gain or loss is not recognized as a result of section 1031, the basis of the like-kind property received is adjusted to preserve the gain or loss that the taxpayer realized but did not recognize.

The Regulations provide that an exchange of intangible personal property of non-depreciable personal property qualifies for non-recognition of gain or loss under section 1031 only if the ex-

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changed properties are of a like kind and there are no like classes are provided for these properties. Whether intangible personal property is of a like kind to other intangible personal property generally depends on the nature or character of the rights involved and also on the nature or character of the underlying property to which the intangible personal property relates. However, goodwill or going concern value of a business is not of a like kind to the goodwill or going concern value of another business.⁴²

G. The Takeaway

The government generally takes the position that a taxpayers' allocation of personal in a transaction is merely an afterthought. Despite this pessimistic view, personal goodwill allocations are consistent with the common law of substantive tax. One of the earliest cases of the common law of tax is *Lucas v. Earl*,⁴³ which stands for the proposition that the substance of the transaction, rather than the form, is controlling for tax purposes. Allocations to goodwill in the transaction document reflect these two basic principles. As opposed to being afterthoughts, allocations to personal goodwill are consistent with tax professionals' obligation to determine the correct tax. Personal goodwill allocations force courts to decide between well-established axioms: (1) that in tax law, the substance must prevail over the form; and (2) that a person should be free to contract and that contracts should be enforced as made (absent certain enumerated exceptions). One interpretation out of the Third Circuit, the *Danielson* Rule, tends to emphasize form. Yet it also provides for the court's right to look to the substance of the transaction in certain situations:

[A] party can challenge the tax consequences of his agreement as construed by the Commissioner only by adducing proof which in an action between the parties to the agreement would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, etc.⁴⁴

In contrast, consider *Wilson Athletic Goods Mfg. Co. v. Commissioner*, in which the Seventh Circuit used purely substance over form reasoning to determine that covenants, which were not specifically allocated in the purchase price, clearly possessed value saying:

But in tax matters we are not bound by the strict terms of the agreement; we must examine the circumstances to determine the actualities and may sustain or disregard the effect of a written provision or of an omission of a provision, if to do so best serves the purpose of the tax statute. * * * Therefore, it was the duty of the tax court and is our duty here to ascertain the true intent, insofar as tax consequences are concerned. Consequently, it is immaterial whether the contract did or did not define a specified amount as the value of the covenant. * * * In view of the silence of the contract in this respect, it became necessary to determine then from the

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other evidence whether the covenant had a value, and if so the amount thereof. Where realistically and actually the covenant has a discernible value, the purchaser, of course, may amortize the price paid for it and claim annual deductions pro rata during the life of the covenant.⁴⁵

The Tax Court prefers a rule somewhere in between *Danielson* and *Wilson Goods*, the so-called strong-proof rule, also known as “economic significance” or “economic reality.”⁴⁶

[W]e think that the covenant must have some independent basis in fact or some arguable relationship with business reality such that reasonable men, genuinely concerned with their economic future, might bargain for such an agreement.⁴⁷

The Tax Court’s test is designed to (1) produce predictability by generally enforcing agreements as made, and (2) assure at the same time that the Court is not hamstrung into enforcing obviously substance-less allocations.⁴⁸

Goodwill should never be an afterthought when planning a transaction. The Tax Court will not uphold goodwill allocations arising late in negotiations, where such allocations are for tax purposes only and not contemplated as substantive components of a transaction.⁴⁹

III. Is Goodwill Treated Differently in Bankruptcy, Divorce and Estate Planning?

A. Bankruptcy

One of the primary purposes of the Bankruptcy Act is to relieve an honest debtor from the weight of oppressive indebtedness, and permit them “to start afresh.”⁵⁰ The question is whether personal goodwill is an asset of the bankruptcy estate in which creditors get to share. Section 541 of the Bankruptcy Act provides in pertinent part that:

The commencement of a case under section 301, 302, or 303 of this title creates an estate. Such estate is comprised of all the following property, wherever located and by whomever held:

(1) [With exceptions,] all legal or equitable interests of the debtor in property as of the commencement of the case.

(6) Proceeds, product, offspring, rents, or profits of or from property of the estate, except such as earnings from services performed by an individual debtor after the commencement of the case.⁵¹

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The question, therefore, is how to value the business of a debtor that relies heavily on personal goodwill. In *In re Schultz*, a sole proprietor accountant filed for bankruptcy but continued servicing his clients throughout the process and after the discharge. The Bankruptcy Court pointed out that, despite section 541(a)(6)'s prohibition against including post-petition earnings in the bankruptcy estate, the value of a professional practice owned by a debtor as of the commencement of a bankruptcy case is attributable to many different assets—and some of its value may be derived from goodwill.⁵² Goodwill includes the practice's name recognition, consumer brand loyalty, or special relationships with suppliers or clients.⁵³ The Court referred to "well-settled" New York law that professional goodwill is a saleable asset which attaches to the place, not the person.⁵⁴ Accordingly, the Bankruptcy Court held that goodwill of the accounting practice retained by the debtor post-petition was an asset of the estate. The *Schultz* Court also acknowledged that to have any significant value, a professional practice would have to be sold, and the seller would have to agree not to compete for a reasonable time in the future.⁵⁵ In order to harmonize the two competing interests (the debtor's need to continue to make a living versus the creditors' right to have all relevant assets included in the bankruptcy estate), the Court adopted a valuation method that valued the accounting practice as a going concern, but modified by the consideration of its value to a third party without a contract not to compete.

For a different perspective, the Ninth Circuit in *In re Fitzsimmons* held that the post-petition income of an attorney as a solo practitioner could be divided between income received as a direct result of his personal services and income attributable to the firm's invested capital, accounts receivable, goodwill, employment contracts with the firm's staff, client relationships, fee arrangements or the like; and that the income attributable to the latter accrued to the estate under chapter 11 of the Bankruptcy Code.⁵⁶ Similarly, the Seventh Circuit in *In re Prince* confirmed a chapter 11 reorganization plan, which required the debtor to pay creditors the equity value of his orthodontist practice, including equity in the corporation's goodwill.⁵⁷

The principles of *Prince* and *Fitzsimmons* were adopted in *In re Thomas*,⁵⁸ in which the Bankruptcy Court held that the goodwill of a chapter 13 debtor's courier service was rooted in his pre-petition efforts to develop a rapport with customers and build his business. The Bankruptcy Court also held that the debtor's assertion that the company's future earnings represented a purely post-petition asset was faulty to the extent that it overlooked the pre-petition effort that went into the creation of the goodwill that would continue post-petition. Ultimately the Court held that the goodwill of the debtor's courier service was an asset separate from income derived from his personal services.

The conclusion to be drawn from the cases is that bankruptcy courts favor a mixed approach which seeks to treat creditors fairly, while at the same time adhering to the principle that bankruptcy is truly a fresh start. Ultimately, those professional clients who find themselves considering

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bankruptcy should be aware that the going-concern value and associated goodwill of their practice will be taken into account when determining the value of their bankruptcy estate.

B. Divorce

Unfortunately, some professionals experience the difficult process of divorce during the course of their career. In New Jersey, courts may “effectuate an equitable distribution of the property, both real and personal, which was legally and beneficially acquired by them or either of them during the marriage,”⁵⁹ while also holding that goodwill is a legally protected interest.⁶⁰ Despite the ethical considerations that may arise and prevent the transfer of a professional practice, its value is subject to equitable distribution.⁶¹

Knowing that professional goodwill is subject to equitable distribution, the question is value. The methods used to determine the value of professional goodwill include (1) reliance on a buy-sell agreement between co-owners of a practice; (2) application of a formula based on earnings, such as the straight capitalization of earnings, the capitalization of earnings in excess of average salaries, and the IRS variation of capitalized excess earnings, based on an expected rate of return on a practice’s tangible assets; and (3) determination of the practice’s fair market value. Courts have held that the value people put on an asset is the most productive place to start such an inquiry: “It would be shortsighted and unwise for courts to reject out of hand consensual solutions to vexatious personal matrimonial problems that have been advanced by the parties themselves.”⁶² In *Stern v. Stern*, the Court considered the most accurate and useful method for purposes of equitable distribution to be the formula for the calculation and payment of a partner’s interest to his personal representative upon death—in other words, the amount the partners had bargained for.⁶³

Goodwill should be valued with great care; for the individual practitioner will be forced to pay the ex-spouse “tangible” dollars for an intangible asset at a value concededly arrived at on the basis of some uncertain elements.⁶⁴ With respect valuing a law practice, New Jersey courts will first ascertain what a similarly situated attorney with comparable experience, expertise, education and age, and effort expended on the practice. Next, the income before federal and state income taxes is determined and averaged. The average is compared with that of a similarly situated employee attorney. In the event the attorney’s actual average exceeds that of the similarly situated employee and a return on the investment in the physical assets of the practice, the excess forms the basis for evaluating goodwill. The excess is subject to a capitalization factor generally considered to be the number of years of excess earnings a purchaser would be willing to pay in advance in order to acquire the goodwill.⁶⁵

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C. Estate and Gift Tax Issues

Code section 2501(a) imposes a tax on the transfer of property, by gift, for which the donor is primarily responsible for paying.⁶⁶ The gift tax is imposed upon the donor's act of making the transfer, and it is measured by the value of the property that passes from the donor, rather than the value of enrichment to the donee.⁶⁷ The imposition of gift tax is based on the objective facts and circumstances surrounding the transfer, rather than the subjective motives of the donor, so that donative intent on the part of the donor is not considered.⁶⁸ In other words, it does not matter whether a person intends to make a gift if the Service later determines that a gift was made pursuant to section 2512(b).⁶⁹

Where property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift.⁷⁰ In addition to transfers for which no valuable consideration is exchanged, "gifts" under section 2512(b) embrace "sales, exchanges, and other dispositions of property for a consideration to the extent that the value of the property transferred by the donor exceeds the value in money or money's worth of the consideration given therefore."⁷¹ Where the transaction occurs between family members, it is "subject to special scrutiny, and the presumption is that a transfer between family members is a gift."⁷² Because family businesses have the potential to possess significant value related to goodwill, the potential exists for unintentional taxable gifts resulting from transferring businesses from one generation of a family to the next.

In *Bross Trucking v. Commissioner*⁷³ negative results from audits and investigations caused Bross Trucking to cease operations. Chester Bross' (of Bross Trucking) three sons established a new company, LWK trucking, which independently acquired its own insurance and regulatory authority to operate. As the court noted, "nothing was transferred from Bross Trucking to LWK Trucking and LWK Trucking met all of the requirements on its own."⁷⁴ LWK Trucking executed new vehicle leases for the vehicles previously used by Bross Trucking, covered the Bross logo with the LWK logo, and extended into new lines of business. The only tangible connection between Bross Trucking and LWK Trucking that LWK Trucking hired about 50% of Bross Trucking's workforce. Nevertheless, the IRS issued a Notice of Deficiency to Bross Trucking, contending that the company distributed intangible assets to Chester Bross, who then made a gift of those intangible assets to his three sons, who had organized a new trucking company.⁷⁵ The Tax Court ultimately held all goodwill stemmed from Chester Bross' personal relationships (except for Bross' workforce). Because Chester Bross had not transferred any of his personal goodwill to Bross Trucking through an employment agreement or covenant not to compete he "was free to compete against LWK Trucking and use every cultivated relationship in order to do so."⁷⁶

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*Cavallaro v. Commissioner*⁷⁷ involved another father and sons operating related entities. The father's company manufactured their product, and the sons' company was the seller. The sons' company would take orders for the product, which were immediately submitted to the father's company, which manufactured the product at its facilities and with its equipment. The sons' company was not billed until the product was complete and ready for delivery, and the sons' company did not pay for the product until it had been paid for by the end customer, leaving the father's company at risk for non-payment. Both companies shared payroll, and the father guaranteed the companies' respective obligations under a financing agreement, which was collateralized by the father's assets and building. The sons' company did not even have its own bank accounts. In 1995, both companies engaged Ernst & Young to determine the prospective value of the father's and sons' companies for purposes of merging. Using a market-based approach, Ernst & Young valued the combined entity at between \$70 and \$75 million, with the father's portion being worth between \$13 and \$15 million. Subsequent to the Ernst & Young valuation, the companies merged in a tax free merger in which Camelot was the surviving entity. However, Ernst & Young prepared their valuation under the assumption that the sons' company owned the technology involved in creating the product. Less than one year later, the merged entity was sold to a third party for \$57 million in cash with a contingent additional amount of \$43 million. The IRS determined that taxable gifts had occurred upon the transfer of the technology to the sons.

The Tax Court found the facts of the sale revealed lack of arms-length dealing, and that the buyer purportedly gave a sum greatly in excess of the worth of the property, such that the facts indicate that what was done was not a real business transaction and "was not intended to have the usual results and significance of a bona fide business deal."⁷⁸ There was no evidence of a transfer of the technology and it was inconceivable that an independent third party would not have wanted to see any proof that the sons' company owned the technology when the father and sons' companies merged.⁷⁹

The lessons to be learned: (1) formalities (remember that the taxpayers in *Bross Trucking* made sure to maintain their independence from the new entity) are important. The two had to expended little capital in the development of the technology necessary to produce its product compared to the value it eventually received; (2) reliance on professional advice can always be raised as a defense to penalties. Despite getting questionable advice from their estate planning attorneys, the taxpayers in *Cavallaro* were able to avoid penalties.⁸⁰

IV. What Methods Are Used to Determine Valuation of Goodwill?

There are three accepted methods of valuing goodwill that are used by the Tax Court: (1) the Asset approach; (2) the Income approach; and (3) the Market approach.

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A. The Asset Approach

The asset approach involves an analysis of the economic worth of a company's tangible and intangible recorded and unrecorded assets in excess of its outstanding liabilities.⁸¹ The asset approach in valuing an entity for estate tax purposes may be used in the valuation of operating companies where the value of the underlying assets in liquidation, as reduced to reflect tax associated tax liabilities, exceeds the value of the business as a going concern.⁸² This approach is in accord with Revenue Ruling 59-60 which states that:

The value of the stock of a closely held investment or real estate holding company, whether or not family owned, is closely related to the value of the assets underlying the stock. For companies of this type the appraiser should determine the fair market values of the assets of the company. Operating expenses of such a company and the cost of liquidating it, if any, merit consideration when appraising the relative values of the stock and the underlying assets. The market values of the underlying assets give due weight to potential earnings and dividends of the particular items of property underlying the stock, capitalized at rates deemed proper by the investing public at the date of appraisal. A current appraisal by the investing public should be superior to the retrospective opinion of an individual. For these reasons, adjusted net worth should be accorded greater weight in valuing the stock of a closely held investment or real estate holding company, whether or not family owned, than any of the other customary yardsticks of appraisal, such as earnings and dividend paying capacity.⁸³

One subset of the asset approach is the adjusted net assets method by which the value is determined by the difference between the fair market value of the business' assets and its liabilities. Book value of the assets are adjusted to fair market value measured by replacement or liquidation value and then reduced by the fair market value of the liabilities.⁸⁴

B. The Income Approach

The income approach converts anticipated economic benefits into a present single amount.⁸⁵ There are two variations of the income approach: (1) the capitalization of earnings/cash flow method; and (2) the discounted earnings/cash flow method. Non-operating assets and liabilities are removed when applying the method and then added back to the capitalized value.⁸⁶

Under the capitalization of earnings/cash flow method, a business is valued based on future estimated benefits, considering the potential future cash flow to the business. The estimated future

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benefits are then capitalized using an appropriate capitalization rate. The method assumes that all of the assets are distinguishable parts of the business and does not separate their values.

Under the discounted earnings/cash flow method, the only expected earnings that are value are cash-flow. The concept is that the business is worth the present value of its future earning potential plus the liquidation value of its assets. The residual amount is the value attributable to goodwill.

C. The Market Approach

Fair market value is defined as the price at which the property would change hands between a willing buyer and a willing seller, if neither is under any compulsion to buy or to sell and both have reasonable knowledge of all relevant facts.⁸⁷ Valuation does not take into account the personal characteristics of the actual buyer or the actual seller.⁸⁸ Instead, valuation considers a hypothetical buyer and seller who are presumed to be dedicated to achieving the maximum economic advantage (maximum profit) from the sale.⁸⁹ There are two common approaches when using this method, 1) a residual purchase price method, and 2) a sales comparison method. Goodwill is rarely sold apart from a business so a sales comparison method will be applicable only when valuing the entire business.

D. Additional Valuation Models

The With and Without method analyzes two scenarios using the discounted cash flow model. First, what is the value of the business continuing as is? Second, what is the value of the business if it were to continue without the key individual who owns the personal goodwill? The individual may eventually be replaced, but the presumption is that it takes many years, and the replacement's salary is accounted for in the model.⁹⁰ The method involves many subjective judgment calls, but, for example, if there are identifiable clients tied to the key person, it is assumed that the clients leave with the key person's departure.⁹¹

The Multi-Attribute Utility Model method begins by calculating the total value of goodwill. After that, a list of attributes is created. Personal goodwill attributes may include personal reputation, specialized knowledge, young age, good health, or personalized business name; enterprise goodwill may include business systems, locations, multiple offices, and high quality staff.⁹² The attributes are assigned weights based on a combination of their importance and presence in the particular business.⁹³ The factors are then combined to arrive at personal versus business goodwill percentages.

The Compensation-for-Contribution Method removes goodwill from the valuation by assuming that the value to the business owner is equal to his or her compensation is indicative of the value

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the owner is generating. Remaining business earnings are assumed to be derived from the tangible assets of the business.⁹⁴

Revenue Ruling 68-609 provides a formula to value intangible assets when no better formula is available. It is capitalized earnings, less return on tangible assets, averaged over the last five years, less proprietor's reasonable compensation.⁹⁵

Ultimately appraisers and courts must analyze economic realities of the transactions, but always consider that individuals and business are free to choose the manner in which they arrange their affairs.

V. Conclusion

Goodwill and its application has always been a contentious issue between taxpayers and the IRS. That tension does not show any signs of letting up. Because of practitioners' duty to determine correct tax treatment coupled with their ethical duties as practitioners, such determination with respect to goodwill should be respected. As the most recent estate and gift tax cases show, the issue of goodwill might become a target of enforcement at the IRS. The Service is taking a tough stand with taxpayers who attempt to limit the value of their estate or business through the allocation of goodwill. Business owners should be proactive and plan early for eventual succession of or exit from their businesses. If you have any questions regarding this article, please contact Frank Agostino at (201) 488-500, ext. 107 or Jeffrey Dirmann at (201) 488-5400, ext. 119.

Footnotes:

1. Frank Agostino is the principal of, and Jeffrey Dirmann is an associates at, Agostino & Associates, P.C. in Hackensack, New Jersey.
2. *Dugan v. Dugan*, 92 N.J. 423, 429 (1983) (citing *In re Hall's Estate*, 99 N.J.L. 1 (Sup. Ct. 1923) at 125).
3. *Id.* at 429 (citing *In re Brown*, 242 N.Y. 1, 6 (1926)).
4. *Martin Ice Cream v. Commissioner*, 110 T.C. 189 (1998). While *Martin Ice Cream* may be the most important recent case on "goodwill," the concept had been developed over the years:
Th[e U.S. Tax] Court has long recognized that personal relationships of a shareholder-employee are not corporate assets when the employee has no employment contract with the corporation. Those personal assets are entirely distinct from the intangible corporate asset of corporate goodwill. See, e.g., *Estate of Taracido v. Commissioner*, 72 T.C. 1014, 1023 (1979) (where sole shareholder was sine qua non of corporation's success, corporation's goodwill did not include the personal qualities of its sole shareholder); *Cullen v. Commissioner*, 14 T.C. 368, 372 (1950) (personal ability, personality, and reputation of sole active shareholder not a corporate intangible asset where there is no contractual obligation to continue shareholder's services); *MacDonald v. Commissioner*, 3 T.C. 720, 727 (1944) ("We find no authority which holds that an individual's personal ability is part of the assets of a corporation by which he is employed where * * * the corporation does not have a right by contract or otherwise to the future services of that individual."); *Providence Mill Supply Co. v. Commissioner*, 2

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- B.T.A. 791, 793 (1925).
- Id.* at 207-08.
5. *Id.* at 208.
6. *Id.*
7. See *O'Rear v. Commissioner*, 28 B.T.A. 698, 700 (1933), *aff'd*, 80 F.2d 473 (6th Cir. 1935).
8. *Id.*
9. *Schilbach v. Commissioner*, T.C. Memo. 1991-556.
10. See *id.*
11. See *Muskat v. United States*, 554 F.3d 183 (2009).
12. See *Solomon v. Commissioner*, T.C. Memo. 2008-102 (a non-compete without an employment and consulting agreement did not demonstrate the presence of personal goodwill).
13. See *Norwalk v. Commissioner*, T.C. Memo. 1998-279.
14. See *Muskat*, 554 F.3d 183.
15. I.R.C. § 168.
16. I.R.C. § 197.
17. The financial impact of the deal must also be analyzed from an accounting cost perspective. Before January 2014, FASB required the amortization of goodwill over its useful life, not to exceed 40 years. In 2001, FASB eliminated goodwill amortization for financial reporting purposes and instead required that goodwill be tested for impairment at least annually using a two-step process. Due to concerns about cost and complexity of the goodwill impairment process, FASB developed an optional qualitative impairment test as a screen for companies to assess whether it is more likely than not that goodwill is impaired before performing the quantitative two-step impairment test. On January 16, 2014, FASB issued FASB Accounting Standards Update No. 2014-02, *Intangibles-Goodwill and Other (Topic 350): Accounting for Goodwill*. The Update permits a private company to subsequently amortize goodwill on a straight-line basis over a period of ten years, or less if the company demonstrates that another useful life is more appropriate. It also permits a private company to apply a simplified impairment model to goodwill. Note that the accounting depreciation period differs from the tax depreciation period.
18. Consider the accounts receivable of a cash basis corporation.
19. I.R.C. § 338.
20. I.R.C. § 1001.
21. I.R.C. § 1001(c). See also *Fed. Inc. Tax. Intell. Prop. & Intangible Ass.* ¶11.04.
22. I.R.C. § 1060. See also *Fed. Inc. Tax. Intell. Prop. & Intangible Ass.* ¶11.04.
23. *Fed. Inc. Tax. Intell. Prop. & Intangible Ass.* ¶11.04.
24. I.R.C. § 1060; Treas. Reg. § 1.1060-1.
25. *Id.*
26. T.C. Memo. 2010-206.
27. I.R.C. § 351.
28. I.R.C. § 197(f).
29. I.R.C. § 362. See also *Fed. Inc. Tax. Prop. & Intangible Ass.* ¶11.02.
30. *Id.*
31. I.R.C. § 351(b).
32. I.R.C. § 362(a).
33. I.R.C. § 731(b).
34. I.R.C. § 732(a)(1).
35. I.R.C. § 197(f)(9)(A); Treas. Reg. § 1.197-2(h)(1). See also *Fed. Inc. Tax. Prop. & Intangible Ass.* ¶11.03[4].
36. *Id.*
37. I.R.C. § 267(b)(1).
38. See I.R.C. § 707(b)(1).
39. I.R.C. § 197(f)(9)(C)(i); Treas. Reg. § 1.197-2(h)(6)(i). A trade or business under "common control" is defined in I.R.C. § 41(f)(1).
40. *Fed. Inc. Tax. Prop. & Intangible Ass.* ¶11.03[4].
41. I.R.C. § 197(f)(9)(B); Treas. Reg. § 1.197-2(h)(9). *Fed. Inc. Tax. Prop. & Intangible Ass.* ¶11.03[4].
42. Treas. Reg. § 1.1031(a)-2(c)(2).

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43. 281 U.S. 111 (1930).
44. *Commissioner v. Danielson*, 378 F.2d 771, 775 (3d Cir. 1967).
45. *Wilson Athletic Goods Mfg. Co. v. Commissioner*, 222 F.2d 355 (7th Cir. 1955).
46. [*Schulz v. Commissioner*, 294 F.2d 52, 55 \(9th Cir. 1961\)](#), *aff'd*, 34 T.C. 235 (1960)
47. *Id.*
48. *Lazitsky v. Commissioner*, 72 T.C. 495
49. *Kennedy v. Commissioner*, T.C. Memo. 2010-206.
50. *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934).
51. 11 U.S.C. § 541(a).
52. *In re Schultz*, 250 B.R. 22 (2000).
53. *Id.* at 35.
54. *Id.* (citing *Spaulding v. Benenati*, 57 N.Y. 2d 418 (1982)).
55. *Id.* (citing *Robertson v. Swanson*, 36 B.R. 99, 100 (9th Cir. B.A.P. 1984)).
56. *In re Fitzsimmons*, 725 F.2d 1208 (9th Cir. 1984).
57. *In re Prince*, 85 F.3d 314 (7th Cir. 1996).
58. *In re Thomas*, 246 B.R. 500 (E.D. Pa. 2000).
59. N.J.S.A. 2A:34-23.
60. *Piscopo v. Piscopo*, 232 N.J. Super. 559 (App. Div. 1989) (citing *J.B. Liebman & Co., Inc. v. Leibman*, 135 N.J. Eq. 288, 292 (Ch.1944); *In re Hall*, 99 N.J.L. 1, 2 (Sup.Ct. 1923), *aff'd* 100 N.J.L. 405 (E. & A. 1924).
61. *Dugan*, 92 N.J. at 429.
62. [*Petersen v. Petersen*, 85 N.J. 638, 645 \(1981\)](#) (enforceability of automatic escalation clause in marital settlement).
63. *Stern v. Stern*, 66 N.J. 340, 346 (1975).
64. *Dugan*, 92 N.J. at 435.
65. *Id.* at 439-40.
66. I.R.C. §§ 2501(a)(1), 2502(c); see also Treas. Reg. § 25.2502-2, Gift Tax Regs.
67. Treas. Reg. § 25.2511-2(a), Gift Tax Regs.
68. Treas. Reg. § 25.2511-1(g)(1), Gift Tax Regs.
69. Consider the case of Sumner Redstone, a wealthy television executive. In 2013, the IRS determined that there was an unreported taxable gift that occurred in 1972. For a more in-depth discussion of the case see Charles Rubin, *IRS Goes Back 41 Years to Assess Gift Tax*, JD SUPRA BUSINESS ADVISOR, May 6, 2013, <http://www.jdsupra.com/legalnews/irs-goes-back-41-years-to-assess-gift-ta-33369/>.
70. I.R.C. § 2512.
71. Treas. Reg. § 25.2512-8, Gift Tax Regs.
72. *Harwood v. Commissioner*, 82 T.C. 239, 258 (citing *Estate of Reynolds v. Commissioner*, 55 T.C. 172, 201 (1970)), *aff'd without published opinion*, 786 F.2d 1174 (9th Cir. 1986).
73. T.C. Memo. 2014-107, 2014 WL 2535094.
74. *Bross Trucking v. Commissioner*, T.C. Memo. 2014-107, 2014 WL 2535094 at *4.
75. I.R.C. § 311(b) provides that if a corporation distributes assets to a shareholder, the corporation recognizes gain as if the property were sold to the shareholder at its fair market value. Gain is then recognized to the extent that the property's fair market value exceeds the corporation's adjusted basis.

The IRS contended that Bross Trucking distributed the company's "operations" to Chester Bross. The notice of deficiency explained that the deficiency was based on distributed intangible assets with the following attributes: (1) goodwill; (2) established revenue stream; (3) developed customer base; (4) transparency of the continuing operations between the entities; (5) established workforce including independent contractors; and (6) continuing supplier relationships.

The Tax Court was not clear whether the IRS considered each attribute to be a separate intangible asset, or whether they were aggregated into the whole. The Tax Court explained that its understanding of section 311(b)(1)(A) supports an interpretation requiring identification of the property to satisfy the requirements necessary to recognize a gain. For purposes of section 311(b)(1)(A), property is defined as money, securities, and any other property, except for stock of the distributing corporation or rights to acquire such stock. Because the Court understood a section 311(b) calculation to be impossible if the property in question is not identified, it interpreted the IRS's position to be that the prop-

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erty was the goodwill that was distributed from Bross Trucking. The IRS's list of attributes mentioned above made up Bross Trucking's goodwill.

76. Bross Trucking, T.C. Memo. 2014-107 at *12.

77. Cavallaro v. Commissioner, T.C. Memo. 2014-189.

78. Dauth v. Commissioner, 42 B.T.A. 1181, 1189 (1940).

79. The Cavallaros appealed to the Court of Appeals for the First Circuit which raising four issues; 1) the original notices of deficiency were arbitrary and excessive; 2) the Commissioner relied a new theory of liability; 3) the Tax Court improperly concluded that Knight owned the CAM/A LOT-related technology; and 4) that the Tax Court erred by misstating their burden of proof and subsequently failing to consider alleged flaws in the IRS's valuation expert. The Court of Appeals affirmed the Tax Court's findings with respect to the ownership of the technology and burden of proof but reversed and remanded the case with respect to the nature of the Cavallaros' burden of proof. See *Cavallaro v. Comm'r of Internal Revenue*, 842 F.3d 16 (1st Cir. 2016).

80. Mr. Cavallaro had limited education and no post-high school training in accounting or bookkeeping.

81. National Association of Certified Valuators and Analysts (NACVA), *Fundamentals, Techniques & Theory - Commonly Used Methods of Valuation - Chapter 6*, (2012), available at http://edu.nacva.com/preread/2012BVTC/2012v1_FTT_Chapter_Six.pdf.

82. Treas. Reg. § 20.2031-1(b).

83. Revenue Ruling 59-60, 1959-1 C.B. 237.

84. NACVA, *Fundamentals, Techniques & Theory*, *supra* note 89. The adjusted net asset approach causes problems when companies or estates take a discount for income tax liability, or built-in gains.

85. *Id.* (citing the *International Glossary of Business Valuation Terms*).

86. *Id.*

87. Treas. Reg. § 20.2031-1(b), Estate Tax Regs.

88. *Estate of Curry v. United States*, 706 F.2d 1424, 1428-29, 1431 (7th Cir. 1983); *Estate of Noble v. Commissioner*, T.C. Memo. 2005-2.

89. *Estate of Noble*, T.C. Memo. 2005-2.

90. E-mail from Don Wenk, partner at Kotzin Valuation Partners, LLC, to Eugene Kirman, associate at Agostino & Associates, P.C. (Mar. 16, 2015, 8:26 PM EST) (on file with authors).

91. *Id.*

92. Don Wenk, Personal Goodwill Revisited: Its Nature and Importance in Business Valuation (Apr. 2013), <http://www.kotzinvaluation.com/articles/personal-goodwill.htm>.

93. The importance of attributes is based on what is important in a particular industry, but also takes the customer view in what is important in selecting a service or product.

94. Brian R. Potter, *What Creates Personal Goodwill*, Spring 2010, <http://www.srr.com/article/what-creates-personal-goodwill>.

95. $\text{Intangible value} = 1 / \text{Capitalization rate} \times [\text{Last 5 year average earnings} - (\text{reasonable rate of return} \times \text{Last 5 year average tangible assets}) - \text{proprietor's reasonable compensation}]$. Reasonable compensation is deducted only for partnerships and small proprietorships. Unusual years should be ignored. The ruling suggests using industry averages for a reasonable rate of return and, if assets are being sold based on a realistic capitalization rate, use that number for capitalization rate. If these numbers are unavailable, it suggests using a 15 to 20% capitalization rate and a 8 to 10% reasonable rate of return. Businesses with stable earnings and small risk should use a low estimate for the rate of return and a high estimate for the capitalization rate.

TRANSFER AND CONFERENCE PROCEDURE CHANGES IN APPEALS

Appeals is implementing changes to its case transfer and conference procedures. Previously, in cases where a face to face conference was requested, Appeals allowed automatic transfer from the Campus Service Center to Field offices. Upon review of this procedure, IRS found taxpayers often requested a case transfer where a Campus employee could have resolved the case. In addition there were added costs for shipping as well as a delay in case resolution. Another consideration was that many of these transferred cases were ultimately resolved by a telephone conference.

The change is that Appeals will not transfer cases solely upon the taxpayer's request and will consider the following before an in-person conference is granted:

- whether there are substantial books and records that cannot easily be referenced with page numbers or indices
- the ability to judge the credibility of oral testimony
- special needs
- number of participants
- alternative conference procedures that may be used (e.g., Post-Appeals Mediation or the Rapid Appeals Process)
- whether another work stream calls for in- person conference

The hearing officer must make the initial determination to grant an in-person conference and the final decision is with the Appeals Team Manager. The Internal Revenue Manual has been updated to reflect changes at IRM part 8.1 and Fact Sheet Changes to Case Transfer and Conference - IRS.gov <https://www.irs.gov/pub/irs-utl/f2f-fact-sheet.pdf>

— Desa Lazar, Esq.

FIRM NEWS

On December 15, 2016, Agostino & Associates was successful in obtaining a judgment in favor of Borgata Hotel Casino & Spa against professional gambler Phil Ivey for \$10.1 million. The case involved the use of marked cards at the game of Baccarat in a unique scheme known as "edge sorting." Because of the parties involved, the case garnered much national attention from its inception. Jeremy Klausner handled the case for the firm in the United States District Court for the District of New Jersey.

On November 30, 2016, the United States Tax Court released its opinion in *Graev v. Commissioner*, a case involving the application of 26 U.S.C. sec. 6751(b), which requires the IRS to obtain written approval before assessing certain penalties. The firm argued that the taxpayer was not liable for a penalty in that case because there was no written authorization. Although a majority of the full Tax Court held that the taxpayer's motion was premature because assessment did not occur until after a Tax Court decision on the underlying merits, a spirited dissent pointed out that such a holding made no sense because, in part, it did not allow the Tax Court itself to determine whether 6751(b) was satisfied. Another case handled by the firm, *Chai v. Commissioner*, is currently on appeal to the United States Court of Appeals for the Second Circuit on a similar issue. Stay tuned for updates on the result of Chai and the interpretation of 6751(b).

Upcoming Speaking Engagements:

On December 28, 2016 Jeffrey Dirmann will moderate a panel titled: Let's Make a Deal: Dealing with the IRS Collections Division, at the New York State Society of CPAs "Effectively Representing Taxpayers Before the IRS" series in New York, NY from 9AM to 5PM.

On January 17, 2017 Frank Agostino & Jairo Cano will present the 6th Annual Introduction to New Jersey Tax Controversy at Seton Hall University School of Law located at 1 Newark Center, Newark, NJ from 8AM to 12PM.

On January 19, 2017 Jairo Cano will serve as a panelist on a panel titled: Tax Basics Through Crowd Funding Transactions at the ABA Mid-Year Meeting, Orlando FL.

On January 23, 2017: Frank Agostino will serve as a moderator for the 8th Annual Criminal Tax Enforcement Forum: 2017 Update for Tax Professionals at Bergen Community College, Technology Center Room 128, located at 400 Paramus Road, Paramus NJ 07652 from 7:30 AM to 12 PM.

On March 8, 2017 Jairo Cano will serve as a panelist on a panel titled: Successful Commercial,

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Employment and Taxation Mediation through the NJ Bar Association.

Upcoming Webinars on CPAAcademy.org:

Jairo Cano, Esq. and Lawrence A. Sannicandro, Esq. will continue to present webinars through CPAAcademy.org, the country's largest provider of free live CPE webinars. A list of Jairo's and Larry's upcoming webinars are:

Fundamentals of Negotiating Collection Alternatives with the IRS: January 4, 2017 at 4 PM (EST)

Effective Representation to Address Enforced Collection Activity from the IRS: January 9, 2017 at 4 PM (EST)

Representing the Innocent Spouse in Pre- and Post- Filing Tax Controversies: January 10, 2017 at 11 AM (EST)

Audits of Cash Intensive Businesses: January 23, 2017 at 11 AM (EST)

Nuts and Bolts of Organizing and Operating a Section 501(c)(3) Nonprofit Organization: January 26, 2017 at 4 PM (EST)

Nuts and Bolts of Employment Taxes and the Trust Fund Recovery Penalty: January 30, 2017 at 4 PM (EST)

Upcoming Webinars on Clear Law Institute:

Lawrence A. Sannicandro, Esq. will present the following webinars through the Clear Law Institute:

International Tax and Reporting for Cross-Border Transactions:
3 p.m. E.S.T. on January 9, 2017.

December 2016

UPCOMING UNITED STATES TAX COURT CALENDAR CALLS

All Calendar Calls Are Held at:

Jacob K. Javits Federal Building
26 Federal Plaza
Rooms 206, 208
New York, NY 10278

December 12, 2016

January 30, 2017

February 13, 2017

March 6, 2017

March 20, 2017

AGOSTINO & ASSOCIATES, P.C. CONTACT INFORMATION

Frank Agostino, Esq. Ext. 107
Fagostino@agostinolaw.com

Jairo Cano, Esq. Ext. 144
Jcano@agostinolaw.com

Philip Colasanto Ext. 105
Pcolasanto@agostinolaw.com

Jeffrey Dirmann, Esq. Ext. 119
Jdirmann@agostinolaw.com

Eugene Kirman, Esq. Ext. 142
Ekirman@agostinolaw.com

Jeremy Klausner, Esq. Ext. 130
Jklausner@agostinolaw.com

Dolores Knuckles, Esq. Ext. 109
Dknuckles@agostinolaw.com

Lawrence Sannicandro, Esq. Ext. 128
Lsannicandro@agostinolaw.com

Michael Wallace, EA Ext. 143
Mwallace@agostinolaw.com

Caren Zahn, EA Ext. 103
Czahn@agostinolaw.com

TAXPAYERS ASSISTANCE CORPORATION - OF COUNSEL

Desa Lazar, Esq. Lazar@tac-nj.org

December 2016

The Bergen Chapter of the New Jersey Society of CPAs invites you to attend:



CPA and Attorney Networking Evening

An evening to network with your CPA colleagues and lawyers of the Bergen County Bar Association. CPE focus will be on real estate lending including current real estate market, financing choices, reverse mortgages, elder care planning, and disability care planning.

Date: Wednesday, January 11, 2017

Agenda:

5:30–6:30pm – Open bar and Hors'd'oeuvres

6:30–9:30pm – Dinner and seminar

Speakers: Marc C. Demetriou, CLU, ChFC
Residential Home Funding Corp.

Richard I. Miller, Esq.
Mandelbaum Salsburg et al

Benefits: Earn 2 CPE credits in Consulting Services

Comments: Season Pass holders must register for each event.

For handouts, please visit your My Events page. Handouts are added as received – remember to check back for updates.

Many thanks to our event sponsor Merchant Advocate!

Seasons Caterers

644 Pascack Road
Washington Township, NJ
201-664-6141

Registration/Cocktails and Dinner

5:30 PM

CPE Program

5:30 PM

\$75 member/non-CPAs

\$125 CPA nonmember

CPE Information

CPE Credit 2 Hours / CS
Level of Knowledge Intermediate
Prerequisite None
Advance Preparation None
Method of Presentation Live

Note: Credit hours are recommended in accordance with the New Jersey State Board of Accountancy.

Mandatory CPE Qualification: Based on our interpretation of NJ State Board of Accountancy regulations, this session will qualify for CPE credit. Our New Jersey CPE sponsorship number is 162.

How to Register

For fast, easy online registration visit:

www.njcpa.org/catalog

To register by fax or by mail, complete the form at right. Please use one registration form per person; forms may be photocopied for your convenience.

To respond by mail, send the completed form(s) with your check or credit card information to:

NJCPA Education Dept.

Attn: Registrar

425 Eagle Rock Ave.

Suite 100

Roseland, NJ 07068-1723

Make checks payable to:

NJCPA Education Foundation, Inc.

To respond via fax: complete this form with credit card information and fax it to:

973-226-8608

Need assistance?

Call 973-226-4494

NJCPA EDUCATION FOUNDATION REGISTRATION

CPA and Attorney Networking Evening
Bergen Chapter • Course No. E1701229 • Wednesday, January 11, 2017

Name _____
Member ID _____
Company _____
Address _____
City _____
State _____ ZIP _____
Email _____
Phone _____

\$75 member/non-CPA, \$125 nonmember

Payment Type: ☐ Check ☐ Season Pass
☐ MasterCard ☐ Visa ☐ Amex

Credit Card # _____

Total Amount Paid \$ _____ Exp. Date _____

Name on Card _____

To guarantee seating, Season Pass holders must register for individual meetings!



SCHOOL OF LAW
SETON HALL UNIVERSITY

AGOSTINO & ASSOCIATES

6TH ANNUAL INTRODUCTION TO NEW JERSEY TAX CONTROVERSY

**FOUR NY & NJ CONTINUING EDUCATION CREDITS FOR
LAWYERS* AND CPAS†**

WHEN:

Tuesday, January 17, 2017
8:00 AM – 12:00 PM
7:30 – Registration

WHERE:

Seton Hall Law School
1109 Raymond Blvd.
Auditorium
Newark, NJ 07102

FEATURING:

Frank Agostino, Esq., *Agostino & Associates*
The Hon. Joseph Andresini, *Tax Court of New Jersey*
Susan A. Feeney, Esq., *McCarter & English LLP*
Michael Guariglia, Esq., *McCarter & English LLP*
Jeffrey Schechter, Esq., *Cole Schotz P.C.*
Representatives from the New Jersey Division of Taxation (Invited)
Representatives from the New Jersey Office of the Attorney General (Invited)

TOPICS:

New Jersey Division of Taxation Priorities for 2017
Recent Developments for Sales & Use Tax, Corporation
Business Tax and Nexus Cases
Recent Developments in New Jersey Nonprofit Property Tax
Cases
Recent Developments in New Jersey Tax Procedure
Recent Developments in NJ Tax Collection Cases – From
Pioneer Credit Recovery to Warrants of Execution
Recent Developments in New Jersey Gross Income Tax, Estate
Tax & Inheritance Tax Cases

Cole Schotz P.C.

**McCARTER
& ENGLISH**
ATTORNEYS AT LAW

REGISTER at goo.gl/7obOi0

* NJ CLE: This program has been approved by the Board on Continuing Legal Education of the Supreme Court of New Jersey for 4 hours of total CLE credit. Of these, 0 qualify as hours of credit for ethics/professionalism, and 0 qualify as hours of credit toward certification in civil trial law, criminal trial law, workers compensation law and/or matrimonial law.
† NY CLE: This continuing legal education course has been approved in accordance with the requirements of the Continuing Legal Education Board for a maximum of 4 credit hours.
Based upon our interpretation of the regulations by the New York and New Jersey State Boards of Accountancy, this event will qualify for CPE credit. Our New Jersey CPE Sponsorship number is 20CE00213700. Our New York CPE Sponsorship number is 002405.





8TH ANNUAL CRIMINAL TAX ENFORCEMENT FORUM

FOUR (4) FREE¹ NY & NJ CLE², CPE³, & EA CE Credits

RSVP at <http://conta.cc/2gPG5Ag>

WHEN	WHERE
MONDAY, JANUARY 23, 2017 7:30 AM – 12:00 PM 7:30 AM – Registration 8:00 AM – Program will begin	BERGEN COMMUNITY COLLEGE Technology Center- TEC-128A 400 Paramus Road Paramus, NJ 07652

PANELISTS	TOPICS
Frank Agostino, Esq., <i>Agostino & Associates</i> Robert Beranger, <i>Navigant Consulting, Inc.</i> Charles Giblin, <i>NJ Office of Criminal Investigation</i> Robert Glantz, <i>IRS, Criminal Investigation Division</i> Jonathan Larsen, SAC, <i>IRS Criminal Investigation</i> Carlos F. Ortiz, Esq., <i>Blank Rome, LLP</i> Joel Sickler, <i>Justice Advocacy Group, P.C.</i>	Federal Tax Criminal Enforcement Update IRS National Priorities for 2017 Current Events - NJ Based Taxpayers State Tax Criminal Enforcement Update Current Events in NJ Enforcement Employment Tax Investigations Return Preparer Prosecutions Sentencing Issues & Trends

 APPROVED CONTINUING EDUCATION PROVIDER	
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¹Tax Professionals that attend the seminar or the series are encouraged to accept a pro bono tax controversy case assignment from a NJ Low-Income Tax Clinic, VITA, an ABA-sponsored Tax Court Pro Bono program or Taxpayers Assistance Corporation.

²This program has been approved by the Board on Continuing Legal Education of the Supreme Court of New Jersey for 4 hours of total CLE credit. Of these, 0 qualify as hours of credit for ethics/professionalism, and 0 qualify as hours of credit toward certification in civil trial law, criminal trial law, workers compensation law and/or matrimonial law. This course or program has been approved in accordance with the requirements of the New York State Continuing Legal Education Board for a maximum of 4 credit hours.

³Based upon our interpretation of the regulations by the New York and New Jersey State Boards of Accountancy, this event will qualify for CPE credit. Our New Jersey CPE Sponsorship number is 20CE00213700. Our New York CPE Sponsorship number is 002405. Our Office of Professional Responsibility Sponsor Number is QVGWD.