Making New Business Opportunities Available to Younger Generations, *Bross Trucking Inc., et al. v. Commissioner,* 142 T.C. Memo. 2014-17 (June 5, 2014) and *Estate of Adell v. Commissioner*, T.C. Memo. 2014-155 (August 4, 2014)

"Personal Goodwill" Not Included in Value of Business Interest

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BACKGROUND

A fascinating way to build value in younger generations is to allow the younger generations (or trusts for them) to take advantage of business opportunities, using the parent's business knowledge and acumen. For example, a business owner-parent might have an idea for opening a new location or opening a new line of services or products. The parent might create a trust and allow the trust to open the new business or to acquire a large non-voting interest in the new business. Or the parent might assist the trust in acquiring financing to build a building or purchase equipment and lease the building or equipment to the business. The children would be able to benefit from the parent's knowledge without any transfer of property ever taking place.

The IRS might argue that a business opportunity is an opportunity that belongs to the owner's business, and that a transfer of that opportunity is treated as a distribution to the owner and as a gift from the owner to the children. The U.S. Supreme Court in *Dickman v. Commissioner*, 465 U.S. 330 (1984) held that allowing the gratuitous use of property constituted a gift, and that gifts could result from interest-free loans. The Supreme Court stated that there was a broad reach in determining what constitutes taxable gifts and that "the gift tax was designed to encompass all transfers of property and property rights having significant value." The IRS has taken the position in various private letter rulings and technical advice that the failure to exercise legal rights can constitute a gift. *E.g.*, Tech. Adv. Memo. 8726005 (failure to convert preferred stock to common stock was a gift if corporation's financing document precluded making dividends for a substantial period), 8723007 & 8403010; Letter Ruling 9117035 (foregoing right of first refusal to acquire father's shares at a below market price was a gift equal to difference between the market price and the option price where the son was financially able to exercise the right of first refusal option). There is relatively little case law regarding the gift consequences of allowing one's children to take advantage of new opportunities. *E.g.*, *Crowley v. Commissioner*, 34 T.C. 333 (1960) (parent created partnership owned by his children that generated income from appraisal fees, insurance fees and title commissions with respect to savings and loan owned by parent; court concluded no gift); *see* Gingiss, *The Gift of Opportunity*, 41 DePaul L. Rev. 395, 410 (1991-1992).

What is the dividing line between transferring a current right owned by the parent and allowing children to take advantage of new opportunities? Two recent cases impact this issue.

BROSS TRUCKING INC., ET AL. V. COMMISSIONER

In *Bross Trucking Inc. v. Commissioner*, T.C. Memo 2014-17 (June 5, 2014) (Judge Paris), the taxpayer's existing company (Bross Trucking) had lost most of its corporate goodwill because of negative publicity from regulatory infractions and a possible shutdown of the company. Mr. Bross (the owner) never had an employment agreement or noncompete agreement. However, he had personal relationships and had a long tenure in road construction industry. His sons created a new trucking company that provided more service than Bross Trucking had offered (including GPS products and mechanic services). The new company acquired its own insurance and license and leased equipment that a separate company had previously leased to Bross Trucking after the lease to Bross Trucking expired. Bross Trucking remained in existence, but its business dwindled while the business of the sons' new business flourished.

The IRS position was that Bross Trucking distributed its goodwill to Mr. Bross (as ordinary income) and Mr. Bross made a gift of that goodwill to the sons. The court concluded that there was little corporate goodwill to be distributed to Mr. Bross and that he made no gift with respect to the sons' new company.

The court pointed to prior cases that have addressed whether sales of certain interests from a corporation included personal goodwill of some of the shareholders that should be excluded in determining the value that should be realized by the corporation. In *Martin Ice Cream Co. v. Commissioner*, 110 T.C. 189 (1998), an ice cream company distributed products to supermarkets and small stores. The controlling shareholder developed valuable relationships with the supermarkets, and the corporation spun off the supermarket distribution rights to a subsidiary wholly owned by that controlling shareholder. The subsidiary subsequently sold the distribution rights and the subsidiary's business records, customer records, and associate goodwill to Haagen-Dazs. The IRS argued that the ice cream company should be taxed on the sale of the subsidiary, but the court held that the customer relationships and distribution rights were the shareholder's personal assets and not company assets (because he never transferred the goodwill to the company through an employment or noncompete agreement), so the company was not taxed on the sale proceeds. In contrast, in *Solomon v. Commissioner*, T.C. Memo. 2008-102, one branch of a pigment manufacturing company was sold to a competitor. The taxpayers claimed that personal goodwill developed by certain shareholders was included in the purchase price, but those personal intangible rights were not corporate assets and the sale proceeds should not be taxed at the corporate level. The court disagreed, concluding that the customers conducted business with the company because of its products, not because of the relationships formed with shareholder.

Key Factors.

Key factors that were noted in *Bross Trucking*, in finding that there was little corporate goodwill, include the following:

- Mr. Bross did not have an employment agreement or noncompete agreement with Bross Trucking.
- Customers of Bross Trucking "patronized the company solely because of the relationships that Mr. Bross personally forged."
- Bross Trucking customers wanted to change truck providers because of regulatory problems and an impending suspension.
- The court referred to goodwill as "the expectation of continued patronage." Under this definition, Bross Trucking had lost any goodwill that it might have had because of the regulatory problems.
- Bross Trucking did not distribute any cash assets and retained all the necessary licenses and insurance to continue in business.
- The only attribute of goodwill left was the workforce of Bross Trucking. While 50% of the employees of the new company worked for Bross Trucking, the court did not view this as a transfer of an established workforce, in part because of the new lines of services offered by the new company. (Furthermore, the court noted that they may have been independent contractors.)
- Mr. Bross was not involved in managing the new company.

– There is no indication the new company used Mr. Bross's relationships; the sons were in a similarly close relationship with Bross Trucking's customers. (The principal customers were Bross family members.)

– "Cultivating and profiting from independently created relationships are not, however, the same as receiving transferred goodwill."

ESTATE OF ADELL V. COMMISSIONER

The Adell estate has been through various court cases previously. One case involved the estate's §6166 election and the termination of the right to defer estate tax payments under §6166 because of the failure to make timely payments. T.C. Memo. 2013-228. A subsequent decision addressed whether an estate tax payment in excess of the portion that was deferrable under §6166 should be applied to gift taxes on a note receivable reported on the estate tax return but that was subsequently determined to have been a gift instead of a valid receivable. The court held that the payment was treated as an estate tax payment and not refundable because the payment did not exceed the total estate tax. T.C. Memo. 2014-89. In the most recent reported decision, the court addresses the value of a business (STN.Com, Inc.) owned by a trust that was includable in the gross estate (presumably, it was a revocable trust). *Estate of Adell v. Commissioner,* T.C. Memo. 2014-155 (Aug. 4, 2014) (Judge Paris).

1. ***Basic Facts***. The facts surrounding STN are very messy. STN was a C corporation that provided uplink equipment to broadcast television programming. STN was wholly owned by the trust that was included in the decedent's estate. Mr. Adell's son, Kevin, was STN's president and the driving force behind its success, but he never had an employment agreement or noncompete agreement with STN and did not own any of the STN stock. Kevin developed relationships with various religious leaders who helped Kevin and the decedent launch a nonprofit entity (which was required to use the available broadcast space) to provide the religious programming. The nonprofit entity was operated as "The Word." The exemption application stated that The Word would not provide compensation to its officers and directors, but the articles of incorporation stated that it may pay reasonable compensation for services. The decedent and Kevin were officers and directors of The Word. They each received only $50,000 annually as compensation from The Word (but they received many millions from STN).

   The Word entered into a broadcast contract with STN for its uplinking services. STN's sole customer was The Word. STN's fee was equal to the lesser of actual cost or 95% of net programming revenue received by The Word in a one month period. Millions of dollars were paid from The Word to STN under this arrangement. The decedent made over $7 million and Kevin made over $1 million *annually* from STN, and STN racked up large expenses for the personal benefit of the family (including high-end furnishings, Bentleys, Rolls Royces, paying off a $6 million judgment against Kevin, etc.). Kevin's sisters sued him after the decedent's death. Yes—the facts are messy. (The court raised the question, in footnote 52, whether the IRS might eventually revoke the exempt status of The Word, perhaps retroactively, in light of the facts that came to light in this case.)

   The estate's estate tax return claimed a $9.3 million value for STN.Com. The appraisal attached to the return used a discounted cash flow approach and applied an "economic charge of $8 million to $12 million for Kevin's personal goodwill" that he contributed but that was not a corporate asset.

An amended Form 706 claimed a lower $4.3 million value (based on an adjusted book value method, primarily because the appraiser discovered that The Word had overpaid STN.Com under the strict contract terms). The IRS notice of deficiency valued the stock at $92.2 million (but the IRS lowered its valuation at trial to $26.3 million).

2. ***Holding and Reasoning***. The court valued STN using the valuation approach on the original Form 706, including the value reduction to account for the significant value of Kevin's personal goodwill that accounted for much of the success of STN.

   a. ***Burden of Proof Did Not Shift—Because of Estate's Inconsistent Positions***. The court found that the burden of proof did not shift to the government under §7491(a), reasoning that the estate did not present "credible evidence" regarding the valuation issue—because of the inconsistent positions in the various estate valuation reports.

   b. ***Value Originally Listed on Form 706 Was Admission Against Interest***. Furthermore, the court observed that the value stated on the estate tax return was an admission by the estate, and a lower value could not be substituted "without cogent proof that the reported value was erroneous." The estate offered that the terms of the services agreement limited STN's compensation to the *lesser* of its cost or 95% of The Word's revenue, and that cost limit had been ignored in determining the payments. Under the agreement, STN could only receive payments for its cost and could not make a profit, so the income valuation approach should not be applicable and the value should be based on the net value of its hard assets. The court disagreed, because The Word did not enforce the cost limitation on the broadcast fee for five years preceding the date of death or the four years thereafter. (Query whether a hypothetical third party buyer would be willing to ignore the restrictions in the legally binding contract that restricted STN from making a profit on the services for its sole customer?) In any event, the court concluded that there was no cogent proof of the changed valuation so the estate's expert testimony was given no weight.

   c. ***Value Attributable to Personal Goodwill Should Be Subtracted***. The court found that the IRS's expert valuation was "not persuasive because it did not reasonably account for Kevin's personal goodwill" and gave too low an estimate of acceptable compensation for Kevin. The court determined that the success of STN depended on Kevin's relationships with The Word and its customers. It determined that Kevin's goodwill was primarily his personal goodwill that had not been transferred to STN:

      "Kevin's goodwill was personally owned independent of STN.com….To launch The Word, it was Kevin who contacted religious leaders in the Detroit area and Rev. Jackson in Chicago. Along with his notable contacts and his father, he went to Los Angeles to meet with DirectTV representatives about broadcasting The Word. His meeting was successful and it eventually led to the national broadcasting of The Word on cable television. Kevin was the face of the operation because he was the individual soliciting content and pursuing broadcast opportunities.

      … The ministers conducted business with Kevin because they trusted him personally, not because he was a representative or employee of STN.Com. In other words, STN.Com could not own Kevin's goodwill because the customers did not readily realize that Kevin actually worked for STN.Com. Thus, he cultivated personal goodwill with these professionals and he independently owned the asset of personal goodwill, not STN.com.

…

"Further, Kevin did not transfer his goodwill to STN.Com through a covenant not to compete or other agreement. Kevin was free to leave STN.Com and use his relationships to directly compete against his previous employer. If Kevin quit, STN.Com could not exclusively use the relationships that Kevin cultivated; thus the value of those relationships should not be attributed to STN.Com."

3. ***Key Factors***.

- Kevin had the key contacts.
- Ministers who provided programming for the exempt entity (the customer of STN) did not realize that Kevin worked for STN; therefore, the relationships were not the goodwill of STN.
- Kevin did not transfer goodwill to STN through a covenant not to compete or an employment agreement.
- Kevin was free to leave any time and use his relationships to compete directly with STN.

PLANNING OBSERVATIONS

1. ***New Business Opportunities***. *Bross Trucking* and *Estate of Adell* both involved situations in which:

   - other family members had key relationships with customers of the business; and
   - there was no employment agreement or covenant not to compete signed by the person with key contacts (the owner/potential donor in *Bross Trucking* and the decedent's son in *Estate of Adell).*

   In addition, in *Bross Trucking* the current business was going to be discontinued for business reasons.

   These are unusual facts that will not apply in many client situations involving new business opportunities. Nevertheless, these cases highlight that the key issue is whether the client (or the existing business) owns existing rights that are transferred to someone else. These two cases refer to this general issue in terms of whether the new opportunity is a result of a personal goodwill or business goodwill that is owned by the existing business. One factor is whether the client (or the person with the relationships) has an employment agreement or noncompete agreement, but that is merely one factor that might or might not be relevant in other particular situations. The key issue is whether the client (or the existing business) is relinquishing legal rights when other family members pursue new business opportunities.

2. ***Key Person Discount***. The classic "key person discount" applies an adjustment in the value of a business in which the decedent was a key driver to the success of the business. *E.g.*, *Blount v. Commissioner*, 428 F.3d 1338 n.3 (11th Cir. 2005) ("The Tax Court, however, completely ignored the significant value Blount represented to the corporation. There is no discussion of the effect on BCC of losing Blount's leadership, connections, and general know-how); *Estate of Huntsman v. Commissioner*, 66 T.C. 861 (1976); *Estate of Ruben Rodriguez v. Commissioner*, T.C. Memo. 1989-13. A hypothetical purchaser would reduce the price when the business is very dependent on the services and relationships of one person—particularly if that person is the decedent who is dead. The same concept applies when the key person is someone other than the decedent, especially if there is nothing "binding" that person to the business. *E.g.*, *Furman v. Commissioner*, T.C. 1998-157 (10% key manager discount for valuing gift of stock).

   Estate of Adell addressed the estate tax value of a business whose success was primarily dependent on a third person (the decedent's son). The court addressed this valuation issue not in terms of a "key person discount" but under an analogous rationale of isolating the portion of the business value that is attributable to the personal goodwill of an individual that was not an asset of the business. Nevertheless, the case supports the general concept of a "key person discount." (Traditional key person discounts have been in the 10-15% general range as compared to the much larger adjustment allowed in *Adell* attributable to the "economic charge … for personal goodwill.")