

Personal Goodwill in Agency Acquisitions

By Michael B. Ryan, CPA

One of the first questions that arises during any potential insurance agency sale is: what are the tax implications of the contemplated sale to the buyer and seller?

When the seller is a C corporation or an S corporation with “earnings and profits” or “built-in-gains,” the use of personal goodwill may provide both buyer and seller with substantial tax savings.

Generally speaking, the shareholder/owner who sells his personal goodwill is eligible for long-term capital gains tax rates on the sale of his goodwill and avoids double taxation at the corporate and individual levels. The buyer of the agency has purchased an amortizable asset that will provide tax deductions over 15 years.

Business vs. Personal Goodwill

Personal goodwill is distinguished from “business goodwill.” Business goodwill is an intangible asset owned by the corporation. A corporation owns business goodwill where shareholders have relinquished managerial control and where corporate interests and identity are separate from its

owners. In this case, none of its shareholders are critical to its success and the loss of any key employees would not significantly reduce its value. Other factors indicating the existence of business goodwill include a loyal customer base, unique operating systems, a well-trained workforce, business reputation and a prolonged period of successful operations.

What is “personal goodwill”? Personal goodwill is owned by the shareholders of an agency and exists when their reputation, expertise, skill and knowledge as well as their relationships with customers and insurers give an agency its intrinsic value. Personal goodwill exists when agency owners are critical to its success and the loss of those owners would significantly reduce the agency’s value. This is typically the case with small- to mid-size agencies where the owners are actively involved in customer service.

Imagine trying to sell an insurance agency without the personal goodwill and cooperation of the key person or persons in the agency. In order for goodwill to be owned personally by the shareholder of an insurance agency, there should not be any contractual

obligation that binds the shareholder to the agency. If the shareholder has entered into an employment contract or noncompetition agreement with the agency, then he may not be free to take his personal goodwill with him/her and, therefore, unable to sell this asset.

The following factors support the existence of personal goodwill in an agency:

- Agency shareholders are actively involved in the business.
- Agency uses personal service to sell its products.
- Agency shareholders have extensive knowledge of the insurance products sold.
- Agency is dependent on the personal skills and relationships of the shareholders.
- Agency has not purchased a significant portion of its book of business.
- Shareholders are not bound by existing noncompete or employment agreements.

Once the existence of personal goodwill has been established, determining the value of the goodwill

can be complex, requiring a valuation by a qualified professional valuation expert.

The sale of the agency will consist of two separate sales; one by the agency selling the corporate tangible and intangible assets and a second sale by the shareholder selling their personal goodwill. All related sales documentation, including “letters of intent” and sales agreements should be care-

ful to clarify that two distinct but related transactions are occurring. The sale of personal goodwill must include a covenant not to compete with the buyer as evidence that personal goodwill has been transferred to the buyer.

Planning to utilize personal goodwill should begin early in the sales process in order to maximize benefits to buyers and sellers. It is critical to establish

facts that can support a finding that goodwill belongs to the shareholders and not to the corporation. If the transaction is not carefully planned, the Internal Revenue Service could deem the sale of personal goodwill to be a fiction. ■

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