TAX COURT CASE UPDATE

Citation:

H&M, Inc. v. Commissioner, T.C. Memo 2012-290, October 15, 2012.

Overview:

The Tax Court concluded that where a corporation sold its insurance brokerage business to its competitor and its sole shareholder entered into employment with that buyer, the compensation under the employment agreement was not a disguised purchase price payment to the selling corporation. In reaching this conclusion, The Court determined that the shareholder's personal ability and other individualistic qualities were not a corporate asset (goodwill) that should be taken into account as part of the purchase price.

The Facts:

Harold Schmeets was the sole shareholder of Harvey Insurance Agency, Inc. Mr. Schmeets stood out among insurance agents in the area, as he had experience in all insurance lines and all facets of running an insurance agency, including accounting, management, and employee training. He also had experience in specialized areas of insurance. It was widely said that no one knew insurance better than Mr. Schmeets. The success of Harvey Insurance's business was due to Mr. Schmeets' ability to form relationships with customers and keep big insurance companies interested in a small insurance market. He grew relationships with large insurance companies that other brokers in the area did not.

Harvey Insurance sold its largest asset, the insurance-brokerage business, to its main competitor, a local bank, in 1992. Mr. Schmeets went to work for the bank that bought the brokerage business.

Under the purchase agreement, Harvey Insurance agreed to sell all files, customer lists, insurance agency or brokerage contracts, the name of Harvey Insurance, and all the goodwill of Harvey Insurance to the bank for $20,000, payable in six equal annual installments plus interest. The agreement was contingent on the execution of an employment agreement with Mr. Schmeets. It also contained a non-compete clause which provided that Harvey Insurance and Mr. Schmeets would not compete with the bank for 15 years and, if they did, the bank could terminate any unpaid purchase price payments to Harvey Insurance and the employment agreement with Mr. Schmeets.

Under the employment agreement, Mr. Schmeets became the manager of the bank's insurance agency for a six-year term. The bank promised to pay Mr. Schmeets a base wage of $38,936, annual variable compensation equal to the greater of $50,000 or 45 percent of net adjusted income for the year, and deferred compensation of $74,000 at the end of the six-year term. If Mr. Schmeets died, the bank still had to pay Mr. Schmeets the annual base wage and deferred compensation for services already performed. The total compensation under the agreement was over $600,000 for his services during the six years.

Both parties thought the compensation package was fair, and they did not have anyone appraise the insurance agency. The bank did not look at the seller's financial records. Mr. Schmeets kept the corporation (renamed H&M, Inc. after the sale) active to exploit two patented inventions.

On audit, the IRS contended that much of Mr. Schmeets' wages were actually disguised purchase price payments to his corporation. In addition, the IRS raised a number of other issues. It disallowed H&M's deduction for interest that it paid to Mr. Schmeets in 2002 through 2005 on an unsecured promissory note (without any payment terms or maturity date) that it treated as accrued officer's compensation. It also disallowed a number of other deductions, including a 2001 net operating loss and expenses that H&M claimed in 2004 and 2005 to develop Mr. Schmeets' patents.

Discussion:

The IRS argued that a substance-over-form analysis showed that the value of the assets that the bank bought should have included not only the $20,000 purchase price, but also the $38,936 annual base wage and $74,000 of deferred compensation under the employment agreement. It claimed that only the annual variable compensation (the greater of $50,000 or 45 percent of net adjusted income for the year) actually represented payment for Mr. Schmeets' services.

The IRS contended that this allocation more accurately reflected the fair market value of Mr. Schmeets' services to the bank and took account of goodwill and the corporation's other intangible assets. The IRS argued that the parties undervalued the assets of Harvey Insurance in the sale so that the bank could deduct the compensation it paid to Mr. Schmeets, and he could avoid being taxed twice on the proceeds of the sale - once at the corporate level when H&M received the purchase price payments, and then again when he received dividends from H&M.

H&M argued that re-characterizing all of the compensation payments as purchase price payments was inappropriate because the allocation did not reflect the economic realities of the transaction. It maintained that Mr. Schmeets' compensation under the agreement was reasonable because the bank needed him to keep the insurance business going, and he had significant responsibilities as the manager of the bank's agency. H&M further contended that any goodwill of the business was attributable to Mr. Schmeets personally. And it pointed out that neither party focused on the tax consequences of the transaction. Instead, both parties wanted to create an employment relationship and both consistently treated the deal as if they had.

The Tax Court found that the payments to Mr. Schmeets were not disguised purchase price payments to H&M. The Court was satisfied that Mr. Schmeets and the bank were genuinely interested in creating an employment relationship and were not just creating paperwork to produce the tax consequences they wanted.

The Tax Court concluded that, in light of Mr. Schmeets' personal relationships, his experience in running all facets of an insurance agency and his responsibilities as manager of the bank's insurance agency, the compensation that the bank paid him was reasonable. The employment agreement contained an extensive list of duties that Mr. Schmeets was required to perform. Not only was Mr. Schmeets an insurance salesman, he also had significant management and

bookkeeping responsibilities. He went from working around 40 hours per week before the sale to double that afterward.

The Court found the IRS's expert's report entirely unbelievable, as it estimated the fair market value of Mr. Schmeets' services to be $22,700 in 1994 and 1995, and $38,300 in 1996, 1997, and 1998. The Court noted that the less experienced manager that replaced Mr. Schmeets was paid roughly $55,000 to $65,000 per year. Further, even after Mr. Schmeets' six-year employment term was up, the bank still paid him around $30,000 per year for part-time work to train his replacement.

The Tax Court found that Mr. Schmeets' case was like *MacDonald* and *Martin Ice Cream Co.* The Court specifically found that when customers came to Mr. Schmeets' agency, they came to buy from him. It was Mr. Schmeets' name and his reputation that brought them there. The Court further found that he had no agreement with H&M at the time of its sale that prevented him from taking his relationships, reputation, and skill elsewhere.

The IRS failed to specify what other purchased intangible assets, other than the name Harvey Insurance, it thought were not accounted for in the purchase price. It did not provide any persuasive evidence that the name of the corporation had much value other than its connection with Mr. Schmeets himself. The Court found that the name Harold Schmeets had far more name recognition in the community than Harvey Insurance.

Conclusion:

While The Court disagreed with the IRS that the amounts the bank paid Mr. Schmeets were disguised purchase price payments for goodwill, it did agree that the payments were not simply the fair market value of his services. Mr. Schmeets not only brought his personal goodwill to the bank, he also signed a non-compete provision. However, since Mr. Schmeets' individual tax liability was not before The Court, it found that it did not have to determine the exact allocation between what he was paid for his services to the agency, his personal goodwill, and his promise not to compete.