

## Current Valuation & Taxation Rulings Regarding Divorce

### Capitalization of Earnings Method Accepted

In *Catherine Trost-Steffen v. Kenneth L. Steffen*, No. 61A05-0110-CV-441 (Ind. App. July 30, 2002), the Indiana Court of Appeals considered the valuation and distribution of stock in a closely held corporation. The corporation was owned and operated by the wife's family. The wife held 3,804 shares as her personal property and was a director of the company. The parties held 400 shares jointly. The company had a redemption program authorizing the repurchase of its stock at book value.

At trial, the wife argued that the stock should be valued at \$135 per share as authorized under the company's redemption program. She further argued and the husband agreed that she should be awarded all the stock in the company. She did not present any additional testimony, expert or otherwise, regarding the value of the stock.

The husband presented a CPA, who determined the fair market value of the stock on the date of filing. The expert valued the stock using a capitalization of earnings method. He applied a combined 30 percent minority interest and lack of marketability discount to arrive at a value of \$242.78 per share. The trial court accepted the valuation offered by the husband's expert and awarded the wife all the stock. She appealed.

On appeal, she argued that the trial court erred in valuing the stock at an amount greater than its book value. The appellate court rejected her argument. It

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### Minority Interest Discount Denied

In *Maria Bunjevac v. John Bunjevac*, No. 80069 (Ohio App. 8 Dist. June 13, 2002), the Ohio Court of Appeals, Eighth District considered whether a magistrate should have applied a minority interest discount. The husband held a one-third interest in a closely held corporation. The valuation date was set at March 6, 1997, the date of filing. After the valuation date but before the divorce judgment, one of the remaining shareholders in the corporation died. As a result, the husband's interest in the business increased to 50 percent. Shortly thereafter, the husband purchased the remaining shareholder's 50 percent interest, giving him full control over the company.

The wife hired an accountant to value the business interest. The expert determined that the husband's one-third interest had an undiscounted, pro rata value of \$324,420.67. He noted that the undiscounted value may be reduced by 25 percent for lack of control. However, the expert indicated in his report that "if the Company were sold by one shareholder to another, the discount used for lack of control would not apply." The magistrate accepted the undiscounted value of the one-third interest in the company as determined by this expert. However, the magistrate declined to apply a minority interest discount because the husband acquired total control of the

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## Medical Practice Valued In-Place In-Use

In *Teresa M. Folkmier v. David R. Folkmier*, No. 229387 (Mich. App. July 26, 2002), unpublished, the Michigan Court of Appeals considered the valuation of a minority interest in a medical practice as well as an award for foregone career opportunities. The parties were married while the husband attended medical school. During that time the wife provided the sole financial support. Three years later, the husband earned his medical degree. After completing his residency, the husband entered private practice.

At trial, both parties presented expert testimony regarding the valuation of the husband's interest in his medical practice. The wife's expert determined the value of the practice to the husband. He determined that the practice had a value of \$105,000. The husband's expert concluded that the fair market value of the practice was \$69,000, inclusive of a minority discount. The trial court accepted the valuation of the wife's expert.

The wife's expert also calculated the value of her efforts and contributions to the husband's degree. The expert determined that the wife contributed \$1,000 per month during the 34 months the husband attended medical school during the marriage, \$500 per month during the husband's internship and residency, and one-half of a \$10,000 gift made to the parties for a total of \$52,000. The expert reasoned that 10 years was a reasonable period of time during which the wife should be entitled

to benefit from the husband's degree. Therefore, her expert reduced the total figure by 60 percent to account for the six years the husband had been in private practice during the marriage. This resulted in a total award of \$20,800. The trial court awarded her \$20,000. The husband appealed.

On appeal, the husband challenged the valuation of the interest in his medical practice. The husband argued that the lower court improperly valued the business interest by using an in-place, in-use standard rather than a fair market value standard. He specifically argued that the lower court should have applied a minority interest discount. The appellate court disagreed. The court noted that case law supported the lower court's decision to value the practice as a going concern to the practitioner. *McNamara v McNamara*, 178 Mich App. 382 (1989). It further stated, "Logically, the value of the business interest to defendant was substantially more than the value of the business interest to plaintiff or any third party. At the very least, by awarding defendant his entire business interest, rather than dividing it between the parties, the trial court maximized the value that could be attributed to this asset." Thus, it affirmed the lower court's valuation of the business.

The appellate court next considered the husband's argument that the trial court overvalued the wife's con-

tributions to the husband's degree. The court affirmed the lower court's consideration of the wife's contributions during the period the husband attended medical school, but reversed an award for the post-medical school period. In doing so, it noted that both parties were employed at approximately equally paid positions and equally contributed to the financial support of the marital community. It stated, "the parties were not relying solely on plaintiff's income for support; thus, plaintiff was not sacrificing part of her income to support defendant's obtaining of a degree that she would not be able to share. Rather, the parties shared their income much like any other dual-income family would in similar circumstances." In reaching this decision regarding post-medical school support, the appellate court noted in some cases a non-degreed spouse may continue to make unrewarded sacrifices during the post-medical school period, but that its decision here was made on the particular facts of this case. The court reversed the consideration of one-half the amount of the gift as well because the gift was received and used after the post-medical school period. Thus, the appellate court reversed and remanded the award for unrewarded sacrifices and contributions to the husband's medical degree.

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## Medical Practice Is a Marital Asset

In *James A. Mace v. Angela T. Mace*, No. 2000-CA-01283-SCT (Miss. May 30, 2002), the Supreme Court of Mississippi considered whether a medical practice was an asset divisible in divorce. During the marriage, the wife worked while the husband attended medical school. After completion of his schooling and while he established his medical practice, the wife remained at home and raised the children.

At trial, neither party presented expert testimony as to the value of the practice. The husband testified that the practice should be valued at six times net monthly earnings of \$24,000 based upon an article he read in a medical journal. The trial court found that the medical practice was a marital asset. It valued the real property of the practice at \$150,000, the equipment at \$80,000 and the practice at \$144,000. The husband appealed the inclusion of the practice as a marital asset.

The Supreme Court noted that the issue of whether a professional practice is a marital asset was an issue of first impression, while noting that it had earlier decided that a medical degree or license was not a marital asset. The majority differentiated the medical degree from the medical practice on the basis of marketability. It reasoned that the medical practice including its property, fixtures, equipment, receivables, and goodwill could be sold, while the medical license was personal to the professional. Therefore, the court concluded that a professional practice may be an asset subject to division in divorce. However, the Supreme Court then reversed the lower court's valuation of the practice. It found that the lower court's valuation of the practice was unclear from the record. Thus, it remanded for a revaluation of the practice. It noted that on remand the parties will have

the opportunity to present expert testimony and the court may appoint an expert of such if "absolutely necessary."

Two justices dissented. The dissenters concluded that a professional practice should not be considered a marital asset because it naturally flows from the attainment of the professional license, which is not a marital asset. The justices determined that the husband's ability to pay alimony and child support awards stem from the combination of his medical degree and the "tools of the trade" (building, equipment, etc.). Thus, they reasoned that to separate the income generating ability of each type of asset from the total value of the asset would be inequitable in light of the fact that the total value of the asset generates the income used to fund the support awards.

## Redemption of Stock Incident to Divorce Taxable under IRC sec. 302

In FSA 200222008 (May 31, 2002), the IRS issued field service advice regarding the application of IRC sec. 1041. The husband owned 100 percent of a closely held corporation during the marriage. Under their divorce agreement, the husband would transfer 16 percent of the corporate stock to the wife, which would then be redeemed for cash by the corporation. The agreement further required that the corporation's obligation to the wife be personally guaranteed by the husband, and that the wife bear all the capital gains tax due on the redemption. The IRS determined the transfer of the corporate stock to the wife was a nontaxable transfer incident to divorce as covered by IRC sec. 1041, but the redemption of that stock was a taxable event arising under IRC sec. 302.

The IRS noted that there has been considerable uncertainty surrounding the application of sec. 1041. Here, it

reasoned that the form of the parties' transaction as determined by their property settlement should be respected. It noted that the parties' agreement indicated there that the wife was responsible for the tax due upon the redemption.

The IRS also reasoned that this situation falls within the purview of sec. 1.1041-1TC, Q&A-9. Under Q&A-9, the parties have the ability to shift between them the tax consequences of a sale outside the marital unit, particularly, like was done here, to a corporation owned equally by the parties. The IRS noted, "Under Q&A-9, there is a deemed transfer of the property from S1 to S2, which is a tax-free transfer under § 1041. S2 is then taxed on the transfer to the third party buyer as if S2 owned the property and S2 sold it to the buyer." Therefore, because the wife owned the stock prior to the redemption, she was subject to

the tax liability arising from the termination of her corporate interest under sec. 302.

In reaching its decision to hold the wife responsible for the capital gains tax arising from the stock redemption, the IRS noted that case law, which was factually similar to the case at hand, has held the husband liable for the tax due on the redemption because the transfer was on behalf of the husband. See *Read v. CIR*, 114 T.C. 14 (2000); *Craven v. CIR*, 215 F.3d 1201 (11th Cir. 2000). However, the IRS differentiated those cases from the situation here. It found that the property settlement agreements in *Read* and *Craven* did not contain a provision where the spouse ending up with the redemption proceeds expressly accepted the tax consequences of the redemption as occurred here.

**(Cap. Earnings method***Continued from page 1)*

noted that the lower court's decision was adequately supported by the testimony of the husband's expert. Further, it noted, "Mother did not call as witnesses any CJT officials or other experts to testify as to the stock's value, but did cross-examine ... [husband's expert] as to his valuation, questioning the information upon which he relied to reach his conclusion." It also noted that the

redemption policy of the company permitted redemption at book value, which is not equal to fair market value. Thus, it affirmed the lower court's valuation.

The wife next argued that the trial court erred in not awarding the husband one-half of the marital stock in kind. The appellate court initially noted that this was not the position the wife took before the trial court. It then found

that considering the fact that the wife's family operated the company; the lower court's decision to award her the stock was "both appropriate and sensible under the facts and circumstances of this case."

**(Minority Interest***Continued from page 1)*

company during the pendency of the divorce, a fact situation not accounted for by the expert. In reaching his valuation decision, the magistrate noted, "whether to apply a minority discount and what minority discount is used is fact and circumstance dependant." The husband appealed.

On appeal, the husband argued that the magistrate erred in failing to apply the minority discount determined by the

expert. He argued, "the court should have assessed the value in exactly the same manner as the accountant assessed it, not taking into consideration the subsequent changes in circumstances in the corporation." The Eighth District disagreed. It found that the husband's argument did not consider the accountant's limiting conditions, specifically the accountant's condition that a discount would not apply in the event a sale oc-

curred between the shareholders. It further found that the magistrate was within his discretion in determining value as equity depends on the totality of the circumstances. Thus, the Eighth District affirmed the lower court's decision denying the application of a minority interest discount.

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