

Current Valuation & Taxation Rulings Regarding Divorce

State Supreme Court Excluded Goodwill from Valuation of Sole Practitioner under Double Dipping Argument

In *Robert Michael Watson v. Patricia Harris Watson*, No. 2001-CA-01178-SCT (Miss. June 24, 2004), the Mississippi Supreme Court clarified its position regarding the inclusion of a value for goodwill when appraising solo practitioner professional practices. The husband established a veterinary practice in Jackson, MS during the marriage, which he operated as a solo practitioner. He earned an average annual salary of \$158,000 from the operation of this business. Both parties presented the court with testimony from credentialed business appraisers.

The wife's valuation expert appraised the business using the discounted future cash flow and capitalization of earnings methods. The methods were weighted equally and resulted in a valuation of \$325,000, inclusive of goodwill. (It is important to note that the trial court's decision was handed down prior to the Mississippi Supreme Court's decision in *Singley v. Singley*, 846 So.2d1004 (Miss. 2002), which held that goodwill should not be included in the valuation of a solo practitioner professional practice.) In reaching his valuation, the expert determined that a replacement veterinarian in Jackson, MS would earn \$93,000 annually. He concluded that this amount would reasonably compensate the husband for his professional services. He utilized this figure in performing his valuations under each method. He further included a 5 percent

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Personal Goodwill Accounted for in Income Valuation that Fully Deducts Solo Practitioner's Compensation

In *Steven R. Hoebelheinrich v. Nancy A. Hoebelheinrich*, No. 2359-03-3 (VA App. August 3, 2004), the Virginia Court of Appeals considered the valuation of a solo practitioner's medical practice. Both parties presented expert testimony regarding the valuation of the practice.

The wife relied upon the opinion of value expressed by the court-appointed expert. This expert performed two calculations under the capitalization of earnings and discounted future cash flow methods. The calculations differed in the treatment of the husband's compensation. In the first calculation, the compensation was treated as an expense of the business. In the second calculation, no amount was deducted from the business for the husband's compensation. He determined a range of values between \$654,776 using the capitalization of earnings method and a compensation deduction to \$1.994 million using a discounted future cash flow method exclusive of compensation.

The husband presented valuation testimony from a CPA. His expert valued the business using a capitalization of earnings and excess earnings method. The results of those valuations were weighted equally. The expert then concluded that the practice had \$300,000 in goodwill, 85 percent of

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Reasonable Compensation Determined Using Average Compensation of a Similarly Situated Professional

In *In re the Marriage of Iredale and Cates*, No. B148135 (Cal. App. 2 Dist. July 9, 2004), the California Court of Appeals, Second District considered the effect of a restricted shareholders' agreement on the value of a minority interest in a law firm. The wife held a .00781 partnership interest in a large Los Angeles-based firm, which was subject to a restricted shareholders' agreement. The agreement clearly indicated that the partner did not have any interest in the firm's work-in-progress, accounts receivable or goodwill, and was entitled to only the value of her capital account upon her voluntary or involuntary termination. Both parties presented expert testimony regarding the valuation of the partnership interest.

The husband's expert accorded the partnership agreement little weight. He valued the interest based on the pro-rata share of the firm's going concern value. Rather than determine the value of her goodwill using the excess earnings method, this expert determined the replacement value of the wife's

services. He concluded that her interest in the firm had a value of \$813,000.

The wife's expert valued the interest under the partnership agreement at \$190,000. He also valued the wife's goodwill using two calculations of the excess earnings method. Under the first calculation, he considered her compensation in relation to the average profits per shareholder in the top 100 national firms. In the second calculation, he considered her compensation in relation to Los Angeles and California-based law firms with more than 100 equity partners. He concluded that under the first calculation, the wife had no goodwill and under the second calculation, she had goodwill worth \$42,318. The trial court accepted the valuation provided by this expert inclusive of his goodwill valuation using comparable city and state firms. The husband appealed.

On appeal, the husband argued that the trial court erred when it valued the partnership interest under the

partnership agreement which excluded accounts receivable, work-in-progress and goodwill and when it valued the wife's personal goodwill using the compensation of her peers in California-based law firms rather than the earnings of a salaried employee. The appellate court disagreed on both fronts. The appellate court, like the trial court, concluded that the partnership agreement clearly indicated that accounts receivable, work-in-progress and goodwill were assets of the partnership and not assets of the individual partners; therefore, the lower court was correct in excluding them from the valuation equation. It further concluded that when calculating the value of goodwill under an excess earnings method, the average salaried employee is not the only valid measure for determining reasonable compensation. It noted that substantial evidence supported the use of the similarly situated professional standard as accepted by the trial court in this case. Thus, it affirmed the trial court's valuation.

Valuation of Insurance Company Based on Actual Transaction

In *Constance S. Freeman v. Middleton L. Freeman*, No. 2003-CA-000907-MR (KY App. July 23, 2004), unpublished, the Kentucky Court of Appeals considered the valuation of an insurance company. The wife wholly owned the company. She bought out her partner two years prior to the valuation date for \$234,000. The company was under a contract with Allstate Insurance Company, which provided for a termination payment of \$56,620.

The valuation of the company was at issue in this case and only the husband presented expert valuation testimony.

The husband's expert valued the company at \$421,076. The wife claimed that the company's value should be limited to the contractual termination payment. The trial court rejected both parties' positions. It relied on the wife's purchase of her partner's interest as the best evidence

of the value of the company. The court doubled the purchase price and reduced that sum by her debt on the agency and \$40,000 for unfavorable market conditions. The wife appealed.

On appeal, the wife argued that the trial court erred in its valuation of the company. The appellate court disagreed. It found that the lower court's valuation was supported by substantial evidence in the record and therefore affirmed the valuation.

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company specific risk premium in his discount rate to account for hazards associated with a solo practice.

The husband's expert's direct testimony was excluded as a discovery sanction. However, he was permitted to testify as a rebuttal witness. This expert successfully testified that the 5 percent addition to the discount rate did not adequately account for the company specific risk associated with this company and its operation as a solo practice. As a result, the trial court reduced the valuation of the practice as determined by the wife's expert by \$75,000. It concluded that the practice had a value of \$250,000. The husband appealed.

On appeal, the husband argued that the trial court erred when it valued the veterinary practice because the value included goodwill. A majority of the Supreme Court agreed. While acknowledging that *Singley* was not law at the time this case was decided, it considered the valuation of the practice at issue here under *Singley's* guidance. The majority concluded that the valuation accepted by the trial court resulted in an inequitable distribution of property when considered in relation to the

award of alimony. It first noted that the valuation was based on the husband's future earnings from and contributions to the practice, which it noted were specifically prohibited under *Singley*. It then found that the appraiser did not account for an alimony award in his valuation; it noted that the appraisal utilized the earnings of a replacement salaried employee in Jackson, MS (\$93,000) to calculate the value of the business while the husband's full compensation (\$158,000) was utilized to calculate alimony. Therefore it concluded that the difference between those compensation figures was utilized twice by the lower court in fashioning its equitable distribution scheme. The court then determined that because the practice was operated as a solo practice, it was synonymous with the owner/professional. This determination led the court to rule: "... although there is a distinction between 'personal goodwill' and 'business enterprise goodwill,' neither should be included in the valuation of a solo professional practice for purposes of a division of marital assets. In such cases, the two are simply too interwoven and not divisible." Thus, the

court remanded the valuation back to the trial court for the exclusion of goodwill. In doing so, it stated, "In the event an asset-based approach is used, the valuation should not exceed the fair market value of the tangible assets, assuming they were sold in their current configuration. Although we do not foreclose the use of other valuation methods, we are mindful that, in using the income approach, extracting goodwill would seem difficult, and must be carefully accomplished and explained."

Several justices dissented. One stated, "The equity aspect of the concept of *equitable distribution* is hardly served by the exclusion of goodwill and the strict reliance on book value." (Emphasis in original). While another justice agreed with the holding of the majority, he noted that it was permissible to consider goodwill when this case was decided and therefore should not be reversed on that ground, but should be reversed because the lower court failed to explain its reasoning for the \$75,000 reduction from the valuation determined by the wife's expert.

(Hoebelheinrich... *Continued from page 1)*

which was personal goodwill and was deducted from the value of the practice. The expert then applied a 35 percent discount for lack of marketability and concluded that the practice had a value of \$140,000.

The trial court accepted its expert's valuation under the capitalization of earnings method inclusive of a deduction for the full amount of the husband's compensation. It denied the application of a discount for lack of marketability because a sale of the practice was not ordered nor was it foreseeable. The husband appealed.

On appeal, the husband argued that the trial court erred when it failed to account for the personal goodwill of the practice in its valuation. The appellate court initially noted that under Virginia law personal goodwill is separate property while enterprise goodwill is marital property. However, the appellate court found that the trial court adequately considered the impact of the husband's personal goodwill when it permitted the full deduction of his compensation. It noted that the husband's expert did not show that the method accepted by

the trial court failed to account for the husband's personal goodwill even though the husband's compensation was deducted. Thus, it rejected the husband's argument that the trial court failed to consider his personal goodwill in making its valuation. However, in doing so, the appellate court noted, "We do not suggest that ... [the court appointed expert's] valuation method correctly accounts for personal goodwill. We hold only that the present record does not allow to conclude that ... [the] valuation method was insufficient as a matter of law."

The brief summaries in this publication discuss only some valuation aspects of the subject cases and pronouncements. The reader is referred to the actual documents for additional details. This publication does not constitute legal, tax, accounting, or valuation advice, and it is offered as an informational service only. Those seeking specific advice should contact a professional advisor. No liability whatsoever is assumed in connection with use of this newsletter.