

Current Valuation & Taxation Rulings Regarding Divorce

Personal Goodwill and Buy-Sell Provision

In *Judith Houchens v. Michael Terence Boschert*, No. 15A04-0011-CV-495 (November 26, 2001), the Indiana Court of Appeals considered the issue of personal goodwill in the valuation of a one-third interest in a limited liability company (LLC). The parties were married in November of 1995. In 1996, the wife and her two uncles formed the LLC to acquire a steel treating company. The wife's share of the acquisition costs was funded by a loan from one of her relatives. The LLC units were subject to an operating agreement that included a mandatory buy-sell provision. Under the provision, the company was required to buy the units of any member who died or withdrew at book value until October 1998, when the purchase price would become fair market value.

The husband worked as an hourly employee at the steel treating company during the marriage. He resigned from the company shortly before filing this divorce action in May 1997.

At trial, both parties presented expert testimony regarding the valuation of the business interest. The wife's expert valued the business under the operating agreement. He concluded that the book value of the wife's one-third interest was \$105,278. He additionally indicated that the value of the LLC was entirely goodwill, but failed to differentiate between personal and business goodwill. The hus-

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ALIMONY?

In *Estelle Kersh v. CIR*, T. C. Summary Opinion 2002-6, the U.S. Tax Court considered whether payments a former spouse received pursuant to a temporary support order in 1995 and 1996 were alimony for federal tax purposes. Petitioner separated in 1994 in New York. The former husband was ordered to pay \$1,600 per month as temporary support. The petitioner received \$1,600 and \$17,400 in 1995 and 1996 under the order, amounts which were not included in her gross income for those years. The IRS contested the exclusion, believing they constituted taxable alimony.

The Tax Court noted that in order for payments to be taxable alimony, they must meet the four requirements of IRC sec. 71(b)(1). The requirements are (A) the payments are received by or on behalf of a spouse under a divorce or separation agreement, (B) the divorce instrument does not designate such payment as a payment which is not includable in gross income under sec. 71 and not deductible under sec. 215, (C) the payor and the payee must not be members of the same household at the time the payments are made, and (D) there is no liability to continue to make the payments after the death of the payee spouse. The petitioner argued that the payments were not alimony because they did not comply with sec. 71(b)(1)(A). She argued that under the final divorce instrument, issued in 1997, the support payments

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Valuation Discounts Denied

In *In re the Marriage of Zane*, No. 00-1041 (November 16, 2001), the Iowa Court of Appeals considered whether valuation discounts should be applied when valuing stock in a family farm corporation. The farm corporation was owned and operated by members of the husband's family. During the marriage, the husband received a 14.21 percent interest in the corporation by gift. The wife also received a 5.88 percent interest in the corporation by gift. The court valued the stock held by the parties at \$512,405 and awarded it the husband. He appealed.

On appeal, the husband argued that the lower court failed to discount the value of the wife's 5.88 percent interest for minority factors and lack of marketability. The appellate court noted, "Courts have discounted the value of stock for minority ownership and lack of marketability in distributing assets in a dissolution of marriage, but there is no

requirement that a discount be applied." It then affirmed the lower

"Courts have discounted the value of stock for minority ownership and lack of marketability in distributing assets in a dissolution of marriage, but there is no requirement that a discount be applied."

court, finding the decision not to apply the discounts was equitable. The court found the facts that the wife's interest was

small and that it was awarded to the husband in the distribution important in reaching this decision.

Appreciation Due to Market Forces Must Be Segregated

In *Payson v. Payson*, No. S01A1117 (September 17, 2001), the Supreme Court of Georgia considered the characterization of a stock account and stock options. The wife was employed prior to the marriage at Home Depot, where she earned employee stock options. She brought a stock account holding Home Depot stock and vested but unexercised options to the marriage. During the marriage, she terminated her employment with the company, and exercised her remaining options with premarital funds. The stock was placed into her stock account. The lower court characterized the account and the appreciation in the account during the marriage as marital property, which it awarded to the wife. She appealed.

On appeal, she argued that the trial court mischaracterized the stock account as well as the appreciation in the account. The Supreme Court noted that

property brought to a marriage by one party is a non-marital asset since it was not generated by the marriage. It further noted that appreciation of non-marital assets is non-marital if it is the result of market forces, but may be marital property if the appreciation is the result of one or both parties' efforts. The Supreme Court then reversed the lower court's characterization of the account as marital property. It found that the stock in the account brought to the marriage and the stock received after exercising the non-marital stock options with non-marital funds was the wife's separate property. It stated, "As a matter of law, non-marital assets are not subject to equitable division, and the trial court erred when it treated the non-marital property as marital property subject to equitable division."

The Supreme Court then turned to the characterization of the apprecia-

tion in the stock account. The court noted that whether and to what extent separate property has appreciated due to market forces or the parties' efforts is a question of fact. It then noted that the lower court found that all the appreciation in the account was marital property. The Supreme Court reversed. It stated, "There is no dispute that *some* of the appreciation in value of Mrs. Payson's stock was due solely to market forces, making it error to include *all* the appreciation in value as marital property." (Emphasis in original). Thus, the court reversed the equitable distribution of the parties' assets. In doing so it ordered the lower court to "reconsider the allocation of marital property, including a determination of the amount of appreciation in value that is due to market forces and the amount due to the efforts of one or both parties to the marriage."

(Alimony ?

Continued from page 1)

ceased upon the former husband's retirement, at which point, the petitioner would receive an interest in his pension under a qualified domestic relations order (QDRO). The Tax Court rejected this argument. It noted that the 1997

final divorce judgment was not the order in effect during tax years 1995 and 1996. It noted that under New York law, temporary support orders terminate upon the death of either party to the divorce action. Therefore,

the Tax Court concluded that the payments did fulfill the four requirements of sec. 71(b)(1) and were taxable alimony.

Minority Interest Set at Book Value

In *Joachim Strenk v. Jean Swanson Strenk*, No. 03-01-00051-CV (November 8, 2001), the Texas Court of Appeals, Third District (Austin) considered the valuation of a minority interest in closely held stock. The parties were married in 1998 and filed for divorce in 1999. It was established at trial that the husband acquired a 35 percent interest in a closely held company during the marriage. The interest generated \$146,000 in dividend income in 1999. The husband sold the interest three days before trial for \$15,000. The lower court determined that the husband had committed waste by selling the business interest for less than its reasonable value, thereby depriving the marital estate of a valuable asset. The court concluded that the wife was entitled to one

half the value of the business interest. To that end it received expert testimony regarding the value of the stock.

Only the wife presented valuation evidence. Her expert, a CPA, calculated the book value of the interest using the corporate tax returns and unaudited financial statements for 1997, 1998, and 1999. He also looked at the corporate books for 1998 and 1999 as well as a buy-sell agreement and other corporate documents. He determined that the interest had a book value of \$168,000 on the valuation date. He did not testify regarding the fair market value of the interest. The trial court accepted this valuation, and the husband appealed.

On appeal, the husband claimed

that the lower court erred in valuing the interest at its book value. Relying on case law, he argued that the proper standard of value was fair market value. The appellate court disagreed. It found that the cases he relied upon did not show that fair market value is the only standard to use when valuing a closely held business interest. It then noted that the husband did not present any testimony establishing the fair market value of the shares or other evidence of the stock's value. Thus, the appellate court upheld the lower court's valuation of the interest using book value.

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band's expert valued the wife's interest at \$476,000. He considered the operating agreement in determining the applicable discounts but concluded that "the transfer restrictions had a 'minimal impact on the discounts that were taken and were applied' in his valuation report." He further indicated that he was not concerned with the wife's improvements to the business in reaching his determination of value. The wife's attorney failed to question this expert regarding why his valuation did not exclude any personal goodwill. The trial court valued the interest in accordance with the husband's expert. In reaching its valuation, the court "considered the lack of company assets, the company's dependence upon its equipment leases, Wife's limited ability to sell her interest, and both Wife's and Husband's 'contributions to the success or failure of the business.'" The wife appealed.

On appeal, the wife argued that the trial court failed to properly exclude her personal goodwill. The appellate court first noted that it is the parties' burden to prove the value of marital assets. It

further stated, "The trial court cannot be expected to exclude personal goodwill from the valuation of a business without any evidence of what would constitute the excludable personal goodwill aspects of the business or any evidence of the value of alleged personal goodwill.... As Wife failed to submit any competent evidence of existence, proportion or value of personal goodwill, she failed to preserve this issue for appeal." The wife further argued that the position espoused in *Yoon v. Yoon*, 711 N. E.2d 1265 (Ind. 1999), which excluded personal goodwill from the value of a self-employed business or professional practice, had been extended to all businesses by *Bertholet v. Bertholet*, 725 N.E.2d 487 (Ind. App. 2000). The court disagreed. It found the business in *Bertholet*, a bail bondsman, was substantially similar to the self-employed business contemplated by the *Yoon* court. It further stated, "In our case, Wife became a one-third owner during the marriage and there is no evidence that

Wife's name or personal association with Queen City Steel is recognized within the steel heat-treating industry in a manner that gives ... [the LLC] any advantage over competitors." Thus, the court affirmed the trial court's valuation with regard to the issue of personal goodwill.

The court then turned to the second argument on appeal. The wife claimed that the trial court did not give sufficient weight to the restrictions on transferability imposed by the operating agreement. The appellate court noted that the lower court was presented with two experts—one weighing the operating agreement heavily and the other giving it little weight. It noted that since a valuation submitted to the trial court by one party in a divorce can provide competent evidence of value supporting the trial court's valuation, the trial court was not clearly erroneous in giving the operating agreement little weight. Thus, the appellate court affirmed the lower court's valuation.

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.

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