

Current Valuation & Taxation Rulings Regarding Divorce

Expert Testimony Accepted over Corporate Accountant's Valuation

In *In re the Marriage of Walbon*, No. A04-1523 (Minn. App. May 3, 2005), unpublished, the Minnesota Court of Appeals considered whether including the appraised value of a business in the marital estate was an appropriate sanction for violating the court's order prohibiting dissipation of assets and whether the appraised value was appropriately calculated. During the marriage, the husband and his brothers started a trucking company. The company was comprised of three corporations – a long haul trucking outfit, a local trucking outfit and a real estate holding company. The husband held 42.5 percent of each of the company, and was its president. He earned an average annual salary of \$92,600 per year. In 2001, the husband resigned from the company during the pendency of the divorce and became employed as an over-the-road driver for an unrelated company. Further, following his receipt of the divorce summons, that specifically prohibited him from disposing of marital assets, the husband sold his interest to his brothers for \$298,562, payable over 20 years at 7 percent interest.

The trial court held that the sale of the businesses violated the company's cross-purchase agreement, Minnesota statutes and its order. Thus, it concluded that the husband's "actions in selling the marital interest in these three family business

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LARSON APPRAISAL SERVICES

11445 E. Via Linda Ste. 2
Scottsdale, AZ 85259

For Professional Appraisals of Privately-Owned Business Interests contact:

**James A. Larson,
Ph.D., ASA, CFA**
(480) 657-6219

Jim@larsonappraisal.com

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For Valuation Expertise...

Expert Testimony Should Have Been Obtained in Connection with Husband's Medical Practice

In *Sandra F. Zerbe v. John J. Zerbe*, 2005-Ohio-1180 (March 18, 2005), the Ohio Court of Appeals, First District considered the valuation of a medical practice. During this long-term marriage, the husband established a medical practice. Through the practice, he realized a substantial income. At trial, both parties presented evidence regarding the value of the practice, but neither party engaged a business appraiser to value the practice.

Before the trial court, the wife argued that the practice had a value of at least \$62,857. This valuation was based on her interpretation of the practice's balance sheet, which showed the net equity in the practice. She then added an amount for accounts receivable. She further argued that the practice's value may be greater than \$62,857 if goodwill was considered, but presented no evidence regarding the value of any goodwill.

The husband interpreted the practice's balance sheet differently. He concluded that the practice had a net value of \$15,948 once his income was excluded. He further testified that the practice had no market because hospitals were no longer purchasing medical practices.

The trial court credited the husband's testimony regarding the weak

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Date of marriage Appraisal Should Be Obtained When Owner-Spouse Seeks Setoff for Pre-Marital Asset

In *Crispina A. Simcock v. Alan F. Simcock*, No. 25688 (March 28, 2005), unpublished, the Hawaii Intermediate Court of Appeals considered the husband's claim for a Category 1 credit for his pre-marital interest in a closely held business. (A Category 1 credit is the net market value (NMV), plus or minus, of all property separately owned by one spouse on the date of marriage (DOM) but excluding the NMV attributable to property that is subsequently legally gifted by the owner to the other spouse, to both spouses, or to a third party.) The husband established a janitorial business nine years before the date of marriage. He obtained an appraisal of the busi-

ness. The appraisal valued the business at \$85,000 at the time of the parties' divorce. The husband did not obtain an appraisal of the business using the date of marriage (DOM) as the valuation date. Rather, he argued that at least one-half of the date of dissolution value should be attributable as his pre-marital property. The trial court denied him any credit for the pre-marital value of his business. The husband appealed.

On appeal, the husband argued that the trial court erroneously denied him credit for the pre-marital value of his business. He argued that he should be credited with one-half the value of the business on the date

of the conclusion of the evidentiary part of the trial. The appellate court disagreed. It stated, "To obtain credit for the Category 1 NMV [net market value] of that asset, it was his burden to prove the NMV of that asset on the DOM, and he failed to do so." Thus, it affirmed the trial court's decision denying the husband a credit for his pre-marital interest in the business.

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assets [to be] presumptively fraudulent." The court then concluded that the value of the business interest should be a constructive asset of the marriage.

Both parties presented testimony regarding the collective value of the businesses. The wife's expert, a CPA with experience in the trucking industry, valued the businesses at book value. In concluding that this was the appropriate value, he reviewed the businesses' tax returns, the residual value of the tractor-trailers after they were fully depreciated, and the businesses' future outlook. He concluded that the businesses had a value of \$2,653,320.

The husband presented testimony from the businesses' accountant. The accountant utilized the liquidation value method. However, he testified that this method "clearly produces the lowest stock value."

The trial court adopted the valuation introduced by the wife's expert. The husband appealed.

On appeal, the husband argued that the wife's expert's valuation was not performed in accordance with the factor enumerated in *Nardini v. Nardini*, 414 N.W.2d 184 (Minn. 1987). *Nardini* indicated that book value was an acceptable starting point for valuing a closely held company, but the factors listed in Rev. Rul. 59-60 should be considered in determining the reasonable value. The appellate court affirmed the lower court's acceptance of the wife's expert's valuation. It found that the expert considered other factors including those explicitly listed in *Nardini* such as economic outlook and business history in settling on book value as the appropriate value indicator.

(Zerbe... Continued from page 1)

market for sales of medical practices. It valued the practice at \$20,000, but did not provide any reasoning for selecting a value between the values presented by the parties. The wife appealed.

On appeal, the wife argued that the trial court improperly valued the practice. The appellate court agreed. It noted that the trial court was presented with two valuations of the practice and selected an amount between those valuations. It stated, "The court cannot take the two extremes presented by the evidence and choose a value somewhere between those two extremes." Thus, it reversed the trial court's valuation and remanded the matter back for a revaluation based on the evidence.

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<http://LarsonAppraisal.com>.

Interest in Emergency Medical Practice Valued

In *Patricia P. Hess v. Ralph C. Hess, III*, No. 2003-CA-002195-MR (March 11, 2005), unpublished, the Kentucky Court of Appeals reviewed a lower court's valuation of an interest in an emergency room medical practice. The husband was a doctor certified in emergency medicine. He was one of 11 doctors operating an emergency medical practice affiliated with a hospital. Under the business' contract with the hospital, the practice was precluded from servicing another hospital within 50 miles of it and the patient records were the property of the hospital. Each doctor was subject to a shareholders' agreement. The agreement specified the repurchase formula for a departing shareholder. The repurchase formula was the amount attributable to the physicians in their profit center based on four months rolling averages less a proportionate share of business expenses. Physician-owner compensation is based on the physician's percentage of billings to the whole based on four months rolling averages, while incoming physicians are guaranteed a salary of \$240,000.

Each party presented expert testimony valuing the business as of the date of dissolution (July 31, 2002). Each expert valued the business as the husband's share of the accounts receivable plus goodwill, if any. The goodwill value was calculated using the capitalization of excess earnings method. With respect to the calculation of the amount of the accounts receivable, each expert utilized an effective tax rate of 45 percent and a collection rate of 31.5 percent. They disagreed over the percentage of the accounts receivable attributable to the husband. The husband's expert utilized the four months rolling average as called for in the shareholders' agreement to compute the husband's compensation. Under this method, the husband would receive 6.056150 percent of the business' ac-

counts receivable. The wife's expert determined the husband's share of the accounts receivable by averaging his annual percentage for 2002 – 8.29 percent. This resulted in a valuation of the business between \$77,000 and \$178,000.

The experts then determined the goodwill portion of the business using the excess earnings method. The experts utilized the gross earnings as reported by the husband for years 1998 through 2001. The husband's expert used actual gross earnings for 2002, while the wife's expert utilized projected earnings for 2002. Furthermore, the wife's expert included income earned by the husband for shift work he performed at another hospital. Both experts then consulted Medical Group Management Association data to determine the average annual earnings of a comparable physician for those years. The wife's expert utilized mean average data for all emergency room physicians for the years in interest, while the husband's expert utilized data from the 75th percentile and made adjustments for geographic location and single specialty. The experts agreed that the excess earnings should be capitalized using a 33.33 percent capitalization rate. The husband's expert computed no value for goodwill while the wife's expert computed excess earnings of \$366,000 value for goodwill.

The trial court did not accept either expert's opinion of value, but preferred the opinion presented by the husband's expert. With respect to the calculation of the accounts receivable, it rejected the wife's expert's use of the 2002 annual average of percentage of receivables. It stated, "That is inappropriate as the amount assigned to each owner-physicians' profit center is calculated on a four month rolling average, not an average for the year." Thus, it accepted the husband's expert's figure.

It then considered the calculation of

excess earnings. It started by noting that this is not a typical medical practice insofar as it is under an exclusive contract to provide services to a single hospital and does not own its patient records, but nonetheless, it criticized the wife's expert for using projected gross earnings when actual gross earnings were available. Moreover, it found the inclusion of earnings not derived from the medical practice in the gross earnings figures inappropriate. It further concluded that the use of mean average data to calculate a similarly situated physician's earnings was inappropriate. It stated, "... use of the mean average for all emergency room physicians is inappropriate as it does not take into consideration board certification, years of experience, or the locale in which he practiced." However, it also concluded that the husband's expert's use of the 75th percentile data was somewhat overstated. Using its judgment, it concluded that the practice, inclusive of goodwill, had a value of \$125,000. Both parties appealed.

On appeal, the parties contested the calculation of the goodwill and the wife contested the valuation of the accounts receivable. The appellate court rejected both parties' arguments. It stated, "We recognize that the DRC heard testimony from experts whose methods and calculations produced a variation in the estimated value of the business ... This simply illustrates that there is no single best mathematical formula for precisely calculating the value of a medical practice." It found that the value determined by the lower court fell within the range of values presented by the expert testimony and therefore the valuation was not clearly erroneous.

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.