

Current Valuation & Taxation Rulings Regarding Divorce

Courts Consider Treatment of S Corporation Earnings as Income for Support Purposes

There are many reasons why a business owner would choose to utilize a pass-through business entity from which to carry on his profession. The primary reason is tax reduction. As a pass-through entity, the entity's profits are taxed only at the shareholder level in proportion the shareholder's interest in the entity. The shareholders report the entire amount of their proportionate profits of the business on their tax returns as income, but frequently do not actually receive the reported amount from the company. Rather, they receive a distribution sufficient to pay their tax liability generated by the business. The treatment of pass-through entities has caused considerable trouble to the courts when estimating the amount of support a shareholder spouse should pay the support recipient.

There had been a split in the districts in Florida regarding the treatment of pass-through earnings for support purposes. Several districts reasoned that since the profits were treated as income by the shareholder spouse, that profit was available for support whether or not actually received by the shareholder spouse. Other districts held that pass-through earnings should only be treated as income for support purposes to the extent actually received, so long as the pass-through entity was not used to shield income for support purposes. In September, the Florida Supreme Court settled the difference between the districts in *Sherry Palicte Zold v. John F. Zold*, No. SC04-

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Doctor's Projected Post-Divorce Reduction in Hours Worked Considered in Valuation

In *Vicki A. Schiro v. William A. Schiro*, No. 252621 (Mich. App. August 25, 2005), unpublished, the Michigan Court of Appeals considered the valuation of an interest in a professional medical practice as a going concern. The husband was an oral surgeon, who worked a significantly greater number of hours than an average practitioner and earned a substantial annual income. The average oral surgeon works 1,600 hours annually. (This annual number reflects only the number of hours the doctor spends performing procedures and not the number of hours he or she spends in the office.) In the year before the filing of this action, the husband worked 2,750 hours. However, as a result of the separation and the assumption of greater responsibility for his son, the husband expected to work only 1,320 hours in the first full year after the date of filing.

Both parties presented the court with expert valuation witnesses. Both witnesses were CPAs with business valuation credentials. Only the husband's expert's valuation was entered into evidence before the court.

The parties agreed to the value of the husband's interest's share of the tangible assets, but disagreed over the value of any intangible assets or goodwill. The husband's expert computed the goodwill value based on number of hours worked. Using the husband's assumption that he

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1858 (Fla. September 15, 2005).

The Florida Supreme Court held that “undistributed ‘pass-through’ income that has been retained by a corporation for corporate purposes does not constitute income within the meaning of Chapter 61.” However, it tempered that holding, “where undistributed ‘pass-through’ income has been retained for noncorporate purposes, such as to shield this income from the reach of the other spouse during dissolution, the improper motive for its retention makes it available ‘income’ under section 61.046(7) or ‘business income’ under sec. 61.30(a)(3).” The court further held that “the shareholder-spouse should have the burden of proving that the undistributed ‘pass-through’ income was properly retained for corporate purposes rather than impermissibly retained to avoid alimony, child support, or attorney’s fees obligations.” In assessing whether the pass-through earnings have been retained for improper purposes, the Supreme Court issued a three prong test. The prongs are (1) the extent to which a shareholder spouse has access to or control over the retained earnings, although, the shareholder-spouse’s ownership interest is a factor in analyzing this, it is not dispositive of the issue; (2) the statutory limitations governing S corporation distributions to a shareholder; and (3)

the purposes for which the earnings are retained by the corporation. Thus, it affirmed the Fifth District in part and reversed it to the extent that the Fifth District gave the burden of proof to the non-shareholder spouse.

The *Zold* decision is in line with cases from Indiana. Indiana held that “(1) undisbursed pass-through income of a minority shareholder in an S-corporation should not be included in child support calculations unless the trial court finds that the corporation is being used to shield income and (2) pass-through S-corporation income that is merely disbursed to offset pass-through shareholder tax liability, and which does not increase the shareholder’s actual income should not be included in ... support calculations.” *Tebbe v. Tebbe*, 815 N.E.2d 180 (Ind. Ct. App. 2004). The Indiana Court of Appeals recently had the opportunity to review the application of this law in *Dennis D. Nowels v. Cathleen Cay Nowels*, No. 57A04-0502-CV-98 (Ind. App. November 3, 2005). The lower court in *Nowels* expressly equated the husband’s 50 percent interest with a minority interest and indicated a willingness to deduct pass-through income reported solely for tax purposes. However, the lower court deducted only the amount of the payments made to

the husband for tax setoff purposes. The appellate court affirmed the lower court’s decision with respect to the amount of the deduction. It noted that the trial court was not presented with any testimony regarding the amount of the pass-through income that was retained by the business. Since the lower court had before it only the amount of husband’s annual salary, the amount of income passed through to the husband, and the amount of the tax setoff check, it appropriately calculated the income by adding the first two figures and then deducting the third. Thus, it affirmed the lower court’s calculation.

The cases show that the courts are willing to entertain the notion that pass-through earnings are not necessarily received by the shareholder-spouse and to the extent proven should not be included as income for support purposes even though treated as income for tax purposes. The courts are further in agreement that the burden of establishing the appropriate amount of income to be included as income for support purposes vis a vis the amount reported for tax purposes is upon the shareholder-spouse. Proper use of expert valuation and accounting testimony will play a crucial role in carrying that burden of proof.

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would work below the average number of hours for oral surgeons, his expert multiplied the projected hours worked by a collection rate and then deducted payroll taxes and other expenses to arrive at her value. This expert computed a goodwill/intangible value of \$585,000.

The trial court rejected this valuation. In doing so, it considered several factors that lead it to believe that the husband’s hours would not be so drastically reduced. It considered the husband’s

work history, the history of the practice, and the husband’s current obligations. This led the court to find that the husband had a history of working harder than average and would likely continue to do so. Thus, it concluded that the husband would reduce his hours to 1,800, which was still greater than the average number of annual hours worked by oral surgeons. Thus, it computed the goodwill value to be \$880,000, for a total value of \$1 million

for the husband’s interest. He appealed.

On appeal, the husband challenged the lower court’s valuation of his interest in the practice, arguing that it should have adopted his expert’s valuation. The appellate court disagreed. Since the trial court was in the best position to judge the credibility of the witnesses and the value was within the range presented to the trial court, the lower court’s \$1 million valuation was not clearly erroneous.

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California Considers Goodwill of an Individual in the Artistic Field

In *In re the Marriage of McTiernan and Dubrow*, No. B161255 (Cal. App. 2 Dist. October 28, 2005), a divided California Court of Appeals, Second District considered whether a movie director or like artistic/athletic professional had goodwill divisible in divorce. The husband was a renowned movie director, whose successes included *Die Hard* and *The Thomas Crown Affair*. He ranked 13th among directors in box office receipts in the industry and he was the number one director in terms of movie budgets. The husband received around \$1 million in compensation per film. The parties were married for 8.5 years and separated in July 1997.

The wife presented the trial court with expert testimony from an economist as to the goodwill the husband possessed. The expert calculated the husband's goodwill by applying a capitalization of excess earnings method. As part of this analysis, he computed the excess earnings by subtracting the earnings of an "average" director from the husband's annual earnings. The expert determined that the husband had \$1.5 million in goodwill. The trial court adopted that figure in its division of the marital community. In doing so, it noted the husband's pre-eminence in the field. The husband appealed.

On appeal, the husband challenged the lower court's finding that the husband had divisible goodwill. He argued that the husband's profession was not a business within the meaning of the business corporation code that was capable of having goodwill nor if goodwill existed was it transferable. The majority for the Second District agreed. It focused on the Business & Professional Code section 14100 and 14102 to find that "the 'goodwill' of a business is the expectation of continued public patronage" and "[t]he good will of a business is property and is transferable." It then defined "a business" as "a professional, commercial or industrial enterprise with

assets, i.e., an entity other than a natural person." It further stated, "No California case has held that a natural person, apart and distinct from a 'business,' can create or generate goodwill." It distinguished the husband's profession from professions such as attorneys and doctors that have businesses, even as sole practitioners, that generate goodwill. Therefore, it found that the husband as a natural person was not a business and could not have goodwill within the meaning of the Business & Professional Code.

The majority further reasoned that to include a natural person in the definition of a business under the Business & Professional Code would create a liability without a guaranteed way to fund it. It stated, "It is clear that, from an economic perspective, the 'goodwill' in this case is based on earnings, and that 'goodwill' is an expression of husband's earning capacity. However, there is no guaranty, especially in the arts, that earnings will not decline or even dry up, even though expectations were to the contrary."

The majority lastly noted that in order for goodwill to be divisible it must be (1) property and (2) acquired during the marriage. The court reasoned that property may be real or personal, and that personal property could be intangible, but must be transferable. Since the husband's 'goodwill' was a direct product of his "elite professional standing" in relation to other motion picture directors, it was not transferable. It stated, "He cannot sell this standing to another, because a buyer would not be John McTiernan, no matter how much the buyer was willing to pay. For the same reason, and unlike a law or medical practice, husband cannot transfer his 'elite professional standing.' That standing is his, and his alone, and he cannot bestow it on someone else." Therefore, the court found that the husband's goodwill was not property within the tradi-

tional definition of property.

Lastly, the Second District noted that the lower court calculated the value of the goodwill using an excess earnings calculation. The court noted that simply because a mathematical calculation results in a value did not "convert husband's skill and reputation into a 'business,' and does not transmute unique and idiosyncratic talents into property that can be transferred and sold." Thus, the majority reversed the lower court's finding that the husband had goodwill of \$1.5 million resulting from his earnings as a motion picture director when compared to his average peer.

One judge dissented to this decision. This judge concluded that the husband had goodwill. He reasoned, "By any realistic understanding, husband earned his professional compensation, and developed an expectation of continued patronage, while practicing a business, of directing motion pictures." Moreover, he concluded the fact that the goodwill was not transferable had no bearing on the value for marital dissolution purposes. This judge stated:

"There is a reason why the existence of goodwill in a marital context does not depend upon the practical transferability of the professional spouse's practice. Insofar as it is assessed and disposed of in a judicial proceeding upon dissolution of the marriage, goodwill is not a commodity in the marketplace, but rather 'a portion of the professional practice as a going concern on the date of the dissolution of the marriage.'

Thus, this judge would have affirmed the lower court's finding of goodwill based on a holder's interest theory of the 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.