A BUSINESS VALUATION GUIDE FOR DIVORCE IN RHODE ISLAND

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Barrett Valuation Services, Inc.

The Business Valuation Advisors

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A Business Valuation Guide

for Divorce in Rhode Island

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Introduction

This analysis is intended to be a guide to the complex issues that often arise, in Rhode Island divorce cases, when one or both of the parties hold an equity interest, in a closely-held business. Lawyers are often faced with a number of factors to consider when a business is involved, in the divorce case. This guide will discuss the following topics: 1) Inclusion in the Marital Estate; 2) Standard of Value; 3) Valuation Date; 4) Retention of the Business Valuation Expert; 5) Normalization Adjustments; 6) Tax Ramifications; 7) Valuation Discounts; 8) Personal Goodwill vs. Enterprise Intangible Value, and Non-Compete Agreements; 9) Relevant RI Court Cases; 10) Recommended Reading.

1) Inclusion in the Marital Estate

Generally, when a closely-held business has been formed or purchased during the course of the marriage, the value of the business or interest in the business is included in the marital estate (R.I.G.L. § 15-5-16.1(a)). Some businesses have little or no value while other businesses have significant value. The prudent divorce attorney will consult with a valuation expert any time a closely-held business is held by one or both parties, in a divorce case. Complexities arise when one of the parties enters into the marriage with an equity interest, in the closely-held business. In such cases, the appreciation in value, of the business, if any, may be included in the marital estate (R.I.G.L. § 15-5-16.1 (b)). Therefore, valuations of the business at the date of marriage and at the date of divorce are required. When the marriage is long-term, it can be very difficult to obtain sufficient records and financial information to value the business, as of the date of the marriage. Nevertheless, every effort should be made to value the business, as of the date of marriage. Keep in mind that the valuation expert should have significant financial and non-financial information regarding the business currently. As a result, even with limited financial information, as of the date of marriage, the business appraiser may be able to provide an estimated value, as of the earlier date. Depending on the specifics of a case, the business appraiser may be able to provide a formal business valuation report including a conclusion of value, as of the date of marriage. In other cases, the information available may be just too limited, for the business appraiser, to provide a conclusion of value. However, there may be sufficient information to provide a calculated value (a more limited estimate of value). The valuation expert should also be prepared to explain the difference between a conclusion of value and a calculated value, and why a calculated value was developed, as of the earlier date.

An interest in a closely-held business that has been received by gift or inheritance is generally excluded from the marital estate, by statute (R.I.G.L. § 15-5-16-1 (b)), unless the property has been transmuted. However, when a gifted or inherited business interest makes up a significant portion of the total assets held by both parties, it may be advisable, for the non-business owner spouse, to obtain a business valuation. Such business value might be considered, by the Family Court, in determining an equitable distribution, of the assets actually included in the marital estate.

In Rhode Island, appreciation of a gifted or inherited property, during the time of the marriage, has been excluded from the marital estate, Hurley v Hurley, 610 A 2nd 80 (R.I. 1992). In Hurley, the court rejected the husband's argument that the appreciation on real property purchased by the wife during the marriage with funds acquired by inheritance should have been included in the marital estate.

Rhode Island General Laws § 15-5-16.1 (a) states:

> In addition or in lieu of an order to pay spousal support made pursuant to a complaint for divorce, the court may assign to either the husband or wife a portion of the estate of the other.

Section §15-5-16.1 (b) then restricts the property that is subject to division.

> The court may not assign property or an interest in property held in the name of one of the parties if the property was held by the party prior to the marriage, but may assign income which has been derived from the property during the marriage, and the court may assign the appreciation of value from the date of the marriage of property or an interest in property which was held in the name of one party prior to the marriage which increased in value as a result of the efforts of either spouse during the marriage. The court also shall not assign property or an interest in property which has been transferred to one of the parties by inheritance before, during, or after the term of the marriage. The

> court shall not assign property or an interest in property which has been transferred to one of the parties by gift from a third party before, during, or after the term of the marriage.

Under the language of § 15-5-16.1 (b), any appreciation on property owned by either spouse prior to their marriage would be considered part of the marital estate and capable of being assigned, provided that either party's efforts helped to cause the appreciation. However, this provision allowing the division of appreciation does not appear to apply to the other two types of separate property, gifts and inheritances. Instead, under a strict reading of the statutory language, it would appear that any appreciation on property acquired by one spouse by gift or inheritance during the marriage would remain that spouse's separate property.

The Hurley case dealt with real estate, where the appreciation was probably due, for the most part, to market influences (passive appreciation), as opposed to the efforts of either spouse (active appreciation). There currently is no Rhode Island case law dealing specifically with active appreciation. Active appreciation would occur when there is appreciation in a gifted or inherited closely-held business and that appreciation is directly attributable to the efforts of one or both parties, rather than general market forces. Many states have developed case law, over the past several years, to include active appreciation derived from separate gifted or inherited property, in the marital estate.

2) Standard of Value

The standard of value generally applied when valuing an interest, in a closely-held business, in Rhode Island divorce cases, is fair market value. This differs from the standard of value generally applied in shareholder dispute cases, at the Rhode Island Superior Court level. In shareholder dispute cases, the Charland Case requires a fair value standard of value, absent entity documents stipulating a different standard of value or a formula approach to value. The difference between the fair market value and fair value standards of value, in Rhode Island, is the application of appropriate valuation discounts. Primarily the downward adjustments, to value, for lack of control and lack of marketability. Fair market value includes application of discounts and fair value does not. These discounts can be significant when one of the parties owns a non-control interest, in a closely-held business. There is no state statute or case law requiring the fair market value standard of value, for Rhode Island divorce cases. However, in the McCulloch case (McCulloch v. McCulloch, 2013 R.I. LEXIS113 (June 25, 2013), the Rhode Island State Supreme Court ruled that discounts should be applied in "In-Kind" distributions of closely-held stock in divorce actions. The Court provided the following language:

"Although this Court has adopt[ed] the rule of not applying [a minority discount or] a discount for lack of marketability" in the context of an action for dissolution of a closely-held corporation, we believe that such discounts are appropriate, and even necessary, when valuing an in-kind distribution of a minority share of a closely-held corporation in a divorce action. DiLugio v. Providence Auto Body, Inc., 755 A.2d 757, 774 (R.I. 2000) (quoting Charland v. Country View Golf Club, Inc., 588 A.2d 609, 613 (R.I. 1991)). The reason that these discounts are not applied "when a corporation elects to buy out a shareholder who has filed for dissolution" is that "[m]inority shareholders should not receive less than [fair market] value if, instead of fighting the dissolution action, the majority decides to * * * buy out the minority * * *." Charland, 588 A.2d at 613 (quoting Robert B. Heglar, Rejecting the Minority Discount, 1989 Duke L.J. 258, 269 n.63 (1989))"

"In this case, however, if the trial justice were to assign Hope an in-kind, minority share of Microfibres and MPL, Hope would be assigned illiquid assets that have no ready market, and she would be left with no control over the companies. Thus, both a minority discount and a marketability or illiquidity discount must be applied when valuing the portions of the companies that will be assigned to each party. However, if the trial justice had awarded Hope the cash equivalent of her equitable ownership interest in the companies, or if he had crafted some other assignment, such discounts would not be necessary. See Josephson, 722 P.2d at 1244 (holding that "such discounting will not be applicable here when the magistrate awards all shares to [one spouse] and orders compensation or an offsetting award of other property to [the other spouse]")."

The Rhode Island Supreme Court states that had the wife received a cash settlement based on the value of the stock, to the husband, then discounts would not be necessary. However, the court recognizes the disadvantage to the wife, of becoming a minority shareholder, in the husband's companies. In this ruling, the Rhode Island Supreme Court recognizes that the value of a cash settlement, based on the value of the husband's controlling interest, in the companies, is greater than the value of a non-control "in-kind" distribution, of minority shares, to the wife.

Perhaps this court case provides some justification for application of the fair market value standard of value, in Rhode Island divorce cases. Fair market value is defined by the Internal Revenue Code:

Section 20.2031-1(b) of the Federal Estate Tax Regulations and section 25.2512-1 of the Federal Gift Tax Regulations define fair market value, in effect, as "the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts." Court decisions frequently state in addition that the hypothetical buyer and seller are assumed to be able, as well as willing, to trade and to be well informed about the property and concerning the market for such property.

In most interpretations of fair market value, the willing buyer and willing seller are hypothetical persons dealing at arm's length, rather than any particular buyer or seller. In order words, a price would not be considered representative of fair market value if influenced by special motivations not characteristic of a typical buyer or seller. There is also general agreement that the definition implies that the parties have the ability as well as the willingness to buy or to sell. The *market* in this definition can be thought of as all the potential buyers and sellers of like businesses or practices.

Complexities arise in a divorce case when the business owner spouse holds a non-control equity interest, in a closely-held business, and the entity documents provide for a buy-out at something other than fair market value. For instance, one of the parties may own a fifty (50) percent, non-control equity interest, in a corporation and the corporate buy-sell agreement or shareholders' agreements may provide a buy-out formula that is much less than the fair market value of such interest. The business appraiser should inform the divorce lawyer of such documents. The business appraiser should also address this issue, in the business valuation report, and provide both valuation outcomes. The resolution may become a legal matter beyond the scope of the business appraiser's expertise.

3) Valuation Date

The date of a business valuation is very important, in a Rhode Island divorce case. For instance, the value of a closely-held business relying on traffic at T.F. Green Airport would probably have very different values, as of August, 2001 and October, 2001, due to the events of 9/11. Many Rhode Island closely-held businesses had a valuation decline, of over fifty percent, from the year 2007 to 2009, due to the great recession. The unexpected gain or loss of a major customer or large contract can have a significant impact on the value of a closely-held business.

Rhode Island Family Court generally utilizes the date of judgment, as the valuation date. In Saback v. Saback, 593 A.2nd 459 (R.I. 1991) the State Supreme Court ruled "we held that a trial justice must assess the marital estate as of the time of entry of judgment." Also in Gervais v Gervais; 688 A. 2d 1303; (R.I. 1997) the State Supreme Court ruled "as in Saback, we do not have before us any evidence from the record that would suggest any necessity for valuing the marital estate as of a time other than the date of judgment." These rulings would indicate that the business appraiser should use as current a valuation date as possible, to value a closely-held business. Rhode Island divorce cases that take a protracted amount of time to resolve may require updated business valuation reports.

The parties, to a Rhode Island divorce case, can stipulate to a date of valuation of marital assets other than the date of entry of judgement, Esposito v. Esposito, 38 A. 2d (R.I. 2012). Also, please see McCulloch v. McCulloch, 2013 R.I. LEXIS 113 (June 25, 2013). The lawyer should advise the business appraiser, as to the date of the business valuation.

4) Retention of the Business Valuation Expert

Retention of the business valuation expert is an important step, in the business valuation process. Certified Public Accountants with a business valuation designation are generally well trained and well suited to assist, in the process. There are four primary business valuation designations. Each represents a certain level of training, education and commitment to the specialized area of business valuation. Of most importance is the valuation expert's level of experience and expertise, in completing a specific valuation assignment. The divorce lawyer should inquire as to the business valuation experts experience in depositions and testifying at trial. Often times, other family law lawyers are a great referral source for recommending an experienced business appraiser familiar with the Rhode Island Family Court system.

Following are some tips for the initial conversation with the prospective business appraiser. First, lawyers should resist the urge to simply ask how much and how soon. Instead lawyers should invest a little time in the initial conversation with the expert. Request the experts C.V. Ask about the expert's relevant experience, in Rhode Island Family Court. Ask if the expert has ever testified. Inquire as to how involved the expert is in the local and national business valuation community. Ask if the expert is familiar with certain landmark Rhode Island business valuation cases and the expert's position, on such cases. Based on how the expert interprets and treats certain issues, he or she may or may not be the right expert, for your client. Remember the business valuation expert is required to be an advocate for his or her opinion of value. The attorney is an advocate, for the client. Inquire if the expert has published. Inquire whether the expert teaches or regularly attends business valuation seminars. Most importantly inquire about the business valuation standards the expert follows and ask follow-up questions. Any hesitation or lack of knowledge, in this area, is problematic.

Prior to the initial conversation, or certainly a second conversation, it is very helpful for the divorce lawyer to have some financial information, even if limited, regarding the business, to be valued. The valuation expert needs some idea as to the size and complexity, of the business valuation assignment, in order to quote a fee. This would include information regarding revenues, profitability, number of employees, ownership percentage to be valued, information regarding the nature and history, of the business, what the business actually does, whether revenues are increasing or decreasing, and some idea as to the assets and liabilities, of the business. A current business income tax return or financial statement will assist in providing this information. The business valuation expert can guide the attorney, as to where to locate specific information, in the company's financials. The actual name, location, and ownership of the business can be found on the Rhode Island Secretary of State's website, under the corporate database. The Company's website can also provide useful information. The expert will need to know if the business interest was acquired before or during the marriage, as more than one business valuation may be required. The business appraiser will also need to know if some or all of the business interest was acquired by gift or inheritance. The business appraiser may also inquire if this specific case, based on the type, size and complexity, of the business, and the dynamics of the litigants, is a candidate for a joint retention. Some cases are and some cases are not.

Once the business appraiser has sufficient information, a fee or an estimated fee can be provided. Some business appraisers will quote an hourly rate and provide an estimate, as to hours. Other appraisers will quote a flat fee, for the business valuation engagement. A time frame for completion of the business valuation engagement should also be discussed. Divorce cases have an odd ebb and flow and each case is different. Sometimes financial and non-financial records are provided quickly. Other times obtaining the necessary financial records becomes an epic struggle. At times, the business owner spouse will initially be difficult, when it comes to providing financial documents. The trial judge will eventually hold the business owner spouse accountable for his or her contumacy. Once instructed, the business appraiser will provide an engagement letter and document request list. The engagement letter will generally state the fee arrangement, required retainer fee and that any additional services, such as depositions or trial time will be billed separately, at a stated hourly rate. Once the divorce lawyer has invested some time in discussing the case with the prospective business valuation expert, a sound decision can be made, on retaining the appropriate expert.

5) Normalization Adjustments

When utilizing the income and market approaches to valuation, the business appraiser will generally normalize the historical earnings, of a closely-held business. Public companies maximize profits and distribute them to the shareholders. Closely-held businesses often distribute profits as salary or other economic benefits, to the business owners. Therefore, the valuation expert adjusts the financial statements to show earnings, as if the business were run by a third party whose goal was to maximize profits, not minimize taxes. In other words, the expert adjusts the income as if the business owner was preparing to sell the Company. The expert typically makes adjustments to the financial information reported on the tax returns or financial statements so that expenses that are not necessary to operate the business are removed. Normalization adjustments include unreported cash (if substantiated), nonrecurring income and expense, extraordinary items, and discretionary expenses. Discretionary expenses often include owners' compensation, owners' perquisites, compensation to family members, automobile expense, travel expense, meals and entertainment expense, related party rent expense, professional and legal fees (divorce lawyers), retirement plan contributions, depreciation expense and charitable contributions. Officers' compensation, related party rent expense and owners' perquisites tend to be the largest adjustments made, in many valuations. These later adjustments often account for the differences, in competing business valuation reports. The business valuation expert should be able to clearly explain and substantiate all adjustments made. The normalization adjustments should be reasonable, understandable and supportable.

The business valuation process, including the normalization adjustments, should not be confused with a forensic audit. A business valuation engagement is not a forensic audit. The normalization adjustments are generally based on a thorough review of the existing financial statements. This may include a management interview, comparison of the company's financial performance year over year, benchmarking the company's expenses and profitability to industry data and applying a certain amount of common sense. The valuation process may include some testing and examination of specific underlying accounts and records, when necessary. For example, examination of certain expense accounts and underlying supporting records may be completed or the accounts receivable account may require detailed analysis. However, this work does not constitute a forensic audit. A forensic audit is a much deeper and thorough analysis and testing of portions or all of the company's books and records, depending on the forensic audit engagement parameters. A forensic audit can be a very costly and time consuming task. Very small businesses are more likely to have very weak accounting records and controls. Sometimes a small business will provide a non-CPA tax service with records to prepare business income tax returns that are not very reliable. However, in many of these cases, a forensic audit is often not economically viable or beneficial. Larger businesses tend to have stronger accounting records and controls. When a CPA firm is providing reviewed or audited financial statements and outside lenders are reviewing that work, the business appraiser will have a higher degree of confidence in the accounting records. When the business appraiser identifies possible underlying problems with a company's accounting books and records, the matter should be discussed with the divorce lawyer. The possible costs and potential economic benefits, of a forensic audit, can then be considered.

The normalization adjustment to officers' compensation is often the single largest adjustment, in the valuation process. This adjustment can have a significant impact on the valuation outcome. In such cases, the double dip concept may come into play. The double dip, for business valuation purposes, arises when the same earnings stream is used to compute the business value, for equitable distribution purposes and for spousal support.

Rhode Island currently has no case law on the double dip issue. Massachusetts has a couple of cases on the matter. In Champion v. Champion, 54 Mass. App. CT 215 (2002), the Appeals Court held that the value of the husband's business had been determined using a "net asset" valuation method. Because this method does not include any intangible value, no double dip has occurred. In Sampson v. Sampson, 62 Mass. App. CT 366 (2004), the Appeals Court determined that there appeared to have been impermissible "double dipping" with respect to the trial judge's divorce judgement thus requiring a remand for further consideration of the apparent inequities that existed. The Appeals Court noted in Sampson that, unlike the "net asset" valuation method that had been utilized in Champion, a "capitalized income" valuation methodology had been used. The capitalization of earnings method resulted in intangible value creating the potential for the double dip. Steneken v. Steneken is a high profile New Jersey Supreme Court case that is recommended reading, in this area (Steneken v. Steneken, 873 A. 2d 501, 507 (N.J. 2005). In the Steneken case the Supreme Court held that "there is no requirement that a court use the same method of calculating income that is used to determine the value of the corporation for equitable distribution purposes." The Court also stated that "the interplay between an alimony award and equitable distribution is subject to an overarching concept of fairness." The dissent wrote "once a court converts a specific stream of income into an asset, that income may no longer be calculated into the maintenance formula and payout." In this case, the Supreme Court of New Jersey provided an excellent explanation of the double dip concept, but ultimately ruled it was within the trial courts discretion to make a determination on the double dip issue.

The following is an example of the double dip concept, in business valuation. In this example, the business appraiser applies an income approach to valuation, specifically the capitalization of earnings method. In the valuation process, the business appraiser adjusts the officer's compensation from $400,000, per year, to an estimated market replacement level of compensation of $200,000, per year. Assume a 20 percent capitalization rate and a 40 percent tax rate. This adjustment increases the business valuation by $600,000 ($200,000 adjustment, less taxes at 40 percent divided by the 20 percent capitalization rate). The non-business owner spouse receives one-half of the increased business value, of $300,000, as a property settlement. Spousal support should be based on $200,000, of officer's compensation, to avoid the double dip. Utilizing the historical compensation, of $400,000, applies the same $200,000, of earnings, that increased the business valuation and creates the double dip. Closely-held businesses are non-liquid assets and often require a payout, over a period of time. In our example, assume a five-year payout, for the business, and five years of spousal support. In this example, the business owner spouse would be required to use the same dollars to pay for part of the property distribution and the spousal support. A dollar can only be stretched so far. Now in the example, after-tax dollars were used to increase the business value and pre-tax dollars are generally considered, for spousal support. So perhaps an argument can be made for adjusting the officer's compensation, for spousal support, to $280,000. However, utilizing the $400,000, of historical compensation for spousal support results in a classic double dip.

It should be considered that the double dip concept primarily relates to spousal support. It is difficult to argue the double dip concept, in terms of child support, as the children are not a party to the division of the marital assets. However, Rhode Island Family Court is a court of equity. Therefore, consideration should be given to the demands placed on the expected future business earnings stream, on a case by case basis, when determining child support, spousal support and the buy-out of the business interest.

6) Tax Ramifications

There are two primary tax issues that can arise regarding the business valuation, of a closely-held business, for RI divorce purposes. The first deals with the capital gains taxes that would be incurred, upon the sale of the business. Rhode Island does not have any divorce case law dealing with this issue. However, trial judges often determine that unless a sale is imminent, the capital gains taxes are too speculative to consider. Many state jurisdictions take a similar position. In Nieman v. Nieman, 2015, Ohio App. LEXIS 5021 (Dec. 14, 2015) the husband had no plans to sell his various business interests. The court stated "1. It is uncertain, whether, or at what point in the future, a business will be sold; 2. It is uncertain that the tax rates will be similar in the future; and 3. A sale is not made necessary by the trial court's division of the marital assets." Under this logic the Appeals Court said the tax consequences in the instant case were too speculative for the Trial Court to factor into its valuation. Other state jurisdictions have made similar rulings. In Elrod v. Elrod, 2004 MO. App. LEXIS 1412, Sept. 2004, the Missouri Court ruled that taxes were denied when a sale is not likely. In Johnson v. Johnson 2004 Mich., App. LEXIS 3153, Nov. 2004, the Michigan Court ruled a speculative sale is not enough to justify tax considerations.

The second tax issue that often arises, in business valuation divorce cases, is that of tax-affecting pass through entities. The issue of whether or not and how business appraisers tax affect pass through entities (PTEs) continues to be a source of debate among valuation professionals. Tax-affecting issues that started in the U.S. Tax Courts (Gross, Heck, Adams, Wall, Dallas and Gallagher) have now also become highly publicized at the shareholder dispute level (Kessler) and the family court level (Bernier, MA).

There has been considerable controversy over the past several years regarding the valuation of S corporations (and other pass-through tax entities). Much of the controversy deals with the issue of tax affecting such entities. S corporations (and other PTEs) do not pay income taxes on their corporate level earnings. Rather, income taxes are paid at the shareholder level, by the shareholders. This is in contrast to the situation of a C corporation, where income taxes are paid at the corporate level, and then again at the shareholder level, on any dividends paid to the shareholders by the corporation. A commonly accepted business valuation practice has been to tax affect the earnings of an S corporation by applying C corporation income tax rates to the earnings. However, a 1999 U.S. Tax Court Case (Gross v. Commissioner) held that tax affecting S corporation earnings was not correct. There have been five additional tax court cases upholding this position since the Gross case.

Several excellent valuation models have been developed by leading business appraisers. Models to develop a PTE premium have been developed by Chris Treharne, Chris Mercer, Roger Grabowski, Daniel Van Vleet and Nancy Fannon. There have also been numerous articles in professional valuation publications. Financial Valuation Applications and Models, edited and co-authored by Jim Hitchner, has an excellent chapter on valuation of pass through entities, written by Nancy Fannon. This chapter summarizes and analyzes the previously mentioned PTE valuation models. Michael A. Gregory has published a book entitled Valuing Interest in S-Corps. As a former Internal Revenue Service territory manager and now valuation consultant, Mr. Gregory provides a unique IRS insider's perspective to the PTE issue. Eric Barr has written a book entitled Valuing Pass-Through Entities. The book takes an in-depth look at the PTE issues and provides a Modified Delaware MRI Model (Kessler).

In a 2006 decision, Delaware Open Radiology Associates v. Howard B. Kessler, et al., 898 A. 2d 290, involving a shareholder dispute case, the Delaware Chancery Court computed a reduced tax rate of 29.4 percent to tax affect the S corporation income. In this case, the vice chancellor utilized his own computational model to compute the S corporation effective tax rate of 29.4 percent, applied to Delaware Open Radiology Associates. It is interesting to note that the vice chancellor references the Chris Treharne PTE model as a "useful model and analysis." In the Bernier v. Bernier case, a Massachusetts divorce case, the Massachusetts Supreme Judicial Court, in 2007, remanded the case with orders for the trial court to adopt the metric employed in the Kessler case.

In Bernier v. Bernier (1) 2007 Mass. LEXIS 598, May 2007, the Massachusetts Supreme Judicial Court stated "We conclude that the metric employed by the Kessler court provides a fairer mechanism for accounting for the tax consequences of the transfer of ownership of the supermarkets from one spouse to the other in the circumstances of record. On remand on the issue of valuation, the judge is to employ the tax affecting approach adopted in Kessler."

The Kessler metric provides us with another approach to determining and presenting a premium to a PTE valuation when warranted. It should be kept in mind that premiums are not necessarily appropriate in all cases. The actual PTE distributions play an important role in determining if such adjustment is proper. However, the Kessler metric, with modification, can be a useful and simpler way to compute a PTE premium in the family court and other contexts.

For a detailed analysis on the Kessler computations and the tax treatment of pass through entities, in general, please see the article Analysis of the Kessler Valuation Metric, by John Barrett, Financial Valuation and Litigation Expert Issue 47, Feb/March 2014. This article can be found on the Barrett Valuation Services, Inc. website resource Page.

Rhode Island has a case dealing with the tax affecting issue of pass through entities, Kathleen C. Vicario v. Paul Michael Vicario, No. 2005-244-Appeal (RI 2006). In Vicario v. Vicario, the Rhode Island State Supreme Court upheld the Family Court Trier of Fact regarding several matters, including the valuation of an S corporation. Tax affecting was one of the underlying valuation issues. The decision reads, in part, as follows:

> "In addition, the Family Court concluded that Mr. Pendergast's appraisal, which included a tax affect in the calculation of the value of Abacus, was in contravention of a decision by the United States Court of Appeals for the Sixth Circuit holding that it is improper to tax-affect a Subchapter S corporation when valuing it. See Gross v. Commissioner of Internal Revenue, 272 F.3d 333 (6^{th} Cir. 2001). Notably, even Mr. Pendergast admitted that he was not aware of any tax court cases subsequent to Gross that allowed for tax-affecting in ascertaining the value of an S corporation."
>
> "In light of these factual findings and the general magistrate's discretion to choose one expert's testimony over the other based on his own determinations of credibility, we are satisfied that he did not abuse his discretion in choosing Mr. Bilodeau's opinion of the value of defendant's interest in Abacus over that of Mr. Pendergast."

The ruling upholds the general magistrate's discretion to choose one expert's testimony over another. A more definitive interpretation of this ruling is beyond the scope of this analysis and certainly the author's expertise. However, a Family Court Trier of Fact did make a ruling on the issue of tax affecting.

In this case, the husband owned a 50 percent equity interest in a Rhode Island corporation (an S Corporation). The business primarily provides employee benefit plan consulting services. The husband was not active in the business. The company historically made annual shareholder distributions only sufficient to cover the pass through individual income tax liabilities of the shareholders. In contrast, the Gross case dealt with a very small minority interest and the corporation distributed 100% of its earnings. The fact pattern in the Vicario case is quite distinguishable from the Gross case. Based on the limited historical distributions, to Mr. Vicario, the fact pattern does not support an increased value, to the Abacus Company, as a result of operating as a pass-through entity. The shareholder was not receiving or likely to receive any additional economic benefit based on the entity structure, of the Company.

In a very lengthy 2004 paper on this subject, Chris Treharne states the following: "Conclusion #5: If S corporation distributions equal the tax liability associated with entity operations and the C corporation pays no dividends, the C and S corporation minority investors' value will be identical (presuming that the C and S corporation income tax rates are identical)." This would indicate that in the Vicario case, there really was no tax benefit associated with the pass through entity. For a more detailed analysis of the Vicario case, please see the white paper business analysis – Pass Through Entities, by John Barrett. This analysis can be found on the Barrett Valuation Services, Inc. website resource page.

It is recommended that the Rhode Island divorce lawyer question the business valuation expert, in regards to the tax affecting issue. The business valuation expert should be consistent on his/her approach to this matter. If the valuation expert simply switches positions on this matter, depending on the client, it undermines the credibility of that expert.

7) Valuation Discounts

There are two primary types of discounts applied to value a fractional interest, in a closely-held business. These discounts are the discount for lack of control and the discount for lack of marketability. Discounts should be examined in the context of the standard of value being applied. In Rhode Island divorce cases, the standard of value normally applied is the fair market value standard of value. The application of the fair market value standard generally requires application of discounts for both lack of control and lack of marketability, when valuing a non-controlling equity interest, in a business. In Rhode Island when using a fair value standard, in connection with dissent and oppression cases, no discounts are considered. In Rhode Island divorce cases, applicable discounts apply not only to operating companies, but also to real estate holding companies.

The International Glossary of Business Valuation Terms defines the discount for lack of control (DLOC) as:

> An amount or percentage deducted from the pro rata share of value of 100 percent of an equity interest in a business to reflect the absence of some or all of the power of control.

The International Glossary of Business Valuation Terms defines the discount for lack of marketability (DLOM) as:

> An amount or percentage deduced from the value of an ownership interest to reflect the relative absence of marketability.

It should be noted that the discount for lack of control and discount for lack of marketability are developed separately and applied separately, on a multiplicative basis, not on an additive basis. In other words, a 20% DLOC and a 20% DLOM results in a combined downward adjustment of 36%, not 40%. 100% x (1-20% DLOC) x (1-20% DLOM) = 64%. 100% - 64% = 36%. Total Discounts = 36%.

8) Personal Goodwill vs. Enterprise Intangible Value

Family courts are increasingly looking to bifurcate the intangible value of a closely-held business, for marital dissolution purposes. To facilitate this result, the courts are requiring the business appraiser to distinguish between enterprise goodwill (or more appropriately enterprise intangible value) and personal goodwill. In Moretti v. Moretti, 766 A.2d 925 (RI 2001), the Rhode Island Supreme Court remanded the case back to the lower court to differentiate the established intangible value, which had previously been determined, between enterprise intangible value and personal goodwill. Many jurisdictions consider only the enterprise intangible value as part of the marital estate, with the personal goodwill treated as a nonmarital asset. Often states indicate that personal goodwill is an entrepreneurial skill to be considered for spousal maintenance and child support purposes, but not a property right subject to division. Of course, this determination varies on a state-by-state basis. Currently the Business Valuation Resources state-by-state summary of U.S. court cases indicates that almost all states have ruled on the personal goodwill issue and that over 30 states require a bifurcation between personal goodwill and enterprise intangible value.

The process of bifurcating the intangible value of a business or professional practice between enterprise intangible value and personal goodwill can be a difficult task. Perhaps a good starting point toward completing this task is to review some definitions of intangible assets and goodwill. *The International Glossary of Business Valuation Terms* defines "intangible assets" as "non-physical assets (such as franchises, trademarks, copyrights, goodwill, equities, mineral rights, securities, and contracts as distinguished from physical assets) that grant rights, privileges, and have economic benefits for the owner. We can determine from this definition that goodwill is only one possible component of intangible assets that might exist in a specific business. Other intangible assets that often exist in a business, based on a going concern premise, include name recognition, customer loyalty or retention, location, a trained workforce in place, and operating systems. *The International Glossary of Business Valuation Terms* defines "goodwill" as "that intangible asset arising as a result of name, reputation, customer loyalty, location, products, and similar factors not separately identified." This would indicate that goodwill is often used as a catchall when intangible assets are not separately identified and valued.

In his book, *Valuing a Business*, Shannon Pratt states, "The criterion as to whether goodwill exists usually is the ability to earn a rate of return in excess of a normal rate of return on the net assets of a business, after reasonable compensation to operating personnel. "This definition could probably be expanded to include all the intangible assets of the business. Mr. Pratt also states, "[P]ersonal goodwill may be described as the intangible value attributable solely to the efforts of or reputation of an owner spouse of the business." He further states that institutional or practice goodwill (enterprise intangible value) "may be described as the intangible value that would continue to inure to the business without the presence of that specific owner spouse. In other words, enterprise intangible value focuses on the intangible value of the business that would continue should the current owner spouse be replaced with either a replacement employee or a new owner employee.

Transferability of Goodwill – Enterprise intangible value is generally transferable subject to the usual difficulties embedded in selling or transferring an interest in a closely-held business. Therefore, the market approach to valuation can be a strong indicator as to the enterprise intangible value of the business. This is commonly demonstrated when a business is sold to a financial buyer. New ownership may or may not be interested in retaining the current owner/employee. It is quite common for a buyer of a closely-held business to intend to directly manage the newly acquired business. If the continued services of the owner are not needed, this would indicate there is little or no personal goodwill. Any intangible value would be attributable to the business and represent enterprise intangible value. In a marital dissolution case, an actual sale is usually not contemplated. If it is reasonable to assume that a hypothetical buyer either could or would replace the owner spouse with comparable management, then little or no intangible value should be allocated to personal goodwill.

Personal goodwill also has some degree of limited transferability with proper effort and cooperation by both a willing buyer and a willing seller of a business. In this context, often what is actually transferable is not personal goodwill. Rather, what is transferred is the opportunity offered by the seller to the buyer to forge similar relationships with the business' existing customer base. The transferability of intangible value would be a strong indicator that the intangible value is more likely to inure to the business itself and represent enterprise intangible value rather than be attributable to a specific individual. Once a sales transaction has been consummated and possibly a transitional phase completed, the services of the seller may not be required or desired. If the seller does remain with the business, his or her role is often dramatically altered.

Normally, many of the unique factors that might indicate the presence of personal goodwill should be accounted for in determining an estimate of fair market value. For instance, qualitative factors dealing with such issues as thinness of management, concentration of sales, or other factors that might tend to indicate that the business is overly reliant on one or a few individuals must be taken into account in developing an estimate of value. An income based approach would consider such factors through normalization adjustments to the earnings stream (owner's compensation) and the increased measure of risk through development of an appropriate discount rate or capitalization rate. Also, specific revenues and expenses that would be lost, should the existing business owner sell the business, should be eliminated. This is accomplished through specific identification of such revenues and expenses and through a retention estimate. A market based approach would consider such factors through adjustments to the multiples applied. An asset based approach would consider such factors through factually identifying and valuing specific intangible assets.

The fair market value standard, based on a going concern premise, would indicate a transferable value of the subject business. This would represent the price that a willing buyer would pay a willing seller, with full knowledge of any reliance that the business would have on the seller. In terms of marital dissolution, any risk associated with the business' reliance on a specific individual should be factored into the overall estimate of value of the business. The development of an estimate of fair market value essentially adjusts for any such defect.

As previously mentioned, enterprise intangible value focuses on the intangible value of the business that would continue should the current owner spouse exit the business. This assumes, of course, that competent or at least similar management is brought in to replace the existing owner spouse. Whether the services of the current owner spouse would be desired would be part of the negotiating process, but separate and apart from the value of the business. Such negotiations would result in an employment contract. Therefore, the fair market value standard, based on a going concern premise, would primarily represent enterprise intangible value except for any amount allocated to a noncompete agreement.

Rhode Island has three cases that consider the goodwill issue or the personal goodwill vs. enterprise intangible value issue. The first two cases, Robert W. Gibbons v. Lucinda M. Gibbons, 619 A.2d 432 (RI 1993) and Daniela J. Becker v. Kleo K. Perkins-Becker, 669 A.2d 524 (RI 1996) considered the value of small professional practices (a podiatric practice and chiropractic practice, respectively). In the second case, the State Supreme Court did not allow the value of any goodwill, in the determination of the value, of such practices. It should be kept in mind that some small professional practices have little value over and above the assets minus the liabilities, while other small professional practices have significant value over and above the assets minus the liabilities. For instance, small medical practices currently have little value, as Rhode Island is currently an underserved market. However, small CPA firms and small dental practices may have significant value, over the net book value, based on the quality of the underlying client or patient base. These practices can often be sold, on average, in about 183 days (based on market transaction data and discussions with business brokers).

The value of these practices represents an estimated value that can be reasonably determined, as of a specific date. These practices can often be sold in a similar time frame, as a divorcing couples' home. In a court of equity, it would seem appropriate to include the fair market value, of such a business asset, in the marital estate. The valuation of a solo or small professional practice is primarily based on the underlying client or patient base, often developed during the course of the marriage. The valuation does not include or impede the future earnings power, of the practitioner.

The following language is taken from the Becker case:

> "The capitalization of earnings of a professional practice on the basis of the services of a single individual in order to arrive at a goodwill factor in ascertaining the value of such practice is improper as a matter of law."

A literal reading of this language would indicate the capitalization of earnings method is excluded. However, this language does not exclude utilization of a market transaction method or an asset based method, to determine value. The language specifically refers to a professional practice. This might include medical, legal, accounting and possibly other types of practices. The language refers to the services of a single individual. It is unclear if this language means one professional or one individual. Small CPA firms often have one CPA, sometimes bookkeepers, which generate a revenue source, and an office administrator/receptionist essential to the smooth operations, of the practice. Small dental practices often have one dentist, one or more hygienists, which generate a revenue source and an office administrator/receptionist essential to the smooth operations, of the practice. The language refers to a goodwill factor. As previously discussed, the *International Glossary of Business Valuation Terms* states that goodwill is intangible value, not separately identified. When the business appraiser utilizes market multiples to value a small professional practice, the multiples primarily consist of the value of the underlying client base or patient base plus fixed assets. By adjusting for fixed assets, the business appraiser can then identify and separately state the estimated value of the underlying client or patient base. This separately stated intangible asset can then be applied in both the market approach and the asset approach, to valuation.

The Gibbons case and the Becker are relatively old cases. The business valuation profession has developed considerably since these cases were determined. Stronger business valuation reports and expert testimony, regarding the issue of personal goodwill vs. enterprise intangible value, can assist the Rhode Island Family Court, in resolving future cases, on an equitable basis.

The third case dealing with personal goodwill vs. enterprise intangible value was the Moretti case. In Moretti I – Moretti v. Moretti, 766 A.2d 925 (RI 2001) the Rhode Island Supreme Court considered whether goodwill should be included in the valuation of a landscaping business. The trial court decided Becker did not apply to this case. The Rhode Island Supreme Court agreed stating "certainly, one is not precluded, as a matter of law, from determining that a landscaping business may have a goodwill component to its corporate value."

In considering the goodwill issue, the Supreme Court noted that the wife's expert (Glen Stevenson) admitted that the business' success depended on the husband's involvement with the business. It then applied Yoon v. Yoon, 711 N.E.,2d 1265, 1268-69 (Ind. 1999), which held that enterprise goodwill is available for division in a divorce, but personal goodwill is not. The court concluded that to include goodwill as an asset for division, the experts should distinguish between personal and enterprise goodwill. Thus, the Supreme Court remanded the decision, "so that enterprise goodwill, as opposed to personal goodwill, may be evaluated and applied to the overall value of…[the business], taking into account the risk factor that would be applicable if defendant left the business."

In Moretti II, the Rhode Island Supreme Court considered a second appeal on this case. At the hearing on remand, the wife's expert (John Barrett) determined that based on the market transactions applied in the original valuation, accepted by the Court, that all of the intangible value of the business, less the value of the non-compete agreement, would constitute enterprise intangible value. After finding that his testimony was credible and reliable, the hearing judge accepted the opinions and figures used by the wife's expert. However, the judge ruled that the value of a hypothetical non-compete agreement, as calculated by the wife's expert, would constitute personal goodwill and would not be included in the marital estate. The husband appealed this decision. The Rhode Island Supreme Court upheld the trial judge's decision, stating "we discern no indication that the hearing justice overlooked material evidence or was clearly wrong in accepting the valuation of the wife's expert."

The Moretti II case introduced the concept of a hypothetical non-compete agreement into the business valuation process, for Rhode Island divorce purposes. Generally when the value of a company, in the context of a Rhode Island divorce, exceeds adjusted book value, the value of a hypothetical non-compete agreement should be completed. These computations can either be presented as an appendix to the report or as a separate document.

For more information regarding personal goodwill vs. enterprise intangible value and non-compete agreements, please see the following articles on the Barrett Valuation Services, Inc. website: Bifurcating Enterprise and Personal Goodwill, by John Barrett, *American Journal of Family Law,* Summer 2002; Why Transferable Personal Goodwill Ought to be Included in the Marital Estate, by Mark Filler, *The Value Examiner*, May/June 2013; Noncompete Agreements – What is the Value, by Brian Cockerill, *The Value Examiner*, March/April 2017. Also see BVR's Guide to Personal v. Enterprise Goodwill, by Business Valuation Resources.

9) Relevant RI Court Cases

Robert W. Gibbons v. Lucinda M. Gibbons
Daniel J. Becker v. Kleo K. Perkins-Becker
Marilyn J. Moretti v. Vincent F. Moretti (I)
Marilyn J. Moretti v. Vincent F. Moretti (II)
Donald Gervais v. Virginia Gervais
Kathleen C. Vicario v. Paul Michael Vicario
Joseph P. Esposito v. Sharon Esposito
Hope Billings McCulloch v. James Robert McCulloch

Please visit the Barrett Valuation Services, Inc. website at www.barrettvaluation.com to read analyses and summaries of these cases.

10) Recommended Reading

For practitioners that wish to gain additional insight into the area of business valuation, a great resource is *The Business Valuation Bench Book*, written by William J. Morrison and Jay E. Fishman, published by Business Valuation Resources, 2017. This book was written for judges and lawyers, as a guide to the business valuation process. The book serves as a reference guide of fundamental business valuation concepts. The book includes a process, along with schedules, whereby judges and lawyers can separate a complex business valuation report into its component parts and analyze the expert's factual and theoretical support, for his or her conclusions. The book includes case studies. Also, each section includes "Questions to Ask" to inquire as to the underlying facts and reasoning behind the expert's judgments and opinion. The "Questions to Ask" is a great resource to lawyers in reviewing their own expert's report or in preparation for deposition or trial, of an opposing expert. The book is well written and easy to read, for non-financial practitioners, such as judges and lawyers. The book is not meant to teach how to value a business, but rather how to understand, evaluate and dissect a business valuation report. The book also includes schedules to assist in comparing competing business valuation reports. I highly recommend this book to family law practitioners handling cases involving closely-held businesses.

Conclusion

It is our hope, at Barrett Valuation Services, Inc., that the preceding analysis will be of some benefit to both the very experienced and the less experienced Rhode Island family law practitioners. It is also our hope that the preceding analysis will be of benefit to business valuation experts assisting in Rhode Island divorce cases. Business valuation issues, in Rhode Island divorce cases, can often be complex and challenging. Managing client expectations, in such cases, is very important. The divorce lawyer and business appraiser need to work together, in this regard. Successful resolution, in cases involving a closely-held business, can be very rewarding from both a business perspective and from a sense of professional accomplishment.

Divorce Valuation Case Summaries

Valuation of Professional Practice Using Capitalization of Future Earnings Method

In *Robert W. Gibbons* v. *Lucinda M. Gibbons*, 619 A.2d 432 (R.I. 1993), per curiam, the Rhode Island Supreme Court considered the valuation of the husband's podiatric practice. Both parties presented valuation experts to the family court. The wife's expert valued the practice using a capitalization of future earnings method. In doing so, he considered Rev. Rul. 59-60. He applied a 20 percent lack of marketability discount and concluded that the practice had a fair market value of $672,000. The husband's experts also valued the practice's goodwill using a capitalization of future excess earnings method. One expert applied a 40 percent lack of marketability discount. The lower court valued the practice at $504,000. It accepted the undiscounted valuation of the practice put forward by the wife's expert and applied a 40 percent lack of marketability discount as proposed by the husband's expert. The husband appealed.

On appeal, he argued that the lower court erred in valuing the goodwill of his practice using a capitalization of earnings approach. Two justices agreed. They concluded that "it [wa]s improper as a matter of law to capitalize the earnings of a professional practice on the basis of the services of a single individual in order to arrive at a good-will factor in ascertaining the value of such practice." However, two justices disagreed. They concluded that "this issue has not been preserved on appeal by reason of the fact that the husband's experts also purported to value the goodwill of this practice, utilizing the factor of capitalizing a portion of future excess earnings." Since the Supreme Court was divided on this issue, it affirmed the family court's valuation of the podiatric practice.

Personal Goodwill and Enhanced Earning Capacity Considered

In *Daniel J Becker v. Kleo K. Perkins-Becker,* 669 A.2d 524 (R.I. 1996), the Rhode Island Supreme Court considered the valuation of a chiropractic practice and the characterization of an advanced degree. The husband, a chiropractor, established a professional practice in the year prior to the parties' marriage. The practice became successful during the marriage. The husband earned $126,904 annually from the practice. The husband also earned a professional degree-Diplomate of the American Board of Chiropractic Neurology-during the marriage.

The trial court denied the husband's motion in limine to bar the testimony of wife's expert regarding the goodwill value of the husband's practice. The wife's expert valued the chiropractic practice using a capitalization of excess earnings method. He calculated the excess earnings using the business' past five years tax returns and industry data from the American Chiropractic Association. He capitalized the excess earnings using a 33.3 percent capitalization rate. He determined that the practice's goodwill had a value of $102,991, which he then added to the value of its tangible assets for a total of $134,463. The lower court accepted this valuation and awarded the wife one-half the practice's goodwill value. The trial court also considered whether the enhanced earning capacity of the husband derived from the advanced degree he earned during the marriage should be divided in the divorce. The lower court declined to divide the enhanced earnings capacity finding, as a matter of law, that enhanced earning capacity is not a marital asset. Both parties appealed.

On appeal, the husband argued that the lower court erred in denying his motion in limine to exclude evidence of the goodwill value of his practice. The Rhode Island Supreme Court agreed. It ruled, "The capitalization of earnings of a professional practice on the basis of the services of a single individual in order to arrive at a good-will factor in ascertaining the value of such practice is improper as a matter of law." Thus, it reversed the lower court's order awarding the wife one-half the value of the goodwill.

It then considered the wife's appeal. She argued that the lower court erred in determining that the husband's enhanced earning capacity was not a marital asset. It noted that this was an issue of first impression in Rhode Island. It then reviewed the law from diverse jurisdictions and concluded that "professional degrees and licenses and the resulting enhanced earning capacity of the holder spouse is not a marital asset subject to equitable distribution under § 15-5-16.1. The value of a professional degree or a license may not be included in the distribution of marital assets upon the dissolution of a marriage." The court further commented, "To embrace a rule that would subject such an item to distribution upon dissolution would result in the foreclosure of consideration of the effect on the individual's earning capacity of such future events as death, illness, or unpredictable market variables."

Enterprise Goodwill and Personal Goodwill Must be Distinguished

In *Marilyn J. Moretti v. Vincent F. Moretti,* No. 99-171-A (February 9, 2001), the Rhode Island Supreme Court considered whether goodwill should be included in the valuation of a landscaping business. The husband started the 17-year-old business during the marriage. He owned and operated the business, and was the only employee that dealt with clients. Both parties provided CPAs to value the business.

The wife's expert used the excess earnings approach. He described this approach "as a combination of an income approach and an asset approach." He began by determining the fair rate of return on the business' assets. He deducted this figure from the business' earnings and capitalized the difference to determine goodwill. He determined the goodwill value to be $164,011. He added the goodwill value to the value of the assets for a fair market value of $477,000.

The husband's expert valued the business using an asset approach. He concluded that the business was worth $321,058. The expert conceded that "[t]he earning capacity of the Company is also based on the primary contact person of the Company…" However, he relied on *Becker v. Perkins-Becker*, 669 A.2d 524, 528 (R.I. 1996), to exclude any amount for goodwill. *Becker* holds that "[t]he capitalization of earnings of a professional practice on the basis of the services of a single individual in order to arrive at a good-will factor in ascertaining the value of such practice is improper as a matter of law."

The trial court decided *Becker* did not apply to this case. It then accepted the valuation proposed by the wife's expert. The husband appealed.

On appeal, the husband argued that the lower court should not have considered the business' goodwill under *Becker*. The Supreme Court agreed with the lower court that *Becker* was distinguishable. It stated, "Certainly, one is not precluded, as a matter of law, from determining that a landscaping business may have a goodwill component to its corporate value."

In considering the goodwill issue, the Supreme Court noted that the wife's expert admitted that the business' success depended on the husband's involvement with the business. It then applied *Yoon v. Yoon,* 711 N.E.2d 1265, 1268-69 (Ind. 1999), which held that enterprise goodwill is available for division in a divorce, but personal goodwill is not. The court concluded that to include goodwill as an asset for division, the experts should distinguish between personal and enterprise goodwill. Thus, the Supreme Court remanded the decision, "so that enterprise goodwill, as opposed to personal goodwill, may be evaluated and applied to the overall value of…[the business], taking into account the risk factor that would be applicable if defendant left the business."

Distinguishing Between Enterprise Goodwill and Personal Goodwill

In *Marilyn J. Moretti v. Vincent F. Moretti,* No. 01-523-A, (June 2, 2002), the Rhode Island Supreme Court considered a second appeal involving this case. In the earlier appeal, the Supreme Court affirmed the trial justice's decision in all respects except for his valuation of the goodwill interest in the defendant's landscaping business. The Supreme Court remanded the case "so that enterprise goodwill, as opposed to personal goodwill, may be evaluated and applied to the overall value."

At the hearing on remand, the parties agreed on the overall value of the business's goodwill, in the amount of $164,011. At the hearing on remand, the parties each presented an expert in the field of business valuation. The wife's expert defined enterprise goodwill as that value which will attach to the business itself because of its ability to earn a rate of return over and above what is normally expected for the rate of return on tangible assets. Enterprise goodwill would therefore be expected to continue should management or ownership of the business change. He also defined personal goodwill as a value that would attach to the business due to a specific individual because of that person's capabilities, special training and continued presence in the business.

The wife’s expert testified that if Mr. Moretti were to sell the business applying the standard of fair market value, it would be expected, in order to maximize the sale price, he would do all in his power to see that existing customers stayed with the new buyer. He further stated that in order for any sale of the corporation to be successful, a so-called non-compete agreement must be entered into with the prospective buyer.

This contract would be necessary to ensure that Vincent Moretti did not compete with the new business. The contract would prohibit the seller from coming into competition with the buyer. In order to be enforceable, it would be limited by geographical area and type of business. The defendant's witness concurred that in order for a voluntary sale at a fair market standard, it would be necessary for Mr. Moretti to enter into a non-compete contract.

The wife's expert testified that the value of the non-compete agreement would be approximately $27,243. After subtracting this figure from the total value of goodwill, he opined that the remaining sum would be all enterprise goodwill. He found the value of the enterprise goodwill of Tangleridge to be $136,768.

The wife's expert made his calculation as to the value of enterprise goodwill by considering the total valuation of Tangleridge Landscaping, Inc., previously determined by the court and in reviewing transactions from the Institute of Business Appraisers' database as well as other statistical reports.

The husband’s expert defined enterprise goodwill as that value which the corporation would have due to its reputation, location, name, and assembled work force regardless of the presence or absence of a specific individual. He testified that to determine the existence of personal goodwill, one must consider several factors; the most important of which are that the customers are referred and retained by the key individual because of that person's skill, reputation, knowledge, and personality. In other words, customer loyalty is not to the product or work force, but rather to the individual.

The husband's expert opined that Tangleridge had enterprise goodwill value of $16,401. Apparently, he came to this conclusion based upon the fact that, in his opinion, 10 percent of Tangleridge's customers are so-called transient. They have not been with the corporation on a long-term basis, as has the remaining 90 percent of the other customers. He further testified that the remaining amount of $147,610 represents personal goodwill.

After finding that his testimony was credible and reliable, the hearing judge accepted the opinions and figures used by the wife's expert. However, the judge ruled that the value of a hypothetical non-compete agreement, as calculated by the wife's expert, would constitute personal goodwill and would not be included in the marital estate. The husband appealed this decision. The Rhode Island Supreme Court upheld the trial judge's decision stating "we discern no indication that the hearing justice overlooked material evidence or was clearly wrong in accepting the valuation of the wife's expert.

Date of Valuation in Marital Dissolution

In *Donald Gervais v. Virginia Gervais*, *Gervais v. Gervais*; *688 A.2d 1303; 1997 R.I LEXIS 45* (February 18, 1997) the Rhode Island Supreme Court considered the appropriate valuation date of the husband's closely held stock.

The Supreme Court ruled "Donald's final contention with respect to the distribution of the marital estate involves the choice made by the trial justice to value the estate on the basis of financial figures computed in 1990 rather than the value of the estate as of 1992, the date of the trial. Donald points out that all assets were valued as of 1990 except for the marital domicile, which was valued as of 1992. The record supports Donald's contention. The trial justice failed to explain in his decision why he elected to value the marital estate upon the basis of records that were produced two years prior to the trial. He referred to no case law or statute giving him the authority to value the marital estate prior to the date of trial and he did not make any findings of fact with respect to this issue. In *Saback v. Saback, 593 A.2d 459 (R.I. 1991),* we held that a trial justice must assess the marital estate as of the time of entry of judgment, *Id. at 461;* see also *Briceno v. Briceno, 566 A2d 397 (R.I. 1989).* As in Saback, we do not have before us any evidence from the record that would suggest any necessity for valuing the marital estate as of a time other than the date of judgment."

Tax-Affecting S Corporation Rejected

In *Kathleen Vicario v. Paul Michael Vicario*, No.2005-244-Appeal (R.I. June 29, 2006), the Rhode Island Supreme Court considered whether a lower court properly rejected a tax-affecting adjustment in computing the value of a professional practice. The husband, a CPA, held a 50% interest in an actuarial consulting business. He was a passive investor in the business, which was formed as an S corporation. The business distributed only enough money to cover the shareholders' taxes. Both parties presented the court with expert testimony from CPAs with business valuation credentials.

The wife's expert valued the business using a capitalization of earnings method. He applied a 21% capitalization rate to the weighted adjusted net cash flows to arrive at the undiscounted value. He then applied a 25% discount for lack of marketability and a 10% discount for minority interest. He concluded that the husband's interest had a fair market value of $268,000.

The husband's expert determined the business had a value of $100,000. He utilized the same general methodology as the wife's expert, but made several significant adjustments. He adjusted the value of the business for the husband's non-compete agreement; the goodwill of the husband's partner, who operated the business, and tax-affected the business's earnings.

The husband's expert was vigorously cross-examined regarding the propriety of tax-affecting. He acknowledged familiarity with the decision in *Gross. V. CIR*, 272 F.3d 333 (6th Cir. 2001), affg T.C. Memo. 1999-254, which held it inappropriate to tax-affect the earnings of an S corporation. He further acknowledged that he was unaware of any subsequent U.S. Tax Court decisions reaching the opposite conclusion. The wife's expert determined that tax affecting was inappropriate because the corporation did not actually pay any corporate-level tax.

The magistrate adopted the valuation proposed by the wife's expert. The husband appealed. On appeal, the husband argued that the magistrate erred when it rejected the valuation proposed by his expert. The Supreme Court disagreed. It noted that a lower court has the discretion to adopt some, none, or all of an expert witness's opinion. It found that the magistrate did not abuse his discretion in rejecting the husband's expert because the husband's expert (1) included anticipatory expenses without any basis; (2) considered the role of the husband's partner in the business, which the magistrate found irrelevant to the issue of value, and (3) tax-affected the earnings of the business in contravention to accepted case law. Thus, the Supreme Court affirmed the magistrate's decision to adopt the wife's expert's valuation.

Unequal Distribution of Family Business Stock Requires Discounts

In re *McCulloch v. McCulloch*, 2013 RI. LEXIS 113 (June 25, 2013). When three financial experts declared themselves unable to put a definite value on two closely held businesses, the trial court decided to assign an in-kind minority interest in both entities to the wife without valuing the considerable assets before distribution. The wife appealed.

At the core of "a protracted, if not epic, battle" (the court's description) for divorce were two family-owned businesses that "comprised an enormous portion of the marital estate." One entity was a manufacturer of fabric at which the husband served as president and CEO; all of the company's stock was in his name. The other was an affiliated company that owned equipment and real estate in which the first company had a 10% interest. Sometime after 2007, the fabric manufacturer became involved in "the China venture," a plan to buy a controlling interest in a printing and dyeing company in China. Both the husband and CFO of the company testified that the project was vital to the survival of the business, which had been losing money each year.

Economic crisis thwarts valuation. At trial, in late 2008, both sides presented experts, and the court appointed a neutral, third expert to help it determine the value of the businesses. The wife's expert initially prepared a report that placed the value of the first entity as of Dec. 31, 2007, at about $126.4 million. At the time, the expert stated that she "couldn't place [a] value o[n] the China investment" because she lacked the requisite data to determine its impact on the company. In later testimony, she said she had not completed an updated valuation for the company and any numbers related to the China investment were merely estimates. She concluded she was unable to "provide an opinion of value with respect to the China venture." She cautioned, however, that any valuation had to account for the state of the economy.

The husband's expert rebutted that there was no justification for the $126 million value; rather, he concluded the value was $106 million. He also said he lacked information about the China venture because at the time of valuing the company "the deal was not closed."

The court-appointed expert testified that since the December 2007 valuation date, "there ha[d] been a meltdown in the financial market." Job losses and reduced consumer spending dramatically changed the economic situation in countries to which, or in which, the company would sell. Considering the parties' experts had received incomplete information, this expert also lacked the data necessary to "place a value or an economic benefit on the China venture" at the valuation date.

The trial court took judicial notice of the global economic crisis that had taken place since the valuation date. (The opinion does not provide details on valuations, if any, for the second company.)

The trial court decided the stock of the first company was a marital asset. As to the second company, a fraction short of 50% was marital property because the husband had acquired the remainder before marriage or received it as a gift. It stated it did not have any "credible evidence upon which to base a fair and reasonable valuation of the value of the stock in th[e] corporation" because of the "extraordinary change in circumstances that could not have been contemplated by the parties" since the valuation date. The global financial crisis, the fact that the China venture had not been completed, and the fact that "[n]one of the experts had given any detailed consideration to the potential impact" of that project, the court said, made it impossible to accurately value the two businesses. For all these reasons, it ordered an in-kind distribution of the stock of the first company and an in-kind distribution of a partnership interest in the second company, instead of a sum in cash.

As to what percentage of stock to award to the wife, the court noted that it "would be completely inequitable" for her to receive the same portion as the husband considering her minimal contribution "towards the acquisition, preservation or appreciation of the corporate assets." The husband's "blood, sweat and tears and contributions by his family" were responsible for the company's past and perhaps future success. Accordingly, it gave the wife a 25% interest in the fabric manufacturer and a 25% interest of the portion that was marital property in the second business. The husband received 75% of the two assets.

A case for valuing assets. The wife appealed to the Rhode Island Supreme Court on a number of grounds, particularly because (1) the trial court declined to value the assets before it assigned to her a percentage of them; and (2) the trial court's distribution of stock rendered her a minority shareholder in a closely held corporation.

Regarding the first issue, the husband argued that state law did not require a valuation of marital property before distribution.

The Rhode Island State Supreme Court agreed with him that there was no bright-line rule imposing a valuation requirement on trial courts, and it declined to adopt one. At the same time, it decided that in this case the trial court had abused its discretion in failing to value the companies before assigning interests in them for two reasons.

First, the assets at issue made up "the vast majority of the marital estate." Experts for both sides stated a range between $106 million and $126 million as of the end of December 2007. Even assuming fluctuations in value since then, there was no question as to their importance.

Second, the law generally disfavors assigning stock in a closely held corporation in a way that makes one spouse a minority shareholder. Even if this type of distribution is not error per se, it was in this case, the Supreme Court continued, because the parties received unequal percentages. "[A] 25 percent minority share of a closely held corporation will likely not be the equivalent of 25 percent of the total value of the company" because that type of stock lacked liquidity considering "there is no established public market for the stock." Also "a minority shareholder lacks control over the company, and therefore, the value of his or her stock is diluted in comparison to that of a majority shareholder.

It was true that the court itself earlier had adopted a rule not to apply a minority discount or a discount for lack of marketability (DLOM) in the context of an action for dissolution of a closely held corporation. But, the high court said, "we believe that such discounts are appropriate, and even necessary, when valuing an in-kind distribution of a minority share of a closely held corporation in a divorce action." Considering the illiquidity of the wife's asset and her lack of control over the business, it ordered the lower court on remand to apply both a minority discount and a DLOM when valuing the assigned portions. Finally, it pointed out that if the trial court had granted the wife the "cash equivalent of her equitable ownership interest in the companies" or "had crafted some other assignment, such discount would not be necessary."

Business Valuation Articles

Financial Valuation and Litigation Expert

VIEWS AND TOOLS FROM LEADING EXPERTS ON VALUATION, FORENSIC/FRAUD AND LITIGATION SERVICES

Editor's Outlook

Jim Hitchner
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In this issue, we continue our popular series on common mistakes in business valuation. This month, we take a look at errors sometimes found in calculating discount and capitalization rates.

Hats off to Carla Glass, who has tackled a topic often laden with confusion— use of "calculations," including the similarities and differences among different sets of BV standards. Carla defines, examines and then compares calculations and the various terminology used within the Statement on Standards for Valuation Services 1 (SSVS-1) of the American Institute of Certified Public Accountants (AICPA), Uniform Standards of Professional Appraisal Practice (USPAP) of The Appraisal Foundation (2014-2015 edition), and BVS-I: General Requirements for Developing a Business Valuation (BVS-I) of the American Society of Appraisers (ASA).

Next up, Gil Matthews shows us why amortization must be excluded from normalized free cash flow in the Gordon Growth Model.

Two guest columnists join us in this issue. First, Robert Reilly helps our readers to understand the differences between an intangible asset valuation and an intangible asset damages analysis. Next, John Barrett delivers an examination of the *Kessler* (Delaware

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Business Valuation Mistakes: How to Avoid Them, Part Two

Discount and Capitalization Rates

In *FVLE* Issue 44, August/September 2013, we started a new series titled "Business Valuation Mistakes: How to Avoid Them." We now continue this series based on some of the more prominent mistakes we see. We believe we have seen *almost* every kind of mistake in business valuation; however, there is always a new one that can be added! There are many mistakes that we see on a frequent basis. We call these *common* mistakes. We also see mistakes that are *uncommon*. Both can be deadly, and both can be hard to detect. That is the purpose of this article— to assist in the identification and avoidance of mistakes.

Before we get started here, let's set some foundation by defining what a mistake is.

Mistake *(oxforddictionaries.com)*

- an act or judgment that is misguided or wrong
- something, especially a word, figure, or fact, which is not correct; an inaccuracy

Mistake *(merriam-webster.com)*

- a wrong judgment: misunderstanding
- a wrong action or statement proceeding from faulty judgment, inadequate knowledge, or inattention

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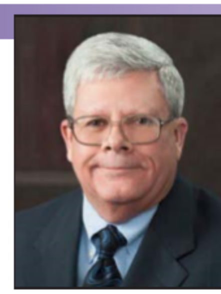
Analysis of the *Kessler* Valuation Metric



~ GUEST COLUMNIST ~

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This analysis reviews the *Kessler (Delaware MRI)* valuation metric utilized to determine the value of pass-through entities. The issue of whether or not, as well as how business appraisers tax affect pass-through entities (PTEs), continues to be a source of debate among valuation professionals. Tax-affecting issues that started in the U.S. Tax Courts *(Gross, Heck, Adams, Wall, Dallas* and *Gallagher*) have now also become highly publicized at the shareholder dispute level *(Kessler*) and the family court level (*Bernier, MA*).

There has been considerable controversy over the past several years regarding the valuation of S corporations (and other pass-through tax entities). Much of the controversy deals with the issue of tax affecting such entities. S corporations (and other PTEs) do not pay income taxes on their corporate level earnings. Rather, income taxes are paid at the shareholder level, by the shareholders. This is in contrast to the situation of a C corporation, where income taxes are paid at the corporate level, and then again at the shareholder level, on any dividends paid to the shareholders by the corporation. A commonly accepted business valuation practice has been to tax affect the earnings of an S corporation by applying C corporation income tax rates to the earnings. However, a 1999 U.S. Tax Court Case *(Gross v. Commissioner)* held that tax affecting S corporation earnings was not correct. There have been five additional tax court cases upholding this position since the *Gross* case.

Several excellent valuation models have been developed by leading business appraisers. Models to develop a PTE premium have been developed by Chris Treharne, Chris Mercer, Roger Grabowski, Daniel Van Vleet and Nancy Fannon. There have also been numerous articles in professional valuation publications. *Financial Valuation Applications and Models,* edited and co-authored by Jim Hitchner, has an excellent chapter on valuation of pass-through entities, written by Nancy Fannon. This chapter summarizes and analyzes the previously mentioned PTE valuation models. Michael A. Gregory has published a book entitled *Valuing Interest in S-Corps.* As a former Internal Revenue Service territory manager and now valuation consultant, Mike provides a unique IRS insider's perspective to the PTE issue. Eric Barr is currently writing a book entitled *Valuing Pass-Through Entities.* The book takes an in-depth look at the PTE issues and provides a Modified Delaware MRI Model *(Kessler)*, which differs from the *Kessler* modification in this analysis. The book should be available through Wiley & Sons later this year. The book has a great deal of information beneficial to practitioners and is highly recommended, once available.

In a 2006 decision, *Delaware Open Radiology Associates v. Howard B. Kessler*, et al., 898 A. 2d 290, involving a shareholder dispute case, the Delaware Chancery Court computed a reduced tax rate of 29.4 percent to tax affect the S corporation income. In this case, the vice chancellor utilized his own computational model to compute the S corporation effective tax rate of 29.4 percent, applied to Delaware Open Radiology Associates. It is interesting to note that the vice chancellor references the Chris Treharne PTE model as a "useful model and analysis." In the ongoing *Bernier v. Bernier* case, the Massachusetts Supreme Judicial Court, in 2007, remanded the case with orders for the trial court to adopt the metric employed in the *Kessler* case.

The *Kessler* metric provides us with another approach to determining and presenting a premium to a PTE valuation when warranted. It should be kept in mind that premiums are not necessarily appropriate in all cases. The actual PTE distributions play an important role in determining if such adjustment is proper. However, the *Kessler* metric, with modification, can be a useful and simpler way to compute a PTE premium in the family court and other contexts.

The following computations (see Exhibits 1-6, pp. 21-24) indicate an adjustment is required to the *Kessler* metric to derive a result consistent with the Treharne PTE model. Based on the following simplified assumptions, the following exhibits indicate the required adjustment and the effect such adjustment has in both the *Kessler* case and the *Bernier* case. Exhibit 4 indicates that the actual *Kessler* metric overstates the value of the subject PTE. The modified *Kessler* metric provides a result consistent with the Treharne model or by simply computing a premium adjustment as a percentage of

Continued on next page

expert TIP

The *Kessler* metric provides us with another approach to determining and presenting a premium to a PTE valuation when warranted.

the preliminary value of a business as if it were a C corporation. Exhibit 5 reflects the ramifications of applying the actual *Kessler* metric to the *Bernier* case and the corrected outcome after applying the modified *Kessler* metric.

Once again the computations indicate that blindly following the *Kessler* computations provides a higher result. Application of the modified *Kessler* metric in the *Bernier* case indicates an effective S corporate tax rate of 16.0 percent. Of course, this assumes 100 percent distributions. If the actual historical distributions were less than 100 percent or the cash flows that were available for actual distribution were less than one hundred percent, the effective S corporate tax rate would increase.

James Reto wrote an excellent article on this topic in the July 2011 *Business Valuation Update*.[1] He provides the following mathematical formulas for determining the effective corporate income tax rate to be applied to a PTE. Once again, the assumption is 100 percent distributions and the focus is solely on the benefit of distributions to a PTE equity holder.

Str = Ctr – ((1-Ctr)*Dtr)

Where:
Str = S corp effective tax rate
Ctr = C corp tax rate
Dtr = Dividend tax rate

The formula can be modified to also capture the difference (negative or positive) between corporate and individual tax rates as follows:

Str = (Ctr - ((1-Ctr) * Dtr)) - (Ctr – Itr)

Where:
Str = S corp effective tax rate
Ctr = C corp income tax rate
Dtr = Dividend tax rate
Itr = Individual income tax rate

Continued on next page

EXHIBIT 1

Analysis of the *Kessler* Metric

Assumptions
1 - 100% distributions.
2 - Corporate and individual tax rates are approximately the same.
3 - Holding period is a long-term horizon, minimizing any impact on basis differential.
4 - Combined federal and state income tax rate 40%.
Combined federal and state dividend income tax rate 15%.
5 - After-tax cash flows and after-tax net income are the same.
6 - Capitalization rate of 18%.

	C Corp.	S Corp.
Pre-Tax Net Income	$1,000	$1,000
Corporate Taxes (40%)	<400>	-0-
Available Earnings	$600	$1,000
Individual Taxes (40%)		<400>
Dividend Taxes (15%)	<90>	
	$510	$600

S Corp. after-tax cash flow differential of $90.

EXHIBIT 2

Simple Valuation
Treharne Model
Capitalization of Additional Cash Flow

	As if a C Corp.
Pre-Tax Net Income	$1,000
C Corp. Taxes (40%)	<400>
Available Earnings	600
Capitalization Rate	÷18%
Preliminary Estimated Value	$3,333
S Corp. Adjustment	
Additional Cash Flow to the S Corp. Shareholder	$90
Capitalization Rate	÷18%
S Corp. Adjustment	$500
Preliminary Estimated Value	$3,333
S Corp. Adjustment	500
Estimated Value of S Corp.	$3,833

Applying Reto's first formula to the *Kessler* case provides the same result as the modified *Kessler* metric computed in Exhibit 4 of this analysis. The computations are as follows:

Str = Ctr – ((1-Ctr) x Dtr)
Str = .40 – ((1-.40) x .15)
Str = .40 – (.60 x .15)
Str = .40 - .09
Str = 31%

Applying Reto's first formula to the *Bernier* case provides the same result as the modified *Kessler* metric computed in Exhibit 5 of this analysis. The computations are as follows:

Str = Ctr – ((1-Ctr) x Dtr)
Str = .40 – ((1-.40) .40)
Str = .40 – (.60 x .40)
Str = .40 - .24
Str = 16%

The next step in this analysis is to check the premium adjustment computed in Exhibit 3 to actual computations in the Treharne model. To accomplish this, an example from Chris Treharne's article "S Corporation Valuations– The Simplified Treharne Model," published in *Business Appraisal Practice* 2009,[2] *(see www.4avalue.com)*, was analyzed. To test the computations, certain adjustments have been made to the example in that article (see Exhibit 6).

It would seem that the starting point for Exhibit 4 (article) would be the net cash flow to equity (Line 13 of Exhibit 1) (article) rather than after-tax net income [Line 7 of Exhibit 1) (article), Line 25 of Exhibit 4, (article)]. These amounts represent the distributions the corporation can actually make, assuming 100 percent distributions. By eliminating the Exhibit 3 (article) variable (difference between corporate and individual tax rates and assuming these rates are identical), we can focus on the differential attributable solely to the dividend tax avoidance of the S corporation. Exhibit 4 of the article was adjusted, as shown on the page 24.

Continued on next page

EXHIBIT 3

Premium Adjustment Applied to the S Corp.

Additional Cash Flow to the S. Corp. Shareholder Divided by After-Tax C Corp. Net Income	$90 / 600	= 0.15%
Preliminary Estimated Value (From Exhibit 2)	$3,333	
S Corp. Premium (1 + 15%)	x 1.15%	
Estimated Value of S Corp.	$3,833	

EXHIBIT 4

***Kessler* Approach**

	C Corp.	S. Corp
Pre-Tax Net Income	$1,000	$1,000
Corp. Taxes (40%)	<400>	-0-
Available Earnings	$600	$1,000
Personal Tax Rate (40%)		<400>
Dividend Tax Rate (15%)	<90>	
Available After Dividends	$510	$600
Gross-up [$90 ÷ (1-15%)]		106
Total		$706

Kessler Estimated Effective Tax Rate ($1,000 - $706 = 294 ÷ $1,000 = 29.4%)

Pre-Tax Net Income	$1,000
Adjusted Corp. Tax Rate (29.4%)	<294>
Available After Dividends	$706
Capitalization Rate	÷18%
Estimated Value of S Corp. (Per Kessler)	$3,922

Modified *Kessler* Approach

Tax Rate $600 + 90 = $690
($1,000 - $690 = $310 ÷ 1,000 = 31%)

Pre-Tax Net Income	$1,000
Adjusted Corp. Tax Rate (31.0%)	<310>
Available After Dividends	$690
Capitalization Rate	÷ 18%
Estimated Value of S Corp.	$3,833

Please note that the adjusted *Kessler* effective corporate tax rate provides an estimated S corporation value that is consistent with the estimated value provided in Exhibits 2 and 3. Application of the actual Kessler effective corporate tax rate overstates the estimated value.

When the only variable is hypothetical dividend taxes paid, by a C corporation, and the corporation is making 100 percent distributions, the S corporation value should always be equal to one plus the combined effective dividend tax rate times the C corporation value. This would indicate that the after-tax cash flows are the starting point in Exhibit 4 (article) of the Treharne model computation.

Once these adjustments are made, the capitalized cash flows in the Treharne model, or a direct premium adjustment, or an adjustment to the effective S corporation tax rate, as computed, in the *Kessler* case (modified), provide the same result. As additional factors are introduced into the process, such as different tax rates for corporations and individuals, distributions of less than 100 percent, or a higher risk assessment of maintaining the S corporation distributions, all three applications of computing the PTE premium will remain consistent, as long as the proper adjustments are made to each application on a consistent basis.

CONCLUSION

The *Kessler* metric is beneficial to the body of knowledge being developed by the valuation community regarding the valuation of PTEs. The *Kessler* metric really presents a simplified application and presentation of the Treharne model. This can be helpful in the context of a family court case, where the time and opportunity to explain PTE premium adjustments can be limited. The preceding analysis indicates that the actual *Kessler* metric results in an overstatement of premium differential of PTEs compared to C corporations. However, the modified *Kessler* metric, as computed in this analysis, provides a more appropriate outcome. This is increasingly important as the *Kessler* computations tend to be utilized by the family courts, such as those in Massachusetts. ⅇ *Exhibit 6 on next page*

[1] Reto, James, "Four Potential Problems When Calculating the S Corps Benefit," *Business Valuation Update*, July 2011, pp.14-17.

[2] Treharne, Chris, "S Corporation Valuations– The Simplified Treharne Model," *Business Appraisal Practice* 2009, pp. 27-32. (see www.4avalue.com).

EXHIBIT 5

Application of the *Kessler* Metric to *Bernier*

	C Corp.	S. Corp
Pre-Tax Net Income	$1,000	$1,000
Corp. Taxes (40%)	<400>	-0-
Available Earnings	$600	$1,000
Individual Taxes (40%)		<400>
Dividend Taxs (40%)	<240>	
	$360	$600
Gross-up [$240 ÷ (1 - 40%)]		400
Total		$1,000
Kessler Estimated Effective Tax Rate ($1,000 - $1,000 = 0)		
Pre-Tax Net Income		$1,000
Adjusted Corp. Tax Rate (0%)		-0-
Available After Dividends		$1,000
Capitalization Rate		÷18%
Estimated Value of S Corp.		$5,556

Modified *Kessler* Approach to *Bernier*

Tax Rate $600 + $240 = $840
($1,000 - $840 = $160 ÷ 1,000 = 16%)

Pre-Tax Net Income	$1,000	
16% Adjusted Tax Rate	<160>	
	840	
Capitalization Rate	÷ 18%	
	$4,666	

Proof

Capitalization of Earnings

Pre-Tax Net Income	$1,000	
Less Corp. Tax Rate (40%)	<400>	
Available Earnings	600	
Capitalization Rate	÷ 18%	
	3,333	3,333
Additional Cash Flow	240	
	÷ 18%	
	$1,333	1,333
Estimated Value of S Corp.		$4,666

Premium Adjustment

Estimated Value	$3,333
S Corp. Premium	x 1.40
Estimated Value of S Corp.	$4,666

EXHIBIT 6

Adjusted Exhibit 4 (Treharne Article)

	2009	2010	2011	2012
Equivalent C Corp. Dividends	$387,624	$262,830	$<119,072>	$183,140
Dividend State Tax (Personal) 7.8%	30,235	20,501	<9,287>	14,285
Dividend Federal Tax (Personal) 15.0%	53,608	36,349	<16,468>	25,328
Dividend Tax Avoidance	$83,843	$56,850	$<25,755>	$39,613
Terminal Value				204,007
Total S Corp. Tax Benefit (Liability)	$83,843	$56,850	$<25,755>	$243,620
Present Value	$68,164	$37,578	$<13,841>	$106,438
Total				$198,339

Resultant S Corp. Value	
Exhibit 1 (article) Value	916,963
Exhibit 4 (article) Value	198,339
S Corp. Value	$1,115,302

Proof of Analysis	
Value from Exhibit 1 (article)	$916,963
Multiplied by Effective Combined Federal & State Dividend Tax Rate + 1	1.2163
S Corp. Value	$1,115,302

Effective Dividend Tax Rate	100.00%
Less: Dividend State Tax Rate	<7.8>
	92.20
Less: Dividend Federal Tax Rate (15% x 92.20)	13.83
	78.37
	100.00%
Less:	<78.37>
Effective Combined Federal & State Dividend Tax Rate	21.63

American Journal of
Family Law

VOLUME 16 NUMBER 2 SUMMER 2002

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The Valuation Report Card© permits matrimonial attorneys to assess rapidly and objectively the opponents valuation work product. It can also be provided to your client, the other party's counsel, other experts, and the judge to encourage them to agree with your viewpoint. This useful tool is described and illustrated.

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A valuation expert takes matrimonial practitioners through the various issues that arise when valuing goodwill in a closely held business or a professional practice. Among the subjects discussed are transferability and the hypothetical noncompete agreement (in the context of the hypothetical sale in a divorce case).

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Bifurcating Enterprise and Personal Goodwill

JOHN E. BARRETT, JR., CPA, ABV, CVA, MST, MBA

Family courts are increasingly looking to bifurcate the intangible value of a closely held business, for marital dissolution purposes. To facilitate this result, the courts are requiring the business appraiser to distinguish between enterprise goodwill (or more appropriately enterprise intangible value) and personal goodwill.[1] In each of these cases, a state appellate court remanded the cases back to the lower court to differentiate the established intangible value, which had previously been determined, between enterprise intangible value and personal goodwill. Many jurisdictions consider only the enterprise intangible value as part of the marital estate, with the personal goodwill treated as a nonmarital asset. Often states indicate that personal goodwill is an entrepreneurial skill to be considered for spousal maintenance and child support purposes, but not a property right subject to division. Of course, this determination varies on a state-by-state basis.

SOME BASIC DEFINITIONS

The process of bifurcating the intangible value of a business or professional practice between enterprise intangible value and personal goodwill can be a difficult task. Perhaps a good starting point toward completing this task is to review some definitions of intangible assets and goodwill. *The International Glossary of Business Valuation Terms* defines "intangible assets" as "non-physical assets (such as franchises, trademarks, copyrights, goodwill, equities, mineral rights, securities, and contracts as distinguished from physical assets) that grant rights, privileges, and have economic benefits for the owner."[2] We can determine from this definition that goodwill is only one possible component of intangible assets that might exist in a specific business. Other intangible assets that often exist in a business, based on a going concern premise, include name recognition, customer loyalty or retention, location, a trained workforce in place, and operating systems. *The International Glossary of Business Valuation Terms* defines "goodwill" as "that intangible asset arising as a result of name, reputation, customer loyalty, location, products, and similar factors not separately identified."[3] This would indicate that goodwill is often used as a catchall when intangible assets are not separately identified and valued.

In his book *Valuing a Business*, Shannon Pratt states, "The criterion as to whether goodwill exists usually is the ability to earn a rate of return in excess of a normal rate of return on the net assets

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of a business, after reasonable compensation to operating personnel."[4] This definition could probably be expanded to include all the intangible assets of the business. Mr. Pratt also states, "[P]ersonal goodwill may be described as the intangible value attributable solely to the efforts of or reputation of an owner spouse of the business."[5] He further states that institutional or practice goodwill (enterprise intangible value) "may be described as the intangible value that would continue to inure to the business without the presence of that specific owner spouse."[6] In other words, enterprise intangible value focuses on the intangible value of the business that would continue should the current owner spouse be replaced with either a replacement employee or a new owner employee.

Enterprise intangible value focuses on value that would continue should the owner spouse be replaced.

TRANSFERABILITY OF GOODWILL

Enterprise intangible value is generally transferable subject to the usual difficulties embedded in selling or transferring an interest in a closely held business. Therefore, the market approach to valuation can be a strong indicator as to the enterprise intangible value of the business. This is commonly demonstrated when a business is sold to a financial buyer. New ownership may or may not be interested in retaining the current owner/employee. It is quite common for a buyer of a closely held business to intend to directly manage the newly acquired business. If the continued services of the owner are not needed, this would indicate there is little or no personal goodwill. Any intangible value would be attributable to the business and represent enterprise intangible value. In a marital dissolution case, an actual sale is usually not contemplated. If it is reasonable to assume that a hypothetical buyer either could or would replace the owner spouse with comparable management, however, then little or no intangible value should be allocated to personal goodwill.

Personal goodwill also has some degree of limited transferability with proper effort and cooperation by both a willing buyer and a willing seller of a business. In this context, often what is actually transferable is not personal goodwill. Rather, what is transferred is the opportunity offered by the seller to the buyer to forge similar relationships with the business' existing customer base. The transferability of intangible value would be a strong indicator that the intangible value is more likely to inure to the business itself and represent enterprise intangible value rather than be attributable to a specific individual. Once a sales transaction has been consummated and possibly a transitional phase completed, the services of the seller may not be required or desired. If the seller does remain with the business, his or her role is often dramatically altered.

BIFURCATION FACTORS

In attempting to bifurcate the overall intangible value of a closely held business or professional practice between enterprise intangible value and personal goodwill, there are a number of factors that should be addressed. These factors should be considered on a case-by-case basis and will vary based on the applicable fact pattern. Factors that would be indicative of enterprise intangible value would include, but not be limited to, such elements as: (1) name recognition; (2) location; (3) computer systems; (4) operating procedures; (5) a trained and assembled workforce; and (6) an existing customer base.[7] Factors to review in considering personal goodwill would include the business spouse's: (1) age; (2) health; (3) past earning power; (4) reputation and business skills; (5) technical skills; and (6) past success.

Standard of Value

The next step in completing the process of allocating intangible value between enterprise intangible value and personal goodwill is to review the applicable standard of value utilized. The majority of family courts apply a fair market value standard or some variation of that standard, depending on state law. Revenue Ruling 59-60 defines fair market value as, "[T]he price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy, and the latter is not under any compulsion to sell, both parties having reasonable knowledge of the relevant facts."

Premise of Value

In addition to the standard of value, the appraiser must also consider the premise of value.

The going concern premise of value is the value of a business in continued use. This is often the appropriate premise of value in a marital dissolution case. The appraiser will frequently base valuation assumptions on existing management continuing in the business. This is often the case, even when a sale is contemplated and the potential new owner plans to replace the existing owner in managing the business. There is frequently either a stated or an implied assumption that replacement management of equal or similar capabilities could be substituted for the existing management. This assumption would tend to be correct in situations in which many potential buyers of the business would have the needed skills to operate the business successfully on an on-going basis.

Unique Factors

Normally, many of the unique factors that might indicate the presence of personal goodwill should be accounted for in determining an estimate of fair market value. For instance, qualitative factors dealing with such issues as thinness of management, concentration of sales, or other factors that might tend to indicate that the business is overly reliant on one or a few individuals must be taken into account in developing an estimate of value. An income based approach would consider such factors through normalization adjustments to the earnings stream (owner's compensation) and the increased measure of risk through development of an appropriate discount rate or capitalization rate. A market based approach would consider such factors through adjustments to the multiples applied. An asset based approach would consider such factors through actually identifying and valuing specific intangible assets.

The fair market value standard, based on a going concern premise, would indicate a transferable value of the subject business. This would represent the price that a willing buyer would pay a willing seller, with full knowledge of any reliance that the business would have on the seller. In terms of marital dissolution, any risk associated with the business' reliance on a specific individual should be factored into the overall estimate of value of the business. The development of an estimate of fair market value essentially adjusts for any such defect.

As previously mentioned, enterprise intangible value focuses on the intangible value of the business that would continue should the current owner spouse exit the business. This assumes, of course, that competent or at least similar management is brought in to replace the existing owner spouse. Whether the services of the current owner spouse would be desired would be part of the negotiating process, but separate and apart from the value of the business. Such negotiations would result in an employment contract. Therefore, the fair market value standard, based on a going concern premise, would primarily represent enterprise intangible value, except for any amount allocated to a noncompete agreement.

HYPOTHETICAL NONCOMPETE AGREEMENT

The business valuation process, in marital dissolution cases, also may require the business appraiser to value not only a hypothetical sales transaction but also a hypothetical noncompete agreement, as if a sale were to take place. The noncompete agreement is not a value in addition to the value of the business, but rather an allocable portion of the overall value of the business. That is to say, if the business were valued at $500,000, a buyer would not pay $500,000 plus the value assigned to the noncompete agreement. Rather, the value assigned to the noncompete agreement would be included in the $500,000. To determine the value of a noncompete agreement, the appraiser must first value the business. Then the appraiser must estimate future cash flows that would be lost to the seller should the seller compete. Next, the appraiser must consider the probability that the seller would compete. This analysis would be applied over the estimated life of the hypothetical noncompete agreement and present valued to today's dollars.[8]

Various states have formed differing opinions as to whether a noncompete agreement should be considered a marital asset. Several take the position that the noncompete agreement is not a marital asset because it restricts the postmarital activity of the owner spouse. A few states have ruled that the noncompete agreement is a marital asset. This is based, in part, on the conclusion that the noncompete agreement is signed in conjunction with the sale of a business and represents the goodwill of the business.

Noncompete agreements are usually time specific and geographic specific. Normally, a prudent business advisor would not advise that a prospective buyer complete a purchase transaction without a noncompete agreement in place. This is to ensure that the buyer gets what the buyer sees. Basically, the noncompete agreement is an implied warranty that would have no value but for the sale of the business. This would tend to support the conclusion that the noncompete agreement simply represents a portion of the enterprise intangible value.

To determine the value of a hypothetical noncompete agreement, the appraiser must first value the business.

The definition of intangible value was discussed previously in this article. Intangible value was defined, in part, as having economic benefits for the owner. Therefore, to exist, intangible value must have some foundation in terms of economic benefits. A noncompete agreement, in and of itself, does not provide an economic benefit. Rather it functions as a form of protection to the prospective buyer. A noncompete agreement would not be sold or transferred independent of a sale of a business. It has relevance only in terms of a sales transaction. As such, any value assigned to a noncompete agreement would represent an allocable portion of the overall enterprise intangible value. Certainly the noncompete agreement places restrictions on the seller. These restrictions, however, apply only in a limited geographic and a limited time specific manner. The seller can generally apply his or her specific abilities outside of that limited scope.

SUMMARY

Family courts are increasingly looking to the business appraiser to distinguish the components of intangible value in a closely held business or professional practice. The appraiser should keep this in mind and review applicable state law with attorneys before beginning an engagement. The business appraiser may also be called on to value a hypothetical noncompete agreement in a marital dissolution case. The appraiser should be prepared to meet these tasks.

END NOTES

1. *See* Frazier v. Frazier, 737 N.E.2d 1220 (Ind. App. 2000); and Moretti vs. Moretti, 766 A.2d 925 (R.I. 2001).

2. Shannon P. Pratt, Robert F. Reilly, Robert P Schweihs, Valuing a Business, the Analysis and Appraisal of Closely Held Companies. 4thh Edition, Appendix, A.1

3. *Id.*

4. Shannon P. Pratt, Robert F. Reilly, Robert P. Schweihs, Valuing a Business, the Analysis and Appraisal of Closely Held Companies, 4th Edition, p. 820.

5. *Id.*

6. *Id.*

7. *See* Shannon P. Pratt, Robert F. Reilly, Robert P. Schweihs, Valuing Small Businesses and Professional Practices, 3d Edition, p.585.

8. For a detailed analysis of valuing noncompete agreements, *see* Mark O. Dietrich, "Valuing Covenants Not to Compete in a Professional Practice," *AICPA's CPA Expert*, Summer 2002.

The Rhode Island Supreme Court Rules on Case Involving Business Valuation Issues
BVS Analysis
John E. Barrett, Jr.
(2006)

In *Vicario v. Vicario*, the Rhode Island Supreme Court upheld the Family Court Trier of Fact regarding several matters, including the valuation of an S corporation. Tax affecting was one of the underlying valuation issues. The decision reads, in part, as follows:

> "In addition, the Family Court concluded that Mr. Pendergast's appraisal, which included a tax affect in the calculation of the value of Abacus, was in contravention of a decision by the United States Court of Appeals for the Sixth Circuit holding that it is improper to tax-affect a Subchapter S corporation when valuing it. See Gross v. Commissioner of Internal Revenue, 272 F.3d 333 (6th Cir. 2001). Notably, even Mr. Pendergast admitted that he was not aware of any tax court cases subsequent to Gross that allowed for tax-affecting in ascertaining the value of an S corporation."
>
> "In light of these factual findings and the general magistrate's discretion to choose one expert's testimony over the other based on his own determinations of credibility, we are satisfied that he did not abuse his discretion in choosing Mr. Bilodeau's opinion of the value of defendant's interest in Abacus over that of Mr. Pendergast."

The ruling upholds the general magistrate's discretion to choose one expert's testimony over another. A more definitive interpretation of this ruling is beyond the scope of this analysis and certainly the author's expertise. However, a Family Court Trier of Fact did make a ruling on the issue of tax affecting.

In this case, the husband owned a 50 percent equity interest in a Rhode Island corporation (an S Corporation). The business primarily provides employee benefit plan consulting services. The husband was not active in the business. The company historically made annual shareholder distributions sufficient to cover the pass through individual income tax liabilities of the shareholders. In contrast, the Gross case dealt with a very small minority interest and the corporation distributed 100% of its earnings. The fact pattern in the Vicario case is quite distinguishable from the Gross case.

There has been considerable controversy over the past several years regarding the valuation of S corporations (and other pass-through tax entities). Much of the controversy deals with the issue of tax affecting such entities. S Corporations do not pay income taxes on their corporate level earnings. Rather income taxes are paid at the shareholder level, by the shareholders. This is in contrast to the situation of a C Corporation, where income taxes are paid at the corporate level, and then again at the shareholder level, on any dividends paid to the shareholders, by the corporation. A commonly accepted business valuation practice has been to tax affect the earnings of an S corporation by applying C corporation tax rates to the earnings. However, a 1999 U.S. Tax Court Case (Gross v Commissioner) held that tax affecting S corporation earnings was not correct. There have been three additional U.S. tax court cases upholding this position since the Gross case.

There has been a great deal of debate, and numerous articles have been written regarding this matter, since the Gross case decision. The Business Valuation Review, published by the American Society of Appraisers, dedicated the entire September 2004 issue to this matter. There were articles by Chris Treharne, Chris Mercer, Roger Grabowski, and Daniel Van Fleet. Each author provides information concluding there is little or no difference, in value, when valuing a controlling interest in an S or C corporation. Grabowski indicated there could be some adjustment, based on a Code Section 338(h) election, but does not elaborate. Such an adjustment is often just a reimbursement for income taxes incurred by the seller, for structuring a tax advantaged deal to the buyer, and does not represent a real economic increase in the purchase price. This is simply an application of tax arbitrage. Each author also provides a model for valuing minority held interests, in S corporations.

Shannon Pratt states in his Business Valuation Update (January, 2005), "There is also consensus that the valuation issues are different for controlling interests than for minority interests. For controlling interests, some believe that there is no difference (in value), whereas others believe that there may be a small difference depending on the facts and circumstances." In a very lengthy 2004 paper, on this subject, Chris Treharne states the following: "In contrast, if valuing a controlling interest, the studies that have been conducted on controlling interest transactions in the marketplace provide no evidence that S corporations should be treated any differently than C corporations. Logically, we recommend that C corporation valuation methods be used for controlling ownership interests in S corporations." Mr. Treharne also provides the following information in his paper: "Conclusion #5: If S corporation distributions equal the tax liability associated with entity operations and the C corporation pays no dividends, the C and S corporation minority investors' value will be identical (presuming that S and C corporation income tax rates are identical)."

The current business valuation literature, on the subject of tax affecting, overwhelmingly indicates the issue is dependent on the facts and circumstances, of a particular case. Factors to consider include the size of the business, the actual income tax ramifications of the business, the size of the interest valued, and the current and historical cash distributions of the business.

The size of the business is important. For large businesses, if the only likely buyers are C corporations, the S corporation status of the business should be disregarded. Conversely, most small to mid-market C corporations general do not create a situation where shareholders pay income tax on dividends. These companies pay our earnings in other legally acceptable ways.

The actual income tax ramifications incurred by a business are important and simply cannot be disregarded. Most small to mid-market companies pay tax on the profits from the business either at the corporate level or the individual shareholder level, depending on the entity structure. Small to mid-market C corporations rarely pay out taxable dividends to shareholders, other than when dealing with an accumulated earnings tax issue. In the second edition of his book *Financial Valuation*, Jim Hitchner includes an entire chapter on the valuation of pass-through entities. The author of that chapter, Nancy Fannon, provides the following information "Note further that C corporations generally bonus out salaries, not pay dividends. Although this ability is limited by tax regulations on excessive compensation, this contributes to the notion that double taxation is more myth than reality." This statement makes a great deal of sense.

The after-tax cash flow for a small to mid-size business, while somewhat different, frequently is not all that different whether the business is an S corporation or a C corporation. So the valuation should be about the same. Tax affecting makes a great deal of sense in such cases.

The size of the interest valued is also very important. Current valuation literature generally does not support a premium for a 100 percent controlling interest in an S corporation. As previously discussed, the Code Section 338(h) election may include some amount of premium for an S corporation. However, this premium is often just a reimbursement of income taxes paid by the buyer to the seller.

The current and historical cash distributions, of a business, play an integral part in the valuation of minority held interests in closely-held businesses. The valuation models put forward by Treharne, Van Fleet, Grabowski, and Mercer generally indicate no increase in value or only a small increase in value, for minority held interest, in S corporations, when the company only makes distributions to cover the shareholders' annual income tax liabilities, on business profits. Van Fleet's model does show some increase in value of an S corporation over a C corporation in this scenario. However, all of the difference is predicated on hypothetical capital gains computations.

The Vicario case valued a 50% equity interest (on a non-controlling basis), in the Subject Company. A 50% interest presents certain unique factors in the valuation process. Rhode Island requires a greater than 50% voting interest to control a corporation. Also, a 50% voting interest is not really a minority interest, as there is no other shareholder with a larger voting ownership interest in the Company. The interest valued in the Vicario case is very different than the small minority interest valued in the Gross case. It should also be noted, Chris Treharne writes that if an S corporation simply makes shareholder distributions to cover the shareholders' income tax liability, there should be no difference in value between an S corporation and a C corporation. In the case at hand, the Company was distributing cash to the shareholders only sufficient to cover the shareholders' income tax liabilities. This would further support tax-affecting in this specific case. It is highly unlikely that a potential buyer would pay a premium for a 50% equity interest, in this business, based on the fact pattern. The articles previously discussed indicate that the value of the Subject Interest should be substantially the same, whether the Company operates as an S corporation or a C corporation.

The significant impact of tax-affecting on a business is demonstrated in the following hypothetical example. The hypothetical example assumes two identical companies except one is a C corporation and the other is an S corporation.

	C Corporation	S Corporation
Revenues	$5,000,000	$5,000,000
Less: Expenses	(4,000,000)	(4,000,000)
Pre-Tax Profits	$1,000,000	$1,000,000
Less: Corporate level Income Taxes (40%)	(400,000)	0
After-Tax Net Income	$600,000	$1,000,000
Divide by an assumed Capitalization Rate	÷ 20%	÷ 20%
Indicated Value	$3,000,000	$5,000,000

The difference is astounding. This is a very important valuation issue. The computations indicate the S corporation is essentially worth 67 percent more than a C corporation. However, the reality is that the S corporation shareholder will have to pay a similar amount of income tax, on the business profits, at the shareholder level rather than corporate level. There simply is not a sufficient amount of after-tax cash flow to justify the $5,000,000 indication of value. This analysis strongly indicates tax-affecting would be appropriate, in this hypothetical case, to avoid significantly overstating the value of the business.

Now let us review the impact of tax-affecting on the Vicario case. The following information was gleaned from reading the Rhode Island supreme Court decision.

Pre-tax cash flows	$167,000
Divided by Capitalization Rate	÷ 21
Preliminary Value	$795,238
Preliminary Value (rounded)	$795,000
Less: Discount for Lack of Marketability (25%)	(198,750)
	$596,250
Less: Discount for Lack of Control (10%)	(59,625)
	$536,625
Times interest valued	x 50%
Indicated Value	$268,313
Indicated Value (rounded)	$268,000

The following analysis indicates the impact of not properly tax-affecting, in the Vicario case, and resultant overstatement of value. The difference, once again, is significant.

	With Tax-Affecting	Without Tax-Affecting
Pre-Tax Cash Flows	$167,000	$167,000
Less: RI Corporate Taxes (9%)	(15,030)	0
	$151,970	$167,000
Less: Federal Corporate Taxes	(42,518)	0
After Tax Net Income	$109,452	$167,000
Divided by Capitalization Rate	÷ 21%	÷ 21%
Preliminary Value	$521,200	$795,238
Preliminary Value (rounded)	$521,000	$795,000
Less: Discount for Lack of Marketability (25%)	(130,250)	(198,750)
	$390,750	$596,250
Less: Discount for Lack of Control (10%)	(39,075)	(59,625)
	$351,675	$536,625
Times Interest Valued	x 50%	x 50%
Indicated Value	$175,838	$268,313
Indicated Value (rounded)	$176,000	$268,000

The analysis indicates a probable overstatement of value, of approximately 52 percent or approximately $92,000, in this particular case. It is the responsibility of the business appraiser to provide detailed objective valuation information, to the court, to assist the court in reaching fair and equitable decisions. This information should be included in written format (the valuation report) and provided in testimony when required.

Business Valuation Resources recently hosted a teleconference entitled "Ask the IRS," on July 27, 2006. The IRS representative, Michael Gregory, stated the issue of tax-affecting is determined by the facts and circumstances of each case. He further stated that the IRS looks at the facts and circumstances of each and every case and does not simply argue against tax-affecting, as a general rule. This indicates that the IRS does not blindly follow the Gross case, but rather determines each case on its own merits. In fact, I am not aware of a single U.S. Tax Court case where the IRS has argued against tax-affecting in S corporation earnings, when dealing with a 100 percent controlling interest.

A recent case from the Delaware Chancery Court, Delaware Open MRI Radiology Associates, P.A. v. Kessler, et al., 2006 Del. Ch. Lexis 84 (April 26, 2006), dealt with the tax-affecting issue of minority held interests, in an S corporation. The minority interests valued totaled approximately 37 percent. The case dealt with a shareholder squeeze-out merger. The Vice Chancellor noted the business was a highly profitable entity that generates and distributes income well in excess of the stockholder level taxes its stockholders have to pay.

The court "embraced" the reasoning of prior decisional law citing the U.S. Tax Court cases of Gross, Adams, and Heck. However, the Court also relied on the specific facts of the case to depart from precedent. The case reads, in part, as follows:

> "My difference with these prior decisions is at the level of implementation, rather than at the level of principle. Certainly, in this context when minority stockholders have been forcibly denied the future benefits of S corporation status, they should receive compensation for those expected benefits and not an artificially discounted value that disregards the favorable tax treatment available to them. But the minority should not receive more than a fair S corporation valuation. Refusing to tax affect at all produces such a windfall, as I next explain."
>
> "The Internal Revenue Code states "[t]he taxable income of an S corporation shall be computed in the same manner as in the case of an individual…" This tax, though assessed at individual rather than corporate tax rates, is dependent solely upon the corporation's net earnings. Even if Delaware Radiology were to retain 100% of its earnings annually, its stockholders still would owe taxes on Delaware Radiology's income even though they received no distributions. Affording a remedy to the Kessler Group that denies the reality that each shareholder owns taxes on his proportional interest in Delaware Radiology would result in the Kessler Group receiving a higher per share value from the court than it could ever have realized as a continuing shareholder."

In this case the Vice Chancellor provided his own business valuation analysis, to reach a determination of value. The valuation analysis was well reasoned and based on current business valuation literature. The Court's decision results in an approximate 17.6 percent premium to the value of the minority held interests. Note that the business, unlike Vicario, distributed most of its profits, to the shareholders, well in excess of the shareholders' income tax liabilities. The Vice Chancellor cites both Chris Treharne's and Chris Mercer's work in reaching a conclusion. This decision is a must read for any business valuation analyst.

<u>Conclusion</u>

The issue of properly valuing S corporations, and other pass-through entities, will continue to be a controversial topic. The issue has evolved from one of "to tax-affect or not to tax-affect" to one of determining the proper tax ramifications, for a specific business. Current valuation literature indicates that the matter is case specific, depending on the particular facts and circumstances. When valuing a 100 percent controlling interest, in a business, normal C corporation tax adjustments would seem appropriate, in most cases. When valuing a minority held interest, in an S corporation, the issue depends on a number of factors, including the size of the business, the size of the interest valued, the overall income tax ramifications of the business, and the cash distribution policy, of the business. Hopefully, business appraisers will meet the challenges of providing relevant and thorough valuation information, to the Rhode Island Family Courts, on this matter, when required to do so.

Company Profile

Barrett Valuation Services, Inc. (BVS), located in Cranston, Rhode Island, is a Certified Public Accounting firm, focusing primarily on business valuation and litigation support related matters. The firm also provides business valuation review services to lawyers, accountants, and business owners. BVS can guide you through the complete business valuation process. We have the expertise and experience to value businesses from the mom-and-pop operations to multi-million dollar entities.

Barrett Valuation Services, Inc. is committed to providing the highest quality of service and professional excellence, in the field of business valuation, to our clients. BVS subscribes to the professional standards developed and published by the Appraisal Foundation with its Uniform Standards of Professional Appraisal Practice (USPAP). BVS subscribes to the business valuation standards of the American Institute of Certified Public Accountants, the National Association of Certified Valuators and Analysts, the Institute of Business Appraisers, and the American Society of Appraisers. These highly respected organizations are recognized as being the leaders in the field of business valuation. Our adherence to these standards demonstrates a commitment to providing the client with a well-developed value conclusion that is supportable and credible.

What benefits do I get from working with Barrett Valuation Services?

BVS can benefit our clients in the following ways:

- Assess the valuation factors that impact the value of a closely-held business.
- Provide unique insight into the valuation process.
- Offer a systematic, professional approach to determine business value and provide a high-quality final report.
- Employ our expertise to solve your particular valuation problem.

Whether you need a comprehensive business valuation for Rhode Island divorce purposes, a Rhode Island shareholder dispute, Massachusetts divorce purposes, a Massachusetts shareholder dispute, estate and gift planning purposes, or other reasons, BVS can guide you through the process.

Client Resources

We are dedicated to sharing our knowledge and expertise in business valuation with our stakeholders and clients by offering a business valuation guide for Divorce in Rhode Island to our clients as well as judges, attorneys, accountants, consultants and fellow business valuation analysts and appraisers.

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