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Valuation Verdicts®

Current Valuation & Taxation Rulings Regarding Divorce

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Post-Bernier Ct. Prefers DCF to Value Hedge Fund, Plus Tax-affects

***Adams v. Adams,* 2011 WL 1385570 (Mass.) (Apr. 14, 2011).** In 2007, the Supreme Judicial Court of Massachusetts was among the first to analyze the "bedeviling" issue of tax-affecting the income stream of a closely held S corporation in a divorce in *Bernier v. Bernier*, 2007 Mass. LEXIS 598 (2007). Recently, the same panel revisited the still "thorny" issues to determine the present value interest in a highly profitable hedge fund partnership.

Annual income tops $56 million. The husband was a partner in Wellington Management Co., an asset management and investment advisory firm. Under the firm's partnership agreement, the husband earned his annual pay in four parts: (i) base salary; (ii) incentive compensation; (iii) return on capital; and (iv) merit distribution (the latter two determined after calculation of the firm's net profits). The amounts varied dramatically from year to year, depending on the markets as well as the firm's and the husband's performance; for example, in 2008 the husband made more than $56 million in merit pay plus return on equity. Upon retirement or departure from the firm, the partnership agreement also entitled the husband to certain withdrawal payments.

When the parties divorced in 2006, the trial court appointed a special master to determine the value of the partnership interest. The husband claimed it was "not susceptible to any present value other than zero." In particular, the partnership interest constituted a "mere expectancy of future earned income," he argued, and as such, was too speculative to be reduced to a divisible asset value. The special master disagreed, however. Despite its variability, the partnership interest consistently generated cash flow and had a dollar value "which may be expressed by capitalizing the average profit distribution over a period of time," the special master found.

To value the interest, the wife retained the managing director of valuation at a national financial firm. He used the discounted cash flow (DCF) approach to value 1) the partnership's income stream during the husband's employment, and 2) his withdrawal payments on retirement. He then applied *Bernier's* tax-affecting formula.

Specifically, the wife's expert used various actuarial and labor statistics to conclude that the husband would likely retire 14 years after the divorce, at age 62. Next, he projected the husband's merit and equity distributions over each of the 14 years, excluding salary and incentive compensation (earnings not subject to marital division). Believing that the three years prior to trial were the most representative of firm profits (2006 to 2008), the expert predicted the husband would average $27 million each year until retirement. To this amount, he applied a 4% growth rate, reduced to present value by a rate composed of two variables: the partnership's 8.25% borrowing rate (in 2008) plus a "morbidity factor" (the probability that the husband would survive to age 62, based on statistics from the U.S. Centers for Disease Control). Finally, he tax-affected the future cash flows at 31.5%, which approximated the husband's average effective income tax rate for the three representative years (2006-2008).

The wife's expert also computed the present value of the husband's post-retirement withdrawal payments, which he projected would equal 2.93% of the partnership's gross income (based on 2007 earnings) during a 10-year payout period. Assuming the IRS would classify these as "guaranteed payments," he tax-affected the withdrawal amounts at the husband's highest marginal rate (38.5%). Ultimately, the wife's expert determined the present-value of the partnership interest, including withdrawal payments, to be worth between $134 million and $145 million.

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In sharp contrast, the husband "steadfastly maintained" that his partnership interest could not be reduced to a present value, except for his retirement payments. Thus, his expert valued 10 years of withdrawal payments beginning at the time of trial (and not at retirement, as the wife's expert had done). After applying a 40% tax-affected rate, he concluded these payments were worth between $28.5 million and $40 million.

Special master applies direct capitalization of earnings. The special master prefaced his findings by noting that the "direct capitalization of income approach" was an accepted valuation method, as applied by the *Bernier* court. He also credited the assumption by the wife's expert that the husband would work until age 62.

At the same time, the special master rejected the 2006 to 2008 period of firm earnings as a reliable benchmark, due to the "notoriously cyclical" economy. Instead, he input merit compensation since the husband first joined the firm in 1993, noting these averaged 3% of annual partnership net profits. Due to the current economic recession, he reduced the husband's share to 2%, and then applied the firm's projections of 2009 income, holding it flat in 2010 (due to general securities market predictions), to reach a baseline merit distribution of $5.7 million for each of those two years.

Due to the same economic concerns, the special master applied a 3% growth rate over the 14-year pre-retirement period, to find an average $6.8 million in annual merit distributions, plus $600,000 per year return on capital. He then applied an 8.5% capitalization rate to reach a total present value of $87 million for the partnership interest. Finally, he applied the combined state and federal capital gains tax rate (rather than the income tax rate) for a total tax-affected value of $69 million. To this, he added the total present-value computation of post-retirement payments, as calculated by the wife's expert ($11.6 million), for a final distributable value of $80.9 million.

The trial court adopted the special master's report and the husband filed a "voluminous" appeal, objecting to nearly every finding. The Mass. Supreme Judicial Court granted an expedited review.

First, the court considered whether the hedge fund partnership interest constituted a divisible marital asset. A partnership "fits squarely" within the state's broadly defined equitable distribution statute, particularly its inclusion of "profit sharing" rights and funds, whether vested or non-vested, the court noted. Unlike a professional degree or license, which requires a valuation of its inherent earnings potential, an interest in an established partnership—though variable—was more akin to an interest in non-vested stock options, the court said:

Accordingly, we hold that a divorcing spouse's interest in a partnership that produces a consistent stream of profits and reliably disburses those profits to the partner-spouse over a period long enough to appraise the present value of the partnership interest fairly is, in the discretion of (trial) judge, assignable to the marital estate.

Further, the trial court's discretion depended on the contribution of each spouse to the acquisition of the partnership asset and the likelihood that it would continue to produce steady profits. "Our holding today is not intended to...compel a divorcing spouse into effective servitude," the court said. Here, the husband's partnership interest entitled him to a share of a substantial profit pool, encompassing a reasonably predictable stream of future profit distributions as well as an enforceable contract right to retirement payments. Accordingly, its present value was properly included in the parties' marital estate, the court held.

Valuation methodology more problematic. The income approach has earned a broad consensus for valuing a marital business among experts and appraisers, the court observed, citing *Valuing Small Businesses and Professional Practices*, by Shannon Pratt, Robert Reilly, and Robert Schweihs (3rd ed., 1998). A variant of the income approach—the direct capitalization method—is the "preferred" method for valuing corporations, stocks, and similar interests, because it presumes a perpetual stream of income and corporations are defined, in part, by their infinite lives, the court said, citing the same source. Thus the direct capitalization method was appropriate for the closely held businesses in *Bernier.*

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"It was, however, error to use that method in this case," the court held, because the husband's partnership interest was limited by a finite period of cash flows: 14 years until retirement and 10 years following. Since the direct capitalization formula did not account for these limits, the special master may have overvalued the partnership's merit distributions. Instead, he should have elected "some variant" of the DCF methodology, which was better suited for reducing a finite period of future partnership income to present valuation, the court said, once again citing *Valuing Small Businesses* and also *Valuing a Business: The Analysis and Appraisal of Closely Held Companies*, by Shannon Pratt and Alina Niculita (5th ed., 2008).

The special master also erred by failing to make consistent adjustments to the valuation of the retirement payments as he did to the value of the partnership. On remand, the trial court (or special master) should apply consistent adjustments (e.g., the same growth rate) in assessing both the partnership distributions and the withdrawal payments, the court held.

Finally, although the special master was "certainly correct" to tax-affect the present value of the partnership interest according to *Bernier*, he failed to provide a "reasonable explanation" for rejecting the rates used by the parties' experts in favor of a combined capital gains tax rate, the court said. According to the wife's expert, the IRS would classify the partnership distributions and withdrawal payments differently. Further, partnership distributions are itemized rather than subjected to a uniform income or capital gains tax rate. On remand, the trial court should clearly explain which rates apply to tax-affecting the present value of the partnership interest, the court held, and sent the case back for further proceedings consistent with its opinion.

Unclear Discount of Medical Practice Value Causes Remand

Peltzer v. Peltzer, 2012 N.C. App. LEXIS 1103 (Sept. 18, 2012). The parties in this divorce case agreed that the husband should keep his medical practice, but disputed its value. At trial, only the husband presented a CPA expert, who provided pre- and post-tax estimates of the practice's stock value, in particular focusing on the negative consequences of any liquidation. He also emphasized the closely held nature of the practice and the "informal" nature of the shareholders' noncompete and consulting agreements.

Rather than a traditional valuation methodology, he applied a "rule of thumb" or "common sense" approach to value the practice. As the basis of his calculation, he averaged two years of gross annual receipts by a factor of 50% to conclude that the husband's shares were worth just over $328,000. If the husband were to sell his interest, the expert said, the value of his shares would drop to approximately $197,000 due to federal and state taxes.

The trial court acknowledged the difficulty in valuing the husband's illiquid interest and relied on his expert's valuation and approach. Given the close nature of the practice, any valuation should include a discount, the court stated. At the same time, it found the husband was unlikely to sell his shares and, without elaborating on any specific discount, adopted the expert's pretax value of $328,000.

Challenging his own expert. On appeal, the husband claimed that the trial court failed to use a reliable valuation methodology, including application of a discount, and failed to consider the adverse tax consequences from any sale of his medical practice.

As to the first issue, "you can't complain about a result you caused," the appellate court observed. The husband offered his expert as the sole witness to testify on business value; any deficiencies in the expert's evidence meant the husband failed to meet his burden of proof, not that the trial court erred by adopting the expert's value.

The court also dismissed the argument on tax effects. Under the applicable state statue, a trial court need only account for the consequences of a sale if these were "reasonably likely to occur." Here, the trial court expressly determined that, given the husband's age and vested interest in "continuing the protective and financially rewarding practice," he was unlikely to sell his share.

At the same time, it was "unclear what 'discount' the trial court applied to determine the value of the practice," the court said. Most likely, the "discount" related to the 50% reduction that the husband's expert applied to the gross annual receipts, "but we cannot say for sure," the court said. "A better practice would have been to make a clear finding of fact...as to the valuation

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of the medical practice at [$328,000] and how the court arrived at this value" it said, and remanded this sole issue for reconsideration.

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