Valuation Verdicts®

Current Valuation & Taxation Rulings Regarding Divorce

Barrett Valuation Services, Inc.
989 Reservoir Avenue, Cranston R.I. 02910
Tel: (401) 942-3900 • Fax: (401) 942-3988
email: info@BarrettValuation.com
www.BarrettValuation.com

John E. Barrett, Jr., CPA
Accredited in Business Valuation
Certified Business Appraiser
Certified Valuation Analyst

Goodwill Determination Turns on Classification of Auction Business

In re. *McCarter v. McCarter,* 2014 Tenn. App. LEXIS 778 (Dec. 1, 2014). A Tennessee divorce ruling deserves close reading for what it says and what it implies about professional and enterprise goodwill. The crux of the matter is whether a business owner who is not a professional in the usual sense, i.e., a lawyer, doctor, or CPA, can have professional goodwill that is nontransferable and not subject to division.

Goodwill value changes. The husband was a licensed auctioneer and real estate agent, who was the sole shareholder of a thriving auction business that he built during the marriage. The valuation of the company became a flashpoint during the parties' messy divorce proceedings.

At trial, the husband presented expert testimony from a CPA and experienced business valuator. The expert provided two reports, each based on the company's financial records for the past five years, from 2007 through 2011. He explained that he had completed an initial valuation based on the company's draft 2011 federal tax return and a revised report based on the 2011 final tax return. Although both reports were admissible evidence, the appraiser said the revised report more accurately represented his opinion as to the business's value.

He said in both instances the valuation was based on two methods. One was an asset approach that he described as "adjusted book value—going concern method"; he also used an income approach, the "capitalization of cash flow method," which he said "effectively determin[ed] the present value of the Company's ongoing benefit stream growing perpetually at a fixed rate and discounted at the required rate of return."

In both reports, he determined that under the income approach the fair market value was $210,000. In the first report, the adjusted net book value was $176,000, but in the final report it had dropped to $125,000. He explained the change had to do with the different numbers that appeared in the company's 2011 draft and finalized federal tax returns for accumulated depreciation and cost of fixed assets. When he first prepared his valuation, the company's CPA had not yet made the requisite adjustments to the tax returns.

The expert also explained that the goodwill attributable to the husband was the difference between the enterprise value—$210,000—and the adjusted net book value—$178,000 initially and $125,00 0 in the final report. Accordingly, the goodwill value increased from $34,000 to $85,000.

Further, he reviewed a profit-and-loss statement for the first quarter of 2012, which ended approximately three weeks before trial. It suggested a $71,000 loss during that period, prompting the appraiser to lower the adjusted net book value from $125,000 to $104,000 as of March 31, 2012. At trial, the husband explained that this loss was in keeping with the seasonal nature of land auction sales.

The wife offered rebuttal expert testimony from a CPA who also had a background in business valuation. However, this valuator did not perform an independent valuation of the company but instead reviewed both versions of the opposing expert's report. The expert said her main concern was the significant change in goodwill: how could it reasonably have increased from $34,000 to $85,000, she asked. She did not contest the $210,000 figure resulting from the husband expert's capitalization of cash flow analysis and also did not argue with his approach to determining the adjusted net book value.

The wife's expert said the drop in enterprise value from $176,000 to $104,000 was completely the result of the first-quarter-2012 loss and did not credit the adjustment the husband's expert made based on the finalized federal tax return. If the first-quarter loss was seasonal, then the enterprise value would not change and the goodwill would be $34,000, she suggested.

Finally, she proposed that some of the husband's professional goodwill was attributable to the business rather than the husband personally.

The husband's expert explained that the husband's goodwill was not marketable; therefore, there was no enterprise goodwill. If the husband were to ask him to sell the business, "I would simply say, 'I'm sorry, I can't do that because his business isn't transferable in that sense.'" According to the husband's expert, the husband was "providing a professional service. It's not like manufacturing…. That's the reason we opine that all of the goodwill in excess of the adjusted net book value was personal goodwill."

The trial court adopted the valuation of the husband's expert, finding the business was worth $125,000 and rejecting the adjustment for seasonal loss. The expert used valuation methods that were acceptable under state law, the court said.It expressly stated that it "did not feel comfortable with the testimony of the wife's expert witness."

Flexibility on goodwill? The wife appealed the trial court's findings on multiple grounds to the state Court of Appeals. In terms of the business, she argued that the trial court failed to give due consideration to her expert's testimony and inflated the value of the husband's goodwill.

The appeals court disagreed. The trial court heard both experts, but only the husband's appraiser conducted a valuation of the business. The trial court explicitly stated that he used "competent" methods. The wife's expert did not object to either methodology. At the same time, she seemed not to understand how to calculate the goodwill. "It appears from her testimony that [the wife's expert] interpreted the goodwill estimate as a fixed amount rather than a remainder derived from subtracting

Continued on next page...

the adjusted net book value from the total market value," the appeals court said. It also noted that the trial court expressed its lack of comfort with the testimony the wife's expert gave. According to the appeals court, as the fact finder, the trial court was in the best position to assess the credibility of the witnesses.

As for the goodwill in particular, the appeals court noted that under state law professional goodwill was not a marital asset. Without specifically saying so, both courts appear to have adopted the position the husband's expert took when he described the goodwill at play as "professional" and called the husband, an auctioneer, "a professional." Once characterized in this way, the goodwill was nontransferable and, therefore, not subject to division in a divorce proceeding. The appeals court did allow that under a recent decision some goodwill might be attributable to the business, "where the practitioner has one or more partners or pre-established contracts that could be assumed by another practitioner." See *Hartline v. Hartline*, 2014 Tenn. App. LEXIS 7 (Jan. 13, 2014) (available at *BVLaw*). However, in this instance, the husband was the only licensed auctioneer in the company and its sole shareholder, the Court of Appeals said.

For all these reasons, it affirmed the trial court's valuation.

Editor's note: This opinion leaves a lot unsaid, but a number of points deserve amplification. It is noteworthy that the husband's appraiser called an auctioneer a professional, a status that makes the husband's goodwill nontransferable. This attempt (successful) aligns with other divorce cases in which parties sought to expand the scope of what qualifies as "professional service" beyond the traditional professions such as law, medicine, and accounting. See *Brave v. Brave,* 2014 Ark. LEXIS 232 (April 17, 2014) (available at *BVLaw*) (chef and restaurant owner arguing unsuccessfully all goodwill in business is professional and nontransferable). Here, both courts accepted the characterization without explaining what makes the auctioneer a professional. Was it the license? Also, the appeals court suggests that where a business has only one partner it cannot have enterprise goodwill—a proposition with which appraisers might argue.

Court Nixes Double Dip Claim Based on Accounts Receivable Treatment

In re. *Settele v. Settele,* 2015 Ohio App. LEXIS 3746 (Sept. 15, 2015). Raising a double dip argument seems par for the course in Ohio divorce cases notwithstanding recent decisions from the Court of Appeals that have limited the applicability of the theory to the context of an income-based business valuation and have gone as far as to say that double dipping is permissible. Recently, the owner-spouse tried to fit the case into a double dip framework by analogizing the opposing expert's use of accounts receivable in the asset-based valuation to using a future stream of income. There was no prior law directly on point.

Adjustments to balance sheets. The parties narrowed their dispute to the valuation of the husband's dental business. The husband initially set the practice up as a sole proprietorship but during the divorce proceedings reorganized it as a single-member limited liability corporation (LLC).

The wife's expert used an adjusted net asset approach to value the practice. He said the income approach marked the value as less than the business assets, which generally represented the floor of a business. The market approach resulted in a range of results that was too wide to be reliable.

He explained that the asset approach considered the value of "certain assets, bank accounts, accounts receivable, equipment" at a certain point in time. He used the company's balance sheets, he said, and made three major adjustments.

First, he added over $53,000 in expense payments made at year-end 2013 to the business value because those payments did not "absolutely" have to be paid then. Also, under generally accepted accounting principles, they would represent prepaid expenses that were an actual asset to the company at that date.

Second, he added over $206,000 in accounts receivable to the value. In so doing, he followed the standard method of aging accounts to capture risk related to collectability.

Third, he changed the book value of the practice's furniture and equipment, first adding back in part of the value of furniture bought at the end of 2013, which was depreciated entirely, and then subtracting nearly $17,000 in leasehold improvements. He acknowledged that he did not perform his own appraisal of the equipment but said an appraisal likely would not produce a different value than what appeared on the company's balance sheets.

Based on the three adjustments, he concluded the assets of the business totaled nearly $358,400. After subtracting liabilities and using a 7% discount for lack of marketability, he arrived at a net asset value of approximately $313,000.

The expert's accounts receivable treatment prompted questions on cross-examination. He explained that in terms of taxes "[w]hen those receivables are collected in the subsequent period or in the following year, they would be recognized as taxable income as the collection of those receivables in that subsequent year." He clarified that "there's going to be approximately 200-some thousand dollars of accounts receivable in existence and those are going to, as a rolling advantage, continue being collected and recognized as cash-basis income."

The wife's expert also was asked about the applicability of the 2008 *Heller* case ruling, which ostensibly prohibited double dipping. See *Heller v. Heller*, 2008-Ohio-3296. He responded:

> The double-dipping issue has no bearing on an instance where the company is valued based on an asset approach. That issue is relevant when the company is based on a cap-

The summaries in this publication discuss only some valuation or taxation aspects of the cases, and are not complete analyses. The reader is referred to the actual cases for more detail. This publication does not constitute legal, tax, accounting or valuation advice. It is provided as an informational service only. Please contact a professional advisor if you need specific advice. No liability whatsoever is assumed in connection with the use of this newsletter. Copyright © 2015.

italization of earnings approach with the argument, or the potential counting, being that you counted a net earnings stream and capitalized it to determine the business value, and then you may also be using that same earning stream for determining income level for support purposes. Therein lies the potential for a double counting.

The husband's expert used an income approach, specifically the capitalization of earnings method. To determine the appropriate future earnings base, he used figures in the Schedule C tax forms for 2011 and 2012 and the company's financial statement for 2013. He adjusted for officer compensation and arrived at a "going forward income" for the business of $74,000. Using a capitalization rate of 19%, he concluded the business was worth $390,000.

He stated that he had "[n]o problem" with the opposing expert's approach or calculations. He noted that he thought the business typically prepaid expenses each year, but he acknowledged that there was no record that it had done so prior to December 2013. He also explained that, even though appraisers should visit the business they are valuing, it sometimes proved hard to do so because the opposing side might not cooperate.

Asset approach prevails in trial court. The trial court adopted the business valuation the wife's expert proposed, saying it was the "most conservative and directly relevant—and therefore the most equitable"—determination. Using the three-year average earnings the wife's expert had determined, the court found the husband's earning capacity was nearly $255,000. Accordingly, it ordered the husband to pay monthly spousal support of nearly $6,300 for an indefinite period, reserving the right to change the amount and spousal support period.

No future income stream in play. The husband attacked the trial court's findings essentially on two grounds: double dipping and relying on a valuation whose methodology was fatally flawed. The Court of Appeals considered the arguments in turn.

Double dip. The gist of the husband's double dip claim was that, notwithstanding the asset-based valuation, the testimony of the wife's experts showed that the accounts receivable in play was analogous to "future business profits" or a "future stream of income," as contemplated in *Heller* and subsequent decisions from the Ohio Court of Appeals. Under these circumstances, an asset-based approach does not preclude the occurrence of a double dip.

Citing to a 1990 Wisconsin case that prohibited any account receivable from being classified as a marital asset and as income includable in the spousal support calculation, the husband claimed the wife's expert did just that in his business valuation and determination of income subject to the spousal support award. The trial court should have adjusted the income for 2014 to counteract the double dip attributed to the accounts receivable.

The Ohio Court of Appeals dismissed the argument for several reasons. First, the record suggested that the portion of the accounts receivable the expert considered in the business valuation was eliminated when he averaged the husband's earnings to determine income available for spousal support.

Further, Ohio's statutory provision on spousal support expressly requires the trial court to consider income of the parties *from all sources* (court's emphasis) "Thus, in a divorce where a spouse owns a business, merely considering the same assets in both a business valuation and in an income evaluation is not in error and is likely unavoidable." According to the Court of Appeals, the risk of double counting arises only when a court twice dips into a *future income stream*, which is avoidable if the business valuation is based on an asset approach, as it was in this case (citing *Gallo v. Gallo*, 2015-Ohio-982).

Also, not only was the Wisconsin case not controlling authority, but it was also not persuasive, the Court of Appeals in the instant case found. The Wisconsin decision left it unclear whether the Wisconsin court considered only the accounts receivable on hand, future accounts receivable, or both.

Moreover, the accounts receivable the wife's expert in the instant case added into his business valuation did not represent "future income streams" for the purpose of a double dip analysis. The cash and accounts receivable were *present* assets of the company, the Court of Appeals emphasized.

The court explained that Ohio law did not provide a ready definition of "future income streams," but cases such as *Gallo* and *Bohme* suggested the phrase meant the "projected, ongoing value of an asset." *Gallo* specifically mentioned "pensions, business and professional goodwill, and dividend-yielding stock" as the kind of asset that produces future income streams, the court observed. *Bohme* mentioned pensions and annuities as future income streams to which the double-counting framework might be applicable. See *Bohme v. Bohme*, 2015-Ohio-339.

Further, in a post-*Gallo* decision, the trial court treated the accounts receivable that was included in the prevailing asset-based valuation as present, not future, income, the Court of Appeals noted. See *Sieber v. Sieber*, 2015-Ohio-2315.

Accordingly, "under *Gallo* and considering the facts of this case, even if the record could establish that the same cash and accounts receivable were actually considered twice, no double dip occurred," the Court of Appeals concluded. The trial court did not err when it calculated the husband's income for spousal support and adopted the asset-based valuation of the wife's expert.

Flawed methodology. The husband claimed it was wrong for the trial court not to consider the tax increase resulting from the expert's adding back expenses when adjusting the company's balance sheet. The applicable statute required the trial court to consider the tax consequences of the awards to each spouse.

The Court of Appeals said the applicable statutory provision did not require the trial court to perform an independent examination of the tax consequences of the adjustments an expert made in valuing the business. Nor was there evidence in the record of what the tax benefits were of prepaying expenses.

Another argument as to why the valuation was defective was that the wife's expert did not obtain appraisals of the business assets and did not visit the site or talk to the husband or his business accountant.

This argument also had no traction with the court. The husband did not cite to any case supporting his claim that it was a "fundamental concept" that asset valuations require the fair market value of the assets. Moreover, the husband's expert affirmed the accuracy of the opposing expert's calculations and methodology and noted the difficulties in divorce cases of ob-

Continued on next page...

taining access to a business. Also, at trial, the husband did not contest the equipment values the wife's expert used.

The trial court did not abuse its discretion when it relied on the adjusted net asset valuation the wife's expert offered, the Court of Appeals concluded. It affirmed the judgment.

This newsletter is a publication of Barrett Valuation Services, Inc. This firm specializes in providing business valuation services for closely-held companies, primarily for estate planning and litigation support purposes. John E. Barrett, Jr. is a Certified Public Accountant Accredited in Business Valuation by the American Institute of Certified Public Accountants (AICPA), Certified Valuation Analyst and a member of the National Association of Certified Valuators and Analysts (NACVA), a Certified Business Appraiser and a member of the Institute of Business Appraisers (IBA), and an associate member of the American Society of Appraisers (ASA). This firm subscribes to the Uniform Standards of Professional Appraisal Practice (USPAP) and has experience in providing valuation conclusions that are supportable and credible. For further information on how BVS can serve your business valuation needs please call.

John E. Barrett, Jr., CPA/ABV, CBA, CVA
Barrett Valuation Services, Inc.
989 Reservoir Avenue
Cranston, RI 0910
Phone: (401) 942-3900
Fax: (401) 942-3988
Email: info@BarrettValuation.com
www.BarrettValuation.com

Read Rhode Island and Massachusetts BV Court Cases at www.BarrettValuation.com

BVS
Barrett Valuation Services, Inc.
The Business Valuation Advisors
989 Reservoir Avenue
Cranston, RI 02910
Return Service Requested

Recent Valuation and Taxation Opinions Affecting Your Family Law Practice