# Valuation Verdicts®

Current Valuation & Taxation Rulings Regarding Divorce



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## Business Debt Renders Expert's Lack of BV Credentials Inconsequential

**In re. *Sternat v. Sternat,* 2015 Wisc. App. LEXIS 776 (Oct. 28, 2015). A** recent divorce case featured a noteworthy challenge to the prevailing testimony of the wife's expert. The husband claimed the opinion of the wife's expert was unreliable because the expert had fewer credentials as a business valuator than did the husband's expert. The court found under the circumstances business valuation experience did not matter very much.

**Business awash in tax problems.** The company was a healthcare staffing agency that the wife set up in 2005. The wife was its president, and the husband was responsible for payroll processing and invoicing. Throughout the company's history, the wife ran into problems with the Internal Revenue Service for failing to pay payroll taxes. She defaulted repeatedly on a formal repayment plan the agency put in place, but she made "good faith" payments. To keep the business operating and deal with its debt, she secured several loans. At the time of divorce, the business had accumulated approximately $200,000 in debt.

At trial, both parties presented expert testimony. The husband's expert was a CPA and credentialed business valuator, who also was certified in financial forensics. She was experienced in testifying in a litigation setting in business valuation matters. She determined that the company's fair market value was $230,000, notwithstanding its debt. She acknowledged that, for the company to have any marketable value, it would need to be a going concern.

The wife's expert was an experienced CPA with no business valuation credentials. His practice specialized in working with "problem tax clients," he stated. He also said he had performed business valuations for buyers and sellers. Further, he had represented the company in its dealings with the IRS and was "intimately familiar" with its income, expenses, and the nature of its tax debt. The source of the company's financial problems was "mismanagement," he acknowledged. He concluded the company was no longer a going concern and assigned zero ($0) value to it.

The trial court adopted the zero value the wife's expert proposed.

A related issue was how to treat the business's $200,000 in debt stemming from the wife's failure to pay payroll taxes. The husband argued, under controlling case law, the debt represented marital waste. By her conduct, the wife had squandered marital assets.

The trial court disagreed. It allowed that the wife's decision not to pay payroll taxes "wasn't a very smart business decision, in fact, it was probably very bad." It likely could "cause the collapse of this company," the court added. But the court decided to treat this liability as marital debt subject to equal division. Both spouses worked for the business, and the husband, almost from the beginning, was aware that the taxes remained unpaid. The husband, in fact, testified the debt did "not really" create a problem between him and the wife, the court noted. And it pointed out that the wife made continuous, albeit unsuccessful, efforts to pay down the debt.

Post-trial, the husband filed a motion for reconsideration, arguing that the opinion of the wife's expert was inadmissible under the state's statute on expert testimony. That statutory provision essentially adopted the Daubert standard on reliability. The wife's expert lacked the necessary business valuation expertise and was unqualified to testify, the husband contended.

The trial court allowed that the husband's own expert was "eminently qualified" and "did a very good job." She "might have come out ahead," had it been a question of who was "the better expert on business valuation." But, given the company's ever-increasing liabilities, it was not a going concern, the trial court decided. Accordingly, the court denied the husband's motion.

**Valuation a 'non-issue.'** The husband appealed the judgment with the state Court of Appeals. He argued

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the trial court committed two errors. One, it admitted the opinion of the wife's expert even though that expert had less business valuation experience and fewer credentials and professional affiliations than the husband's expert.In that regard, the husband also noted the wife's expert based his opinion only on the expert's experience working with the company and on the company's financials. This narrow approach made the expert's opinion unreliable. In contrast, the husband's expert used a "broader array of data and valuation methods," the husband contended.

The appeals court was not persuaded. The key issue for the trial court was whether the business was a going concern and would still be in business in 12 months, the appeals court said. There was ample evidence to support the trial court's conclusion that it was not a going concern. "Valuation thus was a non-issue," the appeals court said. Even if allowing the wife's expert to testify were error, the error would be harmless. The testimony did not interfere with the husband's substantial rights, the appeals court added.

According to the husband, the trial court also erred when it declined to consider the business's debt marital waste. The appeals court again disagreed. The trial court's decision to assign the debt to both parties was based on the involvement of both spouses in the business and the husband's awareness of the unpaid taxes, the court observed. It was not error for the trial court to find that both parties benefited from the business when it was doing better and "that the debts were incurred in the interest of the marriage," the appeals court said. It added that the trial court's "reasoned refusal" not to divide the debt equally was a proper exercise of its discretion. The appeals court affirmed the trial court's valuation of the business.

## Ohio Appeals Court Clarifies Provision on Tax Affecting at Divorce

**In re.** ***Nieman v. Nieman,*** **2015, Ohio App. LEXIS 5021 (Dec. 14, 2015).** An Ohio divorce statute requires a court to consider the tax consequences of the property division. But case law says that taxes are only a proper consideration in valuing a business when they are not "speculative." Recently, the Ohio Court of Appeals reviewed a trial court's decision to tax affect even though the owner spouse did not contemplate a sale anytime soon and the distribution of assets did not require him to sell his business interests. This decision provides valuators with a test of what "too speculative" means.

**Similar pretax valuations.** The husband, an orthopedic surgeon, held a minority interest in four companies related to his practice. At divorce, the parties' assets were substantial, and for trial both spouses retained financial experts to determine the value of the husband's ownership stake.

The husband was 44 years old when he filed for divorce. He indicated he planned to remain in the community in which he was working at the time. He did not indicate he planned to sell his ownership stake in any of the businesses anytime soon or at any time before retiring. The record suggested he might have to sell his interest in one of the businesses when he retired. But it was unclear as to whether he would need to sell his interest in the other businesses at retirement or ever.

The appraisers' pretax valuations were close. The husband's expert calculated that the husband's interest in the four businesses before accounting for taxes was about $4.74 million. The wife's expert arrived at an aggregate value of just above $5 million.

The husband's expert also performed a valuation that considered the tax effects related to a possible sale of the ownership interests. He said he used the current tax rates. He explained that, since the tax rates and the husband's current income were known, the valuation was not based on speculation. He did not believe the tax rates would change much in the near future. Under this calculation, the value of the husband's interest dropped by over $1 million.

In support of tax affecting, the husband cited the applicable code, ORC Ann. Section 3105.171(F)(6), which provides that "the Court … consider the tax consequences of the property division upon the respective awards to be made to each spouse."

The husband claimed "there will be some tax consequences associated with the disposition of these assets … at the time the asset is distributed." At this

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particular time, he said, the parties were dividing the assets, which meant a distribution, disbursement, or transfer of assets was occurring." There was "a known set of economic circumstances and a known and determinable tax calculation as a result."

The wife's expert did not tax affect because it was "speculative" and not done as "a general practice."

The wife acknowledged the cited statutory provision but argued against factoring in the tax consequences where the asset was distributed pursuant to divorce but was not liquidated at the same time.

The trial court favored the husband's position even though "the considerations and offsets made at this time may in fact not be actually what would occur at the disposal of the asset in the future due to the changing nature of the economic conditions of the parties individually or any changing tax code."

According to the trial court, the wife's argument would make it impossible to consider the tax consequences except in a case in which there was an immediate disposition of the property. "Under the statute the Court can determine the current tax consequences and consider the same in distributing the property," the court decided.

The trial court valued the interests in the four businesses at approximately $3.3 million. The court's calculation also factored in noncompete clauses at $100,000 for two businesses. Applying a 40% tax rate to them, the court added the remaining $60,000 to the value of the two businesses. Even though the wife questioned whether it was appropriate for the trial court to value the noncompetes, she did not raise this issue on appeal. In the final analysis, the trial court deducted more than $1 million for tax consequences from the valuation of the husband's business interests.

**Test for 'too speculative.'** The wife appealed. The gist of her argument to the state Court of Appeals was that the taxes in this case were too speculative based on prior appeals court decisions that dealt with similar circumstances. The trial court erred when it factored the tax consequences of a potential sale of the businesses into its valuation, the wife contended.

The Ohio Court of Appeals agreed with the wife's argument. At the start of its analysis, it noted that, notwithstanding the statute, the very court in an earlier decision said: "Tax consequences of property division … awards are proper considerations … as long as those consequences are not speculative." See Day v. Day, 40 Ohio App. 3d 155 (1988).

The appeals court noted that cases that have found taxes were "too speculative" involved the following situations:

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. The husband indicated a desire to sell his businesses at the time of retirement, but the retirement date was uncertain. And retirement likely would occur in the distant future considering the husband was only in his 40s at the time of divorce.

The trial court used the current tax rates, but doing so required it to assume the tax rates would be the same or substantially the same in the future. But, said the appeals court, by the time the husband was ready to sell his business interests, "they could be worth far more, or far less. His percentage share could have grown larger or smaller, or the capital gains tax could rise or could be abolished." Consequently, a court would "necessarily" engage in speculation if it imposed "a present-day tax-affect upon the value of the businesses in this case."

Moreover, there was no indication that the distribution of the assets required the husband to sell his businesses, the Court of Appeals found.

The husband contended that the earlier appellate court decisions erroneously cited to the "speculative" language in Day even though in that case the appeals court allowed the trial court to deduct future tax consequences from a retirement plan. He also cited to other cases in which he claimed Ohio appellate courts gave trial courts discretion to consider speculative tax consequences.

The Court of Appeals dismissed the husband's claims. It noted that the line of cases the husband cited related to retirement plans; as such they were not as persuasive as the cases the wife cited. The latter decisions were "directly on point and related to business valuation in particular," the court said.

Under the facts, the taxes were too speculative, the Ohio Court of Appeals concluded, ordering the trial

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court to recalculate the value of the husband's business interests without factoring in tax consequences of a potential sale. The appeals court added that the redetermination would require the trial court to distribute additional assets.

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