Spring 2017

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

Expert's Best-Effort Medical Practice Valuation Holds Up on Appeal

In re Ramundo v Ramundo, 2017 NJ Super. Unpub. LEXIS 443 (Feb. 24, 2017). A recent New Jersey divorce case revolving around the valuation of a chiropractic practice is a good example of how a skilled valuation expert may produce a credible, if incomplete, appraisal when denied access to vital information by the opposing party. Here, even though the expert's analysis did not address such fundamental issues as goodwill, the appeals court declared the testimony "reasonable and competent."

The husband owned a successful chiropractic practice, which he had set up two years before the marriage, as well as a business spun off from the practice. Throughout litigation, the husband disobeyed discovery orders and failed to make financial documents available in a timely manner. Because of his contumacy, the trial court limited his participation to cross-examination.

The wife's expert valued the practice based on limited data using the capitalization of earnings method. He determined that the business's annual gross revenue was about $1.6 million. He added back expenses the business paid for, but which he did not consider legitimate business expenses. The expert's reasonable compensation determination was based exclusively on survey data. The expert never received a breakdown of the time the husband actually spent working at the practice or the number of patients the husband saw. Details about the actual conduct of business might have changed the reasonable compensation calculation, the expert admitted. The expert determined his discount rate by balancing factors such as the practice's strong referral base and the practice's being well-established with the fact that there was a problem with limited parking, which affected the number of patients who could be seen. The practice was worth $1.2 million, the expert concluded.

As a check, the expert also performed a market-based analysis using data from the Institute of Business Appraisers, BIZCOMPS, and Pratt's Stats. This analysis produced a value of $983,000.

The expert acknowledged that he was unable to develop the premarriage value of the business because he never received the tax returns covering that period. He also said missing financial data made it impossible to perform an excess earnings or "goodwill" analysis.

The trial court record was replete with instances in which the husband had failed to comply with discovery orders. The court adopted the wife's expert's $1.2 million valuation but only awarded the wife a one-third interest in the business: almost $403,000.

In appealing the valuation findings, the husband tried to exploit gaps in the valuation analysis and mischaracterized a number of the expert's trial statements to argue the valuation was "not supported by credible evidence." For example, the husband claimed the expert "admitted" that he "arbitrarily excluded certain expenses, which, if included, would have yielded a substantially lower value for the practice." The record showed the husband's characterization was "misleading," the appeals court said. In fact, the expert specifically said the exclusion was not arbitrary, and he "thoroughly explained his reasoning and thus established a solid basis" for removing certain expenses.

Moreover, the husband alleged it was unprofessional for the expert not to consider information the husband had submitted the weekend before the trial. The appeals court dismissed the argument as "wholly without merit." The trial court forbade the husband to make late submissions, and it did not allow the expert to consider any late material.

The expert had a "complicated" job given the husband's refusal to follow discovery orders, the appeals court observed. He used the information available to

Continued on next page...

produce a valuation the trial court duly considered and found credible. Accordingly the appeals court affirmed the trial court's value findings.

Court Upholds Inclusion of Premarital Value in Property Distribution

In Code & Code, **2016 Ore. App. LEXIS 1003 (Aug. 17, 2016).** In an Oregon divorce case involving a podiatrist practice, there were two sticking points: the valuation of goodwill and the treatment of the premarital value of the practice. The owner-spouse appealed the trial court's decision to attribute most of the goodwill to the business and to treat the entire business as a marital asset.

Eleven years prior to the marriage, the husband set up his own practice. It was successful, providing an average annual income that was well above the average income for a podiatrist in the state.

At trial, the wife's expert used an excess earnings approach and determined 60% of the business's goodwill was enterprise goodwill; the remainder was personal to the husband. The expert said the value of the enterprise goodwill, $360,000, plus the value of tangible assets was the value of marital property subject to equitable distribution.

The husband's expert maintained that in general enterprise goodwill could be anywhere from 0% to 33%. Here, it amounted to 24% of the total goodwill. The expert concluded the amount subject to equitable division was the net fair market value minus the personal goodwill, i.e., $16,000.

The husband's expert also valued the business as of the year immediately preceding the marriage. Collections then were about half the collections in the year prior to divorce, he determined. As a result, the husband argued the business had zero value for purposes of equitable distribution.

The trial court credited the testimony of the wife's expert but made a "slight" modification to the calculation and arrived at an FMV for the practice of $304,000.

The court awarded the husband the business and used the FMV of the business for equalization payment purposes. It declined to exclude the premarital value from its calculation.

The husband appealed, arguing the wife's expert "merely pulled a number out of thin air for enterprise goodwill." The appeals court noted it was bound by the trial court's findings if supported by "any" evidence. Here the "any" evidence was the testimony and report of the wife's expert.

The husband also claimed it was error for the trial court not to award him the premarital value of the practice. The appeals court noted that the applicable statute directs trial courts to divide property in a way that is "just and proper in all the circumstances." Ultimately, the appeals court said, the trial court's decision comes down to whether the property division is equitable in view of all the circumstances of the parties.

Here, the trial court used the correct analytical framework to arrive at its final valuation and distribution of the practice. The appeals court pointed to the trial court's explanation that there was commingling of assets and that it took into account how the distribution of assets and debts squared with the parties' circumstances.

Consequently, the appeals court affirmed the trial court's valuation for purposes of equitable distribution.

In Solo Practice Valuation

In Fuller v. Fuller, **2016 Tenn. App. LEXIS 974 (Dec. 21, 2016).** In an important ruling, the Tennessee Court of Appeals recently explained why and how trail income resulting from a financial planner's solo practice was different from goodwill. The trial court considered the practice's continuing trail income a marital asset, whereas the goodwill attributable to the husband was not. The appeals court agreed. The crux of the matter was salability. The appeals court also found a related double recovery issue.

Two types of income. During the marriage, the husband became a certified financial planner and set up his own company. He was affiliated with a broker dealer but had no partner(s). The business was the husband, a desk, and a computer.

At trial, the husband explained the business generated two different kinds of income. One was in the form of direct commissions stemming form the sale of financial products. The other kind was "trail" income - ongoing earnings from managing client funds and accounts. The trail income made up the majority of his earnings. Of the company's total revenue for 2014, the trail income was $220,000 and the direct commissions amounted to $50,000.

At trial, the husband conceded that a financial planning practice typically sells for one times the annual value of income because of the direct commissions plus two times the annual value of trail income. The husband explained that, if there were a sale of the practice, his clients were not required to keep their accounts with the new owner. Therefore, the sale price would be paid over a period of time to ensure client retention.

Moreover, the husband admitted that in case of death or disability, he could assign the trail income to another professional to maintain an income stream for himself and his family. An agreement would entitle the assignee to a percentage of the ongoing trail income.

The husband and wife stipulated to testimony from a veteran financial planner who explained that for purposes of valuing a financial planning practice the "guideline is two times a year's trail, plus...one times the [direct] commission."

The trial court determined that the trail income generated by the husband's continuing management of client accounts was a marital asset subject to equitable distribution. The trail income was worth $400,000, half of which belonged to the wife, the court ruled. In addition, court awarded child support and alimony to the wife based on the husband's income from the financial planning practice, specifically, the average of revenue during the past two years.

On appeal, the husband objected to the classification and valuation of the trail income as well as the trial court's child support and alimony determinations.

Assets of a different nature. In terms of the trail income ruling, the husband argued that the business depended solely on his efforts to produce income. It had no tangible assets and no value besides the husband's professional (personal) goodwill. Under state law, professional goodwill in a sole proprietorship was not a divisible asset. Therefore, the trial court erred in awarding half of that income to the wife.

The wife in turn claimed the trial court correctly ruled the trail income resulting from the practice was separate from goodwill and subject to distribution.

The Tennessee Court of Appeals upheld the trial court's ruling. It began its discussion with a review of the legal principles applicable to goodwill issues. "[I]t is well settled under Tennessee law that professional goodwill is not a marital asset that can be divided in a divorce proceeding," the court said. The reason, the court explained, is because it would be unfair to compel a professional practitioner to pay a spouse a portion of an intangible asset, as determined by the court, when that asset was not saleable or could be liquidated by other methods.

Citing controlling case law, the appeals court said that although a business's good reputation, "which is essentially what its good will consists of," has value to the individual owners in that it assures continued substantial earnings in the future, "[i]t cannot be separately sold or pledged by the individual owners." See *Smith v Smith,* 709 S.W.2d 588 (Tenn. Ct. App. 1985).

"By contrast," the Court of Appeals in the instant case emphasized, "the trail income under review in the present case could be sold or assigned by the Father [husband], as he acknowledged." What's more, the court noted, an industry expert confirmed the husband's testimony that there were guidelines for valuing a financial planning practice in the event of a sale depending on what was being sold: the practice and therefore the direct commissions as opposed to the trail income that continued to flow from the management of client funds and accounts.

The fact that trail income could be sold separately was "a controlling actor, distinguishing its nature as an asset from the concept of goodwill," the Court of Appeals ruled.

Based on the applicable valuation formula, the appeals court affirmed the wife's right to half of the $400,000 trail income.

Double counting. The husband also found fault with the trial court's calculation of income available for child and spousal support. However, it was the Court of Appeals that brought up "another question" concerning the income determination. In basing the husband's income amount on the total revenue the practice generated, the trial court "appears to have included the trail income that was also divided as a marital asset," the appeal court noted.

Under the applicable statutory provision, Tenn. Code Ann. §36-4-121(b)(1)(E), "assets distributed as marital property will not be considered as income for child support or alimony purposes, except to the extent the asset will create additional income after the division."

Continued on next page...

Consequently, the appeals court said, the trial court should have deduced the amount of the trail income subject to distribution as a marital asset. It added: “The [trial] court should consider, however any additional income generated by this asset after the division.”

The Court of Appeals set aside the child and spousal support determinations and ordered the trial court to recalculate the husband’s income.

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

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

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