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Valuation Verdicts®

Current Valuation & Taxation Rulings Regarding Divorce

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Improper Use of Active/Passive Framework Skewers Valuation

In re Bair v Bair, 2017 Fla. Super. App. LEXIS 3737 (May 22, 2017). When confronted with quantifying the appreciation of nonmarital property, it is common for valuators first to classify the change in value as "active" or "passive" and then do the valuation. A recent Florida case shows that, when applied prematurely, this active/passive analysis may result in an improper valuation.

The parties fought over the valuation of the husband's interest in a boat dealership - a family business that was organized as an S corporation. The corporation also owned real property whose value had dropped significantly during the relevant portion of time.

The parties agreed the husband's ownership interest was separate. They also agreed that the husband's efforts had contributed to an increase in the company's value during the marriage. But they disagreed over how much the company had appreciated in value and how much of the appreciation was the result of the husband's marital labor. The trial court adopted the company valuation the wife's expert proposed, which was about $1 million higher than the value determination of the husband's expert. Further, the court largely adopted the wife's expert's calculation of the marital labor.

On appeal, the husband contested a number of the trial court's valuation-related findings.

The wife's expert had "refused to include" the value of the real property in his company valuation, arguing that the change in value of this asset was passive in nature, that is, the result of market forces rather than the husband's management.

The husband claimed that excluding a major asset of the corporation from the valuation was a serious error of law that necessitated a reversal of the equitable distribution decision. The Court of Appeal sided with the husband. Florida law requires that the valuation of a company include *all* of the company's assets and liabilities, the reviewing court explained. "In other words, the sum of *all* parts, not a select few, is what encompasses a business's 'value.'" Further, it is improper to exclude the appreciation or depreciation of certain company assets as "passive" when one party's marital labor contributed to the change in value of the company as a whole, as was the case here, the appeals court emphasized.

Had the husband, rather than the company, owned the real estate, the concept of active or passive appreciation might come into play, the appeals court said. In that situation, the passive appreciation or depreciation *might* be excluded from the term "marital assets." Here, however, the owner was the company, which the husband's marital labor "indubitably" increased. By excluding the real estate from the valuation of the company, the trial court overvalued the company by almost $1 million, the appeals court said.

The Court of Appeals also agreed with the husband that the trial court's valuation double counted retained earnings in favor of the wife. The trial court had discretion to value the company by including the retained earnings and distributing that value. "But having done so, it could not then order distribution of the retained earnings while still valuing [the company] as if the retained earnings were retained as this would result in impermissibly including the same asset twice."

The appeals court also noted the trial court did not seem to understand what retained earnings were; it considered them to be "some type of corporate savings account, which it is not." The trial court acted as if the husband, "unquestionably a minority shareholder," had a direct interest in the retained earnings and could simply order their distribution, when this was not the case, the appeals court said.

Moreover, the husband successfully contested the trial court's alimony determination. The trial court found that the income for purposes of spousal support was the husband's K-1 income, which reflected his share of the business income whether distributed or not. Under Florida law, however, undistributed pass-through income the corporation had retained for corporate purposes "must not be used by a shareholder-spouse to satisfy financial obligations imposed upon dissolution of marriage." If the undistributed income has been retained for noncorporate purposes, to shield it from the reach of the other spouse in divorce proceedings, an improper motive exists that makes the money available as income.

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Here, the appeals court found, there was no evidence that the company retained undistributed pass-through income for noncorporate purposes. The court of Appeal remanded for a new valuation and new spousal support calculations.

Double-Dip Claim Fails to Resonate with Appeals Court

In re Marriage of Kirkendoll, 2**016 Wash. App. LEXIS 2357 (Oct. 4, 2016).** In a recent Washington state divorce case, the appeals court delved into "the notion of the impermissible 'double dip'" and explained why the concept was not applicable to the facts of the case.

The dispute centered on the couple's only income-generating asset, a company that sold manufactured homes. In 2007, the spouses bought the company for $1.2 million. When shortly after the purchase the housing market collapsed, the wife went to work outside the company. In 2014, the husband filed for divorce.

Only the husband offered expert testimony at trial. His CPA expert determined the company was worth $100,000. She said all of the value was business goodwill. Her calculation primarily was based on five years' worth of tax returns (2009 through 2013) the husband provided. When cross-examined the expert conceded her time frame coincided with the worst period in terms of home sales "since the Great Depression." She allowed the 2014 figures indicated a considerable turnaround for the company. The trial court found the expert's responses "support a valuation in the $200,000 range."

It awarded the company to the husband. For purposes of equitable distribution, the court relied on an exhibit the wife submitted that suggested the business was worth between $100,000 and $1.2 million. Based on this range, the court awarded assets to the husband of between $300,000 and $1.4 million, and it awarded assets to the wife worth about $274,000.

Relying on the husband's 2014 tax return, the court found his income that year was over $12,400 per month whereas the wife's income was about $3,900. The court used these figures to award the wife long-term maintenance in the amount of $3,000 per month.

On appeal, the husband attacked the court's distribution of assets and its spousal support order from different angles. He contended the trial court had erred when the court considered a $72,000 sum the husband had taken from the business to pay business taxes and debts as the husband's separate asset. This was not disposable income for purposes of determining spousal support, he said.

He also argued that, by awarding him the value of the company and the $72,000 from the business, the trial court "effectively" and impermissibly awarded him the same asset twice.

The appeals noted the husband was trying to invoke the "impermissible 'double dip.'" He cited a 1991 case that had found impermissible double counting where the trial court had awarded the wife a lien on the family salvage business as well as a monthly maintenance award. The husband in the case was selling off the existing scrap and had no plans to acquire more. The proceeds to the husband from the business were from liquidating its assets not from its operation.

The appeals court in the instant case distinguished the 1991 case. In the early case, the business was a "diminishing asset," it said, whereas in the instant case, the company awarded to the husband remained a going concern. Another difference between the two cases was that the trial court in the instant case awarded the husband the $72,000 of business income as well as the business itself. It neither awarded the wife the $72,000 nor a portion of the business, the appeals court noted.

The appeals court also pointed out the husband had cited no authority that said a trial court should not award business income used to pay taxes or debt related to the business as separate property to the same person it awarded the business itself.

The appeals court affirmed the trial court's business valuation and income findings.

Dip Analysis

In re Marriage of Cheng, 2**016 Wash. App. LEXIS 2854 (Nov. 22, 2016).** A recent Washington state divorce case, *In re Marriage of Kirkendoll*, briefly discussed "the notion of the impermissible double dip." Double dip (double-recovery) claims may arise when a business valuation is based on the income approach an the trial court awards the nonowner spouse both a portion of the business value and considers the income from the business in its determination of spousal support.

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Because different state courts handle the double-dip issue differently, it may be challenging for valuators to know the law in a given jurisdiction. A new Washington state case provides a more in-depth analysis than the *Kirkendoll* case and clarifies the analysis.

Maintenance must be 'just.' The husband founded a management consulting and distance learning business during the marriage. Over the years, he became a recognized expert in the consulting field and achieved significant growth for his company. In 2009, gross revenue was $275,000, but, by 2013, the year the husband and wife separated, revenue had increased to $1.54 million. The same year, the husband's income was nearly $943,000 - almost all came from the company. The husband projected that revenue in 2014 would match that from 2013.

At trial, both parties presented expert testimony on the value of the company. The valuators agreed on the capitalization of excess earnings approach but used different replacement income figures. According to the husband's expert, the market wage for a replacement for the husband was $300,000; the wife's expert found the wage was $245,000. The trial court credited the wife's expert on this point. (The appeals court opinion does not provide further detail on the expert testimony.)

The trial court noted the company "has significant goodwill and profits, has experienced significant growth and will, more likely than not, continue to enjoy significant growth in the near future." It seems the trial court split the difference in the expert valuations and determined the company was worth $3.6 million.

The trial court awarded the company to the husband and awarded half of the value to the wife. In addition, it granted the wife monthly maintenance support of $20,000 for eight months, $15,000 for the next two years, and $10,000 for another year.

The husband argued giving the wife maintenance payments and half of the value of the company represented double recovery. The trial court rejected the argument as a matter of law.

The husband appealed. The state Court of Appeals began its review by noting Washington state spousal support law required trial courts to consider "all relevant factors including but not limited to" six factors set forth in the applicable maintenance statute (RCW 26.09.090). Trial courts have great discretion in awarding maintenance, the appeals court observed. The overriding concern is that the award by "just." Relatedly, "when maintenance and property awards are paid from the same asset in a manner that unfairly burdens the payer spouse, the maintenance award duplicates the property division of that asset," the appeals court said.

Not a diminishing asset. In terms of case law dealing with the double-dip issue, the seminal case is *In re Marriage of Barnett*, 818 P.2d 1382 (1991). The asset in *Barnett* was a salvage business that included real property and scrap meta. The trial court awarded the wife a lien on the business as well as a monthly maintenance award. The state Court of Appeals found the trial court wrongly had distributed the same asset twice to the wife. It was clear that the husband would sell the remaining scrap and not acquire more. He had no other source of income. His proceeds from the business came from liquidating its assets, not from the future sale of salvage. At the same time, the appeals court found maintenance was appropriate until the business was sold and the wife had received her share of the property value or until interest started accruing on the lien.

The Court of Appeals in the instant case noted that the key fact in the *Barnett* case was that the property the court divided was a diminishing asset. The "unstated" assumption was that, after the parties' assets had been divided, the husband could not pay the maintenance without eroding the portion of the asset left to him, the Court of Appeals explained.

In the instant case, however, the business was not a diminishing asset but a going concern that would continue to grow, the court noted. Experts for both spouses determined that the company would generate annual income to the husband into the foreseeable future in the neighborhood of $927,000 similar to what the husband had received in 2013. The husband was not required to erode the company's value to pay maintenance, the appeals court pointed out.

The appeals court also considered in *Re Marriage of Valente,* 320 P.3d 115 (2014), a case in which the husband claimed there was double recovery because the business was valued based on its future stream of income and the wife had obtained a portion of the value of the business. According to the husband, the wife was already compensated for her interest in the income stream from the business. The appeals court in *Valente* said there was no double recovery because the amount of reasonable replacement compensation for the husband was "carved out of the income streams used for the valuation."

The husband in the instant case tried to distinguish *Valente* by arguing in *Valente* the replacement compensation ($400,000) was sufficient to support a $120,000 annual maintenance award. By contrast, in the instant case, the monthly replacement income would not be able to cover the high maintenance award to the wife. Consequently, the trial court must have considered more than the replacement compensation in its determination of income available for maintenance, the husband claimed.

The Court of Appeals rejected the husband' argument. The court said no ruled required the trial court "to consider only a business owner's replacement

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compensation in determining maintenance when the other spouse has been awarded a portion of the business's value." Regardless of the property distribution in the instant case, the husband would have at least $927,000 a year to pay the wife's maintenance "*without having to erode [the business's] value.*" (emphasis in original) The trial court did not err in awarding maintenance based on the husband's full income, the appeals court said.

The takeaway from the court's decision is there is no double recovery (double dipping) where the business continues to operate and generate net profit available to the owner spouse as income with which to pay maintenance.

The Court of Appeals affirmed the trial court's maintenance rulings.

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