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Current Valuation & Taxation Rulings Regarding Divorce

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Michigan Court Explains How to Handle Retained Earnings in Divorce Cases

In re Jensen v Jensen, 2018 Mich. App. LEXIS 40 (Jan. 9, 2018). This Michigan divorce case involving an S corporation that was the owner's separate property raised a number of valuation-related questions, including an issue of first impression: Are the earnings a closely held company retains during the marriage includable in the marital estate, such that the nonowner spouse has a claim to them? In answering this question, the Michigan Court of Appeals rejects all bright-line rules but instead provides a set of guidelines for trial courts to resolve the issue.

Trial court proceeding. The marriage was short. The husband had significant premarital assets, including a company that customized commercial trucks and the property that the company leased. The company was organized as an S corporation. The parties fought over the valuation of the company, specifically the increase in value. Relatedly, the wife claimed that any retained earnings of the business not accounted for in determining the increase in value was marital property and as such divisible.

Valuation dispute. Both parties retained valuation experts. To determine the company's value as a going concern, both experts' used an income approach and calculated the company's EBITDA margin. The experts arrived at similar values for the company at the start of the marriage, but their valuations at the date of separation were eons apart.

The enormous value gap seems to have stemmed from a disagreement over which financial data to use and the formula for calculating the EBITDA margin. In testimony, the husband's expert said he had interviewed the husband about the company and had reviewed its internal financials. The wife's expert testified that he had not done this. The husband's expert concluded that, during the two-year marriage, the company's value increased by \$400,000. The wife's expert determined the company's worth had increased by over \$2 million.

The trial court credited the husband's expert. That expert's calculation was "more detailed" and "involved seeing the site, interviewing the owner of the business, understanding the business in more detail," the court said.

Without analysis, the trial court rejected the wife's proposition that the earnings the company retained during the marriage were marital property.

Admissibility of expert opinion dispute. At trial, the wife at various points unsuccessfully challenged the admission of the opposing expert report. (The Court of Appeals opinion is vague about some of the underlying facts, which makes it difficult to report on the arguments.)

The wife seems to have argued for exclusion of the report because it included financials that had not been produced and not been placed into evidence. However, it seems the husband's expert testified that he relied on those records in formulating his opinion and the wife's attorney cross-examined the husband's expert on the difference in valuation that was attributable to the contested financials. The wife's lawyer did not seek to strike the opposing expert's testimony. In the end, the trial court admitted both the report and the testimony by the husband's expert.

Appeals court proceeding. Both parties appealed aspects of the trial court's findings.

Husband's claim. According to the husband, the company represented separate property. Because the wife did not make substantial enough contributions to increase the value of the business, she had no right to any portion of the increase. The trial court erred when it included the increase in value in the marital, divisible estate, the husband contended.

The Court of Appeals rejected this argument. It noted that there was evidence that the wife supported the husband's efforts to run the company, even though the trial court found the wife did not directly contribute to the company. The appeals court noted the trial court had not determined whether the wife provided sufficient indirect support. But, said the appeals court, "even if [the wife] did not indirectly support [the husband's] efforts, [his] efforts alone warranted treating the increased value of Arista as a marital asset."

Under the applicable case law, an increase in the value of a separately owned asset belongs to the marital estate when the increase occurs as the result of one spouse's active efforts

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the appeals court explained. It noted that the increase in value might be includable under two theories: one is to consider the increase an indirect contribution of the nonowner spouse; the alternative is to consider it an appreciation owing to one spouse's active efforts. "It is only when a separately owned asset increases in value without regard to either spouse's active efforts that the increase will remain separate property," the Court of Appeals explained. Here, the husband managed and actively increased the company's value during the marriage. Therefore, the trial court did not err in considering the increase in value part of the marital estate.

Wife's claim. On appeal, the wife claimed that any net income the company had generated and not distributed to the husband during the marriage represented marital property. That amount was divisible at least to the extent the trial court found the company's value had not increased by an amount equal to or greater than its retained earnings. To support her argument, the wife referred to federal tax law under which the income of an S corp is taxed to the owner. She also relied on decisions from other jurisdictions (not precedent and several dealing with child support formulas) that have held that the retained earnings are the income of the spouse who owns or controls the entity.

The Court of Appeals said the wife's proposition presented an issue of first impression in Michigan. It noted that, although there was a presumption that property earned by one spouse during the marriage was marital property, "it is not clear that the revenue generated by an entity that is wholly owned by one spouse as his or her separate property *invariably* constitutes earnings of that spouse." (emphasis added) The key word that kept coming up in the opinion is "invariably."

The court first disposed of the tax argument, pointing out that federal taxation and domestic relations are two different things. Congress makes federal tax law, states deal with marital disputes. Both entertain different policy concerns. "So this Court is not bound to ignore [the company's] separate existence merely because Congress chose not to tax the income of a closely held corporation when it is included in the owner's personal income for tax purposes," the Michigan Court of Appeals said.

In terms of rulings from other (foreign) jurisdictions, the court favored decisions that have adopted a case-by-case analysis. A rule that says the retained earnings "invariably" are the property of the entity until distributed is improper, the Michigan Court of Appeals said. The risk is that this bright-line rule would encourage the owner-spouse of a separate

entity to hide wealth from the nonowner spouse. However, the court found a rule that requires the inclusion of retained earnings in the marital estate whenever the owner-spouse has control over the distribution of earnings would be equally problematic because such a rule does not consider "ordinary business practices," that is, respect the owner's judgment as to what funds he or she needs to maintain the business over time and what funds are available for distribution.

Presumption against inclusion. The Court of Appeals provided guidelines for trial courts faced with the issue of retained earnings in a closely held company. The court places a high burden of persuasion on the spouse seeking the inclusion of retained earnings in the marital estate.

- The ground rule is that trial courts must make a case-by-case assessment as to whether it is appropriate to treat the retained earnings of a closely held entity as marital (divisible) income;
- There is a presumption that the retained earnings are not part of the marital estate "until the spouse claiming otherwise demonstrates that the facts warrant including some or all of the earnings in the marital estate";
- There is no inclusion unless the nonowner spouse asking for it "first demonstrates that the owner spouse had the authority to distribute the earnings";
- Even if the owner spouse has control, this fact "does not in and of itself mandate the conclusion that the retained earnings are part of the marital estate"; and
- Trial courts must consider "the historical operations of the entity." They may ask:
 - What are the business's needs for operating capital?
 - Was the owner-spouse reasonably compensated for his or her work for the entity?
 - Did the owner-spouse "deliberately" retain earnings to deprive the nonowner spouse of income?

Principles applied to case. The Court of Appeals applied its "totality of circumstances" approach to the instant case and found the trial court did not determine whether the husband unreasonably caused his company to retain earnings. However, the appeals court, in reviewing the record, concluded it was not improper for the trial court to decline to treat part of the retained earnings as marital income. The reviewing court mentioned the husband's history of being "conservative with his distributions." He only caused the company to make substantial distributions to him so he could take care of tax liabilities. He said he did not personally receive the distribution. There was no evidence

that the husband fraudulently withheld income from the marital estate. Also, the evidence showed that the retained earnings were accounted for in the increased valuation of the business. Accordingly, the wife received a portion of the increase in value attributable to the retained earnings, the appeals court noted.

Admissibility challenge fails. On appeal, the wife reiterated her admissibility objection.

The appeals court agreed with the wife that the opposing expert's report contained inadmissible hearsay and that the trial court had erred in admitting it. At the same time, the Court of Appeals decided this error ultimately was harmless because there was sufficient testimony and financial data introduced at trial to support the trial court's valuation findings. "This Court will presume that the trial court sitting as the finder of fact did not improperly use the report," the appeals court said.

Notwithstanding the wife's claim that the expert testimony relied on data that were not in evidence, the appeals court considered the report cumulative to testimony by the husband's expert, saying the expert had testified to relying on that data and had discussed the reasons for doing so.

Concerning the challenge by the wife to the testimony by the husband's expert, the Court of Appeals noted the wife had failed to ask the trial court to strike the testimony. The court explained that simply objecting to the admission of the expert's report did not mean the wife also objected to that expert's oral testimony. "Therefore, she has not preserved her claim." The court added that, had the wife objected to admission of the opposing testimony at trial, the opposing attorney would have been able to show that the expert opinion had adequate support in the evidence, that it was based on reliable principles and methods, and that the expert applied the principles and methods correctly, the appeals court said. Also, the husband's expert apparently had the contested documents in his possession and could have produced them at trial. According to the Court of Appeals, doing so would have satisfied state Rule of Evidence 703, which provides that the factual bases for the opinion may be admitted after the expert testifies. Further, Rule 705 provides that an expert does not have to disclose the underlying facts or data before he or she may offer an opinion, the Court of Appeals said. It added that, if there had been a timely objection and the trial court had insisted that the expert base his opinion on the evidence, the husband's expert could have modified his opinion at trial, using the records that were in evidence.

The Court of Appeals further noted that it was "doubtful" that the expert opinion would have "materially" changed were it based on the admitted as opposed to the unadmitted figures. To the extent the trial court erred in admitting the

expert testimony, this error, too, was harmless, the appeals court concluded.

The Michigan Court of Appeals upheld the trial court's valuation findings.

In Florida Divorce, Expert's 'With-and-Without' Valuation Withstands Appeal

In re Muszynski v Muszynski, 2019 Fla. App. LEXIS 9913 (June 25, 2019). In a nasty Florida divorce case, an appellate court recently upheld the trial court's valuation findings concerning the husband's 50% interest in a successful company that operates in the waste disposal industry. The trial court adopted the valuation of the wife's expert, which included the value of certain intangibles belonging to the company but excluded the value of the husband's personal goodwill. In Florida, enterprise goodwill is a marital asset, but personal goodwill is not.

Separating out personal goodwill: During the marriage, the husband set up a business, soon selling a 50% ownership interest to a third party. The husband had sole ownership over the remaining 50%. The company facilitated waste removal in that it had relationships with companies that generated waste and those that hauled it away. Apparently, the company did not, itself, remove the waste.

A few years before filing for divorce, the husband sold a 45% interest (nonvoting stock) to a trust but retained a 5% interest that represented 50% of the total voting rights in the company. Ostensibly, he did so for estate planning purposes. But the trial court noted that, at that time, the parties' marriage was breaking down and that the wife was not properly informed of the sale and its implications.

The trial court first determined that the totality of circumstances suggested the sale "did not serve a valid marital purpose and was unconscionable." The transaction was the husband's "unilateral decision" and did not change the classification of the husband's interest from a marital asset to a nonmarital asset. The value, for purposes of equitable distribution, was the full 50% of the company's stock (not the retained 5% interest), the trial court decided.

The parties' experts prepared fair market value determinations but disagreed on how to value the husband's interest. The husband's expert proposed a net asset valuation, noting, however, that the company had no significant assets as it didn't produce anything or own much. According to this expert, all intangible value was linked to the husband's (and his business partner's) client relationships and therefore was not a marital asset. This value represented nothing more than the husband's future earning capacity, which must not be considered in dividing marital property in a divorce proceeding, the expert said.

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The wife's expert valued the company's assets and teased out the value of all identifiable intangibles which, he explained, belonged to the enterprise (including workforce, trade name, employees' noncompetes, and customer relations). Proceeding from the premise that a buyer would not buy the company without having a noncompete for the husband in place, which evidences personal goodwill, he used the with-and-without method to determine the value of the husband's noncompete and subtracted this value from the overall valuation.

In crediting this expert's testimony, the court emphasized that the valuation did not include any personal goodwill of the husband. The court said it accepted the wife's expert's "methodologies for separating out any value related to Husband's personal goodwill." A state court of appeal recently affirmed the trial court's decision per curiam, without issuing an opinion.

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