

# 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

### GA Adopts Majority Rule on Dividing Professional Practice Goodwill in Divorce

**Miller v. Miller, 2010 WL 4704326 (Ga.) (Nov. 22, 2010).** With this decision by the Georgia Supreme Court, only one state in the country (Alabama) has yet to address how to determine and divide the goodwill value of a professional practice in divorce.

**Value of solo medical practice at stake.** At the parties' divorce, the wife's expert, a CPA and business valuation analyst, used a weighted combination of the asset, market, and income approaches to value the husband's internal medical practice at \$331,214. The trial court adopted this value, awarding one-quarter to the wife and the remainder to the husband. The husband raised several challenges, which went on an expedited appeal to the state Supreme Court.

First, the husband argued that the market approach was inappropriate because a market for solo medical practices does not exist. However, the wife's expert said that she used two national transactions databases (the court does not name the sources), and utilization of this data is a commonly accepted method for valuing medical practices. The court also found that, in general, the market approach is one of several valid methods for valuing a professional practice and overruled the husband's objection.

Second, the husband said the trial court wrongly accepted the excess earnings approach when he was paying himself a "normal" salary. "This contention shows a fundamental misunderstanding of such capitalization of excess earnings, which is the most commonly relied upon method for valuing professional practices," the court held. Under this method, as applied by the wife's expert, the first step is to deduct the owner's reasonable salary, based on similarly situated professionals, from the average net income of the

*practice*, not from the practitioner's actual compensation. This properly adjusts excess earnings for those practices that increase or decrease their retained earnings by means of a lower or higher than normal salary, the court explained. "The mere fact that the practitioner is paid a normal salary hardly means that there are no excess earnings in the practice."

Third, the trial court's use of the capitalization of earnings approach did not improperly include the husband's future earnings. By capitalizing only the excess earnings of the owning spouse and providing a present value for his interest, the method actually excludes most future earnings and avoids the problem of valuing the practice based on post-divorce earnings and profits, the court explained:

Most courts would accept that method especially where, as here, the appraiser makes appropriate modifications for taxation as a Subchapter S corporation and for any "individual" goodwill; excludes annual income representing reasonable compensation for services; and capitalizes actual past earnings instead of estimated future earnings based upon a future growth rate.

Fourth, the trial court did not count the husband's earnings twice by awarding portions of his business in its support awards and then again in its property division. Under the capitalization method, the wife's expert deducted a reasonable salary expense for the husband, and the trial court acknowledged separate bases for its award of alimony and child support. Accordingly, no double-dipping occurred in this case, the court held. "We join those courts which have rejected outright a double-dipping claim with respect to

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child support, reasoning as between parent and child, the asset subject to property division is being counted twice.”

**Court prefers term “personal” goodwill.** Fifth, and finally, the husband claimed the trial court incorrectly divided his professional goodwill, which is not marital property under the current majority rule. The court found his use of “professional” goodwill to be somewhat ambiguous. “If by that term he includes enterprise goodwill and means that none of a professional practice can be divided, we resolve this [terminology] by following the vast majority of jurisdictions and including enterprise goodwill in the valuation of a professional practice as part of marital property,” the court ruled.

If, as is more likely, the husband was arguing that the trial court divided his individual goodwill, the court resolved this issue by assuming for purposes of this case only that “individual goodwill does not constitute marital property in Georgia.” (Presumably, the court is implicitly asking analysts, attorneys, and litigants to use the terms “personal” and “enterprise” goodwill going forward.)

In this case, the trial court in fact excluded individual (or personal) goodwill from its valuation of the husband’s medical practice. The wife’s expert testified that she did not apply a “key man” discount, because the husband was replaceable. She accounted for any loss of patients, should the husband sell the practice, by using the market approach, which adjusts for a “key man” in the purchase price. She also used a higher capitalization rate in the income approach, which appropriately reflected the risk that some patients might not return. An additional adjustment would have overemphasized personal goodwill by factoring it into the calculation twice, the court said.

Overall, the trial court’s valuation of the husband’s medical practice, including goodwill, was sufficiently supported by the expert evidence, the Supreme Court ruled, and confirmed the same.

## Wisconsin High Court Says Majority Rule on Goodwill is ‘Mistaken’

***In McReath v. McReath* 2011 WL 2706249 (Wis.) (July 12, 2011).** When digesting the appellate court decision in this case, we predicted fertile ground on questions for appeal - particularly on the issues of distinguishing the “saleable” personal goodwill value in a professional practice and double-counting practice income in a maintenance determination. Now, a year later, the Wisconsin Supreme Court has indeed settled both questions - at least in its state.

**Non-compete critical to practice purchase.** During the 1990s, the husband purchased an orthodontic practice for \$930,000, including a non-compete agreement. The husband estimated that \$100,000 of the purchase price went toward the firm’s tangible assets plus its corporate name and goodwill. The remainder was for, as he said, the selling doctor’s “name, the non-compete clause, and the employment agreement that [the former owner] would stay on to introduce me to his existing patients, and to counsel me through the process of learning how to do business.” Without this non-compete, he would have not purchased the practice for such a high price, because the former owner could have opened up a business right down the street, presumably taking his former and future clients with him.

The husband successfully developed the practice during his marriage, working 60 hours per week (compared to a peer average of 35) and reaping up to \$1.8 million in annual revenues and nearly \$700,000 in annual net cash flows. Notably, his was the only orthodontic practice in his local region. During his divorce, the husband presented an expert who valued his practice at only \$415,000. The trial court found this value to be problematic, because the expert relied significantly on information provided by the husband

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with little independent or critical analysis. Moreover, the husband's expert only used financial data from 2007 (one of the practice's worst years) and did not look to outside or industry norms to adjust or support his conclusions. He also ignored the husband's \$930,000 to buy the practice nearly a decade earlier.

By comparison, the wife's expert provided a "thorough and comprehensive" valuation, according to the trial court. He supported his conclusions by "direct work" with the practice, including site visits, conversations with the husband, and a review of historic financial records. He also relied on "external information sources unique to the profession such as surveys and professional journal data," the trial court said in adopting the experts \$1.1 million value. The court also used the husband's annual earnings, normalized to reflect a 40-hour work week, to award \$16,000 in monthly maintenance to the wife - and the husband appealed.

The husband argued that the trial court incorrectly treated his personal goodwill in the practice as a divisible property and that it double-counted this goodwill in its maintenance award. The Court of Appeals disagreed, however, finding that the husband's personal goodwill was *saleable*, as evidenced by the value he assigned to the non-compete in his purchase of the practice and by "the reality" that any hypothetical buyer would demand a similar non-compete. The appellate court also found no double-counting in this case, and the husband appealed again.

**Saleable goodwill provides the distinction.** The Supreme Court reviewed state precedent on defining and distinguishing goodwill value in divorce. An early (1967) case recognized the goodwill value of a retail discount store as a divisible marital asset. Later cases held that when the personal goodwill inherent in a professional practice, such as a law or accounting firm, could not be "assigned, transferred, conveyed, or pledged," then the asset was not *saleable* (court's emphasis) and has "computable value to the individual only to the extent that it promises increased future earnings." Subsequent Wisconsin cases excluded personal goodwill from the marital estate when it was "nonsaleable" (no evidence that a hypothetical buyer

would require a non-compete) and when, in fact, there was an ethical or contractual barrier to selling the professional's goodwill - as in the case of a restrictive partnership agreement.

Against this backdrop, the Supreme Court held that a trial court "shall" include saleable professional goodwill in the divisible marital estate. The husband urged the court to consider adopting a standard, similar to the current majority rule among state jurisdictions, which would require the trial courts "to divide professional goodwill into two subgroups, 'personal' goodwill and 'enterprise' goodwill, and to create a presumption that [the former] is excluded from the marital estate."

After reviewing the cases cited in support of the majority rule, however, the high court declined to require family court judges to draw such a distinction. "This is so because the premise on which the distinction is grounded - that enterprise goodwill is saleable and personal goodwill is not - is mistaken," it held. As this case demonstrated, particularly through the husband's testimony regarding how critical a non-compete was to his purchase, "in some situations, personal goodwill is saleable," the court said.

Similarly, it found that the rule against "double-dipping" in Wisconsin was not absolute but "advisory," depending on the asset at issue. For example, "it would be double counting to count the present value of [a] pension fund and also count the future payments as income, since the income, up to the valuation placed on the pension at the time of the division, are one and the same," the court explained. By contrast, when a trial court assigns an income-earning asset to one spouse, it is awarding the full, fair market value of that asset at the time of the property division. Presumably, that spouse could turn around and sell the asset the next day, attaining the same value; or he/she could retain the asset for its income-producing properties.

Thus (unlike the present value of pension funds), the value of such investment property is separate from the income it generates, the court held. Given the varying nature of marital assets, "it would be unwise to proscribe inflexible double-counting rules." Instead, a more flexible approach allows the trial courts to

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carefully consider income producing versus non-income producing assets in a marital division along with the probable related effects on a spouse's need for maintenance.

In this case, the husband's professional practice was similar to an income-producing asset value with a "set" value of \$1.1 million, the court stated. The husband could have sold the practice the day after his divorce, or he could retain its "substantial" income-generating properties and sell at a later date. The trial court made a separate finding of the husband's adjusted annual income for purposes of its support determination; consequently, it did not "double count" the practice's professional goodwill when it made its maintenance award, the court held, and confirmed the same.

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**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](mailto:info@BarrettValuation.com)

[www.BarrettValuation.com](http://www.BarrettValuation.com)

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