

# Viewpoint on Value



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# Factoring taxes into divorce settlements

How assets are split up in a divorce can have significant tax consequences, especially when the marital estate includes a private business interest. Valuation is just part of the picture. Equitable distributions require the parties to premeditate tax issues, too.

## What's at stake?

Common marital assets allocated in divorce settlement agreements include:

- Cash,
- Investments,
- Retirement accounts,
- Autos and personal property,
- Real estate and mortgage debt, and
- Private business interests, shareholder loans and stock options.

The perceived values of these items vary, depending on their tax consequences, liquidity, risk and the parties' personal preferences. Cash is generally the most desirable asset, because it's liquid and risk-free and has no hidden tax consequences when you spend it.

Receiving a business interest with significant built-in gains isn't the same as receiving a lump sum of cash, unless adjustments are made to reflect the tax liability.

But a family business owner may prefer to retain his or her business interest and, therefore, be willing to trade his or her spouse's share of the business for cash. Spouses also may have emotional ties to homes and personal property, such as family heirlooms and jewelry, which they may be willing to trade for cash.



## How do taxes affect value?

Emotional issues aside, tax consequences can significantly affect an asset's perceived value. Discuss each asset's tax consequences *before* agreeing on how to split up the estate. In general, when spouses transfer assets to each other, there are no federal income tax or gift tax consequences as long as the transfer happens before the divorce is final, under Internal Revenue Code Section 1041(a).

This tax-free treatment even extends to private stock buyouts that occur within six years after a divorce, provided they're done per the terms of a divorce property settlement. One spouse generally takes over

## Other financial considerations in divorce settlements

Like private business interests, real estate and other investments may create taxable gains when they're sold. In some cases, divorcing spouses decide to sell these assets before the divorce is final to eliminate any uncertainty about future tax obligations and take advantage of the higher home-sale gain exclusion on the principal residence, which is \$250,000 for a single taxpayer and \$500,000 for a married couple (if they meet certain use and ownership tests).

On top of taxes, the couple should consider the liquidity and risk associated with owning noncash assets. For example, real estate and private business interests (especially minority interests) take time and effort to sell. The spouse who receives them also bears the risk that values could change in an uncertain economy.

To further complicate matters, maintenance payments and tax deductions for such items as dependents, mortgage interest and attorneys' fees may become valuable bargaining tools in settlement talks. In general, alimony is taxable to the recipient and deductible for adjusted gross income for the payer, as long as the payments meet the requirements of Internal Revenue Code Section 71. However, child support, noncash transfers and payments for the use of property are never taxable (or deductible to the payer). Property settlements should also be carefully scrutinized to determine whether the transaction itself is a taxable event.



the other's tax basis and holding period for the stock purchased. It's essentially as if the buyer had always owned the shares and the selling spouse has no taxable gain or loss on the deal.

However, it's important to realize that, if a business interest transfers between spouses tax-free, the spouse who retains it eventually will incur taxes on any gain when it's sold in the future. So, receiving a business interest with significant built-in gains isn't the same as receiving a lump sum of cash, unless adjustments are made to reflect the tax liability.

### How are corporate redemptions taxed?

The tax consequences are more complicated when a C or S corporation redeems a spouse's business interest, because the redemption usually triggers a gain or loss upfront. If the corporation redeems the shares to fulfill a spouse's obligation to buy those shares under the couple's divorce agreement, the deal is treated as if the spouse who will retain an interest in the business (the buyer-spouse) collected a redemption

payment and then transferred it in exchange for the shares. The spouse who's redeeming his or her interest (the seller-spouse) has no tax consequences; instead, the buyer-spouse bears the tax burden.

However, the parties may also opt to structure the sale strictly between the seller-spouse and the corporation. Depending on the circumstances, the seller-spouse may be able to treat the redemption as a sale of stock back to the corporation or as a corporate dividend. This deal structure is often preferred, because the seller-spouse can offset the stock redemption payment with his or her basis in the redeemed shares. In this situation, the seller-spouse bears all the tax consequences — and the other spouse bears none.

### How can clients avoid surprises?

Arriving at an equitable distribution of a couple's marital estate is a juggling act. To ensure that you don't drop the ball, hire a valuation advisor who understands how taxes factor into the cash-equivalent value of assets held in a marital estate, especially when private business interests are at stake. ●

*Potok v. Rebh*

# What's the value of personal goodwill?

Personal goodwill belongs to employees or shareholders, not companies. But a recent dissenting shareholder case demonstrates that, when a company is sold, the value of personal goodwill may be limited to the extent that key people enter into noncompete and consulting agreements with the buyer.

## Background

FLOORgraphics, Inc. (FGI) was an in-store advertising and marketing company that specialized in floor advertising. Its revenues peaked at \$70 million in 2004. That same year, FGI initiated a five-year lawsuit against a major competitor, News America Marketing In-Store (News America), alleging anti-competitive activities, including interfering with business contracts, issuing unprofitable bids to win contracts, and luring away FGI employees and retailer accounts.

In March 2009, News America offered to purchase FGI's assets for \$29.5 million in exchange for dismissing the lawsuit. There were other stipulations of the purchase agreement:

- FGI and its majority shareholders must enter into seven-year noncompete agreements.
- FGI's majority shareholders must agree to 12-month consulting agreements for \$1,000 per month per person.
- No value could be allocated to the dismissal of the lawsuit between FGI and News America.

FGI's founder filed dissenting shareholder claims for breach of fiduciary duty against FGI's four majority shareholders on behalf of himself and the company's other minority shareholders.



## Purchase price allocation

Personal goodwill is intangible value inextricably tied to the efforts and experience of key people, such as employees and shareholders. In the years preceding News America's purchase agreement, the four majority shareholders conducted all of FGI's negotiations with retailers. So, the company's CEO decided that \$12 million should be allocated to personal goodwill and paid to the majority shareholders, not FGI. This amount was based on an arbitrarily selected figure of 40% of the total purchase price.

The plaintiff contended that the \$12 million paid to the majority shareholders for personal goodwill should have been paid to FGI and distributed to all of the shareholders as a dividend.

## Court findings

The Commerce Division of the Philadelphia Court of Common Pleas agreed with the plaintiff, finding

the defendants guilty of unjust self-dealing and ordering them to pay \$12 million back to FGI. The judge ruled that the purchase price allocation didn't account for other assets, such as corporate goodwill, the company's noncompete agreement, synergies between FGI and News America, and the value of dismissing the lawsuit, which could have resulted in a damages award anywhere from zero to \$95 million.

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Although \$13 million was reasonably assigned to inventory and retailer contracts, the court found it unfair to pay the remaining \$16.5 million — more than 70% of the purchase price — to the four

majority shareholders individually for noncompete and consulting agreements and personal goodwill.

The court concluded that it was reasonable for the majority shareholders to receive compensation for entering into noncompete and consulting agreements with News America. But it was “improper to separately value personal goodwill for any amount, let alone \$12 million. ... Economically, the dollar values of [the noncompete and consult agreements] are the correct measure of any personal goodwill.”

### Lessons learned

In other cases, such as *Martin Ice Cream Company*, key people have been allowed to individually receive cash for their personal goodwill. However, *Potok* illustrates that, when key people enter into noncompete and consulting agreements, it may offset the value of their personal goodwill. Moreover, when one is valuing personal goodwill in dissenting shareholder cases, fairness and reasonableness are overriding concerns. ●

## No clear-cut answers to the tax-affecting dilemma

Pass-through entities — such as partnerships, S corporations and limited liability companies — aren't subject to corporate-level income taxes. Instead, their income “passes” onto the shareholders' personal tax returns based on their respective equity interests in the company. But is this favorable tax treatment valuable in the eyes of hypothetical investors? Tax-affecting remains a controversial issue that requires careful consideration when one is valuing these types of businesses.

### Tax Court denies tax-affecting

At one time, it was common for valuation professionals using income-based methods to include an S corporation premium or to “tax-affect” the earnings

of pass-through entities — that is, reduce earnings by an assumed corporate tax rate. Valuators argued that tax-affecting was necessary to reflect certain risks assumed by a hypothetical buyer, including the risk that the corporation could lose its pass-through status. In addition, they felt that hypothetical buyers would make decisions based on the fact that the cash flow generated by the company is nevertheless subject to income taxes (through the shareholder level) and, as such, isn't available to the investor.

In *Gross v. Commissioner*, the Tax Court ruled that tax-affecting was inappropriate in valuing an S corporation. The court reasoned that the primary benefit of S corporation status — the absence of corporate-level taxes — shouldn't be ignored during an appraisal.



The U.S. Court of Appeals for the Sixth Circuit upheld *Gross* in 2001.

The decision was controversial, and many valuers felt it was wrong. But the court appeared to leave the door open for tax-affecting under certain circumstances. For example, in reaching its conclusion, the court emphasized that there was no evidence that the subject corporation was likely to lose its S status.

### Some courts prefer a hybrid approach

Before *Gross*, valuers typically tax-affected the earnings of pass-through entities by applying a 40% tax rate, which approximated the combined federal and state taxes a C corporation would pay. The Tax Court in *Gross* permitted no tax-affecting at all. Increasingly, however, courts are choosing a middle ground that better reflects the value of a pass-through entity.

The Delaware Chancery Court took this approach in *Delaware Open MRI Radiology Associates v. Kessler*. This 2006 case involved a squeeze-out merger, which is a transaction used to eliminate unwanted minority shareholders. The court was required to determine the fair value of the minority shareholders' interests in an S corporation. The court noted that S status was a highly valuable attribute and it was unlikely that the corporation would ever convert to C status.

The court explained that fully tax-affecting the S corporation's earnings would *undervalue* the company, depriving the minority shareholders of fair value. But declining to tax-affect would *overvalue* the company by ignoring the impact of personal taxes.

The court's solution was a hybrid approach designed to capture the economic advantages enjoyed by an S corporation shareholder, who receives dividends free of corporate taxes.

To tax-affect the S corporation's earnings, the court applied a hypothetical "predividend" corporate tax rate of 29.4%. This rate, when combined with an assumed 15% dividend rate, taxed the company as if it were a C corporation but reflected the enhanced after-tax benefits enjoyed by S corporation shareholders.

Increasingly, courts are choosing a middle ground that better reflects the value of a pass-through entity.

Keep in mind that a different approach may be required if there's evidence that a pass-through entity is likely to lose its ability to avoid paying taxes at the corporate level.

### The future remains unclear

There's no clear-cut guidance on tax-affecting the earnings of pass-through entities. At a 2012 business valuation conference, U.S. Tax Court judge David Laro stated that the issue of tax-affecting "bears further review." In the meantime, valuers must support their decisions to tax-affect earnings (or not) with the facts and circumstances of the subject company and its shareholders. ●

Back to basics

# Review statements of limiting conditions for weaknesses

Most valuers attach statements of limiting conditions to the end of their written reports. Similar to financial statement footnotes required under Generally Accepted Accounting Principles, these appendices are worth reading, especially when you're reviewing the opposing expert's report.

## Looking past the conclusion

Reviewing appraisal reports doesn't stop with the final conclusion. It's important to turn the page and review the statement of limiting conditions to better understand the valuator's procedures. These statements also may reveal potential weaknesses or incomplete analyses.

Consider a statement that contains an admission that the valuator's firm has also provided audit and corporate tax services for the subject company during the last 10 years. This revelation could be perceived as a conflict of interest, because failure to arrive at a favorable conclusion could potentially jeopardize audit and tax services provided to the client going forward.

## Finding an Achilles' heel

When reviewing a valuator's statement of limiting conditions, look for potential weaknesses that could discredit him or her on the stand. Examples include:

- Scope limitations imposed by the hiring attorney or clients,
- Conflicts of interest that compromise the expert's objectivity, and
- Unreasonable management representations about future earnings.



Many of the items contained in the statement of limiting conditions may seem to be boilerplate in order to comply with the appraiser's professional standards. For example, statements of limiting conditions typically say that valuers rely on financial statements and tax returns prepared by outside accounting firms and don't verify the completeness or accuracy of this information. Management may also represent certain information during site visits and interviews that the valuator has assumed to be accurate and reliable.

In connection with these customary disclosures, most appraisers require clients to sign management representation letters. You may request a copy of this letter to get a better handle on the information used to arrive at the valuator's conclusion. In turn, the management letter may reveal other weaknesses, including reliance on unrealistic forecasts and projections.

## Casting light on problematic disclosures

Review your own valuator's statement and ask him or her to clarify or reword potentially problematic disclosures before going to court. Your valuator should also know how to explain why limiting conditions don't compromise the quality or objectivity of his or her conclusion.

It's equally important to review the opposing valuator's statement and probe into potential weaknesses during deposition and cross examination. Any opportunities to cast doubt on the opposing side's analyses or imply that he or she is a "hired gun" could be the difference between winning and losing the case. ●



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**John M. Leask II (Mac), CPA/ABV, CVA**, values 25 to 50 businesses annually. Often, Mac's valuations, oral or written, are compiled in conjunction with the purchase or sale of a business, to assist shareholders prepare buy/sell agreements, or to set values when shareholders purchase the interest of a retiring shareholder. Here are examples:

- **Due Diligence & Assist with Purchase of a Business.** Mac has assisted purchasers of businesses by determining or reviewing the offer. He helps negotiate the price, perform due diligence prior to closing and/or helps structure and secure financing. Services have included, but are not limited to, verifying liabilities and assets, reviewing sales and expense records, and identifying critical issues relating to future success, and helping management plan future operations.
- **Family Limited Liability Partnerships, Companies & Closely Held Businesses.** Mac regularly values various sized business interests for estate and gift tax purposes. He provides assistance to estate and trust experts during audits of reports prepared by other valuers.

Mac also helps business owners and their CPAs and/or lawyers in the following ways:

- Planning — prior to buying or selling the business
- Prepare valuation reports in conjunction with filing estate and gift tax returns
- Plan buy/sell agreements and suggest financing arrangements
- Expert witness in divorce & shareholder disputes
- Support charitable contributions
- Document value prior to sale of charitable entities
- Assist during IRS audits involving other valuers' reports
- Succession planning
- Prepare valuation reports in conjunction with pre-nuptial agreements
- Understanding firm operations & improving firm profitability

More information about the firm's valuation services (including case studies) may be found at [www.LeaskBV.com](http://www.LeaskBV.com).

To schedule an individual consultation or to discuss any other points of interest, Mac may be reached at 203 - 255 - 3805. The fax is 203 - 380 - 1289, and e-mail is [Mac@LeaskBV.Com](mailto:Mac@LeaskBV.Com).

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