John R. Janicek, CPA, P.C

Valuation Perspectives

"Your Valuation Solution"

Spring 2012 | 115 Shivel Drive | Hendersonville, TN 37075 | Phone: (615) 822-8315 | www.johnjanicekcpa.com

Buy-Sell Agreements Receive Varying Consideration in Divorce

Three recent cases illustrate the various ways in which courts can consider a buy-sell agreement when valuing a spouse's interest in a professional practice, from using the formula to fix a limit on value to rejecting its purported limitations altogether. And one other considered division of goodwill and whether to divide other assets.

Interest in medical clinic worth no more than $1,000. In *In re Marriage of Baker*, 2011 Iowa App. LEXIS 1460 (Dec. 21, 2011), the husband owned a single unit in a general surgery clinic. In some years, the clinic had advanced him up to $12,000, but the husband insisted these amounts represented income, not assets. Further, under the buyout provisions of the owners' agreement, his single unit was worth only $1,000.

Based on this testimony, the trial court valued the husband's interest in the medical clinic at $1,000; the wife appealed, arguing that it should have been valued at $83,780 (presumably based on evidence that she presented at trial). The appellate court summarily dismissed her appeal, however, finding the trial court's valuation fell within the "permissible range of evidence."

Effect of law firm dissolution agreement on shareholder's interest. In *In re Marriage of Restaino*, 2012 Cal. App. Unpub. LEXIS 273 (Jan. 13, 2012), the husband owned a 9.7% equity interest in a law firm that specialized in large contingency fee cases. Prior to trial, the law firm began winding down, paying out substantial distributions pursuant to a confidential dissolution agreement. These funds did not represent a "buyout" of shares, the husband insisted, because "it was impossible to value a pure contingency firm." Instead, the distributions reflected the net fees remaining from any ongoing litigation, to be paid according to the firm's traditional practice of paying bonuses and income after resolution of cases.

The trial court accepted this characterization of the payouts as income, and the wife appealed, arguing that the law firm's "settlement agreement" did not control the characterization of the husband's equity interest as community property. The appellate court agreed, citing cases that permit courts to consider certain factors in deciding whether to rely on buy-sell formulas in valuing a spousal interest in a professional practice. "Merely because [the] husband agreed to alter the manner in which he would receive payment of his equity interest should not affect [the] wife's right to her portion of it," the court held. Other than sums expressly designated as salary, the court construed any distributions to the husband as "quantification of his interest in the firm" and remanded the case for further findings on its value.

Effect of shareholders' agreement on goodwill value of law firm. In *In re Marriage of Kingery*, 2011 Okla. Civ. App. LEXIS 110 (Dec. 29, 2011), the husband owned a 25% interest in a law firm. During the marriage, he (and his two partners) purchased the law firm from his father-in-law at a "practice acquisition cost" of $200,000, as determined by the buy-sell formula in a shareholders' agreement. On his divorce, the husband's CPA expert valued his fractional interest in the firm at nearly $97,000, excluding the "practice acquisition" or goodwill cost; if he included this value, the husband's interest was worth just over $133,000.

To rebut this evidence, the wife's expert agreed with the higher value, disagreed with the lower, but considered the $200,000 "asset" that the husband and his two partners purchased was "goodwill." The trial court adopted the $133,000 value, and the husband appealed, arguing that it improperly included goodwill. In a rather cryptic opinion,

Continued to next page...

the Court of Appeals found that the trial court's valuation included goodwill, "which, under this set of circumstances, should not be considered *for the purposes of marital property division* due to the effect of the shareholders' agreement" (emphasis by the court). As a result, it reversed the case for findings consistent with "valuation evidence not including goodwill as a factor."

In ***In re Marriage of Hanscam*, 2011 Ore. App. LEXIS 1664 (Dec. 14, 2011),** when the parties married in 1989, the husband, a CPA, already held a 25% interest in his father's accounting firm. Five years later, he purchased the remaining 75% interest, paying for it over the course of the marriage. During the same time, the husband's parents gave him (and his siblings) interests in a family limited partnership (FLP), so that, by the time the parties divorced in 2009, he owned just over 26%. Both parties retained experts to value the husband's solo CPA firm in a small town using standard methodologies. The wife's expert provided values under the income ($409,000), market ($439,000), and adjusted net asset ($154,000) approaches, but ultimately relied on the market approach and his "personal 'real-world' experience" to conclude that the CPA firm was worth $439,000.

Unlike the wife's expert, the husband's expert conducted a site visit and concluded the CPA practice was "very standard." He also rejected the market approach in this case, citing the lack of comparable CPA firms in the databases and the absence of specific identifying information. Accordingly, the husband's expert put more weight on his income ($313,000) and net asset ($202,000) values. Any value "over and above the hard assets" of the business was attributable to goodwill, he said, and in this case, all of that goodwill was personal, particularly because the husband couldn't sell his practice or transition his clients without signing a noncompetition agreement. Based on this determination, the expert concluded that the firm was worth $202,000 under the net asset approach.

The trial court relied on the husband's expert's income approach to value the firm at $313,000, less the husband's 25% premarital share but including its appreciation during the marriage (for a total of $55,000 as the husband's separate property). It also awarded the husband all of his FLP interest as his separate property, and the wife appealed.

Held: Although assets acquired before a marriage are not "marital assets," the appellate court explained, under state law (Oregon), they are considered "marital property," subject to a "just and proper division." As to the CPA firm, the court concluded that under a "just and proper" analysis, the wife was entitled to share equally with the husband's 25% premarital portion. And when a business has no value beyond its assets, absent the owner promising to continue his or her services after a sale, "there is no goodwill," the court said. Finally, the trial court correctly rejected the net asset value by the husband's expert for its failure to include enterprise goodwill, and the appellate court affirmed its $313,000 value under the income approach. It also agreed with the trial court that the husband maintained his separate property interest in the FLP during the marriage, to which the wife made no contribution and from which any appreciation was purely passive.

How to stop the 'hired gun' question before it kills credibility

Litigation experts know what's coming when they hear opposing counsel ask: "So, just how many times have you been hired by Mr. (or Ms.) Attorney?" Or worse: "Isn't it true that you are his 'go-to' expert?"

The attorney is trying to paint the expert as a "hired gun," of course—but the next time that happens, try this response: "I've worked on cases *against* the same attorney, too. Shall I tell you about them?" The aggressive line of questioning "immediately stops," says Neil Beaton (Grant Thornton), who frequently speaks on litigation tactics. Since it's so important to maintain a reputation of neutrality and credibility, Beaton suggests that expert business appraisers don't let the same law firm or attorney repeatedly (or exclusively) retain them. "You don't *want* to be a hired gun," he said, even in smaller communities in which attorneys may not have as many choices among available experts. Even so, watch out for relationships with attorneys that get *too* close. "So—how many times have you had dinner at Attorney X's house?" can be a killer question, so try to keep your professional relationships as neutral as possible, too.

FASB issues ASU on indefinite-lived intangibles

Recently, the Financial Accounting Standards Board (FASB) issued its proposed Accounting Standards Update 2012-12 on indefinite-lived intangible asset impairment testing. The new update, which is now open for public comment, "is intended to simplify impairment assessment and reduce the recurring costs" of compliance with existing standards "while improving the consistency of testing methods among long-lived asset categories for preparers," the FASB explains in a news release.

Intangible assets such as indefinite-lived trademarks, licenses, and distribution rights, would be subject to the new standard, which would apply to all public, private, and not-for-profit organizations and would be effective for annual and interim impairment tests performed for fiscal years beginning after June 15, 2012, with the option for early adoption. Comments are due by April 24, 2012, to the exposure draft.

Latest 'Bad Facts' FLP Case Emphasizes Poor Planning, Operations

***Estate of Liljestrand v. Commissioner*, T.C. Memo 2011-259; 2011 Tax Ct. Memo LEXIS 251 (Nov. 2, 2011)**

After retiring in 1978, a doctor exchanged his interest in a Hawaiian hospital for several real property holdings, including condominiums and a shopping center in California, a warehouse in Oregon, a Florida strip mall, and a medical building in Arizona. Just about six years later, the doctor formed a revocable trust to hold the real property, naming his eldest son as trustee and also paying him to manage the property.

FLP to ensure son's employment. By 1996, the doctor wanted to plan his estate on behalf of all his four children, but also wanted to make sure that his eldest son kept his position managing the real estate businesses, in which none of his siblings showed an interest. In addition, he was concerned that if he gifted the property while it remained in trust, then local (Hawaiian) law would allow his other children as beneficiaries to seek judicial partition of the property and oust him as manager.

To alleviate these concerns, an estate planning attorney suggested that the father form a family limited partnership (FLP), funded with the trust-owned properties. In 1997, the FLP was formed, naming the father as the 99.8% general partner and giving the son a small Class A limited partnership (LP) interest. Within six months, the father transferred all his real property investments, appraised at roughly $6 million, to the FLP.

Over the next two years, he gifted Class B LP units to four trusts established for each of his grown children. Since the father had contributed all but his personal residence to the FLP, the FLP made disproportionate distributions, larger than those provided by the partnership agreement, to pay his living expenses and debts as well gifts to his grandchildren. Then in 2008, the IRS assessed a $2.6 million deficiency, based on including the entire fair market value of the father's real estate holdings in his estate pursuant to IRC Section 2036(a), and the taxpayer petitioned the court for a determination of liability.

FLP asserts three business purposes, which the court rejected. The court also found several "bad facts" that indicated the FLP transfers were not bona fide sales. For example, the FLP failed to follow "even the most basic of partnership formalities," including keeping regular books and meetings, making proportionate distributions, and refraining from paying the father's personal expenses and the son's debts. The father also stood on "both sides of the transaction" in funding and forming the FLP, without any evidence that he held "arm's-length" negotiations with the other partners or created the FLP to fulfill anything but his own objectives. Based on the totality of these

Continued to next page...

facts, the court concluded that the father did not have a legitimate, nontax reason for transferring his assets to the FLP, which were thus were not “bona fide” sales.

The court also considered the estate’s claims that the father did not retain possession of the FLP assets during his lifetime—but the bad facts of its formation, funding, and operations undermined these arguments as well. Although the father retained some assets outside of the partnership, they were not enough to maintain his lifestyle or satisfy his future obligations, including payment of his estate taxes.

Lastly, the “partnership served primarily as a testamentary device through which [the father] would provide for his children at his death,” the court held. Taking this feature in light of all the other factors in the case, the court included the full, fair market value of the FLP assets in the father’s gross estate, pursuant to Section 2036, and denied the estate’s petition to not pay the $2.6 million in tax deficiencies.

About Our Firm.................

Our firm has years of experience assisting attorneys and business owners in determining value for litigation support, gift and estate tax planning, marital dissolution, buy and sell agreements, and business sale purposes. Whether you are determining the fair market value of a closely held business interest for sale, gift, or estate planning, knowing what your company is worth is one of the most important financial aspects of being in business.

In addition, you may use a business valuation as a management and planning tool. Besides acting as a scorecard that will help management determine whether the company is gaining or losing value, the valuation provides a better understanding of the real profitability of the business. Whatever reason you have for needing a business valuation, John R. Janicek, CPA P.C. is prepared to assist you in being your valuation solution.

John R. Janicek, CPA, P.C.
115 Shivel Drive
Hendersonville, TN 37075