

# Viewpoint on Value

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# Who says there's no goodwill in a divorce?

## Intangibles often play a key role in marital assets

Determining equitable distributions of marital assets in a divorce can be challenging — especially when the estate includes an interest in a privately held business. Business appraisals require subjective interpretations, and there is little consensus from state to state regarding which company assets to include in the marital estate.

### Plying the murky waters

When a spouse owns his or her own business, it often represents a significant portion of the marital estate. Each side has a vested interest in maximizing its share of the company's value. When business values are based on hard assets — such as cash, securities, real estate or equipment — the value is fairly clear-cut. Thus, the parties are less likely to disagree.

When a company's value resides in intangible assets, however, the waters become murkier. Intangible value can be difficult to quantify and categorize. Moreover, depending on a case's venue and proposed support

payments, assets might be counted twice, leading to inequitable allocations.

This practice, known as “double dipping,” occurs when a nonmonied spouse is credited for the monied spouse's contribution to a business twice: once in the form of support payments and again with half of the company's intangible value (or goodwill).

### Understanding the terminology

In a divorce context, the term “goodwill” is a catchall phrase that refers to all intangible value. Valuers customarily quantify goodwill as the difference between the fair market value of a business and its net tangible value.

Although many states are undecided on how to handle goodwill, approximately half recognize the double-dipping argument by excluding personal goodwill (intangible value attributable specifically to the business owner) from the marital estate. In lieu of divvying up personal goodwill, courts in these states allocate the value of the monied spouse's personal efforts via support payments, which are based on the owner's salary, bonuses, business perks, dividends and distributions.

But the appropriate treatment of intangible assets varies substantially across state borders. Some states exclude all goodwill from the marital estate. Others include the company's entire value in the marital estate, regardless of maintenance payments.

Family courts sometimes transcend state boundaries when deciding on the appropriate treatment of goodwill and other intangibles. The inconsistent, unpredictable treatment of intangible value requires attorneys and appraisers to understand how other jurisdictions deal with goodwill and discuss the appropriate course of action before jumping head first into the valuation assignment or settlement talks.

### OWNER COMPENSATION: MORE THAN JUST A SALARY

A business owner's compensation includes more than just his or her salary. When quantifying how much the owner truly takes away from the company, a valuator typically includes bonuses, benefits and quasi-business expenses — such as lavish automobiles, country club dues or travel expenses. He or she also adjusts for payroll tax and income tax deductions.

In addition to considering the monied spouse's compensation, the appraiser looks at salaries paid to other related parties. Sometimes, the business owner may drain the company's cash flow by overcompensating salaried relatives or others.

## Identifying the likely candidates

Professional practices, startups, technology firms and single-owner businesses tend to rely more on intangibles than manufacturers or retailers. Balance sheets seldom identify intangible assets. When goodwill and other intangibles do show up, their values may be understated.

A formal business appraisal is the most accurate way to quantify a company's intangible value. In most jurisdictions, divorce cases require valuers to go beyond simply appraising the business. They must also bifurcate goodwill into two components: business and professional goodwill.

## Determining reasonable compensation

To accurately value the company or award fair support payments, the owner's compensation must also be reasonable. And though valuations and equitable support payments generally assume the monied spouse's compensation is reasonable, some monied spouses cut back their salaries or hide business perks in anticipation of an impending divorce. By understating personal income, they hope to lower alimony and child support payments.

On the other hand, some owners *overpay* themselves to avoid the double taxation of C corporation dividends or because they overestimate the cost of finding a replacement. If a monied spouse's compensation is too



high, the company's income stream will be understated and, if unadjusted, the business will be undervalued.

Of course, what's fair or reasonable is in the eye of the beholder. Few business owners would admit under oath that their compensation was unreasonable. A less emotionally charged way of broaching the subject is to call it "replacement" compensation, which is the amount it would cost to find an unrelated party to perform the owner's current duties. Doing so is also less likely to raise a red flag with the IRS.

## Recognizing the difference

At face value, the difference between business values and support payments may seem like a wash. But the mechanics behind these calculations can have unexpected valuation outcomes and tax consequences.

To ensure an equitable split, the valuator needs to estimate reasonable (or replacement) compensation and adjust the company's income stream and the owner's salary accordingly. ■

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# Going on the offensive

## 3 issues to raise during depositions and cross-examinations

Depositions and cross-examinations provide an opportunity for attorneys to discredit opposing experts and poke holes in their valuation analyses, assumptions and conclusions. A successful offensive against a valuator compromises the reliability of his or her qualifications and report, regardless of a subject company's "true" value.

By default, it also presents the other side in a more positive light and may persuade the court to accept the opposition's conclusions — or at least to "split the baby."

But drafting pertinent deposition and cross-examination questions can be a daunting task — especially for attorneys who are unfamiliar with business appraisal

issues. The following potential weaknesses and pitfalls may impair a valuation expert's effectiveness.

## 1. The independence issue

One way to discredit an appraiser is to imply that he or she is a “hired gun” or advocate for the client. Professional standards require valuers to be independent and unbiased. Some experts compromise their perceived objectivity by specializing in one specific side, such as monied spouses in divorce or taxpayers in IRS proceedings. Others change their positions on major issues, depending on which side hired them. A review of previous testimony transcripts may reveal these conflicts of interest.

Appraisal experts must also disclose any financial interests in or relationships with their clients in appendices to their valuation reports. Highlighting any ongoing relationships between the valuator and the client — or noting a failure to disclose the relationship — is a sure-fire way to discredit the expert.

For instance, the Sarbanes-Oxley Act (SOX) prohibits accounting firms from concurrently providing certain consulting services for their public audit clients. Attorneys could use SOX to argue that the ongoing relationship between an auditor and its audit client prevents the firm from objectively providing valuation or expert witness services.

Small errors chip away at the report's reliability and should be brought to the court's attention.

In addition, some attorneys address independence by focusing on whether the expert has been paid for his or her time. Most professional standards specifically prohibit appraisers from accepting fees contingent on the case's outcome.

Moreover, if the client has an outstanding balance — including anticipated deposition or courtroom time — an attorney could claim that the expert has a vested interest in the case's outcome. An unhappy client who blames his or her valuation expert for an unfavorable ruling may not pay the expert's bill.



## 2. The quality control issue

Mathematical errors and deviations from acceptable valuation principles provide other effective means of discrediting a valuator. Time permitting, all mathematical computations should be recalculated and tied back to original source documents. To illustrate, all columns and rows should add up and profits should tie to the company's income statement.

Material misstatements can have a dramatic impact on the appraiser's conclusion once corrected. But small errors chip away at the report's reliability and should be brought to the court's attention as well.

Also inquire about the administrative procedures of the expert's firm. To cut costs, some firms employ junior staff members to perform the legwork and the testifying partner simply performs a superficial review of the subordinate's work. Other firms implement no quality control procedures and issue reports without requiring any formal peer review.

## 3. The subjectivity issue

Addressing subjective issues can be particularly effective if the valuation expert's judgment disproportionately favors the client's financial interests. Here are several subjective areas that can materially affect the outcome of a valuator's report:

- Adjusting for reasonable officers' compensation,
- Tax-affecting the income of S corporations,

- Building up discount and capitalization rates (for example, support for small-stock premiums, company-specific risk premiums and long-term sustainable growth rates),
- Selecting guideline companies in the market approach (for example, selection criteria, fair market value vs. strategic value and cash-equivalent values),
- Estimating valuation discounts (for example, using averages and customizing samples to match the distinctive characteristics of the subject company), and
- Weighting the valuation methods.

Professional opinions and subjectivity are inevitable parts of the valuation process. By bringing subjective components to light, however, an attorney can introduce uncertainty into a seemingly rock-solid case.

## Invaluable assistance

A valuator can provide invaluable assistance by helping to review the opposition's valuation report, prepare a rebuttal report, and draft effective deposition and trial questions from a technical perspective.

In addition to helping attorneys hone their offensive strategies, an awareness of these points can also help attorneys fend off ambushes by opposing counsel — creating the likelihood of a successful outcome. ■

# Estate tax valuations and subsequent events

## When appraised values seem to contradict real-life transactions

Estate tax issues can be tricky. Suppose a business owner dies or gifts shares of his or her company to family members. So far, so good. But what if six months or a year later, the company sells for significantly more than its previously appraised value? If the IRS catches wind of this apparent discrepancy, the family members may receive a deficiency notice.

It's important to keep in mind, however, that a discrepancy between a previous appraisal and a subsequent event doesn't guarantee an IRS win. You can protect your gift and estate returns with a strong defensive strategy. A valuator can protect your gift and estate returns by preparing a comprehensive rebuttal memo supported by facts and empirical evidence.

## Management's intentions

The IRS requires appraisers to address only those facts and circumstances that are *known or reasonably foreseeable* on the valuation date. As soon as a



sale is imminent, minority interests suddenly become more liquid and appealing to investors. The proposed transaction price also provides a clear-cut indicator of the company's value.

The IRS may contend that the subsequent sale price should override the appraised value. It may also try to reduce or eliminate minority interest and marketability discounts.

The first step in supporting a gift or estate tax return is to ascertain whether management intended to sell the business on the valuation date. The valuator can

compile a timeline based on management interviews, business calendars and meeting notes as well as answers to the following questions:

**On the valuation date, was management entertaining any serious offers for the sale of the company?** If so, and the valuation report didn't disclose or address pending offers, how did those offers compare to the subsequent sale price? An offer that occurred closer to the valuation date may better indicate the company's value than its subsequent sale price.

**Before the valuation date, had management met with investment bankers or business brokers to discuss selling the business?** Notes from these meetings may provide evidence of the company's probable sale price around the valuation date. If revised throughout the negotiation process, these preliminary estimates may provide insight into changes in the outlook of the business from the valuation date to the closing date.

**How active was the merger and acquisition (M&A) climate within the subject company's industry on the valuation date?** The IRS may argue that an active M&A market suggests that a subsequent sale of the business was foreseeable on the valuation date.

## Viability explanations

Management's intentions may be moot if the valuator can legitimately explain why the appraised value should differ from a subsequent sale. Here are some possible explanations an appraiser might suggest for this apparent contradiction:

**Unforeseeable changes in business performance or economic conditions.** In some cases, the company's outlook might change significantly from the valuation date to the closing date. For instance, new technology within the industry may render a business more (or less) competitive.

Or a catastrophic event — such as a terrorist attack or a tornado — may impair future profits. Conversely, a disaster may reduce the number of competitors in the company's industry. As long as these events were unforeseeable at the valuation date, they may support a change in the business value over time.

**Noncash transactions.** Transactions often involve complex terms and conditions, such as earnouts, non-compete agreements, employment contracts or stock in the acquiring company. By contrast, fair market value

## FAIR MARKET VALUE VS. STRATEGIC VALUE

Fair market value and strategic value are two different concepts. The former, which is the required standard of value for estate tax valuations, is the price that the universe of well-informed "hypothetical" buyers and sellers would settle on for the subject company. The latter is unique to one specific buyer. Strategic value may incorporate certain synergies that aren't available to the "hypothetical" buyer.

Prospective buyers possess differing value perceptions. A competitor seeking to obtain a specific competitive advantage or boost market share may be willing to pay a premium for the subject company. Similarly, a participant up or down the subject company's value stream may pay more to become vertically integrated.

To defend an appraisal that is lower than the sale price, a valuator can demonstrate how the actual buyer differed from other potential (hypothetical) buyers. In other words, he or she can show what motivated the purchaser to pay a premium above fair market value.

is a cash-equivalent price. If a transaction involved noncash or nonpresent value terms, the valuator must convert that transaction to a cash-equivalent value. Otherwise, the comparison is invalid.

**Control transactions.** Gift and estate tax appraisals typically estimate a business value on a minority, nonmarketable basis. Conversely, a sale of the entire company provides a value estimate on a *controlling* basis. After the appraiser applies reasonable valuation discounts to a subsequent sale price, the apparent discrepancy often shrinks dramatically.

## Manageable discrepancies

A discrepancy may arise between a valuator's estimate and the subsequent sale price for many reasons, and it's true that the Tax Court has been somewhat inconsistent in its treatment of subsequent events and value. But well-supported valuations — accompanied by thorough rebuttal reports — are likely to withstand IRS scrutiny. ■

# The lowdown on the buildup method

For a business appraiser, estimating a privately held company's cost of equity is one of the most challenging and subjective components of a valuation assignment. Unlike the cost of debt, the cost of the equity is not directly observable in the marketplace. Instead, it requires analyses of comparable publicly traded investments as well as the valuator's own professional judgment.

## No universal cost of equity

Based on the principle of substitution, the cost of equity is the return the market demands to invest in a particular type of security. A key determinant of this return is risk. Because each company faces different risks and opportunities, the cost of equity differs from industry to industry and from business to business.

To lend credence to their chosen cost of equity, appraisers usually provide empirical support. Valuators can use several viable techniques to derive the cost of equity. But the buildup method is a popular choice when valuing small to midsize private companies.

## Buildup method components

Each component of the buildup method requires diligent consideration. The following variables typically make up the cost of equity:

**Risk-free rate.** The least controversial component of the buildup method, the risk-free rate is typically based on the 20-year Treasury Bond rate on the valuation's "as of" date. The risk-free rate estimates inflation and interest-rate risk.

**Equity risk premium.** The equity risk premium (ERP) estimates the incremental return a major market index, such as the S&P 500, provides. In essence, ERP measures historic systematic (or market) risk. But it's somewhat controversial: Appraisers often disagree, for instance, about whether arithmetic or geometric returns are appropriate.

**Small stock premium.** Many valuers also believe that small stocks warrant additional returns to compensate investors for their added uncertainty. In recent years, however, the IRS and several academic studies have challenged this conventional wisdom.

**Company-specific risk premium.** Arguably the most subjective piece of the puzzle, the company-specific risk premium measures unsystematic risk. Appraisers generally consider factors that both increase and decrease an investor's exposure to risk.



For instance, reliance on key individuals and excess leverage are factors that support a higher company-specific risk premium. Conversely, above-average profits and an experienced, decentralized management team support a lower company-specific risk premium.

## Same facts, different numbers

Appraisers often disagree about the appropriate source for several of these variables. In fact, two competent valuers could theoretically come up with entirely different — but well reasoned — estimates for the same company's cost of equity. ■

**John M. Leask II (Mac), CPA, CVA**, values 25 to 50 businesses annually. Most 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, 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 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
- Plan charitable contributions
- Assist during IRS audits involving other valuers' reports
- Succession planning
- Understanding firm operations & improving firm profitability
- Prepare valuation reports in conjunction with pre-nuptial agreements

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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