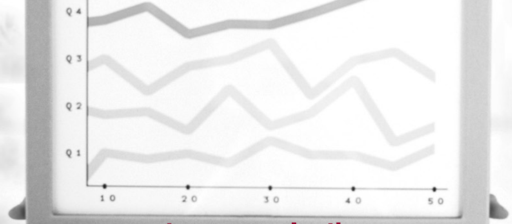

VALUATION Trends

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Court Prefers Expert with BV Experience and Better Application of Fair Value Law

***California DHI, Inc. v. Erasmus*, 2010 WL 3278224 (C.A. 10 (Colo.))(Aug. 20, 2010)(unpublished)**

In the early 1990s, a veterinarian formed a company to develop an animal food supplement with two partners, including the defendant. When the company discovered the defendant was creating a competitive supplement based on the same formula, it sued and won an $800,000 verdict. Six months later, the company merged with a California firm and the defendant invoked his statutory right to dissent and demanded purchase of his shares. Not surprisingly, the parties were unable to agree on the fair value of his 33% interest and found themselves back in court.

The parties' experts proposed widely divergent fair value appraisals. The company's expert was an experienced business appraiser who valued the enterprise at approximately $3.7 million. The defendant's expert, an investment banker with experience in the natural foods industry, valued the company at more than twice that amount—or $7.6 million. The federal district court ultimately adopted the lower value by the company's expert, finding it more reliable for several reasons, including her "significant appraisal experience; her application of the fair value standard as reflected in Colorado law; her reliance on [the company's] financial records; and the thoroughness with which she explained and duplicated her methodology." By contrast, the court noted several "gaps" in the methodology used by the defendant's expert, questioned his choice of comparable companies and products, and discredited his anticipated growth rate calculation.

The court accepted the defendant's assertion that the company's $800,000 judgment against him was too contingent on collectability to be included as an asset. However, the court declined to subordinate the company's debt to the defendant's share, and ultimately reached a going concern value of roughly $2.3 million—or just $800,000 for the defendant's 33% interest (ironically, just about the same amount as the defendant owed the company in the prior lawsuit).

After an unsuccessful request for reconsideration, the parties appealed to the U.S. Court of Appeals for the Tenth Circuit. On "careful" review of the record and the applicable state law, the 10th Circuit summarily dismissed all claims. The district court correctly determined the valuation date and the more credible valuation. It also correctly decided that the $800,000 judgment in favor of the company was too contingent to include in the fair value appraisal, but that all corporate debt should be included before an award of the defendant's proportionate share.

Divorce Courts Still Caught In 'Quagmire' of Goodwill

Dividing the value of professional practice goodwill is still creating a "quagmire for courts," according to the first of these recent decisions. Are corporate and professional goodwill truly distinct? How does a non-compete agreement affect the distinction? Should there be a rule against considering the professional's earnings in both the practice valuation and the maintenance award? Whether these four cases help answer the questions or deepen the quagmire, only time (and future litigation) will tell.

Wisconsin may have crafted a new standard. In *McReath v. McReath*, 2010 WL 2943198 (Wis. App.) (July 29,2010), the husband bought his orthodontic practice during the marriage for $930,000. During

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the divorce, his expert valued the practice at only $415,000, but the trial court rejected this value, based largely on the husband's buy-in price and his consistently high earnings. It adopted the $1 million valuation by the wife's expert, attributing a substantial portion to professional goodwill, and used the husband's earnings to award the wife substantial maintenance. The husband appealed, arguing that state law precluded the division of professional goodwill and, further, it should not be used as a basis for spousal support when it was also factored into the overall practice value (the "double dip"). The wife's argument was simple: because the husband's professional goodwill was all *salable*—i.e., subject to a non-compete agreement—it was all divisible marital property.

The appellate court agreed that a non-compete would effectively transfer a substantial portion of the husband's goodwill to a potential buyer. Prior case law precluded the division of non-salable goodwill, but said nothing about "salable" goodwill, the court noted. Fairness considerations might also support dividing such salable goodwill. For example, what if the husband planned to retire and sell his practice the day after divorce? Under a per se rule prohibiting the division of all professional goodwill, the wife wouldn't share in the practice's full value, but the court would set maintenance knowing that retirement was imminent. Alternatively, a court could include salable goodwill in the property division and adjust maintenance accordingly, but without expert evidence to explain the correct offset, the court could not make such a determination or remand the case with adequate guidance. As a result, it confirmed the trial court's approach, "to include all salable goodwill, both corporate and professional, as a divisible asset and then, essentially, ignore . . . that [the husband's] earnings are intertwined." A single, strong dissent would have remanded the case for a fairness review of the maintenance award vis à vis the division of assets.

Tennessee court excludes patient files as professional goodwill

In *McKee v. McKee*, 2010 WL 3245246 (Tenn. Ct. App.)(Aug. 17, 2010), the wife owned a long-standing dental practice with two partners, one of whom recently bought his share for $749,000, allocating 45% to professional goodwill and 34% to patient files and records. The wife's divorce expert appraised her 33% interest at only $97,000, however, because state law required the exclusion of all professional goodwill, which he believed included the patient records. By contrast, the husband's expert classified the patient files as a separate asset from professional goodwill. This view was consistent with the two prior valuations for the partnership buy-ins, which he relied on to apportion the goodwill value between the business and the professionals, ultimately appraising the wife's one-third interest at $460,000.

The trial court adopted the $97,000 value, because in its opinion, the only salable assets would be the equipment and accounts receivable. It also found the patient records "had no value without a non-compete." The court awarded 75% of the marital property to the wife and 25% to the husband—and the husband appealed, but the appellate court deferred to the lower court's factual findings. It also found that state law excludes personal goodwill from the valuation of a professional practice, and confirmed the $97,000 value of the wife's interest.

Ohio court limits professional goodwill to value of non-compete

In *Banchefsky v. Banchefsky*, 2010 WL 3527578 (Ohio App.)(Sept. 9, 2010), the husband sold his solo cosmetic dentistry practice for $580,000 during the divorce, specifically allocating $20,000 to patient records, $15,000 for a non-compete, $416,000 for unspecified goodwill, and the remainder to tangible assets. At trial, the husband's expert said the value attributed to the non-compete in the purchase agreement was "arbitrary." Using a quantitative model, the expert allocated $215,000 to the non-compete as professional, non-divisible goodwill. The trial court accepted the model, but found it didn't apply due to the arm's length sale of the practice. It valued the husband's professional goodwill at $15,000 and divided the remainder of the sale proceeds ($565,000) equally between the parties.

On appeal, the court confirmed, finding 1) under state law, a covenant-not-to-compete constituted professional goodwill and was a non-marital asset; and 2) evidence of an actual sale and assigned value supported the trial court's $15,000 valuation of the non-compete and distribution of the remaining sale proceeds.

Iowa declines to rule against the 'double dip'

Finally, in *In re Marriage of Barten*, 2010 WL 2598333 (Iowa App.)(June 30, 2010), the wife owned her own law practice, earning just $44,000 per year from about $88,000 in gross revenues and reported earnings of $8,000, after payroll and expenses. The wife testified her practice had no value and operated at a loss, supported by her credit cards. "It is essentially like a job to me," she said. The husband estimated the practice was worth $200,000, based on his estimate of the firm's gross. Neither party retained an appraisal expert.

The trial court valued the practice, its law office fixtures plus the wife's earnings, at $56,000. The wife appealed, arguing that state law precluded the court from considering her earnings (professional goodwill). The Court of Appeals disagreed, citing Iowa cases that acknowledge precedent from other jurisdictions that permit divorce courts to value goodwill. Moreover, the Iowa cases that declined to value professional goodwill did consider the practitioner's earnings to determine child and spousal support. "Contrary to [the wife's] position, Iowa courts are not prohibited from considering goodwill or future earning capacity when determining the value of a professional practice," the court held, and confirmed the lower court's value.

Tax Court Adopts Discount for Embedded Capital Gains but Declines Dollar-for-Dollar Rule

***Estate of Jensen v. Commissioner*, 2010 WL 3199784 (U.S. Tax Ct.)(Aug. 10, 2010)**

A wealthy widow held the majority (82%) of a private C corporation, which owned and operated real estate and improvements. At her death, the estate's appraiser used the net asset approach to value the corporation at just over $4.2 million, minus $965,000 for built-in long-term capital gains tax (LTCG) liability, calculated on a dollar-for-dollar basis. After applying a 5% marketability discount, the appraiser valued the decedent's share at $2.55 million.

The IRS agreed with the net asset value approach and the 5% marketability discount, but calculated a $250,000 discount for LTCG liability and assessed a deficiency of just over $333,000. (Interestingly, the IRS did not explain how it determined the LTCG liability in its deficiency notice.) The estate appealed to the Tax Court, claiming a 100% LTCG discount applied not only because the net asset method presumes a sale of assets, but also because the U.S. Court of Appeals for the Second Circuit (the appellate forum in this case) would most likely follow recent decisions in both the 5th and 11th circuits that have a dollar-for-dollar discount.

The IRS argued that the 2nd Circuit's decision in *Estate of Eisenberg* was still controlling, and permitted a discount for embedded capital gains tax based on the facts and circumstances of the case, taking into account the fair market value standard of willing buyer/seller. Accordingly, its expert began with the $4.2 million net asset value calculated by the estate's expert and then examined data from general closed-end funds. He found no direct correlation between a higher exposure to built-in capital gains tax liability beyond 41.5% of net asset value (NAV), and thus applied a dollar-for-dollar discount only to the portion of the unrealized capital gains beyond 41.5% of NAV in this case. This resulted in a LRCG liability of just over $415,000, or approximately 10% of net asset value.

The Tax Court agreed that the broader factual inquiry of *Eisenberg* applied to this case, and it expressly declined to consider how the 2nd Circuit might interpret other federal circuit decisions. At the same time, the court rejected the IRS expert's analysis, because closed-end data were simply not comparable to the assets in this case. The expert also failed to account for the assets' appreciation and the time value of money. As a result, the court conducted its own present value calculations based on the fair market value of the improved property, multiplied by appreciation and compounded interest rates (over a 17-year holding period), plus a 40% effective tax rate to reach an LTCG tax liability of approximately $1.2 million. This amount was higher than the estate's appraised dollar-for-dollar discount, which led the court to adopt the same, "because although not precise, it is within the range of values that may be derived from the evidence (and the estate did not argue for a greater amount)." Having specifically declined to adopt a *per se* rule of 100% discount for LTCG liability, the Tax Court has left the issue ripe for appeal to the 2nd Circuit.

Non-Compete Is a Corporate Asset, for Income Tax Purposes

***Howard v. United States*, 2010 WL 3061626 (E.D.Wash.)(July 30, 2010)**

In 1980, a dentist incorporated his practice, becoming the sole shareholder, officer, and director. He also entered an agreement not to compete with

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his corporation (in effect, protecting the company from himself). The agreement did not address whether the dentist or the business owned the related professional goodwill.

When the dentist retired in 2002, he sold his practice for approximately $613,000, allocating $549,900 for personal goodwill and $16,000 for a covenant not to compete with the buyer. In filing his federal tax returns that year, the dentist reported just over $320,000 as long-term capital gain income resulting from the sale of goodwill. The IRS re-characterized the goodwill as a corporate asset, however, and treated the dentist's receipt of $320,000 as a dividend. After the dentist paid the deficiency, he sought a refund in district court, claiming the goodwill was personal.

In support of his arguments, the taxpayer pointed to state divorce law, which holds that professional goodwill "has value to the professional" and is included among the divisible assets. (Note: Washington, a community property state, follows the minority rule, finding no distinction between professional and enterprise goodwill; both are assets subject to disposition in divorce.) In particular, a 1979 divorce decision by the Washington Supreme Court held that the patients of the dentist are part of goodwill and have a real pecuniary value to a hypothetical buyer. The taxpayer also claimed that the sale agreement controlled the characterization of goodwill in this case and effectively terminated the original, 1980 non-compete agreement.

Covenant not to compete is controlling. The IRS relied on federal income tax law to argue that the goodwill of the dental practice was a corporate rather than personal asset. It cited *Martin Ice Cream Company v. Commissioner*, 110 T.C. 189 (1998) and *Norwalk v. Commissioner*, T.C. Memo. 1998-279 (1998) for the proposition that if a professional works for a corporation under a non-compete, then the corporation owns the associated goodwill. The IRS also argued the parties' asset purchase agreement was not dispositive, and that, even if it somehow terminated the 1980 covenant not to compete, it did not change the character of the goodwill that the dentist generated from 1980 through the sale of his practice in 2002. Finally, the IRS claimed the "economic reality" of the transaction should determine the outcome of the case.

The Tax Court sided with the IRS and its citation of law. The parties' asset purchase agreement did not control the ownership of goodwill, nor did it reflect the contractual relationship between the dentist and his corporation. The corporation was clearly the entity that earned, controlled, and reported the dentist's income from the time of incorporation through the sale, and the covenant not to compete reinforced the corporate control of the assets, including the dentist's earnings. On review, the federal district court (E.D. Wash.) confirmed the Tax Court's decision in all respects, and denied the taxpayer's claim for a refund.