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# VALUATION ISSUES™

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KLARIS, THOMSON & SCHROEDER, INC.

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## GOODWILL IN MARITAL DISSOLUTION

*Written by: Nancy Matheny, CPA/ABV, ASA*



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### **Business is Personal**

You may have heard the same advice that was given to me years ago, “People buy from their friends.

Do everything you can do to have the best product or service at a fair price, and then, be a friend.”

The value of your reputation is huge. Many professionals spend years developing a solid reputation of honesty, integrity and professional skill within their community. We go to a doctor, attorney, or repairman we can trust. We buy a product from a person that we know we can count on.

Understanding this dynamic and how it affects the value of your business can be very important if you are facing a divorce.

### **Goodwill**

The value of a closely held company is the sum of its tangible and intangible assets. The intangible asset value of the company is the value over and above its tangible assets.

Goodwill is defined as the portion of the value of the business that relates to intangible assets such as name, reputa-

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tion, customer loyalty, location, telephone number, work-force in place, etc. In the Indiana case of Yoon v. Yoon, the court defined goodwill as “the expectation of continued public patronage.”

The term “goodwill” is familiar to us, but the type and definition of goodwill that is inherent in your business can either be “marital” or “separate”, as viewed by the courts. The key to determining whether goodwill is marital or separate lies in segregating the goodwill that is personal.

There are two types of goodwill: goodwill that relates to a particular person and is generally referred to as Professional, or Personal Goodwill, or goodwill that relates to a business, and is generally referred to as Enterprise Goodwill.

**Personal goodwill** is further defined as the value of earnings or cash flow directly related to an individual’s characteristics and attributes. Personal characteristics include ability, skills, judgment, work habits, age and health. It is the portion of the earnings from public patronage that will seek out the **individual** rather than the enterprise.

**Enterprise goodwill** is the value of earnings or cash flow directly attributable to the business entity. Enterprise goodwill may include location, organization, trade name, business know-how, computer systems, and customer lists. Even in a personal business such as a professional practice, a set of systems that make the business efficient and profitable can generate enterprise goodwill. It is the portion of the earnings from patronage that will seek out the **business** rather than the individual. A company may have a reputation for integrity and honesty. It may have a high visibility within the community. Perhaps it is known for fair dealing, or first class operating procedures. It may have a long history of operation, a trade

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## GOODWILL IN MARITAL DISSOLUTION

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name that is well-known, and a developed work-force.

Quantifying the portion of the value of a business that is attributable to this personal goodwill is of utmost importance in a marital dissolution.

### Goodwill in Marital Dissolution

The concept that there can be a component of goodwill that is “personal”, or belonging to an individual separate from the goodwill of the business is not new. In *Thompson v Thompson*, 576 So2d 267 (Fla. 1991), a spouse was looking for half of the value of a law practice. In that case, the judge distinguished between personal and professional goodwill, and indicated that personal goodwill was dependent on the presence of a particular person.

Does this personal reputation, or personal goodwill, belong to a marriage? Is personal goodwill a marital asset? That often depends on where you live.

Family courts in many jurisdictions are requiring business appraisers to separate personal and business goodwill. A majority of state courts, including Illinois and Missouri, have taken the position that personal goodwill is not

marital property. Thus, a process must be undertaken that can segregate the personal goodwill on the in-spouse business owner and exclude it from the valuation process.

There are hundreds of divorce court cases dealing with goodwill. One of the most well-known cases was *Hanson v. Hanson*, a Missouri case dealing with the valuation of the husband’s oral surgery practice. Dr. and Mrs. Hanson married on March 20, 1974. At the time of the divorce trial in 1987, Dr. Hanson was earning approximately \$120,000 per year in an oral surgery partnership. The court defined goodwill as the value of the practice that exceeds tangible assets that is dependent on clients returning to the business irrespective of the individual practitioner. *If goodwill depends on the practitioner, it is not marketable, and represents probable future earning capacity, which may be relevant to determining alimony but not property distribution.*

At this point, you may argue that all of the goodwill of your business is personal. The argument may be that if you were to sell the business and set up shop down the street, all of the customers would go with you. Therefore, the company does not own

any enterprise goodwill.

Not so fast. The valuation standard we live by in most states – Revenue ruling 59-60 – assumes the sale of the business by a willing seller. If you are a willing seller, you want to sell the business for a fair price. You would not be able to sell and move down the street, but would likely sign a non-compete agreement and help the new owner relate positively to the new clients. The goodwill that CAN be transferred, therefore, is marital.

Allocation between tangible and intangible amounts is normally not a concern. Most business valuation methodologies collectively value the tangible and intangible assets of the business and do not attempt to distinguish between the two. The conclusion is only meant to value an owner’s entire equity.

In a divorce, however, the need to quantify goodwill may exist beyond knowing the value of the business. If goodwill exists and you are in a state that considers personal goodwill to be separate property, you may require further analysis to quantify the portion of goodwill that is attributable to personal goodwill.

You have spent many years building a reputation. Sometimes it cannot be sold or divided. □

# ‘TIS THE SEASON FOR ESTATE PLANNING

*Written by: Douglas Braunstein, JD*



*Douglas Braunstein, JD*

As we prepare to exit the last quarter of 2009, and find ourselves, notwithstanding recent stock market gains, still nursing a hangover from the financial, credit and economic crisis of the past eighteen months, we can look to at least one silver lining..... estate planning<sup>1</sup>. The current diminution in asset values provides an attractive opportunity to transfer assets to one’s heirs at

values, which hopefully will materially appreciate in future years. Such transfers may be implemented by the direct transfer of these assets, or by the contribution of these assets to family limited partnerships (“FLP’s”) or family limited liability companies (“LLC’s”) and the subsequent transfer of limited partnership or membership units to one’s heirs. Consideration could also be given to contributing limited partnership or membership units to a Grantor Retained Annuity Trust (GRAT) with the beneficiaries thereof being the settlor’s heirs.

Implementing any of the aforementioned strategies will permit the donor to maximize his or her lifetime gift tax exemption of \$1 million and his or her annual per donee gift tax deduction of \$13,000. In circumstances where one transfers interests in a family entity or a closely-held enterprise a transferor is permitted to reduce the value of such gifts by taking discounts for lack of control and lack of marketability. The recent volatility in the markets and the decline in the value of auction rate securities, may provide objective

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## 'TIS THE SEASON ...

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evidence for increasing the discounts previously taken by appraisers for lack of marketability.

By taking advantage of minority and illiquidity discounts as well as the favorable Annual Federal Rates (AFR), which for loans up to 9 years is currently 2.66%, a parent is able to loan a child funds which a child can thereafter contribute to a family enterprise in exchange for an equity interest. In cases where the equity interest is a non-marketable minority interest, the equity interest received by the child in the enterprise could be greater than it would otherwise be if the interest received were in direct proportion to his or her cash investment, with the result that the parents' interest in the enterprise may be reduced without any adverse gift tax consequences<sup>2</sup>. In addition, the parent has exchanged cash for an unsecured promissory note, and if interest rates were to rise in the future and the parent died before repayment of the note, the fair market value of the promissory note in the parent's estate may be less than its face value, thereby decreasing the parent's estate tax.

With respect to determining an appropriate discount for lack of control, appraisers give effect to the fact that a minority owner lacks the ability to influence operational decisions (e.g., selection of management, dividend policy, determination to buy and sell assets) or unilaterally liquidate and/or sell the company. Accordingly, a controlling owner in a business enjoys substantial rights and benefits that a minority shareholder does not. A minority interest discount represents the discount from a controlling interest basis that is applied to determine the fair market value of a minority interest.

In determining an appropriate discount for lack of control, appraisers often use the inverse of control premiums paid in take-over transactions. Control premium data is observable in the market place for controlling interest transactions in pub-

licly traded companies where the buyers paid a premium above the target firm's quoted price per share (minority interest price per share). In addition appraisers will also utilize the discounts that publicly traded closed-end mutual fund shares trade at from their underlying net asset value (NAV). Publicly traded closed-end mutual funds, unlike open-end funds, generally do not buy their shares back from investors who wish to cash in their holdings. Instead, fund shares trade on a stock exchange. As

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reported in last years Wall Street Journal<sup>3</sup> the weighted average discount for the 650 U.S.-listed closed-end funds increased from 6.2% to 15.6%. This is an indication that the economic crisis has had an impact on appropriate discounts for lack of control.

In addition to a discount for lack of control, a marketability discount is also appropriate when valuing closely-held companies. The discount for lack of marketability reflects the difficulty or inability of the owners to sell their interests owing to the fact that there is no established market for interests in closely-held entities. The level of risk assumed by the buyer of an illiquid security is affected by a number of factors, including the risk associated with the industry in which the business operates, general economic conditions, general market risks, and the buyer's own financial situation. However, where everything else is equal, a key

factor is the length of time that an investor will have to hold the illiquid security. The longer the holding period, the fewer potential buyers there will be for the security and therefore the greater the marketability discount in these circumstances. There has been some evidence that the economic crisis has also had an impact on discounts for lack of marketability. For example, investors having experienced a loss in the value of their portfolios, as well as a reduction in available credit, have been more reluctant to commit to investments which cannot be readily monetized, unless they are substantially compensated for that risk.

So instead of giving your family members cash or gift certificates, consider transferring some of your depressed, undervalued assets or consider transferring these assets to a FLP or a LLC and thereafter either (i) gift a portion of such limited partnership or membership units, or (ii) loan funds to a child who in turn will invest these funds in either the FLP or the LLC, so as to take advantage of current minority and lack of marketability discounts as well as current AFR rates. This strategy may afford a parent the opportunity to achieve significant estate tax savings as well as provide economic benefits for his or her children. -It is a strategy whose benefits will continue to be realized for many years to come. □

<sup>1</sup>If Congress does not act this year, the estate tax would be repealed for one year in 2010 before returning to the Clinton-era rate of 55% and a \$1 million exemption. The Obama administration has supported making permanent the current 45% estate tax rate with an exemption for up to \$3.5 million per individual. A potential compromise might result in a 35% estate tax rate and an increased exemption of \$5 million per individual. However, any material reduction in the estate tax rates and increase in the personal exemption may be offset by the elimination of minority discounts in family controlled enterprises, which change has been proposed by several members of Congress.

<sup>2</sup>Thus, assume a family owned company has a fair market value (“FMV”) of \$9 million. If a child were to contribute \$1 million, the FMV of the company would be \$10 million, and the child would receive a 10% interest in the company to reflect his or her proportionate interest. However, for the child to receive \$1 million in value, he or she may have to receive, say a 20% interest in the company since a third-party purchaser would not pay \$1 million for a 10% non-marketable minority interest in a closely-held company.

<sup>3</sup>Gullapalli, Diya, Investors Dump Closed-End Funds, The Wall Street Journal, Monday, October 20, 2008, pC2.

# NEWS & NOTES

## ANNOUNCEMENT



Our Klaris, Thomson & Schroeder, Inc. Tampa office has a new Manager and location. We welcome Sean H. Hayes. Mr. Hayes has over 14 years of experience in the valuation of businesses and intangible assets.

The address of our Tampa office is:  
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is a full service valuation and consulting company specializing in business valuations, intangible asset valuations, financial consulting, expert testimony and litigation support. In addition, we also perform real estate valuations, machinery and equipment valuations, and international transfer pricing analyses.

For more information or a free valuation seminar for your firm or professional group, please call Anita Thomson at (877) 587-7008, or e-mail your request to [ktsinc@verizon.net](mailto:ktsinc@verizon.net).

— Oscar Wilde  
“A cynic is a man who knows  
the price of everything, and  
the value of nothing.”

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