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A Publication of the San Fernando Valley Bar Association

Putting the "Family" Back in Family Law

Earn MCLE Credit

Business Valuation Services for Marital Dissolution

SFVBA Succeeds in Protecting Membership List

Jonathan Cole and Mark Schaeffer Represent SFVBA in Court

VALLEY LAWYER

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VALLEY LAWYER

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Business Valuation Services for Marital Dissolution

By Chris Hamilton

IN A DIVORCE MATTER, THERE are two primary financial questions: “What are the assets and debts of the marital estate?” and “What is the income available for support?”.

In most divorces these two questions can be resolved without the use of a forensic accounting firm. This is generally true where the spouses derive their income through employment. However, in cases where a business (or several) is owned by the marital estate, the complexities involved can increase exponentially. The value of the business is almost always a difficult issue. Income earned from the business also becomes an elusive issue that often requires extensive discovery and analysis.

It often surprises divorcing couples that they own a business that needs to be valued for purposes of determining an equitable asset split. For example, a business activity where there are no employees and it generates self-employment income is, in fact, a business. To the degree there is any goodwill value in the business it is subject to the asset split.

Business appraisal in the context of divorce is a function of both of the primary financial issues – income and assets. The business itself is an asset subject to an equitable split. Often, the business is also the primary source of income for the family and, as such, is the primary source for marital and child support. This is why, for most family court lawyers, retaining the same expert to address both issues is the most efficient solution.

The most common method used to value a business is an income approach. In simple terms, this approach

capitalizes cash flow generated by the business after payment of all business expenses and taxes. This is done by either capitalizing income or determining “excess income” and capitalizing the portion of income associated with intangible assets.

Under either method, business expenses should include the market value of services provided to the business by the divorcing spouse. To the extent profit distributions are included in the compensation of the business owner, there is an adjustment to increase the operating cash flow from the business. Or, said another way, a buyer of the business would want to determine the cash flow that is available from the business before any profit distributions are made. That cash flow is what would be used to value the business.

The interaction between income and asset value comes down to this single adjustment. The challenge in a divorce matter is that alongside the issue of valuing the business is the question of spousal and/or child support. You cannot use the same income to value the business as you use to determine support – this is commonly known as double-dipping and is generally viewed as unfair. Understanding the separation of cash flows between those produced by the business and those produced via the personal efforts of the owner is key to grasping the potential results of a marital dissolution. Failure to understand, or to retain an expert that does, can result in unfair and inaccurate results.

It is very common, almost automatic, to expect to see profits

in a closely held business at or near zero. There are powerful tax and cash flow motivations to eliminate taxable income from the business. This is done a number of ways that involve increasing the income of the owner: bonuses, perks, personal expenses, etc. Therefore, the valuation expert will attempt to determine the total compensation of the owner. This, as noted above, has a dual purpose in a divorce matter. Once total compensation has been determined, there is ultimately an allocation made between “reasonable compensation” for services to the business vs. profit distribution. The profit distribution is used to value the business. The compensation is used to determine support.

For example, if Husband draws \$500,000 per year from the business each year leaving a profit of zero, the appraiser will determine whether the services provided to the business would be fairly valued at \$500,000. It is very likely that some portion of the compensation will be deemed as profit distribution rather than payment for services. In this example, assume that reasonable compensation is determined to be \$200,000. The value of the business would be based on annual net income for the business of \$300,000. Support calculations would then reasonably be based on annual compensation of \$200,000. While this is a simplified example, it illustrates the point that using the \$500,000 draws for support and business valuation would work out to an unfair result.

To illustrate the interaction of the two elements assume that the appropriate capitalization rate for the

business in dispute is 25%. In the example given above, the value of the business would be \$1,200,000 (\$300,000 ÷ 25%) and the income available for support is \$200,000. If, however, the determination was that reasonable compensation is \$75,000. The resulting business value is \$1,700,000 and the income available for support is \$75,000.

The temptation is to approach this kind of an allocation from the standpoint of asset split vs. support calculation. While that kind of “trading” is unavoidable, counsel is best served by a valuation/accounting expert that can provide the opinion of what will be the likely conclusion of the court. If it becomes a matter of negotiation the valuation expert can be utilized to assist in the calculations of the impact to each party on the proposed allocation.

The dynamics of these calculations in a small closely-held business can be confusing and difficult to grasp. The extreme of expectations between the “out-spouse” and the “in-spouse” (directly involved in the business) are a primary factor driving litigation in this area. The expectation gap is often a function of the lack of understanding that income can only be used once.

The gap is also due to the difference in knowledge about the affairs of the business. The spouse who will retain the business invariably insists that all revenue has been reported and all expenses are true business expenses. Suspicions on the other side revolve around revenue not being reported (particularly in cash businesses) and personal expenses being deducted for tax reasons as business expenses. This is another reason that most family law practitioners use a single expert to assist with income and business expenses. A single process of discovery is more efficient when the expert is assisting in the development of document request lists that will result in information supporting income and business value conclusions. 📌

Chris Hamilton is a Certified Public Accountant, Certified Fraud Examiner, and a Certified Valuation Analyst. He spends most of his professional time assisting lawyers with complex financial litigation and has testified in family, civil, criminal and probate courts. He can be reached at CHamilton@arxisgroup.com.

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President

Help is Needed Even in Troubled Waters

ON THE EVENING OF SATURDAY, JUNE 5, 2010, the Foundation will hold its annual Law Day Gala. Once again, we will be at the fabulous CBS Studios.

This year, the Heroes in Law Enforcement and Firefighter's Award will be given to Los Angeles County District Attorney Steve Cooley. The Award will be presented to the District Attorney by California Court of Appeal Justice Judith Ashmann-Gerst.

The Armand Arabian Law & Media Award will go to Jerriane Hayslett, author of *Anatomy of a Trial: Public Loss, Lessons Learned from The People v. O.J. Simpson*, former public information officer of the Los Angeles Superior Court and a national speaker and writer on media in the courts.

The Masters of Ceremonies for the evening will be the famed show-business couple Shirley Jones and Marty Engels.

So the evening will be both impressive and fun. Just as importantly, attending the event will demonstrate a continued commitment to the Foundation's valuable charitable work

– providing scholarships to students seeking a career in the law, providing grants to institutions doing legally-related chaitable work and enabling the Foundation to move forward in supporting projects like the Van Nuys and San Fernando Children's Waiting Rooms.

Although these are not the best of times in which to be seeking charitable contributions, the true quality of a community is judged not by how it behaves when times are good but rather by how the community helps its members when times are hard. It is in hard times that character is tested. Sacrificing a little can help others a lot.

When SFVBA members get their Gala invitation, don't just put it aside or, even worse, throw it out. Members not able to be an event sponsor should consider sponsoring a table; if unable to sponsor a table, then just buy a ticket! Every little bit will help the Valley community a lot.

The VCLF looks forward to seeing all SFVBA members at the Gala on June 5. 🐾

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