BUILDING VALUE

A Business Valuation Newsletter for Business Owners and the Professionals Who Advise Them

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Personal Goodwill in Divorce

Personal goodwill is an evergreen topic. It is continuously changing, especially in the divorce arena, because of the myriad of cases in the various states and jurisdictions and the attendant myriad of interpretations held forth in these cases. That is one reason that it is so important for an expert to know what the "rules" are in the jurisdiction in which he/she is testifying. As professor Harold Hill says in *The Music Man*, "You gotta know the territory."

First, a primer on goodwill. It is my belief that there are three divisions of goodwill: entity goodwill, transferrable (salable) personal goodwill, and "pure" personal goodwill.

Entity goodwill is that which attaches to the entity or enterprise and belongs to the enterprise. Transferrable (salable) personal goodwill is that goodwill which has been developed and nurtured by the individual possessing it but which can be transferred to another through use of a covenant, training, transference of relationships, etc. The *McReath* Supreme Court case in Wisconsin is an excellent guide to transferrable (salable) personal goodwill.[1] "Pure" personal goodwill is that goodwill that is so unique to the individual that it simply cannot be transferred to another.

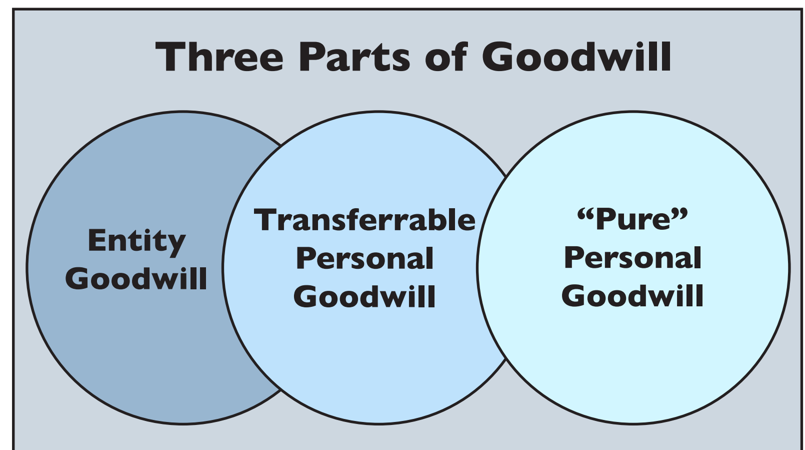
Even though the courts have created a morass in this area, there are some concepts that the expert should look for in any divorce valuation where personal goodwill is an issue.

STANDARD OF VALUE

Many courts will insist that the standard of value in their jurisdiction is fair market value. This is often a myth. Let's look behind the curtain. Fair market value (FMV) is a well-defined term. At risk of insulting you, I will repeat it here from the *International Glossary of Business Valuation Terms*:

> The price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm's length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts.

What does this tell us about personal goodwill? Is "pure" personal goodwill included in a value determined under the FMV standard? It is not, of course. That is because it cannot be transferred and cannot be sold. Thus, a com-



pany valued on the FMV standard would already exclude "pure" personal goodwill. However, you will find many valuation analysts who will "exclude" "pure" personal goodwill from a value already assumed to be on a FMV basis. Now it might or might not be true that the supposed FMV has, appropriately, excluded the "pure" personal goodwill. If it has, then taking an additional haircut to exclude "pure" personal goodwill would be double-dipping. If it has not already excluded "pure" personal goodwill, then the value thus determined is not yet on a FMV standard basis.

You can see how confusing this can be to the judges, the attorneys, and, sadly, even the experts. I have found the clearest way to explain this to the court and the attorneys is to start the value with the "investment value" (standard) of the business. Per the *International Glossary*, investment value is:

> The value to a particular investor based on individual investment requirements and expectations.

Expert Tip

It is important to make sure the proper elements of personal goodwill have been considered in arriving at the value for the marital estate.

Generally, a value on the investment value standard will include all income sources available to the particular owner of the business. This value then would clearly include all income from personal goodwill sources. By then valuing the "pure" personal goodwill in the business and excluding it from the investment value, a value under the FMV standard can be clearly derived and explained to the parties and the court.

RECOGNITION OF A SALE OF THE BUSINESS

While most states recognize that there is an assumption of the business actually being sold (clearly a premise for FMV) as part of the process of valuing a business interest in divorce, there are a few states or jurisdictions that do not. In these states or jurisdictions there is an assumption that the value of the business should be on the investment value standard (as described previously). Interestingly, this leaves open the question of not only what to do with "pure" personal goodwill but transferrable (salable) personal goodwill as well. In these jurisdictions it is necessary to determine whether personal goodwill is excluded at all. My experience has been that these jurisdictions will call for an investment value but then also exclude at least "pure" personal goodwill. The valuation analyst needs to have a clear understanding of what is included and what is not in these jurisdictions.

TRANSFERRABLE (SALABLE) PERSONAL GOODWILL

As mentioned above, the *McReath* case in the Supreme Court of Wisconsin (*McReath v. McReath*, 2011 WI 66, 2009AP639) clearly outlines the premise that personal goodwill that is transferrable by the individual possessing that personal goodwill is includable in the marital estate in Wisconsin. This is a concept that has been implied in a number of other personal goodwill cases in other states or jurisdictions, but not clearly delineated and certainly not by the highest court of a state until the *McReath* case.

Even though this case is not precedent for cases in other states, it can be used to present the argument in another state or jurisdiction as to whether transferrable (salable) personal goodwill should be included or excluded from the marital estate in a divorce. This is relatively new territory for most states or jurisdictions, but one that bears watching. Regardless of the jurisdiction, it behooves the valuation analyst to discuss this issue with the attorney. It is a good idea to provide a copy (or at least a citation) for the *McReath* case to the attorney. In some cases the attorney might decide to be aware of the issue but not to deal with it directly (i.e., to go ahead and exclude both "pure" and transferrable [salable] goodwill from the marital estate).

COVENANTS NOT TO COMPETE (CNTC)

The determination of a value under the FMV standard generally assumes the existence of a CNTC where one is warranted in the circumstances.[2] The existence of a CNTC thus captures and transfers the transferrable personal goodwill in the value so determined. In this instance, if the state or jurisdiction allows for exclusion of *all* personal goodwill (i.e., both "pure" personal goodwill and transferrable goodwill) the valuation analyst needs to make an adjustment from the FMV to exclude the transferrable personal goodwill that might have been trapped in the assumption of the execution of a CNTC in FMV.[3] Without excluding the transferrable personal goodwill the value for marital dissolution purposes will likely be overstated.

Once again this brings into question whether or not FMV is truly the standard that is being used (despite the assertion of the courts). If both "pure" and transferrable personal goodwill are to be excluded from the value, the adjustment noted above must be made.

MAKING SURE THE VALUE IS RIGHT

It is important to include and exclude the proper elements of personal goodwill in arriving at the value for the marital estate. Below is a summary that might help you determine the right answer:

I have testified in cases where I presented both the investment value and the FMV starting points and then showed the court how I arrived at the value for purposes of the marital estate that excluded the elements of personal goodwill. I believe more of this will be seen in the future as the courts struggle with this issue.

DEALING WITH PERSONAL GOODWILL IN A LESS-THAN-CONTROL INTEREST

It is possible to have personal goodwill when the interest being valued is a less- than-control interest. Consider the following example:

> Mr. A is the one-third owner of XYZ Corp. which provides environmental cleanup management services. Mr. A controls the personal relationship with the two major clients who comprise 90 percent of XYZ's business. XYZ would not retain the business without Mr. A's continued involvement. Ninety percent of the goodwill of XYZ (as an example) can be attributed to Mr. A. Therefore, 90 percent of the goodwill included in his one-third interest is attributable to his personal goodwill and therefore excludable in a jurisdiction where personal goodwill is not included in the marital estate.

Further consideration should be given to taking a discount for lack of marketability and a discount for lack of control (where appropriate) to recognize the diminished value of the interest. That begs the question of whether the level of DLOM would be as high as it might be was it not for the prior exclusion of the personal goodwill. That is a subject for another time, but I would say it could be as high or even higher depending on the circumstances.

CONCLUSION

We really have only broken the surface of some of the issues that can arise in dealing with personal goodwill in a divorce setting. Hopefully, the topics we have covered will provide a framework for understanding personal goodwill.

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1 Alerding, James. "Salable Professional (Personal) Goodwill: Is It IN or OUT?," *Financial Valuation and Litigation Expert*, Issue 27, Oct./Nov. 2010, pp. 17-18.

2 Some might argue with this conclusion, but that is not a topic for discussion in this article. In most cases a CNTC is part and parcel of a sale and thus a part of FMV.

3 Again some might want to argue whether FMV includes the assumption of a CNTC or not, but I believe that is the general consensus.

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IF YOUR JURISDICTION...	AND YOUR STARTING VALUE IS FMV	OR YOUR STARTING VALUE IS INVESTMENT VALUE
Excludes both "pure" and transferrable personal goodwill	You might have to make an adjustment to FMV to further exclude the transferrable personal goodwill included in the assumed CNTC	You might have to make an adjustment to calculate and exclude BOTH the "pure" and transferrable goodwill
Excludes only "pure" personal goodwill	Assuming the FMV has been calculated correctly it should already have excluded the "pure" personal goodwill and includes the transferrable personal goodwill	You would need to calculate and exclude the "pure" personal goodwill from this value
Excludes no personal goodwill	You would have to calculate and add back to the FMV the value of the "pure" personal goodwill	Assuming the investment value has been calculated correctly, it should already include both the "pure" and the transferrable personal goodwill

FEATURED CASE

MOUNTANOS V. COMMISSIONER

CITATION:
MICHAEL S. MOUNTANOS, PETITIONER V. COMMISSIONER OF INTERNAL REVENUE
T.C. MEMO. 2013-138; DOCKET NO. 8158-10, JUDGE: HON. DIANE L. KROUPA, FILED JUNE 3, 2013

OVERVIEW

Through a living trust, taxpayer owned a California ranch which was used for related-family recreational purposes. In 2005, taxpayer claimed a $4,691,500 charitable deduction for a conservation easement placed on the ranch, but section 170(b)(1)(B) limited his deduction to $1,343,704 for that year. The unused portion of the charitable deduction was claimed in the subsequent three years.

Citing two issues, the IRS asserted deficiencies exceeding $1.1 million for the taxpayer's 2006, 2007, and 2008 personal income tax returns:

- Taxpayer was not eligible for carryover deductions for a conservation easement charitable deduction, and
- Taxpayer was liable for an accuracy related penalty for each of the three years.

DISCUSSION

Although the IRS acknowledged that the deduction was a "qualified conservation contribution" under section 170(f)(3)(B)(iii), it denied the subsequent deductions because they were overstated. The court indicated the "before-and-after" approach of *Stanley Works & Subs. v. Commissioner*, 87 T.C. 389, 399 (1986), is often used to value such easements because actual sales are rarely available.

The taxpayer provided three experts who testified to the current and expected highest and best use of the property. The IRS provided no such expert testimony and instead relied on cross examination.

While the court agreed with the experts' assessments of highest and best use after implementation of the conservation easement, it disagreed with the taxpayer-experts' pre-easement assessments. Regarding the pre-easement uses, the taxpayer failed to:

- Demonstrate that he had the right to access the land (access was controlled by a third party) for its asserted use,
- Had adequate water rights to develop the land for its highest and best use,
- Show adequate demand existed for one of the uses, and
- Address legal limitations imposed by subdivision statutes.

Additionally, the court noted that the taxpayer failed to provide evidence that the alleged pre-easement highest and best uses were economically viable. Furthermore, one taxpayer-expert's testimony was disregarded because he failed to establish that he was qualified to appraise real estate, saying:

> "Although [taxpayer's expert] has been a real estate broker for a number of years, he does not hold an appraisal designation from a recognized professional appraiser organization. Additionally, the record does not reflect that Mr. Lazaro has any formal training or education in appraising real estate or that he regularly performs real estate appraisals." [insertion substituted in original]

The author notes the court's criticism was similar to its criticism of finance and accounting professors who performed business appraisals in *Estate of Ray A. Ford v. Commissioner*, T.C. Memo 1993-580, and *Estate of Edgar A. Berg v. Commissioner,* T.C. Memo 1991-279.

CONCLUSION

Ultimately, the court concluded "that the taxpayer failed to show that the before and after highest and best use of the ranch differed," and more specifically, the taxpayer failed to show the conservation easement had any value. Hence, the taxpayer was not entitled to the claimed charitable deduction carryover deductions for 2006, 2007 and 2008.

Because the ranch was worth no more after implementation of the conservation easement, the court upheld the IRS assertion that it had met the burden of production associated with fair market value exceeding 400% or more of the correct fair market value.

Additionally, the court ruled that the taxpayer had not acted with reasonable cause or in good faith, and therefore was not eligible for an accuracy related exemption under Sec. 6664(c)(1) or Income Tax Regs. 1.6664-4(a). Hence, the asserted accuracy related penalty was upheld.

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