

Cantor Forensic Accounting, PLLC
1490 S. Price Rd. Suite 308
Chandler, AZ 85286
480-620-8486
david@dscfac.com
www.dscfac.com

One Dip Or Two....The “Double Dip” Issue Of Goodwill And Support In A Divorce

The issue almost always arises when you are dealing with the issue of goodwill in a business (usually a personal service business) and spousal maintenance and/or child support. First and foremost, this article will focus on the accounting aspects of this ongoing issue and I will not address the legal foundation or make legal argument...I'll save that for the attorneys.

For those of you not familiar with the issue, a double dip may occur when the same dollars are counted twice...once as part of the property division and then again in determining support. You may see this when a pension is being divided or allocated and then support is based on the pension benefits or you may see this with the aforementioned business goodwill and support issue. What I will discuss in this article is the issue of when goodwill and support may or may not be a double dip.

David Cantor, CPA/ABV has been working almost exclusively in Family Law Accounting since 1990 in both Arizona and California.

He has worked on over 1,000 Family Law cases and has experience in all aspects of Family Law Accounting including Business Valuations, Separate Property Tracings, Calculation of Income For Purposes of Determining Maintenance and Support as well as many other financial issues.

Mr. Cantor has testified in Court over 100 times as an expert witness.

We all know that goodwill is an intangible asset and is not easy to assign a value to. When a business valuation is prepared related to a divorce, you have many issues to contemplate in the determination of goodwill (ignoring for a moment whether or not goodwill should even be included). You need to address, among other things, capitalization/discount rates, reasonable compensation, normalizing adjustments and stream of income/cash flow. It is the stream of income/cash flow that may be the hidden, and often overlooked, key in the double dip controversy.

In most business valuations prepared outside of the divorce arena, the appraiser will project a stream of income/cash flow into the future and use that stream as a basis for determining the value; including goodwill....which makes perfect sense. However, in preparing a business valuation for a divorce you now have a mixture of business valuation methods, case law and state statutes which can result in conflicting guidance for the person preparing the valuation resulting in really muddy the waters.

So let's start throwing dirt in the water with ARS §25-213(B) which states: "Property that is acquired by a spouse after service of petition for dissolution of marriage, legal separation or annulment is also the separate property of that spouse...". Does this mean that if a business continues to grow after

DOP that the growth is separate property to the spouse running the business, or since the Court has discretion in determine the valuation date, does the separate property commence after the date of valuation, resulting in the value growing after date of petition?

Now I have another clod of dirt for the water, and this may really fine tune the focus on the double dip. As I stated earlier, most valuations are predicated on a projected future stream of earnings/cash flow. For argument's sake, let's assume the business is being valued at DOP. So when preparing my valuation, do I look at projected future earnings/cash flow.....which can be construed as separate property of the spouse retaining the business, or do I look at the historical earnings/cash flow up to DOP which were based 100% on community efforts? If you have a business that is growing steadily, any projections will continue this growth, possibly showing income greater than was ever achieved during marriage. If goodwill is based on these projections, isn't it possible that the ultimate value is based in part upon the separate property efforts of the spouse retaining the business.....or is it possible that the foundation of the value was based on the efforts of the community during marriage to get the business built up to this point to be able to continue to grow?

Let's look at some case law that may clarify this issue....or not.

- Walsh (2012 Arizona) - ¶26: “We underscore, however, that our holding does not equate goodwill with future earning capacity. While future earning capacity may be evidence of goodwill, the earning capacity is not itself a divisible community asset.” ¶27: “And we are cognizant of the risk that future income (which is not a community asset), to the extent it is relevant to the valuation of goodwill, is at risk of unlawful division.”
- Molloy (1994 Arizona) – “It is true that in Arizona future income is not subject to equitable distribution. However, future income that is a result of goodwill that existed at the time of dissolution and not as a result of the spouse's labors alone is properly included in the marital community estate.”
- Blazer (2009 California) – “Whatever method is used, “goodwill may not be valued by a method that takes into account the post-marital efforts of either spouse,” because those efforts constitute separate property.” Later in its decision, the Court referred to the Grunfeld case (2000 NY): “There is no double counting to the extent that maintenance is based upon spousal income which is not capitalized and then converted into and distributed as marital property.”

From an accountant's perspective, it appears that these decisions may be leaning towards not projecting income/cash flow, but instead using historic income/cash flow in arriving at value. Blazer, via Grunfeld, even says that if you don't use the same income stream for capitalization in the valuation as you are using for maintenance, then there is no double dip.

So now we have vague guidance on calculating goodwill, and we haven't even discussed maintenance. Of course, the primary determination in maintenance is income of the parties. Now we start looking at whether or not that income being used to determine the maintenance was the same income to determine goodwill and therefore raising the issue of a double dip. But, as I like to do, let's throw some more dirt in the water as I pose this question; what if maintenance is based on the marital standard of living or the needs of the parties? Can an argument still be made that there is a double dip since income was not the primary factor in determining maintenance?

Let's be realistic. The source of maintenance is coming from the earnings of the business post date of petition. There is really no way around that one. The big question comes back to; was the goodwill determine based on these same earnings used to pay maintenance or was the goodwill based on earnings that aren't used to pay maintenance?

This is an intricate issue that involves mathematical calculations, valuation theory and legal arguments, none of which are clear cut or clearly defined. More importantly, the facts and circumstances of each case will dictate the approach that is taken when performing the valuation, maintenance calculations and then arguing to the Court what your position is.

With that said, I leave you with the following key points to consider when you may have a double dip issue:

- Carefully consider the income/cash flow stream used in the valuation (either historic, projected or a combination of both)
- Consider the type of business that is being valued (personal service, professional or enterprise).
- In determining maintenance, consider needs and marital standard of living in addition to income.
- Don't let general valuation methods automatically override case law and local statutes.

This is not a cut and dry issue and there are very legitimate arguments for both sides of the issue. But, if you are not prepared, you can leave a lot of your client's money on the table.

Calculation Reports For Family Law Business Valuations – A Less Expensive Alternative

A relatively new type of valuation engagement is the Calculation Engagement. *These engagements are less expensive* than the valuation engagement, but can often be used to facilitate settlement when an outstanding issue is the business value.

Calculation engagements (which have certain requirements detailed in the American Institute of Certified Public Accountants Statement on Standards For Valuation Services No. 1) are agreed upon procedures by the valuation consultant and the client(s) as to the valuation assignment. These procedures do not include all of the procedures that would be considered necessary in a valuation engagement.

This type of valuation is often used to get an idea of the business value without incurring the expense of the full valuation engagement. It should be noted that the results of calculation engagement may not be the same as if the full valuation engagement had been performed.

If there are no complex issues and all of the documents are provided as requested (and of course there is cooperation from the parties), calculation engagements **can be prepared for as little as \$2,000.**

Considering that a swing in value of just \$5,000 can mean a cost or benefit to your client of \$2,500, a calculation of value is a small price to pay to ensure that your client is well informed on the value of a community asset.

It should be noted that in all probability a valuation consultant will NOT testify to a calculation engagement that they have performed. However, if it is determined that the case is headed to Court and testimony will be needed, additional work can be performed to convert the calculation report into a valuation report which the consultant would testify to.

Whenever you retain someone to perform a business valuation for you, make sure that they are credentialed in business valuations (ABV, CVA, ASA....). This will ensure that you are hiring someone who has proven knowledge in the area of business valuations.

Always feel free to call me if you would like to discuss this newsletter or any other Family Law accounting issues that you may have.

FREE CLE CLASSES IN YOUR OFFICE

Cantor Forensic Accounting offers free 2 hour CLE* classes at your office. Working with you, I can customize a class on any Family Law accounting issue to meet your office needs and fulfill a minimum of two hours of CLE. Topics can include:

- ◆ Business valuation issues related to marital dissolutions
- ◆ Calculation of income
- ◆ Separate property tracing
- ◆ Document requests
- ◆ Marital Standard of Living
- ◆ Income tax issues related to marital dissolutions
- ◆ Reimbursement claims
- ◆ Stock option allocations

Please call David to receive more information on these classes.

*The State Bar of Arizona does not approve or accredit CLE activities for the Mandatory Continuing Education requirements of Specialists. This activity may qualify for up to two hours toward your annual CLE requirement for the State of Arizona, including two hours of advanced level training in the area of Family Law. A minimum of 5 attorneys are required to attend.

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