

# Tennessee Family Law

## Valuation & Forensic Insights for Attorneys

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We are pleased to launch the inaugural issue of Mercer Capital's *Tennessee Family Law Newsletter*.

Mercer Capital is the largest valuation and financial advisory firm in Tennessee with offices in Nashville and Memphis. Complex financial issues are a critical part of many of your client engagements. The focus of this newsletter is to provide useful content about these financial issues from the perspective of financial experts. We seek to help you assist your clients in financial and accounting matters.

We hope that you find the newsletter to be a resourceful tool and appreciate any feedback that you have along with any suggested content topics or ideas that you'd like to see in future editions. You can send your feedback and ideas to **Scott Womack** or **Karolina Calhoun**.

# How Does the New Tax Law Affect Personal Goodwill in Family Law Cases?

Most professionals have seen countless reports of the 2017 Tax Cuts & Jobs Act (TCJA) on national news and been bombarded with requests to discuss the impact and various changes in the new law. For the family law community, obvious takeaways are the change in the deductibility, or lack thereof, in alimony payments after 2018, elimination of personal exemptions, and expanded use of 529 plans to include secondary and lower-level education expenses. Can a provision in the TCJA actually provide some insight into the presence of personal goodwill?

## Personal Goodwill Under Tennessee Law

Under Tennessee case law, personal goodwill is not a divisible marital asset. As discussed in the seminal case *Koch*, the Court reiterates the findings and definition of personal goodwill provided by the Wisconsin Court of Appeals in *Holbrook*. *Holbrook* describes personal goodwill as follows:

*“The concept of professional goodwill evanesces when one attempts to distinguish it from future earning capacity. Although a professional business’s good reputation, which is essentially what its goodwill consists of, is certainly a thing of value, we do not believe that it bestows on those who have an ownership interest in the business, an actual, separate property interest. The reputation of a law firm or some other professional business is valuable to its individual owners to the extent that it assures continued substantial earnings in the future. It cannot be separately sold or pledged by the individual owners. The goodwill or reputation of such a business accrues to the benefit of the owners only through increased salary.”*

## Section 199A of the TCJA and Personal Goodwill

So, what does personal goodwill have to do with the TCJA? Upon closer examination of the provision for a Section 199A deduction, some individual’s trusts and estates could be eligible for a 20% deduction on certain pass-through income. However, there are special limitations that apply to “specified service businesses.” According to the TCJA, “specified service businesses” are defined as follows:

*A specified service trade or business means any trade or business involving the performance of services in the fields of health, law, accounting, actuarial sciences, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners, or which involves the performance of services that consist of investing and investment management trading, or dealing in securities, partnership interests, or commodities.*

Sound familiar? Both the *Holbrook* and “Specified Service Businesses” definitions have some common elements including reputation and skill of the employee. Under the TCJA, can tax returns now be used to assist attorneys and business appraisers to determine if the presence of personal goodwill exists? In other words, if an individual fails to qualify for a Section 199A deduction because of the “specified service businesses” limitation, does that illustrate that personal goodwill is present?

We think the Section 199A provision and a person's deductibility or exclusion of this deduction can provide another data point for attorneys and appraisers in determining whether personal goodwill is present. As with any thorough analysis of personal vs. enterprise goodwill, other important factors to consider are:

1. Size of business and number of owners/practitioners
2. Presence/lack of covenants not to compete
3. Dependence on owner(s) for selling feature with Company's products
4. Presence/lack of ancillary income

## Conclusion

The 2017 Tax Cuts & Jobs Act may assist attorneys and appraisers in determining if personal goodwill is present via the Section 199A deduction.

As we've pointed out, this deduction/exclusion is just one of several data points that should be considered. It should also be noted, that determining whether personal goodwill is present or not is only the first step to an analysis. If personal goodwill is present, the second step is to determine or assign value to the personal goodwill. In other words, a company's value could be comprised of both enterprise and personal goodwill. A qualified business appraiser is necessary to make this determination and to provide an allocation of the goodwill.



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# Mercer Capital in the News

## Impact of the 2017 Tax Cuts and Jobs Act on Family Law & Business Valuation



**Scott A. Womack, ASA, MAFF** spoke to the **Tennessee Trial Lawyers** at their Spring CLE at the Nashville School of Law on February 8, 2018 on the changes and impact of the new Tax Cuts and Jobs Act of 2017. Specifically, Scott focused on the impact on family law and business valuation issues. Four key takeaways are as follows:

1. **Alimony.** For divorces granted after 12/31/18, alimony will no longer be deductible by the payor and taxable to the payee as under the previous tax law. The new law makes alimony taxable to the payor.
2. **Personal Exemptions.** Under the new tax law, personal exemptions are eliminated. Previously, personal exemptions were often used during divorce settlement negotiations with the parties splitting these deductions and sometimes one spouse compensating the other spouse to “purchase” the use of this exemption.
3. **529 Plans.** The new tax law expands the use of 529 plans to include secondary education and other uses, whereas it was previously only available for college and higher education. Often, 529 plan accounts exist in a marital estate and become a topic discussed during settlement negotiations for how/when they will be used.
4. **Business Valuation.** With the declining corporate tax rates in the Tax Cuts and Jobs Act, the valuation of C corporations could be higher simply due to the mechanics of income approaches to value a business. Early indications seem to indicate that value might increase by approximately 15-18%, all other things being equal. For further information on this topic, see the Mercer Capital's “**2018 Tax Reform: The Implications for Valuation**”.

## Upcoming Speaking Engagements



**Karolina Calhoun, CPA/ABV/CFF** will be speaking at the upcoming AICPA Forensic & Valuation Services Conference (November 5-7, 2018) in Atlanta, Georgia on the topic of “Lifestyle Analysis/Pay & Need Analysis” and is a member of the conference planning committee. Karolina is also co-facilitating the NextGen pre-conference workshop.



**Z. Christopher Mercer, FASA, CFA, ABAR** will be participating in a panel discussion on the topic of “Active Passive Appreciation Analysis” on October 9, 2018 at the 2018 Advanced Business Valuation Conference of the American Society of Appraisers in Anaheim, California.

# Tennessee Case Reviews



## Morelock v. Morelock

Tennessee Court of Appeals, Eastern Section, August 18, 2017

In the Morelock divorce, Husband appealed the trial court's decisions of the division of marital property and valuation of one of the marital assets. He asserted the trial court overvalued the business owned by the parties (51% owned by Husband, 49% owned by Wife) and the court should have equally divided the assets and liabilities of the business rather than awarding it entirely to him. The trial court found that "Husband operated, controlled, and managed all aspects of the business."

In this case, neither party retained a business valuation expert. Husband's accountant testified to the historical income of the business and the parties provided an asset and liability summary as well as estimates of the business's earning power. Husband argued the business had no value, while Wife argued the business had a value in excess of \$200,000. The trial court determined a value of \$150,000 based on the business's assets and its ability to generate income. Husband was awarded 100% of the business value as the trial court found that "Husband operated, controlled, and managed all aspects of the business" and did not include Wife in the management or operations of the business. On appeal, the trial court's decision was affirmed. Furthermore, based on the limited information presented, the Court of Appeals affirmed the trial court's valuation of the business.

Divorcing individuals who have full or partial ownership in a business(es) should consider retaining a business valuation expert to assist in the conclusion of the business and/or interest value, rather than providing limited documentation to the court for decision on value.



## Watts v. Watts

Tennessee Court of Appeals, Western Section, July 11, 2017

Business valuation was a fundamental element for property division in this Memphis divorce as Husband and Wife owned three small businesses. Husband and Wife filed a stipulation agreement with the trial court agreeing to retain a financial expert to determine the value of two of the three businesses. Both the stipulation agreement and initial engagement letter sent by the business valuation expert provided that other professionals, such as a forensic accountant, could be retained if deemed necessary. Husband and Wife went back and forth over this provision, resulting in the expert receiving the engagement letter signed by both parties only five days before the trial date. At the beginning of the trial, Wife's counsel requested a continuance to allow the valuation expert time to complete the valuations. The trial court denied the request, and both parties proceeded with the trial. Wife appealed, and the Court of Appeals ruled that the trial court erred in not granting the request for continuance, hence declining to enforce the parties' stipulation agreement as it related to the division of marital property.

Retaining a qualified expert, providing transparent and current documents (both financial and qualitative), as well as allowing adequate time for a business valuation are important to preparing valuation as evidence in divorce for property division.

# The Important Role of Personal Financial Statements in Divorce

High dollar, contested divorce litigation engagements often involve complex financial issues. In turn, those financial issues usually include business valuations and voluminous amounts of documents and financial information. How does an attorney or business appraiser determine what is crucial to the case and what is trivial or secondary information? One such piece of financial information that varies wildly in its interpretation and importance to the case is a personal financial statement.

## Why Is a Personal Financial Statement Important?

A personal financial statement is a document submitted to a bank or lending institution for the purpose of securing financing by representing an individual or couple's financial position or net worth. In other words, it's an asset and liability statement with estimates of value for each item. If the individual or couple owns a business, there generally is an estimate of value assigned to that asset.

Family law attorneys and business appraisers should always ask for personal financial statements as part of their discovery or information request for the business valuation. If one exists, how important is this document and how much weight should be given to it? Here's where there are wildly different views of the same document.

One view of a personal financial statement is that no formal valuation process was used; so at best, it's a thumb in the air, blind estimate of value of the business.

The opposing view would say the individual or couple submitting the personal financial statement is attesting to the

accuracy and reliability of the financial figures contained in that document under penalty of perjury. Further, some would say the business owner is the most informed person regarding his business, its future growth opportunities, competition, and the impact of economic and industry factors on the business.

With such polar views, how do family law attorneys and business appraisers use personal financial statements? Dismiss them and throw them out? Use them as a gold standard and forgo a formal business valuation? As usual, the two adages "it depends" and the "truth lies somewhere in the middle" are both probably accurate in this situation.

## Do You Like Surprises?

Attorneys and business appraisers never want to be surprised by not knowing about information or documents that exist. Therefore, you should always ask for personal financial statements. They should then be used as another data point along with the other indications of value that a business appraiser is considering, such as an asset value, income value, market value, recent transactions within the Company's stock, etc. As with recent transactions within the Company's stock, consideration should be given to the timing of submission for the personal financial statement and the relevance and motivation involved in the event.

If the value indicated by the personal financial statement falls within a reasonable range of the estimates from the other methodologies, it should probably be given more weight. Be cautious if the value indicated by the personal financial statement is ma-

terially higher or lower than a reasonable range indicated by the other methodologies. In which case, it may require the business appraiser to ask more questions regarding the thought process behind the estimate in the personal financial statement.

## Conclusion

Bottom line, ask for personal financial statements, analyze them, but consider them along with other factors and methodologies before concluding on a value for the business. These documents

can be helpful in the divorce process, but don't let them become the smoking gun by not asking for them or by not being aware that they exist.

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# Benefits of a Financial Expert in Family Law: Why & When to Hire

Most family law attorneys do not have a background in finance or accounting, yet are often confronted with complex financial issues in divorce matters. The services of an experienced financial expert can be vital to you and your client in such matters.

In vetting financial experts, look for those who specialize in business valuation and forensic accounting. However, don't pigeon-hole your expert. If your matter doesn't require a business valuation or the tracing of dissipated assets, a financial expert can still be of great help to you in each phase of the process: discovery, deposition, and trial.

Beyond valuation, tracing, and testifying, below is a list of services a skilled financial expert provides to help you uncover and understand financial issues:

- Determine financial documentation requests for subpoena
- Examine submitted financial documents
- Evaluate the accuracy of previously mentioned documents
- Assess whether further support is necessary
- Assemble relevant information
- Quantify the financial elements of a case

- Identify and classify marital and nonmarital assets and liabilities
- Assist with interrogatory drafting
- Support deposition questionnaire drafting
- Attend depositions for real-time financial support

In financial situations that may be scrutinized by regulators, courts, tax collectors, and a myriad of other lurking adversaries, the financial, economic, and accounting experience and skills of a financial expert are invaluable.

To receive the highest benefit of financial expert services, hire the financial expert with ample time to assist with the various stages of the case and provide the expert access to pertinent documentation and information.

A competent financial expert will be able to define and quantify the financial aspects of a case and effectively communicate the conclusion. For more information or to discuss your matter with us, please don't hesitate to contact us.

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# Family Law Services

Mercer Capital is a national business valuation and financial advisory firm with offices in Memphis, Nashville, and Dallas. We bring a team of experienced and credentialed experts and over 35 years of experience to the field of dispute analysis and litigation support. Services for family law attorneys and advisors are listed below.

## Valuation Services

- Valuation of privately held businesses and professional practices
- Valuation of intellectual property and other intangible assets
- Determination and valuation allocation of personal and enterprise goodwill
- Valuation of stock options, pensions, notes, & other investment assets
- Employment contracts and other compensation agreements
- Serving as the business valuation professional in a collaborative divorce

## Forensic Services

- Classification of assets and liabilities
- Investigation of asset flight and/or dissipation of assets
- Asset-tracing of separate versus marital property
- Lifestyle/needs and ability to pay analyses for assistance to determine spousal support
- Tracing appreciation of separate retirement assets
- Identification of diverted or unreported income and double-counted expenses
- Identification of and interviewing parties of interest
- Data analysis
- Lost profits analysis

## Advisory Services

- Expert witness testimony
- Serving as the financial neutral in a collaborative divorce
- Serving in mediation, arbitration, or as court-appointed and/or mutually agreed-upon experts
- General litigation support
- Assistance with discovery
- Critique of opposing expert reports
- Impact of transactions on valuation
- Economic research
- Public securities, market, and industry research
- Assistance with depositions and cross-examination
- Developing case strategy
- Preparation of demonstrative exhibits

## Who We Serve

- Divorcing spouses
- Consulting for family law attorneys
- Courts, mediators, and others in need of neutral experts
- Business owners
- Family offices
- High-wealth professionals

## Our Qualifications

- Deposition and testimony experience
- Technical and industry expertise
- National reputations for independence and objectivity
- Valuation and forensic credentials from the AICPA, the American Society of Appraisers, the CFA Institute, the Royal Institute of Chartered Surveyors, and the National Association of Certified Valuators and Analysts
- Trained in collaborative law

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