MERCER CAPITAL
BUSINESS VALUATION & FINANCIAL ADVISORY SERVICES

Tennessee Family Law

Valuation & Forensic Insights for Attorneys

Third Quarter 2018

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This quarter's issue of the *Tennessee Family Law Newsletter* focuses on the delineation between marital and separate property in a divorce. In addition, we highlight the factors that contribute to the active or passive appreciation of the asset or business. Our review of the *Telfer v. Telfer* case colors the discussion of distinguishing between marital and separate property both for the asset and its appreciation, which, as in this case, may differ.

Additionally in this issue, we provide insight into other ways that business owners should view their business or could benefit from a business valuation other than for obvious events. We hope that this perspective bolsters conversations between advisors and their business owning clients in an effort to help their clients achieve optimal results.

We appreciate the great feedback of this newsletter and encourage you to provide any suggested content topics that you'd like to see in future editions. You can send your feedback and ideas to **Scott Womack** or **Karolina Calhoun**.

How to Determine Whether an Asset and Its Appreciation is Marital or Separate Property

Under Tennessee law, marital property is subject to property division and separate property is excluded from property division in a divorce. The underlying factor in this distinction is whether the increase in value between the date of marriage and the date of divorce resulted from efforts by a spouse, known as *active appreciation*, or from external (economic, market, industry) forces, known as *passive appreciation*. While these concepts seem simple, the classifications are only part of the story.

Classification of Marital and Separate Property

Tennessee Code 36-4-121 defines marital property as "all real and personal property, both tangible and intangible, acquired by either or both spouses during the course of the marriage up to the date of the final divorce hearing."

The same code section defines separate property as "all real and personal property owned by a spouse before marriage, property acquired in exchange for property acquired prior to marriage, property acquired by a spouse at any time by gift, bequest, devise or descent, etc."

Can a Marital Asset Ever Become Separate or Can a Separate Asset Ever Become Martial?

Let's examine this question in the context of a business or business interest as an example. If a couple or spouse starts a business or acquires a business interest during the marriage, then it would be classified as marital. Any appreciation or increase in value of the business or business interest would also be classified and remain a marital asset.

Conversely, if a spouse starts a business or business interest prior to the date of marriage or acquires it by gift, bequest, devise or descent, then initially that business or business interest would be classified as a separate asset. What happens to that business or business interest if the value changes during the marriage? The increased value or appreciation of a business or business interest could be classified as marital or separate. How is this possible?

If both spouses contribute to the preservation and appreciation of a separate property business or business interest and the contribution is "real" and "significant," then the appreciation (increase in value) of the business or business interest would be determined to be a marital asset and subject to division. This is known as *active appreciation*.

If, on the other hand, both spouses do not contribute to the appreciation in value, there is no appreciation in value, or the appreciation is attributable to passive forces, such as inflation, then the separate property business or business interest would remain separate.

The following steps assist the financial analyst during the process:

1. Is the business, or business interests, marital or separate?
   a. Compare the formation or inheritance date(s) to date of marriage.
2. If the answer to (1) concludes pre-marital, separate property, value the business as of the date of marriage as a starting point. Then, value the business as of the date of divorce (or as close to as possible).
3. If the value has increased from the date of marriage to the date of divorce, a determination of active (marital) versus passive (separate) shall commence.

What Must Be Demonstrated

Tennessee code states that the substantial contribution of the non-business spouse "may include, but not be limited to, the direct or indirect contribution of the spouse as a homemaker, wage earner, parent or financial manager, together with such other factors as the court having jurisdiction thereof may determine."

A non-business owner spouse must be able to demonstrate two things in order for appreciation of a separate property business or business interest to become a marital asset: substantial contribution of both spouses contributing to the appreciation,and actual appreciation in the value of the business or business interest during the marriage. Most often, a valuation of the business or business interest at the date of marriage and also the date of filing would be required among other things to try and support this claim.

This article has used a business or business interest to illustrate the concepts of martial vs. separate assets and also the appreciation in value. It should be noted that there could be potentially other considerations for these same issues with other assets, such as investment properties or passive assets (401Ks, etc.).

Conclusion

A financial expert, specifically one with expertise in business valuation, is vital in the determination of active appreciation (separate) versus passive appreciation (marital).

The professionals of Mercer Capital can assist in the process. For more information or discuss an engagement in confidence, please contact us.

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Tennessee Case Reviews

Trezevant v. Trezevant

Tennessee Court of Appeals, Western Section, April 25, 2018

This divorce case involved financial issues including the valuation of marital properties and dissipation of marital assets, among others. Husband and Wife were married in 1990, and a final divorce decree was entered in March 2017. Husband established a successful real estate management, development, and maintenance company, and the marital estate included 49 commercial and residential properties. The trial court valued the estate at over $44 million.

Marital Properties

Husband appealed on the issue that the trial court overvalued the marital property awarded to him by over $24 million. The values presented by Husband differed from those presented by Wife by millions of dollars. Wife based the values of the properties on a financial statement prepared by Husband from July 2012. Husband offered over 20 certified appraisals of the parties' most valuable properties as an indication of value. The trial court relied on the financial statements submitted by Wife, and awarded Husband $34.2 million and Wife $10.1 million, of the martial assets. On appeal, the Court ruled that the trial court favored the financial statements submitted by Wife over the certified appraisals "with very little explanation." As a result, the Court vacated and remanded the issue for further analysis by the trial court.

The documentation presented by both parties proved to be significant in the valuation and distribution of the marital assets in this case. Our **previous newsletters** discussed the role of personal financial statements in a marital dissolution as well as the process of business valuation and noted the importance of being aware of all potentially relevant documents. A financial expert can assist in gathering and analyzing the necessary documents to ensure that all relevant information has been reviewed before making a presentation to the court.

Dissipation

Another issue raised on appeal was the dissipation of marital assets. Husband transferred approximately $2.1 million to an individual in the Cayman Islands, during the divorce proceedings. This sum of money was related to the sale of a business venture that Husband and business partner were equal owners in, according to Husband. However, the equal dual-ownership was not documented. The trial court found that the real estate was owned exclusively by Husband.

Husband argued that the trial court improperly put the burden on him to show that there was no dissipation and that the business partner's deposition was sufficient evidence to show that he was an equal partner in the venture. Both Husband and business partner testified about this agreement, but certain points of testimony were conflicting according to the Court. Husband was not able to identify what expenses his business partner was responsible for, and Wife presented various examples to demonstrate that this business partner was not actually tied to the deal. The Court of Appeals concluded that the evidence did not preponderate against the trial court's determination that Husband dissipated the $2.1 million transferred to the business partner during the divorce proceedings.

Proper documentation and support in a divorce proceeding can prove to be extremely important, factoring in decisions about the distribution of marital assets. A financial expert can help gather, trace, and organize the necessary documents to present at trial. An experienced forensic expert can assist in determining if dissipation has occurred and provide strong support to present to the court.

Telfer v. Telfer

Tennessee Court of Appeals, Middle Section, June 28, 2013

We addressed the second appeal of this case **in our previous newsletter** and focused on the application of a marketability discount in the valuation of a business entity. The original appeal of this case involved the disagreement of separate and marital property. The parties were married in 1985, and a final divorce decree was entered in 2012. Wife's father was chairman and owner of an information technology services company. In 1995, he formed a business entity, CCP, for the purpose of transferring ownership of certain assets to Wife (his daughter, Mrs. Telfer). He formed another entity, Young Leasing, in 1999 to provide for equal distribution of assets between Wife and her brother. In 2000, Wife began receiving distributions of $8,500 per month from CCP. The distributions were deposited in a joint checking account and used to pay marital expenses. Young Leasing operated at a loss until 2005, when it generated approximately $619,000 in income. Wife did not receive distributions out of this amount, as all income was retained by the company. Since these businesses were "pass-through entities," the income generated was included on the parties' joint tax returns. The parties had a $331,000 personal tax liability in 2006 related to Wife's pro rata share of the income generated by Young Leasing, in addition to the parties' other sources of income. To cover the tax liability, Husband liquidated the parties' joint brokerage account which contained approximately $317,000 inherited from Husband's aunt. According to the Court, it was undisputed that these funds were marital. This event proved to be a key point the Court's analysis and ultimate determination that the appreciation in value of CCP and Young Leasing were both marital assets.

The Court noted that it was "fair to find a causal link between the expenditure of these marital funds [brokerage account] in 2006 and the preservation and appreciation in value of Young Leasing in 2006." The Court found a similar link between the expenditure and the preservation and appreciation in value of CCP. In addition, the Court found that the Husband served as the family "financial manager," which constitutes "substantial contribution." As a result, the Court determined that the appreciation in value of both companies during the marriage was marital property. The case was remanded to the trial court to reconsider equitable division of the marital estate.

In his appeal, Husband also brought up the fact that Wife's distribution income was deposited in a joint bank account and used to pay marital expenses, including taxes on distribution income. The Court found that Wife's income from the distributions "commingled and became a marital asset," because it was deposited in a joint bank account with other marital funds. However, the Court found that this did not imply that the appreciation in value of the business was marital property. The key point in the Court's finding that the appreciation in value was marital property was the expenditure of funds from the brokerage account to cover the pass-through taxes in 2006.[1]

A subtle but important distinction in a marital dissolution is the ownership of a business interest and the appreciation in value of a business interest. As in this case, the ownership of a business interest can be separate property while the appreciation in value can be marital property. Divorcing business owners can engage a forensic expert to provide support in the determination and value of separate and marital property.

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[1] In the second appeal of this case, the Court changed the division of the marital estate from 84/16 in favor of Wife to 65/35 in favor of Wife. The Court did not change its conclusion that the appreciation in the value of the businesses was marital property.

6 Ways to Look at a Business

Along the road to building the value of a business it is necessary, and indeed, appropriate, to examine the business in a variety of ways. Each provides unique perspective and insight into how a business owner is proceeding along the path to grow the value of the business and if/when it may be ready to sell. Most business owners realize the obvious events that may require a formal valuation: potential sale/acquisition, shareholder dispute, death of a shareholder, gift/estate tax transfer of ownership, etc. A formal business valuation can also be very useful to a business owner when examining internal operations.

So, how does a business owner evaluate their business? And how can advisers or formal business valuations assist owners examining their businesses? There are at least six ways and they are important, regardless of the size of the business. All six of these should be contemplated within a formal business valuation.

1. **At a Point in Time**

   The balance sheet and the current period (month or quarter) provide one reference point. If that is the only reference point, however, one never has any real perspective on what is happening to the business.

2. **Relative to Itself over Time**

   Businesses exhibit trends in performance that can only be discerned and understood if examined over a period of time, often years.

3. **Relative to Peer Groups**

   Many industries have associations or consulting groups that publish industry statistics. These statistics provide a basis for comparing performance relative to companies like the subject company.

4. **Relative to Budget or Plan**

   Every company of any size should have a budget for the current year. The act of creating a budget forces management to make commitments about expected performance in light of a company's position at the beginning of a year and its outlook in the context of its local economy, industry and/or the national economy. Setting a budget creates a commitment to achieve, which is critical to achievement. Most financial performance packages compare actual to budget for the current year.

5. **Relative to your Unique Potential**

   Every company has prospects for "potential performance" if things go right and if management performs. If a company has grown at 5% per year in sales and earnings for the last five years, that sounds good on its face. But what if the industry niche has been growing at 10% during that period?

6. **Relative to Regulatory Expectations or Requirements**

   Increasingly, companies in many industries are subject to regulations that impact the way business can be done or its profitability.

Why is it important to evaluate a company in these ways? Together, these six ways of examining a company provide a unique way for business owners and key managers to continuously reassess and adjust their performance to achieve optimal results.

A formal business valuation can communicate the company's current position in many of these areas. Successive, frequent business valuations allow business owners and key managers the opportunity to measure and track the performance and value of the company over time against stated goals and objectives.

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Mercer Capital in the News

Upcoming Speaking Engagements

NOV
5-7

A couple of Mercer Capital professionals are on the schedule at this year's AICPA Forensic & Valuation Services Conference in Atlanta, Georgia.

Karolina Calhoun, CPA/ABV/CFF will be speak on the topic of "Lifestyle Analysis/Pay & Need Analysis," will participate in panel discussion on "Collaborative Law the New Horizon," and is a member of the conference planning committee.

Z. Christopher Mercer, FASA, CFA, ABAR will be participating in two panel discussions on "Active Passive Appreciation" and "Valuation Tax."

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Karolina Calhoun, CPA/ABV/CFF will co-present on "Corporate & Business Transactions from a Legal and Financial Perspective" to the Memphis Chapter of Tennessee Society of CPAs.

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Z. Christopher Mercer, FASA, CFA, ABAR will be speak on "How to Present Complex Finances to Judges" at next year's AAML/BVR National Conference.

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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