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Critical Issues in Divorce Litigation

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Society of Kentucky Certified Public Accountants



BUSINESS VALUATION &
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Karolina Calhoun, Vice President at Mercer Capital, has been involved with hundreds of valuation and litigation support engagements in a diverse range of industries on local, national and international levels. Prior to joining Mercer Capital, Karolina was a Senior Auditor at EY (Ernst & Young) in their Audit and Assurance Services practice.

As a member of Mercer Capital's Litigation Group, she provides valuation and forensics services for family law, gift & estate planning, commercial litigation, transactions (M&A), and further matters related to privately held businesses, dissenting shareholders, intellectual property, personal goodwill, etc. With her forensics accreditation, she provides economic and financial damages studies, asset tracing, lost profits, and lifestyle analyses.

Karolina served as the 2020 and the 2021 Valuation Chair of the AICPA's Forensic and Valuation Services Conference and is a member of the AICPA's CFF Exam Writing Task Force. In 2018, she received the Forensic and Valuation Services (FVS) Standing Ovation award, presented by the AICPA to professionals for significant contributions in their specialty areas and in their communities. Karolina served as the President of the Memphis Chapter of TSCPA's (2019-2020).

In February 2022, Karolina was invited and admitted to the American Academy of Matrimonial Lawyers (AAML) Foundation, Forensic and Business Valuation Division, a division of the AAML. In addition, she has been appointed to the AICPA Business Valuations Committee for the 2022-2023 volunteer service year.

Session Overview

What are the nuances and critical issues of valuation, forensic and other analyses for marital dissolution? In this session, we delve into specific issues that must be considered since they are unique to marital dissolution as well as state statute and precedent.

Objectives:

1. Identify the critical issues unique to valuations for marital dissolution
2. Evaluate the need for further investigations and/or services in conjunction with valuation services for purposes of divorce

Reminder & Disclosure!

Facts and circumstances differ tremendously from matter to matter.

In real life, refer to attributes unique and specific to the ownership and subject interest at hand, which may vary (and do vary) from entity to entity, matter to matter, and so on...

The following presentation is for informative purposes only and does not present any absolute opinions.

Reminder & Disclosure!



The Basics. The Starting Point(s).

Expert and lawyer working together: Roles of each

Document request: gathering appropriate information

In-spouse vs. Out-spouse

Potential need for other experts – vocational, property appraisal, etc.

The Basics. The Starting Point(s).

Deliverable

- Summary vs Detailed
- Settlement Purposes or Trial?

Starting Point:

- Figure out who owns what, who controls what, who all the players are, governance, and the relationships between the players (direct v. indirect ownership, org. charts, company agreements, etc.)
- **Facts and circumstances are unique from matter to matter**

Business Valuation: Date(s) of Valuation

Why is this possibly ‘tricky?’

- Any Separate/Non-marital Component?
 - Date of Marriage
- State Statue
 - Date of Separation
 - Current/Date of Trial
 - Agreed-upon Date depending on reporting
- **Passing of time – lengthy processes**



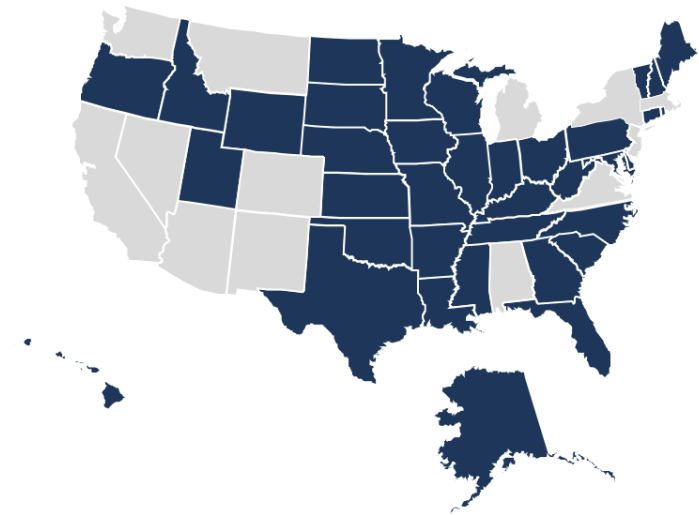
Business Valuation: Standard of Value

- **Most of us are in Fair Market Value states**
- **Confirm if you are hired out of state**
 - Others include Fair Value and Investment Value

Standards of Value

Fair Market Value

AK, AR, CT, DC, DE, FL,
GA, HI, IA, ID, IL, IN,
KS, KY, LA, ME, MD, MN,
MO, MS, NC, ND, NE, NH,
OH, OK, OR, PA, RI,
SC, SD, TN, TX, UT,
VT, WI, WV, WY



Business Valuation: Ownership Interest Under Consideration

- **Confirm in planning phase**
 - Any changes in owned % interest during marriage
 - i.e. DOM vs DOD?
 - How acquired?
- **Level of Value**
 - DLOC and DLOM
 - Confirm with state statute



Separate / Non-marital Component?

- **Pre-marital ownership?**
- **Inheritance?**
- **State Statue**
 - Equitable Division, Community Property or Dual Class
- **If a Business Asset: Understand involvement of divorcing party**
 - In-spouse vs. out-spouse

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

Examined in the context of a business ownership

- 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?

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

Examined in the context of a business ownership, continued

- 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.
- 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.



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

Other Considerations and Terms to Be Aware of - General

- Comingled
- Transmutation
- Tracing
- Coverture Fraction

Separate / Non-marital Ownership Component?

- **Pre-marital ownership?**
- **Inheritance?**
- **State Statue**
 - Equitable Division, Community Property or Dual Class
- **Understand involvement of divorcing party**
 - Is individual(s) keyperson or passive?
 - If involved in business, how much?
 - Active / Passive Analysis
 - Refer to state statute and confirm with attorney
 - Personal vs. Enterprise Goodwill

Personal vs. Enterprise Goodwill

- Depends on the unique facts and circumstances of the underlying entity and individual
- **Enterprise Goodwill:** derived from characteristics specific to the business, regardless of who operates it.
 - Examples could be franchises, nationally known names of business, others...
- **Personal Goodwill:** derived from characteristics specific to the individual.
 - Examples could be a solo service-provider with limited staff and saleable opportunity, or, another example could be a person with unique, specialized skillset that would be not transferable in a sale if he/she was not present.

Enterprise Goodwill versus Personal Goodwill

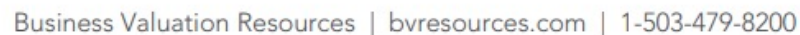
Enterprise goodwill generally is interpreted as representing value that is owned and/ or that has been created by an enterprise and that can be transferred. Identifiable intangible assets typically classified within the enterprise goodwill category include the following:

1. Trademarks and trade names
2. Patented and unpatented technology
3. Copyrights
4. Customer lists and relationships (patient files/records)
5. Contracts (employment, noncompete agreements)
6. Phone number
7. Leasehold
8. Trained and assembled workforce
9. Location

Personal goodwill generally is interpreted as representing attributes, that are unique to, and inseparable from, an individual. Attributes typically classified within the personal goodwill category include the following:

1. Personality
2. Reputation
3. Personal skill, expertise and knowledge
4. Personal relationships

In essence, personal goodwill is represented by certain attributes that are deemed to be incorporated into the very being of an individual, and, therefore, are unable to be sold or transferred to another individual.



Why Is Personal vs. Enterprise Goodwill Important?

- **Thorough analysis necessary**
 - Various reasonable methodologies
 - Refer to statute and state precedent
 - Work closely with your attorney
- If personal goodwill is present, and you are in a state that treats it as separate, that component (often a % expressed then in dollar amount) becomes non-divisible
- **Often, this is where experts (or clients!) disagree**

In-spouse or Out-spouse

- **Are you working on behalf of the “in-spouse” or “out-spouse?”**
 - Does this impact the ability to collect information (qualitative and quantitative) to support the adjustments?
 - The importance/ability to conduct management interviews and/or site visits
 - Information limitations: one spouse may not possess as much knowledge of the business



Valuation Adjustments in Valuations for Divorce

- **Importance of Adjustments**
- **Importance of Adjustments in Divorce**
 - Potential for altering the financial position of the business and/or compensation of divorcing party in anticipation of divorce
 - Potential for “true income” to be different than wages

Adjustments & Their Impact on Income Determination

- **Owner Compensation**

- How paid?
- How is the owner is paid over a period of time not just at the current day?
- Possible pay-out arrangements?
- What roles & responsibilities?
- Market rate?
- Perquisites?
 - Support marital/family lifestyle?
- Others, example: rent expense if related-party entities – FMV?
- “True Income”

Adjustments & Their Impact on Income Determination

- **Owner Compensation Continued ... when Entity is Family-Owned**
 - Who are the players?
 - Multiple family members in the business
 - Composition of family member management and personnel
 - Compensation per family member
 - Related-party issues
 - Loans to shareholders
 - Internal/intercompany transactions
 - ... reliability and accuracy of financial statements



Adjustments & Their Impact on Income Determination

- **Income determination**
 - Adjusted income from compensation adjustment
 - Evidence for marital/family historical lifestyle, and in turn, support for pay and need analyses
- **Used for alimony and child support determination**

So, how are these connected?

Income, Business Value, Division of Marital Estate, and others...



Beware of the Double Dip

- **Adjusted Owner Compensation in Business Valuation**
 - Basis for alimony and child support
 - Beware of the **double count**:
 - Earnings of the business used to create *value* of business asset vs.
 - Owner compensation reflected in expenses of the business



Beware of the Double Dip

- **Property assets on balance sheet**
 - Rental income
 - Pass-through income
 - *Do not double count as an asset and income*



Example: Lots of Characteristics of 'Income'

Green Highlight to warn of double counting. These earnings are captured as earnings for asset value of the business and should not be double-counted for income determination.

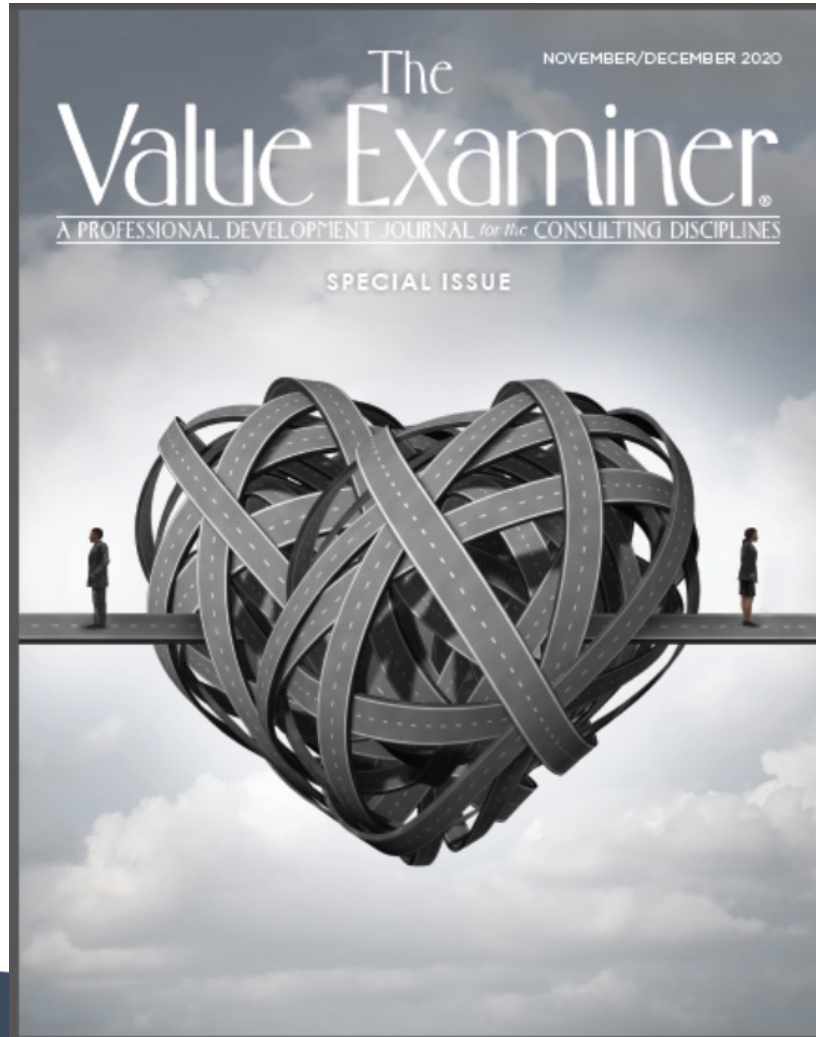
Ownership		2019	2018	2017	2016	2015	2014
Dr. B's Non-Passive Income		Interest					
Operating Company - Income Share Earnings - BV	56.67%	\$464,134	\$473,749	\$458,915	\$237,718	\$233,151	\$107,712
Consulting Company - Earnings - No BV	50.00%	517,945	489,695	481,974	457,297	418,497	385,638
Eat What You Kill' - Earnings - No BV	20.00%	426,978	537,465	564,440	447,697	518,367	441,656
Directorship Earnings - No BV	100.00%	34,585	23,639	28,165	30,443	37,009	43,984
Other Earnings - No BV		0	0	0	0	0	6,750
Other Earnings - No BV			0	0	0	0	14,375
Expert Medical Witness 1099 income		0	0	0	1,138	0	0
Total		\$1,443,642	\$1,524,548	\$1,533,494	\$1,174,293	\$1,207,024	\$1,000,115
Less Operating Co Distributions - included in VALUATION		(\$464,134)	(\$473,749)	(\$458,915)	(\$237,718)	(\$233,151)	(\$107,712)
Adjusted Total Non-Passive Income		\$979,508	\$1,050,799	\$1,074,579	\$936,575	\$973,873	\$892,403

Dr. B's Passive Income							
Property 1 - Valued by Mercer Capital	10.00%	8,698	158,559	209,161	191,239	148,039	101,486
Property 2 - Valued by Mercer Capital	47.50%	52,150	136,516	92,586	69,557	0	0
Property 3 - Valued by Mercer Capital		0	504,562	0	0	0	0
Interest Income		13,794	16,060	5,464	1,708	761	1,095
Dividend Income		0	2,414	2,559	298	0	0
Total		\$74,642	\$818,111	\$309,770	\$262,802	\$148,800	\$102,581
Less Property 1 Distributions - included in Property 1 Valuation		(\$8,698)	(\$158,559)	(\$209,161)	(\$191,239)	(\$148,039)	(\$101,486)
Less Property 2 Distributions - included in Property 2 Valuation		(\$52,150)	(\$136,516)	(\$92,586)	(\$69,557)	\$0	\$0
Less Property 2 One-time Gain on Sale		-	(\$504,562)	-	-	-	-
Adjusted Total Passive Income		\$13,794	\$18,474	\$8,023	\$2,006	\$761	\$1,095

Total Income before adjustments for double-counting	\$1,518,284	\$2,342,659	\$1,843,264	\$1,437,095	\$1,355,824	\$1,102,696
Adjusted Total Income	\$993,302	\$1,069,273	\$1,082,602	\$938,581	\$974,634	\$893,498
Difference	\$524,982	\$1,273,386	\$760,662	\$498,514	\$381,190	\$209,198

Forensic Accounting Services

Constructing A Lifestyle Analysis – A Multipurpose Analytical Tool in Marital Dissolution Engagements



IN THIS ISSUE...

7 Constructing a Lifestyle Analysis—A Multipurpose Analytical Tool in Marital Dissolution Engagements

By Karolina Calhoun, CPA, ABV, CFF

In marital dissolution engagements, a lifestyle analysis can help the parties assess division scenarios and settlement alternatives, facilitate negotiations during mediation, and support the trier of fact in determining equitable distribution of marital assets and alimony needs.

This article was featured in the November/December 2020 issue of *The Value Examiner*. Excerpts by the author have been made for this presentation.

Overview of Lifestyle Analysis (aka Pay and Need Analysis)

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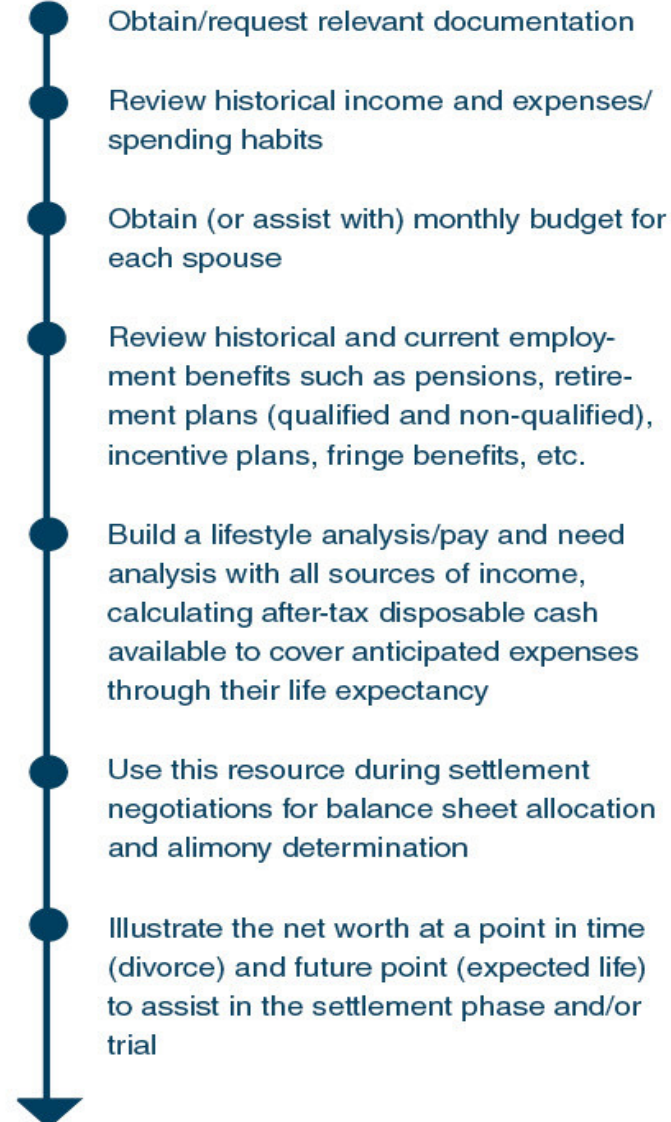
A lifestyle analysis is a multifaceted analytical tool that includes several detailed analyses and can be very helpful in **marital dissolution engagements**.

A lifestyle analysis provides an overview of each party's sources of income and expenses, historically and into the anticipated future, **using the facts and circumstances unique to each particular case**. The analysis pulls together all considerations and provides a visual representation.

A lifestyle analysis **assists the marital dissolution process** in many ways, including assessing division scenarios and settlement alternatives such as different alimony proposals, assisting with negotiations during mediation, and supporting the trier of fact in determining the equitable distribution of marital assets and alimony needs.

Sample Timeline of Events

Sample Timeline of Events for the Analysis



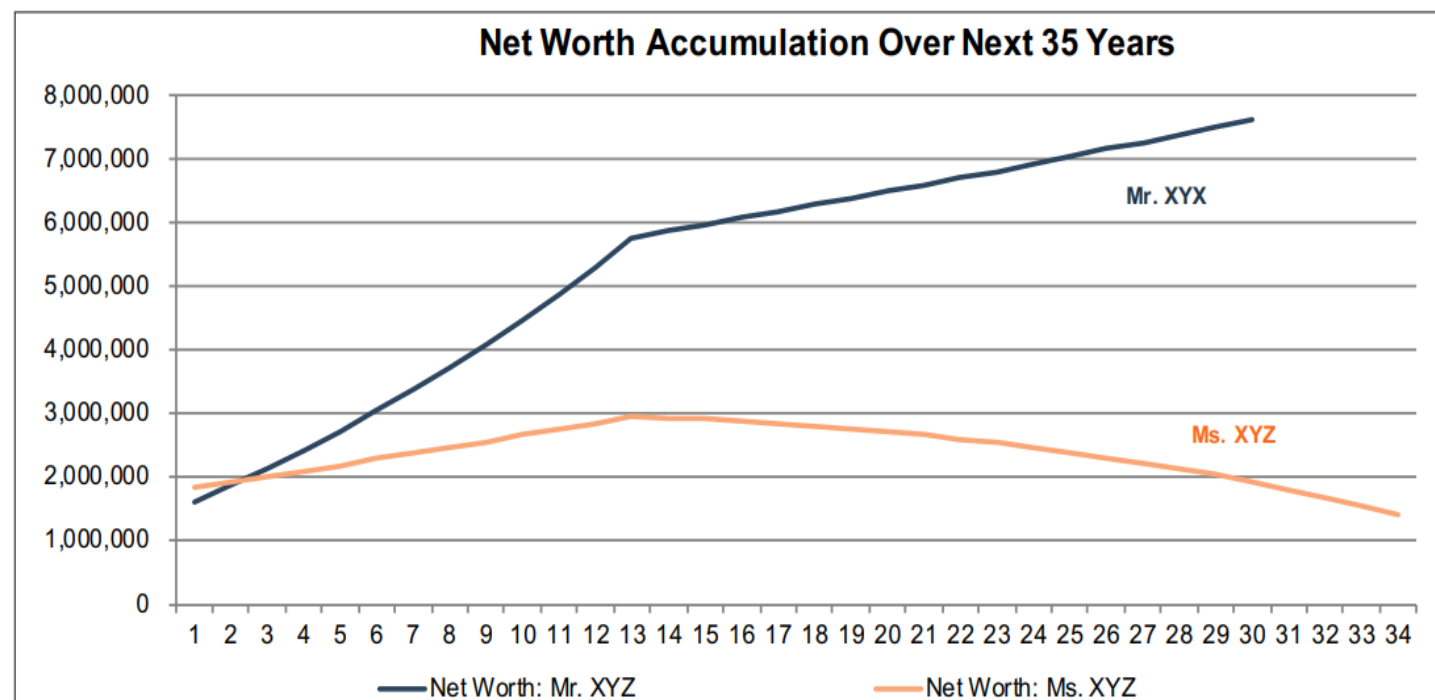
Pay & Need Analysis

- Beyond the division of the marital estate, is there still a 1) need and 2) ability?
 - If Yes:
 - Constructing the pay & need analysis pulls together the division of the net assets at divorce date, future income and in turn, net cash available after taxes, and future expenses ...
 - What about the earnings of the business (used in asset value) vs. compensation?
 - What if personal goodwill is concluded upon – how is it treated in division and then in the income analysis?
 - What is the level of ongoing income and how was it calculated (average, most recent, etc)?
 - What about the ultimate proceeds from the sale of a business?
 - What about the gains on investment vehicles?
 - What about retirement age?
 - ...
 - ...

This analysis MUST be customized to the facts and circumstances of the matter at hand. If done well, the analysis operates much like a Net Worth Analysis – both at a point in time AND over time.

Sample Net Worth Analysis of the Pay & Need Analysis

Figure 2: Net Worth Accumulation Analysis



Note: this chart takes **MANY** steps to get to – this is an output of the moving net worth over the remaining life of the divorcing parties.

Output of the Lifestyle Analysis aka Pay & Need Analysis

“

Ultimately, the lifestyle analysis illustrates—collectively and on an annual basis for the couple’s remaining expected life—sources of income, tax obligations, and net disposable cash before and after expected (estimated) expenses.

A common output illustrated is the deficit or surplus based on inputs. The financial expert may build scenarios for the client based on varying inputs, including different potential settlements of assets, varying alimony payouts (both amounts and duration), and even one-off life events. **Because no two cases are alike, with facts and circumstances varying from case to case, all components of a lifestyle analysis must be carefully assessed.**

Asset Tracing

Asset tracing is the analysis used to determine the marital or separate nature of assets and liabilities. Depending on state statutes and circumstances, property deemed as separate is usually not subject to division with the marital estate.

However, a separate asset may have the potential to become partially or fully marital. Asset tracing is the process of investigating an asset to its original source and the characteristics over time, ultimately categorizing it as marital or separate, or a blended allocation.

Asset Tracing

Tracing Marital Vs. Separate Asset Ownership with Complex Multi-Entity Ownerships

- **Source of funds; Time & Manner of Acquisition**
- **Considerations arising from related entities**
 - Is further analysis necessary on source of funds used to fund ownership interest?

Other Services

- **Tracing of hidden assets?**
- **Valuations of other assets and liabilities**
 - Stock options
 - Restricted stock
 - Pensions
 - Promissory Notes
 - Other
- **Assistance with division of marital estate**
 - Liquidity of various assets
 - Tax considerations of various assets
 - Liabilities – don't forget the quarterly tax payments/estimates for business owners

Concluding Thoughts

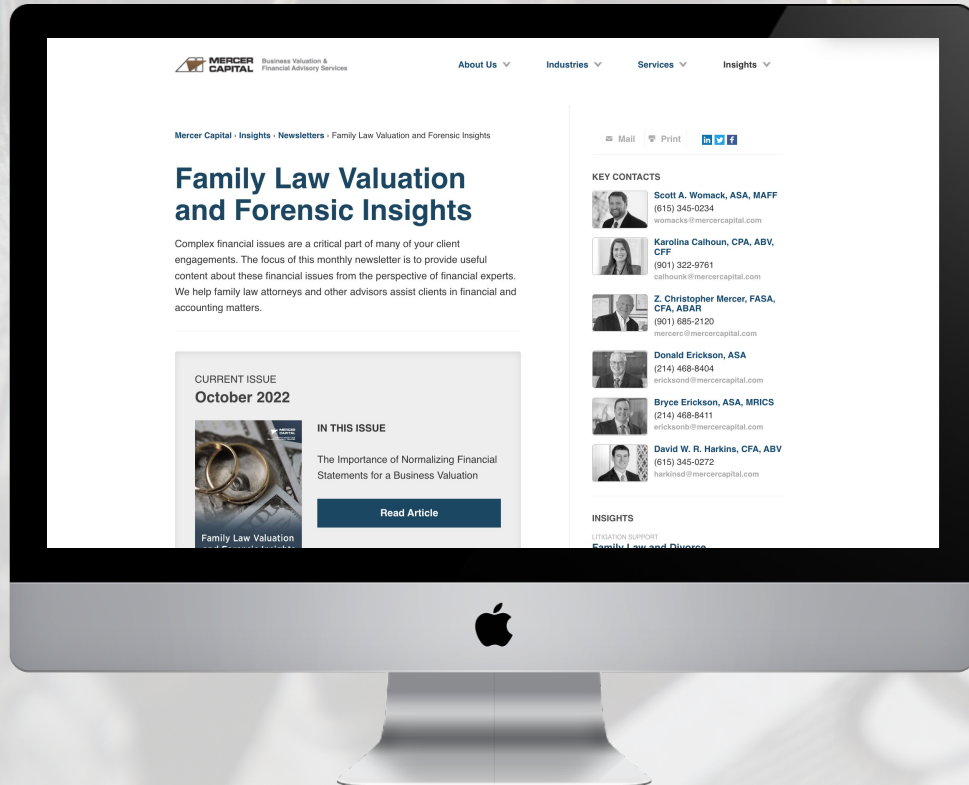
No case is just like the previous. There is no one size fits all approach.

We must always be independent, skeptical, prudent & wise when applying our analytical and investigative toolkits.



MERCER CAPITAL'S MONTHLY NEWSLETTER

Family Law Valuation and Forensic Insights



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Complex financial issues are a critical part of many divorces. The focus of this monthly newsletter is to provide useful content about these financial issues from the perspective of financial experts.

We help family law attorneys and other advisors assist clients in financial and accounting matters.

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- Damages Analysis
- Lost Profits Analysis
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