Issues in a Texas Divorce: Tracing Separate Property; Business Valuation; Undercompensation; Future Taxes

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Tracing

Forensic tracing is the process of --

- Gathering information;
- Analyzing the circumstances;
- Applying rules of law and legal presumptions to establish the character of property.

Common Reasons for Tracing

- To prove SP.
- To prove CP.
- To prove non-marital property.
- To prove a reimbursement claim.
- To support imposition of a constructive trust.

Separate Property

Texas Family Code §3.001, defines separate property:

- Property owned or claimed by the spouse before marriage
- Property acquired during marriage by gift, devise, or descent
- Recovery for personal injuries sustained during marriage, except recovery for lost earning capacity

Additionally:

- Property made separate by partition and exchange or spousal income agreement, Texas Family Code §4.102 & §4.103

Community Property

Texas Family Code §3.002, community property:

Community property is property, other than separate property, acquired by either spouse during marriage.

Community Credit

Debts incurred by a spouse during marriage are community credit, and the money or assets acquired with credit is community property--unless it is shown that the creditor agreed to look solely to the borrowing spouse's separate estate for repayment.

Character is Maintained

- All increase in value of SP is separate.
- SP retains its character through changes in form (mutations).
- Increase in value of CP is community.
- CP retains its character through changes in form.
- Non-marital property retains its non-marital character through changes in form.

Mutation Example

a) Wife owned Apple stock on date of marriage.

b) 1 month later, Wife sold her Apple stock and used the sales proceeds to buy Amazon stock.

(No other funds have accumulated in this brokerage account)

The Amazon stock is SP under the doctrine of mutation.

Community Property Presumption

- Texas Family Code §3.003, presumption of community:
  - Property possessed by either spouse during or on dissolution of marriage is presumed to be community property.
  - The degree of proof necessary to establish that property is separate property is clear and convincing evidence.
- The elevated "burden of persuasion" under § 3.003 does not apply to proof that property is not marital property.

Separate Property Presumptions

- Deed from 3rd party to spouse reciting SP.
- Deed from one spouse to the other.
- One spouse uses SP to buy land, but takes title in the name of the other spouse.
- Gift from one spouse to the other includes future income.
- Transfer from parent to child.

Commingling

- Commingling occurs when SP and CP are mixed together.

- When SP and CP that are similar in nature have been commingled, tracing must be used to identify and segregate the portion that is SP.

- When SP cannot be clearly identified and segregated from the CP, the CP presumption will prevail and all of the commingled property will be considered CP.

- SP of one spouse can be commingled with SP of the other spouse. Absent tracing, it is all CP.

Tracing Methods for Commingled Funds

- Community-Out-First Method
- Minimum Balance Method
- Matching Transactions
- Pro Rata Method
- Exhaustion Method
- Maximum Community Property Available
- Use Determines Character
- Net Contributions Method
- LIFO/FIFO
- Intent
- Backward Tracing
- Replenishment
- Any Equitable Rule

Tracing Deposits/Withdrawals

- Deposits
  - are presumptively <u>CP</u>
  - must apply characterization law & presumptions
- Withdrawals
  - apply some rules of allocation

Community-Out-First Method

- Withdrawals from an account with mixed SP and CP funds are taken from CP funds to the extent that they exist.
- When all CP funds have been exhausted, withdrawals are taken from SP funds.

Line Item Tracing (Missing Information)

- In a 10-year marriage, the first five years' bank records are lost; but later records are available.
- The line-item tracing starts with the earliest of a continuous line of bank statements. The starting balance is assumed to be 100% CP.
- What happens if one monthly bank statement is missing from the last five years?
- What if one year of statements are missing?
- What if there are no bank records, but a QuickBooks ledger exists? Or a hand-written check register?

Minimum Balance Method

- Show that the balance of the account never went below the amount proven to be SP.
- This method withdraws CP funds first (i.e. community-out-first).
- SP funds “sink to the bottom.”

Matching Transactions Method

- Certain deposit(s) are matched to certain withdrawal(s) (they need not be on the same date or in identical amounts).
- Persuasiveness is diminished the longer the period of time between the transactions.
- Persuasiveness is heightened if the amounts are identical, but identical amounts are not required.
- Involves an element of inferred intent.

Pro Rata Method

- If funds are withdrawn from a mixed character account, the withdrawal is characterized *pro rata* in proportion to the respective balances of SP and CP funds in the account at the time of withdrawal.

EXHAUSTION METHOD

Zagorski v. Zagorski, 116 S.W.3d 309 (Tex. App.–Houston [14th Dist.] 2003, pet. denied):

- H "introduced an exhibit showing less than $115,000 in interest was earned during the marriage. Another exhibit shows approximately $366,000 was withdrawn for marital living expenses."
- "Because the withdrawals for community expenses depleted the community funds in the Account, the Account remained Tony's separate account."
- "Tony's tracing of the community funds into and out of the Account rebutted the statutory presumption the Account was a community asset. Here, the evidence demonstrates community funds in the Account were depleted."

Coggin v. Coggin, 204 S.W.2d 47, 52 (Tex. Civ. App.–Amarillo 1947, no writ):

- W commingled agricultural rentals with separate property in various bank accounts over a period of four years, out of which she purchased a home and several tracts of land.

- Rental income was $1,000 per year, while living expenses ranged from $200 to $500 per month.

- The jury found, and the appellate court agreed, that none of the community money deposited into the accounts was used to buy the real property

***DePuy v. DePuy*, 483 S.W.2d 883, 887-88 (Tex. Civ. App.—Corpus Christi 1972, no writ):**

“There was also evidence of the income as well as living expenses of the parties during their marriage. It is apparent that the parties had net earnings which approximated their living expenses with only small amounts, if any, left over. The combined take-home pay of the parties for most of the period involved was about $750.00 per month. Mr. DePuy did not work for short periods of time. The earnings of Mrs. DePuy tended to increase, particularly after the parties moved to Corpus Christi, Texas in the summer of 1969.”

The court found this sufficient proof that assets acquired during marriage were SP.

Living Expense Method

- W had SP at the time of marriage; H had none.
- In years one and two of marriage, records reflect that family <u>living expenses matched</u> net after-tax community <u>income</u>.
- In year three, several lucrative investments were made, but the records from year three were lost.
- <u>Assume</u> that <u>CP</u> income was <u>used</u> to pay <u>living expenses</u>, leaving only SP to make the investments.
- Or, are the investments CP because there are no records to allow <u>line-item tracing</u>?

Community Property vs. Separate Property Funds
Community Living Expense Presumption

From 1993 Income Tax Return:	Comm. Prpty	H's Separate	Total
Wages	$ 313,196	$ -	$ 313,196
Interest & Dividends	26,126		26,126
Sch. D			
Sale of H's Separate Stk.		2,909,490	2,909,490
H's Pension	-	99,237	99,237
Sch A			
Real Estate Taxes	(17,000)		(17,000)
Mortgage Interest	(35,000)		(35,000)
Contributions	(18,227)		(18,227)
Taxable Income	269,095	3,008,727	3,277,822
Tax (Actual or Theoretical?)	105,058	15,000	120,058
Income after taxes	$ 164,037	$ 2,993,727	$ 3,157,764

Community Property vs. Separate Property Funds
Community Living Expense Presumption

Income after taxes	$ 164,037	$ 2,993,727	$ 3,157,764
Non - Cash adjustments			
Sch. D-Adj to Gross Proceeds			
H's Stock Basis		199,080	199,080
Available cash for living and investing	$ 164,037	$ 3,192,807	$ 3,356,844
Other Cash Sources			
Net Borrowings	$ 100,000		$ 100,000
Net Gifts		$ (50,000)	(50,000)
Other Community Living Expenses			
Personal Credit Cards	(60,000)		(60,000)
Other Checking Account Disbursements	(35,000)		(35,000)
Net Funds Available for Investing	$ 169,037	$ 3,142,807	$ 3,311,844

MAXIMUM COMMUNITY AVAILABLE FOR INVESTMENT

Duncan v. US, 247 F.2d 845 (5th Cir. 1957)

The Estate . . . insists that to the extent the record does not, or cannot, indicate the facts as to the origin of the money . . . , the presumption operates to make it all community even though, without contradiction and established as an absolute fact, community income during the three years . . . of this short three-year marriage available for investment was only $16,737.19.

The result would be that, with neither showing nor purpose of showing circumstances from which gifts of the husband's separate property to the community could be inferred, the application of the presumption not only turns the sow's ear into a silk purse, but by alchemist's wizardry, fills it with gold by making the maximum of all community funds $16,737.19 turn into $81,688.84

Duncan v. US, 247 F.2d 845 (5th Cir. 1957) (CONT.)

"When facts demonstrate positively and conclusively that on the assumption that every cent of community funds was invested, it was but a fraction of the cost of the property thus acquired, the presumption no longer has any basis in fact, and indeed, flying in the face of facts, it is overcome."

Maximum Community Available for Investment

- During the first five years of marriage, tax returns establish net after-tax CP income.
- No account records or ledgers are available to do a line-item tracing.
- Money invested during those five years exceeds the total CP income net of tax.
- SP was available to make the investments.
- Can the CP ownership of investments be limited to the total CP net after tax income during those five years?
- Should any adjustment be made for community living expenses?

Use Determines Character

- H’s SP, W’s SP, and CP are commingled in an account
- Some withdrawals were to maintain H’s SP, some to maintain W’s SP, and some for community living expenses.
- The tracing allocated H’s SP funds to maintain his separate estate, W’s SP funds to maintain her separate estate, and CP funds to pay living expenses
- What about withdrawals to make investments or buy assets?

Tracing Based on Use of Funds

- How difficult is it to construct a line-item tracing based on the use of funds?
- If an expenditure cannot be attributed to a use, what is the default allocation (to the community, half to each party's separate, or pro rata based on account balance that day?)
- A check to a credit card company requires that the credit card charges be allocated.

Replenishment

- An account contains $10,000 of CP.
- H withdraws $10,000 to pay his SP debt.
- A week later, H deposits $10,000 of SP.
- The judge finds that the cash in the account is 100% CP.
- The alternative is that the $10,000 in the account is 100% H’s SP, and the community has a $10,000 reimbursement claim.

Intent

- A bank account contains H's SP and CP funds.
- H withdraws funds to purchase an investment.
- H tells his forensic CPA that he <u>intended</u> to invest his SP funds.
- Does that override a community-out-first allocation?
- Is H's testimony of intent alone clear and convincing evidence?
- What if there is a contemporaneous memo indicating H's intent, or a pattern of investing SP?
- What are the implications of H's fiduciary duty to W?
- Does it matter if the investment went up or down in value?

Backward Tracing (#1)

- A bank account contains $50,000 of CP.
- W writes a check to purchase an investment for $20,000. The next day she deposits $20,000 of her SP funds into the account. The original check clears 7 days later.
- The withdrawal is treated as CP under the community-out-first method, based on either the check written date, or the statement date.
- The withdrawal is treated as SP under the matching transactions and backward tracing methods.
- What if the SP deposit was made after the original check cleared? One year later?

Backward Tracing (#2)

- An account contains $10,000 CP.
- W writes a $20,000 check to buy a CD.
- The account goes into overdraft.
- W later deposits $20,000 into the account.
- The judge rules that the CD is SP and the $10,000 cash in the account is CP.
- The alternative is to treat the CD as being purchased with CP loan proceeds, and create a SP reimbursement claim for paying off the CP overdraft.

Net Contributions Method

- This tracing method is based on Texas Estates Code §113.102, which says how to determine the ownership of funds in a joint account during the parties' lifetimes.

- During the lifetime of all parties to a joint account, the account belongs to the parties in proportion to the net contributions by each party to the sums on deposit.

Net Contributions Method (continued)

- Texas Estates Code §113.003 says that the net contributions of a party to an account "at any given time is the sum of all deposits made to the account by or for the party, less all withdrawals made by or for the party, less all withdrawals made by or for the party that have not been paid or applied to the use of any other party, plus a pro rata share of any interest and dividends."

- The Net Contributions Method allocates withdrawals based on who withdrew or received the benefit of the money.

- This Method exhibits the features of the Use-Determines-Character Method.

FIFO/LIFO

- How can an electronic spreadsheet be constructed to allocate based on FIFO or LIFO?
- Is FIFO/LIFO only practical for low-activity accounts, and sales of mixed character blocks of securities?

Distribution From an Entity

- W has a 50% separate property interest in a corporation that owns only 5 buildings.
- A building is sold and W receives 50% of the sales proceeds; the entity remains active.
- What is the character of the distribution?
  - All distributions are presumed to be CP.
  - Can the entity preferentially distribute capital and not income (i.e., directors' intent)?
  - Can you apply an exhaustion method, withdrawing current year earnings, then retained earnings, and finally capital?

Tracing Inside Trust

- One half of trust principal has matured and is free of trust, but remains in the name and control of the trustee.

- Held in trust:
  - Trust principal
  - Undistributed income on trust principal
  - Undistributed matured trust principal
  - Undistributed income on matured trust principal.

- What is the order of distributions of mixed funds?

- Can commingling occur inside the trust?

- Is line-item tracing appropriate, or instead aggregate level tracing as of year-end?

Trust Distributions

- W is both a <u>trustee and beneficiary</u> of a <u>testamentary</u> trust.
- The trust allows wife to make distributions to herself of income and principal, subject to a <u>HEMS standard</u>.
- Wife distributes <u>all income</u> and <u>some principal</u>.
- What is the character of the undistributed income?
- What is the character of the distributed principal?
- What is the character of the distributed income?
- What if the distributions <u>violated</u> the HEMS standard? (See *Sharma v. Routh*)

Missing Records

- When the parties separated, W moved out of the house and left all the parties' financial records in the home.
- W needs those records to trace some separate property transactions.
- H says there are no financial records at the house.
- W claims spoliation.
- Is a spoliation sanction appropriate?
- If so, what would it be (Rule that SP is proved; reverse burden of proof; presume destroyed records support SP)?

Brokerage Account - Partial Sale, Mixed Block

- At the time of marriage, W had 500 shares of AAPL stock. During marriage, 500 more shares of AAPL were purchased with CP funds.
- 500 shares of AAPL stock were sold.
- What is the character of the remaining shares under community-out-first, pro rata, intent, FIFO/LIFO, IRS presumptions, brokerage statement methods of tracing?

Brokerage Account - Time Gap

- H has a brokerage account containing SP and CP securities and CP cash.
- H tells broker to sell his SP IBM and buy AAPL.
- The AAPL shares are acquired <u>before</u> the proceeds from the IBM shares are deposited.
- Are the AAPL shares SP or CP?
- Apply Matching Transactions, Intent, or Backward Tracing.
- What if Community-Out-First is applied?

Brokerage Account - Margin Before Marriage

- H had a margin investment account prior to marriage. The margin debt was $50,000 on DOM.
- One month into marriage, H buys stock on margin.
- H later sells SP shares in the same amount, which pays down the margin debt.
- Did the SP sale proceeds pay down the SP debt or the CP debt? Why?

Capital Contribution to Entity

- H owns separate property oil and gas interests worth $499,000. He contributes them to a limited partnership.
- The LP agreement states the consideration to be exchanged for his LP interest is $1,000 of agreed value. Accounting records booked the $1,000, but no bank records reflect the payment.
- What is the character of H’s limited partnership interest: 100% CP, 1/500 CP, or zero CP?

Tax Return - Schedule B

- W currently owns 500 shares of IBM in street name. DOM brokerage statements are lost.

- Tax returns from before marriage through the most recent year reflect IBM dividends equal to the expected dividend on 500 shares based on public information.

- Is this clear and convincing evidence that the shares are W's SP?

- Does this prove separate property *as a matter of law* (i.e. summary judgment?)

Tax Return - Schedule D

- Husband sold 1,000 shares of Microsoft during marriage but does not have brokerage statements from DOM.
- Schedule D from year of sale shows an acquisition date before marriage.
- Clear and convincing evidence?
- Proof as a matter of law?

Quality of the Data

- TRE 704(c) provides: “An expert’s opinion is inadmissible if the underlying facts or data do not provide a sufficient basis for the opinion.”

- Under TRE 703, “an expert may base an opinion on facts or data in the case that the expert has been made aware of, reviewed, or personally observed. If experts in the particular field would reasonably rely on the kinds of facts or data in forming an opinion on the subject, they need not be admissible for the opinion to be admitted.”

Business Valuation in a Texas Divorce

Propositions to Consider

- Slavish adherence to the fair market value (FMV) standard is dogmatic.
- There is no FMV for a small, closely-held business, because there is no active market to generate comparable market data.
- Using NYSE data and scaling down to small company size is generally accepted but has dubious validity.
- Texas cases <u>do not require</u> FMV in a divorce.
- Texas cases say <u>not to use</u> FMV if there is <u>no active market</u>.
- Texas cases say <u>not to use</u> FMV if a <u>transfer restriction</u> precludes sale to outsiders.
- The better alternative to FMV is Intrinsic Value based on Fundamental Analysis.

Propositions to Consider (continued)

- The only viable approach to valuing an operating closely-held business is the Income Approach.
- W/O a market value, there is no DLOM.
- W/O a market value, a buy-sell formula does not apply.
- Goodwill is residual value. Personal goodwill can be determined, and the balance of residual goodwill is enterprise goodwill, but not vice-versa.
- The cost of a covenant not to compete does not capture all the value of personal goodwill. Combining the cost of a covenant with the cost of a consulting agreement is better (after subtracting the wages component).
- Personal goodwill is best measured by the projected reduction in profits/cash flow if the seller leaves the business, or leaves and competes.

Exit Price --The Exxon Example

- On March 31, 2019, 4.27 billion sh. of Exxon Mobil were outstanding.
- Ave. XOM trading volume is 6-7 million shares per day.
- At 7 million sh. per day, on one day 0.16% of total XOM shares are sold.
- The other 99.84% of total XOM shares were kept by shareholders who did not want to sell.
- What is the justification for assuming that the decisions of so few represent the views of so many?
- The “equilibrium” price involves a tiny set of investors.
- Are we just measuring what is measurable?

Standards of Value

- Fair Market Value (willing buyer/willing seller)
- Investment Value (unique buyer with special motive)
- Intrinsic Value (value to owner based on Fundamental Analysis)
- Liquidation Value (selling tangible & identifiable intangible assets; ignores goodwill)
- Book Value (historical cost, +/- adjustments)
- Rules of Thumb (used by buyers/sellers of similar companies)

IRS Reg. § 20.2031-2 Hierarchy

- Selling price on stock market (best).
- Mean of bid and asked prices (next best).
- Blockage.
- Valuing controlling interest when all sales are minority interests (don't use market data).
- Absent reliable market data, consider net worth, earning power, dividend-paying capacity, and "other relevant factors."
- "Other relevant factors": goodwill, industry outlook, position in industry, management, control, comparables.
- Alternative to market data is <u>Fundamental Analysis</u> to estimate <u>Intrinsic Value</u>.

FAS 157 Fair Value Hierarchy

- Promulgated by the FASB, the ultimate authority on accounting practices.
- FAS 157 is for financial reporting purposes.
- FAX 157 established fair value hierarchy.
- Three levels of Inputs (1 is better than 2; 2 is better than 3).
- Reliability declines from Level 1 to 2 to 3.

Level 1 Inputs (Best)

- Quoted prices for identical assets in active markets.

- An "active market" is a market in which transactions for the asset occur with sufficient frequency and volume to provide pricing information on an ongoing basis.

Level 2 Inputs (Middle)

- Quoted prices for similar assets in active markets (best).
- Quoted prices for similar assets in inactive markets (next best).
- Inputs principally formed or corroborated by observable market data (least best).
- Significant adjustments may drop the valuation to Level 3 (Guideline Public Company Approach fits here. Also, Income Approach using Build-Up Method with Size Premium.)

Level 3 Inputs (Worst)

- Still seeking fair value measured by "exit price."
- Based on <u>unobservable</u> inputs.
- <u>Making assumptions</u> about the assumptions that market participants would use in pricing the asset.
- Use "<u>best information available</u>."
- Income Approach using Build-Up Method with Specific Company Risk Premium fits here.

Texas Pattern Jury Charges (Family & Probate 2018)

PJC 203.1 Value

- The value of an asset is its fair market value unless it has no fair market value.
- “Fair market value” means the amount that would be paid in cash by a willing buyer who desires to buy, but is not required to buy, to a willing seller who desires to sell, but is under no necessity of selling.
- If an asset has no fair market value, its value is the value of its current ownership as determined from the evidence.
- In valuing an asset to be received in the future, you are to find its present value as determined from the evidence.

The *Wendlandt* Case

In *Wendlandt v. Wendlandt*, 596 S.W.2d 323, 325 (Tex. Civ. App.--Houston [1st Dist.] 1980, no writ), the court said:

> Fair market value has been consistently defined as the amount that a willing buyer, who desires to buy, but is under no obligation to buy would pay to a willing seller, who desires to sell, but is under no obligation to sell. *City of Pearland v. Alexander*, 483 S.W.2d 244 (Tex.1972). This standard or test <u>presupposes an existing, established market</u>.

The *Beavers* Case

Beavers v. Beavers, 675 S.W.2d 296, 299 (Tex. App.--Dallas 1984, no writ), said:

> The valuation problem arises because the sale of these shares is <u>restricted</u> by a requirement that they be offered first to other shareholders at book value. Experts from both parties testified that essentially because of this restriction, the <u>market value of the stock was *zero*</u>….While market value is usually the best evidence of the value of the personal property, <u>in the absence of a market value, the actual value of the property to the owner may be shown</u>.

The *Roberts v. Harvey* Case

Roberts v. Harvey, 663 S.W.2d 525, 528 (Tex. App.--El Paso 1983, no writ), says:

> There can be no cash market value of corporate stock where it has not been sold in sufficient quantities to establish a prevailing sales price. Where there is <u>no evidence of market value</u>, it is <u>error</u> to submit to the jury an issue on market value.

The *Mandell* Case

Mandell v. Mandell, 310 S.W.3d 531, 536-37 (Tex. App.--Fort Worth 2010, pet. denied), the court said:

> When the sale of stock is restricted by a requirement that the shares be offered first to the corporation or to other shareholders, then essentially the fair market value of the stock is zero. . . . In this situation, the parties may show the actual value of the property interest to the owner.

If You Abandon Market Value

- It means no Market Approach.
- It means no DLOM.
- It means relying on the Income Approach.
- It means lack of control must be factored into projected future benefits or an increased capitalization or discount rate.
- It means you ignore buy-sell formulas, because there is no hypothetical sale.

Differing Concepts of Goodwill

- Lawyers think of goodwill as positive feelings on the part of customers.
- Accountants think of goodwill as the price paid to buy a business in excess of the values of all identifiable assets added together.
- Valuators think of goodwill as the undefined qualities of a business that generate profits in excess of expected rates of return on identifiable assets.
- Economists say that goodwill is standard human capital, and social and organizational capital.

Standard Human Capital

- According to economist John F. Tomer, "standard human capital" consists of a person's knowledge, skill and experience. It involves cognitive intelligence, intellectual knowledge, and skill or judgment developed through training and experience.
- A business can also have "organizational capital," which is embodied in organizational relationships, repositories of information, and the like.
- A business makes a profit by utilizing it's "human capital" and "organizational capital."

Social and Organizational Capital

- Economist Paul M. Romer (Nobel Prize 2018), social and organizational capital is the intangible value resulting from activities that create social and business relationships.
- Social and organizational capital do not reside in individuals but rather in the relationships between people.
- Let's call the social and organizational capital of a person or a business "relational goodwill." "Relational goodwill" is different from "standard human capital," because "standard human capital" inheres in an individual, while "relational goodwill" exists between people, or between a business and its customers, suppliers, and sources of future business. The business owner may have "relational goodwill," but so may the other owners and employees of the business. Even the business itself can have "relational goodwill" with its employees, its customers, its suppliers, and its sources of future business.

Expenses vs. Assets

- In financial reporting, the accounting profession treats the company's investment--in human capital and in social and organizational capital--as an expense on the income statement and not as an asset on the balance sheet.

- Such expenditures constitute an unrecognized capital investment that create income in excess of the expected return on recognized assets. Since this excess income cannot be attributed to recognized assets, by default it falls into "residual goodwill" that is sometimes mistakenly treated as personal goodwill of the owner, when it is really enterprise goodwill, or, more accurately, income arising from unrecognized intangible assets of the business, such as human, social and organizational capital.

Financial Accounting's Treatment of Intangible Assets - FAS 141 (2001)

- An intangible asset shall be recognized as an asset apart from goodwill if it <u>arises from contractual</u> or other <u>legal rights</u>. If an intangible asset does not arise from contractual or other legal rights, it shall be recognized as an asset apart from goodwill only if it is <u>separable</u>, that is, it is capable of being separated or divided from the acquired entity and sold, <u>transferred</u>, licensed, rented, or exchanged (regardless of whether there is an intent to do so).

Financial Accounting's Treatment of Intangible Assets - FAS 141 (2001)

- "For purposes of this Statement, an assembled workforce shall not be recognized as an intangible asset apart from goodwill." [Emphasis added]

- Assembled workforce is ignored because:

  --replacement cost (the cost to hire and train a comparable assembled workforce) is "not a representa-tionally faithful measurement of the fair value of the intellectual capital acquired in a business combination," and

  --the "techniques to measure the value of an assembled workforce and the related intellectual capital with sufficient reliability are not currently available."

Financial Accounting's Treatment of Intangible Assets - FAS 141 (2001)

- In other words, because the financial accounting profession cannot determine how to value an assembled workforce, they just ignore it!
- Because assembled workforce is lumped into the "residual goodwill" of the business, sometimes valuators and courts mistakenly attribute some or all of the value of assembled workforce to the personal goodwill of the owner.

Internal Revenue Code § 197(d)

Tax accounting does recognize an assembled workforce as an identifiable intangible asset, called "workforce in place." Under IRC § 197(d):

"Intangible" means--

(A) goodwill,

(B) going concern value,

(C) any of the following intangible items:

(i) workforce in place including its composition and terms and conditions (contractual or otherwise) of its employment;

(ii) business books and records, operating systems, or any other information base (including lists or other information with respect to current or prospective customers);

(iii) any patent, copyright, formula, process, design, pattern, know-how, format, or other similar item.

Internal Revenue Code § 197(d)

(iv) any customer-based intangible,

(v) any supplier-based intangible,

(vi) any other similar item,

(D) any license, permit, or other right granted by a governmental unit or an agency or instrumentality thereof,

(E) any covenant not to compete (or other arrangement to the extent such arrangement has substantially the same effect as a covenant not to compete) entered into in connection with an acquisition (directly or indirectly) of an interest in a trade or business or substantial portion thereof, and

(F) any franchise, trademark, or trade name.

Segregate from “Residual Goodwill”

- Part of the “enterprise goodwill” of a business consists of the standard human capital and the social and organizational capital of the business. If we can value it, we can call it “enterprise goodwill” and remove it from “residual goodwill.”
- The best way to determine enterprise goodwill, is to value:

(1) “workforce in place” or “assembled workforce”;

(2) customer-based intangibles;

(3) supplier-based intangibles;

(4) employment agreements; and

(5) covenants not to compete.

Proposition One

Components of Value of a Closely-Held Business

The value of a business as a going concern consists of (i) the value of tangible assets, plus (ii) the value of intangible assets that can be individually valued, plus (iii) the enterprise goodwill of the business, plus (iv) the personal goodwill that is so identified with the selling owner that it is lost to the business when the seller leaves, or leaves and competes.

Proposition Two
Components of Personal Goodwill

The reduction in future profits attributable to the business's loss of the seller's personal goodwill contains three components: (i) the reduction in profits associated with losing the seller's knowledge, skill and experience;* (ii) the reduction in profits associated with losing co-owners, employees, suppliers, customers and referral sources as a result of the seller leaving the business; and (iii) the reduction in profits associated with losing co-owners employees, suppliers, customers and referral sources as a result of the seller leaving and competing with the business.

*(The seller's knowledge, skill, and experience is John F. Tomer's Standard Human Capital.)

Proposition Three

Account for Knowledge, Skill & Experience by Normalizing Compensation

The first of these three components of personal goodwill can be ignored if the seller’s knowledge, skill and experience can be replaced by hiring a new employee with equivalent knowledge, skill and experience, while the loss of profits resulting from losing the seller’s “relational goodwill” cannot be made whole by hiring a new employee.

Proposition Three (continued)

Account for Human Capital by Normalizing Compensation

The reasonable compensation assigned to the selling owner in normalizing the owner’s historical compensation is identical to the cost of hiring a replacement employee with similar knowledge, skill and experience, so after normalizing the owner’s compensation there is no net reduction in profitability purely from the loss of the owner’s knowledge, skill and experience.

Seller's Relational Capital

The selling owner's ties to other owners, employees, customers, suppliers and referral sources cannot be replaced by hiring a new employee with equivalent knowledge, skill and experience, since the new employee will have none of the seller's relationships with co-owners, employees, customers, suppliers, and referral sources. These ties are like Paul Romer's concept of "social capital" (i.e., personal relationships), not John Tomer's "standard human capital" (i.e., knowledge, skill and experience).

Determining the Selling Owner's Personal Goodwill

- The first step in determining the seller's personal goodwill is to remove the factor of knowledge, skill and experience from the personal goodwill determination by including that factor in the adjustment made to normalize the seller's historical compensation. Then the effect on profits of losing the selling owner's "relational goodwill" should be projected. The reduction in value attributable to that reduction in profits is a measure of the seller's personal goodwill. The remaining residual goodwill of the business is enterprise goodwill.

Proposition Four

Covenant not to Compete ≠ Seller’s Personal Goodwill

Valuing the seller’s personal goodwill by estimating the cost of a covenant not to compete does not, as is commonly assumed, measure the personal goodwill of the seller, because the covenant not to compete does not stop co-owners, employees, customers, suppliers, and sources of future business from drifting away simply because the seller has left the business.

Proposition Five

Assume the Seller Will Compete

- If the selling owner's historical compensation is adjusted to reflect his/her knowledge, skill and experience, and if the valuator adjusts the projection of future profits downward to reflect the seller's leaving and competing, then the remaining goodwill is, by process of elimination, enterprise goodwill.
- The cost of a covenant not to compete should be equal to the profits that are preserved by eliminating the seller's competition. So the net effect on the business's profits is the same.
- When the seller dies, retires, or moves away there will be no loss from the seller's competing. But there will still be a loss from the seller's ceasing to participate in the business, which can be estimated.

Yoon v. Yoon, 711 N.E.2d 1265, 1268-69 (Ind. Sup. Ct. 1999)

- "Enterprise goodwill 'is based on the intangible, but generally marketable, existence in a business of <u>established relations</u> with <u>employees</u>, <u>customers</u> and <u>suppliers</u>.'" [Emphasis added] [Halleluiah!—recognizes standard human capital and "relational goodwill" of employees of a business]
- "Enterprise goodwill is an asset of the business and accordingly is property that is divisible in a dissolution to the extent that it inheres in the business, independent of any single individual's personal efforts and will outlast any person's involvement in the business. . . ." [Recognizes the "before and after" analysis of personal goodwill]

Goodwill Conclusions

1. The goodwill of a business is the expected return on intangible assets that we have failed to recognize.
2. We fail to recognize these assets because they are intangible, and our definition of intangible assets is too restrictive.
3. Abandon the requirement that intangibles be separable and transferable before they can be recognized as assets.
4. In this light, residual goodwill largely consists of standard human capital, and social and organizational (or relational) capital.
5. Isolate the selling owners’ human capital and relational capital, and the remaining capital belongs to the business, and constitutes enterprise goodwill.

Daubert/Robinson Reliability

***E.I. du Pont de Nemours v. Robinson*, 923 S.W.2d 549 (Tex. 1995):**

“In order to constitute *scientific* knowledge which will assist the trier of fact, the proposed expert testimony must be relevant and reliable.”

Non-exclusive list of factors:

1) the extent to which the theory has been or can be tested (x);

2) the extent to which the technique relies upon the subjective interpretation of the expert (x);

3) whether the theory has been subjected to peer review and/or publication (√);

4) the technique’s potential rate of error (x);

5) whether the underlying theory or technique has been generally accepted as valid by the relevant scientific community (√);

6) the non-judicial uses which have been made of the theory or technique (√).

Gammill v. Jack Williams Chevrolet, Inc., 972 S.W.2d 713 (Tex. 1998):

We conclude that whether an expert's testimony is based on "scientific, technical or other specialized knowledge," *Daubert* and Rule 702 demand that the district court evaluate the methods, analysis, and principles relied upon in reaching the opinion. The court should ensure that the opinion comports with applicable professional standards outside the courtroom and that it "will have a reliable basis in the knowledge and experience of [the] discipline."

General Acceptance; Peer Review

- Fair Market Value
- Rev. Rul. 59-60
- Treas. Reg. § 20.2031-2
- FAS 147
- Books
- Magazines
- Ibbotson; Duff & Phelps
- BV Organizations' Continuing Education
- Court Cases
- CAPM (Modified)
- Build-Up Method
- Equity Risk Premium
- Industry Risk Premium
- Specific Company Risk
- Discount for Lack of Control
- Marketability Discount
- Future Tax Rates

Undercompensation Claims

1. Common Law: *Jensen v. Jensen*, 665 S.W.2d 107 (Tex. 1984)
   - Value of community time, toil, talent, and effort;
   - Less effort necessary to manage and preserve separate estate;
   - Offset for paid salary, bonus, dividends, and fringe benefits.
2. Tex. Fam. Code § 3.402:
   - Inadequate compensation for time, toil, talent, and effort of a spouse,
   - By a business entity under the control and direction of that spouse.

Estimating Future Tax Liability

- Tex. Fam. Code § 7.008 --in dividing the estate in a divorce, the court can consider whether a specific asset will be taxed, and when the tax will have to be paid.
- What tax rate should be used? Found only one case:
- *Oddi v. Ayco Corp.*, 947 F.2d 287, 261-63 (7th Cir. 1991), a case involving negligent investment advice:
  - applied a presumption that existing tax rates would continue;
  - but a party can convince the fact finder otherwise;
  - for example, by proof of legislation pending to change the tax law; or
  - "a probability analysis for a number of different tax rates from which a court could strike a statistically supportable middle ground, different from the status quo."

The End