

EQUITABLE DIVISION

(VALUING ASSETS, NON-MARITAL PROPERTY ISSUES)

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I. Introduction

There is no other area of family law that allows the domestic lawyer to use his or her skills of creativity and persuasion more than in the area of equitable division. More appellate cases have been issued dealing with this principle of divorce than any other. Equitable division does not necessarily mean an equal division, but rather, a “fair” division. The following paper is intended to give the practitioner an overview of equitable division, with an emphasis on recent cases, which will then be applied to the set of facts presented at this particular seminar.

II. Overview of Authority

Equitable Division

“ . . . [A]n equitable division of marital property does not necessarily mean an equal division. The purpose behind the doctrine of equitable division of marital property is 'to assure that property accumulated during the marriage be fairly distributed between the parties. Each spouse is entitled to an allocation of the marital property based upon his or her respective equitable interest therein. Thus, an award is not erroneous simply because one party receives a seemingly greater share of the marital property.’” *Wright v. Wright*, 277 Ga. 133, 134 (2) (2003); see *Walton v. Walton*, 285 Ga. 706 (2009).

As a general matter, “where equitable division of property is in issue, the conduct of the parties, both during the marriage and with reference to the cause of the divorce, is relevant and admissible.” *Peters v. Peters*, 248 Ga. 490 (1981); *McEachern vs. McEachern*, 260 Ga. 320 (1990).

Marital Property v. Non-marital Property

Marital property is subject to equitable division, separate property is not. *McArthur*, 256 Ga. 762, 763 (1987). “[O]nly [the real and personal property and assets] . . . acquired as a direct result of the labor and investments of the parties during the marriage is subject to equitable division.” *Wright v. Wright*, 277 Ga. 133, 133 (1) (2003).

“A property interest brought into the marriage by one of the marriage partners is a non-marital asset and is not subject to equitable division since it was in no sense generated by the marriage.” *Mathis v. Mathis*, 281 Ga. 865, 866 (2007) (citing *Campbell v. Campbell*, 255 Ga. 461 (1986)).

“[P]roperty acquired during the marriage by either party by gift, inheritance, bequest or devise remains the separate property of the party that acquired it, and is not subject to equitable division.” *McArthur*, 256 Ga. at 763.

“However, if property acquired during the marriage is acquired by one spouse as the result of an interspousal gift of marital property, the property retains its status as marital property.” *Coe v. Coe*, 285 Ga. 863, 864 (2009). It follows that a spouse can make a gift of non-marital property to the marital unit, which transforms the separate property into marital property, subject to equitable division. *Coe v. Coe*, 285 Ga. 863, 864 (2009); *Lerch v. Lerch*, 278 Ga. 885 (2005). In *Coe*, the marital home was allegedly purchased by the husband with his separate property funds after the parties were married. However, because the husband put title to the home jointly in the parties’ names, a rebuttable presumption was created that the home was a gift to the marital unit. The husband’s gift of his non-marital funds to purchase the home transformed his

separate property into marital property subject to equitable division.

Additionally, co-mingling, withdrawals, and contributions by the other spouse to one party's separate estate can destroy the separate estate concept and render the asset to be a part of the marital estate in its entirety. *Horsley v. Horsley*, 268 Ga. 460 (1997). "[W]hether a particular kind of property can ever be classified as marital property is a question of law for a judge to decide." *Bass*, 264 Ga. 506 (1994). "However, whether a particular item of property actually constitutes a marital or non-marital asset may be a question of fact for the trier of fact to determine from the evidence." *Bass*, 264 Ga. 506 (1994). See also, *Franklin v. Franklin*, 267 Ga. 82 (1996); *Janelle v. Janell*, 265 Ga. 116 (1995); and *Mathis v. Mathis*, 281 Ga. 865 (2007).

Blended Assets

Where an asset is both marital and non-marital in nature, the method of equitable division utilized at trial is the "source-of-funds" rule which provides that a spouse contributing non-marital property is entitled to an interest in the property in the ratio of the non-marital investment to the total non-marital and marital investment in the property. *Thomas v. Thomas*, 259 Ga. 73, 76 (1989). The remaining property is characterized as marital property and its value is subject to equitable distribution. *Thomas v. Thomas*, 259 Ga. 73, 76 (1989). Thus, the spouse who contributes non-marital funds, and the marital unit that contributes marital funds, each receives a proportionate and fair return on their investment. *Thomas v. Thomas*, 259 Ga. 73, 76 (1989). "In applying the 'source of the funds' rule to the equitable division of [an asset] ..., the trial court must determine the contribution of the spouse who brought the [asset] to the marriage, and weigh it against the total non-marital and marital investment in the

property.” *Hubby v. Hubby*, 274 Ga. 525, 525 (2001).

Where an asset is in part non-marital, there must be evidence introduced at trial as to the value of the asset at the time of the marriage, or if acquired after the marriage, at the time of acquisition. *Snowden v. Alexander-Snowden*, 277 Ga. 153, 153-154 (2003). A fact finder cannot properly apply the ‘source of the funds’ rule when apportioning the parties’ respective interests in a marital home which husband brought into the marriage when no evidence is presented as to the fair market value of the home as of date of marriage and no evidence is presented as to the fair market value of the home as of the end of the marriage. *Horsley v. Horsley*, 268 Ga. 460 (1997). In order to carry that party’s burden of proof, it is essential that the party claiming a non-marital interest in an asset present evidence of the value as of the date of marriage, or time of acquisition if that asset was acquired during the marriage, as well as evidence of the value as of the time of divorce.

Market Forces Law

[A]s a matter of law, if the separate non-marital property of one spouse appreciates in value during the marriage solely as the result of market forces, that appreciation does not become a marital asset which is subject to equitable division; but, if the separate non-marital property of one spouse appreciates in value during the marriage as the result of efforts made by either or both spouses, that appreciation does become a marital asset which is subject to equitable division. *Bass*, 264 Ga. at 507; *Thomas*, 259 Ga. 73, 75 (1989); *Halpern*, 256 Ga. 639 (1987).

In *Halpern*, the trial court granted the husband's motion for partial summary judgment and found that the appreciation in his family's corporation was the husband's non-marital property because there was no evidence that any of the appreciation in the corporate stock was caused by the efforts of husband. During the marriage, husband began working for his father's real estate development corporation. Husband owned less than 8% of the stock, which he owned as of date of marriage, with the remaining stock being owned by his siblings and his mother. Husband's duties for the corporation were to repair and maintain the corporate properties for which he received a salary of \$100,000 per year which the court found was reasonable income for his services. At no time were there any dividends paid on the stock to husband or loans from husband to the corporation or capital contributions by husband. The court found that there was no evidence that husband had contributed to the appreciation of the stock value and therefore, any appreciation of husband's stock value in the corporation was his separate property.

EXAMPLE OF APPLICATION OF "SOURCE OF THE FUNDS" RULE

using the facts in Hubby v. Hubby, 274 Ga. 525 (2001):

Facts of *Hubby*:

Purchase Price of Home:

\$145,500

\$80,500 from H's separate funds or 94.6% of net equity in home

\$65,000 loan

Refinance:

Amount that principal amount of original loan had been reduced was \$1983 (principal loan balance \$63,017 as of date of refinance)

Amount of New Loan: \$68,500

Divorce:

FMV \$183,000 (Increase in value of \$37,500)

Loan Balance: \$65,915 (Amount that principal amount of refinance loan had been reduced was \$2,585 as of divorce)

Net equity at time of divorce was \$117,085

Analysis

(1) Determine net equity based on purchase price:

\$80,500 + 1,983 + 2,585 for a total net equity of \$85,068

(2) Determine what percentage of total net equity is separate and marital:

H's separate is 94.6% (\$80,500 divided by \$85,068)

Marital is 5.4% (\$1,983 + \$2,585 divided by \$85,068)

(3) Determine current value of separate and marital as of divorce:

H's separate is \$110,762 (net equity at time of divorce \$117,085 multiplied by 94.6%)

Marital is \$6,322 (\$117,085 multiplied by 5.4%)

THEREFORE, \$6,322 IS SUBJECT TO EQUITABLE DIVISION.

Valuing Pre-marital Corporate Stock when third party shareholder's stock was redeemed during the marriage leaving shareholder-spouse as sole shareholder:

In *Anson v. Anson*, 772 So.2d 52 (2000), the District Court of Appeal of Florida issued a detailed opinion involving a set of facts where the husband formed a company 19 years prior to the marriage wherein he owned 60% of the stock. Husband actively worked in the company even after the date of marriage. During the marriage, the company redeemed husband's partner's stock pursuant to the buy/sell agreement. The redemption of the stock came from company funds. Husband argued that 100% of the stock in the company was his non-marital asset. Wife argues that since the redemption happened during the marriage, it was a "purchase" by the husband with marital funds and was a marital asset because the redemption increased the husband's proportionate interest in the stock of the company.

The Court found that the stock was 100% a non-marital asset of the husband. In making its determination, the Court reasoned that, assuming the book value had been paid by the corporation from corporate funds for the partner's redeemed stock, then the value of the husband's stock was the same before and after the redemption. (Husband's stock value would be affected though if a discount or premium was paid to the partner for his stock rather than book value). In other words, husband's 50% ownership is the same after the redemption since the corporation owns 50% of the stock it redeemed and such stock was not purchased by the husband individually. "A stockholder's interest in a corporation is limited to the legal rights flowing from the ownership of capital stock. Those rights do not include a pro-rata interest in corporate assets. The corporation, as a legally recognized entity, holds title to its assets. The earnings of a corporation do not become a marital asset upon marriage. Assets acquired through corporate earnings are corporate assets until payments are made for services or dividends. If a shareholder-spouse devotes work efforts to a corporation during marriage, the corporation's income is not immediately converted into marital income. If the corporation retains assets acquired from earnings of a corporation rather than distributing them as dividends to shareholders, the value of the outstanding stock should appreciate in value." *Anson* at 54-55.

The court in *Anson* states that the correct approach in determining whether any portion of the husband's stock in the company was marital would be to first determine the value of that stock as of date of marriage and again at time of dissolution of the marriage. If the stock appreciated between these two dates, then an analysis would have to be done of the reasons for the appreciation to determine whether all or a portion of

the appreciation should be classified as marital. Just because the shareholder-spouse devotes work efforts to the corporation during the marriage, it does not necessarily follow that the entire appreciation in stock value should be transformed into a marital asset. Was the appreciation caused because of the corporate attributes, such as goodwill, underlying investments, customer supplier and employee bases, operating assets, and inventory?

In doing the analysis to determine whether the stock in *Anson* had increased or decreased during the marriage, the fact finder determined that the stock value had actually decreased in part due to the dividends enjoyed by the parties during the marriage and to the loss of a valued customer. Therefore, no part of husband's stock in the company should be regarded as a marital asset. (A copy of this case is attached as Appendix D)

Factors to Use in Evaluating Equitable Division

In making an equitable division of marital property, the fact finder may consider all facts, circumstances, and evidence which he or she deems relevant. Factors that the fact finder may consider might include, but are not limited to, the following:

1. the age and health of each party;
2. the occupation and income of each party;
3. the duration of the marriage;
4. the contribution of service of each to the family unit;
5. the separate estate (assets) of each party;
6. the indebtedness of each party;
7. the present income, future earning capacity, and financial resources of each party;
8. the causes which led to the separation and the conduct of the parties towards each other prior to the separation;
9. the needs of each of the parties;
10. the contribution of each party to the acquisition and maintenance of the property (which includes non-monetary contributions of a spouse or a homemaker); and
11. the purpose and intent of the parties regarding the ownership of the property.

Halpern vs. Halpern. 256 Ga. 639, 640 (1987);
McArthur vs. McArthur. 256 Ga. 762, 764 (1987).
Sparks vs. Sparks. 256 Ga. 788, 789 (1987).
McEachern vs. McEachern. 260 Ga. 320 (1990).

STEPS TO TAKE IN MAKING AN EQUITABLE DIVISION:

1. Classify each item of property as marital or non-marital.
2. As to non-marital items, determine the value (equity) of each item as of the date of marriage or date of acquisition if acquired after date of marriage.
3. As to non-marital items, determine the current value (equity) of each item as of date of divorce.
4. As to non-marital items, determine whether any increase in value (equity) during the marriage is a result of efforts made by either or both spouses and, if so, that increase is marital. But, if the determination is made that any increase, or portion of the increase, in value (equity) during the marriage is due solely to market forces, then that portion of the increase remains the non-marital asset of that party and does not become marital property subject to equitable division.
5. Using the facts in the case, apply them to the factors to be used in determining an equitable division of the marital portion of each asset.

Gift Law

A valid gift must meet the requirements of O.C.G.A. § 44-5-80:

1. The donor must intend to give the gift;
2. The donee must accept the gift (O.C.G.A. § 44-5-81 states that the law assumes acceptance if the gift is of substantial benefit.) *Avera v. Avera*, 268 Ga. 4, 7 (4) (1997); and
3. The gift must be delivered or some act which under law is accepted as a substitute for delivery must be done. (The delivery of a valid deed is an acceptable delivery of the property itself.) *McLemore v. Wilborn*, 259 Ga. 451 (1989); *Avera v. Avera*, 268 Ga. 4, 6 (4) (1997).

Georgia cases specific to gifts in divorce have consistently established the following rules:

Rule #1: A gift made to only one spouse by a third party during the marriage will be considered the separate property of the recipient spouse. *Bailey v. Bailey*, 250 Ga. 15 (1982).

Rule #2: A gift given to the marital couple by a third party is deemed to be marital property absent evidence of a contrary intent by the donor. *Braly v. Braly*, 244 Ga. 773 (1979).

Rule #3: A gift between spouses of property acquired during the marriage will remain marital property subject to equitable division. *McArthur v. McArthur*, 256 Ga. 762 (1987).

Rule #4: A gift of separate property by a spouse to the marital unit will result in the entire property becoming marital subject to equitable division. *Lerch v. Lerch*, 278 Ga. 885 (2005).

In *Avera v. Avera*, 268 Ga. 4 (1997), the Court gives a good overview of gift law in the context of a divorce involving property titled solely in the wife's name. In *Avera*, wife acquired title from an irrevocable trust set up by the husband. The husband was the trustee of the trust. The property was conveyed from the trust to the wife as a result of the joint efforts of husband and wife to further the financial security of their family. Most of the improvements to the land were made while the property was in the name of the trust rather than in wife's name. The Supreme Court addressed the issue of whether the conveyance of the property from the trust to the wife was a gift from a third party and thus, the separate property of the wife. The Court found that the deed from the trust to the wife was a gift thus making the property the separate property of the wife as of the time title was conveyed to her. The Court vacated and remanded the case instructing the trial court to determine whether any portion of the property or improvements were paid for with marital funds after the trust had conveyed the

property into wife's name. If so, then a proportional share of the property may be a marital asset subject to equitable division. Regardless of whether any portion of the purchase price was found to be a marital asset, the Supreme Court instructed the trial court to not end its inquiry there. If the home had appreciated in value during the marriage since the time title was conveyed from the trust to the wife, and the appreciation was the result of the efforts of both or either spouse, then this amount of appreciation would be marital property subject to equitable division.

Implied Trusts

Several of the cases involving classification of assets as marital or non-marital involve implied trusts. An implied trust is either a resulting trust or constructive trust. The intention of the parties is the essential element of a resulting trust. The essential ingredient giving rise to a constructive trust is fraud. O.C.G.A. § 53-12-90. In all cases in which a trust is sought to be implied, the fact finder may consider oral testimony about the nature of the transaction, the circumstances, and the conduct of the party either to imply or rebut a trust. O.C.G.A. § 53-12-94.

A constructive trust is a trust implied when the circumstances are such that the person holding legal title to the property, either from fraud or otherwise, cannot enjoy the beneficial interest in the property without violating some established principle of equity. The person who claims the beneficial interest in property under a constructive trust may be found to have waived his rights to the property by his subsequent ratification or long consent to the use of the property by the other. O.C.G.A. § 53-12-93. *O'Neal vs. O'Neal*, 176 Ga. 418 (1933); *Hancock vs. Hancock*. 205 Ga. 684 (1949). A

constructive trust is a remedy created by a court in equity to prevent unjust enrichment. *Whiten vs. Murray*, 267 Ga. App. 417 (2004).

As between husband and wife, parent and child, brothers and sisters, payment of the purchase money by one and causing the conveyance to be made to the other shall be presumed to be a gift. However, a resulting trust in favor of the one paying the money may be shown and the presumption of a gift rebutted if it is shown that a resulting trust was contemplated by both parties by way of an understanding or agreement. The understanding or agreement can either be expressed or shown by the nature of the transaction, the circumstances, or the conduct of the parties, but must have existed at the time the transaction was consummated. In order to rebut the presumption of a gift, the proof must be clear and convincing. O.C.G.A. § 53-12-92.

Brock v. Brock, 279 Ga. 119 (2005). is a Supreme Court of Georgia divorce case with a resulting trust argument. In *Brock*, the parties lived throughout their marriage in a home bought by husband prior to the marriage. The home was titled in husband's name until sometime in the marriage when he transferred ownership to his wife in consideration for her "love and affection." The wife contends that this was a gift to her and the husband contends that the wife simply held title to the home in an implied resulting trust for husband. Husband claimed that the conveyance to wife was done solely for the purpose of protecting the home from potential future creditors. The trial court found that the property was held as an implied resulting trust for husband. However, the Supreme Court reversed this portion of the trial court's ruling. A good discussion is given on implied trust within the Court's opinion. (See also O.C.G.A. § 53-2-91 on resulting trusts.) In this case, the Court found that the husband had not

presented clear and convincing evidence to rebut the presumption of a gift to the wife. Under O.C.G.A. § 53-12-92(c), a gift will be presumed if the payor of consideration and transferee of the property are husband and wife. To rebut this presumption, the husband was required to prove by clear and convincing evidence that a resulting trust was contemplated by both parties by way of an understanding or agreement. There was no evidence of mutual intent to create a trust and there was no evidence of any mutual understanding or agreement between husband and wife of a trust at the time the deed was executed. Therefore, the trial court erred in finding a resulting trust and awarding the home to the husband. See *Ford v. Ford*, 243 Ga. 763 (1979) and *Scales v. Scales*, 235 Ga. 509 (1975), in which the Court found in both cases that the evidence presented was also insufficient to rebut the presumption of a gift.

Practice Tip

In the case of *Mathis v. Mathis*, 281 Ga. 865 (2007), the husband brought a house into the marriage, among other assets. That house was sold and another home was bought. On appeal, the husband argued that the trial court should have awarded him a greater interest in the marital home because he had used premarital assets to pay for it. While this argument could have been persuasive, the Supreme Court was unable to conclude that the trial court's equitable division of marital property was improper due to the fact that there were no findings of fact contained in the final judgment and decree. Since the issue being appealed was dependent on the factual determinations made by the trial court, and those determinations were not reflected in the decree, nor were they required to be, the Supreme Court could only affirm the ruling. This case, along with several other appellate cases, underscores the importance of the lawyer

requesting that the trial court make findings of fact in its order. This request must be made prior to the entry of the written judgment. O.C.G.A. § 9-11-52(a)

Most recently, in *Windham v. Araya*, 286 Ga. 501 (2010), the trial court was not asked by either party to make any findings of fact. While the order entered by the trial court contained some findings of fact, it did not contain all of the findings of fact to clarify the rationale used by the trial court to reach its result. Since the issues on appeal (blended assets) depended upon the factual determinations made by the trial court and neither party had asked the trial court to make findings of fact prior to the entry of the written judgment, then the Georgia Supreme Court was unable to conclude that the court's ruling on equitable division was improper as a matter of law or fact. So, be sure to request written findings of fact from the trial court prior to the entry of the written judgment!!

Other Tips on Equitable Division Issues

Title to property which is not specifically described and disposed of in a divorce decree will remain unaffected by the divorce. Such property will remain titled in the name of the owner(s) the same as it was prior to the divorce and this is true even if both parties have an interest in the property. *Messaadi v. Messaadi*, 282 Ga. 126 (2007).

Do not forget about alimony claims. While periodic alimony is the most commonly known and used form of alimony, lump sum and in kind alimony can be a fantastic tool to use to get to the other party's non-marital assets or to avoid the impact of seemingly inequitable results from the transformation of what was formerly non-marital property into marital property by simply conveying title to both names. Beware of adultery barring an alimony claim!

A court cannot refuse to allow the testimony of a licensed real estate agent concerning the market value of real estate based on the fact that the agent is not qualified as an expert in the field of real estate appraisal. See *Wilson v. Wilson*, 277 Ga. 801 (2004). A lack of expertise as an appraiser merely goes to the weight of the testimony and not to its admissibility. In fact, a person need not even be a licensed real estate broker, appraiser, or salesman to qualify as an expert sufficiently qualified to give an opinion on the value of property. *Longino v. City of Atlanta*, 127 Ga. App. 299, 300 (1972).

Newman v. Patton, 2010 WL 1005114 (March 22, 2010), held that wife's stock options that vested prior to the marriage but were exercised during the marriage were her separate property but that options which vested during the marriage were marital assets if the options vested because of efforts during the marriage.

III. Analysis, Argument, and Application of Law to Seminar Fact Pattern

The Dental Practice

This asset is arguably a blended asset, that is to say having aspects that are both marital in nature and non-marital in nature. Thus the source of the funds rule set forth in *Thomas* will likely be applied. The Husband will argue that the "below market value" portion of the dental practice at the time he acquired it was a gift from his father and thus, that portion of the practice is non-marital and not subject to equitable division.

Where the husband started the family business after the marriage, but used his own separate funds to do so, only the appreciation in the value of the business attributable either to his and Wife's individual efforts or to their joint efforts was subject to an

equitable division. See *Wright v. Wright*, 277 Ga. 133, 134 (1) (2003).

It is well established tax law that the internal revenue service may re-characterize how a taxpayer treats a specific transaction.

- * hobby loss rules vs. a business
- * independent contractor vs. employee status
- * treatment of shareholder loans as debt (with deductible interest) vs. equity
- * creation of a partnership as a viable business vs. a tax avoidance scheme

The burden is on the Husband to prove that the “below market value” portion of the dental practice was a gift and the value of gift. To properly meet this burden, the Husband will need to have testimony and evidence presented as to the market value of the practice at the time he purchased it from his father. The difference between that value and the actual purchase price would be the gift value. For instance, if the evidence presented by the Husband reflects that the market value was \$800,000 at the time he purchased it but that the actual purchase price he paid to his father was \$600,000, then he would argue that \$200,000 or 25% of the practice value was a gift to him not subject to equitable division in this divorce. Husband will also want to produce any other evidence he can find to show his father’s intention to make a gift. Obviously, the requirements of O.C.G.A. § 44-5-80 must also be proven by the Husband. He will need to show that his father intended the \$200,000 to be a gift, that the Husband accepted the gift, and that the gift was delivered. Delivery can be shown by transfer of the stock to Husband by his father.

intent

To rebut this evidence and Husband's argument, Wife would want to determine if any gift tax returns were filed by Husband's father that demonstrate the value of the "gift"? Do any other documents establish that this was truly a gift rather than additional compensation from the Father and his practice to the Husband for the Husband's labors at the practice prior to the sale of the practice? Did Husband's father have any valuations done at the time of transfer to establish the amount of the gift? If no documents exist to indicate that a gift was contemplated at that time between Husband and his father, then Wife would argue that the purchase price paid for the practice was actually what everyone believed was fair market value and if it were a gift, then tax returns would need to be amended.

Section 2501 of the Internal Revenue Code imposes a tax on the transfer of property by gift. The gift tax is separate from the income tax. The donor is responsible for paying the gift tax. An annual gift tax exclusion (currently \$13,000 per donee per year) is available. Additionally domestic taxpayers are allowed a lifetime \$1,000,000 unified credit against transfers that are subject to either the estate or gift tax. However, if this shelter is used for lifetime gifts, it reduces the amount that can be transferred at death by large estate owners.

Was the stock of the practice actually transferred in writing to Husband by his father? What do the minutes show? Does the stock transfer ledger show the value or any portion as being a gift? Wife will need to make sure she has done thorough discovery on this issue. Fortunately for Wife, professional corporations frequently will not go to the trouble of formally issuing stock or keeping corporate records. Therefore, if Husband fails to produce the best evidence of delivery of the "gift" from his father by

way of the transfer of a stock certificate dated at the time of the acquisition, then Wife could argue that Husband has failed to meet his third tier of the gift test and that there was no delivery of the gift. Assuming the Husband does produce documents reflecting that his father intended to make a gift of a portion of the practice to him, then Wife may want to counter the valuations presented by Husband with her own valuations in hopes of reducing the gift percentage. However, this will be very difficult to do with the parties using the same business valuator in this case. Since the parties have decided to use one valuator, they will at least need the business valuator to determine the value of the practice when acquired through historic financial records and historic “biz comp” data as well as the present value of the practice. This will help isolate the value of the “gift” portion of the practice.

The Wife will need to determine the purchase price for the practice and how the purchase price was paid for as well as the source of the funds to purchase the practice. Assuming that the purchase price was paid out of marital funds with monthly payments of principal and interest, the question arises as to whether the Court should include both principal **and** interest paid for the practice and offset that against the fair market value of the practice or only use the principal paid to offset against the fair market value.

Once the parties have presented their respective evidence on what portion of the practice constitutes a gift versus marital property, the next step is to determine the appreciation, if any, of the practice. Obviously, the parties would have their joint business valuator establish the current value of the practice. Since they have stipulated to use his value, each of them have eliminated a lot of argument that could be used at

trial. For instance, the Wife will want to present the value of the practice to be as high as possible. Assume the stipulated value of the practice by the joint business valuator was \$1.3 million. The Wife would likely argue that the true value is \$1.5 million as consistently set forth for years on Husband's financial statements to the bank which were sworn to under penalty of perjury by him. However, the Wife's argument on this is greatly weakened due to the fact that she stipulated to be bound to the \$1.3 million value.

The Husband will claim that any appreciation in the "gift" portion of the practice in ratio with the total appreciation in value of the practice is his non-marital property. For instance, using a gift portion of \$200,000 or 25% of the \$800,000 (market value as of date of acquisition), and assuming the stipulated market value as of divorce is \$1.3 million, then Husband would argue that the appreciation in the practice of \$500,000 is \$125,000 his non-marital property (25% of \$500,000). Therefore, Husband would contend that his total non-marital share of the practice is \$325,000 (\$200,000 gift plus \$125,000 appreciation) and that \$975,000 is marital subject to equitable division.

In applying the factors of equitable division, the following arguments could be made:

(A) Husband should argue that it is not equitable to give Wife any portion of the practice value since this is the means by which he earns an income and it allows him to pay his child support and alimony obligations to her. To equitably divide the practice and to give Wife alimony would be double dipping. Conversely, Wife should argue that this is not double dipping but is an asset to be equitably divided like the other assets of the marriage. The dental practice, at some point, will be sold for value and, at that time,

Husband will have the value paid to him of this marital, or at least partially marital, asset. To not include it into the overall division would be inequitable. Similarly to a piece of real estate, the asset may not be sold now but when it is, a sum will be recognized from its value. Besides, Wife assisted Husband in building up and maintaining the practice by being supportive, caring for the children and home to the detriment of her own career, and helped his practice grow through her contacts and involvement with the church. She even worked for some amount of time at the practice. So, this is not double dipping. Also, the Wife can argue that her support of Husband while he finished his dental school education and obtained his license should be a factor the court uses in making an equitable division of this asset. (Wife's attorney correctly recognized that Husband's dental education and license are not marital property but, instead, represent simply his possibility of enhanced earnings.) *Lowery v. Lowery*, 262 Ga. 20 (1992).

(B) Husband would argue that he should certainly get the vast majority of the practice value due to the fact that he was the one who worked there and it was his father's reputation and his reputation that made it grow.

On the other hand, Wife would argue that it was her efforts that increased the value of the practice. She worked tirelessly in the church and has created an impeccable reputation for herself, her Husband, and their children. That she even worked in the practice when needed. That without her efforts and without Husband's reputation being built up in the community under her guidance, any goodwill of Husband's father would have been lost the moment he retired and sold the practice to them.

(C) Once the present market value of the practice is determined, the reason for the increase must be established. Some of the factors include the following:

Are nine employees normal for this type and size of practice?

Do the practice's credit card statements reveal personal expenses that the Husband has run thru the practice? If so, these will need to be added back in to the gross profit of the practice.

How many days a week and what hours does he work? Is this normal for this type of practice?

Is the increase due to the goodwill that was built by Husband's father during the pre-marital years?

Are the majority of Husband's patients from the church that they have given so much time and energy to during the marriage?

Has the community involvement of the family during the marriage contributed to the increase in value?

Has the value increased due to capital expenditures during the marriage?

Has Husband manipulated the practice's finances in order to increase the value of the practice while depriving the marital estate of assets or income that would have ordinarily been allocated to it?

Even if the Court determines that the "below market value" portion of the dental practice was a gift from the Husband's father, the Wife can still argue that this separate asset of the Husband can be used to demonstrate the Husband's ability to pay alimony, including lump sum alimony, when the Court determines the appropriate amount of alimony for the Wife.

Whatever amount is determined to be non-marital of the Husband and marital subject to equitable division, the parties will simply take these allocations and add them to the values of the other marital assets and then argue the factors of equitable division to support his or her proposed division. Obviously, it makes sense for the Husband to actually retain the entire stock of the practice in the division. It is the value of the stock that Wife will need to either offset with other marital assets she is awarded in the final analysis or to get a cash payout for the value of the stock. Wife will want immediate payment of any cash property division due to her. This is especially true given the questionable impact that Husband's new lifestyle may or may not have on his practice. In addition, the value of the cash now to Wife is certainly greater than the value of that same amount five to ten years later. Plus, cash now is one less item the Wife has to worry about collecting from her soon to be ex in the future. However, Husband most likely doesn't have the cash available to pay Wife now. That means he would have to get a loan and, given the lending environment today, his ability to get a loan may be slim. If Husband can pay Wife cash now, he may can negotiate a lower amount to pay to her in consideration for immediate cash in hand to her. If Wife ends up receiving all, or any part of her cash property settlement in the future, she will want to insure the following:

- (A) she obtains appropriate collateral to secure the payment such as A lien on real estate, guarantee from the practice and/or LLC which owns the building where the practice is located, security interest on the equipment, accounts, fixtures, furnishings, and inventory of the practice, and assignment of life insurance insuring Husband's life.
- (B) be clear on the exact date the payment is due. Will Husband's

death trigger full payment? Will sale of his stock?

(C) will interest be paid on the principal amount due to Wife? If she is agreeing to finance the payment just as a lender would, she should get interest on the amount. Clearly establish the interest amount and when it will be paid.

(D) can the practice secure a line of credit to pay all or a portion of the amount due to Wife now?

(E) what effect will a non-compete clause in a sale of the practice have on Wife's ability to collect the money due?

(F) consult with a tax expert to weigh the tax consequences and advantages of one option over another.

Tax Ramifications of the Purchase of the Dental Practice:

The IRS will likely say that the transaction was part sale and part gift despite the lack of a gift tax return. It is well established tax law that the IRS may reclassify how items are categorized. If the Father sold the practice at below market value, the IRS could reclassify this as part sale/part gift.

What if the Husband claims a gift in the divorce case and the Court rules against him, and then the IRS and/or the Georgia Department of Revenue discover and assess gift tax subsequent to the divorce case? If a gift tax was not declared and a return filed at the time of the alleged gift, it is unlikely the courts will allow the taxpayer the ability to claim a prior gift was made. (See *Burnett v. Burnett* no. COA95-1086, NC Court of Appeals, June 1996.)

The use of one Business Valuator:

Not recommended unless divorce is a collaborative divorce.

Other information needed and factors to consider:

(See Appendix A for a list of documents to request for a business valuation).

Obtain corporate tax returns for past five (5) years.

Obtain corporate tax returns for five (5) years including and prior to the gift.

Obtain financial statements (income statements, balance sheets, and statement of cash flows) for the same periods of time.

Obtain company bank account statements and credit card statements.

Consider interviewing/deposing company accountant and bookkeeper.

Perform Financial Ratio and common statement analysis.

Compare financial ratios with industry ratios.

Are the practice's financials audited?

Investigate cash flow and where company income is going.

Daubert and Business Valuation

The parties will want the business valuator to use one of the three IRS approved methods of business valuation in order to satisfy O.C.G.A. § 24-9-67.1 and *Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. 579 (1993). These three methods are 1) the income approach, 2) the asset approach and 3) the market approach.

The Daubert factors include: (1) whether a method consists of a testable hypothesis; (2) **whether the method has been subject to peer review**; (3) the

known or potential rate of error; (4) the existence and maintenance of standards controlling the technique's operation; (5) **whether the method is generally accepted**; (6) the relationship of the technique to methods which have been established to be reliable; (7) the qualifications of the expert witness testifying based on the methodology; and (8) the non-judicial uses to which the method has been put.

Yibulayin v. Yellow Freight Sys., 2005 U.S. Dist. LEXIS 23836 (E.D. Penn 2005); see also *Oddi v. Ford Motor Co.*, 234 F.3d 136, 145 (3rd Cir. 2000) (Same).

Concerns About Reliability of Financial Data

The *Daubert* standard also impacts on the business valuator's use of potentially unreliable financial data as the foundation of the valuator's opinion given that the Husband has potentially engaged in expensing personal expenses through the business. The valuator may need the assistance of a forensic accountant in order to secure more reliable financial data. The Wife will likely want to secure an "accountant's copy" of the practice's Quickbooks accounting software as early as possible in order to prevent the Husband from changing the data.

Goodwill Value

There are two types of goodwill: enterprise goodwill and professional goodwill. Assuming that the Husband's Father has given or sold a portion of the practice to his son, the Husband can argue that a portion of the practice's enterprise goodwill is his separate estate. However, the Husband's professional goodwill is likely a marital asset unless the Husband was not paid a reasonable salary during the marriage.

Importantly, the Husband's professional goodwill may have been harmed in the community and the fundamentalist church where he is a member due to his current lifestyle. The Husband's professional goodwill may also have been reduced since his involvement in the church has declined.

The Multiattribute Utility Model ("MUM") analyzes the differences between enterprise and personal goodwill and has been accepted in the Appellate Courts of Illinois and a Georgia case in Valdosta. (See Appendices B and C) This model considers all criteria affecting value of goodwill: location, patients, equipment, cost of employees, value of business based on reputation of Husband (and even the Father if he still has any participation in the practice).

Husband's Prior Financial Statements

The husband's prior financial statements place a value of the dental practice at 1.5 million dollars. This can be very helpful to the Wife if the dental practices gross revenues and net profit have either stayed the same or increased since the financial statement was generated. However, if the Husband's financial statements year after year contain the same value while gross profit and net profit fluctuates year after year, the Husband can argue that he really wasn't trying to be accurate in giving the value or really wasn't knowledgeable on the value. Or has the Husband defrauded his creditors? Financial statements can be like gold in a case like this. In past cases, subpoenaing the other party's lenders and creditors has turned up helpful personal financial statements.

Dental Office Building

The fact pattern is silent as to when this building was acquired and the source of

the funds used to acquire the building. However, the analysis on this asset would be similar to that of the dental practice.

First, the current value needs to be determined through a commercial appraisal. If the building was bought at the time that the practice was bought, was it purchased at a below market price thus injecting more *Thomas* issues into the case?

Was a loan taken out to finance the purchase of the building? What was the source of the funds to pay down/off the loan? Most likely it was rent paid by the PC to the LLC. Has the building appreciate-d in value? Has the appreciation been solely due to market forces or have either of the spouses contributed time, effort or marital funds to increase in the value of the building?

From the Wife's perspective, and assuming that the building has no debt and is a marital asset; this may be a good place for the Wife to get a portion of her property settlement. Is the dental practice the sole tenant? Is the building in good repair? The Wife may want to consider taking this as part of the property settlement and executing a triple net lease with the practice. This will generate a stream of income for the Wife reducing or potentially eliminating alimony. The Wife's counsel will likely need to associate real estate/transactional counsel to review the LLC operating agreement, lease and other associated documents. The Wife may want language in the lease that prohibits the practice from subleasing the property without her prior written consent. Of course, Wife would have the option at any time to sell the building and would get all net proceeds from that sale. The Wife will have to be willing to evict the husband's practice though if he fails to pay rent. The lease between Wife and husband's practice may or may not be done outside the divorce action. The Wife may simply have the Husband

transfer all of his membership rights in the LLC to her so that the same LLC continues to own the building and receive the rent. Be aware that operating agreements of an LLC oftentimes prevent a member's interest in an LLC from being transferred or may require the written consent of the other members for any transfer. This is particularly true when the LLC is not a single member entity.

Dental Licence

The dental licence is not marital property and thus, not itself subject to equitable division. *Lowery v. Lowery*, 262 Ga. 20 (1992) (Husband's medical school education and license is not considered "marital property," subject to equitable division). In *Lowery*, the Court reasons that the value of a professional degree or license is too speculative to calculate and that their real value is simply the possibility of enhanced earnings they provide. The professional education and license do not have any value that can be exchanged or transferred on an open market. Instead, such rights are personal to the holder and terminate at his or her death. Further, a professional degree or license cannot be assigned, sold, transferred or pledged. However, the wife's contributions to the marriage during the time the husband earned his degree and license, including her contributions to the husband to help him attain the degree and license, may be considered relative to alimony and the division of other marital property. *Lowery*, 262 Ga. at 20 (Citing O.C.G.A. § 19-6-5 (5)(6)(7) and *Stokes v. Stokes*, 246 Ga. 765, 772 (1980)).

The Marital Residence

There is no evidence in the fact pattern that the marital residence is a

separate estate or a blended asset. “The party claiming a right, including property division, has the burden of proof to establish that right.” *Southerland v. Southerland*, 278 Ga. 188, 189 (1) (2004). (Husband failed to bear his burden of proving the properties involved were marital property and not the non-marital property of the wife). In light of this, it appears that the house is marital property subject to equitable division. It has a fair market value of \$750,000, debt of \$500,000 and therefore equity of \$250,000.

Does the Wife want to keep the house for the stability of the children? If so, can she afford the payments and the upkeep? If the Wife wants to keep the house, the Husband should require the Wife to use the cash portion of her property settlement to be applied directly to the mortgage balance with the Wife refinancing any remaining balance solely into her name. The Husband wants to have the mortgage paid down and refinanced so that he can get out from under the mortgage, free up his credit to buy another residence, and reduce the monthly mortgage amount thereby reducing Wife’s need for monthly alimony. Can the Wife qualify to refinance the note on the marital residence?

If the Wife cannot afford to keep the house will the Husband pay the mortgage in lieu of child support or as part of alimony?

401(k) Account

There is no evidence in the fact pattern that the 401(k) account is a separate estate or a blended asset. “The party claiming a right, including property division, has the burden of proof to establish that right.” *Southerland v. Southerland*, 278 Ga. 188,

189 (1) (2004). (Husband failed to bear his burden of proving the properties involved were marital property and not the non-marital property of the wife). In light of this it appears that the 401(k) account is marital property subject to equitable division. However, any transfer of funds from this account to the wife needs to be done pursuant to a Qualified Domestic Relations Order.

This could be an asset from which the Wife requests more than a 50% share of as an offset for supporting her husband through dental school. Since his dental education and license are not marital assets but merely tools that allow Husband to earn enough income to create and contribute to the 401(k) account both during the marriage and in the future, then giving Wife more than half of the present value in this asset will help compensate her for her role in giving Husband this opportunity. Husband will continue to have high income in the future. Further, he will have a much greater ability to accumulate retirement assets in the future than Wife given her sacrifices during the marriage for his career and his enhanced earning capabilities.

Assets should be analyzed with keeping in mind the following:

Tax consequences upon subsequent disposition and liquidity. With respect to future tax consequences, the following assets are preferable in decreasing order:

- 1 . Cash (all taxes have already been paid)
- 2 . Personal residence (no taxes are due on the first \$250,000 of capital gain upon disposition)
- 3 . Investment accounts held outside of a retirement account and other real estate (only the amount of appreciation over the adjusted basis is subject to tax and possible capital gain rates apply)

- 4 . Privately held businesses (distributions are most likely subject to ordinary income tax but some return of capital or even capital gain treatment is possible)
- 5 . Retirement accounts (distributions are subject to ordinary income tax and possible penalties)

The second consideration should be liquidity---how easily can the asset be converted to cash?

- 1 . Cash is the most liquid asset
- 2 . Investment accounts
- 3 . Retirement accounts
- 4 . Privately held businesses (that consistently generate profits)
- 5 . Personal residence and other real estate

Savings Account

There is no evidence in the fact pattern that the \$25,000 savings account is separate estate or a blended asset. “The party claiming a right, including property division, has the burden of proof to establish that right.” *Southerland v. Southerland*, 278 Ga. 188, 189 (1) (2004) (Husband failed to bear his burden of proving the properties involved were marital property and not the non-marital property of the wife). In light of this, it appears that the savings account is marital property subject to equitable division.

Securing the Judgment or Settlement

1. **Life Insurance:** the traditional way of protecting spousal and child support payments. However, if the Husband is uninsurable, what other options are there?
2. **Structuring the payout of the W's share of the business**
4. **How to increase the Wife's ability to refinance the mortgage.**
5. Think about keeping the Husband on the mortgage with obligations put in decree requiring prompt payment by the Wife and upon default or a late payment, the house would go to the Husband.
6. **Wife's ability to borrow against the 401(k).**
7. **Potential future tax problems.** How will parties share in this? How should this be structured? Husband's liability for creative accounting in the practice; is the Wife truly an innocent spouse? Use of a hold harmless and indemnification clause. What if the IRS or Georgia Department of Revenue come back and call this a gift?
8. **What options are there for protecting the children's financial security?**
9. **Use of a promissory note** from the Husband to the Wife guaranteed by the practice and/or secured by the building with guarantee from the LLC.
10. **Collateral to secure any future property settlement payments due to Wife.** Examples are a guarantee and deed to secure debt on the building from the LLC; pledge agreement of the stock in the practice from Husband to Wife; assignment of Husband's portion of his 401(k); life insurance on Husband; security agreement from Husband and his practice of his accounts receivable, equipment, furnishings and fixtures secured by UCC filings.

Additional Facts

Assume that the Father only sold 60% of the practice at a reduced price (it is still part sale and part gift). The practice set up a share redemption agreement funded with life insurance. The Father then dies, triggering the life insurance which was paid to the practice, and the practice then redeemed the Father's 40% stock interest from his estate. The Husband's interest in the practice has now gone from 60% to 100%. Is this additional 40% interest marital or separate property? Is the answer dependent upon how the court rules with respect to the part sale/part gift question above? See Marty Varon's article in Winter 2009 edition of The Family Law Review citing *Halpern v. Halpern* 256 Ga 639 and the 2008 Kentucky case of *Allison v. Allison*.

Other Considerations

What if the business has loans from shareholders? Is this additional capital contributed and thus, part of the equity or is it a loan; thus, reducing the value of the entity? If one side claims it is a loan, is there interest expense being incurred by the entity and paid to the shareholder? Is there an offsetting asset (receivable) being reported by the shareholder on his personal assets?

What if the entity is pre-marital but there are subsequent loans from shareholders made to the entity and the loans are clearly from marital assets?

What if the entity is clearly a marital asset, but there are loans from shareholders made to the entity in order to support the working capital requirements of the entity? What if the loans are made from the other spouse's separate property?

APPENDIX "A"

Not recommended unless divorce is a collaborative divorce.

Other information needed and factors to Documents Requested For Valuation Engagement

- * five year corporate (entity) tax returns
- * aged accounts receivable listing (current and most recent year end)
- * fixed asset register or depreciation schedule
- * detailed list of notes payable by date of origination, maturity date, interest rate
- * if loans from shareholders, who, when, why, any interest being paid by entity to owner
- * copies of business plans (if any)
- * marketing brochures, catalogs, or product information
- * list of stockholders or partners, when they became owners, percentage owned, how they became owners
- * list of five largest customers and suppliers and total amount of sales and purchases (respectively) for each during last year
- * copies of major leases, loans, (including notes receivables and notes payable)
- * minutes of Board of Directors meetings
- * employment contract for owners (if applicable)
- * detail of stock options (if applicable)
- * list of duties performed by owners and any family members
- * copies of W-2s for last two years
- * financial statements (those used for internal purposes and those submitted to lenders)
- * profit and loss statements
- * bank statements
- * ledgers (including general ledger for last three years)
- * any prior valuations
- * any buy-sell agreements
- * documentation of any prior sales or buy-outs
- * life insurance policies on officers and directors
- * sales or profit projections
- * company website
- * **Separate meetings with owner at the site of the business and the outside CPA at his/her office to review my extensive questionnaire after I had an opportunity to review the financial statements, tax returns, and run common statement ratio analysis**
- * Additional documents depending upon information reviewed in tax returns, financial statements, and other documents listed above

- * Perform Financial Ratio AND COMMON STATEMENT analysis

MULTI-ATTRIBUTE UTILITY MODEL

Personal Goodwill Attributes	Importance Utility	Existence Utility	Multiplicative Utility	Percent
Ability, Skill and Judgment	5	4	20	11%
Work Habits	5	4	20	11%
Age and Health	3	3	9	5%
Personal Staff	3	3	9	5%
Personal Reputation	5	4	20	11%
Personalized Name	3	3	9	5%
Marketing and Branding	3	2	6	3%
In-bound Personal Referrals	5	4	20	11%
Closeness of Contact	3	4	12	6%
Important Personal Nature	3	4	12	6%
Total Personal Utilities	38	35		
Total Multiplicative (PGA) Utility			137	73%
Enterprise Goodwill Attributes	Importance Utility	Existence Utility	Multiplicative Utility	Percent
Enterprise Staff	3	3	9	5%
Business Reputation	5	2	10	5%
Business Name	3	1	3	2%
Marketing and Branding	3	0	0	0%
Business Location	1	3	3	2%
Multiple Locations	0	0	0	0%
Multiple Providers	0	0	0	0%
Systems and Organization	5	3	15	8%
In-bound Referrals	5	0	0	0%
Repeating Revenue Stream	5	2	10	5%
Total Enterprise Utilities	30	14		
Total Multiplicative (EGA) Utility			50	27%
Total Multiplicative Utility (TMU)			187	100%

This analysis is included through special permission from Mr. Will Geer, CPA/CVA. Mr. Geer successfully presented Mr. Woods' MUMs model in a case in Valdosta, Georgia.

MUM's the Word And Excel

MUM Can Help You in Court In re: Alexander



NOTICE

Decision filed 09/07/06. The text of this decision may be changed or corrected prior to the filing of a Petition for Rehearing or the disposition of the same.

NO. 5-05-0109

IN THE
APPELLATE COURT OF ILLINOIS
FIFTH DISTRICT

In re MARRIAGE OF
JAMES O. ALEXANDER,

Plaintiff-Appellant,

and

VALERY M. ALEXANDER,

Respondent-Appellee.

) Appeal from the
) Circuit Court of
) **Saline County.**

)
) No. 01-D-207

) Honorable
) Brocton Lockwood,
) Judge, presiding.

This analysis is included through special permission from David Wood CPA/AB/CVA, Wood Forensic/Valuation Services, Mount Vernon, Illinois. Mr. Wood first developed and then presented analysis in the Illinois case cited.

APPENDIX "B"

Goodwill Attributes: Assessing Utility

The purpose of this article is to assist valuers using the multi-attribute utility model (MUM) to allocate enterprise and personal goodwill by assessing the utility of each attribute identified. Whether you use MUM or another allocation approach, the article will help you understand how the attributes of a business¹ affect your efforts to allocate goodwill between enterprise and personal.

Details on how MUM works can be found in the sidebar, "MUM's the Word" (page 28). Note that MUM has been accepted in the Appellate Court of Illinois (5th District), in a case where its validity and acceptance were challenged.²

This article will focus on MUM's steps three and four: defining the attributes and as-

sessing their utility. MUM divides attributes into those that tend to indicate either enterprise or personal goodwill, and then uses the relative weights to challenge, confirm, and communicate the valuator's opinion.

A common method of allocating enterprise and personal goodwill involves a generic "point-scoring" system. All too often a report using such a system contains a general discussion of various personal and enterprise attributes, often focusing on just a few; then a conclusion is presented without much in the way of analysis or explanation. On the witness stand, it sounds like this. "That is my opinion based on my experience as a CPA and business valuator."

Some valuers prefer to duck the allocation of enterprise and personal goodwill and assign all personal or all enterprise, believing that they can defend the "zero proposition" easier than concluding that the goodwill actually consists of both. While a zero conclusion for either enterprise or

personal goodwill occurs in many cases, it seems that in most cases goodwill includes both enterprise and personal elements.

Whether the valuator uses MUM or a point-scoring method, or even the "duck" method, the report should contain a complete discussion of the attributes of enterprise and personal goodwill and how the valuator arrived at the opinion.

Enterprise and Personal Goodwill Defined

Goodwill, a concept based in old English law dating from the early 1800s, is "that intangible asset arising as a result of name, reputation, customer loyalty, location, products, and similar factors...."³

In the early 1900's in the United States, Justice Cardozo captured the essence that goodwill was the tendency for customers to return to the same location or company because of its name.

I define the two elements of goodwill, personal and enterprise, as follows:

Personal goodwill is the value of earnings or cash flow directly attributable to the individual's characteristics or attributes. Personal goodwill, sometimes referred to as professional goodwill, is a function of the earnings from repeat business that will patronize the individual as opposed to the business, new consumers who will seek out the individual, and new referrals that will be made to the individual.

Enterprise goodwill is the value of earnings or cash flow directly attributable to the enterprise's characteristics or attributes. Enterprise goodwill, sometimes referred to as practice goodwill, is a function of the earnings from repeat business that will patronize the business as opposed to the individual, new consumers who will seek out the business, and new referrals that will be made to the business.

Goodwill Attributes

The word attribute describes a characteristic or a tendency toward a result. Used as a noun, attribute is a quality, property, or characteristic. Used as a transitive verb, attribute ascribes a feature taking on the qualities of causation. In the valuation assignment of determining enterprise goodwill and personal goodwill, the valuator uses the word attribute in both ways – by examining the qualities of the various attributes and by determining their causation on the allocation between the two. Thus, attributes

are properties we need to define, and they are causations we need to understand.

Most valuers approach the problem of allocation by dividing the attributes into enterprise and personal. MUM takes this approach one step further. Each attribute is placed into one of three categories: personal, business, and industry. I believe that classifying the attributes in this manner helps the valuator establish the importance and existence of the attributes, as well as the causation of the attributes to both types of goodwill—enterprise and personal.

Personal Attributes

Personal attributes are those that specifically and directly relate to the goodwill subject, i.e., the person for whom the goodwill allocation is being performed, e.g., physician, architect, accountant, etc. Personal attributes reflect the efforts by the goodwill subject, or they are inherent in the individual, such as age and health.

The Importance Utility. How does one determine if a particular attribute is important in the valuation process? This is assessing the importance utility for the valuator using MUM. A fundamental question is, "What is the impact on earnings of the specific attribute?" The greater the impact, the greater the importance of the attribute.

For personal attributes, I first examine whether the attribute is important to the personal success of the goodwill subject in the business. Generally, if the personal attributes contribute significantly to the goodwill subject's earnings, then I would consider the attribute at least moderately important. However, not all abilities, skills, and work habits are

necessary to one's success. Consider the following example.

Cosmetic surgeons must have terrific skills in order to perform face-lifts. However, recently a new treatment—Botox injections given three or four times a year—has created an enormous revenue-producing capacity for the cosmetic surgeon's practice. Regardless of what the surgeon may tell you, the Botox treatment does not require the same high-skill set as a face lift. Thus, it is important for the valuator to examine the personal attributes with a view to the earnings, particularly recurring earnings.

Second, I look to the requirements or expectations of the industry to determine the importance of the attribute. In your own valuation business, think how essential credentials and training have become. Generally, if the industry requires the attribute, the valuator should consider the attribute at least moderately important. If the attribute significantly contributes to the personal success of the goodwill subject and the industry requires such skills sets, it would likely require a most important weight.

The Existence Utility. After you determine the importance of the attribute, then you must find a way to assess the presence of each attribute. To a large extent, this effort depends on your intuition and research into the business and the industry. Sometimes the importance of the attribute is obvious, sometimes not.

Throughout the attribute assessment, you must ask this question: "Does the presence of this attribute add to the earnings of the business?" The greater the impact on earnings, the greater the presence of the attribute.

1. Goodwill allocations often have significant impact on marital valuations involving professional and service businesses.

However, the courts in most jurisdictions do not limit such determinations of personal goodwill to professional practices and service businesses. In this article, I refer to the target of the valuation as the business instead of the more limiting term practice.

2. *In re Marriage of Alexander*, Appellate Court of Illinois (5th District) No. 5-05-019, September, 2006. www.state.il.us/court/Opinions/AppellateCourt/2006/

3. International Glossary of Business Valuation Terms (AICPA).

Ability, Skills, and Judgment Attribute. This attribute focuses on the "doing" by the goodwill subject, the ability to perform at a level to generate sufficient earnings to establish goodwill. The goodwill subject's education, training, and demonstrated ability will almost always be an important attribute, although, as the above Botox example demonstrates, the valuator should not put this down as most important without giving it some consideration. Does the ability of the goodwill subject directly affect the value of the goodwill?

Does the industry require certain skills as a prerequisite to entry; advanced skills to progress; master skills to excel? In our industry, generally the CPA with some training will gain access to the valuation business, but it requires much training and experience to qualify for various credentials and progress to more an advanced level; and a great deal more training and experience to excel and gain wide recognition.

Specialization of skills is an issue separate and apart from ability—after all, a general practitioner may have extraordinary skills, though not highly specialized skills. Specialized skills are generally correlated with personal goodwill, but it is not clear that a specialized skill is a direct cause of personal goodwill. Specialized skills are probably more of a factor in assessing the ability, skills, and judgment attributes, as well as others, as opposed to being a separate attribute.

If the goodwill subject's ability drives earnings, and the industry regards these skills as necessary, then the attribute would likely be considered at least moderately important, and probably most important.

The most direct way to determine the presence of the attribute is to examine the education and training, degrees, special designations, and certifications of the goodwill subject. However, not all abilities

come from education, training, and experience. The successful funeral director often has more people skills than mortician skills.

What skills drive the earnings? Very often the skill will be something that sets the successful person apart from the pack. Don't forget to determine if those same skills are lacking. The valuator must know what drives earnings down as well as up.

Work Habits. Work habits can encompass many things and should be interpreted broadly. Think of work habits as personal efficiency and dedication to the work ethic. Long hours usually outweigh efficiency. My personal physician is known as the "six million dollar man" because of the tremendous fees brought to his hospital. However, he would hardly be described as efficient, with papers piled on every flat surface of his office.

A workaholic has certain habits that most of us can recognize. Some know how to stop and smell the roses, others only know how to work. A physician I know works extraordinarily hard, never says no to a new patient, works long hours at the office and hospital, and is on call. His office is running at maximum performance: He uses lab technicians, nurses, and even an ultrasound technician. The office is well organized and his waiting room is full, as is his well-organized appointment calendar. This is an example of a physician with strong work habits that result in more revenues.

Age and Health. MUM permits only increases in the amount of personal goodwill from personal attributes. In other words, there is no negative rating for importance or existence. Perhaps this is most apparent for the age and health attribute. Age and health are significant because they help determine the longevity of the goodwill subject's impact on earnings. Underlying all value is the time frame for

cash flow or earnings. Older and less healthy could mean a shorter and more uncertain stream of future earnings, and thus a lesser personal goodwill allocation.

Young and healthy should contribute to personal goodwill. However, given two healthy goodwill subjects, one age 35 and one age 50, there would likely be little or no difference in the personal goodwill impact for this attribute. In this case, younger would not necessarily increase the overall value of the personal goodwill. Discounting earnings would likely be unaffected if the goodwill subject's life expectancy is long, because other factors keep the time frame shorter. Most discount periods would be 10 years or less. Because of this, age and health would likely be moderately important, or even less important.

Business Attributes

Business attributes are the result of decisions made by management that affect the organization, operations, finances, and the business's image. The decisions may be made by the goodwill subject or by other management who may be supervised by the goodwill subject. Who makes the decisions does not affect the goodwill allocation. The goodwill subject making decisions that improve enterprise attributes does not increase personal goodwill—it increases enterprise goodwill!

To determine the importance utility I ask the fundamental question, "Do the business attributes successfully contribute to the earnings of the enterprise?" Specifically, does the attribute actually contribute to the earnings of the business, such that without the attribute, the earnings would be less? It is a good idea to return to this fundamental question throughout your assessment of the importance of an attribute.

As with personal attributes, the industry's expectations or requirements influence the importance of a

business attribute. Take a pharmacy as an example. It should have a drive-up window. Nearly all pharmacies have gone to this marketing strategy in this age of fast food and ultra-convenience. If the business needs and the expectations of the industry are high, the business attribute would likely be most important.

Determining the presence of business attributes, like personal attributes, is a matter of intuition, research, and observation, and can vary significantly from valuation to valuation. In this case, a good location and well designed layout of the parking lot and drive-up would give a high presence to this enterprise attribute.

Enterprise: Location. The multiple locations attribute and the business location attribute, although separate and distinct, can be discussed together. Multiple locations should not necessarily lead one to assume a strong indication of enterprise goodwill. You must assess how the locations are being used. If a goodwill subject uses two offices as a way to expand his market reach, but only one office is providing service at a time, i.e., when the physician is present, then the multiple offices would have less impact. However, if a physician were using one office for his practice, but had satellite offices that provided limited service through physician's assistants, then enterprise goodwill would arguably increase.

The business location is important if location is important in the industry and it is a primary factor in customers' decision to return. Many medical offices and pharmacies are located near hospitals and clinics. A specialty formalwear dress shop or retail shoe store need locations with good visibility. A property management company most often would need an office convenient for its employees, but not necessarily a high-profile location. Look at the industry to determine how important

the location is, and whether a good location means increased earnings.

It is not too difficult to determine the existence of multiple locations, although a visit to each will often reveal how the business uses the locations to increase earnings. Determining and showing that a location is a good one is more difficult. I have used the Department of Transportation to get drive-by statistics. Aerial photography, generally available in the county assessor's office, can give the top-down view to show location. Another great source is Google Map and Google Earth, which can show satellite images with street overlays. I have used this to pinpoint outdoor advertising sign locations.

Enterprise: Systems and Organization. The systems and organization attribute refers to all of the decisions made by management that help the business perform. Without such systems in place, the business functions in chaos and inefficiency. An efficient, well defined and well maintained set of systems make up a strong organization. This attribute is a good indicator of enterprise value, even if the goodwill subject is the one who created the systems. The issue is not who created it, but whether the systems drive the earnings.

Even in a highly personalized business, a set of systems that make the business profitable, efficient, and transferable can generate enterprise goodwill. For most businesses, effective systems and organization is sought after, and nearly all industries have an expectation of such systems. Thus, it would be likely that the systems and organization attribute would be weighted at least moderately important.

Determining the presence of systems requires broad thinking. Systems would include computer systems, templates and forms, customer lists and databases, collections systems, internal audit controls, financial reporting systems—literally

every system in place. You cannot evaluate each and every system, but must be sufficiently familiar with the business's systems to assess them in their totality.

Sometime asset efficiency can give clues to systems. Are collections better than most as a result of a well designed billing system? Are inventory levels maintained at low levels, but still sufficient to avoid back orders? Are there forms used by employees to avoid errors or time spent recreating solutions for tasks? Are reminder cards sent to customers regarding future appointments, such as pet owners for their pets' annual vaccinations? Is there a Web presence—and does the website content help to increase revenues, or is it just "tombstone" information?

I get a call from my dentist's appointment system reminding me of my semiannual checkup five days before the appointment. Such systems are invaluable for keeping professionals busy and profitable.

Enterprise and Personal: Reputation. Business reputation is the customer's perception about all aspects of the product or service, including price, customer support, quality, and satisfaction. If the reputation is based on the goodwill subject, then the characteristic is personal. However, it is common for a customer to associate a business with an individual, when, in fact, it is the business reputation that they are counting on.

The business reputation is based on many more things than just the reputation of one person, such as the reputation of other professionals and staff, the quality of the product or service, convenience, and price. Even when there is a strong case for personal reputation, it often operates in conjunction with the business reputation. For example, a patient often has a strong connection to both the dentist (personal) and the dental hygienist (business).

Personal reputation is the customer's perception about the goodwill subject's ability, skills, and judgment. Whether the goodwill subject has these qualities may be entirely different from whether he is perceived by customers to have these qualities. It is difficult to measure the perceptions of others, but it can be done.

Consider the ophthalmologic surgeon. The surgery aspect of the service may strongly suggest that personal reputation is at play. But a surgery patient may also become a regular patient for annual eye examinations, performed by other members of the practice. One could reasonably make the case that the patient came to the practice for the surgery, but stays with the practice for other reasons, including the reputation of the business.

Determining a business's reputation can be tricky. Management's opinion is probably biased. Consider checking with others in the community, even the competition, if appropriate. If the competition says the business has a good reputation, your research may be nearly complete.

Does the company maintain a complaint file (some businesses are required to do so)? How are complaints dealt with? Have there been lawsuits alleging poor service or a defective product? Has the business won any awards? Quality service and sales are often recognized by vendors, industry organizations, and communities, and may be hanging on the wall right in front of you during your field visit.

Assessing the personal reputation attribute is similar to assessing the abilities, skills, and judgment attribute, except that the focus is more on the recognition of the abilities. Indicators of significant personal reputation include, awards recognizing one's abilities, a high position with a highly rated medical institute, holding a teaching position in addition to one's tax practice, and bylined articles published. People

often look at these accomplishments when selecting a professional.

As with each of the attributes, you must attempt to connect the business and personal attributes to the earnings. If the business or personal reputation is strongly connected to earnings, then these attributes would likely be at least moderately important.

Enterprise and Personal: Staffing. Staffing describes all the employees of the business other than the goodwill subject. Usually employees in place would be associated with enterprise goodwill. However, it is possible that staffing can indicate personal goodwill, such as when personal reputation is the reason the employee sought the position. This might occur with a professional who has a national reputation for excellent training. Essentially, the question is whether the staff would have sought the position if the goodwill subject had not been involved in the business.

Consider the importance of the staff to the earnings, and their contribution to keeping business returning. Is the business labor-intensive? Is there close contact between the staff and the customer? Is the contact of a personal or confidential nature? Is there a high level of training required? Does the work require special physical strengths? These are many of the same characteristics used to assess personal goodwill of the goodwill subject.

Clerical, secretarial, and office administrators are generally less important, primarily because they normally could be replaced more easily and may have less contact with customers, although certainly there are exceptions.

There are no hard and fast rules in making this determination. Generally, I believe that enterprise staff is likely to be more important than personal staff. They are separate attributes and require separate analysis.

One last thought about staffing: Multiple service providers, such as

multiple accounting partners, are sometimes listed as a separate attribute. Since staffing includes all employees other than the goodwill subject, it seems that evaluating the impact of multiple service providers can easily be accomplished within the context of the staff attribute. If the multiple service provider's attribute is listed in addition to the staffing attribute, take care not to double-count the impact.

Enterprise and Personal: Name. There is probably no more misunderstood attribute than the personalized name attribute. Judges and attorneys often leap to the conclusion that if someone's name is on the business, then all the goodwill must be personal. This is false. If it were true, those businesses with personal names would sell for much less. I know of no evidence to support such a claim.

Many businesses with the founders' names are sold and simply carry on with the personal names. Others buyers acquire the name and change it. The question you must address is, "Would the customers abandon the business solely because it changed its name?" Not very likely. Methinks Shakespeare was right—it is "still a rose."

Barring unusual circumstances, I would normally consider the naming attributes to be of moderate importance or less. As for their presence, there are certainly different levels of the attribute for the personal and business name. A very personalized name, such as Dr. I. C. Yue, Inc., might have an above average or strong presence for the personal name attribute and a weak presence for the business name attribute; while the Yue Eye Institute might be a moderate or below average presence for the personal name and a moderate or above average presence for enterprise goodwill.

Enterprise and Personal: Marketing and Branding. Marketing and branding tend to be

thought of as indicators of enterprise more than personal goodwill. However, when the marketing focus is the goodwill subject rather than the business, the marketing drives the personal goodwill higher. In St. Louis, there is an ophthalmologic surgeon who has a large and very successful clinic. I am sure that there is a large amount of goodwill and that there is a significant element of enterprise goodwill associated with it. However, the marketing of the clinic is extremely personal; print media advertisements with endorsements of local celebrities, business persons, and sports figures all standing next to Dr. P. In this case, the marketing focuses on the doctor, and therefore it adds to the personal goodwill.

Consider whether the marketing and branding contribute to the success of the business. Is marketing being done by the competition? Is it customary for businesses in the goodwill subject's industry to have active marketing campaigns? Even when it is not customary, is the business doing an exceptional job of marketing the business?

Determining that a business has a marketing plan is much easier than determining how effective the plan is at increasing earnings. The marketing plan will differ by industry, so you should perform industry research and determine what type of marketing is typical, and then assess how well the business is meeting this task.

Industry Attributes

Industry attributes are defined by the industry, as opposed to some action taken by the goodwill subject or decisions made by the business. For example, the first attribute, closeness of contact, is generally a function of the industry. Dentists have close contact, radiologists do not. Sometimes the goodwill subject's style is more personal, with an emphasis on contact; I consider this to be a work habit, however.

In determining the importance utility of industry attributes, I consider the requirements, expectations, and nature of the industry. As with personal and business attributes, you should understand the connection between the industry attribute and the returning business.

Consider the repeating revenue stream attribute. It is the nature of accounting firms to have repeat business. This attribute in an accounting firm might be considered most important, while in an architectural firm, whose business is less likely to be repeated, would likely give repeating revenue stream a lesser weight.

Personal: Closeness of Contact. Politicians have known from the very first elections that "pressing the flesh" helps to get votes. For much the same reason, the more contact and the more direct the contact, the more likely the subject will enjoy personal goodwill from the beneficiary of that contact.

The importance of closeness of contact is a function of the industry. In the case of the radiologist, where the

work often involves no more than examining x-ray film or other images, the closeness of the contact may be of little importance. A general practitioner often has numerous or annual appointments with each patient, which would be considered normal and important in their relationship. Some cases are more intuitive than others, but you should try to determine what the customary practice is for the business. If closeness of contact is important and customary in the industry, then it is likely that it would be at least moderately important.

Personal: Important Personal Nature Attributes. Not all kinds of contact are equal when it comes to building goodwill. However, the closeness of the contact should not be confused with the importance or nature of the contact. Two eye doctors spending roughly the same amount of time with a patient could easily have different levels of goodwill resulting from the contact. The eye doctor who places a sharp instrument into the center of your eye during surgery has a different connection than the eye doctor who puts a puff of air on your eye during your annual exam.

Generally, significant close contact in combination with important personal service would tend to create more personal goodwill than either of the two attributes separately.

Enterprise or Personal: Referrals. "Inbound referrals" to a goodwill subject often indicate a high level of respect for his or her abilities. Referrals are usually personal in nature, made to a particular individual, increasing personal goodwill. However, referrals can certainly be made to a business, supporting a greater enterprise allocation.

Referrals are a direct source of business, and therefore directly impact the earnings of the business. Often the industry will show you the importance of this attribute. Keep in mind that referrals can come from customers or from others, such as general practitioners recommending a specialist. Referrals from general practitioners probably represents a stronger impact on earnings than referrals from customers when non-customer referrals are a strong source of earnings.

"Outbound referrals," such as a general practitioner dentist to an oral surgeon, may indicate a collateral relationship; it would not seem to have great value to most buyers, since outbound referrals do not likely mean increased earnings. The problem with using a collateral relationship is the absence of causation.

Enterprise: Repeating Revenue Stream. Repeat business is at the heart of goodwill. Business can return because of enterprise or personal attributes. However, some businesses are inherently more likely to have repeat business by the very nature of their industry. Thus, this attribute is not concerned with the reason for the repeating business—for example, a great location or a consummate professional. The attribute deals with the specific nature of the revenue stream. Dentists, veterinarians, tax accountants, eye doctors, OB/GYNs,

internists, and many non-surgical medical specialists all have one thing in common: The customer keeps coming back on a regular or nearly regular basis.

This is a powerful element of enterprise goodwill. If the repeating income stream is likely to continue with a new owner, then a significant portion of the goodwill is enterprise-related. If the nature of the industry includes a repeating income stream, then it is likely that such an attribute would be at least moderately important.

If the business is taking full advantage of the repeating income stream, then the existence would be strong. One veterinarian sends out postcards reminding pet owners that their pet needs an annual vaccination, and then follows up by having a staff person make reminder phone calls to set up appointments for any pet not vaccinated within 60 days. This is an excellent system in an industry that enables the professional to take advantage of the repeating income stream. Another veterinarian chooses not to send out the reminders, or does not have the staff or systems in place. Which has a greater percentage of enterprise goodwill? The industrious veterinarian with the efficient reminder system, of course.

Enterprise: Intellectual Property. Copyrights, patents, trademarks, processes, and other intellectual property are intangible rights conferred on the business by law or contract. You may place values on the specific intangible rights separate and apart from the value of goodwill. However, it is not unusual for a valuator to include in the value of goodwill the unspecified value of the intangible rights. This is especially true when (a) the value of those rights is small in relation to the value of the business and the value of the goodwill, or (b) the realities of time, budget, and methodology limit the valuator. Whatever the approach, you must synthesize the weighting of this attribute with the determination of a separate value.

Transferability of Goodwill

This is a difficult subject. In the past, I have treated ease or difficulty of transferability as an attribute of enterprise or personal goodwill. However, it does not seem to add much to the analysis, since personal goodwill is difficult to transfer and enterprise goodwill is relatively easy to transfer. In the final version of MUM, I decided to exclude it as an attribute. Of course, you are welcome to use it if you find it useful.

If you decide to use transferability as an attribute, it is the ease or difficulty you are assessing, not the ultimate ability to be transferred. For an asset to have value to a willing buyer, the asset must be transferable.

Thus, for enterprise goodwill to have value, it must be transferable. But wait a minute—is that not also true for personal goodwill? Of course it is. So personal goodwill, at least the portion of it that would have value to a buyer, must also be transferable.

Take the case of two physicians, a general practitioner and a highly specialized one. A valuator could easily conclude that the GP has the greater enterprise goodwill percentage. If the practices and financial statements are generally similar, would it be fair to conclude that each would have a similar total fair market value, but with the GP getting a larger percentage share of goodwill allocated to the enterprise?

At first blush the answer might seem logical. But consider the transferability of goodwill. It is nearly certain that the GP's practice will have a greater overall value than the specialist's. Due to the MUM allocations of goodwill and the issue of transferability, the GP's practice will have more enterprise goodwill as a percentage, but also a greater overall value. Thus a MUM allocation of goodwill must be a part of a valuation that starts with a solid value of the enterprise. In short, you cannot allocate goodwill if it does not exist or is not transferable. ■

MUM

MUM's the Word

How the Multi-attribute Utility Model Works

By David N. Wood, CPA/ABV, CVA

The multi-attribute utility model (MUM) has been used extensively in fields such as economics, politics, and science for making decisions based on subjective and imprecise information. As used in valuations, MUM is an allocation model for distinguishing enterprise goodwill from personal goodwill. It assists valutors in marital dissolution cases in jurisdictions that require separation of goodwill into the two components, enterprise and personal. MUM was first described in 2004 in the *American Journal of Family Law*.¹ The model has been accepted in the only appellate court to review

the method, in a case where its validity and acceptance under Frye were directly challenged.²

Many subjective judgments and decisions are made in every valuation. The valuator uses methodologies that bring more objectivity and consistency to these judgments and decisions, and provide results that are better understood and more meaningful to those who depend on the valuations. MUM is one such methodology. It is sophisticated enough to be useful in various scientific disciplines, yet relatively simple to use.

MUM provides a seven-step guide that can offer a reasonable support against evidentiary challenges. The steps are as follows:

1. Define an Objective

Determine the value of the two elements of goodwill, personal and enterprise, from the total goodwill, such that a reasonable, well founded basis can be communicated as the support for the opinion of value.

2. Establish the Alternatives

The alternatives define the possible outcomes in which MUM will result. The alternatives are selected as a range of percentages of personal goodwill. The outcome for each range is a specific personal goodwill percentage within the range. Enterprise goodwill is the reciprocal percentage. Table 1 shows five alternatives and the resulting percentage values.

Table 1: Establish the Alternatives

Five Alternative Ranges			
	From	To	Outcome
1	0%	20%	10%
2	20%	40%	30%
3	40%	60%	50%
4	60%	80%	70%
5	80%	100%	90%

3. Define the Attributes

Divide the attributes into the two categories, personal attributes and enterprise attributes. (See the main article, "Goodwill Attributes: Assessing Utility," page 20.)

4. Determine the Attribute's Importance and Existence Utilities

The importance utility is an assessment of how important the attribute is in making an allocation between enterprise and personal goodwill. MUM presumes that an attribute selected has some merit and, thus, has a weight greater than zero. An example of importance utility weights are shown in Table 2.

Table 2: Determine the Attribute's Importance Utility

MUM Importance Utility Weights	
	Weight
Least Important	1
Moderately Important	3
Most Important	5

To determining the existence utility, you assess the presence of the specific attribute. An important attribute would not have as much impact on goodwill if the attribute exists only in small quantities. Each attribute is assessed to determine its existence, and then is weighted accordingly. An example of existence utility weights are shown in Table 3.

Table 3: Determine the Attribute's Importance Utility

MUM Existence Utility Weights	
	Weight
Weak Presence	0
Below Average	1
Moderate Presence	2
Above Average	3
Strong Presence	4

1. "An Allocation Model for Distinguishing Enterprise Goodwill from Personal Goodwill," by David Wood, American Journal of Family Law, Fall, 2004. The author will be happy to forward a PDF copy of this article upon request (david@woodvaluation.com).
 2. In re Marriage of Alexander, Appellate Court of Illinois (5th District) No. 5-05-019, September, 2006. www.state.il.us/court/Opinions/AppellateCourt/2006/.

APPENDIX "D"

772 So.2d 52, 25 Fla. L. Weekly D2403
(Cite as: 772 So.2d 52)

H

District Court of Appeal of Florida,
Fifth District.
Joseph B. ANSON, Appellant/Cross-Appellee,
v.
Susan Marie ANSON, Appellee/Cross-Appellant.
No. 5D99-204.

Oct. 6, 2000.

Dissolution of marriage proceeding was brought. The Circuit Court, Seminole County, Seymour Benson, J., found that investment accounts and capital stock were marital assets. Husband appealed and wife cross-appealed. The District Court of Appeal held that: (1) capital stock did not constitute marital asset, and (2) although District Court of Appeal did not approve or endorse use of analysis of retained earnings bookkeeping account of corporation in order to determine whether dividends to fund two investment accounts were marital property, Court would not disturb use of such analysis.

Affirmed in part; reversed in part; remanded.

Peterson, J., concurred and filed opinion.

Griffin, J., concurred in result and filed opinion.

Harris, J., concurred in part, dissented in part, and filed opinion.

West Headnotes

III Divorce 134 ↪ 252.3(3)

134 Divorce

134V Alimony, Allowances, and Disposition of Property

134k248 Disposition of Property
134k252.3 Particular Property or Interests and Mode of Allocation

134k252.3(3) k. Separate Property and Property Acquired Before Marriage. Most Cited Cases
Capital stock did not constitute marital asset, where 57.5% of corporation's capital stock was issued to

husband prior to marriage, corporation redeemed during marriage 37.5% of capital stock held by co-founder, and stock value declined during marriage due to dividends enjoyed by parties during marriage and loss of valued customer. West's F.S.A. § 61.075(5)(a)2.

[2] Divorce 134 ↪ 252.3(1)

134 Divorce

134V Alimony, Allowances, and Disposition of Property

134k248 Disposition of Property
134k252.3 Particular Property or Interests and Mode of Allocation

134k252.3(1) k. In General. Most Cited

Cases

The correct approach in determining whether any portion of a spouse's capital stock is marital is to determine the value at the time of marriage and again at the time of dissolution; if appreciation took place, an analysis of the reasons for appreciation must be undertaken to determine whether to classify all or a portion of the appreciation as marital. West's F.S.A. § 61.075(5)(a)2.

[3] Divorce 134 ↪ 252.3(3)

134 Divorce

134V Alimony, Allowances, and Disposition of Property

134k248 Disposition of Property
134k252.3 Particular Property or Interests and Mode of Allocation

134k252.3(3) k. Separate Property and Property Acquired Before Marriage. Most Cited Cases
Simply because a shareholder-spouse devotes work efforts to a corporation during marriage should not transform the entire appreciation of the stock held prior to marriage into a marital asset.

[4] Divorce 134 ↪ 252.3(1)

134 Divorce

134V Alimony, Allowances, and Disposition of Property

134k248 Disposition of Property

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134k252.3 Particular Property or Interests
and Mode of Allocation

134k252.3(1) k. In General. Most Cited

Cases

Although appellate court did not approve or endorse use of analysis of retained earnings bookkeeping account of corporation, of which divorcing husband was major shareholder, in order to determine whether dividends to fund two investment accounts were marital property, appellate court would not disturb use of such analysis, where both divorcing parties used such analysis and convinced trial court to use it in fashioning distribution.

*53 Robert W. Thielhelm, Jr., John W. Foster, Sr., and Eric S. Golden, of Baker & Hostetler, LLP, Orlando, for Appellant/Cross-Appellee, Joseph B. Anson.

Martin L. Haines, III, of Martin L. Haines, III, Chartered, of North Palm Beach, for Appellee/Cross-Appellant.

EN BANC

PER CURIAM.

Joseph B. Anson (husband), appeals his final judgment of dissolution of marriage and Susan M. Anson (wife) cross-appeals.

The parties were married in 1989 and had a six year old child when the petition for dissolution was filed in 1996. The husband had assets of considerable value when he entered the marriage and the wife had little. The primary focus on appeal is the trial court's treatment of the husband's pre-marital assets. Specifically, the husband contends that no portion of the capital stock owned by him that was issued by Anson-Stoner, Inc. (Anson-Stoner), should be regarded as a marital asset. Additionally he contends that two investment accounts known as the "Consults Accounts," largely funded with dividends from Anson-Stoner and established for the benefit of his sons from a prior marriage, should not be regarded as marital property.

The wife, who was awarded an interest in the Consults Accounts, requests clarification of the party entitled to appreciation in that account between the time of final judgment and the disposition of this appeal. Both parties raise additional issues which we affirm without discussion.

I. *Anson-Stoner Capital Stock*

[1] The husband and Michael Stoner formed Anson-Stoner, Inc. in 1970. The husband received 60% of the capital stock and Stoner received the remaining 40%. Both founders actively worked for the corporation. A third-person acquired 5% of the stock in 1992 after which Stoner owned 37.5% of the outstanding stock and the husband's interest was reduced to 57.5%. Stoner's stock was redeemed by the corporation with corporate funds on December 31, 1994, pursuant to a buy/sell agreement entered into in the early 1980's between the corporation and Stoner.

Influenced by the decision in Rutland v. Rutland, 652 So.2d 404 (Fla. 5th DCA 1995), the wife urged and the trial court found that although the redemption was funded by the corporation, the redemption was deemed a "purchase" by the husband during the marriage with marital funds and was a marital asset because the redemption increased the husband's proportionate*54 interest in the outstanding stock of Anson-Stoner.

A. *Rutland v. Rutland*

In *Rutland*, the husband and his brother were equal stockholders of a corporation that engaged in the retail sales of clothing. The business was a family business of long standing and the husband's stock had been acquired prior to the marriage. The corporation redeemed the brother's stock during the marriage and the husband became the sole shareholder. We learn the additional fact from today's dissent that the corporation obtained a loan in order to provide funds to redeem the brother's stock. *Rutland* reasoned that because the redemption took place during the existence of the marriage and because the brother's stock was redeemed with funds of a corporation that realizes profits from the husband's active management and work, the corporate entity should be ignored and the redemption treated as though the purchase was made directly by the husband. *Rutland* also reasoned that the redemption was no different from a transaction in which the husband would purchase a 50% interest in a competing corporation even if he paid for it out of his wholly owned corporation. The court ruled that the husband owned 50% of the stock as non-marital property and the remaining 50% as marital.

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(Cite as: 772 So.2d 52)

We recede from the decision in *Rutland* for the following reasons:

1. The opinion failed to recognize that the brother in *Rutland* owned a 50% interest in the corporation and relinquished it in exchange for funds flowing from the corporation to himself. The surviving shareholder, the husband, was not affected by the redemption unless a discount or a premium was paid to the brother. Assuming that book value was paid to the brother, the value of the husband's stock was the same before and after the redemption. Fifty percent ownership of a corporation is theoretically the same as 100% of that same corporation after the other 50% shareholder has had his interest redeemed. If the redemption had been accomplished by the liquidation of 50% of the corporate assets, the husband's remaining interest of 100% would have the same value as before the redemption. This result would not be changed by the corporation having obtained a loan to finance the redemption rather than liquidating corporate assets. In fact, the corporation would be better off since its operating assets would not have been impaired by a liquidation of one-half of them.

2. The example used in *Rutland* to wit: "We find no difference in this acquisition than had Mr. Rutland, during the marriage, purchased fifty per cent in a competing corporation even if he paid for it out of his wholly owned corporation," is confusing. If Mr. Rutland had used, replaced, or diminished in value, a non-marital asset to acquire another asset, the acquired asset would also be a non-marital asset.

3. A stockholder's interest in a corporation is limited to the legal rights flowing from the ownership of capital stock. Those rights do not include a pro-rata interest in corporate assets. The corporation, as a legally recognized entity, holds title to its assets.

4. The earnings of a corporation do not become a marital asset upon marriage. Assets acquired through corporate earnings are corporate assets until payments are made for services or as dividends.

5. If a shareholder-spouse devotes work efforts to a corporation during marriage, the corporation's income is not immediately converted into marital income. If the corporation retains assets acquired from earnings of a corporation rather than distri-

buting them as dividends to *55 shareholders, the value of the outstanding capital stock should appreciate in value. Section 61.075(5)(a)2, Florida Statutes, provides that the appreciation of a non-marital asset during marriage is to be classified as a marital asset if the appreciation resulted from marital efforts. In the absence of extra-ordinary circumstances, the statutory scheme for determining whether non-marital corporate stock is available for equitable distribution is based upon a comparison of values at the time of marriage and at the time of dissolution without enlisting the extreme measure of ignoring the corporate entity.

B. Valuation Approach

[2][3] The correct approach in determining whether any portion of the husband's stock issued by Anson-Stoner is marital is to determine the value at the time of marriage and again at the time of dissolution. This approach conforms to the statutory concept of appreciation of non-marital assets as described in section 61.075(5)(a)2, Florida Statutes. A comparison of the two values would reveal whether the stock appreciated. If appreciation took place, an analysis of the reasons for appreciation must be undertaken to determine whether to classify all or a portion of the appreciation as marital. Simply because a shareholder-spouse devotes work efforts to a corporation during marriage should not transform the entire appreciation of the stock into a marital asset. Analysis is required to determine whether appreciation occurred because of corporate attributes, such as, goodwill, underlying investments, customer supplier and employee bases, operating assets, and inventory. Allocation of the appreciation should be no more difficult in marital law than is the allocation of fault in a negligence action in tort law.

In the instant case, the record reveals that a remand for that analysis is unnecessary. The stock value declined during marriage with the decline partially attributable to dividends enjoyed by the parties during marriage and to the loss of a valued customer. Therefore, no portion of the Anson-Stoner stock should be regarded as a marital asset.

II. The Consults Account

[4] Both of the parties adopted the use of an analysis of the retained earnings bookkeeping account of An-

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son-Stoner in order to determine whether dividends to fund two investment accounts called the "Consults Accounts" were marital or non-marital. We do not approve or endorse such an approach; but, since both parties used it and convinced the trial court to use it in fashioning a distribution, we will not disturb it.

We also are inclined to affirm the conclusion that the account is a marital asset because both marital and non-marital funds were used to establish the account.

III. Conclusion

We reverse the finding of the trial court that any portion of the Anson-Stoner stock constitutes a marital asset as a result of the redemption of the stock of a third-party shareholder. Because that stock was an important element when the trial court fashioned the plan of equitable distribution, we must vacate the plan and remand for further consideration. A plan must be adopted that preserves the Anson-Stoner stock as a non-marital asset.

THOMPSON, C.J., COBB, SAWAYA and PLEUS, JJ., concur.

PETERSON, J., concurs and concurs specially with opinion.

GRIFFIN, J., concurring in result specially with opinion.

HARRIS, J., concurring in part, dissenting in part with opinion.*56 PETERSON, J., concurs and concurs specially with opinion.

I enthusiastically applaud the majority's decision to recede from *Rutland*. My comments are directed towards the issue of using retained earnings of a corporation to determine the marital or non-marital nature of distributions from the corporation, an approach that I consider incorrect.

Two of the assets that created much difficulty before the trial court and on appeal are the "Consults Accounts." These are two accounts held by a stockbroker and managed by an independent financial manager. The accounts were funded during the marriage by a dividend from Anson-Stoner of several hundred thousand dollars and grew in value to \$962,000 by the time of the dissolution. The accounts were established by the husband for his two sons of a prior marriage, but apparently he retained non-fiduciary control over the accounts.

The parties concluded that it was important to classify the dividends used to fund the Consults Accounts as either marital or non-marital income; that classification would also carry over to the balances in the Consults Accounts and determine the manner of distribution. In order to accomplish the classification of dividends, both of the parties engaged in an analysis of the retained earnings account of Anson-Stoner. The husband argued that the dividend that was used to establish the Consults Accounts was from income posted to the retained earnings account before marriage and the wife argued that the dividend was from income earned by the corporation during the marriage. Accountants were called as expert witnesses by each of the parties to classify the dividends. One employed the use of a first in, first out (FIFO) inventory method to classify the Anson-Stoner dividends while the other accountant determined a last in, first-out (LIFO) method was appropriate. The trial court ruled that an analysis of the retained earnings account using either LIFO or FIFO resulted in classifying the Consults Accounts as marital property. By employing the retained earnings account to determine the source of income, the parties and the trial court seemed comfortable in assuming that a stockholder of a corporation has a vested interest in a corporate general ledger bookkeeping account that has no value.

I agree that we should affirm the finding that the Consults Accounts was marital property, but only because the approach used to reach that conclusion was employed by both parties. However creative that approach may be, I cannot subscribe to it. A stockholder has no interest in any corporate bookkeeping account. The sole interest that a stockholder has in a corporation is represented by corporate stock. The certificate of stock entitles the shareholder to certain rights, none of which includes a direct interest in any corporate holdings or a corporate bookkeeping account. *See Fla. Stat., ch. 617 (1997)*.

I believe that the parties approach is incorrect for the following reasons.

1. The retained earnings account of a corporation is a bookkeeping account maintained to keep a historical record of net income, net losses, dividend distributions, and other matters affecting the equity of a corporation. It is not a cash or asset account, nor does it reflect any amounts of cash or funds available for distribution to stockholders. In fact, a cor-

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poration could have a balance in a retained earnings account, yet have no cash to pay any dividends.

2. A balance in a retained earnings account does not mean that dividends must be paid to stockholders. In order to conduct a business, a corporation must always maintain working capital, purchase fixed assets, maintain accounts receivable, and maintain inventory among other things, all of which, reduces cash available for dividends. The extent to which *57 these requirements must be maintained fluctuates from year to year.

3. A corporation is a recognized separate legal entity capable of owning its own assets and managing its own business. A stockholder has certain rights in a corporation, but those rights do not include a direct interest in any corporate asset or income nor do these rights include an interest in a corporate bookkeeping account.

4. Analyzing a corporate retained earnings account to determine marital earnings ignores the corporate entity. Neither a stockholder nor the stockholder's marital partner has any direct interest in the account and cannot require the corporation to make any distributions simply because an entry was made in the account during the term of the marriage.

5. The balance shown in a retained earnings account is not a direct indication of the value of a corporation. An analysis of the entire business structure of the corporation is required in order to determine the market value of its stock. This is most apparent when one considers the values of publicly traded corporations that have no income.

6. Losses are also posted to the retained earnings account. Under the theory adopted by the parties and the court, how does one treat a net loss?

7. How does one treat distributions of cash dividends to a married stockholder when the retained earnings account had a balance both before and after marriage? Neither of the expert witness accountants in the instant case were able to agree on how the distributions were to be classified. Not surprisingly, each one took the position favorable to their clients because no rules exist to guide them.

8. It was argued below that because Anson-Stoner was an "S" corporation under the U.S. Internal Revenue Code, stockholders had some vested right to corporate income for each accounting period. "S" corporation status does nothing more than regulate the manner in which corporate income is taxed and determines the basis of the stock in the hands of the shareholder for purposes of calculating capital gains or losses upon its disposition. Florida corporate law is not affected by the election of "S" corporation status under the Internal Revenue Code.

9. Analysis of a company's retained earnings account to determine whether stock held in that company by a husband or wife is a marital or non-marital asset is not consistent with the criteria for determining the same as set forth in section 61.075(5)(a)2.

The question presented by the instant appeal is: How may an asset, existing at the time of dissolution of marriage, be determined to be marital or non-marital where the asset was purchased from funds received in the form of dividends from a corporation (in which a shareholder-spouse had a pre-marital interest and continued to devote time and effort toward during the marriage)? I regret to say that I have struggled with the problem without arriving at a bright line rule. So far, I can only offer the suggestion that each situation must be examined on a case by case basis to include: appraisals of the corporate stock at the time of marriage and at the time of dissolution, review of corporate distributions, determining the use of corporate distributions during marriage, and determining the extent of the shareholder-spouse's involvement with corporate business and the contribution that involvement made to corporate business.

My approach in the instant case would have been to compare the value of the corporate stock at the time of marriage *58 and at the time of dissolution. I would then consider the amount of dividends paid and the amount of those distributions the shareholder-spouse has claimed and maintained as separate property.

Under this approach, I would first observe that the value of the stock was much greater at the time of marriage than at the time of dissolution. Part of the reason for the decline was the payment by the corporation of substantial cash dividends during the marriage in addition to the amounts devoted to establish-

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ing the Consults Accounts. Presumably, those dividends were enjoyed by both of the marital partners during happier times. Those dividends depleted the corporate cash and necessarily reduced the value of the corporate stock of this small service corporation. In analyzing the flow of cash through dividends and trying to ascertain the extent to which the segregated Consults Account was derived if at all through marital income, I would then add the total amount of corporate dividends used to establish the Consults Accounts to the value of the corporate stock at the time of dissolution and compare it with the value at the time of marriage. That comparison shows that the value of the stock at the inception of the marriage exceeds the total value at the time of dissolution plus the dividend used to establish the Consults Account. This decline in value in excess of the amount used to fund the Consults Account convinces me that the shareholder-spouse's separate property should not be charged with the loss and that the Consults Accounts should not be classified as marital property.

The non-shareholder spouse in the instant case was not willing to consider the stock's loss of value that occurred during marriage arguing that section 61.075(5)(a)2, is only directed toward consideration of appreciation of separate property during marriage, not reduction in value. While I might agree that the non-shareholder spouse should not have to compensate the shareholder spouse for loss of value during marriage with marital assets, I believe it is grossly unfair to allow the non-shareholder spouse to enjoy the corporate distributions during marriage that at least partially led to reduction in value of the corporate stock and then ignore that reduction in value when the Consults Accounts are to be distributed at the time of dissolution.

My last concern involves the concept that once a marital partner devotes *any* effort to an asset constituting separate property, the entire appreciation during marriage constitutes a marital asset. This concept is particularly disturbing in the context of the capital stock involved in the instant case. The concept freezes the value of the capital stock at the time of marriage and does not allow the non-marital value to appreciate at all.

Most successful corporations, the stock of which has been owned by one of the marital partners prior to marriage and which perhaps has been in business for

some years such as the retail clothing store in *Rutland*, realize profits from influences other than a marital partner that works for or even manages the corporation. Goodwill that was built during pre-marital years, customer supplier lists, operating and plant assets, employees, inventory, and working capital all contribute to the business success. Yet from the day of marriage, any appreciation of the stock in the hands of the shareholder-spouse is said to be a marital asset although any depreciation for whatever reason is of no concern. *Rutland*, 652 So.2d 404, 405.

I believe that consideration should be given to the allocation of appreciation so that both the marital and non-marital portion increases. Sure it is difficult to apply, but not impossible. If allocation of fault expressed in percentages can be determined in cases of comparative negligence in tort litigation, allocation of appreciation can also be expressed in percentages to distinguish the appreciation attributable to the efforts of a marital partner from the contributions attributable to other factors.

*59 GRIFFIN, J., concurring in result specially with opinion.

Both of my colleagues appear to be saying that where a spouse's non-marital interest in a closely held corporation appreciates during marriage, some or all of the appreciation may be marital property, depending on whether the appreciation was attributable to the labors of the separate-interest-owing spouse during the marriage, or other factors unrelated to the efforts of that spouse during marriage. This notion appears to be a fair way for the courts to deal with a problem we see fairly often. Where a closely held corporation is owned or controlled by one spouse as a non-marital asset, that spouse may manipulate the corporation's finances in order to enhance the value of the non-marital asset while depriving the marital estate of assets that ordinarily would be allocatable to it. That was the concern that motivated the decision in the *Rutland* case. I agree with Judge Peterson that these situations are best considered on a case-by-case basis, taking into account the factors he identified as well as others. It does seem to me, however, that since it is the spouse controlling the non-marital asset who controls the relevant evidence on this issue, and who is in the best position to adduce the relevant facts, that spouse ought to have the burden of showing the appreciation is non-marital. In this sense the result in *Rutland* was not wrong.

HARRIS, J., concurring in part, dissenting in part:
First, although the parties and the trial judge treated

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this dissolution as a *Rutland* case ^{FN1}, a mistake for which I take sole responsibility, it is not one. Because a critical fact, the fact that the purchase money for the buy-out in *Rutland* came not from corporate assets but from a new corporate bank loan to be repaid solely from future corporate earnings, was unfortunately left out of our *Rutland* opinion, I agree that an *en banc* decision is necessary to correct the wrong impression made by that holding. I do not agree, however, with the majority view that the redemption of a shareholder's interest by a sub-chapter S corporation is outside the equitable reach of a domestic court.

FN1. *Rutland v. Rutland*, 652 So.2d 404 (Fla. 5th DCA 1995). We held in *Rutland* that the kind of business organization involved was not the test when considering marital equities. We held that an asset purchased during marriage with funds earned by the husband from his labor or management is marital whether the business organization involved was a wholly-owned corporation or a sole proprietorship. Other courts have taken this same approach. See *Pannell v. Pannell*, 64 Ark.App. 262, 981 S.W.2d 531 (1998) (“[U]nlike the minority shareholder obligor ... Vick is the sole owner of his S corporation and, as such, has complete control over the retained corporate earnings.”). See also *Ab-salom v. Absalom*, 1991 WL 232291 (Ohio App. 9 Dist.1991), in which the court held that the retained earnings in the husband's sub-chapter S corporation could be considered as part of his disposable income because “he alone controlled the amount of his salary, bonuses, expenses, and the resulting retained earnings of his corporation.” In *Rutland*, the source of the payment for the additional half interest in the business acquired by the corporation but which inured to Rutland's benefit was a bank loan to the corporation (thereafter owned entirely by Rutland) which had to be repaid by the corporation from future income earned from Rutland's labor and management. The traditional concept of title is immaterial in considering the equities of marital distribution. Thus courts, in order to do marital justice, ignore the status of title in real estate, personal property, and bank accounts, a status which has historically conferred rights to the title holder. We believed a corporate shelter

to be no more sacrosanct than legal title when considering assets acquired from the labor or management of its sole or controlling shareholder. The court in *Speer v. Quinlan*, 96 Idaho 119, 525 P.2d 314 (1974), “[found] especially unsatisfactory the artificial distinction made between a separate property business organized in the form of a close corporation and an unincorporated sole proprietorship or partnership.” We believed in *Rutland* that a husband should not be able to “shelter” what would otherwise be marital income from the legitimate expectations of his wife that the rewards from his labors would go either to create a more comfortable lifestyle or future security for the two of them. This explains, if it doesn't justify, our holding in *Rutland*.

*60 To explain my view, I resort (with all due apologies to Aesop) to the following fable:

The Bear Brothers and the Fox Brothers

In the deep woods lived Ralph and Robert Bear who conducted a partnership dealing in produce obtained from a bee-hive located in a nearby hollow tree. The partnership agreement contained a buy-sell provision. Robert married Honey and subsequently decided to buy Ralph's interest in the partnership. He thereafter saved a portion of all of his bonuses and salary and placed it in a bank account solely in his name.^{FN2} From this account, Robert purchased Ralph's interest in the partnership. Sometime thereafter, Robert met Cutie and left Honey. Honey claimed half interest in that share of the partnership purchased with marital assets and Prince Owl, the beloved local magistrate, agreed.

FN2. Editor's Note. Under sections 61.046(7) and 61.075(5)(a) 1, Fla. Stat., this account, regardless of how it was titled, became a marital asset.

Also living in the woods, were Si and Sly Fox who dealt in chicken products obtained from Farmer Jack's hen house. But, being aware of Robert Bear's predicament, they conducted their business as a sub-chapter S corporation with a stockholder redemption agreement. Sly married Sucha and later, although the corporation had distributed all its earnings to the shareholders in the form of dividends or salary and thus had

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no assets with which to fund the redemption agreement, Si wanted out.

Si suggested that Sly personally borrow the necessary money and buy his stock directly. "No, no," responded Sly. "The stock might be held to be marital property."

"Then take money from your joint bank account and put it in the corporation and have the corporation redeem the stock," urged Si.

"That would be no better," replied Sly. "The money for the purchase could be traced to marital funds and the acquisition would be deemed marital."

"Then the redemption agreement is meaningless," lamented Si.

"Not so," said Sly. "I'll have the corporation borrow the money and then repay the loan with what would be my bonuses and salary and my wife will be unable to challenge my new acquisition."

And it came to pass that while keeping his wife and children in second-hand clothing for three years, Sly was able to repay the loan and now owned 100% of the business. He then met Greatta and left Sucha. Good Prince Owl, seeing the correlation between this and the Bear case, ruled that it didn't matter which business organization was used, the acquisition was made by what should have been marital assets and held Sucha entitled to half interest in the stock purchased by the loan to be repaid from the husband's future labor and management. But Good Prince Owl was overruled by the wicked Council of Princes ^{FN3} which held that a sub-chapter S corporation, although treated remarkably like a partnership or sole proprietorship for tax and management purposes, has a magical shield which protects it from a finding that its redemption of stock might be marital property.

FN3. Hey, it's my fable.

The moral of this fable is that when a young man goes for his blood test, he should stop by his lawyer's office and form a sub-chapter S corporation. It is more potent than a pre-marital agreement in that it cannot be challenged in court and it has the added benefit of stealth so that the prospective wife will not know what hit her until it is too late.

The second issue involves a corporate distribution made to the husband from cash retained by the corporation in an *61 amount sufficient to pay the taxes on the distribution and to put \$150,000 into each of two Consults accounts with Merrill Lynch in the name of his children and himself as joint tenants with the right of survivorship. These gifts were made some four years before the dissolution of marriage action was filed. The husband contends that these accounts remain non-marital because they were established from corporate distributions of premarital retained earnings. While the wife acknowledges that the children's accounts were established from a distribution of retained corporate earnings, she nevertheless urges that since a portion of the retained earnings accumulated during the marriage, it was a "commingled" account and hence the distribution should be considered marital. She also urges a "first in, first out" analysis of the retained earnings account.

I disagree with the wife's claims that because marital income derived from the husband's labor or management was merged with premarital retained earnings that the entire retained earnings "account" becomes marital. This was not an account into which the husband deposited both non-marital and marital funds and from which he paid both marital and non-marital obligations. The retained earnings account is a corporate account which reflects, among other things, funds available to meet corporate obligations and requirements. Any excess reflected by the retained earnings account is available for distribution to shareholders in relationship to their percentage of stock ownership. Even though the retained earnings account may increase during the marriage either from passive causes or because of the labor or management of the husband, the husband individually acquires no interest in that account even though, as controlling shareholder, he may cause distributions from corporate funds which will affect that account.

But clearly the corporation has benefited from the husband's labor or management and the wife is entitled to some consideration because of this. In giving this consideration, is it the appreciation of the husband's premarital stock or the income produced by the labor and management of the husband retained by the corporation which should be considered as a marital asset?

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There are various ways for a court to recognize the contributions of a spouse's labor and management to a corporation in a dissolution of marriage action. One approach, the one adopted by the majority from which I dissent, is for the court to ignore the retained earnings account altogether and to recognize the spouse's contributions of labor and management to the corporation by treating any increase in the value of the corporate stock *not caused by inflation or market conditions* from the date of marriage to the date of dissolution of marriage as a marital asset. As recognized by the majority, there are many factors other than a spouse's labor and management which might affect the value of the corporation as evidenced by this case.^{FN4} On the other hand, if we treat the corporate retained earnings accumulated after marriage as the marital asset, then we have more closely identified the corporate benefit from the husband's labor and management. And by removing the retained earnings from consideration in evaluating the stock in the marital distribution, we can avoid the problem of appreciation or depreciation of the stock unrelated to the marital relationship.^{FN5}

FN4. Further, this approach causes the wife to risk her portion of marital benefits earned by the husband to a down market. For example, suppose the stocks would have lost X value because of market decline but, because of the high retained earnings accumulated by the husband's labor and management, lost only X-Y. This differential is a benefit lost by the wife.

FN5. See *Martinez v. Martinez*, 761 So.2d 433 (Fla. 3d DCA 2000), which holds that retained earnings, at least so far as alimony and child support are concerned, is a valid source of distribution.

*62 This case is complicated by the fact that at the time of the marriage there was a large retained earnings account in the corporation. Distributions to the husband from this premarital source of funds should be non-marital regardless of when it is distributed. Therefore, when we consider the retained earnings account as reflecting a source for distribution, we should decide what portion represents a premarital asset. How should we do this?

This will require a case by case analysis of when (in

relation to the marriage) and to what extent the accumulation of the retained earnings account occurred. If a distribution comes from that portion of the retained earnings which preexisted the marriage, the distribution should be considered non-marital. If the distribution comes from that portion of the retained earnings which accumulated during the marriage, then it should be considered marital. But how do we determine the status of the retained earnings account from whence the distribution comes?

If we apply the case by case analysis to the facts of this case, the question remains as to whether the distribution in 1992 used to establish the children's accounts was a distribution of marital or premarital retained earnings. The wife argues, and the court below agreed, that the inventory accounting principle of "first in, first out" should be utilized in order to determine whether that portion of the retained earnings distributed in 1992 was premarital or marital. The wife's position is that although there were substantial retained earnings at the time of the marriage, over the years additions were made and withdrawals were taken. She convinced the court that under the "first in, first out" accounting concept it should be held that the premarital retained earnings were distributed first so that those remaining at the time of the 1992 distribution were marital. Even though "first in, first out" is a recognized method for determining the value of inventory at any given time, it has no relevance in determining how retained earnings are distributed. It is reasonable to assume in inventory evaluation, particularly for tax purposes, that a business would use its oldest inventory first in order to mitigate against obsolescence. There is no reason for such assumption in the withdrawal of retained earnings.

But there should be some assumptions (some guidelines) relating to withdrawals from corporate retained earnings when considering marital distribution. First, retained earnings subject to distribution at the time of marriage should be considered non-marital even if no distribution is taken at that time and the funds are left in the corporation for future corporate needs. This is because the controlling shareholder could distribute such funds to himself or herself prior to marriage and preserve them as non-marital. Any funds required for future corporate needs could be met by a corporate loan to be repaid from future earnings. Therefore, leaving the excess funds in the corporation as retained earnings should be considered a premarital "loan"

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from the controlling shareholder to the corporation. Second, it should be assumed that the corporation will meet its current obligations from current income. This means that the shareholder spouse's premarital "loan" to the corporation should be repaid from post-marriage earnings. With these assumptions, funds reflected by the retained earnings account which do not exceed those retained at the time of marriage less prior premarital distributions should be considered non-marital. This is consistent with an expectation that a shareholder would first use his marital assets to pay marital obligations before resorting to his non-marital assets.

Therefore, in order to determine whether the 1992 distribution was marital or non-marital, the court will have to determine whether the husband had taken prior distributions which were from his premarital asset and how that might have affected the retained earnings account at the time of the 1992 distribution. If any of the 1992 distribution exceeded the husband's remaining⁶³ premarital asset, then to that extent the children's accounts are marital assets. Further, upon dissolution of marriage, the court should consider any sums reflected in the retained earnings account *available for distribution* as though it was distributed. This is consistent with the earlier assumption that the controlling shareholder spouse could withdraw any excess funds from retained earnings upon marriage in order to protect his premarital asset. We should likewise assume that upon dissolution of marriage he or she can make the same kind of withdrawal. In this case, any such sums which exceed the remaining amount of the husband's premarital asset should be subject to marital distribution. It may be, because of corporate requirements, payment of such sums will have to be paid out of future earnings or from other sources.

Because the trial judge applied the "first in, first out" analysis, I agree this cause must be reversed.

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APPENDIX "E"

RENDERED: FEBRUARY 15, 2008; 2:00 P.M.
TO BE PUBLISHED

Commonwealth of Kentucky

Court of Appeals

NO. 2006-CA-001967-MR

&

NO. 2006-CA-002575-MR

JOHN FRED ALLISON

APPELLANT

APPEALS FROM FAYETTE CIRCUIT COURT, FAMILY BRANCH
v. HONORABLE TIMOTHY NEIL PHILPOT, JUDGE
ACTION NO. 04-CI-02664

VICKI LYNN ALLISON

APPELLEE

OPINION
AFFIRMING IN PART
AND
VACATING IN PART AND REMANDING

** ** * * *

BEFORE: THOMPSON, JUDGE; BUCKINGHAM AND HENRY, SENIOR JUDGES.¹
BUCKINGHAM, SENIOR JUDGE: John Fred Allison appeals from orders
and judgments of the Fayette Circuit Court, Family Branch,
relating to the resolution of issues in a dissolution of
marriage action that he filed against Vicki Lynn Allison. John
appeals from the court's rulings regarding the

¹ Senior Judges David C. Buckingham and Michael L. Henry sitting as special judges by assignment of the Chief Justice pursuant to Section 110(5)(b) of the Kentucky Constitution and Kentucky Revised Statute (KRS) 21.580.

marital/nonmarital nature of his family's business, the marital/nonmarital nature of a \$66,714 debt allegedly owed by Vicki to her mother, and the award of attorney and expert witness fees. We affirm in part and vacate in part and remand.

John and Vicki were married on September 5, 1986. They had one child, Courtney, who is now emancipated. John filed a dissolution of marriage action on June 29, 2004. The court held hearings and issued a decree and several orders. John's dissatisfaction with the court's rulings on the aforementioned three issues is the subject of this appeal.

In the early 1970's, John's mother and father acquired all stock in a business known as Action Business Suppliers, Inc. (ABS). John now owns all shares of stock in ABS, and he claims that the shares are his nonmarital property. He first states that in August 1984 (prior to his marriage to Vicki), he entered into an employment and stock option agreement with his parents that gave him the right to acquire an 8% interest in ABS. He acknowledges that this option was not exercised. Rather, he maintains that in April 1986 (four months prior to the marriage), he entered into a new agreement that continued the terms of his employment and gave him a 16% interest in the business in exchange for a promissory note from him for \$32,000. John never paid the note, and the court found that his father had forgiven the debt. John contends that he owns this portion of the outstanding ABS shares as his nonmarital property because the forgiveness of the debt constituted a gift to him.

Alternatively, he contends that this ownership interest is his nonmarital property because he acquired it before marriage.

As to the remaining shares of corporate stock, in December 1996, there was a stock redemption agreement between John's parents and the corporation whereby they sold their 84,800 shares of ABS stock to the corporation for \$1,152,125 to be paid to them over a ten-year period. The court found that this amount had been paid in full over a period of years by the corporation. John claims that these shares were also his parents' gift to him and that he never paid any money, from marital funds or otherwise, for the stock.

The court found that all shares of stock were acquired during the marriage and that John had not provided adequate proof to overcome the presumption that his entire interest, or even any interest, in ABS was marital. The court specifically rejected testimony that the 84,800 shares of stock were a gift to John from his parents. Rather, the court found that John's parents had been paid over \$1 million by the corporation for those shares.

The court noted that John had initially stated that he and his parents had agreed he would purchase their shares of stock and become full owner, but that he later recanted that statement and stated the shares were a gift. Further, John's father had stated that the shares were a gift to John and that he had made similar gifts to other children. However, the court noted that there was no proof of such similar gifts.

In determining that all shares of stock owned by John were marital property, the court found that "in the present case the ownership interest increased from either 0%, 8%, or 16% to 100%. The value of his interest increased this much as well. Regardless, the Husband failed to prove by documents or evidence what interest he acquired before marriage or by gift, and the Court[']s only real proof is that he paid for the stock after 1996."²

John first argued in his brief that he has at least a 16% nonmarital interest in ABS. He asserted that he acquired such interest by agreement with his parents in April 1986 (before the marriage) and that his father later forgave the payment of the \$32,000 promissory note that John had given in return. In fact, the court specifically found that the indebtedness had been forgiven. Thus, John claims that such interest was a gift to him and was therefore nonmarital and that the court erred in not so finding. In support of this argument, John cited KRS 403.190(2)(a) which expressly excludes property acquired by gift from the definition of "marital property" unless "there are significant activities of either spouse which contributed to the increase in value of said property and the income earned therefrom."

² The court later amended its findings to state that the corporation (not John) had purchased John's parents' shares of stock pursuant to the redemption agreement.

Alternatively, John stated that the 16% interest is nonmarital because it was acquired before marriage. He cited *Overstreet v. Overstreet*, 144 S.W.3d 834, 837 n. 7 (Ky.App. 2003), to support that argument. In his oral argument before the court, John's attorney modified John's position and stated that John only owned an 8% interest, not a 16% interest, in the corporation prior to the 1996 redemption agreement.³

The court stated in an order amending its original ruling that John's father "forgave the original \$32,000 which was due for a 16% interest in the business pursuant to an alleged agreement in 1986. This change however does not change the Court's finding that the business is marital property." The court did not explain its ruling in this regard and did not make more specific findings. While the court said that John's father forgave the debt, it did not make any finding that the 16% interest was a gift or even that John owned a 16% interest. In fact, as we have noted, the court stated that John had failed to prove "what interest he may have acquired before marriage or by gift."⁴ At any rate, John now claims that his interest in the

³ The corporation was authorized to issue 100,000 shares. The redemption agreement states that there were 92,000 shares outstanding, of which 84,800 were sold by John's parents back to the corporation. Of the remaining 15,200 shares, John apparently claims that he owned 7,200 (7.8%, not 8%, of all outstanding shares) of them at the time, although he had not been issued share certificates, and that the remaining 8,000 shares were never issued.

⁴ Although John claimed in his brief that he purchased a 16% interest in the corporation in 1986, he never received any shares of stock representing that interest. There was no ABS stock in John's name prior to the 1996 stock redemption agreement.

corporation prior to the redemption agreement was 8% rather than 16%.

The first issue, therefore, is whether John had no ownership interest in the corporation at the time his parents sold all their shares to the corporation or whether he had an 8% interest. We conclude that the facts indicate John must have had an ownership interest at the time of the redemption agreement. Otherwise, there would have been no interests owned by anyone once John's parents sold their shares back to the corporation. Further, we conclude that the evidence appears to support only an ownership interest of 8%.⁵

The next issue concerns when John acquired that interest and whether that interest was marital or nonmarital. The burden was on John to prove any nonmarital interest in the family business. See *Sexton v. Sexton*, 125 S.W.3d 258, 266 (Ky. 2004). See also *Smith v. Smith*, 235 S.W.3d 1, 16 (Ky.App. 2006). The trial court determined that John failed to meet that burden.

John claims he acquired that interest pursuant to the 1986 agreement. The court found that the payment of the indebtedness represented by the note had been forgiven. The court also stated that the note was for payment of a 16% interest in the corporation. If, in fact, John acquired his ownership interest in exchange for the note, and that

⁵ A 1993 corporate tax return shows John having an 8% ownership interest.

indebtedness was later forgiven, then it would appear that the forgiveness of the indebtedness would be a gift to John and would constitute a nonmarital interest in the corporation.⁶ See KRS 403.190(2)(a).

For this reason, we conclude that the court's ruling contains some inconsistency that we are unable to explain. Thus, we vacate the trial court's determination that John did not have a nonmarital interest in the corporation and remand the matter for the court to determine the extent of John's interest prior to the redemption agreement (which appears to us to be 8%) and whether such interest was marital or was proven by John to be nonmarital as a result of a gift or nonmarital as having been acquired before marriage.

Concerning the stock redemption agreement and whether the redeemed shares of stock constituted John's nonmarital property, that issue will be moot unless the court determines that John's interest prior to the redemption was nonmarital. If the court determines that John's interest at that time was marital, then any increase in ownership interest because of the redemption agreement was also necessarily marital.⁷

If the court determines upon remand that John's interest prior to the redemption was nonmarital, then it must

⁶ Alternatively, if the forgiveness of the note was a gift, it could have been a gift to both John and Vicki, rather than a gift to John only. See *Sexton*, 125 S.W.3d at 267-70.

⁷ The trial court determined that these redeemed shares were not a gift to John, and John did not appeal from that portion of the court's order.

determine whether any increase in value was marital or nonmarital. John and Vicki agree that this case is one of first impression in Kentucky. Both have cited cases from other jurisdictions that have addressed similar fact situations. While we will decide this issue under principles of Kentucky law, an overview of these cases is appropriate.

John relies primarily on *Hoffmann v. Hoffmann*, 676 S.W.2d 817 (Mo. 1984). In that case, the Missouri Supreme Court rejected a wife's claim that the husband's increase in his ownership interest in a closely-held corporation after marriage resulted in the increase being marital property. The husband's father owned a corporation, and the husband acquired a 16.17% interest prior to the marriage. After husband and wife were married, the corporation purchased and retired some of the shares owned by the father. The result of the stock redemption was that husband's ownership interest increased to 35.3%. Husband then gave some shares to his son and one share to a newly hired corporate officer. The result was that the husband owned a 29.5% interest.

First, the court rejected the wife's argument that the increase in ownership percentage was marital property. *Id.* at 823. Based on a Missouri statute, Mo. Rev. Stat. 452.330.2(2),⁸ the court stated that the increase was the husband's separate property because it was "property acquired during marriage in exchange for property acquired prior to marriage." *Id.* at 822.

⁸ This statute is identical to KRS 403.190(2)(b).

The court reasoned that "the 16 percent ownership interest acquired prior to the husband's marriage was merely exchanged for a larger ownership percentage of a corporation that was worth less." *Id.* The court analogized the situation to one involving a stock split. *Id.* Thus, the court rejected "the wife's contention that the increase of percentage of ownership of the corporation transformed a portion or all of the husband's stock to marital property." *Id.* at 823.

Second, the court rejected the wife's argument that the increase in ownership was marital property because marital funds were expended to redeem the father's stock. *Id.* Although the court recognized that a lien against the separate property could arise had marital funds been expended, it held there was no evidence that corporate funds that would otherwise have been used to pay the husband's salary or dividends were used to redeem the stock. *Id.*

The court also rejected the wife's argument that the increase in value of the husband's ownership interest was partially due to her efforts as a homemaker, traveling companion, and entertainer. *Id.* at 826. The court reasoned that "she made no substantial financial contributions to the business nor were her personal contributions sufficiently extensive to warrant additional compensation by sharing in the husband's separate property." *Id.*

As for the wife's arguments that the marital efforts of the husband led to the increase in value of the ownership

interest, the court stated that the husband had been compensated by the corporation with salary, bonuses, and dividends in which the wife shared and that "the unusual growth and prosperity of the company was directly attributable to the unforeseen but salutary (for the corporation) consequences of federal and state legislative enactments vis-a-vis sole efforts of the husband." *Id.* The court also stated that "it would require substantial speculation to conclude that the stock's value had appreciated in any amount due to the husband's forsaking marital property compensation for his services." *Id.*⁹

In citing cases from other jurisdictions on this issue, Vicki first cites *Smith v. Smith*, 475 S.E.2d 881 (W.Va. 1996). In that case, the husband owned a 28% interest in an independent insurance agency that was a closely-held family business prior to the marriage. Following the marriage, the corporation purchased the shares of one of the shareholders, resulting in the husband's ownership interest increasing from 28% to 44%. While the trial court determined that the increase in ownership interest was nonmarital property, the West Virginia Supreme Court reversed the trial court and held that any "active appreciation" in husband's interest would be marital property and that husband's full-time efforts as officer or director together with significant stock ownership created at least some

⁹ John also cites *Watkins v. Watkins*, 924 S.W.2d 542 (Mo.App. 1996), to support his argument. In that case the Missouri Court of Appeals followed the holding of the Missouri Supreme Court in *Hoffmann*. *Id.* at 546. We will not discuss herein the facts in that case.

degree of "active appreciation" and, therefore, marital property interest. *Id.* at 888.

Vicki also cites *McLeod v. McLeod*, 327 S.E.2d 910 (N.C.App. 1985), overruled on other grounds by *Johnson v. Johnson*, 346 S.E.2d 430, 440 n. 4 (N.C. 1986), in support of her argument. In *McLeod*, the husband inherited 30% of a closely-held corporation during the marriage. Thereafter, the corporation purchased all its outstanding shares, resulting in the husband becoming the sole shareholder. As for the 30% of stock inherited by the husband, the court held that the shares were his separate property. *Id.* at 914. However, the court further held that any increase in value of that interest due to "active appreciation" was marital property. *Id.* Also, the court held that the redemption of the remaining outstanding shares resulted in "active appreciation" of the husband's stock and "was a business decision from which plaintiff as president derived substantial economic advantage which, in terms of our statute and cases, is property acquired during the marriage." *Id.* at 915.

In Kentucky, all property acquired by either party during the marriage is presumed to be marital property. KRS 403.190(3). However, this presumption may be overcome by a showing that the property was acquired by one of the methods stated in KRS 403.190(2).

John argues that the shares of stock acquired in the 1996 stock redemption were excepted from the definition of

marital property because they were "[p]roperty acquired in exchange for property acquired by gift, bequest, devise, or descent." See KRS 403.190(2)(b). He reasons that his "16% ownership [which he now states is only 8%] was exchanged for a 100% interest. Therefore, [his] entire 100% interest in ABS is non-marital." He relies on the reasoning of the Missouri Supreme Court in the *Hoffmann* case.

John explains that "the Allisons were careful to leverage the redemption to insure that there would be no appreciable change in ABS' value." He then argues that "[s]ince there was no appreciable increase in the value of ABS during redemption, its only effect on John was to increase his percentage of ownership." Thus, he concludes that "[b]ecause this is nothing more than an exchange of non-marital property, KRS 403.190 demands that 100% of ABS be attributed to John as non-marital property."

In *Travis v. Travis*, 59 S.W.3d 904 (Ky. 2001), the Kentucky Supreme Court stated

An item of property will often consist of both marital and nonmarital components, and when this occurs, a trial court must determine the parties' separate nonmarital and marital shares or interests in the property on the basis of the evidence before the court. Kentucky courts have typically applied the "source of funds" rule to characterize property or to determine parties' nonmarital and marital interests in such property.

Id. at 909. Further, "[t]he 'source of funds rule' simply means that the character of the property, i.e., whether it is marital,

nonmarital, or both, is determined by the source of funds used to acquire property." *Id.* at 903 n. 10. See also *Sexton*, 125 S.W.3d at 265.

Under the "source of funds" rule used by Kentucky courts and courts in other states to determine whether property is marital or nonmarital, "[t]he property is considered to be acquired as it is paid for" *Hoffmann*, 676 S.W.2d at 824. "[C]haracterization of property as nonmarital or marital depends upon the source of each contribution as payments are made rather than the time at which equitable title to possession of the property is obtained." *Harper v. Harper*, 448 A.2d 916, 929 (Md. 1982).

Under this analysis, the shares of stock sold to the corporation in the 1996 stock redemption agreement were not "acquired", within the meaning of KRS 403.190 and the determination of marital/nonmarital interest, until they were paid for. These shares were paid for during the marriage over a period of years by corporate earnings. Thus, they were "acquired" during the marriage.

Because the shares were "acquired" during the marriage, there is a presumption that they are marital property. See KRS 403.190(3). John seeks to avoid the presumption by arguing that he exchanged his 16% (or 8%) interest for a 100% interest when the stock redemption occurred. He relies on KRS 403.190(2)(b).

It is true, as John argues, that the value of his ownership interest did not increase at the time of the stock redemption because while the percentage of ownership interest increased, the value of the corporation decreased because of the debt liability created to pay John's parents for their shares. See *Hoffmann*, 676 S.W.2d at 822. Although John's ownership interest at the time of the redemption of his parents' shares increased, the value of John's shares did not. Rather, the value of John's shares increased during the marriage as the corporation gradually paid the debt to John's parents. The real issue is how to treat the subsequent increase in the value of John's shares (assuming those shares were nonmarital) as the debt to John's parents was paid.

In *Goderwis v. Goderwis*, 780 S.W.2d 39, 40 (Ky. 1989), the Kentucky Supreme Court addressed a somewhat similar situation. In that case, the husband owned an auto repair garage business prior to marriage. During the course of the parties' 18-year marriage the value of the corporation grew substantially. The husband argued that the corporation was his nonmarital property because he was the corporation and his wife took no active role in the operation of the business. Rather, she cared for the parties' four children and was a homemaker.

Our supreme court stated that there was "a certain amount of confusion on the question of how to treat business property which is the primary occupation of one spouse during the marriage but which was acquired prior to marriage when it

increases in value during the marriage." *Id.* at 40. The court stated that although the business was the principal source of the marital funds, the wife could contribute to the marital assets in her role as a homemaker.¹⁰ *Id.* The court further held that

An increase in value of nonmarital property during the marriage which is the result of a joint effort of the parties establishes the increase in value of the nonmarital property as marital property. The efforts of the parties may include the contribution of one spouse as a primary operator of the business and the other spouse as primarily a homemaker.

Id.

We believe that the principles in *Goderwis* are applicable herein. John may have had a nonmarital interest in the corporation at the time of marriage.¹¹ The value of that interest likely increased in time as the years passed and the corporation paid off the debt owed to John's parents. To the extent the increase was due to John's efforts as the primary operator of the business and Vicki's efforts as homemaker, it was marital property. See *id.* However, to the extent the increase in value was due to general economic conditions, the increase was not marital property. See *id.*

¹⁰ This view is contrary to the *Hoffmann* case where the court rejected the wife's argument that the increase in value of her husband's ownership interest in a closely-held corporation was partially due to her efforts as a homemaker, traveling companion, and entertainer. See *Hoffmann*, 676 S.W.2d at 826.

¹¹ The trial court will make this determination on remand.

KRS 403.190(3) creates a presumption that any increase in value in property acquired during the marriage is marital property. In the *Travis* case, the Kentucky Supreme Court stated as follows:

[T]herefore, a party asserting that he or she should receive appreciation upon a nonmarital contribution as his or her nonmarital property carries the burden of proving the portion of the increase in value attributable to the nonmarital contribution.

59 S.W.3d at 910. Further, "[b]y virtue of the KRS 403.190(3) presumption, the failure to do so will result in the increase being characterized as marital property." *Id.* at 910-11.

To summarize, on remand the court must first determine the interest that John had in ABS prior to the redemption agreement and whether that interest was marital or nonmarital. If that interest is determined to be marital, then any increase in its value must necessarily also be marital. If that interest is determined to be nonmarital, then the court must determine whether the increase in its value during the marriage is marital or nonmarital. In making this determination, if the value of the interest increased due to general economic conditions, then the increase is John's nonmarital property. See *Goderwis*, 780 S.W.2d at 40. If the value of the interest increased due to the joint efforts of the parties, then the increase is marital property.¹² *Id.* Because KRS 403.190(3) creates a presumption

¹² As we have noted, the efforts of the parties may include the contribution of John as the primary operator of the business and the contribution of Vicki as primarily a homemaker. See *Goderwis*, 780 S.W.2d at 40.

that the increase is marital property, the burden is on John to prove that the increase in value is nonmarital. See *Travis*, 59 S.W.3d at 910. If he fails to prove that the increase in value of his nonmarital interest (if he had a nonmarital interest) was his nonmarital property, then he should be awarded only the value of the nonmarital interest at the time he acquired it or at the date of marriage, whichever date is later, as his nonmarital property.

John's second argument is that the court erred in finding that checks from Vicki's mother written to Vicki after she and John separated constituted a marital debt. After the parties separated, Vicki was awarded \$2,000 per month for temporary maintenance and \$1,000 for child support. Thereafter, as power of attorney for her mother, Vicki wrote checks totaling \$66,714 on her mother's checking account. Some of the checks were written before the maintenance and child support awards to Vicki, and some were written after the awards. Of this amount, \$27,300 in checks apparently were written to Vicki herself for cash.

Vicki claims that all the checks were loans from her mother that were needed because she could not meet her living expenses despite her maintenance award of \$3,000 per month. She claims that much of the money went for home maintenance and

repair and that the remainder went for living expenses for her and her daughter, who was a senior in high school at the time.¹³

John was not aware of the alleged loans, and he argues that the checks were likely to be gifts from Vicki's mother and that Vicki's testimony that the checks were loans and the notations of "loan" on some of the checks were insufficient to prove the existence of a loan. In support of his argument, John cites *Bodie v. Bodie*, 590 S.W.2d 895 (Ky.App. 1979), and *Neidlinger v. Neidlinger*, 52 S.W.3d 513 (Ky. 2001). Further, John states that the court's finding that "[m]ost if not all of the money loaned from the mother was used to make improvements on the marital residence which is part of the marital estate" is simply untrue and, therefore, an erroneous fact finding.

In the *Bodie* case, this court affirmed the trial court's ruling that debts of \$14,610 incurred by the husband during the marriage were not marital debts but were debts that should be assigned solely to the husband. *Id.* at 896. The court noted that there is no presumption whether debts arising during the marriage are marital or nonmarital and that the burden of proof that the debt is marital is upon the party that incurred it. *Id.*

While we agree with John that the court in *Bodie* accurately stated the law, we disagree that the facts therein have similarity to those in this case. In *Bodie*, the husband,

¹³ Vicki also presented evidence of \$8,000 in checks from her mother that were written prior to the parties' separation. The court did not allow this amount as a marital debt.

who had incurred the debt, declined to answer questions relative to the nature of the debts. Further, he offered no canceled checks, bills, or receipts to support his claim that the debts were marital in nature. In this case, Vicki testified as to the nature of the debts and had documentation in the form of checks from her mother that supported her testimony that there was actually a loan.

In the *Neidlinger* case, the Kentucky Supreme Court affirmed a trial court's ruling that a \$26,000 indebtedness from a wife to her mother and two friends was the separate debt of the wife and was thus nonmarital. *Id.* at 523. First, the court stated as follows:

Debts incurred during the marriage are traditionally assigned on the basis of such factors as receipt of benefits and extent of participation, whether the debt was incurred to purchase assets designated as marital property, and whether the debt was necessary to provide for the maintenance and support of the family. (Citations omitted.)

Id. The *Neidlinger* court held that the debt was "incurred primarily for Appellant's own benefit and secondarily to maintain the parties' child in an expensive school to which the Appellee objected." *Id.*

In reviewing the determination by the trial court, the supreme court in *Neidlinger* held that "issues pertaining to the assignment of debts incurred during the marriage are reviewed under an abuse of discretion standard." *Id.* The court further stated that "[i]f the[] debts were assigned to Appellee

[husband], the effect would be to allow Appellant to unilaterally increase Appellee's maintenance and support obligation to a level substantially higher than established by court order." *Id.*

We conclude that *Neidlinger* is distinguishable from the facts of this case in at least three ways. First, in *Neidlinger* the supreme court stated that the debt was primarily for the wife's benefit and secondarily for the education of the parties' daughter in an expensive private school pursuant to the wife's unilateral decision. In this case, much of the expense went for maintenance and repairs of the marital residence. Second, in *Neidlinger*, the court was faced with whether the lower court's decision declaring the debt to be nonmarital was an abuse of discretion, while in this case we are faced with whether the lower court's decision declaring the debt not to be nonmarital was an abuse of discretion. Third, in *Neidlinger*, the court held that to assign the debt to the husband would, in effect, increase his maintenance obligation. In this case, the court did not assign the debt to John but assigned it to Vicki.

The trial court in this case accepted Vicki's claim of indebtedness to her mother based on her testimony and copies of the checks. We conclude that the evidence was sufficient to support the determination that the checks represented loans, not gifts. We decline to tamper with that portion of the court's ruling.

However, in determining that the loans were a marital debt, the court stated that "[m]ost if not all of the money loaned from the mother was used to make improvements on the marital residence which is part of the marital estate." According to Vicki's own exhibit introduced into evidence at trial, that was not the case. Thus, the trial court made an erroneous fact finding in that regard.

We agree that the portion of the debt that related to improvements to and maintenance of the marital residence could be held to be a marital debt. Likewise, loans to cover valid living expenses incurred by Vicki prior to the maintenance and child support awards were within the court's discretion to allow. However, to the extent that Vicki may have used loan proceeds for her personal expenses and expenses for her child after being awarded temporary maintenance and child support, those debts should be held to be Vicki's personal debts. To do otherwise would be to increase John's temporary maintenance and child support obligations during that period of time. See *Neidlinger*, 52 S.W.3d at 523. We remand the matter to the trial court to determine what part of the \$66,714 should be excluded pursuant to the principles of the *Neidlinger* case.

John's third and final argument is that the court erred in ordering him to pay 25% of Vicki's attorney fees and expert witness fees. Vicki's attorney fees were slightly less than \$40,000. Thus, the court ordered John to pay Vicki's

attorney \$10,000. Vicki also incurred accounting fees, and the court ordered John to pay her \$6,922.19 of those fees.

Attorney fees may be awarded to a party pursuant to KRS 403.220. Expert witness fees may also be awarded pursuant to that statute. See *Culver v. Culver*, 572 S.W.2d 617, 622 (Ky.App. 1978). The statute states that the court should consider "the financial resources of both parties[.]" KRS 403.220. Further, the statute states that the court may award a "reasonable amount" for the fees. *Id.* An award of fees is reviewed by this court under an abuse of discretion standard. *Neidlinger*, 52 S.W.3d at 520.

John's first argument in this regard is that the court erred in awarding fees because there was not an imbalance in the financial resources of the parties. To support his argument, John cites *Lampton v. Lampton*, 721 S.W.2d 736 (Ky.App. 1986), wherein this court held that attorney fees may be awarded "only when it is supported by an imbalance in the financial resources of the respective parties." *Id.* at 739.

John states that he was awarded \$1,584,087 in marital property, that Vicki was awarded \$1,000,845, and that he was ordered to pay Vicki \$291,621 in a lump sum to equalize the property distribution. Further, he states that the majority of his assigned marital property (\$1.2 million) was the family business. Further, John notes that Vicki was awarded the marital residence unencumbered, as well as checking, savings,

and investment accounts. He thus argues that "there is no appreciable financial disparity between John and Vicki."

On the other hand, Vicki asserts that while John has a salary of over \$100,000 per year, as well as potentially more due to retained corporate earnings not paid by the corporation, she was 55 years old at the time, had been out of the work force for 10 years, and had only a high school education. She states that although the marital property was divided equally, the financial resources of the parties were not balanced due to these additional facts.

John also correctly states that the court made no specific finding that there was an imbalance in the financial resources of the party, but that it appeared to base its award on John's obstructive tactics in failing to comply with discovery requests and orders of the court. John did not move the court to make a more specific finding in that regard. See Kentucky Rule of Civil Procedure (CR) 52.04. Vicki argues that John thus waived the issue for purposes of this appeal because he didn't move the court for a specific finding. See *Underwood v. Underwood*, 836 S.W.2d 439, 445 (Ky.App. 1992), overruled on other grounds by *Neidlinger*, 52 S.W.3d at 523.

Also, John cites the *Lampton* case for his argument that attorney fees may be awarded pursuant to KRS 403.220 only when there is an imbalance in the parties financial resources, even though attorney fees may be warranted otherwise under CR 37.01 due to obstruction tactics. *Lampton*, 721 S.W.2d at 739.

John notes that pursuant to *Gentry v. Gentry*, 798 S.W.2d 928 (Ky. 1990), attorney fees may be awarded under KRS 403.220 for fees incurred due to the obstructive behavior of the other party, but such fees must also be based on the financial disparity of the parties' resources. *Id.* at 937-38.

It is not entirely clear whether the court also based its award of attorney fees under KRS 403.220 on the financial resources of the parties as well as John's obstructive tactics. While the court did not specifically address the parties' financial resources prior to making the award, it did cite the statute, which requires the court to consider such resources, verbatim. In light of John's failure to seek a more specific finding from the court, and in light of the fact that a finding of disparity in the parties' financial resources due to the parties' respective incomes was supported by the evidence, we conclude that the court did not abuse its discretion in awarding Vicki 25% of her attorney fees and expert witness fees.

John also argues that KRS 403.220 allows an award for a "reasonable" fee and that the court did not conduct an analysis of the eight factors to be considered in this regard. See *Boden v. Boden*, 268 S.W.2d 632, 633 (Ky. 1954). John further notes that the court stated at one point in its order that "[t]he attorney fees in this case border on outrageous." However, the court stated in other portions of its orders that the award to Vicki of 25% of her attorney fees and expert witness fees was reasonable. John also admitted that he had

paid a considerable portion of his own attorney fees and expert witness fees from marital funds. Given the circumstances surrounding the award to Vicki, we conclude that the court did not abuse its discretion.

The decree and orders of the Fayette Circuit Court, Family Branch, are therefore affirmed in part and vacated in part and remanded.

ALL CONCUR.

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