

# P E N N S Y L V A N I A LAW WEEKLY

## **FAMILY BUSINESS - DATE AND METHOD OF VALUATION**

### *Court Mandates Tax Effects of Alimony Award Be Considered*

On July 14, 2006 the Superior Court decided, *Smith v. Smith*, 2006 Pa. Super. LEXIS 1617 (2006), where the court was asked to rule on the following issues:

1. When valuing a closely held business, must an expert state how much goodwill is professional (personal) and how much is enterprise (business) goodwill?
2. What is the date of valuation of a business? Date of separation or date of trial?
3. Must a trial court consider the tax ramifications when making an award of final alimony?

While the Superior Court upheld the trial court concerning date of valuation, it reversed and remanded on the valuation methodology and the tax effects of an award of alimony.

Husband and Wife were married on August 7, 1965 and separated on October 16, 2000. Wife filed for divorce seeking equitable distribution, alimony, and counsel fees. The parties had three emancipated children. Husband was 60 years old at the time of trial and had been the proprietor of a trucking business, D&D Truck Lines Inc., since 1969. Wife was 62, never completed the tenth grade, and had handled the accounting work for the business. Following separation, Wife worked part time as a Kmart cashier making \$6.50 an hour. Due to injuries she sustained in a car accident, Wife's employment was terminated on December 19, 2001, and she had been unemployed thereafter.

The Master took testimony for four days and filed his report on March 30, 2004 to which both parties filed Exceptions. On July 26, 2004 the trial court granted both parties' Exceptions. The trial court reviewed the Master's record and a "supplemental" trial took place on March 9 and 10, 2005. The court directed both parties to provide business valuations for Husband's trucking company prior to trial. On June 30, 2005, the trial court entered an Opinion and an Order granting the parties' divorce, equitably dividing the property, denying Wife counsel fees, and awarding Wife one thousand dollars (\$1000.00) per month in alimony until she became eligible to draw upon Husband's Social Security benefits. The parties cross-appealed with Wife challenging the alimony award, the denial of counsel fees, and the use of the date of distribution instead of date of separation as the valuation date for Husband's business. Husband challenged the trial court's acceptance of Wife's expert's valuation, arguing that any goodwill in the business was professional goodwill rather than enterprise goodwill.

The majority view in Pennsylvania for date of valuation of a business is the date of distribution. *Sutliff v. Sutliff*, 518 Pa. 378, 543 A.2d 534 (1988). In *Smith v. Smith*, 653 A.2d 1259 (Pa. Super.) 1995, appeal denied, 541 Pa. 641, 663 A.2d 693 (1995), the trial court determined that the date for valuation is the date which will effect economic justice. There is no statute in the Divorce Code setting a date of valuation of assets, and as such it is left to the discretion of the trial court to implement a date which best effects "economic justice" between the parties. Wife argued the minority view, stating that using any date other than the date of separation was

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improper and, citing *Benson v. Benson* 624 A.2d 644 (Pa. Super 1993) and *McNaughton v. McNaughton*, 603 A.2d 646 (Pa. Super. 1992). In both *McNaughton*, supra, and *Benson*, supra, the trial court ordered valuation of the family business at the date of separation, due to the fact that Husband had great control over the value of the business and could therefore manipulate the value so that the date of trial valuation was for more favorable to Husband regarding equitable distribution. In *McNaughton*, supra, the court found that Husband controlled the family business and that the value would vary due to his influence and held:

“A family business warrants a deviation from the general rule that assets should be valued as of the date of distribution because of the great influence that the controlling spouse may have upon the business’s assets.” *McNaughton*, supra, 603 A.2d at 649.

In the instant case, the Superior Court affirmed the decision of the trial court, stating that it was clearly possible for the business to be valued at the time of distribution, and that the trial court did not abuse its discretion in so doing. The court noted that the trucks involved in Husband’s business depreciated each day that they were used. The date of valuation as date of trial was permitted to stand.

Husband challenged the valuation of his business as determined by the trial court. Wife submitted an expert’s valuation of the business of \$279,000.00 which the court below accepted over Husband’s valuation of \$56,044.00, an amount based exclusively on adjusted net asset value.

“In determining the value of marital property, the court is free to accept all, part or none of the evidence as to the true and correct value of the property.” *Litmans v. Litmans*, 449 Pa. Super. 209, 673 A.2d 382, 395 (1996).

The trial court exercised its discretion by choosing Wife’s valuation over Husband’s. However, Wife’s expert’s findings as to goodwill were not explained and the Superior Court remanded for findings as to how much professional (personal) goodwill the expert found and how much enterprise (business) goodwill he determined to be present.

Husband’s specific contention, was that the trial court erred in accepting Wife’s valuation, arguing that the goodwill in the business was completely professional (personal to Husband) and not enterprise goodwill. The Supreme Court has stated:

“Since good will is essentially positive reputation, the factors that have given rise to the positive reputation will necessarily control the determination of whether good will exists for purposes of equitable distribution. If the positive reputation is due only to the reputation of a single individual as opposed to the business entity in general, then the business has no good will for purposes of equitable distribution.” *Solomon v. Solomon*, 531 Pa. 113, 611 A.2d 686, 692 (1992).

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The Superior Court has declared:

“If the nature of the economic good will is purely personal to the professional spouse, it is not alienable; hence, it cannot actually be realized and may not be included in equitable distribution. If, however, a portion of the economic good will is attributable separately to the corporation or business and can be realized by sale to another (by selling the enterprise in whole or in part, buy-in’s and buy-out’s included), then to that extent, there is good will value subject to equitable distribution.” *Fexa v. Fexa*, 396 Pa. Super. 481, 487, 578 A.2d 1314, 1317 (1990).

Wife’s expert’s valuation accepted by the trial court did not expressly provide for any professional goodwill which may have existed in Husband’s business. As a result, the Superior Court remanded to the trial court to determine whether Husband’s business had any professional goodwill and, if it did, to revalue the business accordingly for purposes of equitable distribution.

Only enterprise goodwill can be sold or transferred and therefore only enterprise goodwill can be valued for equitable distribution purposes.

A trial court must take into consideration both enterprise and professional goodwill when valuing a business for the purposes of equitable distribution. Only that portion which comprises enterprise goodwill can be valued. The appropriate date of valuation of a business as well as the amount of professional and/or enterprise goodwill must be determined on a case by case basis.

In Wife’s appeal of her alimony award, she averred that the trial court had erred by not taking into account tax ramifications to Wife when calculating her final alimony award. The Superior Court concluded that the trial court did commit error by not considering the tax effects of alimony. Alimony is includable in the recipient’s gross taxable income and therefore is subject to local, state, and federal income taxes on such income. 26 USCS § 71(a) Furthermore, the payment of alimony is tax deductible to the payor. 26 USCS § 215(a) The Divorce Code in 23 Pa. C.S.A. § 3701(b) enumerates seventeen criteria which a court must take into consideration when awarding alimony. In the instant case, the trial court specifically referenced eleven of the seventeen statutory factors as being relevant, but neglected to include Subsection 15 which requires consideration of the “Federal, State and local tax ramifications of the alimony award.” 23 Pa. C.S. § 3701(b)(15).

As a result of the trial court’s failure to take tax issues into consideration, the Superior Court vacated the portion of the Order awarding alimony and remanded the issue back to the trial court to consider all tax ramifications and adjust the award as necessary.

Since Wife will pay taxes on her alimony income, the court must deduct that amount to ascertain her true after tax income. The court must “gross up” the figure to award Wife what she must net in order to live. Consequently, Husband gets a tax benefit by being able to deduct the amount of alimony paid “above the line” before his adjusted gross income is determined. A court must consider both the benefit to Husband and the tax burden to Wife.

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The family law practitioner is well advised to do the math and to educate the court regarding taxability of alimony. Since alimony is taxable to the payee and deductible to the payor, the practitioner must have the “real” numbers ready for the Court. The valuation of a closely held business, both the date of valuation and whether the goodwill is professional or enterprise or both and in what percentages must be addressed by the expert in a well-reasoned report. Our grade school teachers taught us long ago that “Show and Tell” will serve us well.

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