The Double Dip in Valuing Goodwill in Divorce

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The Double Dip

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- Property division
- Support

In circumstances in which the property division includes a business to be valued, it will most likely include both tangible and intangible assets. If the value of an intangible asset, such as goodwill, is charged to one party, the income stream, which is being used for the calculation of income available for support, is most likely the same income stream that was used for the computation of goodwill. Hence, the double dip.

Part I: Defining the Problem

The issue of double dipping has frustrated many business owners involved in a marital dissolution because of the financial hardship it may create. This article deals with identification of the problem, causes, and some possible solutions.

The problem

There are two basic financial issues in a marital dissolution:

1. Property division
2. Support

In circumstances in which the property division includes a business to be valued, it will most likely include both tangible and intangible assets.

If the value of an intangible asset, such as goodwill, is charged to one party, the income stream, which is being used for the calculation of income available for support, is most likely the same income stream that was used for the computation of goodwill. Hence, the double dip. This is true because of the very nature of what goodwill is, how it is computed, and what it represents. At the valuation date, the goodwill so-valued is for the expectation of what will be earned in the future.

This may, or may not, cause a hardship in dealing with the financial aspects of the dissolution. Most of the time it does. The fact that it may not cause a hardship does not mean there is not an inequity that needs to be dealt with.

The financial hardship can exist for several reasons:

1. The business involved may be the only significant asset of the marital estate.
2. There may be no offsetting assets for the non-business operator to have.
3. The business may have insufficient cash or other assets to distribute to the non-operating spouse.
4. A major portion of the value of the business may consist of the intangible goodwill and, as such, is not cash in the bank.
5. The non-operating spouse may receive a note from the operating spouse in payment of their share of the business, which will call for principal and interest payments to be made. These payments will be made with after-tax dollars from the earnings of the business operator.
6. Spousal support payments are to come from the earnings of the business operator.
7. Child support payments are to come from the earnings of the business operator.
8. The value of the business may have taken years to create. Trying to pay the non-operating spouse for their half may take a long time.

Intangible assets

It may be best to begin the discussion of what an intangible asset is by stating what it is not. It is not something that you can touch or feel. I can hold cash in my hand or put it in my pocket. Accounts receivable I can touch because I can hold the invoices that represent them. Equipment I can bump into and hurt myself if I am not careful. Intangible assets are none of those.

The Business and Profession's Code § 14100 defines "goodwill" (the intangible in question) as the "... expectation of continued public patronage." We can tell by the above definition that goodwill, therefore, is an ability to earn in the future. Just because a business was profitable in the past does not mean that past is what creates the value. It only has value if that past is expected to repeat itself, or will give some indication of the future.

Valuation of goodwill

While many businesses have the elements of goodwill, the real question is whether that goodwill has any separate, distinguishable, quantifiable value.

In determining the value of goodwill at a point in time (the valuation date), one has to look to the future to estimate the "expectation of continued patronage." Webster defines "expect," in part, as "to look for as likely to occur." If it has not occurred, it must be in the future (measured from our valuation date).

Whether someone will pay for the goodwill based on past events depends entirely upon the expectations of the buyer. In real-life business acquisitions and valuations, when someone buys a business, they are dealing with what they expect to happen in the future. Certainly they may look to the past, but only if they think the past is some indication of what will happen in the future. A smart buyer will do projections of the future income statements. No one would pay to acquire a business just because the business was profitable in history. Those earnings are either converted to cash, other assets, or distributed. They are paying for it because they think it will bring earnings to them in the future. Imagine purchasing a very successful slide rule manufacturing company shortly after the advent of the electronic calculator. I dare say that a well-informed buyer would not use the history of the business to determine if there is any goodwill for which to pay money.

Family law goodwill

It should be pointed out that, in many cases, there is a difference in the methods used to determine goodwill in the family law arena as compared to the "real world" of business appraisal. One of the most common differences lies in the fact that the courts do not want appraisers to use a projection of future income for the purposes of determining an income stream to capitalize. They consider it speculative and, if you think about it, there is another reason.

The appraiser's goal is to compute the community property interest in a particular business. Often, the business will be a service business whose success or failure depends on the efforts of the spouse operating the enterprise. We know from the law that efforts after the date of separation are no longer community property and become the separate property of the person performing them. A projection into the future of what the spouse could do is, in fact, a view of the separate property of the spouse operating the business. If our goal, once again, is to compute the community property value of the business, how can you use separate property to determine the community value?

The solution is to use historical (community) earnings and adjust them for what may not repeat itself (loss of a major product line, etc.). There is no question that this is a surrogate for a projection. The difference is that you are using community earnings to determine the community value. It is then assumed that what the community has built up (an ability to earn) will continue in the future.

Principal or income?

Part of the problem also stems from the distinction between two financial concepts. They are:

- Return on Investment
- Return of Investment

The above are problems because the courts, attorneys, and litigants do not distinguish consciously between these concepts. The result: Cash flow from a self-liquidating investment is mistaken for income. Stated differently, the goodwill (income which one spouse had paid for) is included by the courts as income available when it is a return of principal. The following examples will help illustrate this:

Example 1

Assume that in a divorce proceeding, HUSBAND and WIFE have two assets of equal value:

A. WIFE is to receive a $100,000 bond paying interest at the rate of 10% per annum, redeemable at the end of five years, and;

B. HUSBAND is to receive a fully secured promissory note, also bearing interest at the rate of 10%, payable on a fully amortized basis at the rate of $2,124.70 per month so that the note will be entirely paid off in five years. During the time he collects the principal portion of each payment, he deposits the principal portion into an account which also earns 10% per annum.

C. Over the five-year period, WIFE would receive $833.33 per month in interest income (return on investment), and at the end of five years would receive back $100,000 (return of investment), the redeemable value of the bond.

D. HUSBAND would receive $2,124.70 per month, of which part would be principal (return of investment) and part would be interest (return on investment). The interest portion would decline each month as the principal portion increases. If he obtains a like return (10%) on the deposit of his return of capital into an account (not allowing for the earnings of interest on the interest earned), he will earn additional interest each month as the capital return increases inversely to the interest reduction on the note.

E. The amount received by each party over the course of the five years, would be exactly the same.

F. It would be an error, however, in determining spousal support, to attribute $833.33 in income to WIFE, but $2,124.70 to HUSBAND. Both would have income of $833.33 per month. The additional amount received by HUSBAND is a return of investment, not income.

Example 2

Assume the following assets received in a dissolution:

A. WIFE is awarded the proceeds from the sale of the family home--$280,000 in cash--plus a parcel of community real property valued at $351,000 for a total of $631,000 in tangible property.

B. HUSBAND, who is 56 years old, is awarded the goodwill of a business, which he operates, having no marketable value, but valued for purposes of divorce at $631,000.

C. Dealing with WIFE's half of the equation, WIFE should be charged with income that she earns on the $280,000 cash and the fair rental value of the real property she has received. If, however, she should begin withdrawing $10,000 per month from the $280,000 which she was initially awarded, that amount should not be treated as income (because it is not income) in computing spousal support. At the end of nine years, subject to fluctuations up or down in the real estate market, WIFE would still retain capital assets valued at $631,000, and she would have been charged for support purposes, only with the income earned on that capital asset.

D. The same thing should be true on HUSBAND's side of the ledger except, by definition, HUSBAND's capital asset (goodwill) will be worth nothing at the end of nine years. This is because he is going to retire and the business is not transferable/salable. The value at the time of the division of property took into consideration the value of the earnings above and beyond reasonable compensation for his services (goodwill). The amount he receives each month, therefore, includes a return of capital (goodwill). Remember, HUSBAND paid WIFE for those earnings. Those earnings are a return of his investment. Under these circumstances, in determining what HUSBAND's true earnings are, we would need to separate his monthly income into the two distinct parts. By this means, and only by this means, will HUSBAND and WIFE be treated equally.

Accounting issues and considerations

There are no standards promulgated by the AICPA in the form of an Accounting Principals Board Opinion (APB) or Financial Accounting Standards Board (FASB) statements that discuss or give direction to the recognition of goodwill in the area of family law.

Goodwill, such as that which has been attributed to HUSBAND's corporation, therefore, is essentially a creature of the divorce courts.

Part II: Possible solutions

Accounting issues and considerations

As mentioned in Part I, there are no standards promulgated by the AICPA in the form of an Accounting Principals Board Opinion (APB) or Financial Accounting Standards Board (FASB) statements that discuss or give direction to the recognition of goodwill in the area of family law.

Goodwill, such as that which has been attributed to HUSBAND's corporation, therefore, is essentially a creature of the divorce courts. Nevertheless, it can be properly treated for accounting purposes in the same fashion as the purchased goodwill of any other business.

The following is a discussion of how the accounting profession would look at the acquisition (HUSBAND acquiring the business from the community) starting with the basics:

I. From an accounting standpoint, goodwill is the excess cost of an acquired enterprise over the sum of identifiable net assets (Accounting Principals Board Opinion 17 d 1).

II. Accounting for the acquisition of intangibles, such as goodwill, requires that an enterprise record as an asset the cost of goodwill acquired from other enterprises or individuals (Accounting Principals Board Opinion 17 d 24). They shall be recorded as of the date of acquisition (Accounting Principals Board Opinion 17 d 26).

III. The recorded costs of intangibles, including goodwill, shall be amortized by systematic charges to income over the periods estimated to be benefited. This is because the payment for goodwill is a result of the expectation of earnings. The matching concept (the matching of revenue with the expenses incurred to generate that revenue) would necessitate this allocation so that earnings would not be over-stated. It would be a fallacy to look at the earnings of an enterprise without recognizing the fact that the acquiring company paid for those earnings. The decision would then need to be made as to what time period should be charged with the cost of its acquisition. According to FASB, the factors which shall be considered in estimating the useful lives of intangibles include:

   A. Legal, regulatory, or contractual provisions may limit the maximum useful life.
   B. Provisions for renewal or extension may alter a specified limit on useful life.
   C. Effects of obsolescence, demand, competition, and other economic factors may reduce useful life.
   D. A useful life may parallel the service life expectancies of individuals or groups of employees.
   E. Expected actions of competitors and others may restrict present competitive advantages.
   F. An apparently unlimited useful life may in fact be indefinite, and benefits cannot be reasonably projected.
   G. An intangible asset may be a composite of many individual factors with varying effective lives.

IV. The period of amortization of intangible assets shall be determined from the pertinent factors shown above (APB17 d27).

V. Analysis of all of the factors should result in a reasonable estimate of the useful life of most intangible assets. The straight-line method of amortization--equal annual amounts--shall be applied for accounting purposes unless an enterprise demonstrates that another method is more appropriate.

Possible solutions

Pay the goodwill out over time as support

At first blush this sounds like a logical solution because it then comes from the very income which generates it. However, there are major problems with this method. The first problem is that a court would not be able to make such an order. It would have to be settled and agreed to by the parties. The second problem is that spousal support must terminate upon the death of the recipient. If the recipient dies the day after the agreement is signed, his or her estate would never receive the value of the goodwill. Exposure for the practitioners involved would exist from the heirs of the recipient. Life insurance on the recipient would help, but what if he or she is not insurable or the cost of the insurance becomes a burden? What if the business has a downturn and the payer cannot continue to make the payments? In short, this method of dealing with the situation is fraught with problems.

Amortize the goodwill over an appropriate time period

Another possible solution: Treat the dissolution transaction for what is really happening; one person is acquiring the other half of a business from another. They pay for it by surrendering other assets, which they have an interest in, or with a promise to pay in the future. When this happens outside the dissolution arena, the accounting profession knows how to handle it.

Applying the foregoing discussion about generally accepted accounting principals to this case, the amount which HUSBAND has paid for goodwill ($631,000) should be amortized over the anticipated life of HUSBAND's business from the date it was "acquired from the community" (nine years). While arguments could be made as to the relative merits of different types of amortization, the straight-line method is undoubtedly the easiest to compute and would appear to be both fair and appropriate.

On that basis, applying generally accepted accounting principals, it would be appropriate to write off, as an amortization of goodwill, the sum of $70,111.11 per year from HUSBAND's annual earnings over the course of the period from the date of judgment until age 65, in measurement of his true earnings for the purpose of determining spousal support. All sums earned by HUSBAND, in excess of $70,111.11 per year, would be considered in computing spousal support, irrespective of whether the source of those funds were the result of HUSBAND's independent efforts or the result of this attributed $631,000 of goodwill.

Other considerations for the amortization period:

- Absent the facts and circumstances of this case, dealing with a person close to retirement age, the amortization period should be considered with all the facts and circumstances.

- An argument could certainly be made that the marital goodwill decreases and is replaced with separate goodwill as time goes on.

- That is to say that 10 or 15 years after the marriage, the value created during the community is worthless, and the separate efforts after the date of marriage are what then have the value. This would seem to permit some sort of reverse sum-of-the-years' digits method, which has a small amount of amortization at the beginning of the period and a greater amount at the end.

The difficulty of this reality is that the computations, which are necessary to communicate to the courts, are far more complicated than can be reasonably understood. In addition, excluding community goodwill in the earlier years would result in unrealistic levels of spousal support. This would seem to be a good reason to argue for a straight-line amortization method.

Without some reasoned, rational method, the straight-line method could be employed with a 15-year period for the amortization. This would coincide with the current state of the tax law. Until a few years ago, the tax law did not permit a reduction of taxable income for the goodwill acquired of a company. It now permits the amortization over a 15-year period. However, the family law arena is still governed by IRS Code Section 1041, and no tax deduction is permitted.

Situations where amortization will not work

There are situations where the analysis herein does not apply. The reason it does not apply would depend on whether the computation of the income available to the business owner is the entire income available to the business.

If the owner is not taking out all the profits of the business, for real business reasons, then there may not be a double dip. This is because there would be a difference in the income used for the valuation of goodwill and the income available for support.

> **For example**, assume a business has a pre-tax profit of $500,000, and the owner only takes out $200,000, because the money is needed to fund the growth trend each year. The court has determined that the income available to the owner is $200,000. In that case you have not dipped twice. This would be true since the goodwill was determined using the $500,000 in earnings. Stated differently--if the business has goodwill because of its earnings, and the owner takes the earnings out each year, the owner is taking out the goodwill. If the court is basing spousal support on those same earnings, there is a double dip. The other spouse got the benefit of the value of those earnings in the property division and received support from those same earnings.

Other solutions

It is difficult, if not impossible, to design one solution to fit all situations. There is no "one size fits all." Other solutions can be created to fit the circumstances unique to each case. Care should be exercised to create a solution that is simple in design and can withstand mathematical modifications when circumstances change.

Only one of the factors

The ability to pay of the supporting party is only one of the many factors the court considers in determining the level and duration of spousal support (Family Code § 4320). It is hoped that the courts will consider the economic reality in double dipping.

Child support

The law requires that child support be computed using all income of the parties. Because the children of the marriage are not a party to the contract (the marital community property laws), child support would be based on a figure without regard to the amortization.

Conclusion

Charging one party in a marital dissolution with the community property goodwill and using the same earnings to compute spousal support is counting the same income twice. Many times this can contribute to the financial hardships that are inherent in the divorce arena. Methods can be derived to help solve this inequity.

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