16th Annual Symposium
of the
Family Law Council of Community Property States

April 15 through 17, 2004, Madison, Wisconsin

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April 16, 2004

ISSUE: The division of property when the major marital asset is a family-owned business, or partnership interest in a business, including Nevada's methods for examining and resolving this issue.

1. The Court's perspective on divorce and the family owned business.

2. Guidance from the IRS Code or Revenue Rulings.

3. Valuation issues and methods for family-owned businesses.

4. Options for distribution of the value.

THE COURT'S PERSPECTIVE
ON
DIVORCE AND THE FAMILY OWNED BUSINESS

INCREASE IN VALUE OF SEPARATE PROPERTY DURING MARRIAGE – GROWTH MAY BE CONSIDERED COMMUNITY PROPERTY

In Nevada, by statute, the rents, issues, and profits of separate property remain separate property.[1] It is a well-established principle of community property law, however, that the labor and skills of a spouse are considered to be a community asset, and that the income generated during the marriage from such labor and skills also is community property.[2]

When a spouse owns a business or an asset at the time of marriage and thereafter devotes labor and skills to that business, the statutory mandate conflicts with that well-established principle. Nevada courts have consistently held that in such a situation, the community should receive a fair share of the profits which derive from the owner-spouse's devotion of more than minimal time and effort to the handling of the separate property business.[3]

The Nevada case law adopted the California analysis[4] for resolving reimbursement issues arising from contributions of community effort to separate property. California law requires that appreciation in separate property be allocated between marital and nonmarital causes, and recognizes two different possible rules for making the allocation. Under the *Pereira* method, the separate interest gets a reasonable return on the separate capital, and all

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[1] NRS 123.130.

[2] Married couples own property either separately or as a community. The rights of husband and wife in Nevada are set forth in NRS Chapter 123, which provides the statutory definition of community property in NRS 123.220. Property specifically excepted from this definition is "separate property," which is defined in NRS 123.130. NRS 123.121 addresses the issue of the appropriate allocation of personal injury damages between spouses who sue jointly. Damages awarded for personal injuries and pain and suffering are the separate property of the injured spouse; damages for the loss of comfort and society are the separate property of the spouse who suffers such loss, and damages awarded for the loss of services and hospital and medical expenses belong to both spouses as community property. If the action is for injury to property, damages are to be awarded according to the character of the injured property. NRS 123.121(2).

[3] *See Johnson v. Johnson*, 89 Nev. 244, 510 P.2d 625 (1973).

[4] *Pereira v. Pereira*, 103 P. 488 (Cal. 1909); *Van Camp v. Van Camp*, 199 P. 885 (Cal. App. 1921). *See also In re Estate of Adams*, 132 Cal. App. 2d 190, 282 P.2d 190 (1955) and *In re Ney's Estate*, 212 Cal. App. 2d 891, 28 Cal. Rptr. 442 (1963) as almost perfect examples of ideal fact situations on each side of the issue when reviewing investments.

other appreciation is attributable to the community. Under the *Van Camp* method, the community estate gets the value of the community contributions, and all other appreciation is attributable to the separate estate. *Van Camp* generally proceeds on the premise that the measure of reimbursement is the value of the marital efforts; *Pereira* generally proceeds on the premise that the measure of reimbursement is the amount of the resulting increase in value.

Johnson and the Nevada cases that followed it held that the *Pereira* method is strongly favored, and that *Van Camp* will be used only where there is a strong equitable supporting reason.[5] The Nevada preference makes sense, for the community estate generally is entitled to the actual proceeds of marital efforts. If a spouse actually received a salary of $100,000 per year, no one would ever argue that the community estate should receive only $80,000, because that was the objective "fair" value of the services which the owning spouse provided. *Pereira* is the better formula, because it gives the community estate the ***actual*** proceeds of marital effort.

Cord specifically applied the *Pereira* method to separate investments. The court held that the *Pereira* method should be used to allocate between the separate and community estates a fivefold increase in the value of the husband's separate property. Thus, the separate interest would receive only a fair rate of return on the separate capital.

The court presumed a "fair rate of return" to be the rate of legal interest, which was apparently 7% at the time. In a long footnote, the court actually applied that method to the facts for some of the relevant years of the marriage (data for other years was not contained in the appellate record),[6] and held that a separate computation should be made for each year of the marriage. Between 1937 and 1946, the rate of return was less than 7%, so the court found no community interest. From 1947 until 1952, the rate of return exceeded 7%, so that some community value was earned. The court ultimately suggested that 11.6% of the total value of the separate interest at the end of 1952 was community property.[7]

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[5] *See Cord v. Neuhoff*, 94 Nev. 21, 573 P.2d 1170 (1978); *Hybarger v. Hybarger*, 103 Nev. 255, 737 P.2d 889 (1987).

[6] *Cord*, 94 Nev. at 27, n.4.

[7] *Cord* stopped short of mandating that the trial court use the calculations in the footnote. On remand, however, the parties stipulated to the 11.6% figure. They then litigated the classification of the remaining investment earnings. Each spouse submitted an expert, and not surprisingly, the experts differed greatly. The trial court agreed with the husband's expert that there was no additional community return.

GUIDANCE FROM THE IRS CODE OR REVENUE RULINGS[8]

INTRODUCTION – LIMITING THE SCOPE OF REPRESENTATION

There are very few family practitioners greatly versed in tax law. Therefore, we need to identify issues, and protect ourselves from the appearance of dispensing tax advice. The two critical times to inform a client that you will ***not advise*** on tax matters are in the *Retainer Agreement* and the *Closing Letter*.

The following is a suggestion of language for inclusion into a *Retainer Agreement* on tax issues:

> No advice is given regarding tax consequences, and Attorney specifically is *not* providing tax advice, although questions relating to tax matters may very well come up during the course of the case. Client agrees to seek tax advice elsewhere, and to hold Attorney harmless from any tax effects.

The following is a suggestion of language for inclusion into a *Closing Letter* to a client for tax issues:

> The *general* rules outlined in the next few paragraphs are intended to alert you to issues and provide some general information. Before you sign any tax return or take any action with respect to your federal or state income returns, please review your situation with your tax advisor.
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> You may officially notify the IRS that you have changed your mailing address from the address used on your last tax return by filing IRS Form 8822.
>
> Spousal support or alimony is taxable to the recipient and deductible from the income of the payor if all IRS requirements are met.
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> Child support payments are *not* deductible from the income of the payor or taxable to the recipient.
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> Unless specifically addressed in your *Decree,* generally the custodial parent will be entitled to claim the dependence exemption on his or her income tax return. The custodial parent may execute IRS Form 8332, releasing the dependency exemption to the noncustodial parent.

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[8] Resources in this area include: CINDY LYNN WOFFORD, THE FAMILY LAW REPORTER TAX GUIDE, *Tax Aspects of Divorce & Separation, A Detailed Analysis* (BNA 1999); MELVYN B. FRUMKES, FRUMKES ON DIVORCE TAXATION (3rd ed. 2001); and, CCH FAMILY LAW TAX GUIDE (CCH 1986).

Generally, there is no tax gain or loss recognized as a result of the division of property between spouses upon divorce. Thus, there may be no tax incurred by dividing the property.

It is important to know the basis of the property that you receive in the division of your assets. The basis is generally the cost of acquiring, and in some cases maintaining, a capital asset. If the asset has appreciated, the person who receives that asset will be responsible for tax on the appreciation when the asset is sold.

If your *Decree* provides that you and your former spouse will sell your jointly owned residence, you each will be responsible for reporting your portion of any capital gain. Capital gain is the profit resulting from the sale of capital investments, such as the marital real estate. Under new tax law, there is a limited exemption per person for capital gains for the sale of a home. If you are going to sell your home, make sure you consult your tax advisor to be sure you qualify for this exemption.

Again, these tax pointers are general in nature. *Only* a qualified tax advisor can advise you about their application to your specific case.

THE TROUBLE WITH MIXING ALIMONY AND PROPERTY – THE DEADLY COCKTAIL

Generally, property passes between the parties without tax impact under IRC §1041. In the complex divorce case involving ownership of a small business, the obligor party may offer to pay an increased sum of alimony (an increase splintered off of the property division) so part or all of the property division can be deducted from his gross income each year of the payout. This arrangement "makes sense" to the parties because Husband can reduce his taxable income each year by paying higher alimony, and there is no "loss" to him by paying Wife property. The Wife's incentive is to receive more alimony, and if her income is low enough, there will be a negligible tax impact for funneling property through the alimony award. Everybody is happy – except the IRS.

This arrangement, if too piggish with all four feet in the trough,[9] will fall under review of the IRS, and it will impose a different tax arrangement on the substance of the transaction, overriding the form set out in the decree. Under these circumstances, the review by the IRS results in ***excess alimony recapture*** – what happens when you try to squeeze too much property into the alimony column.

Any informed discussion of the combining of alimony and property payout begins with understanding the major components – alimony payments and property division.

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[9] A phrase often used by tax practitioners. A pig farmer may tolerate a pig with one foot in the trough at feeding time, sometimes two feet. But when all four feet are in the trough, the farmer will chase the pig out so the others can have a chance to eat.

ALIMONY

IRC §71 and IRC §215 govern the tax treatment of alimony (and child support). Congress has enacted three major pieces of legislation which directly affect divorced and separated taxpayers. These are the Tax Reform Act of 1984, the Retirement Equity Act ("REA"), and the Tax Reform Act of 1986. In 1998, Congress passed the IRS Restructuring and Reform Act, which makes important changes in the "innocent spouse" rules relating to liability for unpaid taxes on joint returns.

Alimony, also named "separate maintenance" or "spousal support," must meet all of the elements of IRC §71 to be deductible to the payor and taxable to the payee. There are seven characteristics of alimony defined under IRC §71(b):

1. The payment must be in cash.[10]
2. The payment must be pursuant to a divorce or written separation instrument.[11]
3. The divorced or legally separated spouses must reside in separate households when payment is made.[12]
4. The payments to a third party on behalf of the payee spouse must be evidenced by a writing.[13]

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[10] This includes checks and money orders, received by or on behalf of a spouse or former spouse. Payments made to third-parties in satisfaction of any legal obligation of the payee spouse (such as payment of housing costs) can qualify for alimony treatment. Payment of a monthly mortgage, for example, can qualify, to the extent of the payee's legal interest in the real property. However, mortgage payments made for property owned by the payor but used by the payee are not payments on behalf of the payee and will not qualify for alimony treatment. *See* Treas. Reg. §1.71-1T(b), Q&A-6, 7.

[11] IRC §71(b)(1)(A). Qualifying divorce or separation instruments are defined by IRC §71(b)(2) to include:

(1) A decree of divorce or separate maintenance or a written instrument incident to such a decree (including writings containing marital settlement terms which are referred to but not merged in the divorce decree).

(2) A written separation agreement.

(3) A decree of support (temporary and *pendente lite* support orders).

[12] Where the payor and payee are legally separated under a decree of divorce or separate maintenance, IRC §71(b)(1)(C) requires *separate residences*. Physical separation in the same dwelling does not qualify. Note, however, that this requirement only applies to divorced or legally separated spouses. If no decree of divorce or separate maintenance has been obtained, payments made pursuant to a written separation agreement may qualify as alimony, even if the parties reside in the same dwelling. *See* Treas. Reg. §1.71-1T(b), Q&A-9.

[13] Cash payments made to third parties on behalf of a spouse under a qualifying divorce instrument may qualify for alimony treatment. This encompasses payments to third parties made pursuant to the written request, consent or ratification of the payee. The qualifying instrument or writing must declare the parties' intent that the payment be treated as alimony subject to the rules of IRC §71 and must be received by the payor spouse prior to the date of filing his or her income tax return for the taxable year in which the payment is made. *See* Treas. Reg. §1.71-1T(b), Q&A-7.

5. The liability for payment must not continue beyond the death of the payee spouse.[14]
6. The married payor and payee may not file a joint return.
7. The divorce instrument must not designate a non-alimony treatment.

As to the last point, in order to qualify for alimony treatment, payments must not be designated as payments which are non-deductible by the payor and non-includable in income by the payee. This provision gives parties the *ability to choose* whether payments will be taxable and deductible under IRC §71 and IRC §215, or non-taxable property transfers under IRC §1041. The following is an example of language which, if included in a qualifying divorce instrument, will satisfy the requirements for a non-alimony election:

> *Excludability Designation*. In accordance with IRC §71(b)(1)(B), the parties expressly agree to designate, and do designate, all payments required under marital settlement agreement sections _________ as excludable/non-deductible payments for purposes of IRC §71 and IRC §215, respectively.

PROPERTY DIVISION – PART ONE: TAX-FREE TRANSFERS

The division of property is a no-tax-impact event. No gain or loss is recognized on the transfer from a spouse to a spouse, or a former spouse, if the transfer is incident to divorce.[15]

Unlike the alimony provisions which allow an individual to elect out of the taxation of alimony, the non-recognition provisions of IRC §1041(a) are mandatory. As a result, the transfer of property is treated as a gift for income tax purposes.[16] Further, the tax basis of the property in the hands of the receiving spouse is the same as the adjusted tax basis of the property in the hands of the transferor spouse.[17] Therefore, the receiving spouse will have

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[14] IRC §71(b)(1)(D) provides that liability for payments constituting alimony must terminate on the death of the payee spouse. This section also states that there can be no requirement to make any payment in cash or property as a substitute for such pre-death payments after the payee's death. If such a requirement exists, neither the pre-death nor post-death payments will qualify as alimony. *See* Treas. Reg. §1.71-1T(b), Q&A-13.

[15] IRC §1041(a).

[16] IRC §1041(b)(1).

[17] IRC §1041(b)(2).

no depreciation recapture until the property is actually sold.[18] The holding period of property received is the same ("tacked on") as that held by the transferor spouse.[19]

IRC §1041(c) states that a transfer is incident to a divorce if it occurs within one year after the date of divorce, or is related to the cessation of marriage. Under Treas. Reg. §1.1041-1T(b), Q & A-6, if the transfer occurs ***within one year of divorce***, it need not even be pursuant to divorce in order to still receive non-recognition treatment. If a transfer occurs one year or more ***after*** divorce, it must be related to the cessation of marriage. Under the temporary regulations, a transfer will be deemed related to the cessation of marriage if:

1. It is pursuant to a divorce or separation instrument as described in IRC §71(b)(2).
2. The transfer does not occur more than six years after the date of divorce.[20]

Transfers which do not pass the two-part test described above, are rebuttably presumed to be ***not*** related to divorce, and are subject to gain or loss.

A transfer of property to a third party on behalf of a spouse, or former spouse, may qualify for non-recognition of gain or loss treatment.[21] For example, if an ex-husband agrees to transfer securities, or other appreciated property, to a creditor to satisfy a debt assumed by an ex-wife, then ex-husband recognizes no gain, but the transferee ex-wife ***would*** recognize gain upon the satisfaction of the debt on her behalf.[22]

Transfers to third parties are traps for the unwary where a spouse is redeemed and cashed out of the family corporation. In *Arnes v. U.S.*,[23] the wife's transfer of her McDonald's franchise stock to the corporation pursuant to a redemption of her community interest was not taxable to her under IRC §1041. The 9th Circuit found that the transfer of her interest to the corporation was on behalf of the husband; therefore, ***he*** was liable for the gain and resulting tax.

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[18] IRC §1245(b)(1) and §1250(d)(1).

[19] *See* IRC §1223(2).

[20] *See* Treas. Reg. §1.1041-1T(b), Q & A-7.

[21] Treas. Reg. §1.1041-1T(c), Q & A-9.

[22] A helpful "rule of thumb" approach for the practitioner is that the IRC often will allow for a ***deferral*** of paying tax on a transaction, but there is ***almost never*** an instance of ***eliminating*** tax. Thus, the focus on divorce planning needs to be directed towards the ultimate beneficiary of the deferral of tax, and that is where the eventual tax burden will almost always rest.

[23] *Arnes v. U.S.*, 981 F.2d 456, 457 (9th Cir. 1992).

Resolution of complex divorce cases requires a level of tax planning, including the impact of the basis of property and the corresponding capital gains at the eventual sale/transfer. The tax-free exchange provisions of IRC §1041 should be used to achieve net tax savings where the spouses/former spouses are in different tax brackets. The parties should consider allocating the assets with greater built-in capital gain to the spouse with the lower tax bracket.

Under *Ford v. Ford*,[24] Nevada courts are specifically permitted to consider a potential tax liability when valuing the assets – if a taxable event has occurred as a result of the divorce or distribution of property, or is certain to occur within a time frame such that the trial court may reasonably predict the tax liability. This is sometimes called the "immediate and specific tax liability" rule. If a transfer of an asset simply means that the recipient will someday have to pay taxes when an asset is liquidated, that test is not met.

PROPERTY DIVISION – PART TWO: TAX IMPACT TRANSFERS

There is an exception to the general rule: where property is transferred to trust for the benefit of a spouse or former spouse, and the liabilities assumed by the trust exceed the basis of the property transferred, then gain ***is*** recognized to the transferor spouse.[25]

IRC §1041 has no application with regard to interest components. For example, when one spouse owes the other an equalizing note as part of the divorce and the note is paid in installments, then the interest component of the note must be included in the recipient spouse's gross income, and may be deducted by the payor spouse.[26]

A transfer of an installment obligation ***directly to*** a spouse or former spouse ***does not*** require recognition of gain or loss,[27] but transfer to ***trust*** for the benefit of a spouse or former spouse ***does*** require recognition of gain or loss. Further, a transfer to a ***nonresident alien spouse***, or former spouse, requires the recognition of gain or loss.[28]

Transfers of property prior to marriage, usually in the context of a prenuptial agreement, require recognition of gain or loss. A prospective spouse will seek the transfer

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[24] *Ford v. Ford*, 105 Nev. 672, 681, 782 P.2d 1304, 1310 (1989).

[25] IRC §1041(e).

[26] *See Seymour v. Commissioner*, 109 TC 279, 284 (1997); *Gibbs v. Comm'r*, 73 TCM (CCH) 2669 (1997).

[27] *See* IRC §453B(g).

[28] IRC §1041(d).

of property after execution of the premarital agreement, but prior to the marriage. The release of marital rights by the future spouse in exchange for the transfer of appreciated or depreciated property prior to marriage under a prenuptial agreement causes a tax impact and results in the recognition of gain or loss.

EXCESS ALIMONY RECAPTURE – WHAT HAPPENS WHEN YOU TRY TO SQUEEZE TOO MUCH PROPERTY INTO THE ALIMONY COLUMN

In 1984, Congress enacted IRC §71(f) in an effort to discourage ***characterization*** of property settlements as alimony. This section of the IRC re-characterizes "excess" alimony payments as a property settlement and requires the payor spouse (Husband, in our example) to "recapture," or include in gross income, an amount equal to the amount of the alimony deduction attributable to the excess payments.[29]

The excess alimony rule operates on a three-calendar year basis.[30] Only payments made in the first and second post-separation years are subject to recapture. Payments made in the third post-separation year and in subsequent years are not subject to recapture.[31]

There are some exceptions found in IRC §71(f)(5):

1. No recapture is required if either spouse dies during the first, second, or third post-separation year, and the alimony payments cease as a result of the death.
2. No recapture is required if the payee spouse remarries during the first, second, or third post-separation year, and as a result of such remarriage, the payments cease.

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[29] *See* CINDY LYNN WOFFORD, THE FAMILY LAW REPORTER TAX GUIDE, *Tax Aspects of Divorce & Separation, A Detailed Analysis* §355:016(F) (BNA 1999).

[30] Computation of the excess payments in the first and second post-separation years is a two-step, sequential process. First, the aggregate amount of alimony payments made in the third post-separation year is compared to the aggregate amount of alimony payments made in the second post-separation year. If the payments in the second post-separation year exceed the aggregate payments in the third post-separation year by more than $15,000, the excess over $15,000 is subject to recapture in the third post-separation year. Second, the aggregate amount of alimony payments made in the first post-separation year is compared to the average of the aggregate amount of the non-excessive alimony payments made in the second post-separation year and the alimony payments made in the third post-separation year. If the payments in the first post-separation year exceed the average of the non-excessive payments in the second post-separation year plus payments in the third post-separation year by more than $15,000, the excess over $15,000 is subject to recapture in the third post-separation year.

[31] A "post-separation" year is a calendar year in which "the payor pays to the payee an alimony or separate maintenance payment." *See* Treas. Reg. §1.71-1T, A-22.

3. The recapture rules do not apply to temporary support orders made pursuant to IRC §71(b)(2)(C).
4. The recapture rules do not apply where payments fluctuate outside of the payor's control because they are a percentage or a fixed portion of income or compensation received by the payor.

While divorce practitioners are not expected to have all these rules committed to memory, it is necessary for them to identify issues when the facts present themselves – especially when "creative" solutions are being proposed – and seek the help of a tax professional, when necessary.

BONUS FEATURE – CAN I "WRITE-OFF" MY ATTORNEY'S FEES?

Most of the time – no. In general, attorney fees incurred in obtaining and litigating a divorce decree are considered to be personal expenditures, and are not deductible.[32]

There are, of course, some exceptions. So-called "IRC §212(1) expenditures," including attorney's fees incurred or paid for the production and collection of income (including alimony under IRC §71) are deductible. However, such expenses are itemized deductions on an individual income tax return, and are subject to the 2% floor for miscellaneous itemized deductions.[33] This also includes attorney's fees incurred to recover arrearages of alimony.[34]

Additionally, attorney fees incurred for receiving tax advice incident to divorce are deductible under IRC §212(3). This would include tax advice regarding the federal tax consequences of provisions of a property settlement agreement or a divorce decree.[35]

As a practice tip, in order to provide maximum value to the client, it is a good idea to clearly itemize the bills generated by the attorney and describe which tasks relate to the determination and collection of spousal support and tax advice rendered incident to a divorce.

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[32] *See* IRC §262(a); Treas. Reg. §1.262-1(b)(7); *U.S. v. Patrick*, 372 U.S. 53, 57 (1963).

[33] *See* IRC §67(a) and (b); *Hesse v. Comm'r*, 60 TC 685, 693-94 (1973).

[34] *See Dalton v. Comm'r*, 34 TC 879, 884 (1960).

[35] *See* Rev. Rul. 72-545, 1972-2 C.B.179.

VALUATION ISSUES AND METHODS
FOR
FAMILY-OWNED BUSINESSES

HOLDINGS & REMAINING ISSUES

In Nevada, it is has been well-settled for decades that goodwill is an accepted part of the value of a business for purposes of community property division.[36] Both businesses and professional practices are recognized as "property" subject to valuation and division upon divorce.[37] The Nevada Supreme Court has held that there is goodwill in a professional practice (whether or not that practice is marketable), and has approved the practice of allowing for the value of such goodwill in valuing the practice as part of the marital property.[38]

Since 1975, when Nevada switched from husband-as-managing-spouse to a mutual-management model of community property, statutory control of community property has included the restriction on the buying and selling of any business, depending upon whether one or both spouses is involved in the management of that business:

> Neither spouse may acquire, purchase, sell, convey or encumber the assets, including real property and goodwill, of a business where both spouses participate in its management without the consent of the other. If only one spouse participates in management, he may, in the ordinary course of business, acquire, purchase, sell, convey or encumber the assets, including real property and goodwill, of the business without the consent of the nonparticipating spouse.[39]

To date, the Nevada Supreme Court has not differentiated between professional and personal goodwill for purposes of valuation or division, and the Court has approved the measurement of goodwill by "any legitimate method of valuation which measures the present value of goodwill by taking into account past earnings."[40]

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[36] *See Fox v. Fox*, 84 Nev. 368, 371, 441 P.2d 678, 679 (1968) (second of three appeals between the same divorcing couple, in which Court noted restaurant goodwill was to be included in divisible value).

[37] *See Ford v. Ford*, 105 Nev. 672, 782 P.2d 1304 (1989).

[38] *Id*., 105 Nev. at 679, 782 P.2d at 1309.

[39] NRS 123.230(6).

[40] *Malmquist v. Malmquist*, 106 Nev. 231, 792 P.2d 372 (1990) (citing to *Ford*).

In the context of the family-owned business, the Nevada Supreme Court has indicated that courts should take into account the income-generation aspect of that business when allocating division of the remainder of the community estate, and deciding matters of alimony. In *Shydler v. Shydler*, 114 Nev. 192, 954 P.2d 37 (1998), the husband went into construction shortly after marriage, and began a company which by the late 1980s earned substantial profits, allowing the husband salaries of $60,000.00 to $200,000.00 per year. The wife went into business as an insurance broker, but made a maximum of $57,000.00 in 1983, while the company itself lost money, and had profits of less than $21,000.00 per year after 1986.

On appeal, the Court found it significant that, during a 17-year marriage, the husband obtained a contractor's license and built up a successful company, and so "developed the business acumen which has provided him with a thriving business and substantial assets." While the wife "had the opportunity to develop marketable skills," the Court found that her income did not and would not ever reach parity with the husband's earnings, and so reversed the trial court's denial of alimony. The Court labeled the lower court decision "unfair" where "the district court awarded [the husband] the portion of the community property which was producing an annual income in excess of $100,000, while [the wife's] share of the community property was to be dissipated in the immediate future to provide for [her] living expenses so that [the husband] would not have to pay spousal support."

The essential lesson relating to closely-held businesses is that the allocation of such an asset to one party, where the business has thrown off significant income and might be expected to continue doing so, will give rise not only to division of the actual value of the business, but also to an alimony award in favor of the other party.

The dearth of binding statutory or case authority has led to a great deal of creativity and variation in valuation practice. For example, one local business evaluator has opined the existence of a ***"five year rule"*** for law practices under which everything significant that a new lawyer is going to learn arises within the first five years of practice.[41] That evaluator therefore looks to the five year average salary (measurable by national and local standards) to set the "base salary" for valuation purpose, and interprets any money above that sum as part of the measurable goodwill.[42] This concept can be applied to other professions for measuring goodwill.

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[41] This generally refers to the "up or out" rule for law practice partnership offerings. The theory is that a new lawyer reaches a sufficient level of experience to conduct themselves in the profession in about five years, but that no measurable goodwill is developed because the associate's "grunt work" function does not include developing the client base. This can be applied in a like/kind manner for other professions with different time periods.

[42] *See also Howell, III v. Howell*, 31 Va. App. 332, 523 SE 2d 514 (2000) (measuring goodwill in a law practice).

Another emerging issue under recent review at the trial level (and not yet tested at our Supreme Court level), is dealing with the issue of the propriety of a ***minority interest discounts*** in valuation, and what this means to "fair value":

> "Fair value" is not the same as, or short-hand for, "fair market value." "Fair value" carries with it the statutory purpose that shareholders be fairly compensated, which may or may not equate with the market's judgment about the stock's value. This is particularly appropriate in the close corporation setting where there is no ready market for the shares and consequently no fair market value.
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> A closely-held corporation is one that has few shareholders and little market for the stock, or one that has an integration of ownership and management. When appraising shares of a close corporation, fair value cannot be fairly equated with the company's fair market value. Close corporations by their nature have less value to outsiders, but at the same time their value may be even greater to other shareholders who want to keep the business in the form of a close corporation.
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> The "fair value" concept is inherently inconsistent with discounting value to reflect limited marketability. That which has been labeled a "marketability discount" reflects the theoretically limited market for the sale of a privately-held, small business. That which has been labeled a "minority discount" reflects a theoretically more limited market for sale of a non-controlling interest in such a business. The significance of a limited market is that the asset is illiquid. Both discounts represent an attempt to account for the fact that unlike shares in a publicly-traded company, shares in a closely-held corporation have limited liquidity.
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> But liquidity is of little consequence . . . [where] there is no evidence of a contemplated sale of all or part of the business, forced or otherwise.[43]

Minority interest discounts become meaningless when the business continues to operate under the same ownership for the foreseeable future. Essentially, why should a minority shareholder/partner have the beneficial use of ownership without paying the spouse for its beneficial use at divorce, if there are no changes in ownership or operation?[44]

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[43] *See Brown v. Brown*, 348 NJ Super. 466, 487-488, 792 A.2d 463 (2001)(the court adopting the ALI's rationale for fair value (not fair market value), that neither the minority shareholder, majority shareholder, nor veto-wielding shareholder, can be allowed to exploit the very situation triggering a right to an appraisal, thereby capturing more than a proportionate share of the corporation's value and depriving other shareholders of their fair share).

[44]*Use of Minority Discounts in a Valuing Closely-Held Corporation or Its Stock*, 2003 ALR 5th 11 (2003WL21106574). Summary: Courts often are called upon to determine the value of closely-held corporations (sometimes called close corporations) or the stock of such corporations in a number of contexts, including dissolution and compulsory acquisition of a shareholder's stock, determination of damages to the value of a corporation, marital dissolution and property division proceedings, dissenters' rights cases, estate and gift tax determinations, and others. In each of these cases, the court must determine whether a marketability

METHODS

THE CARE AND FEEDING OF YOUR EXPERT – SUPPORT FOR THE OPINION

STEP ONE – INITIAL FACT GATHERING

Developing and managing information on a complex divorce case may be the two hardest tasks of litigation. It drives the issues and legal arguments. Unfortunately, there is no magic system or single source where you will come to "know all." Gathering the facts and placing them into some style of organization will allow you to fine tune searches, and it invites deeper questions on how the marriage worked financially. With a reasoned and diligent approach, the picture will come into focus and you will be very prepared for trial, or a well-supported settlement for your client.

The first source of information is your client, and the second source on a financially complex case should be the accountant. There may be several financial players on the field, but at the end of the day there is almost always just one person that is "most knowledgeable" about the finances. The paperwork path eventually will lead you to him.

We lay out the core information of the case in the format set out in the Appendix, entitled *Case Status and Plan*, after the initial client interview. By reviewing each subsection and making a decision on action, the basic parameters of the discovery search are established. There are no shortcuts to developing this information, and forcing yourself to sit down to fully analyze the case, however time consuming, will greatly assist you in the long haul of preparing for trial. The memorandum is an *active document* which is modified *every time* a new fact or event is uncovered. It is likely that many of the sections will be blank after your first pass, but do not become alarmed. The idea is to develop the information and then restate it in terms of the major issues of the case.

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discount should be applied in fixing the corporation's (or its stock's) value to reflect the lack of liquidity of an investment in a close corporation as a consequence of the inherently small market for close corporation's stock. In *Brown v. Brown, 348 N.J. Super. 466, 792 A.2d 463 (App. Div. 2002),* opinion corrected, (June 11, 2002) and certification denied, *174 N.J. 193, 803 A.2d 1164 (2002),* the court held that it was improper to apply a marketability discount in valuing the stock of a close corporation for purposes of establishing an equitable distribution of property in a divorce proceeding. This annotation collects and analyzes all federal and state cases applying or declining to apply a marketability discount in the valuation of close corporations or the stock of close corporations.

STEP TWO - THE GENERAL DISCOVERY REQUEST

The next step in the case is to make a broad sweep for information at the *Early Case Conference*, which in Nevada, falls under NRCP 16.1. The standardized general requests we use are available at request, but as these are "broad initial strokes," we do not include all of these in the course materials, just some, and are listed below in the Appendix. The responses from your opponents will drive the next level of the case – the specific pursuit of discovery. At the Early Case Conference, it is very important to obtain a commitment as to where the records are stored, who may be the custodian of the records, and the best way to reach that person, even though you may have been provided some of the documentation.[45] The idea is to obtain some level of assurance that the information provided is complete and accurate – an audit.

STEP THREE - GETTING SPECIFIC

Assume you represent Plaintiff Wife. It is a long term marriage with adult children. Defendant Husband is a sole practitioner criminal defense lawyer sharing office space. He has a cash business and claims to have almost no records retention. He has a significant gambling problem. As a result of his addiction, the retirement and life insurance plans have been raided, but some funds still exist. He has had a variety of small business investments over the years, all of which are now inactive. The only significant investment was partial ownership in a bar with slot machines with notes still owing to the Defendant. Wife is woefully ignorant of the financial situation and is calling your office nonstop. There are more assets than the average wage earner, and the ability of Husband to earn is quite high.

The *First Request for Production of Documents* narrows the general requests mentioned above in the hopes of finding hidden assets, other going concerns in various stages of operation, retirement accounts, etc., as well as providing the business valuator with sufficient information to perform his expert witness tasks. Listed in the Appendix are detailed requests for *Business Valuation*, the *Bar with Gaming*, and *Individual Gaming Activity*.

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[45] As a practice tip, an evading opponent will try to substitute volume of paper in lieu of the production of real information, and then argue "We produced X number of pages . . . " at the discovery sanctions hearing. It is important to review the items received promptly, and if you are unclear as to its value, work with your business valuation expert to determine how to follow up.

STEP FOUR - WHAT'S NEXT?

When representing the financially disadvantaged party, the attorney must follow every "branch of the tree" to its end, and then try to narrow the scope of case, either through discovery sanctions, third party recovery of documents, or sworn commitments from the opponent (which would set up post divorce recovery should any assets later "magically appear"). Given the assumptions made for the problem assumptions stated in *Step Three*, you can expect stall tactics, including claims of privilege, lack of available records, harassment, and overburdensome requests.

It is important to calendar due dates for discovery, and then diligently apply for sanctions. Depending on the timing for trial, you may want to concurrently send *subpoena duces tecum* to the appropriate sources of financial data. Additionally, depositions of key witnesses and the "most knowledgeable person" accountant (preferably at his office where the records are located) will map out the complex financial arena. The participation of the Plaintiff's business valuator, or a reliable accountant, at the deposition is vital to trying to decipher and collate all of the information obtained.

An option available on the cases with little accessible paperwork, leaving no real option for litigation other than "he said, she said," is an affidavit from the Defendant which commits him to a course of action. Once obtained and filed with the court, the Plaintiff Wife is set for post-divorce litigation for omitted assets, if and when assets start to appear once the "eyes of the Court" are off the Defendant. See Appendix for an example of such an affidavit.

STEP FIVE - WHAT IF ASSETS ARE MISSED?

If you follow your case diligently and work your way through problems in an organized fashion, with the invaluable help of the business valuator, hidden assets will be brought to light. However, there are instances when clever opposing parties can evade releasing information. If an asset later appears and can be traced to the community, post-divorce action is an option for recovery.

Our state law on this point is a bit confused. For the past 12 years, in an unbroken chain of cases since *Amie v. Amie*, 106 Nev. 541, 796 P.2d 233 (1990), the Nevada Supreme Court has ruled that any community property not specifically disposed of by a decree remains owned by the parties as tenants in common, leaving it subject to partition by way of later motion or action. But the Court never overruled (or later acknowledged) its decisions to the contrary in a pair of military cases in the late 1980s. *See Tomlinson v. Tomlinson*, 102 Nev. 652, 729 P.2d 1363 (1986) and *Taylor v. Taylor*, 105 Nev. 384, 775 P.2d 703 (1989).

Decrees should reflect the lawyers' choice of evils. If it is thought that there is a greater risk that the other side might be hiding some property than a fear that the other side might litigate truly trivial property matters for the purpose of harassment, then a clause specifically permitting an *Amie* action should be inserted. If the fear of baseless litigation is greater, than an anti-*Amie* clause (prohibiting later litigation, and stating that whoever gets possession of unmentioned property keeps it) should probably be used.

OPTIONS FOR DISTRIBUTION OF THE VALUE

We have found no magic solution that fits all cases. The needs of the clients must to be factored into the payout of value. For example, a less sophisticated client with some health overlays may benefit from an annuity styled payout. Others might have a support system to help invest a lump sum payout. Also, the strength of the business must be evaluated. The valuation might support a large number for division, yet if the business is operating on a marginal cash flow, the only viable option may be periodic payments. Below are some of the resolution options we have encountered, and some comments on each:

1. FULL CASH OUT

This option is the easiest for the courts to apply. The value is ascertained, and the division follows according to the division fraction, taking into account the separate property portion of the asset. As practitioners, the sole concern is delivery by a date certain.

We are informed of one recent deal, unrelated to our firm, where the offer is stated as the guarantee of price for the payout at a date certain in the future (several years in the future for a sizable sum). On its face, this option violates the "one year rule" for tax free exchanges under IRC §1041(c), mentioned above. However, the practitioner can seek approval from the IRS for the deal in a letter request. The methodology for this is fairly simple, but beyond the scope of this course. We refer you to your tax specialist for specific guidance.

2. PERIODIC PAYMENTS WITH INTEREST COMPONENT

If for any reason full payment cannot be made, then periodic payments can be arranged. Of course the time value of money becomes a factor, and a rate of interest must be applied. Further, the pledge of assets (internal or external to the business), life insurance, bankruptcy provisions, etc., can be used to reduce the risk of non-payment.

As mentioned above, the alimony recapture problems arise if there is no clear distinction between the property pay out and the alimony payments. We note that there are some tax planning options/break-even points you can develop with your tax specialist to reduce the term of the asset payout with a combination of alimony. To figure this, your tax specialist will have to calculate the alimony recapture numbers against the projected "front end" payment and the alimony provisions.

3. SHARES OF STOCK WITH RESTRICTIONS FOR "CALL" AT A PRICE CERTAIN, BUT NO OPERATIONAL VOTING

Related to the securing of an interest during the pendency of the payout, depending upon the business form, it is possible for the obligor to create a restricted share of stock providing actual ownership in the business to the receiving spouse. Although most contract terms could be inserted, the few meaningful terms which are likely to be considered are: preferred stock ownership (no operational voting rights as in common stock), restrictions on transfer to third parties or a right of first refusal, and a "call" at a price certain.

4. USE OF A TRUST

Although we have never encountered this in actual practice, it is possible to place the business into a trust document, and detail the ownership terms, definitions of profit and payments, and insert all operational guidelines.

5. DIVISION IN KIND IF PARTIES HAVE EQUAL FOOTING IN THE BUSINESS

Little needs to be said on this point as it is only viable if there are more than one business location and both parties have contributed to the going concern with equal skills, for example, two or more small retail locations. The differential measure then becomes "which" locations and their respective profit generation capacities.

APPENDIX

SAMPLE DISCOVERY REQUESTS FOR THE STEPS MENTIONED IN THE MATERIALS.

STEP ONE – INITIAL FACT GATHERING

CASE STATUS AND PLAN

PURPOSE OF MEMO:

Develop strategy and trial preparation to carry case to conclusion.

our theory of the case
our litigation goals
opposing counsel's goals from 16.1 meeting
client goals
contact information

BRIEF HISTORY OF MARRIAGE:

The chronological history of the marriage, including premarriage cohabitation and significant financial and social events, year by year of the relationship.

BASIC LEGAL ISSUES:

The issues before the Court from the *Complaint, Answer* and *Motions*.

temporary spousal and child support, exclusive possession of certain items
divorce or separate maintenance
minor children - custody and visitation, child support, medical insurance
life insurance
division of property (non retirement account)- valuation issues, appraisals
retirement accounts
division of debt
alimony

SPECIAL ISSUES:

community waste
hidden assets
marital torts
business valuation

CURRENT CASE STATUS:

The most recent filings and the communications with opposing counsel.

PROCEDURAL HISTORY:

DISCOVERY:

Scope and litigation budget.

witnesses and experts
requests for production of documents
interrogatories
requests for admissions
depositions
subpoena duces tecum

SCHEDULING ORDER:

Note the difference between Discovery Commissioner and Court orders.

discovery deadlines
trial dates
internal calendaring

RETIREMENT ACCOUNTS:

Information on both husband and wife:

date of birth
SSN
date of marriage
beginning and ending dates of employment and any variations in employment
employer and plan information

TRIAL EXHIBITS TO BE PREPARED:

time lines
posters

WHAT STILL NEEDS TO BE DONE AS OF TODAY:

The "to do" list.

STEP TWO - THE GENERAL DISCOVERY REQUEST

The following assumes you represent the Plaintiff, and only those items going towards business valuation are included:

Tax Returns

1. Defendant's tax returns, whether filed jointly or individually for the past 5 years, inclusive of all schedules, and copies of all records of membership or contributions to any charity, or any other organization or association including private and professional clubs or associations, and the amount of dues or contributions to such organizations for the 4 most recent calendar years, and the present calendar year to date.

2. All Form W-2, Form K-1, schedules, or other type of document, evidencing any sort of income with relation to Defendant's work in the last 5 years. Copies of federal and/or state income tax returns and any communications

regarding tax returns from the Internal Revenue Service or state tax department for the 5 most recent tax years, and the current tax year to date.

3. All tax returns for partnerships or business entities in which Defendant participates and which are direct references for individual partnership tax returns.

Corporate or Partnership Records

4. Copies of the federal income tax returns of any corporation or partnership in which the Defendant has a financial interest for the 5 most recent fiscal years, and the current fiscal year to date.

5. Copies of the balance sheets and profit and loss statements of any corporation in which the Defendant has a financial interest for the 5 most recent fiscal years, and the current fiscal year to date.

6. Copies of any written employment contracts into which the Defendant has entered for the 5 most recent calendar years, and the present calendar year to date.

7. The names of all partners and/or directors with which Defendant participates as a partner, or a shareholder, with sufficient information to permit service of a subpoena.

Work Schedules

8. Copies of all office hour schedules for the past 12 months, or the identity of the custodian of such records, with sufficient information to permit service of a subpoena.

Resume

9. Any resumes or curriculum vitae prepared during the 5 most recent calendar years including the present calendar year to date.

STEP THREE - GETTING SPECIFIC

Business Valuation

1. Documents relating to the valuation of the law practice.

2. The name and address of each law practice in which the Defendant has an ownership interest.

3. With regard to each such practice please provide the following:
    (a) Copy of all organizational documents, such as, Articles of Incorporation or Partnership agreement.

(b) A list of the names, addresses and social security numbers of all persons having an ownership interest in said practice, and the percentage ownership interest of each owner as of 12/31/__.
(c) If any ownership interest in said practice has been sold in the last three years, provide complete details of the terms, price and conditions of sale, and copies of all documents relating to said sale.
(d) Copies of Form W-2 prepared by the practice for each employee for the past 5 years.
(e) Copies of Form 1099 prepared by the practice for any person who received $4,000 or more in any 12 month period from the firm for the past 5 years.
(f) Copies of any year end financial statements prepared for any purpose for the past 5 years; and copies of any interim financial statements prepared for the purpose of obtaining a loan, credit rating or a license to do business during that period.

4. Copies of all personal financial statements prepared for Defendant for the past 5 years, including interim financial statements prepared for the purpose of obtaining a loan, credit line or credit rating for the past five years.

5. A list of all credit and debit cards held at any time in the past five years in the name of the Defendant, and a list of all credit cards held in the name of any business or any other person in which the cards could be used by the Defendant during that period, and copies of the monthly statements and year end account summaries for each such card.

6. A copy of each pension, profit-sharing, 401(k), IRA, disability, health insurance, and any other employee benefit plans for the benefit of Defendant which have been in force at any time between 1/1/__ and today.

7. Copies of the last 5 years of federal and state income tax returns filed by any business in which Defendant had an ownership interest at any time between 1/1/__ and 12/31/__. If the business has been sold or otherwise disposed of, during that period, then copies of said tax returns for the period beginning on 1/1/__ through to the date of sale or other disposition.

8. Copies of any state or federal reports generated by audits of any tax return described in this request.

9. Copies of generally accepted accounting principle (“GAAP”) and federal income tax (“FIT”) depreciation schedules for the businesses and for the time periods described above.

10. A copy of the accounts receivable, and payment history for same, for every law practice in which Defendant has an interest in said accounts as of 12/31/__, and a statement showing the percentage of ownership of

Defendant in said accounts - if said percentage is different from his ownership interest in said law practice.

11. Copies of accounts payable as of 12/31/__ for each law firm in which Defendant had an interest at that date.

12. Copies of all malpractice insurance policies covering Defendant and/or his professional practice as of 12/31/__.

13. A list of any malpractice actions pending against Defendant as of 12/31/__, and a thumbnail description of the nature of each action.

14. Produce copies of any and all health, life and disability policies owned by Defendant either personally or through employment. Including information regarding beneficiaries to each policy and sufficient information to permit service of a subpoena.

15. Copies of all pages of Defendant's passport.

16. Produce any and all records and/or any receipts Defendant has for any gifts, trips, expenses paid, etc., by the Defendant for the benefit of a third party.

17. Identify and list all items located in the Defendant's professional office(s) valued more than two hundred and fifty dollars ($250.00).

18. Produce copies of all employment agreements, partnership agreements, shareholders agreements, buy-sell agreements, management agreements and income distribution agreements in use in any of the businesses.

Bar with Gaming

19. Produce copies of any and all documents related to the sale of the entity known as the gaming establishment name here and a complete writing and documentation of the disposition of the proceeds of the gaming establishment name here sale. In addition please produce the following in regards to the business:
    (a) All documentation relating to income and expenses since the date of its inception.
    (b) All tax returns, or schedules prepared for this business since its inception.
    (c) All sales documentation and contracts relating to the purchase and sale of this business.
    (d) Any and all bank statements and financial statements including, but not limited to, general ledgers, accounts receivable, accounts payable, profit and loss statements, and balance sheets since the inception of the business.

(e) All documentation regarding any payments received regarding the sale of this business either by you or any other person associated with the business.

(f) All documentation pertaining to the State of Nevada Gaming Control Board ("GCB") application, including attachments and supplements, associated with this business.

20. Produce copies of gaming establishment name here tax returns and all supporting exhibits and attachments and schedules submitted therewith, to include copies of all Form W-2 with relation to Defendant's employment, all documents and records submitted to, prepared for, or reviewed by the IRS concerning tax returns or any audit conducted by the IRS of any income tax returns of the Defendant since date.

Individual Gambling Activity

21. Produce copies of all IRS Form 1099 and Form W2G statements reflecting any and all monies claimed by Defendant for gaming winnings for the past 5 years.

22. Produce copies of any and all gaming markers, credit lines, hotel credit reports and play activity reports from each hotel showing any and all amounts advanced, repaid, and/or any outstanding balances or any other transactions conducted by Defendant for the past 5 years, including the legal name and address of same, with sufficient information to permit service of a subpoena.

23. Produce copies of any and all statements, reports, memoranda, and/or documents related to any and all slot clubs or promotions in which Defendant participated in for the past 5 years, including the legal name and address of same, with sufficient information to permit service of a subpoena.

24. Produce membership applications made to all casinos in the past 5 years.

25. Produce copies of all player club membership cards and/or slot play cards obtained from each casino in the past 5 years.

26. Produce a copy of all rules and regulations provided to you by casinos issuing its benefits of membership and/or special privileges, i.e., markers, lines of credit, and "comps" (free meals and/or rooms) at the local or related casino properties.

STEP FOUR - WHAT'S NEXT?

Defendant Husband, first being duly sworn, deposes and says:

1. I am the Defendant in the above captioned matter and in response to the inquiry before the Discovery Commissioner on _______________, I submit the following responses.

2. The only personal financial statement created and that exists for me is that one dated December 31, ____. There are no other documents of this nature.

3. My law practice, similar to others that focus on criminal law, is on a cash basis. There are no account receivables or ledgers for such. Some clients pay in installments, but in ______ years of practice, this has only occurred two or three times.

4. The tax filings for gaming establishment name here, were prepared by ___________, CPA, and are stored at that location on his records retention schedule. I do not have any of those records in my possession or control, including those relating to the capital gains or capital losses.

5. All other documents for gaming establishment name here which are stored in the warehouse are limited to the voluminous daily restaurant receipts and daily logs for gaming machines. All of this information is summarized and stated on the tax returns.

6. The debt to ________________ is not a gambling marker, but a promissory note.

7. I have no documentation for any gifts, trips, expenses paid, etc., for the benefit of a third party.

8. The artwork in my office, specifically the two paintings by ________, are fake. I had them examined and was given that expert opinion by two individuals. I have no documentation relating to these paintings. There are no other works of art, other than ordinary decorations, in my law office.

9. I throw out or destroy all of my check registers once my taxes are filed, and accordingly, I have no such documentation prior to ____.

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