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# For What It's Worth

Winter 2007

## Greetings everyone,

We are well on our way to making the best of 2007. We are excited to announce that we have made an addition to the CBIZ team. Steve McBride CDFA has joined our practice and we are excited about the contribution Steve will make in serving our clients. Steve brings a well rounded expertise to our practice and will help us grow over the next year.

For those that don't know, a CDFA is a Certified Divorce Financial Analyst. The credential is given by the Institute of Certified Divorce Financial Analysts (IDFA). The IDFA is dedicated to the certification, education, and promotion of the use of financial professionals in the divorce arena.

In this newsletter we've included an article on how to avoid some of the pitfalls when drafting buy-sell agreements; an article on how financial specialists can be of assistance in a wide range of marital dissolution cases; a Tax Tip related to the division of assets in marital dissolution cases; and finally, a short article on a maintenance issue which is sometimes overlooked.

As always, I hope all of you are doing well. Please give us a ring if you'd like to get to know us: we'll buy lunch. If you'd like to sign up for additional copies of our newsletter, receive it by email, or opt-out of receiving it, please email [lvsnews@cbiz.com](mailto:lvsnews@cbiz.com).

Kind regards,  
Eric Six, CPA/ABV

## The Substitute Maintenance Trap

IRC Section 71 requires that for payments to be considered maintenance for tax purposes, they must satisfy all of the following:

1. payments must be made in cash, or by check or money order;
2. there must be a written court order or separation agreement;
3. the couple has not agreed that the payments will not receive alimony tax treatment (i.e. one spouse cannot deduct alimony from gross income if the other is not claiming the payment as taxable income);
4. they may not be residing in the same household;
5. they may not file a joint tax return;
6. there can be no obligation to make payments with respect to any period after the death of the recipient, nor can the payor be obligated to make any payment in cash or property as a substitute for any cash payments after the death of the recipient; and,
7. no portion may be considered child support.

A common practice for larger less liquid marital estates is to include a note in the property settlement from one party to the other. Some attorneys suggest treating the interest payment on the note as maintenance. This creates a maintenance tax deduction for the payor as opposed to non deductible personal interest. Payee would be liable for income tax on the interest/maintenance being received, so they are not at a tax disadvantage to accept this agreement.

It is important to note that one of the requirements is that maintenance discontinue at death. As such, the attorney would correctly structure the maintenance to discontinue at the death of the payee. This leaves the payee's estate with a note that doesn't include interest. Some attorneys may attempt to write the note to have the interest "start" upon the death of the payee. While this seems like a reasonable solution, the problem is that this could be seen as a "substitute" payment

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(Item 6 above). This might leave the parties with the unenviable position of having to defend the reported tax treatment of the “quasi-interest” maintenance during the life of the payee. It is possible that none of those payments would be treated as maintenance if it is determined that the new interest is a substitute payment at death.

## The Role of Financial Specialists in Marital Dissolution Cases

Those of us working in marital dissolution recognize that it is an emotional event, many times fueled by the financial issues. We often see clients who are struggling with the financial aspects of settlement negotiations. This makes it difficult for their attorney to move the case forward. The client could be struggling with:

- Understanding the financial implications of an independent life;
- The prospect of losing much of their retirement fund;
- The realization that they will have to pay maintenance and child support for an indeterminate number of years;
- The idea of selling or refinancing the family home;
- Having to value a business in which one or both of the parties have an ownership interest; and, or
- Determining whether all the assets are being disclosed and whether they are marital or separate.

The attorney’s role of strategist, counselor and legal advisor can be hindered if the financial aspects of the situation are not handled professionally, efficiently, tactfully and with empathy.

CPAs, Certified Divorce Financial Analysts (CDFAs) and other divorce financial specialists are trained and experienced in providing attorneys and their clients with appropriate levels of financial support and expertise. This is true for both large marital estate situations and for families with more modest financial circumstances. The CPA/C DFA can serve as a **consultant** to the attorney or as an **expert witness**. As a **consultant**, the engagement is commonly focused on developing information that will be used by the attorney during settlement negotiations, and typically, the CPA/C DFA would not be expected to testify and workpapers and reports may be subject to attorney-client privilege. When engaged as an **expert witness**, the CPA/C DFA will often have to provide deposition and courtroom testimony. The workpapers and reports relating to the divorce engagement are then subject to discovery by the other side.

Another role that has emerged in the last few years is when the financial specialist acts as a **joint expert** to

not only provide financial expertise to the parties and their attorneys, but also to assist them in arriving at a settlement agreement. In collaborative cases, financial specialists agree to be independent and neutral advisors to both parties and to the collaborative process.

In a similar vein, mediators call upon financial specialists to assist them and their *pro se* or represented clients with financial issues. The financial specialist might assist one of the parties as an advisor or act as a neutral joint expert to provide financial support and expertise to the mediation process. The analyses provided can include net cash flow forecasts; valuations of business interests, trusts, options and pensions; tax advice; or forensic examinations of income or assets.

### Tax Tip: Don’t forget the basis!

Marital assets are usually divided between divorcing spouses based on their fair market values. Under IRC Section 1041 marital property transfers are generally treated as gifts with carryover basis.

What is often missed when dividing assets is the tax basis and other tax attributes. For example, let’s assume that a divorcing couple own common stock in two companies and that each investment is currently worth \$20,000.

Let’s then assume that the tax basis for each is different: that the husband is awarded the stock with a tax basis of \$18,000 and the wife is awarded the other investment with a tax basis of \$2,000. The distribution would look like:

	Husband	Wife
Fair market value	\$20,000	\$20,000
Tax basis	\$18,000	\$2,000
Taxable gain in the event of sale	\$2,000	\$18,000

Thus, the husband’s award is worth more than the wife’s because he will only have to pay tax on a gain of \$2,000 while the wife will have to pay tax on \$18,000 (assuming they sold the stocks immediately). One would also have to consider the holding period in order to determine if the gains would be considered capital gains.

Tip: Ensure that you find out what the taxable basis of each asset is before agreeing to a division of assets.

## **Bullet-proofing a Buy-Sell: Problem Areas to Address Before Signing the Agreement**

Many parties negotiate a buy-sell agreement under the assumption that the “other guy will go first.” Whether naïve or optimistic, the premise can prove true for only one of them, and a triggering event such as death, divorce, shareholder dissent, or other departure can expose parties to a buy-sell agreement to a multiplicity of problems.

A better tactic would be to identify the concerns of the parties at the outset while their interests are still aligned. Even better would be to engage a valuation appraiser during the negotiation of the buy-sell to propose “up-front” solutions to the problems that are likely to arise and to ensure that the agreement addresses both the amount and liquidity of the transferred shares. Although some clients may balk at the additional professional fees, these are minimal compared with the expensive—and extensive—litigation that can ensue from a poorly drafted or incomplete buy-sell agreement.

### **Most common pitfalls**

Often, it's less important how clients resolve certain valuation issues, as long as their buy-sell agreements are clear and unambiguous and reflect the parties' intent. A business appraiser can help resolve the “how,” while the following checklist will help the parties as well as their attorneys and accountants identify the most troubling issues associated with buy-sell agreements:

- *Standard of value.* A buy-sell agreement must clearly specify the standard of value. Some agreements simply mention “the value” of the company or interest: Does this mean fair market value, fair value, or some other standard? Each of these terms denotes a significantly different interpretation. If the agreement is not clear, the parties will have to try to agree on a standard of value upon a triggering event, long after their interests have diverged.
- *Book value.* One of the biggest problems is using the book value standard, as this often does not compensate the withdrawing or deceased shareholder for the value of intangible assets, for example, or contingent liabilities not reflected on the balance sheet. An inference that the book value of the shares equals their fair market value may depend on unwarranted or unreasonable assumptions, which may not account for changed conditions from the negotiation of the buy-sell to its triggering event.

- *Goodwill.* The agreement should also specifically address whether goodwill stays with the remaining shareholders.
- *Level of value.* Values can range from a controlling interest in a company to a nonvoting or nonmarketable minority interest to an illiquid, minority interest. Different assumptions apply to each level, such as the application of discounts or control premiums. If possible, buy-sell provisions should clearly identify which, if any, discounts and/or premiums apply.
- *Valuation date.* The “as of” date clearly identifies when the appraiser should value the interest and grounds the appraisal in such relevant and time-sensitive factors as the company's financial performance, the local and national economic conditions, etc.. The “as of” date could be the triggering event, the last fiscal year, an annual ESOP appraisal, or some other date or event.
- *Appraisal/arbitration process.* This is a key provision, defining the rights of each party to obtain an appraisal, and involving a single arbitrator/appraiser or a panel of two or three appraisers. The agreement must decide when the arbitrator(s) will be chosen—at the start of the engagement (preferable) or after a dispute has arisen; and who will choose the appraiser(s). A “shotgun” approach permits one party to provide the value, the other party to choose the share. Rights of first refusal can also provide a sanity check.
- *Appraiser qualifications.* Some buy-sell agreements identify a specific appraiser or list of appraisal firms; others address the credentials and specific qualifications of the appraiser, such as practice scope, industry expertise, education, and training. Without these, a real estate appraiser or general accountant could qualify. Provisions can also identify specific appraisal standards of various professional societies or the IRS.
- *Payment provisions.* How will the agreed-upon value be provided to the departing or deceased shareholder? Can the company afford the price? What funding mechanism will be used?
- *Miscellaneous.* Additional provisions can address time limits for each step of the appraisal, provisions to break deadlocks, alternative dispute mechanisms, and third party involvement. Some buy-sell agreements even provide for psychological or “family” counseling to reduce conflict and ease the transition.

**The CBIZ Litigation and Valuation Services group has been practicing in the Denver area since 1988. Our specialized expertise includes:**

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- Asset Tracing
- Business Valuation
- Tax Aspects of Divorce
- Lifestyle Analysis
- Gross Income Analysis
- Professional Practice Valuation
- Mediation

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- Business Interruption
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- Intellectual Property Disputes
- Wrongful Termination
- Wrongful Death
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**Business Valuation**

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- Shareholder Disputes and Dissention Actions
- Estate Planning
- Election of Subchapter S Status
- Mergers and Acquisitions
- Buy/Sell Agreements
- Partnership Dissolutions
- Stock-Related Employee Benefits
- Purchase Price Allocations
- Goodwill/Intangible Impairment Testing



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