

## Idea of the Month — Owner Divorce

### ***Bitter Divorce: Husband Sues for Half of Wife's Business Ownership***

*The company:* Manufacturer of relays, switches, and other components for the telephone and cable industries. Revenues of \$9 million, profits of \$585,000, and net book value (stockholders' equity) of \$3.8 million.

*Situation:* A bitter divorce with financial discussions extending to the wife's ownership in a closely held business. Her 60,000 shares of stock, which represented about 8% of this New York company, had been inherited from her father who had founded the company in 1948.

*Court order:* The stock must be independently valued and the husband is to receive cash equal to the fair market value of 30,000 shares (50% of her 60,000 shares) *less* an appropriate discount for a minority ownership interest.

The valuation was simplified by the fact that the wife gifted some shares to her two children in a previous year and filed a gift tax return at the time, which indicated a value of \$12 per share, more than double the \$5 per share being offered by her lawyer. However, in reviewing the woman's "penciled" valuation notes, the judge noted that she did not provide for a minority discount on the gifted shares for lack of control, nonpayment of dividends, and a **minority** owner's inability to sell the shares in the public market (the company was still privately held).

The \$12 per-share value was acceptable to her husband for purposes of the divorce settlement. The question was the discount to apply to his minority ownership position of 4% (half of her 8%). The Valuation Opinion, prepared by an independent appraiser, set the **discount at 25%** (\$3 per share) which was accepted by the court. *Result:* The husband received \$270,000, 30,000 shares times the \$9 value (\$12 less \$3 discount). The judge stipulated that the amount could be paid quarterly over five years at 8% interest from the date of the formal divorce decree.

**There's a big lesson here!** In valuations "*...all relevant data must be considered*"...in accordance with Internal Revenue Ruling 59-60. So be very

careful; any time you, as a majority or minority business owner, **specify** a value for your ownership position, it can be used against you. This can happen when gifting stock to family members (as in this case), granting stock options to key executives, or even when indicating a high company value on a personal financial statement submitted as part of a loan application. A high value also can be a problem for your heirs, who may be confronted with that value if your estate tax return is audited by the IRS. (*Editor's note:* That audit also could include a review of the values indicated on prior gift tax returns or even gifts made when no tax returns were required to be filed.)

### **Conversion of Gift Value to Value of the Company**

Since this woman owned 60,000 shares of stock valued at \$12 per share — \$720,000 total — the value placed on the company before the 25% discount is computed as follows:

$$\begin{array}{rcl} \frac{\text{Value of Stock Holdings}}{\text{Percent Ownership}} & = & \text{Value of Business} \\ \\ \frac{\$720,000}{8\% (0.08)} & = & \$9,000,000 \end{array}$$

Based on last year's profits of \$585,000, the \$9 million value represents a price-earning's multiple of 15.4. In terms of the company's stockholders' equity account of \$3.8 million, the \$9 million value is 2.4 times that amount. Both valuation methods/computations are reasonable and thus the \$12 price is a fair price to place on the husband's 30,000 shares of stock. □