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## Purchase Price Allocations

When the assets of a going concern are sold to a single buyer, the buyer and seller generally must allocate the purchase price among the tangible and intangible assets that are being sold. If you are the seller, you will want to allocate as much of the purchase price as possible to assets that yield capital gains, rather than ordinary income. If, on the other hand, you are the buyer, you will want to allocate as much of the purchase price as possible to assets that either can be currently deducted or that can be written off quickly.

These tensions are at play in all business asset sales, but they vary with changes in the parties' circumstances and in the tax laws. If you plan to sell the assets of your business, or are engaged in purchasing a business, we want to give you an overview of how the allocation process required by the Internal Revenue Code works.

The mandated method is called the "residual allocation method," which has a hierarchy of seven categories:

- Class I assets: These are cash, and cash equivalents, such as demand bank accounts.

- Class II assets: These are items such as certificates of deposit, government securities, and other readily marketable securities.
- Class III assets: These are market-to-market assets such as accounts receivable and certain debt instruments.
- Class IV assets: These are stocks in trade and inventory.
- Class V assets: These consist of all assets other than Class I, II, III, IV, VI and VII assets. This includes furniture, fixtures, land, buildings, equipment and machinery.

*continued*



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that the "valuation of securities is, in essence, a prophesy as to the future and must be based on facts available at the required date of appraisal." In order to determine the expected future benefits, the appraiser will utilize past financial performances and other assumptions, including future growth, risk, and the required rate of return.

The standard of value for valuation in a divorce may vary depending upon the statute and the case law of the particular jurisdiction. In most jurisdictions the standard of value is fair market value which is defined as:

The price at which the ownership interest would change hands in an arm's-length transaction between a willing buyer and willing seller neither being under any compulsion to buy or sell, each having reasonable knowledge of the relevant facts (*U.S. v. Cartwright*, 411 US 546 (1973); Reg § 20.2031-1(b); Reg § 25.2512-1; Rev Rul 59-60, 1959-1 CB 237).

The premise of value that might be used is going concern value or liquidation value. Going concern value views the firm's assets as being a greater value in the sum compared to a combination of its parts. The going concern value of the firm is often an underlying assumption in business valuations. Liquidation value sets the minimum for a value of a business since a business cannot be worth less than its liquidation value. By valuing a business using liquidation value, the appraiser assumes the firm's operations are to cease and the assets are to be sold either piecemeal or in groups with the obligations of the business to be settled with the proceeds of the sale.

In a divorce, when there are marital assets that are difficult to value, a qualified appraiser should be utilized for both spouses to receive a fair and equitable distribution of the parties' assets and liabilities.



- Class VI: These are all Section 197 intangibles other than goodwill and going concern value. This class includes business books or records, patents, formulas, licenses, covenants not to compete, workforce in place, customer- and supplier-based intangibles, franchise, trademarks, trade names, etc.

- Class VII: Section 197 intangibles in the nature of goodwill and going concern value.

Section 197, of course, allows for the asset purchased to be amortized and deducted over a 15-year period.

Allocations are made first to the top category of assets, then to the second, and third. Whatever is left unallocated automatically is allocated to intangible assets in the nature of goodwill and going concern value.

Buyers and sellers will try to the extent possible to make allocations that serve their own tax interests. While no asset can receive an allocation greater than its fair market value, that value cannot always be determined with mathematical precision, so there often is some room to maneuver. The buyer and seller, however, both must use whatever allocation they finally agree to.

Until 1993, sellers wanted to allocate as much as possible to goodwill and going concern value, because it gave them capital gain. Buyers hated allocations to these assets, because they couldn't be written off. Now, however, they can be written off over 15 years per Section 197.

Many other purchased intangible assets, such as covenants not to compete, that buyers used to write off over their terms, now can't be written off over less than 15 years. So buyers may want to enter into consulting agreements to shift some allocation away from the covenant not to compete and to get more immediate tax benefit from their expenditures. Although covenants not to compete and consulting fees both are taxable as ordinary income, sellers have to remember that consulting agreements generally will require them to perform services, while covenants not to compete do not.

We hope this overview of the allocation requirements is helpful to you in your negotiations. If you need additional advice on this complex subject, please call for an appointment.



## The Legal Concept of an Expert Witness

The federal and state courts rely on valuation experts to supply testimony in matters dealing with the complexities of business valuation theory and techniques. What does the court expect from this Expert Witness?

The elementary expectation is professional competence expressed in the form of experience and communication skills. The expert must have the academic and work experience qualifications to render an opinion on the specific valuation matters at hand in the particular case. He must then be able to communicate this opinion both verbally—deposition and testimony—and in writing a report.

The premise is that the expert's testimony and report is both "relevant" and "reliable." The relevancy of a testimony refers to whether or not the expert's evidence "fit" the facts of the case. The reliability is expressed in the use of the scientific method to support conclusions and opinions. The scientific method contains these factors:

- Has the expert's theory and technique been tested? Does empirical data exist to support or refute the work?
- Does peer review and publication subject the work to appropriate scrutiny and discussion?
- Does the method have a "known or potential error rate?" Are there standards controlling the technique's operations?
- Has the theory and technique been generally accepted within the relevant professional or scientific community?

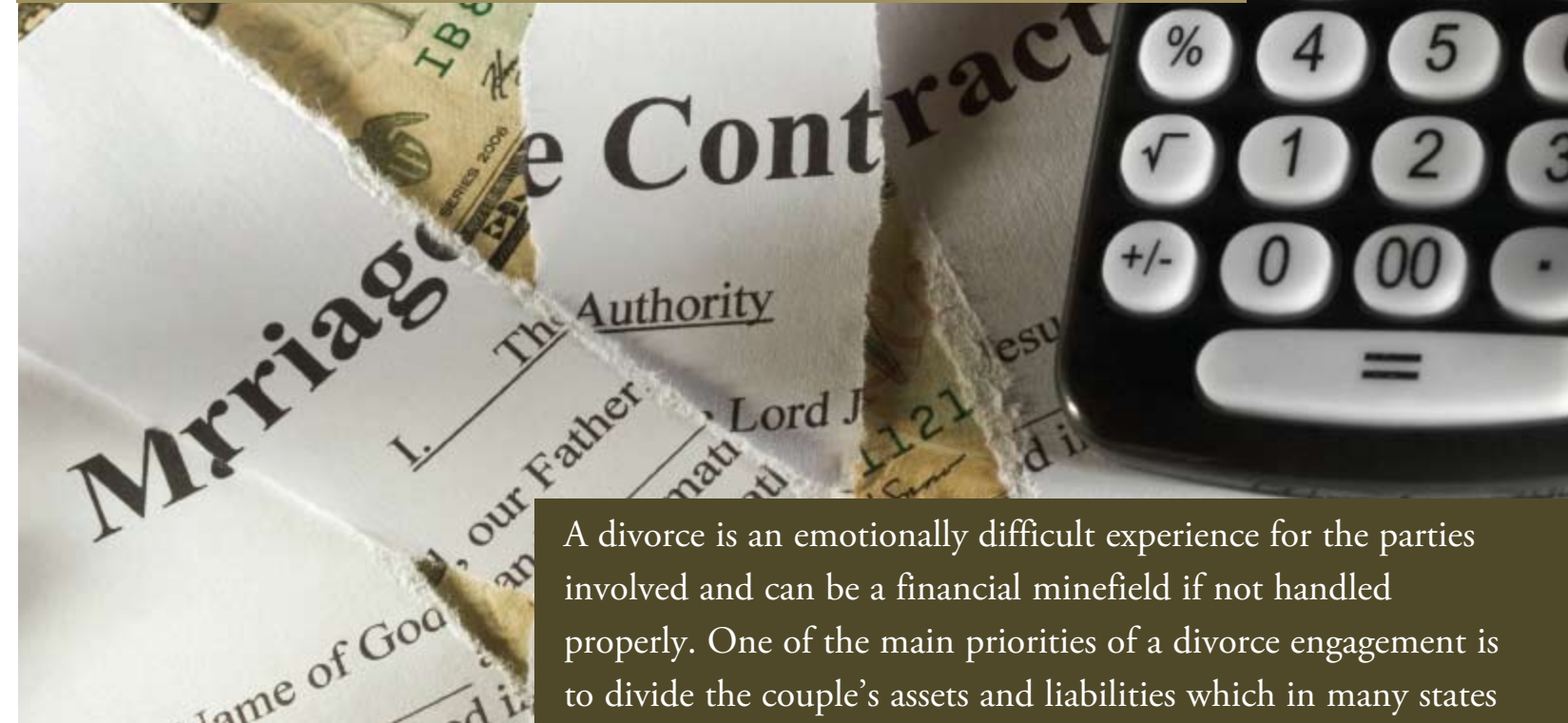
The expert witness must be properly disclosed to the court. *Federal Rules of Civil Procedure*—Rule 26(a)(2) mandates specific disclosures to accompany the expert's signed, written report. The Rule states the report shall contain:

- A complete statement of all opinions to be expressed and the basis and reasons therefore;
- The data or other information considered by the witness in forming the opinions;
- Any exhibits to be used as a summary of or support for the opinions;
- The qualifications of the witness, including a list of all publications authored by the witness within the preceding ten years;
- The compensation to be paid for the study and testimony;
- A listing of any other cases in which the witness has testified as an expert at trial or by deposition within the preceding four years.

Several professional associations exist to provide guidance and credibility to business valuers. These associations provide their membership with professional certifications, prescribed practices and standards, and an on-going continuing education curriculum. Expert witnesses are often members of one or more of these associations.

The National Association of Certified Valuation Analysts (NACVA) is one of the primary associations with certain members capable of providing Expert Witness services. A NACVA certified member, representing him or herself as an Expert Witness, will possess the competence and qualifications to provide Expert Witness services. Written reports will comply with the organization's professional reporting standards and guidelines. Visit the NACVA website ([www.NACVA.com](http://www.NACVA.com)) to review Professional Standards, certification programs and other key information about the association.

# Valuing Assets in a Divorce



A divorce is an emotionally difficult experience for the parties involved and can be a financial minefield if not handled properly. One of the main priorities of a divorce engagement is to divide the couple's assets and liabilities which in many states can fall into two classes: non-marital and marital.

**NON-MARITAL ASSETS AND LIABILITIES** are properties which are generally treated as separate assets and are not subject to division during the divorce. Some common examples are:

Any property acquired before the marriage and not commingled with marital assets during the course of the marriage. A common example would be a childhood baseball card or doll collection.

The property that was inherited property by the husband and wife.

Property acquired as a gift, although, gifts between spouses are considered marital.

Any property excluded by agreement. This is usually a result of a prenuptial agreement.

Any property acquired with the proceeds from the sale of a non-marital property. A common example would be a mutual fund purchased with the proceeds from the sale of a non-marital securities account.

Any property that is qualified as separate property for other reasons, as determined by the state where the married couple petitioned for a divorce.

**MARITAL ASSETS AND LIABILITIES** are properties that were acquired during the course of the marriage, regardless of whose name they are in, and are subject to division during the divorce. In order to obtain an equitable distribution, these marital assets need to be properly valued and split between the spouses. Some of these properties are easier to value while others require the services of a qualified business appraiser. An appraiser will be able to assist in the divorce by valuing the following assets:

- Family run business
- Investments in family limited partnerships
- Investments in other non-marketable entities
- Employee stock options
- Pension and retirement accounts
- Deferred compensation plans
- Investment accounts

In addition, other non-business appraisers may be required to value certain assets, such as real estate, including the marital residence, contents of the marital home, boats, artwork, jewelry, collectibles, planes, automobiles, and other assets which require a trained appraiser to value.

In order to value a business, the appraiser takes the following factors into account:

- 1) The history and nature of the business;
- 2) The economic outlook of the United States, the local economy, and that of the specific industry in particular;
- 3) The book value of the subject partnership and the financial condition of the business;
- 4) The earnings capacity of the business;
- 5) The distribution-paying capacity of the business;
- 6) Whether or not the enterprise has goodwill or other intangible value;
- 7) Prior sales of the interest and the size of the interest to be valued; and
- 8) The market price of publicly traded companies engaged in similar industries or lines of business.

One of the most important and fundamental valuation principles that business appraisers utilize comes from the Internal Revenue Service's Revenue Ruling 59-60, which states