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# Professional Practices and Licenses in Divorce: Enterprise vs. Personal Goodwill, Valuation Methods, and More

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WEDNESDAY, APRIL 10, 2019

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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Today's faculty features:

Sherri Evans, Managing Shareholder, **KoonsFuller**, Houston

Taylor Toombs Imel, Shareholder, **KoonsFuller**, Houston

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# Valuing Professional Practices in Divorce

STRAFFORD LIVE CLE WEBINARS

APRIL 10, 2019



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# Revenue Ruling 59-60

- ▶ IRS Interpretation of the Internal Revenue Code
- ▶ Outlines approaches, methods, and factors to be considered
- ▶ Originally intended as valuation guide for estate tax purposes
- ▶ Use has now been broadened to income tax, partnerships and other entities
- ▶ “Factors to be considered” is the foundation for business valuation

# Factors to be Considered

- ▶ Nature and history of business from inception
- ▶ Economic outlook both in general and industry specific
- ▶ Financial condition of the business
- ▶ Earning capacity of the business
- ▶ Does the business have goodwill or other intangible value
- ▶ Percentage of business at issue/shares owned
- ▶ Market price of stocks of business in the same or similar line of business

# REQUIREMENTS OF VALUATION



# Start with a Mission Statement

The appraiser is required to identify and define:

1. the standard of value;
2. the effective date of the appraisal;
3. the ownership interest; and
4. the purpose and use of the evaluation.

***General Requirements for Developing a Business Valuation, Business Valuation Standards, BVS-I § IIB 3,4 (Am. Soc. Appraisers, 1994)***

# Standard of Value

- ▶ May be determine by statute or case law
- ▶ Most often the definition is *fair market value*
- ▶ Fair market value: the price, expressed in terms of cash equivalents, at which property would change hands between hypothetically willing and able buyer and able seller, acting at arm's length in an open and unrestricted market when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts. ***International Glossary of Business Terms***

# Documents to Review

## FINANCIAL INFORMATION:

- ▶ Tax Returns
- ▶ Financial Statements
- ▶ Fixed asset list and depreciation schedule
- ▶ Aged accounts receivable
- ▶ Aged accounts payable
- ▶ Unbilled work in process
- ▶ Documents regarding total compensation for each owner
- ▶ Documents detailing related-party receipts and/or payments
- ▶ Prior business valuations

# Documents to Review

## CONTRACTS AND OTHER AGREEMENTS:

- ▶ Leases
- ▶ Employment agreements
- ▶ Joint venture agreements
- ▶ Loan agreements
- ▶ Compensation agreements

# Documents to Review

INFORMATION RELATING TO OWNERSHIP,  
RIGHTS OF OWNERS AND TRANSACTIONS:

- ▶ Articles of Formation
- ▶ Partnership Agreement
- ▶ Buy-Sell Agreement
- ▶ Shareholder Agreement
- ▶ Documents detailing ownership transactions
- ▶ Offers to purchase company or sell the company

# Documents to Review

## ACTIVE CASE INFORMATION:

- ▶ Current active contingent fee cases
- ▶ Status of each case
- ▶ Accrued time and fees spent on each case
- ▶ Settlement demands, offers, and agreements
- ▶ Detail of funds in firm's trust account

# Documents to Review

## OTHER INFORMATION:

- ▶ Brief history of the business
- ▶ List of owners and ownership interest
- ▶ Organizational chart
- ▶ Key employee information: age, responsibility, length of service, experience
- ▶ Five largest customers
- ▶ Summary of contingent or off-balance sheet assets or liabilities
- ▶ Minutes of management and owner meetings

# Financial Statements

- ▶ Company Prepared Internal Use Only Statements: no CPA involved
- ▶ Compiled Financial Statements: minimum level of service by CPA; no inquiries, verification or review of information required
- ▶ Reviewed Financial Statements: limited assurance by CPA; inquiry of company personnel
- ▶ Audited Financial Statements: most complete and reliable



# DETERMINE ENTERPRISE VALUE

# Valuation Approaches

- ▶ Asset Approach: net assets of the company (assets less liabilities) are revalued to current values
- ▶ Market Approach: data from transactions involving comparable businesses is used to develop value measures which are then applied to the subject company
- ▶ Income Approach: based upon the premise that the amount that an investor will pay for a business is a function of the amount of money that investor will receive over time as a benefit of ownership

# Revenue Ruling 59-60

- ▶ All three approaches must be considered
- ▶ Relative weight assigned to each approach to determine FMV
- ▶ “Averaging” is strictly prohibited
- ▶ Valuation is subjective and not based upon a prescribed formula

# Enterprise Value

	<u>Value:</u>	<u>Relative Weight:</u>	
Assets Approach:	200,000	33.33%	66,660
Market Approach:	1,000,000	33.33%	333,300
Income Approach:	500,000	33.34%	<u>166,700</u>
Enterprise Value:			566,660

# Enterprise Value

	<u>Value:</u>	<u>Relative Weight:</u>	
Assets Approach:	200,000	0.00%	0
Market Approach:	1,000,000	50.00%	500,000
Income Approach:	500,000	50.00%	<u>250,000</u>
Enterprise Value:			750,000

# Enterprise Value

	<u>Value:</u>	<u>Relative Weight:</u>	
Assets Approach:	200,000	0.00%	0
Market Approach:	1,000,000	20.00%	200,000
Income Approach:	500,000	80.00%	<u>400,000</u>
Enterprise Value:			600,000

# Professional Practice

- ▶ “The use of one’s knowledge in a particular profession”
- ▶ Seems rather obvious so why is this important???
- ▶ Asset Approach
- ▶ Market Approach
- ▶ Income Approach

# Income Approach

1. Start with the company Income Statement
2. Normalize the Income Statement
3. Establish the true earning power of entity independent of current owner
  - ▶ Determine reasonable compensation
  - ▶ Eliminate nonrecurring expenses
  - ▶ Recognition of accrued expenses/bad debt



# Income Approach

Two methods:

1. Discounted Cash Flow
2. Capitalization of Earnings

# Discounted Cash Flow

- ▶ Projection of cash flow into the future which is then discounted to present value
- ▶ Used when company cash flow can be reasonably projected and is expected to differ from current operations
  1. Normalize income
  2. Determine net cash flow
  3. Project net cash flow into the future
  4. Determine time period to be used
  5. Determine discount rate

# Capitalization of Earnings

- ▶ Applies a multiplier to earnings/cash flow
- ▶ Used when future earnings/cash flow are expected to be consistent with current normalized and future growth is predictable

# Discount and Capitalization Rates

## Discount Rate

- ▶ The total expected rate of return that an investor requires to justify investing in an asset because of the amount of risk associated with the investment
- ▶ The higher the risk, the higher the required rate of return

## Capitalization Rate

- ▶ Divisor used to convert a defined stream of income to an indicated value
- ▶ Derived by subtracting the expected sustainable growth rate from the discount rate
- ▶ Used when future earnings/cash flow are expected to be consistent with current normalized and future growth is predictable

# Reasonable Compensation

## Actual Compensation

Based upon what the entity can afford, how well the entity has performed or how the owner wants to be compensated

## Reasonable Compensation

Based upon the cost of hiring a non-owner outsider to perform the same function as the owner

# Reasonable Compensation

Five factor test to establish the reasonableness of owner compensation:

1. Owner qualifications and role in the company;
2. Company's character and condition;
3. Compensation levels for comparable positions in similar companies;
4. Company's salary policy and owner salary history; and
5. Independent investor standard.

***Automobile Investment Development, Inc. vs Commissioner, 66 T.C. M.298 (1993)***

***L&B Pipe & Supply Company vs. Commissioner, Docket No. 10329-91, T.C.M. 187 (1995)***

# ***Exception – Market Approach***

- ▶ Similar transactions
- ▶ For example: Kelsey Seybold
  - ▶ 19 care centers
  - ▶ 100's of doctors

# INTANGIBLE VALUE: DETERMINING THE EXISTENCE OF GOODWILL



# What is Intangible Value?

- ▶ Enterprise Value less Net Asset Value = Intangible Value
- ▶ Net Asset Value determined in analysis of Asset Approach
- ▶ Intangible Value represents specific factors responsible for the entity's earning and cash flow generating capacity

# What is Intangible Value?

- ▶ Goodwill
- ▶ Going concern value
- ▶ Workforce in place
- ▶ Business books and records
- ▶ Patent, copyright, formula, process, design, pattern, knowhow, format
- ▶ Franchise, trademark or trade name
- ▶ Covenant not to compete

# Defining Goodwill

“The ability of a business to generate income in excess of a normal rate on assets due to superior managerial skills, market position, new product technology, etc. In the purchase of a business, goodwill represents the difference between the purchase price and the value of the net assets.” **Black’s Law Dictionary**

“The ability to earn a rate of return in excess of a normal rate of return on the net assets of the business.” **Shannon Pratt, et. al., Valuing Small Businesses and Profession Practices**

“That intangible asset arising as a result of name, reputation, customer loyalty, location, products, and similar factors not separately identified.” **International Glossary of Business Valuation Terms**

# Personal vs. Enterprise Goodwill

“The allocation of goodwill between personal and enterprise is driven by the degree to which the success or failure of the business depends upon the individual’s personal services. ” **Business Valuation Revenue’s Guide to Personal v. Enterprise Goodwill**

“The separation of personal versus enterprise goodwill depends on whether (or the extent to which) the customer returns because of the individual, or because of an element or elements that belong to an enterprise.” **Shannon Pratt, et. al., Business Valuation and Federal Taxes: Procedure, Law and Perspective**

“As a business enterprise increases in size and complexity, goodwill typically shifts the personal goodwill category to the enterprise goodwill category.” **Business Valuation Revenue’s Guide to Personal v. Enterprise Goodwill**

# Goodwill Indicators: Personal Goodwill

- ▶ Small business highly dependent upon owner's personal skills and relationships
- ▶ No pre-existing covenant not to compete and/or employment agreement between selling company and owner
- ▶ Personal services
- ▶ No significant capital investment in either tangible or identifiable intangible assets
- ▶ Solely employee owned
- ▶ Sales largely dependent upon personal relationships with customers
- ▶ Products and services, as well as supplier relationships, rest primarily with owner

(See Frank “Chip” Brown, CPA, *Personal Goodwill and Corporate Goodwill within the Family Law Context*, *Family Law Valuation Insights* (Spring 2017), [www.Willamette.com](http://www.Willamette.com))

# Goodwill Indicators: Enterprise Goodwill

- ▶ Larger business/practice with formalized strictures and controls
- ▶ Pre-existing covenant not to compete and/or employment agreement between selling company and owner
- ▶ Not heavily dependent on personal services
- ▶ Significant capital investment in either tangible or intangible assets
- ▶ Multiple owners, not all employees
- ▶ Sales generated from name recognition, contracts, and other company-owned intangibles
- ▶ Products and services, as well as supplier relationships, are contractually-based or otherwise formalized

(See Frank “Chip” Brown, CPA, *Personal Goodwill and Corporate Goodwill within the Family Law Context*, *Family Law Valuation Insights* (Spring 2017), [www.Willamette.com](http://www.Willamette.com) )

# “Goodwill Hunting in Divorce”

- ▶ Valuations differ from jurisdiction to jurisdiction as a direct result of varying state interpretations of the community or marital property rules applicable to the value of business goodwill.
- ▶ The majority of states – 25 – differentiate between enterprise goodwill and personal goodwill, finding that personal goodwill is not marital property.
- ▶ For a complete state-by-state breakdown of goodwill jurisprudence, please refer to Business Valuation Resources’ guide, “Goodwill Hunting in Divorce”

# “Goodwill Hunting in Divorce”

## California

- ▶ If the professional practice is community property, no distinction between enterprise and personal goodwill
  - Goodwill of a professional practice in which one spouse is a sole practitioner should be taken into consideration as a community asset. Non-practitioner spouse contributed to the intangible value of the practice and therefore is entitled to be compensated for that contribution. **Golden v. Golden, 270 Cal. App. 2d 401 (1969).**
- ▶ If the professional practice is commenced prior to marriage and goodwill is found to exist, the characterization of that goodwill is case specific and fact intensive
  - Professional goodwill of a professional practice commenced prior to marriage may be considered separate property, community property, or varying degrees of both depending upon particular circumstances. **In re Marriage of Lopez, 38 Cal. App. 3d 93 (1974)**
- ▶ Standard of Value: Investment Value



# “Goodwill Hunting in Divorce”

## Florida

- ▶ Personal goodwill of professional practice is not a marital asset. *Thompson v. Thompson*, 576 So. 2d 267 (Fla. 1991)
- ▶ Standard of Value: Fair Market Value

# “Goodwill Hunting in Divorce”

## Illinois

- ▶ Personal goodwill of professional practice is not a marital asset; however, enterprise goodwill is. *In re Marriage of Head*, 652 N.E. 2d 1246 (Ill. App. 1995)
- ▶ Trial court must consider, among other things, the sources of income and earning power of the parties in apportioning total marital assets. Ill. Rev. Stat., ch. 40, par. 503(d)
- ▶ Personal goodwill (future earning capacity) can be used as a factor of income potential in considering maintenance and support following dissolution. Ill. Rev. Stat., ch. 40, par. 504
- ▶ Standard of Value: Fair Market Value

# “Goodwill Hunting in Divorce”

## Michigan

- ▶ Personal goodwill and enterprise goodwill are marital assets (no distinction made). *Kowalesky v. Kowalesky*, 384 N.W.2d 112 (Mich. App. 1986)
- ▶ Standard of Value: Fair Market Value/Investment Value
- ▶ Approximately 13 states total recognize personal and enterprise goodwill as marital assets

# “Goodwill Hunting in Divorce”

## Mississippi

- ▶ Neither personal goodwill nor enterprise goodwill are marital assets.
  - Goodwill is not property and thus cannot be deemed a marital asset. *Singley v. Singley*, 846 So. 2d 1004 (Miss. 2002)
- ▶ Five states do not include goodwill as a marital asset

# “Goodwill Hunting in Divorce”

## New York

- ▶ Personal goodwill and enterprise goodwill are marital assets (no distinction made). ***Nehorayeff v. Nehorayeff*, 108 Misc. 2d 311 (1981)**
- ▶ Standard of Value: Fair Market Value/Investment Value

# “Goodwill Hunting in Divorce”

## Texas

- ▶ Personal goodwill is not a marital asset; enterprise goodwill is.
- ▶ Standard of Value: Fair Market Value

# CALCULATING GOODWILL

# Personal vs. Corporate/Enterprise Goodwill

- ▶ Reputation of John Doe vs. The Doe Company
  
- ▶ Two prong test to assess the existence of divisible goodwill:
  1. Goodwill must be determined to exist independently of the personal ability of the professional spouse; and
  
  2. If such goodwill is found to exist, then it must be determine whether that goodwill has a commercial value in which the community estate is entitled to share.

***Finn v. Finn, 658 S.W.2d 735 (Tex.App.-Dallas 1983)***



# Discounts

1. Lack of Control/Minority Discount: designed to reflect the decreased value of shares that do not convey control of a closely held corporation
2. Lack of Marketability: designed to reflect the fact that there is no ready market for shares in a closely held corporation

# Lack of Control/Minority Discount

- ▶ Degrees of Control:

1. 100% Control – no minority discount
2. Slightly less than 80%
3. Less than 2/3<sup>rd</sup> - super majority
4. Exactly 50% - neither minority nor control
5. Swing vote minority block
6. High enough to bring a minority oppression dissolution action

- ▶ Discount usually ranges from 0 – 15%

# Lack of Marketability

▶ Degrees of Marketability:

1. Registered with the SEC with active trading market
2. Registered with the SEC with somewhat thin trading market
3. Stock with contractual “put” rights (right of owner to sell to the issuing company)
4. Registered with SEC but not required to file 10-K
5. Private company with imminent or like public offering
6. Private company with frequent private transactions
7. Private company with few or no transactions
8. Private company with interests subject to restrictive transfer provisions
9. Private company with ownership interests absolutely prohibited from transfer

▶ Discount usually ranges from 20 – 25%

## Lack of Marketability Discount with Controlling Interest

- ▶ Controversial among valuation experts
- ▶ Some believe that a marketability discount for controlling interest owning 100% or super majority is never appropriate
- ▶ Others argue that even a controlling interest cannot sell instantly
- ▶ When discount applied, it is significantly less than discounts for non-controlling interests

# Summary of Value

Enterprise Value:	1,000,000
Tangible Asset Value	<u>( 600,000)</u> <i>per Asset Approach</i>
Intangible Value	400,000
% attributable to Personal Goodwill	<u>40%</u>
Personal Goodwill	160,000

# Summary of Value

Enterprise Value:	1,000,000
Personal goodwill:	( <u>160,000</u> )
	840,000
% ownership:	<u>25%</u>
	210,000
Lack of Control	<u>10%</u>
	189,000
Lack of Marketability:	<u>20%</u>
Value to Marital Estate	151,200

# “The Diploma Dilemma:”<sup>1</sup>

## Valuation of Professional Licenses

<sup>1</sup> Brett R. Turner, *Degrees and licenses – Degrees and licenses as Property*, 2 *Equit. Distrib. of Property*, 4<sup>th</sup> §6.61 (Jan. 2019 Update)

# Approaches to Valuation of Professional Licenses

- ▶ APPROACH 1: Value as a separate marital asset to be divided upon divorce
- ▶ APPROACH 2: Compensate the non-licensed spouse for efforts used to obtain the license, either through disproportionate division or monthly maintenance
- ▶ APPROACH 3: No value assigned and no compensation granted as non-licensed spouse and/or marital estate benefitted from licensed spouse's pursuit of professional license or graduate degree
- ▶ An overwhelming majority of states view that degrees and/or professional licenses are not property and thus cannot be divided upon divorce



# California

- ▶ *In re Marriage of Sullivan*, 134 Cal. App. 3d 634, 184 Cal. Rptr. 796 (4<sup>th</sup> Dist. 1982), opinion vacated, 37 Cal. 3d 762, 209 Cal. Rptr. 354, 691 P.2d 1020 (1984)
- ▶ A professional education, degree, and license is not only not community property, but it not property at all. However, the trial court must determine the reimbursement owed to the community for the non-licensed spouse's contributions to the education or training that substantially enhanced the earning capacity of the other spouse.
- ▶ Trial court must also consider the extent to which the non-licensed spouse contributed to the attainment of an education, training, a career position, or license of the other spouse in ordering spousal support (calculation of earning capacity)
- ▶ Now codified in Cal. Fam. Code §§ 2641 (reimbursement) and 4320(b) (compensatory support)

# Colorado

- ▶ *In re Marriage of Graham*, 194 Colo. 429, 574 P.2d 75, 77 (1978); see also *In re Marriage of Olar*, 747 P.2d 676 (Colo. 1987) (reaffirming *Graham* in light of subsequent developments)
- ▶ An educational degree is not marital property subject to division upon dissolution of marriage.
- ▶ “An educational degree, such as an M.B.A., is simply not encompassed even by the broad views of the concept of property. It does not have an exchange of value or any objective transferable value on an open market. It is personal to the owner . . .It is simply an intellectual achievement that may potentially assist in the future acquisition of property.”
- ▶ Trial court may consider a spouse's contribution to the education of the other spouse when awarding post-dissolution maintenance

# Florida

- ▶ *Joachim v. Joachim*, 942 So. 2d 3 (Fla. 5<sup>th</sup> DCA 2006)
- ▶ Although an educational degree can be considered by the trial court in distributing marital assets and in determining the propriety and amount of alimony, an educational degree is not property subject to distribution.
- ▶ The value of degrees, as measured by future earning capacity, is too speculative in nature to calculate or divide.

# Illinois

- ▶ *In re Marriage of Goldstein*, 97 Ill. App. 3d 1023, 423 N.E.2d 1201 (1<sup>st</sup>. Dist. 1981); see also *In re Marriage of Weinstein*, 128 Ill. App. 3d 234, 470 N.E.2d 551 (1<sup>st</sup>. Dist. 1984)
- ▶ Increased potential derived from professional license is not a marital asset divisible by the court.
- ▶ Rather than being classified as a marital asset, a spouse's professional degree or license, earned while married through the financial support of the other spouse, is a relevant factor in distribution of the marital assets and liabilities, as well as maintenance awards.

# Michigan

- ▶ *Postema v. Postema*, 189 Mich. App. 89, 471 N.W.2d 912 (1991)
- ▶ Fairness dictates that a spouse who did not earn an advanced degree be compensated whenever the advanced degree is the end product of a concerted family effort involving mutual sacrifice and effort by both spouses.
- ▶ The interest of the non-degreed spouse consists of an “equitable” claim regarding the degree
- ▶ Value ascertained via two methods:
  - 1) Earning capacity without degree vs. earning capacity with degree (future earnings attributable to the degree)
  - 2) Cost of obtaining the licenses/degree (restitution)
- ▶ Value of professional license is greater earlier in the marriage and morphs into enterprise goodwill as the marriage endures
- ▶ Note: other appellate courts in Michigan have held that a professional degree is not a marital asset. However, per Mich. Ct. Rule 7215(J)(1), *Postema* remains binding precedent unless overturned by the Michigan Supreme Court or a special conflict resolution panel of the Michigan Court of Appeals

# New York

- ▶ From 1985 – 2005, a professional license or degree was considered a valuable property right, subject to equitable distribution, to be valued by the enhanced earning capacity afforded to the holder. **O'Brien v. O'Brien, 66 N.Y.S.2d 743, 489 N.E.2d 712 (1985)**
- ▶ Beginning in 2005, the trial court shall, in distributing marital property equitably between the parties, consider the joint efforts and contributions and services of a spouse to the career or career potential of the other party; however, the trial court shall not consider as marital property the value of a spouse's enhanced earning capacity arising from a license, degree, or career enhancement. **N.Y. Dom. Rel. Law §236(B)(5)(d)(7) (McKinney)**

# Oregon

- ▶ From 1995 to 1997, a professional degree, measured by the present value of future earning capacity, was considered marital property and division mandated by statute.
- ▶ In 1998, the Supreme Court of Oregon interpreted the aforementioned statute to be discretionary, holding that there must be evidence of material contributions by the non-degreed spouse that are sufficiently sizeable and over sufficiently long period of years to justify treating the intangible asset of enhanced earning capacity as marital property subject to division, rather than simply giving the contributing spouse compensatory spousal support. **Matter of Marriage of Denton, 326 Or. 236, 951 P.2d 693 (1998)**
- ▶ In 2003, the former Oregon statute was repealed and replaced with an expanded provision providing for compensatory spousal support to spouses contributing to the other spouse's enhanced earning capacity. **Or. Rev. Stat. Ann. §107.105 (West)**

# Texas

- ▶ A professional education acquired during marriage is not a property right and is not divisible upon divorce. *Frausto v. Frausto*, 611 S.W.2d 656 (Tex. Civ. App. – San Antonio, 1980)
- ▶ The trial court may not recognize a marital estate's claim for reimbursement for payment of a student loan by a spouse. **Tex. Fam. Code Ann. §3.409(5)**
- ▶ The trial court has wide discretion in dividing the state of the parties and may consider many factors including the difference in earning capacity, education, need for support, and the benefits an innocent spouse may have received from continuation of the marriage in reaching a just and right division of the parties' community estate. **Tex. Fam. Code Ann. §7.001; see also *Murff v. Murff*, 615 S.W.2d 696 (Tex. 1981)**





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