Marital Property Valuation

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I. Introduction

The classification of property as marital or nonmarital, discussed in the chapter Distinctions Between Marital and Nonmarital Property, is only part of the analysis. In the majority of marriages most property is marital, and the Illinois Marriage and Dissolution of Marriage Act (IMDMA), 750 ILCS 5/503(d), requires the court to divide the marital property "in just proportions." For a court or the parties to divide marital property, the value of all marital assets must be determined. Valuation of property apportioned to each spouse is also a consideration in the determination of maintenance, § 504(a)(1), and child support, § 505(a)(2). Different types of property require different valuation approaches. This chapter discusses the valuation of specific types of property.

II. Statutory valuation requirements

In all divorce proceedings any asset owned by a spouse, whether marital or nonmarital, requires valuation. The parties, attorneys and court must know the value of all assets for division or assignment purposes as well as for the determination of maintenance and child support. Section 504 of the IMDMA directs the court to consider "the income and property of each party, including marital property apportioned and nonmarital property assigned...", among other factors in awarding maintenance. The act further directs the court to consider the financial resources of each parent in determining child support. 750 ILCS 5/505. It is important to note that even if a party is the owner of nonmarital assets, those assets must be valued since the value of those nonmarital assets is one of the factors a court must consider in dividing the marital assets and determining maintenance and child support.

III. Valuation of specific assets

The following sections discuss how to value specific types of property. Different types of property require different approaches in arriving at a value. Because of the nature of a specific type of property there may or may not be a great urgency to place a precise value as opposed to a "ballpark" value. In many cases the economics of the case determine the extent of the valuation; in other words, some cases cannot justify the cost to have the asset evaluated by expensive experts. Household furniture, automobiles, and personal property are examples of assets where "ballpark" approaches are typically used.

Assets that are capable of being divided in kind may not require expert evaluation, especially if those assets are being divided equally. Likewise, assets whose value is readily ascertainable, such as bank accounts, publicly traded stocks, bonds

and other securities, and life insurance with cash surrender values, do not require the services of an expert to value. Often parties will stipulate to the value of assets to save both time and costs.

On the other hand, many major assets are not capable of an easy valuation. These assets include real estate, closely held businesses, retirement benefits, and other larger assets. As an attorney representing a client in a divorce case, one must make value judgments, weighing the cost of an expert evaluation with the asset and benefit involved. One of the more frequent complaints against attorneys by their clients involves the claim that the attorney failed to properly evaluate all the assets involved in the case. If there is any question at all concerning whether or not to hire an expert to value a particular asset, it is suggested the attorney obtain a written direction from the client.

A. Real estate

1. Fair market value

The Illinois Supreme Court has held that "fair cash value" means "'what the property would bring at a voluntary sale where the owner is ready, willing and able to sell but not compelled to do so, and the buyer is ready, willing and able to buy but not forced so to do * * *.' " *Springfield Marine Bank v. Property Tax Appeal Board,* 44 Ill. 2d 428, 430, 256 N.E.2d 334 (1970).

2. Owner testimony as to value of real estate

Illinois courts, as a general rule, have allowed owners to testify concerning the value of their property where it can be demonstrated the owner has specific knowledge concerning the property, such as the purchase price paid, taxes paid, improvements made, current condition of the property, income the property generates, and the potential uses of the property. *In re the Marriage of Vucic,* 216 Ill. App. 3d 692, 576 N.E.2d 406, 159 Ill. Dec. 737 (2d Dist. 1991). However, in the *Vucic* case, the wife's testimony concerning the value of her home was not allowed when it was demonstrated on cross examination that the wife did not know how her home compared to others in the neighborhood and her only basis for her valuation opinion was when an unnamed appraiser walked through her home several months earlier and told her it was worth $200,000.

3. Appraisers

Most divorce cases contain real estate as an asset to be valued. As previously stated, in some instances courts have allowed the spouse-owner to give an opinion as to value of the marital home. However, generally the value of real property requires the opinion testimony of an expert witness. There are two major groups of experts who provide opinions on the value of real property: real estate brokers and sales people, and professional real estate appraisers. Typically, real estate brokers and sales organizations will provide a homeowner with a "market analysis" free of charge. In a market analysis the broker will attempt to value the property based upon the cost of recent "comparable" sales. While the real estate market analysis can be useful to obtain a general "ballpark" value for asset analysis, it generally is not as authoritative as a real estate appraisal provided by a professional real estate appraiser. Also, market analyses are typically only used for the valuation of a single family residence and are not available for rental or commercial property. A professional real estate appraiser will always charge you for the cost of the appraisal as well as the time spent giving a deposition or testifying at trial. This cost has to be considered when determining how you want to present to a court the opinion testimony concerning property valuation. Generally, greater weight and credibility is given to a professional appraiser's opinion as opposed to the opinion of a real estate agent or broker.

a. Appraisal Institute

In this country the major professional real estate appraisal organization is the Appraisal Institute, headquartered at 875 N. Michigan Avenue, Chicago, IL 60611 (312) 335-4100. The Appraisal Institute will provide attorneys with a list of professional appraisers by geographic area. The Appraisal Institute has recently merged the American Institute of Real Estate Appraisers and the Society of Real Estate Appraisers into one umbrella organization. This organization requires completion of extensive qualification programs, training and testing. The Appraisal Institute has general appraisal members who hold the MAI (Member Appraisal Institute), SRPA (Senior Real Property Appraiser) or SREA (Senior Real Estate Analyst) designations and residential members who hold the SRA (Senior Residential Appraiser) or RM (Residential Member) designation. Membership is only accepted after passing general and advanced courses and meeting the strict admission standards. Residential members, SRA or RM, are qualified to appraise residential property from one to four units whereas the MAI, SRPA and SREA are qualified to appraise all types of property including commercial and income-producing property as well as residential.

b. Low-cost appraisals

In some cases it is possible to obtain a real estate appraisal prepared by a professional appraiser for only the small cost of issuing a subpoena to the bank or savings and loan association requiring them to produce the appraisal in their mortgage loan file. This generally is only useful if the property has been mortgaged or refinanced in the recent past.

c. Appraisal valuation methods

In arriving at an opinion as to the value of real estate, professional appraisers typically consider three methods of valuation: (1) cost approach, (2) sales comparison approach, and (3) income capitalization approach. The Appraisal Institute defines these three valuation methods as follows:

> The cost approach is based on the premise that the value of a property can be indicated by the current cost to construct a reproduction or replacement for the improvements minus the amount of depreciation evident in the structures from all causes, plus the value of the land.
>
> The sales comparison approach produces a value indication for a property in comparison with similar sale properties. The sale prices of properties judged to be most comparable tend to set a range in which the value indications for the subject property falls.
>
> The income capitalization approach measures the present value of the future benefits of property ownership. Income streams and values of property resale (reversion) are capitalized (converted) into a present, lump sum value.

The physical, economic, and environmental characteristics of the property and surrounding area will determine the appropriate valuation method utilized. Depending on the type of property being appraised and the availability of pertinent market data, one or more approaches to value could be appropriate. Typically, the professional appraiser will consider all three approaches and arrive at a value range for the property. In making a final value opinion the appraiser reconciles the various value indications into the most reasonable value conclusion. This reconciliation process should not just be an average of the indicated value but should be predicated on an analysis of the strengths and weakness of the individual approaches to value the property in relationship to typical market conditions. Matrimonial cases for the most part involve opinion testimony concerning real property value focused on the sales comparison or market approach. For discussions of the other valuation methods or approaches one must look at Illinois cases in real estate tax assessments or condemnation areas.

i. Cost or reproduction approach

Generally, Illinois courts favor the sales comparison or market approach over the cost or reproduction approach. In *People ex rel. Rhodes v. Turk,* 391 Ill. 424, 63 N.E.2d 513 (1945), the Illinois Supreme Court held that it was in error for the county assessor to value property at its reproduction cost value of $82,100 when the owners had purchased the property for only $25,000 that same year. Likewise, in *Willow Hill Grain Inc. v. Property Tax Appeal Board of the State of Illinois*, 187 Ill. App. 3d 9, 549 N.E.2d 591, 139 Ill. Dec. 865 (5th Dist. 1990), the court held "The market or comparison approach to valuing property is preferred, and heavy reliance upon the replacement cost method of valuation has been frowned upon. *Chrysler Corporation v. State Property Tax Appeal Board*, 69 Ill. App. 3d at 211, 387 N.E.2d at 355, 25 Ill. Dec. at 699, (2nd Dist. 1979). The replacement cost method should be used only when there is no actual or potential market for the property in question, and even then it should be only one factor in the valuation process and not the sole, conclusive method of valuation. *Chrysler Corporation*, 69 Ill. App. 3d at 21, 387 N.E.2d at 355, 25 Ill. Dec. at 699 (2d Dist. 1979). Where there is evidence of comparable sales, the market approach should be used. *Chrysler Corporation*, 69 Ill. App. 3d at 211, 387 N.E.2d at 355, 25 Ill. Dec. at 699 (2d Dist. 1979).

ii. Sales comparison or market approach

As indicated above, the courts in Illinois generally prefer using a market approach when comparable sales information is available. In *DuPage Bank and Trust Company v. Property Tax Appeal Board of The Illinois Department of Revenue,* 151 Ill. App. 3d 624, 502 N.E.2d 1250, 104 Ill. Dec. 590 (2d Dist. 1986), the appellate court noted the property in question had not been used as a farm for the 10 years preceding the tax year in question, but had been farmed the year following the tax year in question. Consequently, the assessor was correct in classifying the property as commercial real estate instead of farmland where the land was zoned commercial/industrial. The assessor based his valuation on recent sales of several comparable properties in the area having the same zoning. The court referred to the fact that the land had not been farmed for the tax year in question and stated the focus must be on the present, as opposed to future use of the property. The farming practice of allowing the land to remain fallow does not classify it as farmland.

iii. Income capitalization approach

This valuation approach is typically used with commercial properties. Good discussions of the methodology and considerations to be used in the income capitalization method can be found in *Kankakee County Board of Review v. Property*

Tax Appeal Board, 131 Ill. 2d 1, 544 N.E. 2d 762, 136 Ill. Dec. 76 (1989), which speaks about a property's income-earning capacity as being a most significant element in arriving at the "fair cash value." Also see *Town of Cunningham v. Property Tax Appeal Board,* 225 Ill. App. 3d 769, 587 N.E.2d 573, 167 Ill. Dec. 304 (4th Dist. 1992), and *Lake County Board of Review v. Property Tax Appeal Board,* 172 Ill. App. 3d 851, 527 N.E.2d 84, 122 Ill. Dec. 712 (2d Dist. 1988).

B. Valuation of businesses

1. Introduction

Prior to the adoption of the IMDMA the need to accurately value an ongoing business was not a major concern in family law. Illinois, being a title state, awarded a business to the titled owner, typically the husband, and just as typically, the wife was awarded the house. Under the prior Illinois law (Illinois Divorce Act, Ill. Rev. Stat. Ch 40 (1977)) there was a greater likelihood the wife would then receive permanent alimony. All of this changed with the passage of the IMDMA in 1977. The statutory principles that governed the IMDMA were grounded in the idea that it was preferable to think of marriage as a partnership where each partner made a unique but definable contribution to the marital estate, whether it be the contribution of running a home, raising children, or managing a business. Upon the dissolution of that marital partnership the assets of that partnership had to somehow be equitably divided, taking into consideration a variety of factors including marital contributions and postmarital financial needs.

The valuation of a business interest owned by a spouse going through a divorce presents the practitioner with one of the more difficult valuation problems in domestic relations proceedings. Of course, if the business happens to be a corporation whose stock is publicly traded, the valuation task becomes easier. However, today's closing price may not be reflective of the true value in the stock, and the careful attorney still needs to have an understanding of the business, including the market forces effecting value.

Typically, however, the divorce practitioner is confronted with a spouse who is an owner of a non-publicly traded closely held corporation, sole proprietorship or partnership. There are many practical issues involved in this type of business that present problems both in determining a value and dividing that asset. These issues and problems include the fact that it is generally undesirable to require an on-going business to be sold just because a divorce occurs and it is rare that a business can be divided in kind on dissolution. Division of a business in kind is generally undesirable because it requires an on-going business relation between two spouses. *In re Marriage of Morrical*, 216 Ill. App. 3d 643, 576 N.E.2d 465, 159 Ill. Dec. 796 (3d Dist. 1991).

In many cases the business represents by far the largest single asset in the marital estate and there are not enough other marital assets to offset the business. Therefore, courts will generally award the business to one of the spouses, usually the spouse involved in the concern, and attempt to fashion an equitable balance by awarding assets of like value to the other. If such like value assets do not exist, which is more often the case than not, the court generally needs to fashion an asset division using payments over time, usually in combination with awarding other marital assets to the non-business awarded spouse. The IMDMA's statutory scheme then asks — after this equitable division of marital assets, and after taking into consideration the employment and earning capabilities of each spouse, and the needs of each spouse and any children — if one of the spouses still requires support from the other in the form of maintenance. In order for a court to fully consider all of these statutory requirements it must be able to determine, with a much greater degree of accuracy than was previously required under the old Divorce Act, what the value of the business is.

2. Expert witnesses for business

Expert witness testimony is generally required when a business is being valued for divorce purposes. The experts most often used are certified public accountants, chartered financial analysts, and professional business appraisers. Many times a spouse will use one of the business's accountants as the expert. Many larger banks with trust departments will have a small business section where they employ experts on business valuation, since decedent's estates require this service for estate and inheritance tax purposes. The following professional societies and umbrella organizations can provide the practitioner with names of members in a particular geographic area qualified to appraise on-going businesses. As with all such lists, the practitioner is advised to thoroughly check the credentials and qualifications of any "expert" recommended. The list below is not intended to be all inclusive and the authors make no representations as to any of the listed organizations or their members. It is provided only as a guide or place to start when locating experts.

Organization and Address	**Phone**
American Society of Appraisers	

535 Herndon Parkway
Herndon, VA 22070 (703) 478-2228

Institute of Business Appraisers
112 S. Federal Highway
Boynton Beach, FL 33435 (407) 732-3202

Association of Machinery & Equipment Appraisers
1110 Spring Street
Silver Springs, MD 20910 (301) 587-9335

3. Valuation of business interests

a. Businesses begun during the marriage

Section 503(a) of the IMDMA provides that all property acquired during the marriage is marital property and therefore, unless a spouse can prove that a business begun during the marriage was acquired through one of the nonmarital exceptions listed in section 503(a)(1) through (8), that business will be held to be a marital asset. When a spouse owns a business as a sole proprietorship or partnership before the marriage and later incorporates that business after the marriage, exchanging his or her sole proprietorship or partnership interest for stock in the corporation, that stock will be treated as nonmarital property. *In re Marriage of Wilder,* 122 Ill. App. 3d 338, 461 N.E.2d 447, 77 Ill. Dec. 824 (1st Dist. 1984); *In re Marriage of Thacker*, 185 Ill. App. 3d 465, 541 N.E.2d 784, 133 Ill. Dec. 573 (5th Dist. 1989).

b. Valuation date

Illinois courts have held that the value of a business should be determined as of the date of the dissolution of the marriage. 750 ILCS 5/503(f); *In re Marriage of Morrical*, 216 Ill. App. 3d 643, 576 N.E.2d 465, 159 Ill. Dec. 796 (3d Dist. 1991); *In re Marriage of Rossi*, 113 Ill. App. 3d 55, 446 N.E.2d 1198, 68 Ill. Dec. 801 (1st Dist. 1983).

c. Valuation methods

In the valuation of a closely held corporation all evidence reflecting the worth of the entity should be considered, including the future economic outlook. *In re Marriage of Olson*, 223 Ill. App. 3d 636, 585 N.E.2d 1082, 166 Ill. Dec. 60 (2d Dist. 1992). There are several methods used to value a closely held corporation or small business. Illinois courts have used the market approach, capitalization of earnings or income method, the replacement cost method, and the book value or net asset approach. Some courts have included goodwill in the valuation while others have excluded goodwill. Because the existence or non-existence of goodwill can have a major affect on the value of a business, that subject will be treated separately in this chapter. The Internal Revenue Service has promulgated Revenue Ruling 59-60 which establishes criteria to be used in the valuation of closely held corporations for estate and gift tax purposes. Generally, Revenue Ruling 59-60 forms the basis that valuation experts use in determining a value of a business in divorce cases. Revenue Rulings 65-193 and 68-609 also pertain to the valuation of a closely held corporation. Since these IRS revenue rulings form the basis of business evaluations they are reprinted in the appendix to this chapter.

d. Goodwill

As any accountant or economist will tell you, the value of an on-going business is made up of several elements: the hard assets (i.e. cash, bank accounts, equipment, inventory, buildings and land, accounts receivable, etc.) and the intangible assets (i.e. goodwill, patents, trademarks, contracts, etc.). Where Illinois courts have had the most problems since the enactment of the IMDMA in valuing an on-going business concern in a dissolution proceeding is in the area of assigning a value to goodwill. The most misunderstood concept that courts have faced in this area is in attempting to equate the accounting principles of defining goodwill with the totally inconsistent IMDMA statutory scheme of asset division and postmarital maintenance and child support considerations. The accounting principles in defining goodwill conflict with the IMDMA scheme because the future earnings and income factors the accountant or business evaluator must consider in all the various formulas used to determine goodwill are the same statutory mandated considerations and factors the court is required to evaluate in determining the award of maintenance and child support. Illinois courts now are giving greater recognition to the fact that using pure principles of accounting in valuing a business's goodwill is inconsistent with the considerations the IMDMA mandates in the support arena.

Another major IMDMA statutory principle that is inconsistent with accounting criteria used in the valuation of goodwill involves the projection or estimation of *future income* to determine goodwill. Accountants and business evaluators typically

will use a multiplier (the specific multiplier varies depending on the type of business being valued) times an average of a given number of years of the company's income. By using this *future income* the valuation not only considers a factor required to be considered by the court in determining maintenance and child support (i.e., the "double dip") but also considers something which is clearly nonmarital since the *future income* will be earned after the dissolution of the marriage. In the case of *In re Marriage of Frazier*, 125 Ill. App. 3d 473, 466 N.E.2d 290, 80 Ill. Dec. 838 (5th Dist. 1984), the husband owned a State Farm Insurance agency and the wife's expert testified as to the value of the business using the capitalization of earnings method to value the agency. In his calculation the expert took a five-year average of the net after-tax earnings and multiplied that times the number of years it was assumed the husband would continue to work. The expert then reduced that amount to its present cash value using a 12% discount rate. The trial court accepted this calculation as the value of the business. There was no maintenance awarded so the use of the future earnings in the capitalization of earnings method could not be argued to be a double consideration (double dip) of the same assets. In reversing the trial court, the appellate court discussed the capitalization of earnings method:

> Although this [capitalization of earnings method] may prove an accurate measure of the value of a business for some purposes, there is a fallacy in using it to value marital property to be divided upon dissolution. Marital property, as it is defined in the Marriage and Dissolution of Marriage Act ..., must be valued at the date of the dissolution of the marriage. ... Marital property rights cannot inure in property acquired after a judgment of dissolution of marriage. *In re Marriage of Frazier*, 125 Ill. App. 3d 473, 466 N.E.2d 290, 80 Ill. Dec. 838, 841 (5th Dist. 1984) (cites omitted).

The court went on to reason that since the husband was required to service his accounts after the divorce in order to receive the future income that the expert used in the capitalization of earnings approach, the valuation was erroneous since it valued labor that will be performed after the dissolution.

i. Existence of goodwill

The existence of goodwill as an asset of a business has long been recognized by the courts. The classic definition of goodwill was authored by Justice Story in 1968, who wrote:

> Goodwill may be properly enough described to be the advantage or benefit which is acquired by an establishment beyond the mere value of the capital stock; funds or property employed therein. In consequence of the general public patronage and encouragement which it receives from constant or habitual customers on account of its loyal position, or common celebrity, or reputation for skill or affluence, or punctuality, or from other accidental circumstances or necessities or even from ancient partialities or prejudices. Story, J., Commentaries on the Law of Partnership , § 99 at 178 (6th Ed., 1868).

Illinois courts simplified the definition of goodwill and have referred to it as the ability to generate future income. *In re Marriage of White*, 98 Ill. App. 3d 380, 424 N.E.2d 421, 53 Ill. Dec. 786 (5th Dist. 1981). Until recently there had been some disagreement among the Illinois appellate courts about whether to recognize goodwill in a professional practice as an asset divisible upon dissolution of marriage. See *In re Marriage of Scarfuri,* 203 Ill. App. 3d 385, 561 N.E.2d 402, 149 Ill. Dec. 124 ((2d Dist. 1990) (medical corporation); *In re Marriage of Feldman*, 199 Ill. App. 3d 1002, 557 N.E.2d 1004, 146 Ill. Dec. 62, (2d Dist. 1990), *appeal denied,* 133 Ill. 2d 554, 561 N.E.2d 689, 149 Ill. Dec. 319 (medical practice); *In re Marriage of White*, 151 Ill. App. 3d 778, 502 N.E.2d 1084, 104 Ill. Dec. 424 (5th Dist. 1986) (dental practice); *In re Marriage of Courtright*, 155 Ill. App. 3d 55, 507 N.E.2d 891, 107 Ill. Dec. 738 (3d Dist. 1987) (medical practice); *In re Marriage of Wilder,* 122 Ill. App. 3d 338, 461 N.E.2d 447, 77 Ill. Dec. 824 (1st Dist. 1984) (ophthalmology practice).

One of the first Illinois courts to consider the valuation of goodwill was the Fifth District in the case of *In re the Marriage of White,* 98 Ill. App. 3d 380, 424 N.E.2d 421, 53 Ill. Dec. 786 (5th Dist. 1981). In *White*, the husband owned a dental corporation which he acquired during the marriage. The trial court determined the value of the professional corporation by examining tax records, ignoring the issue of goodwill. The appellate court remanded the case with instructions for the trial court to consider evidence regarding the goodwill of the corporation as a factor in its valuation. In reaching its decision, the *White* court considered the competing philosophies underlying the treatment of goodwill. The court cited the case of *Nail v. Nail,* 486 S.W.2d 761 (Tex. 1972) to stand for the proposition that goodwill should not be considered in the valuation of a business because of its contingent and speculative nature, the argument being that goodwill evaporates if the professional dies, retires or sells the practice. The *White* court rejected this reasoning based on the premise that, in many cases, goodwill does in fact survive the death or retirement of the practitioner. Instead, *White* chose to embrace the dicta of an earlier Illinois case, *In re the Marriage of Leon,* 80 Ill. App. 3d 383, 399 N.E.2d 1006, 35 Ill. Dec. 717 (2d Dist. 1980). The *Leon* court held that the trial court had failed to establish sufficient evidence as to the value of the husband's solely owned insurance proprietorship. The appellate

court directed the trial court to supplement the previously admitted books and records with expert testimony, stating,

> [P]arenthetically, we note that the weight of authority in other jurisdictions is that the interest of a spouse in a law or medical partnership including the "good will" of such business has been held to be marital property." (See *Stern v. Stern,* 66 N.J. 340, 331 A.2d 257 (1976); *In re Marriage of Goger,* 27 Or.App. 729, 55 P.2d 46 (1976); *In re Marriage of Lukens,* 16 Wash App. 481, 558 P.2d 279, (1976); *Moss v. Moss*, 190 Colo. 491, 549 P.2d 404 (1976); *In re Marriage of Kelly,* 40 Or.App. 605, 595 P.2d 1294 (1979). See, also 52 A.L.R.3d 1344, 74 A.L.R.3d 621. *In re Marriage of Leon,* 80 Ill. App. 3d 386, 399 N.E.2d 109, 35 Ill. Dec. 720.

In accepting *Leon's* reasoning, the *White* court emphasized that goodwill should be included in the valuation of a corporation under the theory that it is of value to the professional spouse and that its value is manifested in the income that he or she generates. *In re Marriage of White*, 98 Ill. App. 3d 380, 424 N.E.2d at 424, 53 Ill. Dec. at 789 (5th Dist. 1981).

The First District arrived at a different conclusion when it was confronted with the issue of goodwill in *In re Marriage of Wilder,* 122 Ill. App. 3d 338, 461 N.E.2d 447, 77 Ill. Dec. 824 (1st Dist. 1983). In *Wilder,* the husband was an ophthalmologist who was employed by a professional corporation in which he owned 50% of the stock. The husband had established the professional corporation out of his sole proprietorship that had existed prior to the marriage. The trial court characterized the corporation as nonmarital property. On appeal, the wife argued that the trial court had abused its discretion in failing to place a monetary value on goodwill in valuing the stock in the corporation. The *Wilder* court accepted the husband's argument that including goodwill in the value of the business would lead to double consideration of the income producing capacity of the practicing spouse. The court reasoned that under §503, the court is already required to consider future earning potential when apportioning marital property. Future earning potential is also considered in awarding maintenance. If a court places a value on a professional practice based upon potential future earnings and then considers those same future earnings in awarding property, maintenance and child support, there will be double consideration. This is the first recognition by an Illinois reviewing court of the "double dip" concept. In its opinion, the *Wilder* court specifically rejected the court's reasoning in *White;* stating

> [White] held that good will is a factor to be considered in valuing a professional corporation "under the theory that despite the intangible quality of good will in a professional practice, it is of value to the practicing spouse both during and after the marriage and its value is manifested in the amount of business and consequently, the income which the spouse generates. We do not find this reasoning persuasive, since the White court's definition of good will is reflected in three of the factors which the trial court must consider in apportioning marital property under section 503[d] of the Act -"the relevant economic circumstances of each spouse when the division of property is to become effective"; the occupation, amount and sources of income, vocational skills [and] employability of each of the parties"; and "the reasonable opportunity of each spouse for future acquisition of capital assets and income." Thus, the ability to generate income, which petitioner argues is what "good will" reflects, is already taken into account under the Act. If we were to adopt petitioner's argument, that factor would in effect be given double consideration under the Act. *Wilder,* 122 Ill. App. 3d. 338, 461 N.E.2d 447.

ii. The Zells *decision*

As can be seen from the above cases, prior to 1991 there was a division of opinions by Illinois courts on the valuation of professional goodwill. This confusion was resolved by the Illinois Supreme Court *In re the marriage of Zells,* 197 Ill. App. 3d 232, 554 N.E. 2d 289, 143 Ill. Dec. 354 (1st Dist. 1990). In the *Zells* case the First District affirmed a trial court that found a personal injury attorney's practice had professional goodwill of $77,000. The appellate court however reversed the trial court's ruling requiring several contingent fees to be divided equally if and when received. The appellate court ruled that contingent fees cannot be considered a marital asset to be divided now or in the future. The Illinois Supreme Court affirmed the appellate court's holding that attorney's contingent fees are not marital assets and went on to state, "Goodwill represents merely the ability to acquire future income. Consideration of goodwill as a divisible marital asset results in gross inequity." *In re the marriage of Zells,* 143 Ill. 2d 251, 572 N.E.2d 944, 157 Ill. Dec. 480, 481 (1991). The court cited with approval the "double dip" reasoning contained in *In re the marriage of Wilder* and *In re the marriage of Courtright,* holding:

> Adequate attention to the relevant factors in the Dissolution Act results in an appropriate consideration of professional goodwill as an aspect of income potential. The goodwill value is then reflected in the maintenance and support awards. **Any additional consideration of goodwill is duplicative and improper**. (emphasis added).

While the *Zells* case involved a law practice, the Supreme Court's approval of cases involving medical practices (*Wilder* and *Courtright*) together with the reasoning and broad language quoted above more than suggests that the inclusion of

any professional goodwill as a divisible marital asset will be reversed. The "double dip" in Illinois appears to have ended.

In the case of *In re Marriage of Brenner* 235 Ill. App. 3d 840, 601 N.E.2d 1270, 176 Ill. Dec. 572 (1st Dist. 1992) the First District held that goodwill is a recognized asset of a closely held corporation and should be included in its valuation. The court went on to hold that *Zells* precludes any double consideration of goodwill. The court is free to consider goodwill in the value of the business or, in the alternative, in determining future support, but not both. That is, if the goodwill in the corporation is reflected in the income producing capacity of the spouse, then considering goodwill in the value of the corporation is duplicative. The significance of this holding is that the court has taken the holding in *Zells* and applied it to a business corporation and not just a professional practice.

Brenner is also illustrative of what not to do if you want your expert's opinion to be accepted. In *Brenner* the expert hired by the non-owner spouse made numerous errors including the admission that his valuation was a "preliminary valuation." He further stated he could not give a "formal conclusion" as to the value of the company, he never took into account a $50,000 corporate debt, and he never obtained a competent appraisal of the equipment and machinery. Instead he relied on the three-year-old insurance replacement cost value, and he included the owner's salaries as a corporate asset contrary to Revenue Ruling 68-609.

In *Brenner* the husband also argued that the corporation's value should not include goodwill because such an item was unique to the owner and could not be sold with the company. The court stated this argument really goes to the value or lack of value of the goodwill, not to whether goodwill should be included. Although the *Brenner* court did not go further on this issue, the uniqueness of any goodwill and its ability to be transferred with the sale of the corporation raises the distinction of personal goodwill versus enterprise goodwill.

iii. Personal goodwill v. enterprise goodwill

There is more than one type of goodwill. Much of the early confusion in the courts stemmed from the failure to differentiate between personal goodwill and enterprise goodwill. Enterprise goodwill has marketable value that is deliverable to a purchaser and, as such, a purchaser is willing to pay for it. On the other hand, personal goodwill is unique to an individual and not severable from him or her, therefore it cannot be delivered to a purchaser, nor does it have saleable value. Enterprise goodwill is an intangible asset that relates to the business's name, reputation, customer base, products and similar factors. Its value lies in the probability that customers of the old enterprise will continue to be customers when a new owner enters. Personal goodwill on the other hand, is nontransferable. It consists of those individual attributes of the owner, including his or her education, reputation, relationship with customers, etc. Personal goodwill will not stay with a business once the owner leaves. An example of personal goodwill would be a CEO who, through the force of his or her personality, has been a major factor in the company's success and without his or her continued participation, the business may well not succeed.

One of the first courts to recognize a distinction between personal and enterprise goodwill was *In re the Marriage of Foley*, 163 Ill. App. 3d 1, 516 N.E.2d 455, 114 Ill. Dec. 300 (1st Dist. 1987). In *Foley,* the First District held that the trial court acted within its discretion in valuing the goodwill of the respondent's manufacturing corporation at zero. The respondent owned 90% of the stock in a corporation ("EMD") that manufactured electric wire harnesses for the automotive industry. The respondent's expert valued the corporation at 1/5 the value of the petitioner's expert, primarily because respondent's expert valued goodwill at zero. The respondent's expert explained that he did in fact consider goodwill as an asset of the corporation, but determined it had no value. Respondent's expert distinguished between personal goodwill and enterprise goodwill and found the latter to be lacking in EMD. The expert supported his conclusion by noting that EMD owned no patents or trademarks, almost 80% of EMD's output was sold to a single customer based solely on purchase orders (i.e. no contract), and the continued viability of the sales depended on the personal relationship between the owner and that customer. He concluded that in light of the economic contingencies, a willing buyer would pay nothing for EMD's goodwill. Petitioner's expert rejected these arguments, asserting instead that the respondent was only one of 75 employees and that there was no evidence that the respondent intended to sell or liquidate the corporation. Accordingly, petitioner's expert found that goodwill existed as a valuable asset to the corporation. The *Foley* court agreed with respondent's expert noting that the future earnings of the corporation were directly related to the husband's continued employment with the corporation. The court stated:

> In *In re Estate of McCubbin*, 125 Ill. App. 3d 74, 465 N.E.2d 672, 80 Ill. Dec. 560 (1st Dist. 1984), this court previously reviewed Illinois law regarding corporate goodwill. *McCubbin* pointed out that the goodwill of a business is characterized primarily by the personal relationships and customer contacts which the owner of the business has been able to develop. (*McCook Windows Co. v. Hardwood Door Corp*., 52 Ill. App. 2d 278, 202 N.E.2d 36 (1964).) Goodwill may not be separated from or disposed of independently

of the business in which it inheres and it can have existence only as an incident of a continuing business having locality or name (*McIlvaine v. City National Bank & Trust Co.,* 314 Ill. App. 496, 42 N.E.2d 93 (1st Dist. 1942). Goodwill is not a tangible asset and not all businesses possess goodwill. *Behn v. Shapiro,* 8 Ill. App. 2d 25, 130 N.E.2d 295 (1st Dist. 1955).

In *Foley*, respondent's expert testified that the goodwill of EMD rested with the respondent with whom all the customers did their business, rather than the products or the services produced by EMD. Respondent's expert distinguished enterprise goodwill, which he found to be lacking in EMD, from personal goodwill, which he found to exist in respondent as the owner of EMD. We do not believe that this expert's evaluation of the goodwill of EMD was erroneous under Illinois law.

C. Professional licenses and educational degrees

Does a professional license or educational degree obtained during the marriage constitute a marital asset which requires valuation and is subject to division on divorce? If a license or degree is a marital asset, how is it to be valued? Since a license or degree is basically just an avenue to obtain a job and earn income, is it proper to attempt to place a present value on it and divide that value today when that future income is a consideration in determining maintenance and child support as well as a factor in the division of other marital assets? If we value and divide a license or degree now, do we not commit a "double dip" in considering future income for support? These questions have been bothering Illinois courts since the enactment of the Illinois Marriage and Dissolution of Marriage Act in 1977.

Illinois appellate courts have held that professional licenses and degrees do not constitute marital property subject to division under section 503 of the IMDMA. *In re Marriage of Fahy,* 208 Ill. App. 3d 677, 567 N.E.2d 552, 153 Ill. Dec. 594 (1st Dist. 1991); *In re the Marriage of Einhorn,* 178 Ill. App. 3d 212, 533 N.E.2d 29, 127 Ill. Dec. 411 (1st Dist. 1988). However, if a spouse contributes to the education or support of a student spouse, the contributing spouse is entitled to some form of compensation for the contribution, whether in the form of maintenance or in awarding a disproportionate division of the marital property in the non-student spouse's favor. *In re Marriage of Weinstein,* 128 Ill. App. 3d 234, 470 N.E.2d 551, 83 Ill. Dec. 425 (1st Dist. 1984).

One of the first Illinois cases to comment on the value of a professional degree was *In re Marriage of Woodward*, 83 Ill. App. 3d 253, 404 N.E.2d 575, 39 Ill. Dec. 191 (3d Dist. 1980). In *Woodward*, as the wife worked full time as a keypunch operator, the husband was a full-time student and only worked part-time until he graduated and obtained his degree from Illinois State Normal University. The couple separated approximately one year after the husband's college graduation, and at the time of the trial the husband was employed as a physical education teacher in an elementary school. The *Woodward* court held that the husband was able to acquire a college degree due to the wife's efforts, thereby increasing the husband's opportunity for future employability and income and awarded a disproportionate share of the marital property in the wife's favor.

One of the first Illinois cases to address the issue of whether a professional degree constitutes marital property subject to distribution under the IMDMA was the First District case of *In re Marriage of Goldstein,* 97 Ill. App. 3d 1023, 423 N.E.2d 1201, 53 Ill. Dec. 397 (1st Dist. 1981). In *Goldstein*, the wife sought to characterize her husband's increased earning potential from his medical degree as a marital asset, claiming that she had supported the husband while he was in medical school. Evidence of the extent of the support was controverted by the husband who claimed that his parents had paid his tuition, medical books and living expenses from the time he began medical school. Regardless of these controverted facts, the court held that in Illinois, the term "property" has been defined as tangible and intangible ownership of property. A medical degree could not be considered "property" because it held none of the attributes of property, such as objective transfer value on the open market. The court also noted that the student spouse's future earning capacity was contingent on future events such as continuation of employment. Future earning capacity is considered when determining maintenance and in the division of marital property (i.e., the economic circumstances of each spouse and the reasonable opportunity of each spouse to receive income in the future). *Goldstein*, 423 N.E.2d at 1244, 53 Ill. Dec. at 400 (1st Dist. 1981).

In 1984, the First District court was again confronted with the issue of categorizing a professional degree in the case of *In re the Marriage of Weinstein,* 128 Ill. App. 3d 234, 470 N.E.2d 551, 83 Ill. Dec. 425 (1st Dist. 1984). In *Weinstein*, the wife claimed that her husband's osteopathy degree was marital property because he had completed his education during the marriage. She sought to introduce expert testimony pertaining to the value of the husband's osteopathy degree and his license to practice surgery. The court engaged in an in-depth analysis of the classification of the degree by examining the treatment of licenses and degrees in 23 other jurisdictions. The court noted that 16 jurisdictions did not treat professional degrees as marital property, however these jurisdictions permitted compensation to the contributing spouse for any financial contribution to the student spouse's education and degree. The *Weinstein* court agreed with these jurisdictions

and in doing so recognized three alternative methods for compensating the contributing spouse.

Comparative analysis reveals a developing majority consensus which recognizes these three alternative methods to permit such compensation: (1) distribution of marital assets and liabilities, (2) some form of maintenance or alimony, or (3) an equitable monetary award to the spouse based on unjust enrichment or some other equitable principle. Usually, the first alternative, and the most preferred, is to distribute the couple's marital assets and liabilities such that the supporting spouse's past contributions and the student spouse's resulting increased earning capacity are taken into consideration. *Weinstein*, 83 Ill. Dec. 425 at 431. The *Weinstein* court commented that although the term property in Illinois has been defined very broadly, property must be more than a mere expectancy interest. "An expectancy interest is the "interest of a person who merely foresees that he might receive a future beneficence, such as the interest of an heir apparent...or a beneficiary designated by a living insured who has a right to change the beneficiary." at 433 citing *In re the Marriage of Peshceck* , 89 Ill. App. 3d 959, 964, 412 N.E.2d 698, 45 Ill. Dec. 347 (1st Dist. 1980). A degree is simply an expectancy of future income and is therefore not property. However, the degree is relevant in distribution of the couple's marital assets. *Weinstein,* 128 Ill. App. 3d 234, 470 N.E.2d 551, 83 Ill. Dec. 425 (1st Dist. 1984).

The *Weinstein* facts should be distinguished from *In re the Marriage of Einhorn*, 178 Ill. App. 3d 212, 533 N.E.2d 29, 127 Ill. Dec. 411 (1st Dist. 1988), where the court held that wife was not entitled to additional compensation where husband and his parents financed the majority of his education and support during the marriage. In *Einhorn*, the husband earned a bachelor's, master's, and doctorate degree during the marriage. However, the husband testified that his father paid all of the tuition for his undergraduate education, most of the tuition for his master's degree, and part of the tuition for his doctorate degree. The remaining portion of the husband's tuition was paid by the husband and a student loan. The husband also testified that while in school he was employed either full time or part time depending on his school schedule. The wife had several different part-time waitress positions during the marriage and worked periodically until after the parties' second child was born. The *Einhorn* court held that after taking into consideration the husband's contribution while he earned his degrees and both parties' financial status, an equal division of the marital property was not unreasonable.

In the First District case of *In re the Marriage of Fahy,* 208 Ill. App. 3d 677, 567 N.E.2d 552, 153 Ill. Dec. 594 (1st Dist. 1991), the trial court was reversed for including the classification of the husband's law license as a marital asset holding that the trial court failed to follow the

governing law established by *Weinstein,* 128 Ill. App. 3d 234, 470 N.E.2d 551, 83 Ill. Dec. 425 (1st Dist. 1984). The *Fahy* court cited to the reasoning used in the *Weinstein* case and noted that *Weinstein* suggests ways a court may deal with spousal contributions to a license or degree. W*einstein* suggested three methods to compensate for spousal contributions to a student spouse's education and/or support to reach an equitable result. Professional degrees may only be considered as *Weinstein* suggested and may not be treated as a marital asset.

D. Pensions Plans

1. Introduction

Retirement plans along with the marital home are the two greatest assets in many divorce cases. It is therefore extremely important that the practitioner understand retirement plans, what they entail, how to value such plans, and finally how to divide the benefits those plans contain. In order to fully appreciate what is involved in retirement plans the divorce practitioner needs to have an understanding of federal laws concerning these plans including the federal ERISA provisions as well as the Internal Revenue Code. In addition, there are numerous retirement plans not subject to the federal ERISA provisions and which are instead governed by state law. This chapter is not intended to discuss federal and state statutes and regulations concerning retirement plans, including the tax aspects. Readers are referred to the other chapters in this book dealing with those issues. Instead, this chapter will discuss the marital property nature of retirement plans and their valuation.

2. Terminology

Retirement plans come in all different types, and in order to understand how these plans differ it is important to have a clear definition of the terminology used in this chapter. While there is not one definitive source that carves in stone the definitions and terms used herein, the following descriptions are generally used when referring to retirement plans.

- **Defined benefit plan**. Typically a pension plan where the employee's benefit on retirement is defined. This generally is distinguished from a "defined contribution plan." In a defined benefit plan, the employer agrees to pay the employee a benefit based upon a set percentage of the average of a given number of years of the employee's earnings. As an example, a defined benefit pension plan might provide that on retirement the employee should receive 80% of the average of the highest five years of that employee's compensation. These plans generally express their benefits in terms of so many dollars per month on retirement. In a

defined benefit plan there is no segregated account assigned to the employee, rather the employer contributes to the plan actuarially determined sums required to fund the benefits to be paid. A defined benefit plan generally requires expert valuation to determine present value.

- **Defined contribution plan.** Typically, a profit-sharing plan where the employer makes a specific contribution for each plan participant. When eligible, that plan participant will receive that specific amount contributed for his or her benefit together with the increase or decrease in the value of that contribution based upon how that contribution was invested. A defined contribution plan is easier to value since at any given point in time the participant's account can be determined.
- **Pension plan**. A plan that pays an employee upon retirement a defined sum which can be paid in a single lump sum or in installments for a defined period of time. Typically pension plans are established as "defined benefit plans."
- **Profit-sharing plan**. A plan that pays an employee upon retirement a defined sum which can be paid in a single lump sum or in installments for a defined period of time. Typically profit-sharing plans are established as "defined contribution plans."
- **Qualified plan**. These are plans that qualify under the requirements of ERISA and the Internal Revenue Code. Generally speaking, in a qualified plan, the employer can make tax deductible contributions to the plan and the employee is not required to include those contributions as taxable income. However, income taxes must be paid on the sums paid out of those plans when received.
- **Vested and non-vested**. A plan is said to be "'vested' if it is not forfeitable by the discharge or voluntary retirement of the employee prior to retirement age," *In re Marriage of Hunt*, 78 Ill. App. 3d 653, 397 N.E.2d 511, 34 Ill. Dec. 55 (1st Dist. 1979). A plan can be vested even if it is not "matured" which *Hunt* defined as being the "unconditional right to immediate payment." What this means is that an employee can be 100% vested in retirement benefits, yet not be entitled to receive such benefits for many years to come.
- **Contributory and non-contributory plans**. A non-contributory plan is one where all the contributions are made by the employer. In a contributory plan, both the employer and the employee make contributions into the plan.
- **Pay status**. A retirement plan is described as being in pay status when the employee is currently receiving periodic payments under the plan.
- **QDRO**. Qualified Domestic Relations Order is an order entered by a divorce court which allows a qualified plan to designate the spouse of a plan participant as an "alternate payee" to be able to receive part or all of what the employee-spouse is entitled to receive under the plan. After a QDRO is entered by a domestic relations court it is served upon the retirement plan administrator, who, if the order is accepted as a QDRO, will pay the benefits directly to the alternate payee. The specific requirements of a QDRO are established by federal law. QDROs are very useful in dividing retirement benefits in kind in divorce cases.
- **ERISA**. Employee Retirement Income Security Act of 1974. This is the basic Federal law which governs retirement plans 29 USC § 100 et seq.

3. Retirement plans as marital property

Any part of a retirement plan benefit which is earned by the employee spouse while married is property "acquired" during marriage within the meaning of section 503 of the IMDMA and is, therefore, marital property. The first significant case in Illinois which considered the distribution of a pension plan in a divorce was in 1979 in the case of *In re Marriage of Hunt*, 78 Ill. App. 3d 653, 397 N.E.2d 511, 34 Ill. Dec. 55 (1st Dist. 1979). In *Hunt* the husband argued that since his non-contributory pension and profit-sharing interests were not fully vested at the time of divorce, they were not marital property. The court held that an employee's interest in a pension or profit-sharing plan is said to be "vested" if it is not forfeitable by the discharge or voluntary retirement of the employee prior to retirement age. Citing *In re Marriage of Brown*, (1976), 15 Cal.3d 838, 126 Cal.Rptr. 633, 544 P.2d 561. *Hunt* distinguished the meaning of the vested interest from "matured" interest, which is an unconditional right to immediate payment.

> We hold that an employee spouse's contractual right to a pension or profit sharing interest is "property" under section 503 of the Illinois Marriage and Dissolution of Marriage Act (750 ILCS 5/503) regardless of whether the interest is matured, vested or non vested, or contributory or non-contributory. *Hunt, supra* .

4. Methods to divide retirement plans

Retirement benefits can be divided in a divorce using three methods: total offset, reserved jurisdiction, and division in kind. The total offset method gives the retirement plan to the employee spouse while assigning a value to that plan which is then offset by other marital assets being awarded to the other spouse. In the reserved jurisdiction method, the court reserves jurisdiction to divide plan benefits if and when paid. The division in kind method will divide the plan benefits by awarding either a specific dollar amount or a percentage of the benefits to each spouse, typically through the use of a QDRO. Historically, Illinois cases seem to prefer the total offset approach in the interest of finality between the parties. The total offset approach is used most efficiently when the pensioner spouse is approaching retirement age and there are sufficient marital assets to allow an offset to the non-pensioner spouse. In the total offset approach, the court uses actuar-

ial evidence to determine the future value of the pension, and then discounts that value to account for the probability that the pension will not vest. The court then determines the present value of that amount, and the portion of that value that can be attributed to the marital estate. This often requires actuarial expert testimony to determine the actuarial factors and vesting probabilities.

5. Expert appraisers

As previously discussed, it is relatively easy to value a defined contribution type of plan such as a profit-sharing plan. The employer provides the employee spouse with a yearly statement of the amount in the employee's account. On the other hand, the present value of a defined contribution plan generally requires the services of a professional, typically an actuary. The Society of Actuaries located at 425 N. Martingale Road, Schaumburg, IL, (708) 706-3500, maintains a listing of current actuaries who are members or fellows of their organization. In order to achieve the status of a "fellow" of the Society of Actuaries, one must pass a series of examinations. The requirements to become a member of the Society of Actuaries is significantly less challenging. Another designation for an actuary is an "enrolled actuary" which requires three years of responsible pension actuarial experience, and passing two pension examinations administered by the Joint Board for the Enrollment of Actuaries, located in Washington, DC. This is a designation given by the federal government and is required to practice fully as an actuary in the pension area. An actuary can also achieve the designation as a "Member of the American Academy of Actuaries" with those three years of responsible actuarial work and either the status of the Society of Actuaries, Casualty Actuarial Society, or Enrolled Actuary.

6. Valuation methods

Even with the most experienced actuary, it may be difficult to place a present value on a pension or a profit-sharing interest, particularly in the case where the interest has not matured. The fact that it may be difficult to determine a present value does not prevent a court from considering how that asset should be treated. The *Hunt* court has stated:

> Difficulties in valuation are not an insurmountable barrier to including a pension or profit-sharing interest, whether matured, vested or non-vested, as marital property. Trial courts can in some cases determine, by actuarial evidence, the present value of such an interest at the time of divorce. The amount of the pension or profit-sharing interest included as marital property would then be the present value of the interest multiplied by a fraction whose numerator is the number of years (or months) of marriage during which benefits were being accumulated, and whose denominator is the total number of years (or months) during which benefits were accumulated prior to divorce. Once the trial court has determined the present value of that part of the pension or profit-sharing interest which is marital property, the trial court may award the interest to the employee spouse and give the non-employee spouse other marital property to offset her marital share in the interest." *Hunt* 397 N.E.2d at 519, 34 Ill.Dec. at 63.

This is the formula which the *Hunt* court used in its total offset approach. It should be noted that *Hunt* was decided before the advent of QDROs. When applying the total offset approach in attempting to arrive at a present value of a retirement plan, some experts will use a market value approach. In determining the market value of a benefit, the monthly retirement benefit for the plan participant is compared to the cost of a single premium annuity at the time of the valuation.

A department of the United States government, the Pension Benefit Guarantee Corporation, publishes tables that contain the cost of a single premium annuity. These tables can be used to determine the present value of a future string of payments. The logic contained in the market value method is as follows: the present value of a defined benefit plan is equal to the present sum of money required to purchase a single premium annuity for a male/female, who is __ years old which amount if invested today at __% interest would pay that individual $____ per month when that person reaches the retirement age of ___. This market value then can be adjusted for such things as a discount for taxes that will be paid when the payments are received.

The reserved jurisdiction method of allocating the marital interest at the time of retirement does not require a computation for present value, but it does require a complete understanding of what retirement benefits will be paid in the future. The reserved jurisdiction method may be appropriate especially where it is difficult to place a present value on the pension or profit-sharing interest due to uncertainties regarding vesting or maturation, or when it is impractical or impossible to award sufficient offsetting marital property to the non-employee spouse. In the non-vested situation, by using the reserved jurisdiction method, both spouses assume the same risk that the benefits may never vest. The court may award each spouse an appropriate percentage of the pension to be paid "if, as and when" the pension become payable. In using a reserved jurisdiction approach, it is necessary to calculate the marital portion of the benefits since additional benefits will probably accrue after the divorce. The court in *Hunt* stated a formula for this calculation:

> The marital interest in each payment will be a fraction of that payment, the numerator of the fraction being the number of years (or months) of marriage during which benefits were being accumulated, the denominator being the total number of years (or months) during which benefits were accumulated prior to when paid. The trial court, when using this method of allocation, will retain jurisdiction and award the non-employee spouse some percentage of the marital interest in each payment. *Hunt*, 397 N.E. 2d at 519.

Under the reserved jurisdiction approach, the court orders the employee spouse to pay an allocated portion of the pension fund to the former spouse as it is received, while retaining jurisdiction to enforce the decree. *Id.* Considerations of the parties' ages, amounts of property (both marital and nonmarital), the duration of the marriage, health, types of benefits, amount of benefits to be received, and other circumstances encountered in a dissolution proceeding may make it impractical to hold that the disposition of pension entitlement in a dissolution proceeding under section 503 of the IMDMA must always be limited to the offset or reserved jurisdiction approach. For example, the reserved jurisdiction method has been considered appropriate when the pensioner will not reach payee status for a number of years, and where there are few remaining marital assets to adequately compensate the non-pensioner spouse for the marital portion of the pension. *In re Marriage of Dooley,* 137 Ill. App. 3d 401, 484 N.E.2d 894, 92 Ill. Dec. 163 (2d Dist. 1985). Valuation may not be necessary under the reserved jurisdiction method because spouses are given a set percentage of the pension payments at the time that they are received. On the other hand, the offset method is more appropriate where the pensioner is close to mandatory retirement age or retirement is otherwise imminent, and there are sufficient other marital assets to allow an offset to the non-pensioner spouse. *In re Marriage of Wisniewski*, 107 Ill. App. 3d at 717, 437 N.E.2d at 1305, 63 Ill. Dec. at 383 (4th Dist. 1982). Similarly, in *In re Marriage of Wiley*, 199 Ill. App. 3d 160, 556 N.E.2d 809, 145 Ill. Dec. 191 (4th Dist. 1990), the trial court's application of the offset method was affirmed in awarding the marital home to the wife and the pension rights to the husband although no expert testimony or actuarial evidence was presented. The trial court applied the present value of the husband's pension which was listed in the husband's financial affidavit. *Id.*

7. Reimbursement principles

The valuation and distribution of pension plans is subject to classification and reimbursement principles. Thus, if a pension plan existed prior to the marriage, and increases in value during the marriage due to the personal efforts of the pensioner spouse, the pension retains its nonmarital status but the marital estate may be entitled to reimbursement for such contributions. *In re Marriage of DiAngelo,* 159 Ill. App. 3d 293, 512 N.E.2d 783, 11 Ill. Dec. 1394 (2d Dist. 1987). In *DiAngelo*, the husband rolled his profit-sharing account, which was established prior to the party's marriage but had increased in value resulting from the contribution of the marital estate, into an individual retirement account. To determine the amount of reimbursement, courts must determine the amount of the pension that is attributable to the marital estate. Again, there is no one method that courts consistently apply in reaching this determination. *In re Marriage of Davis*, 215 Ill. App. 3d. 763, 576 N.E.2d 44, 159 Ill. Dec. 375 (1st Dist. 1991). One method that courts use in determining the portion of the pension that will be considered marital is the contribution formula. The contribution formula uses the actual cash contributions made to the plan both before and after the marriage, and considers those contributions in ratio to each other to determine the value of the marital portion. This tends to favor the marital estate when the employee was not married during the early years of employment and his or her contributions increased with any increase in compensation.

Another method used in determining the marital portion of a pension or profit-sharing interest is to calculate the ratio of years of accumulation during the marriage to the total years of accumulation. *In re Marriage of Davis*, 215 Ill. App. 3d. 763, 576 N.E.2d 44, 159 Ill. Dec. 375 (1st Dist. 1991). If the value of the premarital portion is known, an alternative method can be used. This alternative method is used in similar apportionment decisions concerning life insurance and equity in a home to determine the correct marital portion. This method involves comparing the ratio of the premarital portion to the value of the entire plan at the time of dissolution to produce the correct marital portion. For example, in *Davis,* the parties stipulated that the premarital portion of the IRA rollover of the profit-sharing plan in 1968 was $57,815.23. Between 1968 and 1976, the company contributed $96,556.61 to the plan. The percentage of the nonmarital portion to the marital portion is therefore 37.5 to 62.5% and the marital estate was entitled to reimbursement for the portion it contributed.

Certain retirement benefits are not subject to distribution in a divorce proceeding under ERISA, which generally preempts state law relating to retirement plans, benefits under a pension, profit-sharing, or stock bonus plans (i.e., federal retirement plans are not subject to QDROs under ERISA). Also, state retirement plans, including municipal plans, police and fire department plans, Teacher's Retirement System, and other non-qualified plans not subject to ERISA cannot be divided through the use of QDROs. Courts may not divide federal benefits such as the right to receive Social Security benefits. In *In re Marriage of Hawkins,* 60 Ill. App. 3d 71, 513 N.E.2d 143, 111 Ill. Dec. 897 (5th Dist. 1987), the trial court erred in ordering the husband to pay the wife an additional $10,000 because of a disparity in Social Security contributions and because of a contribution by the

wife of nonmarital assets to the marital estate. The *Hawkins* appellate court adopted the reasoning of *In re Marriage of Evans,* 85 Ill. App. 3d 260, 263, 460 N.E.2d 916, 917-918, 40 Ill. Dec. 713, 714-15 (3d Dist. 1980) *rev'd on other grounds*, 85 Ill. 2d 523, 426 N.E.2d 854, 55 Ill. Dec. 529 (1981) which held:

> The right to receive social security benefits is derived from statute and not from the common law. The Federal statute, consistent with its remedial purpose, provides for the various contingencies of life including the dissolution of marriage. Since the statute itself provides for an equitable distribution of its benefits to dependents, spouses, divorced spouses, and other family members in the event certain contingencies occur, we will not disturb the statutory scheme by suggesting any award of any part of the actual social security retirement benefits to which respondent may be entitled upon his reaching retirement age.

Pensions under the Illinois Code (Ill.Rev.Stat. ch. 1081/2 § 1-101 et seq.) may be classified as marital property, which are subject to division between the spouses despite the anti-attachment provisions of the ERISA statute. Paradoxically, the most common pension plan, Social Security, is not subject to distribution in a divorce proceeding under ERISA.

Careful attention must be given to retirement benefits in dissolution cases. Retirement plans contain many pitfalls for the practitioner. Indeed, failure to properly divide a plan benefit may not become known until 20 to 30 or more years in the future when the plan goes into pay status or the employee-spouse dies.

E. Personal injury awards and settlements

1. Existing Illinois law

Illinois courts have held that personal injury cause of actions and settlement proceeds that occur during the marriage are marital property *Gan v. Gan,* 83 Ill. App. 3d 265, 404 N.E.2d 306, 38 Ill. Dec. 430 (5th Dist. 1980). This includes worker compensation awards that accrue during the marriage even though the award is paid after the divorce. *In re Marriage of Dettore,* 86 Ill. App. 3d 540, 408 N.E.2d 429, 42 Ill. Dec. 51 (3d Dist. 1980). However, claims that arise before the marriage are nonmarital property despite the fact that the proceeds might be distributed during the marriage. *In re Marriage of Drone,* 217 Ill. App. 3d 758, 577 N.E.2d 926, 160 Ill. Dec. 601 (5th Dist. 1991).

In the case of *In re the Marriage of Burt,* 144 Ill. App. 3d 177, 494 N.E.2d 868, 98 Ill. Dec. 746 (4th Dist. 1986), the court held that a cause of action for personal injury occurring during the course of dissolution proceedings would be considered marital property subject to division. This was the case notwithstanding the fact that a significant portion of the subsequent settlement was attributable to future pain and suffering and future loss of earning capacity. The *Burt* court rejected the New Jersey case of *Amato v. Amato,* 180 N.J.Super. 210, 434 A.2d 639, (App. Div. 1981), which held that any part of a personal injury settlement which was attributable to pain and suffering or physical disability was the sole property of the injured spouse. The *Amato* court focused on both the inherently personal nature of pain and suffering and the fact that the pain would be suffered in the future. The court in *Burt* justified its position by relying on previous worker compensation cases which held that awards for job-related injuries occurring were considered marital property, including such awards that were not for loss of earning capacity, but rather for loss of a specific body part. Citing *In re Marriage of Thomas*, 89 Ill. App. 3d 81, 411 N.E.2d 552, 44 Ill. Dec. 430 (3d Dist. 1980). The *Burt* court also relied on the fact that the complete list of property excluded under section 504(a) of the IMDMA made no mention of any types of causes of action. This was the same reasoning used by an earlier Illinois court in *Gan v. Gan*, 83 Ill. App. 3d 265, 404 N.E.2d 306, 38 Ill. Dec. 430 (5th Dist. 1980) which stated:

> The husband's personal injury settlement does not fit within any of the exceptions to marital property enumerated in the Act. Thus, the presumption that the personal injury was marital property as provided by section 503(b) of the Act was raised. In accordance with the statutory presumption, the personal injury settlement proceeds must be deemed marital property.

In *Burt,* the court acknowledged the fact that some portion of the personal injury award may be for pain and suffering that is inherently personal. However, this fact will not keep the proceeds from being characterized as marital property; rather this issue should be considered in dividing the marital assets pursuant to 503(d). The court stated,

> By the terms of section 503(d), in dividing marital property, the court is expressly directed to consider "the age, health,...employability...,and needs of each of the parties" (750 ILCS 5/503(d)(10)). This of itself, authorized the court to consider the disability of an injured spouse and award a larger portion of marital property, including the proceeds of a case of action to that spouse. Moreover, the factors expressed in section 503(d) are not the only factors that can be considered. Other factors may be considered if relevant. (*Atkinson v. Atkinson,* (1981), 87 Ill. 2d 174, 57 Ill. Dec. 567, 429 N.E.2d 465; pocket parts; (Ill.Ann.Stat., ch 40. par. 503; Historical & Practice Notes, 61 (Smith-Hurd Supp. 1986).) The pain and suffering and disability of an injured spouse

would be relevant considerations.

Personal injury awards or causes of action that occur after the dissolution of marriage are not marital property, notwithstanding the fact that the nonmarital injury aggravated a preexisting marital injury and apportioning the damages between the two would be difficult. *In re Marriage of Waeckerle,* 219 Ill. App. 3d 937, 579 N.E.2d 1275, 162 Ill. Dec. 461 (5th Dist. 1991)

2. Arguments against including personal injury awards as marital property

Even though it appears Illinois is committed to including personal injury awards as marital property, there exists numerous arguments against this classification. Many jurisdictions outside Illinois are divided in their treatment of personal injury awards and causes of action. Perhaps one of the stronger arguments is contained in *Johnson v. Johnson,* 317 N.C. 437, 346 S.E.2d 430 (1986). In *Johnson,* the Supreme Court of North Carolina discussed the analysis of the Fourth District Illinois Appellate Court in *Burt* and classified it as being mechanical. This North Carolina Supreme Court rejected this approach in favor of the analytical approach.

> The mechanistic approach is literal and looks to the general statutory definitions of marital and separate property and concludes that since the award was acquired during the marriage and does not fall into the definition of separate property or into any enumerated exception to the definition of marital property, it must be marital property. [cites omitted} at 435.

The North Carolina Supreme Court went on to note that eight out of nine community property states have embraced the analytical approach to analyzing personal injury awards. The analytical approach seeks to apportion the award into three substantive categories: (1) those compensating the injured spouse for pain and suffering, disability, disfigurement, or lost limbs; (2) those compensating for lost wages, lost earning capacity, and medical and hospital expenses; and (3) those compensating the non-injured spouse for loss of services or loss of consortium. *See* Nev.Rev.Stat. §123.121[1][1](1985). *Cf. Amato v. Amato,* 180 N.J. Super. 210, 434 A.2d 639 (1981). *Johnson,* at 436. Those jurisdictions which apply the analytical approach uniformly apportion the part of the award which constitutes damages for economic loss (i.e. lost wages, medical expenses, etc.) and which have been directly or indirectly paid out of marital funds as marital. However, they classify that portion of the award which represents compensation for non-economic loss, such as personal suffering and disfigurement, as the separate property of the injured spouse. In the case of *Jurek v. Jurek,* 124 Ariz. 596, 606 P.2d. 812 (1980), the Arizona Supreme Court stated:

> In the same fashion as pointed out in *Soto,* the body which [the husband] brought to the marriage is certainly his separate property. The compensation for injuries to his personal well-being should belong to him as his separate property. Any expenses incurred by the community for medical care and treatment and any loss of wages resulting from the personal injury should be considered community in nature, and the community is entitled to recover for such losses. *Johnson,* 346 S.E.2d at 436 quoting *Jurek v Jurek* 124 Ariz. 596, 598, 606 P.2d. 812, 814

The *Johnson* court quoted favorably the *Johnson* appellate decision which stated the basic premise underlying the equitable distribution act.

> The obvious purpose of the Equitable Distribution Act is to require married persons to share their maritally acquired property with each other — it is not to require either party to contribute his or her bodily health and powers to the assets for distribution — and the funds that the appellant [wife] claims to have a right to share in were paid the appellee [husband] for injuries suffered by his body, which, of course, he had before the marriage. *Johnson v. Johnson,* 346 S.E.2d 430 quoting *Johnson v. Johnson,* 75 N.C.App. 659, 661, 331 S.E.2d 211, 212.

After weighing the relative strengths and weaknesses of the two approaches, the North Carolina Supreme Court chose to join the minority of equitable distribution states who employ the analytical approach to analyzing personal injury awards.

Many of the statutory provisions of the IMDMA would seem to argue against the inclusion of personal injury awards as marital property. Section 503(6) excludes from the marital estate that property that was acquired before the marriage. Obviously, an individual's body is nonmarital, therefore, one would think any compensation for injury to that nonmarital body should also be treated as nonmarital. Also, to the extent that a portion of a recovery can be determined to be for future lost earnings, earnings that would have been received after the divorce, section 503(3) clearly states that property acquired by a spouse after a judgment of dissolution or legal separation is nonmarital. That is not to say a court could not

consider that future income for maintenance and child support purposes, again keeping in mind that it is improper to give a double consideration or "double dip" to the same asset. *In re the marriage of Zells,* 143 Ill. 2d 251, 572 N.E.2d 944, 157 Ill. Dec. 480, 481 (1991). The *Zells* decision certainly adds great weight to the argument that if a personal injury award is held to be marital and divided, then that same award should not be used in calculating maintenance or support.

Shortly after this section on personal injury awards was written, an Illinois court finally recognized that a personal injury award can be divided into marital and nonmarital property. In May 1994, the Fifth District in *In Re Marriage of Waggoner*, 247 Ill. App. 3d 639, 643 N.E.2d 1198, ___ Ill. Dec. ___ (5th Dist. 1994), adopted the analytical approach and held that a worker's compensation award for an injury that occurred during the marriage consisted of the injured spouse's nonmarital property when it involved compensation for a permanent disability and the recovery was for pain and suffering, disability, disfigurement, loss of limbs or loss of earnings and medical expenses which shall accrue after the divorce. That portion of the award for loss of earnings and medical expenses incurred during the marriage is marital property.

F. Income tax refunds

All property acquired during the marriage is presumed to be marital property. IMDMA §503(b). Income tax refunds which are based upon income earned during the marriage are marital property subject to division on dissolution. The practitioner should be especially careful when reviewing tax returns prepared or filed during the pendency of a divorce proceeding to determine who is receiving the tax refunds. There are generally three methods to deal with income tax refunds generated during divorce cases. The first approach is to agree to divide the refunds when received either equally or in proportion to the taxes incurred or taxes withheld for each taxpayer. The second method is to place all refunds in an interest-bearing escrow account for later division by agreement or court order. The third method involves applying the refunds to the next year's taxes. It is not uncommon for the major income producer to attempt to apply a refund to the next year's taxes. While this may be required because of cash flow considerations or be the most expedient way to deal with the refund at the time of filing, the amount of the refunds should not be overlooked and must be included as part of the marital estate.

A federal income tax refund based on a couple's joint tax return was held to be marital property when the taxes were withheld during the marriage and before judgment of dissolution even though the wife earned no income for the tax year in question and withholding was solely from the husband's earnings. *In Re Marriage of Ormiston,* 168 Ill. App. 3d 1016, 523 N.E.2d 148, 119 Ill. Dec. 680 (1st Dist. 1988); also see *In Re Marriage of Brooks,* 138 Ill. App. 3d 252, 486 N.E.2d 267, 93 Ill. Dec. 166 (1st Dist. 1985). However, where the tax refund was traced to income, the bulk of which was earned before the marriage, the money was a nonmarital asset. *In Re Marriage of Philips,* 200 Ill. App. 3d 395, 558 N.E.2d 154, 146 Ill. Dec. 191 (1st Dist. 1990).

G. Life insurance policies and benefits

There are many different types of life insurance policies, some of which have a value independent of their death benefit that should be included as a part of the marital or nonmarital estate. Whole life and universal life insurance provide a cash value in addition to the stated death benefit. Also, dividends generated by the policy may be used to buy additional insurance, be added to the cash value, or actually paid out to the policy owner. The value of whole life insurance may be determined from the cash surrender value less any amounts borrowed. *In re Marriage of Ryman*, 172 Ill. App. 3d 599, 527 N.E.2d 18, 122 Ill. Dec. 646 (2d Dist. 1988).

A variation of this is split life insurance, which includes a term insurance component and a retirement annuity. The retirement annuity may be valued by using actuarial tables to estimate the number of years the annuity will likely be received (retirement age to age of expected mortality) and than calculating the present value of the expected future stream of payments. An actuary or other life insurance expert can be used to calculate this present value. Term insurance provides only a benefit paid upon the death of the insured, and does not have any cash surrender value. There are many other variations of life insurance, so it is important in discovery to obtain a copy of the policy as well as a current statement indicating the cash surrender value and the history of borrowing.

In *In re Marriage of Ryman*, 172 Ill. App. 3d 599, 527 N.E.2d 18, 122 Ill. Dec. 646 (2d Dist. 1988), the trial court found the cash surrender value of the husband's three nonmarital policies to be $5,690. It was established by clear and convincing evidence that the marital estate paid $4,492.50 to maintain these policies. The trial court ruled that the marital estate's right to reimbursement was offset by the coverage benefits that it received. The appellate court order reversed and remanded for the trial court to determine the amount of reimbursement by multiplying the cash surrender value of the policies by the ratio of marital contributions to the total amount of premiums paid.

The case of *In re Marriage of Fairchild,* 110 Ill. App. 3d 470, 442 N.E.2d 557, 66 Ill. Dec. 131 (3d Dist. 1982), dealt with the issue of whether term life and health insurance benefits enjoyed by the wife as a result of her husband's employment were property within the contemplation of the Illinois Marriage and Dissolution of Marriage Act. The *Fairchild* court held that these benefits are merely "a right to current payments by reason of current employment" as distinguished from "the contractual right to future payments by reason of past employment" and therefore not "property" as defined in the IMDMA.

The cash surrender value of a policy, or its present value, must be distinguished from the face value of the policy, which is of no consequence in valuation. Life insurance policies that do not have a cash surrender value (such as term insurance policies) are not valued as an asset in dissolution proceedings, even though a court may order a spouse to maintain such insurance to secure the payment of maintenance or child support.

H. Stock options

The current Illinois cases discussing the treatment of employee stock options hold that the employee's interest in the options does not constitute property under section 503 of the IMDMA until the options are exercised. *In re Marriage of Moody,* 119 Ill. App. 3d 1043, 457 N.E.2d 1023, 75 Ill. Dec. 581 (1st Dist. 1983); *In re Marriage of Frederick,* 218 Ill. App. 3d 533, 578 N.E.2d 612, 161 Ill. Dec. 254 (2d Dist. 1991). The court employs a reserved jurisdiction approach whereby it allocates the profits from the exercise of the option, "if and when" it is exercised. This effectively allows the employee spouse to retain complete discretion over whether to exercise the option or not.

The Supreme Court of Illinois addressed the issue of whether contingent future benefits arising out of one's employment should be treated as marital property in the case of *In re Marriage of Evans*, 85 Ill. 2d 523, 426 N.E.2d 854, 55 Ill. Dec. 529 (1981). The *Evans* court held that where the value of an employee spouse's future benefit could not be ascertained at the time of dissolution, the other spouse could not be awarded a defined interest in such benefits. In doing so the *Evans* court stated

> ...Again, if the payment of benefits is contingent upon future events, such as the continuation of employment, a present award based on the discounted value of future payments to the employed spouse will prove excessive if the amount of benefits which he actually receives is less than the amount which was assumed. *Id.* at 532.

In 1983, an Illinois appellate court first specifically addressed the issue of employee stock options in the case of *In re Marriage of Moody*, 119 Ill. App. 3d 1043, 457 N.E.2d 1023, 75 Ill. Dec. 581 (1st Dist. 1983). In *Moody*, the trial court held that the husband's stock options, given to him as compensation, were property accumulated by the parties during the marriage and therefore marital property. The appellate court rejected this classification and held that the stock options did not constitute marital property until exercised. The appellate court relied on *Evans* in stating that it was improper to value the options where the evidence presented did not establish the present value of the benefits. *Id.* at 584. The *Moody* court identified several factors that led it to the determine that the options were not property: the stock options were nontransferable, only half of the shares were vested, and the husband did not have the financial means to exercise the options. The court concluded that due to these factors the husband might never exercise the options before they expired. Therefore it would be inequitable to attribute the predetermined profits to the husband in the dissolution proceeding. Instead, the court allowed the husband to retain his interests in the options as his separate property. In addition, the trial court was directed to retain jurisdiction until the options were exercised (or expired) and then to distribute the profits accordingly.

The most recent Illinois case that addresses the treatment of employee stock options is *In re Marriage of Frederick,* 218 Ill. App. 3d 533, 578 N.E.2d 612, 161 Ill. Dec. 254 (2nd Dist. 1991). In *Frederick*, the husband was an executive of the Hilton Hotels Corporation and had received certain stock options by virtue of his employment. At the time of the decision, the husband was fully vested in certain unexercised options. The options were nontransferable and subject to certain other restrictions, such as automatic expiration. The court relied on *Moody* and *Evans* in holding that the options did not constitute property. The court noted that while there was no evidence that the husband would not be able to exercise the options due to poor health or financial reasons, the lack of those factors alone did not effect the fact that the options could not be properly valued until they were exercised. The husband retained exclusive discretion to exercise the options and the trial court retained jurisdiction to allocate any profits realized. The appellate court approved the trial court's decision that awarded to each spouse 50% of any profit from the exercise of any vested options and 50% of the marital fraction of any profit from the excursus of non-vested options.

Indeed, it would appear that this present award to each spouse of a percentage of profits received from the future exercise of an option is preferred and eliminates the *Leopando* (*Leopando v. Leopando*, 96 Ill. 2d 114, 449 N.E.2d 137, 70 Ill.

Dec. 263 (1983)) problem of the finality of a judgment. The judgment should provide for proper notification concerning the future exercise of the options as well as a definitive statement that each spouse should be responsible for the income taxes realized from the exercise. In most cases the entire tax liability will fall on the employee upon the exercise of the options, so any judgment should provide that the profits will be divided after taxes.

I. Marital debts

Section 503 of the Illinois Marriage and Dissolution of Marriage Act provides that the trial court "shall divide the marital property without regard to marital misconduct in just proportions considering all relevant factors including the 12 enumerated factors. These relevant factors are also considered when distributing debt accumulated during a marriage. Accordingly, the court's power to allocate marital property in a dissolution proceeding necessarily includes the power to allocate marital debts. Where the partners to a marriage accumulate debts which exceed the value of their assets, then the debt must be distributed equitably, the same as marital assets. *In re Marriage of Douglas*, 195 Ill. App. 3d 1053, 552 N.E.2d 1346, 142 Ill. Dec. 605 (5th Dist. 1990). In *Douglas*, the evidence adduced at trial showed that the bulk of the marital assets had been taken from the parties via foreclosure proceedings. The appellate court held that the trial court erred in not allocating the debt as marital property.

1. Trial court's discretion

A trial court has a great amount of discretion in allocating marital property among the parties through a divorce proceeding. That discretion includes the power to allocate debts associated with the property awarded. *In re Marriage of Hopkins*, 106 Ill. App. 3d 135, 435 N.E.2d 897, 62 Ill. Dec. 99 (4th Dist. 1982). The case of *In re the Marriage of Gunn*, 233 Ill. App. 3d 165, 598 N.E.2d 1013, 174 Ill. Dec. 381 (5th Dist. 1992) shows how the trial court carefully considers the factors outlined in section 503 of the IMDMA in the distribution of the marital assets and debts. In *Gunn*, the trial court's distribution of assets and debts was found to be equitable where the husband was awarded $335,335 of the marital property and directed to pay all of the marital debts totaling $87,775 compared to the $231,928 awarded to the wife. In determining whether a trial court abused its discretion in allocating the marital property and debts, the appropriate inquiry is whether the court, in view of the totality of circumstances, acted such that no reasonable person would take the view it adopted. *In re Marriage of Lee*, 78 Ill. App. 3d 1123, 1127, 398 N.E.2d 126, 34 Ill. Dec. 451 (1st Dist. 1979).

The trial court in *In re the Marriage of Jacks*, 200 Ill. App. 3d 112, 558 N.E.2d 106, 146 Ill. Dec. 143 (2d Dist. 1990), after hearing evidence relative to several promissory notes received by the husband from his mother, questioned the authenticity and enforceability of said notes. The husband also presented testimony relative to a debt he owed to his friend, a credit card obligation and a credit union loan. The trial court found that these debts were to be the husband's personal debts and not marital obligations. The appellate court would not second guess the trial court's determination regarding the credibility of the witnesses, and found that the trial court's award was not an abuse of discretion where there was ample evidence in the record to support the court's distribution of the marital assets.

2. Business vs. personal debts

In *In re Marriage of Hopkins,* 106 Ill. App. 3d 135, 435 N.E.2d 897, 62 Ill. Dec. 99 (4th Dist. 1982), there was testimony that $30,000 was borrowed by the husband from the wife's relatives. Under the particular facts involved, the trial court held that it was irrelevant whether the debt was a personal obligation or a business debt because all assets and debts involved were marital. The trial court awarded the husband approximately one-fourth of the marital estate including the business, but the wife was ordered to hold the husband harmless for the $30,000 "business loan" borrowed from her relatives. In this case the doctrine of assigning a loan to the spouse whose relative was the lender outweighed the doctrine of assigning the debt to the asset it is associated with.

3. Allocation of debts

In determining the responsibility for marital debts, the court should consider the overall circumstances of the parties, the source of the debt, the purpose of the debt and the party who incurred the debt. *In re the Marriage of Hagshenas*, 234 Ill. App. 3d 178, 600 N.E.2d 437, 175 Ill. Dec. 506 (2d Dist. 1992). In *Hagshenas*, the husband and wife owned a travel agency in partnership with others. There was a falling out with the other owners and the husband established a new travel agency, taking the sales staff and customers with him. At the time of the divorce, the husband was sued by the former travel agency partners and was found liable for breach of his fiduciary duty. In the divorce the wife received the new travel

agency and the trial court required the husband to be liable to the former partners. In this case, since the basis of the liability was the husband's breach of his fiduciary duties, the husband argued that "a debt created by an asset should follow that asset." The court held that under the circumstances, the doctrine was not appropriate.

In most cases, a debt is assigned to the spouse who is awarded the asset to which the debt is attached. In *In re Marriage of Guntren*, 141 Ill. App. 3d 1, 489 N.E.2d 1120, 95 Ill. Dec. 392 (4th Dist. 1986), the court held that the trial court abused its discretion by awarding the husband the debt on farm implements and machinery which were awarded to the wife. One of the determining factors in allocating the responsibility of marital debts is the party who incurred the debt. In the case of *In re Marriage of Ryan*, 138 Ill. App. 3d 1077, 487 N.E.2d 61, 93 Ill. Dec. 617 (1st Dist. 1985), the court allocated the entire $103,000 marital debt to the husband since the overwhelming majority of the debt was created by the husband, and the wife was unaware of the extent of the husband's borrowing and had no control over it. Similarly, in the case of *Szesny v. Szesny*, 197 Ill. App. 3d 966, 557 N.E.2d 222, 145 Ill. Dec. 452 (1st Dist. 1990), the court found that the husband was solely responsible for the $82,000 in debt based on testimony that the wife had drastically reduced her expenditures, while the husband maintained or increased his expenditures. The husband had opened charge accounts without the wife's knowledge or permission, and he used same to incur the debt. The *Szesny* case was distinguished by *In re Marriage of Goforth*, 121 Ill. App. 3d 673, 459 N.E.2d 1374, 77 Ill. Dec. 125 (5th Dist. 1984), which involved the reverse situation. In *Goforth*, the wife incurred the debt to defray living expenses for herself and the children. This debt was incurred between the time that the husband left the marital home and the date of the court's dissolution judgment. The appellate court held that it was within the trial court's discretion to assign said debt, which was incurred by the wife, to the husband.

4. Debts from relatives and friends

Generally, the court will assign the debt to the spouse whose relatives or friends were the lenders. In the case of *In re Marriage of Einhorn*, 178 Ill. App. 3d 212, 533 N.E.2d 29, 127 Ill. Dec. 410 (1st Dist. 1988), the trial court heard conflicting testimony as to whether wife's father loaned or gifted $10,000 to the parties. The court ordered the wife to repay "whatever loans she deems outstanding to her father." Similarly, in the case of *In re Marriage of Click*, 169 Ill. App. 3d, 523 N.E.2d 169, 119 Ill. Dec. 701 (2d Dist. 1988), the trial court did not believe the wife's testimony that she owed approximately $30,000 to her mother and $15,000 to her brother since there were no records of amounts loaned and the wife's name appeared together with her mother's name on several well-funded checking accounts, even though the wife claimed such accounts belonged exclusively to her mother. In contrast, the trial court was reversed in the case of *In re Marriage of Harding*, 189 Ill. App. 3d 663, 545 N.E.2d 459, 136 Ill. Dec. 935 (1st Dist. 1989), when it erroneously assigned to the wife the entire liability on a note owed to the wife's mother, where the husband, for 14 years, accepted the benefit of an income tax deduction which related to the existence of the note, by deducting the interest paid on the loan on the parties' joint income tax return.

5. Nonmarital debts

The case of *In re Marriage of Shields,* 167 Ill. App. 3d 205, 521 N.E.2d 118, 118 Ill. Dec. 50 (4th Dist. 1988), involved special circumstances and deviates from the general rule that a spouse would usually be required to pay his or her nonmarital debts. In *Shields*, the court ordered the wife to pay her husband's nonmarital tax debt where the husband had suffered a stroke and was confined to a nursing home and the wife was awarded a disproportionate amount of the marital assets.

6. Potential liabilities

The court requires "some evidence" of the value or liability attending to an asset in order to divide the property in just proportions. *In re Marriage of Mitchell*, 103 Ill. App. 3d 242, 248, 430 N.E.2d 716, 58 Ill. Dec. 684 (2d Dist. 1981). For example, in *In re Marriage of Hagshenas*, 234 Ill. App. 3d 178, 600 N.E.2d 437, 175 Ill. Dec. 506 (2d Dist. 1992), the husband argued that the trial court had no basis on which to divide the marital property because it did not know the exact amount of the potential liability which would arise from a lawsuit pending against the husband (liability had been established but damages had not yet been determined). The appellate court held that the trial court's knowledge that the husband's liability was $388,100 or less was a sufficient basis on which the court could divide the marital property.

7. Indemnification clauses

When a settlement agreement states that a party "shall hold the other harmless from any liability for the debt" and the other party pays the debt directly and seeks reimbursement from the spouse who was liable for the debt per the agreement, the spouse who paid the debt voluntarily may not be entitled to reimbursement. *In re Marriage of Milliken*, 199 Ill. App. 3d 813, 557 N.E.2d 591, 145 Ill. Dec. 821 (1st Dist. 1990). In *Milliken,* a clause in the parties' property agreement stated that the husband was to be solely responsible for, and shall hold the wife harmless of any liability for the debt of the husband to the wife's brother. The wife subsequently paid the debt and demanded reimbursement. The *Milliken* court did not impose a duty

upon the husband to reimburse or indemnify the wife for any voluntary and gratuitous payment made by her on a debt for which she had no legal obligation in the first instance.

The inclusion of language in a marital settlement agreement which specifically designates certain debts as being the debts of each of the parties, and the exclusion of language relating to other debts, indicates that the parties agreed that only the certain debts were individual rather than marital debts.

8. Sale of marital property to pay debts

Section 503(i) of the IMDMA gives the court the power to order the sale of marital assets and to determine how the proceeds should be applied. In the case of *Hall v. Hall*, 31 Ill. App. 2d 70, 175 N.E.2d 667 (1st Dist. 1961), the court ordered the sale of jointly owned real estate to pay existing debts which were inured to the mutual benefit of both parties and their children. The court may further order the parties to share the capital gains liability resulting from the sale of the marital residence. *In re Marriage of Olson*, 223 Ill. App. 3d 636, 585 N.E.2d 1082, 166 Ill. Dec. 60 (2d Dist. 1992).

J. Personal property

Personal property acquired during the marriage is marital property subject to division upon dissolution of the marriage. IMDMA § 503.

Even though in most cases household furniture and furnishings can be the least valuable asset, it can often be the source of unreasonable arguments and positions in light of the amounts involved. Typically, the spouse who is awarded the former marital residence wants to retain the contents and argues that it is used furniture of little value. On the other hand, the other spouse views the furniture left behind as possessing great value when viewed in the light that it will have to be replaced. The truth is both are correct. Experts will tell you used furniture is worth between 10 to 30% of the original cost —depending on age and condition — if sold on the open market. This rule of thumb does not apply to antiques, which are really old, used furniture. Art work and collectibles also do not fall under this 10 to 30% rule. On the other hand, the other spouse will be required to purchase furniture to replace that left behind and this requires an immediate outlay, which diminishes the amount of the assets awarded that spouse. In many cases the spouses agree to divide the furniture and furnishings in kind on either an equal or unequal basis. The spouse who receives the former marital residence often is the primary custodian of the minor children and in that situation the parties must consider the effect on the children if half the furniture leaves with the departing parent. Courts recognize that furniture has more value remaining in the former marital residence than being sold as used furniture and accordingly will award the furniture to the spouse who receives the home. *In re Marriage of Landfield,* 209 Ill. App. 3d 678, 567 N.E.2d 1061, 153 Ill. Dec. 834 (1st Dist. 1991). Both trial courts and appellate courts are reluctant to engage parties who may desire to litigate every item of personal property. The cost of legal fees and court time seldom justifies the time required to try each item of personalty when compared to the value of the item in dispute. Generally it probably costs less to purchase an item new than to pay the attorneys to argue over the old one. The appellate court in *In re Marriage of Thornton,* 89 Ill. App. 3rd 1078, 412 N.E.2d 1336, 45 Ill. Dec. 612, 623 (1st Dist. 1980) stated:

> We decline to hold that in every case the court must assign to one party or the other every item of property no matter how insignificant its value. Once the major assets have been distributed the parties are often able to agree on the distribution of miscellaneous items. Should a dispute arise as to one or more items the court could be called upon to make a determination.

One way to avoid the expense of a trial on the value or division of personal property is either for the parties to agree or the court to order an equal division of the household goods and furnishings since when there is an equal division in kind the value of the property is irrelevant. *West v. West,* 77 Ill. App. 3d 828, 396 N.E.2d 1382, 33 Ill. Dec. 658 (4th Dist. 1979); also see *In re Marriage of Frederick,* 218 Ill. App. 3d 533, 578 N.E.2d 612, 161 Ill. Dec. 254 (2nd Dist. 1991), which holds that an in kind apportionment need not require an exact valuation. Often, the parties will testify about the value of personal property, attempting to value assets they believe they will ultimately retain as having a low value while placing a high value on the assets they think their spouse will be awarded. This can be dangerous and in one case a party was almost hoisted on her own petard. In *In re Marriage of Meyer,* 140 Ill. App. 3d 1031, 489 N.E.2d 906, 95 Ill. Dec. 344 (5th Dist. 1986), the wife and her witnesses placed a high value ($22,500) on the personal property used by her husband in his business and hobbies, undoubtedly assuming he would be awarded these items in the property distribution. The husband placed a much lower value ($3-4,000) on this property. The trial court accepted the wife's value and awarded those items to her. While the appellate court stated that the trial court's approach was "an ingenious and simple way of apportioning marital property" it nevertheless reversed and remanded since there was no reasonable basis to award the wife items only useful to the husband, such as his tools, cameras, scuba gear, and hunting and fishing equipment. The dissent in this case makes a better argument by pointing out that the wife and

her witnesses testified as to each item's fair cash market value, which valuation the trial court accepted. Since the wife believed these items could be sold for the values she subscribed to them, she should be given these items to sell. The dissent felt the majority improperly interjected usefulness as an element to be considered by a court in dividing marital property.

In order to value antiques, works of art, and collectibles, it is generally necessary to hire an expert. The following is a list of professional societies and umbrella organizations that can provide the practitioner with names of members in a particular geographic area qualified to appraise particular types of personal property. As with all such lists the practitioner is advised to thoroughly check the credentials and qualifications of any "expert" recommended. The following list is not intended to be all inclusive and the authors make no representations as to any of the listed organizations or their members. The list is provided only as a guide or place to start when locating experts.

TYPE OF PROPERTY	ORGANIZATION AND ADDRESS	PHONE
Antiques	Antique Appraisal Society of America 11361 Garden Grove Blvd. Garden Grove, CA 92643	(714) 530-7090
Fine arts	International Society of Fine Arts Appraisers P. O. Box 280 River Forest, IL 60305	(708) 848-3340
Personal property; antiques; art; books; firearms; furniture	Appraisers Association of America 60 E. 42nd Street, Suite 2505 New York, NY 10165	(212) 867-9775
Personal property	International Society of Appraisers P. O. Box 726 Hoffman Estates, IL 60195	(708) 882-0706
Automobile collections	Collector Car Appraisers Association 25 Myrtle Avenue Buffalo, NY 14204	(716) 855-1931
Jewelry	National Association of Jewel Appraisers 4256 N. Brown Avenue Scottsdale, AZ 85251	(602) 994-9000

Courts have accepted the value each spouse places on the automobile that he or she drives even if that testimony is only as to the original purchase price and there is a lack of knowledge of the value at the time of trial. *In re Marriage of Greenberg,* 102 Ill. App. 3d 938, 429 N.E.2d 1334, 58 Ill. Dec. 1 (4th Dist 1981). Courts also typically award a vehicle to the person for whom the vehicle was purchased, who has historically driven it, or who may need it to get to work or to provide transportation for the parties' children. *In re Marriage of Ayers,* 82 Ill. App. 3d 164, 402 N.E.2d 401, 37 Ill. Dec. 511 (3d Dist. 1980); *In re Marriage of Zummo,* 167 Ill. App. 3d 566, 521 N.E.2d 621, 118 Ill. Dec. 339 (4th Dist. 1988). The availability of a company vehicle also can have an impact on the court's determination concerning a marital vehicle. In *In re Marriage of Dall,* 191 Ill. App. 3d 652, 548 N.E.2d 109, 138 Ill. Dec. 879 (5th Dist. 1989), the trial court's order that a marital vehicle be sold was affirmed on the basis the husband had a company vehicle for his personal use as well as for business use.

In addition, the following types of personal property have been held to be marital assets subject to division if acquired during the marriage:

- Lottery winnings. *In re the Marriage of Mahaffey,* 206 Ill. App. 3d 859, 564 N.E.2d 1300, 151 Ill. Dec. 638 (1st Dist. 1990).
- Seat on major commodities market. In the case of *Rochford v. Laser,* 91 Ill. App. 3d 769, 414 N.E.2d 1096, 46 Ill. Dec. 943 (1st Dist. 1980), the appellate court held that a seat on the Chicago Mercantile Exchange was not "goods or chattels"

and as such was not "tangible personal property subject to execution of judgment." A seat on an exchange is a privilege to trade and is not freely transferable because a transfer is subject to the rules and approval of the exchange; therefore, a court could not award a seat to the non-owing spouse. However, this does not mean the seat cannot be valued or sold. In *Rochford* the husband retained his seat on the Chicago Mercantile Exchange in the divorce and he later was held in contempt for failure to pay child support. The appellate court affirmed the trial court's appointment of a sequestrator to sell the seat and apply the proceeds to the support arrearages.

IV. Conclusion

Before the parties or a court can divide marital property and determine maintenance and child support, under the Illinois Marriage and Dissolution of Marriage Act, the parties' marital and nonmarital assets must be valued. Valuation methods differ for different types of property. In formulating advice to a client involved in a dissolution case, the practitioner should consider the cost of each applicable valuation method and the importance of placing a precise value on the property. Property valuation is the foundation of all dissolution of marriage cases.

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INTERNAL REVENUE SERVICE
REVENUE RULING 59-60
1959-1 C.B. 237

In valuing the stock of closely held corporations, or the stock of corporations where market quotations are not available, all other available financial data, as well as all relevant factors affecting the fair market value must be considered for estate tax and gift tax purposes. No general formula may be given that is applicable to the many different valuation situations arising in the valuation of such stock. However, the general approach, methods, and factors which must be considered in valuing such securities are outlined.

Revenue Ruling 54-77, C.B. 1954-1, 187, superseded.

Section 1. Purpose.

The purpose of this Revenue Ruling is to outline and review in general the approach, methods and factors to be considered in valuing shares of the capital stock of closely held corporations for estate tax and gift tax purposes. The methods discussed herein will apply likewise to the valuation of corporate stocks on which market quotations are either unavailable or are of such scarcity that they do not reflect the fair market value.

Sec. 2. Background and Definitions.

.01 All valuations must be made in accordance with the applicable provisions of the Internal Revenue Code of 1954 and the Federal Estate Tax and Gift Tax Regulations. Sections 2031(a), 2032, and 2512(a) of the 1954 Code (sections 811 and 1005 of the 1939 Code) require that the property to be included in the gross estate, or made the subject of a gift, shall be taxed on the basis of the value of the property at the time of death of the decedent, the alternate date if so elected, or the date of gift.

.02 Section 20.2031-1(b) of the Estate Tax Regulations (Section 81.10 of the Estate Tax Regulations 105) and Section 25.2512-1 of the Gift Tax Regulations (Section 86.19 of Gift Tax Regulations 108) define fair market value, in effect, as the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts. Court decisions frequently state in addition that the hypothetical buyer and seller are assumed to be able, as well as willing, to trade and to be well informed about the property and concerning the market for such property.

.03 Closely held corporations are those corporations the shares of which are owned by a relatively limited number of stockholders. Often the entire stock issue is held by one family. The result of this situation is that little, if any, trading in the shares takes place. There is, therefore, no established market for the stock and such sales as occur at irregular intervals seldom reflect all of the elements of a representative transaction as defined by the term “fair market value.”

Sec. 3. Approach to Valuation.

.01 A determination of fair market value, being a question of fact, will depend upon the circumstances in each case. No formula can be devised that will be generally applicable to the multitude of different valuation issues arising in estate and gift tax cases. Often, an appraiser will find wide differences of opinion as to the fair market value of a particular stock. In resolving such differences, he should maintain a reasonable attitude in recognition of the fact that valuation is not an exact science. A sound valuation will be based upon all the relevant facts, but the elements of common sense, informed judgment and reasonableness must enter into the process of weighing those facts and determining their aggregate significance.

.02 The fair market value of specific shares of stock will vary as general economic conditions change from “normal” to “boom” or “depression,” that is, according to the degree of optimism or pessimism with which the investing public regards the future at the required date of appraisal. Uncertainty as to the stability or continuity of the future income from a property decreases its value by increasing the risk of loss of earnings and value in the future. The value of shares of stock of a company with very uncertain future prospects is highly speculative. The appraiser must exercise his judgment as to the degree of risk attaching to the business of the corporation which issued the stock, but that judgment must be related to all of the other factors affecting value.

.03 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. As a generalization, the prices of stocks which are traded in volume in a free and active market by informed persons best reflect the consensus of the investing public as to what the future holds for the corporations and

industries represented. When a stock is closely held, is traded infrequently, or is traded in an erratic market, some other measure of value must be used. In many instances, the next best measure may be found in the prices at which the stocks of companies engaged in the same or a similar line of business are selling in a free and open market.

Sec. 4. Factors to Consider.

.01 It is advisable to emphasize that in the valuation of the stock of closely held corporations or the stock of corporations where market quotations are either lacking or too scarce to be recognized, all available financial data, as well as all relevant factors affecting the fair market value, should be considered. The following factors, although not all-inclusive are fundamental and require careful analysis in each case:

(a) The nature of the business and the history of the enterprise from its inception.

(b) The economic outlook in general and the condition and outlook of the specific industry in particular.

(c) The book value of the stock and the financial condition of the business.

(d) The earning capacity of the company.

(e) The dividend-paying capacity.

(f) Whether or not the enterprise has goodwill or other intangible value.

(g) Sales of the stock and the size of the block of stock to be valued.

(h) The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter.

.02 The following is a brief discussion of each of the foregoing factors:

(a) The history of a corporate enterprise will show its past stability or instability, its growth or lack of growth, the diversity or lack of diversity of its operations, and other facts needed to form an opinion of the degree of risk involved in the business. For an enterprise which changed its form of organization but carried on the same or closely similar operations of its predecessor, the history of the former enterprise should be considered. The detail to be considered should increase with approach to the required date of appraisal, since recent events are of greatest help in predicting the future; but a study of gross and net income, and of dividends covering a long prior period, is highly desirable. The history to be studied should include, but need not be limited to, the nature of the business, its products or services, its operating and investment assets, capital structure, plant facilities, sales records and management, all of which should be considered as of the date of the appraisal, with due regard for recent significant changes. Events of the past that are unlikely to recur in the future should be discounted, since value has a close relation to future expectancy.

(b) A sound appraisal of a closely held stock must consider current and prospective economic conditions as of the date of appraisal, both in the national economy and in the industry or industries with which the corporation is allied. It is important to know that the company is more or less successful than its competitors in the same industry, or that it is maintaining a stable position with respect to competitors. Equal or even greater significance may attach to the ability of the industry with which the company is allied to compete with other industries. Prospective competition which has not been a factor in prior years should be given careful attention. For example, high profits due to the novelty of its product and the lack of competition often lead to increasing competition. The public's appraisal of the future prospects of competitive industries or of competitors within an industry may be indicated by price trends in the markets for commodities and for securities. The loss of the manager of a so-called "one-man" business may have a depressing effect upon the value of the stock of such business, particularly if there is a lack of trained personnel capable of succeeding to the management of the enterprise. In valuing the stock of this type of business, therefore, the effect of the loss of the manager on the future expectancy of the business, and the absence of management-succession potentialities are pertinent factors to be taken into consideration. On the other hand, there may be factors which offset, in whole or in part, the loss of the manager's services. For instance, the nature of the business and of its assets may be such that they will not be impaired by the loss of the manager. Furthermore, the loss may be adequately covered by life insurance, or competent management might be employed on the basis of the consideration paid for the former manager's services. These, or other offsetting factors, if found to exist, should be carefully weighed against the loss of the manager's services in valuing the stock of the enterprise.

(c) Balance sheets should be obtained, preferably in the form of comparative annual statements for two or more years immediately preceding the date of appraisal, together with a balance sheet at the end of the month preceding that date, if corporate accounting will permit. Any balance sheet descriptions that are not self-explanatory, and balance sheet items comprehending diverse assets or liabilities, should be clarified in essential detail by supporting supplemental schedules. These statements usually will disclose to the appraiser (1) liquid position (ratio of current assets to current liabilities); (2)

gross and net book value of principal classes of fixed assets; (3) working capital; (4) long-term indebtedness; (5) capital structure; and (6) net worth. Consideration also should be given to any assets not essential to the operation of the business, such as investments in securities, real estate, etc. In general, such non-operating assets will command a lower rate of return than do the operating assets, although in exceptional cases the reverse may be true. In computing the book value per share of stock, assets of the investment type should be revalued on the basis of their market price and the book value adjusted accordingly. Comparison of the company's balance sheets over several years may reveal, among other facts, such developments as the acquisition of additional production facilities or subsidiary companies, improvement in financial position, and details as to recapitalizations and other changes in the capital structure of the corporation. If the corporation has more than one class of stock outstanding, the charter or certificate of incorporation should be examined to ascertain the explicit rights and privileges of the various stock issues including: (1) voting powers, (2) preference as to dividends, and (3) preference as to assets in the event of liquidation.

(d) Detailed profit-and-loss statements should be obtained and considered for a representative period immediately prior to the required date of appraisal, preferably five or more years. Such statements should show (1) gross income by principal items; (2) principal deductions from gross income including major prior items of operating expenses, interest and other expense on each item of long-term debt, depreciation and depletion if such deductions are made, officers' salaries, in total if they appear to be reasonable or in detail if they seem to be excessive, contributions (whether or not deductible for tax purposes) that the nature of its business and its community position require the corporation to make, and taxes by principal items, including income and excess profits taxes; (3) net income available for dividends; (4) rates and amounts of dividends paid on each class of stock; (5) remaining amount carried to surplus; and (6) adjustments to, and reconciliation with, surplus as stated on the balance sheet. With profit and loss statements of this character available, the appraiser should be able to separate recurrent from nonrecurrent items of income and expense, to distinguish between operating income and investment income, and to ascertain whether or not any line of business in which the company is engaged is operated consistently at a loss and might be abandoned with benefit to the company. The percentage of earnings retained for business expansion should he noted when dividend-paying capacity is considered. Potential future income is a major factor in many valuations of closely held stocks, and all information concerning past income which will be helpful in predicting the future should be secured. Prior earnings records usually are the most reliable guide as to the future expectancy, but resort to arbitrary five- or ten-year averages without regard to current trends or future prospects will not produce a realistic valuation. If, for instance, a record of progressively increasing or decreasing net income is found, then greater weight may be accorded the most recent years' profits in estimating earning power. It will be helpful, in judging risk and the extent to which a business is a marginal operator, to consider deductions from income and net income in terms of percentage of sales. Major categories of cost and expense to be so analyzed include the consumption of raw materials and supplies in the case of manufacturers, processors and fabricators; the cost of purchased merchandise in the case of merchants; utility services; insurance; taxes; depletion or depreciation; and interest.

(e) Primary consideration should be given to the dividend-paying capacity of the company rather than to dividends actually paid in the past. Recognition must be given to the necessity of retaining a reasonable portion of profits in a company to meet competition. Dividend-paying capacity is a factor that must be considered in an appraisal, but dividends actually paid in the past may not have any relation to dividend-paying capacity. Specifically, the dividends paid by a closely held family company may be measured by the income needs of the stockholders or by their desire to avoid taxes on dividend receipts, instead of by the ability of the company to pay dividends. Where an actual or effective controlling interest in a corporation is to be valued, the dividend factor is not a material element, since the payment of such dividends is discretionary with the controlling stockholders. The individual or group in control can substitute salaries and bonuses for dividends, thus reducing net income and understating the dividend-paying capacity of the company. It follows, therefore, that dividends are less reliable criteria of fair market value than other applicable factors.

(f) In the final analysis, goodwill is based upon earning capacity. The presence of goodwill and its value, therefore, rests upon the excess of net earnings over and above a fair return on the net tangible assets. While the element of goodwill may be based primarily on earnings, such factors as the prestige and renown of the business, the ownership of a trade or brand name, and a record of successful operation over a prolonged period in a particular locality, also may furnish support for the inclusion of intangible value. In some instances it may not be possible to make a separate appraisal of the tangible and intangible assets of the business. The enterprise has a value as an entity. Whatever intangible value there is, which is supportable by the facts, may be measured by the amount by which the appraised value of the tangible assets exceeds the net book value of such assets.

(g) Sales of stock of a closely held corporation should be carefully investigated to determine whether they represent

transactions at arm's length. Forced or distress sales do not ordinarily reflect fair market value nor do isolated sales in small amounts necessarily control as the measure of value. This is especially true in the valuation of a controlling interest in a corporation. Since, in the case of closely held stocks, no prevailing market prices are available, there is no basis for making an adjustment for blockage. It follows, therefore, that such stocks should be valued upon a consideration of all the evidence affecting the fair market value. The size of the block of stock itself is a relevant factor to be considered. Although it is true that a minority interest in an unlisted corporation's stock is more difficult to sell than a similar block of listed stock, it is equally true that control of a corporation, either actual or in effect, representing as it does an added element of value, may justify a higher value for a specific block of stock.

(h) Section 2031(b) of the Code states, in effect, that in valuing unlisted securities the value of stock or securities of corporations engaged in the same or a similar line of business which are listed on an exchange should be taken into consideration along with all other factors. An important consideration is that the corporations to be used for comparisons have capital stocks which are actively traded by the public. In accordance with section 2031(b) of the Code, stocks listed on an exchange are to be considered first. However, if sufficient comparable companies whose stocks are listed on an exchange cannot be found, other comparable companies which have stocks actively traded in on the over-the-counter market also may be used. The essential factor is that whether the stocks are sold on an exchange or over-the-counter there is evidence of an active, free public market for the stock as of the valuation date. In selecting corporations for comparative purposes, care should be taken to use only comparable companies. Although the only restrictive requirement as to comparable corporations specified in the statute is that their lines of business be the same or similar, yet it is obvious that consideration must be given to other relevant factors in order that the most valid comparison possible will be obtained. For illustration, a corporation having one or more issues of preferred stock, bonds or debentures in addition to its common stock should not be considered to be directly comparable to one having only common stock outstanding. In like manner, a company with a declining business and decreasing markets is not comparable to one with a record of current progress and market expansion.

Sec. 5. Weight to Be Accorded Various Factors.

The valuation of closely held corporate stock entails the consideration of all relevant factors as stated in Section 4. Depending upon the circumstances in each case, certain factors may carry more weight than others because of the nature of the company's business. To illustrate:

(a) Earnings may be the most important criterion of value in some cases whereas asset value will receive primary consideration in others. In general, the appraiser will accord primary consideration to earnings when valuing stocks of companies which sell products or services to the public; conversely, in the investment or holding type of company, the appraiser may accord the greatest weight to the assets underlying the security to be valued.

(b) The value of the stock of a closely held investment or real estate holding company, whether or not family owned, is closely related to the value of the assets underlying the stock. For companies of this type the appraiser should determine the fair market values of the assets of the company. Operating expenses of such a company and the cost of liquidating it, if any, merit consideration when appraising the relative values of the stock and the underlying assets. The market values of the underlying assets give due weight to potential earnings and dividends of the particular items of property underlying the stock, capitalized at rates deemed proper by the investing public at the date of appraisal. A current appraisal by the investing public should be superior to the retrospective opinion of an individual. For these reasons, adjusted net worth should be accorded greater weight in valuing the stock of a closely held investment or real estate holding company, whether or not family owned, than any of the other customary yardsticks of appraisal, such as earnings and dividend paying capacity.

Sec. 6. Capitalization Rates.

In the application of certain fundamental valuation factors, such as earnings and dividends, it is necessary to capitalize the average or current results at some appropriate rate. A determination of the proper capitalization rate presents one of the most difficult problems in valuation. That there is no ready or simple solution will become apparent by a cursory check of the rates of return and dividend yields in terms of the selling prices of corporate shares listed on the major exchanges of the country. Wide variations will be found even for companies in the same industry. Moreover, the ratio will fluctuate from year to year depending upon economic conditions. Thus, no standard tables of capitalization rates applicable to

closely held corporations can be formulated. Among the more important factors to be taken into consideration in deciding upon a capitalization rate in a particular case are: (1) the nature of the business; (2) the risk involved; and (3) the stability or irregularity of earnings.

Sec. 7. Average of Factors.

Because valuations cannot be made on the basis of a prescribed formula, there is no means whereby the various applicable factors in a particular case can be assigned mathematical weights in deriving the fair market value. For this reason, no useful purpose is served by taking an average of several factors (for example, book value, capitalized earnings and capitalized dividends) and basing the valuation on the result. Such a process excludes active consideration of other pertinent factors, and the end result cannot be supported by a realistic application of the significant facts in the case except by mere chance.

Sec. 8. Restrictive Agreements.

Frequently, in the valuation of closely held stock for estate and gift tax purposes, it will be found that the stock is subject to an agreement restricting its sale or transfer. Where shares of stock were acquired by a decedent subject to an option reserved by the issuing corporation to repurchase at a certain price, the option price is usually accepted as the fair market value for estate tax purposes. See Rev. Rul. 54-76, C.B. 1954-1, 194. However, in such case the option price is not determinative of fair market value for gift tax purposes. Where the option, or buy and sell agreement, is the result of voluntary action by the stockholders and is binding during the life as well is at the death of the stockholders, such agreement may or may not, depending upon the circumstances of each case, fix the value for estate tax purposes. However, such agreement is a factor to be considered, with other relevant factors, in determining fair market value. Where the stockholder is free to dispose of his shares during life and the option is to become effective only upon his death, the fair market value is not limited to the option price. It is always necessary to consider the relationship of the parties, the relative number of shares held by the decedent, and other material facts, to determine whether the agreement represents a bona-fide business arrangement or is a device to pass the decedent's shares to the natural objects of his bounty for less than an adequate and full consideration in money or money's worth. In this connection see Rev. Rul. 157, C.B. 1953-2, 255, and Rev. Rul. 189, C.B. 1953-2, 294.

Sec. 9. Effect on Other Documents.

Revenue Ruling 54-77, C.B. 1954-1, 187, is hereby superseded.

INTERNAL REVENUE SERVICE
REVENUE RULING 65-193
1965-2 C.B. 370

Revenue Ruling 59-60, C.B. 1959-1, 237, is hereby modified to delete the statements, contained therein at section 4.02(f), that "In some instances it may not be possible to make a separate appraisal of the tangible and intangible assets of the business. The enterprise has a value as an entity. Whatever intangible value there is, which is supportable by the facts, may be measured by the amount by which the appraised value of the tangible assets exceeds the net book value of such assets."

The instances where it is not possible to make a separate appraisal of the tangible and intangible assets of a business are rare and each case varies from the other. No rule can be devised which will be generally applicable to such cases.

Other than this modification, Revenue Ruling 59-60 continues in full force and effect. See Rev. Rul. 65-192, page 259, this Bulletin.

INTERNAL REVENUE SERVICE
REVENUE RULING 68-609
1968-2 C.B. 327

The purpose of this Revenue Ruling is to update and restate, under the current statute and regulations, the currently outstanding portions of A.R.M. 34, C.B. 2, 31 (1920), A.R.M. 68, C.B. 3, 43 (1920), and O.D. 937, C.B. 4, 43 (1921).

The question presented is whether the "formula" approach, the capitalization of earnings in excess of a fair rate of return on net tangible assets, may be used to determine the fair market value of the intangible assets of a business.

The "formula" approach may be stated as follows:

A percentage return on the average annual value of the tangible assets used in a business is determined, using a period of years (preferably not less than five) immediately prior to the valuation date. The amount of the percentage return on tangible assets, thus determined, is deducted from the average earnings of the business for such period and the remainder, if any, is considered to be the amount of the average annual earnings from the intangible assets of the business for the period. This amount (considered as the average annual earnings from intangibles), capitalized at a percentage of, say, 15 to 20 percent, is the value of the intangible assets of the business determined under the "formula" approach.

The percentage of return on the average annual value of the tangible assets used should be the percentage prevailing in the industry involved at the date of valuation; or (when the industry percentage is not available) a percentage of 8 to 10 percent may be used. The 8 percent rate of return and the 15 percent rate of capitalization are applied to tangibles and intangibles, respectively, of businesses with a small risk factor and stable and regular earnings; the 10 percent rate of return and 20 percent rate of capitalization are applied to businesses in which the hazards of business are relatively high.

The above rates are used as examples and are not appropriate in all cases. In applying the "formula" approach, the average earnings period and the capitalization rates are dependent upon the facts pertinent thereto in each case.

The past earnings to which the formula is applied should fairly reflect the probable future earnings. Ordinarily, the period should not be less than five years, and abnormal years, whether above or below the average, should be eliminated. If the business is a sole proprietorship or partnership, there should be deducted from the earnings of the business a reasonable amount for services performed by the owner or partners engaged in the business. See *Lloyd B. Sanderson Estate v. Commissioner,* 42 F.2d 160 (1930). Further, only the tangible assets entering into net worth, including accounts and bills receivable in excess of accounts and bills payable, are used for determining earnings on the tangible assets. Factors that influence the capitalization rate include (1) the nature of the business, (2) the risk involved, and (3) the stability or irregularity of earnings.

The "formula" approach should not be used if there is better evidence available from which the value of intangibles can be determined. If the assets of a going business are sold upon the basis of a rate of capitalization that can be substantiated as being realistic, though it is not within the range of figures indicated here as the ones ordinarily to be adopted, the same rate of capitalization should be used in determining the value of intangibles.

Accordingly, the "formula" approach may be used for determining the fair market value of intangible assets of a business only if there is no better basis therefor available.

See also Revenue Ruling 59-60, C.B. 1959-1, 237, as modified by Revenue Ruling 65-193, C.B. 1965-2, 370, which sets forth the proper approach to use in the valuation of closely held corporate stocks for estate and gift tax purpose. The general approach, methods, and factors, outlined in Revenue Ruling 59-60, as modified, are equally applicable to valuations of corporate stocks for income and other tax purposes as well as for estate and gift tax purposes. They apply also to problems involving the determination of the fair market value of business interests of any type, including partnerships and proprietorships, and of intangible assets for all tax purposes.

A.R.M. 34, A.R.M. 68, and O.D. 937 are superseded, since the positions set forth therein are restated to the extent applicable under current law in this Revenue Ruling. Revenue Ruling 65-192, C.B. 1965-2, 259, which contained restatements of A.R.M. 34 and A.R.M. 68, is also superseded.