ACCOUNTING FOR DIVORCE

Forensic Accounting, Business Valuation, Taxes, Retirement & Expert Testimony

2010

JEFFREY W. BREND
LEVIN & BREND, P.C.
20 North Wacker Drive, Suite 2920
Chicago, Illinois 60606
Telephone (312) 726-4440
Facsimile (312) 726-0029
j.brend@levinbrend.com
Edited By: Jennifer M. Fletchall
and Jennifer C. Levin

TABLE OF CONTENTS

CHAPTER ONE - FORENSIC ACCOUNTING **1**

A. FINANCIAL TRACKING DOCUMENTS 1
B. E-TRACKING 2
- Statutes 2
- Application to the Family Law Setting 6
- Methods of Obtaining Information 8

C. FINANCIAL REPORTING DISTORTIONS 8
- Specific Income Distortions 9
- Expenses, Liabilities and Tax Credits That May Identify Undisclosed Assets 16
- Specific Income/Expense Distortions 17

D. HOW TO COMMUNICATE THE RESULTS OF A FORENSIC ANALYSIS 18

CHAPTER TWO- BUSINESS VALUATIONS **21**

A. BUSINESS VALUATION PROCESS 21
B. DIVISION OF BUSINESS GOODWILL IN DISSOLUTION OF MARRIAGE CASES 43
C. COMMON ERRORS IN THE VALUATION PROCESS 46
D. REVENUE RULINGS 47
E. FULL TEXT OF REVENUE RULING 59-60 48

CHAPTER THREE – TAX ASPECTS OF DIVORCE **57**

A. TAX RATE STRUCTURE 57
B. TAX ISSUES PERTAINING TO FAMILY AND DEPENDENTS 58
- Marriage Penalty Relief 58
- Innocent Spouse 60
- Dependency Exemptions 63
- Head of Household 64
- Child Tax Credit 65
- Adoption Credit 66
- Dependent Care Tax Credit 66

C. TAX TREATMENT OF PROPERTY TRANSFER INCIDENT TO A DIVORCE 66
D. TAX TREATMENT OF CHILD SUPPORT 69
- General Rules 69
- Child Support Calculation 69
- Temporary Child Support 76
- Shared Custody 77
- Enforcement 78
- Modifying Support Orders 82

E. TAX TREATMENT OF MAINTENANCE PAYMENTS 84
- General Rules 84
- Temporary Maintenance 85
- Voluntary Impoverishment to Avoid Support Obligations 85
- Unallocated Maintenance and Support 86
- Recapture Issue: Excessive Front-Loading of Maintenance or Unallocated Maintenance and Support 87
- Furnishing of Identifying Number 89

F. TAX ISSUES ARISING FROM THE SALE OF THE MARITAL RESIDENCE 89
G. PLANNING FOR EDUCATION 92
- College Tax Credits 92
- Coverdell Education Savings Account (ESA) 94
- Qualified Tuition Plans 95

Deducting Student Loan Interest 96
Employer Provided Educational Assistance 97
H. MISCELLANEOUS TAX PROVISIONS 97
Gift and Estate Tax 97
Medical Expenses 97
Legal and Accounting Fees 98
Mortgage Debt Forgiveness Exclusion 98
Alternative Minimum Tax 99

CHAPTER FOUR- RETIREMENT PLANNING 100

A. TYPES OF QUALIFIED PLANS 100
Defined Contribution Plans 100
Defined Benefit Pension Plans 100
B. NON-QUALIFIED PLANS 101
Roth IRA's 101
Traditional IRAs 103
C. DIVIDING BENEFITS 104
Immediate Total Offset Method 104
Reserved Jurisdiction Approach or Plan Payment Method 104
Division in Kind 105
D. DISTRIBUTION TRAPS 105
E. VALUATION OF PENSION BENEFITS 106
Valuation Date 107
Determining the Total Benefit 108
Determining the Marital Portion of Benefits (Hunt Formula) 108
F. OTHER CONSIDERATIONS 109
Retirement Savings Tax Credit 109
Retirement Account Rollovers 109
Exceptions to the 10% Penalty 110
Social Security 111

CHAPTER FIVE – ADR 112

A. WHEN MEDIATION IS APPROPRIATE 112
Convenience of Mediation 112
B. PARTICIPANTS IN THE PROCESS AND THEIR ROLES 114
Who is the Mediator? 114
What Does the Mediator Do? 117
How Does the Mediator Do These Things? 118
C. COLLABORATIVE LAW 119

CHAPTER SIX – EXPERT WITNESS PREPARATION 121

A. INTRODUCTION 121
B. EXPERT DEPOSITIONS 121
C. PRETRIAL MOTIONS 123
Report Drafts 124
Expert Qualifications 125
D. VOIR DIRE AND METHODOLOGY 127

CHAPTER ONE - FORENSIC ACCOUNTING

A. FINANCIAL TRACKING DOCUMENTS

There are several common financial tracking documents that an accountant should obtain when seeking to ascertain whether a party's assets and/or income are being distorted or are being intentionally hidden.

Obtaining large or unusual checks can provide useful information to a forensic examiner. An examination of the back of checks negotiated by the suspect party or subject business may show unknown bank accounts being used by the party or business. Payroll checks, for instance, may show a spouse's money being funneled through an employee. In addition, hidden liabilities and assets may be found by obtaining a credit report. A credit report which contains joint information can be obtained by either spouse; however, bear in mind that it is illegal to obtain or use an unauthorized credit report. Obtaining loan and leasing applications, prior divorce decrees, tax returns, and W-2s for the party oftentimes also provides useful information. With W-2s, specifically, examine each of the boxes as they contain important information regarding pension, deferred compensation, dependent care benefits, etc. From these documents, you should always attempt to determine whether the alleged income matches the lifestyle of the parties.

There are several business documents which can prove valuable in tracking assets or determining income. Comparative statements for as many years as possible can alert you to nonrecurring, unusual or extraordinary financial occurrences. The general accounts receivable and accounts payable ledgers of the business should be reviewed by your client for entries that appear out of the ordinary. Particular attention should be paid to the cost of goods sold, repairs, outside services and expenses of the business. In addition, be sure to obtain any buy/sell agreements adopted by the business. Finally, attempt to determine whether personal expenses of the party are being paid by the business.

Any business documents obtained should be reviewed to determine whether the business is utilizing an accrual or cash basis of accounting since that may significantly alter income. For example, a business using the accrual basis of accounting can manipulate both its income and assets by simply making a journal entry that adjusts its accounts receivable. Other adjustments to income or irregularities hidden in the journal entries may also be discovered.

B. E-TRACKING

E-tracking has become an important device for financial tracking purposes to ascertain whether a party's assets and/or income are being distorted or are being intentionally hidden. Unlike paper documentation, electronic documents are not easily deleted or destroyed, may contain valuable information such as a creation date, what computer or person created the document, and may be easier to navigate using search functions in large volumes of documents.

Statutes

A. The Wiretap Act - 18 U.S.C. §§2510-2521

The Wiretap Act, 18 U.S.C. §§2510-2521, states in relevant part the following:

It is unlawful for any person to:

intentionally intercept any wire, oral, or electronic communication;

intentionally use any electronic, mechanical, or other device to intercept any oral communication;

intentionally disclose to another person the information contained in any wire, oral, or electronic communication when the person knows or has reason to know that the information was obtained through the interception of a wire, oral, or electronic communication in violation of this subsection;

intentionally use the information contained in any wire, oral, or electronic communication when the person knows or has reason to know that the information was obtained through the interception of a wire, oral, or electronic communication in violation of this subsection;

In other words, acquisition of a communication, such as email on a computer, during the transmission is a violation of the Wiretap Act. A defense to Wiretap Act violations is that a person had prior consent to such interception. 18 U.S.C. §2511(2)(d). Consent may be express or implied and if a party consents to the interception of a portion of a communication, a court must inquire as to whether the interception exceeds the scope of the consent. *In re Pharmatrak, Inc. Privacy Litig.* 329 F.3d 9, 23 (1st Cir. 2003).

Sanctions for violations of the Act include fines, imprisonment of not more than five years, or both. 18 U.S.C. §2511(4). An individual also may obtain relief in a civil action and obtain preliminary and other equitable or declaratory relief, damages (including punitive damages), and reasonable attorney's fees and court costs. 18 U.S.C. §2520(a)-(c).

The Circuits were previously split on whether there was an interspousal exception to the Wiretap Act. Today no Circuit recognizes an interspousal exception to the Wiretap Act therefore a spouse may be liable to the other spouse if they violate the Act. *Glazner v. Glazner*, 347 F.2d 1212, 1216 (11th Cir. 2003). There is an exemption called the extension phone exemption. That exemption allows for interception of any telephone instrument, equipment or facility "furnished to the subscriber or user by a provider of wire or electronic communication service in the ordinary course of business and being used by the subscriber or user in the ordinary course of business." 18 U.S.C. §2510(5).

The issue then becomes whether evidence obtained from a violation of the Wiretap Act is admissible in court. The answer is no. The Wiretap Act expressly prohibits the use of any wire or oral communication intercepted in violation of the Act from being admitted in any trial, hearing or other court proceeding. 18 U.S.C. §2515.

B. The Stored Communications Act - 18 U.S.C. §§2701-2711

The Stored Communications Act, 18 U.S.C. §§2701-2711, in relevant part makes it unlawful to:

1) intentionally access without authorization a facility through which an electronic communication service is provided, or

2) intentionally exceed an authorization to access that facility, and thereby obtains, alters, or prevents authorized access to a wire or electronic communication while it is in electronic storage in such system.

Just like the Wiretap Act, consent is a defense to Stored Communications Act violations. *In re Pharmatrak, Inc. Privacy Litig.* 329 F.3d 9, 16-17 (1st Cir. 2003). Sanctions include fines, imprisonment, or both. 18 U.S.C. §2701(c). In contrast to the Wiretap Act, evidence obtained in violation of the Store Communications Act may be admitted in any trial, hearing or other court proceeding unless the person provides an electronic communication service. 18 U.S.C. §2702(a). *Wesley College v. Pitts*, 974 F.Supp. 375, 389 (D. Del. 1997).

C. Federal Computer Fraud and Abuse Act – 18 U.S.C. §1030

The Federal Computer Fraud and Abuse Act (CFAA) prohibits intentional unauthorized access or access exceeding authorization of a protected computer and the protected computer is damaged (at least $5,000 of damage to one or more persons during a 1 year period). 18 U.S.C.

§1030(a). A protected computer is defined as computers "exclusively for the use of a financial institution or the United States Government" or a computer "used in or affecting interstate or foreign commerce or communication…" 18 U.S.C. §1030(e)(2).

A plaintiff has the burden of proving damage *or* loss in order to have a cause of action. *Bloomington-Normal Seating Co., Inc. v. Albritton*, 2009 U.S. Dist. LEXIS 40302 (C.D. Ill. May 12, 2009). The term "damage" means "any impairment to the integrity of data, a program, a system, or information." 18 U.S.C. §1030(e)(8). Merely copying data from a computer system does not satisfy the damage element. The court in *Cassetica Software Inc.* reasoned that the CFAA merely copying data does not necessarily in itself cause damage to the computer system which is required by the Act. *Cassetica Software, Inc. v. Computer Scis. Corp*., 2009 U.S. Dist. LEXIS 51589, 8-9 (N.D. Ill. 2009).

The term "loss" means any reasonable cost in responding to unauthorized access, damage assessment, and restoring data, programs, systems, or information to its original state. 18 U.S.C. §1030(e)(11). Loss also includes lost profits or costs associated with interruption of service or other consequential damages. *Id*. In other words, loss must relate to costs of investigating and repairing a computer system and not lost revenue that is cause by copying confidential information. *Cassetica Software, Inc. v. Computer Scis. Corp.*, 2009 U.S. Dist. LEXIS 51589, 8-9 (N.D. Ill. 2009). *See also SKF USA, Inc. v. Bierkness*, 2009 U.S. Dist. LEXIS 34781 (N.D. Illl. 2009).

D. Illinois Eavesdropping Act – 720 ILCS 5/14-1 et. seq.

The Illinois Eavesdropping Act, 720 ILCS 5/14/2 states in relevant part that a person commits eavesdropping in the following three situations:

> 1) A person knowingly and intentionally uses an eavesdropping device for the purpose of hearing or recording all or any part of any conversation or intercepts,

> retains, or transcribes electronic communication UNLESS he does so with the consent of all parties to such conversation or electronic communication; or
>
> 2) A person manufactures, assembles, distributes, or possesses any electronic, mechanical, eavesdropping, or other device knowing that or having reason to know that the design of the device renders it primarily useful for the purpose of the surreptitious hearing or recording of oral conversations or the interception, retention, or transcription of electronic communications and the intended or actual use of the device is contrary to the provisions of this Article; or
>
> 3) A person uses or divulges any information which he knows or reasonably should know was obtained through the use of an eavesdropping device.

Just like the Federal Wiretap Act, evidence obtained in violation of the Illinois Eavesdropping Act is inadmissible at trial unless the affirmative defense of consent applies. "The element of consent under the eavesdropping statute 'may be satisfied without a showing of the type of informed consent necessary for a defendant to waive a fourth amendment right.'" *People v. Ceja* 204 Ill.2d 332, 789 N.E. 2d 1228 (Ill. 2003). Consent may be express or implied. *Id*. Implied consent is consent in fact, not constructive consent and is inferred from the surrounding circumstances. *Id*. Factors considered include language or acts that shows a person knows that they are making otherwise private information available to others. *Id*.

<u>Application to the Family Law Setting</u>

For discovery purposes, the parties are entitled to full disclosure regarding any matter relevant to the subject matter involved in a pending action. Ill. Sup. Ct. Rule 201(b). This means that even if a spouse takes a computer of the other spouse, and that computer was used for both personal and business purposes, there may not be a violation of any statute. *Byrne v. Byrne*, 650 N.Y.S.2d 499, 500. In *Byrne,* the court analogized a computer's memory to a filing cabinet containing financial documents located in the marital residence which is "obviously subject to discovery." *Id*. at 500. *See also Etzion v. Etzion*, 796 N.Y.S.2d 844, 2005 NY Slip Op 25115 (2005).

The issue of whether a GAL may consider information obtained in violation of electronic communication statutes in order to make a determination of the best interests of the child has been in dispute. In Illinois, the Second District in *In re Marriage of Karonis*, the GAL listened to tapes that were arguably obtained through violations of the eavesdropping statute. *In re Marriage of Karonis*, 296 Ill.App.3d 86, 693 N.E.2d 1282 (2nd Dist. 1998). The court determined that a GAL could consider otherwise inadmissible evidence in their determination of a child's best interests because compelling reasons of public policy dictated that the GAL "perform duties essential to the health and welfare of the child." *In re Marriage of Karonis*, 296 Ill.App.3d 86, 92, 693 N.E.2d 1282, 1286 (2nd Dist. 1998). The *Karonis* court relied on *Scheib v. Grant* , 22 F.3d 149, 22 F.3d 149 (7th Cir. 1994).

Scheib v. Grant followed the Tenth and Second Circuit cases *Newcomb v. Ingle*, 944 F.2d 1534 (10th Cir. 1991) and *Anonymous v. Anonymous*, 558 F.2d 677 (2nd Cir. 1977). *Newcomb* and *Anonymous* took a broad reading of the phone exemption under the Wiretap Act where the "ordinary course of business" requirement extended to a person's home. *Newcomb v. Ingle*, 944 F.2d 1534, 1535 (10th Cir. 1991), *Anonymous v. Anonymous*, 558 F.2d 677, 678-79 (2nd Cir. 1977). Therefore, tape recording phone conversations of a child living in the home falls under the exemption in 18 U.S.C. §2510(5)(a)(i). The court in *Scheib* reasoned that the terms "subscriber" and "user" stated in the exemption must be read in conjunction with "ordinary course of business" and that a subscriber's conduct or business in raising their children falls within the exemption. *Scheib v. Grant*, 22 F.3d 149, 154 (7th Cir. 1994). The *Sheib* court held that because the defendant did not violate any statutes in the Federal Communications Privacy Act, there was no unlawful disclosure of the evidence to his attorney's and the GAL. *Id*. at 155. The court upheld the district court's finding that the attorney's and the GAL had absolute immunity from damages under the Illinois Eavesdropping statute for "using or divulging the tape recorded conversations in a manner intimately associated" with the court proceeding and for not disclosing the recorded conversations beyond those intimately involved with the litigation. *Id* at 156-57.

<u>Methods of Obtaining Information</u>

- Keystroke/Spector Program (Spyware)
    - Records every keystroke and when it is made, received and sent emails, instant messages, chat room conversations, website browsing history, and screen captures without the user's knowledge.
        - Wife secretly installed spyware program on marital computer that intercepted and recorded husband's emails and instant messages by taking snapshots of what was on the computer screen and recorded websites visited. The court precluded the introduction of the evidence in the divorce proceeding because it was obtained in violation Florida's Security of Communications Act. *O'Brien v. O'Brien*, 899 So.2d 1133, 1134 (Fla. App. 5th Dist. 2005).
- Trojan Horse (Malware)
    - Virus allowing a hacker to access another person's hard drive.
        - No violation of the Wiretap Act when hacker used Trojan horse virus to copy information stored on a hard drive which then transferred the information to the Hacker's computer because no "real time interception" of information during transmission. *U.S. v. Steiger*, 318 F.3d 1039, 1049 (11th Cir. 2003).
- GPS Tracker
    - Small device that records data such as location within 8 feet, records speed every second, software can animate a car driving on a digital street map and generate reports which can be downloaded onto a computer where reports can be generated.
        - 720 ILCS 5/12-7.3: Crime of stalking requires putting someone under surveillance. The definition of surveillance includes "placing a tracking device on the person or the person's property." 720 ILCS 5/12-7.3(d).

C. FINANCIAL REPORTING DISTORTIONS

When reviewing financial statements, always make sure the financial statements correlate with the underlying books and records of the business. In addition, there are certain general financial abuses you should be looking for such as:

- The duplicate processing of income or expenses;
- The recording and reporting of transactions before they occur;
- The shifting of current income or expenses to a later or earlier period;
- Whether profits or losses are the results of non-recurring transactions;
- Whether income is being assigned to business partners, family members and/or close, personal friends; and
- Whether there are income timing differences due to accrual vs. cash basis of accounting.

There are also some common financial abuses that will not be recorded in the financial statements, underlying books and/or records of the business. These include:

- Unrecorded promises and commitments;
- Unrecorded or pending legal liabilities;
- Unrecorded sales, receipts and disbursements in separate, unrecorded accounts;
- Inadequate or incomplete disclosures;
- Use of funds for illegal payments and transfers;
- Hidden interests in joint ventures;
- Transfers at other than fair value; and
- Insider trading.

In addition, the following specific areas should be examined to protect your client's rights:

<u>Specific Income Distortions</u>

1. Cash vs. Accrual

    a. Accounts receivables

        (1) Watch for unreasonable write-off of accounts receivable as uncollectible.

        (2) View aged accounts receivable

(3) Are orders booked as accounts receivables when an order is placed or shipped

(4) Double dipping issue - asset or next months income

2. Compensation

a. Compensation for services

(1) Salary or wages

(a) Overtime

(b) Holiday pay

(c) Vacation pay

(d) Sick days

(2) Tips

(a) 10% of gross receipts; or

(b) IRS negotiates with restaurant to set the percentage based on local customs - ask for signed agreement with IRS

(3) Bonus

(4) Commission

(5) Severance pay

(6) Golden parachutes

(7) Cash payments

(a) Tips

(b) Side jobs

b. Cash register type business

c. Petty cash

d. Car and entertainment reimbursements

e. Paid with property

(1) Organizer of limited partnership receives partnership interest

(2) Give car title

f. Barter

(1) Contractors

(2) Barter clubs

g. Incentive stock options

(1) Salesmen and executives

(2) Not taxed when received

(3) Tax postponed until stock disposed of

h. Deferred compensation

(1) Is the W-2 box checked?

(2) Executive agreements

(3) Attorneys may arrange for their fee to be structured as part of the settlement

i. Employee benefits

(1) Accident and health plans

(2) Medical reimbursement plan

(3) Meals and lodging if:

(a) On employer premises

(b) Convenience of employer

(c) Employee must accept as condition of employment

(4) Dependent Care Plan - W-2 box checked?

(5) Commuter passes

(6) Parking

(7) Tuition reimbursement

(8) Moving expense reimbursement

(9) VITA program

(10) Professor family tuition waiver

(11) Employee achievement awards

(12) Employee discounts

(13) Group term life insurance a

(14) Cafeteria plans

   (a) Choice between cash and tax-free benefits

   (b) Flexible spending accounts

      i) Group legal services

      ii) Group life insurance

      iii) Disability insurance

      iv) Accident and health benefits

      v) Dependent care

      vi) Commuter passes

(15) Pensions

   (a) Is the W-2 box checked?

   (b) Employer plans

      i) No FICA

      ii) Profit sharing

      iii) Money purchase

iv) Defined benefit: state or federal plans; union plans

(c) Employee plans

i) Employee controls level

ii) Watch for employer matching

iii) 401(k)

iv) 403(b)

3. Interest income

a. EE Savings Bonds

(1) Tax deferred until bonds mature or redeemed

(2) Not reported on tax return

(3) Often part of contents of safe deposit box

b. Federal obligations: not subject to state tax

c. State and local bonds

(1) Not subject to federal tax

(2) Add back to divorce net income

4. Dividend income

a. Constructive dividend

(1) Paying shareholders personal expenses:

(a) Home or cellular phone

(b) Company car used for personal use

(c) Personal meals & entertainment

(d) Reimbursing commuting expenses

(e) Withdrawals above salary without obligation of repayment

b. Bargain sale to shareholder

c. Do yearly comparative analysis of dividend: look for gifts, unreported sale of securities

5. Tax-free exchanges: spouse can arrange a non-simultaneous exchange of like-kind property around the judgment date

6. Rents

a. Examine leases

(1) Back loaded rental leases may give free year of rent up front for higher payments at the end of the lease

(2) Straddle income around divorce

b. Indirect payments of rent affect value of property

(1) Taxes

(2) Mortgage

(3) Tenant's improvements stipulated in lease

(4) Tenant perform services for lower rent

c. Relatives not paying fair market value

d. Security deposits in escrow

7. Pension income

a. Annuities not reported on tax return when purchased

b. Lump-sum distributions: watch for roll over to IRA or another qualified plan

8. Personal injury damages are usually tax-free, but the interest on tax-free amount still taxable will be reported on tax return so look for a sudden increase in interest

9. Illegal or unreported income: does cash flow match lifestyle?

10. Depreciating assets: examine prior year depreciation schedules for assets in the business

11. Other non-reported income

a. Life insurance proceeds, withdrawals and loans

b. Gifts and bequests

c. Scholarships and fellowships

d. Parsonage housing allowance

12. Schedules M-1 and M-2 on Form 1120, page 4 provide book vs. tax income (i.e., tax exempt interest, key man insurance, etc.)

a. Schedule M-1

(1) Add back book provision for federal income tax to net income per book to equal taxable income on Form 1120

(2) Add back capital losses in excess of capital gains

(3) Adjust for income subject to tax though not recorded on books

(4) Adjust for expenses reported on books though not deductible

(a) Adjustment for meals and entertainment (50% differential)

(b) Key person life insurance premiums

(c) Depreciation

(d) Contributions carryover

(e) Foreign tax credit

(5) Adjust for income recorded on books though not included on tax return

(a) Hidden income

i) Tax-exempt interest

ii) Key person life insurance proceeds

(6) Adjust for deductions not charged against book income

(a) Depreciation (Straight Line vs. Accelerated)

(b) Hidden tax benefits

i) Contribution carryover

ii) Capital loss carryover

b. Schedule M-2 -- Unappropriated retained earnings

(1) Opening and end of year balance figured on Schedule M-2 and entered on Schedule l

(2) Hidden income -- look for distributions and other columns

(a) Pending lawsuits

(b) Declines in inventory values

(c) Sinking fund for capital expenses

(d) Purchase of treasury stock

(e) Appropriations with bond holders or creditors

(f) Prior period adjustments for change in accounting principles

13. Examine all partnership and S corporation K-1s for amount distributed to partner which may not be the same amount as that reported as income

<u>Expenses, Liabilities and Tax Credits That May Identify Undisclosed Assets</u>

1. Retirement, Keogh and SEP contributions can be found in adjusted gross income section on Form 1040 and face of business tax returns. See if personal efforts are going into pension investment activities. Is compensation being diverted to pension? This is particularly important if it is a non-marital asset.

2. State tax deduction on IRS Form 1040 - Schedule A may identify undisclosed income in another state

3. Real estate tax deduction on IRS Form 1040 - Schedule A may identify undisclosed real estate

4. Investment interest expenses on IRS Form 1040 - Schedule A may disclose investment assets

5. Inventory in cost of good sold often approximated

6. General business credit on IRS Form 3800 may identify undisclosed assets

7. Foreign tax credit on IRS Form 1116 may identify undisclosed foreign assets

Specific Income/Expense Distortions

1. Shipping goods before a sale is finalized
2. Reporting revenue when important uncertainties exist
3. Recording revenue when future services are still due
4. Recording income on the exchange of similar assets
5. Recording funds from suppliers as revenue
6. Using bogus estimates on interim financial reports
7. Boosting profits by selling undervalued assets
8. Boosting profits by retiring debt
9. Failing to segregate unusual and non-recurring gains or losses
10. Improperly capitalizing costs
11. Depreciating or amortizing costs too slowly
12. Failing to write off worthless assets
13. Reporting revenue rather than a liability when cash is received
14. Failing to accrue expected or contingent liabilities
15. Failing to disclose commitment and contingencies
16. Engaging in transactions to keep debt off the books
17. Accelerating discretionary expenses into the current period
18. Writing off depreciation or amortization for future years
19. Do inventory or supply purchases make sense in light of revenue reported?

In closing, parties can effectively deal with the most simple and the most complex issues in divorce, by utilizing experts in the underlying fields associated with the mediation topics. In divorces requiring the use of accountants, the accountant should determine the possible reasons why income from a business may be distorted. The accountant can then request the documents that may expose those distortions. Upon receipt of the documents, the accountant should identify specific deviations from the business income as presented by the opposing party's actual income. If the deviations are then presented in the divorce proceeding in an organized and understandable manner, you will often be able to persuade your opponent to adopt your client's theory.

D. HOW TO COMMUNICATE THE RESULTS OF A FORENSIC ANALYSIS

In the context of a financial investigation, the accountant can help the parties in numerous ways, such as:

- Deciding how to gather all the pertinent information;
- Understanding the scope of the property to be divided;
- Discussing the available choices for dividing the assets and the consequences of such choices;
- Ultimately helping the parties draft an agreement to present to their attorneys for review; and
- Can provide a neutral third party point of view.

One of the methods often used by attorneys to help parties resolve an impasse is to find an impartial way to generate a solution. On important issues such as valuation, taxes, tracing questions, characterization issues or related problems, an impartial solution may mean finding a professional whom or a method that both parties will trust or at least consider. In litigation, parties resolve (and sometimes create) such differences by using various kinds of experts. If the parties can agree on a single expert or a single method or approach to addressing the issue, they can lessen the controversy and also lessen the cost of finding the necessary information.

When one party in divorce believes that the other party is not providing full disclosure of information or is in some way distorting the information provided, it may be prudent for that party to retain a forensic accountant. Businesses often manipulate revenues, expenses, assets and liabilities on financial statements to conform to a specific purpose. Often, the reason(s) a business has for distorting income are legitimate and legal. Some of the common reasons why a business owner might understate a company's assets and revenues are:

- The owner intends to get divorced;
- To pay less federal and state taxes;
- To pay less rent when rent is based on revenue earned;
- To make future earnings look better when management is newly appointed; and/or
- To negotiate legal settlements.

Some common reasons why a business owner might overstate a company's financial strength and performance are:

- To obtain additional credit from lenders;
- To make the company more attractive to investors;
- To earn greater management bonuses and sales commissions;
- To establish a stronger track record of earnings;
- To lower costs of loans;
- To avoid filing bankruptcy;
- To induce prospective buyers; and/or
- To list the company on a stock exchange.

Commonly, business decisions relating to the operation of a business and reporting of income are decided long before a divorce is contemplated or without regard to a pending divorce. Judges can consider the reasons why a party's income and assets as reported by a business should not be the same as the party's income and assets within the context of the divorce proceeding. Often such reasons provide a strong argument when attempting to eventually persuade a court to equitably divide assets and set a spouse's income level in a manner compatible with the accountant's theory of the case rather than as indicated by the records of the business.

In the event that financial issues are litigated, the courtroom presentation of evidence can be a deciding factor in a judge's decision. As such, it is imperative to remember the Boy Scout Motto – "Be Prepared". The attorney should spend adequate time preparing you for your testimony. It is important to sequence your testimony so it is easy for the judge to follow. This will also help lay the proper foundation for your testimony and paint a picture for the court. At all times you must remember that Judges are normally not financially sophisticated. Therefore, explain as much as possible in layman's terms and use demonstrative evidence to highlight the facts you relied on to develop your opinion.

There are several courtroom mannerisms that can affect the Judge's assessment of your credibility. First, be prepared, second, be confident, third, be professional, fourth, do not lose your composure, fifth, do not evade the examiners questions and finally, and most importantly, never lie. The attorney you work for will advise you to LISTEN to the questions asked of you, THINK about the answer to the question prior to answering it, and Answer ONLY the question asked of you and then STOP TALKING. In addition, if you do not know the answer to the question or do not understand the question asked of you, do not guess at the answer. Ask your examiner to repeat the question, to rephrase the question, or simply respond with the truth, "I do not know and I do not want to venture a guess."

CHAPTER TWO- BUSINESS VALUATIONS

The following information is intended to provide attorneys and accountants with a guide for reviewing business valuation reports. In addition, this guide may serve as an outline for attorneys to prepare and question a business valuator in the context of a deposition or during trial.

A. BUSINESS VALUATION PROCESS

a. The Appraisal Process

(1) Obtain information regarding the entity to be appraised, such as the name and form of the organization (S corporation, C corporation, LLC, sole proprietorship, general or limited partnership, etc.) and any other information necessary to prepare an appraisal fee estimate.

(2) Prepare a list of documents needed to complete the appraisal.

(3) Tour the company's facilities and interview key management personnel.

(4) Collect and analyze information regarding the outlook for the national economy, regional economy, and industry.

(5) Determine which valuation methods are most appropriate given the facts and circumstances of the engagement.

(6) Collect the data needed for the selected valuation methods.

(7) Adjust the historical income statements of the company to eliminate nonrecurring and unusual expenses or income, and eliminate any non-business (i.e., personal) expenses.

(8) Perform the necessary procedures within each selected valuation method.

(9) Synthesize the indications of value from the valuation methods into one valuation conclusion or a range of values.

(10) Prepare a draft of the valuation opinion report.

(11) Discuss the draft valuation opinion report with the client.

(12) Prepare the final valuation opinion report.

(13) For marital engagements, however, some of the steps in the appraisal process may be handled differently than in other engagements. For example, it is generally recommended that the appraiser should be retained by the divorce attorney, not by one of the spouses involved in the matter, so that the appraisal work papers may be protected by the attorney work product privilege.

(14) In addition, for some types of divorce cases, the appraiser may have to rely on information obtained from third-party sources (e.g., depositions and/or interrogatories), rather than direct interviews.

b. Appraiser designations and experience

(1) Analysts who perform business valuation services must have adequate training and experience in this field. Typical designations earned by analysts specializing in business valuations include Accredited Senior Appraiser (ASA) awarded by the American Society of Appraisers to individuals with at least five years of full-time valuation experience and who have fulfilled certain educational, demonstration report, and examination requirements, Chartered Financial Analyst (CFA), and Certified Public Accountants can become Accredited Business Valuators (ABV).

(2) In addition to appropriate designations, the attorney should consider the experience of the appraiser with respect to estimating the value of similar businesses. An appraiser who specializes, for example, in medical practice valuations may be preferred for an engagement involving the value of an internist’s practice. Obviously, the more experience the appraiser has in valuing businesses similar to the subject company, the more credible the appraiser is likely to be as an expert witness.

c. Documents and information needed

(1) Financial statements

(a) Annual financial statements (balance sheets, income statements, statements of changes in financial position, and statements of stockholders’ equity or partners’ capital accounts) for the previous five fiscal years

(b) Latest available interim statements and interim statements for the comparable period for the prior year

(c) Federal income tax returns for the previous five years; state income tax returns, if applicable

(d) List of subsidiaries and/or financial interests in other companies in which the subject company has an ownership interest, and financial statements for these entities

(e) Copies of any available forecasts or projections

(2) Other financial data

(a) General ledger

(b) Journal entries

(c) Aged accounts receivable

(d) Aged accounts payable list

(e) Check register

(f) List of cash accounts and any significant cash investments

(g) Equipment list and depreciation schedule

(h) List of prepaid expenses

(i) List of items comprising inventory (description of quantity and cost) and information on inventory accounting policies

(j) List of any items comprising significant other asset balances

(k) List of notes payable and other interest-bearing debt

(l) List of any items comprising significant other liability balances

(m) Compensation schedule for owners, including all benefits and personal expenses

(n) Schedule of insurance in force (key-person life, property and casualty, liability)

d. Other operating data

(1) List of stockholders, or partners, with number of shares owned by each or percentage of each partner’s interest in earnings and capital

(2) Detail of any transactions with related parties

(3) Organization chart

e. Legal documents

(1) Copies of any significant leases and loans, including notes receivable and notes payable

(2) Copies of any other existing contacts (employment agreements, covenants not to compete, supplier and franchise agreements, customer agreements, royalty agreements, equipment lease or rental contracts, loan agreements, labor contracts, employee benefit plans, etc.)

(3) If a corporation, articles of incorporation, by-laws, and any amendments to either

(4) If a partnership, articles of partnership, with any amendments

(5) Copies of stockholder or partnership agreements, including any stock option agreements

(6) Minutes of board of directors meetings

(7) Copies of buy-sell agreements and/or written offers to purchase or sell company stock

(8) Details of any litigation, including pending lawsuits

(9) Details of any employee benefit plans

(10) Copies of any reports issued by government agencies such as EPA, OSHA, IRS, and EEOC

f. Other information

(1) Brief history, including years in business and details of any changes in ownership and/or bona fide offers received

(2) Brief description of business, including position relative to competition and any factors that make the business unique

(3) Marketing literature (including, for example, catalogs, brochures, and advertisements)

(4) List of locations where company operates, with size, and whether owned or leased

(5) List of states in which licensed to do business

(6) If customer or supplier base concentrated, list of major accounts, with annual dollar volume for each

(7) Completed contract summaries for 10 largest customers

(8) List of competitors, with location, relative size, any other relevant factors

(9) Resumes of key personnel, with age, position, compensation, length of service, education, and prior experience

(10) Personnel profile - number of employees by functional groupings (e.g., production, sales, engineering, personnel and accounting, customer service, field support, etc.)

(11) Trade associations to which company belongs or would be eligible for membership

(12) Relevant trade or government publications

(13) Any existing indicators of asset values, including latest property tax assessments and any appraisals that have been completed

(14) List of patents, copyrights, trademarks, and other intangible assets

(15) Any contingent or off-balance-sheet assets or liabilities (pending lawsuits, compliance requirements, warranty or other product liability, etc.)

(16) Details of transactions in the company's stock during the last five years

g. Management Interview

(1) Appraisal standards suggest that business appraisers conduct on-site visits and conduct management interviews to learn the background and operations specific to a particular company.

(2) Once an appraiser has reviewed the background information listed above, a management interview should take place in which the appraiser can obtain from the owner/manager of the business information related to the background, current status and future prospects of both the company being valued and the industry in which it operates.

(3) A management interview provides the appraiser an opportunity to obtain information and knowledge of the business in a manner that cannot be obtained through a company's website or printed marketing materials. With the face-to-face contact, an appraiser can analyze the responses of the manager to determine the skills and thoroughness of the manager.

(4) An important component of a business valuation in the context of a divorce is the determination of personal and enterprise goodwill. A management interview is a valuable opportunity for the appraiser to achieve an understanding of the manager's role in the operations and determine this person's value to the business.

h. Valuation date

(1) The date of marriage may be the most relevant valuation date if the business is non-marital and contributions from the marital estate are made to the business both in assets and personal effort

(2) The date of legal separation or filing of the divorce action may be the relevant valuation dates when the business interest included in the marital estate is dependent upon the efforts of one of the parties in the divorce action. The valuation of accounting, law, medical, and other professional practices are typical examples of situations in which the efforts of the "practicing" spouse may exert a significant impact upon the continuing operations of the related business; and thus, significantly affect the underlying value of the entity.

(3) The date of divorce, or date closest to the trial, is generally considered the most relevant valuation date when the business interest included in the marital estate represents ownership in an entity whose success is dependent upon the continuing efforts of numerous individuals. The valuation of an ownership interest in a large manufacturing or service business that is not dependent upon the efforts or reputation of one of the divorcing parties is a typical example of a situation in which the date of divorce may represent the most relevant valuation date.

i. Standard of value

(1) Fair market value

(a) 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 sell, both parties having reasonable knowledge of relevant facts. (See Rev.Rul. 59-60, the full text of which is at the end of this chapter)

(b) 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.

(c) In Illinois, the Courts have adopted the use of fair market value as the proper foundation for the valuation of a business. (See In re Marriage of Schneider, 214 Ill. 2d 152, 824 N.E.2d 177 (2005), In re Marriage of Zells, 143 Ill.2d 251, 572 N.E.2d 944 (1991), In re Marriage of Talty, 166 Ill.2d 232, 652 N.E.2d 330 (1995).

(2) Intrinsic value

(a) The "true" or "real" worth of an asset to an investor, is based upon a fundamental analysis of the relevant company's assets, and assumes, at least temporarily, a higher level of insight and knowledge regarding the subject business than the typical investor.

(b) The intrinsic value standard is often more relevant than the fair market value standard in divorce situations. This is because no firm basis for an assumed hypothetical sales transaction can be established. In these particular circumstances, it is often more reasonable to estimate value assuming the intrinsic value standard - based on the premise that no actual transfer of ownership will occur.

j. Valuation approaches

(1) Market Approach Method

(a) The value of the company is estimated by identifying and analyzing the price at which similar companies have been exchanged between willing buyers and sellers.

(b) Analysts may rely on the guideline publicly traded company method and/or the guideline merged and acquired company method. These methods rely on prices paid for minority interests in the equity of publicly traded companies (the guideline publicly traded company method) or on prices paid for minority or controlling ownership interests in companies transferred in mergers or acquisitions (the guideline merged and acquired company method).

(c) Buy-sell agreements may provide for valuation of stock above or below the fair market value. These agreements are commonly entered into in the small business setting at the time the business is formed. These agreements are usually drafted to ensure continuity of ownership and management by restricting the transfer of ownership interest upon the occurrence of a triggering event. Examples of triggering events include death, retirement, or bankruptcy.

Although a buy-sell agreement may set a purchase price below fair market value, the IRS may disregard a valid agreement and tax the shares using the fair market value. Under Internal Revenue Code §2703, the agreement price may be disregard and fair market valuation applied unless the agreement:

(1) Is a bona fide business arrangement;

(2) Is not a device to transfer property to family members for less than full and adequate consideration; and

(3) Has terms comparable to similar arrangements entered into by persons in an arms' length transaction.

The adequacy of consideration requirement is compared to those resulting from parties dealing at arm's length and must reasonably relate to the "unrestricted fair market value of the interest in question." True v. Commissioner, 390 F.3d 1210, 1225 (10th Cir. 2004). The focus is on intent to determine whether the agreement is a testamentary device. Estate of Lauder v. Commissioner, T.C. Memo 1990-530 (T.C.1990). Factors analyzed in determining an inference of intent include:

i) the age and health of the decedent when entering the agreement;
ii) the lack of regular enforcement of the agreement;
iii) the exclusion of significant assets from the agreement;
iv) the manner the price term was selected (i.e. was an appraiser used?);
v) the extent of negotiations before reaching an agreement;
vi) whether the parties are equally bound by the agreement; and
vii) whether adjustments may be made to the terms;

True v. Commissioner, 390 F.3d 1210, 1220 (10th Cir. 2004). See also St. Louis County Bank v. U.S., 674 F.2d 1207 (8th Cir. 1982).

As the case law developed, additional requirements arose to create what is referred to as the "price term control test." In addition to the exceptions laid out in IRC §2703(b), the price term control test requires that the price be readily determinable from the agreement and that the agreement is legally binding and enforceable throughout the life and death of the decedent. Treas. Reg. §20.2031-2(h). True v. Commissioner, 390 F.3d 1210, 1218 (10th Cir. 2004). See also Estate of Blount v. Commissioner, 428 F.3d 1338, 1344 (11th Cir. 2005).

(2) Asset-Based Approach Method

(a) The value of the company's assets is the estimated cost to either purchase or construct assets of equal utility.

(b) Analysts may rely on the asset accumulation method, in which the value of the equity of a company is estimated by: (1) appraising the value of each of the assets owned by the company, including assets not listed on the balance sheet such as intangible assets, and (2) subtracting the value of each of the company's liabilities.

(3) Income Approach Method

(a) The value of the company is equal to the present value of the expected economic income earned from the ownership of the equity of the company.

(b) Analysts may rely on a discounted cash flow method and/or a capitalization of income method.

i) In the discounted cash flow method, the value of a company is estimated by discounting the projected earnings of a company to the present value at an appropriate present value discount rate that is based on the level of risk associated with an investment in the company.

ii) In the capitalization of income method, the value of a company is estimated by dividing the expected earnings of a company (excluding nonrecurring or extraordinary income and expenses) by an appropriate capitalization rate that is equal to the present value discount rate less the expected long-term growth rate of the company.

(4) Excess Earnings Methods

(a) Analysts sometimes use the excess earnings method, which is a combination of an asset-based approach method and an income approach method, to estimate the value of a company's tangible and intangible assets.

(b) There are typically seven steps involved in the excess earnings method:

i) Estimate the net tangible asset value of the company. That is, estimate the fair market value of each of the tangible assets owned by the company, and subtract the fair market value of each of the liabilities of the company.

ii) Estimate the normalized level of earnings. That is, estimate the expected level of earnings for the company in the next year, adjusted for all income and expenses that are non-recurring, abnormal, or not related to ongoing operations. To estimate normalized earnings for a sole proprietorship or partnership, a reasonable amount must be deducted from reported earnings for normal compensation related to services provided by the owner (or, the expected amount that would have to be paid to a third party with similar skills and experience).

iii) Estimate the percentage rate of return for the net tangible assets of the company. The percentage rate of return for the net tangible assets depends upon the mix of assets owned by the company. An entity with assets that are acceptable as loan collateral (that is, lower risk assets) requires a lower rate of return on net tangible assets than a company with assets that are more risky. One method for estimating the percentage rate of return for the net tangible assets is to estimate the fair rate of return on the market value of each asset (for example, cash and cash equivalents should return a money-market rate, receivables a somewhat higher rate of return, and so on). Weighing the estimated fair rate of market return for each tangible asset based on the fair market value will result in the percentage rate of return for the net tangible assets of the business.

iv) Multiply the percentage rate of return for the net tangible assets of the company (as estimated in step iii) by the net tangible asset value (as estimated in step i). This results in the earnings attributable to the net tangible assets.

v) Subtract the result from step iv from the normalized level of earnings for the company, as estimated in step ii. This results in the excess earnings, or the earnings derived from assets other than the tangible assets of the company. These other - or intangible - assets may include, among others, customer relationships, a trained and assembled workforce, patents, and goodwill.

vi) Estimate the appropriate capitalization rate to apply to the excess earnings of the company, and divide the excess earnings computed in step (v) by the excess earnings capitalization rate. This rate typically ranges from 20% to 100%, depending on the expected persistence and predictability of the earnings derived from the intangible assets. The higher the anticipated risk, the lower a purchaser of the company would pay for the intangible assets. This results in an estimated value of the intangible assets.

vii) Add the results from step (i) (the estimated value of the net tangible assets) to the result from step (vi) (the estimated value of the intangible assets).

b. Discount/Capitalization Rates

(1) The income approach requires the valuation professional to develop an appropriate rate of return applicable to the business being valued.

(2) In the case of the discounted future returns method, this rate is known as the discount rate. In the case of the capitalized returns method, this rate is known as the capitalization rate ("cap rate").

(3) The discount rate represents the rate of return an investor would require in order to purchase an ownership interest in a particular business, given the inherent risk associated with that business.

(4) A capitalization rate is equal to a company's discount rate less the company's expected long-term annual growth rate. For example, a company with a discount rate of 25% and an expected long-term growth rate of 5% would have a capitalization rate of 20%.

(5) Generally, a company's cap rate is derived from its discount rate, as demonstrated above. Where comparative publicly traded companies can be identified, a cap rate can be obtained by analyzing the comparative companies' price to earnings ratios (P/E ratio). A cap rate is simply the inverse of a company's P/E ratio. For example, a company with a P/E ratio of 10 (10/1) would have a cap rate of 10% (1/10).

(6) Financial theory states that investors must be compensated for increasing levels of risk. Thus, an investor must be given a premium for assuming risk over and above the risk-free rate. The equity risk premium of

common stocks returns over intermediate-term government bond income returns was sourced from a study performed by Ibbotson Associates. An additional premium of the return of small stocks over common stock returns was also added.

(7) Discount rates are usually calculated by means of a process known as the "build-up method". Under this method the valuation professional attempts to match the perceived level of risk associated with the subject company to other investments that are readily available in the marketplace.

(8) The build-up rate utilizes a risk-free rate as a base. The rate most often used as a proxy for a risk-free rate is that of long-term (20 year) U.S. Treasury bonds.

(9) To this rate the valuator will add additional risk premiums to account for differences between the level of risk associated with a risk-free investment versus the subject company.

(10) The most common types of risk premiums used in the process are as follows:

(a) Equity risk premium - represents the additional return an investor would require based on the perceived risk of equity ownership in a publicly traded company, over the return on U.S. Treasury bonds. Adding the equity risk premium to the risk-free rate produces an average market return. Much has been written comparing the realized returns reported in sources such as Ibbotson Associates with what would have been expected by investors given the underlying economics of publicly traded companies and the underlying economics of the economy.

i) Ivo Welch, in an article titled "The Equity Premium Consensus Forecast Revisited," surveyed academic financial economists and found that the interquartile equity risk premium over T-Bills was expected to range from 4 to 7 percent. Ibbotson adjusted these numbers for the horizon premium on Treasury bonds, resulting in a projected equity risk premium of 2.6 to 5.6 percent over 20 year Treasuries.

ii) In a working paper by John Graham and Campbell Harvey titled "Expectations of Equity Risk, Volatility and Asymmetry," the authors surveyed chief financial officers and found an average expected equity risk premium of 3.8 percent.

iii) Robert Bruner, in his article “Best Practice in Estimating the Cost of Capital: Survey and Synthesis,” showed a representation equity risk premium of 4 to 6 percent from corporate analysts and 7 to 7.4 percent from financial advisors.

iv) Greenwich Associates, in a 1999 survey of pension plan officers, found an expected equity risk premium of 4.4 percent.

v) Eugene Fama and Kenneth French, in an article titled “The Equity Risk Premium,” estimate an equity risk premium of 3 to 4.5 percent, after adjustments for an arithmetic average over long-term Treasury yields.

vi) In the wake of discussions over expected versus historical equity risk premiums, Roger G. Ibbotson and Peng Chen analyzed historical equity risk premiums relative to market fundamentals. Ibbotson and Chen observed that from 1925 to 2003, the overall stock market price grew faster than overall economic productivity, a condition they believe is not likely to continue into the future. With the benefit of hindsight, Ibbotson and Chen computed actual corporate growth over the historical period and noted that actual growth was highly correlated with the actual growth of overall economic activity. This growth was then compared to the growth expected by investors at various historical periods as indicated by stock price multiples at that point in time. Ibbotson and Chen confirmed that investors routinely overestimated corporate growth projections, resulting in an artificial increase of approximately 1.13 percent in the historical average arithmetic equity risk premium of 7.19 percent.

(b) Size premium - represents the additional return that investors require for investing in small companies versus large companies.

(c) Specific company risk premium - represents the additional return an investor would require to account for other specific risks associated with the subject company. Some of the factors to be considered in making this assessment include:

i) The degree of financial risk associated with the company

ii) Diversification of the company’s products or services

iii) Geographic diversity of the company's market

iv) The depth and quality of the company's management

v) The volatility of the company's earnings history

vi) The company's operating trends

vii) The company's access to additional capital

(d) Industry risk premium

i) Determine if there are industry trends

ii) Often this factor is already accounted for in the specific company risks

(e) S Corporation Adjustment, if applicable

i) An adjustment is made to account for the advantages of a controlling interest in an S corporation (i.e. the ability to control distributions, the ability to affect corporate governance, and the ability to control all financial decisions, etc.). The major benefits of an S corporation election that should be measured are:

.1. The income from the S corporation is subject to only one level of taxation;

.2. The shareholders of an S corporation receive an increase in their basis to the extent that income exceeds distributions (i.e., income retained by the S corporation adds to the tax basis of the shareholders' stock which will reduce the gain upon sale), and

.3. The shareholder of an S corporation may realize more proceeds on sale of the S corporation itself (i.e., the S corporation is more likely to sell assets to a buyer of the S corporation business).

(11) The discount rate produced from the build-up method is generally perceived to be a rate to be applied to net free cash flows (net income, plus depreciation, minus capital additions, plus or minus the expected change in required working capital).

(12) If the earnings stream to be used is something other than net free cash flows, such as net earnings, the discount rate needs to be adjusted further to account for this difference. In most companies experiencing positive growth cash flows lag behind net income and, accordingly, the discount rate for net income would require an additional upward adjustment to compensate for this relationship.

(13) The summation of the risk-free rate and all the various risk premium adjustments results in a discount rate appropriate for the subject company's perceived level of risk.

c. Consideration of Business Size

(1) Utilizing different methods for businesses of significantly different sizes is necessary due to the critical financial, operational, and organizational differences between large and small businesses.

(2) Typically, for small businesses, guideline publicly traded companies or guideline merged and acquired companies are not available. Therefore, in many instances, these market approach methods are not applicable to estimate the value of small business.

(3) In addition, prospective financial information is generally not available for small businesses. In marital dissolution cases where prospective financial information is not available, the analyst often will not rely on the discounted cash flow method. Instead, if an income approach is used, the analyst may rely on the capitalization of income method.

(4) The excess earnings method is widely adopted by analysts to estimate the value of small businesses and professional practices. However, it is not generally used to estimate the value of large businesses for marital dissolution purposes.

(5) Consideration of the size of the business to be appraised as part of the marital dissolution is obviously important, since it affects the applicability of valuation methods; and therefore, the ultimate estimation of the value of the business.

d. Small Business Adjustments

(1) Small businesses (which, for the purpose of this discussion, are defined as businesses with revenues of less than $5 million) frequently do not have many of the documents listed above.

(2) Data used to determine the small business adjustment is often obtained from Ibbotson Associates. Companies included in their classification of

small businesses often include large businesses compared to mom and pop shops typically handled in divorce proceedings. These large corporations are small in the context of the public markets in which they are comparatively small to the largest of the public companies such as Microsoft and General Electric. Ibbotson presents its data in 10 deciles in which companies are segregated by size with (1) being the largest and (10) being the smallest.

(3) Any expenses of a personal nature are to be excluded from the historical financial statements. If an appraiser does not adjust historical financial statements to reflect the true economic income generating capacity of the company, then the values indicated by income approach valuation methods may be meaningless.

(4) Financial statements of some smaller businesses are typically internally prepared or compiled. These financial statements are less reliable than reviewed or audited financial statements that are more likely to be available for large businesses.

(5) Small businesses may report financial statements on a cash basis instead of on an accrual basis. In cash accounting, revenues and expenses are recognized when the money is received or paid. In accrual accounting, revenues are recognized when they are earned, and expenses are recognized when they are incurred.

(6) If the subject business reports earnings on a cash basis, additional information regarding beginning and ending accounts receivable and accounts payable balances for the historical financial statement dates will be required. With this information, the appraiser can convert earnings reported on a cash basis to earnings on an accrual basis, since valuations are typically based on accrual accounting information.

(7) It is also usually important that the appraiser tour the company facilities and interview key management personnel.

(8) Additional facts about the business may need to be obtained through the active spouse's deposition.

e. Growth Rate

(1) To obtain a firm's capitalization rate, the long-term annual growth rate must be subtracted from the company's discount rate.

(2) The long-term annual growth rate can be estimated by adding:

(a) The long-term inflation estimate, and

(b) A long-term rate of GDP growth.

f. Discounts and Premiums

(1) Control premium

(a) A controlling shareholder is typically paid a premium because of the following rights:

i) Ability to set corporate policy

ii) Appoint management

iii) Declare dividends

iv) Determine compensation & perquisites for employees

v) Acquire or sell corporate assets

vi) Liquidate, dissolve, or recapitalize the company

vii) Register the company's stock for a public offering

viii) Change the article of incorporation or bylaws

ix) Block any of the above actions

(b) Various studies over the years have examined the range of premiums buyers were willing to pay for a controlling interest in a company. One such source for data on control premiums is Mergerstat Review which provides historical summaries of the average and median premiums paid for control and certain non-control blocks of common shares. Mergerstat Review, Houlihan, Lokey, Howard & Zukin, Los Angeles.

(c) Mergerstat premiums are measured by the percentage difference between acquisition price and the price of the freely traded public shares five trading days before the announcement of the acquisition.

(d) Over the ten year period from 1988 to 1997 the Mergerstat median premium paid ranged from 27.3% to 35.0% and averaged 30.8%.

(e) Houlihan, Lokey, Howard & Zukin (HLHZ) also provides data on premiums paid for the purchase of control interests and measures the premiums at various intervals prior to the takeover. Control

Premium Study 1998, Houlihan, Lokey, Howard & Zukin, Los Angeles.

(f) The HLHZ study over the ten year period 1988 to 1997 showed the median premium paid to range from 27.0% to 54.6% and averaged 41.3%.

(g) The HLHZ study does not include premiums from any non-control transactions. This, and the fact that the HLHZ study allows for a longer period of time between the acquisition date and freely traded date in order to mitigate the effects of takeover rumors, cause the HLHZ premiums to be higher than those of Mergerstat.

(2) Minority Discount

(a) A minority discount is the opposite adjustment as compared to a control premium. When the results of the primary valuation methods are a controlling value, a minority discount must be applied to account for the lack of control inherent in a minority position.

(b) If a buyer would be willing to pay a 30% premium for a controlling interest, the same buyer would require a 23% discount from a controlling value in order to purchase a minority interest.

(c) This relationship can be demonstrated as follows:

Control value $130
Minority value $100
Minority discount (30/130 = 23%)
Control premium (30/100 = 30%)

(d) In arriving at a minority discount for the subject company's interest it is important to note that there are varying degrees of minority interest. A 2% interest and a 49% interest can both be minority interests, but they certainly should not be subject to the same amount of minority discount.

(e) An important factor in considering where in the range, or outside of the range, the subject company should fall is the makeup of the shareholder group. Where there is one shareholder with at least 51% of the outstanding shares, the minority discount will be greater. When the shareholder is highly fragmented, and no one shareholder has at least 51% of the outstanding shares, the minority discount will be less due to the fact that shareholders could band together in order to exert control over corporate activities.

(f) It is important to be aware of applicable state law for the subject company. Some states require a super-majority for certain actions while others only require a simple voting majority.

(g) Translating the Mergerstat control premium data for the period 1988 to 1997 into implied minority discounts shows a range of 21.5% to 25.9% and averaged 23.5%.

(h) The HLHZ study shows a range of 21.3% to 35.3% and averaged 28.9%.

(3) Lack of Marketability Discount

(a) Just as a discount is appropriate to account for a buyer's lack of control when valuing a minority interest, it is also appropriate to account for the fact that a privately owned business lacks a ready market for its stock.

(b) Several studies and court cases over the years have analyzed the relationship between the prices at which restricted stocks change hands as compared to their freely traded counterparts.

(c) Since the restricted shares have all the rights enjoyed by the holders of the unrestricted shares, the differences in price at which these shares sell appear to be solely due to their impaired marketability.

(d) In general the studies also reported that the discounts were highest for small companies with a poor earnings record and were lowest for large companies with a profitable track record.

(e) Restricted stock studies provide empirical evidence on the relationship between marketability and price. The results of these studies must take into consideration one important factor: restricted shares will eventually be available for sale on the open market. The shares of most privately owned companies will never be listed on a public stock exchange. Therefore, shares of closely held companies should require a higher discount for lack of marketability than comparable restricted shares of publicly traded companies, everything else being equal.

(f) The following cases and studies of restricted stock transactions have been performed over the years [1]:

1 Chart from Shannon P. Pratt, Robert F. Reilly and Robert P. Schweihs, Valuing a Business: The Analysis and

Study	Time Period	Average Discount(%)
SEC Overall Average	1966-1969	25.8% [2]
SEC Non-Reporting OTC Companies	1966-1969	32.6% [3]
Gelman	1968-1970	33.0% [4]
Trout	1968-1972	33.5% [5]
Moroney	1969-1972	35.6% [6]
Maher	1969-1973	35.4% [7]
Standard Research Consultants	1978-1982	45.0% [8]
Williamette	1981-1984	31.2% [9]

(g) A second group of studies looked at the issue of marketability from a different perspective. These studies compare the prices at which private stock transactions took place to the price at which the stock later sold in an initial public offering.

(h) John D. Emory of Robert W. Baird & Company, studied transactions occurring within five months of the initial public offering. Emery found, in a series of eight studies, average mean discounts ranged from 40% to 66% and averaged 43%. John D. Emory, "The Value of Marketability as Illustrated in Initial Public Offerings of Common Stock, February 1992 through July 1993," Business Valuation Review, March 1994.

Appraisal of Closely Held Companies, Third Edition, Irwin, Chicago, Illinois 1996.

2 "Discounts Involved in Purchases of Common Stock," Institutional Investor Study Report of the Securities and Exchange Commission, Washington, D.C., Government Printing Office, March, 1971.

3 "Discounts Involved in Purchases of Common Stock," Institutional Investor Study Report of the Securities and Exchange Commission, Washington, D.C., Government Printing Office, March, 1971.

4 Milton Gelman, "An Economist-Financial Analyst's Approach to Valuing Stock of a Closely Held Company," Journal of Taxation, June 1972.

5 Robert R. Trout, "Estimation of the Discount Associated with the Transfer of Restricted Securities," Taxes, June 1977.

6 Robert E. Moroney, "Most Courts Overvalue Closely Held Stocks," Taxes, March 1973.

7 J. Michael Maher, "Discounts for Lack of Marketability for Closely Held Business Interests," Taxes, September 1976.

8 Charles H. Stryker and William Ittock, "Revenue Ruling 77-287 Revisited," SRC Quarterly Reports, Spring 1983.

9 Williamette Management Associates Study (unpublished).

(i) Due to the fact that the IPO studies used the actual sales of private securities, they have a stronger connection to the marketability discount for closely-held companies than the restricted stock studies. However, they may be tainted by an upward bias associated with the rising stock value of a typical company going public.

(4) Portfolio Discount (heterogeneous assets and/or activities that are not appealing as a group to most buyers)

(a) This discount is appropriate when the subject company owns a number of dissimilar operations or assets which are not necessarily complimentary.

(b) A discount is taken into account for the fact that a buyer having an interest in one of the operations may not have as strong an interest in taking on the entire assemblage of operations.

(c) The buyer would require a discount in order to persuade him to acquire the less desirable assets along with the operations that are of interest to him.

(d) Empirical evidence of this phenomenon can be found by comparing the price at which conglomerates have traded in the open market as compared with the prices obtained by breaking-up the company into separate companies.

(5) Key Person Discount

(a) A key person discount is taken when the valuator expects a reduction in the value of the subject company due to the loss of services of an individual who is actively involved with the companies operations.

(b) The person must play a significant role in the management of the company and possess talents or information that could not easily be replaced, or which would require a significant investment on the part of the company in order to replace.

(c) These factors may already have been taken into account in developing the discount rate used under the income approach. If this is the case, an additional discount should not be taken, as this would result in a double counting of the impact of this situation.

(6) Blockage Discount

(a) A blockage discount is generally taken when a large number of shares of a publicly traded company are valued and the disposition of which, under normal trading conditions, would require a significant period of time.

(7) Discount for a 50-50 Deadlock

(a) When a person owns 51% of a company's shares, they have a controlling interest. This means that the shareholder has control over company affairs such as declaring dividends, liquidating the company, going public, issuing or buying stock, directing management, setting management's salaries, etc. This means that the non-controlling shareholder (49% owner) is basically powerless to make changes to a company. As such, a premium is placed on the valuation of the controlling interest to reflect the power over company affairs while a discount is applied in valuing the non-controlling interest to reflect the lack of power. A 50% ownership is neither a controlling interest nor a minority interest and as such, is treated as a separate category of interest.

(b) The discount applied to a 50% interest is less than the discount applied to a 49% interest. In a 50-50 deadlock situation, there are two shareholders with an equal interest in a company. This means that neither shareholder has a controlling interest of the company. Even though a 50% shareholder does not have the power to control the company, their shares have more value than a 49% shareholder such as having the power to block actions of the other 50% shareholder. For example, if the shareholders are deadlocked regarding company affairs, are unable to break the deadlock, and irreparable injury to the company is threatened or being suffered, then this can be grounds for judicial dissolution of the company. Model Business Corporation Act §14.30. Also, having a 50% interest gives the shareholder an opportunity to enter into shareholder agreements in order to break the deadlock, an opportunity which is not available to a 49% shareholder. Model Business Corporation Act §7.32(a)(6). Therefore, the 50% shareholder's interest is valued more than a 49% shareholder's interest because even though neither has control over a company, the 50% shareholder has certain statutory powers (varying by state) that a 49% shareholder does not have such as the power to create grounds for judicial dissolution of the company. Therefore, a discount applied to a 50% shareholder should be less than a discount applied to a 49% interest.

(c) Under normal circumstances, approximately a 10% deadlock discount is applied to a shareholder's 50% interest as supported by the case *Wheeler v. U.S.* In *Wheeler*, the court concluded that a

10% discount was appropriate where the decedent taxpayer held 50% of the voting stock of a closely held corporation. *Wheeler v. U.S.*, 1995 U.S.Dist. LEXIS 21432, 77 A.F.T.R.2d (RIA) 1405 (W.D. Tex. 1995) (Magistrate Document), *Wheeler v. U.S.*, 1996 U.S. Dist. LEXIS 20531, 96-1 U.S. Tax. Cas.(CCH) P60,226, 77 A.F.T.R.2d (RIA) 1411 (W.D. Tex. 1996) (Order). The court compared the decedent's 50% share to a minority position because a 50% shareholder lacks sufficient interest to control corporate affairs even though they have the power to block action by the other shareholder. *Id*. Based on the rationale that 50% ownership is less than a controlling interest, the court found for valuation purposes a 10% discount was appropriate.

B. DIVISION OF BUSINESS GOODWILL IN DISSOLUTION OF MARRIAGE CASES

Goodwill represents the value of a business or practice above the value of the physical assets. *In re Marriage of Talty*, 166 Ill.2d 232, 238, 652 N.E.2d 330 (1995). See also *In re Marriage of Schneider,* 214 Ill.2d 152, 166, 824 N.E.2d. 177 (2005). Illinois courts have broken down goodwill into two categories: enterprise goodwill and personal goodwill. Enterprise goodwill exists independently of one's personal efforts and will outlast one's involvement in a business. *In re Marriage of Alexander*, 368 Ill.App.3d 192, 195, 857 N.E.2d 766 (5th Dist. 2006). Personal goodwill is attributed to a person's personal efforts which ceases when that person is no longer involved in the business. *Id*. The purpose of distinguishing between enterprise and personal goodwill is said to avoid the issue of "double dipping" (utilizing the same income stream to determine support and asset value).

The Illinois Supreme Court first addressed the issue of personal goodwill and "double dipping" in *In re Marriage of Zells*, 143 Ill.2d 251, 572 N.E.2d 944 (1991). The Illinois Supreme Court readdressed the issue of personal goodwill and addressed for the first time the issue of enterprise goodwill in *In Re Marriage of Talty*, 166 Ill.2d 232, 652 N.E.2d 330 (1995). In *Talty*, the court stated "…we were not called upon in that case (*Zells*) to distinguish between personal goodwill and enterprise goodwill." In *Talty*, the court provided guidance on how to avoid "double dipping" in the context of a divorce business valuation. The court decided that no discount should be given for enterprise goodwill in the context of a divorce proceeding (See *Talty*); however, a discount for personal goodwill is appropriate where applicable. It then set forth the method to determine how to calculate the enterprise goodwill value of a business in Illinois.

> "To the extent goodwill inheres in the business, existing independently of William's personal efforts, and will outlast his involvement with the enterprise, it should be considered an asset of the business and hence of the marriage. In contrast, to the extent that goodwill of the business is personal to William, depends on his efforts, and will cease when his involvement with the dealership ends, it should not be considered property." *Id*. at 240.

As such, the value of an income-producing asset in a divorce is its value even if the owner-spouse is no longer involved in the operations of the income-producing asset, thereby avoiding the "double dipping" issue. We analogize the nature of the practice to an income-producing asset such as an apartment building generating rental income. The value of an apartment building is generally treated as 100% enterprise goodwill even though the rental income of the property is considered when valuing the asset as well as in setting support. This is because without any further involvement of the owner-spouse, the value of the asset will remain the same.

Subsequently, *In re Marriage of Schneider*, 214 Ill. 2d 152, 824 N.E.2d 177 (2005), the Illinois Supreme Court, clarified that the standards it had enunciated in *Talty* should be adhered to even if support is not at issue in the case.

In separating enterprise goodwill from personal goodwill, the expert in *Alexander* utilized the multi-attribute utility model (MUM). The expert analyzed "attributes" of the business by first defining the attributes, categorizing them as either enterprise or personal, and then assigned a value to each attribute. *In re Marriage of Alexander*, 368 Ill.App.3d 192, 199, 857 N.E.2d 766 (5th Dist. 2006). The expert testified that there are no universal attributes that must be defined in every situation, therefore the attributes analyzed will vary from business to business. *Id*. In *Alexander*, the following attributes were categorized and analyzed by the expert in valuing the goodwill of a medical practice:

Personal Goodwill

(1) Lack of transferability;
(2) Specialized knowledge;
(3) Personalized name;
(4) Inbound referrals;
(5) Personal reputation;
(6) Personal staff;
(7) Age, health, and work habits; and
(8) Knowledge of the end use.

Enterprise Goodwill

(1) Number of offices;
(2) Business location;
(3) Multiple service providers;
(4) Enterprise staff;
(5) Systems;
(6) Years in business;
(7) Outbound referrals; and
(8) Marketing.

In addition to the attributes utilized in *Alexander*, other attributes of personal goodwill include the ability, skill and judgment in their work and the person's closeness of contact with the business. Additional enterprise goodwill attributes include business reputation, number of business locations, general/un-personalized business name, branding, and repeating revenue stream. Completing the MUM analysis determines the level of personal goodwill associated with a subject company which should be discounted against the business's total goodwill in calculating the value to include in the martial estate.

C. COMMON ERRORS IN THE VALUATION PROCESS

b. Selection of an inappropriate standard of value and/or premise of value.

c. Confusion over or inconsistent use of the ownership characteristics of the interest being valued (i.e., minority or control ownership characteristics).

d. Failure to identify and reflect the correct valuation date.

e. Inadequate documentation and supporting historical data must be properly supported, documented and corroborated by third parties.

f. Errors in research theory or practice by failing to properly consider external forces and conditions that may have a bearing on the analysis and opinion of value or the failure to draw appropriate conclusions from the research is another common error.

g. Rigid or mechanical application of business valuation methods

h. Reliance on real estate appraisal methods

i. Inappropriate use of rules of thumb (a simplified industry formula designed to be applied to an earnings measure or other financial benchmark (e.g., revenues) to provide a value)

   (1) Rules of thumb should be used very carefully, if at all, and parameters for their use should include:

      (a) An adequate transaction base where each transaction is understood

      (b) A transaction base comprised of reasonably similar businesses

      (c) Application of appropriate adjustments for dissimilarity between the subject company and those in the transaction base

j. Indiscriminate use of price/earnings multiples by applying the price/earnings multiple to a non-comparable earnings stream or not making proper adjustments to the earning stream (i.e., in closely held businesses, officers' compensation is often higher than normal, reducing corporate earnings. Particularly when valuing businesses with control interest ownership characteristics, an adjustment of officers' compensation to "normalized" levels is generally called for. The subject company will be undervalued if the adjustment is not made).

k. Errors in deriving and applying capitalization rates by using rates from a different time period than the valuation date or not making proper adjustments related to risk.

l. Failure to estimate a realistic normalized earnings base by relying on past results without proper analysis and thought will cause the valuator to overlook critical financial statement items affecting value, such as depreciation in cash flow items or adjustments to owner's compensation or prepaid expenses.

m. Internal inconsistencies in the written report.

n. Indiscriminate use of boiler plate language.

o. Poor or careless editing and review.

p. Careless or inadequate review of value conclusions.

D. REVENUE RULINGS

a. Revenue Ruling 59-60 provides the following list of eight key items that should be considered in a business valuation.

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

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

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

(4) The earning capacity of the company.

(5) The dividend-paying capacity.

(6) Whether or not the enterprise had goodwill or other intangible value.

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

(8) 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.

b. Revenue Ruling 65-192 states that the theory used in Rev.Rul. 59-60 applies to income and other taxes as well as estate and gift taxes.

c. Revenue Ruling 65-193 approves only those valuation methods that can be used separately to determine tangible and intangible asset values.

d. Revenue Ruling 66-49 deals with the methods the IRS uses to arrive at valuations and valuation reports.

e. Revenue Ruling 68-609 deals with the calculation of return on tangible assets and capitalization rates for intangibles when a formula approach is selected.

f. Revenue Ruling 77-12 describes the acceptable methods to be used for allocating a lump sum purchase price to inventory values.

g. Revenue Ruling 77-287 provides information on valuation, for tax purposes of securities that cannot be resold because federal security laws restrict their marketability (marketability discounts).

h. Revenue Ruling 83-120 clarifies Rev.Rul. 59-60 with additional factors to be considered in valuing the common and preferred stock of a closely held company for gift taxes and recapitalization purposes.

i. Revenue Ruling 85-75 states the IRS is not bound to accept values that it accepted for estate tax returns as the basis for determining income taxes on capital gains from a later sale of the assets or depreciation expenses allowed.

j. Revenue Ruling 93-12 allows minority discounts to be applied when valuing minority interests of family members in a closely held corporation. Prior to this, the IRS used family attribution rules to disallow these minority discounts.

E. FULL TEXT OF REVENUE RULING 59-60

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.

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.

Section 2. Background and definitions.

a. 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 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.

b. 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 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.

c. 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”.

Section 3. Approach to valuation.

a. 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.

b. 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 the 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.

c. Valuation of securities is, in essence, a prophecy 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 fair 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 similar line of business are selling in a free and open market.

Section 4. Factors to consider.

a. 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:

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

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

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

(4) The earning capacity of the company.

(5) The dividend-paying capacity.

(6) Whether or not the enterprise had goodwill or other intangible value.

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

(8) 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.

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

(1) 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 changes its form of organization but carries 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.

(2) 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.

(3) 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 the 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 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 recapitalization 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.

(4) Detailed profit-and-loss statements should be obtained and considered for a representative period immediately prior to the required date of appraisal, preferably for 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) 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 non-recurrent 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 be 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 to 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.

(5) 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 dividends 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 understanding the dividend-paying capacity of the company. It follows, therefore, that dividends are less reliable criteria of fair market value than other applicable factors.

(6) 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.

(7) 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 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.

(8) 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 facts. 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 stock actively traded on the over-the-counter market also may be used. The essential factor is that whether the stock is 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 sue 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.

Section 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 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 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.

Section 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 the 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 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.

Section 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.

Section 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 a 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 as 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 share to the natural objects of his bounty for less than an adequate and full consideration in money or money’s worth. In the connection see Rev.Rul. 157 C.B. 1953-2.255 and Rev.Rul. 189, C.B. 1953-2.294.

Section 9. Effect on other documents.

Revenue Ruling 54-77, C.B. 1954-1.187. Is hereby superseded.

CHAPTER THREE – TAX ASPECTS OF DIVORCE

A. TAX RATE STRUCTURE

THE 2010 AND 2011 (PROJECTED) TAX RATE SCHEDULES:

2010 TAX RATES:

SINGLE

Base on Taxable Income	Tax on Base	% on Excess 0ver Base
$ 0	$ 0.00	10%
$ 8,375	$ 837.50	15%
$ 34,000	$ 4,681.25	25%
$ 82,400	$ 16,781.25	28%
$ 171,850	$ 41,827.25	33%
$ 373,650	$ 108,421.25	35%

MARRIED FILING JOINTLY OR SURVIVING SPOUSE

$ 0	$ 0.00	10%
$ 16,750	$ 1,675.00	15%
$ 68,000	$ 9,362.50	25%
$ 137,300	$ 26,687.50	28%
$ 209,250	$ 46,833.50	33%
$ 373,650	$ 101,085.50	35%

MARRIED FILING SEPARATELY

$ 0	$ 0.00	10%
$ 8,375	$ 837.50	15%
$ 34,000	$ 4,681.25	25%
$ 68,650	$ 13,343.75	28%
$ 104,625	$ 43,416.75	33%
$ 186,825	$ 50,542.75	35%

HEAD OF HOUSEHOLD

$ 0	$ 0.00	10%
$ 11,950	$ 1,195.00	15%
$ 45,550	$ 6,235.00	25%
$ 117,650	$ 24,260.00	28%
$ 190,550	$ 44,672.00	33%
$ 373,950	$ 105,095.00	35%

2011 TAX RATES (PROJECTED):

SINGLE

Base on Taxable Income	Tax on Base	% on Excess 0ver Base
$ 0	$ 0.00	10%
$ 8,425	$ 842.50	15%
$ 34,200	$ 4708.75	25%
$ 82,850	$ 16,872.25	28%*
$ 192,000	$ 47,433.25	36%*
$ 375,700	$ 113,565.25	39.6%*

MARRIED FILING JOINTLY OR SURVIVING SPOUSE

$ 0	$ 0.00	10%
$ 16,850	$ 1,685.00	15%
$ 68,400	$ 9,417.50	25%
$ 138,050	$ 26,830.50	28%*
$ 232,950	$ 53,402.00	36%*
$ 375,000	$ 104,540.00	39.6%*

MARRIED FILING SEPARATELY

$ 0	$ 0.00	10%
$ 8,425	$ 842.50	15%
$ 34,200	$ 4,708.75	25%
$ 69,025	$ 13,415.00	28%*
$ 116,475	$ 26,701.00	36%*
$ 187,850	$ 52,396.00	39.6%*

HEAD OF HOUSEHOLD

$ 0	$ 0.00	10%
$ 12,000	$ 1,200.00	15%
$ 45,800	$ 6,270.00	25%
$ 118,300	$ 24,395.00	28%*
$ 189,350	$ 44,289.00	36%*
$ 375,700	$ 111,375.00	36.9%*

*Based on proposed budget propoasl. If congress does not act, in addtion to the increase of the 33% bracket to 36% and the 35% bracket to 39.6%, the 10% tax bracket will be eliminated and the 15% bracket will expand, the 25% bracket increases to 28%, and the 28% bracket increases to 31%.

B. TAX ISSUES PERTAINING TO FAMILY AND DEPENDENTS

Marriage Penalty Relief

A "marriage penalty" has existed for years. Married taxpayers paid more tax when they filed a joint income tax return than if each spouse had filed separately using the single filing status. The principal factors contributing to the marriage penalty are the size of the standard deduction for married taxpayers, and the makeup of the tax bracket breakpoints. The Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTTRA) accelerated the increase in the standard deduction and tax bracket breakpoints for married taxpayers.

A. Increase in Standard Deduction

The JGTTRA increased the basic standard deduction for married taxpayers filing a joint return to twice the basic standard deduction for a single taxpayer in 2003 and 2004. The Working Families Act extended this relief through 2008. For 2010, the standard deduction for a single filer was $5,700; joint filers, $11,400; married filing separately, $5,700; and for those filing with the status of head of household, $8,400. In 2011, the standard deduction is projected to be $5,800 for a single filer; $11,600 for joint filers; $5,800 for those who are married but filing separately; and $8,600 for those who are filing with head of household status.

B. Expansion of 10% and 15% Rate Bracket

The size of the 15% income tax bracket for married taxpayers filing a joint return expands to twice the size of the corresponding rate bracket for a single taxpayer. The JGTRRA accelerated the expansion of the ten and fifteen percent tax brackets for the tax years 2003 and 2004 and added an inflation adjustment for 2004. The Working Family Act extended to 2007 the expansion of the ten percent bracket and accelerated the marriage penalty relief in the fifteen percent bracket.

C. Earned Income Credit

If a taxpayer claims the earned income credit, the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) attempted to provide parity between married and single taxpayers. For a married taxpayer who files a joint return, the beginning and ending points of the earned income credit phase-outs are increased by $2,000 for tax years beginning in 2005-

2007; and by $3,000 for tax years beginning after 2007. The $3,000 amount will be adjusted annually for inflation after 2008. In 2009, the credit was be equal to $3,043 with one qualifying child; $5,028 with two qualifying children; $5,657 with three or more qualifying children; and $457 with no qualifying children. For 2010, the earned income credit will be $3,050 with one qualifying child; $5,036 with two qualifying children; $5,666 with three of more qualifying children and $457 with no qualifying children. The phase out of the earned income credit in 2010 is as follows:

Single, Head of Household, No Child	$7,480 - $13,460
Single, Head of Household, One Child	$16,450 - $35,535
Single, Head of Household, Two or More Children	$16,450 - $40,363
Joint Filers, No Child	$12,490 – $18,470
Joint Filers, One Child	$21,460 - $40,545
Joint Filers, Two or More Children	$21,460 - $45,373

Innocent Spouse

In many marriages, one spouse handles the couple's finances and prepares their joint income tax returns. However, each spouse is jointly and severally liable for any taxes incurred, no matter which spouse generated the income. This includes the amount shown on the return and any later additions or adjustments that may be assessed. In some cases, often in connection with a divorce, one spouse discovers that the other spouse misstated or underreported their tax liability, either intentionally or inadvertently.

There may be relief in these situations for the spouse who was not at fault under the "innocent spouse provisions" of the Code (Section 6015). The circumstances under which this protection is available, however, are limited. Prior to amendments made in 1984, Section

6013(e) provided innocent spouse protection only in situations where (1) gross income was omitted from a joint return, (2) the innocent spouse did not know or have reason to know of the omission, and (3) it would be inequitable to hold the innocent spouse liable.

The Tax Reform Act of 1984 deleted Section 6013(e) and replaced it with Section 6015. Section 6015 extended innocent spouse relief to apply in situations where there were improper deductions, credits, and/or basis amounts, as well as omitted income. To qualify for relief, the innocent spouse must establish that:

- Both spouses filed a valid joint return;
- There was a substantial understatement of tax;
- The understatement was caused by a "grossly erroneous item" attributable to the other spouse;
- In signing the return, the innocent spouse did not know or have reason to know of the substantial understatement; and
- It would be inequitable to hold the innocent spouse liable.

In 1998, Section 6015(f) of the Code again expanded the grounds for innocent spouse relief by adding a catch-all for situations where the facts and circumstances make it inequitable for the IRS to collect against one spouse. An individual must elect the type of relief being sought on Form 8857.

To qualify for the innocent spouse relief election, the taxpayer must meet all of the following requirements:

- Filed a joint return which has an understatement of tax due to erroneous items of the spouse;
- Establish that at the time of signing the tax return the taxpayer did not know, or have reason to know, there was an understatement of tax; and
- Taking into account all of the facts and circumstances, it would be unfair to hold the innocent spouse liable for the understatement of tax.

A key element for the IRS will be whether the electing spouse received any substantial benefits or later was divorced, separated from or deserted by the other spouse.

Section 6015(c) of the Code provides further protection by allowing a spouse to elect to only be liable for the additional tax assessed on those items that would have been allocated to that spouse had a separate return been filed. In other words, one spouse would not be liable for the additional tax assessed by reason of the other spouse having unreported income or having taken improper deductions. This election, however, does not apply in situations where the spouse seeking relief had actual knowledge of the item when the return was signed.

The election pursuant to Section 6015(c) is valid if made at any time prior to the actual collection of the money and within the two year period after the IRS has commenced collection proceedings. To make the election, the individual must no longer be married to the joint filer or must have lived in a separate household for a minimum of one year from the time the election is made. There are provisions which prevent individuals from misusing this election such as by fraudulently separating to protect their assets from collection.

Finally, should one fail to qualify for either of the first two types of relief, one may still obtain relief from the tax liabilities, interest and penalties by electing equitable relief. The taxpayer must show that, under all the facts and circumstances, it would be unfair to be held liable for the understatement or underpayment of taxes. One should note that under equitable relief, the “innocent spouse” can receive relief from tax liabilities caused by underpayment of taxes.

With this election available, a lawyer can advise clients that there is reasonable protection in filing joint income tax returns during the pendency of a divorce action. If one party has a history of dishonesty, then a joint income tax return may best be avoided. However, in those situations where items such as complicated business dealings might previously have discouraged the filing of a joint return, a client may now file a joint return with some confidence that he or she will not be liable for taxes assessed for errors made on items attributable to the other spouse.

Dependency Exemptions

A taxpayer (other than a dependent) can claim a $3,650 personal exemption for himself in 2010 (projected to be $3,750 in 2011). On joint returns, spouses combine the personal exemptions to which they are entitled. Taxpayers can also claim an exemption for each qualifying dependent so long as the following six conditions are met: (1) the support test, (2) the gross income test, (3) the member of the household or relationship test, (4) the joint return test, (5) the citizenship test, and (6) social security number.

The 2010 phase-out threshold amounts are:

Joint Returns or Surviving Spouse	$250,650
Head of Household	$208,850
Single Taxpayers	$167,100
Married Filing Separately	$125,325

Projected phase-out thresholds for 2011 are:

Joint Returns or Surviving Spouse	$258,150
Head of Household	$215,150
Single Taxpayers	$172,100
Married Filing Separately	$129,075

In the tax year beginning in 2007, the amount of the exemption phaseout reduction that would otherwise apply is reduced by one-third and for the tax years beginning in 2008 and 2009 by two-thirds. For tax years beginning after 2009, the exemption phaseout is repealed.

There are exceptions to these conditions, one of which applies to divorced or legally separated taxpayers. For parents who were divorced or legal separated after 1984, the custodial parent is entitled to a child's dependency exemption unless he or she signs a written waiver to give the exemption to the non-custodial parent. This waiver must be attached to IRS Form 8332, "Release of Claim to Exemption for Child of Divorced or Separated Parents," of the non-custodial spouse in order to claim the dependency exemption and can be an annual or permanent waiver. The IRS will no longer accept Marriage Settlement Agreements or court orders as determinative as to who gets the dependency exemption. The custodial parent will be determined for IRS purposes by the number of a parent's overnights. The parent with the most overnights throughout the year will be deemed the custodial parent who may claim the dependency exemption by the IRS. There is one exception to the overnight rule. If the custodial parent, pursuant to the party's Judgment for Dissolution works nights, then the number of overnights will not be used to determine the custodial parent, but rather the terms of the Judgment of Dissolution will be used to determine the custodial parent for purposes of claiming the dependency exemption. (hereinafter in this subsection referred to as the "custodial parent").

<u>Head of Household</u>

The "head of household" filing status provides a taxpayer with tax rates which fall almost exactly between those for taxpayers who are married filing jointly and those for single individuals. A taxpayer is eligible for "head of household" status if: (a) the person is divorced or legally separated, (b) he or she paid more than half of the cost of maintaining a home for a child, and (c) the child resided with the taxpayer for more than half of the year. In addition, a married taxpayer will be eligible for “head of household" status if the taxpayer’s spouse was not a member of the household for the last six months of the tax year and if the household is the principle place of abode of a child for whom the taxpayer is entitled to a dependency exemption. The taxpayer will still be eligible for “head of household" filing status even if he or she is not entitled to claim the dependency exemption because it was waived pursuant to a divorce decree or separation agreement. For purposes of determining eligibility, an individual’s marital status is evaluated at the end of the calendar year. Beginning in 2005 under the Working Families Act, the child must either be a qualifying child or qualify as the taxpayer’s dependent.

Child Tax Credit

Parents receive a credit of $1,000 per child for children under age seventeen (17) in 2010, however beginning in 2011, the credit decreases to $500 per child. The Working Families Tax Relief Act of 2004 maintained the relationship requirement, but eased the support and residence requirements. The taxpayer will no longer have to prove that he/she provided over half of the support for the child but rather that the child did not supply more than one-half of his or her own support. Further, the qualifying child needs only to live six months in the same household as the taxpayer. Under the 2001 Act, the child tax credit can be applied against a taxpayer’s AMT liability on a permanent basis. Beginning with the 2004 tax year, the child tax credit will be refundable to the extent of 15% of the taxpayer’s earned income in excess of $10,000. The American Recovery and Reinvestment Act of 2009 extended the refundable credit to 15% of earned income over $8,500 for 2008 and the refundable credit for 2009 and 2010 is extended to 15% of earned income over $3,000.

In order to obtain the child tax credit, the taxpayer must be entitled to claim the dependency exemption for the child. The credit, however, begins to phase out for single taxpayers with an adjusted gross income (AGI) of $75,000 and $110,000 for joint filers. Due to the phase out provisions, divorcing couples need to assess which of the parties will be able to maximize the benefit of the credit in deciding who will be entitled to claim the dependency exemption of the child(ren).

Adoption Credit

Taxpayers are allowed an increased adoption credit of up to $13,170 per child adopted in 2010. Beginning in 2003, taxpayers who adopt a child with special needs are allowed to claim an adoption credit regardless of the actual expenses paid or incurred in the year the adoption becomes final. The law begins the phase-out range for this credit at $182,520 and no credit is given to those with an AGI of $222,520 or more.

Dependent Care Tax Credit

Taxpayers are allowed to claim a credit for the care of dependents under age thirteen (13) or a dependent or spouse who is physically or mentally incapable of caring for themselves. The credit rate for dependent care is 35% if the taxpayers' AGI is less than $15,000 and decreases one percentage point for every $2,000 to a floor of 20% for taxpayers with an AGI in excess of $43,000. The amount of eligible employment related expenses to which the credit can be applied is $3,000 ($6,000 if the credit is taken for more than one qualifying individual at the rate of $3,000 for each dependant).

C. TAX TREATMENT OF PROPERTY TRANSFER INCIDENT TO A DIVORCE

Section 503(d)(12) of the Illinois Marriage and Dissolution of Marriage Act (750 ILCS 5/503(d)(12)) ("IMDMA") provides that the court shall divide marital property without regard to marital misconduct in just proportions considering all relevant factors, including "the tax consequences of the property division upon the respective economic circumstances of the parties." Internal Revenue Code (hereinafter referred to as the “Code”) Section 1041 provides that no gain or loss shall be recognized on transfers of property between spouses incident to a divorce. Such transfers, including cash as well as non-cash transfers are to be treated as gifts. Cash transfers which do not qualify for tax purposes as maintenance or child support will generally be governed by Section 1041.

A transfer of property is incident to the divorce if such transfer occurs within one year after the date on which the marriage ceases, or is related to the cessation of the marriage. Transfers of property made pursuant to a divorce or separation instrument, and occurring within six years after the date the marriage ceases, are presumed to be related to the cessation of the marriage. Transfers made more than six years after a marriage ends are presumed to be unrelated to the cessation of the marriage and, therefore, do not qualify for Section 1041 treatment. This presumption may be overcome by showing that the transfer is to effect the division of property owned by the former spouses as of the date the marriage ended.

There are several situations where tax consequences are likely to arise from a property settlement, including:

- When a party is ordered to withdraw funds from a restricted account;
- When the parties are ordered to sell certain assets resulting in capital gains tax liability;
- When the parties are ordered to make an in-kind division of property;
- The future sale of an asset received in settlement; and
- When future income is received from a pension.

Courts are to consider all relevant factors, except marital misconduct, in dividing the marital property. The IMDMA provides a non-exhaustive list of factors to consider including the "tax consequences of the property division upon the respective economic circumstances of the parties." 750 ILCS 5/503(d)(12). "Tax consequences" means those immediately flowing from the court's decision and not remote consequences or consequences resulting from voluntary actions. *In re Marriage of Perino*, 224 Ill.App.3d 605, 609, 587 N.E.2d 54, 56-57 (3rd Dist. 1992). Courts are not required to contemplate speculative future tax implications based on a hypothetical transaction which may never occur. *In re Marriage of Hawkins*, 160 Ill.App.3d 71, 79-80, 513 N.E.2d 143, 148-1479 (5th Dist. 1987). *In re Marriage of Olson*, 223 Ill.App.3d 636, 650, 585 N.E.2d 1082, 1091-1092 (2nd Dist. 1992).

In those cases where courts have been called upon to consider the tax consequences of equitable distribution awards, courts have generally held that weight should be given to the tax factor only where the tax arises directly from the decree itself, or when a party adequately proves to the court that tax consequences are immediate and specific. Courts will not consider the tax factor, or will decline to give the tax factor any appreciable weight, unless the tax consequences are immediate and specific. It is up to the party claiming the tax consequences to prove them. *In re Lakin*, 278 Ill.App.3d 135, 662 N.E.2d 617 (1996). Even if a taxable event is reasonably likely to occur, it still cannot be considered if the amount of tax is unduly speculative. Thus, it is incumbent upon the party asserting the tax factor to prove the amount of the tax consequence.

The tax-free treatment provided by Section 1041 does not apply if the spouse (or former spouse) of the individual making the transfer is a nonresident alien. This tax-free treatment also does not apply to transfers of property in trust to the extent that the sum of the amount of the liabilities assumed, plus the amount of the liabilities to which the property is subject, exceeds the total of the adjusted basis of the property transferred. Proper adjustment will be made in the basis of the transferee of such property to take into account the gain recognized.

D. TAX TREATMENT OF CHILD SUPPORT

General Rules

Payments made for the support of a child as child support are neither deductible by the payor spouse nor includable in the income of the recipient spouse. See "Unallocated Maintenance and Support" section of this manual for the tax treatment of unallocated maintenance and support.

Child Support Calculation

In Illinois, child support obligations are set pursuant to Section 505 of the Illinois Marriage and Dissolution of Marriage Act [750 ILCS 5/505]. It states:

> § 750 ILCS 5/505. Child support; contempt; penalties
>
> (a) In a proceeding for dissolution of marriage, legal separation, declaration of invalidity of marriage, a proceeding for child support following dissolution of the marriage by a court which lacked personal jurisdiction over the absent spouse, a proceeding for modification of a previous order for child support under Section 510 of this Act [750 ILCS 5/510], or any proceeding authorized under Section 501 or 601 of this Act [750 ILCS 5/501 or 750 ILCS 5/601], the court may order either or both parents owing a duty of support to a child of the marriage to pay an amount reasonable and necessary for his support, without regard to marital misconduct. The duty of support owed to a child includes the obligation to provide for the reasonable and necessary physical, mental and emotional health needs of the child. For purposes of this Section, the term "child" shall include any child under age 18 and any child under age 19 who is still attending high school.
>
> > (1) The Court shall determine the minimum amount of support by using the following guidelines:

Number of Children	Percent of Supporting Party's Net Income
1	20%
2	28%
3	32%
4	40%
5	45%
6 or more	50%

(2) The above guidelines shall be applied in each case unless the court makes a finding that application of the guidelines would be inappropriate, after considering the best interests of the child in light of evidence including but not limited to one or more of the following relevant factors:

(a) the financial resources and needs of the child;
(b) the financial resources and needs of the custodial parent;
(c) the standard of living the child would have enjoyed had the marriage not been dissolved;
(d) the physical and emotional condition of the child, and his educational needs; and
(e) the financial resources and needs of the non-custodial parent.

If the court deviates from the guidelines, the court's finding shall state the amount of support that would have been required under the guidelines, if determinable. The court shall include the reason or reasons for the variance from the guidelines.

(3) "Net income" is defined as the total of all income from all sources, minus the following deductions:

(a) Federal income tax (properly calculated withholding or estimated payments);
(b) State income tax (properly calculated withholding or estimated payments);
(c) Social Security (FICA payments);
(d) Mandatory retirement contributions required by law or as a condition of employment;
(e) Union dues;
(f) Dependent and individual health/hospitalization insurance premiums;
(g) Prior obligations of support or maintenance actually paid pursuant to a court order;
(h) Expenditures for repayment of debts that represent reasonable and necessary expenses for the production of income, medical expenditures necessary to preserve life or health, reasonable expenditures for the benefit of the child and the other parent, exclusive of gifts. The court shall reduce net income in determining the minimum amount of support to be ordered only for the period that such payments are due and shall enter an order containing provisions for its self-executing modification upon termination of such payment period.

.
.
.

(g) An order for support shall include a date on which the current support obligation terminates. The termination date shall be no earlier than the date on which the child covered by the order will attain the age of 18. However, if the child will not graduate from high school until after attaining the age of 18, then the termination date shall be no earlier than the earlier of the date on which the child's high school graduation will occur or the date on which the child will attain the age of 19. The order for support shall state that the termination date does not apply to any arrearage that may remain unpaid on that date. Nothing in this subsection shall be construed to prevent the court from modifying the order or terminating the order in the event the child is otherwise emancipated.

.
.
.

(i) The court does not lose the powers of contempt, driver's license suspension, or other child support enforcement mechanisms, including, but not limited to, criminal prosecution as set forth in this Act, upon the emancipation of the minor child or children.

<u>What Is Net Income?</u>

Illinois courts have found income for child support to include, passive activity investment profits (*In re Marriage of Partney*, 212 Ill. App. 3d 586, 593, 571 N.E.2d 266, 270 (5th Dist. 1991); *In re Marriage of O'Daniel*, 382 Ill.App.3d 845, 850, 889 N.E.2d 254 (4th Dist. 2008) ("The only portion of the IRA that would constitute a gain for the individual would be the interest and/or appreciation earnings from the IRA")), lump sum worker's compensation awards (*In re Marriage of Dodds*, 222 Ill. App. 3d 99, 103, 853 N.E.2d 608, 611 (2nd Dist. 1991), distributions from a "pro forma" capital account (*In re Marriage Winne*, 239 Ill. App. 3d 273, 285, 606 N.E.2d 777, 784 (2nd Dist. 1992)), severance pay received in the year prior to the period for which support is due (*In re Marriage of Bekendorf*, 252 Ill.App.3d 429, 447, 62 N.E.2d 1241, 1254 (1st Dist. 1993)), military allowances for housing expenses, variable housing allowance and basis allowance for subsistence (*In re Marriage of McGowan*, 265 Ill.App.3d 976, 980, 638 N.E.2d 695, 698 (1st Dist. 1994)), tax refunds attributable to maintenance payments made to a former spouse and overpayment of Federal Income Tax due to over withholding on W-2 (*In re Marriage of Pylawka*, 277 Ill. App. 3d 728, 733, 661 N.E.2d 505, 509 (2nd Dist. 1996)), settlement under the Federal Employers Liability Act (*IDPA v. White*, 286 Ill.App.3d 213, 220, 675 N.E.2d 985, 989 (3rd Dist. 1997)), military pension awarded under Judgment for Dissolution of Marriage (*In re Marriage of Klomps*, 286 Ill.App.3d 710, 715, 676 N.E.2d 686, 689 (5th Dist. 1997)), distributions from a disability pension (*Myers v. Kidd*, 308 Ill.App.3d 593, 596, 720 N.E.2d 1125, 1128 (5th Dist. 1999)), per diem payments to a truck driver to cover expenses for meals and lodging while on the road subject to a reduction to the extent that the payer can prove the per diem was used for actual travel expenses (*In re Marriage of Worrall*, 334 Ill.App.3d 550, 555, 778 N.E.2d 397, 401 (2nd Dist. 2002)), distributions from an IRA award to a party as an asset in their Judgment for Dissolution of Marriage (*In re Marriage of Lindman*, 356 Ill.App.3d 462, 471, 824 N.E.2d 1219, 1226 (2nd Dist. 2005)), income from the exercise of stock options awarded to a party as an asset in their Judgment for Dissolution of Marriage (*In re Marriage of Colangelo*, 355 Ill.App.3d 383, 392, 822 N.E.2d 571, 578 (2nd Dist. 2005)), despite a spendthrift provision shielding one's interest in a trust from claims of creditors and restricting alienation, distributions from a spendthrift trust (*In re Marriage of Sharp*, 369 Ill. App. 3d 271, 282, 860 N.E.2d 539, 550 (2nd Dist. 2006)), and non-recurring bonuses and bimonthly car allowance (*Einstein v. Nijim*, 358 Ill.App.3d 263, 271-272, 831 N.E.2d 50, 57-58 (4th Dist. 2005)).

What is Not Included in Income?

Illinois courts have found the following not to be income for child support purposes: compensatory damages awarded in a personal injury case except the component of the award for lost wages (*Villanueva v. O'Gara*, 282 Ill.App.3d 147, 151, 668 N.E.2d 589, 593 (2nd Dist. 1996)), accounts receivable of a company are assets of a company, not income earned (*In re Marriage of Schneider*, 214 Ill.2d 152, 176, 824 N.E.2d 177, 175 (Ill. 2005)), a line of credit is not income because they represent loans rather than money an individual actually receives and does not increase an individual's wealth (*In re Marriage of Tegeler*, 365 Ill.App.3d 448, 457, 848 N.E.2d 173, 181 (2nd Dist. 2006)).

Income of a later spouse may not be included in the calculation of net income for child support. *In re Marriage of Boland*, 308 Ill.App.3d 1063, 1067, 721 N.E.2d 815, 818 (4th Dist. 1999). However, a new spouse's income may be equitably considered to determine whether the child support obligation is appropriate (*In re Marriage of Drysch*, 314 Ill.App.3d 640, 646, 732 N.E.2d 125, 130 (2nd Dist. 2000)), meaning would the child support obligation "endanger the ability" of the payor and their current spouse from meeting their needs. *In re Marriage of Keown*, , 813, 587 N.E.2d 644, 647 (4th Dist. 1992).

Note that income for child support purposes is not the same as taxable income. For example, gifts, including non-recurring gifts, are included in net income for child support purposes but not included in taxable income. *In re Marriage of Rogers*, 213 Ill.2d. 129, 137, 820 N.E.2d 386, 390 (Ill. 2004). In *Rogers* the husband earned a modest teaching salary of $15,000 but received an additional $46,000 per year in gifts and loans from his parents. The trial court found that the money the husband received from his parents was a steady source of dependable annual income that he had received each year over the course of his adult life. It also found that the husband never had to repay any portion of the money he received from his parents, nor did he pay tax on it. The trial court held that the sums the husband received from his parents could be included in his net income for the purpose of determining his child support obligation. The Illinois Supreme Court agreed. Expressly overruling two prior cases in which the appellate court had held that gifts were properly excluded from consideration of income for purposes of calculating child support, the court held that the circuit court "correctly took into account the gifts and loans that the father received in determining his net income." The court also commented that the trial courts must include even nonrecurring gift income when computing a parent's net income for child support purposes.

Deductions from Net Income

750 ILCS 5/505(a)(3)(a)-(h) lays out the deductions from net income for child support purposes:

(a) Federal income tax (properly calculated withholding or estimated payments);

(b) State income tax (properly calculated withholding or estimated payments);

(c) Social Security (FICA payments);

(d) Mandatory retirement contributions required by law or as a condition of employment;

- *In re Marriage of Pylawka*, 277 Ill.App.3d 728, 733, 672 N.E.2d 505, 509 (2nd Dist. 1996).
- Penalties and interest incurred for late payment and non-payment of taxes are not deductible. *In re Marriage of Charles*, 284 Ill.App.3d 339, 347, 672 N.E.2d 57, 63 (1st Dist. 1995).

(e) Union dues;

(f) Dependent and individual health/hospitalization insurance premiums;

- Health insurance premiums paid by non-custodial parent which benefit the child. *In re Marriage of Stone*, 191 Ill.App.3d 172, 175, 547 N.E.2d 714, 716 (4th Dist. 1989).

(g) Prior obligations of support or maintenance actually paid pursuant to a court order;

- Obligation must arise from a previous, unrelated marital action. Cannot deduct current obligations of support in conjunction with the same marital dissolution. *In re Marriage of Baptist*, 232 Ill.App.3d 906, 598 N.E.2d 278, 283 (4th Dist. 1992).
- "Prior" refers to an obligation to a family first in time. *In re Marriage of Potts*, 297 Ill.App.3d 110, 115, 696 N.E.2d 1263, 1266 (2nd Dist. 1998).

(h) Expenditures for repayment of debts that represent reasonable and necessary expenses for the production of income, medical expenditures necessary to preserve life or health, reasonable expenditures for the benefit of the child and the other parent, exclusive of gifts. The court shall reduce net income in determining the minimum amount of support to be ordered only for the period that such payments are due and shall enter an order containing provisions for its self-executing modification upon termination of such payment period.

- The word "necessary," as used in section 505(a)(3)(h), was intended to describe "those expenses out laid by a parent with a good-faith belief his or her income would increase as a result, and which actually did act to increase income, or would have done so absent some extenuating circumstances." *Gay v. Dunlap*, 279 Ill.App.3d 140, 149, 664 N.E.2d 88, 94 (4th Dist. 1996).
- In order to determine what is a "reasonable," one must consider the relationship between the amount of the expense and the amount by which income is in good faith expected to increase as a result. "This definition implies the same expense could be reasonable in one context and not in another." *Id*.
- Includes non-reimbursed business expenses as long as they are necessary and reasonable for the production of income. *In re Marriage of Rimkus*, 199 Ill.App.3d 903, 910, 557 N.E.2d 638, 643 (1st Dist. 1990).
- Expenses for meals and entertainment and car related expenses for purchases of gas, auto repairs, and insurance premiums are not expenditures for the repayment of debt and are therefore not proper deductions. Allowing day to day business expenses to be deducted ignores the language of the statute for "repayment of debt." Only expenses which constitute repayment of debts may be deducted from net income and non-reimbursed business expenses do not fit this category. *Gay v. Dunlap*, 279 Ill.App.3d 140, 145-146, 664 N.E.2d 88, 92 (4th Dist. 1996) (declining to follow *Rimkus*).
- The deduction of the non-custodial parent's day to day operating expenses of his on-going business is proper. Schedule F to non-custodial parent's tax return established a prima facie showing that the day to day operating expenses were legitimate. There is no explicit deduction in Section 505 for cost of goods sold, but disallowing a deduction would impute to payor income he does not actually possess. Even if a merchant pays cash for his goods and there is not actual "repayment of debt" a deduction must be allowed. *In re Marriage of Tegeler*, 365 Ill.App.3d 448, 454, 848 N.E.2d 173, 178 (2nd Dist. 2006).

- Real estate investment losses were not shown to be reasonable or necessary to the production of any income to the supporting parent and because the losses could not be presented in a specified repayment schedule the deduction was not proper. *In re Marriage of Partney*, 212 Ill. App.3d 586, 591, 571 N.E.2d 266, 269 (5th Dist, 1991).
- Deferred compensation is not proper deduction. Tax reported income does not provide conclusive evidence of gross or net income for child support purposes. Depreciation is not income but a return of capital. Straight line depreciation expense is a fair and proper deduction where the supporting payer has shown it to be reasonable and necessary expense for the production of income. *Posey v. Tate*, 275 Ill. App. 3d 822, 826 656 N.E.2d 222, 225 (1st Dist, 1995).
- Depreciation expense is not an "expenditure for repayment of debts" even though it may be a reasonable and necessary expense for the production of income. *In re Marriage of Boland*, 308 Ill.App.3d 1063, 1066-67, 721 N.E.2d 815, 817-18 (4th Dist. 1999).
- Personal expenses are not an expenditure for repayment of debts and therefore must be added back to determine net income for child support purposes.
- Child care expenses are reasonable expenses for the benefit of the child and therefore deductible from net income. *In re Marriage of Stanley*, 279 Ill.App.3d 1083, 1084, 666 N.E.2d 340, 341 (4th Dist. 1996).

<u>Temporary Child Support</u>

Temporary child support is obtained pursuant to 750 ILCS 5/501, "Temporary Relief," where "[e]ither party may move for: (1) temporary maintenance or temporary support of a child of the marriage entitled to support, accompanied by an affidavit as to the factual basis for the relief requested…" A temporary order "does not prejudice the rights of the parties or the child which are to be adjudicated at subsequent hearing; and may be revoked or modified before final judgment on a showing by affidavit and upon hearing; and terminates when the final judgment is entered or when the petition for dissolution of marriage or legal separation or declaration of invalidity of marriage is dismissed."

The purpose of temporary child support is to maintain the status quo on a temporary basis during the case. See "Recapture Issue: Excessive Front-Loading of Maintenance or Unallocated Maintenance and Support" below for more information.

<u>Shared Custody</u>

When there is shared custody, both parents may be spending substantial time with the children. In calculating child support in shared custody situations, the courts have broad discretion in determining whether deviation from the statutory support guidelines is warranted. For example, the 4th District rejected a father's argument that his child support obligation be reduced below statutory guidelines because both parents provided the children's primary care, namely the father provided "day care" for the children four days a week. *In re Marriage of DeMattia*, 302 Ill. App.3d 390, 393, 706 N.E.2d 67, 69 (4th Dist. 1999). The court limited its holding to the facts of that case and reasoned that "caring for one's own children is not day care nor is it a chore for which to be compensated." *Id*. at 395. In 2005, the fourth district found that the statutory percentages did not apply to the parties' split custody arrangement but that the court should still consider the factors stated in 750 ILCS 5/505(a)(2) to make sure the best interests of the child are served by deviating from the statutory support. *In re Marriage of Wittland*, 361 Ill.App.3d 785, 788, 838 N.E.2d 308, 310 (4th Dist. 2005). *See also In re Marriage of Reppen-Sonneson*, 299 Ill.App.3d 691, 695, 701 N.E.2d 1159, 1162 (2nd Dist. 1998) (when parents have shared custody, the court "is not obliged to rely on the statutory [child support] guidelines" and can "consider the factors listed in [IMDMA] section 505(a)(2)).

Enforcement

Requirements of actions to enforce child support orders based on a payor's failure to make ordered support payments in 750 ILCS 5/505 states in relevant part the following:

> (a-5) In an action to enforce an order for support based on the respondent's failure to make support payments as required by the order, notice of proceedings to hold the respondent in contempt for that failure may be served on the respondent by personal service or by regular mail addressed to the respondent's last known address. The respondent's last known address may be determined from records of the clerk of the court, from the Federal Case Registry of Child Support Orders, or by any other reasonable means.
>
> (b) Failure of either parent to comply with an order to pay support shall be punishable as in other cases of contempt. In addition to other penalties provided by law the Court may, after finding the parent guilty of contempt, order that the parent be:
>
> (1) placed on probation with such conditions of probation as the Court deems advisable;
>
> (2) sentenced to periodic imprisonment for a period not to exceed 6 months; provided, however, that the Court may permit the parent to be released for periods of time during the day or night to:
>
> (A) work; or
>
> (B) conduct a business or other self-employed occupation.
>
> The Court may further order any part or all of the earnings of a parent during a sentence of periodic imprisonment paid to the Clerk of the Circuit Court or to the parent having custody or to the guardian having custody of the children of the sentenced parent for the support of said children until further order of the Court.
>
> If there is a unity of interest and ownership sufficient to render no financial separation between a non-custodial parent and another person or persons or business entity, the court may pierce the ownership veil of the person, persons, or business entity to discover assets of the non-custodial parent held in the name of that person, those persons, or that business entity. The following circumstances are sufficient to authorize a court to order discovery of the assets of a person, persons, or business entity and to compel the application of any discovered assets toward payment on the judgment for support:
>
> (1) the non-custodial parent and the person, persons, or business entity maintain records together.
>
> (2) the non-custodial parent and the person, persons, or business entity fail to maintain

an arms length relationship between themselves with regard to any assets.

(3) the non-custodial parent transfers assets to the person, persons, or business entity with the intent to perpetrate a fraud on the custodial parent. With respect to assets which are real property, no order entered under this paragraph shall affect the rights of bona fide purchasers, mortgagees, judgment creditors, or other lien holders who acquire their interests in the property prior to the time a notice of lis pendens pursuant to the Code of Civil Procedure [735 ILCS 5/1-101 et seq.] or a copy of the order is placed of record in the office of the recorder of deeds for the county in which the real property is located.

The court may also order in cases where the parent is 90 days or more delinquent in payment of support or has been adjudicated in arrears in an amount equal to 90 days obligation or more, that the parent's Illinois driving privileges be suspended until the court determines that the parent is in compliance with the order of support. The court may also order that the parent be issued a family financial responsibility driving permit that would allow limited driving privileges for employment and medical purposes in accordance with Section 7-702.1 of the Illinois Vehicle Code [625 ILCS 5/7-702.1]. The clerk of the circuit court shall certify the order suspending the driving privileges of the parent or granting the issuance of a family financial responsibility driving permit to the Secretary of State on forms prescribed by the Secretary. Upon receipt of the authenticated documents, the Secretary of State shall suspend the parent's driving privileges until further order of the court and shall, if ordered by the court, subject to the provisions of Section 7-702.1 of the Illinois Vehicle Code [625 ILCS 5/7-702.1], issue a family financial responsibility driving permit to the parent.

In addition to the penalties or punishment that may be imposed under this Section, any person whose conduct constitutes a violation of Section 15 of the Non-Support Punishment Act [750 ILCS 16/15] may be prosecuted under that Act, and a person convicted under that Act may be sentenced in accordance with that Act. The sentence may include but need not be limited to a requirement that the person perform community service under Section 50 of that Act [750 ILCS 16/50] or participate in a work alternative program under Section 50 of that Act [750 ILCS 16/50]. A person may not be required to participate in a work alternative program under Section 50 of that Act [750 ILCS 16/50] if the person is currently participating in a work program pursuant to Section 505.1 of this Act [750 ILCS 5/505.1].

A support obligation, or any portion of a support obligation, which becomes due and remains unpaid as of the end of each month, excluding the child support that was due for that month to the extent that it was not paid in that month, shall accrue simple interest as set forth in Section 12-109 of the Code of Civil Procedure [735 ILCS 5/12-109]. An order for support entered or modified on or after January 1, 2006 shall contain a statement that a support obligation required under the order, or any portion of a support obligation required under the order, that becomes due and remains unpaid as of the end of each month, excluding the child support that was due for that month to the extent that it was not paid in that month, shall accrue simple interest as set forth in Section 12-109 of the Code of Civil Procedure [735 ILCS 5/12-109]. Failure to include the statement in the order for support does not affect the validity of the order or the accrual of interest as provided in this Section.

When is a Parent in Contempt?

Basically, there are four types of contempt. The first determination that is made is whether the contempt is criminal in nature or civil in nature. Criminal contempt is where a court imposes sanctions to punish past misconduct. Civil contempt is where sanctions are imposed for coercive purposes. The second determination is whether the contempt is direct or indirect. Direct contempt is conduct which occurs in the presence of the court or a constituent part of the court. Indirect contempt is a grouping of all acts which do not occur in such proximity to a court that they fall within the direct contempt category.

The four actual findings of contempt that a court has the power to order with the underlining considerations that are necessary for such a finding and the sanctions that can be imposed upon such a finding are as follows:

1. *Direct Criminal Contempt* – In this type of contempt there is no formal charge that is filed nor is there any plea issued or trial that is required and as such presentation of evidence is unnecessary. Upon the issuance of such contempt order and because such order is summarily made without a jury the fine must not exceed $500.00 and the jail sentence must not exceed six months.

2. *Indirect Criminal Contempt* – If the judge finds that indirect contempt has occurred then an order of adjudication of indirect criminal contempt must be written which must: 1) Be in writing; 2) Set forth the grounds upon which contempt is based; 3) Contain facts showing the basis for the contempt (not merely conclusions or opinions of the trial court); and, 4) Contain specific adjudication of contempt and the sanctions imposed. If a jury is not allowed then the sanctions are limited to a fine not to exceed $500.00 and/or jail time

not to exceed six months. If a jury has been permitted then the fine can be unlimited as can the jail term with the obvious exception that either fine and/or jail must be reasonable. If the court believes prior to a hearing on indirect criminal contempt that there is a good chance that the fine and or jail term would exceed the minimum of $500.00 and/or six months then the defendant must be informed of his right to a jury trial along with the other admonishments previously referenced.

3. *Direct Civil Contempt* – Recalling the definition of direct contempt as conduct which occurs in the presence of the court and civil contempt meaning that which is imposed for corrosive purposes. The court should impose its sanctions with a "Purge Order". The purge order is clearly similar to giving a defendant "the keys to his own jail". The court, by including a purge order is giving the defendant the right and the ability to end the finding of contempt by giving that defendant the ability to perform a particular act which will then bring him or her into compliance. Direct civil contempt is probably the most imposing type of contempt that can occur simply because the sanctions that are available to the court are continuing fines and/or indefinite jail sentence until the purge order is complied with.

4. *Indirect Civil Contempt* – This is what is customarily utilized and requested in a petition for Rule to Show Cause. If the court finds a sufficient basis then a written contempt order shall impose as sanctions an indefinite and continuing fine and/or a jail sentence until a purge order is complied with.

<u>Petition for a Rule to Show Cause</u>

The Court upon the presentation of a verified petition, if the Court determines that said petition constitutes a prima facie case, the Court must issue the Rule to Show Cause. Once the rule issues, a Court will set a return date. The return date is the hearing date for the respondent to come to Court and tell the judge why he or she should not be held in contempt. Personal service is required once the Rule to Show Cause issues. There is no requirement of personal service regarding the initial service which may be served upon the alleged contemnor as in any other motion.

The effect of the rule issuing is that the burden of proof now shifts to the respondent. The alleged contemnor now must prove and inability to comply with the Court Order.

Defenses are very limited and include:

1) The Order sought to be enforced is void;
2) The Order sought to be entered was ambiguous;
3) The failure to comply was not willful;
4) Lack of ability to comply;
5) Equitable estoppel – the alleged contemnor relied on the statement or conduct of someone else;
6) Laches.

Once the Court finds civil contempt, it must fashion a purge, so that if the contemnor performs the affirmative acts required by the Court the contempt is purged.

Modifying Support Orders

Courts are not bound by a parties' agreement to make child support non-modifiable. The reasoning is that "courts have a responsibility to protect the best interests of the children in child-support matters…The right to modify child support is a statutory right, and parties are always able to petition the court upon a change in circumstances." *In re Marriage of Wittland*, 361 Ill. App.3d 785, 788, 838 N.E.2d 308, 310 (4th Dist. 2005).

When the parties have agreed to unallocated maintenance and child support, the entire amount is subject to the statutory right of modification. This is true even if the agreement states that the unallocated amount is non-modifiable. *In re Marriage of Semonchik*, 315 Ill.App.3d

395, 403, 733 N.E.2d 811, 817 (1st Dist. 2000). See the unallocated maintenance and support section below.

Modifying a child support obligation requires a showing of a substantial change in circumstances. 750 ILCS 5/510(a)(1). Courts consider the circumstances of the parents and the child in determining whether there is a sufficient basis to warrant a modification. An example of a substantial change in circumstances where modification is appropriate is when a payor voluntarily changes their employment in good faith. *Coons v. Wilder*, 93 Ill.App.3d 127, 132, 416 N.E.2d 785, 791 (2nd Dist. 1981). The test for good faith is "whether the change in status was prompted by a desire to evade financial responsibility for supporting the children or to otherwise jeopardize their interests." *Id*. Making a good faith investment or changing employment can justify a modification, even though there is a risk of a loss or decrease in salary, because ordinarily a person makes an investment or changes employment hoping to increase their income in the future. *In re Marriage of Kowski*, 123 Ill.App.3d 811, 816, 463 N.E.2d 840, 844 (1st Dist. 1984).

Even if a payor voluntarily changes employment, the court may find that the payor is voluntarily unemployed or underemployed. Courts have the authority to impute income on a payor who is voluntarily underemployed so that the amount of child support corresponds to their earning potential. *In re Marriage of Adams*, 348 Ill.App.3d 340, 344, 809 N.E.2d 246, 249 (3rd Dist. 2004). *See also In re Marriage of Sweet*, 316 Ill.App.3d 101, 107, 735 N.E.2d 1037, 1043 (2nd Dist. 2000) (The interests of the other spouse and the children may take precedence over a party's desire to be self employed). *See also In re Marriage of Deike*, 381 Ill.App.3d 620, 632, 887 N.E.2d 628, 638 (4th Dist. 2008) (No substantial change in circumstances when voluntarily underemployed payor spent thousands of dollars renovating business instead of concerning self with how to continue to pay for support).

E. TAX TREATMENT OF MAINTENANCE PAYMENTS

General Rules

If certain requirements are met, maintenance payments are deemed income to the recipient spouse in the year received (Code Section 71). For the payor spouse, then, maintenance payments are deducted from gross income in arriving at adjusted gross income in the year paid (Code Section 215). Section 71(b)(1) of the Code defines maintenance as cash payments made which meet all of the following four requirements:

- Each maintenance payment must be received by a spouse or former spouse pursuant to a written separation agreement, decree of divorce or separate maintenance, or a decree requiring maintenance payments;

- The provisions of the agreement or decree must not designate the payment as not being taxable;

- The spouses must not be members of the same household (even if still married); and

- The payments must cease upon the payee's death.

To satisfy the requirement of a written separation agreement, the husband and wife may enter into a written agreement providing for the payment of maintenance. The tax treatment of the payments does not change even if not followed by a divorce or legal separation. See Treasury Regulation 1.71-1(b)(2)(I). In addition, the written agreement may be as simple as a written agreement between the parties' attorneys, provided the attorneys are acting as agents for the parties in entering the agreement. See *J.D. Azenaro*, 57 TCM 355, TC Memo 1989-224, wherein a letter agreement between counsels constituted a "written separation agreement."

The requirement of a judicial decree of divorce or separation may be satisfied by a temporary interim or interlocutory order. With such interim orders and separation agreements, the requirement that spouses not be members of the same household does not apply.

Temporary Maintenance

Courts have authority to award temporary maintenance pursuant to 750 ILCS 5/504. Just like permanent maintenance, if the requirements are met, it is tax deductible to the payor and income to the recipient under Internal Revenue Code Section 71. A petition for temporary maintenance must include a financial affidavit to show a factual basis for the relief. 750 ILCS 5/501. A temporary maintenance order is revocable or modifiable and terminates upon the entry of the final judgment for dissolution. 750 ILCS5/501(d). Courts can also award retroactive temporary maintenance if based on the factors the award is proper. *In re Marriage of Heroy,* 385 Ill.App.3d 640, 659-60, 895 N.E.2d 1025, 1044-45 (1st Dist. 2008).

Voluntary Impoverishment to Avoid Support Obligations

If a person is ordered to pay maintenance and that person is unemployed, the court may order that person to seek employment. 750 ILCS 5/505.1. The court may also order a person to maintain a job diary listing their job seeking efforts. *Id*. This rule does not only apply to the person paying maintenance but has been extended to people receiving maintenance. *In re Marriage of Mayhall*, 311 Ill.App.3d 765, 770, 725 N.E.2d 22, 26 (4th Dist. 2000).

If a person ordered to pay maintenance voluntarily terminates their employment and they fail to show good faith, the termination of employment is not considered a basis for modification (i.e. substantial change in circumstances). *In re Marriage of Dall*, 212 Ill.App.3d 85, 95-96, 569 N.E.2d 1131, 1137-1138 (5th Dist. 1991). The test for good faith is "whether the change in status was prompted by a desire to evade financial responsibility for support. *Coons v. Wilder*, 93

Ill.App.3d 127, 132, 416 N.E.2d 785, 791 (2nd Dist. 1981). Making a good faith investment or changing employment can justify a modification, even though there is a risk of a loss or decrease in salary, because ordinarily a person makes an investment or changes employment hoping to increase their income in the future. *In re Marriage of Kowski*, 123 Ill.App.3d 811, 816, 463 N.E.2d 840, 844 (1st Dist. 1984).

Unallocated Maintenance and Support

In order to achieve the maximum tax benefit allowable between the parties relating to child support and alimony, the divorcing spouses will often calculate a combined alimony and child support amount called "unallocated maintenance and support." The entire unallocated maintenance and support amount is then treated as maintenance. By converting otherwise nondeductible child support into a tax deduction, the payor spouse (who is often in a higher tax bracket) can pay a higher combined amount of support to the recipient spouse. This provides the recipient spouse with greater cash flow to support the child(ren), while at the same time yielding the payor spouse an overall lower payment after taxes.

The termination of unallocated maintenance and support, however, cannot be related to the happening of a child-related event or the entire amount of the payment will be deemed nondeductible child support. There is a rebuttable presumption that any reduction of unallocated maintenance within six months before or after a child attains the age of 18 or 21 is a child-related event. It is also possible for this rebuttable presumption to arise in situations where the parties have child(ren) between the ages of 18 and 24. If, on two or more occasions, the payments are reduced in regard to different children within one (1) year of each other, then a rebuttable presumption arises that the payment reduction is related to the children. In addition, if the amount of unallocated maintenance is reduced within six (6) months of one of the following child-related events, there is a rebuttable presumption that the amounts being paid are nondeductible child support rather than deductible unallocated maintenance:

- The child's death;
- The child's leaving school;
- The child's marrying;
- The child's leaving the spouse's household;
- The child's gaining employment; or
- The child's attaining a specified level of income.

<u>Recapture Issue: Excessive Front-Loading of Maintenance or Unallocated Maintenance and Support</u>

To prevent nondeductible property settlement payments in a divorce proceeding from being disguised as deductible maintenance payments, the Internal Revenue Service has instituted rules to avoid "frontloading." The payor spouse must make a mathematical calculation of the alimony payments paid during the first three (3) years after the divorce. If it is determined that the payments are frontloaded, then the tax due from the recaptured amount is paid in the third post-separation year.

The calculation is based on the actual amounts paid during the year and not the amounts set forth in the Judgment for Dissolution of Marriage or Marital Settlement Agreement. The payor spouse, therefore, must be careful if he or she must pay past-due maintenance in that, if it is paid in a later year, it may trigger the recapture rules. Another tax concern arises at the end of the payor spouse's obligation to pay maintenance. At that time, the loss of the deduction for maintenance payments may increase the adjusted gross income of the payor spouse. This increase may prevent the payor spouse from using the one hundred percent (100%) safe harbor for estimated taxes.

The IRS has provided a tax recapture safe harbor for maintenance payments that do not exceed $15,000 per year in any of the first three years following the divorce. If payments in year one exceed the average of payments made in years two and three by more than $15,000, then the excess will be recaptured in year three. Additionally, the average payments in years two and three will be reduced by the amount recaptured in year two. There is also an additional recapture rule if the maintenance payments in year two exceed those made in year three by more than $15,000.

The recapture rules do not apply if either spouse dies or the payee-spouse remarries before the end of the third post-separation year. The rules also do not apply to temporary support payments. When the rules do apply, the amount which will be recaptured is determined pursuant to the following statutory formula:

For the first post-separation year, the excess payment is:

Maintenance paid Year 1 – [$15,000 + [(Maintenance Paid Year 2 – Excess Payment in Year 2) + Maintenance paid Year 3] / 2]

For the second post-separation year, the excess payment is:

Maintenance paid Year 2 – (Maintenance paid Year 3 + $15,000)

The following is an example of how the recapture rules work:

In 2004, Mr. Black makes maintenance payments totaling $50,000 to his ex-wife. In 2005, he makes $20,000 in maintenance payments, but in 2006 he makes no maintenance payments. Assuming that none of the exceptions apply, the total amount that must be recaptured in the third year is $32,500. This represents $5,000 from the second year ($20,000 - $15,000) and $27,500 from the first year. The amount recaptured the first year equals the excess of $50,000 (the payments made) over the sum of $15,000 plus $7,500 [$50,000 - ($15,000 + $7,500) = $27,500]. The $7,500 is the average of the payments for years two and three after reducing the payments by the $5,000 recaptured for year two ($15,000 ($20,000 payment in year two plus $0 payment in year three minus the $5,000 that was required to be recaptured) divided by two equals $7,500).

Furnishing of Identifying Number

The recipient spouse of maintenance is required to give the payor spouse his or her social security number. The payor spouse is required to put the recipient spouse's social security number on his or her tax return next to the maintenance deduction.

F. TAX ISSUES ARISING FROM THE SALE OF THE MARITAL RESIDENCE

A taxpayer may exclude up to $250,000 ($500,000 for married persons filing jointly) ("exclusion") of gain realized on the sale or exchange of a principal residence if a taxpayer sells his/her principal residence. To claim the exclusion, the taxpayer must have owned the residence and used it as a principal residence for at least two of the five years prior to the sale. Additionally, the exclusion generally may not be claimed more often than once every two years. A partial exclusion of gain is available on a pro rata basis if failure to satisfy the "no sale in 2 prior years" requirement or the "ownership and use" requirement is not satisfied due to a change in the taxpayer's health, unemployment or unforeseen circumstances.

There are several tax traps and planning opportunities which must be accounted for when negotiating the disposition of the marital residence:

- Under Code Sec. 1041(a), the period of time during which the transferor spouse owned the property will be added to the transferee spouse's ownership period for purposes of satisfying ownership requirement. However, the period of use by the transferor spouse is not added (or "tacked") to the minimum use requirement of the transferee spouse. If the transferee spouse fails to meet all of the requirements, he/she may claim a portion of the exclusion equal to the fraction of the two years that the requirements were met.

- Gain will be recognized to the extent of any depreciation allowable with regard to rental or business use of a principal residence after May 6, 1997.

- For joint filers not sharing a principal residence, an exclusion of only $250,000 is available on a qualifying sale or exchange by one of the spouses.

- If a single taxpayer who is otherwise eligible for the exclusion marries someone who has used the exclusion within the two years prior to the marriage, the otherwise eligible taxpayer would be entitled to a maximum $250,000 exclusion. Once both spouses satisfy the eligibility rules and two years have passed since the last exclusion was allowed to either of them, the taxpayers may then exclude up to $500,000 of gain on their joint return.

- An estate-planning strategy used by some taxpayers involves keeping a lifetime interest in a residence and selling the right to the property after that lifetime interest ends (called a "remainder interest"). The new law provides that gain from the sale or exchange of a remainder interest in a taxpayer's principal residence may qualify for an otherwise allowable exclusion.

- If a taxpayer acquired her/his current residence in a rollover transaction, periods of ownership and use of the prior residence are taken into account for meeting the requirements of the new exclusion.

Following are several typical scenarios illustrating the application of the exemption during a divorce or separation:

<u>Separated Filing Joint Tax Returns</u>. Tony and Tina have been separated for 6 months. Tina lives in the family house in Berwyn which they bought 10 years ago and Tony has moved into an apartment in Cicero. They decided to sell the Berwyn house and realized profit of $350,000. Because they owned the house in joint tenancy and occupied it for more than 2 years (during the last five years) and have not had a previous sale of a principal residence during the last 2 years, they may exclude the entire gain ($350,000) from their taxable income.

<u>Divorced after Long Term Separation</u>. Assume Tony and Tina have been separated for 2½ years. Shortly after the separation Tina bought a house which she and her children have occupied as their principal residence for the last two years. Tina has rolled over the profit from two earlier home sales into her current home, which is in her name. Shortly before the divorce in

December, Tina sold the house and realized a $300,000 profit. Because Tony and Tina were divorced on December 31, they can not file joint income tax return for that year. Accordingly, Tina, filing a separate tax return, will exclude $250,000 of her $300,000 profit and will pay capital gains tax on the remaining profit of $50,000 ($300,000-$250,000).

Remarriage Issue. Tina has remarried. Her new husband, George, is selling his principal residence. Tina, however, participated in the sale of hers and Tony's principal residence within 2 years prior to the sale of George's principal residence. George may exclude only $250,000 of gain on the sale of his residence even if he and Tina file a joint income tax return for the year of sale.

Recapture of Depreciation Expense. Tony had a home office in the residence for many years prior to the separation and divorce from Tina. Over the years he and Tina took $30,000 in depreciation expense deductions in connection with the home office. Tina received the house as part of the property settlement. Two years later, she sold the house and realized a gain of $250,000. Because of the recapture of previous depreciation expense deductions ($30,000), Tina may only exclude $220,000 of her gain and must claim the remaining $30,000 as taxable income.

Partial Exclusion Exception. One month after the divorce and the sale of Tony and Tina's former residence, Tina buys another house. Twelve months later, Tina is transferred to a job out of state and sells her house. At the time, the residence had appreciated substantially and she realized a gain of $250,000 on the sale. A total of $125,000 of the gain (i.e. $250,000 x 12/24) would be excluded from her taxable income on her return for the year of sale.

Tacking Ownership Requirement Time. At the time of their separation, a house is bought solely in Tony's name which Tina lives in. During the 2½ years of their legal separation, Tony does not reside in the new residence and Tina has not had an ownership interest in the new residence. At the beginning of the third year, a divorce is granted and Tina moves out of the house bought by Tony at the time of their separation. Tony then sells the house for a profit of $400,000. Absent a valid separation agreement providing that Tony is required to provide a house for Tina's use during the separation period, Tony may not exclude any of the gain from the sale of the house on his separate tax return for the year sale. Rationale: Tony, the taxpayer, is seeking the exclusion of $250,000 of gain based on having used the residence for at least 2 of the previous 5 years. In this example, Tony was the owner but Tina used the property as her principal residence during the entire 2½ years that Tony owned the house and their divorce proceedings were pending. Tony must have described the arrangement in a valid separation agreement in order to add or "tack" Tina's use period of the house and thereby retain the right to exclude gain on a subsequent sale.

G. PLANNING FOR EDUCATION

College Tax Credits

The Hope Scholarship Credit is available only for the first two years of college education. For each college student for whom the taxpayer is entitled to claim the dependency exemption, the taxpayer will receive a credit of 100% for the first $1,200 paid in tuition and fees and 50% for the second $1,200, for a total credit of $1,800. To qualify for the Hope credit, the student must be enrolled for a minimum of half of the course hours/credits required to be a full-time student.

The American Opportunity Tax Credit is available for the 2009 and 2010 tax years. It is a modification to the Hope Scholarship Credit, the taxpayer will receive a credit of 100% for the first $2,000 paid in tuition and fees and 25% for the second $2,000, for a total credit of $2,500.

To qualify for the American Opportunity Tax Credit, the student must be enrolled for a minimum of half of the course hours/credits required to be a full-time student.

The Lifetime Learning Credit is worth up to $2,000 per year. Starting in the year 2003, a taxpayer became able to receive a credit of up to $2,000 per year (the equivalent of 20% of the first $10,000 paid in tuition and fees). A taxpayer can claim the Lifetime Learning Credit for each college student he or she supports and for whom he or she is entitled to claim the dependency exemption, regardless of the number of hours the student is enrolled.

Divorcing parents, however, need to be careful in allocating the dependency exemption and the tuition payments. If one spouse claims the child as a dependent but the other spouse pays the tuition, neither of the spouses will be able to claim the credit. The credits offset the amount paid for tuition and eligible fees (after deducting any grants) at qualified institutions of higher learning, including trade schools, community colleges, and four-year schools. The credit does not apply to expenses paid for room and board.

Both the Hope Credit and the Lifetime Learning Credit are designed to benefit families with middle incomes. The credits offset the amount of tax due dollar for dollar. In 2010 unmarried individuals can claim the full amount of the credit(s) if his or her AGI is under $80,000. Over that AGI, the credits decrease. At an AGI of $90,000 in 2010, the credits phase out entirely. Married couples filing jointly can claim the full amount of the credit(s) if their AGI is $160,000 in 2010 or less, with the credit completely phasing out at an AGI of $180,000 in 2010. These limits will be adjusted annually for inflation.

A taxpayer, however, may not use both of these credits at the same time in regard to the same child; however, a taxpayer may use different credits simultaneously for different children. When a parent claims a child who is in college as a dependent on his or her tax return, the credit(s) is also reported on the parent's tax return, not the child's tax return. Independent students can claim the credit on their individual returns as long as the student also pays the tuition.

These education tax credits are not without some drawbacks. The credits may affect student financial aid. By lowering a taxpayer's tax liability, these credits raise the taxpayer's after-tax income. Under current law, the higher the taxpayer's income, the less aid the student will be able to receive. Student aid is generally based on the taxpayer's income from the previous year. Additionally, the use of a Coverdell Education Savings Account (described below) may limit a taxpayer's ability to utilize the college tax credits.

Coverdell Education Savings Account (ESA)

Taxpayers are able to make an annual investment toward an Education Savings Account (ESA) for the benefit of a child ranging in age from birth to age eighteen (18). In the case of a special needs beneficiary, the age limitation does not apply. Currently, the annual contribution amount toward an ESA is equal to $2,000 per child. Additionally, ESA's are able to accept contributions from corporations, tax-exempt organizations and other entities; however, the total amount contributed for any one child may not exceed $2,000 per year.

Funds from an ESA do not need be used only for higher education expenses. Distributions from an ESA may be used to pay for elementary and secondary school expenses (grades K-12), regardless of whether the school is public or private. Expenses that are covered include tutoring, acquisition of computer equipment, room and board, uniforms and extended day programs.

Contributions to an ESA are not tax deductible, but any appreciation is, at a minimum, tax-deferred. As long as the distributions are used to pay covered expenses, the disbursements are tax-free. The ability to use an ESA begins phasing out for single taxpayers with AGI greater than $95,000 and completely phases out at $110,000; for married taxpayers filing jointly with AGI greater than $190,000 the phase out begins and at an AGI of $220,000 the phase out is complete.

The Hope and lifetime learning credits can be claimed in the same year that a distribution from an ESA is made so long as the distribution is not used to cover the same expenses for which the education credits are claimed. Additionally, taxpayers can make contributions to both an ESA and a qualified state tuition program in the same year for the same child without incurring a penalty.

Qualified Tuition Plans

Section 529 of the Code provides for qualified tuition programs to assist in savings for college education costs. Originally, the Code provided for states to establish prepaid tuition programs. The 2001 Act, however, expanded the scope of qualified tuition plans. A taxpayer is not restricted to making pre-payments of tuition or other higher education expenses to state-sponsored, qualified tuition programs. Under law, private institutions of post-secondary learning are also able to sponsor qualified tuition programs.

In Illinois, the University of Illinois was the benchmark for establishing costs under Section 529 plans. The costs of tuition and certain other costs, or a percentage thereof, were deposited with the state based upon the cost at the time of contribution. Deposits may be made in a lump sum or over a period of years.

When the beneficiary of the plan reaches college age, the state pays the beneficiary the amount of the current costs of tuition, etc. as charged by the University of Illinois. The beneficiary, however, may apply those funds to costs incurred at any legitimate institution of higher learning, not just the University of Illinois.

Qualified withdrawals from state-sponsored qualified tuition programs are exempt from federal income tax. Likewise, qualified withdrawals from non-state programs are exempt from federal income tax. For both types of plans, non-qualified withdrawals remain subject to federal income tax and a 10% federal penalty on the earnings portion of the withdrawals. There are, however, provisions which allow for withdrawals from the plans without penalty in the event of scholarships and other such situations.

If the named beneficiary of the plan never attends a qualifying institution, the fund may be transferred to members of the family of the beneficiary, including siblings, descendants and spouses. First cousins are also included in the list of family members who qualify as successor beneficiaries.

Currently a single rollover per year per beneficiary is allowed and each college is allowed to determine the appropriate amount for its students who commute and for those who live on- or off-campus. Generally, this increased the amount of room-and-board expenses that qualify. Also, the definition of “qualified higher education expenses” has been expanded to include expenses for “special needs services” for “special needs beneficiaries.”

Deducting Student Loan Interest

Up to $2,500 per year of interest paid on qualified higher education loans may be deductible. Qualified higher education loans can be the taxpayers, their spouses or their dependants. The current law holds the income phase-out range at $60,000-$75,000 for single taxpayers and $120,000-$150,000 for joint filers.

Employer Provided Educational Assistance

The income tax exclusion for employer-provided educational assistance to pay for graduate courses, as well as undergraduate courses is $5,250.

H. MISCELLANEOUS TAX PROVISIONS

Gift and Estate Tax

The estate tax applies to property owned by a taxpayer at the time of death. The current tax rate for years 2007-2009 is 45%, and in 2010, the estate tax is repealed for one year. A fixed amount of property can be exempt from estate tax. Currently the exemption sits at $2.0 million and it will remain so through 2008. Eventually, the estate exemption will increase to $3.5 million in the year before repeal. The following chart illustrates the eventual repeal, and reinstatement of the estate tax. The estate tax will return in 2011.

Calendar Year	Exemption	Highest Rate
2007	$2 million	45%
2008	$2 million	45%
2009	$3.5 million	45%
2010	repealed	0%
2011	$1 million	55%

For the gift tax, the exclusion will remain at $1.0 million dollars.

Medical Expenses

Medical expenses can be claimed as itemized deductions to the extent they exceed 7.5% of a taxpayer’s AGI. The term “medical expenses" includes any payment made for the diagnosis, cure, treatment, mitigation or alleviation of a physical or mental defect or illness, or for the purpose of affecting any bodily function or structure, other than unnecessary cosmetic surgery.

For parents who are divorced or separated, either parent may claim an itemized deduction for medical expenses paid on behalf of the child regardless of the parent's right to claim the dependency exemption for the child. When parties are divorcing, if one party will be able to exceed the AGI threshold for the itemized deduction of medical expenses, then he or she should be allocated the medical expenses in the martial settlement agreement or divorce decree.

Health or Medical Savings Accounts can be established to pay medical expenses provided that the accounts are used in conjunction with high deductible health insurance.

Legal and Accounting Fees

Legal and accounting fees are deductible on an individual's income tax return if the fees relate to the production of income or management and conservation of property. These fees are not deductible when they relate to the acquisition or defense of title. Additionally, tax-planning expenses incurred during a divorce may be claimed as a deduction on Schedule A of an individual's income tax return. These expenses are typically deductible since acts of dividing property and paying alimony usually have tax implications. Also, it is often necessary for an individual to obtain estate planning in connection with a divorce or to obtain advice related to the management of property or the allocation of tax basis. If an individual intends to claim a deduction for these types of fees, it is advisable to have his or her accountant and/or attorney specifically itemize any tax planning in their billing record.

Mortgage Debt Forgiveness Exclusion

Normally, if a lender forecloses on a property, sells that property for less than the debt owed, and forgives all or part of the unpaid mortgage debt, the cancelled debt would be included in taxable income. Beginning January 1, 2007 and ending December 31, 2012, a taxpayer may exclude up to $2 million of forgiven indebtedness if the debt is secured by a principal residence and is incurred in the acquisition, construction or substantial improvement of the principal residence. The exclusion also applies to situations where the lender chooses to renegotiate the terms of a mortgage, resulting in lower mortgage payments, instead of foreclosing on the property.

Alternative Minimum Tax

The Alternative Minimum Tax (AMT) is a separate method of computing income tax that ensures that at least a minimum amount of tax is paid by high income individuals. The AMT accomplishes this goal by disallowing many deductions and exemptions normally allowed in computing regular tax liability, such as certain itemized deductions, the personal exemption, and the standard deduction. There are, however, AMT exemption amounts. In 2009, the AMT exemption is $70,950 for married filers filing jointly and $46,700 for single and head of household filers. The first $175,000 of AMT in excess of the exemption amount is taxed at a rate of 26% while amounts over $175,000 are taxed at a rate of 28%. The AMT exemption amount is not indexed for inflation which has increased the occurrence of the tax reaching beyond high income individuals in recent years.

CHAPTER FOUR- RETIREMENT PLANNING

Next to the marital residence, the largest asset parties typically own are retirement plans. Given the significance of this asset, the issue of valuation and division of these accounts becomes particularly important. A retirement plan must be recognized by the IRS as "qualified" in order for its sponsoring employer and participating employees to be eligible for the tax benefits that are usually associated with retirement plans. The requirements that qualified plans must satisfy are numerous and complex. The two basic rules of most qualified plans are that they meet minimum participation standards and coverage requirements.

A. TYPES OF QUALIFIED PLANS

Defined Contribution Plans

A defined contribution plan maintains individual accounts for each participant in the plan. The employer makes contributions into the retirement plan, and those contributions are allocated among the participant accounts. Additionally, the participant accounts are credited with investment income or charged with investment losses. The participant's eventual benefit is the value of his account balance. In some plans both the employer and the employee are permitted to make contributions to the plan. Examples of a defined contribution plan include profit sharing plans, 401(k) plans, 403(b) plans, money purchase pension plans, retirement savings plan, employee stock ownership plans (ESOP'S) and simplified employee pension plans.

Defined Benefit Pension Plans

A defined benefit pension plan differs from a defined contribution plan in that the sponsoring company pre-determines the amount of benefit to be provided to the participants at the time of retirement. This is typically done by means of a formula which takes into account the individuals years of service in the plan, age and average compensation earned while an active participant.

For example, the pension plan may specify a lifetime pension at age 65 amounting to 40% of average pay. If an employee's average pay is $30,000, his pension would be $12,000 a year, payable at the rate of $1,000 per month. Generally, there are no individual accounts in this kind of plan. All of the funds are pooled and invested by the plan trustee. Each year the retirement liabilities of the plan are calculated by an actuary who advises the employer on the amount required to be contributed by the company to keep the plan actuarially sound ("fully funded"). At any point in time, the amount of benefits which the participant is entitled to receive at retirement can be computed and are referred to as accrued vested benefits. These amounts are not readily apparent based on a review of the plan's assets, because the assets are not specifically allocated to individual accounts, as they are in a defined contribution plan.

B. NON-QUALIFIED PLANS

Individual Retirement Accounts (IRA's) are not qualified plans as defined by the IRS. They are retirement accounts with their own special rules and limitations; as such, they can not be transferred by a QDRO, as more fully explained below.

Roth IRA's

If a taxpayer has the ability to do so, it is advisable for him or her to take advantage of the Roth IRA. With the Roth IRA, a taxpayer can annually invest up to $4,000 after taxes ($8,000 per married couple filing jointly). However, in no case can contributions to all of an individual's IRAs (regular, non-deductible or Roth) for a taxable year exceed the lesser of $4,000 or the individual's compensation. The maximum amount that may be contributed increases to $5,000 beginning in 2008. An additional $1,000 catch up contribution may be made by an individual who will be at least age 50 by the end of the tax year. Besides making direct contributions, a taxpayer may rollover amounts from existing deductible or nondeductible IRAs to a Roth IRA without an early distribution penalty; however, regular income tax will be due on any taxable amounts that are rolled over. Taxpayers with an AGI exceeding $100,000 and married taxpayers filing a separate income tax return may not take advantage of the Roth rollover provisions.

If the account is held for at least five years, no federal income taxes will be assessed against withdrawals made after the participant reaches age 59½. Even if the taxpayer has not reached age 59½ and the account has been held for at least five years, a withdrawal is still tax-free if the taxpayer is disabled or if the taxpayer has died. Additionally, up to $10,000 of funds may be withdrawn tax-free regardless of the taxpayer's age if they are spent on the taxpayer's first house.

In a situation where a taxpayer unexpectedly needs money for a purpose other than one which would be tax-free, he or she is allowed to make a tax-free withdrawal at any time up to the amount he or she has contributed. All other non-qualified withdrawals will be subject to regular income tax and a 10% early distribution penalty to the extent the withdrawal is subject to investment earnings.

Contributions to a Roth IRA can be made annually for as long as the taxpayer wishes. And, unlike existing IRAs, the taxpayer is not forced to start withdrawing the money at age 70½. The use of a Roth IRA, however, starts phasing out for single with AGI of $105,000 and is eliminated at an AGI of $120,000. For married couples, phase-outs begin at an AGI of $166,000 and the use of a Roth IRA is eliminated at an AGI of $176,000. Finally, it is important to note that these rules are for federal income tax purposes only. Whether individual states will duplicate the tax-free status of the contributions is uncertain.

Traditional IRAs

In addition to the ESA and Roth IRA, the traditional IRA still exists as a viable tool for retirement planning. A single taxpayer can contribute up to $4,000 per year of earned income to an IRA, and have the tax liability on any growth in value deferred until a withdrawal is made (for these purposes, maintenance is treated as earned income). The allowed contribution amount is scheduled to increase in future years to the extent of $5,000 in 2008. Taxpayers who are at least 50 years old by the end of 2007 can add an additional $1,000 per year to their regular IRA contribution as a catch up contribution.

In addition to the deferred tax, a taxpayer will incur a penalty (typically 10% of the amount of the withdrawal), on withdrawals from an IRA made prior to the taxpayer reaching age 59½.

If a taxpayer is a member of a qualified pension plan and contributes to a tax deductible IRA, he or she will only be able to claim the deduction if his or her income is lower than a specified amount. In 2010, the deduction phases out completely for single taxpayers whose AGI exceeds $65,000 and for married taxpayers with AGI in excess of $109,000. These phase outs begin at $55,000 and $89,000, respectively. Each spouse's eligibility to contribute to a deductible IRA is determined independent of the eligibility of the other spouse.

A tax deductible IRA may still be the best choice for an individual who does not expect to hold the investment for very long because of the ability to deduct the contributions from gross income. For an individual who already has a deductible IRA, he or she could consider rolling it over into a Roth IRA so long as his or her AGI does not exceed $100,000. If an individual does this, however, he or she will still be liable for income taxes on his or her current, deductible account. Finally, an individual can have both a Roth IRA and a tax deductible IRA, but his or her combined annual contribution to both IRAs cannot exceed the maximum for either one.

C. DIVIDING BENEFITS

Generally, a qualified retirement plan must provide that a participant's benefits under the plan cannot be assigned to another person or alienated. This creates a problem in a divorce scenario when a state court orders an assignment of one spouses' benefits under the plan to the non-participant. Congress provided a solution to this dilemma when it the Retirement Equity Act ("REA") of 1984. This legislation provided that assignment of qualified plan benefits made pursuant to a separation or divorce will not disqualify the retirement plan if the assignment is made assignment pursuant to a "Qualified Domestic Relations Order" (QDRO).

In looking to divide the retirement plan benefits, a number of methods can be considered.

Immediate Total Offset Method

Under this approach, the present value of the pension or profit sharing plan that is considered marital property would be given to the participant spouse. The non-participant would be given other marital property to offset the value of the retirement plan benefits allocated to the participant spouse.

Reserved Jurisdiction Approach or Plan Payment Method

Under this method, each spouse would retain an interest in the retirement plan and receive a share of the benefit when that particular retirement benefit becomes payable. This approach may be used when it is difficult to determine the present value of the defined benefit plan. Another reason for using this method is that the marital estate may simply lack other marital property or liquidity sufficient to offset the participant spouse's interest in the retirement plan.

<u>Division in Kind</u>

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.

D. DISTRIBUTION TRAPS

In a situation where a divorcing spouse is receiving an IRA or pension distribution from his or her ex-spouse as part of the property distribution, the recipient spouse may avoid current tax liability by making an IRA rollover. The following are several hidden tax traps which the recipient spouse must be aware of in these situations:

QUALIFIED PLANS

- The ten percent (10%) early withdrawal penalty assessed on pension distributions made before the plan participant reaches age 59½ does not apply to distributions made pursuant to a Qualified Domestic Relations Order ("QDRO") for qualified plans. Therefore, the recipient spouse must decide whether he or she will need the money to be distributed prior to him or her turning 59½. If so, the recipient spouse may want to take the distribution outright and pay the tax due on the distribution. Otherwise, if the distribution is rolled over into an IRA and then withdrawn prior to the recipient spouse reaching age 59½, the recipient spouse will be liable for the ten percent (10%) early withdrawal penalty in addition to the tax due.

- There must be a direct rollover from the participant spouse's pension to the recipient spouse's IRA; otherwise, the distribution will be subject to a 20% withholding tax.

- If the distribution is made from the participant spouse directly to the recipient spouse pursuant to a QDRO, and the distribution is then rolled over into an IRA within 60 days, the distribution is not subject to tax so long as the recipient spouse places the equivalent of the 20% withholding into the IRA. If the rollover is not performed, the recipient spouse will have to pay tax on the 20% of the distribution which was not rolled over.

- If a distribution from the participant spouse’s pension is made to the recipient spouse pursuant to a marital settlement agreement rather than a QDRO, the distribution is subject to tax and, possibly, a ten percent (10%) early withdrawal penalty.

- When a distribution is made from the participant spouse’s pension into a joint account and is then rolled into an IRA for the recipient spouse, the distribution is subject to tax. In addition, the distribution will be subject to a six percent (6%) excise tax on excess contributions and may be subject to the ten percent (10%) early withdrawal penalty.

NON QUALIFIED PLANS

- There must be a direct rollover from the participant spouse’s IRA to the recipient spouse’s IRA; otherwise, the distribution will be subject to a 20% withholding tax.

- If a distribution from the participant spouse’s IRA is made to the recipient spouse the distribution is subject to tax and, possibly, a ten percent (10%) early withdrawal penalty.

- When a distribution is made from the participant spouse’s IRA into a joint account and is then rolled into an IRA for the recipient spouse, the distribution is subject to tax. In addition, the distribution will be subject to a six percent (6%) excise tax on excess contributions and may be subject to the ten percent (10%) early withdrawal penalty.

E. VALUATION OF PENSION BENEFITS

One of the more difficult tasks in assessing the scope of the marital estate may be to value the retirement benefits which one or both spouses may have an interest. The non-participant spouse may have little or no information at first concerning the other spouse's retirement benefits. Once it is established that the pension benefits that accrue to a spouse are marital property, they are subject to valuation. The actual distribution of the benefits may occur now or at a later date, by mutual agreement of the parties or by a court order. If equitable distribution is to occur now by offsetting marital property, then there is no deferred distribution, no need for a QDRO and, indeed no actual involvement of the retirement plan.

Valuation Date

The valuation of a pension for equitable distribution involves generally accepted methodology and assumptions. There are certain fundamental concepts, the first of which is the valuation date.

The value of a benefit, in whatever kind of plan, is sensitive to the date at which it is being valued. For example, in a defined benefit pension plan, the same dollar amount of pension has a very different value when it becomes payable at retirement as compared to a date 20 years earlier. The probability of mortality and the discounts for interest change as the participant ages and affect the value of the pension, even if the amount of the pension itself does not vary. In a defined contribution plan, the value of the individual account balance varies over time based on contributions to the plan, investment results and allocations of forfeited balances. The trial court has discretion in setting the valuation date if not specifically prescribed by statute or case law.

Many times lawyers will draft Marital Settlement Agreements with generic language for the division of a pension account, for instance "50% of the account as of the date of the divorce". If this language in the parties' Judgment for Dissolution of Marriage is the only language dividing a Defined Contribution Plan, it may result in inequities and hurt the participant and non-participant equally. For instance, some of the earning in the Defined Contribution Plan may be due to the participant's service prior to the marriage. This language would improperly include the portion of the account that was earned prior to the marriage. In addition, the participant may have outstanding loans from the plan. Unless these amounts were withdrawn for marital purposes, the non-participant may reasonably argue that he or she should be provided with their share after "adding back" any amounts loaned.

Determining the Total Benefit

A. Defined Contribution Plan

In a defined contribution plan, the accrued benefit at any time is the account balance, with possible adjustments for funds on transit and other factors.

B. Defined Benefit Plan

In a defined benefit plan, the accrued benefit is defined by the plan. To find the definition of the accrued benefit, the plan document must be reviewed or correspondence must be received from a reliable plan source, or it may be determined by reference to an authenticated benefit statement. From this information, the present value of the future benefit payments can be computed.

Determining the Marital Portion of Benefits (Hunt Formula)

The value determined above must be adjusted for the length of the marriage. The commonly accepted approach, when valuing a defined benefit plan, is to use a marital coverture fraction. This fraction represents the time of married plan service divided by the time of all plan service to date. If the marriage predates the plan entrance date, then 100% of the benefits are marital.

In the case of a defined contribution plan, then the date of the marriage is subsequent to the plan entrance date, and analysis of the activity during the marriage is required. The balance in the participant spouse's account as of the date of marriage is the starting point to this analysis. All plan contributions subsequent to the date of marriage are considered marital property. The plan earnings subsequent to the date of the marriage should be allocated between marital and non-marital property based on the amount of marital assets in the plan as compared to the total assets in the plan, at least annually.

The court in *In Re Marriage of Hunt* approved of computation to determine the marital portion of a retirement pension plan. 78 Il. App. 3d 653, 397 N.E. 2d 511 (1st Dist 1979). The court ruled that the marital portion of a pension should be computed by multiplying the present value of pension benefit by a fraction whose numerator was the number of months of marriage during which benefits were accumulated and whose denominator was total number of months of employment during which benefits were accumulated or

$$\text{Present Value of Pension} \quad \times \quad \frac{\text{\# of months married}}{\text{\# of months participating in plan}}$$

F. OTHER CONSIDERATIONS

Retirement Savings Tax Credit

A tax credit of up to $1,000 for contributions to a qualified plan, such as a 401(k) plan is available. The actual amount of the credit depends on the taxpayer's level of income for the year. The credit is in addition to any other deduction or exclusion that applies to retirement savings contributions. To be eligible for this credit in 2009, the taxpayer's adjusted gross income must be $55,500 or less for joint filers, $41,625 or less for heads of household, or $27,750 or less for all other taxpayers.

Retirement Account Rollovers

A taxpayer is allowed to roll over amounts from his or her IRA into any eligible retirement plan, whether it is another IRA or a plan sponsored by the taxpayer's employer. However, employer plans will not be required to accept the rollovers. A tax planning tip: In the context of a divorce, rollover to a qualified plan then make a distribution pursuant to a Qualified Domestic Relations Order to avoid a penalty on the distribution.

Also, taxpayers are able to roll over "after-tax" contributions to his or her employer's defined contribution plan or to an IRA. The "after-tax" contributions are amounts on which the taxpayer pays taxes, but which were contributed to a retirement plan sponsored by the taxpayer's employer.

Exceptions to the 10% Penalty

The following exceptions apply to early distributions made from an IRA:

> (1) Medical Insurance Premiums. To the extent that they do not exceed qualifying medical insurance premiums, distributions from an IRA (including a SEP or SIMPLE account) to certain unemployed individuals are not subject to the 10% penalty.
>
> (2) Education Expenses. The 10% penalty does not apply if the individual uses the IRA distribution to pay for "qualified higher education expense" for the individual, the individual's spouse, child or grandchild of the individual or the individual's spouse.
>
> (3) First-time Homebuyer Expenses. The 10% penalty does not apply if the individual used the IRA distribution for certain expenses associated with buying a principal residence. Only $10,000 during the individual's lifetime may be withdrawn without a penalty for this purpose.
>
> (4) Return of Nondeductible Contributions. The 10% penalty does not apply to the portion of the distribution that represents a return of the nondeductible IRA contributions.

Even when the distribution is not rolled over and is required to be included in the individual's gross income, the 10% tax does not apply to:

> (1) Distribution upon death or disability of the participant;
>
> (2) Distributions after separation from service that are a part of a series of substantially equal periodic payments over the life of the participant or the joint lives of the participant and the beneficiary;
>
> (3) Distributions after the participant's separation from service, provided the participant reached age 55;
>
> (4) Distributions to a non-participant under a qualified domestic relations order;

(5) Distributions not exceeding deductible medical expenses (determined without regard to whether deductions are itemized);

(6) Certain distributions by ESOP'S of dividends on employer securities.

Social Security

If parties are married for 10 years, then the parties can qualify under their spouse's benefits. Therefore, social security will give a spouse who has been married for over 10 years the highest benefits that spouse can receive based on either their own individual earning history or their spouses earning history. Interestingly the Illinois Supreme Court has held in *In Re Marriage of Crook* that you cannot even consider social security benefits as property let alone whether there are any tax consequences associated with it. Under the Illinois Supreme Court's holding in *In Re Marriage of Crook*, courts may not consider Social Security benefits in the division of other marital assets. 211 Ill. 2d 437, 813 N.E.2d 198 (2004). In crafting its decision the Court emphasized that it was mindful both of the numerous courts around the county that do allow for the consideration of social security assets in determining a just property division and of the potential inequity created by its decision. The Court held "it is not the province of this court – or of any state court – to interfere with the federal schedule, no matter how unfair it may appear to be." As such, social security cannot even be valued and be used to offset other assets.

CHAPTER FIVE – ADR

A. WHEN MEDIATION IS APPROPRIATE

Mediation is appropriate in virtually any type of family law dispute. However, it is not appropriate when the parties are completely entrenched in their positions, wish to fight at all costs, and have absolutely no wish to try to cooperate. Mediation may not be appropriate when an extreme imbalance of power exists between the parties due to one party having been the victim of repeated domestic violence. Also, mediation may be very difficult with individuals who have substance abuse problems. Mediation is not marriage counseling. If the parties are seeking reconciliation, they should see a qualified psychologist or other mental health professional for marital therapy.

Convenience of Mediation

Besides the confidentiality, one of the aspects of mediation that parties particularly appreciate is that they can be more in control of the scheduling and timing of the process. Depending on the mediator's availability and schedule, the parties can set their sessions to meet their own timing needs. My personal preference, unless the parties need a different schedule, is to meet for two-hour sessions every two weeks. The two hours is long enough that we can really get into the issues and discuss them; the two week span is enough time between to allow them both to digest what's been discussed and to prepare for the next issue on the table. Many mediators conduct their sessions during evenings and Saturdays or otherwise work to accommodate people's work schedules. Sometimes, parties get started and then need to take a break from the process either because something has happened (e.g., a spouse has lost a job, a business lawsuit has been filed; a childcare provider has quit) or needs to happen (e.g., they need to get the house or business appraised; they need to get an opinion from the IRS or tax attorney, they need to gather the paperwork) before they can go further. Mediation is much more tolerant of such breaks in stride than the litigation process is, and it is then the mediator's role to be sure that the parties return to mediation when they are ready to work again. Conversely, if people are in a great hurry to get through a divorce, mediation is a process that can be foreshortened to happen in a smaller time frame if that's what it takes to get it done, all the information needed is readily available, and the parties have the energy to do a marathon session or two.

Another factor that makes mediation appealing to parties undergoing a dissolution is that it tends to be a more cost-effective process than litigation and even than negotiation, so parties tend to have more assets left to divide between themselves rather than use to pay the professionals. This is true even in the model where the parties consult regularly with attorneys, because those consultations tend to be relatively brief. For the bulk of the work, the parties are paying for one professional rather than two. The important thing to remember is that the correct comparison in determining the cost-efficacy of mediation is to consider the same parties with the same problems in litigation. Similarly, the use of experts and other professional help in mediation tends to result in the parties' agreeing to use on expert, again reducing their costs compared to a two-expert litigation process with adversarial posturing

In addition to the scheduling issues, mediation has the benefit that it can take place in more convenient locations. Mediators tend not to have their offices cluster around the courthouse, and my experience is that many clients very much want to avoid coming downtown because it feels too much like going to court. In addition, mediations typically occur in places that are unlike the courtroom setting, and it is the case that the setting can make a difference in people's ability and willingness to discuss, reach decisions, and work together on solutions.

In closing, parties can effectively deal with the most simple and the most complex issues in mediation, because they have the ability and power to work for their particular problems, that keeps them in control of the outcome, and that allows them not to exacerbate the relationship difficulties, not only between themselves but also among their friends and business and for spouses whose families share business relationships that they don't want to disrupt.

B. PARTICIPANTS IN THE PROCESS AND THEIR ROLES

Who is the Mediator?

A mediator is a neutral third person who helps the parties to a dispute, in this case divorce litigation, find mutually acceptable solutions. At the present time, there is no licensing or certification requirement for mediators in Illinois, so anyone who chooses can call herself or himself a "mediator" without running afoul of any rules or regulations. Nevertheless, the mediators who view themselves as professionals, who have the skills to do the tasks that are called for by the process, who belong to the various professional mediator associations, have had training (usually a minimum of 40 hours basic mediation training plus some advanced training or internship experience).

Because there is no licensing or credentialing requirement, mediators com from many different types of backgrounds. The majority of those who practice in the family law area either have some type of therapy/social work background or legal background, although there is a small but growing contingent of certified financial planners and accountants who are getting involved in this type of work. In the area of equitable distribution and related financial issues, it is important for parties to select mediators who are qualified and competent to mediate such issues. This does not necessarily mean that they have to be attorneys or accountants, but they need to have enough depth in the areas that are dealt with in the property distribution of a divorce so that they can guide the discussion and focus the parties on the right questions and issues. Some mediators solve this by following a co-mediation model, where on mediator is a therapist and on mediator is an attorney or accountant. Many mediators, including particularly those who subscribe to the various professional codes of ethics for mediators that have been developed, recommend that the parties each have attorneys with whom they consult as the mediation progresses.

Since mediators may not and should not be giving legal advice when they are functioning as mediators, even if they are also lawyers or accountants by training, the parties need to have a mechanism for finding out what their legal rights and obligations are. This is not so that they can replicate the results that would have come out of the court setting but just using a different process, but rather so that they can understand the parameters of the problem and know the strengths and weaknesses of the positions that they are choosing to take.

I believe that mediators and lawyers should be working together as a team to help their clients use this process as effectively as possible. I also believe that lawyers should be well enough versed in what makes a good or bad mediator, what constitutes good or bad mediation practice, so that the lawyer can help the client select an appropriate mediator by helping ask the right questions (a list of appropriate questions appended) and helping use the process effectively once they are in it. A lawyer who sits back while the parties are in mediation and tells the client to come in when the mediation is done is doing his or her client a great disservice. If at that point the lawyer determines that the client has agreed to things that will not work or will cause financial difficulties, it is much harder to go back and try to rework and correct the agreement, than to have dealt with the problems and issues as they were being discussed. For example, what if the parties agree to sell the marital residence after the judgment is entered but don't adequately address the capital gains tax issue? What if the parties divide the retirement benefits, assuming lump sum distributions are available, only to find that they are not under the particular plan at issue? These and similar issues are best dealt with by having the lawyer/mediator team each do their part in making sure the client is educated and empowered to make appropriate decisions on an ongoing basis.

The difference between mediation and negotiation, besides the existence of the third party neutral, is the atmosphere or tone of the meeting and the creativity or breadth of the solutions that are likely to surface. In the mediation, even if the parties are angry or arguing, the mediator provides the balancing skills and acts as a buffer to be sure that the important things that are said in the heat of the moment don't get lost because of the heat; the mediator is also there to open up choices and help the parties explore all the options they can think of, even sometimes some that may start out sounding ridiculous but that provide the seed for a truly creative and workable solution. In the negotiation, everyone has a "side" to advocate, and that necessarily changes the tone in which things are discussed and the kinds of proposals that people are willing to put on the table. This means that the truly creative solutions are less likely to be considered, because each side is seeking to optimize its gains, which typically comes at the expense of the other side.

Another important difference between mediation and negotiation is the degree of the clients' involvement in the discussions. Typically, when lawyers are in the room, the clients readily defer to the lawyers to do all the bargaining and talking; in mediation, by contrast, the parties do most of the talking and discussing, with the mediator guiding the discussion through questions and restatements to make sure the parties are understanding each other.

What Does the Mediator Do?

The main job of the mediator is to control the process: providing a forum, setting agendas, identifying and defining issues, asking the hard but necessary questions, clarifying statements, helping parties structure alternatives, keeping track of partial and interim agreements, making sure everyone has a chance to speak but that the dialogue is appropriate, not abusive. The mediator is not a substitute decision maker, and it is this unique feature of mediation that differentiates from all other dispute resolution processes. The mediator uses all her or his skills and training and knowledge to help the parties understand their choices and discuss them fully and appropriately so that the parties can then reach a solution to their issues that works for the two of them. Certainly to do this well the mediator must have a thorough understanding of the issues that need to be resolved in a property settlement agreement to make it acceptable to the court and in compliance with the legal requirements.

In the context of property distribution, the mediator would help the parties decide how to gather all the pertinent information, would help the parties understand the scope of the property to be divided, would help them discuss the available choices for dividing the assets and the consequences of such choices, and ultimately would help them write up their agreement to present to their attorneys for review. In this context, depending both on the sophistication of the parties and the extent and elaborateness of the estate, the mediator will help the parties determine whether outside help (accountants, financial planners, investment brokers, and so on) would or could be helpful for the parties; understanding of the issues and their implications.

One of the methods that mediators use to help parties resolve an impasse on an important issue such as a valuation, tax issue, tracing question, characterization issue, or related problems is help the parties identify an impartial way to generate a solution. Often, that means finding a person whom or a method that both will trust or at least listen to. In litigation, parties resolve (and sometimes create) such differences by using various kinds of experts. In mediation, if the parties can agree on a single expert or a single method or approach to addressing the issue, they can lessen the controversy and also lessen the cost for finding the necessary information. In mediation, the parties can also define the specific issues or questions that they want the expert to address, thereby narrowing his focus to the issues that really matter to them or that they cannot resolve by themselves. Sometimes the parties go to consult such an expert together and bring the information or work product back to the mediation session to work with; sometimes the expert is invited to come to a mediation session and provide the information and additional input there. For example, parties trying to figure out the most cost-effective way to divide a variety of retirement benefits, including annuities, pensions, and profit-sharing plans, might bring in an ERISA expert to sort out their options in light of the particular requirements of the various plans involved.

How Does the Mediator Do These Things?

Different mediators have different ways of structuring the way they conduct their mediations. Typically, however, the mediator meets jointly with both parties10 for several sessions, most frequently focusing on different issues at each one, helping the parties decide what the most logical order for discussion is, helping them manage their time, documents and information efficiently. For example, one of the things that is essential to mediating property issues is good and current information, and frequently one person is better informed than the other. How to get the parties both to have all the essential information is part of the mediator's role, and the process can vary vastly from one couple to another, based on their needs (time and

[10] Most mediators also have separate meetings (sometimes called “caucuses”), but mediation works best

resources). Thus some parties do all the work within the mediation session, including sharing and interpreting the various documents about their assets; others, to save money and time, try to do some of that work outside the session and bring the digested and summarized information in for everyone to work with.

C. COLLABORATIVE LAW

Acting as a collaborative lawyer differs in many important respects from conventional representation by a litigation lawyer. A collaborative lawyer's role is limited in purpose where the lawyer is specifically retained to assist the parties in reaching a comprehensive agreement and nothing more. The parties retain the right to terminate the collaborative law process at anytime, retain a litigation lawyer, and go to court. Collaborative lawyers are not the client's lawyer of record except for purposes of representing the client at an agreed upon court appearance (prove up).

By agreeing to the collaborative process, the parties give up their rights to advocacy in the process by their own experts, access to the court system, and the right to formally object to producing any documents or to providing any information to the other side. If the client fails to make full disclosure of the nature, extent, value of-and all developments affecting-their income, assets and liabilities that the lawyer regards as necessary, the lawyer, at their discretion, may withdraw or terminate the collaborative process.

Collaborative law depends on the good faith participation of both parties. There is a risk that a party may use the collaborative law process to delay or create an advantage in litigation therefore, collaborative lawyers should alert the client of any suspicions of bad faith of their

---

and is truest to its form when the parties are working together in one room.

client or of the other party and recommend termination of the collaborative process or withdraw from representation of the client.

CHAPTER SIX – EXPERT WITNESS PREPARATION[11]

A. INTRODUCTION

Testifying as an expert is often a four-stage process: voir dire, direct examination, cross-examination, and redirect examination. It is imperative that the client, attorney, and expert witness have the proper preparation, attitude, and teamwork in each of these stages.

It is the day of trial, the attorney for the expert's client stands up and states to the judge, "Your honor, I would like to call Fraud Buster as my next witness." The expert proceeds to take the witness stand, raises his or her right hand, the bailiff says, "Do you swear to tell the truth, the whole truth, and nothing but the truth?" and the expert replies, "Yes." Experts think they are ready, but are they really? Before the attorney can even begin questioning the expert about the 200-page report, with Exhibits A to ZZZ, the opposing attorney stands and states, "Your honor, I would like to voir dire the expert." But before it begins. . . .

B. EXPERT DEPOSITIONS

A deposition is testimony under oath, especially a statement by a witness that is written down or recorded for use in court at a later date. The opposing attorney will want to depose the retained expert prior to the trial date. A deposition is not a trial; however, testimony is given under oath, and therefore the expert must always tell the truth. At trial, the opposing attorney will attempt to impeach the expert's credibility, so the consistency of the expert's testimony at deposition and at trial is critical.

The expert should follow the ABCs of testifying as a guideline to stay focused:

A. **Avoid** absolutes.

[11] Upcoming chapter in the Wiley Family Law Services Handbook

B. **Bulletproof** reports.
C. Display **class** and act as if in a class**.**
D. Pay attention to **detail.**
E. Know **elements.**
F. Lay a **foundation.**
G. Do not **guess.**
H. Beware of **hypotheticals.**
I. Do not **interrupt.**
J. Do not use j**argon.**
K. Be k**nowledgeable.**
L. Make no l**egal** conclusions.
M. **Missing** issues in report create issues for you.
N. Appear **neutral.**
O. Do not answer a question if there is an **objection** pending.
P. Be **paranoid.**
Q. Be **quiet** after you answer the question.
R. **Respond** only to question asked.
S. Keep it **simple.**
T. **Think** before you speak.
U. **Understand** the question.
V. Keep an even tone of **voice.**
W. Display w**isdom.**
X. Use **X-ray** vision. (See through the cross-examiner's motives.)
Y. Be **yourself.**
Z. Display ethical **zeal.**

The expert should be prepared for invasive questioning by the opposing attorney. The deposition is a fishing expedition. The more the opponent can learn about the arguments the witness intends to present at trial, the more prepared the opponent will be to refute the arguments. Therefore, the number-one rule at an expert's deposition is to *respond only to the question asked*. It is important for an expert to *understand the question*. Some questions have a double entendre. The only time an expert does not have to answer the questions asked is when the answer is protected by the attorney-client privilege or Fifth Amendment right violations.

In some cases, depending on the comfort level between the expert and attorney of the expert's client, it may be helpful to have a test run of the deposition. This is helpful not only for the expert but for the attorney as well. Attorneys often find out information that they were not aware of until the trial run. Sometimes experiencing the process firsthand with the lawyer can give experts a sense of what it will be like in the deposition. This can more adequately prepare the expert, and the deposition will be more productive. Depositions are a very difficult and unnatural process of questions and answers. The question-and-answer process can be very methodical, and therefore hard to keep focused and calm. "I don't recall at this time" and "I am not sure" are better answers than guessing. If experts need to look at notes to answer accurately, they should do so. Remember, the goal of the deposition is to produce a clear and accurate transcript. Doing a test run, if possible, will emphasize the strengths and weaknesses of the expert's testimony and case. The expert can then address the weaknesses prior to the real deposition and/or trial.

C. PRETRIAL MOTIONS

The most common pretrial motions involving experts are the motion in limine to bar a witness from testifying or to bar a deposition and the motion to compel documents. The purpose of a motion in limine in the context of an expert is to bar an expert's report from being admitted into evidence and/or bar the expert from testifying at the trial. The opposing attorney will attempt to bar the expert or the expert's report by challenging the expert's competence, suitability, qualifications, methodology, and relevance of opinion before the trial even starts. If the expert survives the pretrial motions, he or she may be attacked during voir dire.

Additionally, the importance of experts to be educated about what disclosures they need to provide will help avoid motions to compel documents and motions in limine. If experts fail to disclose all required documentation, they may be faced with a motion to compel documents or a motion to bar. If a motion to compel is granted, a court order will be presented stating that an expert has failed to provide certain documents and what must be provided. If a motion to bar is filed it could lead to a disqualification of the expert or limit the expert's testimony to the disclosed information.

Report Drafts

Drafts of experts' reports must be disclosed, or else experts may be faced with motions to compel. Also, if experts do not have drafts of their report, they may be faced with a motion to bar their report and/or testimony. The 1993 amendments added the disclosure requirement under Federal Rule of Civil Procedure 26(a)(2)(B). Since that time, courts universally have required the production of experts' draft reports. See, for example, *Am. Fid. Assurance Co. v. Boyer* 1, 225 F.R.D. 520 (D.S.C. 2004). This rule is also applicable to the notes experts make throughout the process. *Fidelity Nat'l Title Ins. Co. of New York v. Intercounty Nat's Title Ins. Co.,* 412 F. 3d 745 (7th Cir. 2005). However, the question of "When is a draft a draft?" is hard to answer. For instance, if the expert starts drafting a report and after drafting only a few paragraphs quits working on it until the next day, then changes something in the previously drafted paragraphs, are these original paragraphs a draft? According to the rules, probably not. They are nothing more than the beginning concepts of a first draft of the expert's opinion. However, it is not always this clear cut, and courts have been imprecise on answering the question of what is a draft that must be kept and turned over in the discovery process.

The next cases will provide a better general understanding of what some of the parameters the courts have opined on as being a draft.

The case of *Trigon v. Unites States* says that the rationale for requiring disclosure of notes and drafts is that such documents reflect material that the expert "considered" in the course of arriving at the final opinions. *Trigon Ins. Co. v. United States,* 204 F.R.D. 277 (E.D Va.

2001). Some cases hold that *all* drafts be produced even if they reflect core attorney work. *B.C.F. Oil Ref. Inc. v. Consol Edison Co. of New York*, 171 F.R.D. 57 (S.D.N.Y. 1997). Conversely, other cases do not require production if it contains work product. *Ladd Furniture Inc. v. Ernst & Young*, 41 Fed. R. Serv. 3d 1633 (M.D.N.C. 1998). To confuse the issue even more, *Trigon* suggested that although drafts must be produced if they are the result of consultation with counsel, they may not have to be produced if solely a result of the expert's own thoughts. Finally, one appeals court stated that although experts do not have to keep every scrap of paper created in their preparation of the report, experts do have to produce those documents helpful in understanding the testimony or that the opposing party might use in cross-examination. *Fidelity Nat'l Title Ins. Co. of New York v. Intercounty Nat's Title Ins. Co.*, 412 F. 3d 745 (7th Cir. 2005). That being said, if experts destroy drafts and notes, their testimony can be barred in part regarding the destroyed drafts and notes.

Experts should think of record keeping from the cross-examiner's point of view: that is, what drafts and notes will be needed to preserve and produce to show their thought process from. This attention to detail will help experts avoid taking leaps in their thought processes and getting caught on cross-examination. This line of thought, however, could go so far as to include the production to opposing counsel of correspondence between the expert and the attorney about the case, including the case's strengths and weaknesses, thereby exposing one side of the case. But then again, an expert should have nothing to hide.

Expert Qualifications

The attorneys and the judge will follow the rules of the controlling case law in the state in which experts are testifying to attempt to qualify or, on the opponent's side, disqualify them as expert witnesses. The experts' curricula vitae serves as the written evidence of their qualifications. It should list experts' education, licenses, certifications, work history, teaching experience, speaking engagements, professional publications, and professional memberships (including any officer designations). Finally, any distinguished positions experts hold (i.e., adjunct professor) should be highlighted.

Regarding the qualifications of an expert witness and the matters in which they may testify to, the Federal Rule of Evidence 702 titled "Testimony of Experts" states:

> If scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert by knowledge, skill, experience, training, or education, may testify thereto in the form of an opinion or otherwise, if:
>
> (1) the testimony is based on sufficient facts or data,
> (2) the testimony is the product of reliable principles and methods, and
> (3) the witness has applied the principles and methods reliably to the facts of this case.[12]

Thus, before expert witnesses may testify as to their opinion, the attorney for the experts' client must first qualify them (Note: Not all jurisdictions follow the Federal Rules. The Federal Rules are used in the following materials as an example of the types of rules applicable to experts. Therefore, be sure to review the applicable state and local rules). Therefore, it is imperative that an expert *be knowledgeable* about the underlying facts and principles that were applied in forming an opinion. After the attorney for the expert's client has attempted to qualify the expert as an expert, the opposing attorney will have an opportunity to either stipulate that the person is an expert or will cross-examine the expert regarding his or her credentials. It is normal for experts to feel very uncomfortable and defensive during this process, since someone whom they barely know is attacking their education, experience, and methodologies. Although the

[12] Not all jurisdictions follow the Federal Rules. The Federal Rules are used in these materials as an example of the types of rules applicable to experts.

expert's credentials are more than likely to be very impressive, on cross-examination, the opposing attorney will pick holes in those credentials and the expert's compliance with industry standards. The opposing attorney will question the expert's educational background, will specifically point out that the expert has never opined before regarding the specific facts present in this case, and will question whether the expert is qualified to render an opinion regarding the issue present.

Experts should *keep an even tone of voice*. It is important for experts to stay calm and not get defensive or adversarial. Their professionalism and credibility are being assessed by the examiner to determine how good a witness they will be at trial. This determination will affect the examiner's willingness to settle or forge ahead to trial.

Experts should study their deposition, find the holes, and fill them or be prepared to explain their irrelevance to their testimony. Experts need to use their *X-ray vision* to see through the cross-examiner's motives before being trapped. If holes are discovered, it is best to testify about the issue on direct examination, so experts can minimize the weakness before the judge hears their cross-examination.

D. VOIR DIRE AND METHODOLOGY

Voir dire is the preliminary examination of the expert's witness under oath to determine the expert's competence to give relevant testimony that would assist the trier of fact. This will be the first time the judge and jury will see the expert under pressure. Perception can become reality. Experts need to follow the age-old saying, *Be yourself*. If the trier of fact believes an expert is not genuine, it is likely he or she will have the same conclusion about the expert's opinion.

The attorney for the expert's client will begin by questioning the expert about his or her credentials, education, experience, and the methodologies and theories applied to the specific facts of the case, in order to satisfy the elements of the Federal Rules of Evidence and the case law in the applicable circuit to qualify the person as an expert. The attorney should have experts testify to the detailed step-by-step process they utilized in the case. The attorney needs to ask if an expert's methodology is in compliance with standards in the industry. The witness is then proffered to the court as an expert. It is at this point that the opposing attorney will request permission to voir dire the expert. No matter whether it is the expert's first time testifying or fiftieth, the process of voir dire can be extremely unnerving. Voir dire is the opposing attorney's opportunity to bar the witness from being declared an expert on the subject in which the expert is being retained. The expert's credentials, experience, and methodology will be challenged by the examiner. The expert's competency to render an expert opinion will be attacked. The judge will then apply the standards set forth later in this section in formulating its opinion of whether to qualify the witness as an expert.

Part of the voir dire process involves questioning the methodology the expert used to render their opinion. Therefore, it is imperative that the methodology the expert follows is in accordance with the relevant case law of the applicable jurisdiction.

For example, the Federal Rules of Evidence state that the expert must apply reliable principles and methods to the specific facts of the case before the court in order to render an opinion. The sufficiency of the facts and reliability of the methodology have been defined by a series of United States Supreme Court cases.

The first case of importance is *Frye v. US*, 293 F. 1013 (D.C. Cir. 1923) which sets forth the "general acceptance" test. The court in *Frye* ruled that while courts will go a long way in admitting expert testimony deduced from a well-recognized scientific principle or discovery, the thing from which the deduction is made must be sufficiently established to have gained general acceptance in the particular field in which it belongs.

The next and probably more often followed case is *Daubert v. Merrell Dow Pharmaceuticals, Inc. Daubert v. Merrell Dow Pharmaceuticals, Inc.,* 509 U.S. 579 (1993). *Daubert* states that the trial judge is to act as a "gatekeeper" and determines whether the expert's proposed testimony is relevant, by determining whether the testimony is helpful to the trier of fact and whether the testimony truly relates to issues in the case. At this point, Federal Rule of Evidence Rule 702 has superseded *Daubert*, but the standard of review that was established for *Daubert* challenges are still appropriate.

Based on *Daubert*, these are guideline factors on whether the expert's methodology is reliable:

> **Testing:** Has the theory or technique been tested?
>
> **Peer review:** Has the theory been subjected to peer review discussion in publications?
>
> **Error rate:** Does the theory or technique have a high known or potential rate of error?
>
> **General acceptance:** Incorporates the *Frye* "General Acceptance" test as a factor to decide whether the theory or methodology has attracted widespread acceptance in the relevant scientific or professional community.

Another case of primary importance is *Kumho Tire Co. v. Carmichael,* 526 US 137 (1999), wherein the court ruled that *Daubert's* "gatekeeping" standard applies to all expert testimony by stating "[t]he initial question before us is whether the basic gatekeeping obligation applies only to scientific testimony or to all expert testimony. We, like the parties, believe that it applies to all expert testimony."

E. PREPARING FOR EXPERT WITNESS TESTIMONY

It is extremely important for experts to meet with the attorney prior to trial to discuss preparing for it. The courtroom is an extremely adversarial environment and experts who are not properly prepared will be eaten alive. Again, the most important rule while testifying is to respond only to the questions asked. In accordance with that rule, a list of guidelines and reminders for overall preparation for trial is presented next.

- Because experts are witnesses, every word they state, whether in a deposition or trial, is documented, given extreme importance, and intensely scrutinized.
- Experts need to listen to what the attorney actually asks and respond to what was asked. Experts should never assume what the examiner meant to say. If there is more than one way to interpret the question, experts should ask for clarification.
- Experts should treat each question individually. They should not assume that one question builds off the previous question. Experts should *be quiet* after answering a question and wait for the next question.
- Each and every word of a question counts. Experts should not answer the question unless y expert can answer every part of the question truthfully. If experts do not understand the question, they *should not guess*. They should not be afraid to inform the court that they do not understand the question.
- Experts are in charge. Everyone is listening to what they have to say. This is the expert's opportunity to impart his or her *wisdom*.
- Experts can control the speed, tone (they should not be sarcastic), and difficulty of the questions.
- Experts should answer the questions as simply as possible. Technical answers lead to confusion. Experts must remember to *keep it simple* and use laypeople's terms when responding.
- Keys for experts are to *think before you speak*, *answer the question*, and then stop talking. In order to understand the question, experts should repeat it in their head before answering.
- Experts should not try to prove the other side wrong. They should appear *neutral*, impartial, unbiased, and independent. This will greatly enhance their credibility.

Expert Disclosure

Federal Rule of Evidence 501 regarding attorney-client privilege titled "General Rule" states:

> Except as otherwise required by the Constitution of the United States or provided by Act of Congress or in rules prescribed by the Supreme Court pursuant to statutory authority, the privilege of a witness, person, government, State, or political subdivision thereof shall be governed by the principles of the common law as they may be interpreted by the courts of the United States in the light of reason and experience. However, in civil actions and proceedings, with respect to an element of a claim or defense as to which State law supplies the rule of decision, the privilege of a witness, person, government, State, or political subdivision thereof shall be determined in accordance with State law.

The landmark case of *U.S. v. Kovel*, 296 F. 2d 918 (2nd Cir. 1961), extends attorney-client privilege to third parties hired by a lawyer or a client to assist in providing legal services to a client. However, the role of an expert (i.e., a consulting nontestifying expert or a testifying expert, discussed later) will impact whether the expert's work is "discoverable" or whether the work is protected by Federal Rule of Evidence 501 and *U.S. v. Kovel*.

Consulting Expert versus Testifying Expert

There are various types of experts, and it is extremely important from the commencement of the services that experts define with the client what their roles and responsibilities will be, as this will impact whether to execute the engagement agreement with the client or the attorney. In addition, experts' roles impact whether their work is "discoverable." If the expert is retained as a testifying expert, his or her role will be to testify in open court and submit a report; in such cases, experts will need to execute an engagement agreement with the client. As a testifying expert, the expert's working file, including drafts of his or her report, are discoverable. However, if experts are retained as consulting, nontestifying advisors by the attorney, their work file is protected under the attorney-client privilege, and experts can execute the engagement agreement with the lawyer. If experts switch from being consulting experts to testifying experts, all of their notes, memorandums, drafts, and so on become discoverable from the time the experts were retained as a consultant. Therefore, experts need to *be paranoid* from the beginning regarding what they write or information learned, as it may become discoverable.

If experts are retained as consulting, nontestifying advisors by the attorney, their work file is protected under the attorney-client privilege so long as the experts are assisting the attorney in giving legal advice to the client, but there are certain things experts should do to ensure the attorney-client privilege. Specifically, experts should:

- Execute the engagement agreement with the lawyer, not the client, and clearly specify the experts' roles and responsibilities.
- Label work product as "protected by the attorney-client and work product privileges."
- Not speak to the potential client prior to being retained by the attorney. (However, if the expert happens to be the client's current accountant, the expert should segregate the matters that will be part of the attorney-client privilege.)[13]
- Communicate only with the client at the counsel's direction.

U.S. v. Cote, 456 F. 2d 142 (8th Cir. 1972).

This list, although not exclusive, should give experts guidelines. It stresses the importance of abiding by the controlling case law. Experts in a consulting role should request instructions from the attorney on local rules for preserving the privileges.

However, if experts are retained as testifying experts, their role will be to testify in open court and submit a report, and the experts will need to execute the engagement agreement with their client. As testifying experts, the experts' working file, including drafts of their report, are discoverable and not protected by attorney-client privilege.

Direct Examination

The courtroom is like a classroom. The attorney is the teacher, the judge and jury are the students, and the expert is the teacher's aide. Experts should answer the teacher's questions with *class* so the students in the *class* can become educated on the subject experts are testifying to and also trust the information given. On direct examination, the lawyer will ask experts questions. Experts will explain the theories, research, methodology, and processes utilized. Ultimately experts will render an opinion.

Most of the direct examination questions will consist of who, what, where, when, how, and why. These questions are known as foundation questions. Experts must be able *to lay a foundation*, or they will not be allowed to testify about that aspect of the case. On direct, the attorney's use of leading questions (i.e., questions that suggest to the witness the answers the lawyer wants to receive) is very limited. Therefore, expert and attorney must coordinate the testimony in an orderly fashion. A basic understanding of the rules of evidence and the *elements* of the cause of action involved can aid experts in helping the attorney present the experts' testimony.

Because experts are witnesses, every word they state, whether in a deposition or trial, is documented, given extreme importance, and intensely scrutinized. Experts should *avoid absolutes* like "always" and "never." All the cross-examiner has to find is one exception to destroy their credibility.

A. Expert Opinions

Once they are qualified as experts, they will be asked to testify as to their opinion regarding the matter at issue. Federal Rule of Evidence 703 titled "Bases of Opinion Testimony by Experts" states:[13]

> The facts or data in the particular case upon which an expert bases an opinion or inference may be those perceived by or made known to the expert at or before the hearing. If of a type reasonably relied upon by experts in the particular field in forming opinions or inferences upon the subject, the facts or data need not be

[13] Not all jurisdictions follow the Federal Rules. The Federal Rules are used in the following materials as an example of the types of rules applicable to experts.

> admissible in evidence in order for the opinion or inference to be admitted. Facts or data that are otherwise inadmissible shall not be disclosed to the jury by the proponent of the opinion or inference unless the court determines that their prohibitive value in assisting the jury to evaluate the expert's opinion substantially outweighs their prejudicial effect.

Federal Rule of Evidence 704 titled "Opinion on Ultimate Issue" states:

> (a) Except as provided in subdivision (b), testimony in the form of an opinion or inference otherwise admissible is not objectionable because it embraces an ultimate issue to be decided by the trier of fact.
> (b) No expert witness testifying with respect to the mental state or condition of a defendant in a criminal case may state an opinion or inference as to whether the defendant did or did not have the mental state or condition constituting an element of the crime charged or of a defense thereto. Such ultimate issues are matters for the trier of fact alone.

Federal Rule of Evidence 705 titled "Disclosure of Facts or Data Underlying Expert Opinion" states:

> The expert may testify in terms of opinion or inference and give reasons therefor without first testifying to the underlying facts or data, unless the court requires otherwise. The expert may in any event be required to disclose the underlying facts or data on cross-examination.

Federal Rules of Evidence 702 and 704 prohibit experts from offering opinions about legal issues that will determine the outcome of the case. That is, experts cannot testify about legal issues on which the judge will instruct the jury. *Bammerlin v. Navistar Internat'l Transp. Corp.*, 30 F. 3d 898, 900 (7th Cir. 1994); *Harbor Ins. Co. v. Continental Bank Corp.*, 922 F.2d 357, 366 (7th Cir. 1990). *Legal conclusions* made by experts are inadmissible in court. If experts are not careful, their entire report may be subject to a motion in limine and result in them and their reports being barred from trial.

B. Exhibit Evidence

An expert's report is a key part of both direct examination and cross-examination. On direct examination, the lawyer will attempt to put the expert's report into evidence as "exhibit evidence." The expert's report speaks just as if it were on the witness stand testifying; therefore, it must speak for itself. Because the report cannot answer cross-examination questions, experts have to endure cross-examination and attacks on their report. It is not an expert's job to be adversarial. Experts should merely answer the questions and remain professional. As mentioned, experts are making a record, so whatever they say will be documented.

Federal Rule of Civil Procedure 26(a)(2)(B), "Elements Required for Written Reports of an Expert Witness"[14]

The expert's report is the backbone to expert's testimony. In order to testify the expert must produce a report that meets certain requirements. The federal rules of Civil Procedure require the following:

> (B) Unless otherwise stipulated or ordered by the court, this disclosure must be accompanied by a written report—prepared and signed by the witness—if the witness is one retained or specially employed to provide expert testimony in the case or one whose duties as the party's employee regularly involve giving expert testimony. The report must contain:
>
> (i) a complete statement of all opinions the witness will express and the basis and reasons for them;
>
> (ii) the data or other information considered by the witness in forming them;
>
> (iii) any exhibits that will be used to summarize or support them;
>
> (iv) the witness's qualifications, including a list of all publications authored in the previous ten years;

[14] Not all jurisdictions follow the Federal Rules. The Federal Rules are used in the following materials as an example of the types of rules applicable to experts.

(v) a list of all other cases in which, during the previous four years, the witness testified as an expert at trial or by deposition; and

(vi) a statement of the compensation to be paid for the study and testimony in the case.

(C) Time to Disclose Expert Testimony. A party must make these disclosures at the times and in the sequence that the court orders. Absent a stipulation or a court order, the disclosures must be made:

(i) at least 90 days before the date set for trial or for the case to be ready for trial; or

(ii) if the evidence is intended solely to contradict or rebut evidence on the same subject matter identified by another party under Rule 26(a)(2)(B), within 30 days after the other party's disclosure.

<u>Application of Federal Rule of Civil Procedure 26(a)(2)(B)</u>

The primary exhibit experts will be testifying to is their written report. Experts should keep in mind some important guidelines regarding all written reports. All documents, including schedules, charts, graphs, and written narratives, whether part of an expert's report or presented as exhibit evidence in support of the testimony, should clearly indicate that they were prepared solely for use in the subject dispute or litigation. Further, depending on the situation, experts should indicate the status of the document, such as "draft," "tentative," "preliminary," or "subject to change," as experts may obtain additional information prior to the final report. Or when working as nontestifying, consulting experts or before being designated as the testifying expert witness, experts should designate that the report is "privileged and confidential" and prepared for litigation under the attorney work product privilege. These types of documentation may be utilized in the court process:

- Written reports submitted to the trier of fact (usually prior to oral testimony)
- Exhibits that support or explain oral testimony

- Written reports prepared by an expert and submitted to the client (for purposes of settlement)
- Affidavit in lieu of testimony
- Working papers, supporting documents submitted for discovery

It is imperative that experts *pay attention to detail*, or it will come back to haunt them. In particular, *missing issues* or critical facts in the report is an open invitation to the cross-examiner to destroy an expert's credibility by pointing out the holes in the report. Experts' final written report and any supporting exhibits should be *bulletproof*, meaning they should be so specific, credible, and substantiated that expert testimony is unnecessary.

In sum, in the written report, experts must state all opinions and all explanations for the basis and reasons for the opinions. Experts' final opinions should be supported in a step-by-step process or drill-down method listing of exhibits. The analysis and data should be laid out succinctly and methodically, with one exhibit leading to the next to explain an expert's final opinion. There should be no holes or leaps in an expert's report, and each fact supporting an expert's opinion should be stated in an exhibit, with the next exhibit building off it. One exception, however, is that sometimes experts will have a subjective opinion that they testify to; this is acceptable, but experts should definitely have some underlying facts to support their subjective opinion.

Expert witnesses cannot read their testimony from the report but must testify based on their knowledge of preparing the report. During direct examination, experts can be on the witness stand for a significant period of time, and sometimes they may need to refresh their memory about the report. If this happens, experts may use their report to refresh their recollection, to substitute for their forgotten testimony upon authentication of the writing, or in cross-examination of the witness.

There are two ways in which a witness may refresh his or her recollection: (1) present recollection revived or (2) past recollection recorded. For present recollection revived, witnesses may use any writing or thing for the purpose of refreshing present recollection. Experts usually may not read from the writing while they testify, because the writing is *not authenticated*, is *not in evidence*, and may be used solely to refresh their recollection. The writing is intended to help experts recall by jogging their memory. The sworn testimony must demonstrate a *present* recollection.

For past recollection recorded, if experts state that they have insufficient recollection of an event to enable them to testify fully and accurately, even after they have attempted to revive their recollection, *the writing itself may be read into evidence* if a proper foundation is laid for its admissibility. This use of a memorandum as evidence of a past recollection is frequently classified as an *exception* to the hearsay rule. The foundation for receipt of the writing into evidence must include proof that:

- The witness had personal knowledge.
- The writing was made by the witness under his or her direction or that it was adopted by the witness.
- The writing was timely made when the matter was fresh in the mind of the witness.
- The writing is accurate.
- The witness has insufficient recollection to testify fully and accurately.

C. Rules of Evidence

It is important for experts to understand how the courtroom operates so that they are fully educated and, therefore, more at ease while testifying. Further, experts' opinions and testimony, in order to be admitted into evidence, must comply with the rules of evidence. This discussion focuses on the Federal Rules of Evidence; however, each state has its own rules that may not be the same as the federal rules. As such, be sure to review the applicable state and local rules.

The Federal Rules of Evidence are applicable in all *civil and criminal* cases in the United States courts of appeal, district courts, the court of claims, and in proceedings before United States magistrates. Evidence law can be stated in one sentence: Material and relevant evidence is admissible if competent.

Materiality exists when the proffered evidence relates to one of the substantive legal issues in the case. The use of probative evidence contributes to proving or disproving a material issue.

Relevance is defined by Federal Rule 401 as evidence having any tendency to make the existence of any fact that is of consequence to the determination of the action more probable or less probable than it would be without the evidence.

Competence is the requirement that the proffered evidence, concededly material and relevant, does not violate an exclusionary rule. The most common exclusionary rule is Federal Rule of Evidence 403 titled "Exclusion of Relevant Evidence on Grounds of Prejudice, Confusion, or Waste of Time," which states:

> Although relevant, evidence may be excluded if its probative value is substantially outweighed by the danger of unfair prejudice, confusion of the issues, or misleading the jury, or by considerations of undue delay, waste of time, or needless presentation of cumulative evidence.

D. Testimonial Evidence

There are two types of evidence experts will be testifying about: direct and circumstantial evidence. Direct evidence relies on actual knowledge and goes directly to a material issue without intervention of an inferential process. Circumstantial evidence relies on inference and is evidence of a subsidiary or collateral fact from which, alone or in conjunction with a cluster of other facts, the existence of the material issue can be inferred. To the extent possible, experts want to rely on direct evidence (i.e., a paper trail). Sometimes experts will have to rely on circumstantial evidence. When relying on circumstantial evidence, experts will be vulnerable on cross-examination. Therefore, the underlying facts of experts' circumstantial evidence need to be as bulletproof as possible.

It is the job of experts to anticipate every possible attack that can be made on their opinion. The courtroom presentation of evidence can be a deciding factor in a judge's decision. As such, it is imperative for experts to remember the Boy Scout Motto: "Be prepared." The attorney should spend adequate time preparing experts for their testimony. It is important to sequence experts' testimony so it is easy for the judge to follow. This will also help lay the proper foundation for experts' testimony and paint a picture for the court. Experts must remember at all times that jurors and judges are normally not financially sophisticated. Therefore, experts should explain as much as possible in lay terms and use demonstrative evidence to highlight the facts they relied on to develop their opinion. However, experts should *avoid jargon* in order to keep an impression of authority.

When testifying, it is important to avoid absolutes, such as "never" or "always." Using absolutes often comes back to haunt experts on cross-examination. There is, however, "usually" an exception. Experts should use modifiers such as, "almost" or "rarely" when describing a situation. If the cross-examiner finds any exception to an expert's absolute, the expert will lose credibility. If experts use words that allow a little wiggle room, it is difficult to impeach them. It also gives experts some flexibility to adjust their testimony to avoid impeachment.

It is just as important for experts to be prepared as it is for them to help prepare the attorney. As experts, it can be intimidating to testify. If the experts are not attorneys, or not practicing attorneys, they may not know the procedures involved in testifying. There are many common things that witnesses may not know but are afraid to ask or won't tell the lawyers. This fact can cause more damage than good. Preparing is a two-way street, experts have to know how the legal system works, and the lawyer has to understand the work experts performed and the reports they prepared.

Experts should not be afraid to ask the lawyer questions. Experts should never feel embarrassed about clarifying procedural or substantive issues. They should ask the lawyer to explain any legalese that they may not understand. Further, experts should never feel threatened by lawyers; it is okay to ask for help. The bottom line is that most experts are not used to testifying and may not always properly explain the legal process and its intricacies. Because experts are highly educated, lawyers may assume that they understand the legal process and how to testify.

However, keep in mind that being an expert does not automatically mean being a communicator. Communicating the results of experts' reports can be difficult. Experts should meet with the lawyer and discuss the report. Doing so will alleviate some of the difficulty. Further, meeting with the lawyer will give experts an opportunity to make sure the lawyer understands the methodologies, process, and opinions contained in the report. It is experts' job to make sure the lawyer understands the basis of their report and what their testimony will encompass, so that the attorney can ask the proper questions on direct examination.

Preparing for Objections

Last, throughout the course of the litigation, many times when an attorney asks a question to a witness, the other lawyer will object. experts should *not answer the question if an objection is pending*. The judge will either state "Sustained" or "Overruled." Then, depending on the ruling, the judge should instruct the expert whether to answer the question posed. If the objection is sustained, experts do not have to answer the question; if overruled, experts will answer the question. The six most common questions that are objected to, with a brief description, are presented next.

1. **Compound.** Requires a single answer to more than one question
2. **Argumentative.** Leading questions that reflect the examiner's interpretation of the facts
3. **Conclusionary.** Calls for an opinion that the witness is not qualified to answer
4. **Assuming facts not in evidence.** A question that assumes a disputed fact is true and in evidence
5. **Cumulative.** A question that has already been asked and answered
6. **Harassing and embarrassing**

Preparing for Cross-Examination

Cross-examination is the most important and effective part of litigation. The experts have explained their theories, research, methodology, processes, and ultimately their expert opinion on direct examination. Now the opposing lawyer will use leading questions to pick and choose what to attack and highlight and how to challenge the experts' credibility. Experts should *not interrupt* the examiner or become argumentative. A qualified and experienced litigator will use leading questions, which, more often than not, can be answered with a yes or no. If experts can answer the question with a yes or no, they should do so and not try to elaborate. Experts can elaborate on redirect examination. Whenever possible, experts are better off explaining an issue with their attorney, not the opponent's attorney. They should resist that urge to explain the flaw in the cross-examiner's portrayal of their opinion during cross.

On cross-examination, attorneys will try to trap experts by using these tactics:

- The lawyer will try to make experts *their* witness and use experts to reinforce their case by attempting to get them to agree to facts that support the opposing side's case without reexplaining the experts' theory.
- The lawyer will attack an expert's facts, because the expert's opinions are based on his or her facts.

- Experts need to *beware of hypotheticals*. The lawyer will change the facts that experts interpret to see how that would change their conclusion.
- The lawyer will try to expose an expert's bias (i.e. money, friendship).
- The lawyer will attack the expert's credibility based on treatises, books, or articles of well-known scholars.
- The lawyer will attack the big and little mistakes in the report.
- The lawyer will try to expose why the expert's thinking is wrong. (Usually this backfires, so experts need be patient and calm.)

In response to these tactics, the job of experts is to take their time, answer the question asked, and stay calm. It is acceptable to answer "I don't know," but experts should not use this as an escape. Most important, experts should try to remain consistent with their previous testimony from their deposition. One of the easiest ways for an opposing attorney to lower an expert's credibility with the judge is to show inconsistencies with the expert's testimony from deposition and at trial. This process is called impeachment. At the deposition, the expert testified under oath, and a transcript of the proceedings was made. If the opposing attorney finds inconsistencies with the expert's testimony, although the transcript will not be admitted into evidence, the lawyer will use the transcript to attack the expert's credibility and try to impeach him or her.

To survive these tactics, experts must learn to think like litigators. Litigators are very paranoid, and they think of every angle or twist that a piece of evidence can present. They question what different perceptions exist from a sentence of testimony or in a report. Experts should also think of every way a litigator may twist their words.

Redirect Examination

The opposing attorney may not give experts an opportunity to explain why there are inconsistencies in their report or testimony, but that is okay. The experts' attorney will have an opportunity to "rehabilitate" them on redirect examination by asking questions either to clarify or expand on any answers that may have been damaging. Experts should remain confident, knowing that they can rely on their attorney to clarify their position on redirect. However, it is highly unlikely that the experts' attorney has the financial sophistication to know that an expert needs to be rehabilitated. Therefore, experts should establish a signal to alert the attorney that they want to be asked on redirect a question that allows them to clarify their answer on cross-examination.

F. CONCLUSION

Attorneys are under an ethical obligation to advocate zealously on behalf of their clients. An expert's ethical obligation is to be unbiased and impartial when rendering opinions. This difference can put an expert in an uncomfortable position, when the attorney or client requests certain results. Experts must maintain *ethical zeal* throughout their retention. It is imperative that experts not succumb to pressures put on them by the attorney or client. It is unethical to guarantee predetermined results. Although experts may gain financially by telling an attorney or client that they can achieve a predetermined result, this will surely result in short-term gain, long-term pain. Once an expert's reputation is impugned, his or her credibility with the courts is compromised. It will not be long before attorneys no longer retain that expert's services. If an expert has a reputation of ethical honesty, however, such credibility before the court will provide him or her long-term benefits, both professionally and financially. It is therefore advisable for experts to be zealously ethical.