

FAMILY LAWYER

Winter 2021

LAWYER

MAGAZINE

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The Price of Vice

Divorce cases that involve “vice” industries can seriously impact property division, spousal and child support awards, and parenting time. Here are some challenges – and strategies – for family lawyers.

By Ron Seigneur, Business Valuator, and Kim Willoughby, Family Lawyer



This article is based on a seminar the authors presented at the 2019 AAML/BVR National Divorce Conference.

When a divorce involves a business that is illegal in certain jurisdictions, there are bound to be some unique considerations. When sin is sold for economic gain, what special issues need to be addressed in valuation and discovery? How can a family law practitioner most effectively present these issues to a judge?

The truth is, vice industries, such as marijuana, bookmaking/gambling, pornography, and prostitution, can be especially difficult to forensically examine and value. Generally speaking, they all have the following hallmarks:

- All are legal in some ways in some states and illegal in other states or federally;
- All have a high propensity for abundant cash coming in and going out;
- All are relatively risky businesses; and
- All involve questions of morals and values in cases that often involve children and always involve “equities.”

Special Issues Concerning the Valuation of Vice Businesses

Several challenges accompany the forensic analysis and appraisal of vice-related activities. There is often a lack of reliable market comparables or financial data from prior and current operating periods. And there can be significant federal income tax liabilities outstanding due to the inability, under the Internal Revenue Code, to deduct ordinary and necessary operating expenses for illegal activities. Other state and local income and excise taxes, and associated penalties, can also be at issue.

As a primary example, as more states embrace medical- and adult-use cannabis¹, we expect to see massive growth in this area in the near future. With more than 100 publicly traded companies now actively involved in the Canadian cannabis industry – and “big pharma,” tobacco, and alcohol corporations investing heavily through private equity and related funds in cannabis-related enterprises – it is likely that the US public market will soon be a player in this field.

There are two distinct sides to the cannabis business: the highly regulated segment and the unregulated black market. In between the two is the “grey market:” individuals who are legally allowed to grow small quantities of cannabis, either for personal consumption or as a “compassionate caregiver” for others. Often some of this grey market production makes its way to friends, neighbors, or relatives, and essentially becomes an illegal activity that can be material on an economic basis to a marital estate.

Hemp and cannabidiol (CBD) are also emerging as cannabis-related industries, and each one has its own unique issues, requiring special attention and expertise when present in a marital dissolution proceeding.

Whether the subject business is involved in

medical or recreational cannabis, hemp, or CBD, there is one constant: the entire sector is evolving rapidly with regard to the regulatory and legislative landscape. This makes valuation and any associated financial forensics extremely challenging. For example, the jurisdictional differences in license rights and the transferability thereof make the valuation of ownership rights particularly complex when compared to most other types of business ownership.

Considerations when Trying to Identify the Income from Vice Businesses

A primary consideration in evaluating income and expense activity in a vice business is whether or not the activity uses traditional banking with respect to deposits and disbursements – operating solely with cash or through diverted bank accounts that are maintained under the guise of another purpose.

Revenue estimates from vice-related activities often require a build-up based on factual evidence of the nature and scope of the activities, supplemented by reasonable estimates and assumptions.

For example, one might estimate illegal cannabis sales in the context of a cultivation operation based on evidence of the number of plants harvested over a set period combined with market evidence of the market price/values of product sold. Revenues from prostitution-related activities might be compiled based on market prices for services. Likewise, gambling and bookmaking activities might be compiled based on evidence of the frequency and magnitude of bets made over time. A lifestyle analysis similar to what is employed by the IRS when examining unreported income cases can be helpful in identifying and estimating the magnitude of illegal vice-related activities

Discovery Considerations

Discovery can be one of the most difficult parts of a divorce case that involves vice businesses. The questions to ask yourself are:

1. What am I looking for?

2. Where do I look for it?
3. How can I get it?
4. Does the court actually care about it?
5. If I do get it, will there be unintended consequences?

1. What Am I Looking For?

- Within the businesses: cash sales.
- Trade/barter transactions.
- Hidden compensation (options, perks, non-qualified retirement, etc.).
- Prepaying all sorts of expenses.
- Loading up on inventory and writing off to COGS when still in stock.
- Delaying billing clients/customers.
- Offshore retirement funds set up with a percentage of third-party receivables collections, so only the net collections are reported.
- Siphoning foreign-source income into undisclosed foreign bank accounts.
- Siphoning domestic income into domestic undisclosed accounts.
- Stockpiling cash and keeping it in a business safe or at home in a shoe box, which suddenly disappears when the parties are divorcing.

Less obvious places to look:

- Cash: Review bank reconciliations for large or unusual outstanding checks.
- Cash: Look at the detail of outstanding checks for stale checks that should be voided.
- Cash: Review deposit details for a time period after valuation date to see if deposits were held.
- Cost of goods sold or other accounts with large balances: the larger the balance, the easier it is to bury items.
- Sales revenue: Look for offsetting/debit entries.
- Inventory: Watch for the purchase of large items at year-end or valuation date.
- Repairs and maintenance: some may be for personal or household items.
- Fixed assets: Watch for changes in the composition of personal assets, such as autos, vacation homes, jet skis, boats, private jets,

etc. This can extend to an examination of changes for friends and relatives as well.

- Credit cards: Look for any credit balances or large payments at year-end or valuation date.
- Lines of credit: Watch for draws at year-end or valuation date and follow the proceeds.
- Within the personal finances: Look for cash, bartering activities, offshore, and foreign accounts. Cash for a variety of services is most common.
- Deliberately overpaying taxes, with the extended due date falling after the divorce.
- Buying property in someone else's name: a paramour, friend, business partner, brother, estranged child, etc.
- "Borrowing" money from family or a friend and giving them a mortgage on the marital home to reduce equity.
- Transferring property/funds into an irrevocable trust out of spouse's reach.
- Gifts from family during the marriage that suddenly show up as loans on personal financial statements, along with copies of backdated promissory notes.
- Selling personal assets to "friends," way below market value.
- Buying large gift cards at department and grocery stores, which they use for themselves after the divorce is finalized.
- Making advance payments on credit cards, utility bills, loans, mortgages, quarterly tax payments and then agreeing in the settlement to "assume" those accounts, thereafter reaping untold funds in the "credit balance."
- PayPal, Bitcoin, cryptocurrency, etc.

¹ The term "cannabis" refers to the larger family of hemp and marijuana. The latter is the hallucinogenic side of the plant and industrial hemp, and the former concerns the segment of the cannabis family that does not possess more than trace amounts of tetrahydrocannabinol, or THC, the psychoactive agent of cannabis.

2. Where Do I Look for It?

- Often in the information right in front of you, but you must drill down on that information.
- Spouse's information: Conduct a really good data retrieval from a spouse. Find out everything they know. Often, they don't realize how much they know, or they do not attach enough importance to information that is crucial from an economic and forensic perspective.
- Employees and bookkeepers.
- The person on the other side of transactions.
- Business partners.
- Poker, golf, fishing, or hunting buddies.
- Past girlfriends/boyfriends.
- Bankers: As information holders and/or as co-conspirators.
- Wealth managers and estate planners.
- Computers and peripheral devices.
- Business tools and "equipment."
- Business and family calendars.
- Old, deleted emails.
- The kids' devices.

Borrow the concept of a lifestyle audit from IRS audit techniques when you suspect unreported income. Focus on what the subject spends money on: housing, clothing, vehicles, travel and entertainment, and beyond. This can shine a spotlight on the sources of cash needed to sustain such a lifestyle over time. It is not uncommon for the IRS to assume all expenditures are from taxable income, unless the taxpayer can prove where other sources of cash come from, such as family loans and otherwise undisclosed savings and investments.

Obviously, getting information from all of these sources can become very time consuming and expensive. It is a good idea to start with the lifestyle audit to see how large the delta is between the reported income and what seems to be the income based on lifestyle, then decide how much of your resources to spend on finding information. The harder question is

how to decide how much of those resources to spend if the client's spouse thinks money has been siphoned from the marital estate and hidden over time in anticipation of divorce. If cash income is not reported and not used in lifestyle maintenance but is "stashed," it will be hard to find any way other than tracing income into a business.

3. How Can I Get It?

- Well-planned and executed discovery.
- Special Master Appointments for discovery.
- Uniform Interstate Depositions and Discovery Act.
- File civil cases based upon joint venture/partnership against third parties who need a nudge to disclose.
- Find a way to breach attorney/client privilege. Who else was in the room that would have useful knowledge?

4. How Do I Make the Court Care?

In general, state courts are overburdened. Some states' discovery rules expressly limit discovery. For instance, in Colorado, case law trends more and more towards "limiting discovery" to "further the efficient resolution of domestic relations cases." *IRM de Koning*, 364 P.3d 494, 498 (Colo. 2016).

Courts impose docket controls that make movement through the system and resolution the most important goals in a case.

Opposing counsel will say requested discovery is "too expensive, overbroad, unduly burdensome."

Looking for a needle in a haystack will not be well received by the Courts. Discovery requests must look like something other than a "fishing expedition," which is sometimes pretty difficult.

Catch the Court's attention. Don't waste the judge's time. Make it interesting. Do it the way the Court wants it done (ask the clerk). Make

sure this does not look like it's about your fees. Show some proof. Show the need to get the information and the need to get the information from where you are asking for it. Make sure your client's emotions/need for vengeance or to embarrass is not the prime motivator.

5. Could There Be Unintended Consequences?

In general, the unintended consequences are that the attorney for the spouse has done all of the legwork for third-party entities that might use this information to the detriment of both spouses, such as:

- The IRS.
- State agencies, including the Department of Revenue & Excise and employment-based taxes.
- The Federal Government.
- Angry third parties (e.g., disgruntled employees and business partners, vendors, competitors, or customers).

How can you avoid these unintended consequences?

- You can suppress the Court file via confidentiality agreements and indemnification clauses or through closed hearings
- You can appoint a private judge.

Unique Post-Divorce Issues Potential IRS Audits and Resulting Liabilities

In vice businesses, there is a likelihood of unreported income and the income tax burdens that are associated with such activities. The IRS has a long reach when it comes to unreported income and can assess substantial penalties. These penalties can include both civil and criminal actions that can even extend to paid tax preparers when an understatement should have been recognized by the tax return preparer.

As such, care should be taken to identify what the parties' responsibilities are with respect to audits and actions related to marital year tax returns after the divorce.

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Other Liabilities

- Ancillary judgment creditors.
- Cannabis and landlords/other property owners.
- State excise and income taxes.

Potential for Post-Divorce Incarceration and Being Named Co-Defendants

Non-Disclosed Assets

How to check for non-disclosed assets after divorce:

- Income tax return exchanges.
- Website review.
- Social media monitoring.
- Business journals.

What to do when you find non-disclosed assets:

- Most states have a rule that gives a specific time frame in which to bring issues of non-disclosed assets to the Court. They vary from one to five years.
- Also, look to the state's general rule for re-opening a judgment, often found at Rule 60.
- Finally, settlement agreements often include language about how to address non-disclosed assets. ■



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