



# Active Passive Appreciation: A Discovery Roadmap

## ● PART I: Steps for Non-Owner Spouses Prior to the Formal Discovery Process

### STEP ONE: Identify all businesses and business interests owned as of the Date of Separation.



**REVIEW TAX RETURNS.** Conduct a detailed review of your client's individual income tax returns, including all tax return schedules, to develop an initial list of potential business entities (PBEs) owned.

1. Identify the CPA or CPA firm that prepared individual returns in anticipation of future discovery requests.
2. Identify all bank and security accounts referenced in tax return schedules (such as Schedule D - Capital Gains, which often includes printouts from the investment firm reporting annual gains and losses).
3. Review capital gains reported on the tax return. This may reveal the sale of PBEs or interests therein. Sales or mergers of PBEs, in turn, may lead to value indications.
4. Examine changes in reported taxable income from PBEs. This may indicate whether PBE business operations expanded, stayed level, or contracted over time.



**CHECK BACKGROUND.** Research relevant Secretary of State websites to gain background information on identified PBEs (e.g., formation date, organizers, changes in name, etc.).



**RESEARCH WEBSITES.** Research websites if applicable of all identified PBEs and print or capture screen shots of available information along with source and timing of information (e.g., web site address (URL), date of accessing web site, etc.).

**TIP:** A spouse controlling a business might undertake divorce planning by modifying or removing information from the business' website. The sooner web research is conducted, the better.



**SEARCH WEB.** Search the web to determine if any significant events about the operations or activities of the PBE were publicly reported during the relevant time periods. (e.g., between the date of marriage (DOM) and the date of separation (DOS).)

**STEP TWO:** Obtain copies in the possession of non-owner spouse of any prenuptial agreements or trust agreements referencing or involving any PBEs.

**STEP THREE:** Download all available electronic bank, credit card and investment account statements that are currently available on bank accounts to which non-owner spouse has access.

**TIP:** This should be occur as quickly as possible, as banks and investment firms discard older documents after a set number of years as part of the organization's standard document retention/destruction policies.

**STEP FOUR:** Create a detailed narrative describing the non-owner spouse's recollection of all significant events, actions or activities during the marriage involving each identified PBE.

**EXAMPLES.** A non-exhaustive list of activities that might be included in the narrative:

- mergers and acquisitions
- refinancing activities
- the development of new products or services
- the addition or removal of owners
- estate planning activities (e.g., gift transfers)

**STEP FIVE:** Develop a list of names, gathered from the non-owner spouse, of all professional business advisors mentioned recurrently during the marriage.

**STEP SIX:** Create a timeline, ideally using software with timeline capability and the ability to attach links to relevant electronic documents.

**TIP:** The timeline should be regularly updated with new dates, events and activities involving each PBE as discovery commences.

## ● PART II: Document and Information Requests for Either Spouse Once Formal Discovery Commences

**STEP 1:** Draft and send a non-spoilation letter to opposing party and their counsel to suspend all document destruction practices while litigation is pending.

**STEP 2:** Request documents or information related to active passive appreciation (APA). These might have been included in typical business valuation and/or information requests. However, APA often covers longer periods than a typical business valuation.

**TIP:** APA requires close interaction between a divorce attorney and business appraiser, who is typically not a lawyer. Counsel would be well advised to prepare a legal memorandum outlining the relevant APA statute and case law for the business appraiser.

### **A CHECKLIST OF APA-RELATED DOCUMENTS and INFORMATION TO REQUEST**

- Gift and estate tax returns involving transfers of interests in each PBE, including business, real or personal property appraisals. This will include transfers of interests in each PBE that occurred before and during the marriage.
- Correspondence related to IRS challenges or audits of gift or estate tax returns, including changes to any previously filed gift or estate tax returns.
- Offering memorandums or similar “pitchbooks” related to any attempts to buy or sell PBEs or interests therein during the marriage.
- Personal financial statements prepared by one or both spouses during the marriage.
- Organizational charts of officers and employees of each PBE developed before or during the marriage.
- In the absence of available organizational charts, copies of annual W2 forms or payroll summaries showing the names and compensation of PBE employees during the marriage.

**TIP:** W2 and payroll information can be used to help develop organizational charts of PBEs during the marriage, estimate employee turnover, and other valuable information.

- Meeting minutes of shareholders, boards of directors, LLC members and/or partners (depending on the business structure) for all PBE meetings that occurred during the marriage.
- Identities of all trade associations and business or industry groups to which each PBE, its owners or managers belonged during the marriage. Include all activities—such as serving as state or national officers, leaders or committee members—engaged in by PBE owners and managers.
- Information on the identity of any recurring benchmarking studies developed by or for industry or trade groups, information on whether the PBE acquired or participated in such studies, and copies of any such studies in the possession of the PBE.
- Industry estate tax, gift tax or income tax audit guides prepared by the IRS or state taxing authorities for the industries in which each PBE participated.
- Copies of all strategic plans developed by each PBE during the marriage.
- Workpapers developed by PBE company CPA related to annual intangible asset impairment testing performed during the marriage (should the company have CPA-prepared financial statements reflecting significant intangible assets).
- PBE ownership transfer ledgers (e.g., stock ledgers) to trace all ownership changes in the PBE during the marriage.
- Forms K-1 with any PBE tax returns filed during the marriage. This will allow schedules to be developed showing changes in beginning and ending ownership percentages of capital, income, debt, and distributions during the marriage.
- Internal schedules or reports regularly maintained and used by PBE management to manage the PBE.

**TIP:** Internal schedules may include items like sales or gross profit by geographic location or sales or gross profit by industry concentration. This information may be maintained in greater detail or in a different format than the financial statements issued by the PBE.

- Tax returns for the initial year in which an existing PBE elected to be taxed as a Subchapter S corporation. This tax return is required to report certain differences between the fair market value and tax basis of certain PBE assets on the date of the Subchapter S election and can provide value indications.
- Identification of any other PBE owners who have also gone through divorces, as this could reveal sources of potential publicly available filings or information on settlements that might give value indications.
- Annual budgets prepared by PBEs during the marriage. The budgets allow a party to schedule and compare the PBEs actual versus budgeted performance and to gauge the success, or lack thereof, of PBE management to project the future.

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- Franchise or dealer reports (if applicable) that compare the financial performance or condition of the PBE during the marriage to other comparable franchisees or dealers. For example, auto dealerships typically participate in “20 Groups”, and each member receives a monthly composite analysis comparing its operating results with the rest of the group.
  - For franchisees, the most recent Federal Trade Commission Franchise Offering Circular that most franchisors must prepare.
  - In-force life insurance policies insuring the lives of PBE owners, which can be either held by the PBE or the individual equity owner. Include annual premium, cash surrender value (if applicable), death benefit, outstanding loans (if applicable), owner and beneficiary designation.

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Forensic Strategic Solutions is a national financial investigation firm with a long track record of assisting counsel and their clients with litigated business valuation issues, including active passive appreciation. If you have any questions, please contact us for a consultation.