

Analyzing the History of *Bernier* After the Most Recent Massachusetts Appeals Court Decision, *Bernier II*

By Marc Bello, CPA/ABV, CVA, CFFA, MST

In January 2012, the Massachusetts Appeals Court was the third court¹ to hear arguments in the matter of *Bernier v. Bernier*. The latest hearing on appeal involved the issue of tax affecting the income from two S corporations owned 50% each by the husband and wife. This article focuses on the interpretations and opinions set forth by business valuation experts, attorneys, and the courts over the span of 10 years specific to tax affecting. The cases referred to are available on *BVLaw*.

The tax affecting valuation conundrum stems from income taxes being imposed directly on C corporations, whereas income taxes on S corps are assessed indirectly, through their shareholders. Further complicating this issue is that different tax rates are imposed on C corps and individuals. When applying an income approach for the valuation of privately owned S corps, the cost of capital is largely based on historical returns of publicly traded C corps where market data and rates of investor returns are available. The valuation challenge, then, is to arrive at the apples-to-oranges adjustment to an S corp's income that makes it comparable to the after-tax returns of C corps.

Throughout the history of *Bernier*, the foundational concept set forth from the courts has been consistent with regard to the following:

1 The case was first heard in the Probate Court in 2002 and then, after remand, in 2009. The appellate court opinions were rendered by the Massachusetts Supreme Judicial Court in 2007 and the Massachusetts Appeals Court in 2012.

- The income from an S corp is passed through to its shareholders; the shareholders then face the burden of paying the income taxes on behalf of the corporation; and
- An S corp can be distinguished from a C corp based on the avoidance of a dividend (double) tax.

Conceptually, applying an imputed tax for a pass-through entity should result in a cash flow that can be used in the calculation of an equitable value for the company. As far back as the initial decision in 2003, the Probate Court, when faced with such disparity in opinions from the experts, incorporated insightful reasoning and displayed an understanding of valuation theory that, in part, was subsequently overlooked. In its initial decision, the Probate Court recognized “that a deduction for taxes that will be owed must be made to either the earnings or cash flow before an appropriate valuation can be made”² and, in part, “rejected the wife’s expert valuation recognizing that it was improper to combine pre-tax and post-tax data in establishing a capitalization rate.”³ Both of these concepts are taught in fundamental business valuation courses.

Throughout the history of testimony in *Bernier v. Bernier*, there have been differences of opinion from all the business appraisers relating to the tax affecting of an S corp. The wife retained two different business valuation experts during these proceedings: one during the initial hearing and

2 *Bernier v. Bernier*, 449 Mass. 774.

3 *Ibid*.

BUSINESS VALUATION UPDATE

Executive Editor:	Jan Davis
Legal Editor:	Sherrye Henry Jr.
CEO, Publisher:	David Foster
Managing Editor:	Janice Prescott
Graphic & Technical Designer:	Monique Nijhout
Customer Service:	Jasmine Pearsall
VP of Sales:	Lexie Gross
President:	Lucretia Lyons

EDITORIAL ADVISORY BOARD

CHRISTINE BAKER
CPA/ABV/CFF
PARENTEBEARD
NEW YORK, NY

NEIL J. BEATON
CPA/ABV, CFA, ASA
ALVAREZ & MARSAL VALUATION
SERVICES
SEATTLE, WA

JOHN A. BOGDANSKI, ESQ.
LEWIS & CLARK
LAW SCHOOL
PORTLAND, OR

MICHAEL A. CRAIN
CPA/ABV, ASA, CFA, CFE
THE FINANCIAL VALUATION GROUP
FORT LAUDERDALE, FL

NANCY J. FANNON
ASA, CPA/ABV, MCBA
FANNON VALUATION GROUP
PORTLAND, ME

JAY E. FISHMAN
FASA, CBA
FINANCIAL RESEARCH ASSOCIATES
BALA CYNWYD, PA

LYNNE Z. GOLD-BIKIN, ESQ.
WEBER GALLAGHER
NORRISTOWN, PA

LANCE S. HALL, ASA
FMV OPINIONS
IRVINE, CA

THEODORE D. ISRAEL
CPA/ABV/CFF, CVA
ECKHOFF ACCOUNTANCY CORP.
SAN RAFAEL, CA

JARED KAPLAN, ESQ.
MCDERMOTT, WILL & EMERY
CHICAGO, IL

GILBERT E. MATTHEWS CFA
SUTTER SECURITIES
INCORPORATED
SAN FRANCISCO, CA

Z. CHRISTOPHER MERCER
ASA, CFA
MERCER CAPITAL
MEMPHIS, TN

JOHN W. PORTER, ESQ.
BAKER & BOTTS
HOUSTON, TX

RONALD L. SEIGNEUR
MBA, ASA, CPA/ABV, CVA, CFF
SEIGNEUR GUSTAFSON
LAKEWOOD, CO

BRUCE SILVERSTEIN, ESQ.
YOUNG, CONAWAY, STARGATT &
TAYLOR
WILMINGTON, DE

JEFFREY S. TARBELL
ASA, CFA
HOULIHAN LOKEY
SAN FRANCISCO, CA

GARY R. TRUGMAN
ASA, CPA/ABV, MCBA, MVS
TRUGMAN VALUATION
ASSOCIATES
PLANTATION, FL

KEVIN R. YEANOPLOS
CPA/ABV/CFF, ASA
BRUEGGEMAN & JOHNSON
YEANOPLOS, P.C.
TUCSON, AZ

Business Valuation Update™ (ISSN 1088-4882) is published monthly by Business Valuation Resources, LLC, 1000 SW Broadway, Suite 1200, Portland, OR, 97205-3035. Periodicals Postage Paid at Portland, OR, and at additional mailing offices. Postmaster: Send address changes to *Business Valuation Update*™, Business Valuation Resources, LLC, 1000 SW Broadway, Suite 1200, Portland, OR, 97205-3035.

The annual subscription price for the *Business Valuation Update*™ is \$399. Low-cost site licenses are available for those wishing to distribute the *BVU* to their colleagues at the same address. Contact our sales department for details. Please feel free to contact us via email at customerservice@BVResources.com, via phone at 503-291-7963, via fax at 503-291-7955 or visit our web site at BVResources.com. Editorial and subscription requests may be made via email, mail, fax or phone.

Please note that by submitting material to *BVU*, you are granting permission for the newsletter to republish your material in electronic form.

Although the information in this newsletter has been obtained from sources that BVR believes to be reliable, we do not guarantee its accuracy, and such information may be condensed or incomplete. This newsletter is intended for information purposes only, and it is not intended as financial, investment, legal, or consulting advice.

Copyright 2012, Business Valuation Resources, LLC (BVR). All rights reserved. No part of this newsletter may be reproduced without express written consent from BVR.

one after the Supreme Judicial Court ordered the case to remand. Both business valuation experts on behalf of the wife imputed a tax rate of zero. The husband also retained two experts. The husband's first business valuation expert imputed a 35% tax rate. On remand, the other expert (a CPA and tax specialist) imputed a tax rate of 46%.

With such disparity in valuation conclusions at each trial, the court was left to resolve the tax affecting of a pass-through entity for divorce. Exhibit 1 is an overview covering 10 years of the tax-affecting controversy surrounding this matter prior to the most recent appellate decision.

Most recently, the Massachusetts Appeals Court weighed in on the ongoing question on how and what is an appropriate imputed income tax rate to apply to the valuation of a pass-through entity for purposes of equitable division of a marital asset. In *Bernier II*, the court said: "The proceedings on remand were marked by some uncertainty and disagreement between the parties as to what the Supreme Judicial Court intended when it directed that the *Kessler* metric or the *Kessler* approach be applied."⁴

- If the application of the tax-affecting metric in *Kessler* should be interpreted as a binding formula—the position taken by the wife's expert on remand—the result is zero tax affecting. This is based on a change in the tax laws consistent with the valuation date, where the dividend tax rate is equivalent to the ordinary income tax rate. When these two rates are the same, the imputed tax rate is zero.
- If the interpretation of *Kessler* is based on a premise that the imputed tax rate should mimic an applicable tax rate attributed to the individual owner—the position taken by the husband's expert—the result is an imputed tax rate of 46%. The husband argued that following the *Kessler* metric based on pure mathematics would result in an inequitable value.

4 *Judith E. Bernier vs. Stephen A. Bernier*, No. 11-P-394, 2012 Mass. App.

Reprinted with permissions from Business Valuation Resources, LLC

- If the imputed tax rate calculated by the metric in the *Kessler* case should be applied to the earning stream of a pass-through entity, the result would be an imputed tax rate of 29.4%, which was the Probate Court’s conclusion on remand.

Although the Appeals Court acknowledges that the Massachusetts Supreme Judicial Court adopted generally the metric employed in *Kessler*, the appellate decision seems to lead the reader to believe that “adopted generally” means following the metric as a mathematical formula.

Exhibit 1. 10-Year Overview of Tax-Affecting Controversy			
Date	Wife’s Expert	Husband’s Expert	Court Interpretation
August 18, 2003 Probate Court Decision 3rd Supplemental Judgment	Imputed Tax Rate 0%	Imputed Tax Rate 35%	<ul style="list-style-type: none"> • Accepted tax affecting imputed by husband of 35%. • The case used to assist the Probate Court at the time of trial was <i>Gross v. Commissioner</i>.* • The court recognized a deduction for taxes must be made to the earnings or cash before an appropriate valuation can be made. • Found wife’s expert improperly combined pretax and post-tax data in establishing a capitalization rate.
September 14, 2007 Supreme Judicial Court Decision			<ul style="list-style-type: none"> • Tax affecting at average corporate tax rate of 35% is not appropriate because applying C corp rate of taxation to an S corp severely undervalues the fair market value of the S corp by ignoring the tax benefits of the S corp structure. • Failure entirely to tax affect an S corp artificially will inflate the value of the S corp by overstating the rate of return that the retaining shareholder could hope to achieve. • Guidance on tax affecting: <i>Delaware Open MRI Radiology Assocs. v. Kessler</i>**
September 1, 2009 Probate Court Decision 4th Supplemental Judgment	Imputed Tax Rate 0%	Imputed Tax rate 46%	<ul style="list-style-type: none"> • Found both parties “took unreasonable positions in regards to their interpretation of the [Supreme Judicial Court’s] ruling” • Did not believe it was the Supreme Judicial Court’s intention to “literally plug in the formula utilized in <i>Kessler</i>” • Rejected the opinions of both experts • Imputed a tax rate of 29.4%
* 2001 U.S App. LEXIS 24803 (6th Cir., Nov. 19, 2001).			
** 898 A.2d 290, 328-330 (Del. Ct. Ch., 2006).			

Exhibit 2. Summary of Values by Various Experts and the Court			
Date	Wife’s Expert	Husband’s Expert	Court Interpretation
Probate Court Decision August 18, 2003	Imputed Tax Rate: 0% Value: \$16,400,000	Imputed Tax Rate: 35% Value: \$9,700,000 ³	Accepted 35% Imputed Tax Rate Value: \$9,700,000 ⁴
Difference in value due to tax affecting, \$6,700,000			
Probate Court Decision 4th Supplemental Judgment September 1, 2009	Imputed Tax Rate: 0% Value: \$14,000,000	Imputed Tax Rate: 46% Value: \$9,300,000	Accepted 29.4% Imputed Tax Rate Value: \$11,400,000
Difference in value due to tax affecting @ 29.4%, \$2,600,000			
Difference in value between 46% and 29.4%, \$2,100,000			

Reprinted with permissions from Business Valuation Resources, LLC

The Appellate decision appears to be swayed by the mathematical analysis applied in the Kessler matter. “While resolution of the issue is not a foregone conclusion, in interpreting *Bernier I*, we think the wife presents the more cogent position. Consequently, we reject the approaches taken by the judge on remand and by the husband, both on remand and on the appeal.”⁵ With the appellate decision in, Exhibit 2 provides a summary of values determined by the various experts and the court.

5 Ibid.

After 10 years of deliberations, imputing income taxes to determine an equitable value of an S corp for divorce in Massachusetts remains unresolved. Although conceptual guidance, including the facts that income taxes need to be paid from S corp profits and S corps do not pay double taxation on dividends, arise throughout the *Bernier* hearings, the application of these concepts appears to get lost in translation.

Marc Bello, CPA/ABV, CVA, CFFA, MST, is a partner at Edelstein & Co. LLP, certified public accountants in Boston. He may be reached at mbello@edelseteincpa.com.