Bernier Trial Court Gets Tax Affecting Wrong Once Again

Case name: Bernier v. Bernier
Citation: 2012 Mass. App. LEXIS 211
Date of decision: June 29, 2012
Country: US
State or Federal: State
State/Jurisdiction: Massachusetts
Court: Court of Appeals
Type of action: Marital Dissolution
Experts: Howard Gordon (wife); David Merfield (husband)
Judge: Sullivan
SIC: 5411 Grocery Stores (except convenience stores, freezer plans, and grocery stores with substantial general merchandise)

As one of the first (and perhaps only) U.S. jurisdictions to adopt a clear stance on tax affecting the earnings streams of S corporations when determining value for purposes of divorce, the Massachusetts Supreme Court garnered quite a bit of attention in the BV as well as legal circles. But as this iteration of the case illustrates, by its willingness to embrace the conceptual as well technical aspects of tax affecting, the high court might have opened the door to more complexity and confusion among the lower courts than it originally intended.

Brief recap of proceedings. At the parties original divorce trial back in 2002, their principal dispute focused on the value of their two successful groceries stores. Although their experts agreed on a valuation date (Dec. 31, 2000) and on applying the income approach, they arrived at markedly disparate appraisals due to their different approaches to tax affecting and discounts.

In particular, the husband's expert tax affected the S corporations as if they were C corporations, applying the then-average corporate rate of 35% as well as a key person discount to reach a fair market value of $7.85 million. The wife's expert declined to tax affect or to apply any discounts and valued the stores at nearly $16.4 million. The trial court rejected this as "unreliable" and adopted the husband's valuation without much alteration, including his expert's tax-affecting method and discounts.

On expedited appeal, the state Supreme Court concluded the trial court erred by adopting the husband's tax-affecting approach. Applying a C corporation rate of taxation to an S corporation "severely undervalues the fair market value of the S corporation by ignoring the tax benefits of the S corporation structure and failing to compensate the seller for the loss of those benefits," the court held. At the same time, the failure to tax affect an S corporation at all would artificially inflate its value by overstating the retaining shareholders expected rate of return.

After reviewing the scant authority on the subject, the Supreme Court sent the case back, with orders for the trial court to adopt the metric employed in *Delaware Open MRI Radiology Assocs.*

v. Kessler, 898 A.2d 290 (Del. Ch. 2006). In that case, the Delaware Court of Chancery assumed a dividend rate of 15% and a personal income tax rate of 40% to impute a "pre-dividend" rate of 29.4%. Applying this rate to the earnings of the pass-through entity measures "with the greatest practicable precision" the fair value of the going concern, the Chancery Court said. (Note: Both the *Delaware MRI* decision and *Bernier I* are available at *BVLaw*, with accompanying case digests.)

Husband retains a non-BV expert. The directive to use the "*Kessler* metric" or the "*Kessler* approach" created some uncertainty on remand, arising in large part due to a change in federal income tax treatment of corporate dividends. When *Kessler* was decided in 2004, the applicable rate was 15%, but in 2000—the stipulated date in this case—the rate was 40%. Since the Massachusetts Supreme Court did not address the rate change, the trial court, the parties, their attorneys, and their experts were without explicit guidance on what specific rates to use in applying the "*Kessler* metric."

The wife's new expert, a credentialed business appraiser, testified that he used the formula set forth in *Kessler* but input the applicable dividend rate in 2000 (40%). This resulted in an overall zero effect of taxes because the personal income tax rate at the stipulated valuation date was also 40%. Utilizing this tax affecting rate of zero, the wife's expert valued the two grocery stores as of 2000 at $14 million.

By contrast, the husband retained a CPA who had never conducted a business valuation but who qualified purely as a tax expert. Since an S corporation's earnings are taxable to the shareholders at state and federal ordinary income tax rates, he applied a 5.85% Massachusetts rate and 39.6% federal rate to reach a 46% combined rate, which resulted in a value of approximately $9.3 million for the two supermarkets.

The trial court discredited both approaches. The zero percent net effect applied by the wife's expert overlooked the "clear mandate" by the Supreme Court that not to tax affect "was unfair." At the same time, the valuation by the husband's expert ignored the implicit finding in *Bernier I* that *any* tax affecting rate above 35% would undervalue the businesses. To apply a 46% rate—which substantially exceeded the 35% rate proposed by the husband in the original proceedings—"would lead to an even more significant undervaluation of the supermarkets," the trial court held. Having rejected both the expert opinions, it strictly applied the 29.4% *Kessler* rate and valued the stores at just under $11.4 million. This time, both parties appealed.

Trial court too literal. The wife argued the trial court should have strictly applied the overall *Kessler method* instead of its rates, which did not apply to the timing of this case. Although the husband conceded that applying the applicable 2000 rates would net a tax affecting of zero, he argued that the decisions in *Bernier I* as well as *Kessler* and the intervening *Adams v. Adams*, 459 Mass 361 (2011)(also available at *BVLaw*), stand for the proposition that "subchapter S corporation earnings must be tax affected to avoid an inequitable result in the valuation process." The "accidental timing" of this case should not control its outcome, the husband added. Rather

than applying the *Kessler* metric on the "basis of pure mathematics," the more equitable solution would be to adopt his expert's combined 46% rate.

The Massachusetts Court of Appeals decided the wife presented the more "cogent position" than the husband or even the trial judge. The Supreme Court's orders on remand were to apply the same general tax-affecting metric as in *Kessler*, but only the wife's expert offered a valuation consistent with the mandate. "Furthermore, application of the Kessler metric, even as it results … in a zero percent tax affecting rate, does not necessarily lead to an inequitable result," the appellate court stated, continuing:

There is a distinction … between failing to tax affect at all the earnings of the supermarkets because an S corporation does not pay federal taxes at the entity level (a basis for the approach taken by the wife's expert … in *Bernier I*), and utilizing a zero percent tax affecting rate arrived at through application of "all applicable rates," as the Supreme Judicial Court ordered.

In attempting to capture the tax benefit to the buyer of S corporation shares of receiving taxable cash dividends that were not already taxed at the corporate level, the *Kessler* metric also calculates "the effect of taxes on the buyers and the sellers." In effect, the metric prompts a trial judge to ask: "If the S corporation at issue were a C corporation, at what hypothetical tax rate could it be taxed and still leave to shareholders the same amount in their pockets as they would have if they held shares in an S corporation?" the court explained, quoting *Bernier I*. Because the dividend tax rate in effect in 2000 was 40%, a tax affecting rate of zero percent was necessary to answer the question accurately, the court held:

While the [trial] judge clearly sought to reach what she viewed as an equitable result in this difficult and complex case, her ultimate determination of the value of the supermarkets, which utilizes a 29.4 percent tax affecting rate, cannot stand, because the 29.4 percent tax rate bears no relationship to, and is contrary to, the parties' stipulated valuation date of December 31, 2000.

Finally, even if the court were to accept the husband's argument regarding the general application of the *Kessler* approach (rather than its specific metric), he presented no evidence that his expert's methodology constituted an accepted form of tax affecting for valuing an S corporation. His expert was qualified only in tax matters, the court pointed out; he failed to present a business valuation expert who could testify specifically to tax affecting as part of a traditional and commonly accepted appraisal.

To the extent the husband cited the *Adams* case for additional support, "we fail to discern anything … that would cause us to reach a different result," the court ruled, and remanded the case—once again—to the trial court for a valuation of the parties' S corporations consistent with its opinion as well as *Bernier I*. The trial court could also order additional evidentiary hearings as necessary to reach a proper result.