

## BUSINESS VALUATION

# The New Business Valuation Standard for Divorce

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**T**he standards for valuing a business for the purpose of equitably dividing assets in divorce cases have been ruled upon in Massachusetts, and that ruling will likely have implications for divorce valuations nationwide. This is the first Supreme Court ruling of its kind with detailed guidance on the debate over “tax-affecting” for S corporations and discount issues specific to divorce valuations. The conclusions provide appraisers nationwide with guidance on these important issues.

In *Bernier v. Bernier*, SJC-09836 (Sept 14, 2007), the Massachusetts Supreme Judicial Court considered the question of whether it is proper to discount the value of an S corporation by tax-affecting income at the rate applicable for C corporations. The court also considered whether the trial court judge erred in discounting the fair market value of the S corporation by applying key man and marketability discounts, which are widely used by appraisers when calculating fair market value. Many businesses will now be assigned a higher value for divorce purposes as a result of this opinion.

The following summarizes the outcome of the opinion and the new standards:

1. The court’s opinion represents a departure from the use of fair market value in divorce cases.
2. The court ruled that tax-affecting is necessary when valuing S corporations.
3. When tax-affecting S corporations, it is not appropriate to use an average 35 percent corporate tax rate.
4. Key man discounts are not appropriate in cases where the owner does not intend to sell the business and the owner is not critical to the financial success of the business.
5. Discounts for lack of marketability are not appropriate in cases where the owner does not intend to sell the business

Here is how these standards will play out in many cases: Use of a lower tax rate for tax-affecting will result in a higher after-tax earnings stream for the business. A higher after-tax earnings stream results in a higher value to the business. Key man and marketability discounts are reductions taken in a valuation calculation under the income approach to arrive at fair market value. Eliminating these discounts results in a higher value in the valuation calculation. The combination of these two factors can result in a significantly higher value.

## Example of *Bernier* Impact

Table 1 (page 8) illustrates this potential impact. Example A represents a hypothetical valuation calculation similar to the facts of the *Bernier* case. It includes

<b>Table 1</b>	<b>Example A</b>	<b>Example B</b>
Earnings before Federal Taxes	1,000,000	1,000,000
Federal Taxes	<u>(350,000)</u>	<u>(235,000)</u>
After Tax Earnings	650,000	765,000
Sample Capitalization Rate	<u>0.25</u>	<u>0.25</u>
Calculated Value before Discounts	2,600,000	3,060,000
Less Key Man Discount 10%	(260,000)	
Less Marketability Discount 10%	<u>(260,000)</u>	
Calculated Value	2,080,000	3,060,000
Increase in Value		980,000
Percentage Increase in Value		47%

a 35 percent tax rate, a key man discount, and a marketability discount. The calculated value is \$2,080,000.

Example B in Table 1 takes the same calculation but modifies it in accordance with *Bernier*. A lower tax rate is used for tax-affecting and both discounts have been removed. The recalculated value then becomes \$3,060,000—a difference of 47 percent.

**FMV vs. Investment Value**

There are several standards of value used by professional appraisers, including fair market value (FMV), investment value, and fair value. Business valuations for divorce in Massachusetts have historically been prepared according to the FMV standard. Revenue Ruling 59-60 defines FMV as “the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell, and both having relevant knowledge of relevant facts.” FMV in this context is essentially the price someone would pay for a business in the open market.

The *Bernier* opinion departs from this widely accepted standard.

Despite references to FMV, the court’s position was more reflective of what appraisers call investment value, emphasizing that “the judge must take particular care to treat the parties not as arm’s length hypothetical buyers and sellers in an open market but as fiduciaries entitled to equitable distribution of their marital assets.” An investment value approach is used to calculate the value of a business to a particular investor rather than to buyers in the open market. Some states have adopted a similar standard called fair value, which is also applied to shareholder disputes. If the new standard is going to be a departure from FMV, it will have a significant impact on future valuations.

**Tax-affecting Issue**

In the *Bernier* case, the long running debate over tax-affecting played out in opposite positions. One expert treating the S corporation as if it were a C corporation and applying an average 35 percent corporate tax rate. The opposing expert did not tax-affect at all, taking the position that S corporations don’t pay any corporate-level tax. The court agreed that tax-affecting is necessary for S corpora-

tions, but disagreed with the application of C corporation tax rates. It stated, “Careful financial analysis tells us that applying the C corporation rate of taxation severely undervalues the fair market value of the S corporation.” The court concluded that the metric employed in the *Del. Open MRI Radiology v. Kessler* case, 898 A.2d, 327 (Del. Ct. Ch.2006), provides a fairer mechanism for accounting for the tax consequences. The Delaware court determined that a 29.4 percent rate was appropriate. This rate was determined by creating a fictional percentage to represent federal corporate tax at the entity level, and dividend tax at the shareholder level, to arrive at the same equivalent figure that would be left in the pockets of an S corporation shareholder.

I would like to comment that the calculations used to arrive at the 29.4 percent figure (in the Delaware case) assumed that the shareholder paid income tax at the highest individual tax rate in effect at that time (2001), which was close to 40 percent. The highest individual tax rate for 2006 was only 35 percent, which means that the calculation requires adjustment before being applied to current valuations. Also, it would seem that business owners who are not in the highest individual tax bracket would need to apply a modified percentage as well, while still utilizing the same metric.

Table 2 illustrates the court’s calculation of an appropriate rate to tax-affect an S corporation. The table demonstrates the different results using 40 versus 35 percent.

**Disallowing Discounts**

In *Bernier*, the trial court accepted the husband’s expert, who took a key man discount on the premise that the husband’s expertise was critical to the success

of the enterprise. He also took a discount for marketability to adjust for a lack of liquidity in the ownership interest. Both of these discounts are widely used by business appraisers.

The Supreme Judicial Court disagreed with the decision to accept both discounts. The court stated that “given the husband’s uncontradicted testimony that he would maintain total control of the business, i.e., not sell it, it is beyond reason to conclude that the business’s value should be reduced to account for the loss of a man who is the whole show.” Using a similar rationale, the court also concluded that the discount for marketability was also inappropriate, since the husband did not plan to sell the business.

**Applying Bernier**

The *Bernier* decision will affect many cases, but there are certain situations where it may not have an impact. Certainly the opinion on

tax-affecting for S corporations will impact all future S corporation valuations, but you should take caution in calculating the tax rate based on current rates for the specific business owner.

The court’s opinion regarding key man discounts seems to indicate that these discounts may still be allowable, but that they will apply in fewer circumstances. It seems clear that discounts for lack of marketability will not be allowed when the owner testifies that the intention is not to sell the business. However, this raises the question as to how the result would differ if the owner testified to the possibility of a sale. In a fair market value analysis based on the open market, the owner’s intention would not be considered. Under the standard employed in the *Bernier* case, it is now a contributing factor.

There are other aspects of a business valuation that may be affected by *Bernier*, including certain

normalizing adjustments to adjust expenses to market level, the application of the market approach in cases where no sale is contemplated, distinctions between enterprise and personal goodwill when no sale is contemplated, and others. Certainly, more guidance will be needed from the courts to address these important issues. **VE**



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**Table 2: Tax-affecting Calculations: Application of Bernier Case Methodology**

	Calculation A		Calculation B	
	S Corp	Bernier	S Corp	Bernier
	40% Indiv	Tax Rate	35% Indiv	Tax Rate
	<u>Tax Rate</u>	<u>Calculation</u>	<u>Tax Rate</u>	<u>Calculation</u>
Earnings	100.00	100.00	100.00	100.00
Less Tax	<u>-40.00</u>	<u>(29.40)</u>	<u>-35.00</u>	<u>(23.50)</u>
Net of tax	60.0	70.6	65.0	76.5
Less Dividend Tax	<u>0</u>	<u>(10.6)</u>	<u>0</u>	<u>(11.5)</u>
Net of all taxes	<u>60</u>	<u>60</u>	<u>65</u>	<u>65</u>
Tax Rate	40.0%	29.4%	35.0%	23.5%

Calculation A shows how a “Bernier tax rate” of 29.4 percent was calculated in the methodology described in the *Bernier* case (based on 40 percent individual income tax rate). Calculation B applies the same methodology,

but assumes a 35 percent individual tax rate rather than a 40 percent rate, resulting in a “Bernier tax rate” of 23.5 percent – which represents a 20 percent difference (29.4 minus 23.5, divided by 29.4).