

## Valuation of Closely-Held Corporations



***Bernier* provides that the earnings of an S corporation should be “tax affected” for purposes of making an equitable distribution between shareholders in a fiduciary relationship.**

A recent decision by the Commonwealth’s highest court, the Supreme Judicial Court (SJC), has provided much needed clarification on how to value S corporation earnings in the divorce context. The concept of tax affecting derives from the difference in tax treatment of S and C corporations. C corporations pay tax on earnings at the corporate level, while S corporation earnings pass through to their shareholders on a pro rata basis and are taxed to the shareholders when earned by the corporation, whether or not the corporation pays dividends. When C corporations are valued using the income approach, earnings are reduced by the applicable corporate taxes to determine an accurate value. Valuers also reduce S corporation earnings for taxes. In some instances, valuers base that adjustment on an assumed personal tax rate, but, more commonly, they base the adjustment on corporate tax rates.

In *Bernier v. Bernier*, 449 Mass. 774 (2007), the SJC was presented with the novel question of whether to

discount the value of an S corporation by “tax affecting” income at the rate applicable for C corporations, where one spouse would receive ownership of all shares of the S corporation after the divorce and the other would be required to relinquish all ownership in the business. The SJC concluded that doing so seriously understates the fair market value of the S corporation structure and fails to compensate the seller for the loss of those benefits.

During trial, each party presented the testimony of an expert witness on valuation of the couple’s two S corporations, two supermarkets on Martha’s Vineyard, of which the husband and wife each owned one-half. The husband’s expert claimed that application of the C corporation rate was proper because a potential purchaser would factor these tax consequences into the expected rate of return. In contrast, the wife’s expert did not tax affect the S corporations’ income in his valuation because an S corporation

does not pay taxes at the entity level and because the husband had no plans to sell the business.

The Probate & Family Court judge adopted the husband’s “tax-affected” value, citing the 6th U.S. Circuit Court of Appeals’ 2001 decision in *Gross v. Commissioner of Internal Revenue*.

On review, the SJC noted, as a preliminary matter, that in the context of divorce, where one party will retain and the other be entirely divested of ownership of any marital asset, “the judge must take particular care to treat the parties not as arm’s-length hypothetical buyers and sellers in a theoretical open market, but as fiduciaries entitled to equitable distribution of their marital assets.” The SJC observed that while the IRS appeared, in its training materials, to endorse the tax-affecting approach utilized by the husband’s expert, “both case law and professional scholarship have cast serious doubt on the validity of this practice.” Indeed, the Probate & Family Court judge had misapplied *Gross*, citing it for the proposition that “tax affecting Subchapter S income for valuation purposes should be reflected in determining the ‘cost of capital,’” but ignoring the application of a zero percent corporate tax rate when she adopted the 35% rate

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proposed by the husband's expert.

Under these circumstances, the SJC found the Delaware Chancery Court's 2006 decision in *Delaware Open MRI Radiology Assocs. v. Kessler* persuasive. Specifically, the SCJ equated the fiduciary considerations that constrain the equitable property division in divorce cases to those that constrained the majority and minority shareholders in *Kessler* and statutory fair value cases. In *Kessler*, the Chancery Court held that treating the enterprise as a C corporation failed to account for the comparative tax benefits of S corporation ownership and therefore depressed the estimate of the business's fair value. However, not tax-affecting it at all would lead to a windfall for the minority shareholders.

The SJC recommended a metric devised by the *Kessler* court that provided a "fairer mechanism for accounting for the tax consequences of the transfer of ownership" of the S corporations from one spouse to the other. The Court concluded that applying the tax rate applicable to a C corporation to the valuation of the supermarkets understated the value of the supermarkets while failing adequately to account for the loss of S corporation benefits to the wife. This was particularly so in light of the fact that the supermarkets would continue to operate as S corporations after the couple's divorce; they would continue to be owned by the husband; and the supermarkets were profitable and would continue their historic practice of making cash distributions.

The SJC remanded the case back to the Probate & Family Court on the

issue of valuation, as well as on discount and growth rate issues.

***The SJC concluded that the Probate & Family court judge erred in adopting the valuation of the husband's expert witness that tax affected the fair market value of the parties' S corporations at the "average corporate rate" of a C corporation.***

*For questions, please contact Attorney Robert Berluti, the Firm's Litigation Partner, or John McLaughlin, the Firm's Corporate Partner.*