Zivetz, Schwartz & Saltsman CPAs
4th Quarter 2012 www.zsscpa.com

Bernier Trial Court Gets Tax Affecting Wrong Once Again

***Bernier v. Bernier*, 2012 Mass. App. LEXIS 211 (June 29, 2012)**

At the parties original divorce trial back in 2002, their principal dispute focused on the value of their two successful grocery 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.

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%.

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. 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), 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

Continued on next page...

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.

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 0% 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.

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.

Top errors and omissions in tax court appraisals

No one likes to focus on mistakes in business appraisals—unless he or she is a Tax Court judge. Then appraisers and attorneys will want to pay attention. In their current book, *A Reviewer's Handbook to Business Valuation: Practical Guidance to the Use and Abuse of a Business Appraisal* (Wiley, 2011), authors L. Paul Hood Jr. and Timothy Lee (Mercer Capital) devote two chapters to a comprehensive review of the most common errors and omissions in tax court appraisals. The top 12:

- Failure to comply with applicable professional standards;
- Overstatement of valuation credentials (or inadequate listing of credentials);
- Too much involvement by the attorney;
- Misapplication of the standard of value;
- Misapplication of the valuation date (most commonly, the inclusion of hindsight);
- Failure to identify the correct business interest to value;
- Bias and/or lack of independence;
- Incomplete or incorrect sources of data;
- Pure reliance on case law;
- Failure to make a site visit or inspection or conduct management interviews;
- Failure to create a replicable analysis; and
- Inadequate explanation or support for the valuation analysis and conclusions.

Ironically, business appraisals can also suffer from too much information and analysis, say Hood and Lee. "The court's first objection to appraisals is an overarching concern that there are diminishing returns in extensive numerical analyses in the appraisal process and that, no matter how the appraisal is fashioned, it has many areas for subjective determination along the way, which culminates in a subjective opinion."

Bankruptcy judges 'inherently suspicious' of valuation adjustments and alternative methods, says one of their own

Bankruptcy judges "have become familiar and comfortable with the DCF, comparable companies, and comparable transactions methodologies," writes the Hon. Christopher S. Sontchi, U.S. bankruptcy judge for the District of Delaware, in his new article in the Spring 2012 *American Bankruptcy*

*Institute Law Review (*available by subscription or purchase from ABI). "Indeed, these methods are often referred to as the 'standard' methodologies," said the judge, adding:

While use of an "alternative" valuation may be appropriate, one should be reluctant to depart from the familiar. The judge will be inherently suspicious of the use of such an alternative valuation. The valuation professional should be prepared to provide a clear reason for not using the DCF, comparable companies, and/or comparable transactions methodologies. Otherwise, the judge may suspect that the professional is manipulating the valuation to reach a predetermined result and, thus, will give the valuation little or no weight.

Similarly, although financial professionals will often add a risk premium or other adjustment to their selected approach, "judges are inherently suspicious of these adjustments," Sontchi says, concerned that they are "being made to manipulate the valuation to reach a predetermined result." The valuation expert also risks "confusing the judge" with any alternative method or adjustments. "Remember, most bankruptcy judges are 'self-taught' in corporate finance." In fact, Sontchi credits an "excellent treatise" by Professor Aswath Damodaran as his primary source*: Investment Valuation: Tools and Techniques for Determining the Value of Any Asset* (2nd edition, 2002). Although the article is a bit basic for BV experts, the judge's peers are reading and referring to it.

Sontchi also says courts still prefer use of market data

"Courts have consistently held that the use of actual market data is the preferred method to value an asset," Judge Sontchi writes in his article in the Spring 2012 *American Bankruptcy Institute Law Review.* At the same time, he recognizes that "finding similar and comparable assets and/or firms is the challenge" of any such "relative" valuation. "Given that no two companies are exactly alike in terms of risk and growth, the definition of comparable firms is a subjective one," he says. "Consequently, a biased analyst can choose a group of [comparables] to confirm his or her biases about a firm's value."

Another problem, Sontchi says, is that the market might err in valuing the comparables, e.g., the current tendency to overvalue software companies. Although experts try to control for the differences between the selected benchmarks and the subject company, the multiples are "easy to misuse and manipulate, especially when comparable firms and comparable transactions are used."

Proposed USPAP revisions prompt sharp criticism from ASA BV Committee

Members of the American Society of Appraisers (ASA) "are not happy with" some of the current proposed revisions to the Uniform Standards of Professional Appraisal Practice (USPAP), reports Linda Trugman, chair of the ASA BV Committee, in a recent e-update to members. Among other changes set forth in the exposure draft for the 2014-2015 USPAP, the most controversial are those to the definitions of "assignment results" in Section 2a and "report" in Section 2b.

In particular, a letter signed by Trugman on behalf of the ASA BV Committee expressed its concern that elevating draft reports to the status of "assignment results" would counter the prevailing trend in litigation matters to preclude discovery of an appraiser's draft materials. Moreover, the proposed broader definition of "report" would include "any communication of an opinion of value ≈ at any time" (emphasis added in the letter). Instead, "we believe the definition of a 'Report' should be linked to the completion of an assignment."

Stockdale's 'Top 10' list for litigation experts—or how to avoid the 'nightmare' of a Daubert or credibility disqualification

In June, John Stockdale Jr. (Schafer & Weiner) presented a case law update to the annual meeting of the Michigan Society of CPAs in Detroit. In the midst of his slides, he included the "Top 10 Issues With Experts," or the problems that he and his law firm colleagues frequently encounter when working with appraisal experts in cases ranging from bankruptcy to shareholder dissent and oppression.

Continued on next page...

"I was first asked to talk about 'nightmares in valuation cases' over the years, but when I started reading through those cases, I realized that case nightmares come under two varieties: 1) being excluded under *Daubert*, or 2) you've given the testimony but you are found not credible," Stockdale said. Rather than talk about the individual cases that resulted in these two situations, Stockdale chose to focus on the issues that lead to them—and the ways experts can avoid them:

1. Communicate with the lawyer
2. Understand the standard of value. In contexts such as shareholder dissent and divorce, "Michigan has unsettled standards of value," Stockdale explains. "So you're going to want to talk to your lawyer."
3. Understand the case or even more importantly, understand your role on the litigation team. The attorney is the quarterback, and depending on the case, he or she may want to make the call regarding what standard of value is appropriate to apply.
4. Draft your report clearly.
5. Put your backup in your report.
6. Don't argue in depositions or on the stand.
7. Have a complete and detailed CV. Stockdale recalls a recent case in which the expert listed his two schools and his many hours of CPE, without specifying what all those hours entailed.
8. Avoid technical jargon whenever possible in your written report and in testimony.
9. Provide the documents you relied on.
10. Ensure your credentials are current. Stockdale told of another recent case in which the expert allowed his credentials to lapse between his retention and trial.

Zivetz, Schwartz & Saltsman CPAs
11900 W. Olympic Bl., # 650
Los Angeles, CA 90064-1046
www.zsscpa.com