After this seminar, Congress passed the Tax Cuts and Jobs Act which reshaped the landscape of company taxation. Read "Divorce Valuation Tax Trap" on our ***Business Valuation Articles* page which deals with a few of the many possible impacts of the Act for business valuation.**

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Tax Issues in Business Valuations: S Corporations and LLCs

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A Taxing Day for Family Lawyers: Tax Traps, Strategies, Basics and More: 2017 North Carolina Family Law Section Fall Program (9/15/17), Greensboro, NC

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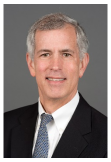
DISCLAIMER

These materials, and the oral presentation accompanying them do not constitute advice to be applied to specific valuation matters as every situation is unique. No legal, accounting or business valuation advice is provided herein or as a result of this seminar. Consult qualified valuation and legal advice for a particular situation.

Speaker



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TOPICS REGARDING S CORP. ISSUE

- History- What gave rise to the idea that S corps. might be worth more than C corps.?
- Why?- Reasons for potential greater value for S Corp/LLC interests.
- Implications- How do valuators adjust for the issue and what are the issues for attorneys?
- Status and controversies- Where do things stand in the courts and the valuation field?

An Income Tax Refresher

- **C Corporation:**
  - **Corporate earnings-** Corp. pays taxes on earnings.
  - **Dividends-** Shareholder pays income taxes on dividends.
  - **Earnings retained in the corp. (not paid out as distributions)-** No effect on shareholder's cost basis.
  - **Sale of shares-** Shareholder taxed personally on any taxable gain. Gain based on selling price vs. the shareholder's cost basis (typically purchase cost).

An Income Tax Refresher (Continued)

- **S Corporation:**
  - **Corporate earnings-** "Passed through" to shareholders for taxation personally at their individual income tax rates.
  - **Distributions-** Not subject to personal income taxes (see manuscript for caveats).
  - **Earnings retained in the corporation (not paid out as distributions)-** Increases shareholder's cost basis in shares.
  - **Sale of shares-** Shareholder taxed personally on gain upon the sale. Gain based on the selling price minus shareholder's cost basis. Earnings retained in the corp. and not distributed to shareholders increase's the cost basis, reducing taxable gain.

Valuing S Corps Prior to 7/29/99

- S corps. were valued like C corps. when using the income valuation approach.
- Tax affecting ruled- Earnings of the S corp. were reduced at C corp. tax rates, with after tax income capitalized.
- IRS internal training manual said to tax affect (but it was not official policy).

Table 1
When Tax Affecting in the Capitalization Method Ruled:
Valuing The S Corporation as if it Were a C Corporation

	C Corp.	**S Corp.**
Revenues	$10,000,000	$10,000,000
-Expenses	($8,000,000)	($8,000,000)
Pre-Tax Profits	$2,000,000	$2,000,000
C Corporation Tax Rate	*36%*	*36%*
-Corporate Level Income Taxes	($720,000)	($720,000)
Net Income	**$1,280,000**	**$1,280,000**
Divided by Capitalization Rate	20%	20%
Value of Shares	**$6,400,000**	**$6,400,000**

The *Gross (W. Gross, Jr. T.C. Memo. 1999-254)* Case Rocks the Valuation World

- Where were you when …
- 1999 gift tax case (U.S. Tax Court), upheld on appeal (*2001 FED App. 0405P, 6th Circuit*).
- G&J Bottling, Pepsi Cola bottler, S corp.
- G&J distributed all of its earnings.
- Taxpayer's expert used discounted cash flow method, tax-affecting G&J earnings as if an C corp.

The *Gross* Court findings

- Valuation must consider the benefits of the S corp. Tax affecting G&J cash flows at a C corp. rate did not consider these benefits.
- A shareholder agreement prevented termination of the S election and its associated benefits.
- Rate of return data used in the income approach based on publicly traded C corps.

The *Gross* Result

- Absent showing the full benefits of the S corp., the Tax Court selected the IRS expert's valuation, which valued pre-tax cash flows of G&J without considering any income taxes.
- This seminar will not show the *Gross* DCF method.
- Instead (next slide- Table 2), see a hypothetical example of the impact of the *Gross* court's logic as applied in the capitalization method.

Table 2

Valuing the S Corporation Without Tax Affecting: *Gross* Logic

	C Corp.	S Corp.
Revenues	$10,000,000	$10,000,000
-Expenses	($8,000,000)	($8,000,000)
Pre-Tax Profits	$2,000,000	$2,000,000
Corporation Tax Rate	*36%*	*0%*
-Corporate Level Income Taxes	($720,000)	$0
Net Income	**$1,280,000**	**$2,000,000**
Divided by Capitalization Rate	20%	20%
Value of Shares	**$6,400,000**	**$10,000,000**
S Corporation Worth More		**56%**

Gross Did Not End the Issue…

- Followed by similar Tax Court rulings in *Heck, Adams and Gallagher*.
- The valuation field was in chaos.
- Seminars/articles/studies/models of how to deal with the issue continue to this day.
- The S corp. issue found its way into all types of valuation matters (e.g. Delaware courts).

The Tax Court and Tax Affecting- More Than Meets the Eye

- *Gross* and progeny were incorrectly taken by many as a rebuke of tax affecting, missing the point.
- The latest case (*Gallagher, T.C. Memo 2011-148*) stated the following:

"As we stated in *Gross v. Commissioner, T.C. Memo. 1999-254*, ***the principal benefit enjoyed by S corporation shareholders is their reduction in total tax burden, a benefit that should be considered when valuing an S corporation*** (emphasis added). Mr. May has advanced no such reason for ignoring such a benefit, and we will not impose an unjustified fictitious corporate tax burden on PMG's future earnings."

In Short…

- Tax Court had no choice but to eliminate the imposition of C corp. taxes in the S corp. valuation because the experts stopped there and did not consider the full S corp. benefits.
- As a result of *Gross*, valuators were stuck in the denial and anger stages.
- Next came the studies analyzing whether S corps. actually sold for more than C corps.

Studies Attempt to Address the Issue

- *Wang and Erickson:*
  - 2003 study of sales of companies.
  - Found S corps. sold for 12% to 17% more than similar C corps. There was criticism regarding the study methodology.
- *Mattson Shannon and Upton:*
  - 2002 study of transactions involving 1,285 S corps. and 1,202 C corps.
  - Found no evidence of a premium paid for S corporations.

The Studies Continued:

- *DiGabriele:*
  - 2008 peer reviewed study covering sales of companies from 2000 to 2006.
  - Evidence of a premium for S corporations in certain circumstances:
    - Acquired cos. with higher net sales have a higher premium for being an S corp., vice versa.
    - Greater prevalence of lower S corp. premiums with public co. buyers vs. private buyers.
    - Lower S corp. premium paid in a stock sale as compared to an asset sale.
  - A formula calculating the premium (if present).

Problems with the Studies

- Tax rates have changed materially since the studies, making them difficult to apply today.

- The studies focus on the sale of 100% interests in companies, not less than full control or minority interests.

- Other factors beyond income tax rates could lead to an S corp. having more value- e.g., an asset intensive entity whose assets can be written up by the acquiror to market value to give greater depreciation expense write-offs.

Quants to the Rescue…

- Models developed with assumptions about earnings/net cash flow and tax rates to determine benefits to S corp. shareholders versus C corp. shareholders.
- There are multiple models, all with issues.
- This seminar uses the *S Corporation Economic Adjustment Model* ("SEAM"), by Dan Van Vleet, ASA, as it is speculated it may be the most widely used.

Applying the S Corporation Economic Adjustment Model ("SEAM")

- Step 1- SEAM is used to quantify additional after-tax benefits to the S corp. shareholder from distributions and capital gains versus a C corp.
- Step 2- S corp. earnings are tax affected as if the company were a C corp. and then capitalized to give an "as if C corp. value."
- Step 3- The adjustment factor representing the additional S corp. after-tax benefit is applied to the "as if C corp. value" to give an "as if S corp. value."

Table 3- Calculation of Net Benefits to S Corp. Shareholder- “SEAM” Method

		C Corp.		S Corp.
Pre-tax Income		$2,000,000		$2,000,000
-Income Taxes (corporate)	36.0%	($719,600)		N/A
Net Income		**$1,280,400**		**$2,000,000**
x Dividend/Distribution Payout %	75.0%	0.75		0.75
Dividend (C) / Distribution (S)		**$960,300**		**$1,500,000**
-Income Taxes (personal)		N/A	45.1%	($902,000)
-Dividend Taxes (personal)	25.5%	($244,877)		N/A
Net After-Tax Distribution Benefit (A)		**$715,424**		**$598,000**
Net Income		$1,280,400		$2,000,000
-Dividend (C) / Distribution (S)		($960,300)		($1,500,000)
Capital Gain, Increase in Retained Earnings		**$320,100**		**$500,000**
-Effect of Increase in Tax Basis of Shares		$0		($500,000)
Taxable Capital Gain		**$320,100**		**$0**
Gross Capital Appreciation, Before Tax		$320,100		$500,000
-Capital Gains Tax Liability on Taxable Gain	25.5%	($81,626)		$0
Net After-Tax Capital Appreciation Benefit (B)		**$238,475**		**$500,000**
Net After-Tax Distribution Benefit (A)		$715,424		$598,000
+Net After-Tax Capital Appreciation Benefit (B)		$238,475		$500,000
Total Net Benefits to Shareholder		**$953,898**		**$1,098,000**
TOTAL BENEFITS, S CORP. VS. CORP.			**15.1%**	

Table 4
Valuing the S Corporation With Tax Affecting, But Next Adjusting to Take Into Account Estimated S Corporation Additional Benefits

	C Corp.	S Corp.
Revenues	$10,000,000	$10,000,000
-Expenses	($8,000,000)	($8,000,000)
Pre-Tax Profits	$2,000,000	$2,000,000
C Corporation Tax Rate	*36%*	*36%*
-Corporate Level Income Taxes	($720,000)	($720,000)
Net Income	**$1,280,000**	**$1,280,000**
Divided by Capitalization Rate	20%	20%
"As if C Corp." Value of Shares	**$6,400,000**	**$6,400,000**
x Adjust. for Addit. S Corp. Benefits (15.1%)		**1.151**
As if S Corporation Value of Shares		**$7,366,400**

Problems with SEAM (and models like it)

- Simplifying assumptions. For example:
  - Tax rates used- In family law does the court interpret rates to be the divorce holder's as the marriage is ending but ownership is not?
  - Who is the most likely willing buyer (e.g., individual, a C corp., etc.)? Does this violate the hypothetical willing buyer and seller standard?
  - Passive or active investor (as defined by the Internal Revenue Code)?- A passive shareholder has a 3.8% ACA surtax.

Problems with SEAM (and models like it)

- Distribution payout ratio does not matter- SEAM assumes that a shareholder is ambivalent about the value of distributions received now versus capital gains savings received in the future.
- Real world behavior?- A model is just that, a model, but does it capture how real buyers and sellers operate?

Problems with SEAM (and models like it) continued:

- Corporate welfare?- Many public companies do not pay full C corp. tax rates of 34%/35%. The GAO found C corps. paid a 20.7% average federal tax rate in 2010.
- Let's see the impact- Table 5 (next slide) recalculates the SEAM adjustment from Table 4, but assuming C corps. pay the 2010 average of 20.7%.
- Poof goes the premium!- Those assumptions SEAM gives a 4.2% *downward* adjustment in value of the S corp. relative to the C corp.

Table 5- Calculation of Net Benefits to S Corp. Shareholder- "SEAM" Method

		C Corp.		S Corp.
Pre-tax Income		$2,000,000		$2,000,000
-Income Taxes (corporate)	23.1%	($461,580)		N/A
Net Income		**$1,538,420**		**$2,000,000**
x Dividend/Distribution Payout %	75.0%	0.75		0.75
Dividend (C) / Distribution (S)		**$1,153,815**		**$1,500,000**
-Income Taxes (personal)		N/A	45.1%	($902,000)
-Dividend Taxes (personal)	25.5%	($294,223)		N/A
Net After-Tax Distribution Benefit (A)		**$859,592**		**$598,000**
Net Income		$1,538,420		$2,000,000
-Dividend (C) / Distribution (S)		($1,153,815)		($1,500,000)
Capital Gain, Increase in Retained Earnings		**$384,605**		**$500,000**
-Effect of Increase in Tax Basis of Shares		$0		($500,000)
Taxable Capital Gain		**$384,605**		**$0**
Gross Capital Appreciation, Before Tax		$384,605		$500,000
-Capital Gains Tax Liability on Taxable Gain	25.5%	($98,074)		$0
Net After-Tax Capital Appreciation Benefit (B)		**$286,531**		**$500,000**
Net After-Tax Distribution Benefit (A)		$859,592		$598,000
+Net After-Tax Capital Appreciation Benefit (B)		$286,531		$500,000
Total Net Benefits to Shareholder		**$1,146,123**		**$1,098,000**
TOTAL BENEFITS, S CORP. VS. CORP.			**(4.2%)**	

Does this Mean S Corp. Shares Are Worth Less?

- No! Yes! Maybe!

- Rate of return data used to develop cap rates comes from public company studies (*Duff & Phelps*) of long-term average annual returns, while the GAO only showed C corp. rates in one year, 2010, as the economy was exiting the Great Recession.

- Hopefully, *Duff & Phelps* can develop tax rate data over the term of its study. Our conversations with its author indicates it is not yet available.

But Could An S Corp. Interest Be Worth Less?

- Yes! As always, it depends on the facts.
- Consider:
  - A minority shareholder in a profitable S corp. has to pay taxes on his or her share of company earnings.
  - The majority refuses to pay distributions and the minority cannot change it, not even just to get distributions sufficient to pay the tax liability.
  - Ouch!- Not a very attractive interest absent a major lawsuit to attempt to force distributions.

Can an S Corp. Interest Have a C Corp. Value?

- Fair market value considers ALL relevant facts. Consider:
  - Highly profitable LLC owned 50% by a public company C corp. and 50% by Joe Doaks.
  - Operating agreement gives the public co. a right of first refusal if Joe wants to sell his interest.
  - There are contractual/other strategic business reasons why the public co. would not let a third party buy Joe's 50%.
  - A put/call provision makes it highly probable that the public company is the only prospective buyer of Joe's interest.

Can an S Corp. Interest Have a C Corp. Value? (Continued)

- Implications for Valuation:
  - The most likely buyer is the public co. C corp. who must pay C corp. rates.
  - Therefore, the 50% interest might be valued using tax affecting at C corp. rates with no further S corp./LLC adjustment.

Models are in Widespread Use

- Skeptics versus practice- While some disagree on the use of the models, they are believed to be in widespread use.
- *Cecil* case pending in U.S. Tax Court- The Biltmore House joins the controversy- SEAM was recently used in U.S. Tax Court involving The Biltmore Company (owns Biltmore Estate, related resort operations) by another valuator and me (for Cecil family) and by the IRS's valuator.
- Outcome unknown- It will be interesting to see if the Tax Court overturns precedent outlined earlier.

S Corporation Benefits Considered and Incorporated in Other Courts

- Dissenting shareholder case- *Delaware Open MRI Radiology Assocs. v. Kessler, 898 A.2d 290, 327 (Del. Ct. Ch. 2006).*
- Corporate merger case- *Nathan Owen v. Lynn Cannon, Bryn Owen, Energy Services Group, Inc., and ESG Acquisition Corp., C.A. No. 8860 CB (Del. Ct. Ch. 2015)*
- Family law- *Bernier v. Bernier (Sept. 14, 2007, Massachusetts Supreme Court).* There an several subject iterations of this case.

Massachusetts Supreme Court in *Bernier*:

"Further, careful financial analysis tells us that applying the 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. On the other hand, in the circumstances of this divorce action, we agree with a recent decision of the Delaware Court of Chancery that failure to tax affect an S corporation entirely artificially will inflate the value of the S corporation by overstating the rate of return that the retaining shareholder could hope to achieve. See *Delaware Open MRI Radiology Assocs. v. Kessler*, 898 A.2d 290, 327 (Del. Ct. Ch. 2006) (Kessler)."

Bottom Line for Attorneys:

- Make those poor valuators squirm under cross-examination- have some fun!
- While the impacts are smaller than at the time of *Gross*, they are still material and cannot be avoided.
- Become familiar with the subject.
- Hire valuation experts that understand the issue.
- Do not be caught off guard on an issue that has a potentially material impact on value.
- Know all the facts in the matter at hand that might impact the valuation treatment of the issue.
- Research, case law, models, and tax reform may change or eliminate the topic entirely.

Resources: S Corp., Other Valuation Issues:

Banister Financial's website at businessvalue.com:

- Cases- Resources>Business Valuation Cases tab.
- Articles- Resources>Business Valuation Articles tab.

Banister's *Valuation Business Card USB Key* (handed out at conference) has hundreds of valuation items:

- Cases.
- Articles on a wide range of valuation issues.
- Checklists.
- Reviewing valuation reports.
- Information needs lists for different business types.
- Deposition and company interview questions.

Questions

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