



Pass-Through Entities and the Appraisal Process – To Tax Affect or Not To Tax Affect?

Presentation to:

**2011 SME Annual Meeting & Exhibit
Valuation II Session**

Denver, Colorado

March 1, 2011

Craig R. Wood

Stagg Resource Consultants, Inc.



Difference Between C Corp and S Corp Total Income Taxes Paid

Company A
(C Corp)

Pre-tax Income

\$1,000,000



Difference Between C Corp and S Corp Total Income Taxes Paid

		Company A
		<u>(C Corp)</u>
Pre-tax Income		\$1,000,000
Corporate Income Tax	40%	<u>(400,000)</u>
Net Income		\$600,000



Difference Between C Corp and S Corp Total Income Taxes Paid

	Company A <u>(C Corp)</u>	Company B <u>(S Corp)</u>
Pre-tax Income	\$1,000,000	\$1,000,000
Corporate Income Tax 40%	<u>(400,000)</u>	
Net Income	\$600,000	



Difference Between C Corp and S Corp Total Income Taxes Paid

	Company A <u>(C Corp)</u>	Company B <u>(S Corp)</u>
Pre-tax Income	\$1,000,000	\$1,000,000
Corporate Income Tax 40%	<u>(400,000)</u>	0% <u>-</u>
Net Income	\$600,000	\$1,000,000



Difference Between C Corp and S Corp Total Income Taxes Paid

	Company A <u>(C Corp)</u>		Company B <u>(S Corp)</u>
Pre-tax Income	\$1,000,000		\$1,000,000
Corporate Income Tax 40%	<u>(400,000)</u>	0%	<u>-</u>
Net Income	\$600,000		\$1,000,000
Personal Income Taxes	<u>-</u>	40%	<u>(400,000)</u>
Net Distributable Proceeds	\$600,000		\$600,000
Total Income Taxes Paid	\$400,000		\$400,000



S Corporation Valuations

- Start with C corporation data
(Examples: Ibbotson, Duff & Phelps)
- Convert S corporation earnings for comparison

Tax-Affecting – Reducing a pass-through entity's earnings by a hypothetical corporate income tax rate to make the income streams from the entity and other C corporations comparable.



Prior IRS Publications

“S corporations lend themselves readily to valuation approaches comparable to those used in valuing closely held corporations (C corporations). You need only adjust the earnings from the business to reflect estimated corporate income taxes that would have been payable had the Subchapter S election not been made.”

*IRS Valuation Guide for Income, Estate and Gift Taxes:
Valuation Training for Appeals Officers*



Prior IRS Publications

“If you are comparing a Subchapter S Corporation to the stock of similar firms that are publicly traded, the net income of the former must be adjusted for income taxes using the corporate tax rates applicable for each year in question...”

IRS's *Examination Technique Handbook for Estate Tax Examiners*



Another School of Thought

Tax-Affecting the earnings of pass-through entities is inappropriate since they do not pay tax at the entity level.

As a result, the value of a pass-through entity will be much higher than if income taxes had been deducted in determining its value.



Federal Tax Court Decisions

- Walter L. Gross, Jr. v. Commissioner
- Estate of John E. Wall v. Commissioner
- Estate of Richie C. Heck v. Commissioner
- Estate of William G. Adams, Jr. v. Commissioner
- Robert Dallas v. Commissioner



Gross v. Commissioner

G&J Bottling

- Had increasing profits from 1988 to 1992
- Shareholder distributions ~100% of net income
- Two families – each with 50% ownership
- Restrictive stock agreement
 - Permitted intra-family transfers
 - Prohibited transfers outside of the family
 - Prohibited transfers that jeopardize S corp status



Gross v. Commissioner

- In 1992, five gifts of <1% interest were made
- Taxpayer estimated a value of \$5,680 per share
- IRS estimated a value of \$10,910 per share
- Two main issues in dispute:
 - Tax-Affecting the discounted cash flow analysis
 - Taxpayer's expert applied 40% corporate tax rate
 - IRS's expert did not tax-affect earnings
 - Size of marketability discount allowed



Gross v. Commissioner

Taxpayer Expert

1. Tax-affecting is the accepted practice
2. S corporations sacrifice growth opportunities and capital appreciation in exchange for current income
3. S corporation shareholders at risk to cover tax liabilities
4. S corporation might lose “S” status
5. Tax-affecting approved by Tax Court previously
6. IRS endorsed this policy in internal documents
7. IRS previously allowed tax-affecting including a prior gift tax return of this same taxpayer four years earlier



Gross v. Commissioner

IRS Expert

1. G&J Bottling does not currently pay corporate taxes
2. No indication it would not continue as an S corporation
3. G&J Bottling historically distributed nearly 100% of its net income to shareholders
4. G&J Bottling receives a benefit (no corporate taxes) – this should not be ignored in valuing its stock
5. Data used to develop the discount rate (Ibbotson) is based on public company returns that are after corporate income tax but before personal income tax – improper to apply this return to tax-affected earnings of an S corporation



Gross v. Commissioner

Tax Court's Opinions

- Tax-affecting G&J's earnings is not appropriate “without facts or circumstances sufficient to establish the likelihood that the election would be lost”
- “This concern is more appropriately addressed in determining an appropriate cost of capital” and does not justify tax-affecting G&J's earnings



Estate of Wall v. Commissioner

- Several small gifts of S corporation (Demco) stock
- Income Approach to Value
 - Taxpayer's expert tax-affected earnings at 34%
 - IRS's expert tax-affected earnings at 40%



Estate of Wall v. Commissioner

Tax Court's Opinion

Cited *Gross* and stated, “both experts’ income-based analyses probably undervalued Demco’s value, because they determined Demco’s future cash flows on a hypothetical after-tax basis, and then used market rate of return on taxable investments to determine the present value of those cash flows”



Estate of Heck v. Commissioner

- Neither side's experts tax-affected earnings
- Tax Court accepted this approach, but also approved a 10% discount for the additional risk assumed by a minority shareholder in an S corp



Estate of Adams v. Commissioner

- Neither side's experts directly tax-affected earnings, but estate's expert converted an after-tax discount rate to a before-tax discount rate
- Tax Court cited *Gross* and stated an S corp should be valued on an after-corporate tax basis, therefore the discount rate must be on an after-tax basis



Dallas v. Commissioner

- Non-voting interests in Dallas Group of America, Inc. (“DGA”), an S corporation, sold to two trusts
- Petitioner had two experts



Dallas v. Commissioner

- First expert –
 - Applied 40% corporate income tax on the assumption DGA would lose “S” status after a sale
 - Tax Court rejected this position –
 - “No evidence in the records that [DGA] expects to cease to qualify as an S corporation”
 - DGA “has a history of distributing enough earnings for shareholders to pay their individual income tax liabilities... There is no evidence that [DGA] intends to change its practice...”



Dallas v. Commissioner

- Second expert –
 - Reduced income by 35% “because a shareholder is liable for income tax of S corporation profits even if those profits are not distributed to the shareholder”
 - He has tax-affected S corporation earnings for 20 years
 - Informal poll at a recent conference indicated 90-95% of appraisers tax-affect S corporation earnings
 - ASA rejects applications of candidates for certification if the candidate does not tax-affect S corporation earnings
 - He tax-affects earnings in valuing S corporation ESOP plans that are submitted to the Department of Labor



Dallas v. Commissioner

- Second expert –
 - Tax Court gave “little weight” to the expert’s opinion and rejected his calculation –
 - Refuted claims regarding ASA and the “informal poll at an unidentified conference held on a date not stated in the record”
 - Stated DOL has a different definition of value than fair market value
 - Concluded “there is insufficient evidence to establish that a hypothetical buyer and seller would tax-affect DGA’s earnings and that tax-affecting DGA’s earnings is not appropriate”



Valuation Experts' Reaction

“There is consensus in the business valuation community that the decisions generally do not comport to good economic theory.”

– Shannon Pratt



Valuation Experts' Reaction

Models created to quantify the fair value of earnings in an S corporation versus a C corporation:

- Grabowski
- Van Fleet
- Treharne
- Mercer
- Fannon



Delaware Radiology v. Kessler

- Delaware Chancery Court not Federal Tax Court
- Majority shareholders in a highly profitable company “squeezed out” the minority shareholders in a forced merger
- Majority’s expert tax-affected earnings as C corp
- Minority’s expert did not tax-affect earnings



Delaware Radiology v. Kessler

Chancery Court Opinion

- Found fault with both experts
- Determined earnings should be tax-affected at the S corporation's shareholder level
 - Although income taxes are avoided at the business level for pass-through entities, the owners are ultimately responsible to pay income taxes on their share of the entity's earnings that "pass-through"



Delaware Radiology v. Kessler

Chancery Court Opinion

	<u>C Corp</u>	<u>S Corp</u>	<u>S Corp Valuation</u>
Income before tax	\$100.00	\$100.00	\$100.00
Corporate tax rate	40%	--	29.4%
Available earnings	\$60.00	\$100.00	\$70.60
Dividend/personal income tax rate	15%	40%	15%
Total, post-tax distributions	\$51.00	\$60.00	\$60.00

Equivalent, hypothetical “pre-dividend” S Corporation tax rate = 29.4%



Delaware Radiology v. Kessler

Chancery Court Opinion

- The Vice Chancellor estimated an equivalent, hypothetical “pre-dividend” S corporation tax rate of 29.4%
- He deemed it applicable “to the earnings of Delaware Radiology to measure with the greatest practicable precision the fair value of the [minority’s] interest in the going concern value”



Bernier v. Bernier

- Divorce settlement in Massachusetts concerning jointly owned supermarkets organized as S corps
 - Husband's expert tax-affected the earnings
 - Wife's expert did not tax-affect the earnings
- Judge in original case accepted the valuation of the husband's expert entirely



Bernier v. Bernier

- However, on appeal, the Appellate Judge:
 - Found fault with both experts' methods
 - Ruled each value was extreme and not appropriate
 - Cited *Delaware Radiology* as evidence a more reasonable value lies somewhere in the middle
 - Remanded the case to the Lower Court for review of this and other issues



Conclusions

- Only consensus opinion – tax-affecting must be decided on a case-by-case basis
- Understand how the business valuation professional intends to handle and defend the tax-affecting issue
- It will impact the opinion of value reached
- It can determine the likelihood of IRS challenge



Craig R. Wood
Vice President and CFO
Principal Economic Analyst

Stagg Resource Consultants, Inc.
5457 Big Tyler Road
Cross Lanes, West Virginia
Phone: (304) 776-6660
Email: cwood@staggconsultants.com
www.staggconsultants.com