<u>Throwing Darts at the S Corporation Tax Affecting Valuation Dartboard—After Years of Tax Court Abuse, Do we Finally Know How to Hit a Bull's-eye</u>?

1. <u>Confusion on Tax Affecting for S Corporations</u>

In valuing minority interests in C corporations, appraisers will typically start with a variable related to earnings on an after tax basis. C corporations pay tax at the entity level.

With S corporations, there is no corporate level tax. Earnings for S corporations will then always start off with a before tax number. In valuing minority interests in S corporations, appraisers will seek to "tax affect" S corporation earnings.

"Tax affecting" takes a variable in the S corporation valuation, like net earnings, and fictitiously reduces its value by C Corporation taxes. This could have the affect of reducing the overall valuation by 35 % (the C corporation tax rate). This is a substantial reduction, and every bit as important as the marketability and minority discounts.

The cases on whether valuations can tax affect   S corporation earnings continue to arise, as does the confusion of what the right approach should be. The most recent case in the estate and gift tax area, *Estate of Gallagher v. Comm'r*, T.C. Memo 2011-148 (2011), again points out the Tax Court's (or at least certain Tax Court Judge's) antipathy to a non quantitative approach to this area. There is also intellectual debate in the appraiser area as to how to approach this area. And between the Tax Court not allowing tax affecting in S corporation valuations, and appraisers providing different theories as to how to tax affect, the landscape out there is difficult.

The purpose of this article is to converge the divergent opinions into an approach that is intellectually honest and consistent with the Tax Court opinions.

Estate of *Gallagher*

The most recent Tax Court case on tax affecting earnings is *the Estate of Gallagher*. The taxpayer's expert applied a 39 % income tax rate in calculating future cash flows to the S corporation income.[1] Judge Halpern, who is no rookie when it comes to valuation issues, indicated that the expert "failed to explain his reasons for tax affecting PMG's earnings." This is probably not the complete story. Judge Halpern likely found the (taxpayer's) expert's approach neither reasoned nor quantitative.

In disallowing tax affecting, Judge Halpern focused on the need to attribute a benefit to the potential tax savings with an S corporation. Citing *Gross*, T.C. Memo 1999-54, Judge Halpern noted that to allow tax affecting, an expert has to logically provide an adjustment for "the principal benefit that shareholders expect from an S corporation election," that being, "a reduction in the total tax burden imposed on the enterprise"

The takeaway from *Gallagher* and *Gross* is not that tax affecting is to be disallowed. Rather, that a valuation must accurately consider and quantify the tax detriments and benefits of S corporation (and for that matter, LLC and partnership) status. The way to quantify is subject to a bit of disagreement among appraisers.

The Tax Reality of S corporations (and LLCs and other Passthrough Entities)

[1] The Tax Court Judge also indicated that the taxpayer's expert "assumed a 40-percent marginal tax rate in calculating the applicable discount rate." Here, I am not sure what was done, in that the applicable discount rate should not involve the marginal tax rate. But this dichotomy between 39 % and 40 % really peeved the Judge.

In a valuation's most simple incarnation, a buyer of assets will value the company based on an approach tied to earnings. Whether earnings are actual accounting earnings or cash flow, and whether represented by a multiple or discount rate, the starting point is always the net profits (or cash flow) produced by the company, in a single year, and going forward, <u>on an after-tax basis</u>.

Earnings are taxed. In a C corporation, the C corporation pays them. In an S corporation, the shareholder pays them. But that 35 % tax rate (or 39 % if we are talking the taxpayer) is a reality and will reduce the earnings.

<u>Example 1</u>: If Corporation 1 is a C corporation and has $1,000,000 of earnings, then it faces a 35 % tax rate, and net earnings are $650,000. If Corporation 2 is an S corporation and has $1,000,000 of earnings, then the shareholder could face a 39 % tax rate, and in essence net earnings are $610,000. In the C corporation the tax is paid by the Company. In the S corporation, tax is paid by the shareholder. But the amount available for enjoyment by the shareholder is after tax on the earnings, regardless of who pays it. On the surface, tax affecting is legitimate and seems straightforward.

But if the story ends there, the Tax Court will not be happy.

<u>Example 2</u>: In Corporation 2, an S corporation, with $1,000,000 of earnings, the shareholder has $10,000,000 of NOLs. Hence, the shareholder will pay no tax for a number of years on the $1,000,000 of earnings. Tax affecting the earnings to arrive at an after tax cost seems wrong in this example. Importantly, this shareholder with NOLs is not the hypothetical willing buyer. It is an idiosyncratic one; and the hypothetical willing buyer will be paying taxes on this income. The example does illustrate the beginning of the dilemma in the tax affecting

area—there is a wide array of variables that changes the actual benefit or detriment of S corporation earnings. The Tax Court expects appraisers to account for these variables.

The Benefits of an S corporation for Tax Purposes to be Taken into Account in Valuations

Assuming the hypothetical purchaser will be an S corporation shareholder,[2] there are benefits that need to be quantified in an appraisal with S corporations.

First, as to earnings that are distributed, those earnings, net of the payment of income taxes, pay no further taxes. In a C corporation, those earnings, distributed as dividends, pay an additional dividend tax. A valuation premium could be applied for to the S corporation shareholder, and the value of the dividends passing free of income tax needs to be quantified.

Second, as to undistributed earnings, those are added to basis, and the S corporation shareholder will not have to pay capital gain taxes on that additional basis. This advantage needs to be quantified.

Appraisers will be more at ease doing the 2 step approach, tax affecting, and then adding an S corporation premium. And this is empirically pure.

[2] Important distinction: tax adjusting will always be the case in a control case valuation; the purchaser is purchasing the Company, and is not likely to care about the tax status and will not give a premium for an S corporation. The hypothetical purchaser is not likely to be a qualified S corporation shareholder. Further, if there were discounts for S corporation status, this would result in arbitrage opportunities that do not exist in the marketplace. That is, buy a C corporation for $X dollars, convert it to an S corporation, and then sell it for $X dollars plus the S corporation premium. This does not happen in the marketplace. Hence, the tax adjusting concern is a concern only when minority interests in S corporations are valued.

What, Then, is the S Corporation Premium

Much debate has existed in the professional literature about how to arrive at the S corporation premium.[3] Though valuation experts agree that the premium must be applied on a case by case basis, the percentage of and process to arrive at the premium is subject to debate.

A heuristic is that there is a 20 % tax savings (under current federal capital gains rates), either attributable to the dividend not paying tax, or an increased basis step up. However, this 20 % can be adjusted on the margins for a variety of reasons, including discounting at a greater discount rate to account for uncertainty of dividends being paid, company being sold, or other idiosyncratic risk. Each appraisal must have a specific and quantitative rationale for the tax value of the S corporation status.

Example 3: Assume that S corporation earns $600,000 per year, but makes no distribution to its shareholders. Is there really a 20 % current tax savings to the S corporation shareholders if the Company makes no dividend payment? Probably not; hard to say a shareholder is saving taxes on funds that shareholder does not receive currently.[4] That 20 % should probably be adjusted downward to account for no dividends being paid.

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[3] See, e.g, Paschall, "Some Observations on Tax Affecting," 24 The Quarterly Journal of the Business Valuation Committee of the ASA (March, 2005)

[4] There would in that case be a 20 % capital gains savings, at some point in the future, as the basis to the S corporation shareholder is increased by these undistributed earnings.

The Practical Approach to the Lawyer

From a practical perspective, when the practitioner has a valuation that has tax affected earnings, what should he or she do? The practitioner is left in a delicate position knowing that (1) the Tax Court has to date ruled against tax affecting earnings to arrive at a valuation, and (2) the agent can as a result simply refuse to tax affect the earnings.

This is a far more difficult conundrum than how to deal with a marketability or minority discount. On the discounting question, the practitioner knows that a 42 % discount could be negotiated to a 35 or 32 or 30 % discount on audit, or defended at 42 %. On the tax affecting question, if disallowed, the valuation increases by 35 %.[5]

The purest and most defensible approach is for the appraisal to tax affect the earnings but also give a premium for the S corporation value. Using this approach, the appraisal must indicate why tax affecting makes sense—e.g., taxes will be paid by the hypothetical buyer out of earnings-- and the value of the S corporation premium—e.g., saving on dividend taxes, reduced to present value, is X %, and savings on undistributed earnings that add to basis, reduced to present value, is Y %.

[5] Though this should be reduced by the percentage of premium afforded by the valuation to the S corporation status.