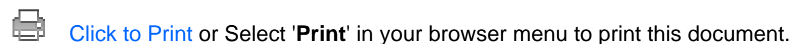

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Litigation Support

Not Even Taxes Are Certain in Valuation of Pass-Through Entities

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As Benjamin Franklin famously observed, "In this world nothing can be said to be certain, except death and taxes." Obviously, Franklin wasn't referring to business valuation where taxation is one of the most uncertain elements in the process. While professional judgment affects almost every aspect of business valuation, few issues raise hackles like the impact of taxes in valuing Subchapter S and other "pass-through entities" (PTEs). PTEs are not subject to tax at the entity level, but rather allocate taxable income and losses to owners who pay tax on the income whether or not the business actually distributes that income to them.

Value is "the price at which the property would change hands between a willing buyer and a willing seller … both parties having reasonable knowledge of relevant facts," according to Internal Revenue Service Revenue Ruling 59-60. At its core, the value of a business interest is the present value of the anticipated future benefits of ownership that is, generally, the company's earnings or net cash flow.

Traditional companies record income taxes on their financial statements, and that entity level tax reduces the business' cash flow equally for all investors. In a PTE, the tax on the business' earnings is levied at the equity holder level. The problem arises from the fact that owners' tax situations vary widely. Federal individual tax rates range from 10 percent to 39.6 percent and depend on the marital status of the taxpayer. State income taxes, depending on residency, can add up to 12.3 percent (without adjusting for the federal income tax benefit of deducting state income taxes). Pension funds, charitable trusts and many other "institutional investors," on the other hand, are tax-exempt. Depending on the owner's specific tax status, the "after-tax" cash flow, the future benefits that are being analyzed to determine value, could vary. Thus, depending on who owns the equity, the value may change.

"Tax affecting" is one way to adjust for the variable scenarios that could apply to a PTE's income. To tax affect the business' income stream, the valuation analyst deducts an estimated tax from the benefit stream as if the entity were subject to a corporate income tax. Until the late 1990s, tax affecting was the accepted means to deal with equity holders' varied tax statuses.

In *Gross v. Commissioner*, T.C. Memo. 1999-254, aff'd. 272 F.3d 333 (6th Cir. 2001), the tax court ruled that shareholders elect taxation under Subchapter S to obtain an economic benefit. The court accepted IRS reasoning that adjusting cash flows for "fictitious" corporate income tax values the subject entity as if it were a C corporation and fails to consider the economic value of the Subchapter S election. Over the next seven years, the Tax Court ruled against tax affecting cash flows in four other PTE cases.

While most business valuation precedent arises in the context of federal tax matters, the Tax Court does not hold all the cards in the game. Long considered for its expertise in corporate matters, the Delaware Chancery Court addressed tax issues of PTEs in *Delaware Open MRI Radiology Associates v. Kessler*, 898 A.2d 290 (Del. Ch. 2006). *Delaware MRI* dealt with a force-out merger where one group of shareholders owning a majority of the company's stock sought to eliminate a group of shareholders that owned the rest of the stock. One of the many issues that Delaware Supreme Court Chief Justice Leo E. Strine Jr., then vice chancellor of the Chancery Court, addressed in determining the value of the company's stock was the impact of the company's Subchapter S election.

Not surprisingly, the majority group's expert utilized a traditional accrual of corporate income tax as if the subject entity were a C, which reduces the value of the shares. Equally unsurprising, the minority group's expert followed the Tax Court position of no adjustment for income taxes, which increases the value of the shares. Strine found that neither approach led to an acceptable valuation of the company.

In dismissing the traditional approach of accruing corporate income tax, Strine cautioned, "The S corporation status is a highly valuable attribute to the shareholders of [the PTE], given its profitability and the affluent status of its physician stockholders, who face top marginal tax rates." In Strine's mind, there was, therefore, "no set of circumstances in which it is likely that Delaware Radiology will convert to C corporation status."

At the same time, in contrast to the Tax Court's analysis, Strine held, "To ignore personal taxes would overestimate the value of an S corporation and would lead to a value that no rational investor would be willing to pay to acquire control. This is a simple premise—no one should be willing to pay for more than the value of what will actually end up in her pocket."

After throwing out both experts' positions on the impact of income taxes on value, Strine performed his own tax effect analysis. "To capture the precise advantage of the S corporation structure to [the minority shareholders], it is necessary to use a method that considers the difference between the value that a stockholder … would receive … as a C corporation and the value that a stockholder would receive … as an S corporation."

Strine proceeded to calculate the differential in taxes on hypothetical earnings of $100. For a C corporation, $100 in earnings would be taxed at the corporate level, resulting in $60 available for distribution that would be taxed at the individual shareholder dividend rate (then 15 percent), yielding $51 in the pocket of a C corporation shareholder. The S corporation pays no entity level tax, but the individual shareholders pay personal income tax on the full $100, which, for the affluent shareholders of Delaware Radiology, was approximately 40 percent. Thus, because of the company's PTE status, the shareholders derive a 9 percent better return than a comparable C corporation.

In the end, Strine determined that, for this particular corporation, tax affecting the pre-tax income stream at 29.4 percent captured the benefit of the S corporation election. But, as Strine cautioned, this is a fact-intensive analysis. He used a top marginal personal-income tax rate based, specifically, on his assessment of the shareholders of Delaware Radiology. Despite Delaware MRI's acceptance in a variety of jurisdictions (including Massachusetts and Minnesota), this consideration of individual shareholder situations flies in the face of the fair market value standard.

As Rev. Rul. 59-60 recognizes, fair market value is the price that hypothetical buyers and sellers would accept to exchange property. Individual considerations, like risk tolerance, investment timeframe and tax rates, have no place in a fair market valuation. The fair market value of a business interest does not change if seller or buyer is a C corporation or an S corporation or an individual or a charitable trust. As a result, the impact of taxes on a PTE's value creates chaos, depending on the purpose of the valuation and what judicial authority might be reviewing that valuation.

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