LJN LAW JOURNAL NEWSLETTERS The Matrimonial Strategist®

Tax Discounts on Valuations of Pass-through Entities

September 2009
By Mary Cushing Doherty

An Interview with Mark Luttrell, CPA/ABV, a Shareholder in Mayer Hoffman McCann, PC, Southern California

The challenge of any attorney who addresses a wide-range of family law issues is to sound intelligent on almost every subject. The responsibility of every attorney is to identify when he/she is over his/her head and needs an expert on the team to avoid an unfair result for a client. In the area of business valuation, the experienced practitioner should know as much, if not more, of the lingo than the competition. The seasoned attorney will know enough to size up his/her expert so the court does not dismiss a valuation as inherently unfair.

Pass-through Entities

This interview addresses the valuation of pass-through entities. Attorneys are undoubtedly aware that there is a certain amount of discretion in business valuation, for example when determining discounts for lack of marketability or minority interests. Those discounts are not the subject of this article. Rather, this interview addresses the common and arguably flawed use of a "tax discount" in many valuations of pass-through entities, such as Subchapter S Corporations. The use of the tax discount is very common. One must challenge this discount when it is inappropriate in a particular valuation case. This article represents a collaboration between the lawyer, who is trying to phrase an intelligent question, and the expert, who is responding to such questions. In this case, the answers are supplied by Mark Luttrell, CPA/ABV, a business appraiser who believes such tax discounts for passthrough entities are generally incorrect for the reasons set forth below.

Q.: Would you please define a "pass-through entity"?

A.: Pass-through entities are business entities that do not pay federal income taxes at the business level. One example is a Subchapter S Corporation; others are partnerships, sole proprietorships and LLCs. With all pass-through entities, the income passes down to the shareholders or owners who report such income on their individual income tax returns, whether or not that income is distributed by the company. Another characteristic of passthrough entities is that when the business is liquidated, there is only one level of tax on any gain — at the shareholder level, not at the business level.

Q.: Is a C Corporation the predominant structure for business entities?

A.: No. Based on information published by the Internal Revenue Service for tax returns filed in calendar year 2005, only 6.4% of businesses in the United States are C Corporations. Of this 6.4% of total business entities structured as C Corporations, 92.2% paid less than $10,000 in tax. (See Table 1 below from the Internal Revenue Service, Statistics of Income.) Thus, one could argue that even the vast majority of C Corporations are substantively passthrough entities as it pertains to certain valuation methodologies.

Q.: Are the remaining 93.6% of companies that are not C Corporations "pass-through entities"?

A.: Yes.

Q.: Combining those pass-through entities with the C Corporations that pay little to no income tax, what is the total percentage of companies that essentially pay no material tax?

A.: According to the Internal Revenue Service, 99.5% of all business entities in the United States — whether C Corporations or pass-through entities — pay little to no tax at the entity level. Therefore, the norm entity structure in the United States is clearly that of a passthrough entity, not a C Corporation.

Q.: What arguments do appraisers use to support a tax discount as seen in many valuation reports for pass-through entities?

A.: A core argument advanced by those who make this adjustment is that every business should be valued first as if it were a C Corporation (presumably because they believe this legal form to be some form of "norm" structure). From there, they adjust the valuation for what they perceive to be the "benefits" of what they consider to be a more anomalous structure — a pass-through entity. In making this adjustment, they simply assume that the hypothetical C Corporation pays about 40% in corporate taxes. As one can see from Table 1, neither premise is factually correct. C Corporations are not a common entity form and do not typically incur taxes at rates even approaching 40%.

Another argument I hear frequently is that since discount/capitalization rates are derived with reference to yields earned by investors in publicly traded corporations, the closely held company must be adjusted to resemble a publicly traded corporation. There is no theoretical basis to support such a premise.

Q.: Let's start with the first argument. Why do appraisers claim that they should value the company first as if it were a C Corporation?

A.: They consider the "benefits" associated with being an S Corporation (*i.e.*, not subject to tax at the entity level) to somehow be unusual or atypical. They conclude that these benefits must be accounted for through a reduction in value from what they the presume to be a "norm" structure — that of a C Corporation. There is no logical or factual basis for this theory. Our tax structure legally allows companies to avoid federal income tax at the entity level and the vast majority of closely held companies follow this option.

Q.: Let's talk about the second argument. What do you mean by "yields" from publicly traded stocks and why do these appraisers impute an adjustment as a result of their reference to these yields in determining their discount/capitalization rates?

A.: In this context, yields are simply what an investor earns, through appreciation and dividends, in publicly traded stocks. Appraisers refer to these yields to assist them in determining the discount/capitalization rate used in connection with the Earnings Capitalization Method of valuing a business — the most common method used in divorce matters. This method is predicated on what appraisers refer to as a Principle of Opportunity Cost. This premise is distinct from the Principle of Substitution, another theoretical basis used by appraisers in methods such as the Market Approach. Regarding the Principal of Opportunity Cost, this simply refers to a potential investor "giving up" one taxable investment opportunity, in order to invest in another taxable investment opportunity. The key point is that both investment opportunities are taxable to the investor.

Q.: That is a bit confusing. Explain that further.

A.: The reality is, most investors deploy their discretionary investment funds in publically traded stocks, real estate, bonds, or other businesses that are passthrough entities. The returns from these investments are generally taxable to the investor. If an investor instead deploys his or her funds to buy a closely held business, he/she is exchanging one taxable investment opportunity for another. There is no theoretical basis to remove the tax characteristics from one of the two opportunities. In fact, doing so brings the discount/capitalization rate out of parity with the earnings stream capitalized and the valuation is in error.

Q.: Where do appraisers find this yield data?

A.: The most common source is Ibbotson, Stocks, Bonds, Bills and Inflation (Chicago: Morningstar, Inc.). This publication has tracked taxable yields earned by investors in publicly traded stocks and other securities since 1926. Those yields constitute the "opportunity cost" that the investor would forego by investing instead in the closely held corporation. It is essential to keep in mind that the yields data referred to in Ibbotson is fully taxable to the investor. Likewise, the returns earned by the investor in closely held businesses are fully taxable. Again, to remove such characteristics from the closely held business brings the discount or capitalization rate out of parity with the investment opportunity and, therefore, results in a critical error.

Q.: My client wants to settle this case. Is this tax-affecting discount a minor issue?

A.: No. The tax discount is often in the neighborhood of 40%. In this case, the other appraiser and I agree on all variables except this tax-affecting discount. Notwithstanding our agreement on all other variables, I valued the business at $10 million and he valued it at $6 million.

Q.: I understand some articles propose revised tax-affecting models that appear to suggest a lower discount than 40%. Do those models have merit?

A.: No. These newer "models" are the result of a consistent series of United States Tax Court cases that have rejected the adjustment in its entirety. In response to those rulings, appraisers in favor of tax affecting have introduced revised models that temper the adjustment to an amount closer to 30%. They continue to start with the premise that all C Corporations pay approximately 40% in corporate income taxes and that C Corporations somehow constitute a "norm" business structure. As we discussed earlier, those assumptions are both factually incorrect. For this and other reasons, the revised "models" you see are still flawed. One such model was specifically rejected by the Tax Court in *Robert Dallas v. Commissioner*, T.C. Memo 2006-212, Sept. 28, 2006.

Q.: You keep referring to an individual investor as the hypothetical purchaser of the company. What if the opposing appraiser states in his report that the tax adjustment was necessary because the most likely buyer of the company was a tax-paying C Corporation? Does that affect your opinion?

A.: No. The appraiser would need to include a strategic premium in his valuation. Without this, the "tax discount" is illogical. If a strategic buyer, such as a C Corporation, was in the mix, the purchasing company would pay a premium for the subject company that exceeded the cost of the tax. If it did not, the seller could simply achieve a greater value by selling to a buyer that maintained the same efficient tax structure that currently existed. This is a common error in valuation, *i.e.*, focusing on risks assumed by a buyer while ignoring the interests of the seller. The definition of value calls for equal emphasis on the interests of both the buyer and seller when conducting a valuation. No seller would part with his/her company for a lower value than he/she could obtain from another source.

Q.: Earlier, you mentioned the "Principle of Substitution" as opposed to the "Principle of Opportunity Cost." Explain that.

A.: In certain valuation approaches like as the Market Approach, which is based on the Principle of Substitution, a company is valued by comparing it to the trading price of similar companies, *i.e.*, the acquisition price for private companies or the price of a publicly traded stock on a given day. In contrast, the Earnings Capitalization Approach is based on the Principle of Opportunity Cost (foregoing taxable yields available from one investment alternative to invest in another taxable investment alternative). With a Market Approach, one must adjust the financial statements of the company being valued to reflect the characteristics of the comparable companies — one such adjustment being income taxes. The Earnings Capitalization Approach is not founded on a Principle of Substitution. There is no theoretical, factual or logical basis to impute such an adjustment to "take on" the characteristics of a public company when employing the Earnings Capitalization Approach. Again, one is simply comparing alternative, taxable, investment opportunities available to the investor and deriving from those alternatives a risk-based rate of return to apply to the earnings stream of the company.

Q.: Are your arguments on this tax discount issue consistent with U.S. Tax Court opinions?

A.: Yes. The attorney and expert should study the cases cited below, including the quoted content. These rulings discredit the use of the tax discount.

W*alter L. Gross, Jr. vs. Commissioner*, T.C. Memo 1999-254, (July 29, 1999) 272 F.3d 333. Regarding the argument that the company, (G&J), should be valued as if it were a C Corporation, the court stated:

> We believe the principal benefit that shareholders expect from an S Corporation election is a reduction in the total tax burden imposed on the enterprise. The owners expect to save money, and we see no reason why that savings ought to be ignored as a matter of course in valuing the S Corporation.

Regarding the argument that the discount rate used by the Commissioner's appraiser was not congruent with the earnings stream capitalized, the court stated:

> Dr. Bajaj [the Commissioner's expert] did not, however, ignore shareholder level income taxes. He simply disregarded them both in projecting G&J's available cash and in determining the appropriate discount rate…Since, in applying his discounted cash-flow approach, Dr. Bajaj assumed a preshareholder-tax discount rate, he made no error in failing to tax affect the expected cash-flow.

In summary, the court completely rejected the imputation of a hypothetical income tax to the earnings stream of G&J, referring to it as a "fictitious corporate tax." The decision was affirmed by the Sixth Circuit, *Walter L. Gross et.al. v. Commissioner*, 2001 Fed.App. 0405P (6th Cir.) November 19, 2001.

Estate of John E. Wall v. Commissioner, T.C. Memo 2001-75. In this case, the appraisers for both sides tax-affected earnings. In response, the court noted that it was not proper for either appraiser to tax-affect the earnings, stating:

> Because Demco is an S Corporation, it is not subject to Federal income tax and pays only a small amount of State income tax. Nevertheless, Ms. Walker computed Demco's normalized free cash-flow by subtracting a hypothetical income tax … Because this methodology attributes no value to Demco's S Corporation status, we believe it is likely to result in an undervaluation of Demco's stock.

With regard to the incongruity between the discount rate and the earnings stream, the court stated:

> However, tax-affecting an S Corporation's income, and then determining the value of that income by reference to the rates of return on taxable investments, means that an appraisal will give no value to S Corporation status.

Once again, the Tax Court stated that tax-affecting was inappropriate and articulated the factual problems inherent in the arguments put forth in support of such an adjustment.

Estate of Heck v. Commissioner, T.C. Memo 2002-34, 83 T.C.M. (CCH) 1181. In this case, neither expert applied a tax-affecting adjustment. However, the expert for the respondent did include a 10% discount for additional risks associated with S Corporations including the potential loss of S Corporation status and shareholder liability for income taxes on S Corporation income, regardless of the level of distribution.

In response to this discount, the court criticized the expert for his failure to quantify the perceived risks associated with S Corporation status. In addition, the court noted that, while the expert acknowledged the economic advantages of such status, he failed to quantify them. Finally, the court stated:

> The parties agree that the only tax applicable to the income of Korbel is California's 1.5-percent income tax on S Corporations.

Estate of William G. Adams, Jr. v. Commissioner, T.C. Memo 2002-80. In *Adams*, the Tax Court again rejected the adjustment, articulating the need for parity between the capitalization rate and the earnings stream capitalized:

> WSA is an S Corporation, and its cashflows are subject to a zero corporate tax rate. Thus, Shriner's estimates of WSA's prospective net cashflows are after corporate tax and not before corporate tax as the estate contends.
>
> We disagree that Shriner properly converted the capitalization rate because there was no need to do so. The parties agree that Shriner's capitalization rate (before he converted it to before corporate tax) is an after corporate tax rate. Thus, as in Gross, the tax character of Shriner's estimate of WSA's prospective net cashflows matches that of the unconverted capitalization rate because both are after corporate tax.

> It follows that Shriner should not have converted the capitalization rate from after corporate tax to before corporate tax because the tax character of both his estimated net cashflows for WSA and unconverted capitalization rate is after corporate tax. We conclude that Shriner improperly increased the capitalization rate from 20.53 percent to 31.88 percent.

Robert Dallas v. Commissioner, T.C. Memo 2006-212, Sept. 28, 2006. In the most recent case, the Tax Court addressed this issue yet again. Of critical importance, the Dallas Court analyzed and distinguished its decision from the ruling of the Delaware Court of Chancery, *Delaware Open MRI Radiology Associates, P.A. v. Kessler, et al.*, Del. Ch. LEXIS 84 (April 26, 2006), which introduced a "new model" for tax-affecting. Contrasting its opinion from the *Delaware Open MRI* case, the Dallas Court stated:

> Petitioner contends that the reasoning in *Delaware Open MRI Radiology Associates, P.A. v. Kessler*, 898 A.2d 290 (Del. Ch. 2006), supports application of tax-affecting in this case. We disagree.

Q.: What is the divorce practitioner to do?

A.: The reality is that the various theories discussed and published by business appraisers are generally sympathetic to the taxpayer. The taxpayer clients want to minimize income and estate tax consequences. Those theories, which have been rejected by the Tax Courts, likewise do not result in an equitable value for the purposes of litigation in a divorce case. Family law attorneys need to be well-prepared to address the issue of the tax discount in order to avoid an unfair result. Below is the Addendum — Hypothetical Questions Commonly Encountered in Cross Examination. If you see a tax discount for a pass-through entity that reduces the value of the business for the non-employed spouse, you need to contact an expert that is familiar with the controversy so you can defend the alternate point of view. In the end, it is always good practical advice to hire a knowledgeable expert, and so you understand the questions and supply the critical answers for the court.

Addendum

Hypothetical Questions Commonly Encountered in Cross-Examination

Arguments in support of tax-affecting are generally presented as a series of hypothetical questions. Such questions are often deceptive and illusory, requiring the attorney and appraiser to be well prepared.

The questions are generally framed as follows. Opposing counsel requests the appraiser to assume two hypothetical companies; one that is an S Corporation and the other that is a C Corporation. The attorney then asks the appraiser to assume that they are identical in every respect except one: tax status. He or she then attempts to get the appraiser to acknowledge that there should be no inherent difference in the value of the companies simply because of their respective tax status [inherently assuming that a C Corporation is for some reason the "norm"]. The attorney asks aggrandized questions such as, "Why would the S Corporation be worth 67% more than the otherwise identical C Corporation simply because of a tax election?" (67% equals a 40% tax rate divided by 1 minus the 40% tax rate.) From there, the attorney asserts that the true value is that of a tax-paying C Corporation as opposed to the factual reality of the S Corporation.

This series of hypotheticals is flawed from the start. It is predicated on the notion that structuring a closely held company as a C Corporation, causing it to incur double taxation, is the norm. As previously discussed, this notion is not supported by fact. In fact, structuring a company as a passthrough entity is the norm while the tax paying C Corporation is the aberration. It is instructive to move through these hypotheticals and review appropriate responses to them:

Question: "Let’s assume two identical companies in a vacuum. In every respect they are the same except one — one of the companies pays tax as a C Corporation and the other does not as an S Corporation. Would you really suggest that there is a 40 percent difference in the value of these two corporations?"

Answer: "Yes, if one could possibly find a company that paid a 40 percent tax when it could clearly and legally be structured in an efficient manner to avoid such double taxation, which is the way this company is structured."

Question: "So you think it is logical that by making a simple tax election, a company can increase its value by 67%?"

Answer: "Yes, if a Company operated in a state of economic ignorance and paid entity level taxes of 40% in the first place, when more efficient tax structures were available. However, I have not encountered such companies in my entire career and that is certainly not the case with this company."

Question: "It appears that you do not believe that C Corporation status makes any sense for a closely-held company, is that true?

Answer: "No. In certain situations, it may make sense. However, not in this situation."

Question: "In what instances might those be?"

Answer: "In situations where the incurrence of a double layer of taxation would be offset by economic advantages that exceeded the tax, which is not the case here."

Question: "Can you describe any situation where it may be advantageous to structure the corporation in such a manner?"

Answer: "Yes. For example, if the company were positioning itself for an initial public offering or for a strategic sale, at a premium price in a consolidating industry, revocation of S status may yield greater economic results and may, therefore, be advantageous. However, that is not the case here, nor is it the way I valued this company which would have resulted in a greater valuation result."

The exchange may continue from here. However, the logic is irrefutable. Companies do not operate in a state of economic ignorance. They will not incur an avoidable expense at the entity level unless there is a superior economic reason for doing so. This is tantamount to management senselessly creating an artificial vendor that would consume 40% of its value each year for no benefit in exchange. Thus, if the two hypothetical companies were deemed to have an identical value in the above example, it would be that of the passthrough entity. A prepared attorney would simply reverse the hypotheticals, asking the expert:

Question: "Do you think it is logical that management, by failing to make a simple tax election or choosing an efficient legal form, would purposefully and permanently decrease the value of its company by 40%?"

Answer: "No."

Question: "In fact, does the company you valued pay income taxes at the entity level of 40%, subjecting its shareholders to double taxation?"

Answer: "No."

Question: "Are you in possession of any facts that support an intention of management to change its tax structure, causing the company to incur taxes at the entity level of 40%?

Answer: "No."

Question: "Did you refer to the returns an investor might earn on publicly traded, equity securities when you derived your capitalization rate?"

Answer: "Yes."

Question: "Is it your understanding that an investor in such publicly traded securities would receive such returns on a tax-free basis?"

Answer: "No

Question: "Are you aware of any corporate equity securities that provide a return to the investor on a tax free basis?"

Answer: "No."

Question: "And an investment in the company you appraised is, in fact, a corporate equity security, correct?"

Answer: "Yes."

Question: "Can you provide me with any examples of a situation where management might structure an entity in a manner that it would incur taxes at an entity level?"

Answer: "Yes, if it were required to do so by law or were positioning itself for an initial public offering or a strategic acquisition."

Question: "Is this company required to do so by law?"

Answer: "No."

Question: "Is it positioning itself for an initial public offering or a strategic acquisition?"

Answer: "No."

Question: "Are you aware that companies that sell in strategic acquisitions often do so at a premium price?"

Answer: "Yes"

Question: "Did you account for any such premium in your valuation?"

Answer: "No."

In conducting such an examination, the attorney should work closely with his/ her expert and be well-prepared to deal with unusual responses he/she may receive from the opposing expert.

Table 1

Income Tax Returns Filed in Calendar Year 2005
Business Entities That Pay Little to No Tax
Sole Proprietorships 20,627,10067.1 %
S Corporations 3,715,20012.1 %
Partnerships 2,720,3008.9 %
Farming Sole Proprietorships 1,688,6005.5 %
C Corporations [1] 1,821,9915.9 %
30,573,19199.5 %
Business Entities that Pay Tax
C Corporations [2] 152,9700.5 %
Total Returns Filed30,726,161
[1] Pays less than $10,000 in tax [2] Pays more than $10,000 in tax

---

Mary Cushing Doherty, a member of this newsletter's Board of Editors, is an equity partner in the Norristown, PA, law firm of High Swartz LLP, where she serves on the Management Committee. She is a frequent lecturer and author in the field of family law, and has served as course planner for programs sponsored by the Pennsylvania Bar Institute, Pennsylvania Bar Association and Montgomery Bar Association.