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Business Valuation of Pass through Entities

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BUSINESS VALUATION OF PASS THROUGH ENTITIES

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Honors Thesis

Valuation of Pass through Entities

Introduction

The majority in the business valuation profession believe that the proper way to value a "pass through" entity is to tax affect the earnings. This may be the traditional understanding, but recent court cases such as *Estate of Walter L. Gross* suggest that tax affecting may not be valid. The focus of this paper is to analyze the arguments presented by valuation experts in the Tax Court for and against tax affecting the earnings of a pass through entities.

Background

A significant increase in the number of pass through entities started in 1982 when Congress passed the Subchapter S Revision Act. (Clarkson et al.) The purpose of this act was to eliminate double taxation at both the corporate and shareholder level. With this act corporations were divided into two groups: the S corps, which operate under the S election; and the C corporations. The election of S corporation status provides many advantages and tax considerations to businesses. However, not every corporation can file for S corporation status to enjoy these benefits. The major limiting qualifications and the potential benefits of pass through entities are presented below.

Qualifications for an S Corporation Status

1. The corporation must be a domestic corporation.
2. The corporation must not be a member of an affiliated group of corporations.
3. The shareholders of the corporation must be individuals, estates, or certain trusts. Corporations, partnerships, and no qualifying trusts cannot be shareholders.
4. The corporation must have seventy-five of fewer shareholders.

5. The corporation must have only one class of stock, although not all shareholders need to have the same voting rights.
6. No shareholder of the corporation may be a non-resident alien. (Clarkson et al)

Benefits of a Pass Through Entity

The benefits of S corporations and other pass through entities include a single tax at the shareholder level rather than a double tax at the corporate and the shareholder level. Also, if the corporation has losses, the shareholders of the corporation can use the losses to offset other income. Another benefit, common to both types of corporations, is the limited liability to shareholders.

Management Structure

The management of an S corporation resembles that of sole proprietorship or partnership. There is usually one individual, or a small number of individuals, who take the position of executives and officers. Special considerations must be taken to meet the specific requirements of state statues concerning the conduct of an S corporation. This may included the actions of a majority shareholder to be approved by more than a simple majority on special issues.

One of the main management problems with a pass through entity is that the number of share holders allowed is relatively small. With a small number of shareholders, the managers may find themselves sharing control with associates they don't know or like. This could happen in the event of a death or transfer of the shares to an outside party. One way to prevent this type of situation is to have a shareholder agreement. This prevents any of the shareholders from selling their shares to anyone outside to the company without first allowing the other shareholders to buy them.

Valuation of a Pass Through Entity

The Tax Code defines fair market value as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts." **Sec. 20.2031-1(b), Estate Tax Regs.; sec. 25.2512-1, Gift Tax Regs.**

Corporations are valued using three common methods of valuation: 1) the asset method; 2) the market method, and 3) the income method. The market method and the income method both require consideration of income taxes in the computations. The focus of this analysis is limited to the income method and particularly the Discounted Cash Flow (DCF) approach which is the most common income valuation method used.

The DCF theory assumes that a company is worth the present value of its projected future cash flow. Generally, cash flow is considered to be net earnings after tax and adjusted to cash flow accounting. Earnings and cash flow are projected into the future using a constant growth rate after a specific projection period of around five years. The growth rate is usually based on the historical earnings of the company. If this data is not available, then market research can be preformed to find a theoretically sound rate.

The difficult part in valuing an S corporation, or any other pass through entity, is whether on not to reduce the projected cash flows by the amount of an income tax liability. As stated earlier, S Corporations do not pay taxes at the entity level, but shareholders must pay taxes on the earnings that flow through the company. This means that the net income of a pass through entity does not have any direct tax burden at the entity level. Projecting the earnings at the entity level will show the value of the company without any tax burden.

The majority in the business valuation profession believe not imposing a tax adjustment on the projected earnings would overstate the value of the company. The opponents of this methodology believe that a net of tax value does not take into consideration tax savings of the S status. This debate on whether to tax affect the income stream of a pass through entity is supported on both sides by appealing arguments, both logical and quantitative. The non-quantitative arguments are presented below.

Arguments for Tax-Affecting

Many of the arguments for tax affecting the earnings of an S corporation were presented in a tax court case know as the *Gross* case. The main arguments are: (Hawkins,Paschall)

1. Tax affecting is the common practice among the experts in the valuation profession.
2. The owners of the S corporation are at risk that the company may not distribute enough of the earnings to cover the liabilities of their shares.
3. The corporation may in the future lose the S corporation status. Tax affecting compensates for this potential risk.
4. The IRS states in two of its manuals that it is appropriate to tax affect the earnings of pass through entities

The Valuation Guide States:

> "S corporations are treated similarly to partnerships for tax purposes. S corporations lend themselves readily to valuation approaches comparable to those used in valuing closely held corporations. You need only to adjust earnings from the business to reflect estimated corporate income taxes that would have been payable had the Subchapter S election not been made."

The IRS Handbook States:

> "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 rated applicable for each year in question, and certain other items, such as salaries. The adjustments will avoid distortions when applying industry ratios such a price to earnings."

5. Most of the potential buyers of an S corporation are C corporations. This may be an already established corporation or a group of individuals who will have to organize as a C corporation to buy the company. This would mean the S corporation would lose all of its apparent benefits and essential become a C corporation. These buyers would not pay for a benefit they are not going to realize.

Arguments for not Tax-Affecting

(Hawkins,Paschall)

1. The company is currently not paying any corporate taxes.
2. There are no signs the company might revoke its S status.
3. Historically the company has distributed nearly 100% of all its earnings.
4. The company receives a benefit of not paying double taxes, and should not be burdened with a negative tax when valuing the companies stock.

The Courts Involvement

The question of whether to tax affect the earnings of a pass through entity came to the front of the business valuation world with four major pieces of litigation.

These four cases are:

- *Walter L. Gross, Jr. et ux, et al. v. Commissioner, T.C. Memo.* 1999-254, No. 4460-97 (July 29,1999), affd.272 F. 3d 333 (6th Cir. 2001)
- *Estate of John E. Wall v. Commissioner,* T.C. Memo. 2001-75
- *Estate of William G. Adams Jr. v. Commissioner,* T.C Memo. 2002-80
- *Estate of Richie C Heck b. commissioner,* T.C Memo. 2002-34

The first and perhaps the most important of these cases was the IRS victory in the *Estate of Walter L. Gross,* in which the Tax Court sited with the evaluation of the IRS expert. This case has since been erroneously misapplied in many subsequent valuation settings.

<u>The Facts of the Gross Case:</u>

This case involved the G& J Bottling Company which was a large bottling company for Pepsi Cola. The G&J was owned by two separate families which each owned 50% of the company. Throughout 1988-1992 the company enjoyed growing profits and distributions to owners, which were almost 100% of the net income. At the time of the case G&J was the third largest bottler for Pepsi Cola. On November 1, 1982 the company decided to file for an S corporation status. The filling included a restrictive stock agreement that limited the sale of the stock to anyone outside of the family. Also, any transfer of stock that would terminate the S corporation status was prohibited by the agreement. Five gifts of less than 1% were distributed on July 31, 1992. The restrictive stock agreement was still in place at the time of the "gifts." The taxpayer's estimated the shares to be worth $5,680 per share, based on the valuation of Business Valuation Inc. The IRS estimated these shares to be worth $10,910 per share, for the purpose of gift tax, the taxpayer's valuation stated the value at $5,680(Gross 1999). The disagreement between the two experts on the value of the stock was the catalyst for the litigation.

The difference in the value of the stock was a direct result of whether or not the earnings were tax-affected. The taxpayer's expert believed the correct method was to tax affect the earnings, while the IRS expert believed it was not appropriate. Dr. Bajaj, the expert for the IRS stated, he did not know what the standard practice for tax affecting was in 1992(Gross 1999). The taxpayer's expert Mr. McCoy, stated that he believed the industry standard was to tax affecting the earnings. Upon cross examination, Mr. McCoy did state that there was growing debate in the valuation practice as to the correct treatment of the tax liability. He also stated, that he might think about tax affecting the earnings in the future. The judges in the case weighed heavily on the testimony of Mr. McCoy stating "The majority opinion seems to place great weight on the fact that Mr. McCoy stated that he might consider tax-affecting now, however the majority gives no weight to Mr. McCoy's statement that tax affecting was the generally accepted practice in 1992."(Gross 1999)

The taxpayer's expert believed that his strongest argument for tax affecting was the fact that two internal documents in the IRS stated it was the correct practice. The majority decision in the case stated that the guidelines in the manuals were irrelevant. The IRS manuals have the following disclaimer "This material was designed specifically by the IRS for training purposes only. Under no circumstances should the contents be used or cited as authority for setting of sustaining a technical position." The Court in the case believed this disclaimer did in no way suggest a legal precedent on tax affecting.

The Court ruled in a two to one vote that the earnings of the corporation were to be valued at a non tax-affected basis, based on the following relevant facts: 1) G&J distributed nearly 100% of its earnings to the share holders and had more than enough to money to cover the tax liability:2) at the time of the gift, the stockholder agreement was in place, prohibiting the S status being jeopardized: 3) G&J had a stable and profitable history; 4) there was no indication that the company was going to revoke the S corporation status any time in the near future; and 5) the last and most important was the valuation concerned a minority valuation.

Valuation of a Minority Shareholder

A minority shareholder valuation means that the share ownership being valued represents less than 50% of the company. In other words, the corporation is controlled by the "controlling interest" majority shareholder of the company. The controlling interest has much more power as to the direction of the company. The controlling interest would have much more say in the dividend payouts and operations of the company. It is widely believed a potential buyer of a corporation would much rather buy a controlling interest, than a minority share. This means that the fair market value of the shares must be discounted to show the potential market for the shares.

Perhaps, the most important implication in the valuation of a minority interest, as in the Gross case, is; who would want to buy a non controlling share in another company? The most likely buyer of a 1% share in G&J would theoretically be another member of the family. In cases, such as the Gross case, the S corporation has specific stock agreements that limit the sell of any of the companies stock that will jeopardize the S status. What this does to the potential sale of the stock, is drastically limit the number of qualified buyers in the market. This means the discount for the lack of marketability would be much higher than for a controlling share.

Analysis of the Gross Decision

The Gross case provided the ideal situation for the IRS to set a precedent that the earnings of S Corporation or other pass through entities should not be tax-affected. The Gross decision was theoretically correct in the fact that the ruling was in favor of not tax affecting the earnings, but this does not mean that every S corporation should not be valued by tax-affecting the earnings. If the company and its shares match up exactly with that of the G&J bottling company, then the Gross decision can be applied to the case. The problem is this type of scenario is practically impossible in the business valuation world. Corporations are all different, each with a unique history and structure. The Tax Court has shown in past rulings that it does not understand that each case should be handled on an individual basis. The Gross decision can not be allowed to be the cookie-cutter solution to the valuation of every pass through entity. The misapplication of the

Gross decision in the case of Adams v. Commissioner clearly displays the problem of a standardized solution.

Facts of the Adams Case

In Adams, the valuation concerned a majority 61.59% controlling interest in *Waddell Sluder Adams & Co., Inc.* (WSA), which is a retail and general managing insurance agency. William G. Adams, Jr. died on September 28, 1995, leaving 178 shares of WSA to his daughter Julia Adams SLipher. At the time of his death the estate valued the shares of WSA at $920,800. The IRS valued the shares at $1,746,000. Both of the experts in the case believed in order to be a true representation of the fair market value of the company the earning needed to be tax affected. The capitalization rates the experts used is a source of debate and is beyond the scope of this essay. The judges rejected each of the expert's estimates on the belief the Gross case proved the earnings of MSA did not need to be adjusted for taxes. The court stated " The result here of a zero corporate tax on estimated prospective cash flows and no conversion of the capitalization rate from after corporate tax to before corporate tax is identical to the result in Gross v. Commissioner, T.C. Memo. 1999-254 [1999 RIA TC Memo ¶99,254], affd. 272 F.3d 333 [88 AFTR 2d 2001-6858] (6th Cir. 2001), of zero corporate tax rate on estimated cash flows and a discount rate with no conversion from after corporate tax to before corporate tax." (Adams). An analysis of this statement shows that the court followed the precedent of Gross without thinking about the details of the company at hand.

Analysis of the Adams Case

Adams was different than Gross because the valuation concerned a majority interest in a company without a limiting stock agreement. The minority interest in Gross was theoretically most likely to be purchased by a member of the family or other shareholders. G&J showed no signs of wanting to break the S status anytime in the near future. Adams, on the other hand, involved a majority interest in a company that did not have a limiting stock agreement. Without a limitation on the sale of the stock, it would be unreasonable to assume the stock would only be purchased by other shareholders in the company. It is probable that the buyer would be an individual that could qualify for S status, but this does not mean the buyer wouldn't be another corporation that would break the S status. By breaking the S status the corporation would have to pay taxes at both the entity level and the shareholder on all the future earnings. The hypothetical corporation would not pay an extra benefit for the S status that it was not going to incur. In order for the corporation to purchase the company the fair market value would have to be adjusted to take out the unrealizable value of the S status.

Analysis of a Recent Case in Litigation

The following facts are from a settled case that was in litigation throughout 2004. The names of both parties have been changed to protect the integrity of the case. The dispute involved a manufacturing company owned by two individuals, Mr Doe and Mr. that filed for LLC status in 1998. Prior to the filling Mr Doe owned a company that was nearing its maximum capacity of 20,000, we will call them widgets, per month. The idea of the new LLC was to increase the overall productive capacity and allow new growth.

Also, the partners agreed that the pre tax earnings of the new capacity would be split equally between the two partners.

This valuation is different from the Gross case in many ways. First, the shares under valuation are that of a controlling interest. Second, the LLC did not have a limiting stock shareholder agreement. Finally, the history did not show a steady history of earnings and distributions. These considerations do not imply that the company is going to continue on into the future as a LLC.

The expert for Mr. Wilson prepared the DCF shown in Exhibit 1. The projected earnings presented in this DCF are clearly pretax. An analysis of the expert report showed no mention of the need to tax affect the earnings of the LLC. I believe the value of this corporation is overstated by not taking into consideration these probable taxes. This is based on the lack of a limiting stock agreement, eliminating the sale of the controlling shares to those who would break the LLC status. Also, the fair market value of this company should be a fair representation of the probable market. The market for the controlling shares of the LLC, as in the Adams case, would most likely include C corporations and other non LLC qualifying entities. The exact amount that this LLC is overstated is based on the amount of taxes the company should have incurred. These earnings would then be discounted back to the present after tax value. The correct capitalization rate is beyond the scope of this essay, but should be taken into consideration when valuing a pass through entity.

Conclusion

I believe the tax court was correct in not tax adjusting the earnings in the Gross case. This opinion is based on the following relevant facts: 1) The corporation under consideration had a stable history and consistent operations; 2) The historical payout ratio of the company was nearly 100%, 3) The G&J S corporation had a limiting shareholder stock agreement, and 4) The valuation concerned a minority shareholder interest. The problem then is not the Gross case, but the application of the Gross decision in other valuations.

A particular example of the misapplication of the Gross decision is that of the ruling by the tax court in the Adams case. Both the tax payer's expert and the IRS's expert believed that the earnings should bet tax adjusted. However, the court dismissed both of these recommendations and ruled that the earnings did not need to show a tax liability. The tax court cited the Gross decision in there opinion of judgment as an example of how to treat the earnings of the LLC. Clearly the tax court did not analyze the relevant facts of the corporation at hand. The value of the corporation should have been tax adjusted to show the amount of the potential corporate tax. The main reason for this would be the hypothetical market of a controlling interest in Waddell Sluder Adams & Co., Inc. This market would certainly include other entities that would not be able to continue on with the S status. This hypothetical buyer would not pay a tax bonus that it is not going to enjoy. They would pay the same amount for the S corporation as they would if it were a C corporation. Therefore, the value of the company needs to show this fact and be tax adjusted, valuing it as if it were a C corporation.

It is certainly a fact that judges look for judgments in other cases as a precedent to be followed. The problem with this type of situation in a business valuation setting is that each case must be handled on a case by case basis. A Judge in the Adams case stated:

> "A determination of fair market value, being a question of fact, will depend upon the circumstances in each case. No formula can be devised that will be generally applicable to the multitude of different valuation issues arising in estate and gift tax cases.... A sound valuation will be based upon all the relevant facts, but the elements of common sense, informed judgment and reasonableness must enter into the process of weighing those facts and determining their aggregate significance."

Many people in other types of disciplines, such as mathematics, are used to conclusions that are concise and specific. The answer to the proper valuation of a pass through entity does not fit into this simplistic category. Each case presented for valuation is unique from any others in many ways. Sure there are aspects of each case that resemble circumstances of others, but there is always a new challenge. The only way to ensure the equity of the court is to analyze each case on its own merits.

In the future, I hope that more than the judge in the Adams case will understand that each case must be analyzed separately from any other. To ensure the fairness in the court of law this aspect can't be overlooked.

Exhibit 1

Projected Income Statements & Multi-Period Capitalization Method

	10 Months Ended Oct. 31, 2004	2004	2005	2006
Revenues:				
Gross Revenue	$ 1,420,199	$ 1,704,239	$ 1,866,141	$ 2,034,094
Breakage & Other	$ (10,651)	$ (12,782)	$ (13,996)	$ (15,256)
Net Revenue	$ 1,409,547	$ 1,691,457	$ 1,852,145	$ 2,018,838
Cost of Goods Sold	$ 112,764	$ 135,317	$ 148,172	$ 161,507
Gross Profit	$ 1,296,784	$ 1,556,140	$ 1,703,974	$ 1,857,331
Expenses:				
Advertising	$ 2,083	$ 2,500	$ 2,500	$ 2,500
Depreciation*	$ 68,170	$ 81,804	$ 81,804	$ -
General & Administrative * (Dep.)	$ 10,362	$ 12,434	12,807.22	13,191.43
Insurance	$ 13,221	$ 15,865	$ 17,451	$ 19,197
Interest*	$ 29,608	$ 35,021	$ 28,663	$ 21,603
Occupancy	$ 16,157	$ 19,388	$ 19,388	$ 19,388
Payroll*	$ 246,671	$ 296,005	$ 324,125	$ 353,297
Payroll Taxes*	$ 18,007	$ 21,608	$ 23,661	$ 25,791
Phone	$ 2,104	$ 2,525	2,651.22	2,783.78
Travel*	$ 8,333	$ 10,000	$ 10,000	$ 10,000
Utilities	$ 7,943	$ 9,532	$ 10,485	$ 11,533
Total Expenses	$ 422,659	$ 506,682	$ 533,535	$ 479,284
	$ -			
Operating Income	$ 874,125	$ 1,049,458	$ 1,170,438	$ 1,378,048
Other Expense	$ -	$ -	$ -	$ -
Pretax Income	$ 874,125	$ 1,049,458	$ 1,170,438	$ 1,378,048
Terminal Value				$ 6,756,792
Nominal Cash Flows		$ 1,049,458	$ 1,170,438	$ 8,134,839
Discounted Cash Flows		$ 871,679	$ 807,480	$ 4,661,478
Value Estimate of OLP LLC	$ 6,340,637	Minority Interest		
Control Premium	10%			
Value Estimate of OLP LLC	$ 6,974,701	Controlling Interest		
50% of Value Estimate	$ 3,487,350	[redacted] Interest		

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