

BVS – ANALYSIS

By

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The Rhode Island Supreme Court rules on case involving Business Valuation issues.

In *Vicario v. Vicario*, the Rhode Island State Supreme Court upheld the Family Court Trier of Fact regarding several matters, including the valuation of an S corporation. Tax affecting was one of the underlying valuation issues. The decision reads, in part, as follows:

“In addition, the Family Court concluded that Mr. Pendergast’s appraisal, which included a tax affect in the calculation of the value of Abacus, was in contravention of a decision by the United States Court of Appeals for the Sixth Circuit holding that it is improper to tax-affect a Subchapter S corporation when valuing it. See Gross v. Commissioner of Internal Revenue, 272 F.3d 333 (6th Cir. 2001). Notably, even Mr. Pendergast admitted that he was not aware of any tax court cases subsequent to Gross that allowed for tax-affecting in ascertaining the value of an S corporation.”

“In light of these factual findings and the general magistrate’s discretion to chose one expert’s testimony over the other based on his own determinations of credibility, we are satisfied that he did not abuse his discretion in choosing Mr. Bilodeau’s opinion of the value of defendant’s interest in Abacus over that of Mr. Pendergast.”

The ruling upholds the general magistrate’s discretion to choose one expert’s testimony over another. A more definitive interpretation of this ruling is beyond the scope of this analysis and certainly the author’s expertise. However, a Family Court Trier of Fact did make a ruling on the issue of tax affecting.

In this case, the husband owned a 50 percent equity interest in a Rhode Island corporation (an S Corporation). The business primarily provides employee benefit plan consulting services. The husband was not active in the business. The company historically made annual shareholder distributions sufficient to cover the pass through individual income tax liabilities of the shareholders. In contrast, the Gross case dealt with a very small minority interest and the corporation distributed 100% of its earnings. The fact pattern in the Vicario case is quite distinguishable from the Gross case.

There has been considerable controversy over the past several years regarding the valuation of S corporations (and other pass-through tax entities). Much of the controversy deals with the issue of tax affecting such entities. S Corporations do not pay income taxes on their corporate level earnings. Rather income taxes are paid at the shareholder level, by the shareholders. This is in contrast to the situation of a C Corporation, where income taxes are paid at the corporate level, and then again at the shareholder level, on any dividends paid to the shareholders, by the corporation. A commonly accepted business valuation practice has been to tax affect the earnings of an S corporation by applying C corporation tax rates to the earnings. However, a

1999 U.S. Tax Court Case (Gross v Commissioner) held that tax affecting S corporation earnings was not correct. There have been three additional U.S. tax court cases upholding this position since the Gross case.

There has been a great deal of debate, and numerous articles have been written regarding this matter, since the Gross case decision. The Business Valuation Review, published by the American Society of Appraisers, dedicated the entire September 2004 issue to this matter. There were articles by Chris Treharne, Chris Mercer, Roger Grabowski, and Daniel Van Fleet. Each author provides information concluding there is little or no difference, in value, when valuing a controlling interest in an S or C corporation. Grabowski indicated there could be some adjustment, based on a Code Section 338(h) election, but does not elaborate. Such an adjustment is often just a reimbursement for income taxes incurred by the seller, for structuring a tax advantaged deal to the buyer, and does not represent a real economic increase in the purchase price. This is simply an application of tax arbitrage. Each author also provides a model for valuing minority held interests, in S corporations.

Shannon Pratt states in his Business Valuation Update (January, 2005), "There is also consensus that the valuation issues are different for controlling interests then for minority interests. For controlling interests, some believe that there is no difference (in value), whereas others believe that there may be a small difference depending on the facts and circumstances." In a very lengthy 2004 paper, on this subject, Chris Treharne states the following: "In contrast, if valuing a controlling interest, the studies that have been conducted on controlling interest transactions in the marketplace provide no evidence that S corporations should be treated any differently than C corporations. Logically, we recommend that C corporation valuation methods be used for controlling ownership interests in S corporations." Mr. Treharne also provides the following information in his paper: "Conclusion #5: If S corporation distributions equal the tax liability associated with entity operations and the C corporation pays no dividends, the C and S corporation minority investors' value will be identical (presuming that S and C corporation income tax rates are identical)."

The current business valuation literature, on the subject of tax affecting, overwhelming indicates the issue is dependent on the facts and circumstances, of a particular case. Factors to consider include the size of the business, the actual income tax ramifications of the business, the size of this interest valued, and the current and historical cash distributions of the business.

The size of the business is important. For large businesses, if the only likely buyers are C corporations, the S corporation status of the business should be disregarded. Conversely, most small to mid-market C corporations generally do not create a situation where shareholders pay income tax on dividends. These companies pay out earnings in other legally acceptable ways.

The actual income tax ramifications incurred by a business are important and simply cannot be disregarded. Most small to mid-market companies pay tax on the profits from the business either at the corporate level or the individual shareholder level, depending on the entity structure. Small to mid-market C corporations rarely pay out taxable dividends to shareholders, other than when dealing with an accumulated earnings tax issue. In the second edition of his book Financial Valuation, Jim Hitchner includes an entire chapter on the valuation of pass-through

entities. The author of that chapter, Nancy Fannon, provides the following information "Note further that C corporations generally bonus out salaries, not pay dividends. Although this ability is limited by tax regulations on excessive compensation, this contributes to the notion that double taxation is more myth than reality." This statement makes a great deal of sense. The after-tax cash flow for a small to mid-size business, while somewhat different, frequently is not all that different whether the business is an S corporation or a C corporation. So the valuation should be about the same. Tax affecting makes a great deal of sense in such cases.

The size of the interest valued is also very important. Current valuation literature generally does not support a premium for a 100 percent controlling interest in an S corporation. As previously discussed, the Code Section 338(h) election may include some amount of premium for an S corporation. However, this premium is often just a reimbursement of income taxes paid by the buyer to the seller.

The current and historical cash distributions, of a business, play an integral part in the valuation of minority held interests in closely-held businesses. The valuation models put forward by Treharne, Van Fleet, Grabowski, and Mercer generally indicate no increase in value or only a small increase in value, for minority held interest, in S corporations, when the company only makes distributions to cover the shareholders' annual income tax liabilities, on business profits. Van Fleet's model does show some increase in value of an S corporation over a C corporation in this scenario. However, all of the difference is predicated on hypothetical capital gains computations.

The Vicario case valued a 50% equity interest (on a non-controlling basis), in the Subject Company. A 50% interest presents certain unique factors in the valuation process. Rhode Island requires a greater than 50% voting interest to control a corporation. Also, a 50% voting interest is not really a minority interest, as there is no other shareholder with a larger voting ownership interest in the Company. The interest valued in the Vicario case is very different than the small minority interest valued in the Gross case. It should also be noted, Chris Treharne writes that if an S corporation simply makes shareholder distributions to cover the shareholders' income tax liability, there should be no difference in value between an S corporation and a C corporation. In the case at hand, the Company was distributing cash to the shareholders only sufficient to cover the shareholders' income tax liabilities. This would further support tax-affecting in this specific case. It is highly unlikely that a potential buyer would pay a premium for a 50% equity interest, in this business, based on the fact pattern. The articles previously discussed indicate that the value of the Subject Interest should be substantially the same, whether the Company operates as an S corporation or a C corporation.

The significant impact of tax-affecting on a business is demonstrated in the following hypothetical example. The hypothetical example assumes two identical companies except one is a C corporation and the other is an S corporation.

	<u>C Corporation</u>	<u>S Corporation</u>
Revenues	\$ 5,000,000	\$ 5,000,000
Less: Expenses	<u>(4,000,000)</u>	<u>(4,000,000)</u>
Pre-Tax Profits	\$ 1,000,000	\$ 1,000,000
Less: Corporate Level		
Income Taxes (40%)	<u>(400,000)</u>	<u>- 0 -</u>
After-Tax Net Income	\$ 600,000	\$ 1,000,000
Divide by an assumed		
Capitalization Rate	<u>÷ 20%</u>	<u>÷ 20%</u>
Indicated Value	<u>\$ 3,000,000</u>	<u>\$ 5,000,000</u>

The difference is astounding. This is a very important valuation issue. The computations indicate the S corporation is essentially worth 67 percent more than the C corporation. However, the reality is that the S corporation shareholder will have to pay a similar amount of income tax, on the business profits, at the shareholder level rather than the corporate level. There simply is not a sufficient amount of after-tax cash flow to justify the \$5,000,000 indication of value. This analysis strongly indicates tax-affecting would be appropriate, in this hypothetical case, to avoid significantly overstating the value of the business.

Now let us review the impact of tax-affecting on the Vicario case. The following information was gleaned from reading the Rhode Island Supreme Court decision.

Pre-Tax cash flows	\$ 167,000
Divided by Capitalization Rate	<u>÷ 21</u>
Preliminary Value	<u>\$ 795,238</u>
Preliminary Value (rounded)	\$ 795,000
Less: Discount for Lack of	
Marketability (25%)	<u>(198,750)</u>
	\$ 596,250
Less: Discount for Lack of	
Control (10%)	<u>(59,625)</u>
	\$ 536,625
Times interest valued	<u>x 50%</u>
Indicated Value	<u>\$ 268,313</u>
Indicated Value (rounded)	<u>\$ 268,000</u>

The following analysis indicates the impact of not properly tax-affecting, in the Vicario case, and resultant overstatement of value. The difference, once again, is significant.

	<u>With Tax-Affecting</u>	<u>Without Tax-Affecting</u>
Pre-Tax Cash Flows	\$ 167,000	\$ 167,000
Less: RI Corporate Taxes (9%)	<u>(15,030)</u>	<u>- 0 -</u>
	\$ 151,970	\$ 167,000
Less: Federal Corporate Taxes	<u>(42,518)</u>	<u>- 0 -</u>
After Tax Net Income	\$ 109,452	\$ 167,000
Divided by Capitalization Rate	<u>÷ 21%</u>	<u>÷ 21%</u>
Preliminary Value	<u>\$ 521,200</u>	<u>\$ 795,238</u>
Preliminary Value (rounded)	\$ 521,000	\$ 795,000
Less: Discount for Lack of Marketability (25%)	<u>(130,250)</u>	<u>(198,750)</u>
	\$ 390,750	\$ 596,250
Less: Discount for Lack of Control (10%)	<u>(39,075)</u>	<u>(59,625)</u>
	\$ 351,675	\$ 536,625
Times Interest Valued	<u>x 50%</u>	<u>x 50%</u>
Indicated Value	<u>\$ 175,838</u>	<u>\$ 268,313</u>
Indicated Value (Rounded)	<u>\$ 176,000</u>	<u>\$ 268,000</u>

The analysis indicates a probable overstatement of value, of approximately 52 percent or approximately \$92,000, in this particular case. It is the responsibility of the business appraiser to provide detailed objective valuation information, to the court, to assist the court in reaching fair and equitable decisions. This information should be included in written format (the valuation report) and provided in testimony when required.

Business Valuation Resources recently hosted a teleconference entitled "Ask the IRS", on July 27, 2006. The IRS representative, Michael Gregory, stated the issue of tax-affecting is determined by the facts and circumstances of each case. He further stated that the IRS looks at the facts and circumstances of each and every case and does not simply argue against tax-affecting, as a general rule. This indicates that the IRS does not blindly follow the Gross case, but rather determines each case on its own merits. In fact, I am not aware of a single U.S. Tax Court case where the IRS has argued against tax-affecting an S corporation earnings, when dealing with a 100 percent controlling interest.

A recent case from the Delaware Chancery Court, Delaware Open MRI Radiology Associates, P.A. v. Kessler, et al., 2006 Del. Ch. Lexis 84 (April 26, 2006), dealt with the tax-affecting issue of minority held interests, in an S corporation. The minority interests valued totaled approximately 37 percent. The case dealt with a shareholder squeeze-out merger. The Vice Chancellor noted the business was a highly profitable entity that generates and distributes income well in excess of the stockholder level taxes its stockholders have to pay.

The court "embraced" the reasoning of prior decisional law citing the U.S. Tax Court cases of Gross, Adams, and Heck. However, the Court also relied on the specific facts of the case to depart from precedent. The case reads, in part, as follows:

"My difference with these prior decisions is at the level of implementation, rather than at the level of principle. Certainly, in this context when minority stockholders have been forcibly denied the future benefits of S corporation status, they should receive compensation for those expected benefits and not an artificially discounted value that disregards the favorable tax treatment available to them. But the minority should not receive more than a fair S corporation valuation. Refusing to tax affect at all produces such a windfall, as I next explain."

"The Internal Revenue Code states "[t]he taxable income of an S corporation shall be computed in the same manner as in the case of an individual...." This tax, though assessed at individual rather than corporate tax rates, is dependent solely upon the corporation's net earnings. Even if Delaware Radiology were to retain 100% of its earnings annually, its stockholders still would owe taxes on Delaware Radiology's income even though they received no distributions. Affording a remedy to the Kessler Group that denies the reality that each shareholder owes taxes on his proportional interest in Delaware Radiology would result in the Kessler Group receiving a higher per share value from the court than it could ever have realized as a continuing shareholder."

In this case the Vice Chancellor provided his own business valuation analysis, to reach a determination of value. The valuation analysis was well reasoned and based on current business valuation literature. The Court's decision results in an approximate 17.6 percent premium to the value of the minority held interests. Note that the business, unlike Vicario, distributed most of its profits, to the shareholders, well in excess of the shareholders' income tax liabilities. The Vice Chancellor cites both Chris Treharne's and Chris Mercer's work in reaching a conclusion. This decision is a must read for any business valuation analyst.

Conclusion

The issue of properly valuing S corporations, and other pass-through entities, will continue to be a controversial topic. The issue has evolved from one of "to tax-affect or not to tax-affect" to one of determining the proper tax ramifications, for a specific business. Current valuation literature indicates that the matter is case specific, depending on the particular facts and circumstances. When valuing a 100 percent controlling interest, in a business, normal C corporation tax adjustments would seem appropriate, in most cases. When valuing a minority held interest, in an S corporation, the issue depends on a number of factors, including the size of the business, the size of the interest valued, the overall income tax ramifications of the business, and the cash distribution policy, of the business. Hopefully, business appraisers will meet the challenges of providing relevant and thorough valuation information, to the Rhode Island Family Courts, on this matter, when required to do so.