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At Last, a Valid Way To Value S Corps

The Delaware Chancery Court sets the Tax Court straight

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The Delaware Chancery Court has developed a unique approach to an appraisal issue that has dogged estate and gift tax valuations of subchapter S corporations ever since a string of controversial Tax Court cases earlier this decade. In *Delaware Open MRI Radiology Associates, P.A. v. Kessler*,[1] the Chancery Court takes direct aim at the Tax Court's repeated acceptance of a methodology that significantly overvalues interests in S corps. The court also presents a cogent discussion of the economic benefits associated with pass-through income tax status and provides a well-reasoned alternative approach for valuing S corps.

VALUATION OF S CORPS

The proper valuation treatment of S corps has long been a source of debate in tax appraisals. The sheer number of closely held companies that are S corps (or other pass-through entities such as partnerships and limited liability companies) makes their valuation a hotly contested issue.

Pass-through entities generally do not pay income taxes at the entity level.[2] But their earnings do not escape taxation; the tax is merely shifted (or "passed through") to shareholders. The primary economic benefit of pass-through status is that owners avoid the so-called "double taxation" that C corp shareholders experience when taxed on dividends at the shareholder level in addition to the corporate-level tax on earnings.

Historically, when the value of an S corp was based on an income approach, the earnings were taxed at a C corp tax rate. Yet practitioners differed on whether to give separate consideration to the S corp benefits. Citing certain disadvantages and risk factors that offset the benefits, many advisors were wary of making additional adjustments that would reflect the value of the S corp benefits.[3] In fact, the *IRS Valuation Guide for Income, Estate and Gift Taxes* sanctioned this approach.[4] Others added a modest premium for the S corp status relative to the C corp equivalent value in recognition of the tax benefits.

Then came a string of tax court cases—*Estate of Gross* (2001),[5] *Estate of Heck* (2002)[6] and *Estate of Adams* (2002)[7]—that offered a much different treatment of the issue. In each, the Tax Court accepted a method for valuing S corps that involved the capitalization of earnings that were not reduced by any taxes. Carried to its logical conclusion, this method would result in an S corp interest being valued almost 70 percent higher than an otherwise identical C corp interest.[8] While there had never been a clear consensus on the proper valuation treatment of S corp benefits, most practitioners recognized that the method approved by the Tax Court did not make sense, because it ignored the income tax consequences at the shareholder level. In the aftermath of these cases, professionals in the estate-and-gift-tax field have been in a quandary over how to deal with case law that contradicts economic reality.[9]

DELAWARE RADIOLOGY

Delaware Radiology involved a radiology practice organized as a Delaware S corp; the eight shareholders were all radiologists. The interests of three of the shareholders were purchased in a squeeze-out merger. These minority shareholders brought an equitable entire fairness claim and a statutory appraisal claim in response to the merger. Despite the dual claims, the fundamental issue was the fair value of the minority shareholders' shares.[10]

This case is unique because it addresses the proper method for valuing an S corp (and, by implication, other pass-through entities) when using an income approach. The opposing experts took extreme positions on the tax-related valuation issues. The expert for the minority shareholders followed the method commonly accepted by the Tax Court by not deducting any taxes from the earnings. Conversely, the expert for the majority shareholders applied taxes to earnings at a hypothetical C corp rate and made no provision for the value of the S corp benefits. The Chancery Court, on the other hand, disregarded both of these methods in favor of a more balanced approach.

THOUGHTFUL DECISION

The Delaware court dealt with both the principle of whether additional value should be attributed to the S corp benefits and the specific method for quantifying such benefits. Conceptually, the court agreed with *Gross*, *Adams* and *Heck* that pass-through status was a "highly valuable attribute" to shareholders and should be taken into consideration in the valuation.[11]

While agreeing that the S corp benefits should be reflected in the valuation, the Delaware Chancery Court disagreed with the Tax Court about what valuation method to use. The Chancery Court criticized the Tax Court's previous decisions, saying that "to ignore personal taxes would overestimate the value of an S corporation and lead to a value that no rational investor would be willing to pay to acquire control."[12] Stating that "the value of the S corporation structure is experienced at the shareholder level and is easy to overstate,"[13] the court went on to conclude that the difference in value between S corps and C corps was nowhere near that implied by the difference in taxes at the corporate level.

The court used a hypothetical example to compare an S corp to a C corp based on the amount of every $100 of a company's pre-tax earnings received by shareholders after corporate and personal taxes. (See "A Balanced Approach,.)

> *Delaware Radiology* addressed whether additional value should be attributed to S corp benefits and which method to use.

A very important assumption in the court's analysis was that 100 percent of the corporation's pre-tax income was available for distribution to shareholders. (Though this fit the fact pattern of *Delaware Radiology*, this does not apply to the majority of S corps). In its example, the court simplified matters by making the assumption that the tax rate on earnings was 40 percent, paid at the corporate level in the case of a C corp and at the personal level in the case of an S corp. In the court's S corp scenario, shareholders received $60 after paying the tax on earnings at the personal level. In its C corp scenario, after paying taxes on earnings at the corporate level, a 15 percent tax on dividends was paid on the available earnings resulting in shareholders receiving $51 after corporate and personal taxes. The difference in the combined corporate and personal tax rates implies an 18 percent valuation premium for S corp status.[14] This is far less than the almost 70 percent implied premium using the method accepted by the Tax Court.

The court went on to develop a practical solution to a fundamental valuation problem posed by S corps. Because the market rates of return that are used to value a corporate income stream are measured after corporate-level taxes but before personal taxes, an argument can be made that it is inappropriate to deduct personal taxes when valuing an S corp. Indeed, when valuing a C corp, one does not deduct personal taxes on dividends from the income stream being capitalized. The valuation problem is to reconcile two conflicting notions: (1) deducting personal taxes from income is inconsistent with the market data used to value S corps, and (2) failing to deduct any taxes will result in the overvaluation of the S corp. The court's solution to this problem was to estimate "what an equivalent, hypothetical 'pre-dividend' S corporation tax rate would be."[15] The court determined that a corporate tax rate of 29.4 percent, combined with a hypothetical 15 percent personal tax on dividends, yielded the same $60 after-tax return that an S corp shareholder would receive by taxing S corp earnings at a 40 percent personal rate.[16] Thus, the court concluded that by applying a 29.4 percent tax rate to S corp earnings, the value of the S corp status was captured in the higher income stream relative to a C corp. While the 29.4 percent tax rate falls between the zero and 40 percent respective rates of the two opposing experts, it is much closer to that asserted by the majority shareholders' expert.

DISTRIBUTION LEVELS

Because *Delaware Radiology* distributed all of its taxable income, the case represents a fact pattern that yields the greatest current benefit from S corp status. However, most S corps do not distribute all of their earnings. The Delaware Chancery Court's method for capturing the value of the S corp status using a presumed corporate tax rate does not address how the value of the S corp benefits is reduced when earnings are retained in the corporation and not distributed.

A substantial number of S corps distribute just enough to cover the owners' personal tax liability on the corporation's earnings. If, in the court's example, shareholder distributions were $40 instead of $100, the shareholders would realize no current tax savings as a result of the S corp status because all of their distributions would go to pay personal taxes. Many professionals have argued that in such a situation no additional value should be given to the S corp status. The Delaware Chancery Court's method can be modified to account for situations in which the corporation distributes less than all of its pre-tax earnings. The modification should be a function of the personal tax on dividends that is saved on the difference between the total S corp distributions and that portion of S corp distributions that represent the personal tax on earnings. If, in the court's example, distributions were $70 instead of $100, the current value of the S corp benefit would be the dividend tax saved on the $30 difference between the $70 in total distributions and the $40 tax on earnings. Our firm proposes to adjust the presumed S corp tax rate calculated by the court to reflect different distribution levels. Using our adjustment, we calculated that the presumed S corp corporate tax rate would increase from 29.4 percent to 35.1 percent if distributions went from $100 to $70.[17] This reflects a lower value of the S corp benefits because the incremental increase in earnings relative to a C corp are less than when all earnings are distributed.

A BALANCED APPROACH

The Delaware Chancery Court in *Delaware Radiology* calculated a hypothetical corporate tax rate of 29.4 percent to account for the value of S corp benefits

	C Corp	S Corp	S Corp Valuation
Income Before Tax	$100	$100	$100
Corporate Tax Rate	40%	0%	**29.4%**
Corporate Net Income	$60	$100	$70.59
Dividend or Personal Income Tax Rate	15%	40%	15%
Shareholders After-tax Return	$51	$60	$60

This chart is based on the table that appears in Delaware Radiology, *898 A.2d 290 (Del. Ch. 2006).*

Source: Bret A. Tack

CAUTION

The court's method (including our proposed modification) involves some simplifying assumptions. The court assumed that the C corp corporate tax rate and the S corp personal tax rate were identical when in fact they are usually different (though often not enough to make a material difference in the analysis). Also, the court's 15 percent dividend tax rate is understated, because it ignores state taxes. Any increase in the dividend tax rate assumption would increase the value of the S corp benefits by lowering the presumed S corp corporate tax rate. Finally, the method only considers the current tax benefit to S corp shareholders. When the S corp does not distribute all of its earnings, there are potentially significant tax savings to owners at the time of a sale or other liquidity event.[18] However, because the realization of these benefits is dependent on uncertain future events, they are difficult to quantify and an argument can be made that they should not be incorporated into the valuation.

> In most instances, it is advisable to account for the value of S corp benefits.

BRAVO!

Delaware Radiology is perhaps the best judicial treatment of the highly controversial S corp issue to date. The case provides a solid rationale behind the conclusion that the capitalization of pre-tax earnings significantly overstates the benefits of S corp status. Despite the Tax Court's decisions, there is overwhelming evidence against disregarding taxes when valuing an S corp under the income approach.

On the other hand, *Delaware Radiology* adds to the weight of judicial opinion that strongly discourages ignoring the value of the S corp benefits altogether. Practitioners involved in tax valuations should be very careful about applying C corp taxes to S corp earnings without addressing the issue of pass-through benefits. While there are situations in which it may be appropriate, the rationale for this decision should be stated clearly in the valuation report.

In most instances, it is advisable to account for the value of S corp benefits. Despite some shortcomings, the Delaware Chancery Court provides a relatively simple, yet fundamentally sound, alternative method when the company distributes substantially all of its income. When the corporation distributes less than all of its income, the court's model can be adjusted to demonstrate a decrease in the value of the S corp benefits. This provides the analytical flexibility needed within the four corners of the court's opinion. ▮

Endnotes

1. *Delaware Open MRI Radiology Associates, P.A. v. Kessler*, 898 A.2d 290 (Del. Ch. 2006).
2. However, California S corps pay a 1.5 percent franchise tax on earnings.
3. The disadvantages of S corp status include limitations on the number and type of shareholders and classes of stock, and the risk that a company might not be able to maintain its S corp status. Some practitioners valued S corps without deducting any taxes from earnings but applied a premium to the required rate of return to account for these risks and disadvantages. *Estate of Adams v. Comm'r*, T.C. Memo 2002-80 specifically rejected the practice of increasing the rate of return for these reasons.
4. *See Estate of Gross*, 272 F.3d 333 (6th Cir. 2001), for a detailed discussion of the *IRS Valuation Guide*.
5. *Ibid.*
6. *Estate of Heck v. Commissioner*, T.C. Memo 2002-34.
7. *Estate of Adams v. Comm'r*, T.C. Memo 2002-80.
8. Assuming a 40 percent C corp tax rate, the premium is calculated as (1/(1-.4))-1, or 0.667.
9. This is somewhat analogous to the quandary of valuation professionals over the tax court's refusal to allow a reduction in fair market value for unrealized gains in C corps prior to the *Estate of Davis* (110 T.C. No. 35) and *Estate of Eisenberg* (T.C. Memo 1997-483) decisions.
10. This "fair value" standard is different from the "fair market value" standard for tax valuations.
11. The court made a distinction between the sale of an S corp, in which no premium would be warranted if the most likely buyers were C corporations, and the value to existing shareholders under a continuation of the S corp structure.
12. *Delaware Radiology*, at p. 59.
13. *Ibid.*, at p. 55.
14. Calculated as follows: (60/51)-1.
15. *Delaware Radiology*, at p. 61.
16. The Delaware court's presumed S corp corporate tax rate can be replicated using this formula: Str = 1 – [(1- Ctr) / (1 - Dtr)] where: Str = Presumed S corp corporate tax rate; Ctr = C corp corporate tax rate; and Dtr = Personal tax rate on C corp dividends. Using the court's assumptions, the S corp corporate tax rate of 29.4 percent is calculated as: 1 – [(1 - 0.4) / (1 - 0.15)] = 0.2941.
17. We propose multiplying the dividend tax rate used in the court's formula by a "hypothetical dividend factor." Recognizing that the first $40 of S corp distributions is intended to cover the shareholders' personal tax liability, the excess of actual S corp distributions over $40 (the "hypothetical dividend") is expressed as a percentage of the S corp's earnings after personal taxes. The hypothetical dividend factor is: HDF = (Sd – Spt) / (Spe - Spt) where: HDF = Hypothetical dividend factor; Sd = S corp distributions; Spt = Personal taxes on S corp earnings; and Spe = S corp pre-tax earnings. Following the example, the hypothetical dividend factor is 50 percent, calculated as: (70 - 40) / (100 - 40) = 0.5.
   The modified formula to calculate the presumed S corp corporate tax rate is: Str = 1 – [(1- Ctr) / (1 – (HDF x Dtr)] where: Str = Presumed S corp corporate tax rate; Ctr = C corp corporate tax rate; Dtr = Personal tax rate on C corp dividends; and HDF = Hypothetical dividend factor. Following the example, the S corp corporate tax rate is 35.1 percent, calculated as: 1 – [(1 - 0.4) / (1 – (0.5 x 0.15)] = 0.3514.
18. Because an S corp shareholder's tax basis increases by the amount of undistributed income, in the event of a sale or other liquidity event, he will pay less in taxes.

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