

## **The ‘Real’ S Corp Debate: Impact of Embedded Tax Rates from Public Markets**

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It has been eight years since *Gross v. Commissioner* thrust tax-affecting into the collective consciousness of the business appraisal community. In that decision (affirmed by the Sixth Circuit in 2001), the U.S. Tax Court declined to allow an income tax deduction in the application of the income approach. In so doing, the Court believed that it was properly accounting for the benefit of owning an S corporation compared to a C corporation.

Since then, most analysts have acknowledged that the true benefit of S corporation ownership lies in the avoidance of dividend and capital gains taxes, relative to the public C corporation cost of equity capital they use to value the interest. At least two courts have also come to the same realization—the Delaware Chancery Court, in the *Delaware Radiology* case,<sup>1</sup> and the Supreme Judicial Court of Massachusetts in *Bernier v. Bernier*, 2007.<sup>2</sup> Because analysts derive rates of return from public C corporations to value an S Corporation interest, adjustments must be made to account for differences between the public C corporation and the S corporation. But just when you might have thought the S corporation debate was about to settle down around these simple concepts, we have more to talk about than ever.

When analysts use a public market cost of equity capital to value an S corporation, they apply the S Corp valuation models<sup>3</sup> to account for the different returns that a public market investor realizes compared to an S corporation investor. They do this primarily by measuring the dividend and capital gains taxes that the S corporation investor avoids. Typically, they have measured this benefit to the S corporation shareholder, relative to the public C corporation shareholder, at the current statutory dividend and capital gains tax rates. Thus far, the models have been silent as to the distinction between the current dividend and capital gains tax rates and the rates embedded in the public market equity return which analysts use to value the S corporation. The distinction is notable and bears further discussion.

### **Theoretical framework**

Any one of the S corporation financial models captures the benefit of the avoided dividend and capital gains taxes and recognizes that it provides incremental value to the S corporation relative to the publicly traded C corporation. The various models accomplish this common goal in different ways.

The Grabowski and Mercer models treat the S corporation similar to how one would value a tax-exempt bond, capitalizing the “grossed-up” cash flow (by multiplying (1-dividend rate)). The Treharne model and the Fannon “Simplified” model calculate the present value of the expected tax benefit of the avoided dividend tax (and also of the

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capital gains tax, in the Simplified model). The Van Vleet model calculates a multiple for the S corporation cash flow—which is higher because of the avoided dividend and capital gains tax—over the C corporation cash flow, to be multiplied times the C corporation value. One can obtain this same result by using the method that the Delaware Chancery Court used in the *Delaware Radiology* case.

All of these methods adjust the numerator in the income approach: the net income (or cash flow). Alternatively, one could account for the benefit of S corporation ownership through the capitalization rate (the denominator in the income approach), by calculating the rate of return to the investor, after the payment of dividend and capital gains tax.<sup>4</sup>

Whether accounting for the benefit of avoided dividend or capital gains tax through the cash flow or the cost of equity capital, the goal is the same: to account for the differences between the publicly traded C corporation, from which the analyst derives the cost of equity capital, and the S corporation, to which the analyst applies it. However, there is one significant clarification that the models have not made evident and that bears further examination.

In calculating the return used to value the S corporation, analysts select an equity risk premium (an element of the discount rate used to value the stock) from the public markets. Public-market returns inherently include the dividend and capital gains taxes that the public-market investor realizes. *These* are the taxes—the dividend tax and the capital gains tax—that are “baked into” the equity-risk premium from the public markets; they are the taxes which the S-corporation investor avoids and the analyst must account for.

To the extent that these taxes affect public-market returns, they affect value in the public market. Because the S corporation investor avoids the dividend and capital gains tax, when analysts use public-market returns they must remove from the equity risk premium the effect that such taxes have on value. Numerous academic studies have endeavored to research the impact that personal taxes (dividend and capital gains) have on value.<sup>5</sup>

### **Empirical studies show impact of dividend, capital gains tax**

“Value” is a function of cash flow, growth (resulting in capital appreciation) and risk (expressed as the capitalization rate). The S corporation valuation models generally quantify the benefit of S corporation ownership by measuring the additional cash flow to the S corporation shareholder. As discussed above, one could just as effectively calculate the effect on the cost of equity capital used to value the corporate entity. With this in mind, consider the empirical evidence of the effect of shareholder taxes on value. (For full citation to all references, please see the accompanying sidebar.)

Numerous studies have attempted to research the effect of shareholder taxes (that is, personal dividend and capital-gains tax) on share-pricing in the public markets. Several studies found that shareholder taxes are impounded in equity price (Harris & Kemsley, 1999; Collins & Kemsley, 2000; Harris, Hubbard & Kemsley, 2001). Poterba & Summers (1985) and Zodrow (1991) claim that the timing of dividend payments does not affect shareholder price, and that the present value of shareholder-dividend tax is capitalized in price. Hanlon, Myers, and Shevlin (2001) question these findings because

of: 1) tax clienteles (that is, the ownership of dividend-paying firms' by a combination of taxable, tax-favored, and non-taxable entities); and 2) empirical observations that many firms rarely pay dividends at all. By contrast, Dhaliwal, Erickson, Myers and Banyu (2001) find that the timing of retained-earnings distributions does affect equity price, and that the present value of shareholder dividend tax is capitalized in price.

Lang & Shackelford (2000) found a reduction in future capital-gains taxes resulted in an increase in share price; however, they also found that the *anticipation* of changes lead to a reduction in the market's supply of stock, thus impacting price. Bolster and Janjigian (1991) found that relative changes in the tax rates on dividends and capital gains affect the market prices of stocks; and that the prices of dividend-paying stocks are affected differently than the prices of stocks that do not pay dividends. The timing of distributions (i.e., the dividend payout policy) influences equity price.

Perhaps one of the most notable references of the Dhaliwal, Erickson, Myers and Banyu study is found in a footnote. In the public markets, investors form clienteles (i.e., a mix of owners with different tax motivations) based on the taxation of asset returns. For example, Erickson and Maydew (1998) found that corporations (for which dividend income is tax-favored) are the marginal investors in high-yield stocks. Dhaliwal, Erickson, and Trezevant (1999) provide evidence that increases in dividend payouts are associated with increased levels of institutional ownership. Seida (2001) finds evidence consistent with the existence of clienteles on dividend-paying stocks. Dhaliwal, Erickson, Myers and Banyu conclude that there is one tax-affect in market returns: the present value of taxes arising from retained-earnings distributions.

The federal dividend tax rate reduction in 2003—when ordinary income tax rates dropped to 15% as a result of the Jobs and Growth Tax Relief Reconciliation Act of 2003 (the “2003 Act”)—allowed research that had not been possible before. In part, this was because there had never been a reduction of this magnitude, un-coupled with other tax cuts.

Blouin, Raedy and Shackelford (October 2004) studied the impact of the dividend tax cuts that the 2003 Act put in place. They found dramatic increases in the dividends that public companies paid after enactment. They also found a decline in share repurchases by firms. They did not find a correlation of dividends paid to companies owned by individuals (as opposed to corporations or institutions), but they did find a correlation to insider holdings. This implies that insiders found the reductions in the dividend tax to be in their own favor, thus voting to increase them. At the time of the study, the researchers allowed that the increase in dividends was possibly tied to a general improvement in the economy. However, subsequent studies have found a marked increase in dividends following the rate cut, irrespective of improvements in the economy.

Amromin, Harrison and Sharpe (2005) found that the decrease in the dividend rate failed to boost stock values overall, but it did boost the values of high-dividend-paying stocks, though not for a sustained time. Notably, Grullon and Michaely (2002) found that companies substitute stock buy-back programs and liquidations (therefore resulting in capital-gains tax to investors) when dividend rates are high. In the most recent study Blouin, Shackelford and Raedy (November 2007) studied changes in the mix of dividends and share repurchases resulting from the 2003 Act, predicting a shift from repurchases to dividends. Honing the work that others had done since the 2003

Act, they found that firms substituted dividends for repurchases after the 2003 Act at a rate that accelerated as firms adjusted their dividend and repurchase policies. The authors note that they “accept the fact that some firms paid dividends before the 2003 Act....(and) assume that the mix of dividend and repurchases was optimal before passage of the legislation....(and)...predict that firms will pay even more dividends after 2003.”

Clearly, another reason why the effect of dividend and capital-gains taxes on pricing is muted in the public markets is due to clientele. A study by Mehra and Prescott (2003) found that from 1962 to 2000, the share of public equities held in retirement accounts and in pension funds increased from zero to slightly over 50%, indicating that half of corporate dividends are subject to *no* dividend taxation. As a result, the marginal tax rate on dividends, which was 43% from 1955 to 1962, had dropped to only 17% from 1987 to 2000. Most S corporation valuation models use the current rate of 15% (federal) plus a state rate to calculate the benefit of the avoided dividend tax, approximating the rate that is mirrored in the equity risk premium in this most recent study.

Thus—notwithstanding *Gross* and its progeny in the Tax Court<sup>6</sup>—current empirical evidence demonstrates that taxes influence share price. While there has been little debate in the financial literature on the deduction for the tax burden on corporate income, there has been much research on the influence of personal (investor dividend and capital gains) taxes, as examined and discussed here.

### **Measuring the advantage to the S Corp shareholder**

At issue is the advantage to the S corporation investor when valuing the shares using a public-market rate of return. Despite the Tax Court rulings, there is no question that income taxes are incurred on the corporate income of both the public C corporation and the S corporation. The only material matter is the extent to which the S-corporation investor has an advantage over an investor in the public markets with respect to personal (dividend and capital gains) taxes—as it is from the public markets that analysts obtain the cost of equity capital.<sup>7</sup>

Public market stocks and their returns experience the effects of clientele: a blending of many investors. In addition, individual investors in the public markets are able to participate in arbitrage—to hedge stocks against each other, muting the effects of their respective gains and losses—and taxes. By contrast, a private market stock will likely have only one investor type (or a few similar investors); and the investor in the private company typically has little opportunity to arbitrage compared to the public market investor. The *public* market may show little reaction to a drop in the dividend rate, because companies on the whole may change strategy from one tax scheme to another (say, change from stock buy-backs to the payment of dividends). Or individual investors may change investments accordingly, moving toward low dividend-paying stocks; or they may change their holding period to a longer term, thereby benefiting from the deferral of taxes in the form of capital gains. If dividend rates return to their former, higher rates, it may mean a similar shuffling of corporate strategy—for example, return to stock buy-backs and curtailment of dividends in the public markets, for those companies that chose this strategy.

The private markets also react to changes in tax policy, attempting to minimize taxes and maximize value. Like the public C corporation, in times of high dividend-tax

rates, private C corporations may engage in stock buy-backs or redemptions, turning returns into capital gains. Some private C corporations increase compensation payments as a means of avoiding a second tax. S corporation investors face neither a tax on dividend distributions nor a tax on capital gains, to the extent that they are able to build basis in their stock.

When the Tax Court decided the *Gross* case in 1999, the dividend rate was the same as the ordinary income tax rate. This rate highly discouraged the payment of dividends, and, in fact, dividends in the public markets had been declining since 1982 (Chetty and Saez, 2004). As stated above, Dhaliwal, Erickson, Myers and Banyu conclude that there is one tax-affect in market returns: the present value of taxes arising from retained-earnings distributions. As also described above, Mehra and Prescott contend that the marginal rate on dividends by 2000 was 17%. Regardless to which view one ascribes, it is clear that the return to an average investor in the public marketplace--*the assimilation of which we use to determine our cost of equity capital*--did not have personal taxes equivalent to the current dividend tax rate (in 2000, equal to the ordinary income tax rate) embedded in them. Rather, it was likely a blending of the dividend tax rate that was impounded in the cost of equity capital—such as the 17% found by Mehra—and of the capital gains tax rates.

To the extent that an S corporation uses a cost of equity capital from the public markets—and avoids these taxes—it has an advantage, *but only to the extent to which it avoids these taxes*. At the time of *Gross* and through 2002 (until the dividend rates changed), the underlying valuation of the S corporation did not include a rate of return from public markets that inherently assumed investors paying a dividend tax at ordinary income tax rates; instead, it was valued with a rate of return that had “built-in” assumptions from the public marketplace. Thus, we needed only adjust from the public marketplace to the private S corporation’s reality. Any assumption of additional dividend taxes would overcompensate for a valuation effect in the public market that is not present. Similarly, failure to recognize this relative benefit would under-compensate for the effect that is in the market rate of return.

Following the drop in the dividend tax rate in 2003, one would expect the overall dividend rate impounded in the equity risk premium to fall, since the dividend tax rate dropped significantly. However, the studies observed an increase in dividends as corporations altered strategies. For some, these strategies replaced buy-backs (thus substituting one low-tax option with another). The studies following the 2003 decrease in the dividend rate seem to indicate that should the dividend rate either increase or drop following the upcoming Presidential election, corporations and their investors would alter their strategies accordingly.

## Summary

The valuation models for S corporations account for the benefits that the S corporation shareholder enjoys compared to the publicly traded C corporation investor: the benefit of avoiding dividend and capital gains taxes. They each measure the benefit by reference to the current dividends and capital gains tax rates that investors face. The amount of tax impounded in the equity risk premium is a shifting mix of corporate and investor strategy that responds to tax policy to reap the greatest advantage.

Therefore, when measuring the S corporation premium, the valuation analyst should consider that the tax rate actually embedded in the public market may not be the same as the statutory rate in effect at the valuation date—and is likely less than the present rate. This differential will probably be even more pronounced if dividend rates increase in the future, as corporations and investors in the public markets seek alternative return strategies.

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<sup>1</sup> *Delaware Open MRI Radiology Assoc. v. Kessler*, 898 A.2d 290, 314 (Del. Ch. 2006) (hereafter *Delaware Radiology*).

<sup>2</sup> *Bernier v. Bernier*, 2007 Mass. LEXIS 598 (May 7, 2007).

<sup>3</sup> The S Corporation valuation models include: 1) the Simplified Model (*Fannon's Guide to the Valuation of Subchapter S Corporations*, BVResources, 2007); 2) the Grabowski Model (Grabowski, Roger J., "S Corporation Valuations in a Post-Gross World," *Business Valuation Review*, Sept. 2004; 3) the Van Vleet Model (Van Vleet, Daniel, "the S Corp Economic Adjustment Model," *Business Valuation Review*, Sept. 2004; 4) the Treharne Model (Treharne, Chris D., "Valuation of Minority Interests in Subchapter S Corporations," and 5) the Mercer Model (Mercer, Z. Christopher, "Are S Corporations Worth More Than C Corporations?," *Business Valuation Review*, Sept. 2004). These financial models all accomplish substantially the same goal: recognition of the avoided dividends and capital gains tax. The Delaware Chancery Court also accomplished this goal with the model it used in the *Dela. Radiology* case.

<sup>4</sup> A basic form of this analysis appeared in Fannon, Nancy J., "The Shortest Distance Between Two Points," *Business Valuation Review*, July 2007.

<sup>5</sup> To date, these studies have received sparse attention in literature concerning valuation of closely held businesses—but it is anticipated that research that builds on the most current empirical studies will be forthcoming.

<sup>6</sup> See *Estate of Wall v. Comm'r*, T.C. Memo 2001-75; *Estate of Adams v. Comm'r*, T.C. Memo 1999-254, 2002-80; *Estate of Heck v. Comm'r*, T.C. Memo 2002-34; *Dallas v. Comm'r*, T.C. Memo 2006-212.

<sup>7</sup> This point is often the source of confusion, because analysts are tempted to compare how an S corporation would fare versus a comparable private C corporation. However, we do not draw our rates of return from private markets; thus, such a comparison is separate from our calculation of the income approach. Further, any private C Corp may have particular comparability issues with the public C Corp rate of return, notwithstanding the differences between a public C Corp and an S Corp.