S Corporations and Value: Simplifying the Debate

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Nearly 62% of all corporations that filed income taxes in 2003 were S corporations. Many of those corporations have transitioned ownership in the last several years, oftentimes handing the stock down from parent to child in the natural order of the family businesses. Undoubtedly, few of them knew that they made such a gift at their peril, in the midst of what has become the most hotly debated issue in the history of valuation—how to value stock in a Subchapter S corporation.

To understand the basic issue is simple: when determining the value of a corporation, it was established practice to deduct income taxes from the corporate earnings stream. Value would then be calculated either as a multiple of that earnings stream or by capitalizing it. However, we now have five decisions in which the tax court has declined to deduct income taxes from corporate earnings when calculating the value of the S corporation for gift and estate tax purposes. The implications are obvious: if you don't deduct corporate income taxes of (say) 40% from the income stream to which you apply a multiple (or capitalize), you get a much higher value than if you do deduct corporate income taxes.

Unfortunately, this basic view of the issue is deceptively simple, and misses the true economic benefit of investing in an S corporation. It is this deceptively simple concept which first reared its head in the case of *Gross v. Commissioner*[1] , and has wreaked havoc on small businesses attempting to transfer ownership ever since. Further, it has emboldened the I.R.S. to take positions relying solely on the tax court cases, rather than financial reality.

S corporations, first recognized as a corporate form in 1958, were intended to bring tax relief to small business. It is doubtful if valuation was thought of at the time the original bill was written, as it wasn't the motivation behind crafting the legislation that lead to their creation. Among financial analysts, the notion that the valuation of these entities would be any different than any other corporate form was barely an afterthought, receiving only scant attention in professional journals. Any attention it did receive was largely ignored by analysts. That changed after *Gross.* Since then, the valuation of S corporations has been the subject of significant debate, the result of which was the creation of substantive financial and economic models for the valuation of these entities.[2]

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[1] *Gross v. Commissioner*, TCM 1999-254, July 29, 1999

[2] The methods established today for the valuation of S corporations can be found in the work done by Roger J. Grabowski, Chris D. Treharne, Z. Christopher Mercer, Daniel R. Van Vleet, and a Simplified version by the author of this article. While a discussion of each of their specific methodologies is beyond the scope of this article, their collective works form the core of the financial reality facing the S corporation owner that this article presents.

The foundation for these models are not new: the notion that income taxes affect rates of return and value dates back to work done by the most noted and distinguished financial experts of their time in the 1960's, and it was upon their early work that the models that we use today were built.

It is not surprising that the courts have been slow to adopt appropriate techniques for valuing this complex form of entity, as they have heard precious little evidence to convince them. Many analysts themselves have been slow to accept the valuation models for S corporations. In some cases, the analyst has become frustrated with complicated financial modeling, made worse by the deluge, some of it flawed, of financial analysis that added to the fray since the *Gross* case was decided. Other cases are simply the result of expert-advocacy, a desire for no increase in value on behalf of their client. However, nearly all financial analysts who have seriously studied the issue now agree that the value of an S corporation or interest in it is often greater than a comparable publicly traded C corporation. *This differential is typically between 5-20%*[3]*, and not anywhere near the 65% premium that has been placed on them by the I.R.S. and in tax court decisions.* This is a very material difference between the real value to the investor and the "phantom" value found in I.R.S. and court decisions, and can result in millions of dollars of over-valuation.

The balance of this article is an effort to bring clarity to the valuation of S corporations, in the hope that judges, practitioners, attorneys, and the courts can begin to understand the fundamental issues that drive the value of this form of entity.

Let's Start with Perspective

It is often said that beauty is in the eyes of the beholder; so, too, is value. This statement is true, no matter what one is valuing, or what standard of value one is using. Something does not have value unless it is desirable to someone. In order to determine its worth, the appraiser determines the qualities of the thing, whatever it is, that are desirable to the individuals who desire it. Is the diamond cut in a manner that is pleasing? Is it clear? Will it sparkle on her finger in a way that delights her? If she desires it, she will buy it. The diamond has no value on its own; it only has value when someone desires it, and believes that they will benefit from it personally; the greater the perceived benefit and value, the more they will pay. If it is cut poorly, if it has color and does not have clarity, and no one desires it, no one will buy it; it will have no value.

So it is with an investment. People invest, because they perceive a personal benefit to doing so. If there was no personal benefit, there would be no point. Whether you're considering investing in Google, Ohio Gas & Electric, or a U.S. Government bond, you

[3] This discussion does not bring in the many disadvantages of being an S corporation that are being brought before Congress even as this is being written. S corporation reform is being sought, in order to modernize S corporations and bring them in parity with other forms of entities such as LLC's and partnerships. Some practitioners believe that these factors serve to offset the financial benefits that accrue to an S corporation shareholder. These issues are beyond the scope of this simplified article, but are nevertheless substantive and should not be ignored in a complete analysis of the issue.

consider the amount of money that will eventually end up in your pocket. If you won't end up with anything in your pocket, you won't pay anything for it. If everyone in the market concludes that they won't end up with anything in their pockets from investing in an investment, then no one will buy it. Therefore, it will have no value. It has no value unless individuals decide, individually or collectively, that they desire to have it, because they will benefit from it.

It is no different with an investment in a closely-held business. Investors invest in them because they have an expectation that they will end up with a certain amount of money in their pocket. They measure the worth of that investment based on how much they expect to end up with—how much they will actually benefit from it. As Michael Paschall so aptly stated, a fine meal cannot be enjoyed unless it is actually eaten.[4]

So, what do we know about perspective when we value an investment?

> *Value is from the perspective of the individual investor, and reflects their expectation of what they, personally, will get out of it.*

Value and Taxes

Let's go back to our investment choices above.

You know that you want Google to pay a higher rate of return than Ohio Gas & Electric, because Ohio Gas will be tax-free to you. You'll accept the 4 or 5% rate of return on Ohio Gas & Electric because you won't have to pay any taxes on it when you get it. If Google started paying that, however, you'd dump it pretty quick, because the net to you, after you had paid your taxes, would be next to nothing.

Anyone who has done any amount of investing understands this fairly simple concept: if you have to pay taxes on the income you receive from an investment, you end up with less in your pocket than if you didn't have to pay taxes. Therefore, all things being equal, if one investment had taxes levied on it, and the other didn't, an investor would choose the one that didn't. This issue has formed the heart of the S corporation debate: an investment in an S corporation must be worth more than an investment in a publicly traded C corporation, simply because there is a level of taxes being avoided.

We know this about investments and taxes:

> *All things being equal, if you don't have to pay taxes, you end up with more money in your pocket relative to an investment on which you do have to pay taxes.*

[4] Paschall, Michael, *Some Observations on Tax-Affecting*, page 23, March 2005 Business Valuation Review, Volume 24, No. 1

What tax isn't being paid?

In order to understand what tax is being avoided, a brief review of the legislative history of Subchapter S is in order.[5]

From 1945 to 1950, the highest marginal tax rate for corporations ranged from 42% to 53%, while the highest rate at which individuals were taxed ranged from 82% to 91%. The double taxation system put a particular strain on small businesses. A corporation making $1,000,000 profit could end up paying $420,000 corporate income taxes, and another nearly $4-500,000 in individual taxes if all were distributed, leaving precious little for the investor's efforts. That said, then, as now, the distinction between the small corporation and the investor was something of a misnomer, as the investor controlled income, dividend, and compensation policy. The investor had the choice to simply not distribute profits, or to pay compensation (within limits) to dampen the affect of the dividend tax; still, it hampered businesses' that required the corporate protection of limited liability the ability to freely operate, particularly compared to the partnership form of entity, which had no such second level of tax.

Recognizing this, in 1954, President Eisenhower proposed that new, closely-held corporations with a small number of active shareholders have the option of being taxed in the same manner as partnerships, *in order to avoid the second level of tax on dividends*. While the Senate adopted this proposal, it did not pass the Conference Committee.

In 1958, President Eisenhower made his proposal to Congress again. These recommendations, along with Treasury-drafted provisions, developed into Subchapter S which Congress ultimately adopted in the Technical Amendments Act of 1958 under the Small Business Tax Revision Act. All corporate earnings would be treated as if they were distributed, and taxed once. In explaining the rationale, the committee wrote that they "…believe…that the enactment of a provision of this type is desirable because it permits businesses to select the form of business organization desired, without the necessity of taking into account major differences in tax consequence… Where the earnings are distributed (and are in excess of what may properly be classified as salary payments), the benefit will extend to individuals with somewhat higher rates *since in this case a "double" tax is removed*."[6]

Neither Eisenhower in his proposal, nor Congress in their adoption, had any intention of removing taxes on corporate income. Rather, their intent was to tax small corporations in the same manner as partnerships, and do away with the dividend tax that hampered the corporate form.

The tax avoided under the S corporation form of operating is the dividend tax that the individual has to pay.

[5] The Honorable Donald C. Alexander , testimony before the Subcommittee on Regulatory Reform and Oversight, June 27, 2006

[6] 1958 *U.S. Code Congressional and Administrative News*, p. 4876 (1959).

The current direction of the I.R.S. and the tax court on this issue is inconsistent with the very intention of subchapter S. The tax court has, in five decisions, eliminated any deduction for corporate income taxes. This implies that Congress intended to avoid taxes on corporate income, *and* avoid the dividend tax. Clearly, if this were the reality for owners of S corporations, it would both delight those owners, and break our federal (and state) budgets. While this many be wishful thinking, it is flawed, as any investor in an S corporation knows.

So how does our investor who is looking for the amount of cash that will end up in his pocket view this? Personal and corporate income tax rates are nearly equal, and the investor must pay taxes on the entire corporate income, whether it is distributed or not. No corporate income taxes are being avoided. *However, he will not have to pay dividend tax on any amount that is distributed to him—the exact result Congress intended. Therein lies the benefit of investing in an S corporation.*

What does this have to do with how we value the S Corporation?
Value is usually a function of two things:

1. How much cash flow a company produces, and
2. How much an investor will require for a rate of return in order to invest in that cash flow.

Let's compare how that analysis would work for two companies: Publico, a publicly traded stock, and SubSco, a private S corporation.

Let's assume you invest $1,000 in a publicly traded stock--Publico. You're an owner of Publico, just like the other hundreds (or thousands) of owners, yet you don't have to pay income taxes on the earnings of Publico, because as a publicly traded stock the company is a C corporation, paying taxes at the corporate level. You know that your share of Publico had $217 of pre-tax earnings, paid $87 of taxes, and reported net income of $130, which it paid to you as a dividend. Therefore, the $130 comes to you after corporate taxes have already been paid—a 13% return on your investment. You only have to pay taxes on the $130 dividend that you received. So, after paying $26 in dividend tax, you pocket $104. Publico reports a 13% rate of return[7] (the $130 dividend it paid out, divided by $1,000 you invested.)

Let's say that instead of investing in Publico, you want to consider investing in SubSco, a private Subchapter S company. It is identical to Publico, except that it is privately held. The CFO predicts that your share of the company's pre-tax earnings for that year will be $217, which you will report as taxable income on your personal tax return, and which you will receive in cash. As an S corporation shareholder, you will have to pay income tax on the corporate income allocated to you from SubSco. You will pay $87 in federal

[7] For simplicity's sake, this analysis has focused only on dividend returns assuming all earnings are distributed, and assuming net income equals cash flow; note public and private returns are actually made up of dividends and capital gains.

and state income tax, leaving you with a net $130. Since it is an S corporation, you won't have to pay any dividend tax, so you will pocket the entire $130—$26 more than if you had invested in Publico.

How do we value SubSco? Usually, value is determined by looking into the future, and trying to figure out how much cash will be produced *after taxes on corporate income have been satisfied*, and *before shareholder level taxes are assessed*—that is, before the "second level" of tax. The cash flow we would measure is $130 in the case of Publico. It would be the same cash flow if Publico were a private C corporation. *It is no different for SubSco, on whose earnings corporate income taxes must be paid; where it bears them makes no difference to the investor*[8]. Therefore, when we are valuing the S corporation, we would similarly measure $130 of income becoming available to the investor.

Once we predict how much cash we think the investment will produce before shareholder-level (dividend) taxes, we then have to determine an appropriate rate of return for the investment. This rate of return is the second part of the value equation.

In our calculations for Publico above, we calculated the return to the shareholder as follows:

Amount Invested	$1,000
Times Publico Rate of Return	X 13%
Equals dividend to investor in Publico	$ 130

The most basic way to calculate value is to reverse this calculation, as follows:

Dividend to investor in Publico	$ 130
Publico rate of return	./. 13%
Equals value of Investment in Publico	$1,000

Thus, if you know the dividend you expect to get and the company's rate of return, you can calculate how much you should be willing to invest in this manner.

These calculations for Publico confirm that value, rate of return, and the cash dividend to the investor are in synch with each other. Note that in deciding to accept the investment in Publico at a 13% rate of return, the investor expects to have to pay a dividend tax on the $130 dividend he receives.

When we value an S corporation, we obtain information about its future cash flow from the company, weighing in the outlook for the current industry and economic conditions. This is the amount that will be available as a dividend (the same thing as what we typically refer to as a distribution when we're talking about an S corporation) to the

[8] This statement sets minority and control issues aside, which may affect control over payment of distributions.

investor.[9] We reduce that cash flow by the taxes on corporate income that will be borne by the individual investor. Again, these taxes will be paid, and who pays them makes no difference to the investor. This is because the investor only cares about the amount that will end up in his pocket. Thus, it is the net, after-tax cash flow that we will value. *We will set aside for the moment, but will not forget, the avoided dividend tax—a benefit that we will come back to later.* For now, we need to find information that helps us predict an investor's rate of return for the S Corporation's net cash flow.

For this, the only place we have to go to for meaningful, substantive guidance is the public stock markets. In our example, the rate of return from the public stock markets was 13%. Remember, this is a rate of return that is after corporate income taxes, and before the investor's dividend taxes. From an investor in the public market's point of view, this rate is acceptable and is one that would induce him to invest $1,000 in Publico, knowing that he would end up with $104 in his pocket after he paid dividend taxes.

If we use this same rate of return to value SubSco's after-corporate tax income, we would get the same answer—that your investment is worth $1,000. However, we know that the cash that would end up in your pocket is more if you invest in SubSco than it would be if you invested in Publico—so all things being equal, you should be willing to pay more than $1,000. Why? Because you get to keep $26 more than if you invest in Publico. This is the benefit of the avoided dividend tax. But how much more should you be willing to pay? And how do you measure that in terms of value?

The Value of the Avoided Dividend Tax

In simple terms, the additional cash in the investor's pocket leads to additional value.

For SubSco, we calculate value the same way we always do: cash flow divided by rate of return. In this example, we have:

Dividend tax avoided (equals additional cash to investor relative to publicly traded C corporation)	$ 26
Divided by rate of return from public markets	./. 13%
Equals value of dividend tax avoided	$200

Adding this to the value determined for Publico, this tells us that you should be willing to invest $1,200 in SubSco—the $1,000 that you would be willing to invest in Publico, plus $200 for the value of the avoided dividend tax.

[9] The degree to which the cash flow available is paid out as current dividends influences the valuation in terms of both current recognition versus retained net income (basis), the latter of which may be deferred, and control versus minority issues.

We can see if this works, by checking the investment we have calculated for SubSco against the rate of return in the market:

Investment in SubSco	$1,200
Times rate of return from public markets	X 13%
C-Corp equivalent dividend to investor in SubSco	$ 156

In fact, this checks back to the return to an investor in SubSco:

After-corporate tax cash return same as Publico	$130
Additional savings from dividend tax avoided	$ 26
Total C-Corp equivalent dividend to investor in SubSco	$156

The "C corporation equivalent dividend" is the metric we should be calculating when using a rate of return from the public markets. This is because the rate of return from the public markets is one on which the investor expects taxes on corporate income to be satisfied, but out of which dividend taxes will have to be paid from personal funds. Thus, for the S corporation investor, we have calculated the equivalent publicly traded C corporation return after the satisfaction of corporate income taxes, but before the imposition of personal dividend taxes. Since the dividend tax rate for an S corporation shareholder is zero, the amount of implied dividend is necessarily higher than it is for a C corporation.

This calculation results in a premium for the S corporation of 20%, relative to the publicly traded C corporation.

Added complexity

All of these calculations assume that 100% of profits are paid out of the company to the investor. It gets a little more complicated when some of the earnings are retained by the company. In that case, the benefit of the avoided dividend tax is balanced by the avoidance of a portion of capital gains taxes when the stock is sold in the future. This is because if an S corporation does not distribute 100% of their earnings, those earnings increase the shareholders' basis in their stock.

Basis is the total amount the investor has invested in their stock. In the example of Publico, it will always be $1,000. In the case of SubSco, if all of the earnings are not distributed, the shareholder's basis will increase to greater than $1,000, by whatever earnings are not distributed. This will benefit a shareholder in SubSco when they sell their stock, as they will have a larger amount of basis to subtract from the sales price than would a shareholder in Publico, resulting in a lower taxable gain. Thus, the dividends, if not distributed this year, result in a benefit in a later year to the shareholder. That said, the risk of receiving the benefit of built-up basis is much greater than the risk of receiving current distributions of earnings. Therefore, in most models, they are discounted differently.

Why doesn't the model used in the Tax Court decisions work?
Several tax court cases have taken the position that it is *both the income tax and the dividend tax* that the S corporation shareholder is avoiding. Let's examine the economics of this position, using our same companies, Publico and SubSco.

Recall there are identical opportunities to invest in Publico or SubSco. We know that you are willing to invest $1,000 in Publico stock; you would receive a dividend of $130 and after payment of the dividend tax, you would pocket $104 on that investment.

Now let's look at the model used in the tax court decisions, and consider the investment in SubSco. Your share of the company's pre-tax earnings for that year will be $217, which, as in our prior example, will be allocated to you on a Form K-1, and will be distributed in cash. According to the tax court decisions, corporate taxes are avoided. However, you will still have to pay $87 in federal and state income tax on corporate earnings, leaving a net $130 in your pocket. Since it is an S corporation, you won't have to pay any further personal dividend or capital gains tax, so you will pocket the entire $130—$26 more than if you had invested it in Publico.

Now let's run through our value calculation, using these numbers:

Cash flow if income taxes are treated as avoided	$ 217
Divided by rate of return from public markets	./. 13%
Equals value of Investment	$1,669

Just as before, we can see if this works by checking the investment we have calculated for SubSco against the rate of return in the market, to ensure that the cash calculated indeed equals the amount of cash that the investor will end up with:

Value of Investment—assuming corporate taxes avoided	$1,669
Times rate of return from public markets	X 13%
C corporation equivalent dividend	$ 216

But wait—the investor will only have $130 in his pocket—a C corporation equivalent dividend of $156. Yet this calculation indicates that he should have a C corporation equivalent dividend of $216. The investor will not end up with nearly enough to cover the amount this calculation suggests that he should pay for the investment, because the investment isn't producing nearly the cash that the model predicted it would. More aptly put, the taxpayer was charged with a significantly overstated value, *created from a model that inherently predicts far more cash flow than is possible from the investment.*

What went wrong?
This model estimates a 67% premium for the S corporation, 47% more than the model described above. How can this happen?

The model used by the tax court and currently advocated by the I.R.S. infers that the investor in SubSco avoids the $87 income tax, instead of the $26 dividend tax. From the

perspective of the investor, the income tax is real and must be paid before value can be achieved, and it is only from the investor's standpoint that the investment must be viewed.

If we use a rate of return from the public stock markets, we must consider that those returns are *after corporate income tax obligations, but before personal (dividend) tax obligations*. To ignore the reality of corporate income taxes is to create phantom income for the S corporation shareholder, and to place a false burden on them.

It is also important to keep in mind that value in an S corporation is *relative to a publicly traded C corporation.* Holders of publicly traded stock must pay personal dividend and capital gains taxes on their investments, while these taxes are avoided by investors in S corporations. This is important because we use the rates of return of these publicly traded C corporation investors when we value an S corporation; in using this information, we must distinguish *that which is different* from *that which we borrowed*. The avoidance of the dividend tax is different. An S corporation owner will end up with more cash in their pocket as a result of the avoided dividend tax. This is the benefit that the economic models for the valuation of the S corporations measure. [10] [11]

Concluding Remarks

The valuation of S corporations has a solid foundation in financial and economic theory. While we have at least one opinion that demonstrated these economics, the Delaware Court of Chancery in the case of *Delaware Open MRI Radiology Associates*[12], these financial fundamentals have yet to be embraced by financial analysts, and have been largely ignored by the courts as a result. It is my hope that with a simplified view of the issue, more analysts, attorneys, and judges can begin to understand this issue which affects over 3.5 million U.S. companies and their investors.

[10] Note in particular that we do not use private C corporation rate of return information in the valuation of S corporations—we use publicly traded C corporation rates of return. Therefore, studies comparing the value of S corporations to private C corporations, while pointing out useful information about the relative value of different forms of private corporations to each other, are a separate discussion from the impact of public C corporation rates of return on an S corporation's value. This is a complex issue that involves many separate considerations outside of the issues discussed in this article, notably the value drivers in each of these forms of private entities, which empirical data shows to be dramatically different. A further discussion of this complex issue is beyond the scope of this article, but there is little doubt that the lack of attention given to these differences has hindered the advancement of the "S versus C" value discussion.

[11] Note that in many cases it is also appropriate to consider the benefit of additional shareholder basis; however, a full discussion of this issue is beyond the scope of this article.

[12] DE Open MRI Radiology Associates v. Howard B. Kessler, et al. CA-275-N

