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S Corporation Tax Treatment for Minority Interests

Suggested Treatment for a Controversial Issue

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Overview of S Corporation Tax Affecting Issue

A primary benefit of S corporation status is the avoidance of double taxation. In S corporations, earnings are not taxed at the corporate level for federal income tax purposes, thereby avoiding the double taxation that occurs in C corporations where earnings are taxed both at the corporate level and at the personal level when the earnings are distributed. The elimination of federal taxes at the corporate level is clearly a benefit to the shareholders and has been a motivating factor for many businesses to make conversions from C corporation status to S corporation status.

For valuation purposes, however, it has been common for a large percentage of appraisers to adjust S corporation earnings by deducting C corporation taxes in determining the income stream of a company to be capitalized or to which valuation multiples will be applied. The application of C corporation taxes to S corporation earnings has led to much disagreement in the appraisal profession and continues to be an issue of spirited debate. The spectrum of disagreement ranges from those that believe C corporation taxes should be applied to the full amount of S corporation earnings, to those that believe no adjustment at all for taxes should be applied to S corporation earnings.

The purpose of this article is to identify the areas of concern and to present a methodology that business appraisers can implement for the valuation of a minority interest in an S corporation based upon the projected net cash flow for an S corporation while incorporating the favorable tax treatment that an S corporation enjoys. This proposed methodology is based on a 1995 article written in *Business Valuation Review.*[1]

In certain instances, it is reasonable that S corporation earnings should be fully tax affected for C corporation taxes. For example, if a controlling interest is being appraised for purposes of the sale of the entity to a C corporation, or when the pool of potential buyers is limited to C corporations, the earnings should be tax affected for C corporation taxes. Additionally, if the pass-through status of the S corporation is expected to terminate in the near future, application of the C corporation taxes would be appropriate. Contrarily, when valuing a minority interest that cannot control the sale of the company and when a sale is not anticipated, tax affecting the full amount of the S corporation earnings may not be appropriate (depending upon the facts).

Table 1

Fiscal Year	Net Income	Shareholder Distributions	Distribution Percentage
1988	$17,731,135	$17,778,483	100.3%
1989	$19,479,830	$19,458,148	99.9%
1990	$23,946,605	$24,032,651	100.4%
1991	$24,338,440	$24,126,041	99.1%
1992	$27,585,873	$28,188,889	102.2%

Tax Court Opinions

Several recent tax court cases reflect the courts' position that tax affecting S corporation earnings for C corporation taxes will no longer be accepted as routine or entirely appropriate. The most highly publicized case is *Walter L. Gross, Jr., et ux., et. al. v. Commissioner.*[2] The company involved, G&J Pepsi-Cola Bottlers, Inc. (G&J), had historically paid out 100% or more of its net income in the form of distributions to its shareholders. Furthermore, there was no expectation to sell the company to a C corporation and there was no expectation for the company to lose its S corporation status. G&J's net income and distributions for the five years prior to the valuation date are shown in Table 1.

G&J was expected to continue to distribute 100% of its net income in the future. After both the taxpayer and IRS had presented their arguments, the Tax Court stated that there is an advantage to being an S corporation and that an appraiser should identify the economic benefit to the shareholder to determine a proper appraisal. The *Gross* Court stated:

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> We believe that the principal benefit that shareholders expect from an S Corporation election is a reduction in the total tax burden imposed on the enterprise. The owners expect to save money, and we see no reason why that savings ought to be ignored as a matter of course in valuing the S corporation.

On appeal, the judges on the U.S. Court of Appeals for the Sixth Circuit were in disagreement over the application of corporate taxes with the majority ruling that tax affecting earnings was not appropriate.[3]

In *Estate of William G Adams, Jr. v. Commissioner*,[4] the court ruled that it was not appropriate to tax affect the net cash flow of the entity involved because the entity was "an S corporation and its cash flows are subject to a zero corporate tax rate." The *Adams* Court held that ". . . it is appropriate to use a zero corporate tax rate to estimate net cash flow when the stock being valued is stock of an S corporation."

In *John E. Wall v. Commissioner*,[5] both the taxpayer's expert and the IRS's expert applied C corporation tax rates to the cash flows of an S corporation in order to calculate a value. The Tax Court took exception to the application of C corporation taxes, stating:

> We note that [both the IRS and taxpayer experts] tax effected Demco's future cash-flows by subtracting hypothetical income tax from Demco's projected net income ... We believe this is likely to result in an undervaluation of Demco because Demco is an S corporation.

Consideration of Economic Benefits

To resolve the differences of opinion that exist, it is important to focus on the specific benefits available to the shareholder of the respective entities. As noted in the 4th edition of *Valuing A Business*, "In theory, the value of a business or an interest in a business depends on the future benefits that will accrue to it . . ."[6]

Therefore, to properly value an interest in an S corporation, an appraiser must identify and focus on the economic benefit to the equity holder. The economic benefit to be determined is the cash flow available for distribution that can be retained by the shareholder immediately prior to the application of personal taxes.

When valuing a C corporation, deriving an estimate of future benefits is relatively straightforward using the income approach. An appraiser projects net cash flow available for distribution by:

- Analyzing the company's historical performance,
- Forecasting sales, expenses and income from operations,
- Deducting state and federal taxes,
- Adding back depreciation,
- Deducting capital expenditures and required increases in working capital,
- Adding or subtracting changes in debt.

The forecast of available cash flow reflects the amount that can be distributed and utilized by the shareholder of a C corporation immediately prior to payment of personal taxes. Upon distribution of the earnings, the shareholder will be subjected to personal taxes on the amount distributed.

When valuing S corporations, determining the specific benefits requires consideration of key differences that exist between C corporations and S corporations. Whereas C corporations pay federal taxes, which can reduce net income by 30% to 40%, an S corporation does not pay federal taxes, which results in a significantly greater level of cash flow available for distribution to the shareholder. While a C corporation will have less cash flow available for distribution, the shareholder will not pay personal taxes until the cash flow is actually distributed. Contrarily, the S corporation will have a greater level of cash flow available for distribution, and the shareholder is liable for personal taxes regardless of whether it is distributed or not. In the event the available cash flow of the S corporation is not distributed, the shareholder will pay taxes on the full amount but can receive the distributions at a later date without additional personal tax consequences.

Many appraisers argue that the possibility exists that a shareholder of an S corporation may be required to pay taxes on earnings that are never distributed, thereby reducing the value and increasing the risk to the S corporation shareholder. This is an invalid assumption to make for valuation purposes. It is not reasonable to assume that a shareholder would make an investment in an S corporation unless such issues had been satisfactorily addressed (i.e., that at least sufficient distributions would be made to satisfy the tax liability of the shareholders). Further, to assume that no distributions were made would place both the controlling shareholder and the minority shareholder in the same predicament. In most cases, it is unreasonable to assume that the controlling shareholder would be in a position to pay taxes on earnings that are never received. Rather, at a minimum, the controlling shareholder would pay sufficient dividends to cover the tax liability on the earnings generated. To do less than this could be viewed as unfavorable treatment to the minority shareholders and a violation of the controlling shareholder's fiduciary duty.

Another argument raised by practitioners preferring to apply C corporation tax rates to S corporation earnings is that the discount rate used in the income approach is based on rates of return from C corporations in the public market. According to the *Guide to Business Valuations*:

> The capitalization rates determined in accordance with either the build-up method or the CAPM method . . . relate to after tax earnings. Many valuation practitioners therefore feel that the earnings of an S Corporation, partnership or proprietorship should be tax effected.[7]

While this sounds logical, it is not supported by the authorities that provide rate of return information generally relied on for valuation purposes. Many appraisers use Ibbotson Associates' *Stocks, Bonds, Bills and Inflation Yearbook* or similar sources of information to calculate discount rates. Ibbotson's equity returns are calculated on an after-corporate-tax but pre-personal-tax basis. Ibbotson states the following concerning the nature of its rate of return data: ". . . Ibbotson Associates uses the total return . . . comprised of income return, reinvestment of income return and capital appreciation . . ."[8]

When valuing a noncontrolling interest, what is being valued is the return to the investor, which is defined as the benefit to the shareholder before personal taxes. The Grabowski/King studies by PricewaterhouseCoopers (now subsequently produced by S&P Corporate Value Consulting and available through Ibbotson Associates) also base their discount rate calculations on the same premise. Their study states that "Our measure of return is based on dividend income and capital appreciation..."[9]

In both cases, these authorities provide discount rate information based on the return to the investor. This is crucial because instead of viewing returns as after corporate taxes, appraisers should be viewing them as before personal taxes.

The objective of the appraiser, then, is to quantify the cash flow of the S corporation available for either immediate or subsequent distribution, prior to consideration of personal tax consequences. A key element for consideration is the amount of cash flow required for reinvestment to support ongoing operations. The shareholder will be required to pay personal taxes on the reinvestment amount, which reduces the amount of cash flow available for the personal use and consumption of the shareholder. The amount of personal taxes paid on the amount of cash flow required to sustain existing operations and achieve the forecasted level of growth represents an after-personal-tax reinvestment and a reduction of the economic benefit available to the shareholder. Whether valuing a C corporation or S corporation, the focus should be shifted to the amount of dollars shareholders can actually retain for their own benefit.

Application of Valuation Methodology

To illustrate the impact of the application of federal taxes when valuing an S corporation, the following simplified example is provided. As shown in Table 2, comparable cash flow streams are valued both as a C corporation, including the application of federal taxes, and an S corporation, excluding the application of federal taxes.

Both entities have a comparable level of operating income of $200,000. The C corporation has net income of $120,000, assuming a corporate tax rate of 40%, and the S corporation has a net income that would equal $200,000 since it is not subject to corporate taxes.

After deductions for reinvestment, net cash flow available for distribution equals $90,000 for the C corporation and $170,000 for the S corporation. Therefore, the difference in net cash flow between the two entities would be $80,000. Assuming a capitalization rate of 25%, the difference in the value of the companies would be $320,000.

On the surface, it would appear that the cash flow available for use by the shareholder would be $90,000 for the C corporation and $170,000 for the S corporation. However, this is not the case. Although both entities required the reinvestment of $30,000 to support the ongoing operations of the entities, the shareholder of the S corporation will be subjected to personal taxes on the $30,000 reinvestment amount. The taxes paid on the reinvestment amount further reduce the economic benefit to the S corporation shareholders and will not be available for their personal consumption.

Table 2: Example of Differences in Value Between C Corps. and S Corps.

	C Corp.	S Corp.	Difference
Sales	$1,000,000	$1,000,000	
Cost of Goods Sold	$500,000	$500,000	
Gross Profit	$500,000	$500,000	
Operating Expenses	$300,000	$300,000	
Operating Income	$200,000	$200,000	
Taxes	($80,000)	$0	
Net Income	**$120,000**	**$200,000**	**$80,000**
Net Reinvestment			
Plus Depreciation	$50,000	$50,000	
Less Capital Expenditures	($70,000)	($70,000)	
Less Increases in Working Capital	($10,000)	($10,000)	
Changes in Debt	($30,000)	($30,000)	
Net Cash Flow	**$90,000**	**$170,000**	**$80,000**
Capitalized @ 25%	**$360,000**	**$680,000**	**$320,000**

To account for the reduction of benefit to the S corporation shareholder due to the personal taxes paid on the amount of income reinvested into the company, a further adjustment to the cash flow available for use by the S corporation shareholder must be considered. To quantify the actual benefit to the shareholder, the $30,000 that is reinvested should be multiplied by an estimate of personal taxes (assume 36% as used in Table 3) that must be paid by the S corporation shareholder, as shown in Table 3. The result is that the value of the S corporation is more than if it were taxed as a C corporation, but not as much as if corporate taxes were excluded entirely.

In utilizing the above analysis for valuing S corporations, an appraiser would perform the followings steps:

1. Derive adjusted net income,
2. Determine the required reinvestment to support ongoing operations,
3. Estimate and deduct personal taxes on the reinvestment amount not available to the shareholder to derive the actual benefit to the shareholder.

The above computation results in the estimated economic benefit to the S corporation shareholder.

Conclusion

When companies do not require large levels of reinvestment into fixed assets and working capital, there are significant economic benefits to operating as an S corporation as opposed to a C corporation. It is because of the increased benefit to the shareholders that many companies are willing to incur the expense to make the conversion from a C corporation to an S corporation. The reduction of federal taxes results in an increased level of cash flow available for distribution to the shareholders. The increased level of cash flow results in an increase in the value of the entity and should not be ignored. By focusing on the level of cash flow that can be utilized by shareholders for their own personal consumption, a reasonable estimate of value for an interest in an S corporation can be derived.

End Notes

1 "Tax Treatment When Valuing S-Corporations Using the Income Approach," *Business Valuation Review*, Vol. 14, No. 2 (June 1995), 83-85.

2 78 TCM 201, T.C. Memo. 1999-254, CCH Dec. 53,481(M).

3 CA-6, 2001-2 USTC ¶60,425, 272 F3d 333.

4 83 TCM 1421, T.C. Memo. 2002-80, CCH Dec. 54,696(M).

5 81 TCM 1425, T.C. Memo 2001-75, CCH Dec. 54,289(M).

6 Shannon Pratt, Robert Reilly, and Robert Schweihs, *Valuing A Business*, 4th ed. (New York: McGraw-Hill, 2000), 153.

7 Jay Fishman, et al., *Guide to Business Valuation* (Forth Worth, Texas: Practitioners Publishing Company, 2000), 5-35, 5-36.

8 Ibbotson Associates, *2001 Stocks, Bonds, Bills and Inflation Yearbook: Valuation Edition*, pp. 56, 250.

9 Roger Grabowski and David King, "New Evidence on Equity Returns and Company Risk," p.7.

Table 3: Incorporating an Additional S Corporation Adjustment Factor

	C Corp.	S Corp.	Difference
Sales	$1,000,000	$1,000,000	
Cost of Goods Sold	$500,000	$500,000	
Gross Profit	$500,000	$500,000	
Operating Expenses	$300,000	$300,000	
Operating Income	$200,000	$200,000	
Taxes	($80,000)	$0	
Net Income	$120,000	$200,000	$80,000
Net Reinvestment			
Plus Depreciation	$50,000	$50,000	
Less Capital Expenditures	($70,000)	($70,000)	
Less Increases in Working Capital	($10,000)	($10,000)	
Changes in Debt	$0	$0	
Net Reinvestment	($30,000)	($30,000)	
S Corporation Adjustment	**$0**	**($10,800)**	
Net Cash Flow	$90,000	$159,200	$69,200
Capitalized @ 25%	**$360,000**	**$636,800**	**$276,800**