S Corporation Valuation Analysis Considerations

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This discussion addresses issues that the valuation analyst ("analyst") may consider when developing the business or stock valuation of an S corporation. These valuation issues include (1) the appropriate level of value for the valuation, (2) the sources of empirical data on which the analyst may rely, (3) the economic benefits associated with the S corporation's tax pass-through entity ("TPE") income tax status, (4) the quantitative models that analysts apply to account for the economic benefit associated with TPE tax status, and (5) the judicial precedent related to TPE valuation adjustments. Specifically, this discussion summarizes the so-called dividend income tax avoidance valuation adjustment model that was applied in the Estate of Jones *U.S. Tax Court judicial decision.*

Introduction

Historically businesses had two choices regarding federal income taxation status—before the Department of Treasury proposed the concept of creating an entity that had both:

1. a single layer of federal taxation and
2. limited liability protection.

That is, a business could elect C corporation federal income tax status that offered limited liability but was subject to taxation both on corporate income and shareholder distributions. Alternatively, a business could elect to be taxed as a partnership or sole proprietorship. While this structure shielded the business owners from double taxation, it offered no mitigation of liability.

Neither of these alternative income tax status elections were particularly advantageous to the typical small business.

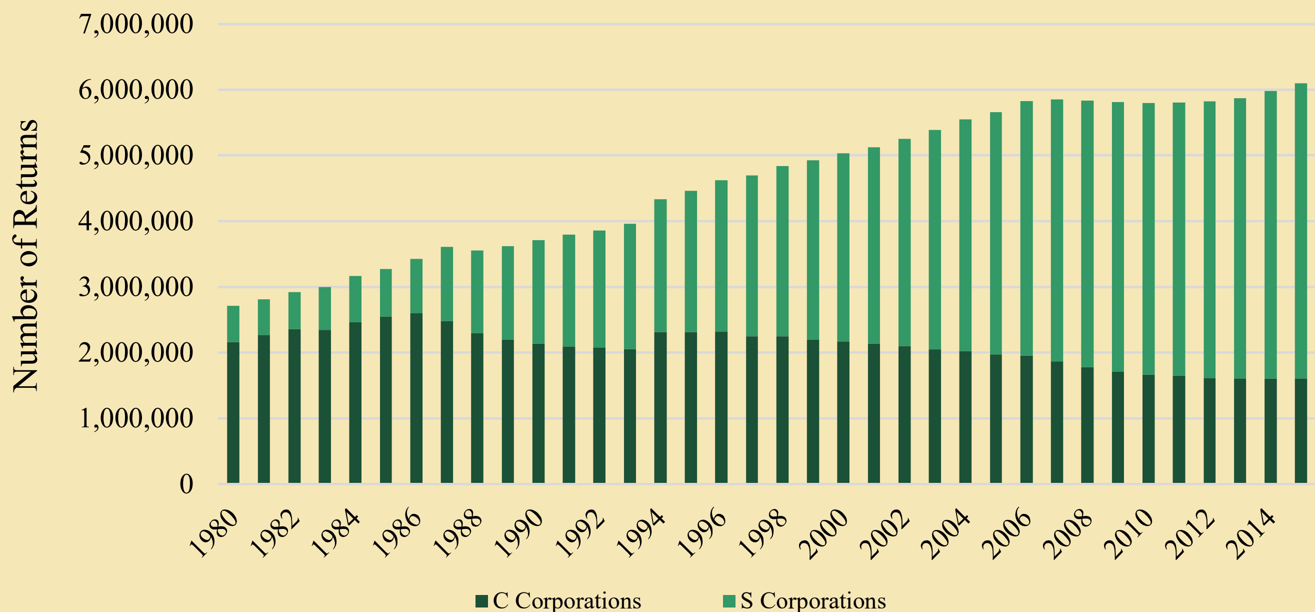
In 1958, Congress created the S corporation as part of a tax program to aid small businesses. The congressional intent was to mitigate the influence of income tax considerations in the selection of business form—by providing certain corporate entities and shareholders with the option to be taxed on a partnership basis. Therefore, S corporations achieved the advantageous corporate characteristics of limited liability—combined with the pass-through income attributes of a partnership.

Since the creation of subchapter S of the Internal Revenue Code, S corporations have become the most common business taxation structure in the United States.[1]

According to the most recently published statistics of the Internal Revenue Service (the "Service"), there were approximately 4.5 million S corporations operating in the United States as of 2015.[2]

Figure 1 illustrates the allocation of corporate income tax returns filed by S and C corporations between 1980 and 2015. Specifically, S corporations accounted for 20.1 percent of corporate income tax returns filed by corporations during 1980. That figure increased to 77.3 percent for the 2015 tax year.

Figure 1
S Corporation and C Corporation
Income Tax Returns Filed between 1980 and 2015



Therefore, it is important for a valuation analyst ("analyst") to be cognizant of (1) issues that may arise when developing a business valuation of an S corporation and (2) relevant judicial precedent guidance to both taxpayers and analysts concerning such issues.

Definition of an S Corporation

The Internal Revenue Code defines S corporations as "corporations that elect to pass corporate income, losses, deduction, and credits through to their shareholders for federal tax purposes."

S corporation shareholders (1) report their pro rata share of pass-through income and losses on their personal income tax returns and (2) pay federal income tax at their individual income tax rates. Additionally, dividends paid to shareholders (in excess of the amount of income tax due on the shareholder's pro rata share of S corporation taxable income) are received without the burden of federal income taxes.

Finally, the S corporation income that is not distributed will increase the equity tax basis of its shareholders.

In contrast, C corporations (1) are subject to income taxes at the corporate level, (2) are subject to dividend income taxes at the shareholder level, and (3) do not increase the equity tax basis by retaining earnings.

According to Internal Revenue Code Section 1361 and the corresponding Treasury Regulations, a company may elect S corporation status if the following criteria are met:

- The corporation must be a domestic corporation.
- The corporation must have only allowable shareholders which include the following:
    1. Individuals
    2. Certain trusts
    3. Estates
- Shareholders that do not meet the allowable shareholder criteria are as follows:
    1. Partnerships
    2. Other corporations
    3. Nonresident aliens
- The corporation must not have more than 100 shareholders.
- The corporation must only maintain one class of stock. As such, distributions and liquidations to shareholders must be made on a pro rata basis. However, the single class of stock can be differentiated with voting and nonvoting characteristics.

- The corporation must not be classified as an ineligible corporation; ineligible corporations include the following:
  1. Certain financial institutions
  2. Insurance companies
  3. Domestic international sales corporations

If the company meets the criteria listed above and elects S corporation status, the analyst should be aware of (1) the potential economic benefits associated with the advantageous business tax structure and (2) the various empirical data that may be applied in the course of developing the S corporation business valuation.

S Corporation Valuation Considerations

When developing an S corporation business valuation, the analyst typically considers the following questions:

1. Is there incremental value attributable to the income tax advantages of the company's tax pass-through entity ("TPE") status? If so, what is the most appropriate method to account for this incremental value in the business valuation?
2. Was the value of the S corporation derived from comparison with valuation characteristics of non-TPE entities? If so, what adjustments are appropriate to apply to the valuation of the subject S corporation?

There is not a one-size-fits-all answer to these questions. The analyst should first consider the assignment purpose and objective before selecting the appropriate (1) business valuation approaches and methods or (2) TPE-related valuation adjustments.

The following sections outline specific valuation considerations that an analyst should be aware of when developing a business valuation. A multitude of factors differentiate S corporations. Therefore, the following sections do not encompass all of the valuation issues an analyst may consider when developing an S corporation business valuation .

Level of Value

Controlling Equity Ownership Interest

It is important that the analyst understand the purpose and objective of the assignment before beginning any analysis of the S corporation. If the valuation purpose is to estimate the value of an S corporation controlling ownership interest for purposes of buying, selling, or merging the company, then the company's income tax status should be considered in the valuation.

One example of when a C corporation acquirer would pay a price premium for a TPE would be if the transaction included an election under Internal Revenue Code Section 338(h)(10) ("Section 338 election"). The Section 338 election may be made when the shareholders of the acquired company sell at least 80 percent of the equity.

The Section 338 election allows a stock equity purchase to be treated as if it were an asset purchase. This provides certain federal income tax advantages to the acquirer.[3]

It has been observed that "the positive income tax benefits to the buyer—of the step-up in the basis of the acquired assets available under the Section 338 election—is often much greater than the negative income tax attributes to the seller."[4]

Not only does the seller pay higher income taxes under a Section 338 election, but the buyer enjoys income tax advantages. A seller may use this as a bargaining chip when negotiating the transaction terms, effectively increasing the acquisition price in exchange for agreeing to the Section 338 election, which benefits the acquirer.[5]

This situation would be similar to the reason why acquirers pay control price premiums of which a portion of the premium includes synergies. Essentially, buyers and sellers share in the cost savings as part of the transaction consideration.

A specific example of this occurring is when Marvin J. Herb sold his Chicago bottling company to Coca-Cola Enterprises Inc. in 2001. The Chicago bottling company was an S corporation. The transaction was structured as an equity sale under a Section 338 election, under which Coca-Cola Enterprises identified $125 million in income tax savings it would achieve under Section 338. A spokesman for Coca-Cola Enterprises Inc. confirmed that it increased the price paid to Mr. Herb by $100 million due to these income tax benefits.[6]

Noncontrolling Equity Ownership Interest

If the analyst is developing a noncontrolling ownership interest valuation, then a direct comparison with values of other noncontrolling ownership interests may be an appropriate procedure in the business valuation. However, there may be a lack of reliable empirical data related to transactions involving noncontrolling equity ownership in S corporations.

Examples of situations in which the analyst may rely on empirical market data of publicly traded C corporations include the following:

- The analyst may apply an income approach method (i.e., the direct capitalization method or the discounted cash flow method). In the application of these income approach methods, the direct capitalization rate or the present value discount rate may be derived from empirical studies of investment rates of return on noncontrolling equity ownership interests in publicly traded C corporations.
- The analyst may apply a market approach method (i.e., the guideline publicly traded company method) to estimate the value of the S corporation equity interest. When applying the guideline publicly traded company method, pricing multiples applied to the subject S corporation are derived from empirical studies of (1) stock prices and (2) financial fundamentals of publicly traded C corporations.
- The analyst may apply (1) the market approach guideline merged and acquired company method or (2) an asset-based approach business valuation method to estimate the value of the S corporation equity interest. However, these valuation methods develop indications of value on a controlling interest level of value basis. In order to develop an opinion on a noncontrolling interest level of value basis, the analyst typically applies a discount for lack of control ("DLOC"). Such a DLOC may be derived from empirical studies of acquisitions price premiums paid for the equity securities of publicly traded C corporations.

If the analyst relies on empirical market data of publicly traded C corporations, all three generally accepted business valuation approaches can yield the equivalent value of a noncontrolling interest in a C corporation for a noncontrolling interest in an S corporation.

There are differences in the tax treatment of corporate income, dividends, and capital gains between S corporations, C corporations, and their respective shareholders. Those disparities in the income tax treatment of S corporations and C corporations may result in differing economic benefits attributable to the shareholders of each respective entity.

Exhibit 1 illustrates an example of those economic benefits. Exhibit 1 was developed using the following assumptions:

- Distribution (i.e., dividend) payout ratio of 50 percent of net income
- C corporation corporate income tax rate of 35 percent
- Individual ordinary income tax rate of 35 percent
- Dividend income tax rate of 15 percent
- Capital gains income tax rate of 15 percent
- Capital gains tax liability is economically recognized when incurred
- Capital appreciation of equity is derived from increases in retained earnings on a dollar-for-dollar basis
- No adjustment was made for qualified business income or the operations of the subject company

As presented in Exhibit 1, the net economic benefit differs between S corporation shareholders and C corporation shareholders. The primary economic benefit to the shareholders of an S corporation is the avoidance of double taxation on dividend income.

As such, analysts have developed and applied several models to measure the economic benefit to shareholders associated with the S corporation TPE taxation status.

Some of the economic generally accepted applied models that quantify this benefit include (1) the Van Vleet (S corporation economic adjustment multiple or "SEAM") model, (2) the Treharne model, (3) the Mercer model, (4) the Grabowski model, (5) the Fannon model, (6) the Sellers model, and (7) the adjustment for dividend income tax avoidance model.

This discussion focuses on one of these mathematical frameworks that quantify the adjustment that may be applied to the unadjusted equity value of an S corporation to account for differences in taxation status: the adjustment for dividend income tax avoidance model.

Adjustment for Dividend Income Tax Avoidance Model

As presented in Exhibit 1, a primary economic benefit to the S corporation shareholder is the avoidance of the C corporation dividend income tax on earnings that have already been taxed at the corporate level. The adjustment for dividend income tax avoidance model measures the economic benefit to S corporation shareholders through the application of an income approach valuation method (e.g., the direct capitalization method).

Exhibit 1
C Corporation versus S Corporation Income Tax Status
Comparison of the Net Economic Benefit to the Corporation Shareholders

Financial Fundamental		C Corporation	S Corporation
Pretax Income		$ 100,000	$ 100,000
Provision for Corporate Income Taxes	35%	$ (35,000)	NM
Net Income		$ 65,000	$ 100,000
Dividends:			
Distributions to S Corporation Shareholders	50%	NM	$ 50,000
Income Taxes Due by S Corporation Shareholders	35%	NM	$ (35,000)
Net Cash Flow Benefit to S Corporation Shareholders		NM	**$ 15,000**
Dividends to C Corporation Shareholders	50%	$ 32,500	NM
Dividend Tax Due by C Corporation Shareholders	15%	$ (4,875)	NM
Net Cash Flow Benefit to C Corporation Shareholders		**$ 27,625**	NM
Capital Gain:			
Net Income		$ 65,000	$ 100,000
Distributions/Dividends		$ (32,500)	$ (50,000)
Retained Earnings (net capital gain)		$ 32,500	$ 50,000
Effect of Increase in Income Tax Basis of Shares		NM	$ (50,000)
Taxable Capital Gain		$ 32,500	$ -
Capital Gain Tax Liability	15%	$ (4,875)	$ -
Net Capital Gain to Shareholders		**$ 27,625**	**$ 50,000**
Total Net Economic Benefit to Shareholders:			
Net Cash Flow Benefit to Shareholders		$ 27,625	$ 15,000
Net Capital Gain to Shareholders		$ 27,625	$ 50,000
Total Net Economic Benefit to Shareholders		**$ 55,250**	**$ 65,000**

Specifically, the analyst (1) estimates a normalized level of distributions (in excess of S corporation shareholder income tax liabilities), (2) estimates dividend income tax savings associated with those previously calculated excess distributions, and (3) capitalizes that level of savings into perpetuity in order to estimate the economic benefit attributable to the S corporation shareholders.

Normalized Level of Distributions

In applying the adjustment for the dividend income tax avoidance model, the analyst estimates a normalized level of income distributions in excess of shareholder income tax liabilities. Shareholders of an S corporation are taxed based on their apportionment of corporate income—whether or not that income is distributed.

Any S corporation income distributed to the shareholders in excess of their individual income tax liability is passed through tax free to the shareholder. Therefore, the analyst may estimate a normalized level of excess shareholder distributions to quantify the income tax savings.

The analyst may consider multiple factors when estimating a normalized level of distributions for the S corporation. Those factors may include, but are not limited to, the following:

1. The level of historical income distributions made to shareholders by the S corporation. If the S corporation has a specific policy

regarding the level of historical distributions, this policy may inform the future distribution expectations.

2. The level of income distributions projected to be paid by the S corporation. As a part of the due diligence process in the valuation engagement, the analyst should conduct a management interview. Information obtained from this management interview may help the analyst select a normalized level of distributions.
3. The stage in the business life cycle the subject S corporation occupies. For example, a start-up or growth-stage company may allocate substantially all of its cash flow to invest in business opportunities instead of shareholder distributions.
4. The current performance and outlook of the industry in which the S corporation operates. Strong industry performance may lead to excess cash flow generation by industry operators, which may then be distributed to shareholders.
5. The availability of investment opportunities with strong anticipated returns. The S corporation may be more likely to allocate funds to profitable investment opportunities than distributions if it can generate a strong return on that investment.

After estimating a normalized level of income distribution in excess of shareholder income tax liabilities, the analyst calculates the normalized benefit associated with dividend income tax avoidance, as compared to a C corporation.

Normalized Benefit for Dividend Income Tax Avoidance

The normalized benefit for dividend income tax avoidance is calculated by multiplying the normalized level of distributions (in excess of shareholder income tax liabilities) by the estimated income tax rate on dividend income.

The estimated income tax rate on dividend income has three components:

1. The federal dividend income tax rate
2. The state dividend income tax rate
3. The net investment income tax rate

For federal income tax purposes, dividends can be categorized as either ordinary or qualified. Ordinary dividends are taxed at the shareholder's standard income tax rate. However, qualified dividends are dividends that are subject to the 0 percent, 15 percent, or 20 percent maximum tax rate that applies to capital gains.[7]

The net investment income tax is imposed by Section 1411. The net investment income applies at a rate of 3.8 percent to certain net investment income earned by individuals, estates, and trusts that have income above statutory thresholds.[8]

After calculating the normalized benefit for income tax avoidance, the analyst should divide that figure by the applicable direct capitalization rate in order to estimate the present value of the benefit of dividend income tax avoidance.

Direct Capitalization Rate

The direct capitalization rate is equal to the present value discount rate (typically the "WACC") less the expected long-term growth rate. The WACC represents the weighted average cost of each of the components in the S corporation's capital structure. In this scenario, the analyst develops an opinion of value on a noncontrolling level of value basis. Therefore, the WACC is based on the actual capital structure of the S corporation.

The basic formula for calculating an after-tax WACC and the implied direct capitalization rate is as follows:

$$\text{Direct Capitalization Rate} = \text{WACC} - g$$

$$\text{WACC} = (Ke \times We) + (Kd\,[1-t] \times Wd)$$

where:

g	=	Expected long-term growth rate
Ke	=	Cost of equity capital
Kd	=	Pretax cost of debt capital
We	=	Percentage of equity capital in the capital structure
Wd	=	Percentage of debt capital in the capital structure
t	=	Effective C corporation income tax rate

The analyst divides the normalized benefit for income tax avoidance by the direct capitalization rate in order to estimate the present value of the benefit of dividend income tax avoidance associated with the S corporation status.

Implied TPE Benefit

The economic benefit associated with dividend income tax avoidance is often presented as a

percentage premium that applies to the indicated value of equity of the S corporation. In order to calculate that percentage premium, the analyst divides the present value of dividend income tax avoidance by the indicated C corporation equivalent value of equity.

Exhibit 2 illustrates the calculation of the implied TPE benefit based on the adjustment for dividend income tax avoidance model.

Exhibit 2 was developed using the following assumptions:

- Normal level of shareholder distributions (in excess of tax liabilities) of $20,000
- C corporation dividend income tax rate of 30 percent
- Direct capitalization rate of 12 percent
- Indicated value of equity (C corporation equivalent value) of $1,000,000

The model, illustrated by the figure presented in Exhibit 2, concludes a 5 percent premium to indicated C corporation equivalent equity value attributable to the TPE status of the S corporation.

The following sections summarize a recent judicial opinion of the U.S. Tax Court related to tax affecting and subsequent adjustments when valuing an S corporation.

The Estate of Aaron U. Jones[9]

The ongoing debate regarding the appropriate application of income tax in a valuation of a TPE has frequently made its way to the U.S. Tax Court. The Service has consistently opposed applying income taxes on TPEs (i.e., partnerships and S corporations) when conducting a business valuation.

However, the judicial decision in the *Estate of Aaron U. Jones v. Commissioner of Internal Revenue* ("*Jones*") represents a landmark decision which confirms that the federal court system may consider the application of income taxes when valuing a TPE.

In the *Jones* case, Willamette Management Associates ("Willamette") was retained by the estate's counsel to provide valuation analysis and testifying expert services. The Tax Court agreed with the Willamette valuation inputs and assumptions in all material respects.[10]

There were a variety of issues considered in the *Jones* decision. But this discussion focuses on the issue of applying income tax to the valuation of a TPE. The Willamette analyst stated that it was appropriate (1) to treat the subject TPEs as C corporations from an income tax perspective and (2) to apply a premium to account for the economic benefit associated with dividend income tax avoidance.

The Willamette analyst provided the following reasons to substantiate his income tax valuation variables:

1. The present value discount rate applied was based on empirical data derived from publicly traded C corporations.
2. The pool of hypothetical willing buyers of a subject TPE often consists of C corporations that may not pay a premium for TPE income tax status.
3. The subject TPEs incurred income taxes at the shareholder level. Therefore, the subject TPEs incurred income tax expenses in the form of shareholder distributions for their respective income tax liabilities.

In the *Jones* case, the Willamette Management Associates analyst applied the adjustment for dividend income tax avoidance model to quantify the premium associated with subject entities' TPE status.

The analyst provided the following support for this position on a premium for the TPE tax status:

Exhibit 2
Illustrative Example of the TPE Valuation Adjustment Dividend Income Tax Avoidance Model

	Value
Normal Level of Shareholder Distributions (excess of income tax liabilities)	$ 20,000
Multiplied by: C Corporation Dividend Income Tax Rate (%)	30.0
Equals: Normalized Benefit for Dividend Income Tax Avoidance	$ 6,000
Divided by: Direct Capitalization Rate (%)	12.0
Equals: Present Value of the Benefit of Dividend Income Tax Avoidance	$ 50,000
Divided by: Indicated Value of Equity (C corporation equivalent value)	$ 1,000,000
Equals: Implied TPE Benefit (%)	5.0
Selected TPE Benefit Based on the Adjustment for Dividend Income Tax Avoidance Model (rounded)	**5.0%**

1. Excess shareholder distributions above income tax liabilities are not subject to taxes at the capital gains rate.
2. An acquiring company would pay an acquisition price premium for the subject entities' TPE tax status.

In contrast, the Service argued that a 0 percent income tax rate was appropriate for the valuation of the subject TPE given the lack of income tax burden incurred by the subject entities at the company level.

In the published judicial decision, the Tax Court concurred with the Willamette analyst's application of income taxes and the premium associated with dividend income tax avoidance.

Specifically, the Tax Court stated:

> We find on the record before us that Mr. Reilly has more accurately taken into account the tax consequences of SJTC's flow-through status for purposes of estimating what a willing buyer and willing seller might conclude regarding its value. His adjustments include a reduction in the total tax burden by imputing the burden of the current tax that an owner might owe on the entity's earnings and the benefit of a future dividend tax avoided that an owner might enjoy.

Summary and Conclusion

The S corporation federal income tax election provides its shareholders with the unique benefit of:

1. limited liability protection and
2. TPE income tax status.

Since its inception in 1958, the S corporation has become one of the most common business structures utilized in the United States. Analysts are frequently asked to value S corporation equity interests. Therefore, analyst should be aware of the issues that may arise in these valuations—as well as the judicial precedent guidance regarding S corporation valuation.

Specifically, analysts may consider whether (1) there is incremental value attributable to the income tax advantages associated with TPE tax status and (2) the value of the S corporation was derived from comparisons with valuation characteristics of non-TPEs.

In the S corporation valuation, many inputs are selected based on empirical data from non-TPEs. Therefore, it may be appropriate for the analyst to tax affect the subject S corporation. Since the subject S corporation maintains TPE tax status and avoids double taxation, it may be necessary to apply a price premium to offset the value decrease associated with the tax affecting procedure.

One method to quantify this price premium is the application of the adjustment for dividend income tax avoidance model. The procedures of (1) tax affecting and (2) applying a price premium (specifically the adjustment for dividend income tax avoidance model) were accepted in the judicial decision of the *Estate of Jones* case.

Given the history of federal court decisions regarding these issues, the analyst should prepare a thorough analysis when developing an S corporation business valuation.

Notes:

1. Shannon P. Pratt, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies*, 5th ed. (New York: McGraw-Hill, 2008).
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3. Robert P Schweihs, "S Corporation Buyers and Sellers Should Consider Making a Section 338 Election," Willamette Management Associates *Insights* (Winter 2016): 73.
4. Ibid.
5. Ibid.: 76.
6. Mark Hendricks, "The S-Corp Windfall," *Crains Chicago Business* (May 7, 2005).
7. https://www.irs.gov/pub/irs-pdf/p550.pdf
8. https://www.irs.gov/newsroom/questions-and-answers-on-the-net-investment-income-tax
9. Estate of Aaron U. Jones, v. Commissions, T.C. Memo 2019-101 (Aug. 19, 2019).
10. Scott R. Miller and Curtis R. Kimball, "Estate of Aaron U. Jones v. Commissioner of Internal Revenue: Increasing Acceptance of Tax-Affecting," Willamette Management Associates *Insights* (Winter 2020).

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