Tax-Affecting and Other Valuation Issues Affecting Pass-Throughs after Estate of Aaron Jones v Commissioner, T.C. Memo. 2019-101

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Overview

- What tax-affecting is
- How the valuation expert persuaded the court to accept tax-affecting for the first time
- Issues to consider in building a case for tax-affecting
- Other issues valuation analysts consider in valuing interests in partnerships and S corporations

Overview - What Tax-Affecting is

- Treating a pass-through entity, such as an S corporation or a partnership, as a C corporation from an income tax perspective for valuation purposes
- Market data relied on to estimate a discount rate is generally based on C corporations and established on an after-tax basis
- The pool of hypothetical buyers of a subject pass-through entity are often C corporations that would place little to no premium on a subject company's pass-through income tax status
- Adjustments may be necessary to account for the value attributable to the subject entity's pass-through income tax status vs. an otherwise comparable C corporation

Overview - What Tax-Affecting is

- Owners do pay taxes at the shareholder level
- Typically the business does incur this tax expense in the form of distributions for shareholder income tax liabilities
- The value impact of a pass-through income tax structure is related to (1) the excess distributions above income tax liabilities that are not subject to taxation at the capital gains tax rate and (2) any premium that an acquiring company may pay for to the subject company pass-through income tax status

Effect of 2017 Tax Reform on Tax Rates

- Type of Entity
- Corporate Level Tax Savings Combined with Level of Dividends Distributed to Shareholders
- Outside Basis and Inside Basis

Type of Entity

- Corporation
  - C Corporation
  - S Corporation
- Partnership
  - Limited Liability Company
  - Limited Partnership
- Limited Liability Company
  - Partnership or Disregarded Entity
  - S or C Corporation

Distributing 100% of Corporate Net Income After Income Tax – Moderate State Income Tax (II.E.1.a.)

Income after Income Tax	Individual in Top Bracket	Individual in Modest Bracket
Corporate Taxable Income	$100,000	$100,00
Federal and State Income Tax	-26,000	-26,000
Net Income after Income Tax	$74,000	$74,000
Income Taxes at 28.8% or 20%	-21,312	-14,800
Net Cash to Owner	$52,688	$59,200

Distributing 50% of Corporate Net Income After Income Tax – Moderate State Income Tax (II.E.1.a.)

Income after Income Tax	Individual in Top Bracket	Individual in Modest Bracket
Corporate Taxable Income	$100,000	$100,00
Federal and State Income Tax	-26,000	-26,000
Net Income after Income Tax	$74,000	$74,000
Distribution to Owner	$37,000	$37,000
Income Taxes at 28.8% or 20%	-10,656	-7,400
Net Cash to Owner	$26,344	$29,600
Corporate Cash Plus Shareholder Cash	$63,344	$66,600

Distributing None of Corporate Net Income After Income Tax – Moderate State Income Tax (II.E.1.a.)

Distributing None of Corporate Net Income After Income Tax	$100,000
Federal and State Income Tax	-26,000
Net Income after Income Tax	$74,000

Comparing Taxes on Annual Operations of C Corporations and Pass-Through Entities – Moderate State Income Tax (II.E.1.)

	Individual in Top Bracket	Individual in Modest Bracket
Distributing 100% of Corporate Net Income After Income Tax	47.3%	40.8%
Distributing 50% of Corporate Net Income After Income Tax	36.7%	33.4%
Distributing None of Corporate Net Income After Income Tax	26.0%	26.0%
S Corporation, Partnership, or Sole Proprietorship (Pass-Through)	34.6%-45.8%	27.4%-46.2%

C corporation deducts state income tax on business operations; pass-through owners have limited state income tax deduction (but unlimited business property tax deductions). Reinvested C corporation earnings will be taxed later when the company is sold, which just changes the timing of the 47.3% or 40.8% rate above, unless held until death or qualify for Code § 1202 exclusion (II.Q.7.k.). Reinvested pass-through earnings add to tax basis.

Comparing Taxes on Annual Operations of C Corporations and Pass-Through Entities S Corp./Pass-Through Valuation Models

- Grabowski Model – C Corp. equivalent, plus tax benefits via discounted future cash flow adjustments to assumed sale date as a C Corp.

- VanVleet (SEAM) Model – C Corp. equivalent, plus steady-state differential formula adjustment multiple (e.g. 1.17x)

- Treharne Model – C Corp. equivalent, plus tax differential benefits via present value of discounted future cash flow of these tax benefits

- Other Models – Simplifications and elaborations

Overview – Prior Tax-Affecting Cases

Tax-Affecting Not Allowed

- *Gross v. Commissioner (1999, Affirmed 2001)*
- *Wall v. Commissioner (2001)*
- *Heck v. Commissioner (2002)*
- *Adams V. commissioner (2002)*
- *Dallas V. Commissioner (2006)*
- *Gallagher v. Commissioner (2011)*
- *Estate of Giustina v. Commissioner (2011, Apealed 2014, Remand 2016)*

Overview – Prior Tax-Affecting Cases

Tax-Affecting Allowed

- *Delaware Open MRI Radiology Associates, P.A. v. Kessler et al (2006) - Court of Chancery, State of Delaware*
- *Kress v. United States (2019) - U.S. District Court*
- *Estate of Cecil v. Commissioner (Undecided as of 9/24/19) - U.S. Tax Court*
- *Estate Aaron Jones v. Commissioner (2019) - U.S. Tax Court, TCM 2019-101*

Overview – *Estate of Jones*

- Two Companies – Seneca Sawmill Company (S corporation) and Seneca Jones Timber Company (partnership)
- Original gifts occurred in 2009, IRS issued a notice of deficiency
- Willamette Management Associates engaged as the expert for the litigation, U.S. Tax Court trial occurred in 2017
- Judge accepts the Estate's value determinations in full, siding with the Estate's expert on all key issues

Key Issues – *Estate of Jones*

- Asset-based approach vs. income approach (both experts applied a market approach)
- Service in-effect assumed a liquidation value
- Subject interests did not have control over liquidation decisions
- General partner relied on the partnership assets and would not likely liquidate the timberland
- Long-running family business, limited partners had no plans to liquidate timberland prior to termination of the partnership
- The timber company was an operating company that produced logs for further processing

Key Issues – *Estate of Jones*

- Treatment of the general partner ownership interest
  - ➢ Income approach vs. asset-based approach
- Which projections to use
  - ➢ Most current vs. prior fiscal-year end
- Tax affecting the earnings of the pass-through income tax entities

Tax Affecting – Estate of Jones

- Important to have an expert with credibility and experience on the issue of tax affecting
- No disagreement between the experts on tax affecting, the argument was IRS attorney vs. valuation expert
- Methodology, empirical evidence, and industry best practices support tax affecting
- Case law vs. *Daubert* and expert opinions
- Not a matter of law but a matter of proof

Pass-Through Entity Premium – *Estate of Jones*

- Benefit from dividend tax avoided
  - Considered historical and projected distributions in excess of shareholder income tax liability
  - Can the subject interest direct shareholder distributions
  - Does the company have any plans to make distributions in excess of shareholder income tax liabilities in the future
  - No income tax benefit to a shareholder if no excess distributions are planned
  - Take a long-term view of the subject company's ability and willingness to make shareholder distributions
  - Personal income tax rates vs. corporate income taxes at the time

Pass-Through Entity Premium – *Estate of Jones*

- Benefit from dividend tax avoided
  - Presented the differences in income tax incurred by the entity vs. an otherwise comparable C corporation
  - This approximated the tax avoided on distributions in excess of shareholder income tax liabilities
  - Calculated difference as a percentage of equity value
  - Different results for the two entities based on the specific facts and circumstances
  - Similar to the SEAM model in that the results are impacted by differences in tax rates and distribution policies
  - Methodology is easier to explain and makes logical sense

Pass-Through Entity Premium – *Estate of Jones*

- We also considered the indicated benefit for pass-through income tax status from the results of an empirical study analyzing S corporation acquisitions
- We considered the premiums indicated from both our dividend income tax avoided analysis and from the empirical study
- In doing so, our analysis incorporated the point of view of both the seller and a hypothetical buyer
- This multi-perspective approach differs from many commonly relied on pass-through entity premium models

Code § 199A Deduction for Qualified Business Income (II.E.1.c.)

- Repealed Code § 199 deduction for domestic production activities
- Taxable years beginning after December 31, 2017 but not beginning after December 31, 2025
- Applies to an individual or trust that owns a partnership interest, S corporation stock, or a sole proprietorship (passthrough entity)
- Deduction up to 20% of qualified business income (QBI)
- Deduction limited to 20% of taxable income that is taxed as ordinary income
- Income tax but not NII tax or SE Tax (II.E.1.c.i.(a))
- Causes underpayment penalty to apply at 5% instead of 10% understatement

Gain on Sale

Focusing on exclusion is one-dimensional:

- Buyers want to receive tax benefits from unrealized gain of corporate assets
- If buy stock instead of assets, buyers frequently require a Code § 338(h)(10) election to treat the sale as an asset sale followed by a corporate liquidation (II.Q.8.e.iii.(f))
- Code § 1202 exclusion does not protect gain on deemed asset sale

Gain on Sale

- S corporation Code § 338(h)(10) or 336(e) election uses gain on deemed sale of assets to increase the seller's stock basis, often avoiding gain on sale of stock (II.Q.8.e.iii.(f))
- However, tax rates on deemed asset sale may be higher:
  - ➢Currently, capital gain rates are relatively close to corporate tax rates, depending on NIIT
  - ➢Depreciation recapture is ordinary income but is eligible for Code § 199A deduction

Gain on Sale

However, this slightly increased tax on S corporations may be worth the benefits of S corporation:

- Corporations that distribute in excess of tax distributions may have lower effective annual tax burden
- GRATs and sales to irrevocable grantor trusts don't work well for C corporations
- Basis step-up on death may obviate need for exclusion

Basis – Inside or Outside?

(II.Q.8.e.iii.)

- “Outside basis” means the basis in your corporate stock or partnership interest
- “Inside basis” means the corporation’s or partnership’s basis in its property
- Death of owner or sale by owner of stock changes outside basis but never inside basis
- Death of owner or sale by owner of partnership interest changes outside basis and will change inside basis if the appropriate election is in place

Basis Step-Up at Death

- When assets are included in the decedent's estate for estate tax purposes, they receive a new tax basis
- Probate estate, revocable trust, marital deduction trust for surviving spouse all create this results

Multiple Depreciation Opportunities

- Original owner depreciates his or her investment
- When first spouse dies, no estate tax on assets passing to surviving spouse, and stepped-up basis obtains depreciation deductions of the new basis
- When surviving spouse dies, possible estate tax, and another stepped-up basis lets children depreciate new basis

Partnership vs. S Corporation

- Some say they are equivalent, but they are not
- Transfer of partnership interest by sale or death allows buyer or beneficiary to get inside and outside basis step-up
- Basis step-up → more depreciation/less gain on sale if partnership sells assets
- S corporation <u>might</u> replicate if it sells all assets <u>and</u> liquidates in the same year

First, Illustrate S Corporation Problem

- S corporation has assets with zero basis and $1,000,000 value
- Sam Sucker buys 50% of stock for $500,000
- Assets are sold
- S corporation gives Sam a K-1 for his $500,000 share of the gain
- Sam is the proud owner of a $1,000,000 basis in his stock ($500,000 purchase price plus $500,000 K-1) that is worth $500,000

First, Illustrate S Corporation Problem

- Smart Sally finds a partnership with the same characteristics - assets with zero basis and $1,000,000 value
- Sally buys 50% partnership interest for $500,000
- Partnership makes a Code § 754 election, giving Sally a $500,000 in her half of its assets
- Assets are sold
- Sally has no gain on that sale and is content with her $500,000 basis
- If assets are not sold, Sally is happy with any depreciation on her share of assets

Basis Step-Up Issues: Depreciable Real Estate in an S Corporation (Sale to Third Party) (II.H.8.)

Sale to Third Party

(Zero basis, $1M value)

Proceeds from sale	$ 1M
Basis of real estate	$ 0
Gain on K-1	$ 1M

Basis Step-Up Issues: Depreciable Real Estate in an S Corporation (Sale to Third Party) (Cont'd)

Sale to Third Party

(Zero basis, $1M value)

Stock basis after death	$1M
Gain on K-1	$1M
Stock basis after sale of real estate	$2M

Basis Step-Up Issues: Depreciable Real Estate in an S Corporation (Sale to Third Party) (Cont'd)

Sale to Third Party

(Zero basis, $1M value)

Liquidation proceeds	$ 1M
Stock basis	($ 2M)
Loss on liquidation	($ 1M)

Basis Step-Up Issues: Depreciable Real Estate in an S Corporation (Sale to Third Party) (Cont'd)

Sale to Third Party

(Zero basis, $1M value)

Long-term capital gain on K-1	$ 1M
Long-term capital loss on liquidation	($ 1M)
Net long-term capital gain (loss)	$ 0

Basis Step-Up Issues: Depreciable Real Estate in an S Corporation (Sale to Third Party) (Cont'd)

- Works to the extent sell to third party, not tangible personal property, and sale and liquidation are in the same year
- If liquidate and distribute assets instead of selling them to a third party, works only for property that the shareholders cannot depreciate/amortize
- State income tax disconnect when shareholders are in different state than business assets

Moving Forward from Here

- For valuation purposes, weight given to exit strategy varies according how close one is to the exit
- When planning a transaction that requires an appraisal for gift tax purposes, consider contacting the appraiser early to find out how the business and transaction structure inform valuation

Follow-Up

- Email Steve at sgorin@thompsoncoburn.com for full searchable PDF of Steve's business structuring materials (over 2,000 pages).
- Free quarterly newsletter includes the most recent version of Steve's PDF. Completing form at https://www.thompsoncoburn.com/forms/gorin-newsletter gets you the PDF and newsletter.
- Blog that is less technical is at http://www.thompsoncoburn.com/insights/blogs/business-succession-solutions.

Follow-Up

- If you have any follow-up questions or are in need of business valuation-related services, please contact Scott Miller at srmiller@willamette.com or Curt Kimball at crkimball@willamette.com.
- For more information about Willamette Management Associates, and to access an extensive library of thought leadership publications, visit http://www.willamette.com.