Passthrough Entity Adjustment: Does One Still Exist?

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Since passing of the TCJA, we have seen significant changes in tax laws, many which impact us in performing a valuation. As a result, we need to be diligent in our analysis of what models are used to quantify benefits of an entity's pass-through status. This paper will explore the impacts of TCJA, its effect on pass-through benefits as a result of historical tax reforms, court cases that support tax effecting earnings when valuing a pass-through entity, and models for quantifying benefits of a pass-through election.

On December 22, 2017, the Tax Cut and Jobs Act ("TCJA") was passed to take effect on January 1, 2018. The TCJA had the following impact to the tax law:

- The C-Corporation tax rate was changed from a graduated structure with rates ranging from 15% to 35%, to a flat rate of 21%.
- Individual rates were lowered.
- Some S-Corporation shareholders became eligible for a 20% deduction on qualified business income of pass-through entities under Section 199A.

As valuation experts, we must ask ourselves the following questions:

- How do the tax changes impact pass-through entity valuations when compared to valuations of C-Corporations ("C-Corp")?
- Should we tax effect earnings when valuing a pass-through entity under the Income Approach?
- Should we apply a pass-through entity adjustment under the Income Approach?

HISTORY OF TAX RATES ON THE PROPRIETY OF TAX EFFECTING

Prior to 1980, pass-through entities had no significant advantage over a C-Corporation. At that time, tax effecting earnings was an appropriate way to value a company's pretax income with no additional pass-through adjustment. From 1986 to 1993, there were other changes in tax rates offering an advantage to owners of pass-through entities. As a result, experts started considering an adjustment in valuations to reflect the tax advantages of an S-Corporation ("S-Corp") versus a C-Corporation. From 1994 to 2017, more changes in tax laws gave owners of pass-through entities an advantage over a C-Corporation, but a smaller one. Again, in 2018, we saw another change bringing us full circle to pre-1980, where pass-through entities have no significant advantages over C-Corporations.

Figure 1: Tax Effecting from 1980 to Present [1]

	1980/1981	1988	2002	2004-2010	2013-2017	2018, no pass-through benefit	2018, with pass-through benefit
Panel A - Enacted Tax Returns (maximums)							
Individual	70.0%	28.0%	39.0%	35.0%	39.6%	37.0%	29.6%
Corporate	48.0%	34.0%	35.0%	35.0%	35.0%	21.0%	21.0%
Capital Gains	37.0%	28.0%	15.0%	15.0%	20.0%	20.0%	20.0%
Dividends Received	70.0%	28.0%	39.0%	15.0%	20.0%	20.0%	20.0%
Net Investment Tax (NIT)					3.8%	3.8%	3.8%
Panel B - Computation of after tax returns to owners of pass-through entity							
Tax on Pass-through Income	$ 7,000	$ 2,800	$ 3,900	$ 3,500	$ 4,340	$ 4,080	$ 3,340
After-Tax Cash Return to Owners	$ 3,000	$ 7,200	$ 6,100	$ 6,500	$ 5,660	$ 5,920	$ 6,660
Panel C - Computation of after-tax returns to owners of C Corporation							
Entity Tax	$ 4,800	$ 3,400	$ 3,500	$ 3,500	$ 3,500	$ 2,100	$ 2,100
After-Tax Income	$ 5,200	$ 6,600	$ 6,500	$ 6,500	$ 6,500	$ 7,900	$ 7,900
Assumed Dividends *	$ -	$ 2,800	$ -	$ 3,500	$ 4,340	$ 4,080	$ 3,340
Income tax left in Company	$ 5,200	$ 3,800	$ 6,500	$ 3,000	$ 2,160	$ 3,820	$ 4,560
Personal Tax & NIT on dividends	$ -	$ 784	$ -	$ 525	$ 1,033	$ 971	$ 795
Capital gains & NIT on retained funds	$ 1,924	$ 1,064	$ 975	$ 450	$ 514	$ 909	$ 1,085
Net after-tax cash return to owners	$ 3,276	$ 4,752	$ 5,525	$ 5,525	$ 4,953	$ 6,020	$ 6,020
Panel D - Measures of pass-through advantage, if any							
Ratio: pass-through return / C corporation return	0.92	1.52	1.10	1.18	1.14	0.98	1.11
Implication for tax effecting	Full	None	Partial	Partial	Partial	Full	Partial

* The most tax-effective strategy for a C corporation in 1980 and 2002 would have been to pay zero dividends. For other years, dividends are assumed to equal the personal tax liability of the pass-through entities.

The argument for tax effecting the earnings of pass-through entities for valuation purposes has varied over the last five decades based on the prevailing tax rate environment. In 1980 and earlier years, there was no reason to assume pass-through entity earnings deserved a valuation adjustment. Over the last four decades, there have been periods when it may have been appropriate to assume pass-through income was subject to an adjustment due to tax benefits of a pass-through status. During the last 20 years, valuation experts and courts have come up with a variety of approaches to this issue.

[1] Figure 1 was obtained and reproduced from the article titled Tax Effecting and the Valuation of Pass-Through Entities, Considering the Impact of the Tax Cuts and Jobs Act as published in the CPA Journal October 2018. The pre-tax income is assumed to be $10,000.

RECENT AND IMPORTANT COURT CASES

Over the past few years, several Tax Court cases were decided that significantly changed how S-Corporations are valued. In 1999, in the case of *Gross v. Commissioner*,[2] the Court commented that by definition and case law, a subject company's earnings should be tax effected as a C-Corp. However, for the Gross case, the Court ruled that the effective C-Corp tax rate was zero percent. This case was followed by *Wall v. Commissioner*,[3] *Heck v. Commissioner*,[4] *Adams v. Commissioner*,[5] and *Dallas v. Commissioner*.[6] In each of the cases subsequent to the Gross case, the Tax Court upheld the decision to tax effect S-Corp earnings using a zero-tax rate. In more recent years, a number of court cases held that tax effecting pass-through entities at various tax rates was appropriate.

Figure 2: Key Court Cases that have held Tax Affecting Pass-Through Entities is Appropriate:

Court Case	Date Decided	Type of Entity	Court Decision
Delaware Open MRI Radiology Associates, P.A.	4/26/2006	S Corp	Uses Delaware Chancery Model to determine pass-through entity adjustment and uses a tax rate of 29.4%
Leilani Zutrau individually and on behalf of Ice Systems, Inc.	7/31/2014	S Corp	Agrees with the tax rate determined by Expert
Owen V. Cannon	6/17/2015	S Corp	Tax effects using an investor level tax (pass through entity benefit) 22.7%
Judicial Dissolution of Gould Erectors & Rigging, Inc.	1/31/2017	C Corp	Tax effected using the current C-Corp rate of 38.7% ignoring the pass through entity benefit
Wright v. Wright	12/21/2017	S Corp	Tax status is relevant
Kress V. United States	3/26/2019	S Corp	Apply C-Corp tax rates but no pass-through adjustment
Appraisal of Jarden Corporation	7/19/2019	S Corp	Tax effects earnings at corporate level with no pass-through adjustment. Uses a tax rate of 35%
Estate of Aaron U. Jones	8/19/2019	S Corp	Tax effects earnings at C-Corp rates and applies a pass-through adjustment

WHY DEDUCT TAXES FROM AN ENTITY THAT DOES NOT INCUR THEM AT THE CORPORATE LEVEL?

Many analysts have routinely deducted taxes at either C-Corporation rates or personal rates in valuing pass-through entities — despite the fact that such entities do not themselves incur such taxes. Often, these analysts would have to explain their recommendations. Some of the more common explanations: [7]

[2] T.C. Memo, 1999-254, (July 29, 1999), affirmed 272 F.3d 333 (6th Cir. 2001).
[3] T.C. Memo 2001-75 (March 27, 2001).
[4] T.C. Memo, 2002-34 (February 5, 2002).
[5] T.C. Memo 2002-80 (March 28, 2002).
[6] T.C. Memo 2006-212 (September 28, 2006).
[7] National Association of Certified Valuators and Analysts - Chapter Six: Commonly Used Methods of Valuation

1. Analysts should consider the whole range of buyers, most of whom are C-Corporations.
2. Analysts must use recognized methods of valuation, including taking a deduction for taxes from the income stream.
3. Interest Holders are at a risk that the S election could be lost.
4. The cost of equity is based on returns of C-Corp, so the income stream should be tax effected, matching the capitalization rate.
5. Shareholders may have to recognize phantom income, potentially without a receipt of equivalent cash flow, or without enough to pay the tax liability on income allocated.
6. The IRS Appeals Officer Manual states that income taxes have to be deducted from the earnings stream.
7. Tax Effecting is meant to address various costs such as the difficulty in raising or selling capital and the difficulty obtaining debt.

Much of the discussion regarding valuation of pass-through entities revolves around the issue of tax effecting the earnings stream. Some issues for consideration:

1. The effect of earnings available for distribution on the value of the firm.
2. Consideration of the structure of the deal (asset versus stock).
3. The size of the company being transacted, and the impact of size on value.
4. The issue of basis step-up.
5. The impact of the company's capital structure on value.
6. The possible benefits of a Section 338(h)(10) election, and when it is appropriate to consider such election.

The valuation of non-controlling interests in pass-through entities has many of the same issues as for controlling interests. The main distinction? Non-controlling interest holders cannot control whether to distribute cash flows nor the amount and timing of distributions. Lacking direct access to cash, non-controlling interest holders are at the behest of those in control of the corporation. Shareholders' investments, access to cash, and returns for a non-controlling interest holder in a pass-through entity are impacted by these issues:

1. Tax rates—personal versus corporate, and capital gains.
2. Holding period and exit strategy.
3. Possible ability to participate in step-up-of-basis transaction.
4. Further effect of minority or marketability discounts.
5. Retained net income.
6. Amount and timing of distributions.

Over the years, there have been multiple theories and models for valuing pass-through entities that have gained traction in the valuation community. Each of these models handles valuations somewhat differently, yet largely agree on key issues.

1. Treharne Model

Treharne's model begins with the value of an equivalent C-Corporation after reinvestment of all necessary cash flows. To this value determination, one makes adjustments to the equivalent C-Corporation value depending on:

a. Distributions to the non-controlling owner.

b. Tax rate differentials.

c. Basis build-up, if relevant using Treharne's model, value distinctions are made for each level of distribution.

2. Van Vleet Model

Van Vleet's model begins with the economic benefits of a C-Corporation equity interest, fully burdened with income tax at the corporate level, as well as dividend tax on distributions and capital gains tax on retained earnings. That benefit is compared to the S-Corporation economic benefit that bears only one layer of income tax. The mathematical formula that results from this difference becomes the S-Corporation Equity Adjustment Multiple ("SEAM") adjustment. The SEAM adjustment assumes that shareholders of publicly traded companies are indifferent between distributions and capital gains. This is generally true because both forms of investment return are equally liquid to the public company shareholder. Therefore, the SEAM inherently assumes that the subject S-Corporation is paying 100 percent of its earnings in distributions, as this is the only way that an investment return on a privately-held security can be completely liquid. Van Vleet's model recognizes that the level of distributions for the subject company can impact value, and recognizes it through the extent of the discount for lack of marketability.

3. Mercer Model

Mercer's model begins with the value of identical C and S-Corporations at the marketable minority level, which he determines to be of equivalent value, regardless of the level of distributions. He calculates the S-Corporation premium or discount at the shareholder level by reference to C-Corporation equivalent yields on distributions, and employs the Quantitative Marketability Discount Model ("QMDM") to determine the values. Such analysis can lead to a positive or negative value differential between the S-Corporation and the C-Corporation, depending on the facts and circumstances. Issues to consider:

a. The length of the holding period that the shareholder may continue to enjoy the benefits of the S election.

b. The extent of the expected distributions.

c. The risk of loss of S election benefits. Such loss may come about by changes in law, a disqualifying event, a change in the distribution policy of the firm, or any number of reasons that cause the S election benefits to diminish or cease. Mercer estimates the differing relative values to retained earnings resulting from tax-sheltered dividends and expected distribution policies.

4. Grabowski Model

Grabowski's modified traditional method begins with the value of a C-Corporation interest, fully burdened with income tax at the corporate level, adding back the savings gained by virtue of being an S-Corporation, and making adjustments for tax differentials on pass-through income. The model recognizes that the distributions for the subject company can impact value. One may either alter the net cash flow available to distribute by increasing retention for reinvestment in the cash flows themselves, or recognize the difference between available cash and distributions through the minority interest and/or lack of marketability discounts. The model assumes that willing buyers of stock in an S-Corporation must estimate their expected holding period, and takes into consideration the build-up of basis from retained net income over distributed cash flow.

5. Delaware MRI Model

The Delaware MRI Model is based on the court case Delaware Open MRI Radiology Associates, PA v. Howard B. Kessler.[8] The Court of Chancery of Delaware determined that a dissenting shareholder's interest should be tax effected. In this dispute, the court was presented with valuations by both groups' experts. The plaintiff's expert submitted a valuation that did not tax effect the S-Corporation's income. The defendant's expert provided a valuation of the S-Corporation and tax-effected the earnings with a 40% corporate income tax rate. The court explicitly recognized that tax would have been paid at some level and applied a formula that considered shareholder level taxes, and the differences between S-Corporations and C-Corporations.

6. Fannon Model

Nancy Fannon developed a simplified approach using a discounted cash flow analysis to measure the benefit of avoided dividend taxes and considers the benefit of the build-up in basis. When using this model an assumption must be made regarding when the subject company will be sold, as well as the likelihood that a purchaser would benefit from the S election. It is important to note Fannon has withdrawn this model and moved to consideration of the S-Corporation benefit in the determination of the cost of capital.

No matter which model used, the key is to consider all facts and circumstances, develop a reasonable foundation with carefully selected inputs, then reach a logical conclusion that a buyer and seller would likely agree on.

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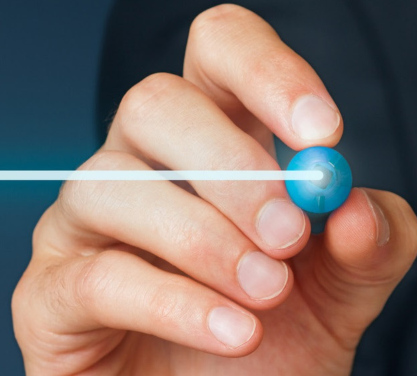
[8] Delaware Open MRI Radiology Associates v. Howard B. Kessler, Court of Chancery of Delaware, New Castle, 898 A.2d 290; (2006).



CASE STUDY

Based on the TCJA, a major question is whether or not a pass-through benefit exists. In order to ascertain whether a pass-through benefit still exists post-TCJA, we performed a detailed analysis and case study of this issue utilizing the following models:

1. Delaware MRI Model
2. Treharne Model
3. Van Vleet SEAM Model
4. Fannon Model

For purposes of this article we have relied on the following key assumptions:

Figure 3: Key Assumptions for Case Study

Assumptions	
Cost of Equity	16.8%
Perpetuity Growth Rate	4.0%
WC as a % of Revenue	40.0%
Capitalization Rate	12.8%
Tax Rate - Federal	21.0%
Tax Rate - New York State	6.5%
Service Business - QBID	None
Non-Service Business - QBID	20.0%

QBID - Qualified Business Income Deduction

Figure 4: Key Financial Assumptions for Case Study

	Budget Years Ended December 31,				
	2018	2019	2020	2021	Terminal Year
Revenues					
Net Revenues	40,106,000	44,116,600	47,646,000	50,028,300	52,029,400
Growth Rate (Year Over Year)	*8.0%*	*10.0%*	*8.0%*	*5.0%*	*4.0%*
Cost of Sales (excluding Depreciation)	28,836,200	31,719,900	34,257,400	35,970,300	37,409,100
Gross Profit	11,269,800	12,396,700	13,388,600	14,058,000	14,620,300
Operating Expenses	5,975,800	6,214,800	6,463,400	6,722,000	6,990,800
EBITDA, Adjusted	5,294,000	6,181,900	6,925,200	7,336,000	7,629,500
Less: Interest Expense	(1,443,800)	(1,588,200)	(1,715,300)	(1,801,000)	(1,873,100)
Less: Tax Depreciation	(2,364,500)	(2,504,900)	(2,628,400)	(2,711,800)	(1,642,400)
Earnings Before Tax	1,485,700	2,088,800	2,581,500	2,823,200	4,114,000
Estimated Income Tax	388,300	545,900	674,700	737,800	1,075,200
Adjusted Net Income	1,097,400	1,542,900	1,906,800	2,085,400	3,038,800
Less: Incremental Working Capital	(1,188,300)	(1,604,200)	(1,411,800)	(952,900)	(800,400)
Plus: Depreciation and Amortization	2,364,500	2,504,900	2,628,400	2,711,800	1,642,400
Less: Capital Expenditures	(1,403,700)	(1,544,100)	(1,667,600)	(1,751,000)	(1,821,000)
Cash Flow	**869,900**	**899,500**	**1,455,800**	**2,093,300**	**2,059,800**

Figure 5: Conclusion of Methods Employed

C Corporation - Equity Value	14,200,000

	S Corporation			
	Service Business	Non-Service Business	Service Business Adjustment	Non-Service Business Adjustment
Delaware MRI	13,500,000	15,300,000	-4.9%	7.75%
Treharne				
Distribute 100% of Cash Flow	12,490,000	13,730,000	-12.0%	-3.3%
Distribute to Tax	10,250,000	11,100,000	-27.8%	-21.8%
No Distributions	Negative	Negative	N/A	N/A
Van Vleet SEAM	14,140,000	15,510,000	-0.4%	9.23%
Fannon	7,290,000	8,530,000	-48.7%	-39.9%

Based on the case study, it is evident that applying the Delaware MRI and Van Vleet SEAM models would arrive at a positive pass-through adjustment for non-service businesses. The Treharne and the Fannon models would indicate there is no longer a pass-through benefit for non-service businesses. All models analyzed indicate there is no longer a pass-through benefit for service businesses.

CONCLUSION

TCJA has brought significant changes, many affecting us in performing a valuation. It is vital to be diligent in our analysis of models and how we apply them. Many analysts fall into the trap of "we applied an adjustment in the past so we must continue to apply an adjustment now." That is a fatal move that could lead to an erroneous conclusion. So, is there still a pass-through benefit that warrants a pass-through adjustment? It depends. For service businesses it appears as if the benefit, and therefore adjustment, is no longer evident post-TCJA, but a pass-through benefit may still be warranted depending on the model one employs for non-service businesses. As evidenced by previous tax law changes, future updates may alter the benefits or lack of benefits, in having a pass-through corporate form.

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