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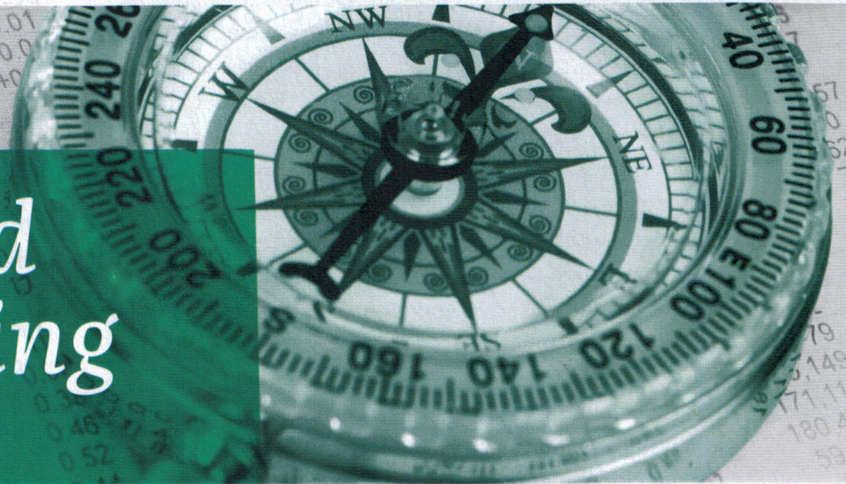

Financial and Estate Planning

Ideas & Trends

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VALUATION ISSUES AFTER THE TAX CUTS ACT

As should be obvious by now, the impact of the 2017 Tax Cuts and Jobs Act (P.L. 115-97) has been far reaching. This month's featured article, "Valuation Considerations Post-TCJA," by Daniel. T. Jordan and Martin M. Shenkman looks at one of the areas taxpayers and their advisors should be thinking about when planning. The article first considers four specific areas of interest that may be impacted by the Tax Cuts Act changes involving valuation—matrimonial cases, buy-sell agreements, estate planning transfers, and post-mortem planning.

The article also presents several examples illustrating the effect of a lower rate on C corporation income, the new Code Sec. 199A rules applicable to certain passthrough income, and the use of S corporations. In conclusion, the article notes that good tax planning can often minimize the impact of double taxation, while leveraging the corporate structure to provide other benefits. Also, with the top individual rate now higher than the top corporate rate and the ability of a C corporation to retain earnings rather than passing the entire amount through to the shareholders, a regular corporation may be the better choice in some cases. Vol. 3, ¶35,261.

GOAL SETTING—THE PLANNING PROCESS—KEYS TO PROFITABILITY

IRS To Issue Regs on Deductions for Estates and Trusts

The IRS has announced that it intends to issue regulations clarifying that certain estate and nongrantor trust expenses will remain deductible and not impacted by the 2018 through 2025 suspension of the deductibility of "miscellaneous itemized deductions" that are subject to the two-percent of adjusted gross income floor limitation (Notice 2018-61, IRB 2018-31). However, if an individual would normally incur such an expense, it is not covered by Code Sec. 67(e) and, therefore, may not be deducted by an estate or non-grantor trust during the suspension of miscellaneous itemized deductions.

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Valuation Considerations Post-TCJA

By Daniel T. Jordan, ASA, CBA, CPA, MBA, and Martin M. Shenkman, Esq.[1]

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Planning Impact of Possible Valuation Changes

Practitioners are well aware of the significant tax law changes to corporate tax rates enacted as part of the Tax Cut Jobs Act of 2017 (TCJA) (P.L. 115-97). The changes include, among many others, a reduction in C corporation tax rates to 21 percent, the 20-percent deduction for qualified business income (QBI) under new Code Sec. 199A, and so forth. These changes may have an impact on valuation of business entities which could impact:

- Matrimonial cases. For example, valuations are used in determining the value of a closely held business of one spouse when computing the values in a property settlement agreement.

- Buy-sell agreements. Some formula clauses may be impacted if tax issues are integrated into them. For agreements that embody a fair-value definition (whether fair market value or otherwise) the calculations may be affected by the changes.

- Estate planning transfer valuations may be affected. While the high exemptions make this irrelevant for most taxpayers, for the wealthy still affected by the estate tax, assumptions in valuation models that increase values may make planning more challenging. This is important as many ultra-high net worth taxpayers seek to shift wealth before the possibility of a change in tax laws under a future administration if there is a change in composition in Washington. For example, a client with $100 million business interest may view the current estate tax environment as a window of planning opportunity to act on before a different administration may enact harsher tax legislation. The impact on values of the TCJA may affect the structure of that transaction. For example, a larger value might trigger a need for a guarantee, whereas at a lower valuation level that may not have been required. For more moderate wealth taxpayers seeking to take advantage of the current high temporary exemption (the new temporary exemptions decline in 2026 from a basic exclusion of $10 million to $5 million) may be affected by changes in valuations. It may be advantageous for only one spouse to make a gift to preserve the exemption of the other spouse.

- Post-mortem planning valuations. For estates that are not taxable, achieving the largest step-up in income tax basis will be a goal that will be free of estate tax cost . . . The tax law changes may make it feasible to increase these date-of-death values thereby maximizing basis step up.

Double Taxation for C-Corporations

A regular corporation (also known as a C-Corporation) is taxed as a separate entity unless it makes an election to be taxed as an S-Corporation. After the corporate income tax is paid on the business income, any distributions made to stockholders are taxed again at the stockholders' tax rates as dividends. This is the often mentioned "double taxation." However, there are ways to reduce or eliminate double taxation that a tax adviser can recommend.

Pass-through entities do not pay income taxes at the corporate level. Instead, the owners of the pass-through entity pay income taxes on the funds allocated to them as individuals on their personal income taxes. (For federal tax purposes, pass-through entities are sole proprietorships, partnerships, limited liability companies, and S corporations.)

Since pass-through entities do not have two levels of tax, pass-through entities have a tax benefit over C-Corporations. Thus, it is proper for business valuators to apply a pass-through entity adjustment either by applying a pass-through entity premium or by lowering the tax rate when tax-affecting the earnings of the pass-through entity.

Valuation Impact Prior to TCJA

How should an appraisal reflect the tax effect of a pass-through entity such as an S corporation? What C and S corporation tax rates should be used?

In computing the corporate taxes, we follow the same methodology based on the *Delaware Open MRI Associates, P.A. v. Howard B Kessler* case in 2006. In rendering the court's decision, the Vice Chancellor applied a 29.4-percent effective tax rate to the earnings of the subject, treating the S Corporation shareholder as receiving the full benefit of untaxed dividends, but equating its after-tax return to the after-dividend return to a C corporation shareholder.[2] The Vice Chancellor compared the cash received by a C Corporation to that of an S Corporation to calculate the implied corporate income tax rate.

In the charts below, we use this model with modified tax rates and assume a high end taxpayer:

Corporate Income Tax Rate

Prior to January 1, 2018 the corporate income tax rate was 35 percent. Assume a state income tax rate of 8 percent. Companies deduct state and local tax expenses. The combined income tax rate for C corporations (federal and state) can be estimated at 40 percent, computed as follows:

35% + 8% - (35% x 8%).

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[2] Shannon Pratt, Roger Grabowski. *Cost of Capital: Applications and Examples, Fifth Edition* (John Wiley & Sons, Inc., Hoboken, NJ), p. 672.

Personal Dividends Income Tax Rate

The top federal rate on personal dividend income is 23.8 percent (20 percent top marginal tax rate plus a 3.8-percent net investment tax to fund the Affordable Care Act). In addition, taxpayer face personal dividend taxation at the state level that ranges from zero in states with no personal income tax to 13.3 percent in California. In this article, we assume an 8 percent state income tax rate. Taking into account the deductibility of state taxes against federal taxes, we estimate a 29.9-percent tax on personal dividend income.

Personal Income Tax Rate

Prior to 2018, non-corporate owners of pass-through entities and sole proprietors faced a maximum marginal tax rate of 39.6 percent (not including the 3.8-percent Medicare surtax).[3] With the state income tax of 8 percent and taking into account the deductibility of state taxes, we estimate a 44.4-percent marginal income tax rate for individuals.

So, prior to 2018, the cash or revenue received by a C-Corporation would be evaluated as compared to that of an S-Corporation, as follows:

	C Corporation Returns	S Corporation Returns	Tax Affecting to Equate Returns
Income before income tax	$100	$100	$100
Corporate income tax (Fed+State)	40.0%	0.0%	20.2%
Available earnings	$60	$100	$80
Dividend or personal income tax rate (Fed+State)	29.9%	44.4%	29.9%
Cash available for shareholders	$42	$56	$56

In other words, the appraisal might apply the effective tax rate of 20.2 percent to the earnings of an S-Corporation, treating the S-Corporation shareholder as receiving the full benefit of untaxed dividends, but equating its after-tax return to the after-dividend return to a C-Corporation shareholder.

Valuation Impact After TCJA

Now, after the passage of the TCJA, the corporate tax rate has been changed to a flat 21 percent starting January 1, 2018. Similar to the above, with an assumed state income tax rate of 8 percent, the combined income tax rate for C corporations (federal and state) can be estimated at 27.3 percent using the following equation:

21% + 8% - (21% x 8%).

Personal Dividends Income Tax Rate

We use the same 29.9-percent tax on personal dividend income as computed above.

What Personal Tax Rate Should be Used?

The issue arises as to what rate should be used to estimate the personal income tax rate? The personal rates that are applicable to income generated by pass-through entities is more difficult to determine as it is subject to a number of factors based on each individual owner's personal tax profile. The new maximum personal income tax rate for 2018 is 37 percent. However, income generated by a pass-through entity may qualify for a 20-percent deduction with a phase out threshold of $315,000 for married filing jointly taxpayers for income from a specified service business (SSB). SSBs include businesses where the principal asset is the reputation or skill of one or more of its employees or owners, except for engineering and architectures services which were specifically exempted. For non-SSB income the deduction is not necessarily phased out, but the limitation rules (50 percent of W-2 wages or 25 percent of W-2 wages and 2.5 percent of the unadjusted basis, immediately after acquisition of tangible asset values) will apply.

In valuing pass-through entities, the following federal tax rates are considered for use in the valuation analysis:

- Specified Service Business Entities – federal tax rate of 37 percent.
- If shareholder's taxable income under $315,000– federal tax rate of 37 percent less 20-percent deduction resulting in a tax rate of 29.6 percent.
- If shareholder's taxable income over $315,000– federal tax rate of 37 percent.

Next, reconsider the above chart for two scenarios: an S corporation shareholder who qualifies for the 20-percent QBI deduction, and an S corporation shareholder that does not qualify for the deduction. If the S-Corp shareholder qualifies, use a federal tax rate of 29.6 percent. This is the 37 percent individual tax rate, less the 20-percent deduction. With the state income tax of 8 percent and taking into account the deductibility of state taxes, we estimate a 35.2-percent marginal income tax rate for this individual.

If the S-Corp shareholder does not qualify, use the maximum 37-percent individual tax rate. With the state income tax of 8 percent and taking into account the deductibility of state taxes, we estimate a 42.0-percent marginal income tax rate for this individual.

The new table starting for 2018 should be as follows:

[3] We do not include the 3.8-percent Medicare surtax. S corporation shareholders are not subject to this tax on their share of S corporation earnings.

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Scenario I:
Assuming the S-Corp Shareholder qualifies for the Code Sec. 199A deduction:

	C Corporation Returns	S Corporation Returns	Tax Affecting to Equate Returns
Income before income tax	$100	$100	$100
Corporate income tax (Fed+State)	27.3%	0.0%	**7.3%**
Available earnings	$73	$100	$93
Dividend or personal income tax rate (Fed+State)	29.9%	35.2%	29.9%
Cash available for shareholders	$51	$65	$65

In this instance we apply the effective tax rate of **7.3 percent** to the earnings of the S corporation. In other words, there is a material S corporation benefit over the C corporation (even more than prior to the TCJA changes).

Scenario II:
Assuming the S-Corp Shareholder does not qualify for the Code Sec. 199A deduction:

	C Corporation Returns	S Corporation Returns	Tax Affecting to Equate Returns
Income before income tax	$100	$100	$100
Corporate income tax (Fed+State)	27.3%	0.0%	17.3%
Available earnings	$73	$100	$83
Dividend or personal income tax rate (Fed+State)	29.9%	42.0%	29.9%
Cash available for shareholders	$51	$58	$58

In this instance it would seem appropriate to apply the effective tax rate of **17.3 percent** to the earnings of the S corporation. In other words, the S corporation benefit over the C corporation is materially lower than in Scenario I (and lower than prior to the TCJA changes).

Based on the above, we can also quantify the S-Corp premium by comparing the available earnings after applying the corporate income tax of 27.3 percent for the C-Corp vs. the effective tax rate of 7.3 percent (Scenario I) and 17.3 percent (Scenario II) for the S-Corp.

Scenario I:
Assuming the S-Corp Shareholder qualifies for the Code Sec. 199A deduction:

Scenario I	**C-Corp**	**S-Scorp**
Net Income Bef Tax	$100.0	$100.0
Tax Rate (Fed+State)	27.3%	7.3%
Taxes	$27.3	$7.3
Net Income Aft Tax	$72.7	$92.8
S-Corp Premium = (92.8/72.7) -1		27.6%

Scenario II:
Assuming the S-Corp Shareholder does not qualify for the Code Sec. 199A deduction:

Scenario II	**C-Corp**	**S-Scorp**
Net Income Bef Tax	$100.0	$100.0
Tax Rate (Fed+State)	27.3%	17.3%
Taxes	$27.3	$17.3
Net Income Aft Tax	$72.7	$82.8
S-Corp Premium = (82.8/72.7) -1		13.8%

The above charts calculate the S-Corp Premium at 27.6 percent for Scenario I (with 199A deduction) and 13.8 percent for Scenario II (without the 199A deduction).

Scenario II will be the most relevant one because we typically perform valuations for medium and large businesses whose shareholders are ordinarily high-end individuals. Also, the S-Corp premium of 27.6 percent in Scenario I seems large. The S-Corp premium of 13.8 percent in Scenario II is more reason-

able. Thus, we are more comfortable with the results from Scenario II.

Conclusion

Based on the above analysis, we conclude that after the passage of the TCJA, the S corporation still has a tax benefit over the C-Corporation. The tax benefit is greater when the S corporation shareholder qualifies for the 20-percent QBI deduction, and lower when the S corporation shareholder does not qualify for the 20 percent QBI deduction.

From the valuation perspective, it is more reasonable to assume that the S-Corp shareholder does not qualify for the Code Sec. 199A deduction for two reasons:

(a) We mostly value successful businesses and our clients are frequently high-net-worth individuals.

(b) The S-Corp premium seems more reasonable and in line with the premium we used prior to TCJA.

Having said this, the C-Corporation may still be a better option than the S-Corporation in some instances.

In our analysis above, we applied the highest rate of corporate tax. However, prior to TCJA, few corporations paid tax at the 35-percent rate because of existing loopholes. Absent the new tax law, companies in 2018 would pay at an effective rate of 21.2 percent. With the new tax breaks, though, that rate will drop to an average of 9.2 percent across all industries, according to the University of Pennsylvania's Penn Wharton budget model.

Moreover, above we discussed that the reason for the S-Corporation Premium is the avoidance of the double taxation.

However, there are ways to reduce or eliminate double taxation, such as:

1. Pay higher salaries to shareholders.
2. Lease property from shareholders.
3. Defer or eliminate dividend payments.
4. Defer capital gains taxes on shares by making lifetime gifts of appreciated stock.

In other words, corporations could structure their affairs to ensure that a portion of their earnings is paid out to shareholders as compensation, rents, or some other such deductible expense. However, the payments must be reasonable (Reg. §1.162-7). Otherwise such payments will be recast as dividends. (Reg. §1.162-8) Alternatively, the corporation could retain its earnings if the shareholders had no need for distributions and the corporation avoids the imposition of the accumulated earnings tax or the personal holding company tax. (Code Sec. 531, et seq).

Thus, good tax planning can often minimize the impact of double taxation, while leveraging the corporate structure to provide other benefits. Plus, with the top individual rate now higher than the top corporate rate and with the ability of a C corporation to retain earnings rather than passing the entire amount through to the shareholders, a regular corporation may be the better choice in some cases.

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