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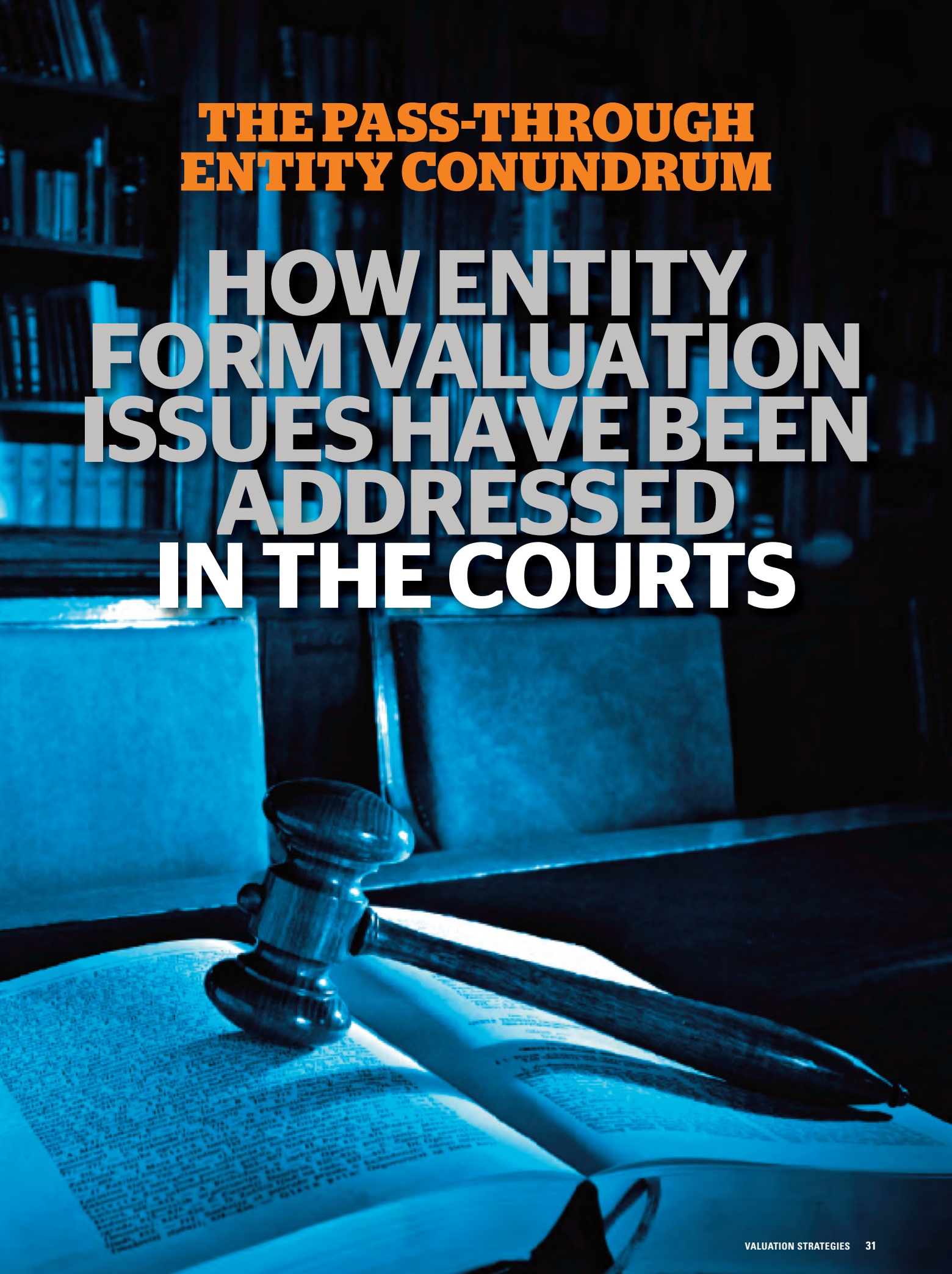
ENTITY FORM AFFECTS AFTER-TAX ECONOMIC BENEFITS AND THUS ENTITY VALUES, AND THE COURTS HAVE PROVIDED CONFLICTING GUIDANCE ON HOW ANALYSTS SHOULD ADDRESS THE ISSUE WHEN VALUING PASS-THROUGH ENTITIES.

THE PASS-THROUGH ENTITY CONUNDRUM

HOW ENTITY FORM VALUATION ISSUES HAVE BEEN ADDRESSED IN THE COURTS



Does entity form affect after-tax economic benefits and thus entity value? If so, why does it, and how much? And if entity form affects economic benefits, what happens when tax laws or tax rates change?

These questions have vexed business appraisers for years. This article examines how the appraisal community and the courts have addressed such entity form valuation issues.

Business entities can be organized as a C corporation, S corporation, partnership, limited liability company (LLC), or as a sole proprietorship. Depending on the form of the entity, different tax laws govern the recognition of income and losses at the entity and owner level.[1]

For example, when the after-tax net income of a C corporation is distributed to its owners, there is a second level of income taxes (a tax on dividend income) paid at the owner level. On the other hand, with rare exceptions, S corporations, partnerships, LLCs, and sole proprietorships do not pay income taxes at the entity level; such entities "pass through" their earnings and losses to their owners. Accordingly, S corporations, partnerships, LLCs, and sole proprietorship are collectively referred to as pass-through entities (PTEs). The earnings of PTEs are only subjected to income tax one time, at the owner level.

The after-tax cash flows to an owner can be materially different depending on the entity form, as illustrated in Exhibit 1 (applying 2013 tax rates). Applying the simplified assumptions contained in this example, the after-tax income for an owner of a PTE (60%) is 25% greater than the after-tax income for an owner of a C corporation (48%).

The Conundrum

PTEs are often valued under the income and the market approaches, using data derived from public company transactions. Such data would be presumed to be relevant, as it reflects many thousands of potentially similar transactions between buyers and sellers. However, if C corporations yield different after-tax investor returns than PTEs, how can a valuation analyst justify applying valuation multiples developed from tax-paying entities, in connection with the valuation of a PTE? The answer is to somehow quantify the tax benefit, if any, associated with an entity's status as a PTE. The issue of how to quantify that tax benefit has vexed valuation analysts for years. It can be called the "PTE conundrum."

The PTE conundrum is a hotly debated topic, with points of view evolving and changing over time. Certain valuation analysts ignore all entity-level income taxes, deeming such income taxes hypothetical, improper, and inappropriate. Some analysts impose C corporation income taxes at maximum marginal rates on the earnings of a business for valuation purposes. Alternatively, an effective combined corporation federal and state tax rate of 40% is sometimes used.

Challenges Presented. Determining how to quantify the tax benefit of PTE status is a challenge when valuing companies for mergers and acquisitions, estate and gift tax purposes, marital dissolution, shareholder disputes, and other purposes. It is an issue when applying different standards of value, such as fair market value, fair value, and investment value. And, rather than providing clear guidance, U.S. courts have issued varying, and seemingly conflicting, decisions on this issue.

Judicial Decisions—Valuation Dates Prior to 2003

Business appraisers often seek guidance from the courts and other authoritative sources when addressing the PTE conundrum. The courts however have issued what appears to be conflicting opinions when addressing the issue of tax-affecting PTEs. There are five cases with valuation dates prior to 2003, in which the courts have applied a 0% tax rate when valuing an ownership interest in a PTE. The cases are *Gross*,[2] *Estate of Heck*,[3] *Wall*,[4] *Estate of Adams*,[5] and *Robert Dallas*.[6] These five cases represent a limited subset of the many estate and gift tax returns that involved the valuation of PTE ownership interests.[7]

What are the lessons to be learned from the positions taken by the IRS and the judicial analysis? First the fact patterns that caused the IRS to challenge the tax-affecting approaches of the taxpayer in the above-referenced cases will be examined. In particular, the following will be analyzed:

1. Purpose of valuation.
2. Standard of value.
3. Controlling versus non-controlling (minority) interest.
4. Date of valuation.
5. Date of court's decision.
6. Form of PTE.
7. Amount of annual taxable income versus annual distributions.
8. Valuation approach.
9. Expectation, or lack thereof, that the business entity would be sold.
10. Expectation, or lack thereof, that the business entity would lose its status as a PTE.

Gross

Gross[8] involved the valuation of 1992 gifts of less than 1% of the common stock of an S corporation, Pepsi Cola Bottlers, Inc. (G&J) to the children of G&J's owners. The standard of value was fair market value on the date that the gift was made.[9]

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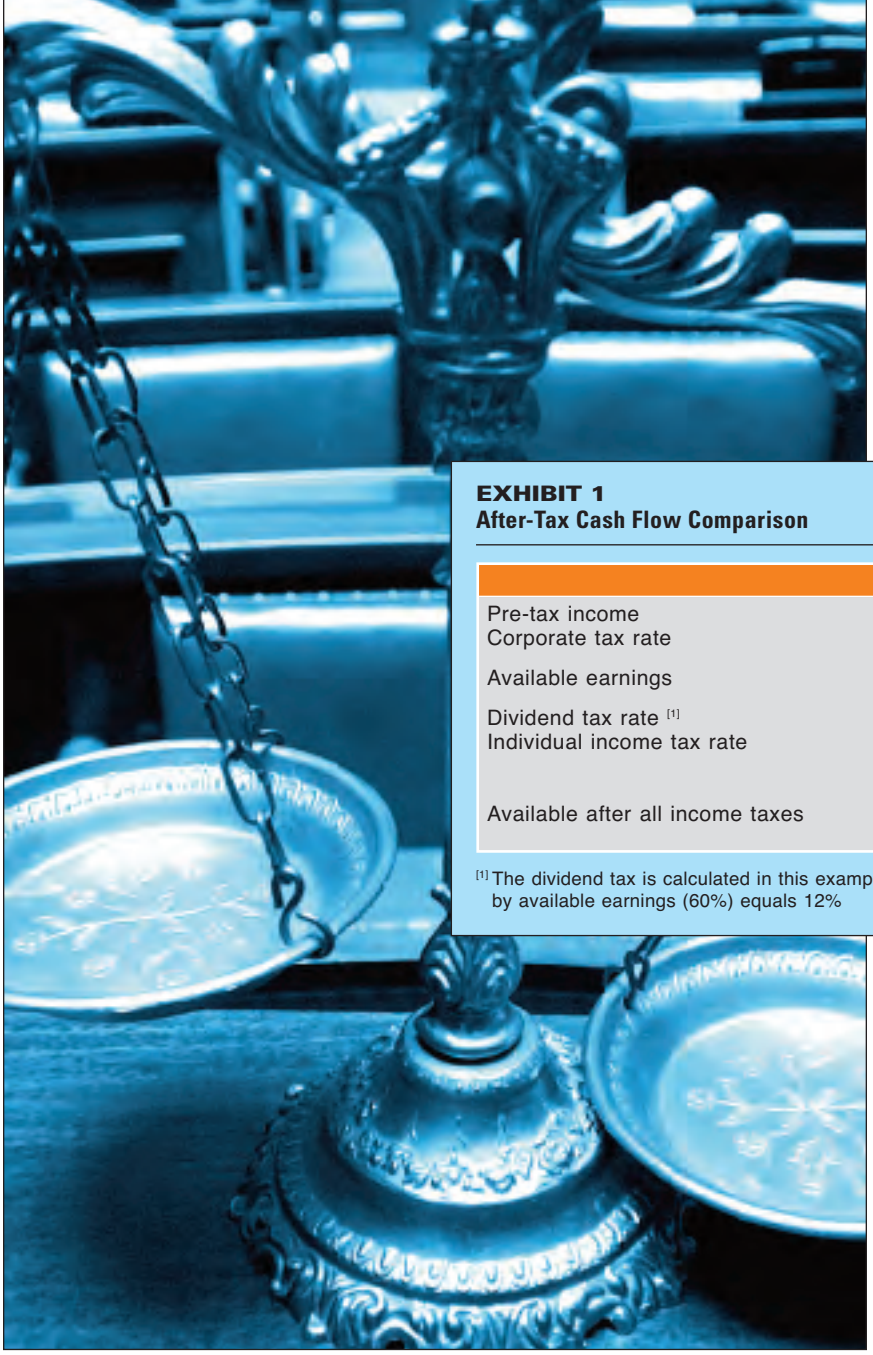

the 60% amount to derive a conclusion of value; the other expert capitalized the 100% amount, yielding a very substantial difference in value.

The taxpayer's expert claimed that a 40% tax-affecting adjustment was appropriate because:

1. It was the generally accepted practice of business appraisal at that time.

EXHIBIT 1
After-Tax Cash Flow Comparison

	C Corp	PTE
Pre-tax income	100.0%	100.0%
Corporate tax rate	40.0%	0.0%
Available earnings	60.0%	100.0%
Dividend tax rate [1]	12.0%	0.0%
Individual income tax rate	0.0%	40.0%
	12.0%	40.0%
Available after all income taxes	48.0%	60.0%

[1] The dividend tax is calculated in this example as follows: Dividend tax rate (20%) multiplied by available earnings (60%) equals 12%

2. The use of a 0% tax affect had not been published or submitted for peer review.
3. "[T]here are costs or trade-offs in electing S corporation status which tax affecting is intended to address." Examples of such trade-offs included the claim "that S corporations sacrifice growth opportunities and capital appreciation in exchange for current income."
4. S corporation shareholders were at risk that the corporation might not distribute enough of its income through dividends to cover the shareholders' tax obligations.
5. S corporations are committed to distributing enough income to their shareholders to cover their tax liabilities and this imbedded cost must be recognized.
6. Tax affecting was necessary in order to protect against the danger that an S corporation might lose its 'S' status.
7. Tax affecting was necessary to compensate for the disadvantages G&J faced as an S corporation in raising capital.
8. The IRS itself had implicitly endorsed the policy of tax affecting in valuating stock of S corporations. In support of this claim that the Service had endorsed the policy, two internal

G&J's predecessor entity was formed in the 1920s by two married couples. The business was incorporated in 1969 and elected S corporation status in 1982. There were no plans to sell the company or change its S corporation status. In fact, the shareholders' agreement contained provisions restricting the transfer of any ownership interests that jeopardized the S corporation status of G&J. By the time of the gifts in 1992, the founders were deceased and ownership of G&J had passed through, 50% to each founder's relatives.

On the date of the gift, G&J was the third largest independent bottler of Pepsi-Cola products and had an exclusive franchise agreement to distribute these products within several geographic territories. The company was highly profitable, and from 1988 to 1992, "enjoy[ed] steady increases in its operational income, total income, and distribution to shareholders. In addition, G&J's shareholder distributions nearly totaled the company's entire income for each of these years."

Use of Experts. The experts engaged by the taxpayers and the IRS both employed the income approach. The taxpayer's expert used a 40% income tax rate to tax affect the earnings of G&J; the IRS's expert applied a 0% income tax rate. The IRS's position was that the earnings of G&J should not be tax-affected for valuation purposes under the fair market value standard of value in the subject instance. Exhibit 2 reflects the positions of the two experts. The effect of these different positions is that one expert capitalized

IRS documents were presented that mentioned making adjustments for taxes of S corporations. The *IRS Valuation Guide for Income, Estate and Gift Taxes: Valuation Training for Appeals Officers* states at page 7:

> S corporations lend themselves readily to valuation approaches comparable to those used in valuing closely held corporations. You need only adjust the earnings from the business to reflect estimated corporate income taxes that would have been payable had the Subchapter S election not been made.

In addition, the *IRS Examination Technique Handbook* provides:

> If you are comparing a Subchapter S corporation to the stock of similar firms that are publicly traded, the net income of the former must be adjusted for income taxes using the corporate tax rates applicable for each year in question, and certain other items, such as salaries. These adjustments will avoid distortions when applying industry ratios such as price to earnings.

1. The IRS had previously accepted the 1988 tax affecting of gifts of G&J stock.
2. The IRS "should not have discretion to treat taxpayers in a manifestly unfair and inequitable manner, especially given the fact that the IRS ha[d] not adopted uniform rules or regulations banning tax affecting S corporations."

Arguments Rejected. The court rejected each of the arguments advanced by the taxpayer's expert for the following reasons:

1. The taxpayer's expert acknowledged under oath that (1) there was a growing controversy within the business appraisal community surrounding the issue of tax affecting at the time of the gift, and (2) if he had to value the gifted stock of G&J as of the date of trial, "he would give further consideration as to whether he would use the [same] method." The Service argued that tax affecting was not the generally accepted practice within the business appraisal community at the time of the gift in 1992.
2. As the Supreme Court recognized in *Daubert v. Merrell Dow Pharmaceuticals, Inc.*,[10] in some instances well-grounded but innovative theories will not have been published. Some propositions, moreover, are too particular, too new, or of too limited interest to be published. The fact of publication (or lack thereof) in a peer reviewed journal thus will be a relevant, though not dispositive, consideration in assessing the scientific validity of a particular technique or methodology on which an opinion is premised.
3. As a "theoretical matter" and "as a matter of economic theory," tax affecting was inappropriate to offset reasons #3—6 cited by the taxpayer's expert.
4. The evidence on the record indicated that G&J distributed substantially all of its income to the shareholders and this fact, combined with G&J's strong growth record, made it unlikely that the corporation would be unable to distribute sufficient income to cover shareholder tax liabilities.
5. [It] was illogical to tax affect an S corporation's income without facts or circumstances that established the likelihood that its S corporation status would be lost. Furthermore, there were "restrictive agreements [in place] that would preempt any transfers that would jeopardize G&J's S corporation status[,] and…there was no indication in the record that G&J planned to terminate this practice."
6. Any potential impediment to G&J's ability to raise capital should impact the company's cost of capital.
7. The IRS documents referenced by the taxpayer's expert were "intended for internal IRS use only," "designed specifically for training purposes only," and "[u]nder no circumstances [were to] be used or cited as authority for setting or sustaining a technical position." The taxpayer's expert acknowledged these limitations. (The

court did acknowledge, however, that the IRS documents "reflect[ed] a certain acceptance of tax affecting as a valid method of valuation.")

8. Given the amount of time between the 1988 gifts and the 1992 gifts at issue, and in the absence of any specific regulation or policy that specifically approved tax affecting, it did not follow that its acceptance of tax affecting with respect to the 1988 gifts created a precedent for the 1992 gifts.

EXHIBIT 2
Expert Appraiser Positions in *Gross*

Gross v. Commissioner Business Appraisers' Tax Affecting Assumptions	Appraiser #1	Appraiser #2
Pre-tax income	100.0%	100.0%
Corporate tax rate	40.0%	0.0%
Available earnings	60.0%	100.0%

EXHIBIT 3
Summary of Pre-2003 Valuation Decisions

Summary of Findings Court Decisions re. Valuation of PTE Ownership Interests		*Gross*	*Heck*	*Wall*	*Adams*	*Dallas*
1	Purpose	Gift	Estate	Gift	Estate	Gift
2	Standard of value	FMV	FMV	FMV	FMV	FMV
3	Non-controlling or Controlling	NC	NC	NC	C	NC
4	Date of valuation	1992	1995	1992	1995	1999
5	Date of court's decision	2001	2002	2001	2002	2006
6	Form of PTE	S Corp	S Corp	S Corp	S Corp	S Corp
7	Valuation approach	Income	Income	Income	Income	Income
8	Income tax rate	0%	0%	0%	0%	0%
9	Tax-affecting decided by	Court	Both parties	Not decided	Court	Court

9. There was no evidence that the taxpayer was being treated in a manifestly unfair and inequitable manner.

The Service's expert "testified that it would be unreasonable to subtract hypothetical corporate income taxes from G&J's projected future taxable income because the company did not (and was not expecting in the future to) pay any income taxes." The *Gross* court accepted this testimony and applied a 0% tax-affecting adjustment.[11] There is no evidence in the record that an alternative tax-affecting rate between 0% and 40% was considered.

Other Cases Prior to 2003

With the exception of *Wall*, each of the five pre-2003 cases mentioned above clearly and consistently articulated the court's position with respect to tax affecting a PTE under the fair market value standard, agreeing with the sentiment expressed by the court in *Gross:*

> 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.[12]

As summarized in Exhibit 3, regardless of the type of tax (estate or gift taxes), the type of interest (controlling or non-controlling), the valuation date, and the form of the PTE, in all five instances there was no tax-affecting adjustment.

Note that the courts did not always address whether the following questions affected their decision:

- Was the subject ownership interest active or passive?
- Was there an expectation that the subject entity would remain a PTE?
- Was there a buy-sell agreement in place that limited the rights of the holder?
- Was there an expectation that the subject company or the subject interest would be sold?
- Was income retained in the business?

The courts never indicated that an alternative to the all-or-nothing tax-affecting methodology was considered. The courts knew that there was a benefit of overall tax reduction for a company that was a PTE, and that this benefit should have been quantified and considered as part of the PTE income tax adjustment.

Decisions with Post-2002 Valuation Dates

From 1954 through 2002, dividend income received by individuals was taxed at ordinary income tax rates, subject to certain exclusions. Commencing in 2003, the tax rate on dividend income received by individuals was lower than the tax rate on taxable income. For the period 2003 through 2012 the federal statutory tax rate in the maximum income bracket was 35%; after 2012, the

1 C corporations are subject to Subchapter C of the Internal Revenue Code; partnerships are subject to Subchapter K; and S corporations are subject to Subchapter S.
2 TCM 1999-254, *aff'd*, 272 F.3d 333, 88 AFTR2d 2001-6858 (CA-6, 2001).
3 TCM 2002-34.
4 TCM 2001-75.
5 TCM 2002-80.
6 TCM 2006-212.
7 The valuation consultant may consult with counsel regarding the interpretation of relevant case law and statutes.
8 Note 2, *supra*.
9 Reg. 25-2512-2(a).
10 509 U.S. 579, 593–94 (1993).
11 Note 2, *supra*.
12 *Id.*

federal statutory rate in the maximum income bracket has been 39.6%. For the period 2003 through 2012, the maximum federal dividend tax rate was 15%; after 2012, the maximum federal dividend tax rate has been 20% (increased by a 3.8% surcharge under Section 1411). The 2003 lowering of individual tax rates relative to dividend income increased the after-tax returns of an ownership interest in C corporations. It also affected the value of an ownership interest in a C corporation relative to a comparable ownership interest in a PTE.

Thus, the facts and circumstances associated with the valuation of ownership interests after 2002 *were materially different* than the facts and circumstances associated with the five court cases noted herein above. Two judicial decisions issued after the 2003 change in federal income rates dealt with the valuation of PTE ownership interests:

- *Delaware Open MRI Radiology Associates, P.A. v. Howard B. Kessler*[13] (*Delaware Open MRI*) having a valuation date of 2004.
- *Bernier v. Bernier*[14] (having a valuation date of 2000).

The following discussion of these decisions illustrates how the courts' thinking has evolved in light of such changed federal income tax rates.

Delaware Open MRI

One of the significant issues in the 2006 Delaware Chancery Court decision, *Delaware Open MRI*,[15] involved the valuation of an ownership interest in an S corporation. The parties were radiologists who formed an S corporation for the purpose of capturing additional revenues by owning MRI centers. Due to a split in the underlying radiology practice, majority and minority stockholder groups were formed. The majority stockholder group (respondents) forced a squeeze-out merger, and the minority stockholder group (petitioners) filed suit in 2004 claiming that they did not receive fair value for their shares in the S corporation that owned the MRI centers.

The Court of Chancery of Delaware considered the testimony of two valuation analysts. Both analysts relied on the discounted cash flow method due to the recent and expected growth of the subject business. However, respondent's valuation analyst imposed a 40% corporate income tax rate, and the petitioner's valuation analyst imposed a 0% corporate income tax rate.[16] The positions taken by each valuation analyst were the same as the positions taken by the two appraisers in *Gross* (see Exhibit 2). But unlike the court's decision in *Gross*, a case with a pre-2003 valuation date, the Delaware Chancery Court rendered a very different decision:

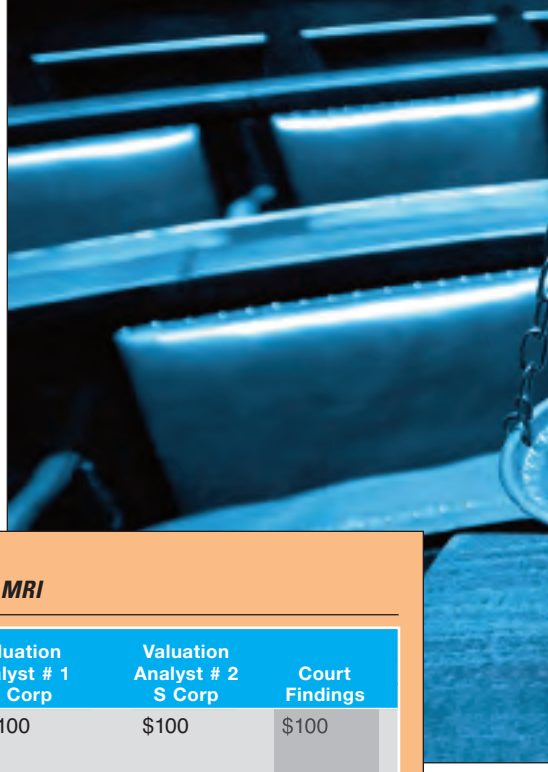

EXHIBIT 4
Judicial Calculations in *Delaware Open MRI*

Delaware MRI vs. Kessler et al	Valuation Analyst # 1 C Corp	Valuation Analyst # 2 S Corp	Court Findings
Pre-tax income	$100	$100	$100
Combined Federal and state C corporation tax rate	40.00%[1]	0.00%	29.40%[5]
After-tax company earnings[2]	$60	$100	$71
Dividend/Income tax rate	15%[3]	40%[4]	15%
Available after corporation and individual income taxes	**$51**	**$60**	$60

[1] Assumed effective combined federal and state C corporation income tax rate (at maximum marginal rates).
[2] Assumes that 100% of available earnings will be distributed in cash in year earned.
[3] Assumed effective combined federal and state tax on dividend income.
[4] Assumed effective combined federal and state individual income tax rate.
[5] Implied effective combined federal and state C corporation income tax rate.

1. Petitioners should be awarded their pro rata share of the subject company's appraisal value on the valuation date. This value was referred to as fair value and is more of a jurisprudential concept than an interpretation of the Delaware appraisal statue.[17]
2. "[I]t would be highly misleading" to (1) determine the value of a market-based acquisition of an S corporation by comparison to C corporations and (2) "then assume that the S corporation would be sold at a higher price because of its [PTE] tax status."[18] The Court was "not trying to quantify the value at which Delaware Radiology would sell to a C corporation"; it tried "to quantify the value of Delaware Radiology as a going concern with an S corporation structure and award the [petitioners] their pro rata share of that value.[19] This conclusion was based on Delaware law, which states that a "petitioner is 'entitled to be paid for that which has been taken from him.'"[20]

13 898 A.2d 290 (Del. Ch. Ct., 2006).
14 82 Mass. App. Ct. 81 (Mass., 2012).
15 Note 13, *supra*. Many of the principles and methodologies applicable to the analysis of the Delaware Open MRI Radiology Associates case were first presented by the present author in Barr, "Pass-Through Entity Valuations and "Value to the Holder": A New Perspective," The Value Examiner (September/October 2012).
16 Delaware Open MRI, note 13, *supra*., at page 326.
17 *Id.* at page 310.
18 *Id.* at page 327.
19 *Id.*
20 *Id.* (quoting Tri-Cont'l Corp. v. Battye, 74 A.2d 71, 72 (Del. 1950)). The standard of value in this case was fair value as defined under Delaware law.
21 *Id.*
22 Note 5, *supra*.
23 Note 3, *supra*.
24 Note 2, *supra*.
25 In re Radiology Assocs., 611 A.2d 485 (Del. Ct. Ch., 1991).
26 Del. Open MRI, 898 A.2d at 327–28 (quoting In re Radiology Assocs., 611 A.2d 485, 495 (Del. Ch. 1991)) (some citations omitted).
27 *Id.* at page 326.
28 *Id.*
29 *Id.* at pages 328–29 (citations omitted).
30 *Id.* at page 330.
31 *Id.* at page 329.
32 *Id.* at page 330; see also Barr, note 15, *supra*, at pages 16, 17.
33 Barr, note 15, *supra* at page 17.

3. Petitioners were "involuntarily deprived of the benefits of continuing as stockholders in a profitable S corporation—benefits that [included] the favorable tax treatment that [potentially] accompanies S corporation status."[21] The court acknowledged that the stockholders of the S corporation paid lower income taxes than they would have if the company operated as a C corporation. In its decision it adhered to the reasoning of prior decisions that recognized that an S corporation structure can produce a material increase in economic interest. It held that such reasoning supports not only the decisions in the *Adams,*[22]*Heck,*[23] and *Gross*[24] cases in the Tax Court, but also an appraisal decision of the same Delaware Court of Chancery, which coincidentally also involved a radiology practice.[25] The opinion in *In re Radiology Associates* noted that "under an earnings valuation analysis, what is important to an investor is what the investor ultimately can keep in his pocket."[26]
4. No evidence was presented to the court indicating that the business would convert to C corporation status in the foreseeable future.[27]
5. The business was "highly profitable" and "distribute[d] income well in excess of the stockholder level taxes its stockholders [would] pay" on the income of Delaware Open MRI taxed on their personal income tax returns.[28]

The court concluded that the second appraiser's 0% tax-affecting adjustment was improper, stating:

> Assessing corporate taxes to a shareholder at a personal level does not affect the primary tax benefit associated with an S corporation, which is the avoidance of a dividend tax in addition to a tax on corporate earnings. This benefit can be captured fully while employing an economically rational approach to valuing an S corporation that is net of personal taxes. To ignore personal taxes would overestimate the value of an S corporation and would lead to a value that no rational investor would be willing to pay to acquire control. This is a simple premise—no one should be willing to pay more than the value of what will actually end up in her pocket.[29]

PTE Premium. The court's analysis fully recognized the PTE premium resulting from the double taxation of C corporation earnings due to the dividend tax on distributions. The court then analyzed how best to quantify the PTE premium. Ultimately, the court concluded that a 29.4% effective corporation tax rate was appropriate in the circumstances.[30] The court assumed the following in connection with its calculations, based on the testimony of the two valuation analysts:[31]

1. A perpetual effective combined federal and state C corporation income tax rate of 40%.
2. 100% of available earnings to be perpetually distributed in cash in the year earned.
3. A perpetual effective combined federal and state individual income tax rate of 40% on ordinary income.
4. A perpetual effective combined federal and state individual tax on qualifying dividend income of 15%.

The court's calculations are presented in Exhibit 4, which is derived from a table in the case opinion.[32]

The court accepted the inputs provided by the two valuation analysts to calculate the amount that was ultimately available to the stockholders after corporation and individual income taxes. The court accepted valuation analyst #1's assumptions that (1) the C corporation would continue to pay federal and state income taxes at a combined effective tax rate of 40%, and (2) the stockholder of a C corporation would continue to pay a tax on dividends received at the federal tax rate of 15%. The court also accepted valuation analyst #2's assumptions that (1) the S corporation shareholders would pay federal and state individual income taxes at a combined effective tax rate of 40%, and (2) $60 is the amount available after corporation and individual income taxes assuming S corporation status. "In its decision, the court mathematically determined [the] 29.4 percent effective corporation tax rate (a plug) in order to produce the desired available after-tax amount" ($60).[33]

Exhibit 4 shows that the amount to the stockholders after individual income taxes as an S corporation, $60, exceeds the amount that is available to the stockholders assuming a 40% effective corporation income tax rate (federal and state) and a 15% qualified dividend tax rate, $51. The $9 benefit of being taxed as an S corporation over the amount that the stockholders would receive as a C corporation is of real value to the S corporation stockholders—it is not a hypothetical benefit.

The court in *Delaware Open MRI* valued the subject interest under the value to the holder assumption by using after-tax company earnings of $71 and dividing it by a capitalization rate. The capitalization rate used by the court was derived using the build-up method from after-tax public company data. Hence, the court *(Continued on page 48)*

(Continued from page 37) consistently matched hypothetical after-tax C corporation earnings of the S Corporation (before individual income taxes) with a capitalization rate derived from after-tax net earnings of public C corporations (before individual income taxes) in deriving its conclusion of value.[34]

Bernier v. Bernier

In its 2012 decision, the Appeals Court of Massachusetts, in *Bernier v. Bernier*,[35] also applied the methodology used in *Delaware Open MRI. Bernier* was a matrimonial dissolution matter that involved the valuation of two supermarkets that were operated as S corporations. The lower court stated that "where valuation of assets occurs in the context of divorce, and where one of the parties will maintain, and the other be entirely divested of, ownership of a marital asset after divorce, the judge must take particular care to treat the parties not as arm's-length hypothetical buyers and sellers in a theoretical open market, but as fiduciaries entitled to equitable distribution of their marital assets." The court applied the concept of "value to the holder," making this Massachusetts decision similar to *Delaware Open MRI*.[36]

In *Bernier*, after applying the applicable year's (2000) tax rates and using the *Delaware Open MRI* methodology, the mathematically derived effective corporation tax rate was 0%. The court concluded that a 0% tax affecting rate does not necessarily lead to an inequitable result. It stated that there is a distinction to be drawn between failing to tax affect at all the earning of the supermarkets because an S corporation does not pay federal taxes at the entity level, and using a 0% tax-affecting rate arrived at through application of all applicable rates.

Exhibit 5 illustrates the application of the Delaware MRI Model to the pre-2003 tax rate facts presented to the court in *Bernier,* with the court deriving a 0% corporate-level income tax, similar to *Gross.*

EXHIBIT 5
Application of *Delaware Open MRI* Model to *Bernier*

Bernier vs. Bernier	S Corp	Court Findings
Pre-tax income	$100	$100
Combined Federal and state C corporation tax rate	0.00%	0.00%[4]
After-tax company earnings[1]	$100	$100
Dividend/Income tax rate	40%[2]	40%[3]
Available after corporation and individual income taxes	$60	$60

[1] Assumes that 100% of available earnings will be distributed in cash in year earned.
[2] Assumed effective combined federal and state individual income tax rate.
[3] Assumed effective combined federal and state tax on dividend income.
[4] Implied effective combined federal and state C corporation income tax rate.

Limitations of *Delaware Open MRI* and *Bernier*

The courts' reported decisions in *Delaware Open MRI* and *Bernier* did not address changes that would need to be made to the model presented above in Tables 4 and 5 in the event that facts and circumstances under the "value to the holder" (assumptions) were different. For example:

- Both decisions used maximum statutory federal tax rates (2004 for *Delaware Open MRI* and 2000 for *Bernier*) as presented in experts' reports. Both decisions were completely silent as to the *effective* individual income tax rates of the S corporation shareholders.
- States have different corporate and individual tax rates; therefore, one effective individual or corporate income tax rate cannot apply to each and every state.
- Certain states or localities (New York City, for example) do not recognize S corporation status.
- Certain states or localities impose unincorporated business taxes on partnership or limited liability company income (e.g., New York City).
- Not all companies and individuals earn levels of taxable income that place them in the highest federal statutory income tax rate.
- The amount of earnings retained in a business significantly impacts the after-tax returns to the owner. It cannot be assumed that substantially all earnings will always be distributed.

What is the effect of changing any of these assumptions? Obviously, a change in income tax rates (all other things being unchanged) would change the amount of after-tax income that is available to a business owner. Therefore, businesses that operate in states (or during years) with higher income tax rates would generate lower after-tax cash flows.

Conclusion

It appears that a modified version of the *Delaware Open MRI* model would be appropriate when valuing PTEs. Such modifications would take into consideration entity-level PTE income taxes, income retained in the business, effective income tax rates of the owners, changes in tax laws, state income taxes, and other factors. The year of valuation would also substantially affect tax rates, after-tax returns, and value.

There are several valuation models that incorporate such modifications and that are currently being used by business appraisers. However, *the IRS has not yet challenged the use of such PTE valuation models.* It is likely just a matter of time before the Service challenges the valuation of a PTE ownership interest where a modified version of the *Delaware Open MRI* model is employed, or any model that assumes a hypothetical tax rate on PTE earnings other than 0%. Stay tuned. ■

34 *Id.*

35 Note 14, *supra.*

36 Barr, note 15, *supra* at page 17 (internal citation omitted). "In *Bernier*, the court referred to its use of value to the holder as fair market value." *Id.* at page 17 n. 2.