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Assigning Value Is More Than a Number

Proper valuations for S corporations and limited-liability companies have critical consequences

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Determining the proper value of an ownership interest in a business is often a critical component of an attorney's legal representation in connection with a marital dissolution, a business split-up, estate and gift planning, employee stock ownership plan (ESOP) transactions, mergers and acquisition advisement, and others. Even though experts are generally engaged to provide an estimate of such values, attorneys should have a certain level of knowledge that will increase the odds of a successful representation in the event that the valuation is contested.

Approximately 80 percent of the businesses filing U.S. federal income tax returns are S corporations, partnerships or limited-liability companies, collectively known as pass-through entities (PTEs). Valuing PTEs is one of the oldest, least resolved and, some would say, most poorly defined issues challenging the business valuation profession. Here are the crucial matters that attorneys need to know about valuing PTEs:

To Tax Effect or Not?

Appraisers are still challenged by the tax effect issue. This may be the most important valuation issue that appraisers and attorneys must address on a contested matter. For example, if one appraiser tax effects the subject company's income stream at a rate of 40 percent and the other appraiser does not tax effect it, the resulting conclusions of value will likely be very different. Know the foundational reasoning for your expert's opinion, as well as the opposing expert's opinion. Understand whether the model (if one is used) has been peer-reviewed and, if so, by whom.

No "One Rate Fits All"

Certain appraisers take pride in being able to testify that regardless of the case facts, the venue, or whether they are the plaintiff's, the defendant's or a neutrally appointed expert, they always use a particular rate when tax effecting the earnings of a PTE. This makes no sense because (a) the level of earnings impact a company's effective income tax rate, (b) federal income tax rates change, (c) federal tax rates with respect to dividend income change and (d) different states have different tax laws.

PTEs Have Different Values

Understand the difference between S corporations and limited-liability companies. S corporations have restrictions as to the types of entities that can be shareholders, as well as the number of shareholders. The members of limited-liability companies, assuming that they are actively involved in the operations of the business, are subject to self-employment taxes on the earnings that pass through (unlike shareholders of S corporations, who are not subject to self-employment taxes on pass-through earnings). State law may also provide certain restrictions for one type of entity (i.e., restricted partnerships and restricted limited-liability companies under Nevada law) but not another. The buyer's tax consequences when purchasing the equity of an S corporation are markedly different than the tax consequences of buying the equity of a partnership or LLC. These factors, among others, impact value.

Know the Case Law

It seems that there is an endless stream of cases involving the valuation of PTEs. Some cases pertain to the fair *value* standard of value; others deal with the fair *market* standard of value. Knowing that these cases exist, the theory underlying the decisions, the venue, the standard of value, the relevant fact patterns, the tax rates in effect as of the valuation date, etc., are critical to knowing whether or not your appraiser can rely on a particular decision.

Tax Rates Change

And they will continue to change. If the process of valuation involves determining the risk-adjusted present value of future net cash flows, why apply current tax rates to an income stream that will be subject to known and knowable changes in tax rates? Challenge all inappropriate tax rate assumptions.

Income Retained Impacts Value

An owner of a PTE is subject to the proportionate share of taxable income of the PTE whether or not such earnings are distributed. Accordingly, two companies that have identical earnings and cash flows can have materially different values if one company distributes all of its earnings and the other one does not make distributions.

Forensics Are Important

If data that has not been subjected to an appropriate forensic analysis is used as inputs for the valuation, such data may not accurately reflect the true economic activity of the business being valued. When discovery is limited, an appraiser's forensic analysis may be unreliable, and the old adage about "garbage in, garbage out" may apply.

Always, Always, Always

Ask for authoritative support from your experts. Make sure that your expert can support each and every valuation assertion contained in the report. Finally, use your experts to assist in cross-examination and to identify contradictions between authoritative, published positions and those taken by the opposing expert.

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