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The Valuation of S Corporation ESOPs

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Overview

- Nuances of an ESOP Valuation
- Number of S Corps Over the Years
- S vs. C Corp
- S Corp ESOP Tax Advantages
- Overview of the S Corp ESOP Valuation
- S Corps in the Courts
- Fair Market Value Vs. Economic Value
- 11 Schools of Thought on S Election "Benefit"
- Six Things the Trustee Needs to Look for or Ask
- Eight Common Valuation Errors

Nuances of ESOP Valuation

What makes an ESOP valuation different from a typical valuation assignment?

- Standard of Value
- Level of Control
- Normalizations
- Specific ESOP Considerations
- Due Diligence
- Oversight of Regulators/Fiduciaries

Valuation Approaches & Methods

- Income Approach
  - Discounted Cash Flow Method
  - Capitalization of Earnings Method
- Asset (Cost) Approach
  - Adjusted Book Value Method
  - Dual Capitalization of Earnings Method (hybrid)
- Market Approach
  - Guideline Public Company Method
  - Guideline Transaction Method

Standard of Value

"Fair market value" as defined by Revenue Ruling 59-60, ERISA § 3(18) (B) and Proposed U.S. Department of Labor Regulation Section 2510.3-18 (b)(2), as:

> "*The price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts. The hypothetical buyer and seller are assumed to be able, as well as willing, to trade and to be well-informed about the asset and the market for that asset.*"

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Normalizations

- Earnings adjustments: Control or minority
- Discretionary expenses
- Non-business related assets
- Real estate (rent)
- Bad debt
- Officers' compensation
- Working capital (excess or deficit)
- Inventory (obsolescence)
- Shareholder, related party notes

Discount for Lack of Marketability

- Company is not publicly traded
- Equity shareholders do not have the same ready, liquid market
- IRC §409(h)(1)(B)
  - Participants are granted a put right exercisable against the employer upon leaving the company.
  - Upon exercise, they receive FMV for their vested shares per the terms of the employer's plan document.
    - Put rights create a market for the shares

Other ESOP Valuation Issues

- ESOP Internal Loan Amortization
- Repurchase obligation
- Planning and funding
- Synthetic equity, SARs, warrants, options
- Treatment of contingent purchase consideration
- Earnout or clawback

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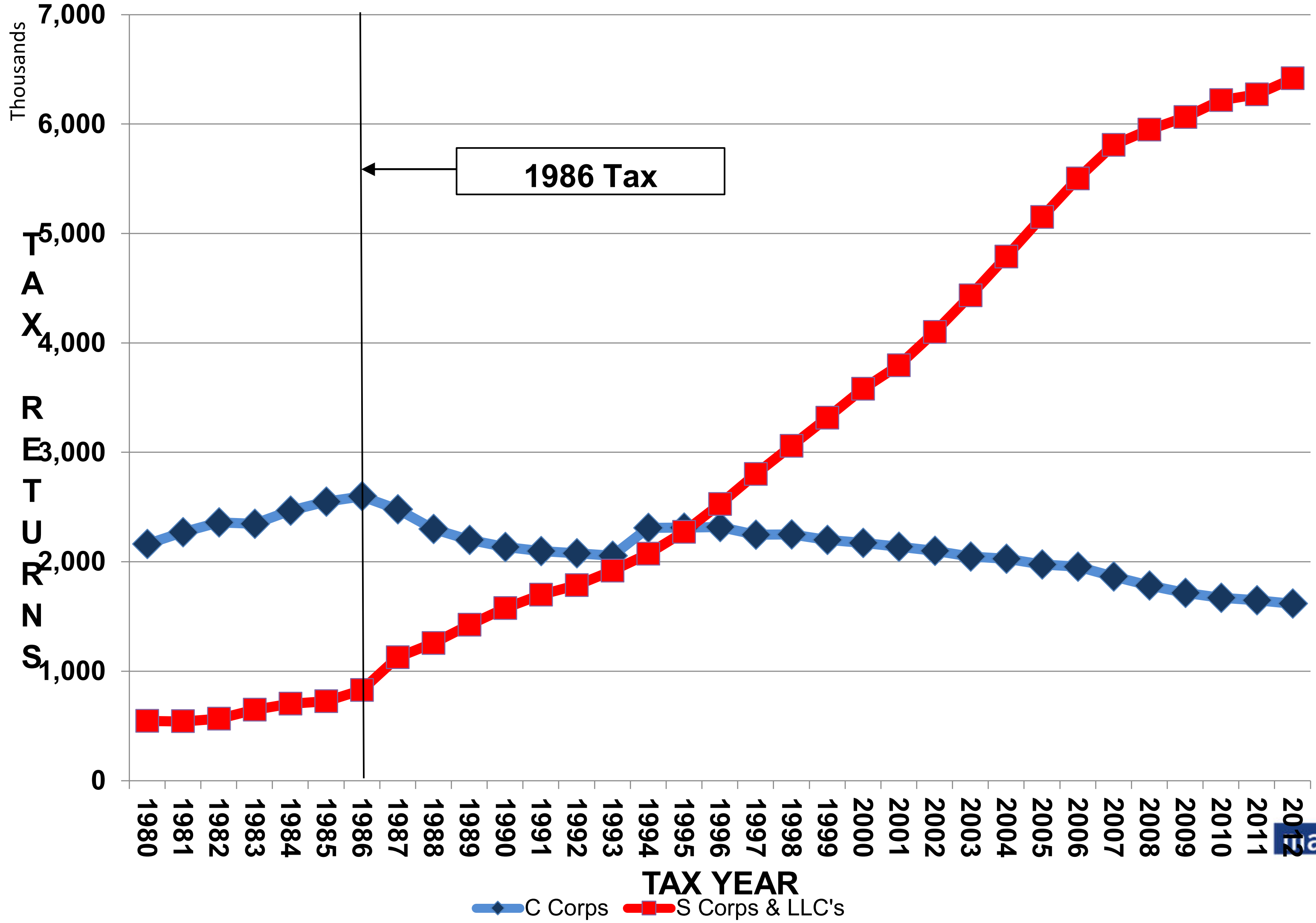
Factors Relating to the S Corp ESOP Valuation:

- Control Vs. Minority
- Distributing Vs. Non-Distributing
- Holding period of the investment
  - S corp shareholder basis
    - Retained earnings increase tax basis of stock
    - Avoidance of capital gains taxes

Number of S Corps Over the Years



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Number of S Corps Over the Years

- S Corp ESOPs have become increasingly popular since1998.
- The NCEO estimates that almost half of all the 11,000 ESOPs sponsored by U.S. Companies are now in S Corps and that the large majority of these are either are or will become 100% ESOP owned.*

*"Recent Developments Making S Corporation ESOPs More Appealing", Corey Rosen and David Ackerman, July-August 2012, *Journal of Passthrough Entities*.

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S Vs. C Corps

Only certain types of shareholders can hold S corp stock. Unqualified S corp shareholders include:

- Non-US residents
- C corps
- Partnerships
- Foreign trusts

S corps can have only 1 class of stock:

- However, voting and nonvoting are permitted

S Vs. C Corps

- S corp income not taxed at the entity level.
  - Not subject to federal corporate taxes
    - Certain States tax S Corps
- S corp shareholders recognize pro rata share of income on their tax returns and pay taxes at the ordinary income tax rate.
  - To the extent of retained earnings accounts - AAA
- Can only have max of 100 shareholders.
  - ESOP is considered a single shareholder

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S Corp ESOP Tax Advantages

- ESOP Trust is pro rata tax exempt (no income tax on S corp distributions)
- S corp income exempt from federal income tax
  - 100% owned ESOP is completely exempt from federal income tax
  - Sometimes exempt from state income tax (some states assess taxes on S corps)
- ESOP receives its pro rata share of distributions
  - Cash build-up in mature ESOP has disadvantages/advantages

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S Corps in the Courts

Case law is inconsistent in application of corporate taxes in S corps:

- *Fair Market Value - Gross v. Commissioner*, T.C. Memo. 1999-254, affd. 272 F.3d 33
- *Fair Value - Delaware Open MRI Radiology Associates, P.A. v. Kessler*, 898 A.2d 290, 2006

Tax Court has denied tax affecting in DCF

Substantial elevation of value

Delaware Chancery used adjusted tax rate to recognize S corp tax benefits

All cases are Facts & Circumstances Specific

C Corp vs. S Corp Per Delaware Open MRI

Delaware Open MRI Radiology Associates P.A. v. Kessler

	C Corp	S Corp	S Corp Valuation
Income Before Tax	$100	$100	$100
Corporate Tax Rate	40%	0%	29.40%
Available Earnings	$60	$100	$71
Dividend or Personal Tax Rate	15%	40%	15%
Available After Dividends	$51	$60	$60

This is the adjustment factor reflecting the S benefit.

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Fair Market Value Vs. Economic Value

Is FMV truly FMV in S corp ESOP valuation?

Does an S corp have more “Economic Value” than a C corp?

- Where, Economic Value (“EV”) = the enhanced cash flow from the S election
- Does the incremental cash flow generated from tax savings increase value?

In an ESOP, does the S election improve the cash flows and operations of the company, so that value is enhanced?

Fair Market Value Vs. Economic Value

Under FMV, “hypothetical” buyers and sellers are assumed in the analysis.

Would sellers demand/expect a premium for S corp status?

Would buyers be willing to pay for S corp status?

Does transaction structuring play a role?

Stock deal, asset deal, 338(h)(10)

What makes a transaction financially fair?

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11 Schools of Thought on S Election "Benefit"

1. Tax structure is not a factor in ESOP value
   - S election not considered a factor that enhances value.

It doesn't ???!

2. Market does not recognize S corp value premium.
3. C corp "hypothetical" buyers would not pay for S corp tax benefits.
4. S corp "hypothetical" buyers already have the tax benefit and would not pay more.

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11 Schools of Thought on S Election "Benefit"

5. Buyers would not pay a premium for an S.
    - Buyer would purchase the C corp and convert to an S corp for little or no cost.
    - Ignores the 5-year recognition period

6. In general, if buyer is a larger C corp, there is no benefit and S election is negated.
    - Ignores asset step up value of a 338(h)(10)

5. Investment Value scenario
    - Transaction tax structure may be a factor and seller may demand a premium (buyer may pay a premium).

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11 Schools of Thought on S Election "Benefit"

8. Would S buyer pay the same for a C corp as an S corp?
   - Cost conversion to an S corp
   - C-to-S conversions subject to 5-year recognition period
9. There are tax savings in a 338(h)(10) election, and the calculation of that premium is on a case-by-case basis.
   - Permits buyers/sellers that make a "qualified stock purchase" of an S corp to elect to treat the acquisition of stock as an asset sale
   - Depreciation tax shield benefit for the buyer

11 Schools of Thought on S Election "Benefit"

10. There is value enhancement in an S corp, IF:

    a) Any tax savings from S status is reinvest in the company to enhance productivity and operations:

    - Capex
    - W/C
    - Bonuses

    a) Shareholders receive distributions.

    b) Otherwise, the S election serves minimal benefit.

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11 Schools of Thought on S Election "Benefit"

11. Various valuation models or ideas that reflect the S corp benefit:

- Fannon
- Grabowski
- Treharne
- Van Vleet

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11 Schools of Thought on S Election "Benefit"

Income Statement	**C Corp**	**S Corp**
Income Before Taxes	$100,000	$100,000
Corp Income Taxes @ 35%	35,000	NM
Net Income	65,000	100,000
Dividends / Distributions	50,000	50,000
Dividend Taxes C Corp Shareholders @ 15%	7,500	NM
Income Tax S Corp Shareholders @ 35%	NM	35,000
Cash Flow Benefit of Shareholders	**42,500**	**15,000**
Net Income	65,000	100,000
Dividends and Distributions	50,000	50,000
Retained Earnings (Capital Appreciation)	15,000	50,000
Effect of Increase in Income Tax Basis of Shares	NM	(50,000)
Taxable Capital Appreciation	15,000	-
Capital Gains Tax Liability @ 15%	2,250	-
Capital Appreciation Benefit of Shareholders	**12,750**	**50,000**
Economic Benefit of Shareholders		
Net Cash Flow Benefit of Shareholders	**42,500**	**15,000**
Net Capital Appreciation Benefit of Shareholders	**12,750**	**50,000**
Total Economic Benefit of Shareholders	**55,250**	**65,000**

S Corp Benefit
17.65%

Van Vleet Model "SEAM"

ESOP Transactions

ESOP cannot pay more than FMV for shares

- No matter if the EV is greater than FMV
- ESOP’s EV increases each time shares are purchased at less than EV.

Purchasing shares from participants

- Departing employees must sell at FMV, and never less than FMV

If ESOP is a minority shareholder, it has no control over BOD

- If ESOP is the majority shareholder, Trustee must decide whether to block the sale of non-ESOP shares at a price above FMV.

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ESOP Transactions

Non-ESOP shares

- Typically Company BOD does not pay more than EV for non-ESOP shares.

Company BOD acts in the best interest of its shareholders

- BOD also wants to enhance shareholder value.
- BOD typically negotiates a price to pay departing shareholders a price that is FMV, but typically not above EV in order to preserve value for remaining shareholders.

Sale of ESOP

- Trustee must: 1) determine if sale is in the best interest of the participants; and 2) assess the expectation of whether the greater value will accrue from holding the investment relative to the price offered.

Impact of Contributions and Distributions

Contributions pay for the purchase of shares

In an S corp, no tax is paid by the ESOP therefore the pro rata distribution may allow a company to reduce its contributions.

1. Using distributions in lieu of contributions increases a company's pre-tax income (and cash flow) by the amount of contributions eliminated.
2. Distributions may be used in lieu of contributions
   - Distributions can then be used for repurchase of stock (recycling) or payment of debt
   - Does the use of distributions in lieu of contributions reduce the S corp economic benefit?

Impact of Contributions and Distributions

3. Distributions are used for repurchase AND contributions continue

   - This increases the economic value in an ESOP
   - The increase in an ESOP's economic value from the S election is the present value of its portion of the tax distributions.

Six Things the Trustee Needs to Look For or Ask

1. Look for application of appropriate discount rate
   - Check source of data (Ibbotson Associates, Duff & Phelps)
2. Look for application of appropriate tax rates
3. The present value of the tax savings in an S corp should NOT be added

4. If dividends (distributions) are paid out regularly should that lower the DLOM?
5. Work with valuation advisor on purpose of analysis (FMV and financially fair), i.e. transaction or annual update.
6. Work with valuation advisor on how to factor in repurchase obligation and repayment debt obligation into the financial forecast.

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Eight Common Valuation Errors

1. Incorrect standard of value applied
2. Inappropriate normalizations – double counting discounts or premia (control v minority)
3. Inappropriate application of methodology
4. Forecasts are not reasonable, defensible or unaffected by conflicts
5. Economic and industry overviews do not tie with financial analysis of subject entity
6. Ignores synthetic equity or deferred compensation liability or dilution
7. Applies after-tax multiples to pre-tax economic income
8. Applies an after-tax discount rate to pre-tax earnings

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Questions?

Thank you!

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Erin D. Hollis, ASA, CDBV, is a Director at Marshall & Stevens Incorporated. She works within the financial practice group and with ESOP clients on financial analysis and consulting services needs.

Experience – Since 2000, Ms. Hollis has worked with advisors and closely-held business owners for valuation needs, and has experience providing valuation advisory and economic analysis services in the areas of litigation, taxation, transactional, and planning purposes. Erin has provided professional services in industries, such as manufacturing, construction, transportation, agricultural, distribution, retail, wholesale, and a wide range of service industries.

She is a qualified expert witness, and has testified for various marital and corporate litigation matters. She is a prolific author on the subject of business valuation, and has written for several industry trade publications and as a contributing author for professional organizations. Erin sits on the Business Valuation Committee of the American Society of Appraisers (ASA) and is a past ASA Chicago Chapter President. She is also a member of The ESOP Association's Valuation Advisory Committee and the Interdisciplinary Advisory Committee on Fiduciary Issues, and the (NCEO) National Center for Employee Ownership.

Education – Erin received a B.A. and B.S. from Michigan State University. She is an Accredited Senior Appraiser (ASA) with the American Society of Appraisers, and Certified in Distressed Business Valuation (CDBV) with the Association of Insolvency & Restructuring Advisors (AIRA).

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