VALUATION IMPACT OF THE TRUMP TAX CHANGES

INTRODUCTION

The Trump administration recently announced plans to significantly change the U.S. tax code for businesses and individuals. The potential impact on the U.S. and world economies as well as the value of C corporations and pass-through entities ("PTEs") could be significant. In this *TGG Valuation Update*, we address the impact of the potential tax rate changes on the valuation of C corporations and PTEs.

CURRENT TAX RATES AND PROPOSED CHANGES

When estimating the value of a business, valuation experts often use stock price and financial information of publicly traded C corporations to value the subject company. This is done through the use of price earnings ("P/E") multiples or equity investment rates of return of public companies in the valuation process.

C corporations and PTEs (e.g., S corporations, LLCs, etc.) have different tax attributes at both the entity and shareholder level. These tax attribute differences can distort the equity value of PTEs when such value is estimated using C corporation data. There are mathematical models that may be used to address these tax rate differences in the valuation process. One of these methods is the Van Vleet Model.[1] The Van Vleet Model addresses the tax differences between C corporations, PTEs, and their respective shareholders by applying an adjustment—referred to as the S Corporation Equity Adjustment Multiple ("SEAM")—to the value of PTE equity when such value has been estimated using C corporation data.[2]

The changes to the tax code proposed by the Trump administration could affect the value of all businesses (both C corporations and PTEs). Since the proposed changes are different for C corporations and PTEs, the impact on the value differential between these two types of business entities will be different. The proposed changes to federal tax rates are as follows:

- Reduce the highest marginal income tax rate on C corporations from 35% to 15%.
- Reduce the highest marginal ordinary income tax rate from 39.6% to 35%.
- Reduce the income tax rate on PTE income reported at the shareholder level from the ordinary income tax rate of 39.6% (the highest marginal rate) to a new tax rate of 15% applied to income from PTEs.
- Keep the dividend and capital gains tax rates at 20% but eliminate the 3.8% Net Investment Income Tax ("NIIT") attributable to the Affordable Care Act.

[1] Van Vleet, Daniel R., "A New Way to Value S Corporation Securities," *Trusts & Estates Magazine*, New York, NY, March 2003.

[2] The Van Vleet Model is one of the most widely used PTE models in the U.S. It has appeared in three respected valuation textbooks, nine published articles, and is the subject of over 30 presentations at the national and regional professional conferences of every major business valuation organization and society in the U.S.

Below, we demonstrate the effect that the proposed tax changes may have on earnings and business value based on the federal and state income tax attributes of the state of California. We selected California because it has some of the highest state tax rates in the nation.

Table 1 provides the statutory tax rates that apply to California C corporations, California PTEs, and their respective shareholders:

TABLE 1 – CURRENT TAX RATE STRUCTURE

	State Tax Rate	Federal Deduction	Effective Tax Rate	Key
Federal Tax Rates				
C Corp Income Tax Rate			35.0%	A
Ordinary Income Tax Rate			39.6%	B
Capital Gains & Dividend Tax Rate			20.0%	C
Net Investment Income Tax Rate (NIIT)			3.8%	D
California State Tax Rates				
C Corp Income Tax Rate	8.8%	3.1%	5.7%	E
Ordinary Income Tax Rate	13.3%	5.3%	8.0%	F
Capital Gains & Dividend Tax Rates	13.3%	5.3%	8.0%	G
PTE State Franchise Tax Rate (1)	1.5%			H
Combined Tax Rates				
C Corp Income Tax Rate			40.7%	A + E
PTE Shareholder Tax Rate			51.4%	B + D + F
Capital Gains & Dividend Tax Rates			31.8%	C + D + G
Notes				
(1) This is a state tax paid at the entity level by the PTE.				
Rates reflect the top marginal statutory rates.				

As illustrated in Table 1 above, state taxes are deductible by businesses and individuals on their federal income tax returns. Consequently, we adjusted the California statutory tax rates by the applicable federal tax rate. For example, the California tax rate on C corporation income is 8.8%. Since this tax is deductible on the federal tax return of the subject entity, the actual effective tax rate is 5.7%.[3] The combined tax rates for California are calculated by adding together the federal and state tax-affected tax rates. For example, the 51.4% California PTE shareholder tax rate is calculated by adding the federal ordinary income tax rate of 39.6%, the NIIT rate of 3.8%, and the tax-affected state income tax rate of 8.0%.

The tax rates listed in Table 1 are statutory tax rates for the highest income bracket and do not necessarily reflect the actual effective tax rates paid by corporate entities or individual shareholders. State and federal tax deductions, graduated tax schemes, tax credits, alternative minimum taxes, net operating loss carryforwards, accelerated depreciation, foreign tax credits, sales taxes, and property taxes are just a few of the tax related issues that taxpayers deal with on a regular basis. Consequently, the actual effective tax

[3] Calculated from Table 1 as 8.8% x (1 – 35.0%) = 5.7%.

rates paid by taxpayers and businesses in any given year may be significantly different than the statutory tax rates listed above. In addition, the tax rates of public companies may be inconsistent with the statutory tax rates on California C corporations. Consequently, it may not be appropriate to simplistically assume that full statutory tax rates will apply when conducting an actual business valuation analysis.

Table 2 provides the tax rates applicable to C corporations, PTEs, and their respective shareholders under the Trump administration proposals:

TABLE 2 – PROPOSED TAX RATE STRUCTURE

	State Tax Rate	Federal Deduction	Effective Tax Rate	Key
Federal Tax Rates				
C Corp Income Tax Rate			15.0%	I
Ordinary Income Tax Rate			35.0%	J
Capital Gains & Dividend Tax Rate			20.0%	K
Net Investment Income Tax Rate (NIIT)			0.0%	L
PTE Income Tax Rate (1)			15.0%	M
California State Tax Rates				
C Corp Income Tax Rate	8.8%	1.3%	7.5%	N
Ordinary Income Tax Rate	13.3%	4.7%	8.6%	O
Capital Gains & Dividend Tax Rate	13.3%	4.7%	8.6%	P
PTE State Franchise Tax Rate (2)	1.5%			Q
PTE Income Tax Rate (3)	13.3%	2.0%	11.3%	R
Combined Tax Rates				
C Corp Income Tax Rate			22.5%	I + N
PTE Shareholder Tax Rate			26.3%	M + R
Capital Gains & Dividend Tax Rates			28.6%	K + P

Notes

(1) This is a federal tax paid at the personal level by PTE shareholders on their share of the PTE's net income. (Under current treatment, the federal ordinary income tax rate is applied.)

(2) This is a state tax paid at the entity level by the PTE. Because PTEs do not pay entity-level federal taxes, there is no federal deduction.

(3) This is a state tax paid at the personal level by PTE shareholders on their share of the PTE's net income.

Rates reflect the top marginal statutory rates.

As demonstrated in Table 2 above, the Trump administration's proposed tax rates would dramatically lower the current tax statutory tax rates shown in Table 1. These lower tax rates may also significantly increase the after-tax net income and cash flows of business entities, which may also have an impact on value.

IMPACT ON TOTAL EFFECTIVE TAX RATES

The disparate income tax treatment of C corporations, PTEs, and their respective shareholders can have a material impact on cash flow and equity value. Since the valuation of most PTEs involves the use of market-derived data for C corporations, these tax rate differences should be addressed in the analysis. In addition, the proposed tax rate changes are different for C corporations, PTEs, and their respective shareholders. Consequently, the impact on future valuations may also be subject to change. Table 3 demonstrates the significant differences between the current and proposed tax rate structures.

TABLE 3 – TOTAL EFFECTIVE TAX RATES

	Current Tax Rates		Proposed Trump Tax Rates	
State of California	**C Corp. ($000)**	**PTE ($000)**	**C Corp. ($000)**	**PTE ($000)**
Income Before Entity Income Taxes	$ 100,000	$ 100,000	$ 100,000	$ 100,000
Entity Level Income Taxes	(40,746)	(1,500)	(22,514)	(1,500)
Net Income	59,254	98,500	77,486	98,500
Tax Obligation of Shareholders	(18,862)	(50,662)	(22,196)	(25,910)
Net Economic Benefit	40,392	47,838	55,290	72,590
Total Effective Tax Rate	**59.6%**	**52.2%**	**44.7%**	**27.4%**

IMPACT ON CASH FLOW AND VALUATION

As demonstrated in Table 3 above, the total effective tax rate for California C corporations and their shareholders under current tax law is 59.6%. Under the Trump administration's proposed tax rates, this rate would decline to 44.7%. For California PTEs, the total effective tax rate is currently 52.2%, but would decline to 27.4% under the Trump administration's proposed tax rates. In other words, a California C corporation that elects to convert to an S corporation could reduce its total effective tax rate from 59.6% under current law to 27.4% based on the proposed tax rates.

Tax rate changes of this magnitude could have a material impact on projected cash flows and valuations for both public and privately held entities. The proposed tax changes could increase the net economic benefit to California C corporation shareholders by 36.9%,[4] and could increase the net economic benefit to the California PTEs shareholders by 51.7%.[5]

Of potentially greater significance is the expansion of the economic disparity between C corporations and PTEs under the proposed tax changes. Under current tax law, California PTEs can generate about 18.4% more in net economic benefit than California C corporations.[6] Under the proposed tax rate changes, this disparity could grow to 31.3%.[7]

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[4] Calculated from Table 3 as ($55,290 / $40,392) – 1 = 36.9%.

[5] Calculated from Table 3 as ($72,590 / $47,838) – 1 = 51.7%.

[6] Calculated from Table 3 as ($47,838 / $40,392) – 1 = 18.4%

[7] Calculated from Table 3 as ($72,590 / $55,290) – 1 = 31.3%

SUMMARY

Based on the information presented above, the values of both C corporations and PTEs could increase under the proposed tax changes. In addition, the values of PTEs could increase more than those of C corporations. Since valuation is a complex interaction between market based data and historical and projected financial performance, the actual impact on the values of C corporations and PTEs remains to be seen. And, the proposed tax rate changes will be subject to congressional negotiation and approval prior to receiving presidential approval. However, it seems clear the Trump administration is intent on lowering tax rates for businesses and individuals.

These issues have valuation implications for gift and estate tax planning, corporate transactions, and shareholder disputes. Corporate executives and financial advisors should be aware of the changing tax rate environment and be prepared to make changes when these potential changes become more certain. The Griffing Group will continue to monitor tax rate legislation and advise its clients on the impact to business valuation.

ABOUT THE GRIFFING GROUP

For nearly 30 years, The Griffing Group has provided expert testimony and consulting services regarding the valuation of business enterprises, fractional equity interests, complex debt and equity securities, and intangible assets. Our senior experts have testified in a variety of federal and state courts including the U.S. Bankruptcy Court, Delaware Court of Chancery, and U.S. Federal District Court. We have appeared and provided expert valuation consulting services before the Internal Revenue Service, the Securities and Exchange Commission, and the American Arbitration Association. We provide our services for a variety of purposes, including:

- Appraisal and Fiduciary Duty Matters
- Bankruptcy and Restructuring Disputes
- Corporate Transaction Advisory and Disputes
- Dissenting Shareholder and Oppression Disputes
- Family Law Valuation Consulting Services
- Tax Valuation and Controversies
- Trustee Valuation Advisory Services

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He has testified more than 30 times in depositions and at trials in U.S. Bankruptcy Court, U.S. District Court, the Delaware Court of Chancery, and various state courts and arbitrations. He has extensive experience providing fair market value opinions to the IRS in controversy matters at audit, appeals, and fast track settlement involving closely-held businesses and fractional equity interests.

He is a contributing author to seven valuation textbooks and author of over 30 published articles. He has presented over 70 lectures on advanced subjects in the areas of business valuation, litigation, and corporate transactions and routinely works on complex valuation issues with some of the largest corporations and wealthiest families in the U.S.

Mr. Van Vleet earned his MBA from the University of Chicago and has served as the International President of the American Society of Appraisers (ASA). He has also served as an Adjunct Professor of Finance at DePaul University; a Finance Instructor at Northwestern University; and a Business Valuation Instructor for the ASA. He is a member of the valuation editorial review board of Trusts & Estates magazine and has served as the ASA representative to the International Valuation Standards Council (IVSC) and the Saudi Authority for Accredited Valuers (TAQEEM).

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Mr. McInerney has provided litigation support for matters heard in a variety of jurisdictions, including U.S. District Court, the Delaware Court of Chancery, New York State Supreme Court, the Superior Court of New Jersey, United States Tax Court, the American Arbitration Association, and other state, district, and county courts in California, Illinois, Oklahoma and Texas.