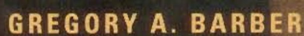
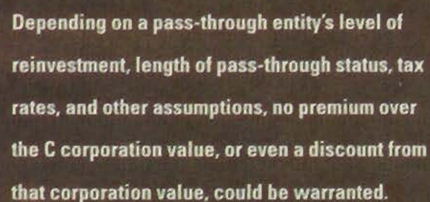
GREGORY A. BARBER



Valuation of Pass-Th

rough Entities


Depending on a pass-through entity's level of reinvestment, length of pass-through status, tax rates, and other assumptions, no premium over the C corporation value, or even a discount from that corporation value, could be warranted.

For more than a decade,

there has been considerable discussion and debate in the valuation community regarding the valuation of pass-through entities, such as limited liability companies, S corporations, and partnerships. The debate was reinvigorated by *Gross*,[1] a Tax Court case, in which Judge Halpern concluded that the subject S corporation should not be treated as taxed at the entity level during the valuation process, contrary to the opinion of many valuation experts. Rarely has an issue's impact been so material, and yet valuation professionals are still without a generally accepted method to value these hybrid entities. With the growing popularity of the limited liability company legal structure, this issue can be expected to grow in importance and scope over the coming years.

The pass-through entities that lead to valuation difficulties are operating entities that, if they were public, would be C corporations.[2] This, of course, renders the market approach difficult to apply because there are no public companies that are comparable in terms of both business operations and tax status. The income approach is also difficult to apply because that approach is structured to discount the cash flows of C corporations, not pass-through entities.[3] Generally, though, there is no difficulty in valuing a pass-through entity that is a holding company in liquidation, where the cost approach would be appropriate. Nor is there much debate on the valuation of pass-through companies that have public counterparts that are also pass-through entities, such as real estate investment trusts.

The Pass-Through Entity: Pros and Cons

A pass-through entity can take many forms, such as an S corporation, a limited liability company, a limited partnership, a general partnership, or a sole proprietorship. What differentiates the pass-through entity from the C corporation, and is its major advantage, is that

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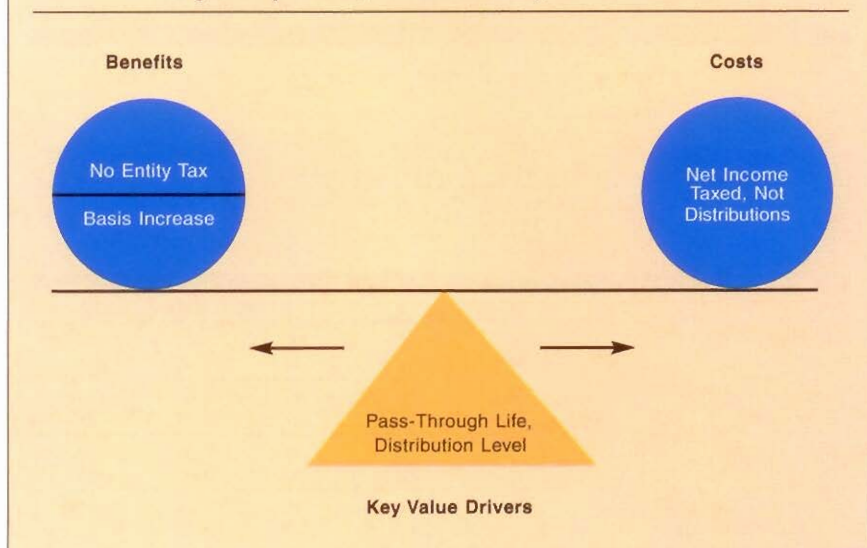
income is not taxed by the federal government at the entity level. Each state has its own legislation governing the taxes and fees to be paid by the various pass-through entities and, as one would expect, each state is unique. Generally, however, these entities do not pay federal or state income tax, and the income is "passed through" to shareholders or owners. The owners then pay personal taxes on the income *regardless of whether or not they receive distributions.*

This is easily said and understood, but as shown later, it is the key to valuing these entities correctly. Some pass-through entities, to appease investors' fears of having taxes "come out of pocket," have included provisions in their operating documents that require distributions in amounts sufficient to fund personal taxes; many, however, do not. This potential liability can have a chilling impact on potential buyers of the interest, even if there is a history of distributions sufficient to pay personal taxes.

The other benefit of being an owner of a pass-through entity is that income retained in the entity increases each owner's basis. This advantage can be material and is commonly overlooked in the valuation of these entities. C corporation shareholders enjoy no such benefit.

A shortcoming of pass-through status is that it may be fleeting. This can result from the sale of the entire entity to a C corporation, revocation of the laws permitting pass-through status, or the destruction of the pass-through status by an unwitting or disgruntled shareholder. Because of these factors and others, it is very rare for a company to expect to retain pass-through status in perpetuity.



The Debate: Positions and Valuation Methods

Many positions have been taken by valuation professionals on the correct way to value a pass-through entity, some intuitive and some more technical. One of the more appealing intuitive arguments is: "Why would a buyer of a pass-through entity pay anything for its tax status if it can be elected for free?" This argument is strongest in a situation in which the entire company is being sold and the likely buyers are C corporations. Clearly, the hypothetical seller would have little chance of receiving a premium for pass-through status (assuming one in fact exists) if none of the buyers were going to benefit from it.

The argument fails through when the hypothetical buyers are pass-through entities. For example, imagine the sale of 100% of the equity of a limited liability company that invests primarily in real estate. If the likely buyers of this company are real estate investment trusts, it is highly likely they will bid for the company based on their assessment of it as a pass-through entity, even though the pass-through status election is "free."

The argument also fails when the subject interest is a minority position. The minority shareholder, standing alone, cannot elect for pass-through status for "free" and must bid for the equity based on what it is, a pass-through entity, not on what it is not, a C corporation. In a competitive market, the shareholder may be outbid for the interest if he or she evaluates it as a C corporation.

Another argument that rings true with some valuation professionals is: "The entity, whether it is a pass-through or a C corporation, essentially pays tax through distributions, or directly, leaving it with approximately the same amount of cash to reinvest. The operating entity then, in either case, is unaffected, so must be worth the same amount." This argument is especially appealing when the pass-through entity is distributing only enough for taxes and has a defined term. For example, how could a pass-through entity be worth more than a C corporation if it is going public in two years and distributes only enough for personal tax? Cash returns to the pass-through and C corporation shareholders are virtually the same net of personal tax: zero net cash for two years, and then the offering proceeds. The only difference in cash flows is the pass-through owner's greater sale proceeds after personal tax, due to the increased basis from undistributed earnings.

This argument starts to lose its appeal, however, when the pass-through entity distributes more than is required for personal taxes. The pass-through shareholder then gains the benefit of a single level of tax, as opposed to two levels of tax in the C corporation. Under the distribution-for-taxes-only scenario, that benefit had been essentially discarded (through reinvestment) and exchanged for the increase in basis benefit. It is thus apparent that the level of distributions does matter in pass-through entity valuation. Exhibit 1 summarizes graphically the costs and benefits of pass-through entity ownership and the key value drivers specific to pass-through entities.[4]

The many proposed methods to value pass-through entities are a reflection

EXHIBIT 2
Cash Flow Valuation

Method I						
Year		1	2	3	4	5
Income before tax		100	100	100	100	100
Entity level tax	40%	40	40	40	40	40
Net income		60	60	60	60	60
Discount rate/factor	15%	.8696	.7561	.6575	.5718	.4972
Discounted cash flows		52	45	39	34	0
Sum		$201				

Method II						
Year		1	2	3	4	5
Income before tax		100	100	100	100	100
Entity level tax	40%	40	40	40	40	40
Net income		60	60	60	60	60
Personal tax	45%	27	27	27	27	27
Net cash flow		33	33	33	33	33
Discount rate/factor*	8.25%	.9238	.8534	.7883	.7283	.6728
Discounted cash flows		30	28	26	24	22
Sum		$131				

**Calculated: 15%(1-45%)*

EXHIBIT 3
Pass-Through Cash Flow Adjustment

		Scenerio A	Scenerio B
Income before tax		100	100
Entity level tax	1.5%	2	2
Net income		98	98
Depreciation		20	20
Capital expenditures		(20)	(20)
Net working capital (needs)/ release		(15)	—
Free cash flow/distributions		83	98
Personal income tax	45%	44	44
After personal tax cash flow		39	54
C corporation-equivalent, pre-personal tax cash flow		71	98
Pass-Through Basis Adjustment			
Increased basis due to undistributed earnings		15	—
Personal tax savings	25%	4	—
C corporation-equivalent, pre-personal tax additional sales proceeds		5	—

of how divided the valuation community is on the issue. The first technique takes the words of the Internal Revenue Service's internal documents[5] to heart and taxes the pass-through as a C corporation. This approach, although refreshingly simple, ignores the major issue: There may be some value adjustment necessary due to the tax status of the entity. This approach and justification has not been accepted by the Tax Court.[6]

Another approach is to tax the entity at the personal tax rate and discount the cash flows using C corporation derived discount rates. This approach mixes apples and oranges. It fails to recognize that after-personal tax cash flows are more valuable to shareholders than pre-personal tax earnings and should not be discounted at pre-personal tax discount rates.

The last approach is not to tax the entity at all, as it does not pay taxes. The resulting cash flows are then discounted using C corporation discount rates. This matches the discount rate with the correct level of cash flow, pre-personal tax. This approach, however, fails to recognize that cash flows from a pass-through entity are not *exactly* like cash flows from a C corporation, as pass-through entity shareholders pay taxes on net income, while C corporation shareholders pay taxes on distributions, or dividends. This approach yields excellent results for the pass-through entity, provided distributions and net income are the same; however, once distributions are less than net income, the true after-tax returns to pass-through and C corporation shareholders diverge, and logically, so do entity values.

One truism that quickly becomes evident from the pass-through entity valuation debate is that after-personal-tax returns are the "bottom line" to investors. This helps explain why non-taxable municipal bonds have yields significantly below their taxable counterparts, and leads to the obvious question: If after-tax returns are how investors evaluate opportunities, why not value pass-through entities on an after-personal-tax basis?

This methodology has two problems; the first is small and the second is more difficult. The small problem is that historical returns for shareholders have not been calculated on an after-personal-tax basis, so those returns are unknown. Based on current tax rates, however, after-personal tax returns may be estimated by multiplying by one minus the personal tax rate.[7] For example, a 15% discount rate, assuming a 45% personal tax rate, would yield an after-personal-tax rate of 8.25% (15% x (1 - 45%)).

The more difficult problem lies in the application of the discounted cash flow methodology for a limited period of time. In Exhibit 2, a company's cash flows for the next five years are valued using two different discounting techniques. In Method I, the cash flows (net income in this case), after entity-level tax, but before personal tax, are valued at $201, using a discount rate of 15%. The same cash flows after personal taxes (Method II) are valued at $131, using an after-personal-tax discount rate of 8.25%. For short periods, it is clear that the after-personal-tax method undervalues cash flows relative to how they are traditionally

valued, i.e., Method I.[8] This makes it difficult to use the after-personal-tax method reliably in valuing pass-through entities because their pass-through benefits are usually valued over a relatively short period—from one to 20 years.

A method is needed that allows the application of traditional, generally accepted discounting techniques, i.e., after entity-level tax but before personal tax, to pass-through entities. This requires some adjustments to the cash flows of the pass-through entity to make them equivalent to C corporation cash flows. Thankfully, in a recent article, J. Michael Julius has provided some insight in this area.[9] Expanding on Julius's previous work, the following model provides some guidance into the valuation of pass-through entities across various reinvestment and pass-through status life assumptions and reveals some surprising results.

The Pass-Through Discounted Cash Flow Model

The pass-through discounted cash flow model (the "Model") is essentially the same as discounted cash flow models used to value C corporations, except for three adjustments.

The first adjustment (the "pass-through cash flow adjustment"), illustrated in Exhibit 3, Scenario A, translates pass-through cash flows to C corporation equivalent cash flows so that traditional discounting techniques can be applied. The company illustrated is an S corporation that generated $100 of pre-entity tax income, paid $2 in state income taxes, and produced net income of $98. Cash requirements for reinvestment were $15 for the year, leaving $83 to be distributed to shareholders.

Normally, if the company was a C corporation, the $83 would be discounted at C corporation discount rates and add to the value of the company. However, because the pass-through entity pays income tax on income, not distributions, the $83 cash flow is not equivalent to $83 from a C corporation. To adjust to a C corporation equivalent amount, the valuation expert must first calculate what would have been realized by the pass-through share-

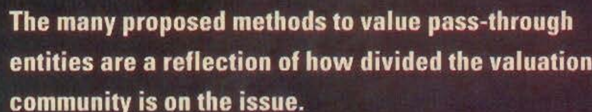


EXHIBIT 4
The Pass-Through Discounted Cash Flow Model (Valuing a C Corporation in Perpetuity With No Growth)

Key Value Driver Assumptions:							
Pass-Through Life (years)	0						
Reinvestment Rate*	100%						
Year		1	2	3	4	5	250
Revenue		2,000	2,000	2,000	2,000	2,000	2,000
Income before tax		250	250	250	250	250	250
Entity level tax rate		40%	40%	40%	40%	40%	40%
Entity level tax		100	100	100	100	100	100
Net income		150	150	150	150	150	150
Depreciation		80	80	80	80	80	80
Capital expenditures		(80)	(80)	(80)	(80)	(80)	(80)
Net working capital (needs)/ release		0	0	0	0	0	0
Free cash flow/distributions		150	150	150	150	150	150
Pass-Through Cash Flow Adjustment							
Personal income tax	45%	(68)	(68)	(68)	(68)	(68)	(68)
After-personal-tax cash flow		83	83	83	83	83	83
C corporation-equivalent cash flow		150	150	150	150	150	150
Discount rate/factor	15%	.8696	.7561	.6575	.5718	.4972	0
Discounted cash flows		130	113	99	86	75	0
Sum of discounted cash flows		1,000					
Terminal value		0					
Pass-Through Basis Adjustment		**0**					
Indicated marketable value		1,000					
Marketability discount	30%	(300)					
Indicated nonmarketable value		$700					

**Capital expenditures as a percent of depreciation.*

holder after personal taxes ($83 - (45% x $98) = $39). This figure is grossed up to an amount that would have been distributed from a C corporation to produce the same after personal tax cash flow ($39 / (1 - 45%) = $71). This example clearly shows that when distributions from the pass-through entity are less than net income, the apparent distributions need to be adjusted in order to apply the traditional discounted cash flow framework. If distributions are equal to net income (Exhibit 3, Scenario B), distributions from a pass-through entity and a C corporation are economically equivalent.

The second adjustment (the "pass-through basis adjustment") accounts for the investor's increase in tax basis due to undistributed earnings. Again, as illustrated in Exhibit 3, Scenario A, assume that the pass-through company did not distribute $15 of net income, and at the end of the year, the company is sold. The pass-through investor is in an advantageous position relative to the C corporation investor because the pass-through investor's basis is $15 higher, and he or she will pay less capital gains tax on sale. In fact, the pass-through investor will receive $4 more, net of tax, assuming a 25% personal capital gains rate (25% x $15 = $4). This increase in net proceeds is equivalent to receiving $5 ($4 / (1 - 25%) = $5) more in sale proceeds if the company had been a C corporation. An after-personal-tax adjustment must again be made to make the cash flows compatible with the C corporation discounted cash flow methodology. In Scenario B, all the income is distributed from the pass-through entity, so no basis adjustment is required. In the Model, the pass-through basis adjustment is discounted back to reflect its anticipated present value.

The third adjustment to the Model allows the user to select the period of pass-through status, from zero to 250 years. Set at zero years of flow-through status, the Model behaves exactly as a traditional discounted cash flow model; under the 250-year assumption, the entity is essentially valued in perpetuity as a pass-through entity. This is the most logical input for the analyst to adjust to reflect the potential loss of pass-through status that, as stated previously, could be anticipated for many reasons.

Importantly, the Model also allows the user to select the reinvestment assumption so that pass-through entities distributing all their income can be valued, as well as those distributing only enough for personal tax. The Model is asset driven, in that growth in revenues and earnings can occur only through capital spending above the depreciation amount or an increase in the expected return on assets. The Model also allows for changes in personal and corporate tax rates to accommodate all jurisdictions, as well as changes in key value drivers such as the discount rate, net working capital requirements, and asset depreciation

EXHIBIT 5
The Pass-Through Discounted Cash Flow Model
(Valuing a Pass-Through Entity in Perpetuity That Distributes All Its Free Cash Flow)

Key Value Driver Assumptions:							
Pass-Through Life (years)	250						
Reinvestment Rate*	100%						
Year		**1**	**2**	**3**	**4**	**5**	**250**
Revenue		2,000	2,000	2,000	2,000	2,000	2,000
Income before tax		250	250	250	250	250	250
Entity level tax rate		1.5%	1.5%	1.5%	1.5%	1.5%	1.5%
Entity level tax		4	4	4	4	4	4
Net income		246	246	246	246	246	246
Depreciation		80	80	80	80	80	80
Capital expenditures		(80)	(80)	(80)	(80)	(80)	(80)
Net working capital (needs)/ release		0	0	0	0	0	0
Free cash flow/distributions		150	246	246	246	246	246
Pass-Through Cash Flow Adjustment							
Personal income tax	45%	(111)	(111)	(111)	(111)	(111)	(111)
After-personal-tax cash flow		135	135	135	135	135	135
C corporation-equivalent cash flow		246	246	246	246	246	246
Discount rate/factor	15%	.8696	.7561	.6575	.5718	.4972	0
Discounted cash flows		214	186	162	141	122	0
Sum of discounted cash flows		1,642					
Terminal value		0					
Pass-Through Basis Adjustment		**0**					
Indicated marketable value		1,000					
Marketability discount	35%	(575)					
Indicated nonmarketable value		$1,067					

**Capital expenditures as a percent of depreciation.*

rates. Finally, to adjust the indicated value to reflect the risk of insufficient distributions to pay taxes, the Model also adds a premium to the marketability discount. Of course, pass-through entities that are required by their operating documents to make distributions in amounts sufficient to pay personal taxes would not warrant this premium. The amount of the premium, and the base marketability discount, will be specific to each circumstance. For illustration purposes, a "middle of the road" base marketability discount of 30.0% and a premium of 5.0% was selected. Valuation practitioners should find enough flexibility in the Model to make it applicable to almost all situations.

Exhibit 4 shows the Model structured to value a C corporation in perpetuity with no growth. As would be expected, the sum of the discounted cash flows, before the marketability discount, of $1,000 is the same as if net income had been capitalized ($150 / 15% = $1,000). Further, according to discounted cash flow theory, the value of the corporation does not vary with different reinvestment assumptions, as the company earns an adequate return of 15.0%, after entity tax, on its asset base. If the company reinvests all its free cash for 250 years, the Model still indicates a value of $1,000 before applying the marketability discount. As expected, the pass-through cash flow adjustment does not result in any change of cash flow for a C corporation.

Exhibit 5 shows a pass-through entity that expects to remain so in perpetuity and distributes *(Continued on page 44)*

1 TCM 1999-254. The case was appealed to the Sixth Circuit Court of Appeals and a decision is expected shortly.

2 The company in the *Gross* case is a soft drink bottler and an excellent example.

3 As shown later, identical pre-personal tax cash flows from a pass-through entity and a C corporation are not always economically equivalent.

4 Other value drivers, such as tax rates, rates of return on investment, etc., obviously affect the value indication also, but are not unique to pass-through entities.

5 The Service's own training documents suggest valuing S corporations as C corporations and reads in part: "S corporations lend themselves readily to valuation approaches comparable to those used in valuing closely held corporations (C corporations). You need only to 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." *IRS Valuation Training for Appeals Officers* (CCH Incorporated, 1998), pp. 7-12.

6 See Note 1, *supra*.

7 Ibbotson Associates suggests a similar method for adjusting discount rates to a pre-entity level tax basis *Stocks, Bonds, Bills and Inflation: 2000 Yearbook TM Valuation Edition* (Ibbotson Associates, 2000), p. 78.

8 In perpetuity, or for long periods, the values are equal, in this case $400, assuming no growth.

9 Julius, "Converting Distributions from S Corporations and Partnerships to a C Corporation Dividend Equivalent Basis," Business Valuation Review (June 1997).

10 It is assumed that the holding period for the investor and the life of the pass-through entity are the same, here, and in the other examples.

11 The pass-through in the example pays 1.5% entity tax and the shareholders 45% personal tax for an effective overall cash tax burden of 46% of income. The C corporation only pays out 40% of income.

12 See Note 1, *supra*.

Pass-Through Entities

(Continued from page 11) all its free cash flow, the same as the C corporation in the previous exhibit. This example reveals a pass-through value premium of 52.4% ($1,067 / 700 - 1), the highest premium one would expect to see for a pass-through entity using these assumptions. This is the maximum premium, given the assumptions, because the pass-through in full distribution status is maximizing its benefit of not taxing earnings twice before they reach the shareholder. Obviously, in full distribution mode, the pass-through entity would not provide its shareholders with any basis increase, so there is no pass-through basis adjustment. It is a rare circumstance though, when pass-through status and full distributions are expected in perpetuity.

Exhibit 6 presents a more prevalent example in which distributions are sufficient only to cover personal taxes and the pass-through status term is expected to be much shorter, four years, at which point the company will be sold.[10] In this case, the pass-through cash flow adjustment reduces cash flow to zero during the term of pass-through status because, after personal tax, that is precisely what the shareholders receive. The pass-through basis adjustment is material in this case because of the significant reinvestment into the company. On balance, a pass-through with these qualities would be worth the same as a C corporation.

Exhibit 7 applies the Model to a company distributing more than is required for personal taxes, but less than all its taxable income. The period of pass-through status is again four years. In this case, both the pass-through cash flow adjustment and pass-through basis adjustment are activated. The pass-through cash flow adjustment reduces the cash flow to the C corporation equivalent amount, and because distributions are less than net income, a pass-through basis adjustment is required. The total of the benefits, net of the increased marketability discount, results in an indicated value of $763, or a pass-through premium of 9.0% ($763 / 700 - 1).

Exhibit 8 contains an analysis using various pass-through status terms and reinvestment rates. One of the main findings is that a pass-through entity distributing only enough for personal taxes (the 235% Reinvestment Rate column) would, under these circumstances, rarely be valued at a premium to its C corporation equivalent. Surprisingly, if the pass-through entity is expected to remain so for more than ten years, under 235% reinvestment, the analyst would need to consider the merits of a discount. The reason the pass-through entity is worth *less* than the C corporation in these circumstances is that it is reinvesting approx-

EXHIBIT 6
The Pass-Through Discounted Cash Flow Model
(Valuing a Four-Year Pass-Through Entity That Distributes Only Enough to Cover Personal Taxes)

Key Value Driver Assumptions:							
Pass-Through Life (years)	4						
Reinvestment Rate*	235%						
Year		1	2	3	4	5	250
Revenue		2,000	2,271	2,578	2,927	3,324	1.1E+17
Income before tax		250	284	322	366	415	1.3E+16
Entity level tax rate		1.5%	1.5%	1.5%	1.5%	40%	40%
Entity level tax		4	4	5	5	166	5.4E+15
Net income		246	280	317	360	249	8.1E+15
Depreciation		80	91	103	117	133	4.3E+15
Capital expenditures		(188)	(214)	(243)	(276)	(313)	-1E+16
Net working capital (needs)/ release		(27)	(31)	(35)	(40)	(45)	-1.5E+15
Free cash flow/distributions		111	126	143	162	24	7.9E+14
Pass-Through Cash Flow Adjustment							
Personal income tax	45%	(111)	(126)	(143)	(162)	(11)	-3.5E+14
After-personal-tax cash flow		0	0	0	0	13	403E+14
C corporation-equivalent cash flow		0	0	0	0	24	7.9E+14
Discount rate/factor	15%	.8696	.7561	.6575	.5718	.4972	0
Discounted cash flows		0	0	0	0	12	1
Sum of discounted cash flows		909					
Terminal value		41					
Pass-Through Basis Adjustment		126					
Indicated marketable value		1,077					
Marketability discount	35%	(377)					
Indicated nonmarketable value		$700					

**Capital expenditures as a percent of depreciation.*

EXHIBIT 7
The Pass-Through Discounted Cash Flow Model
(Valuing a Four-Year Pass-Through Entity That Distributes More Than Is Required for Personal Taxes)

Key Value Driver Assumptions:							
Pass-Through Life (years)	4						
Reinvestment Rate*	175%						
Year		1	2	3	4	5	250
Revenue		2,000	2,150	2,311	2,485	2,671	1.3E+11
Income before tax		250	269	289	311	334	1.7E+10
Entity level tax rate		1.5%	1.5%	1.5%	1.5%	40%	40%
Entity level tax		4	4	4	5	134	6.6E+9
Net income		246	265	285	306	200	9.9E+9
Depreciation		80	86	92	99	107	5.3E+9
Capital expenditures		(140)	(151)	(162)	(174)	(187)	-9.3E+9
Net working capital (needs)/ release		(15)	(16)	(17)	(19)	(20)	-9.9E+8
Free cash flow/distributions		171	184	198	213	100	5E+9
Pass-Through Cash Flow Adjustment							
Personal income tax	45%	(111)	(119)	(128)	(138)	(45)	-2.2E+9
After-personal-tax cash flow		60	65	70	75	55	2.7E+9
C corporation-equivalent cash flow		110	118	127	137	100	5E+9
Discount rate/factor	15%	.8696	.7561	.6575	.5718	.4972	0
Discounted cash flows		96	89	83	78	50	0
Sum of discounted cash flows		1,100					
Terminal value		0					
Pass-Through Basis Adjustment		64					
Indicated marketable value		1,174					
Marketability discount	35%	(411)					
Indicated nonmarketable value		$763					

**Capital expenditures as a percent of depreciation.*

EXHIBIT 8
Premium/(Discount) for Pass-Through Status Model

	Reinvestment Rate*						
Pass-Through Term (Years)	100%	125%	150%	175%	200%	225%	235%
3	13.3%	10.9%	8.3%	5.7%	2.9%	0.1%	-1.2%
5	22.8%	19.5%	15.9%	11.9%	7.6%	2.9%	0.8%
10	37.7%	33.5%	28.4%	22.2%	14.7%	5.6%	1.4%
15	45.1%	40.8%	35.2%	27.8%	18%	5%	-1.5%
20	48.8%	44.7%	39%	31%	19.5%	3%	-5.9%
250	52.4%	49.2%	44.2%	36%	19.7%	-29.3%	-94.5%

**Capital expenditures as a percent of depreciation.*

imately 10% less money every year in earning assets due to its more onerous cash tax burden.[11] The C corporation's additional reinvestment and the compounding effect overwhelm the pass-through entity's increase in basis benefit (which does not grow geometrically) after 12 years of pass-through life and it results in a discount. Carried to the extreme, the pass-through entity would need to be discounted almost 95% if the expected term was 250 years. Of course, the set of assumptions supporting this conclusion is probably not realistic. It is more likely that after some time, the pass-through entity's industry would mature and reinvestment rates would decrease. As expected, the same table shows the largest premiums for pass-through entities that are making the least reinvestment and that are expected to exist for the longest period. Predictably, for any given term, the size of the premium decreases with the increase in reinvestment rate.

Conclusion

The circumstances in *Gross*[12] are relatively rare. Corporations that have a long history of distributing almost all their income, and ones that have agreements in place to preserve their pass-through status, are uncommon. To an outside observer, the circumstances of the case appear to warrant a large premium over the C corporation value. The court and valuation professionals should be aware, however, that a premium is not always supported by the economic returns to the shareholders. In fact, depending on a pass-through entity's level of reinvestment, length of pass-through status, tax rates, and other assumptions, no premium—or even a discount from the C corporation value—could be warranted. ●