

Attorney CLE Series



S Corporations vs. C Corporations

UNDERSTANDING VALUATION DIFFERENCES

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Presented by the Business Valuation Services Group



GROSSMAN YANAK & FORD LLP
Certified Public Accountants and Consultants

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Chapter I – *Introduction*

“Tax affecting” pass-through business entities such as S corporations, partnerships and limited liability companies taxable as partnerships (hereafter, referred to collectively as S corporations, unless noted otherwise) has long been a controversial issue for business valuers, as well as users of business valuation reports. While the so-called “experts” have struggled with this issue for many years, recent U.S. Tax Court decisions beginning with the case *Gross v. Commissioner*¹ in 1999, have brought consideration of this matter to the very forefront of the business valuation and finance profession.

The heart of the issue lies with whether a corporation taxed as an S corporation under United States federal income tax law has a greater value than an identical corporation taxed as a C corporation under that same law. Underpinning this primary issue are a number of ancillary issues that business valuers, users of business valuation reports and legal fact finders grapple with on an almost daily basis. A sample of these issues are briefly discussed below.

Standard of Value

The standard of value most common to litigation, income, estate and gift tax law is fair market value. As will be discussed, this standard of value contemplates a hypothetical sale transaction with a hypothetical buyer taken from a “total” universe of potential buyers.

By inferring a certain buyer, that is, a buyer who will definitely qualify as an S corporation shareholder under Section 1361(b)(i) of the Internal Revenue Code of 1986, as amended², (hereafter, IRC or the Code), those opposing “tax affecting” of these entities operationally exclude a substantial portion of the hypothetical universe of potential buyers.

Failure to consider these hypothetical buyers (i.e., those failing to qualify by definition as S corporation shareholders) would seem to void the very standard of value contemplated by current understanding of fair market value.

Propriety of Tax Rate

If one is an advocate of the position that an S corporation’s earnings should be tax affected in a value calculation, the question next arises as to the proper tax rate to use in this endeavor. Opinions on this issue are diverse within the business valuation and finance community, covering a broad spectrum of possibilities.

¹ *Walter L. Gross, Jr. et ux, et al. v. Commissioner*, T.C. Memo. 1999-254, aff’d 272 F. 3d 333 (6th Cir. 2001)

² All references herein relating to the Internal Revenue Code, unless otherwise noted, reference the Internal Revenue Code of 1986, as amended



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However, the most common tax rates considered include:

- The highest marginal corporate tax rate;
- The highest marginal individual tax rate;
- The buyer's expected effective tax rate;
- The buyer's highest marginal tax rate; or
- A hybrid rate in consideration of the S corporation tax structure benefit.

Discussed in Chapter II of these materials, no answer exists at this time, even within that portion of the business valuation community that advocates tax affecting.

Proper Application of Risk Rate

Business valuers generally determine base discount rates and capitalization rates from historical financial information collected from public companies. In most instances, the earnings utilized in the construction of these rates are “after” corporate-level income taxes but “before” shareholder-level taxes.

As a result of this methodology in building up discount and capitalization rates, an issue has developed regarding whether “after corporate-level income taxes” discount and capitalization rates should be applied to S corporation corporate-level earnings that have not been reduced for corporate-level income taxes.

Tax Affecting and Control/Minority Interests

A school of thought within the business valuation community is that the control prerequisites attaching to a controlling ownership interest in an S corporation have an effect on whether the earnings of that entity should be tax affected.

Many commentators have concluded that an S corporation tax structure may be more valuable in the context of determining the value of a minority interest rather than a controlling interest. In fact, of the four economic models for valuing S corporations that have gained general acceptance, all were originally developed as being applicable to the valuation of minority interests.

Lack of Market Confirmation

While several recent Tax Court decisions have found for the Internal Revenue Service on the issue of tax affecting, there are no published studies or empirical evidence that unequivocally confirm that S corporations trade at premiums over identical C corporations. In many market acquisition transactions, the buyer does not qualify for S corporation shareholder status, and the matter is not considered at all.



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Measurement

If one adheres to the precept that an S corporation ownership interest is worth more than an identical C corporation, the question then becomes one of measuring the value difference. That is, how does one quantify the tax benefits associated with S corporation tax status?

No widely accepted methodology exists for purposes of calculating this value difference, but four models have emerged in the last 10 years that are relatively congruent with the overall concept of according some value premium to S corporation ownership interests.

In addition to the four models, a “simplified model” has been introduced to the business valuation community for consideration as an acceptable means to capture the value difference.

In Summary

This program is intended to serve as a “primer” for those members of the legal community that encounter financial valuation of businesses and fractional business interests in their practices of law. The contents of this program, and these materials, will familiarize the participants with the issue of tax affecting and facilitate an understanding of the many facets of this complex matter.



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Chapter II – *Illustrating the Issue*

Understanding the Income Approach and Calculations

The income approach is perhaps the most widely-used approach to valuing an equity interest in a privately-held business. One of the basic premises of valuation is that value is always forward-looking. “Value today always equals future cash flow discounted at the opportunity cost of capital.”³ The income approach is based upon the economic principle of anticipation (sometimes called the principle of expectation). In this approach, the value of the subject investment (i.e., a minority, non-marketable common stock equity interest in Private Co.) is the value, in today’s dollars, of the economic income expected to be generated by the investment during the holding period. As the name of this economic principle implies, the investor “anticipates” the “expected” economic income to be earned from the investment.

The income approach, in its simplest form, is a mathematical fraction including both a numerator and a denominator. The numerator represents the expected future economic benefits of the specific investment, while the denominator represents the quantification of the risk and uncertainty of the future benefits. For purposes of this presentation we will consider free cash flows as the future economic benefits, as it generally represents the cash that can be distributed to equity owners without hindering future operations.

A well-known income approach valuation method that directly computes this value is the discounted future cash flow (DCF) method. Under this method, a forecast is prepared for future years’ cash flows up to and including a terminal year. Once the future cash flows have been determined, a terminal value computation is required to account for company value attributable to the expected cash flows beyond the discrete forecasted period. The terminal value is calculated by capitalizing the Company’s cash flow at a point of stabilization.

The determination of value is made by applying a rate to the future projected cash flows (including the terminal value estimated) to bring all future amounts back to present value dollars.

The discount rate is the cost of capital or rate of return (as these terms are used interchangeably), which comes from the marketplace and represents investors’ expectations. Three elements comprise investor expectations, including:

1. The real rate of return, which is the amount investors expect to obtain in exchange for letting another party use their money on a riskless basis
2. The expected depreciation in purchasing power while the money is tied up in the investment (expected inflation)
3. The uncertainty (or risk) as to when and how much cash flow will be received⁴

³ *Capital Investment and Valuation*, Richard A. Brealey and Stewart C. Myers, 2003, page 67

⁴ *Cost of Capital – Estimation and Applications*, Shannon P. Pratt, Second Edition, page 5



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Please note: There are several methods available to calculate the cost of capital for a specific investment, which is beyond the scope of this presentation.

Alternatively, a “shortcut” method of valuation under the income approach is known as the capitalization of cash flow method. Most often used when future cash flows are expected to reflect stable growth, this method simply divides a single-year benefit stream by a risk rate known as a “capitalization rate.” A capitalization rate is simply the discount rate less a long-term sustainable growth rate.

Note: Given the identical fact pattern, a determination of value under the discounted cash flow method and the capitalization of cash flow method properly applied will yield identical results, as illustrated by the following example.

Comparison of Multi-Period Discounted Future Cash Flow and Capitalization of Cash Flow Methods

Assumptions:

Discount rate (k_c)	24%
Long-term growth rate (g)	4%
Year 0 cash flow	\$1,000

Multi-Period Calculation:

Projected year	1	2	3	4	5	Terminal Year*
Cash flow (CF)	1,040	1,082	1,125	1,170	1,217	6,328
Present value factor	.8065	.6504	.5245	.4230	.3411	.3411
Discounted cash flow	839	703	590	495	415	2,158
Value Result		\$ 5,200				

*Terminal Year: $CF_n \cdot (1 + g) / k_c - g = \$6,328$

Single-Period Capitalization Calculation:

Year 0 cash flow	\$ 1,000
One year growth factor	1.04
Year 1 cash flow	1,040
Capitalization rate	.20
Value Result	\$ 5,200

This is a very simple example and is intended only to provide an opportunity to understand the inter-workings of the two possible methods.



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The Issue of Tax Affecting

The traditional approach used by appraisers in valuing S corporations under the income approach has been to subtract income taxes as if the entity were taxed as a C corporation and apply rates of return derived from historical returns on publicly-traded C corporation stocks. The fundamental premise of such tax affecting was driven by the fact that proper valuation of an equity interest in any business entity required a proper matching of the discount or capitalization rates (used as a denominator) with the type of economic benefit stream encompassed in the projections or forecasts (used as a numerator). In other words, it has long been held as proper that pre-tax discount and capitalization rates should not be applied under the income approach to after-tax cash flows or other economic benefit streams set forth in the projections or forecasts.

Most commonly-accepted empirical data used by business valuers to develop discount rates and capitalization rates is based on public stock market information. This information is based on expected returns “after” corporate-level income taxes, but “before” shareholder-level taxes.

Historically, it has been deemed appropriate in the finance and business valuation professions, and, in fact, by the Internal Revenue Service, to recognize that, even though an S corporation passes through its income to shareholders without the incurrence of entity-level tax, there is still an “ordinary” rate of income tax assessed against this entity-level income. That ordinary income tax must be distributed by the Company to fund the shareholders’ tax obligations on the corporate income passed through to them. As such, a substantial portion of the S corporation’s free cash flow must necessarily be distributed annually to fund this obligation. It is, and has been, the practice of many professionals in the finance and business valuation community to reduce the entity-level free cash flows by this necessary distribution.

Assuming this distribution is a reflection of ordinary income tax on corporate-level earnings, reducing those earnings by the expected tax distribution (tax affecting) has been suggested as the appropriate base to which the discount and capitalization rates developed from public company information should be applied.

Based on the current controversy, it is important to understand the traditional means by which appraisers have calculated the value of S Corporations by applying corporate-level taxes. This traditional method will be compared, in the following examples, to the circumstance of not tax affecting the earnings of the S corporation. The following assumptions apply to both calculations under the discounted cash flow method and the capitalization of cash flow method of the income approach:

- | | | |
|---------------------------------------|--|-------|
| • Cash flow and income are equivalent | • Rate of return on equity (discount rate) | 24.0% |
| • Long-term growth rate 4.0% | • Terminal value capitalization rate | 20.0% |
| • Entity-level tax rate 40.0% | | |



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Discounted Cash Flow Method Without Tax Affect

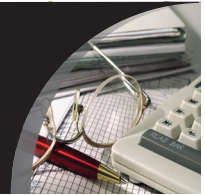
Projected year	1	2	3	4	5	Terminal Year*
Income before tax	1,040	1,082	1,125	1,170	1,217	6,328
Entity-level tax (0%)	(0)	(0)	(0)	(0)	(0)	(0)
Net income/cash flow	1,040	1,082	1,125	1,170	1,217	6,328
Present value factor	.8065	.6504	.5245	.4230	.3411	.3411
Discounted cash flow	839	703	590	495	415	2,158
Value Result	<u>\$ 5,200</u>					

Discounted Cash Flow Method With Tax Affect

Projected year	1	2	3	4	5	Terminal Year*
Income before tax	1,040	1,082	1,125	1,170	1,217	6,328
Entity-level tax (40%)	(416)	(433)	(450)	(468)	(487)	(2,531)
Net income/cash flow	624	649	675	702	730	3,797
Present value factor	.8065	.6504	.5245	.4230	.3411	.3411
Discounted cash flow	503	422	354	297	249	1,295
Value Result	<u>\$ 3,120</u>					

Discounted Cash Flow Method Comparison With and Without Tax Affect

Value Result (pre-tax)	5,200
Value Result (after-tax)	<u>3,120</u>
Value Difference	<u>\$ 2,080</u>



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Capitalization of Cash Flow Method Comparison of With and Without Tax Affect

	<u>With</u>	<u>Without</u>
Year 1 income before tax	\$ 1,040	\$ 1,040
Entity-level tax (40%)	<u>(416)</u>	<u>(0)</u>
Year 1 net income/cash flow	624	1,040
Capitalization rate	<u>.20</u>	<u>.20</u>
Value Result	3,120	5,200
Value Difference	<u>\$ 2,080</u>	

The previous models provide a simplistic illustration of the difference with and without tax affecting. As you can see, this difference in value can be substantial – in this case over \$2 million. Subsequent chapters will address the specific Tax Court cases electing not to apply entity-level taxes to S corporation earnings, as well as models developed by experts in the valuation arena that assist valuers in quantifying the benefits of S corporation ownership.



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Chapter III – *Ancillary Issues*

There are several ancillary issues that business valuers and users of business valuation reports struggle with in an engagement to value an interest in an S corporation. This chapter will address these issues based on the current thinking of the commentators at the forefront of the S corporation debate.

Standard of Value

One important aspect of the tax-affecting debate that has generally been neglected in the midst of the controversy over the valuation of S corporations is the effect of “standard of value.” In order to determine the value of an ownership interest in a business, one must define the meaning of value. There are numerous accepted definitions (standards) of value, including fair market value, investment value and intrinsic value. Each standard has different applications.

The most common standard of value is “fair market value.” This standard is applied in income, estate and gift tax, divorce⁵, and, often, non-shareholder oppression litigation. Fair market value is defined in the United States Treasury regulations (20.2031-1(b)) and Revenue Ruling 59-60, 59-1 CB 237 as:

“the price at which the property could 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. Court decisions frequently state in addition that the hypothetical buyer and seller are assumed to be able, as well as willing, to trade and to be well informed about the property and concerning the market for such property.”

The definition requires that the valuation result be driven by a hypothetical sale transaction. Given that the definition requires consideration of a hypothetical sale, it stands to reason then, that focus and attention must be given by a valuator to those hypothetical buyers and sellers and types of concerns and issues that a potential hypothetical buyer and seller might consider prior to entering into a transaction.

In the definition of fair market value the “hypothetical buyer” is a critical consideration. As fair market value is clearly understood to be a “financial” value without strategic buyer considerations, it is commonly and widely-held within the business valuation community that this is a “non-strategic” value. As a result, the potential hypothetical buyer does not come from a specific, strategic investment group, nor is any single specific buyer relevant. Rather, a broad universe of typical potential buyers must be considered, so as to drive an overall financial value without the taint of certain specific-buyer motivations or synergies that might drive the value to a strategic standard of value.

⁵ Many states use the term “fair market value” in their marital dissolution cases; the definition of fair market value may vary from state to state and will not necessarily be the same definition applied for federal tax purposes.



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Under Section 1361(b)(1)(B) and (C) of the Internal Revenue Code of 1986, as amended, an S corporation must not (B) have as a shareholder a person (other than an estate, a trust described in sub section (c)(2), or an organization described in section (c)(6)) who is not an individual, [or] (C) have a non-resident alien as a shareholder. Further, the tax laws limit the number of shareholders in an S corporation and, thus, limits those to whom S corporation shareholders may sell their interests without causing a reversion to a C corporation.

Thus, a severe statutory restriction applies to potential hypothetical buyers who might fit within the qualification of an S corporation shareholder. Clearly, the statutory restrictions do not allow regular Subchapter C corporations, limited liability companies taxed as partnerships or corporations, and partnerships to qualify as S corporation shareholders. These entities comprise a substantial portion of the “broad universe” of hypothetical buyers contemplated in the definition of fair market value. Moreover, it is required of a valuator under professional standards to consider those market influences on value that a hypothetical buyer might consider. Failure to consider the universe of buyers would seem to void the very definition of the fair market value standard required in various venues.

Evidence regarding the pool of potential buyers may arise from the specific facts and circumstances of the case, as well as the subject company, such as restrictions on transfers of the interest under valuation or from the market.

The standard of value issue has taken a back seat to other concerns in evaluating the S corporation tax-affecting issue. However, where the purpose of the valuation calls for a fair market value standard, this important element of consideration must be addressed to reach the appropriate determination of value.

Propriety of Tax Rate

Even the staunchest proponents of tax affecting S corporation future economic benefit streams cannot agree on the proper tax rate to use. Over many years, valuers have routinely deducted taxes from S corporation future earnings streams at rates that would have been deducted had the entity been a C corporation. Often, this tax “adjustment” included the federal tax rate at the highest corporate marginal rate but the lack of consensus and authoritative guidance led practitioners to also use the effective rate applicable to the earnings stream inclusive of the graduated rate structures inherent in the Internal Revenue Code.

Additionally, most practitioners using this methodology included a reduction for federally-adjusted state income taxes. Thus, the S corporation was treated as a C corporation for all intents and purposes.

The reasoning behind such a methodology included the following:

- The empirical evidence utilized by finance and valuation professionals to develop the discount and capitalization rates are based on studies of corporate performance measures after corporate-level taxes.



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- Current tax rules require that an “ordinary” income tax rate of tax be paid on the S corporation’s income, even though that income is “passed through” to shareholders.
- In consideration of a hypothetical sale of the stock of the S corporation, given the statutory limitations of Subchapter S of the Internal Revenue Code, the most-likely hypothetical buyer would not qualify for S corporation status, thus, reverting the entity to C corporation status and requiring taxes be paid at the C corporation level in the future.
- Historically, the Internal Revenue Service and the Tax Court have appeared to support the use of tax affecting by the allowance of tax affecting in some early court decisions and the fact that certain Internal Revenue Service training materials, including A Valuation Guide for Estate and Gift Taxes, as well as the Examination Technique Handbook for Estate Tax Examiners, which advocate tax affecting S corporation earnings streams.

In spite of this common methodology set forth above, various practitioners moved to using an individual tax rate, given that the ordinary income tax expected to be paid on the S corporation income would be paid at individual shareholder rates. Again, in most instances, the rate used is the highest marginal rate, but it is not unusual to see an effective rate used. Also, as with the C corporation methodology, there is a need to include federally-tax-adjusted state income taxes in the calculation.

Lastly, another methodology commonly used has been one that attempts to match the earnings stream with the expected buyer’s highest marginal or effective tax rates. The issue in using such a methodology, however, is that it includes the “preidentified” buyer or buyers and may not be appropriate to determine fair market value.

All of these methodologies have been challenged and rejected in recent estate and gift tax cases, as well as one marital dissolution case in Florida. These cases are set forth in Chapter IV of these materials.

Currently, there is no answer to the question of which tax rates to use when valuing S corporations. However, the four models used by valuers in connection with the valuation of S corporations consider a deduction for income taxes. These models will be summarized herein at Chapter V.

Proper Application of Risk Rate

In any valuation of an ownership interest under the income approach, it is critical that the discount or capitalization rate match the subject entity’s future economic benefit stream. Most practitioners develop the proper discount or capitalization rates from public company data. This data is analyzed after corporate-level taxes but before shareholder-



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level taxes. In reality these performance measures consider both cash distribution capability from the public companies (i.e., dividends and/or dividend-paying capacity) as well as capital appreciation. Discount and capitalization rates developed from this data, then, are after corporate-level tax.

A question arises as to the propriety of using an after corporate-level discount or capitalization rate to calculate a value for an S corporation whose future earnings have not been reduced for distributions necessary to fund the ordinary tax on the income and that is required of the distributee shareholders.

In almost every instance, shareholders will desire the S corporation to distribute cash to fund the ordinary tax liability on corporate income. Certainly, no return on investment to the shareholder can be realized until the tax obligation on the corporation's income is satisfied from corporate distributions. As such, it appears that this "fictitious" tax, as the Courts have recently referred to it, is really quite real and a true cash flow detriment to the corporation.

If, as a result of this analysis, a valuator were to apply a discount or capitalization rate that was developed from public company "after" corporate-level tax data to a future cash flow stream that is "before" corporate-level tax (such as in the instance of an S corporation), the result would be technically incorrect.

The Tax Court, in *Gross*, tried to circumvent this issue by assuming an effective tax rate for the S corporation at zero, though this approach completely misses the point and demonstrates a clear lack of understanding of the S corporation tax regime and how it ties to financial realities in the market place.

Controlling Versus Minority Interests

Another area of controversy in tax affecting S corporations' future economic benefit streams under the income approach is whether the tax affecting adjustment should be applied to both minority and majority ownership interests. It is clear that a buyer of a 100% controlling interest in an S corporation has the authority to terminate the S election. Conversely, minority (or non-controlling) interests in S corporations do not have this ability. However, in the circumstance of a 51% shareholder and a 49% shareholder, the benefit of tax-free distributions could be equally desirable and valuable.

While each business entity and each ownership interest in that entity will have a unique set of characteristics that must be reviewed and considered, certain fact patterns have been found to serve as a basis for and against tax affecting. There are certain questions that should be answered in connection with the valuation of a controlling interest in an S corporation and, therefore, determining whether to tax affect the entity's earnings.



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These questions include, but may not be limited to:

- Who is the most likely pool of buyers of the controlling interest?
- What is the possibility of breaking the S election?
- What degree of control will the buyer have, and would others make the S election anyway?
- What is the date of the S election, and is there an opportunity to avoid built-in gains tax?
- What is the expected distribution level?
- What is the likely holding period?

It is the opinion of various commentators that even a 100% controlling interest often has value since it is an existing S corporation, especially if the company has been an S corporation since its incorporation or for the past 10 years (the built-in gains holding period). In valuing a controlling interest in an S corporation, the valuator should assess the probability that the pool of likely buyers of a controlling interest would be able to avail themselves of continuing the subchapter S status. At this time, however, there is no conclusive market transactional evidence that S corporation prices/multiples are different from C corporations on a control basis.

Non-controlling interest holders have many of the same issues as controlling shareholders (noted above). The clear distinction is that the non-controlling interest cannot control the level of distributions (if any) or the timing of distributions, which is under the authority of those in control.

In addition to expectations regarding distributions, a non-controlling interest holder's investment and returns are impacted by the following issues:

- Retained net income
- Personal tax rates versus corporate and capital gains
- Holding period of the investment and exit strategy
- Ability to participate in a possible step-up-of-basis transaction

Valuators at the forefront of this issue note that, in some cases, ownership interests in S corporations will be worth less than otherwise identical C corporation interests; in some cases, they will be worth the same; and in some cases, they will be worth more.



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Lack of Market Confirmation

One means by which to settle the controversy over the valuation of S corporations versus C corporations is to focus on actual transactions involving the acquisition of both types of entities. Numerous transaction databases exist compiling a variety of deal transaction facts, including the tax form of the target company. The most widely-publicized of these databases is *Pratt's Stats*, published by Business Valuation Resources in Portland, Oregon.

Pratt's Stats does not include any information that would seem to confirm that an ownership interest in an S corporation is more valuable than an identical interest in a C corporation. To our knowledge, no other databases or studies exist at the current time that would suggest a premium for S corporation interests. Through various discussions with finance and business valuation professionals, attorneys, business brokers, bankers and accountants, we have not been able to identify any market information that confirms that adding a premium to S corporation interests is proper.

Conclusion

Obviously, these issues have led to great controversy and, in fact, a lack of clarity in how best to address the issue of tax affecting S corporations. While all valuation is fact-specific, it is still necessary to move towards a consensus opinion on these matters to add a level of efficiency to the preparation and use of valuation determinations.

Chapter V will introduce the four models for valuing non-controlling interests in pass-through entities, as well as a simplified model, which are gaining recognition in the valuation community. The models handle the issues noted above in slightly different ways, but, the originators of the models largely agree on the key issues surrounding pass-through entities.



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Chapter IV – A Review of Existing Case Law

As of the date of this program, valuation of S corporations and fractional ownership interests in those entities, as well as issues relating to tax affecting, have been addressed by the United States Tax Court, the Delaware Court of Chancery, the Massachusetts Supreme Court and the Florida District Court of Appeal for the Second District. A listing of those cases is as follows:

United States Tax Court

- *Walter L. Gross, Jr. et ux., et al. v. Commissioner*, T.C. Memo. 1999-254, No. 4460-97 (July 29, 1999) aff'd 272 F.3d 333 (6th Cir. 2001)
- *Estate of John E. Wall v. Commissioner*, T.C. Memo. 2001-75, March 27, 2001
- *Estate of William G. Adams, Jr. v. Commissioner*, T.C. Memo. 2002-80
- *Estate of Richie C. Heck v. Commissioner*, T.C. Memo. 2002-34
- *Robert Dallas v. Commissioner*, T.C. Memo. 2006-212, September 28, 2006
- *Estate of Gallagher v. Commissioner*, T.C. Memo 2011-148, 2011 WL 2559847, June 28, 2011

Each of these cases involved valuation of taxable gifts of ownership interests in S corporations.

Delaware Court of Chancery

- *Delaware Open MRI Radiology Associates, P.A. v. Kessler*, CA-275-N, April 26, 2006 Del. Ch. LEXIS 84 (2006)

This case involved a fair value assessment of a cash-out price paid by majority shareholders to minority shareholders in a radiology practice.

Commonwealth of Massachusetts Supreme Court

- *Bernier v. Bernier*, 2007 Mass. LEXIS 598 (May 7, 2007)

This case involved an equitable distribution proceeding that included two separate S corporations that each operated a supermarket in Martha's Vineyard.

State of Florida District Court – Second District

- *Erp v. Erp*, 2005 – 3144, 2006 – 1934, 2007 Fla. App. LEXIS 18726 (November 28, 2007)

This case involved an equitable distribution proceeding that included an S corporation that operated a recreational vehicle dealership.



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While business valuation professionals have long struggled with the issue of tax affecting earnings of S corporations in applying the income approach to valuation of these entities, it was not until the *Gross* decision was rendered in 1999 that the issue gained the attention it deserved.

In a June 19, 2003, hearing before the U.S. House of Representatives Ways and Means Subcommittee on Select Revenue Measures addressing S corporation reforms, Mr. Gregory F. Jenner, Deputy Assistant Secretary of Policy for the U.S. Department of the Treasury, testified with respect to that Department's view on *Gross*,

"the facts of the Gross case were that the Tax Court, and later the Sixth Circuit, basically weighed in on a battle of expert opinions between the IRS and the taxpayer. It was a very fact-specific opinion. While there is some precedential value to it, again, all valuations are very fact-specific. So, with all due respect to the previous witness, we would argue that there is not a serious concern with respect to the Gross opinion, and it may very well never apply in particular fact situations."

Interestingly, in absolute contradiction to these comments, the Internal Revenue Service and the Tax Court have elected to follow *Gross* in four additional cases, even in the face of widely-varying "fact-specific" circumstances.

As a precursor, it must be noted that all valuation is a question of fact. Thus, valid economic theory must ultimately answer the questions surrounding the tax-affecting issue. While none of the cases noted herein are necessarily relevant to the determination of valid economic theory, it is at least helpful to understand the courts' recent positions on this matter as much of the current thinking on this issue, in the business valuation community, has evolved as a result of these cases.

Note: The following summaries are not intended to include comprehensive analysis. Rather, each case is examined as it primarily applies to the issue under consideration – tax affecting future earnings streams of S corporations when determining value under the income approach. Other facts and issues of each case are not addressed in these materials and are generally beyond the scope of this program.

Estate of Gross v. Commissioner, T.C. Memo 1999-254, No. 4460-97 (July 29, 1999)

Gross was the first Tax Court decision directly addressing tax affecting of economic future earnings in the valuation of S corporations. Decided in 1999, the decision to disallow the tax affect associated with future expected earnings immediately drew considerable attention in the business valuation community and serves, even today, as a primary catalyst in the development of ongoing economic theory in this area. In this case, the Tax Court noted,

"The decision whether to tax affect G & J's projected earnings under the discounted cash flow approach accounts for the most significant differences between the parties' expert witnesses."



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Gross – Case Summary

The *Gross* case contested a valuation of a very small, minority-ownership interest in G & J Pepsi-Cola Bottlers, Inc., an S corporation. In this gift tax case, the Taxpayer's expert deducted corporate income taxes from the earnings stream used in his discounted income method under the income approach at 40%. He based his reasoning on the fact that, at the time of his valuation, tax affecting was the most commonly-recognized methodology for valuing S corporations under the income approach.

Further, IRS literature used at the time of the expert's work, including A Valuation Guide for Estate and Gift Taxes (the Guide) and the Examination Technique Handbook for Estate Tax Examiners (the Handbook), both advocated tax affecting the income stream. According to the Guide,

"S corporations are treated similarly to partnerships for tax purposes. 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."

The Handbook states:

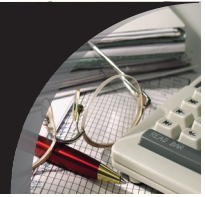
"If you are comparing a Subchapter S corporation to the stock of similar firms that are publicly-traded, the net income of the former must be adjusted for income taxes using the corporate tax rates applicable for each year in question, and certain other items, such as salaries. These adjustments will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

Finally, the Taxpayer's expert provided several disadvantages and negative attributes of maintaining S corporation status. These disadvantages included the risk that controlling shareholders might discontinue making actual cash flow distributions sufficient to cover shareholder-level income taxes on pass-through S corporation income in the future, and the risk that the S corporation could violate a qualification tax statute, thereby losing its favorable S status.

The final risk, due to strict shareholder qualification requirements under Internal Revenue Code, was that the S corporation may have difficulty raising capital and maintaining its S status. The Tax Court rejected each of these arguments out of hand.

Regarding the reference from the Guide, the Court read the excerpt as, "neither requiring tax affecting or providing the basis for a claim of detrimental reliance."

"Both statements lack analytical support, and we refuse to interpret them as establishing respondent's advocacy of tax affecting as a necessary adjustment to be made in applying the discounted cash flow analysis to establish the value of an S corporation."



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Even if we were to interpret the excerpts as petitioners do, petitioners do not claim that the excerpts have the force of a regulation or ruling, nor have they shown the type of detrimental reliance that might work an equitable estoppel against respondent.”

The Court further noted that the Taxpayers, “have failed to prove that they relied on either the Guide or the Handbook in any way,” and the IRS was not “estopped” from disregarding a fictitious tax when valuing an S corporation.”

As to Taxpayers’ expert’s submission of the disadvantages and negative attributes of maintaining S corporation status, the Court ruled that the first two were not reasonable assumptions, and that the third was better addressed in cost of capital aspects of the valuation.

There are other critical elements of the Court’s opinion including the following:

- [The IRS expert] assumed that G & J would continue to distribute all of its earnings annually. He made no explicit adjustment for any shareholder-level taxes, although, undoubtedly, he knew such taxes would be due. [The IRS expert] did not, however, ignore shareholder-level taxes. He simply disregarded them both in projecting G & J’s available cash flow and in determining the appropriate discount rate.
- The present value of any future (deferred) cash flow is a function of three variables (1) the amount of the cash flow, (2) the discount rate, and (3) the period of deferral.
- The discount rate reflects the return, over time, to the investor on the amount invested (commonly expressed as a rate of interest). If, in determining the present value of any future payment, the discount rate is assumed to be an after-shareholder-tax rate of return, then the cash flow should be reduced (tax affected) to an after-shareholder-tax amount. If, on the other hand, a pre-shareholder-tax discount rate is applied, no adjustment for taxes should be made to the cash flow.

Key: It is particularly noteworthy to recognize that G & J had a history of distributing virtually all of its earnings. This characteristic distinguishes *Gross* from all of the other cases.

Additionally, the Court correctly stated that the value of a business can be determined appropriately by applying a pre-tax discount rate to a pre-tax cash flow stream or by applying an after-tax discount rate to an after-tax cash flow stream. The Court found,

“Since, in applying his discounted cash-flow approach, [the IRS expert] assumed a pre-shareholder-tax discount rate, he made no error in failing to tax affect the expected cash flow. If [the Taxpayer’s expert’s] criticism is based on his assumption that [the IRS expert] wrongly disregarded shareholder-level taxes, then he is in error.”



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Walter L. Gross, Jr. and Barbara H. Gross v. CIR, U.S. Court of Appeals for the Sixth Circuit, No. 97-04460; 97-04469, November 19, 2001

The following summary has been excerpted from *FCG Estate & Gift Valuation E-Flash*, Volume 3-21/2001 (used with permission). Portions not related to the topic of tax affecting S corporation income may have been omitted.

Gross Appeal – Case Summary

A U.S. Court of Appeals affirmed *Walter L. Gross Jr., et ux., et al. v. Comm.*, T.C. Memo. 1999-254, July 29, 1999. The Court agreed that it was not proper to tax affect S corporation earnings for valuation purposes. In a split opinion, the Tax Court concurred with the IRS that no tax should be imputed on S Corporation earnings under the discounted cash flow method. The Tax Court also allowed the 25% discount for lack of marketability asserted by the IRS. The Taxpayers appealed the Tax Court decision on two grounds: (1) the admissibility of testimony by the IRS expert under *Daubert v. Merrill Dow Pharmaceuticals, Inc.* 509 U.S. 579, 597 (1993) and (2) the Tax Court valuation of the gifts.

Gross Appeal – Admissibility of Testimony Regarding Tax Affecting Earnings

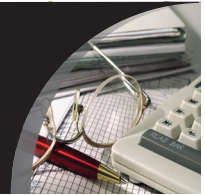
The Taxpayers challenged the IRS expert's contention that a 0% income tax rate should be applied to earnings under the discounted cash flow method. The Taxpayers' experts applied a 40% hypothetical tax rate. The Sixth Circuit said,

"We disagree with the Tax Court's characterization of the respective experts' approaches to tax affecting as a mere difference in variables. There was no spectrum of tax percentages from which the court could have selected. Rather, the choice was either a corporate tax rate of 40% or a rate of 0%, the latter meaning no tax affect at all. But while the Tax Court's analysis was rather cursory, we do not believe that further evaluation was necessary under the circumstances."

Gross Appeal – Valuation of Gifts

The Taxpayers contended that even if the IRS expert's testimony was admissible, the Tax Court's ultimate valuation conclusion was incorrect. The Sixth Circuit's lead opinion written by Judge Clay says,

"Although a majority of the factors the Tax Court used in calculating the valuation amount were proper, I take issue with the Court's use of a 0% tax affect, and would, therefore, hold that to the extent the valuation was based upon the use of a 0% tax affect, the [Tax] Court's ultimate finding that the G & J stock was worth \$10,190 per share was clearly erroneous. However, Judge Daughtrey and Judge Cohn disagree with me on this point, so that our majority holding is that the Tax Court's use of the 0% tax affect was proper."



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Gross Appeal – Tax Affecting (Minority Opinion)

The Taxpayers' main argument in support of tax affecting S corporation earnings was that a hypothetical buyer in 1992 would be presumed to know that tax affecting earnings was the generally-accepted practice of the business appraisal community. The IRS expert was "largely discredited" as he admitted he had no firsthand knowledge of what willing buyers did in 1992.

Both Taxpayers' experts testified that tax affecting S corporation earnings was the approach the appraisal community generally followed. One of the Taxpayers' experts admitted on cross examination that there was growing controversy in 1992 regarding tax affecting, and that this was still being debated at the time of trial. He also admitted that if he had to value the stock of G & J Corporation as of the trial date, he would give further consideration to whether he would use the tax-affecting method.

The Taxpayers also attempted to justify tax affecting based on a number of impediments that exist for S corporations. The Tax Court found that tax affecting was not a substitute for the "difficult to quantify disadvantages" of S corporation status. The minority opinion disagreed with this conclusion:

"On appeal Taxpayers assert that tax affecting was an accepted practice because it had been 'specifically approved' by the Tax Court, citing Maris v. Commissioner, 41 TCM (CCH) 127, 138 (1980) and Hall v. Commissioner, 34 TCM (CCH) 648, 667 (1975). Although not specifically holding that tax affecting was an acceptable approach to valuation in every circumstance, in both of these cases the Tax Court did use after-tax earnings in valuing the stock of S corporations. But perhaps Taxpayers' most persuasive argument is that the IRS itself has implicitly endorsed the policy of tax affecting in valuing stock of S corporations. In support of this claim, Taxpayers point to two internal IRS documents which mention making adjustments for taxes of S corporations. The documents referred to were the IRS Valuation Guide for Income, Estate and Gift Taxes: Valuation Training for Appeals Officers and the IRS Examination Technique Handbook.

...Although I do not agree with the Taxpayers' contention that the IRS is somehow estopped from now disclaiming tax affecting as a recognized practice, I recognize that these documents reflect a certain acceptance of tax affecting as a valid method of valuation.

...I must recognize that we are merely determining those factors that hypothetical parties to a sale of G & J stock would have considered as of the gift date. In this regard, I believe that past practices, which the IRS had not deemed to create a deficiency, are demonstrative of the idea that such hypothetical actors would have considered tax affecting G & J stock. This fact, in conjunction with the testimony of the experts, informs my conclusion that the court's decision to use a 0% tax affect in deriving the value of G & J stock was implausible."



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Gross Appeal – Tax Affecting (Majority Opinion)

The majority opinion said that a careful review of the Taxpayers' expert's testimony revealed that even he was not certain whether tax affecting was generally accepted, acknowledged some disagreement on this point, and was equivocal on whether he would continue to tax affect.

"The lead opinion, however, finds that the Tax Court clearly erred in its decision to not tax affect G & J's stock because willing buyers and willing sellers would have tax affected the stock in 1992. While I do not necessarily disagree with framing the issue in this manner, I do disagree with the way in which the lead opinion analyzes the issue. The lead opinion accuses the Tax Court of focusing on 'its theoretical belief that tax affecting was not appropriate.' The lead opinion also states that 'the Tax Court's judgment was less than sound' and 'flies in the face of the evidence on the record.' I read the record differently. The Tax Court was faced with the opinions of competing valuation experts and accepted one over the other."

The majority opinion also discussed the use of the IRS Valuation Guide for Income, Estate and Gift Taxes, the IRS Examination Technique Handbook and past Tax Court cases, but found these arguments were not compelling. The opinion concluded,

"Valuation is a fact-specific tax exercise; tax affecting is but one tool in accomplishing that task. The goal of valuation is to create a fictional sale at the time the gift was made, taking into account the facts and circumstances of the particular transaction. The Tax Court did that and determined that tax affecting was not appropriate in this case. I do not find its conclusions clearly erroneous."

Numerous facts specific to Gross aided the Tax and Appellate Courts with their decisions:

- The ownership interest under valuation was a very small minority interest (less than 1%),
- The Company was very profitable historically; it assumed that this pattern would continue,
- Historical annual distributions had been at nearly 100% of taxable net income passed through to shareholders,
- A shareholder agreement limited the potential willing buyer of the subject interest to persons who met the legal qualification requirements for the corporation to retain its S corporation status, and
- None of the existing shareholders had expressed an interest in selling his or her shares.

Interestingly, the fact that the required standard of value – that is, fair market value – requires, by definition, that there is consideration of a hypothetical sale to a broad universe of hypothetical buyers, was not discussed in the Tax Court or Appellate decisions.



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Estate of Wall v. Commissioner, T.C. Memo, 2001-75, March 27, 2001

The following summary has been excerpted from *FCG Estate & Gift Valuation E-Flash*, Volume 3-9/2001 (used with permission). Portions not related to the topic of tax affecting S Corporation income may have been omitted.

Wall – Case Summary

This case concerns a dispute over the value of non-voting shares of an S corporation gifted in 1992. After noting that this was a case that should have settled without resorting to the Tax Court, Judge Beghe accepted the IRS valuation, including a 40% discount for lack of marketability and a 2% discount for non-voting stock. The court also noted that it was not correct to subtract imputed income taxes on S corporation earnings in determining fair market value.

In this case, the final conclusion of value was not determined under the income approach, but rather a market approach. However, the Tax Court, in its decision, discusses the merits and issues with tax affecting future-earning streams at length.

Wall – Case Facts

In 1992, John Wall (and his wife as a result of gift-splitting) gifted nonvoting common stock of Demco, Inc. to 20 trusts for the benefit of their children. In the original gift tax return, the Taxpayer claimed a value of \$221.75 per share, while in the statutory notice, the IRS asserted a value of \$260.13 per share. Judge Beghe was critical that the parties could not settle the case with only a 17% difference between values. Citing *Buffalo Tool & Die Manufacturing Co. v. Commissioner*, 74 TC 441, 451-452 (1980), he noted that this was one of those valuation cases that should have been settled, and rather than split the difference in values, the court should adopt the position of one of the parties.

In *Wall*, the IRS and Taxpayer's experts both tax affected the company's income stream. The Court noted,

"[T]he argument against tax affecting stresses that although an S corporation's stockholders are subject to tax on the corporation's income, they are generally not subject to a second level of tax when that income is distributed to them. This could make an S corporation at least somewhat more valuable than an equivalent C corporation."

Wall – Taxpayer's Expert

In her original valuation report, the Taxpayer's expert determined a value of \$211.20 per share, but the Taxpayer raised the value by 5% to \$221.75 on the gift tax return. The Taxpayer testified that he raised the value after his accountants advised him that, based on their experience with local IRS personnel, the marketability and nonvoting stock discounts "might better be a little more conservative."



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In her original report, the Taxpayer's expert relied on the guideline public companies method under the market approach. Because of criticism by the IRS, before trial she prepared a second report that included the income approach. Averaging this income approach value and the original value resulted in the \$192.20 value used in the revised report. The appraisal included a 40% discount for lack of marketability and a 5% discount for non-voting stock.

Wall – IRS Expert

The IRS asserted a value of \$260.13 in its statutory deficiency notice, but this was increased to \$273.99 at trial. The IRS expert used a guideline public companies approach similar to the Taxpayer's expert, except that he considered a \$1,080,000 note from a related party as a non-operating asset and added it separately. He subtracted a 40% discount for lack of marketability and a 2% discount for non-voting stock. He also used the income approach.

Wall – Court Analysis of Experts' Reports

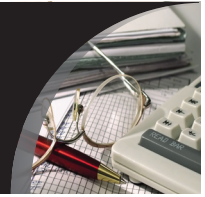
The Tax Court completely ignored the income approach calculation of both experts, citing the inability of the Company to make projections. Even though this approach was ignored, the Tax Court's analysis made several comments about imputing income taxes to the earnings of an S corporation, saying that the tax affected cash flow used by both appraisers was incorrect. The Court said, "Because this methodology attributes no value to Demco's S corporation status, we believe it is likely to result in an undervaluation of Demco's stock."

Nowhere was the Court provided with the tools to attempt to compare the facts of the *Gross* case to the facts of *Wall*. Indeed, the economic circumstances of a minority shareholder in the *Gross* case was drastically different than a minority shareholder in the *Wall* case. However, neither the experts nor the Court made mention of these critical distinctions.

The Court also criticized both experts' calculations under the guideline public companies approach. The judge believed that the Taxpayer's expert's approach significantly understated value while the IRS expert's approach overstated value. The Taxpayer's expert's calculation was criticized because it (1) did not adequately take the \$1,080,000 non-operating note into account, (2) used erroneous measures of the company's projected 1992 income, and (3) did not use all of the guideline company multiples, but instead "picked and chose among the lowest."

The IRS expert was criticized for (1) not applying a minority discount to the non-operating note, (2) only using three guideline companies, (3) using only four performance measures, and (4) using multiples that varied greatly from company to company without an adequate explanation for his choice of multiples.

The Court concluded that the Taxpayer had not established that the fair market value per share was less than \$260.13 and that, in fact, it was at least equal to that amount. The Court accepted the IRS's original statutory deficiency notice.



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The Tax Court took exception to both experts tax affecting the cash flow stream:

“As [the Taxpayer’s expert] acknowledged in her testimony, appraisers disagree on whether it is appropriate to tax affect the income of an S corporation. The argument in favor of tax affecting stresses that many potential buyers of S corporations are C corporations.

Because a C corporation would be unable to maintain a target company’s S corporation status following an acquisition, the C corporation would tax affect the S corporation’s income (at C corporation rates) in deciding how much it would pay for the S corporation.”

In contrast, and, as noted earlier, the Court stated:

“...the argument against tax affecting stresses that although an S corporation’s stockholders are subject to tax on the corporation’s income, they are generally not subject to a second level of tax when that income is distributed to them. This could make an S corporation at least somewhat more valuable than an equivalent C corporation.

However, tax affecting an S corporation’s income, and then determining the value of that income by reference to the rates of return on taxable investments, means that an appraisal will give no value to S corporation status.

We note that [the IRS expert], like [the Taxpayer’s expert], tax affected Demco’s future cash-flows by subtracting hypothetical income tax from Demco’s projected net income ([the IRS expert] used a 40-percent rate, while [the Taxpayer expert] used a 34-percent rate). We believe this is likely to result in a an under-valuation of Demco because Demco is an S corporation.

Finally, we note that one omission from the court’s list of five items upon which the two experts agreed is that both tax affected the cash flow streams.”

Ultimately, the court relied on neither expert’s income methods. Instead, it considered the market approach as the best indicator of value. Even so, the court commented:

“We also note that both experts’ income-based analyses probably understated Demco’s value, because they determined Demco’s future cash-flows on a hypothetical after-tax basis, and then used market rates of return on taxable investments to determine the present value of those cash flows.”

Estate of Adams v. Commissioner, T.C. Memo 2002-80

The following summary has been excerpted from FCG *Estate & Gift Valuation E-Flash*, Volume 4-6/2002 (used with permission). Portions not related to the topic of tax affecting S corporation income may have been omitted.

Note that *Adams* is the only case of the five estate and gift tax cases that involved a controlling ownership interest (61.59%) of an S corporation.



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Adams – Case Summary

The Tax Court calculated the fair market value of a 61.59% interest in a closely-held insurance agency, Waddell Sluder Adams and Co. (WSA). The Tax Court did not allow adjustment of the capitalization rate to account for imputed income taxes on the S corporation's income.

Adams – Case Facts

Decedent died in 1995, owning 61.59% of the common stock of WSA, an insurance agency organized as an S corporation. Experts for both the IRS and the Taxpayer used the income approach to determine fair market value. The two experts agreed on a 20.53% capitalization rate before the tax adjustment discussed below.

The most important disagreement in the case was the treatment of imputed income taxes in S corporations. The Taxpayer expert "grossed up" the 20.53% after-tax discount rate to 31.88% to match the pre-tax S corporation cash flow stream to which it was applied.

The Tax Court, did not allow imputed income taxes to be used in the calculation of fair market value, saying:

"We disagree that [the Taxpayer expert's] estimates of WSA's prospective net cash flows are before corporate tax because it is appropriate to use a zero corporate tax rate to estimate net cash flow when the stock being valued is stock of an S corporation. WSA is an S corporation, and its cash flows are subject to a zero corporate tax rate. Thus [the Taxpayer's expert's] estimates of WSA's prospective net cash flows are after corporate tax (zero corporate tax rate) and not before corporate tax as the estate contends."

Conversion of "After-tax" Capitalization Rate to "Pre-tax" Capitalization Rate

	Tax-Affected Cash/Flow "Normal" Cap. Rate	Pre-Tax Cash Flow/ Grossed-Up Cap. Rate
Pre-tax cash flow	\$ 100,000	\$ 100,000
Income tax	(40,000)	(0)
After-tax cash flow	60,000	100,000
Capitalization rate	10%	
Grossed-up cap. rate ÷ cap. rate (1 – 40%)		16.67
Indicated Value	\$ 600,000	\$ 600,000



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The *Adams* court cited *Gross* and its appeal and agreed that the capitalization rate and income stream should be on the same basis:

“The net cash flow and the capitalization rate used to compute the fair market value of the WSA stock should have the same tax character; i.e., before corporate tax or after corporate tax. See Gross v. Commissioner, T.C. Memo. 1999-254 (both the discount rate and cash flow should be before shareholder tax or after shareholder tax).”

Again, citing *Gross* as a precedent, the court criticized the Taxpayer’s expert in *Adams*:

“We disagree that [the Taxpayer’s expert] estimates of WSA’s prospective net cash flows are before corporate tax because it is appropriate to use a zero corporate tax rate to estimate net cash flow when the stock being valued is stock of an S corporation...”

WSA is an S corporation, and its cash flows are subject to a zero corporate tax rate. Thus, [the Taxpayer’s expert’s] estimates of WSA’s prospective net cash flows are after corporate tax (zero corporate tax rate) and not before corporate tax as the estate contends. We disagree that [the Taxpayer’s expert] properly converted the capitalization rate because there was no need to do so. The parties agree that [the Taxpayer’s expert’s] estimated capitalization rate (before he converted it to before corporate tax) is an after corporate tax rate.

Thus, as in Gross, the tax character of [the Taxpayer’s expert’s] estimate of WSA’s prospective net cash flows matches that of the unconverted capitalization rate because both are after corporate tax. It follows that [the Taxpayer’s expert] should not have converted the capitalization rate from after corporate tax to before corporate tax because the tax character of both his estimated net cash flows for WSA and unconverted capitalization rates is after corporate tax.”

Judging by the proximity of the following citations to the above quote, a reader of the Court’s opinion could assume that the citations were intended to justify the Court’s criticism of the Taxpayer’s expert’s choice to adjust his capitalization rate from an after-tax basis to a pre-tax basis. The cited authorities were:

- Black & Isom Associates, *Fundamentals, Techniques and Theory of Capitalization/Discount Rates* (1995)
- Ibbotson Associates, *Stocks, Bonds, Bills and Inflation: Valuation Edition 1999 Yearbook*
- Pratt, *Cost of Capital, Estimation and Applications* 62 (1998)

The Black & Isom Associates reference states:

“It would obviously be an error to apply pre-tax capitalization or discount rates to after-tax earnings and after-tax capitalization or discount rates to pre-tax earnings. Therefore, the analyst may find it necessary to convert the rates.”⁶

⁶ Robert L. Green, *Business Valuations Fundamentals, Techniques and Theory* (Black & Isom Associates, 1995), Chapter 5, page 24.



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Turning to Ibbotson's reference, the following section was cited:

"All of the risk premium statistics included in this publication are derived from market returns by an investor. The investor receives dividends and realizes price appreciation after the corporation has paid its taxes. Therefore, it is implicit that the market return data represents returns after corporate taxes but before personal taxes. When performing a discounted cash flow analysis, both the discount rate and the cash flows should be on the same tax basis."

It is equally accurate to restate the quote by replacing the underlined words in "Therefore, it is implicit that the market return data represents returns after corporate taxes but before personal taxes" with "Therefore, it is implicit that the market return data represents returns after the tax liability associated with entity operations has been paid but before personal taxes."

As is suggested by the Court, Ibbotson agrees that "both the discount rate and the cash flows should be on the same tax basis." The Court believes its approach is consistent with Ibbotson. As quoted previously, the Tax Court stated:

"WSA is an S corporation, and its cash flows are subject to a zero corporate tax rate. Thus, [the Taxpayer's expert's] estimates of WSA's prospective net cash flows are after corporate tax (zero corporate tax rate) and not before corporate tax as the estate contends."

"While we agree with the Court that S corporations have a 'zero corporate tax rate,' we also recognize that there is an implicit ordinary tax liability associated with entity operations. As suggested by the rewording following the first Ibbotson quote, the 'tax liability associated with entity operations' is recognized in Ibbotson-derived rates of return."

In *Gross*, the Taxpayer's expert chose to make an adjustment to the cash flow stream to recognize what he perceived were the inherent differences between the market data upon which Ibbotson's data is based and the subject company. In contrast, the Taxpayer's expert in *Adams* chose to adjust the capitalization rate to recognize the perceived differences between Ibbotson data and the company's cash flow stream. While not wholeheartedly endorsing the practice, Ibbotson also suggests that the Taxpayer's expert's adjustment to a pre-tax capitalization rate was appropriate if cash flow was reported on a pre-tax basis.

As noted above, the Court indicated the company had a "zero corporate tax rate" which suggests its before-corporate-tax cash flow and after-corporate-tax cash flow are the same. However, as has already been mentioned, one such measure of cash flow is consistent with Ibbotson's market derived rates of return, while the other is not.

⁷ *Stocks, Bonds, Bills and Inflation Valuation Edition, 1999 Yearbook* (Ibbotson Associates, 2000), page 62.



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Continuing with the Court's reliance on recognized authorities, the Pratt citation says:

*"Whether costs of capital are estimated by the build-up model, the Capital Asset Pricing Model (CAPM), or the discounted cash flow (DCF) method, in all cases they are returns realized **after** [emphasis in original] the payment of corporate-level income taxes. If the entity being valued is subject to entity-level income taxes, then it is inappropriate to apply the cost of capital estimated by those methods to pretax return flows."*⁸

While the opinion acknowledged the subject entity was "an S corporation," no distinction was made between it and the facts of *Gross*. However, we noted that the subject interest in *Adams* had control, while the *Gross* interest did not.

Estate of Richie C. Heck v. Commissioner, T.C. Memo 2002-34

The following summary has been excerpted from *FCG Estate & Gift Valuation E-Flash*, Volume 4-2/2002 (used with permission). Portions not related to the topic of tax affecting S corporation income may have been omitted.

Heck – Case Summary

This case concerns the value of a minority interest in an S corporation. The Court did not allow the market approach due to the small number of guideline companies identified as comparable and a lack of direct comparability of these companies. Neither the Taxpayer's expert nor the IRS expert included imputed income taxes in their income approach calculation, although the IRS expert did include a 10% discount for "additional risks associated with S corporations."

Heck – Case Facts

Richie C. Heck died on February 15, 1995, owning 39.62% of the common shares of F. Korbel & Bros., Inc. (Korbel), a California S Corporation. Korbel produced champagne under an exclusive distribution agreement with Brown-Forman Corp. Brown-Forman also had a right of first refusal on any sale of Korbel stock outside of the immediate family.

The IRS expert calculated fair market value using both the market approach and the income approach. The market approach was weighted at only 30% in the final conclusion due to the "lack of perfect comparables." The expert subtracted a 15% "liquidity discount" and a 10% discount for "additional risks associated with S corporations," including "the potential loss of S corporation status and shareholder liability for income taxes on S corporation income, regardless of the level of distribution" to arrive at the operating value.

⁸ Shannon P. Pratt, *Cost of Capital Estimation and Applications* (John Wiley & Sons, Inc. 1998), pages 151-152.



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In addition, it is noteworthy that both experts did not tax affect the company's cash flow stream or discount rates in their valuation analysis. However, it is important to understand that the Taxpayer's expert in *Heck* was also the IRS expert in *Gross*. Additionally, the IRS expert in *Heck* was the same IRS expert used in *Adams*. As a result, the issue of tax affecting did not come up, and the Court had no reason to extensively address the issue as done in *Gross* and *Adams*. Furthermore, it should be noted that the estate was represented *pro se* by its executor.

Finally, here again, no distinction was made between the facts of *Heck* and *Gross*. In all three of the cases following *Gross*, no testimony was presented that would have allowed the parties and the court to examine those issues that affect the financial value of the interest at hand, namely, the economic benefit that ultimately attaches to the particular interest being valued.

Dallas v. Commissioner, T.C. Memo 2006-212, September 28, 2006

Dallas – Case Summary

The Tax Court rejected tax affecting S Corporation earnings, concluding a stock transaction was a bargain sale and, thus, a gift.

Dallas – Case Facts

Mr. Dallas sold non-voting shares of Dallas Group of America, Inc. (DGA) stock to his two sons in 1999 and 2000 in exchange for cash and notes receivable. All of the parties agreed to be bound by a third-party appraisal to determine the sales price. The notes from the sons to Mr. Dallas for the 1999 sale were self-canceling upon the death of Mr. Dallas. The IRS argued that the sales were bargain sales, and therefore, gifts.

The Court noted that interfamily transfers are presumed to be gifts unless the presumption can be overcome by the evidence. Both the 1999 and 2000 sales contained share adjustment clauses that clearly showed the transactions were for estate planning purposes. The sons were not represented by their own counsel in the transactions and did not negotiate the terms of the agreements. The Court concluded the stock sales were not arm's-length transactions.

The Taxpayer's appraiser in the original transaction issued a restricted "letter" report. The Taxpayer engaged an additional appraiser for trial testimony. The Court was critical of the second appraiser's report for including verbatim portions of the first appraiser's report and for being unfamiliar with his own firm's report at trial.

The first Taxpayer's appraiser tax-affected S corporation earnings using a 40% tax rate and the second Taxpayer appraiser used a 35% tax rate. According to the Court, the testimony of the Taxpayer's appraisers was that they tax affected under the assumption that DGA would lose its S corporation status after, or as a result of, the hypothetical sale of its stock.



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The Court said there was no evidence that DGA expected to lose its S corporation status. The Court also noted that DGA had a history of distributing sufficient cash for the shareholders to pay their taxes on their share of S corporation earnings, and there was no evidence that this practice would change.

The first Taxpayer's appraiser testified that:

- He has always tax affected S corporation earnings for the past 20 years.
- An informal poll at a recent conference showed 90% to 95% of responding appraisers tax affect corporation income.
- The American Society of Appraisers (ASA) rejects any application for certification if the candidate submits reports for review that do not tax affect S corporation earnings.
- His experience is that all bankers, investment bankers, and business brokers tax affect S corporation earnings in their calculations.
- His firm tax affects S corporation earnings for ESOP plans submitted to the Department of Labor.

The Court gave little weight to this testimony. The IRS appraiser said his reports for ASA certification had been accepted without tax affecting. The testimony about the ESOP plan valuation for the Department of Labor was also unconvincing because there was no evidence that their definition of value was the same as fair market value for tax purposes. The Court said, "We conclude there is insufficient evidence to establish that a hypothetical buyer and seller would tax affect DGA's earnings and that tax affecting DGA's earnings is not appropriate.

Again, with *Dallas*, the Court selected a fact pattern conducive to their recent position on tax affecting. The Court identified five factors that bolstered the IRS position – four of which are largely present in the *Dallas* case:

- The S Corporation had stable and profitable operations;
- The S Corporation consistently paid out enough dividends for shareholders to pay their pro-rata, "pass-through" income tax;
- There was no evidence that the company's corporate status would change; and
- A minority interest was at stake.

One note: In *Gross* the S Corporation had a consistent, annual 100% pay-out to shareholders; in *Dallas*, the company used retained earnings to expand – a fact that failed to persuade the *Dallas* court to distinguish the two cases.



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“Our analysis [in Gross] did not depend on the proportion of corporate income distributed. ...We said that, in determining the present value of an expected stream of earnings, any tax affecting to reflect the shareholder-level tax burden should be done equally (or not at all) to both the discount rate and the expected cash flows, with the result that, in either case, the present value determined would be the same. That analysis is independent of earnings distributed.”

A fifth factor in *Gross* – restrictive agreements that made it difficult to break the S Corporation status – was not present in *Dallas*. But, the Tax Court did find “the assumptions of the [Taxpayer’s] witnesses that a hypothetical buyer and seller would assume without any supporting evidence that those events would occur,” – i.e., a change in corporate status or dividend practice – “detracts from the credibility of their opinions.”

***Estate of Gallagher v. Commissioner*, T.C. Memo 2011-148, 2011 WL 2559847 (U.S. Tax Court), June 28, 2011**

***Gallagher* – Case Summary**

Decedent owned 15% in a family-founded newspaper publishing company owning a television station and a few special media providers. The company converted to an S corporation in 1996, and prior to valuation date (July 5, 2004), acquired a 100% interest in a small publishing company.

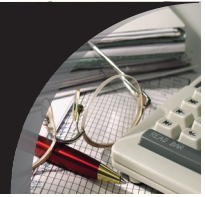
Decedent’s federal estate tax return valued 15% interest at \$34.9 million. The IRS asserted a fair market value of \$49.5 million. Taxpayer petitioned the Tax Court for a redetermination based on a new appraisal at \$26.6 million. Before trial both sides hired new experts – Taxpayer’s expert’s value: \$28.2 million, IRS expert’s value: \$40.86 million.

***Gallagher* – Case Facts**

There were four major points of dispute – date of financial information; adjustments to financial statements; the use of the guideline public company method; and appropriate adjustments to the DCF. For purposes of this course, we focus primarily on the fourth area of dispute, specifically on any tax-affecting adjustments that were necessary in this case.

The IRS declined to tax affect the S corporation’s earnings, while the Taxpayer’s expert applied a 39% income tax rate when calculating future cash flows and a 40% marginal tax rate to determine the discount rate. The Taxpayer’s expert declined to explain his reasons for tax affecting, as well as his reasoning for using two different tax rates.

Court declined to apply any tax-affect referencing *Gross*, “The principal benefit enjoyed by S corporation shareholders is the reduction in their total tax burden, a benefit that should be considered when valuing an S corporation.”



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Delaware Open MRI Radiology Associates, P.A. v. Kessler, CA-275-N, April 26, 2006 Del. Ch. LEXIS 84 (2006)

Delaware Radiology – Case Summary

In a 2006 Delaware Court of Chancery decision, that Court found that the fair value of an S corporation ownership interest in an oppressed shareholder action must include consideration of income taxes on corporate-level income.

Delaware Radiology – Case Facts

A group of practicing radiologists formed a company (“Delaware Radiology”) to capture additional revenues by owning the centers at which patients received MRI scans. Various disputes among the doctors led them to split up, which turned the Delaware Radiology stockholders into two discrete blocks: the majority “Broder” group, which controlled 62.5% of the company, and the minority “Kessler” group, which owned the remaining 37%.

Further competition among the shareholders led to the majority forming an acquisition company to “squeeze-out” the minority in a forced merger. The majority hired a valuation analyst to calculate a price for the minority shares, but it was the fairness of the price, as well as the merger itself, which later became the focus of litigation.

The question for both claims essentially came down to one – the financial fairness of the merger. Or as the Vice Chancellor phrased it,

“This case is another progeny of one of our law’s hybrid varietals: the combined appraisal and entire fairness action. ...Put simply, I must determine the fair value of Delaware Radiology’s share on the merger date and award the Kessler Group a per-share amount consistent with their pro rata share of that value.”

As ‘fair value’ is, by now, ‘a jurisprudential concept that draws more from judicial writings than the appraisal statute itself,’ the Court would examine the company as a going concern on the merger date, considering all relevant, non-speculative data. That included the respective expert opinions offered by both parties – which contained ‘widely divergent’ estimates of fair value while ‘supposedly using the same well-established principles of corporate finance.’

Such a judicial exercise, particularly insofar as it requires the valuation of a small, private company whose shares do not trade in a liquid and deep securities market, using a record shaped by adversaries whose objectives have little to do with reaching a reliable valuation, has, at best, the virtues of good faith attempt at estimation. That is what I endeavor here.”



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Delaware Radiology – Expert Valuations Nearly \$20 Apart

Three disputed valuation issues accounted for the “wide divergence” of expert valuations: (1) the treatment of MRI “reading” and management fees; (2) the company’s expansion plans – at the time of the merger, from two to five MRI centers; and (3) the treatment of the company as an S corporation.

At trial, the Broder (majority) group had relied on the same expert it had used to set the merger price. That expert used a discounted cash flow analysis that: (1) accepted the reading and management fees as proper expenses of the company; (2) attributed “no value” to the company’s known expansion plans; and (3) tax affected its earnings as if it were a C corporation rather than an S corporation. Applying “high” discount rates of 21.4% and 22.4% to the two MRI centers, the expert came to a value of \$6.8 million for the company, or \$17,039 per share.

For the Kessler (minority) group, the expert also relied on a DCF analysis. But that expert: (1) reduced excessive management fees and treated the majority of reading fees as profit to the company rather than expenses to the MRI centers; (2) included an estimate of the two proposed new centers (without estimating the fifth and most speculative); and (3) did not tax affect the company’s earnings at all. The expert also used a lower discount rate to arrive at a value of \$26.4 million for the company, or \$66,074 per share.

The Court reviewed the S corporation issue, as follows:

“Is it appropriate to tax affect the earnings of the S Corp.? In treating the Company as if it were a C Corp., the majority’s expert made the “standard move” of applying a 40% corporate tax to its earnings. The problem: there was absolutely no evidence that the small but highly profitable company would ever convert to a C Corp. Its shareholders – all in premium tax brackets – placed a substantial value on the company’s tax status as an S Corp. The merger had deprived them of these benefits; and the majority’s valuation approach “denied them the value they would have received as continuing S Corp. stockholders,” ensuring the merger price was lower than fair value.

By contrast, in relying on the “operative reality” of the S Corp. company, the minority expert did not tax affect its earnings as a going concern. However, this approach overstated the value of the S Corp. at the stockholder level, as upon its sale, an S Corp. receives no premium over a C Corp. from ‘a universe’ of C Corp. buyers, and a market-based analysis using C Corporation comparables is misleading.

In other words, I am not trying to quantify the value at which the company would sell to a C Corporation; I am trying to quantify its value...as a going concern with an S corporation structure.”

Delaware Radiology – Treatise on Tax Affecting

To capture the precise advantage of the S Corporation to the minority shareholders, the Court considered the difference between the value that a minority member would receive if the company was a C Corporation, and the



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value received as an S Corporation. In its undertaking, the Court “embraced” the leading Tax Court cases (*Gross*, *Heck* and *Adams*), which have “given life to the advantages of S corporation status by refusing to tax affect the ...earnings at all.” It also relied on the factual realities to depart from the precedent.

“My difference with these prior decisions is at the level of implementation rather than the level of principle. Certainly, in this context when minority stockholders have been forcibly denied the future benefits of S Corporation status, they should receive compensation for those expected benefits and not an artificially discounted value that disregards the favorable tax treatment. ...but the minority should not receive more than a fair S corporation valuation.”

Refusing to tax affect at all produces such a windfall...the amount that should be the basis for an appraisal or entire fairness award is the amount that estimates the company’s value to the minority as an S corporation stockholders paying individual income taxes at the highest rates – an amount that is materially more...than if the company were a C corporation.”

To accurately capture this value, the Vice Chancellor estimated what an equivalent, hypothetical “pre-dividend” S corporation tax rate would be, assuming annual earnings of \$100 and highest marginal tax rates (see below).

<u>Equivalent Pre-Dividend S Corporation Tax Rate</u>					
	<u>C Corp.</u>		<u>S Corp.</u>		<u>S Corp. Valuation</u>
Income before taxes		\$ 100.00		\$ 100.00	\$ 100.00
Corporate tax rate	40%	<u>40.00</u>	0%	<u>0</u>	29.4% <u>29.40</u>
Available earnings		\$60.00		\$100.00	\$70.60
Dividend/personal income tax rate	15%	<u>9.00</u>	40%	<u>40.00</u>	15% <u>10.60</u>
Total post-tax distributions		<u>\$ 51.00</u>		<u>\$ 60.00</u>	<u>\$ 60.00</u>

This calculation allowed the Court to treat the S corporation shareholder as receiving the full benefit of untaxed dividends by equating its after-tax return to the after-tax dividend to a C corporation shareholder. “I will therefore apply an effective tax rate of 29.4% to the earnings of Delaware Radiology to measure, with the greatest practicable precision, the fair value of the minority’s interest in the going concern value.”

Having determined the major inputs to a DCF analysis, the Court proceeded to compute its own, noting additional facts that influenced its approach, as well as the more influential texts (such as Shannon Pratt’s, *Valuing a Business*, 4th Ed. 2000). In its detailed and thorough calculations, including the “challenges” of computing a “proper” weighted average cost of capital, the Court also considered the two expert valuations in the case, using only those portions which were “credible and well-grounded in finance and fact.”



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The Court's independent analysis forms the last of the essential reading of this case, which concludes with a \$13.3 million valuation for the Company – a per-share value of \$33,232 – and a finding that the merger was unfair. Of equal importance is the Court's ultimate conclusion regarding the "value" of the two appraisals.

In finding the minority's expert more credible, the Vice Chancellor praised him for approaching his task "in a conservative and restrained manner that, although still reflecting a desire to advance his clients' objectives, reasonably took into account factors limiting the value" of their company.

By contrast, the majority's expert seemed more aggressively driven by his goal of reducing what the majority would be ordered to pay. The Vice Chancellor noted:

"Moreover, he was given his marching orders in his work before and after the merger that led him to undervalue the company...Put simply, this did not instill confidence in me...His knowledge of the relevant facts regarding the company seemed unduly constrained by his clients, and his blinkered view of the business impaired his ability to reach a reasoned determination of value."

Bernier v. Bernier, 2007 Mass. LEXIS 598 (May 7, 2007)

This case, to our knowledge, represents the first time that the tax-affecting issue has been addressed in a marital dissolution proceeding at the state Supreme Court level. It is interesting in that this case reflects careful consideration by the judiciary and a significant dependence on *Delaware Radiology*.

Also interesting is the Court's apparent willingness to move away from the "hypothetical" universe of willing buyers contemplated in the definition of fair market value to another standard of value – notably investment value – where the specific holder of the asset has an influence on the value of the interest.

Bernier – Case Summary

Debate over the valuation of S corporations has "bedeviled the professionals appraisers' community for some time," the Massachusetts Supreme Court observed at the beginning of this divorce case. Here, the debate played out in the "vastly different" appraisals by the parties' experts, as well as their reliance on different precedent. A more subtle debate over the application of fair value versus fair market value in marital dissolutions also played out, making *Bernier* a "must-read" for its overview of the complex financial issues and related case law.

Bernier – Case Facts

At trial, both experts agreed that the income approach was the most accurate approach to valuing the couple's two S corporations, which owned successful supermarkets in the upscale Martha's Vineyard market. The experts also



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agreed that any potential buyers of the S corporations would seek a required rate of return. However, the experts took “diametrically opposed” approaches to tax affecting the businesses.

The husband’s expert treated the couple’s S corporations as if they were C Corporations, applying a 35% “average” tax rate to earnings. This was appropriate, he said, because a potential purchaser would factor these tax consequences into the expected rate for return. He also applied a 10% “key man” discount, because the husband was undisputedly important to the supermarkets’ operation, and a 10% “marketability” discount to account for the costs of any sale. He used no growth rate in his valuation, due to declining revenues and uncertain future growth. Overall, the husband’s expert reached a \$7.85 million valuation for the S corporations.

The wife’s expert declined to apply C corporation tax rates, because no sale of the business was contemplated, and the S corporations did not pay taxes at an entity level. Because the husband intended to maintain full ownership and control after the divorce, no discounts applied, the expert said. Since revenues were just emerging from the downward growth trend, he applied only a 2.5% growth rate to account for inflation. Overall, the wife’s expert valued the S Corporations at \$16.4 million.

The trial judge adopted the husband’s tax-affected value, citing the Tax Court’s decision in *Gross*. It also faulted the wife’s expert for “improperly” combining pre-tax and post-tax data in establishing a capitalization rate, applying an incorrect growth rate, and omitting discounts.

Tax Court v. Delaware Chancery

On review, the Massachusetts Supreme Court first noted that shareholders in a Subchapter S corporation enjoy the “considerable benefit of avoiding the ‘double taxation’ of corporate dividends that is a hallmark of the C corporation.” But this distinction “does little in itself to clarify the issue of valuation” and begs the questions “whether, and how,” to account for tax consequences. Judges, appraisers, and academics have debated these questions, it added.

The debate may have begun with an old IRS training manual, Valuation Guide for Income, Estate and Gift Taxes, in which the IRS appeared “to have endorsed the practice of tax affecting an S corporation in the manner that [the husband’s expert] followed.” Since the *Gross* decision, however, “both case law and professional scholarship have cast serious doubt on the validity of this practice,” the Court said, citing the Tax Court cases that followed *Gross*, from *Adams* and *Heck*, both decided in 2002, through *Dallas v. Commissioner* in 2006.

Looking to the other side of the debate, the Court cited *Delaware Radiology* (2006), in which the Delaware Chancery Court reviewed an S Corporation merger for fair process and statutory fair value. In that case, treating the



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enterprise as a C Corporation failed to account for the comparative tax benefits of S Corporation ownership and, therefore, depressed the estimate of the business's fair value. But not tax affecting at all would lead to a windfall for the minority shareholders.

As a result, the Chancery Court crafted a “hybrid” approach to capture the value of the tax benefit to the shareholders (and potential buyers of the shareholders' interests) by imputing a “pre-dividend” corporate tax rate of 29.4% to the S Corporation. This left the S Corporation shareholder “with the same amount of money in his or her pocket as the shareholder of a C Corporation,” assuming the latter were taxed at the hypothetical 29.4% rate.

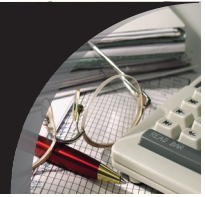
Trial Court Misapplied *Gross*

The Delaware Chancery Court's “trenchant” analysis proved more persuasive. By applying the presumed 35% C Corporation tax rate, the trial court in this case had understated the value of the S Corporation supermarkets and failed to adequately compensate the wife for loss of the attendant ownership and tax benefits. This was particularly true given the “uncontroverted” evidence that the husband would continue to own and operate the profitable supermarkets after the divorce, including the historic practice of making cash distributions. Even though *Delaware Radiology* was decided after the trial, these facts should have prompted the judge to “look past the all-or-nothing approach” of the parties' experts.

Moreover, the trial court misapplied *Gross*, citing it for the proposition that tax affecting Subchapter S income for valuation purposes should be reflected in determining the cost of capital. But then it ignored the Tax Court's application of a 0% corporate tax rate when it adopted the 35% rate proposed by the husband's expert. “The husband has cited no cases, nor have we found any, that apply the presumed [35%] rate of taxation of a C Corporation to estimating the fair market value of an S Corporation using the income approach,” the Court held. The judge's reliance on the IRS training manual was also improper. “The IRS valuation guide cannot be cited as authority.”

A Finding for Fair Value in Divorce?

Under these circumstances, the Court found that the metric employed by the Delaware Chancery Court “provides a fairer mechanism for accounting for the tax consequences” of transferring ownership of the S corporations from one spouse to the other. In particular, it likened the fiduciary considerations that constrain the equitable property division in divorce cases to those that constrained the minority/majority shareholders in *Delaware Radiology* and statutory fair value cases. In the context of divorce, where one party will retain and the other be entirely divested of ownership in any marital asset, “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.”



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The Court did not clearly state fair value as the applicable premise of value. In fact, a few paragraphs after the quoted passage, above, the Court also observed that “[c]areful financial analysis tells us that applying the C Corporation rate of taxation to an S Corporation severely undervalues the fair market value of the S Corporation.” But in its review of the “key man” and marketability discounts, the Court held that both discounts were inappropriate where the husband would remain in complete control, contemplated no sale, and intended to continue the businesses as “ongoing concerns.” A 2.5% growth rate was also appropriate where there was no evidence that future growth would fall short of inflation.

The Court remanded the case back for a determination on the tax affecting, discount, and growth rate issues. It acknowledged the “complex” valuation issues and the trial court’s prior efforts to render a decision without the benefit of the *Delaware Radiology* analysis. As a final note, “We emphasize the judge’s role in ...[ensuring] that the final judgment reflects the statutory requirements of equitable distribution.”

Erp v. Erp, 2005-3144, 2006-1934, 2007 Fla. App. LEXIS 18726 (Nov. 28, 2008)

In this case, the Florida Court of Appeals considered, in its primary focus, whether, as a matter of law, a discount for lack of marketability (DLOM) should not be applied when valuing a business for divorce purposes. However, tax affecting was also addressed within this case and rejected by the trial court.

Erp – Case Summary

During the marriage the couple purchased an RV dealership, formed as an S corporation, which they grew to a business that earned more than \$1 million annually. Each spouse owned a 40% interest, while their two children held the remaining shares equally. Prior to trial, the parties agreed that one of them should be awarded the entire 80% interest, with the other spouse receiving an equalizing payment of one-half the fair market value of that interest.

Demonstrative Exhibit Makes Impact

At trial, both parties’ experts generally used an income-based approach to value the business. The wife’s expert valued the business at \$12.5 million, and \$5 million for her 40% share. By contrast, the husband’s expert valued the business at \$4.56 million, and the wife’s share at only \$720,000.

Although the appellate court notes that both experts testified in “great detail” about their calculated values, the opinion fails to specify further. The husband’s expert presented a “demonstrative exhibit” to the trial court, which presumed to detail the differences between the two appraisals.



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Specifically, the exhibit explained that the expert had:

- Tax affected the income stream;
- Performed a regression analysis;
- Concluded a working capital adjustment was not appropriate;
- Measured income based on a “last in, first out” (LIFO) accounting method – not “first in, first out” (FIFO);
- Applied a minority discount to each party’s shares; and
- Applied a 25% discount for lack of marketability.

The trial court awarded the 80% interest in the business to the husband, with an equitable distribution to the wife. The court took a piecemeal approach, using parts of each expert’s appraisal, and ultimately valued the business at \$6.2 million. Further, it valued the wife’s one-half interest at \$2.48 million (or 40% of the total value of the corporation). The trial court explained its determination by reference to the demonstrative exhibit, and:

- Rejected tax affecting the income stream;
- Applied the regression analysis;
- Included a working capital adjustment;
- Utilized a LIFO accounting method;
- Rejected the application of a minority ownership discount; and
- Applied the marketability discount, but at a reduced level of 10%.

Should DLOMs be Precluded in Divorce?

Among other issues, the wife appealed the application of a marketability discount. She argued that a marketability discount should be prohibited as a matter of law in a divorce valuation. She analogized the divorce context to that of an oppressed and/or dissenting shareholder case. Because a court orders judicial “buyout” in those cases (as it does in divorce), and because local (Florida) law does not permit “discount for lack of marketability” in the oppression context, the wife argued that the court should not be permitted to apply a marketability discount in this case.

The appellate court found this argument unpersuasive. Dissenting shareholder cases arise in the context of an “involuntary change in the fundamental corporate structure.” The appraisal remedy protects minority shareholders who are cashed out of their investment by precluding further reduction of their interests through marketability discounts. This situation is not present in the divorce context.



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The debate is sometimes led astray by the application of broad generalizations that do not differentiate between the types of proceedings within which valuations are required, nor acknowledge that the appropriate analysis for the valuation of a business may change depending upon the specific legal and factual context presented. What is appropriate in the oppressed shareholder or minority appraisal rights cases may not necessarily be desirable in a judicial dissolution of a corporation or in an action for dissolution of marriage involving equitable distribution.

In this case, the wife was not the victim of majority shareholder oppression. She and the husband agreed that they could not run the business together, but disputed who should retain it. The closer and more proper analogy, the court reasoned, is to a judicial dissolution of the business based on shareholder deadlock. In these cases, a court has discretion to determine whether a marketability discount is appropriately applied to a closely-held corporation.

Accordingly, the Florida Court of Appeals declined to prohibit a discount for lack of marketability as a matter of law in divorce cases. Finding no abuse of discretion, it affirmed the trial court's application of a 10% marketability discount.



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Chapter V – *Measurement*

In light of the ongoing debate over tax affecting S corporation future economic benefit streams under an income approach, as well as the flurry of court decisions addressing the issue, commentators within the business valuation community have stepped up efforts to better understand and quantify the benefit of maintaining S corporation status.

Several practitioners were busy developing, refining and testing their own models and theories to support the position for tax affecting S corporations.

The four main models to emerge were developed by:

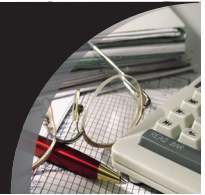
- Roger J. Grabowski
- Daniel R. Van Vleet
- Chris D. Treharne
- Z. Christopher Mercer

There is some common ground between the models and some unique differences. Based on a reading of each practitioner's model, one thing is clear – they all agree that the cases herein above indicate that each valuation, and the issue of whether or not to tax affect, requires the practitioner to take into consideration all the facts and circumstances in each particular case.

The following is an outline of the main components of the various models. A fully-detailed analysis of each model and related theory is beyond the scope of this presentation. In addition, the chapter concludes with a Simplified Model for S Corporation Valuation developed by Nancy Fannon. While techniques have evolved, including this model, it does do a good job accentuating current thinking.

Roger J. Grabowski Model

Grabowski's theory starts with the premise that an interest in an S Corporation may have a greater value than an interest in an otherwise identical C Corporation. However, this should be based on the facts and circumstances of each engagement. Unless one is engaged to value an absolute controlling interest in an entity, a hypothetical willing seller is selling a specific interest with its own unique legal and tax attributes. Therefore, a hypothetical willing buyer is only buying that specific interest along with the related legal and tax attributes.



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According to Grabowski there are three major benefits to owning an S corporation:

- Income is subject to one level of taxation at the shareholder level. There is no issue of double taxation because there is no federal entity-level tax.
- Owners of an S Corporation receive an increase in their basis to the extent that taxable income exceeds distributions to the shareholders.
- Owners of S Corporations may realize more proceeds upon sale if the buyer can realize increased tax savings by pushing the purchase price down to the underlying assets and getting a step-up in basis resulting in favorable tax treatment.

However, in a minority interest valuation the non-controlling shareholder will only be assured of the first two benefits. The third benefit can only be realized when the controlling shareholder decides to sell the business and/or its assets.

Grabowski's valuation model starts with the value of a 100% equivalent C Corporation and the assumption that 100% of the available free cash flow will be distributed to the shareholders. He then adjusts the equivalent C Corporation value for the S Corporation benefits noted above:

- Add present value of entity-level income taxes saved as an S Corporation by converting 100% tax savings from avoiding double taxation into a pre-owner-level tax equivalent amount.
- Deduct the tax savings on the S Corporation's retained earnings as the shareholder pays income taxes on the net income. This is accomplished by computing the present value of tax savings on net income, whether distributed or not.
- Deduct shareholder-level taxes by adjusting for the difference between generally higher shareholder-level taxes over C Corporation tax rates.
- Add the present value of any expected basis build-up. This requires the assumption that net income in excess of distribution will be retained and increase the shareholder basis. As a result, the owner will benefit from reduced income taxes in the future due to any build-up in basis.
- Add the present value of any expected benefit from a step-up in basis benefit. This adjustment should be made based on facts and circumstances of each case. If the facts support the assumption that a buyer will be able to depreciate or amortize the price of the assets expected to be sold in the future, then the present value of the expected tax benefit should be added to the computation.

The last two adjustments require several assumptions and projections be made. These assumptions and projections could be highly speculative and may not apply to all situations. Therefore, all adjustments require the use of



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professional judgment and should be driven by facts. Individual elements of value should be included only when the facts warrant.

Grabowski's model results in the value for a controlling interest in an S Corporation and, therefore, allows for the use of a minority interest discount. His model starts with the assumption that 100% of available free cash flow will be distributed. However, this is not always the case. The analyst needs to look at shareholder agreements and the history of the subject entity to see how free cash flow was handled. However, a minority interest shareholder cannot be assured that all free cash flow will be distributed and agreements can be changed. Therefore, if the facts and circumstance warrant, a minority interest discount may be applicable.

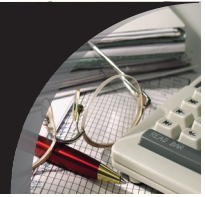
Z. Christopher Mercer Model

Mercer believes that at the entity level an S Corporation has the same value as an otherwise identical C Corporation. However, at the shareholder level, an S Corporation's interest may be worth somewhat less, the same as, or somewhat more than an otherwise identical interest in an otherwise identical C Corporation, all dependent upon the fact of the engagement. Mercer breaks down the value at the entity-level value and then at the shareholder-level value.

Entity-Level Value

Entity-level value is the discounted present value of the expected discounted cash flows. Since there is no difference in entity cash flow by electing S Corporation status, there are no differences in entity values for C and otherwise identical S Corporations. Mercer reasons that there is entity-level Value Equivalency between S Corporations and C Corporations as follows:

- Cash flows at the entity level are not affected by the choice S Corporation versus C Corporation. Also an election of S Corporation status has no impact on revenues or operating expenses of the corporation.
- The S Corporation election is a shareholder-level election and is a costless election. Shareholders make the election for perceived benefits which include:
 - One level of taxation. No double taxation like C Corporations along with the ability to make dividends in excess amounts, required to cover shareholder-level income taxes on the pass-through income, tax free.
 - The build-up of retained earnings or AAA account increase the shareholder's basis.
 - The S Corporation has the ability to sell its assets and take advantage of the opportunity to achieve capital gains status on the sale.



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Mercer concludes that at the entity level an otherwise identical S Corporation and C Corporation will be of equal value. No entity-level value is created by electing S Corporation status, and no value is diminished. Furthermore, the key words used in Mercer's analysis are "otherwise identical." This suggests the obvious that non-identical entities will likely not have identical value.

Shareholder-Level Value

Shareholder-level value is the discounted present value of expected cash flows to shareholders, for the duration or expected holding period of their investment. To determine the discounted present value for shareholders' interests in both S Corporations and C Corporations, Mercer utilizes the cash flow model known as the Quantitative Marketability Discount Model (QMDM).

The QMDM measures shareholder cash flows for the expected duration or holding period of the interest. This requires that S Corporation distributions be grossed up to equate with a C Corporation equivalent and related dividend yields computed.

The QMDM requires that five key assumptions be made:

- What is the expected growth rate?
- What is the expected distribution yield?
- What is the expected growth in distributions?
- What is the expected holding period?
- What is the required holding period return (Shareholder Discount Rate)?

These assumptions are variables used in Mercer's model. The model is a discounted cash flow method which is used to compute the present value of expected future benefit stream of either S Corporations or C Corporations. The model applies the assumptions discussed above in order to arrive at the value of expected future benefits stream at the shareholder level.

Because Mercer's model requires that an analyst make assumptions, these assumptions can have a significant impact on the value computed. Therefore, one must understand the facts and circumstances of each engagement and assumptions required. These assumptions must be reasonable and in context when applied.



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Chris D. Treharne Model

Chris D. Treharne, ASA, MCBA, developed a model (hereinafter “Treharne model”) that is equally relevant to all forms of pass-through entities. The Treharne model assumes that the holding period of the investment is perpetuity. Therefore, the benefit of a build-up in shareholder basis is not considered or quantified.

Note that this is the only model that does not consider the ability to benefit from non-distributed earnings.

Mr. Treharne believes that the impact of a build-up in basis is negligible when in the context of valuing a non-controlling interest in an S corporation. He does note that a deviation from this general principle would occur in the event that an exit strategy was imminent, rendering the assumption of perpetuity invalid.

The Treharne model begins with the development of cash flow, which is segregated into two segments: (1) that which is retained by the company; and (2) that which is distributed to the investor. The cash flow distributed to the investor is further broken down by: (1) that which is necessary to cover the tax on the respective shareholder’s portion of the income flowing through from the pass-through entity; and (2) distributions in excess of the tax liability. The determination of excess distributions should be based on the distribution history as well as future reinvestment needs of the particular company. The benefit of such excess distributions is in the form of taxes saved by the S corporation shareholder – avoidance of the dividends tax for which a C corporation shareholder would be responsible.

When determining the present value of the non-controlling shareholders tax benefit, the discount rate (or risk rate) may be increased to reflect greater uncertainty in connection with receiving the distributions. Mr. Treharne notes that the risk rate associated with the S corporation distributions may be greater than the risk rate attendant to the subject company’s net cash flow benefit stream, as distributions are subordinate to and dependent upon net cash flow, and are at the discretion of a controlling shareholder.

The fact that the S corporation shareholder pays taxes at a different rate than the C corporation is also taken into consideration. The amount is calculated by the present value of the rate difference, which could be an increment or decrement to the value determination depending on the assumed rates.

The model considers the utilization of capitalization rates that are developed from empirical data derived from publicly-traded stocks, which therefore reflect the satisfaction of C corporation tax liabilities. Mr. Treharne notes that even though an S corporation does not have an entity-level tax on the income produced, it is unreasonable to assume that the rates of return derived from the empirical data can be used with a cash flow benefit stream that does not reflect the tax liability associated with the entity’s income. Therefore, the benefit stream and discount rate must reflect the satisfaction of income taxes associated with the income of the entity.



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The assumption behind the Treharne model is that who pays the taxes – the C corporation (as an entity) or the S corporation shareholder – is irrelevant, as the dollars used to satisfy the liability are not available for reinvestment and do not create wealth for the entity or its owners. As a result, Treharne concludes that investors make investment decisions based on net proceeds (after the satisfaction of tax liabilities directly attributed to the investment) whether those liabilities are associated with the security or the investor.

In summary, the Treharne model begins with the value of an equivalent C corporation after reinvestment of all necessary cash flows, meaning tax affecting the S corporation's cash flow at C corporation tax rates. Then adjustments are made to this valuation determination depending on the following:

- The value attributed to the tax benefits associated with the S corporation shareholder not having to pay a second level of taxes on excess distributions (avoidance of dividends tax).
- The present value of the cash flow to the investor should be adjusted for the income tax differences between C corporations and individuals.
- The build-up of basis should be considered only in circumstances where the assumption of perpetuity is invalid.

Daniel R. Van Vleet Model

The conceptual foundation for Van Vleet's model is the differences in the income tax treatment of C corporations, S corporations and their respective shareholders. This model is commonly known as the SEAM – S Corporation Economic Adjustment Multiple. Van Vleet cautions that his model should only be applied in the instance of a valuation of a minority interest in an S corporation and market data of publicly-traded C corporation equity securities are used to estimate the value of a subject S corporation. The model can be applied to all generally-accepted valuation methods including the income, market and asset-based approaches.

There are two basic premises that are relevant to Van Vleet's model:

- There are significant differences in the income tax treatment of S corporations, C corporations and their respective shareholders. These differences include:
 - C corporations are subject to corporate income taxes at the entity level, while S corporations recognize a pro rata share of the net income at the shareholders' personal income tax rates;
 - Dividends from C corporations are subject to dividend income tax rates at the shareholder level, while dividends received from S corporations are not subject to tax; and



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- The undistributed income of an S corporation increases the income tax basis of the security, while undistributed income of a C corporation does not change the income tax basis of the security.
- Capital markets are efficient over the long term, and equity investment rates of return, equity security prices and price/earnings multiples of publicly-traded C corporations inherently reflect the income tax treatment of C corporations and their respective shareholders.

The SEAM is based on several significant assumptions including:

- The subject entity will remain an S corporation into perpetuity.
- Investors are indifferent between distributions and capital gains.
- The buyer is a qualified S corporation shareholder.
- Current tax laws and income tax attributes will continue into perpetuity.
- The entity under valuation will continue to be profitable into perpetuity.

The SEAM model makes no distinction between current distributions and retained net income, taking the position that they are equally valuable to an investor. This is true in the public markets where an investor can sell stock at any time, which we know is not often the case in private markets.

The model begins with the economic benefits of an equity interest in a C corporation including consideration of corporate-level taxes, as well as dividend tax on distributions and capital gains on retained earnings. This benefit is compared to the S corporation economic benefit that is responsible for only one layer of income tax. The mathematical formula that results from this difference becomes the SEAM adjustment.

The Simplified Model for S Corporation Valuations

The four models previously summarized essentially follow a similar method toward the same objective:

- Calculate the value of the S corporation as if it were a C corporation;
- Account for the difference between corporate and individual income tax rates;
- Calculate the benefit of the avoidance of dividends tax (second layer of tax on C corporation dividends); and
- Consider (and calculate if appropriate) the ability to build-up basis in S corporation stock.



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In an effort to synthesize the existing traditional models in the form of a straight-forward, simplified approach, Nancy J. Fannon, ASA, MCBA, CPA, ABV, BVAL, created the *Simplified Model for S Corporation Valuations*. Ms. Fannon's goal was to create an appropriate means to value S corporation interests through a simple transparent model to be effective for valuers to use and convey to clients, legal counsel and the Tax Court.

Drawing on the existing four models and the theoretical framework established by the pioneers in finance and investment as well as the collective wisdom of the valuation community, the components of the Simplified Method are:

- A traditional discounted cash flow methodology;
- Recognition of the benefit of the avoidance of the dividends tax; and
- Recognition of the capital gains tax benefit due to the ability to build-up tax basis in the S corporation stock.

By employing the Simplified Model for S Corporation Valuations the valuator must consider the following:

- Annual distributions, which are calculated as a percentage of net income before tax.
- The holding period of the particular investment.
- The likelihood of the buyer qualifying as a pass-through buyer. In the circumstance that evidence supports this conclusion, it should be weighted in with the benefit conclusion. Conversely, in most minority transfers it is likely that the buyer will be one that qualifies as an S corporation investor. In these cases, the benefit of continuing the single tax would be included in full or slightly discounted.
- The consideration of additions to the rate of return for the ability to realize a build-up in the income tax basis of the S corporation stock. In some instances this benefit may be fully available, however, for some small minority interests there may be little opportunity to transfer their stock, therefore limiting their ability to recognize the benefit of the retained income.

The tables on the following pages illustrate an example of the Simplified Model for S Corporation Valuations and are based on the following additional assumptions added to the prior examples in this program:

- Distributions as a percent of income75%
- Holding period2 years
- Likelihood of buyer qualifying as a pass-through buyer 100%
- Additions to ROR for ability to build-up basis.....0%



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Illustration of Simplified Model

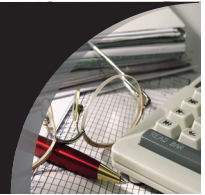
Pass-Through Entity (PTE) Calculation

	1	2	3	4	5	Terminal Year
Net income before tax	1,040	1,082	1,125	1,170	1,217	6,328
Less: personal level taxes (35%)	(364)	(379)	(394)	(410)	(426)	(2,215)
Net income after tax*	676	703	731	761	791	4,113
Present value discount rate (24%)	.8065	.6504	.5245	.4230	.3411	.3411
Discounted cash flows	545	457	384	322	270	1,403
Indicated Value of Cash Flow	<u>\$ 3,381</u>					

*Assume net income and net cash flow are equivalent

Adjustment for Dividend Tax Avoided

PTE distributions						
Percentage of income (75%)		780	812	844	878	913
Total entity taxes (from above)		(364)	(379)	(394)	(410)	(426)
Equivalent C corp dividends		416	433	450	468	487
Dividend tax rates:						
State (3.07%)		13	13	14	14	15
Federal (15.0%)		60	63	65	68	71
Net PTE benefit		73	76	79	82	86
Present value factor (24%)		.8065	.6504	.5245	.4230	.3411
Present Value		59	50	42	35	29
Sum of Double Taxation Adjustment			214			
Likelihood of buyer benefitting from pass-through benefits			100%			
Estimated Benefit			<u>214</u>			



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	<u>Benefit of Build-up in Basis</u>					
	<u>1</u>	<u>2</u>	<u>3</u>	<u>4</u>	<u>5</u>	<u>Total</u>
PTE net income over period	1,040	1,082	1,125	1,170	1,217	5,634
PTE distributions over period	780	812	844	878	913	<u>4,226</u>
Income over PTE distributions						1,409
Capital gains tax (17.5%)						246
Present value factor						.3411
Present value						84
Likelihood of buyer benefitting from pass-through benefits						100%
Estimated Benefit						<u>\$ 84</u>

<u>Summary of Recognized Benefits</u>			
Indicated value of cash flow	3,381		
Adjustment for dividend tax avoided	214	PTE premium	9%
Benefit of build-up in basis	<u>84</u>		
Indicated Value Plus S Corp Benefits	<u>\$ 3,679</u>		



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Emerging Thoughts

There is no question that there has been much debate over tax affecting S corporations. As presented herein, many models have been put forth for consideration and use by the valuation community. Currently, there is a new school of thought regarding the correct way to treat an S corporation in terms of tax affecting. While Nancy Fannon has recently abandoned her simplified model, in December 2011, she co-authored an article with Keith Sellers titled, “Valuation of Pass-Through Entities: Looking at the Bigger Picture.”⁹

This article takes a look at the ways in which valuers try to quantify the value difference between otherwise identical C and S corporations. The article examines academic research, which the authors assert indicates that shareholder-level taxes appear to impact both cash flows to shareholders and cost of capital to entities. It further notes that failure to recognize and consider those impacts will, “potentially result in a mismatch of benefit stream with the appropriate cost of capital.”

The crux of the article states that research on public-market returns demonstrates that shareholder-level taxes do not affect value, dollar-for-dollar. Conversely, private-market valuation treats shareholder taxes as being directly correlated to value – this technique is far different from the reality depicted by empirical research. The authors of the article state that, “this should indicate to private-market analysts the need to carefully consider offsets and other associated risks when different tax schemes than that which exists in the public-market return are assumed.”

The article’s final statement pinpoints the authors’ opinion on where focus needs to turn, “Like all risks that affect value, this [risk associated with different tax schemes] can be demonstrated perhaps most effectively through the cost of capital.”

⁹ Sellers, Keith F. and Fannon, Nancy J. “Valuation of Pass-Through Entities: Looking at the Bigger Picture.” December 2011



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Chapter VI – *Implications*

The result of the recent court cases is somewhat fortuitous in that they have provided the motivation to move the issue of tax affecting forward. That said, the struggle to reconcile the financial mechanics and theory with the position of the courts, especially the Tax Court is, at best, a difficult process and, at worst, impossible.

It is the position of the Valuation Services Group at Grossman Yanak & Ford LLP that some value inures to the holder of an ownership interest in a S corporation over an identical interest in a C corporation. However, in the determination of fair market value, it must be remembered that the definition calls for a hypothetical sale to a hypothetical buyer who comes from a very broad universe of buyers. Surely a large portion of that universe of buyers will not meet the definition requirements of an S corporation shareholder. As such, a sale to those hypothetical buyers will terminate S corporation status and reduce any value accorded that status.

Another difficult element of these considerations rests with the fact that to date, no empirical evidence exists that provides verification that an S corporation will sell for a premium over a C corporation. Grossman Yanak & Ford LLP has been involved in a significant number of acquisition and disposition transactions over the last decade – well over 100 deals – and in no case was a company valued at a premium due to preferential tax status.

A more substantial argument can be made for adding the premium to minority ownership interests. This is especially true where restrictive stock agreements mandate that the minority shares can only be sold to potential buyers that qualify for S corporation status. In this instance, it would seem somewhat more theoretically correct as the hypothetical sale envisioned in the definition of fair market value is not going to terminate the company's S corporation status.

The overriding problem is the courts' constant tendency to focus on a "fair" resolution (as they, of course, see the law and the facts of the case.) Unfortunately, the result of reaching for this resolution moves the result away from a sound and conclusive financial theory, often leaving readers of their opinions to scratch their heads in wonder.

Current thinking on these matters must be addressed on a case-by-case basis. Clearly, alternative views on the tax affecting issue continue to evolve, and more models are expected in the future to assist in dealing with how best to incorporate S corporation tax status on valuation. Until then, we recommend a direct consultation on specific case facts to determine how best to address the issue.