****After this seminar, Congress passed the Tax Cuts and Jobs Act which reshaped the landscape of company taxation. Read "Divorce Valuation Tax Trap" on our *Business Valuation Articles* page which deals with a few of the many possible impacts of the Act for business valuation.**

Tax Issues in Business Valuations: S Corporations and LLCs

***A Taxing Day for Family Lawyers: Tax Traps, Strategies, Basics and More,* 2017 North Carolina Family Law Fall Section Program, September 15, 2017, Greensboro, NC**

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I. INTRODUCTION

One of the most controversial and angst producing valuation issues in recent memory in the business valuation field concerns the valuation of S corporations or other such tax-favored entities such as limited liability companies or partnerships and how or if the valuator should incorporate any additional after-tax benefits to the shareholder in such an entity in determining the value. This seminar will address the following issues:

- **History-** What gave rise to this issue in the first place?
- **Reasons for potential greater value for S Corp/LLC interests-** Why is it possible that an interest in a "pass-through" entity such as an S corporation or LLC might be worth more than the same interest in an otherwise identical C corporation?
- **Implications to value and methodologies used-** What are the implications of this issue to value and how do valuators adjust for it?
- **Status and controversies-** What is the present status of the issue in the courts and in the valuation community? What are the problems/issues/controversies related to the issue?

II. QUALIFICATIONS OF SPEAKER

George Hawkins, ASA, CFA, is President of Banister Financial, Inc., a Charlotte, North Carolina business valuation firm. He is an *Accredited Senior Appraiser (ASA)* in business valuation, and is a *Chartered Financial Analyst (CFA*) charterholder awarded by CFA Institute. George is co-author of *Business Valuation Guide*, a 2,000+ page book published by Wolters Kluwer (formerly by its CCH unit), now in its 19th edition. He has also authored over 100 published articles on business valuation issues. George is qualified as an expert in U.S. Tax Court, North Carolina state courts (including North Carolina Business Court), U.S. Bankruptcy Court, and has been appointed over 80 times by courts to value companies in disputes.

George served six years as the national head of the *International Board of Examiners* of the American Society of Appraisers in business valuation, which approves reports for valuators seeking accreditation. In addition, he also served six years as a nationally elected member of the ASA's *Business Valuation Committee*, its governing body.

George is one of 28 Charter Members of the *American Academy of Matrimonial Lawyers (AAML) Foundation's Forensic & Business Valuation Division*, selected from across the U.S., on the basis of their national reputation and achievements in business valuation, litigation support and forensic accounting, their history of serving AAML members and their clients in complex financial matters during divorce proceedings, and their commitment to integrity in this process.

Hawkins has spoken multiple times to the National Business Valuation Conference of the American Institute of Certified Public Accountants (AICPA) and the Advanced Business Valuation Conference of the American Society of Appraisers. He has also spoken to a variety of national organizations on valuation issues, including the American Law Institute-American Bar Association (ALI-ABA), the American Bar Association, and numerous state and local bar and other groups.

George received his undergraduate degree in Economics from the University of North Carolina at Chapel Hill and his MBA from Wake Forest University, along with a year of study at the University of Bath in Bath, England. Prior to becoming a business appraiser, George was a corporate banker for Bank of America and First Citizens.

III. INCOME TAX DIFFERENCE REFRESHER

A. Overview

Summarized below is a high level overview of the basic fundamental tax differences between C and S corporations (corporations who elect Subchapter S income tax treatment under the Internal Revenue Code):

C Corporation:

- **Corporate earnings-** The corporation pays federal and state income taxes on its pre-tax earnings.

- **Dividends-** The individual pays personal income taxes on any dividends received from the corporation.

- **Earnings retained in the corporation (i.e., not paid out as distributions)-** This has no effect on the shareholder's cost basis in the shares.

- **Sale of shares-** The shareholder is taxed personally on any taxable gain upon the sale of the shares. The amount of any gain (if present) is based on the selling price as compared to the shareholder's cost basis (typically purchase cost).

S Corporation:

- **Corporate earnings-** The earnings of the S corporation are taxed like a partnership, being "passed through" (do not confuse with paid out) to the individual shareholders for taxation personally at their individual income tax rates.[1]

- **Distributions (same thing as dividends)-** Distributions received are not subject to personal income taxes (to the extent the distributions paid by the corporation do not

[1] Some states tax S corporation income at the entity level, but not North Carolina.

exceed its accumulated earnings and profit and to the extent they do not exceed the shareholder's cost basis in the stock).

- **Earnings retained in the corporation (i.e., not paid out as distributions)-** This increases the shareholder's cost basis in the shares.

- **Sale of shares-** The shareholder is taxed personally on any taxable gain upon the sale of the shares. The amount of any gain (if present) is based on the selling price as compared to the shareholder's cost basis. Cost basis is increased (decreased) based on various items. To the extent that earnings are retained in the corporation and not distributed to shareholders this increase's the shareholder's cost basis, thus reducing any gain that is taxable.

Because C corporations pay taxes corporately on their earnings and then again by the shareholders personally on any dividends received, they are frequently referred as "double taxed." By contrast, S corporations (and LLCs and partnerships) are often referred to as "tax favored," with earnings only being taxed once (at the personal level), and with distributions generally not taxable. In addition, any earnings retained by the S corporation increase the shareholder's cost basis in the shares in the event of a later sale of the shares, reducing individual income taxes due on any gain on sale that might be realized. By contrast, the shareholder in a C corporation does not benefit from this increase in basis, paying tax on the gain based on his or her original purchase cost (or basis) for the shares.

As a result of the foregoing differences in tax treatment of ownership in C and S corporations and the different individual and corporate tax rates involved, this has given rise to the controversy over if and how these differences should be incorporated for valuation purposes when valuing the S corporation.

For a corporation to elect S corporation tax status, the corporation must meet the following requirements:

- Be a domestic corporation.
- Have only allowable shareholders.
- May be individuals, certain trusts, and estates.
- May not be partnerships, corporations or non-resident alien shareholders.
- Have no more than 100 shareholders.
- Have only one class of stock.
- Not be an ineligible corporation (i.e. certain financial institutions, insurance companies, and domestic international sales corporations).

This is obviously a simplistic, very generic overview of a highly complex topic of taxation which itself could encompass a whole book. Also, while an S corporation is taxed like a partnership, there are differences between S corporations, partnerships and LLCs which are not the subject of this seminar. Furthermore, LLCs, while usually electing to be taxed as partnerships, do not have to do so and could instead elect taxation like a C corporation.

Confused? For a detailed discussion of the differences between C and S corporations, partnerships and LLCs consult "When Subchapter S Meets Subchapter C," by Martin J. McMahon, Jr. and Daniel L. Simmons in *Tax Lawyer* (Vol. 67, No. 2, pp. 231-310).

Models discussed later demonstrate (from a shareholder perspective) that the shares in an operating S corporation may be worth more than an otherwise equivalent C corporation. These models make simplifying assumptions to reach this conclusion, leading some skeptics to question their validity for reasons that will be addressed.

B. Caveat- Seminar About Operating Entities, Not Asset Holding Companies

This discussion concerns operating S corporations and LLCs, not primarily asset holding companies (e.g., holding real estate or marketable securities). Readers may have heard about the issue of "trapped in capital gains" that can exist in a corporation. This can arise, for example, in a holding company that has real estate that has appreciated greatly from the time it was originally purchased by the corporation, giving rise to the following tax issues:

- **C corporation-** In a C corporation if there is a gain it will be taxed at the corporate level (at ordinary income tax rates, not capital gains tax rates) if the property is sold, with the shareholders taxed personally on dividends when proceeds are paid out to them.

- **S corporation-** In the equivalent S corporation, there is a gain upon the sale of the appreciated property, with the income tax liability on the gain passed through to the shareholder. In addition, the shareholder is taxed on any distributions received in excess of his or her cost "basis" in the shares. A purchaser of the shares of an S corporation inherits this built in gain should it later be realized.

- **LLC or partnership-** In the case of an LLC (assuming it elects to be taxed as a partnership) or partnership, taxes are paid personally by the shareholder as a result of the LLC's sale of the property at a gain as in the S corporation. However, if the partnership has agreed to take a special Section 754 tax election under the federal tax code, the purchaser of the partnership interest has his or her basis "stepped up" to market value so they are not "buying into" the existing gain, making it more palatable for a party to purchase a partnership interest. This ability to take a 754 election is not present with either an S or C corporation.

This is a highly simplistic overview. There are ultimately a variety of complex issues that impact taxation and which are not the subject of this manuscript or seminar which focuses instead on operating companies.

IV. HISTORY AND GENESIS

A. Pre-1999: The Good Old Days When "Tax Affecting" Ruled

Before 1999 there was limited discussion of the issue of whether or not S corporations and LLCs might be worth more than equivalent C corporations, with most (and perhaps all) business appraisers following the process of treating operating (i.e., not asset holding entities) pass-through entities just like a C corporation for valuation purposes. In the use of the income approach (e.g., capitalization or discounted cash flow methods) most business appraisers valued the S corporation by "tax affecting." That is, the valuator reduced the S corporation's earnings by the income taxes it would pay as if it were a C corporation. The theory was that even though the S corporation itself did not pay taxes, the reality is that the shareholder(s) would and that it was sticking one's head into the proverbial sand not to take the impact of income taxes into account.

Table 1 gives a simple example of the old days of "tax affecting." Two otherwise equivalent C and S corporation entities are both being valued by the capitalization method where the earnings are divided by a capitalization rate (which takes into account risk, the time value of money and the future annual growth rate in earnings) to arrive at a business value. By tax affecting the earnings of the S corporation as if it were a C corporation the result is that both have exactly the same value via the income approach:

Table 1
When Tax Affecting in the Capitalization Method Ruled:
Valuing The S Corporation as if it Were a C Corporation

	C Corp.	**S Corp.**
Revenues	$10,000,000	$10,000,000
-Expenses	($8,000,000)	($8,000,000)
Pre-Tax Profits	$2,000,000	$2,000,000
C Corporation Tax Rate	*36%*	*36%*
-Corporate Level Income Taxes	($720,000)	($720,000)
Net Income	**$1,280,000**	**$1,280,000**
Divided by Capitalization Rate	20%	20%
Value of Shares	**$6,400,000**	**$6,400,000**

[1]C corporation rates of 34% Federal and 3% North Carolina (2017), with state taxes assumed deductible for federal purposes.

In the old days, most business appraisers were happy with tax affecting and the S corporation was valued exactly this way. For estate, gift and other tax purposes, the IRS even had its own internal training manual (not official policy- one of the seeds in the dispute to come) for its in-house business appraisers and examiners that also suggested this approach and which was commonly followed. Then the world changed…

B. A *Gross* History Lesson

1999 brought an abrupt end to the tax affecting party and ushered in a period of great uncertainty in the valuation of S corporations and LLCs that persists to this day. While the initial impact was for estate, gift and other tax-related business valuations, the issue soon enveloped valuations for all kinds of purposes. Imagine what would happen if tax affecting were eliminated for the S corporation in the capitalization method- the damage is clear to see in **Table 2**:

Table 2
Valuing the S Corporation Without Tax Affecting
Using *Gross* Logic

	C Corp.	S Corp.
Revenues	$10,000,000	$10,000,000
-Expenses	($8,000,000)	($8,000,000)
Pre-Tax Profits	$2,000,000	$2,000,000
Corporation Tax Rate	*36%*	*0%*
-Corporate Level Income Taxes	($720,000)	$0
Net Income	**$1,280,000**	**$2,000,000**
Divided by Capitalization Rate	20%	20%
Value of Shares	**$6,400,000**	**$10,000,000**
S Corporation Shares Worth More		**56%**

By not taking into account corporate level taxes (based on assumptions in **Table 2**) in valuing the S corporation which was otherwise identical to the C corporation, the S entity is now worth **56%** more! This is with current tax rates in 2017, whereas in 1999 the result was an even greater difference.

Unfortunately, this is the exact logic adopted by the U.S. Tax Court in a case that dropped a massive bombshell on taxpayers and the valuation community. This 1999 gift tax case *(W. Gross, Jr., TC Memo. 1999-254*), upheld on appeal (*2001 FED App. 0405P, 6th Cir.*), held that tax-affecting S corporation earnings was not correct. However, there is more to the story than just tax affecting and the focus on it alone misses the big picture.

The essence of the Tax Court's argument denying the use of tax affecting boils down to the totality of the benefits received at the shareholder level. As such, the *Gross* Court indicated that tax affecting does not take into consideration the additional after-tax benefits available to S corporation shareholders versus those in otherwise equivalent C corporations. Because the S corporation is not double-taxed on earnings as with the C corporation, the argument goes that this imputes a tax at the corporate level that the S corporation never pays. By contrast, the C corporation pays taxes on earnings at the corporate level, with the shareholder paying tax again on dividends received. Furthermore, to the extent that earnings are retained in the S corporation and not distributed, this increases the shareholder's cost basis, resulting in less tax on the gain if or when the shares are later sold. This benefit is not available to the C corporation shareholder. The *Gross* Court argues that simply tax affecting the S corporation like it is a C corporation ignores these other benefits.

The *Gross* case involved the valuation of G&J Bottling (an Ohio based Pepsi Cola bottler), an S corporation that was a highly profitable "cash cow" that distributed nearly all of its earnings to shareholders. Abandoning its long-standing practice and its own internal training manual (which was not official policy), the IRS and its expert argued that tax affecting the S corporation was inappropriate, a stance the IRS has maintained up to the present.

C. The Nature of the Data Used to Develop Capitalization Rates

But someone pays the taxes in the S corporation- the shareholder. Given this, why should the shareholder be treated as if distributions (if they were even paid) received were 100% spendable when in fact the shareholder had to use part of those distributions to pay income tax on the S corporation's earnings? This is where another issue takes center stage- the nature of the publicly traded rate of return data used by business appraisers to develop capitalization rates in valuing the closely held business.

Annual rates of return required by investors to hold shares in privately-held companies are not observable. Therefore, in developing rates of return and capitalization rates used in valuing the closely-held business, business appraisers look to the world of publicly traded companies instead, using published studies such as the annually updated Duff & Phelps *Valuation Handbook, Guide to the Cost of Capital*. This study reports the average annual rate of return (in dividends and capital appreciation) realized by investors in publicly traded stocks from the end of 1963 to the end of the present annual study date.

In addition, the Duff & Phelps study also reports the "equity risk premium," a figure that represents the additional annual rate of return realized by investors (in dividends and capital appreciation in share prices) for holding public company common stocks over and above that of investing in "risk free" U.S. Treasury Bonds. The appropriate equity risk premium from this study data is then selected and employed by the business appraiser in developing a (1) discount rate (or weighted average cost of capital) if the discounted cash flow valuation method is used, or (2) a capitalization rate if the capitalization method (e.g., earnings or net cash flow) is used, to value the privately-held company. For example, the "build-up method" version of the "Capital Asset Pricing Model" (CAPM) is commonly used in developing the capitalization (or "cap") rate used in the capitalization method. The annual rate of return (discount rate) required by an investor for investing in a company's common stock, which is a key part of the capitalization rate, is comprised of the sum of the following components:

- **Risk-free return-** The "risk free" return from a "safe investment" (such as a U.S. Treasury Bond).

- **Equity risk premium-** This represents the additional average, annual return historically realized by the market (in dividends and capital appreciation) for the additional risk risks inherent in investing in publicly traded common stocks over and above that of a risk-free investment. This equity risk premiums comes from data such as *Duff & Phelps*.

- **Company specific risk premium-** This represents the risk premium for any additional risks inherent to the specific company being valued.

From this annual discount rate (which is the annual rate of return associated with risk) is then subtracted the expected long-term, sustainable annual growth rate expected in a company's earnings or net cash flow to arrive at the capitalization rate to be used. In summary, the build-up method can be summarized by the following formula:

	Build-Up Version of the Capital Asset Pricing Model to Reach the Capitalization Rate Used in the Capitalization Method
	Risk-Free Rate
+	Market Equity Risk Premium (this comes from the returns of publicly traded C corporate stocks)
+	Company Specific Risk Premium (if applicable)
=	**Discount Rate (Annual Rate of Return for Risk)**
-	Annual Future Growth Rate in Earnings (or Net Cash Flow if Used)
=	**Capitalization Rate**

The problem, though, is that nearly all publicly traded companies are C corporations. Therefore, the returns realized by investors are (1) after the payment by those C corporations of corporate level taxes, but (2) before the payment by the shareholder of any personal taxes on dividends and capital gains from appreciation of those public company shares.

The IRS successfully argued that when an appraiser uses publicly traded company rates of return to develop the capitalization rate the result is a rate of return that is pre-tax in nature to the shareholder in terms of the returns he or she will receive. Consequently, in the IRS view tax affecting an S corporation's earnings or net cash flow is inappropriate. If the reader thinks the *Gross* case is an outlier, this same position was subsequently upheld in at least six more U.S. Tax Court cases (e.g., *Heck, Adams, Wall, Dallas, Gallagher* and *Giustina*).

D. Was the Tax Court Wrong on Tax Affecting?

The IRS viewed *Gross* and its progeny as an endorsement of the practice of capitalizing pre-tax earnings as exemplified previously in **Table 2**. While this is what the cases actually do, a careful reading of them suggests that Tax Court believed it had no other option based on what it was presented, sowing the seeds of the subsequent new methodologies (an example is shown later) that emerged from the valuation community in response.

The real implication of the cases is that the appraisers simply ***stopped*** at tax affecting. In

Gross, for example, and in the several cases that followed (*Heck, Adams* and *Gallagher*), the appraiser stopped there, that is, reducing the S corporation's earnings as if were a C corporation. Rightly, the Tax Court said that the appraiser in each instance was wrong because he or she did not consider the additional incremental benefits that inured to the S corporation shareholder, (1) due to lower income tax rates and the lack of double taxation on dividends, as well as (2) the lower capital gains tax paid on a future gain from a sale of the shares, the tax savings arising from the increase in the shareholder's basis for any earnings retained by the S corporation and not distributed.

In the latest such case (*Gallagher, T.C. Memo 2011-148*), the Court still denied tax affecting. The *Gallagher* Court stated the following on this issue with regards to tax affecting employed by the taxpayer's appraiser (Mr. May):

> Mr. May failed to explain his reasons for tax affecting PMG's earnings and discount rate and for employing two different tax rates (39 percent and 40 percent) in doing so. Absent an argument for tax affecting PMG's projected earnings and discount rate, we decline to do so. As we stated in *Gross v. Commissioner, T.C. Memo. 1999-254*, ***the principal benefit enjoyed by S corporation shareholders is their reduction in total tax burden, a benefit that should be considered when valuing an S corporation. Mr. May has advanced no such reason for ignoring such a benefit (emphasis added)***, and we will not impose an unjustified fictitious corporate tax burden on PMG's future earnings.

In short, the taxpayer's appraiser in *Gallagher* **stopped with tax affecting**, but did not then take the crucial next step in his analysis of considering the impact of any additional income and capital gains tax benefits that might be present arising from the company's S corporation status. Consequently, it is the failure of valuators to look at the totality of the tax situation of S corporations that is behind the Court's denial of tax affecting. In short, the S corporation issue is not about "tax affecting," but instead about capturing the entirety of the differences of the benefits to the shareholder in a S versus C corporation.

V. THE VALUATION COMMUNITY'S RESPONSE

A. Introduction

After *Gross,* the valuation field was initially in disbelief, disarray and disagreement about how to deal with the valuation of S corporations. The issue subsequently became a major topic in the early 2000s as conference speakers, published articles, and valuation books debated the issue and various quantitative models were proposed to attempt to address the full range of C versus S corporation benefits. Although the initial focus was on estate, gift and other tax-related valuations, it was clear that the exact same logic could apply to valuations for all purposes, including purchase or sale, disputes, and divorces, among others.

There is certainly not unanimity on the issue at present. However, it is this author's opinion that the majority of business appraisers now agree that these C and S corporation valuation differences exist and should be considered, particularly as it relates to the valuation of an individual's shares in a company as opposed to a 100% controlling interest, the latter being less clear for reasons to be discussed. The following sections will discuss one of the more popular of various models developed and used by business appraisers to estimate the adjustment that might be needed to the value when an interest in an S corporation is at issue.

B. The Emergence of Quantitative Models to Estimate C Versus S Differentials

1. Overview

Emerging from the valuation field were various quantitative models attempting to estimate the additional after tax incremental benefits received by the S corporation shareholder so this differential could be incorporated in a valuation. Some were complicated and involved forecasting out the S corporation's earnings and net cash flows (dividend or distribution paying capacity), with the shareholders paying taxes on the earnings and taking into account distributions expected to be received, while also taking into account the future impact of any tax on the gain of the shares upon sale of the Company. Others were more simplistic and static, focusing on the relative differences in the after-tax benefits realized by the shareholder in the S versus C corporation.

For illustrative purposes, this manuscript will focus on a more simplistic model, the *S Corporation Economic Adjustment Model* (or "*SEAM"*) method developed by Dan Van Vleet, among the most commonly seen in our experience. Interestingly, SEAM was used recently by this author and others in a U.S. Tax Court case (*Mary R. Cecil, Donor, William A.V. Cecil, Jr., Fiduciary, Petitioner v. Commissioner of Internal Revenue, Respondent, Docket No. 14640-14)* pending a decision as of this writing, involving shares in The Biltmore Company, the entity which owns and operates the Biltmore Estate and its related resort operations.

George Hawkins of Banister Financial and another firm both valued the shares, being retained by the Cecil family after a challenge was made by the IRS of another firm's appraisal for the original gift tax return. Interestingly, both this author, the other Cecil appraiser, and the outside expert hired by the IRS all used the SEAM method outlined here. While it is unknown if the Tax Court will rule to change precedent, it is nonetheless instructive that all three testifying experts used the SEAM method, and with the Cecil's experts (including this author) having no advance awareness of the methods or contents of the reports or methodologies used by the others.

2. S Corporation Economic Adjustment Model ("SEAM") Example

The SEAM model involves valuing the shares in an S corporation as if it were a C corporation by tax affecting earnings as if it paid C corporation level income taxes. The appraiser then uses information concerning that same company's dividend/distribution payout ratio (dividends as a percentage of pre-tax earnings), the taxes that would be paid on the company's income (at a corporate level as a C corporation and at a personal level as an S corporation), dividends (personally on C corporation dividends) and any capital gains on shares (personally on the increase in value of the shares held in a C corporation versus the S corporation) to calculate the difference in the net after-tax economic benefits realized by the shareholder in the same Company as an S corporation and as a C corporation. This then allows for an appropriate adjustment to be made to the value of the S corporation shares to capture any incremental additional after-tax benefit to the S corporation shareholder that might be present.

If, for example, if the net economic benefit per year to the shareholder in an S corporation were $1,200,000 versus $1,000,000 as a C corporation, the SEAM model would calculate that the shares in the company as an S corporation are worth 20% more than as a C corporation. Therefore, absent other considerations, once the value is determined as if the company were operating like a C corporation based on the capitalization method (that is, reducing the S corporation's earnings by C corporation taxes because the rate of return data is applicable to C corporations), the resulting value is then multiplied by the SEAM adjustment (here hypothetically 1.20 for a 20% greater benefit for the S corporation) to get the resulting value of the interest as it exists as an S corporation.

In the following **Table 3**, a sample adjustment for the additional after-tax benefits of a company an as S corporation is calculated using the SEAM model:

Table 3- Calculation of Net Benefits to S Corp. Shareholder- "SEAM" Method

		C Corp.		S Corp.
Pre-tax Income		$2,000,000		$2,000,000
-Income Taxes (corporate)	36.0%	($719,600)		N/A
Net Income		**$1,280,400**		**$2,000,000**
x Dividend/Distribution Payout %	75.0%	0.75		0.75
Dividend (C) / Distribution (S)		**$960,300**		**$1,500,000**
-Income Taxes (personal)		N/A	45.1%	($902,000)
-Dividend Taxes (personal)	25.5%	($244,877)		N/A
Net After-Tax Distribution Benefit (A)		**$715,424**		**$598,000**
Net Income		$1,280,400		$2,000,000
-Dividend (C) / Distribution (S)		($960,300)		($1,500,000)
Capital Gain, Increase in Retained Earnings		**$320,100**		**$500,000**
-Effect of Increase in Tax Basis of Shares		$0		($500,000)
Taxable Capital Gain		**$320,100**		**$0**
Gross Capital Appreciation, Before Tax		$320,100		$500,000
-Capital Gains Tax Liability on Taxable Gain	25.5%	($81,626)		$0
Net After-Tax Capital Appreciation Benefit (B)		**$238,475**		**$500,000**
Net After-Tax Distribution Benefit (A)		$715,424		$598,000
+Net After-Tax Capital Appreciation Benefit (B)		$238,475		$500,000
Total Net Benefits to Shareholder		**$953,898**		**$1,098,000**
TOTAL BENEFITS, S CORP. VS. CORP.			**15.1%**	

Tax Rates (2017)[1]	Inc. Fed	ACA Tax	Total Fed.	State (NC)	Total Net
Corporate	34.0%	NA	34.0%	3.00%	**36.0%**
Personal (ordinary income)	39.6%	0.0%	39.6%	5.50%	**45.1%**
Personal (dividends)	20.0%	0.0%	20.0%	5.50%	**25.5%**
Personal (capital gains)	20.0%	0.0%	20.0%	5.50%	**25.5%**
Assume Active Involvement in Business For ACA (1 Yes, 2 No):			1		

[1]Total net personal tax rates assume state taxes are not deductible for Federal purposes due to phase-out. C corporation total net tax rates assume state taxes are deductible for Federal purposes. The payout ratio is defined as distributions divided by net income. This illustration assumes the likely buyer is an individual in the 39.6% Federal tax bracket, with a 20% dividend and capital gains rate (before Affordable Care Act surcharge). Because the shareholder is assumed to be actively involved a 3.8% Affordable Care Act surcharge does not apply. If the same analysis were applied assuming the purchaser of shares would be passive, the ACA surcharge would apply and the total benefits of the S corp. would be reduced to **12.9%**.

In the **Table 3** example, the S corporation shareholder is theoretically able to realize total after-tax benefits that are **15.1%** greater than if the same company were instead taxes as a regular C corporation. Therefore, the company would first be valued as if it were a C corporation, with its earnings "tax affected" at C corporation rates. Those earnings would then be capitalized using a capitalization rate that is derived from C corporation rates of return, here as used in the capitalization method. The result is the value of the company's shares as if it were a C corporation. Next, this value is then increased by **15.1%** to take into account the additional net after-tax benefits the shareholder realizes because it is in fact an S corporation rather than a C corporation. All of these methods are applied in **Table 4** using the capitalization method.

Table 4
Valuing the S Corporation With Tax Affecting, But Next Adjusting to Take Into Account Estimated S Corporation Additional Benefits

	C Corp.	S Corp.
Revenues	$10,000,000	$10,000,000
-Expenses	($8,000,000)	($8,000,000)
Pre-Tax Profits	$2,000,000	$2,000,000
C Corporation Tax Rate	*36%*	*36%*
-Corporate Level Income Taxes	($720,000)	($720,000)
Net Income	**$1,280,000**	**$1,280,000**
Divided by Capitalization Rate	20%	20%
Preliminary As if C Corp. Value of Shares	**$6,400,000**	**$6,400,000**
x Adjustment for Additional S Corp. Benefits (15.1%)		**1.151**
As if S Corporation Value of Shares		**$7,366,400**

Many business appraisers now use this type of analysis when valuing shares in an S corporation. It answers the *Gross* and *Gallagher* charges leveled by the Tax Court that the business appraiser, who stops at simply tax affecting the S corporation, does not take into account the full impact of the benefits received by the S corporation shareholder. Consequently, SEAM or similar methods are increasingly in use to value S corporation interests.

3. Impact on S Corporation Value Generally Reduced From the Time of *Gross*

Whether one believes a 15.1% increase in value (in the example) for an S corporation interest is substantial is in the eye of the beholder. However, it is noteworthy that the models, if employed at or closer to the time of *Gross,* would have produced a much larger upward adjustment for the S corporation than at present. Since the time of *Gross* changes in tax rates and laws have narrowed the gap.

VI. STATUS OF THE S CORPORATION ISSUE

A. Introduction

At least on one issue it appears that most (and everyone this author has met, with the exception of IRS valuators) business appraisers disagree with the IRS position and that of *Gross* and its progeny that pre-tax earnings of the S corporation should be capitalized. This grossly (pun intended) overstates the real value of an S corporation. Despite broad acceptance of S corporation adjustment models, there are still objections by some to their use, including:

- The models make simplifying assumptions that do not always equal reality.
- Data from real world studies (discussed later) involving the prices paid in the purchases of companies give conflicting information.
- Data (e.g., from *Duff & Phelps*) involving public company rates of return for C corporations do not address the actual tax rates paid by those companies which may be substantially less than the statutory tax rate.
- Should a differential in value for S corporations also be applied to the findings by other methods such as with the guideline public company method? The previous discussion has focused solely on tax affecting in the income valuation approach.
- It is easy to imagine circumstances where being shares in an S corporation might be less valuable, so facts and circumstances can come into play in a specific matter.

Following sections discuss these and other model and related issues.

B. Alleged Shortcomings of S Corporation Model Assumptions

The SEAM method as previously outlined has certain assumptions that some skeptics maintain negate or limit its usefulness:

- **Distribution payout ratio does not affect value-** The percentage payout of earnings in the form of dividends or distributions does not affect the result of the overall S corporation's relative benefits. This is because to the extent that an S corporation pays out less in distributions it leads to an increase in the shareholder's cost basis in the stock, lessening future capital gains taxes that would be due personally from the sale of the shares. However, this raises the issue below.
- **Are capital gains tax savings in the future worth the same as having more distributions today?-** The SEAM model assumes that the shareholder is ambivalent about receiving distributions presently versus having a build-up in basis (if earnings are instead retained) that will save capital taxes in the future when the shares are sold. One argument is that this saving of the payment of taxes in the future is worth less in present

value terms today to the shareholder than from receiving greater distributions today. However, it is noted that simply because a company does not pay out all of its earnings in the form of distributions is not necessarily bad as it could be retaining the earnings to support additional growth opportunities with the potential for growth in share value. There are countless examples of many highly valuable public companies that have never paid dividends, with a management focus of growing share value through growth opportunities. However, there is one S corporation situation where the payment of no distributions can be a major problem, as discussed later.

Other models have focused on forecasting in future years the earnings, net cash flow and dividend/distribution paying capacity for the company at issue, as well as the anticipated holding period until sale. Besides the fair market value issue above, those models involve making many more assumptions, not the least of which is the holding period until a sale.

C. Prices Paid in the Actual Sale of S Versus C Corporations

1. Introduction

While reacting to *Gross*, the valuation field also attempted to find market evidence that would "prove" or "disprove" the notion that buyers in the real world paid a higher price (a premium) for S corporations versus C corporations.

2. Studies by Wang and Erickson and by Mattson, Shannon and Upton

One of the first studies of the issue was made by Wang and Erickson who reached the conclusion that S corporations sell for 12% to 17% higher than similar C corporations in "taxable" transactions.[2] This led to much debate in the valuation community about the validity of the assumptions Wang and Erickson used, along with countercharges by Wang and Erickson that the criticisms of their study were unfair.[3] Wang and Erickson's findings were contradicted by a study by Mattson, Shannon and Upton which involved a review of 2,487 transactions of S corporations (1,285) and C corporations (1,202) in the *Pratt's Stats* database of merged and acquired companies. This study concluded that there was no evidence of any premium paid for S corporations.[4]

3. DiGabriele Peer Reviewed Study, 2008 (2000 to 2006 Data)

In a May 2007 per reviewed study, James A. DiGabriele, a professor in the Department of Accounting, Law, and Taxation at Montclair State University and a business valuation

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[2]Merle Erickson and Shiing-wu Wang, "The Effect of Organizational Form on Acquisition Price," September 12, 2003.

[3]R. James Aldering, Yassir Karim and Travis Chamberlain, "S Corporation Premiums Revisited: The Erickson-Wang Myth," *Shannon Pratt's Business Valuation Update* (January 2003). Merle Erickson and Shiing-wu Wang, "Response to the Erickson-Wang Myth," *Shannon Pratt's Business Valuation Update* (February 2003).

[4]Michael J. Mattson, Donald S. Shannon and David E. Upton, "Empirical Research Concludes S Corporation Values Same as C Corporations," *Shannon Pratt's Business Valuation Update* (November 2002 and December 2002).

professional, added to this body of knowledge.[5] His research presented a predictive model for determining the premium paid in S corporation acquisitions. His research examined market data involving the prices paid in the purchases of companies from January 2000 through November 2006 to determine the existence and sources of a potential S corporation premium relative to C corporations. DiGabriele's study was based on 4,239 actual private company acquisition transactions as reported in *Pratt's Stats,* a business transaction database.

The study findings were statistically significant and resulted in a predictive model that can be used to estimate the S corporation premium. DiGabriele maintains that his study "confirms the existence of a premium in the valuation of S corporations over C corporations." Furthermore, he found that the "magnitude of this premium is moderated by the levels of the other independent variables that were included in the model." The other included variables were buyer type (private or public), size of the acquired company's annual net sales, and transaction type (stock versus asset purchase). Although earlier studies attempted to address the issue of an S corporation premium, they did not go into the detail used by DiGabriele as to the impact of specific factors and were also not peer reviewed.

DiGabriele found that the magnitude of the S corporation premium relates to the following factors:

- Acquired companies with higher net sales tend to have a higher premium for being an S corporation and vice versa.
- Lower S corporation premiums are associated with public company buyers than with private buyers.
- The S corporation premium paid is lower when the transaction is of a purchase of stock than when it is an asset sale.

An obvious question is whether or not DiGabriele's findings, which spanned the 2000 to 2006 time frame, might be distorted by the effects of the change in taxation that occurred as a result of the Tax Reform Act of 2003, which changed the taxation of dividends and capital gains, among other items, resulting in relative changes between S and C corporations over the time of his study. DiGabriele indicates that this issue was raised in the peer review process and he responded by analyzing the results using data separately from before and after the Tax Reform Act and found no statistically significant difference in his findings or his model's prediction of the actual degree of S corporation premiums observed in real world transactions.

Unlike the theoretical models discussed earlier, DiGabriele's S Corporation Premium Model ("SCoP") is a mathematical model that is descriptive of actual empirical data. As such, it warrants attention. Interestingly, SCoP can produce findings similar to those of the SEAM

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[5] James A. DiGabriele, "The Moderating Effects of Acquisition Premiums in Private Corporations: An Empirical Investigation of the Relative S Corporation and C Corporation Valuations," *Accounting Horizons* (Vol. 22., No. 4, 2008), pp. 415-424. *Accounting Horizons* is a journal of the American Accounting Association.

method, using tax rates in SEAM that were in effect at the same time as his study data and when companies fall into certain annual revenue size ranges.

A potential problem with the application of DiGabriele's study to the present is that it employed data from the 2000 to 2006 time frame. There have subsequently been changes in tax rates and other factors at play that might alter the dynamics were a more recent study undertaken.

Furthermore, it is important to note that the DiGabriele study dealt with prices paid in the purchase of 100% controlling interests in S corporations, i.e., the enterprise. It does not deal with whether or not an adjustment for S corporation benefits is appropriate or can be found involving the purchase and sale of non-controlling shares. If the most likely purchaser of such an interest is likely to be an individual then it may be entirely reasonable to assume that this individual looks at the situation from the viewpoint of the benefits he or she receives as an S corporation shareholder. Also, from a family law standpoint, if the marriage is ending but the spouse holding shares in the S corporation is expected to continue to do so going forward, an argument might be made that he or she will not be selling the company, but will continue to realize its benefits going forward as if a S corporation. This is obviously a legal issue.

D. Publicly Traded C Corporations Payment of Much Lower Tax Rates

The example in **Table 3** estimated that the additional after tax benefits of the S corporation increased its value by 15.1%, based on the assumption that the C corporation paid the full effective Federal corporate tax rate of 34% (or 35% at certain income levels). However, research by the federal General Accounting Office ("GAO"), with assistance from the IRS, states that this is not actually the case.[6] The GAO report, which only examined the year 2010, found that C corporations paid an average actual effective federal tax rate of **only 20.7%**. The GAO report was requested by the U.S. Senate in response to congressional concerns over loopholes and tax avoidance measures available to large corporations, measures sometimes not available to smaller private companies, enabling large C corporations to pay an unfairly low share of their tax burden.

Consider what happens if this reality of what publicly traded C corporations actually pay is taken into account. **Table 5** is the exact same model used previously in **Table 3** to reach a 15.1% upward adjustment as tax affecting to arrive at the S corporation value. It was based on the C corporations paying a full 34% rate. The only change in **Table 5** is assuming the that those C corporations actually pay a much lower **20.7%** rate by using avoidance measures often not available to smaller companies.

6*Corporate Income Tax. Effective Tax Rates Can Differ Significantly from the Statutory Rate, May 2013, United States Government Accountability Office Report to Congressional Requestors.*

Table 5- Calculation of Net Benefits to S Corp. Shareholder- "SEAM" Method

		C Corp.		S Corp.
Pre-tax Income		$2,000,000		$2,000,000
-Income Taxes (corporate)	23.1%	($461,580)		N/A
Net Income		**$1,538,420**		**$2,000,000**
x Dividend/Distribution Payout %	75.0%	0.75		0.75
Dividend (C) / Distribution (S)		**$1,153,815**		**$1,500,000**
-Income Taxes (personal)		N/A	45.1%	($902,000)
-Dividend Taxes (personal)	25.5%	($294,223)		N/A
Net After-Tax Distribution Benefit (A)		**$859,592**		**$598,000**
Net Income		$1,538,420		$2,000,000
-Dividend (C) / Distribution (S)		($1,153,815)		($1,500,000)
Capital Gain, Increase in Retained Earnings		**$384,605**		**$500,000**
-Effect of Increase in Tax Basis of Shares		$0		($500,000)
Taxable Capital Gain		**$384,605**		**$0**
Gross Capital Appreciation, Before Tax		$384,605		$500,000
-Capital Gains Tax Liability on Taxable Gain	25.5%	($98,074)		$0
Net After-Tax Capital Appreciation Benefit (B)		**$286,531**		**$500,000**
Net After-Tax Distribution Benefit (A)		$859,592		$598,000
+Net After-Tax Capital Appreciation Benefit (B)		$286,531		$500,000
Total Net Benefits to Shareholder		**$1,146,123**		**$1,098,000**
TOTAL BENEFITS, S CORP. VS. CORP.			**(4.2%)**	

Tax Rates (2017)	**Inc. Fed**	**ACA Tax**	**Total Fed.**	**State (NC)**	**Total Net**
Corporate	20.7%	NA	20.7%	3.00%	**23.1%**
Personal (ordinary income)	39.6%	0.0%	39.6%	5.50%	**45.1%**
Personal (dividends)	20.0%	0.0%	20.0%	5.50%	**25.5%**
Personal (capital gains)	20.0%	0.0%	20.0%	5.50%	**25.5%**
Assume Active Involvement in Business For ACA (1 Yes, 2 No):			1		

As is evident in **Table 5,** adjusting C corporation rates to the actual effective rate found for 2010 in the GAO study the S corporation's benefits effectively disappear, with the S corporation worth **4.2% *less*** than the C corporation.

The problem with using the foregoing example assumptions in a valuation are simple. It only represents one year (2010) from a GAO study and does not show represent long-term averages over time. In order for business appraisers to take actual C corporation rates over time into account more information is needed. For example, the earlier noted Duff & Phelps study on public company rates of return would need to publish the average corporation tax rates over time from the actual public company sample used for each of its equity risk premium tables to be used in developing the capitalization rate. At present this data is not available and it is not known if this trend would be found to be the case in all years. Although this author has raised this issue with the author of the *Duff & Phelps* study, it is not yet known if this can or will be incorporated in future editions.

E. S Corporation Adjustment in the Use of Other Valuation Methodologies

In the guideline public company method (a market approach), the valuator derives a multiple (e.g., price to earnings, price to cash flow, and various EBITDA and other measures) that reflects what it is paid for shares of a reasonably similar public company and then applies this multiple to the private company being valued.

Some practitioners argue that the S corporation adjustment illustrated previously in the use of the income approach may also be applicable in the guideline public company method, due to the fact that the guideline public company approach is also based on multiples or rates of return for publicly-traded C corporations. Remember from earlier that the data used in developing a capitalization rate employed in the income approach is based in part on the appraiser using study data based on annual rates of return realized by investors (in the form of dividends and capital gains) for investing in public company common stocks.

Another method within the market approach is the guideline transaction method. This method involves examining the prices and multiples paid for the purchase of reasonably similar companies and then applies those multiples to the private company being valued. While sales of reasonably similar companies might include the transactions of public and private companies, in many (and perhaps most) instances the transactions will be of the purchase and sale of private companies. For example, the business appraiser might use databases of transactions such as *Pratt's Stats*. This database generally lists the type of entity sold and tax status of the entity sold. In this author's experience, in industries where a large number of transactions are listed a majority are of either S corporations, LLCs or sole proprietorships, with C corporations a diminishing number. Observationally, this author has not seen material evidence that the valuation community has adopted the application of adjustment for the S corporation issue to the resulting findings from valuations employing the guideline transaction method.

F. Other Approaches to the S Corporation Models May Emerge

Fannon and Sellers have authored a book on the S corporation issue, including data on the effect of taxes on value, along with a summary of academic research on the subject.[7] However, they warn that research on the subject is ongoing and more research needs to be done.

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[7]Nancy J. Fannon and Keith F. Sellers, "Taxes and Value: The Ongoing Research and Analysis Relating to the S Corporation Valuation Puzzle," published by Business Valuation Resources, LLC.

G. An S Corporation Might Be Worth Less

Ownership of shares in an S corporation is not always a rosy scenario. Suppose an outside minority shareholder has shares in a profitable S corporation that pays limited distributions that are in amounts insufficient to enable the shareholder to pay his or her personal tax liability on the company's earnings. In the worst case the shareholder receives no distributions. Furthermore, suppose that there is no plan to change the payout for the foreseeable future and the minority shareholder cannot change this situation. In this instance, the shareholder might have a difficult time finding a purchaser for the shares who is willing to be stuck paying a tax liability, but with no distributions received from the company, a circumstance that would not be present in a C corporation.

Consequently, in valuing the S corporation (particularly the shares of a non-controlling interest) the valuator needs to consider the history of and expectation of future distributions, and any bylaws, minutes and/or shareholder agreements that deal with distributions, such as requiring distributions at a level sufficient to enable the shareholder to pay his or her estimated taxes on company earnings.

H. An S Corporation/LLC Might Have a C Corporation Corporation Value

Fair market value considers all relevant facts. Consider a valuation matter concerning a highly profitable LLC which is owned 50% by a public company C corp. and 50% by Joe Doaks who is getting divorced. The operating agreement gives the public company a right of first refusal in the event Joe wants to sell his interest. There are contractual and other strategic business reasons why the public company would not let a third party buy Joe's 50%. Finally, a put and call provision makes it highly probable that the public company is the only prospective buyer of Joe's interest.

In this specific instance, the most likely buyer is the C corporation who must pay C corporation rates. Therefore, the 50% interest might be valued using tax affecting at C corporation rates with no further S corp/LLC adjustment. It is true that the hypothetical willing buyer and seller portion of the fair market value definition does not contemplate a specific buyer. However, that same standard also requires the consideration of "all relevant facts." The relevant facts here include the factors noted.

The point of the foregoing example is that specific facts and circumstances do matter and that the attorney and valuator must be attuned to them in determining an appropriate course of valuation action.

I. The S Corporation Issue Has Transcended the Tax Realm

The issue of whether or not to tax-affect an S corporation's (or LLC's) earnings or cash flow and to then make additional appropriate adjustments for any S corporation benefits was originally confined to the tax and estate planning arena. However, as debate on the issue spread, family and business law attorneys in many states began to take note. Today, business appraisers in litigated valuation matters find themselves being grilled in depositions about the appropriateness of their decisions on whether or not to tax affect (and how) and how (or if) to adjust for incremental S corporation/LLC benefits. However, there is still incomplete awareness among family and business law attorneys of the issue and its implications to client with interests in closely-held companies.

Amazingly, there are still business appraisers who remain completely oblivious to the issue, calling into serious doubt their competence. This not to be confused with or to cast dispersion on others in the valuation field who either (1) still believe, for what they consider to be valid reasons, that simply tax affecting alone remains reasonable, or (2) who disagree with the various models or fail to find them sufficient to use.

Cases about the difference in C and S corporation values have moved beyond the Tax Court realm and into corporate and family law cases. Examples include the following:

- **Corporate cases**
    - *Delaware Open MRI Radiology Assocs. v. Kessler, 898 A.2d 290, 327 (Del. Ct. Ch. 2006).*
    - *Nathan Owen v. Lynn Cannon, Bryn Owen, Energy Services Group, Inc., and ESG Acquisition Corp., C.A. No. 8860 CB (Del. Ct. Ch. 2015)*
- **Family law**
    - *Judith E. Bernier v. Stephen A. Bernier, 873 N.E.2d 216 (Sept. 14, 2007, Massachusetts Supreme Court).*

The *Bernier* Court provides a clear discussion of the issue and its relevance in family law valuations of S corporations. Shown below is an excerpt from the Massachusetts Supreme Court opinion:

> On the issue of tax affecting, we conclude that the judge erred in adopting the valuation of the husband's expert witness that tax affected the fair market value of the parties' S corporations at the "average corporate rate," in the words of the husband's expert, of a C corporation. As a preliminary matter, where valuation of assets occurs in the context of divorce, and where one of the parties will maintain, and the other be entirely divested of, ownership of a marital asset after divorce, 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 of their marital assets.

The Court's opinion continues:

> Further, careful 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 by ignoring the tax benefits of the S corporation structure and failing to compensate the seller for the loss of those benefits. On the other hand, in the circumstances of this

> divorce action, we agree with a recent decision of the Delaware Court of Chancery that failure to tax affect an S corporation entirely artificially will inflate the value of the S corporation by overstating the rate of return that the retaining shareholder could hope to achieve. See *Delaware Open MRI Radiology Assocs. v. Kessler*, 898 A.2d 290, 327 (Del. Ct. Ch. 2006) (Kessler).

Interestingly, in *Bernier* the Massachusetts Supreme Court disagreed with the approach of the Tax Court in *Gross*, suggesting that by allowing for the valuation of pre-tax income the *Gross* court had failed to complete its task, leading to an overvaluation of the S corporation. The Massachusetts Supreme Court remanded the case with instructions that the trial court should follow the valuation approach used in *Delaware Open MRI Radiology Assocs. v. Kessler,* which involved tax affecting, but at different rates for the S corporation, taking into account its incremental benefits. The result of the remand, too, were appealed, with arguments over the appropriate tax rates to be employed.

While the approach taken in Delaware is to use different tax rates for tax affecting the S corporation, Dan Van Vleet, the creator of the SEAM method, has authored an interesting criticism of this approach and its failure to fully and accurately value the S corporation.[8]

J. IRS Position Remain Unclear

Publicly, it appears that the IRS has no official position on how it deals with S corporation valuations for gifts, estates and other matters. Within the valuation profession, it appears that many appraisers are using various S corporation adjustment models (most of which also involve tax affecting) to quantify if and/or when adjustment to the S corporation value is needed. It is not known if these adjustments are encountering widespread IRS examiner resistance. However, it is frequently heard that the IRS is still arguing against tax affecting. Nonetheless, in some cases this author has actually seen IRS examiners use the SEAM technique in reviewing valuations.

The reality is that anecdote is not necessarily an accurate picture of what is really happening across the entire universe of IRS valuation reviews. To make things even more unclear and scary for the business appraiser about what to do with respect to tax-related valuations, enter the IRS's internal job aid on the subject. On October 29, 2014, the IRS published "Valuation of Non-Controlling Interests in Business Entities Electing to Be Treated as S Corporations for Federal Tax Purposes, a Job Aid for IRS Valuation Analysts."

The *Job Aid* sets forth much of the history and case law on the tax affecting subject and presents a number of arguments as to why the *Job Aid* maintains that tax affecting is inappropriate. For example, the *Job Aid* argues that an appraiser cannot know at what tax rates to affect since every company and shareholder is different. The *Job Aid* also states that tax affecting requires identifying a specific buyer's tax rate which the *Job Aid* says violates the "hypothetical willing buyer" part of the fair market value standard, etc. After its public availability, various professionals within the valuation community assailed various arguments set

[8] "Delaware Open MRI and the Van Vleet Model," Daniel R. Van Vleet, ASA, *Business Valuation Review* (Vol. 34, No. 2, Summer 2015), pp. 74-81.

forth in the *Job Aid* as being faulty, logically flawed, and misleading.[9] It is also noted that the IRS states that its Job Aid is non-authoritative.

VII. FACTORS TO CONSIDER WHEN FACING THE ISSUE

A. Introduction

Every situation is unique and there are a number of factors that need to be considered when dealing with whether or not adjustment for a S corporation or LLC benefit is appropriate. The most prominent of these are discussed below.

B. Most Likely Buyer

An issue to consider is the interest being valued and who the most likely purchaser of that interest would be. The *Gross* case dealt with very small (less than 1%) minority interests. In most circumstances, the most likely buyer of a small minority interest may be an individual, and not a corporate, buyer. This fact may argue more towards the SEAM type of approach earlier as the individual buyer of the small minority interest may enjoy the same tax-advantaged situation enjoyed by the other shareholders.

In contrast, if the interest at issue is a 100% controlling interest in the company, the most likely buyer may be another corporation. In this case, tax-affecting, but without further adjustment for S corporation benefit may be the logical assumption to make as a corporate buyer would likely be paying corporate-level taxes and would certainly consider the impact of those taxes on the expected return of the acquired company. However, it is important to know all of the facts in this type of matter in reaching an appropriate decision. For example, many privately-held companies and now acquired and held in portfolio by private equity companies which are typically structured as LLCs or partnerships and continue to receive its pass-through benefits. Also, since pass-through beneficial acquirors also often compete with public C corporation buyers for the purchase of privately-held companies, some, such as Van Fleet (the creator of SEAM) believe that this forces C corporation buyers to pay more to compete with private buyers who receive these benefits.

Conversely, just because a 100% controlling interest in a company is being valued does not mean that the most likely buyer is a C corporation. Consider the vast majority of small service companies and professional practices in the United States. Companies such as architect firms, smaller accounting firms, and other professional practices are typically owned by one or several individuals and typically (though not always) have elected S corporation status. If a 100% controlling interest in one of these entities is at issue, the most likely buyer of such an interest may well be another individual or group of individuals who would logically desire to keep the S election intact. In such a case, incorporating the totality of S corporation benefits may be appropriate due to the fact that the most likely willing buyer has

[9] For example, see the letter to the editor by Nancy J. Fannon in the June 2015 edition (Vol. 21, No. 6) of *Business Valuation Update, "*IRS S Corporation Job Aid Makes Assumptions Not Backed Up by Academic Research."

the same S corporation perspective as the current owner of the business. As always, however, the facts and circumstances in total will drive the decision on tax-affecting.

In its recent job aid on the S corporation issue, which is not official IRS policy, the Service maintains that assuming the “most likely buyer” violates the fair market value standard for tax purposes. The standard assumes a hypothetical willing buyer and seller, not a specific buyer or seller. However, the Service’s position ignores that the standard assumes the buyer and seller “have all knowledge of the relevant facts.” Relevant facts can and do impact the purchase and value of an interest, something the prospective purchaser, whoever they may be, might be unable to change.

C. Breaking the S Election

This is another subjective issue to deal with as it involves “crystal ball” assumptions. It seems logical to assume that shareholders elect S corporation status for their company for a reason and that, once elected, these shareholders would not want to break the S election. Fact patterns such as in *Gross,* where shareholders have taken prophylactic steps such as a restrictive shareholder agreement, may further strengthen the case that the S election will probably not be broken and that incorporating the full effects of the S corporation’s incremental benefits, if any, may be appropriate. However, the fact that existing shareholders want to preserve the S election does not guarantee either that the S election will be preserved or that the shareholder composition will not change to include shareholders that do not want the S election or are ineligible to be an S corporation shareholder.

D. Distribution Payout Ratio

The *Gross* case involved a company that paid out nearly 100% of its net income to its shareholders each year in the form of distributions. This was a favorable fact pattern for the IRS’s position for no tax-affecting as a high payout ratio ensures that the S corporation shareholders will have enough cash with which to pay their pro-rata income tax liability that is “passed-through” the S corporation to be paid individually by each shareholder.

A less favorable fact pattern for incorporating the totality of S corporation benefits would be a situation where an S corporation generated a positive net income but did not distribute any of this income to its shareholders. Under this scenario, each shareholder would be forced to find alternative sources of funds to satisfy his or her pro-rata share of the income tax liability. In effect, an S corporation shareholder in this position could experience a “negative return” on his investment each year as the shareholder was forced to exhaust personal funds to satisfy his pro-rata income tax liability while receiving no current return from the S corporation.

Also, if the interest being valued is non-controlling in nature, is contractual, historical evidence of, or stated plans going forward with respect to the level of distributions to be paid out of Company earnings? Examples of contractual obligations to pay out distributions might be found in the articles, board minutes, or in a shareholder agreement. In S corporations and LLCs, it is not unusual to find provisions requiring distributions at least sufficient to pay estimated shareholder/member personal taxes on entity earnings. Even if there is no contractual requirement to do so, a historical fact pattern of consistently doing so may serve to lessen a prospective purchaser's concerns about this issue.

E. Plans to Change Corporate Tax Status

Is there a plan in place to convert from S corporation to C corporation tax status? If so, it may be that no adjustment for S corporation tax status is warranted. While it is relatively rare to convert back to C corporation status, it does happen. Also, inquiries should be made as to whether or not a C corporation is planning to convert to S corporation status. While there is presently a five year transition period in such a conversion for "built-in gains" should the assets that existed at conversion be sold, this might not negate consideration of the S corporation adjustment issue.

F. Entity Value Versus Value to a Shareholder

Some practitioners focus on the issue that, at the entity level, the value of an otherwise identical S corporation and C corporation have to be equal. These practitioners correctly note that the S election is a shareholder benefit and not a corporate benefit. This is undoubtedly true; however, business valuation is performed from the perspective of the shareholder and not from the perspective of the corporation. For example, the standard of fair market value contemplates the hypothetical willing buyer and hypothetical willing seller. Or, said another way, the standard of fair market value is concerned with the hypothetical potential shareholder and the hypothetical existing shareholder. Both the potential shareholder and existing shareholder should and will analyze the company from his or its particular perspective, i.e., as either an S corporation-eligible shareholder or a C corporation shareholder.

G. Appropriate Tax Rates

In calculating the SEAM adjustment (or by another similar model) the valuator will need to select the appropriate state and federal tax rates relevant to the valuation and valuation date. This obviously presents the problem of what (or whose) tax rates and whether or not this violates the "hypothetical will buyer, will seller" standard of fair market value if the focus is on a specific type of buyer (individual, etc.). Also, every specific buyer and seller may have a completely different tax position. For example, in a family law matter, the divorcing party may have other losses which offset all or part of the taxable income from the S corporation. It may be that case law and other facts enter into into the tax rate decision.

In general, valuations for most purposes and instances would typically consider the rates appropriate to the asset's income at issue. Dealing with appropriate tax rates to use for valuation purpose is nothing new for the business appraiser, whether it is a C or S corporation, an LLC, and for any type of valuation purpose (litigation, estate, purchase or sale, etc.). This is a bridge the valuator must always cross and facts and circumstances can and do complicate the appropriate decision.

VIII. SUMMARY AND IMPLICATIONS FOR ATTORNEYS

The author believes that most of the valuation field has coalesced around the view that the valuator must consider the applicability of an appropriate adjustment to value when valuing shares in an S corporation or a member interest in an LLC. There are various models now available to assist in quantifying the impact and more research and models may continue to emerge. However, the valuator must still give due consideration to case-by-case issues unique to a given company that may impact the methods and conclusions used. The valuator must place himself or herself in the mindset of a prospective buyer of the interest. How will these and other items affect a buyer at the shareholder/member level?

Most business valuators are well aware of the S corporation issue, although some still fail to deal with it in valuation reports or do so incorrectly. Meanwhile, some family law, litigation and tax and estate planning attorneys have yet to become aware or grasp the significance of this issue, placing their clients and the result values at peril if they are unprepared. While the present magnitude of appropriate adjustments is not as potentially large as it was at the time of the *Gross* decision, material dollars still hang on this issue. The bottom line for attorneys who must deal with valuation issues is as follows:

- The issue cannot be avoided. While the impacts are smaller than at the time of *Gross*, they are still material.
- Become familiar with the subject.
- Hire valuation experts that know how to address the issue.
- In reviewing the valuations of valuation experts make sure this issue is dealt with correctly.
- Do not be caught off guard on an issue that has a potentially material impact on value.
- Know all the facts in the matter at hand that might impact the valuation treatment of the issue.
- Further research, case law, new models, and tax reform may change or eliminate the topic entirely.

IX. RESOURCES ON S CORPORATION, OTHER VALUATION ISSUES

Banister's website at **businessvalue.com** contains extensive business valuation resources as follows:

- **Business Valuation Cases:** Under the Resources>**Business Valuation Cases** tab.

- **Business Valuation Articles:** Under the Resources>**Business Valuation Articles** tab. This includes over a hundred detailed articles on a wide variety of business valuation issues, explanations of methods, published by Banister Financial professionals.

- **Business Valuation Tools-** Under the **Resources>Business Valuation Tools** tab. Provides:

    - Information needs lists for different types of businesses and professional practices helpful in preparing for discovery needs.

    - checklists.

    - company interview and deposition questions.

    - seminars.

Banister's Valuation Business Card USB Key (handed out at this conference) has hundreds of valuation items, including all of the above and many more resources, all of which will be helpful in any valuation matter or case.

X. FOLLOW-UP QUESTIONS

For follow-up questions, please contact:

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