Business Valuation Review

A Gross Result in the *Gross* Case: All Your Prior S Corporation Valuations Are Invalid

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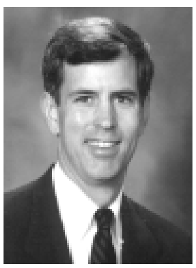
Introduction. Ponder how many S corporation valuations you have prepared for gift and estate tax purposes in recent years where you tax affected a company's earnings for use in the income valuation approach. While there has been a small but growing minority that says tax affecting is improper, you've carefully followed the majority, believing you and your clients were in the clear- and besides, two IRS training manuals say to tax affect. Guess again, because you may soon have to defend your tax affecting in those prior S corporation valuations as a result of the *Gross* case (2001 FED App. 0405P, 6th Cir.) which was decided and filed on November 19, 2001. The case's impact extends into every area of business valuation and is without a doubt the most significant business valuation case in the last 20 years. Read on and see what the Tax Court and Court of Appeals have done and how this landmark ruling may dramatically impact the valuation of S corporations.



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Facts of the case. The company at issue in *Gross*, G&J Bottling, was a large independent Pepsi bottler in the United States. From 1988 to 1992, the company enjoyed increasing profits and shareholder distributions which were almost 100% of net income. Two separate families, directly and through voting trusts, each owned 50% of the company. The company elected S corporation status on November 1, 1982. A 1982 restrictive stock agreement permitted inter-family transfers but prohibited transfers outside the family. The agreement also restricted any transfers that would jeopardize the company's S status. On July 31, 1992, five separate gifts of less than 1% interests were made. The taxpayer estimated a value of $5,680 per share. The IRS estimated a value of $10,910 per share.

The Dispute. There were two main disagreements at the Tax Court level. The first disagreement involved the tax-affecting of the discounted cash flows of the company used to estimate value by the income valuation approach. The taxpayer's expert tax-affected (i.e., reduced) the company's earnings by an assumed 40% corporate rate, as if the Company were a C corporation. That is, in the discounted cash flow model, the taxpayer's expert assumed a hypothetical 40% tax rate on the company's earnings. This was done even though the company, as an S corporation, did not pay any corporate-level taxes. The IRS' expert did not tax-affect the earnings of the S corporation. The second disagreement in *Gross* involved the size of the marketability discount taken, a less important issue that is not discussed in this article.

Tax-Affecting. The significant impact on a company's value by tax-affecting is easily illustrated with the following hypothetical example. Suppose you have two identical companies in the same business with identical revenues and expenses. The only difference between the companies is that one is a C corporation and one is an S corporation. The C corporation must pay taxes on its corporate-level income while the S corporation does not pay any such taxes. Both shareholders must pay personal level taxes on their dividends and distributions. C corporation shareholders must pay personal-level income taxes on the dividends they receive from the C corporation. Like-

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wise, shareholders in the S corporation must also pay personal-level income taxes on their pro rata share of the S corporation's earnings. Assuming a 20% capitalization rate (for illustrative purposes only), the valuation impact of the C corporation's "double taxation" status is as shown in **Table 1**.

As seen in **Table 1**, the value of the S corporation is $10,000,000 while the value of the C corporation is $6,000,000. Both companies are identical save for their tax situation, yet the S corporation is worth 66.7% more than C corporation merely due to its more favored tax status. The long-accepted practice in business valuation when valuing the S corporation has been to tax-affect the S corporation's pre-tax profits by applying the 40% C corporation tax rate to those pre-tax profits. In the illustration above, this would result in a *Net Income* figure of $1.2 million and a *Business Value* of $6 million for the S corporation, both identical to the C corporation.

Table 1
Impact of Tax-Affecting on a Company's Value

	C Corp.	**S Corp.**
Revenues	$10,000,000	$10,000,000
Less: Expenses	($8,000,000)	($8,000,000)
Equals: Pre-Tax Profits	$2,000,000	$2,000,000
Corporation Tax Rate	*40%*	*0%*
Less: Corporate Level Income Taxes	($800,000)	$0
Equals: Net Income	$1,200,000	$2,000,000
Divided by: Capitalization Rate	*20%*	*20%*
Equals: Business Value	**$6,000,000**	**$10,000,000**

Arguments for Tax-Affecting. The taxpayer's business valuation expert in *Gross* (Mr. McCoy) argued that a willing buyer in 1992 would have tax-affected the earnings of the S corporation for the following reasons (among others):

1. Tax-affecting was the generally accepted practice of the business appraisal community in valuing a minority interest in S corporations.

2. S corporations sacrifice growth opportunities and capital appreciation in exchange for current income. Tax-affecting is an appropriate adjustment to capture this trade-off.

3. S corporation shareholders are at risk that the corporation might not distribute enough income to cover its shareholder liabilities.

4. The S corporation might lose its "S" status. Tax-affecting compensates the investor for this risk.

5. Tax-affecting has been specifically approved by the Tax Court in *Maris* (1980) and *Hall* (1975).

6. The IRS itself has implicitly endorsed the policy of tax-affecting in valuing stock of S corporations, particularly in two internal IRS documents. The *IRS Valuation Guide for Income, Estate and Gift Taxes: Valuation Training for Appeals Officers* states: "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 *IRS Examination Technique 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."

7. The IRS should not have discretion to treat taxpayers in a manifestly unfair and inequitable manner, especially given the fact that the IRS has not adopted uniform rules or regulations banning tax-affecting S corporations. The IRS had previously allowed tax-affecting of S corporations, including a prior gift tax return of this very taxpayer, filed and accepted four years earlier.

Arguments Against Tax-Affecting. The business valuation expert for the IRS (Dr. Bajaj) made the following arguments (among others) as to why the

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company's earnings should not be tax-affected:

1. The company does not currently pay corporate taxes.
2. There is no indication that the company would not continue as an S corporation.
3. The company historically had distributed almost 100% of its net income to shareholders.
4. Because the company receives a benefit (no corporate taxes), this should not be ignored in valuing its stock.
5. The data used by appraisers to develop the discount rate (rate of return) for discounting cash flows to present value is based on public company returns that are after corporate income taxes, but before personal taxes. Since no corporate income taxes are paid in an S corporation, it is improper to apply this return to an S corporation's earnings that are tax-affected as so such corporate income taxes will actually be paid.

The Court of Appeals' Decision. The three-judge panel at the Court of Appeals decided that tax-affecting was not appropriate in this instance by a slim two to one vote. A summary of the key issues as discussed by the majority and minority opinions of the Appellate Court is as follows.

Was Tax Affecting the Accepted Method in 1992? IRS expert Dr. Bajaj stated that he did not know what the accepted practice on tax-affecting was in 1992. Taxpayer expert Mr. McCoy stated that tax-affecting was the generally accepted practice in 1992. On cross-examination, Mr. McCoy admitted that there was a growing controversy in 1992 as to the propriety of the tax-affecting, the matter was still being debated as of the time of trial and that if he had to value stock of the G&J corporation as of that time, he would give further consideration as whether he would use the tax-affecting method.

The majority believes there is no compelling evidence as to what the practice was in 1992. The majority notes the growing dispute as to the validity of tax-affecting as of 1992 as well as Mr. McCoy's statement that he would give consideration to tax-affecting were he valuing the stock today. The minority opinion disagrees, noting that although there may have been a growing controversy on tax-affecting, this does not mean that tax-affecting was not the accepted practice in 1992. In fact, Mr. McCoy stated in his testimony that tax-affecting was the accepted practice in 1992 and all the S corporation appraisals he had seen were tax-affected. Dr. Bajaj did not contradict Mr. McCoy's testimony on this point as Dr. Bajaj testified that he did not know what the accepted practice was in 1992.

Comment: We believe the minority has the better argument on this issue. The majority opinion seems to place great weight on the fact that Mr. McCoy might consider tax-affecting now, however, the majority gives no weight to Mr. McCoy's statement that tax-affecting was the generally accepted practice in 1992. Furthermore, the IRS expert stated that he has no idea what the generally accepted practice was in 1992. How can an "expert" testify on an issue and not know what the generally accepted practice in the industry is? Whether that "expert" agrees with the accepted practice in the industry or not is unimportant – he at least should know what the accepted practice is.

Tax-Affecting Suggested in IRS Training Manuals. The majority held that the fact that the IRS manuals recommend tax-affecting is irrelevant. The majority notes that each IRS manual has the following disclaimer: "This material was designed specifically by the IRS for training purposes only. Under no circumstances should the contents be used or cited as authority for setting or sustaining a technical position." The majority further stated that "not only do the statements in the IRS manuals fail to affirmatively advocate tax-affecting for all S Corporation valuation, both the guide and the handbook provide that [they] are not to be relied upon as binding authority, thus even if Taxpayers relied on these materials, their reliance was not justified."

The minority disagreed, stating that "the principles stated in these materials bear evidentiary weight in support of the notion that a willing buyer and seller would have used the same tax-affecting approaches stated therein in valuating shares of G&J stock. Although I do not agree with 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."

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The Gross Case *(continued)*

Comment: We believe the minority has the better argument on this issue. On the topic of taxes (or laws in general, for that matter), shouldn't we strive for a stable and predictable system? Isn't this a more desirable situation than one of uncertainty and unpredictability? We understand that the guidelines in these manuals are suggestions only and are not the law, however, why even have these manuals if their guidelines are not only ignored, but are reversed, by a court?

Prior Tax-Affected Gifts Allowed by the IRS. The majority argues that "the Commissioner is not precluded from correcting an error. Thus, the fact that tax-affecting may have been approved in other cases, and was even approved in prior returns filed by Taxpayers, does not, and should not, preclude a different result in another case, particularly where there is disagreement over whether to tax-affect in determining the value of stock in the first place." The majority opinion does not buy the *Bliss* argument made by the taxpayer (see below), citing that *Bliss* is distinguishable because "there was disagreement among the experts as to whether tax-affecting was generally accepted." The majority also distinguished *Bliss* from the case at hand by stating that *Bliss* "involved an appeal from a decision of the Commissioner to the district court, not an appeal from a decision of the Tax Court. Thus, the district court presumably had more latitude in reviewing the Commissioner's decision to make the determination that the Commissioner acted arbitrarily in that case."

The minority opinion states: "The notion that willing buyers and sellers would have used tax-affecting under the discounted cash flow methodology is further supported by the fact that the IRS had previously approved 1988 taxes paid by Taxpayers based on gifts of G&J stocks valued at…a sum determined by tax-affecting G&J stock." The minority opinion agreed with the taxpayer's reliance on *Bliss* "in which the court held that the Commissioner cannot act retroactively in a particular case where his own regulations are 'broad enough to allow a taxpayer's method as one in accordance with generally accepted accounting principles or best accounting practices and one which was consistently followed. [If a taxpayer's] method of valuing…is substantially in accord with the regulations, great weight must be given to its long record of consistent application of the same method.'"

Comment: Again, we believe the minority has the better argument here. The majority apparently has no interest in the consistent application of law and bases its opinion on its assertion that there is disagreement over whether tax-affecting is proper. Furthermore, as was illustrated above, the majority was not very careful in its investigation of this disagreement on tax-affecting. In effect, the majority reaches its decision that tax-affecting is wrong from the testimony of one expert who states that he doesn't know what the accepted practice is, and one expert who states that tax-affecting is the accepted practice, although it is not accepted universally. From these two opinions, the majority reaches the illogical conclusion that tax-affecting is improper. Also, the majority's position that Bliss *is distinguishable because it dealt with an appeal from the Commissioner to the district court as opposed to an appeal from the Tax Court to the appellate court appears to be splitting hairs. Even if an appellate court doesn't have as much "latitude," can't the appellate court still decide that the Tax Court has acted arbitrarily?*

Importance of Meeting the Willing Buyer / Willing Seller Standard. The majority states that the standpoint of the willing buyer and willing seller must be considered and implies that tax-affecting is a "determination of fair market value based solely on the price-lowering desires of the willing buyer."

The minority opinion comments on this particular issue by recognizing 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."

Comment: We agree completely that the standpoint of both the willing buyer and willing seller must be considered. The issue here, however, is what willing buyers and willing sellers of S corporations were doing in 1992, an issue that the majority fails to adequately address anywhere in its opinion. While it is true that the majority's concern of examining the situ-

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ation from the perspective of the willing seller is important, it is also true that too high a value placed on an interest by a willing seller will result in no willing buyers.

Company May Lose its S Status. The majority believes that the argument that tax-affecting is appropriate because the company might lose its S corporation status in the future is without merit. The majority bases this belief on the facts at hand, namely the longtime family ownership, the restrictive shareholder agreement that prohibits transfers that would break the S election, and the lack of any indication from the company that the S election was going to be broken.

The minority counters that these restrictive agreements were only for ten year periods and the period was set to expire shortly after the 1992 gifts took place. Furthermore, the minority opinion notes that there are other ways to break the S election absent a transfer of the shares. Even if the company's shareholders had no immediate plans to break the S election, this still is no guarantee that the S election would not be broken at some time in the future.

Comment: We believe the majority has the better argument here and illustrates our belief that the facts of each individual case must be considered as to the application of the appropriate valuation technique. In the case at hand, the facts appear to favor the assumption that the shareholders have taken precautions to preserve the S election. This by no means is a guarantee in this situation, however, and highlights the fact that each case must be analyzed on its own merits.

Where do we go from here? While we obviously disagree with most of the majority's logic in the Court of Appeals ruling, the larger issue we are all facing is what to do next. While a 6th Circuit Court of Appeals ruling is not precedent in other circuits, there is a widespread belief in the valuation field that IRS field offices will quickly latch onto this case in their review of gift and estate tax returns involving S corporations. In our opinion, the best way to deal with the tax-affecting issue is the way a professional business appraiser should deal with all valuation issues – on a case-by-case basis.

Great Fact Pattern. To the IRS's credit, they picked a great fact pattern to argue in *Gross*. Some of the many favorable aspects that bolstered the IRS's case are as follows:

1. Company with stable and profitable operations.
2. Consistent annual 100% payout ratio of net income to shareholders.
3. Restrictive agreements that make it difficult to break the S election.
4. No indication from ownership that S election would be broken.
5. Minority interest being valued.

Some of these issues and their impact on the appropriateness of tax-affecting are discussed below.

Most Likely Buyer. A critical 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 not tax-affecting 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 (this may be particularly true with G&J given the rapid consolidation that has occurred in the soft-drink bottling industry). In this case, tax-affecting 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.

Just because an interest is very small, however, does not mean that an individual buyer is the most logical buyer. A number of corporations would love to own even a 1% interest in a competitor as that could open up sensitive financial and other proprietary information that the company was required by statute to make available to all shareholders. And don't believe for a minute that families are united in their front against outside parties. A disgruntled minority shareholder who feels he has been wronged by the family or is desperate for cash may leap at the opportunity to sell his 1% interest to a competitor, particularly to a competitor who is offering an attractive price to get his hands on the stock. All of these issues (and

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more) further muddy the water as to whether tax-affecting is appropriate.

Breaking the S Election. This is another subjective issue to deal with as it involves more crystal ball-type 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 such prophylactic steps as the restrictive shareholders agreement may further strengthen the case that the S election will probably not be broken and that tax-affecting may not be the more appropriate valuation method to employ. 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. How does the valuator quantify this risk?

Payout Ratio. The *Gross* case involved a company that paid out nearly 100% of its net income to its shareholders each year. 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 tax-affecting 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. In the valuation field there is an emerging school of thought that in those circumstances the appraiser might tax-affect the earnings of the S corporation to reflect the portion of the income tax liability that is not distributed to the shareholders and is, in effect, reinvested by the company.

Minority Value Greater Than For Control. One perverse irony business appraisers will sooner or later face is that making the choice not to tax-affect will sometimes result in a value for a small minority interest that is worth more (and sometimes substantially more) per share than the value per share of a 100% controlling interest. This obviously calls into question the very underpinning of the reliability of the decision not to tax-affect.

Conclusion. The bombshell of the *Gross* case has just hit and the business valuation and estate planning world has yet to assess the damage done. As of now, we plan to continue on the same path as before – to address each valuation situation on its own individual merits and make the best judgment as to the proper valuation technique in that case. Business appraisers should continue to utilize as many different valuation approaches as are appropriate for a particular situation, including valuation approaches where tax-affecting is not an issue. Utilizing such valuation multiples as TIC (total invested capital) to EBITDA (earnings before interest, taxes, depreciation and amortization expense) or TIC to Revenues in the guideline public company method or merged and acquired company method takes tax-affecting out of the equation and may prevent an IRS challenge on this issue. We believe that the use of a number of valid approaches strengthens the ultimate valuation result in any case as it allows the appraiser to examine the preliminary range of values to determine any pattern or logical conclusion of value. The use of a number of different approaches also gives support to the final value should the IRS challenge one of the approaches on the tax-affecting issue. If a tax-affected preliminary estimate of value is in line with other preliminary estimates of value utilizing other valuation approaches, it may be very difficult for the IRS to successfully challenge the tax-affected value due to the support it receives from the other approaches.

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