Business Valuation Review

Some Observations on Tax Affecting

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Abstract: In this article, the author questions some of the conventional wisdom and widely-held beliefs on tax-affecting.

Introduction. I read with great interest the September 2004 issue of *Business Valuation Review* and applaud the editors for devoting an entire issue to tax-affecting. I am not a disinterested observer on this issue, having weighed in myself in *BVR* in March 2002.[1] Outraged at the upsetting of our traditional tax-affecting apple cart, my co-author George Hawkins and I were highly critical of much of the reasoning of the Court of Appeals in the *Gross* decision, however, we ultimately concluded that "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."[2]

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In the nearly three years that have passed since that article, I have read everything I could get my hands on to help me with this issue. I was already familiar with many of the ideas and models in the September 2004 *BVR*, however, there remain some thought-provoking issues for me on this topic that I wish to address in this article. While I certainly have some opinions, I do not presume to have all the answers for these issues and look forward to hearing and participating in the ongoing exchange of ideas.

In this article, I would like to pay particular attention to the valuation of a controlling interest in an S corporation, and particularly an S corporation that is a service business or professional practice. As the United States moves more and more towards being primarily a service economy, I am seeing more and more service companies (including professional practices) in my valuation practice. Although there are exceptions, it has been my experience that these companies typically have minimal capital requirements and little need to retain significant earnings. As a result, most if not all of the profits of these companies are distributed to their owner(s). For purposes of illustration in this article, I use the scenario of one 100% shareholder, however, my examples could also apply to a group of S corp-eligible shareholders or a controlling interest that is less than 100%.

Unavoidable Illustration of the Issue. You have seen these illustrations *ad nauseam*, however, I need to use a basic illustration of the tax-affecting

Table 1
Difference Between C Corp and S Corp: Total Taxes Paid *

		C Corp		S Corp
Pre-tax Income		$ 1,000,000		$ 1,000,000
Less: Corporate-level Income Tax	40%	$ (400,000)	0%	$ -
Equals: Net Income Availble to Shareholder		$ 600,000		$ 1,000,000
Less: Personal Income Taxes	40%	$ (240,000)	40%	$ (400,000)
Equals: Net Proceeds to Shareholder		**$ 360,000**		**$ 600,000**
Total Taxes Paid		**$ 640,000**		**$ 400,000**

* I have assumed hypothetical 40% corporate and personal income tax rates for ease of illustration. The actual rate in any particular situation may differ. The assumption of these rates is what results in the often-cited 67% "S corp premium" that is discussed below.

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issue in order to get us all on equal footing and to illustrate some of the points in this article. Therefore, to beat the already-dead horse, here is the basic illustration of the impact of tax-affecting. **Table 1** shows the advantage to the owner of an S corporation versus an otherwise-identical C corporation under the scenario where 100% of the available net income of the company is distributed to the sole shareholder of each company.

As seen above, the owner of the C corp who wishes to take out all the profits of the company pays two levels of income taxes, one at the corporate level and one on the dividends received personally. This results in final proceeds to the C corp shareholder of $360,000, total taxes paid of $640,000, and a combined effective tax rate of 64%. The owner of the S corp who wishes to take out all the profits of the company pays only one level of income tax – at the personal level but based on the income tax liability of the S corp that is "passed-through" to him. No income tax is paid at the entity level of the S corp. This results in final proceeds to the S corp shareholder of $600,000, total taxes paid of $400,000, and a combined effective tax rate of 40%.

Table 2 shows the difference in company value (i.e., what some people refer to as the so-called "S corp premium") between an otherwise-identical C corp and S corp.

Table 2
Difference Between C Corp and S Corp: Valuation Implications **

	C Corp	S Corp
Net Income Availble to Shareholder	$ 600,000	$ 1,000,000
Divided by: Capitalization Rate	20%	20%
Equals: Company Equity Value	**$ 3,000,000**	**$ 5,000,000**
"S Corp Premium"		**67%**

** The "S Corp Premium" is the percentage amount by which the S corp value exceeds the C corp value.

As seen above, because the net income available to the S corp shareholder is not subject to an entity-level income tax (the income tax liability is passed-through to the S corp shareholder who must pay it at his personal level), the net income is 67% higher ($1,000,000 versus $600,000) than that of the otherwise-identical C corp. Therefore, when the same 20% cap rate is applied to the net income figures, the resulting value for the S corp is also 67% higher than the C corp value. This is the so-called "S corp premium" that will be discussed in more detail later in this article.

Consensus (?) on the Tax-Affecting Issue. In all the articles I have read and presentations I have seen, it appears to me that the closest thing we have to a consensus on this issue is that the appropriateness of tax-affecting must be decided on a case-by-case basis. Various commentators have opinions that lean in one direction or another, however, most practitioners (including this author) believe in a company-by-company analysis in deciding the issue. A sampling of practitioners is as follows:

> "The facts and circumstances must be analyzed on a case-by-case basis."[1]

> "Each entity and each ownership interest in an entity may have unique characteristics that must be examined and considered. As a result, no valuation model can be applied blindly without consideration of the specific attributes of the subject ownership interest."[2]

> "The SEAM is not a black box in which to throw numbers and expect meaningful results. A careful and reasoned approach to the initial business valuation analysis and the SEAM analysis is required to estimate meaningful and appropriately supported indications of value of S corporation equity securities."[3]

> "These examples are not intended to imply that an S corp should be valued at 'x' percent greater than the value as if the entity were a C corp. Any differential is a function of the specific facts."[4]

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> "In the [*Gross*] case's aftermath, it's clear that S corporations must be valued on a case-by-case basis."[5]
>
> "What this means to the valuation practitioner is that we must, as always, assess the unique characteristics of the company being valued, including its tax status, while at the same time understanding the valuation implications of true cash flow available to the investor."[6]

Mercer's Take on the Issue. One possible exception to the general "consensus" noted above is the apparent position taken by Chris Mercer in the September 2004 *BVR*.[7] In a wide-ranging treatment of the topic, Mercer opines that "S corporations are worth the same as *otherwise identical* C corporations *at the enterprise level*" but that "*interests* in S corporations *may* be worth more or less than identical interests in otherwise identical C corporations."[8] Perhaps Mercer believes that controlling *interests* in S corporations can be worth more than controlling interests in otherwise-identical C corporations, however, the tone of his article and various statements he makes leads me to conclude that he believes there is no difference in value. Mercer disagrees with the courts' logic in the recent line of tax-affecting cases and, on page 121 of his article, makes a number of "non-quantitative" arguments for tax-effecting S corporation earnings. I repeat his arguments below, followed by my comment on each argument:

Argument 1: "The S election has no impact on the operating cash flows of a business."[9]

Comment: True, but the operating cash flow of a business is not what ultimately reaches the shareholder. See my comment to Argument 2 below.

Argument 2: "The benefits of the S election are *shareholder benefits*. To capitalize those benefits in an enterprise valuation would overstate the value of the enterprise, particularly since the benefits can be taken away involuntarily if any shareholder breaks or causes the S election to be broken."[10]

Comment: Earlier in his article, Mercer makes the point that "**the S corporation benefit is a shareholder benefit, not a corporate benefit**."[11] This is undoubtedly true. In my business valuation practice, though, I have never done an estate tax valuation on behalf of a dead corporation or an equitable distribution valuation on behalf of a divorcing corporation. I have, however, done valuations on behalf of *shareholders* in both instances. This distinction made by Mercer seems to me to be much like the distinction between merely looking at a fine meal and actually eating it. The presentation of a fine meal may certainly allow us to visually identify the particular cuisine and speculate on its palatableness, however, it is not until one actually eats the meal that the ultimate benefit is obtained. It seems to me that in business valuation we are in the business of actually eating the meal. That means we value the company from the perspective of the shareholder and not on some detached or disembodied "corporate" level. A meal is no good unless one can have at it. Neither is a corporation any good unless one can realize its benefits through being a shareholder.

Argument 3: "S corporations virtually always pass through a sufficient portion of their earnings to their shareholders to enable them to pay their shareholder/corporate taxes. This leaves the S corporation in essentially the same position after taxes as if it were a C corporation (assuming an equivalency of corporate and personal marginal tax rates)."[12]

Comment: This argument only holds for a company that pays its income tax liability (either at the entity level for the C corp or via a distribution to the shareholder for the S corp) but then retains the remainder of its earnings. Once a company starts to distribute to shareholders any portion of its earnings that represents an after-tax or real return, the S corp shareholder then begins to enjoy an advantage over the C corp shareholder. Perhaps this is best seen via illustration. In **Table 3** below, I assume that the C corp makes no distributions and retains 100% of its earnings. I also assume that the S corp makes a sufficient distribution to allow for its shareholder to satisfy the pass-through income tax liability of the company but retains the rest of its earnings. This type of company might be one that is heavily capital

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Table 3
Company Retains 100% of Earnings
Distributions Made to S Corp Shareholder to Pay Pass-Through Taxes

		C Corp		S Corp
Pre-tax Income		$ 1,000,000		$ 1,000,000
Less: Corporate-level Income Tax	40%	$ (400,000)	0%	$ -
Equals: Net Income		$ 600,000		$ 1,000,000
Less: Distributions to Shareholder		$ -	40%	$ (400,000)
Amount to Retained Earnings		**$ 600,000**		**$ 600,000**

intensive or is rapidly growing and needs to retain earnings to meet growing working capital requirements.

In the above illustration, the C corp pays its $400,000 of income tax liability at the corporate level and then pays no dividends to its shareholder. This results in the retention of $600,000 of earnings at the C corp. The S corp makes a $400,000 distribution to its shareholder which allows him to satisfy the pass-through income tax liability of the S corp. As such, retained earnings is also increased by $600,000 at the S corp. In both situations, the shareholders are left with no cash – there was no dividend paid at the C corp and, although the S corp shareholder received a total of $400,000 in distributions, he had to use that entire amount to satisfy the pass-through income tax liability of the S corp. Also, the retained earnings at both companies is increased by $600,000, implying equal increases in equity values. All other issues aside, I can see some validity to the argument in this situation for equal treatment of C corps and S corps, however, it still doesn't allow for the potential superior benefits of an S corp versus a C corp should this company reach a position where it can begin making tax-advantaged distributions to its shareholder.

Now consider the opposite end of the spectrum. What do you make of the Company that has no need to retain earnings and pays 100% of available income out to its shareholder? This type of company might be a service business or professional practice that has little need for capital investment and minimal working capital requirements. This situation is seen in **Table 4**.

As seen below, after the payment of all taxes, the C corp shareholder has only $360,000 in his pocket whereas the S corp shareholder has $600,000. Neither the C corp nor the S corp added anything to retained earnings as all income was paid out either in taxes or distributions/dividends. Therefore, the respective equity values of the C corp and S corp are unchanged as related to each other. It appears to me that in this scenario, from the perspective of the shareholder, the S corp has to be more valuable than the C corp. Both companies start with $1,000,000 in pre-tax income but at the end of the day, the C corp shareholder has only $360,000 in his pocket while the S corp shareholder has $600,000. The $240,000 difference did not go to an increase in retained earnings at the C corp or towards any other benefit for the C corp shareholder – it went to the United States Treasury (where it presumably benefits the C corp shareholder and the S corp shareholder equally via the goods and services provided by the federal government).

Table 4
Company Retains No Earnings

		C Corp		S Corp
Pre-tax Income		$ 1,000,000		$ 1,000,000
Less: Corporate-level Income Tax	40%	$ (400,000)	0%	$ -
Equals: Net Income Availble to Shareholder		$ 600,000		$ 1,000,000
Less: Personal Income Taxes	40%	$ (240,000)	40%	$ (400,000)
Equals: Net Proceeds to Shareholder		**$ 360,000**		**$ 600,000**
Amount to Retained Earnings		**$ -**		**$ -**

Let's look at yet one more scenario. Suppose a company desires a maximum retention of its earnings yet the S corp does not make any distribu-

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tion to its shareholder, forcing the shareholder to come out of pocket to pay the pass-through income tax liability of the company. Of course, the S corp really doesn't "force" the shareholder to do this as the sole shareholder has unilateral authority over the payment of distributions. This scenario is illustrated in **Table 5** as follows:

Table 5
Company Retains 100% of Earnings
No Distributions Made to S Corp Shareholder

		C Corp		S Corp
Pre-tax Income		$ 1,000,000		$ 1,000,000
Less: Corporate-level Income Tax	40%	$ (400,000)	0%	$ -
Equals: Net Income		$ 600,000		$ 1,000,000
Less: Distributions to Shareholder		$ -	0%	$ -
Amount to Retained Earnings		**$ 600,000**		**$1,000,000**
Amount to Shareholder (after all taxes)		**$ -**		**$ (400,000)**

In the above illustration, the C corp pays its $400,000 of income tax liability at the corporate level and then pays no dividends to its shareholder. This results in the retention of $600,000 of earnings at the C corp. The S corp makes no distribution to its shareholder which forces the shareholder to come up with $400,000 from other sources to satisfy the pass-through income tax liability of the S corp. Although this appears initially to be a negative for the S corp shareholder, it really is not as the S corp's retained earnings (and, presumably, its equity value) are increased by $1,000,000, or by $400,000 more than the C corp. This scenario is no different than the S corp making a $400,000 distribution to its shareholder to allow for the payment of taxes and the shareholder paying those taxes and then turning around and investing $400,000 back into the company. From the perspective of the S corp shareholder, it is a case of form over substance.

In summary, then, we see that the value to the respective shareholders of the C corp and S corp is equal only in the case when no after-tax or "real" return is made to the shareholder. Once any distribution is made to the S corp shareholder that represents a "real" return (i.e., an amount above the amount needed to pay the pass-through income tax liability), the S corp shareholder benefits as compared to the C corp shareholder due to the tax-advantages of the S corp.

Argument 4: "Except for small corporations owned primarily by individuals, most of the likely buyers of many S corporations are, in fact, C corporations, or groups of investors who may need to organize as C corporations. If there were an incremental benefit to the S election, S corporation buyers of companies would have a comparative advantage relative to C corporation buyers. This advantage is not apparent in the marketplace."[1]

Comment: Although Mercer makes what sounds like a small exception in this argument, I believe it actually is quite large. Perhaps my valuation practice is different from yours, but the great majority of my clients are "small corporations owned primarily by individuals." It is precisely these types of companies for which the S election is made and is most beneficial. I believe it was in a Fannon/Hitchner/Treharne presentation where I heard that the number of S corps in the United States has increased from 736,000 in 1985 to 3.3 million in 2003 (an increase of 350%), while over the same period, the number of C corps has decreased from 2.4 million to 2.1 million (a drop of 13%). This trend is no accident – it has happened for a reason.

I cannot agree with Mercer's statement that "most of the likely buyers of many S corporations are, in fact, C corporations." This is far too broad and overreaching a statement. As many authors (including myself) have noted, one key issue in deciding whether to tax-affect or not is determining whether the most likely buyer of a company is a C corp or S corp. In a consolidating industry where smaller companies are being bought up by larger (and often publicly-traded) companies, it is probably more reasonable that the most likely buyer is a C corp and that tax-affecting may therefore be appropriate. However, in many other cases, the identification of the most likely buyer is not so easy and it well may be that the most likely buyer is an

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individual or group of individuals who would retain the S election and its related benefits. This is particularly true for many service businesses and professional practices.

Argument 5: "Consider that the majority of any benefit that flows from S corporation ownership is driven by prevailing income tax rates. Corporate and personal tax rates are set by the U.S. Congress and are subject to change. Buyers, who paid for alleged S corporation benefits in 2002 prior to the reduction in personal income taxes on dividends in 2003, would have been sorely disappointed because, in retrospect, they would have overpaid. Would this have been avoidable? Yes, because it is known that the tax law can be changed; willing buyers would be reluctant to pay for uncertain benefits. And because the tax law can be changed, willing sellers would have to acknowledge this uncertainty."[2]

Comment: First of all, tax rates can be changed in *two* directions – both up and down. Therefore, under Mercer's example, buyers who paid for "alleged" S corporation benefits prior to an *increase* in personal income taxes on dividends would presumably be delighted because they would have underpaid. There is no guarantee that the current 15% personal income tax rate on dividends will remain there permanently. Secondly, as shown earlier in this article, S corporation benefits are not always "alleged." As seen in the example in **Table 4**, the S corp shareholder did not put an "alleged" extra $240,000 in his pocket as compared to the C corp shareholder – those were real dollars that can buy real houses, pay real tuition, and take real vacations.

Finally, would the buyer of the "alleged" S corp benefits really be "sorely disappointed" with a reduction in personal income taxes on dividends? It seems to me that the buyer of an S corp would determine the capitalization rate and price he was willing to pay based on the anticipated income stream and risk inherent in the specific company. If the S corp shareholder is satisfied that his purchase price accurately reflects the risk inherent in the anticipated income stream of the company (as quantified by the cap rate), it appears to me that the only thing that would disappoint the S corp shareholder would be an increase in personal income tax rates as that would lower his expected return on investment. An increase in personal income tax rates, however, is a risk we all have and a factor that impacts far more than the valuation of S corps.

Argument 6: "Experience of investment bankers at Mercer Capital and elsewhere suggests that buyers will pay no more for S corporations than for equivalent C corporations. Two of Mercer Capital's banking clients recently acquired S corporation banks. The analysis of each transaction involved tax-effected earnings. Why? Because the tax-effected earnings streams were the relevant income streams. Both selling banks considered multiple purchasers – and none stepped forward to pay an S corporation premium. Why? Because it simply does not exist."[3]

Comment: Unfortunately, this real-world example from Mercer does not give us enough information. If the acquiring banks were C corps then their proper return analysis is from the C corp perspective and tax-affecting is most likely appropriate. This doesn't prove that tax-affecting S corps is appropriate in all cases. What if the buyers were other S corps? Would tax-affecting be warranted or relevant in that case? (Note: I have more to say about the so-called "S corp premium" below.)

I am not trying to pick on Chris – I believe he makes some good points in his article. However, I also believe some of his positions (i.e., "[the S corporation premium] simply does not exist"[4]) are too severe and do not afford the proper degree of flexibility needed to address each S corp valuation matter on a case-by-case basis. Mercer, by the way, is by no means alone in his position:

> "Personally, I have a hard time believing that an S corp can be worth between 40-67 percent more than its identical C corp counterpart."[5]
>
> "Additionally, simple logic should tell most of us with experience in the marketplace that informed buyers are not willing to pay a premium to acquire a business just because it is structured as an S corporation when, in fact, that election is freely available to any buyer

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> who otherwise qualifies. It is irrational to apply a 67% premium as the Tax Court and IRS have done to a control interest or even a minority interest in an S corporation."[6]

Transaction Studies Show No S Corp Premium. This last argument by Mercer leads to a another key component of the tax-affecting issue – the transaction studies. Following the 12% to 17% S corp premium supposedly demonstrated by the Erickson-Wang Study, nearly every subsequent study has concluded that C corps and S corps sell for basically identical prices in the market. That is, these studies indicate that, on the whole, buyers do not pay any premium for S corps as compared to similar C corps, or, if some premium is paid, it can be explained by other factors (such as asset sales versus stock sales):

> "Among practitioners, at least, the tentative consensus is that, on a control basis, there is no difference between S corporation and C corporation values."[7]

> "This article compares actual market data from private sales of S and C corporations. It uses simple regression analysis to test the hypothesis. It concludes that the market data comparison does not indicate S corporations are more valuable than otherwise identical C corporations."[8]

> "S corp prices are not always higher than C corp prices. In general, they do not differ."[9]

I have no reason to doubt the findings of these studies. However, I cannot make the leap from the results of these studies to the conclusion that tax-affecting should be done in all cases for S corps. If you could show me that all of the companies in these studies were valued by the buyers and sellers using the *income approach exclusively*, it would be easier to reach this conclusion. I suspect, however, that this is not the case and that a number of different valuation methods were considered by the buyers and sellers in these transactions, including market approaches in which the tax status of the company did not matter.

For example, suppose you had transaction data on the sale of two companies – an otherwise-identical C corp and S corp. Both companies had revenues of $6 million, EBITDA of $1.5 million, and pre-tax profit of $1 million. Suppose each of these companies was sold for $6 million on the basis of a one-times revenue multiple and a four-times EBITDA multiple. If you believe that tax-affecting is appropriate, you believe that a 10% cap rate is right ($600,000 in tax-affected S corp profit divided by the $6 million transaction value). If you believe that tax-affecting is not appropriate, you believe that a 16.7% cap rate is right ($1,000,000 in non-tax-affected S corp profit divided by the $6 million transaction value). I fail to see how you get from these transaction values and multiples to the irrefutable conclusion that the 10% cap rate on the tax-affected S corp income is unequivocally correct. It seems to me you have gone from your hypothesis to your conclusion without any proof.

A Different Perspective. Although it had existed before, this whole tax-affecting business really came about in earnest with the *Gross* decisions in 1999 and 2001. What was so unique about these decisions was the change in perspective that the business appraisal world was forced to take on this issue. That is, for years we had all assumed that S corps should be tax-affected because the rates of return we were using were from publicly-traded C corps which paid entity-level income taxes. Therefore, to get an apples-to-apples comparison, we had to tax-affect our S corp results.

In *Gross* and the cases that followed, we were introduced to the successful argument that our former perspective from the entity's point of view was incorrect and the proper perspective should really be from the shareholder's point of view. That is, it really doesn't matter what kind of taxes, if any, have been paid at the corporate level – the key issue is that these returns to shareholders are before personal-level income taxes. Therefore, no tax-affecting is required for S corps as the S corp shareholder has yet to pay personal level income

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taxes on his distributions, much as the C corp shareholder has yet to pay personal level income taxes on his dividends.

Perhaps, as with the rate of return perspective issue in the pre-*Gross* era, we are looking at all of this "S corp premium" business backwards. What if this alleged "S corp premium" is not really a premium at all but is actually an accurate reflection of value under the income approach? After all, to say that the S corp premium is an irrational and unmerited inflation of value is to imply that the tax-affected C corp equivalent value is the correct measure of value for the S corp. Said another way, one is measuring two things (the non-tax-affected S corp value and the tax-effected S corp or equivalent C corp value) against a third thing (the "true value" of the company). Or, as someone else once said:

> "The moment you say that one set of moral ideas can be better than another, you are, in fact, measuring them both by a standard, saying that one of them conforms to that standard more nearly than the other. But the standard that measures two things is something different from either. You are, in fact, comparing them both with some Real Morality, admitting that there is such a thing as a real Right, independent of what people think, and that some people's ideas get nearer to that real Right than others."[10]

To borrow from the above analogy, it appears to me that the main issue in all of this tax-affecting business is figuring out the "real Right" in each case. As business appraisers, that ultimately is what we are all about. My position in my 2002 *BVR Gross* article on trying to find the "real Right" is unchanged:

> "[A]s 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 each 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 expense, 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…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."[11]

If I value an S corp and come up with preliminary estimates of value under alternative methods (usually market approaches) that are reasonably similar to my non-tax-affected preliminary value under the income approach (which happens more often than not), I do not believe the company has an "S corp premium" – I merely believe this company is correctly and more accurately valued under the income approach by not tax-affecting.

Exit Strategy. Finally, consider the following real-world example. Many of you who are reading this article also own your own business valuation firm. Suppose that after a long and distinguished career as a business appraiser, you have built your organization into one of the most well-respected BV firms in the area. You decide to sell your firm and retire. Your firm has been a S corp since day one and the universe of willing buyers for your firm are individuals (or groups of individuals), each of whom would retain the S election. There are no C corp buyers looming out there, ready to roll-up local business valuation firms into a national "Blockbuster Video" business valuation firm. Let's assume that your firm is an S corp with an income statement similar to the S corp shown earlier in **Table 1** (i.e., pre-tax profit of $1,000,000 – a pipe dream, perhaps, but suspend

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your belief for a moment). It is widely agreed by everyone that a 20% cap rate (or five-year "pay-back" period, if you will) is the appropriate valuation measure to capture the risk and reward inherent in your business.

As you are interviewing potential buyers, one enterprising and eager young man states that he has read the various articles and studies on the subject, believes there is no such thing as an S corp premium and that tax-affecting is appropriate in every case. As a result, instead of giving you credit for the $1,000,000 in pre-tax income generated by your firm (and the corresponding $5 million value based on a 20% cap rate), he is only willing to give you credit for $600,000 in tax-affected net income and is therefore only willing to pay $3 million for your firm.

How fast are you showing this guy the door? Why would you as the seller ever give to a buyer the benefit and windfall of a hypothetical expense that never has been paid by the seller and never will be paid by the buyer? You may as well adjust your income statement for a phantom salary expense to employees who do not exist or a phantom rent expense on a building that does not exist.

Concluding Thoughts. As I said at the beginning of this article, these are just some of my observations on this issue. I don't pretend to have all the answers – I just want to raise some questions. Other authors have done a far more detailed and competent study of this issue, particularly where a non-controlling interest in a S corporation is involved. One thing that has not changed for me since *Gross* is my firm belief in addressing this issue on a case-by-case basis and not assuming there are any absolute truths on this issue.

I still believe that the key issues to consider are as follows:

1. Who is the most likely buyer of the company and from what perspective (i.e., S or C) will the earnings stream of the Company be analyzed? What is the anticipated holding period for this interest?
2. What is the possibility that the S election can or will be broken in the future?
3. What are the historic and expected distribution levels? What is the company's need (or lack thereof) to retain earnings (either for capital needs, increasing working capital due to growth, or some other reason).

Or, as Roger Grabowski puts it:

> "Principal value drivers are, as they should be, the amount of cash distribution the shareholders expect to receive, the expected holding period and, most importantly, the pool of likely buyers."[12]

One Final Observation. Is it tax-**A**ffecting or tax-**E**ffecting? Can we at least get some consensus on this?

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Endnotes

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[2] *Ibid*, p. 13.

[3] Pratt, Shannon P., "Editor attempts to make sense of S versus C corporation debate," *Shannon Pratt's Business Valuation Update*, March 2003, p. 2.

[4] Treharne, Chris D., "Valuation of Minority Interests in Pass-Through-Tax Entities," *Business Valuation Review*, September 2004, p. 105.

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[6] Grabowski, Roger J., "S Corporation Valuations in the post-Gross World-Updated," *Business Valuation Review*, September 2004, p. 149.

[7] Schlueter, Richard A. and Morris, Sonya G., "To Tax or Not to Tax That is the Question: The S Corporation Valuation Controversy," *Business Valuation Review*, June 2002, p. 75.

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