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S Corporation (and LLC): Added Value Due to Tax Status

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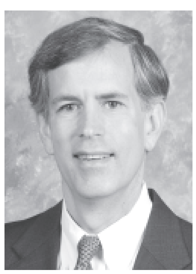
Court: *I am ruling that your client's interest in Acme Company, a Subchapter S corporation, is worth 25% more because of its tax status. I find the opposing valuation expert's analysis, as well as court rulings in other jurisdictions on this issue, to be compelling, logical, and supported by studies on the subject.*

Introduction. This could easily be the outcome today in any venue where valuation is at issue, including family law, dissenting shareholder and estate, gift and other tax matters. The need to consider the possible additional value associated with S corporation (or LLC- the two are considered interchangeably in this article) status is now well established in at least five U.S. Tax Court cases, the Delaware Courts, and, increasingly, in family law venues. With substantial dollars at risk, attorneys and their clients must be aware of this issue and its ramifications as it pertains to both S corporations and LLCs.


George Hawkins

A large proportion of closely-held businesses now operate as pass-through tax entities such as Subchapter S corporations or limited liability companies where the owners are personally responsible for paying their prorata share (based on ownership) of personal taxes on company earnings. A major reason for this trend is that the pass-through tax status often provides greater tax savings to the owners, such that the after-tax cash benefits they realize is often greater than had the business been taxed as a regular C corporation. While a boon to owners, these benefits also create substantial valuation complications. As a consequence, the value of the interest involved might be substantially higher due to the pass-through tax status.

This article explains why an S corporation might be more valuable, several techniques that might be used in determining the additional value that might be present, studies on the subject, and considerations as to whether or not an S corporation premium is indicated. Finally, for the family law attorney, an example is given related to professional practice valuations where a premium might even be applied where the divorcing spouse holds an interest in a ***C corporation***. Note that this article only applies to operating businesses, and not those are primarily asset holding entities (e.g., real estate, marketable securities, etc.).

After-Tax Cash Benefits of Pass-Through Tax Status. Because of the pass-through tax status of an S corporation, shareholders are personally responsible for their pro-rata share of income tax liability on a company's pre-tax profits that is passed through to them. In profitable companies, S corporation shareholders generally receive greater after-tax cash benefits than do shareholders in otherwise identical C corporations. This is because the S corporation shareholder is taxed only once, at the personal level, on his or her share of S corporation earnings. Any distributions that are then taken out are not taxed. To the extent any earnings are left in the company and not distributed, this increases the shareholder's basis upward for computing capital gain should the company later be sold.

By contrast, a C corporation is taxed at the corporate level on its earnings at C corporation rates. Then, when earnings are paid out in the form of dividends the shareholder is again taxed personally on them at applicable individual income tax rates. This double taxation of the C corporation makes its tax status less attractive, leading many companies to elect Subchapter S corporation status, or alternatively, to instead form a company at its inception as a limited liability company, also a pass-through tax entity.

Furthermore, there is another tax benefit associated with S corporation status not available to the C corporation shareholder. In a C corporation, the shareholder's basis in the stock is not increased if earnings are left in the company and not distributed, so the shareholder gets no basis step-up due to retained earnings that reduces his or her taxes on the gain from a later sale of the shares. These differences in taxation mean that the after tax cash benefits available to the shareholder of the S corporation (after personal taxes have been paid) are normally greater than for the same company if taxed as a C corporation.

The obvious next question is easily stated but less easily answered- how is the impact of this tax benefit quantified and applied for purposes of determining the value of a Company or its interest? A second, less obvious question is why? This article deals with the why first, and then provides examples of the methods to answer the first question.

Why Adjusting Value for Tax Status is Necessary. If there are obvious incremental after-tax cash benefits associated with pass-through tax status, why is it necessary to quantify them and apply a premium in a valuation if a majority of privately-owned businesses are now either S corporations or LLCs in the first place? The answer rests in the nature of the data used by valuators to value the privately-owned company.

Data Mismatch Provides the Need for Adjustment. The rate of return data used in developing discount and capitalization rates for valuing privately held companies by the income approach (e.g., the capitalization rate used in the capitalization of earnings method, or the discount rate used in the discounted cash flow method) is, by necessity (as it is the only rate of return data observable), based on rates of return applicable to shares in publicly traded companies, which are C corporations. The rates of return of those publicly traded companies are based on returns to shareholders (in the form of dividends and capital gains) that are ***before*** the payment of personal taxes, but for publicly traded C corporations that have ***already paid corporate level taxes.*** Those rates of return already reflect the impact of the less attractive C corporation tax status (i.e., double taxation).

Therefore, if publicly traded data is used to develop the capitalization rate for valuing the privately owned S corporation by the capitalization method a mismatch is present. A mismatch is also present are also when using the guideline public company valuation method, where the market multiples (e.g., price to earnings, price to cash flow, EBITDA multiples, etc.) of reasonably similar publicly traded companies are used to value the privately-owned business.

Because of this mismatch, the U.S. Tax Court (in at least five cases) and other jurisdictions (e.g., Delaware courts, family law courts), as well as the valuation field generally, have recognized that in valuing the privately held S corporation it may be appropriate to take into account the incremental, additional value that the S corporation shareholder derives in terms of greater after-tax benefits and their effect on value.

Example of SEAM Method Used to Quantify S-Corp. Benefits. Given that this mismatch is present, how then, does the valuator make an appropriate adjustment for the greater S corporation tax benefit that might be present and quantify its impact on the resulting value? The answer is complicated as there are various techniques that might be considered, of which this article will consider one more commonly used method as an example. A warning- the application of the model is not rote or always indicated and will depend upon the particular facts and circumstances of the shares and company being valued.

Suppose the assignment is to determine the fair market value of a minority interest in Acme Corp., an S corporation. In doing so, the valuator decides to use the capitalization of earnings method, where Acme's earnings are divided a capitalization rate to arrive at a preliminary estimate of value. Although an S corporation, there is a mismatch (as noted earlier) with publicly traded data used which comes from publicly traded C corporations. Consequently, the valuator first "tax affects" (reduces for income taxes) the earnings of Acme (which are before any taxes because it is an S corporation and pays none- only the shareholders do) as if it were a C corporation, as shown in **Table 1**. Then, the net after-tax (as if Acme were a C corporation)

Table 1 Preliminary Value of Acme by Capitalization of Earnings Method (As if A C Corporation)	
Pre-Tax Profit (Loss)	$1,000,000
Tax Rate [1]	38.6%
Less: Income Taxes	($386,000)
Adjusted Net Income	614,000
Divided by Capitalization Rate	20.0%
Equals: Preliminary Value	**$3,070,000**

[1] Based on rates as if the Company were a C corporation, including the impact of both federal and state taxes.

earnings are divided by the capitalization rate to arrive at a preliminary, ***as if C corporation value***.

Table 1 values 100% of Acme as if it were a C corporation and properly matches the publicly traded data (based on C corporations) to Acme as if it were a C corporation. But a C corporation Acme is not! Therefore, the valuation must now quantify the additional incremental valuation impact of the greater after-tax cash benefits its shareholders realize because of Acme's S corporation tax status versus the previously computed results as if a C corporation.

Under one well-known model (the S Corporation Economic Adjustment Model, or "SEAM") in using the income approach the valuator reduces the privately held company's earnings as if it were a C corporation, i.e., as if it paid C corporation taxes.[1] Then, using the SEAM model the valuator calculates an S corporation premium that quantifies the degree to which the S corporation shareholder benefits from greater after-tax cash benefits because of the S corporation status. This S corporation premium is then applied to the findings by the income approach, as if a C corporation, to arrive at the S corporation value.

More specifically, the SEAM model involves valuing the shares in an S corporation as if it were a C corporation and tax affecting earnings as if the company paid C corporation level income taxes. The appraiser then uses information concerning the company's dividend 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 personal level for its pass-through tax), dividends (personally on C corporation dividends) and any capital gains on the interests (personally on the increase in value of the interests held in a C corporation) to calculate the net economic benefit realized by the owners in the same company as a pass-through tax entity and as a C corporation.

If, hypothetically, for example, the net economic benefit per year to the owner of a fictitious company as a pass through tax entity were $1,200,000 versus $1,000,000 as a C corporation, the SEAM model would calculate that, based on the model and its simplifying assumptions, the interests in the company as a pass through tax entity are worth 20% more than as a C corporation because of the higher level of economic benefits. Therefore, absent other considerations, once the value is determined based as if the company were a C corporation based on the income approach, the resulting value is then multiplied by the SEAM multiple of 1.2 (in the foregoing example) to get the resulting value of the interests in the company being valued.

Applying the SEAM Method to Acme. Using Acme as an example, the SEAM model will now be applied specifically to its unique circumstances to calculate the incremental economic benefit and effect on value from its pass through tax status. The SEAM model as used here is based on C corporation and personal income tax rates in effect at the valuation date (federal and state) to estimate the SEAM adjustment for Acme (hypothetical example only- tax rates and other assumptions may differ depending upon the facts). The calculation of the specific SEAM adjustment factor for the Acme valuation is shown in **Table 2.**

In **Table 2**, the after-tax cash benefit available to the shareholder is first calculated as if Acme were a C-corporation, after-taking into account that the income is taxed once by the C corporation, and then, when paid out in distributions (at a rate equal to 40% of earnings) are taxed again at the personal level. Furthermore, the earnings that are retained in Acme do not increase the shareholder's basis if the shares were later sold, and assuming they increased the value accordingly, are taxed at some future point upon the sale of the shares, which would result in capital gains taxes to the shareholder. Therefore, the net after-tax cash benefit available to the shareholders as if Acme were a C corporation is **$479,657**.

Conversely, **Table 2** also calculates the net after-tax cash benefit to the shareholder taking into account Acme's beneficial S corporation tax status. Acme's earnings are only taxed once at the personal shareholder level. Furthermore, to the extent that

Table 2- Hypothetical SEAM Application for Acme

	C Corp	S Corp
Income before income tax	$1,000,000	$1,000,000
Corporate Income tax	(386,000)	n/a
Net Income	614,000	1,000,000
Dividends to S Corp shareholders	n/a	400,000
Income tax due by shareholders	n/a	(402,000)
Net cash flow to S Corp shareholders	n/a	(2,000)
Dividends to C Corp shareholders	$245,600	n/a
Income tax on dividends	($54,032)	n/a
Net cash flow to C Corp shareholders	$191,568	n/a
Net Income	$614,000	$1,000,000
Dividends to shareholders	($245,600)	($400,000)
Net Capital Gains	$368,400	$600,000
Effect of increase in tax basis	$0	($600,000)
Net taxable capital gains	$368,400	$0
Capital gains tax liability	($80,311)	$0
Net capital gains benefit to shareholders	$288,089	$600,000
Net cash flow to shareholders	$191,568	($2,000)
Net capital gains benefit to shareholders	$288,089	$600,000
Net economic benefit to shareholders	**$479,657**	**$598,000**
	(A)	**B)**
SEAM Adjustment Factor (A/B)	**1.25**	

earnings are not distributed to shareholders, they increase the shareholders' cost basis in the shares for purposes of determining capital gain when later sold. Therefore, the net after-tax benefit available to the shareholders as an S corporation are **$598,000**.

Dividing the greater S corporation net benefit to the shareholders of Acme as an S corporation ($598,000) by the lesser net benefit as a C corporation ($479,657), gives a ratio of 1.25 (rounded), indicating that Acme's pass-through tax status gives shareholders 25% greater after-tax benefits than were it a C corporation. This SEAM ratio of 1.25 is now multiplied by the preliminary value by Acme (by the capitalization of earnings method in **Table 1**) in **Table 3** to arrive at the value of Acme as an S corporation.

Table 3
Adjustment to Value for S Corp. Status

As if C Corp. Value	Times SEAM Multiple	Equals: S Corp. Value
$3,070,000	1.25	$3,837,500

This is obviously a hypothetical example and is not to be applied to specific situations since the SEAM calculations can vary materially, as well as the facts and circumstances related to a particular company or share interest which may dictate a different treatment of the S corporation issue entirely. However, the point is that there are indeed circumstances where the S corporation may have materially greater benefits to its shareholders that might need to be captured in the resulting valuation.

It is also essential to note that the SEAM model is not the only technique in use. In addition, there are important simplifying assumptions and limitations inherent in the use of the SEAM or other models that need to fully understood and appreciated by the valuator and may dictate whether or not a specific model is appropriately used in a particular circumstance.

S Corporation Valuation Adjustments Now Widely Accepted. As is obvious, the quantification of S corporation benefits might (in some instances) result in a materially greater valuation for a company's shares. It is for this reason that the IRS is well aware of the issue and routinely targets estate and gift tax valuations in audits where the valuator fails to consider the issue and whether or not adjustments are appropriate in the unique circumstances. Similarly, in the family law arena, divorce attorneys are increasingly aware that this issue exists and it is becoming a battleground contention in equitable distribution. Finally, the S corporation premium is now frequently a major point of argument in dissenting shareholder and corporate dissolution cases because of the dollars involved.

While the need to consider an adjustment to value for pass-through tax status was once non-existent in the valuation field, the advent of U.S. Tax Court cases (in the late 1990s and into the early 2000s) forced valuators to take note, subsequently filtering into consideration by the Delaware courts, as well as in family law and other litigated cases throughout the country. Furthermore, valuators, while initially resistant, have now largely embraced the need to consider whether adjustments are indicated, and if so, to use appropriate methods to quantify them. Nonetheless, there remain valuators who, whether through ignorance or stubbornness, have refused to remain in step with the field and fail to consider the need for an S corporation value adjustment. Attorneys should be very wary of using such individuals for a valuation assignment as the result may be exposed to substantial potential for attack, and in the context of an estate of gift tax matter, put the client at risk for penalties.

Are Adjustments Always Warranted? It sounds as if the need to adjust the value of an S corporation is automatic, but that's not necessarily the case. As is the case in life with many things, the answer is that it depends. For example, it is easy to envision circumstances where the shares of an S corporation might actually be a negative to the shareholder, or where there are other factors which make the need to apply a premium less clear.

Consider, for example, an individual who dies owning a 10% minority interest in the shares of Acme. However, rather than paying out 40% of its earnings annually in the form of distributions, Acme has been unwilling to pay distributions because the other 90% shareholder, who controls the company, sees no reason to do so. The purchaser of the 10% minority interest could therefore be stuck paying out of his or her own pocket $40,200 in taxes (10% of the $402,000 in personal taxes on Acme's $1,000,000 in pre-tax earnings) annually, yet realizing no cash payout (in a distribution) to enable the payment of those taxes. By contrast, had Acme instead been a C corporation the entity would pay the taxes and the shareholder who not be out of pocket. Obviously, the shareholder might have a cause of action to sue the majority shareholder to attempt to force the payment of S corporation distributions, but that costs money to litigate, has uncertainty, and there might be fewer prospective purchasers of the shares willing to do so. Thus, it is not difficult to envision a circumstance where an S corporation's shares might actually be worth ***less*** than as a C corporation.

Other Considerations Might Impact Applicability of Premium. Another consideration in whether or not to apply a premium might include whether or not there are factors present that might suggest the S corporation tax status will end and the company will instead soon be taxed as a C corporation. Furthermore, who is the most likely purchaser of the shares at issue and will this party be able to take advantage of the S corporation tax status and its associated benefits? In some instances, the most likely purchaser of a minority interest in a closely held company might be another individual who can benefit from the S corporation tax status. However, in the valuation of a 100% controlling interest this might not necessarily be the case, as the buyer might potentially come from a wide universe of prospective purchasers and could include, for example, publicly traded C corporations who cannot benefit from the S status.

To Apply or Not to Apply a Premium- The 100% Controlling Interest. It is this last issue, the valuation of a 100% controlling interest, that continues to cause the most angst and continuing debate in the valuation field as it pertains to the need for a S corporation adjustment to value. Where the most likely buyers are other S corporations or individuals (such as often the case with small, closely held companies) it might well seem reasonable to apply the S corporation premium, although this might not necessarily be the case as will be shown. Conversely, if the most likely purchaser of the 100% controlling interest is a C corporation it might also seem reasonable not to consider any S corporation impact, but this reasoning might also be flawed.

Studies on the Issue. Numerous studies have been made to study the degree to which premiums are or are not paid in the actual acquisition of S corporations. One such study by Wang & Erickson reached the conclusion that acquired S corporations received prices of around 12% to 17% more than for similar C corporations in "taxable" transactions. This led to much debate about the validity of the Wang & Erickson study, including challenges by others about the assumptions Wang & Erickson used, along with countercharges by Wang and Erickson that the criticisms of their study were unfair.

Another study using a large number of transactions contradicted Wang & Erickson's findings that there was a premium paid at all for the acquisition of S corporations. A study by Mattson, Shannon and Upton of data involving 2,487 transactions of S (1,285) and C (1,202) corporations in the *Pratt's Stats* database concluded that there was no evidence of any premium paid for S corporations.

Ultimately both studies were assaulted for various reasons related to their design and the statistical rigor used and were not used much further by business appraisers. This led to use of the SEAM and other methods noted earlier to predict the premium associated with an S corporation's economic benefits.

Another peer reviewed 2007 academic study on the subject was published by DiGabriele.[1] DiGabriele's analysis took the earlier studies further by identifying the degree to which the type of buyer (public versus private), the nature of the transaction (whether asset versus a stock purchase), and size (in terms of annual revenues) have an effect on the degree to which an S corporation premium was paid, and what those factors predict for premiums based on actual empirical data. The study was based on 4,239 actual private company acquisition transactions (including 2,159 C corporations and 2,080 S corporations) from January 2000 through November 2006 as reported in *Pratt's Stats*, a well-known transaction database extensively used by the valuation field.

DiGabriele's study found that an S corporation premium can (but not necessarily) exist and the magnitude of the premium, if it is present, relates to the following factors in those transactions:

- 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 a purchase of stock than when it is an asset sale.

DiGabriele's findings were statistically significant and resulted in a predictive model that can be used to estimate the premium, with the model derived from actual empirical data. DiGabriele's study culminated in a mathematical regression model that describes the relationship between the price paid based on inputs as to the size of the company (in annual revenues), the company type (an S corporation or a C corporation), the buyer type (public or private) and the nature of the transaction (a purchase of stock or of assets). In short, DiGabriele's formula is simply a mathematical representation of the ***actual relationships observed in real world sales of closely-held companies and the degree to which actual premiums were or were not paid.***

I have discussed DiGabriele's study findings at length with him. For example, DiGabriele was asked if his data and findings might be distorted by the effects of the change in taxation that occurred as a result of the Tax Reform Act of 2003, which modified the taxation of dividends and capital gains, among other items, resulting in relative changes between S and C corporations over time. He indicated that this same question was raised in the peer review of his study and he responded by analyzing the results using data separately from both before and after the Tax Reform Act and found no statistically significant difference in his findings or his model's prediction of the factors affecting the actual degree of S corporation premiums observed in real world transactions.

DiGabriele's SCoP Model. DiGabriele's SCoP model (for S Corporation Premium), which is a derivation of the previously noted research findings, is run based on the subject private company as if were a C corporation and as if it were an S corporation, with the resulting difference in price indicating if an S corporation premium is appropriate based on the results from actual transactions in his study, and if so, the predicted size.

Suppose the valuation of a 100% controlling interest in Acme is at issue. Assume it has annual revenues of $15 million and it has been concluded that the most likely buyer is another private company or individual since Acme operates in a small niche where there are no publicly traded companies. Furthermore, the valuation is of the common shares for an estate or divorce. Using DiGabriele's ScOP model, the predicted S corporation premium that might be paid in a sale of a company can be estimated based on a sale of stock. Based on Acme's net revenues and assuming a private buyer and a stock sale, DiGabriele's model predicts an S corporation premium of **14.3%.** However, assume instead that the most likely buyer had been a public company. DiGabriele's SCoP model would instead suggest that there would be no premium paid based on the empirical data of actual transaction data used in DiGabriele's study.

However, one should not assume this means that the data showed that no premiums were paid for controlling interests by publicly traded C corporations for purchases of private S corporations. When the purchase is treated as a purchase of assets rather than the stock, there was no premium paid in the resulting data as long as the privately owned company had annual revenues of no more than about $400 million. However, once this barrier was crossed, the data showed that premiums started to arise in actual transactions and increased in magnitude as the size of the private company's annual revenues grew.

The specific reason as to why buyers (even C corporations who do not intend to retain the acquired company's S corporation status) pay a premium is not known with certainty, although one possible reason advanced relates to the tax treatment of an acquisition of an S corporation. Under Section 338 of the Internal Revenue Code, the buyer can elect to treat the S corporation that is acquired (even in a purchase of stock) as a purchase of assets for tax purposes. As a result, the buyer can step up the depreciable basis of the assets (that might be heavily or fully depreciated on the acquired company's books) to their full market value at the time of the acquisition, and then generate new, higher depreciation expense as a tax deduction. This reduces taxes on the acquired company's earnings and increases the after tax cash flow generated by the acquired company versus had not such an option have been available. Although a buyer of a C corporation could theoretically do the same step up it could create significant negative tax consequences that would not be present with the acquisition of the S corporation.

Do DiGabriele's Findings Contradict the SEAM Model? The SEAM model, as used earlier, was originally developed for the purposes of valuing a minority interest in an S corporation and quantifying the associated tax benefits that might inure ***to the shareholder*** as a result. By contrast, the DiGabriele findings relate to the sale of whole companies, i.e., 100% controlling interests. If using DiGabriele's findings in a specific circumstance the model predicts no S corporation premium for a 100% controlling interest, does this mean it is unreasonable to apply a premium when valuing a minority interest even though the SEAM method indicates one might be appropriate? The answer, again, as with any answer by an economist, valuator, or attorney, is that it depends.

For example, in the case of a 10% interest in Acme where 1) distributions are paid to enable the payment of taxes, 2) there is no plan or intent to end the S corporation tax status, 3) the most likely buyer of the shares is another individual, and 4) there is otherwise no near term plan to sell the entire company, it might be completely reasonable and supported to apply the SEAM indicated premium. In that circumstance the purchaser of the shares might reasonably continue to realize the benefits of the S corporation's greater after tax cash benefits for the foreseeable future. Therefore, to ignore the valuation impact of these incremental benefits is arguably to ignore the economic reality realized by the shares at issue, precisely the view that has been taken by the U.S. Tax Court. This was obviously a simplistic example, and there may be other factors that enter into the ultimate decision of whether or not an S corporation present.

Equitable Distribution and the S Corporation Issue. Some states have case law stating that the tax implications arising from the sale of marital assets should only be considered if their payment is not speculative. This is under the theory that the ex-spouse with the business is not actually selling his or her company, but merely having it valued for purposes of the dissolution of the marriage. Therefore, these cases maintain that it is unfair to the spouse not in the business to be paid a reduced value (reduced by taxes, such as from the gain on the sale of the business or its assets) in equitable distribution since a sale is not in fact contemplated. Increasingly, attorneys are now pointing to these cases (even though they usually dealt with different types of taxes, such as those on gain) as support for why S corporation (and LLC) tax-affecting is inappropriate. The logic is that the spouse retaining the business will continue to receive pre-tax earnings on which no C corporation level of taxes will be paid. Therefore, to impute taxes on those earnings that are speculative as to their future payment violates case law and results in an unfairly low value for the other ex-spouse.

These arguments about tax affecting are only partly correct. It is not fair to fail to take income taxes into account at all in the valuation of the S corporation. In fact, even in the S corporation income taxes will be paid, just not by the company, but instead by the shareholder personally. As shown earlier with Acme as an example, the proper way to deal with this issue, instead, is usually to value the S corporation as if it were a C corporation, tax affecting the earnings as if C corporation taxes were paid. Then, the incremental additional benefits associated with Acme's actual S corporation status are quantified (using a model such as SEAM) and applied to the value to arrive at as if S corporation value.

Case Opinions Show Judges Get It. Cases have moved beyond the U.S. Tax Court realm and into dissenting shareholder and family law cases across the country. These cases focus on the need to consider the incremental additional impacts on value of S corporation shares that may arise as of result of the additional economic benefits. Examples include the following:

- **Dissenting Shareholder Case-** *Delaware Open MRI Radiology Assocs. v. Kessler, 898 A.2d 290, 327 (Del. Ct. Ch. 2006)*

- **Family Law-** *Bernier v. Bernier (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. [2] 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)*."

S Corporation Premium for a C Corporation? It is common to see C corporation professional practices (medical, dental, etc.) where, although they are legally C corporations as to tax status, produce economic benefits to shareholders as if they were like S corporations. It might be possible that these situations warrant an S corporation premium, particularly in the context of a valuation for equitable distribution. An example will make this clear.

In many (and perhaps most) C corporation professional practices the shareholder professionals (e.g., physicians) take out all of the profit in the form of compensation expense, such that the bottom line leaves little or no practice earnings subject to C corporation taxation, by design. Hence:

- The practice pays no C corporation taxes, like an S corporation.
- There are no taxes on dividends to the individual since everything is taken out as compensation and taxed only once at the personal rate of the shareholder. Note that professional practices can legitimately do this, but not the shareholder in a regular operating C corporation. Outside of the professional practice realm, though, if an operating C corporation shareholder takes all of the earnings out in the form of officer compensation, leaving no taxable income at the bottom line, the corporation is exposed to IRS attack for paying unreasonably high compensation, i.e., that part of the compensation is really a disguised dividend that requires taxation at the personal level, and that the taxable earnings at the C corporation level need to be increased accordingly and taxed at C corporation tax rates.
- There is no build-up in retained earnings in the practice that would create additional basis that would reduce capital gains taxes in a later sale of the shareholder's shares as with an S corporation because all the "earnings" are eliminated through compensation expense. In S corporation professional practices, it also the case that there is often little or no buildup in basis over time since nearly all retained earnings are taken out in the form of compensation expense or by distributions also.
- As a consequence of the above, the professional practice C corporation shareholder ends up only paying personal taxes on his or her compensation. Hence, there is no C corporation double taxation.

In short, while technically being C corporations, the benefits received by the shareholders in many professional practice situations are in fact like those of S corporations. Therefore, the valuation of a professional practitioner's shares might in fact need to consider a quantification of these additional benefits similar to the S corporation valuation as in Acme. When the view shifts to viewing the benefit from the standpoint of the shareholder the need for an adjustment becomes apparent.

It can be the case when an entire professional practice is later sold that the buyer will not want to buy stock, but will instead purchase assets to avoid buying known and unknown liabilities. In this circumstance it may well be true that double taxation of the sales proceeds in a C corporation professional practice could arise–first at the corporate level, and then when the proceeds are paid out to shareholders. In this situation the C corporation practice shareholder may not be in the same advantageous boat as an S corporation.

The Divorcing Professional in Equitable Distribution. However, ponder a common circumstance in which professional practice valuations typically arise–divorces and buy-ins and buy-outs by entering and departing shareholders, situations where a whole practice sale may be unlikely and unplanned. In valuing the shares of a single shareholder in a multi-owner practice there is often no practice sale planned or likely. The medical practice may have been in existence for 30 years, with shareholder physicians coming and going over time–starting their careers, practicing many years, then later retiring, only to be replaced other new physicians on the same life-cycle.

When the physician joins the practice he or she buys-in by purchasing shares, and then sells those same shares back to the practice upon retiring, being fired, moving, etc. Hence, the practice has a long history of reinventing itself with new physician shareholders and no sale of the entire practice is likely or planned that could lead to double taxation of sales proceeds in an asset transaction. Furthermore, in the context of equitable distribution no actual sale of the practice is occurring, but instead the fair market value is being determined for the specific shareholder's shares. If it is unlikely that the practice will be sold and all C corporation earnings are continually eliminated through compensation expense, then the shareholder physician benefits as if his or her shares were like those of an S corporation. Therefore, after considering all of the relevant facts, the valuation might indeed need to take this additional economic benefit into account.

Obviously, the facts and circumstances of a unique valuation may result in a different picture than the one previously outlined. However, to fail to consider the need for an adjustment could result in an undervaluation of the shares.

The Bottom Line for Attorneys. Most business valuators are well aware of the S corporation issue, although some still fail to deal with it in valuation reports, or when doing so perform the analysis incorrectly. Meanwhile, many family law, litigation and tax and estate planning attorneys have yet to become aware of or grasp the significance of this issue, placing their clients and the result values at peril if they are unprepared. The bottom line for attorneys who must deal with valuation issues is as follows:

- The S corporation (and LLC) valuation issue is here- you can't avoid it.
- Become familiar with the subject or else.
- Hire valuation experts that know how to deal with it or else.
- In reviewing valuations of your own and other valuation experts make sure this issue is dealt with correctly. Do not simply assume your valuator knows what he or she is doing.
- Don't be caught off guard on an issue that has a potentially huge impact on value.

Obviously every company is unique, so the treatment of the S corporation issue is not necessarily a "one size fits all" application of models such as SEAM, DiGabriele, or others. The valuator will need to decide the appropriate treatment of the S corporation issue in light of all relevant facts and factors at work in the specific company and interest being valued. ♦

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[2] DiGrabriele, James, "The Moderating Effects of Acquisition Premiums in Private Corporations: An Empirical Investigation of Relative S Corporation and C Corporation Valuations," (May 29, 2007), *Social Science Research Network.*