

## **S CORPORATIONS: TO TAX OR NOT TO TAX?** **by Gary R. Trugman CPA/ABV, MCBA, ASA, MVS**

Flow through entities come in many shapes and sizes, whether an S Corporation, Limited Liability Company, Partnership, etc. This paper will primarily focus on S Corporations, but the same economic theory can be applied to the other flow through entities as well. This paper is not intended to cover everything that you need to know about valuing these types of entities because this subject would take up a book, not just a paper. In fact, Nancy Fannon wrote a book on this topic entitled *Fannon's Guide to the Valuation of Subchapter S Corporations*, published by Business Valuation Resources, LLC. It was just recently published late last year.

Over the past few years, several Tax Court cases were decided that significantly changed the landscape of how S Corporations are valued. These Tax Court cases have now also had an influence on non-tax cases as well. Without going into a lot of detail about each of the Tax Court cases, here is a quick snapshot of the problem:

- *Gross v. Commissioner*, T.C. Memo. 1999-254, affd. 272 F.3d 333 (6<sup>th</sup> Cir. 2001). In this case, the taxpayer's expert argued that the S corporation earnings of G&J Pepsi-Cola Bottlers, Inc. (G&J) should be tax-effected and that its C corporation equivalent earnings should be capitalized with an after-tax discount rate based on the Capital Asset Pricing Model. The expert for the Internal Revenue Service argued that G&J's earnings were after corporate taxes, particularly since an S corporation does not pay any taxes, and before personal taxes of the shareholders. Consequently, according to this expert, the appropriate discount rate applicable to the S corporation's earnings was an after-tax discount rate. The Court agreed with this argument in its written opinion. The valuation subject consisted of small, minority interests of G&J.
- *Wall v. Commissioner*, T.C. Memo 2001-75, March 27, 2001. This case involved several small gifts of S corporation stock. Both experts tax-affected the income stream in the application of the income approach, although at different rates. The Tax Court cited *Gross* and determined that the income stream should not be tax-effected.
- *Heck v. Commissioner*, T.C. Memo. 2002-34, Filed February 5, 2002. In this case, the expert for the taxpayer used a discounted cash flow method in which the pre-tax, flow through earnings of F. Korbelt & Bros., Inc. (Korbelt) were considered. The discount rate that he used was an after-tax weighted average cost of capital. The expert for the IRS used a similar discounted cash flow methodology and an after-tax weighted average cost of capital. The Court's opinion cited *Gross* on the issue of the cost of capital. The finding of The Court in this case was based on discounting the pre-tax earnings of Korbelt with an after-tax cost of capital. In this instance, a 39.6 percent minority interest was being valued.

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- *Adams v Commissioner*, T.C. Memo. 2002-80, Filed March 28, 2002. In this case, the tax-effecting issue became extremely important. In this case, the taxpayer's expert, rather than proposing that the S corporation earnings of Waddel Sluder Adams & Co., Inc. (WSA) be tax-effected, developed an after-tax discount rate using a build-up method and converted the corresponding capitalization rate (after subtraction of expected growth) to a pre-tax capitalization rate. He deemed this discount rate applicable to the S corporation earnings of WSA. This stream of income was before corporate taxes and any distributions that may have been distributed to the shareholders to pay their personal income taxes. The IRS expert argued that an after-tax discount rate was applicable to the S corporation earnings of WSA. While this seems to be consistent with *Gross* and *Heck*, with respect to the issue of pre-tax earnings and an after tax discount rate, the appraisal subject in *Adams* was a 61.6 percent, controlling interest.
- *Dallas v. Commissioner*, T.C. Memo 2006-212, September 28, 2006. After a long hiatus in cases involving S corporations, this case hit our radar. In this case involving Dallas Group of America, Inc. (DGA), one of the issues related to the tax-affecting of the income. The first taxpayer valuation analyst tax-affected S corporation earnings using a 40% tax rate and the second taxpayer valuation analyst used a 35% tax rate. According to the Court, the testimony of the taxpayer's analysts was that they tax-affected under the assumption that DGA would lose its S corporation status after or as a result of the hypothetical sale of its stock. The Court said there was no evidence that DGA expected to lose its S corporation status. The Court also noted that DGA had a history of distributing sufficient cash for the shareholders to pay their taxes on their share of S corporation earnings and there was no evidence that this practice would change. The Court gave little weight to the taxpayer's valuation analysts' testimony. The bottom line is that The Court said, "We conclude there is insufficient evidence to establish that a hypothetical buyer and seller would tax-affect DGA's earnings and that tax-affecting DGA's earnings is not appropriate."

These cases caused an absolute uproar in the valuation community. Almost everyone thought that the Tax Court was nuts. After the dust settled, an entire new way of thinking was born. Relying on the same old theory of always tax-effecting earnings doesn't fly anymore.

However, with that being said, the above four cases could result in bad law if all valuation analysts assume that the Tax Court was correct in its rulings and that the same rules should apply to a different set of circumstances. In fact, as a result of the rulings, it would appear that an S corporation election has value. Why should it have value to the entity? This would make an S corporation worth more than an equivalent C corporation. Besides defying basic economic theory, this lacks the common sense that Revenue Ruling 59-60 suggests that we apply in the valuation process.

There have been numerous articles published over the past several years in *Business Valuation Update*, *Business Valuation Review*, *Business Appraisal Practice* and *Financial Valuation and Litigation Expert*. Furthermore, there have been an abundance of conference presentations on this topic as well. In order to save space, I am not going to repeat the information included in all of that other stuff. However, what seems to be abundantly clear is that the empirical data does not support the notion that an S Corporation sells for more than a C Corporation.<sup>1</sup>

## So Where Do We Go From Here?

Every valuation analyst faces the question of what to do about taxes when valuing an entity that has elected to be treated as an S Corporation under the Internal Revenue Code. Some analysts believe that being an S corporation adds value to the entity since it does not pay income taxes. Others believe that making an S election reduces the value of an ownership interest because of personal taxes that will be paid on profits that are allocated to the shareholder, without the benefit of receiving distributions that enable the individual to pay personal taxes when they come due. In this section, we will explore the never-ending question of, does an S election increase or decrease value?

## What Is An S Corporation?

Although this is not a treatise on income tax laws, a good place to begin a discussion about the value of an S corporation is to understand the rules regarding this type of entity. The term S corporation means a small business corporation for which an election to be taxed under Subchapter S of the Internal Revenue Code is in effect for that year.<sup>2</sup> Once made, this election remains in effect until it is revoked. To be classified as a small business corporation for purposes of Subchapter S, a corporation must meet all of the following requirements:

- The corporation must be a domestic corporation.
- It must not be an ineligible corporation.
- It must not have more than 100 shareholders.
- Only individuals, decedents' estates, estates of individuals in bankruptcy, and certain trusts may be shareholders. Partnerships, corporations, and many types of trusts may not be shareholders.
- No shareholder may be a nonresident alien.
- The corporation may have only one class of stock but different voting rights are allowed.<sup>3</sup>

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<sup>1</sup> John Phillips wrote a terrific article in *Business Valuation Update*, March 2004 summarizing several other articles including a discussion of empirical data.

<sup>2</sup> Code Sec. 1361(a)(1)

<sup>3</sup> Code Sec. 1361(b)

A corporation can elect to become an S corporation by filing the appropriate form with the Commissioner of the Internal Revenue. This election can also be revoked, voluntarily or involuntarily under certain circumstances. Once elected, a corporation will remain an S corporation until such time as a revocation takes place. One thing worth noting is that the election is free. Therefore, why would a willing buyer pay more for the S election, if he or she could elect it for free?

Keeping this discussion of the tax law simple, an S corporation is a pass-through entity. This means that the profits and losses are passed through to the shareholders, and any tax that is payable, will be paid by the shareholders, and not the corporation. The original purpose of an S election was to allow these small business corporations to be treated as if they were a partnership, while continuing to provide the shareholders with the legal protection of operating in a corporate form.

Being an S corporation provides the shareholders with certain tax benefits. These include, but are not limited to, the following:

- Not being questioned by the Internal Revenue Service about reasonable compensation for shareholder/employees.
- Not being subjected to the accumulated earnings tax if dividends are not paid to the shareholders.
- Avoids double taxation upon sale of the corporation's assets (other than those assets that may be subject to the built in gains tax—see discussion below).

While there are certain tax advantages to electing S corporation status, there are also disadvantages. The major disadvantage relates to C corporations that convert to S corporations. Any gain that the corporation recognizes within the 10 years after the election is made to convert a C corporation to an S corporation is taxed as if the asset was owned at the time of the conversion to S status. This is known as the "built in gains tax." Not only does the corporation pay tax on these items, but the shareholders will also be taxed on the income that is flowed through after corporate taxes are paid. This constitutes double taxation.

Another tax consideration relating to the S election is the shareholder's income tax basis in the corporation's stock. Whereas in a C corporation, the income tax basis is generally the purchase price of the stock, an S corporation's shareholders will constantly be adjusting the income tax basis of their shares. The S corporation's shareholders will increase their basis for all earnings reported by the company that are not distributed. A simplified basis calculation is as follows:

Original Investment	\$ 1,000
+ Profit- Year 1	500
- Distributions- Year 1	<u>( 200)</u>

Basis - End of Year 1	\$ 1,300
+ Profit - Year 2	800
- Distributions - Year 2	<u>( 400)</u>
Basis - End of Year 2	<u>\$ 1,700</u>

The tax implication of the adjusted basis is that the amount of tax that is paid by the shareholder upon the eventual sale of the corporate stock will depend on whether the sale is for a greater or lesser amount than the tax basis. While a tax basis adjustment, in and of itself, does not affect the value of the corporate stock, the shareholder's return will be affected. Investment decisions may vary depending upon the shareholders' goals relating to a particular investment. This will be discussed later.

### Valuation Issues

In the valuation of an interest in an S corporation, two main issues arise. First, do the income tax advantages of the S election create value? This gets carried one step further by raising the questions of value to whom, and how do we account for the incremental value in the valuation process? The second issue is, if we value an S corporation by comparing this entity to non-S corporation entities, what adjustments are necessary in the valuation process?

Many appraisers feel that an S corporation should be valued in the same fashion as they would value a C corporation. This is because:

1. C corporations are in substance nearly identical to S corporations.
2. S corporations may lose their S status in the future and convert to C corporations.
3. Most measures of corporate performance used in valuation models, such as growth and discount rates, are derived from C corporations; therefore, S corporations should be valued as C corporations to maintain consistency with these measures.<sup>4</sup>

According to the Internal Revenue Service,

S Corporations lend themselves readily to valuation approaches comparable to those used in valuing closely held corporations (C corporations). You need only to adjust the earnings from the business to reflect estimated

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<sup>4</sup> Simpson, William E. and Wrobel, Peter D., "Income Tax Issues in Valuing S Corporations", *CPA Expert*, Spring, 1996, American Institute of Certified Public Accountants, Jersey City, NJ.

corporate income taxes that would have been payable had the Subchapter S election not been made.<sup>5</sup> (Added for clarification).

Some appraisers believe that the tax benefits of having made an S election should increase the value of the entity. Many of the fundamental issues that affect the appraisal process must be considered, as well, for the determination of whether or not an S corporation election adds value. Some of these factors include:

- Standard of value
- Control vs. minority
- Distributing vs. non-distributing
- Holding period of the investment
- Time value of S corporation benefits

### **Standard of Value**

The standard of value in any business valuation assignment can have a significant impact on the final estimate of value. Valuing an entity that has elected S status is no different. Probably the more significant differences will arise between fair market value and investment value.

A common definition of fair market value is located in Revenue Ruling 59-60. This revenue ruling defines fair market value as

...the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts. Court decisions frequently state in addition that the hypothetical buyer and seller are assumed to be able, as well as willing, to trade and to be well informed about the property and concerning the market for such property.<sup>6</sup>

This definition of fair market value is widely used in valuation practice. Also implied in this definition is that the value is to be stated in cash or cash equivalents and that the property would have been exposed on the open market for a long enough period of time to allow the market forces to interact to establish the value.

Investment value is defined as the “value to a particular investor based on individual investment requirements, as distinguished from the concept of market value, which is

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<sup>5</sup> *IRS Valuation Guide for Income, Estate and Gift Taxes*, Commerce Clearing House

<sup>6</sup> Rev. Rul. 59-60 (1959-1 C.B. 237).

impersonal and detached.”<sup>7</sup> While this definition comes from real estate terminology, a similar application is used in business valuation. Investment value may differ from fair market value for a number of reasons. Among these reasons are:

1. Differences in estimates of future earning power.
2. Differences in perception of the degree of risk.
3. Differences in tax status.
4. Synergies with other operations owned or controlled.<sup>8</sup>

If the purpose of the valuation assignment is to determine the fair market value of a controlling interest in an S corporation for purchasing, selling, or merging the corporation, the corporation's tax structure may have little or no impact on value. If the most probable "willing buyer" is an ineligible shareholder (i.e. a C corporation), then that shareholder will not pay for income tax benefits that it cannot take advantage of. Therefore, corporate income taxes should be a part of the valuation calculations. Conversely, if the "willing buyer" can qualify for the S election, that buyer may pay for the benefits that will be received, and no corporate income taxes may be appropriate in the determination of the benefit stream to the investor.

An important component of determining fair market value is the determination of who will be the "willing buyer." This became evident in the *Estate of Samuel Newhouse*<sup>9</sup> where it was demonstrated that different classes of investors would pay different amounts under the fair market value scenario. Following this logical foundation, an appraiser must make certain assumptions about who the most likely purchaser will be. However, care must be exercised not to fall into a tax trap by identifying a specific buyer. The Tax Court has gone on record to state:

We need not identify directly who the buyer would be or even what class of investors the buyer would belong to. The "willing buyer" is supposed to be a hypothetical amalgam of potential buyers in the marketplace. Although we have, in prior opinions, identified types of hypothetical buyers, we did so only to determine which valuation approach, among several reasonable approaches, would result in the highest bid, and therefore the one most acceptable to a willing seller. The question is not so much "who" but "how."<sup>10</sup>

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<sup>7</sup> The Dictionary of Real Estate Appraisal, 3<sup>rd</sup> ed. (Chicago: Appraisal Institute, 1993).

<sup>8</sup> Shannon P. Pratt, Robert F. Reilly, and Robert P. Schweih. Valuing a Business: The Analysis and Appraisal of Closely Held Companies, 3<sup>rd</sup> ed. (New York: McGraw-Hill, 1996). pp. 25.

<sup>9</sup> *Estate of Samuel Newhouse*, 94 T.C. 193

<sup>10</sup> *Estate of Mueller v. Commissioner*, TC Memo. No. 1992-284 at 1415, 63 TCM 3027-16 (citations omitted).

The issue of who the most likely purchaser of the property will be is an essential element of the determination of the “highest price” that would be offered to a prudent seller. During periods of industry consolidation, companies are offered greater amounts (higher premiums) than they might get from “non-synergistic” buyers. If there is the expectation by the seller that his or her company will sell to one of the industry players, then it seems that fair market value warrants the valuation to be performed in this fashion. This argument can be carried one step further by stating that when an appraiser reviews market data, a determination is generally made as to who is buying up these companies. Therefore, the issue of who the willing buyer is most likely to be needs to be addressed.

For smaller appraisal subjects, this determination will be more easily made. Small businesses are frequently purchased by an individual, or a group of a few individuals, who will continue to qualify as an S corporation. For these types of businesses, the continuity of an S election appears to be a reasonable assumption. However, even small businesses may not qualify to be an S corporation if they are purchased. As the melting pot of the United States continues to grow, a large influx of nonresident aliens are entering the marketplace as possible purchasers of these businesses. It may no longer be a reasonable assumption that the S election will continue after the acquisition.

Larger corporations are even more problematic than small corporations when the appraiser must make assumptions about the willing buyer. Larger entities are more likely to be purchased by a C corporation, which would immediately negate the S election. Therefore, it may not be reasonable to assume that the target company will be able to continue in its present tax status.

### **Purpose of The Assignment**

In addition to the standard of value, the purpose of the assignment may also cause the valuation analyst to make certain assumptions. For example, if the appraisal is being performed for the determination of fair market value to be used in a matrimonial litigation, it may be considered unfair to the non-business owner spouse to make the assumption that the S election will be lost. However, since matrimonial courts are courts of equity, it may be equally unfair to the business owner not to assume taxes will be paid since they are paid at the personal level even if no distributions are made.

With that said, in *Judith E. Bernier v. Stephen A. Bernier*,<sup>11</sup> the Massachusetts Supreme Court addressed the issue of tax-effecting an S corporation. I truly commend the court for taking on this controversial issue. Following the methodology in *Delaware Open MRI*

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<sup>11</sup> *Bernier v. Bernier*, 2007 Mass. LEXIS 598 (May 7, 2007).



*Radiology Associates, P.A. v. Howard B. Kessler, et al.*<sup>12</sup>, (a case that I will discuss shortly), the court applied a methodology to determine the tax impact that I really like.

When the standard of value is investment value, consideration should be given as to whether the specific buyer will qualify as an S corporation. The specific buyer's goals regarding rates of return, or whether he or she wants current cash flow or capital appreciation must be considered when deciding on an S election. More often than not, valuations performed for transaction purposes use pre-tax earning streams, since it is the buyer's expected tax status that should be considered in place of the seller's historical tax structure.

### **Control vs. Minority**

If the business interest being appraised is a minority ownership interest--that is, the appraisal of the ownership interest not having the prerogatives of control--then a direct comparison with values of other minority interests is the most appropriate method of valuation. In essence, if the minority interest cannot effectuate a change in the company's tax structure, no such change should be assumed.

An argument could be made that a minority shareholder could, in fact, cause a change to an S election by selling the shares to a non-qualified shareholder of the S corporation. This violation of the rules regarding ownership could kill the election, therefore changing the status involuntarily. However, a valuation analyst should also consider the likeliness of the shareholders' actions. It would seem that the shareholder would have to have special motivations to intentionally kill the S election for the balance of the shareholders. These special motivations may be enough to violate the definition of fair market value.

The S election may have been made by the shareholders for reasons that have nothing to do with value. For example, an S election may be made so that the issue of reasonable compensation may be avoided upon audit by the Internal Revenue Service. Another reason for an S election may be to avoid double taxation at the time that the company is sold. For a shareholder to want to intentionally violate the S election, the company could be exposed to greater risk of loss, thus reducing its value. The prudent shareholder would not want to diminish the value of the investment. In fact, many shareholder agreements prohibit the transfer by the shareholder to an unqualified entity.

Although the minority shareholder can cause the S election to be involuntarily terminated, it does not seem logical to assume that this will occur. However, the facts and

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<sup>12</sup> *Delaware Open MRI Radiology Associates, P.A., Petitioner, v. Howard B. Kessler, et al., Respondents. and Howard B. Kessler, et al., Plaintiffs, v. George J. Broder, et al., Defendants*, in the Court of Chancery of the State of Delaware, in and for Newcastle County, Consolidated, C.A. No. 275-N.

circumstances of the situation must dictate whether or not to make such an assumption.

## **Distributing vs. Non-Distributing**

An S corporation may be favorable or unfavorable depending upon whether the corporation has the ability to distribute its earnings to its shareholders. If only some, or possibly none of the earnings can be distributed, the result can be extremely unfavorable to the investor. Let me illustrate this point by using a real example. This appears as exhibit 1. Our firm did a critique of another valuation analyst's work for a litigation. One of the many issues was that we tax-affected the earnings and he did not. This is an excerpt from our critique (names have been changed to protect the guilty!)

### **Exhibit 1 To Tax or Not To Tax- Critiquing Another's Report**

#### **Tax Affecting Earnings**

*The issue of tax affecting the earnings of S corporations or other pass-through entities such as general partnerships, limited partnerships, or limited liability companies, is a highly debated issue in business valuation. The conventional wisdom used to be that you would tax affect the earnings of a pass through entity because the willing buyer may not be able to avail itself of the non-taxable status of the seller. Appraisal theory has stated that it is essential to match the earnings stream being capitalized, when using the income approach, with the correct capitalization rate. Since publicly traded companies report their earnings on an after-tax basis, sources that compile this data for use by appraisers in determining discount and capitalization rates consider these rates to be applicable to after-tax earnings streams (or cash flow). The most widely used source in the appraisal field is data publish by Ibbotson Associates. Ibbotson data is clearly after tax at the entity level.*

*The argument first started to be raised about after-taxes to the entity in the Tax Court case Estate of Gross. I will address this shortly. It is not uncommon for an appraiser to tax affect the earnings of S corporations by applying marginal C corporation tax rates to their earnings. This is consistent with the approach employed in our reports.*

*Contrary to Mr. Smith's assertion that we reduce available cash flow by a "hypothetical" corporate income tax, this adjustment does not assume that The Companies will indeed incur a tax, but rather is a necessary adjustment when applying historical Ibbotson return data (which is presented on an after-tax basis) to the subject earnings stream. The following are additional reasons for tax affecting S corporation earnings:*

1. *The S election has no impact on the operating cash flows of the business.*

2. *The benefits of the S election are shareholder benefits and therefore capitalizing these benefits would overstate the value of the enterprise since the benefits can be taken away involuntarily if the S election is broken.*
3. *S corporations usually pass through a sufficient portion of their earnings to their shareholders to allow them to pay their taxes which leaves the S corporation in almost the same position after taxes as if it were a C corporation.*
4. *The public stock markets tend to price the earnings of publicly traded partnerships on a basis equivalent to the after tax earnings of publicly traded C corporations in the same lines of business.*
5. *Most of the likely buyers of S corporations are C corporations or groups of investors who may need to organize as C corporations. There is no apparent advantage for S corporation buyers to C corporation buyers.*
6. *Every C corporation (with eligible shareholders) would either make the S election or would have the option to convert if this was desirable. If a higher value is attainable following the S election, corporate sales of companies would reflect this value. There is no logic for the existence of two levels of corporate value for eligible entities when there are no logical or practical barriers prohibiting election to obtain the higher value.*
7. *It has been suggested that buyers will pay no more for an S corporation than an equivalent C corporation; therefore there are no S corporation premiums.*

*To address the tax treatment of pass through entities from an independent perspective, we consulted textbooks and articles written and published by some of the leading practitioners in the business valuation field. In general, well-known business valuation authorities including Shannon Pratt, Christopher Mercer, and Roger Grabowski all agree that there is no hard-and-fast rule that applies to treatment of pass-through entities in all cases. There is a general consensus among these individuals that the issue of whether or not to tax affect the earnings of a pass-through entity is one that must be addressed on a case-by-case basis.*

*This debate has also been highlighted in four recent Tax Court Cases:*

1. *Gross v. Commissioner, T.C. Memo. 1999-254, affd. 272 F.3d 333 (6<sup>th</sup> Cir. 2001)*
2. *Wall v. Commissioner, T.C. Memo. 2001-75, filed March 27, 2001*
3. *Heck v. Commissioner, T.C. Memo. 2002-34, filed Feb. 5, 2002*
4. *Adams v. Commissioner, T.C. Memo. 2002-80, filed March 28, 2002*

*In all four of these cases, the Court ultimately determined that it was appropriate to capitalize S corporation earnings using an after tax rate. In each case, the valuation*

conclusion was reached without tax-affecting earnings, which is consistent with Mr. Smith's approach.

However, in response to the Tax Court rulings, Christopher Mercer argues that in *Gross, Heck and Adams*, "The Tax Court has rendered opinions based on unsound economic and financial theory." Mercer, with agreement from Dr. Shannon Pratt, concludes that:

- *S corporations are worth the same as otherwise identical C corporations at the level of the enterprise. Their operating cash flows are identical, and there is no rationale that suggests that their enterprise values should be anything but identical.*
- *Interests in S corporations may be worth more or less than otherwise identical interests in otherwise identical C corporations. The cash flows to shareholders may be different between S and C corporations, and these differences, considered in the context of the riskiness of their receipt, can create differences in value.*

*In determining the appropriate discount rate for capitalizing pretax earnings, an analogous situation may be drawn to municipal bonds. Yields on municipal bonds are significantly lower than yields on taxable bonds. This is due to the favorable tax treatment received by investors holding municipal bonds (i.e. no federal taxes and in some cases no state or municipal taxes). In order to convert the yield on a municipal bond to its taxable equivalent for comparison purposes, analysts divide the tax-free yield by  $(1 - \text{tax rate})$ , where the tax rate is the investor's effective personal rate for both state and federal taxes. The term  $(1 - \text{tax rate})$  is simply the factor used to convert pretax dollars to after-tax dollars.*

*Upon issuance, both municipal bonds and taxable bonds are issued at par value. Thus, the trading price (or par value) of a municipal bond is a function of its tax-free yield, as investors discount the present value of future cash flows at the tax-free rate. In essence, the investment community prices municipal bonds as if taxes have been prepaid on interest and principal payments received by investors. Thus, if a business is valued using pretax earnings as the applied earnings measure rather than after-tax earnings, then an additional adjustment is also necessary to the discount or capitalization rate. Accordingly, the future cash flows of the business should be discounted or capitalized at a pretax rate, which is calculated by dividing the after-tax discount rate by  $(1 - \text{tax rate})$ . Mr. Smith does not make any such adjustment.*

*In addressing the issue of taxation in light of recent tax legislation, we conducted our own analysis of the differences between holding stock in The Companies under a tax-affecting scenario (C corporation assumption) versus the current pass-through taxation of the entities. The argument against tax-affecting the earnings of an S corporation or other pass-through entity is predicated upon the belief that the shareholder of an otherwise identical C corporation is burdened by "double-layer" taxation at both the entity and the shareholder levels. Mr. Smith claims that since The ABC Organization will end up owning The Companies, the S Corporation assumption should be continued into the future. The*

*argument, here, is that although The ABC Organization may be an S Corporation, there is no guarantee that it will ultimately be sold to a buyer that can qualify as an S Corporation, and therefore it is a flawed assumption to think that a buyer will pay for a benefit that it will not realize.*

*Another argument, going forward, pursuant to the Jobs and Growth Tax Relief Reconciliation Act of 2003, effective January 1, 2003, dividend income to C corporation shareholders is taxed at the same rate as capital gains (for a maximum rate of 15 percent), while shareholders in pass-through entities continue to be taxed at personal tax rates on S corporation earnings.<sup>13</sup>, thus minimizing differences in tax liabilities at the shareholder level regardless of the level of earnings distributed to shareholders. Although this reduction was not in effect as of the valuation date in this case, given the ongoing litigation associated with this assignment and the anticipated transfer of ownership interests in The Companies, we believe this factor is particularly relevant.*

*For each company, we incorporated the recent decline in dividend tax rates, and examined the cash flows available to a shareholder or member under the two scenarios. For taxable income, we used the adjusted income from our reports before taxes, while the assumed payout ratio of distributions is based on actual distribution levels for each entity.*

*The importance of this calculation is that distributions make a big difference in determining the difference in value of these two types of entities. In this case, the level of indebtedness, and the need for reinvestment into new assets, does not enable the shareholders to receive significant distributions. It is important to note that in the Estate of Gross, distributions to shareholders were at about 100 percent.*

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Anthony J. DeChellis, CPA, CFP® and Sheila Owen, CPA, "A Closer Look at Qualified Dividends under the 2003 Act," PPC National Tax Advisory®, September 9, 2003.

**Company One, Inc.**  
**Comparison of Tax Scenarios**

	<b>C Corporation</b>		<b>S Corporation</b>	
<i>Debt Free Pre-Tax Income</i>		84,166		84,166
<i>Corporate Income Tax</i>	26%	<u>(21,866)</u>		<u>0</u>
<i>Net Income Available to Shareholders</i>		62,300		84,166
<i>Less: Addition to Retained Earnings</i>		<u>(62,300)</u>		<u>(62,300)</u>
<i>Distributions</i>	0%	0	26%	21,866
<i>Less: Personal Taxes</i>	15%	0	40%	<u>(33,666)</u>
<i>Net Cash Flow to Shareholders</i>		<u><u>0</u></u>		<u><u>(11,800)</u></u>
<b>Net Disadvantage to Company One Shareholders</b>				<b>(11,800)</b>

**Company Two, LLC**  
**Comparison of Tax Scenarios**

	<b>C Corporation</b>		<b>S Corporation</b>	
<i>Debt Free Pre-Tax Income</i>		73,046		73,046
<i>Corporate Income Tax</i>	25%	<u>(18,192)</u>		<u>0</u>
<i>Net Income Available to Members</i>		54,854		73,046
<i>Less: Addition to Retained Earnings</i>		<u>0</u>		<u>0</u>
<i>Distributions</i>	100%	54,854	100%	73,046
<i>Less: Personal Taxes</i>	15%	<u>(8,228)</u>	40%	<u>(29,218)</u>
<i>Net Cash Flow to Members</i>		<u><u>46,626</u></u>		<u><u>43,828</u></u>
<b>Net Disadvantage to Company Two's Members</b>				<b>(2,798)</b>

**Company Three, LLC  
Comparison of Tax Scenarios**

	<b>C Corporation</b>		<b>S Corporation</b>	
Debt Free Pre-Tax Income		244,353		244,353
Corporate Income Tax	38%	(91,963)		0
Net Income Available to Members		152,390		244,353
Less: Addition to Retained Earnings		0		0
Distributions	100%	152,390	100%	244,353
Less: Personal Taxes	15%	(22,859)	40%	(97,741)
Net Cash Flow to Members		129,532		146,612
<b>Net Advantage to Company Three's Members</b>				<b>17,080</b>

**Company Four, LLC  
Comparison of Tax Scenarios**

	<b>C Corporation</b>		<b>S Corporation</b>	
Debt Free Pre-Tax Income		68,813		68,813
Corporate Income Tax	24%	(16,848)		0
Net Income Available to Members		51,965		68,813
Less: Addition to Retained Earnings		0		0
Distributions	100%	51,965	100%	68,813
Less: Personal Taxes	15%	(7,795)	40%	(27,525)
Net Cash Flow to Members		44,170		41,288
<b>Net Disadvantage to Company Four's Members</b>				<b>(2,882)</b>

As shown, in three out of the four scenarios, the shareholders actually would receive less cash assuming that the company was not taxed at the entity level. By tax affecting the earnings of The Companies, cash flow to owners is not reduced on an aggregate basis.

*In fact, cash flow to owners is higher after tax affecting earnings. Mr. Smith fails to consider this in his analysis by ignoring the impact of personal taxes on the shareholders and by ignoring the recent reduction in tax rates on C corporation dividends, which has seriously weakened the argument that double-layer taxation is a detriment to C corporation shareholders.*

In the above example, the analyst on the other side of the case thought that by not tax-affecting the earnings, he could support a higher value for his clients. By the way, the difference in our valuations due to the taxes was \$14 million.

It is readily accepted that an investor in common stock of any corporation makes an economic investment for three reasons. They are:

- 1) Immediate cash flow (dividends),
- 2) Future cash flow (capital appreciation), and
- 3) A combination of 1 and 2 above.

The total expected return to the shareholder consists of a part that is currently taxable, and a part that is tax deferred until the time of sale. Under the current tax law, the deferred portion may be subject to favorable capital gains tax rates. Although the discount rate used in the application of a discounting model ignores personal tax rates, the investor does not.

If the shareholders have control of the company, they will generally do everything possible to insure that distributions are made in sufficient amounts to cover personal taxes. They do not want to reach into their own pockets to pay taxes on profits that they did not receive. However, shareholders of a C corporation will usually take the opposite position, as they generally want to avoid paying tax on dividend distributions. However, the new tax law favors the tax treatment of dividends out of a C Corporation over the distributions from an S Corporation.

Since shareholders of an S corporation will frequently attempt to pass through dividends to themselves in an amount at least equal to the estimated tax obligation, the actual dividend distributions may appear to be attractive. This could give the appearance of a company that is a "great" dividend payer. It makes the investment appear as if it has excellent liquidity. The opposite is true with the shareholders of a C corporation. They will generally do everything possible to avoid dividends. This would give the appearance of an investment with far less liquidity. This contrasting position of the shareholders makes dividend paying capacity a more attractive manner in which to assess value.



David C. Dufendach raises an interesting point about these returns.<sup>14</sup> He states:

Research has shown that the slope of the actual security market line is less than predicted by the CAPM.<sup>15</sup> Riskier stocks have lower required returns than predicted, whereas less risky stocks suffer from higher required returns. One possible explanation is that riskier stocks provide relatively more of their return in the form of non-taxable price appreciation. One study suggests that this is the case.<sup>16</sup> If true, then investors who wish to avoid current tax liability on dividend income would prefer higher risk/lower dividend stocks, driving down their required return below that predicted by the CAPM. Another study supported this view, implying that dividends are undesirable (presumably because of their immediate taxability), and that stocks with higher dividends are penalized in the form of higher required returns.<sup>17</sup>

The various studies cited by Dufendach lead to the conclusion that given all other risk factors being equal, a stock that pays a dividend, causing an immediate tax consequence, is worth less than a stock that provides capital appreciation, which is tax deferred and then possibly taxed at more favorable rates. The factor that causes the difference in value is apparently personal taxes. Since we accept the premise that a prudent investor considers personal income taxes in investment decisions (otherwise, if all else were equal, why would anyone buy tax free bonds?), we should not ignore the personal tax effect of the investment. The difficulty is determining which tax rates to use.

### **Corporate or Personal Income Tax Rates**

One of the difficulties that faces the appraiser is the determination of which set of income taxes is appropriate to use in valuing the S corporation. This will most likely depend on the standard of value. However, this can be more trouble than its worth.

If the standard of value is fair market value, the appropriate income tax rates should be those rates that will be applicable in the hands of the willing buyer. The problem is that we

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<sup>14</sup> Dufendach, David C., "Valuation of Closely Held Corporations: 'C' v. 'S' Differentials", *Business Valuation Review*, December 1996, page 176-179, American Society of Appraisers, Herndon, Va.

<sup>15</sup> Brigham, Eugene F. and Louis C. Gapenski, *Financial Management: Theory and Practice*, Sixth Edition, pp. 156-157.

<sup>16</sup> Copeland, Thomas E. and J. Fred Weston, *Financial Theory and Corporate Policy*, Second Edition, p. 513. Refers to a study by I. Friend and M. Puckett, "Dividends and Stock Prices," *American Economic Review*, September 1964, pp. 656-682.

<sup>17</sup> Ibid, pp. 515-6. Refers to a study by R. Litzemberger and K. Ramaswamy, "The Effect of Personal Taxes and Dividends on Capital Asset Prices: Theory and Empirical Evidence," *Journal of Financial Economics*, June 1979, pp. 163-196.

do not know who that specific buyer will be. Will it be an individual, another S corporation or a C corporation? Once again, there is no distinct answer. Depending upon the facts and circumstances, the appraiser may be able to make an assumption about the most probable willing buyer (or category of buyer).

If the standard of value is investment value, the appraiser should consider the tax rates of the specific buyer. In this instance, the appraiser is estimating value to a particular buyer. This makes this task a little bit easier.

Once the standard of value has been identified, the appraiser is still faced with the choice of which rates to use. If corporate tax rates are used, the valuation analyst, with or without the help of the local CPA, can calculate the taxes based on the sliding rates applicable at the time. However, if personal rates are to be used, this calculation can become even more complicated due to factors such as personal exemptions, itemized deductions, phaseout rules and other income or losses from unrelated activities that could affect the income tax rates that may be applicable. This could be a nightmare.

The practical application of income tax rates is up to the valuation analyst. If the rates can be calculated in a relatively straight forward manner, the analyst should do so. If personal tax rates are involved, most analysts believe that there is little to be gained by factoring in personal exemptions and itemized deductions. If the valuation analyst represents a specific individual, these items may be taken into consideration if they are material. Common sense and reasonableness should prevail.

### **Holding Period of the Investment**

Many valuation analysts feel that both S and C corporations should be valued on an after-tax basis. Many subscribe to the premise that the "after-tax" is to the corporation and not the individual. Since capitalization rates are determined from market evidence, usually on a pre-tax basis to the individual, more comparability can be achieved in the selection of these rates. Adjusting the income returns for personal taxes would make the discount rate selection more difficult, particularly since rates of return reported in the empirical literature are based on pre-tax returns to the investor.

Some analysts adjust the benefit stream of an S corporation for the amount of distribution needed to make the shareholders whole after paying the personal taxes. It is fairly common to see distributions being made in at least the amount necessary to pay the personal taxes so that the shareholders do not pay taxes from monies that they have not received. The problem with this approach is that the tax law provides that the shareholders of an S corporation can increase their income tax basis in the S corporation for monies that are taxed and not distributed. Therefore, comparability cannot truly be achieved between the S corporation shareholders and the C corporation shareholders.

Another consideration related to this is that S corporation shareholders are permitted to take subsequent distributions from the S corporation without current tax implications.

Shareholders' undistributed taxable income from previous years is available for distribution since the shareholders have already paid tax on the profits in the year that it was earned. This also causes a significant difference in the timing of the cash flows between the shareholders of these different types of entities.

An argument can be made that the difference between a perpetual S corporation and a C corporation is the present value of the annual corporate tax savings. The analyst must face the question in each appraisal assignment regarding an S corporation of what the holding period of the investment will be while the corporation keeps its S election. Some authors believe that a corporation will lose its S election at some point.<sup>18</sup> This means that the interest in the corporation being valued will be an S corporation for certain years and then a C corporation for its remaining life.

When a valuation analyst is requested to determine the fair market value of an enterprise, one of the factors to be determined by the analyst is who, or what group of investors, would be the most likely "willing buyer." Another factor to be considered in the "willing buyer" scenario is will the willing buyer qualify to be an S corporation. Once it is determined that the willing buyer can be an S corporation, the next question to be answered is for how long? As with many other decisions confronting the valuation analyst, there is no clear cut answer.

### **Timing of the Valuation**

Conventional wisdom dictates that when a business valuation is performed for an interest in a corporation, the value determined is based on the value of the interest without regard to the investor. This means that when we value shares of stock in a corporation, it does not matter who the shareholder is, nor do we consider the tax implications of a sale of the interest by that shareholder. Personal taxes generally have no impact in the valuation of corporate stock (assuming that the shareholder is an individual). Obviously, not all shareholders are individuals, and not all shareholders are tax paying entities. Pension plans, for example, do not pay taxes. Therefore, should the value of a share of IBM be different if an individual owns it or if a pension plan owns it?

At this point, we have come almost full circle in our discussion about willing buyers. The investing public calculates rates of return on an after-tax basis. Since different classes of investors have different tax structures, the required rates of return will vary among the classes. In determining an appropriate discount rate for the net cash flow of an S corporation versus a C corporation, it is reasonable to assume that there is an increased risk relative to the net cash flow of the S corporation that the enterprise may at some point

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Duffy, Robert E. and George L. Johnson, "Valuation of 'S' Corporations Revisited: The Impact of the Life of an 'S' Election Under Varying Growth and Discount Rates", *Business Valuation Review*, December 1993, pp. 155-167, American Society of Appraisers, Herndon, Va.

in time pay taxes and have a lower cash flow. This could be justification for a different discount rate for the two entities. The question to be raised is, by how much?

Without empirical data in the marketplace, it becomes difficult, if not impossible, to quantify the exact level of adjustment. Mathematical quantification cannot be used as readily as it is for the conversion of pre-tax and after-tax discount rates. Valuation analysts continue to struggle with the notion of whether the corporate cash flows from an S corporation are after tax. Authors have argued that there should be a tax equivalency made to reflect the personal taxes that will have to be paid by S corporation shareholders.<sup>19</sup> The reality of the situation is that personal taxes will be paid whether or not distributions are made to the shareholder. It seems reasonable to consider these taxes in a similar fashion as corporate taxes. Either way, the government is going to get paid. There is not going to be a benefit to the shareholder other than as an adjustment to his or her basis in the corporate stock.

Arguments have been raised for years regarding the built in gains tax. For a long time, the position of the Tax Court has been that no discount would be permitted for a built in gains tax, even though investors in the real world consider them in making investment decisions. In the *Estate of Artemus D. Davis v. Commissioner*,<sup>20</sup> part of the discount for lack of marketability was attributed to the built in gains tax. This could influence future valuations of S corporations, particularly those that have exposure to the built in gains tax in the post-conversion period. This raises the issue of the S election having a possible discount associated with it because of the taxes that potentially could be paid at the corporate level.

Valuation in the hands of the owner of the investment in an S corporation may result in a more realistic valuation. However, that is clearly not fair market value. Personal tax rates may vary depending upon too many factors that have nothing to do with the investment. A valuation analyst cannot be expected to consider items such as personal exemptions and itemized deductions. Certainly, the smaller S corporations can be affected by these items. Larger S corporations may not be influenced by these items because the shareholders are more likely to be in higher tax brackets where these items do not matter. Does these mean that valuation analysts should have two standards, one for small companies and one for large companies?

## Back To The Future

Now that we have gone through numerous illustrations that tell us to look at the facts and circumstances of each situation on its own, let's step back to where the Tax Court has taken us and where the future needs to be. In *Adams*, The Court stated "The net cashflow and the capitalization rate used to compute the fair market value of the WSA stock should

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<sup>19</sup> See Cassiere, George G., "The Value of S-Corp Election – The C-Corp Equivalency Model", *Business Valuation Review*, June 1994, pp 84 -91, American Society of Appraisers, Herndon, VA.

<sup>20</sup> *Estate of Artemus D. Davis v. Commissioner*, 110 T.C. 35

have the same tax character; i.e., before corporate tax or after corporate tax."<sup>21</sup> The opinion stated:

We disagree that Shriner (the taxpayer's expert) properly converted the capitalization rate because there was no need to do so. The parties agree that Shriner's estimated capitalization rate (before he converted it to before corporate tax) is an after tax corporate tax rate. Thus, as in Gross, the tax character of Shriner's estimate of WSA's prospective net cashflows matches that of the unconverted capitalization rate because both are after corporate tax. It follows that Shriner should not have converted the capitalization rate from after corporate tax to before corporate tax because the tax character of both his estimated net cashflows for WSA and unconverted capitalization rates is after corporate tax.<sup>22</sup>

Every valuation treatise or course that I have ever read discusses the importance of properly matching the benefit stream with the discount or capitalization rate. In fact, I will discuss this very fact my text, *Understanding Business Valuation*. The reason for this, simply stated is for consistency. If the numerator is changed in a capitalization model, the denominator must also change in order to maintain the same value. Clearly, the value does not change as a result of using a different benefit stream to be capitalized.

The Tax Court has now taken the position through these opinions that while they are not disputing our theory, they find that the benefit stream of an S corporation is higher than the benefit stream of a similar C corporation due to the non payment of taxes at the entity level. Since we are attempting to reach an economic value, shouldn't we consider all economic activities that impact value? In almost every case, S corporations distribute at least enough of their earnings so that their shareholders can pay their taxes based on the amount of profits that flow through to the shareholders. This can almost be thought of as entity-related taxes. Therefore, if S corporations did not distribute cashflow to pay individual income taxes, the shareholders would most likely revoke the S election, assuming that they had the ability to do so.

If you have learned anything as a result of reading this paper, it is probably that the question of an S election adding a premium or a discount to the value of an investment does not have an easy answer. While there appears to be a possible benefit if the willing buyer can continue the S election into the future, there is no guarantee that this will happen. Consideration should be given to all of the factors that influence value in making a determination. The premium or discount issue must be examined on a case by case basis because there is no other way to do it. In many instances, the increase or decrease in value will be based on the manner in which the benefit stream is taxed.

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<sup>21</sup> Adams, p. 13.

<sup>22</sup> Ibid., pp. 14-15.

## S Corporation Models

Over the past several years, various S corporation models have surfaced. The purpose of these models is to calculate the tax differential relating to the S corporation. Valuation analysts seem to agree that there is little or no difference in the market values of controlling interests between S and C corporations under most circumstances. If there is a difference in the values, it depends on finding a buyer that can take advantage of the potential tax savings. However, the valuation community also seems to agree that there may be differences in value at the shareholder level for noncontrolling interests. All of the models appear to have been constructed to address the valuation of noncontrolling shareholder interests in S corporations.

The four models that I have seen include those that were designed by Roger Grabowski, Chris Mercer, Dan Van Vleet, and Chris Treharne. I cannot possibly cover all of these models in the detail that they deserve. Each is solid in its quest to determine the tax impact of an S election. Some are much more complicated than others. Various articles and chapters in books discuss these models in detail. However, this discussion is beyond the scope of this paper.

However, with that being said, the model that I like the most, probably because it is the most simple, is Chris Treharne's model. I used that model in the critique that was included in Exhibit 1. It was also the model that was referenced in *Delaware Open MRI Radiology Associates*. The judge in that case did a fabulous job in explaining what he did. I have excerpted a portion of that opinion for you in Exhibit 2.

The only complaint that I have heard other analysts make about the Treharne model is that it does not take into consideration the potential value that is attributable to the reduced taxes that the shareholder will pay due to the build up in the tax basis of the stock. My attitude about that is, does it really matter when the underlying assumption is that the willing buyer has a long term horizon for the investment. The present value of the tax savings 20 or 30 years from now will be relatively small. I really do not believe that this is a major concern, but who am I to decide that?

The two things that jump out at me about the S corporation issue is that distributions make a world of difference as to whether or not there is a shareholder benefit in an S corporation and the change in the tax law in 2003 brought the rates so much closer that there is no longer as much of a difference as there was when the *Gross* decision was issued.

## Exhibit 2

### Delaware Open MRI Radiology Associates, P.A. v. Howard B. Kessler, et al.<sup>23</sup>,

*The issue was should we tax the S Corp. earnings, and by what rate? Sound familiar? In The Court's opinion, Chancellor Strine addressed the issue of "Is It Appropriate To Tax Affect The Earnings Of Delaware Radiology In Order To Determine Its Fair Value?"*

*The expert on one side of this litigation treated Delaware Radiology as if it were a regular tax-paying entity (a C corporation) when he performed the valuation that the Broder Group used to set the merger price. In fact, he applied a 40 percent tax rate. Not to be surprised, the expert on the other side asserted the proposition that because Delaware Radiology was an S corporation, it faced no corporate-level income taxes. Relying on this as Delaware Radiology's operative reality, the expert did not tax affect its earnings in performing his valuation. Any taxes, he reasoned, would be paid at the stockholder level and should not be considered in valuing Delaware Radiology as an entity.*

#### Chancellor Strine opined

*This dispute raises an interesting question of valuation, which has elicited a fair amount of attention from judges, appraisers, and academics.<sup>24</sup> After careful consideration, I conclude that neither of the experts has taken the most reasonable approach to valuing Delaware Radiology.*

*The problem with Reed's approach of treating Delaware Radiology as a C corporation is obvious. Delaware Radiology is a very small entity. The record reveals no set of circumstances in which it is likely that Delaware Radiology will convert to C corporation status. It is a highly profitable entity that generates and distributes income well in excess of the stockholder level taxes its stockholders must pay. The S corporation tax status is a highly valuable attribute to the shareholders of Delaware Radiology, given its*

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<sup>23</sup> *Delaware Open MRI Radiology Associates, P.A., Petitioner, v. Howard B. Kessler, et al., Respondents. and Howard B. Kessler, et al., Plaintiffs, v. George J. Broder, et al., Defendants*, in the Court of Chancery of the State of Delaware, in and for Newcastle County, Consolidated, C.A. No. 275-N.

<sup>24</sup> See, e.g., *In re Radiology Assocs.*, 611 A.2d 485 (Del. Ch. 1991); *Adams v. Commissioner of Internal Revenue*, 2002 WL 467235 (U.S. Tax Ct. Mar. 28, 2002); *Heck v. Commissioner of Internal Revenue*, 2002 WL 180879 (U.S. Tax Ct. Feb. 5, 2002); *Gross v. Commissioner of Internal Revenue*, 1999 WL 549463 (U.S. Tax Ct. July 29, 1999); Franklin M. Fisher et. al., *The Sale of the Washington Redskins: Discounted Cash Flow Valuation of S-Corporations, Treatment of Personal Taxes, and Implications for Litigation*, 10 Stan. J.L. Bus. & Fin. 18 (2005) (hereinafter "Fisher"); Z. Christopher Mercer, *S Corporation Valuation Issues*, The American Society of Appraiser's 22nd Annual Business Valuation Conference (Oct. 17, 2003) (hereinafter "Mercer").

*profitability and the affluent status of its physician stockholders, who face top marginal tax rates.*

*This starts to sound like the facts in the Gross case from the tax court. The Court indicated that*

*Under Delaware law, an appraisal petitioner is “entitled to be paid for that which has been taken from him . . . .”<sup>25</sup> In this case, the Kessler Group was involuntarily deprived of the benefits of continuing as stockholders in a profitable S corporation benefits that were comprised materially of the favorable tax treatment that accompanies S corporation status. As a matter of fairness, the merger price had to take into account these benefits and provide fair compensation for the Kessler Group’s loss. Reed’s approach denied the Kessler Group members the value they would have received as continuing S corporation stockholders in Delaware Radiology and, therefore, ensured that the merger price was lower than fair value.*

*At the same time, Mitchell’s approach is equally flawed and overstates the value fairly belonging to the Kessler Group. The value of the S corporation structure is one that is experienced at the stockholder level and that is easy to overstate. If an S corporation is to be sold, for example, it will receive no premium over a C corporation if the universe of buyers is principally comprised of C corporations.<sup>26</sup> There is an obvious reason for this: unless the buyer of the S corporation can retain and benefit from that tax status, then the buyer will value an S corporation at the value it would have as a C corporation. Therefore, it would be highly misleading to do a market-based comparable acquisition valuation of an S corporation using sales of comparable C corporations to C corporations, and then assume that the S corporation would be sold at a higher price because of its tax status. In other words, I am not trying to quantify the value at which Delaware Radiology would sell to a C corporation; I am trying to quantify the value of Delaware Radiology as a going concern with an S corporation structure and award the Kessler Group their pro rata share of that value.*

*In this case, then, the more relevant problem with Mitchell’s approach is that his failure to tax affect Delaware Radiology’s earnings at all results in an artificial inflation of the value of S corporation status to the Kessler Group. To capture the precise advantage of the S corporation structure to the Kessler Group, it is necessary to use a method that considers the difference between the value that a stockholder of Delaware Radiology would receive in*

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<sup>25</sup> *Tri-Continental Corp. v. Batty*, 74 A.2d 71, 72 (Del. 1950).

<sup>26</sup> See *Mercer* 9-14.



*Delaware Radiology as a C corporation and the value that a stockholder would receive in Delaware Radiology as an S corporation. By using that method, I can make my best estimate of the value that is relevant in this case — the going concern value in an S corporation that was taken from the Kessler Group in the merger.*

*In undertaking this analysis, I embrace the reasoning of prior decisional law that has recognized that an S corporation structure can produce a material increase in economic value for a stockholder and should be given weight in a proper valuation of the stockholder's interest.<sup>27</sup> That reasoning undergirds not only holdings of the Adams, Heck, and Gross cases in the U.S. Tax Court, but an appraisal decision of this court, which coincidentally also involved a radiology business.<sup>28</sup> The opinion in *In re Radiology Associates* noted that "under an earnings valuation analysis, what is important to an investor is what the investor ultimately can keep in his pocket."<sup>29</sup> In that case, on the record before it, the court held that the way to implement that insight was to ignore tax completely.<sup>30</sup> The *In Re Radiology Associates* decision comported with decisions of the U.S. Tax Court, which has given life to the advantages of S corporation status by refusing to tax affect the corporation's earnings at all.<sup>31</sup>*

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

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<sup>27</sup> See *Adams*, 2002 WL 467235; *Heck*, 2002 WL 180879; *Gross*, 1999 WL 549463.

<sup>28</sup> *In re Radiology Assocs.*, 611 A.2d at 495.

<sup>29</sup> *Id.*

<sup>30</sup> *Id.*

<sup>31</sup> In this regard, the case of *Gross v. Commissioner* is a good example. In *Gross*, the Tax Court held that "[w]e believe that the principal benefit that shareholders expect from an S corporation election is a reduction in the total tax burden imposed on the enterprise. The owners expect to save money, and we see no reason why that savings ought to be ignored as a matter of course in valuing the S corporation." *Gross*, 1999 WL 549463 (page reference unavailable on WL). The Tax Court refused to allow a "hypothetical corporate tax rate in excess of the zero-percent actual corporate tax rate" to be considered in valuing an S corporation and instead required that no corporate tax be applied to the S corporation's earnings. *Id.*

*corporation valuation. Refusing to tax affect at all produces such a windfall, as I next explain.*

*The Internal Revenue Code states that “[t]he taxable income of an S corporation shall be computed in the same manner as in the case of an individual . . . .”<sup>32</sup> This tax, though assessed at individual rather than corporate tax rates, is dependent solely upon the corporation’s net earnings. Even if Delaware Radiology were to retain 100% of its earnings annually, its stockholders still would owe taxes on Delaware Radiology’s income even though they received no distributions. Affording a remedy to the Kessler Group that denies the reality that each shareholder owes taxes on his proportional interest in Delaware Radiology would result in the Kessler Group receiving a higher per share value from the court than it could ever have realized as a continuing shareholder.<sup>33</sup>*

*The amount that should be the basis for an appraisal or entire fairness award is the amount that estimates the company’s value to the Kessler Group as S corporation stockholders paying individual income taxes at the highest rates — an amount that is materially more in this case than if Delaware Radiology was a C corporation. In coming to a determination of how the Kessler Group’s interest in Delaware Radiology would be valued in a free market comprised of willing buyers and sellers of S corporations, acting without compulsion, it is essential to quantify the actual benefits of the S corporation status. That is also essential in order to determine the value of what was actually taken from the Kessler Group as continuing stockholders.*

*Assessing corporate taxes to the shareholder at a personal level does not affect the primary tax benefit associated with an S Corporation, which is the avoidance of a dividend tax in addition to a tax on corporate earnings.<sup>34</sup> This*

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<sup>32</sup> 26 U.S.C.A. § 1363 (2005).

<sup>33</sup> See, e.g., *Fisher*.

<sup>34</sup> See, e.g., *Byrne v. Commissioner of Internal Revenue*, 361 F.2d 939, 942 (7th Cir. 1966) (“We agree with the observation of the Tax Court that the [S Corporation] statute is designed to permit a qualified corporation and its shareholders to avoid the double tax normally paid when a corporation distributes its earnings and profits as dividends and this is accomplished in a specified manner which does not involve ignoring the corporate entity.”); Practising Law Institute, 546 PLI/Tax 249 *Organizing the Corporate Venture* § 1301 (2002) (“This re-inversion of rates lessened the S corporation shareholder’s advantage of being taxed directly on corporate income. Yet, the primary tax advantage of being an S corporation shareholder — i.e., the ability to receive corporate income with only a single level of tax imposed — remains intact. This must be compared to the double tax paid on a C corporation’s income (i.e., once at the corporate level, and again at the shareholder level when distributed) in considering the tax benefit of using an S corporation, rather than a C

*benefit can be captured fully while employing an economically rational approach to valuing an S corporation that is net of personal taxes.<sup>35</sup> To ignore personal taxes would overestimate the value of an S corporation and would lead to a value that no rational investor would be willing to pay to acquire control.<sup>36</sup> This is a simple premise — no one should be willing to pay for more than the value of what will actually end up in her pocket — that can best be firmly grasped through a concrete example.*

*Assume that Delaware Radiology receives \$100 in annual earnings. If Delaware Radiology was organized as a C corporation, its earnings after tax would be \$60, assuming, as is the usual custom, that the effective corporate tax rate is 40%. Then, assume that Delaware Radiology distributes all of its post-tax earnings to its shareholders in the form of a dividend. The shareholders would receive total post-tax distributions of \$51, after an assumed dividend tax of 15% is applied to the \$60 after-tax earnings. That is, a shareholder would experience an effective tax rate of 49% after corporate income and dividend taxes.*

*Now, consider the post-tax benefits of \$100 in income to Delaware Radiology's stockholders, using its actual status as an S corporation. In that scenario, the shareholders would receive all \$100 in earnings as distributions and be subject only to one shareholder-level tax. Thus, the shareholders would be responsible for paying taxes on the \$100 at their individual tax rates. I will also assume that rate to be 40% because the Broder and Kessler Groups are comprised of affluent physicians who pay at the highest marginal rate.<sup>37</sup> Therefore, every dollar of Delaware Radiology's earnings would be taxable at the stockholder level at the highest marginal tax rate. The shareholders in Delaware Radiology, an S corporation, would be able to pocket \$60 after tax if all earnings were distributed. The difference is clear: Delaware Radiology's status as an S corporation allowed the shareholders*

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corporation, for business operations.”); Mercer 9 (“The S election relieves one layer of taxation at the corporate level, providing the potential for greater cash flow at the shareholder level.”).

<sup>35</sup> Fisher 22.

<sup>36</sup> *Id.* at 18 (“[W]e demonstrate that ignoring taxes in a DCF analysis when valuing an S corporation potentially leads to an overestimation of value.”); *id.* at 22 (“A rational investor will only pay up to the present value of an investment’s expected cash flows, net of personal taxes.”).

<sup>37</sup> Currently, at the federal level, the highest personal tax rate is 35%, and the highest corporate tax rate is 38%. Thus, taking into account state taxes, it is reasonable to assume a 40% personal tax rate.

to pocket \$60 of \$100, whereas if Delaware Radiology was a C corporation, the shareholders could pocket only \$51 of the \$100.<sup>38</sup>

*In valuing Delaware Radiology, therefore, it would overstate the value taken from the Kessler Group to require the Broder Group to pay the Kessler Group \$37.50 for its share of every \$100 of future pre-tax earnings. That cash flow, after the favorable S corporation tax treatment, would not be worth \$37.50 to the Broder Group, but only \$22.50. The issue, though, is that tax affecting Delaware Radiology at a 40% level (or C corporation level) would not recognize any S corporation value that flowed to the Kessler Group or compensate the Kessler Group for its involuntarily removal as shareholders in a profitable S corporation. To be consistent with Delaware law, I must tax affect Delaware Radiology's future cash flows at a lower level that recognizes the full effect of the Kessler Group's ability to receive cash dividends that are not subject to dividend taxes.*

*In order to accurately capture the value to the Kessler Group of Delaware Radiology's S corporation status, I have estimated what an equivalent, hypothetical "predividend" S corporation tax rate would be. The following table presents that calculation:*

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<sup>38</sup> This would not be the case if 1) no distributions were being paid by the S corporation to its shareholders or 2) distributions only sufficient to cover tax liability were being distributed to shareholders. The relative value of an S corporation, vis-à-vis a C corporation, to its shareholders is dependent upon the level of distributions paid. For a useful model and analysis, see, e.g., Chris Treharne, et. al., *Valuation of Pass-Through Entities*, American Society of Appraisers 23d Annual Advanced Business Valuation Conference (Oct. 8, 2004). As recognition of the fact that their stockholders must pay taxes on non-distributed earnings, most if not all S corporations distribute a sufficient amount of their profits to cover shareholder tax obligations. Mercer at 17 ("S corporations who attempt to retain all earnings and not pass through the shareholders' tax distributions will likely find themselves C corporations again, as their shareholders arrange to become ineligible to hold S corporation stock."). This makes intuitive and commercial sense. If all earnings are retained, the S corporation's shareholders must dig into their own pockets to fund the tax liability. If all earnings are retained in a C corporation, the entity is responsible for the corporate level tax. If S corporation shareholders elect to receive no distributions, that can be viewed as a reinvestment of their tax savings in that enterprise.

	<u>C</u> <u>Corp.</u>	<u>S</u> <u>Corp.</u>	<u>S Corp</u> <u>Valuation</u>
<i>Income Before Tax</i>	\$100	\$100	\$100
<i>Corporate Tax Rate</i>	40%	--	29.4%
<i>Available Earnings</i>	\$60	\$100	\$71
<i>Dividend or Personal Income Tax Rate</i>	15%	40%	15%
<i>Available After Dividends</i>	\$51	\$60	\$60

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

I have to commend Chancellor Strine for getting this opinion correct with respect to taxes. Most state court judges shy away from this very complex issue and he really got it dead on. In fact, his opinion was so instructive that our firm has started following this very methodology. In fact, I really like the logic behind these calculations because it is simple and easy to explain.

Exhibit 3 is an actual excerpt from a report prepared for a shareholder dispute.

### **Exhibit 3** **S Corporation Taxes - Normalized**

*We have recalculated income taxes based on the fact that The Smith Entities are pass-through entities for income tax purposes. This means that The Smith Entities do not pay tax at the "corporate" level. Over the past several years, the business valuation community has acknowledged that the conventional wisdom of taxing these pass-through entities as if they were taxpaying C corporations is no longer an automatic thing to do. In fact, the United States Tax Court opened up this issue in several court cases.<sup>39</sup> Since that time, many authors have contributed to the valuation literature with ideas about how to treat these non-taxpaying enterprises. In one instance, it was stated*

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<sup>39</sup> *Gross v. Commissioner*, T.C. Memo. 1999-254, affd. 272 F.3d 333 (6<sup>th</sup> Cir. 2001), *Heck v. Commissioner*, T.C. Memo. 2002-34, Filed February 5, 2002, and *Adams v. Commissioner*, T.C. Memo. 2002-80, Filed March 28, 2002.

*In valuing a controlling ownership interest in an S corporation, the analyst should assess the probability that the likely buyers of a controlling interest will be able to avail themselves of continuing the S corporation status. In other words, is the likely buyer a qualified S corporation shareholder who could continue S corporation status indefinitely? Or, is the likely buyer a C corporation? If the pool of likely buyers is made up of qualified S corporation shareholders, then those buyers of a controlling interest can realize all three of the above-listed economic benefits (i.e., no double taxation, pass-through basis adjustment, and increased proceeds upon sale of assets).<sup>40</sup>*

*In this valuation, we are valuing an interest in a going concern that is being taken from the departing shareholder. Fair value attempts to place a value on what is being taken from him. In this instance, the remaining shareholders will most likely continue the S status (and other pass-through status of the other entities within the group), particularly since the S election was recently made as of January 1, 1998. This means that the remaining shareholders will continue to enjoy the benefits of the S election. Furthermore, the remaining shareholders have not expressed any intention to sell The Company. Therefore, we will proceed with the calculation of taxes based on the reality of the situation.*

*In many of the court cases that have addressed the issue of tax-affecting an S corporation, the appraisers on opposite sides have taken an all or none position. They have either taxed the S corporation as if it was a regular taxpaying C corporation, or they have taken the position that since the S corporation does not pay taxes at the corporate level that no tax should be computed. We do not believe that an all or none position is always warranted. We will use a simple illustration to help demonstrate the appropriate level of tax to be applied to The Smith Companies.*

*Assume that The Smith Entities had a pretax profit of \$100. If 100 percent of the earnings was being distributed to the shareholders, the difference between being a C corporation and an S corporation can be explained by the following table.*

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<sup>40</sup> Grabowski, Roger J. and McFadden, William P., "Applying the Income Approach to S Corporation and Other Pass-Through Entity Valuations," *The Handbook of Business Valuation and Intellectual Property Analysis*, Robert F Reilly and Robert P Schweih, Editors, McGraw Hill, 2004, p. 97.

	<u>C Corporation</u>	<u>S Corporation</u>
Annual Earnings	\$ 100	\$ 100
Corporate Income Tax	40% <u>40</u>	0% <u>0</u>
Net Income Available to Shareholders	<u>\$ 60</u>	<u>\$ 100</u>
Dividends	\$ 60	\$ 100
Personal Income Tax	40% <u>24</u>	40% <u>40</u>
Net cash flow to Shareholders	<u>\$ 36</u>	<u>\$ 60</u>
<b>Benefit of being an S Corporation</b>		<b><u>\$ 24</u></b>

*The above table reflects the fact that in a situation where all of the after corporate tax profits are being distributed to the shareholders, the effective corporate tax rate for an S corporation is 0 percent. At the valuation date, the tax rates in effect would have required the shareholders of a C corporation to pay a 40 percent personal income tax after the corporation would have paid the same rate. The amount of money available to the shareholders after all taxes were paid would have been \$36.*

*As an S corporation, the shareholders avoid a corporate tax, but they pay personal taxes on the “pass-through” regardless of the amount of dividends. Since only one 40 percent tax is paid, the shareholders would end up with \$60 in their pockets after all taxes are paid.*

*Now we must deal with the realities of The Smith Entities. Historically, 100 percent of the earnings have not been paid to the owners each year. In fact, we had to analyze the deemed dividends and distributions in order to apply the same type of tax-affecting analysis as above. Dividends and deemed distributions have been as follows:*

	<u>1996</u>	<u>1997</u>	<u>1998</u>	<u>1999</u>	<u>2000</u>
			(In \$000)		
Financial Statement Dividends	\$ 0	\$ 3,500	\$ 3,500	\$ 5,750	\$ 5,000
Officers' Compensation - Addback	4,364	9,614	10,637	8,779	2,114
Officers' Compensation - Reasonable	(927)	(956)	(985)	(1,016)	(1,047)
Shareholder/Partner Loan Movement:					
ABC	(662)	(3,959)	(3,669)	7,605	4,012
Unconsolidated Entities	<u>1,141</u>	<u>360</u>	<u>1,518</u>	<u>1,897</u>	<u>6,225</u>
Total Distributions	\$ 3,916	\$ 8,559	\$ 11,001	\$ 23,015	\$ 16,304
Adjusted Pretax Profits	\$ 8,776	\$ 12,219	\$ 19,090	\$ 19,308	\$ 15,375
<b>% Distributions to Pretax Profits</b>	<b>44.63%</b>	<b>70.05%</b>	<b>57.63%</b>	<b>119.20%</b>	<b>106.04%</b>

Figures may not add due to rounding.

Dividends were included based on the amounts reflected on the financial statements for the consolidated entities. Excess officers' compensation was also considered to be a form of dividend for this analysis. In addition, we included the year-to year movement in the shareholder/partner loan accounts for ABC and the unconsolidated entities. These monies flow to the owners. In reality, they are a form of distribution.

Comparing the total distributions to the adjusted pretax profits reflects the fact that distributions in any given year have ranged from 44.63 percent to 119.20 percent of the adjusted profit. The average for this five year period was about 80 percent. This is the amount of distributions that we will now use to recalculate the effective tax rate as an S corporation. The result is as follows:

	<u>C Corporation</u>	<u>S Corporation</u>
Annual Earnings	\$ 100	\$ 100
Corporate Income Tax	40% <u>40</u>	0% <u>0</u>
Net Income Available to Shareholders	<u>\$ 60</u>	<u>\$ 100</u>
Earnings Retained in Company	\$ 12	\$ 20
Dividends	80% \$ 48	80% \$ 80
Personal Income Tax	40% <u>19</u>	40% <u>40</u>
Net cash flow to Shareholders	<u>\$ 29</u>	<u>\$ 40</u>
<b>Benefit of being an S Corporation</b>		<b><u>\$ 11</u></b>



	<u>C Corp.</u>	<u>S. Corp.</u>	<u>S Corp. Valuation</u>
Income Before Tax	\$ 100	\$ 100	\$ 100
Corporate Tax Rate	40%	0%	33.33%
Available Earnings For Distributions	<u>\$ 60</u>	<u>\$ 100</u>	<u>\$ 80</u>
Distributions	\$ 48	\$ 80	\$ 80
Personal Income Tax Rate	40%	40%	40%
Net Available After Dividends	<u>\$ 29</u>	<u>\$ 40</u>	<u>\$ 40</u>

Since only about 80 percent of the pretax earnings have been distributed historically, we used this amount in our model. Recalculating the net amount available to the shareholders after taxes considers the benefits of the S election.<sup>41</sup> For the purpose of this valuation, the shareholders should be placed in the same position that they would be in after paying tax as an S corporation shareholder. In the above example, they would end up with 40 cents on the dollar. The mathematical calculation to determine the implied S corporation tax rate is as follows:

$$(1 - X) \times (1 - 40\%) = 40\%$$

$$X = 33.33\%$$

In order for the shareholders of The Smith Entities to be placed in a neutral tax position, a 33.33 percent corporate tax rate is appropriate. This is the rate that we have used in the normalization process.

## Conclusion

As you can tell, the landscape that we work under has changed dramatically. The old conventional wisdom of tax-affecting all pass-through entities is gone. Each valuation must consider the facts and circumstances and be performed accordingly.

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<sup>41</sup> This model does not take into consideration the added benefit that the shareholders will receive as a result of the undistributed income of the companies. Since income taxes are paid, and in this model calculated, on the available earnings, regardless of whether they are actually distributed or not, the shareholders of the S corporation can remove the undistributed profits without taxation in subsequent periods. If they do not remove the distributions, they receive a step-up in the basis of their investment and will pay less capital gains, if and when they sell their interest in The Company.

## **GARY R. TRUGMAN CPA/ABV, MCBA, ASA, MVS**

**Gary R. Trugman** is a Certified Public Accountant licensed in the states of New Jersey, New York, Connecticut and Florida. He is Accredited in Business Valuation by the American Institute of CPAs and is a Master Certified Business Appraiser as designated by The Institute of Business Appraisers Inc. He is also an Accredited Senior Appraiser in Business Valuation by the American Society of Appraisers. Gary is regularly court appointed and has served as an expert witness in Federal court and state courts in several jurisdictions, testifying on business valuation, matrimonial matters, business and economic damages and other types of litigation matters.

Gary is currently on the American Institute of CPAs' ABV Examinations Committee and he is a former member of the AICPA's Subcommittee Working with the Judiciary, ABV Credentials Committee, Executive Committee of the Management Consulting Services Division, and the Business Valuation and Appraisal Subcommittee. He is currently Chairman of the Florida Institute of CPAs' Litigation, Valuation, Forensic Accounting and Litigation Services Section and was formerly on the New Jersey Society of CPAs' Litigation Services Committee, Business Valuation Subcommittee (past-chairman) and Matrimonial Committee.

Gary is Chairman of the Ethics and Discipline Committee, and formerly served on the Qualifications Review Committee and is the former Regional Governor of the Mid-Atlantic Region of The Institute of Business Appraisers Inc. He has received a "Fellow" Award from The Institute of Business Appraisers Inc. for his many years of volunteer work in the profession. Gary has also received an AICPA "Hall of Fame" Award for his service to the accounting profession in assisting in the accreditation in business valuation process. Gary formerly served on the Business Valuation Education Subcommittee and the International Board of Examiners of the American Society of Appraisers. He is currently a faculty member of the National Judicial College, educating judges around the country.

Gary lectures nationally on business valuation topics. He is the author of a textbook entitled Understanding Business Valuation: A Practical Guide to Valuing Small to Medium-Sized Businesses, published by the American Institute of CPAs. He has also developed numerous educational courses, including but not limited to, a six day business valuation educational series and a seminar entitled "Understanding Business Valuation for the Practice of Law" for the Institute of Continuing Legal Education. Gary also serves as an editorial advisor for The Journal of Accountancy, The CPA Expert, and formerly for National Litigation Consultants' Review and the CPA Litigation Service Counselor. He has lectured in front of numerous groups and has been published in The Journal of Accountancy, FairShare and The CPA Litigation Service Counselor.

Gary was born in New York and received his undergraduate degree from The Bernard M. Baruch College of the City University of New York. He was the first business appraiser in the United States to earn a Masters in Valuation Sciences from Lindenwood College. His Masters Thesis topic was "Equitable Distribution Value of Closely Held Businesses and Professional Practices". Gary's appraisal education also includes various courses offered by The Institute of Business Appraisers, the American Society of Appraisers, the American Institute of CPAs and others. He has taught federal income taxation at Centenary College, financial statement analysis in the masters degree program at Lindenwood College, and several topics at the AICPA. National Tax School in Champaign, Illinois. He is a member of The Institute of Business Appraisers Inc., the American Society of Appraisers, the American Institute of Certified Public Accountants, the Florida Institute of Certified Public Accountants, the New Jersey Society of Certified Public Accountants and the New York State Society of Certified Public Accountants.