Valuation of S-Corporations

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An S-Corp election can have positive and negative impacts on the valuation of a minority interest in a closely-held company depending on the specific facts pertinent to the company. In the majority of cases, the S-Corp election has a net positive economic impact to the fair market value of a minority interest, but the net effect can vary materially between shareholders of the same company, and between potential buyers of a minority interest in the company. Therefore, the net economic impact cannot be modeled precisely. However, an average net benefit or detriment can be reasonably estimated.

Key Positive & Negative Attributes of S-Corporations

The following summary outlines the key positive and negative attributes of S-Corp share ownership.

Benefits of S-Corp Share Ownership

- Generally, S-Corp income is subject to only one level of taxation.
- S-Corp shareholders receive an increase in tax basis to the extent that income (i.e., AAA account\(^1\)) exceeds S-Corp distributions.
- After a ten-year holding period, S-Corps are no longer subject to built-in-gains tax on C-Corp appreciated assets.

Detrimental Characteristics of S-Corp Share Ownership

- Restrictions are imposed upon the types of permitted shareholders, which further limit marketability.
- Only one class of stock is permitted. A corporation is considered to have one class of stock if all shares bestow equal rights to distributions and liquidation yield. Differences in voting rights are ignored for qualification purposes.
- Shareholders are liable for entity taxes on 100% of earnings regardless of the level of cash distributions.
- If assets acquired as a C-Corp are sold prior to the expiration of the 10-year S-Corp holding period, the company is subject to built-in-gains tax on the C-Corp appreciated assets.

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\(^1\) Accumulated Adjustment Account (“AAA”) represents the accumulated previously taxed income which has not been distributed to the S-Corp shareholders.
• The tax deductibility of certain employee benefits for shareholder employees is more limited than for a C-Corp.

• Tendency to distribute more income reduces retained earnings available to fund future growth. This factor can be material for working capital and fixed asset intensive companies.

• Basis of assets owned by an S-Corp is not adjusted upon sale of shares or the death of a shareholder. If an S-Corp owns depreciable property, such as rental real estate, the inability to adjust the basis of corporate assets (e.g., the real estate) means that a purchaser of S-Corp shares does not receive the benefit of increased depreciation deductions. By contrast, a purchaser of a partnership or limited liability company interest may enjoy increased depreciation deductions if the partnership or limited liability company makes an IRC section 754 election. Unlike a shareholder in an S-Corp, a partner or member in a partnership or limited liability company that has made a section 754 election is deemed to have a basis in assets owned by the entity commensurate with the partner or member’s basis in his/her/its interest in the entity. Although the basis of S-Corp assets could be adjusted if a purchaser of shares in the S-Corp and subsequently liquidates the S-Corp, the liquidation would incur ordinary income pursuant to IRC section 1239. The excess of the value of depreciable assets over the S-Corp’s basis would be ordinary income instead of capital gain. The income realized upon liquidation would flow through to the shareholder and increase the shareholder’s basis in the S-Corp shares, but the loss realized on the liquidation would be a capital loss. The capital loss would not offset the ordinary income. This rule is a significant detriment for S-Corps that own depreciable assets.

Valuation Considerations When Using an Income Approach

Background on S-Corp Valuation: The economic impact of a company’s S-Corp election has recently been a topic of discussion throughout the valuation community with

2 This problem is exacerbated by the fact that small-cap return data compiled by Ibbotson Associates shows that 85% of historical small-cap returns are attributable to capital appreciation, which is primarily driven by growth.

3 IRC section 1239 could be avoided if, instead of selling stock, the S-Corp assets were sold to a third party purchaser and then liquidated. However, the sale of assets would incur recapture of accelerated depreciation under IRC section 1250, real estate transfer and recording taxes and loan prepayment penalties on loans secured by company owned assets. Some of these costs, or even all of them, might have been avoided if the stock were sold instead of assets. Some, but not all, of the costs of an asset sale are avoided if an IRC section 338(h)(10) election is made to treat the stock purchase as if it were an asset purchase. For example, section 1250 depreciation recapture would not be avoided but transfer and recording taxes and prepayment penalties might be avoided. However, a section 338(h)(10) election is not available for purchasers who are not corporations.
many articles being published on the subject. The impetus of these discussions has been a series of U.S. Tax Court rulings that have addressed the issue of tax affecting the earnings of an S-Corp when an income approach to valuation was used.

Historically, when S-Corps were valued using an income approach, appraisers generally tax-affected the company’s earnings using applicable C-Corp tax rates. This was done because under the fair market value definition the willing buyer and willing seller were generally presumed to be C-Corps, and the market rates of return utilized by appraisers are after-tax rates of return compiled from publicly traded C-Corps. Where and when appropriate, appraisers then made discrete separate adjustments for the economic benefits of the S-Corp election at the minority interest level.

In 1999, in the case of Gross v. Commissioner, the Court commented that by definition and case law, a subject company’s earnings should be tax affected as a C-Corp. However, for the Gross case, the Court ruled that the effective C-Corp tax rate was zero percent. This case was followed by Wall v. Commissioner, Heck v. Commissioner, Adams v. Commissioner, and Dallas v. Commissioner. In each of the cases subsequent to the Gross case, the Tax Court upheld the decision to tax affect S-Corp earnings using a zero percent tax rate.

The impact of an S-Corp election on value is complicated and cannot be simply quantified and captured by the simple act of not tax affecting. This is because the S-Corp election impacts multiple interdependent factors including, but not limited to, the: (1) equity cost of capital; (2) cost of debt; (3) weighted average cost of capital; (4) compensation and benefit structure of the company; (5) expected earnings growth rate; (6) existence of operating control; and (7) marketability factors concerning the subject company’s equity.

In each of the aforementioned tax court cases, the Court ruled on multiple interdependent factors applicable to the specific facts and circumstances of each valuation case. Each ruling was case-specific and did not conclude that there is one, and only one, way to value the impact of an S-Corp election on the value of a minority interest in an S-Corp. It can be reasonably argued that in each case the Court made several offsetting adjustments and the decision of a zero percent tax rate was one of those offsetting adjustments.

The impact of moving from a corporate tax rate of 40% to 0%, as was done in the Gross case, results in an increase in value of 66.67%, if all other variables are held constant.

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4 T.C. Memo, 1999-254, (July 29, 1999), affirmed 272 F.3d 333 (6th Cir. 2001).

5 T.C. Memo 2001-75 (March 27, 2001).

6 T.C. Memo, 2002-34 (February 5, 2002).

7 T.C. Memo 2002-80 (March 28, 2002).

8 T.C. Memo 2006-212 (September 28, 2006).
However, an increase in value of this magnitude is unrealistic. Nevertheless, it is recognized that an S-Corp election can have a positive economic impact on value at the minority interest level. The issue becomes how to best quantify the adjustment.

**Quantifying the S-Corp Adjustment:** When assessing the impact of the S-Corp election on the fair market value of a company’s equity, the appraiser must first review and consider all of the relevant factors pertaining to S-Corps. Then, based on these factors, the appraiser must decide if the S-Corp election provides a net benefit to fair market value. If there is a net benefit, the benefit must be quantified. However, there are circumstances when the S-Corp election does not provide a net benefit and an S-Corp adjustment is not applicable.

Economically, the two primary benefits of the S-Corp election are: (1) the elimination of double taxation on distributions and Built-In-Gains Tax (“BIG”) on appreciated assets; and (2) the reduction in personal capital gains taxes when the interest is sold due to the step-up in tax basis associated with retained S-Corp earnings. Therefore, because of these benefits, the S-Corp adjustment becomes a function of the savings associated with the net reduction of dividend and capital gains taxes.

One of the benefits of the S-Corp election is to avoid the double taxation of a company’s earnings when it pays an S-Corp AAA distribution. Under a standard C-Corp, the company’s earnings are taxed at the corporate level, and then the shareholder is taxed again when those earnings are paid out as a dividend. After an S-Corp election, the shareholder pays personal income taxes on his pro rata share of the company’s earnings, but does not pay additional taxes on any AAA distributions. Therefore, if an S-Corp makes an AAA distribution equal to the shareholder’s personal tax liability, then the net cash retained by the company is the same as that of a C-Corp that does not pay a dividend. This assumes that the individual tax rate and C-Corp tax rates are essentially equivalent. Therefore, the economic benefit to the minority S-Corp shareholders is when the company pays an S-Corp distribution greater than the amount needed to pay taxes (i.e., greater than the marginal C-Corp tax rate).

Another prospective benefit is that the shareholder’s tax basis increases for any S-Corp earnings that have not been distributed. This benefit effectively lowers the shareholder’s capital gains tax liability when the interest is sold. However, this economic benefit is only realized if and when the S-Corp shareholder sells his interest. Therefore, because of the loss of double taxation and the step-up in tax basis, the S-Corp adjustment becomes a function of the savings associated with not paying dividend and capital gains taxes, as well as any differences between the corporate and individual tax rates.

Several qualitative factors must also be considered in estimating the magnitude of the S-Corp adjustment. These factors are listed below, and their impact is likely to vary on a case-by-case basis.

- **Level of Value:** One factor that complicates the determination of the fair market value of an interest in a closely-held business is the issue of control. On a 100% control basis, there is no market evidence that suggests that an arms
length-willing buyer will pay a premium in the acquisition of a closely-held company simply because of the S-Corp election. If that were true, then all C-Corp owners would convert to an S-Corp before they sold their company.

The efficient market theory can be cited to argue against the existence of an S-Corp adjustment on a 100% control basis. If such an adjustment existed and was automatically realized with the S-Corp election, then arbitragers would buy C-Corps, make the election, and sell the company at a profit. Proponents of the efficient market theory note that a competitive, efficient market would not allow such arbitrage opportunities to exist. The competitive market for the acquisition of C-Corps would be priced up to the point where no premium remained.

It is also arguable that the application of an S-Corp premium is, in effect, a partial reduction of a lack of control discount. This is because a controlling shareholder controls the distribution policy of a company and it requires a majority vote to revoke a corporation’s S-Corp election. These control rights can be restricted through a shareholder agreement that secures an S-Corp election. However, this is only done if the controlling shareholder(s) were willing to relinquish part of their control.

Therefore, an S-Corp adjustment is generally applicable when valuing a minority interest. However, when valuing a controlling interest (especially a controlling interest that owns less than 100%) the methodology used to derive the control value should be considered when deciding if an S-Corp adjustment is appropriate. Since the S-Corp adjustment is arguably a partial reduction in the lack of control discount, any applicable control premium, either directly applied or inherent in the methodology, should incorporate an S-Corp adjustment when and if appropriate. Nevertheless, the application of an S-Corp adjustment should not be made such that the value of an S-Corp (on a 100% controlling interest basis) is greater than an equivalent C-Corp.

• **Shareholders’ Agreement:** Certain language within a shareholders’ agreement can have an impact on the application of an S-Corp adjustment. A shareholders’ agreement may limit the actions of the controlling shareholder by not allowing him to unilaterally revoke the S-election. However, at the same time, the terms of the shareholders’ agreement may increase the lack of marketability applicable to a minority interest in a company. Additionally, if a shareholders’ agreement restricts the transfer of shares or provides for a “right of first refusal” by the company, then the likelihood of a minority shareholder being able to break the S-Corp election is reduced. Conversely, without a shareholders’ agreement, any shareholder can break the S-Corp election by transferring their shares to a “non-qualified” person or entity.

A second area where a shareholders’ agreement can impact the value of an S-Corp election is where the agreement stipulates that the company will make an agreed amount of annual S-Corp distributions. Without a shareholders’ agreement, a controlling shareholder can set any distribution policy that he
chooses. If the controlling shareholder declares S-distributions below the level needed to pay taxes, then the S-Corp election may, in fact, lower the fair market value of a minority common stock interest.

- **Age of the S-Corp Election:** One of the benefits of making an S-Corp election is that after a 10-year period, the company is no longer subject to corporate entity tax on the sale or disposition of its net assets. The intrinsic value of this benefit is minimal at the beginning of the 10-year period and it is at its maximum after the 10-year period. After the 10-year period, the net gain on the sale of an S-Corp asset passes through and is taxed only at the shareholder level. A more significant tax benefit after the 10-year period occurs when the S-Corp shareholders sell off all of the company’s net assets and liquidate the corporation. Under this scenario, the S-Corp shareholders would be subject to only one level of tax, whereas the sale of net assets and liquidation as a C-Corp would be subject to double taxation. Further, the 10-year holding period may increase the lack of marketability adjustment for a minority shareholder.

- **Distributions:** The amount of AAA distributions paid to shareholders of an S-Corp compared to the shareholders’ tax liability is a significant factor in determining the appropriateness of an S-Corp adjustment. In general, if all other factors are equal, AAA distributions in excess of the amount required for the shareholders’ tax liability would support the application of a positive S-Corp adjustment. This is because shareholders would be subject to one level of taxation, instead of two. This is the principal component of a positive S-Corp adjustment because the economic benefit is realized as the excess distributions are made. However, if a company does not make sufficient AAA distributions to cover the shareholders’ tax liability, then a lower or possibly no S-Corp adjustment would be appropriate. In some cases, where minimal or no distributions are made and the shareholders have “phantom income,” it could be argued that the S-Corp election has a negative impact on fair market value.

- **Owners’ Compensation:** In some valuations, when deriving a company’s cash flow base, an adjustment is made to owners’ compensation to a level deemed appropriate for a C-Corp. This adjustment results in derivation of a cash flow base that represents the cash flow available for potential distributions. In these cases, it can be argued that the company’s historical owners’ compensation policy has consisted of two components: market-based salary and discretionary compensation. The discretionary compensation, which was adjusted for in deriving the company’s cash flow base, represents funds available for potential distributions. As an S-Corp, the issues regarding potential excess compensation challenges that applied to C-Corps are eliminated. Accordingly, the company and its shareholder(s) have elected to distribute cash flow through the payment of owners’ compensation rather than through distributions. As such, the company has distributed substantially all of its taxable earnings through discretionary compensation. In so doing, the Company has paid out a significant
portion of its taxable earnings, which could not have been done as a C-Corp without some level of double taxation.

- **Step-up in Tax Basis:** Again, the maximum economic value of an S-Corp election exists when a company pays out 100% of earnings annually in S-distributions. If the Company pays out less than 100% of earnings, then a shareholder receives a step-up in their tax basis equal to the increase in their AAA account. The economic value of this step-up in tax basis is only realized when the shareholder sells his stock and the sale price is more than his AAA account. Accordingly, the net present value of the economic value of the step-up in tax basis is speculative. If the sale of stock is five to ten years in the future, then the current economic value of the tax basis step-up will be significantly reduced. Accordingly, the economic value attributed to S-Corp distributions in excess of those required to the payment of S-Corp related income tax liabilities is realized immediately in current dollars, whereas the economic value of the remaining undistributed earnings (AAA) is speculative in timing and amount.

The possibility of losing the S-Corp status is clearly a significant consideration in valuing an interest in a closely-held business. Most of the factors discussed above directly relate to the possibility of losing the S-Corp election. The higher the probability of losing the S-Corp status, the lower the S-Corp adjustment.

After assessing all factors pertaining to the company being valued, an appropriate S-Corp adjustment may be estimated. It is important to consider all the factors outlined above before selecting an appropriate S-Corp adjustment. Without properly taking these factors into account, the value of the S-Corp will be misstated.

## Valuation Considerations When Using an Asset-based Approach

**Valuations Prior to the End of the 10-Year Restriction Period:** Several factors were discussed on the foregoing pages which impact the magnitude of the S-Corp adjustment employed when valuing an S-Corp using an income approach. These included the level of value, the existence of a shareholders’ agreement and the age of the S-Corp election, the level of historical and expected future distributions, the level of owner’s compensation paid, and the step-up in basis on undistributed earnings. Of these, the factor which is likely to have the most impact on an asset-based valuation is the age of the S-Corp election. While the other factors should also be considered, the relative importance of those factors is likely to be mitigated and will be based on the facts and circumstances of each engagement.

As described in detail earlier, an S-Corp is no longer subject to corporate entity-level tax on the sale or disposition of its C-Corp appreciated net assets following the expiration of the required 10-year holding period from the date of the S-Corp election. If the S-Corp is near the beginning of the required 10-year holding period, the diminution in value of the
company’s equity may be significant\(^9\) if the company has material C-Corp assets that are highly appreciated relative to their underlying cost basis. In such a situation, a willing buyer and willing seller would consider that a significant capital gains tax liability would exist if appreciated C-Corp assets were sold prior to the expiration of the 10-year holding period. As the valuation date approaches the end of the 10-year holding period, the negative impact on value created by the holding period restriction would tend to decline. Eventually, the willing buyer and seller would tend to discount the impact of the holding period restriction if they were only required to wait a short period of time before it was lifted.

In the event that the appraiser determines that a valuation adjustment is required to capture the adverse impact of an estimated BIG tax liability prior to the end of the 10-year holding period, the adjustment can be incorporated either as a direct adjustment to the subject company’s balance sheet or as a percentage adjustment to the subject company’s net equity. The form of the adjustment and the calculations thereof will be based on the facts and circumstances of the subject company.

Several cases exist in which the application of discounts for BIG taxes have been allowed in determining the fair market value for interests in C-Corporations. The Tax Court’s 2009 decision in *Litchfield v. Commissioner\(^{10}\)* is particularly important because one of the two companies involved was an S-Corp. LRC was incorporated in 1921 as a C-Corp, and elected to convert to an S-Corp effective January 1, 2000. The S-Corp election occurred approximately 22 months prior to the alternate valuation date of October 17, 2001 elected for use by the estate for estate tax purposes. Therefore, a little more than eight years remained between the valuation date and the end of the 10-year required holding period applicable to LRC.

In the *Litchfield* decision, the Tax Court recognized that: (1) experts for the taxpayer and the IRS both used an asset-based valuation approach; (2) LRC owned highly appreciated investment assets at the valuation date; and (3) LRC remained subject to C-Corp tax liabilities at the valuation date. As a result, the Tax Court believed that a willing buyer and willing seller would consider the impact on value of the corporate capital gains tax liability that would be due on the sale of LRC’s appreciated assets, and incorporated a discount reflecting such a liability into its valuation conclusion. The *Litchfield* decision cites several cases in which the application of a discount for BIG tax liabilities was employed, but does not take a position as to which method of estimating the discount is most appropriate.\(^{11}\) Instead, the Tax Court focused on the reasonableness of the method

\(^9\) Relative to the value of its adjusted net assets.

\(^{10}\) T.C. Memo 2009-21 (January 29, 2009).

\(^{11}\) *Litchfield* specifically refers to the decision by the U.S. Court of Appeals for the Eleventh Circuit in *Jelke* that a dollar-for-dollar adjustment be made in an amount equal to 100% of the capital gains tax liability that would be incurred if the company’s assets were sold on the valuation date. However, the *Litchfield* court does not comment on the dollar-for-dollar method of calculating the adjustment because it was not employed by estate’s expert in that case.
employed by the experts for the taxpayer and the IRS in the valuation of LRC, and the underlying assumptions employed by each expert. In Litchfield, the Tax Court also noted that the circumstances of the case were unique because LRC was within the 10-year required holding period at the valuation date, and stated that discounts for BIG taxes would not be allowed in the valuation of all S-Corps.

**Valuations After the End of the 10-Year Restriction Period:** If an S-Corp being valued using an asset approach is beyond the 10-year required holding period, an adjustment for BIG taxes at the corporate level would not be applied. Still, there remains a theoretical impact on fair market value for both minority and controlling interests due to the tax inefficient nature of the S-Corp structure in certain situations.

- **Economic Loss Associated With Inability to Step-up Basis of Depreciable Assets:** A potential buyer of the stock of an S-Corp would inherit the basis of the underlying assets. For example, assume that an S-Corp owning highly appreciated real estate is being valued. The real estate is heavily depreciated, resulting in a large upward adjustment in the calculation of the company’s adjusted book value and a high level of unrealized built-in gains. In valuing the underlying real estate, the real estate appraiser implicitly assumes that the owner will be able to depreciate the property based on its market value, which (in this example) is very high relative to the cost basis. However, because a buyer of this S-Corp interest would assume the corporation’s internal tax basis, the buyer would be unable to depreciate the property based on its market value at the time of the transfer. Therefore, the buyer would be required to continue to depreciate the property according to historical cost basis, foregoing the tax benefit associated with depreciating the property based on its appraised market value at the time of the transfer. This will result in higher income taxes on a going concern basis. This expected higher level of tax is a real cash flow item that a willing buyer would consider in his purchase decision. An analysis may be conducted to model the “lost” tax benefit, and included as a consideration in determining an appropriate discount for lack of marketability.

- **Inability to Offset Ordinary Gains & Capital Losses:** It is also recognized that a willing buyer could liquidate the S-Corp by selling its underlying assets and distributing the proceeds, although there would likely be adverse tax consequences. If the owner of the S-Corp were to undertake a series of transactions which would result in the liquidation of the S-Corp, the built-in gains associated with depreciable assets would be treated as ordinary income instead of capital gain. The income realized upon liquidation would flow through to the shareholder and increase the shareholder’s basis in the S-Corp shares, but the loss realized on the liquidation would be a capital loss. The capital loss would not offset the ordinary income, and the owner would be forced to pay tax on the capital gains as ordinary income. In addition, given that the capital losses can only be carried forward, there would be no guarantee as to the timing of the recognition of such losses for tax purposes.
Conclusion

It is important to consider the impact of a company’s S-Corp status on the value of its equity interests. There are several factors to consider, the impact of which will vary based on the valuation method employed and the facts and circumstances associated with the subject company. While the manner in which a subject company’s S-Corp status is factored into the analysis and the magnitude of related adjustments may be subjective, at least in part, the failure to consider the impact of a subject company’s S-Corp status may result in a material under- or overstatement of the value of its equity.