

# S CORPORATIONS: A TAXING ANALYSIS OF PROPER VALUATION

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## I. INTRODUCTION

Tax affecting<sup>1</sup> S corporations, pass-through entities, for valuation purposes is appropriate under the proper methodology. Valuation of S corporations has been a controversial issue for years, mainly because of the tax benefits associated with S corporations.<sup>2</sup> The decisions handed down by various courts regarding this issue have “emboldened the IRS to take positions relying solely on the tax court cases, rather than financial” theory.<sup>3</sup> The underlying financial theories are important in the context of S corporation valuation. Courts should consider the issue of tax affecting using an appropriate methodology on a case-by-case basis in order to preserve the benefits of S corporation status.

First, “we must acknowledge that the valuation of an S corporation is an inexact science.”<sup>4</sup> *Bernier*, the most recent case concerning this issue, was decided in Massachusetts in September of 2007. The *Bernier* court noted that “the difficulty in the case of an S corporation is the question whether, and how, to account for tax consequences.”<sup>5</sup> Further, this court

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\* J.D. 2009. Thanks to my husband for always encouraging me, my parents and sister for all their support, and Professor Danshera Cords for all her time.

<sup>1</sup> Because S corporations are not taxed at the corporate level, the term “tax affect” relates to the application of an appropriate tax rate to the S corporation’s earnings for valuation purposes. A tax rate may have a significant impact on value. Consider the following comparison of value between (1) no application of a tax affect and (2) application of a tax affect, based on a simple capitalization of earnings method: (1) earnings = \$100,000; capitalization rate = 20% (5x multiple); value of entity = \$100,000 / .20 = \$500,000; (2) earnings = \$100,000; taxes = 40%; after tax earnings = \$60,000; capitalization rate = 20% (5x multiple); value of entity = \$60,000 / .20 = \$300,000

<sup>2</sup> DAVID LARO & SHANNON P. PRATT, *BUSINESS VALUATIONS AND TAXES* 79–80 (2005).

<sup>3</sup> Nancy J. Fannon, *S Corporations and Value: Simplifying the Debate*, [http://www.fannonval.com/pdf/S%20Corporations/S\\_Corporations\\_and\\_Value—Simplify\\_the\\_Debate.pdf](http://www.fannonval.com/pdf/S%20Corporations/S_Corporations_and_Value—Simplify_the_Debate.pdf) (last visited Mar. 29, 2009).

<sup>4</sup> *Bernier v. Bernier*, 873 N.E.2d 216, 225–26 (Mass. 2007).

<sup>5</sup> *Id.* at 226.

observed that “[t]he matter has bedeviled the professional appraisers’ community for some time.”<sup>6</sup>

This comment will focus on the appropriate way to account for taxes in valuing S corporations. The primary issue is whether or not to tax affect S corporations, which are pass-through entities, for valuation purposes.<sup>7</sup> Once this is answered in the affirmative, the next issue is what the appropriate tax affect should be. There is a lack of uniformity among jurisdictions regarding these issues,<sup>8</sup> but recent cases have shed some light on (1) applying a tax affect to S corporations and (2) the proper tax affect.<sup>9</sup> This Comment argues that application of a tax affect to S corporations is appropriate for valuation purposes. A discussion of the differences between S corporations and C corporations is necessary to start the analysis, followed by a discussion of business valuation and its history and applicable approaches and methods. This comment focuses on four basic areas of law where valuation issues arise, including estate, gift, divorce, and shareholder disputes.

This comment then analyzes cases that have touched on this issue and the progress courts have made toward an appropriate analysis. Finally, this comment concludes with an appropriate analysis to apply in S corporation valuations to deal with tax issues.

### III. S CORPORATIONS VERSUS C CORPORATIONS

#### A. S Corporations

Subchapter S corporations emerged in 1958.<sup>10</sup> S corporations are defined under § 1361 of the Internal Revenue Code.<sup>11</sup> To become an S corporation, a company must (1) be a domestic corporation; (2) have shareholders who are individuals, estates, or certain trusts; (3) have

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<sup>6</sup> *Id.* (citing *Gross v. Comm’r*, 272 F.3d 333, 355 (6th Cir. 2001) (Cohn, J., concurring in part, dissenting in part)).

<sup>7</sup> For a simple example and how the impact of a tax affect may impact value, see *supra* note 1.

<sup>8</sup> See discussion *infra* Parts VII–IX.

<sup>9</sup> See, e.g., *Bernier*, 873 N.E.2d at 224–31; *Del. Open MRI Radiology Assocs., P.A. v. Kessler*, 898 A.2d 290, 328–30 (Del. Ch. 2006).

<sup>10</sup> Technical Amendments Act of 1958, Pub. L. No. 85–866, § 1371, 72 Stat. 1606, 1650 (codified as amended at I.R.C. § 1361 (2006)).

<sup>11</sup> I.R.C. § 1361.

shareholders who are citizens or resident aliens; (4) have only one class of stock;<sup>12</sup> (5) have no more than 100 shareholders; and (6) must not be an ineligible corporation.<sup>13</sup>

The purposes of S corporation status include “(1) the prevention of double taxation of earnings received by a ‘small business corporation’; and (2) the avoidance of complex adjustments made necessary by instances of such double taxation.”<sup>14</sup> The chief characteristic for subchapter S corporations, as opposed to other corporations, is that income or loss is not recognized at the corporate level but flows through to the individual members.<sup>15</sup>

### *B. C Corporations*

On the other hand, Subchapter C corporations are defined under §§ 301–385 of the Internal Revenue Code.<sup>16</sup> Becoming an S corporation requires a § 1362(a) election, and a C corporation is any “corporation which is not an S corporation.”<sup>17</sup> Thus, C corporations are the default status. When valuing an S corporation and a C corporation with identical earnings, each company’s value can be significantly different depending on the magnitude of taxes applied to the C corporation’s earnings.<sup>18</sup> Whereas S corporations are not taxed at the entity level, C corporations are taxed both at the entity level<sup>19</sup> and at the shareholder level.<sup>20</sup> An example of the difference in tax treatment follows:

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<sup>12</sup> If non-voting stock has all the characteristics of voting stock, except the voting rights, it is not considered a second class of stock. *Id.* § 1361(c)(4).

<sup>13</sup> *Id.* § 1361(b)(1).

<sup>14</sup> *Shores Realty Co. v. United States*, 468 F.2d 572, 575 (5th Cir. 1972).

<sup>15</sup> SANFORD J. SCHLESINGER, *Estate Planning Update*, in 38TH ANNUAL ESTATE PLANNING INSTITUTE 11, 72 (Sanford J. Schlesinger chair 2007).

<sup>16</sup> I.R.C. §§ 301–385.

<sup>17</sup> *Id.* § 1361(a).

<sup>18</sup> See *supra* note 1 for an example of the difference in tax treatment and the impact on value.

<sup>19</sup> I.R.C. § 11.

<sup>20</sup> *Id.* §§ 301(c)(1), 316.

	<b>C Corp.</b>	<b>S Corp.</b>
<b>Income before tax</b>	\$100	\$100
<b>Corporate tax rate</b>	40%	0%
<b>Earnings available to Shareholders</b>	\$60	\$100
<b>Personal income tax rate<sup>21</sup></b>	35%	35%
<b>Available after dividends</b>	\$39	\$65

This difference in tax treatments is the major advantage of owning an S corporation.<sup>22</sup>

#### *C. Advantages / Disadvantages of S Corporation Status*

The major advantages of S corporation status include one layer of taxation<sup>23</sup> and capital gains incentives.<sup>24</sup> The advantage of a single layer of tax puts more money into the pockets of the S corporation shareholder. The capital gains advantage results from increased shareholder basis and lower capital gains taxes.

One of the most important advantages of owning an S corporation over a C corporation is that the S corporation only has one layer of taxation; that is, the S corporation avoids taxation at the entity level.<sup>25</sup> The taxes of an S corporation are “‘passed through’ to the shareholders on a pro rata basis and taxed to the shareholders when earned by the corporation, whether or not the corporation pays dividends.”<sup>26</sup> Thus, there are three important tax rates to consider: the top corporate rate, the top individual rate, and the

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<sup>21</sup> This tax rate is used for illustrative purposes. The reader should note that the Code currently taxes qualified dividends at lower capital gain rates. *Id.* § 1(h)(11).

<sup>22</sup> LARO & PRATT, *supra* note 2, at 83.

<sup>23</sup> I.R.C. § 1363(a).

<sup>24</sup> See LARO & PRATT, *supra* note 2, at 84.

<sup>25</sup> William C. Brown, *Evaluating a Subchapter S Conversion*, 37 DRAKE L. REV. 395, 399 (1988).

<sup>26</sup> *Bernier v. Bernier*, 873 N.E.2d 216, 225–26 (Mass. 2007).

dividend rate. Currently, the maximum dividend tax rate is 15%,<sup>27</sup> less than the top individual rate of 39.6%<sup>28</sup> and the top corporate rate of 35%.<sup>29</sup> One author refers to this as “rate inversion,” and says that these rates are likely considered when an individual decides whether or not to elect S corporation status.<sup>30</sup> This rate inversion, where the individual rates are higher than the corporate rates, is often a factor when deciding to convert to an S corporation.<sup>31</sup>

Another advantage to S corporation owners is “an increase in their basis to the extent that taxable income exceeds distributions to shareholders.”<sup>32</sup> This is advantageous to an S corporation owner for capital gain purposes. Basically, any income retained in excess of

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<sup>27</sup> I.R.C. § 1(i)(1)(A)(ii).

<sup>28</sup> *Id.* § 1(a)–(d).

<sup>29</sup> *Id.* § 11(b)(1)(D).

<sup>30</sup> Brown, *supra* note 25, at 400–01. The author refers to this as “rate inversion” because “the top individual rate was . . . *higher* than the top corporate rate before the 1986 Act, while it is now . . . *lower* than the top corporate rate.” *Id.* at 400.

<sup>31</sup> In deciding to elect S corporation status, business owners may consider the pros and cons of “rate inversion.” One scholar notes that

in most cases this inversion in the relative corporate and individual rates is not likely to be conclusive in determining whether to convert to Subchapter S, due to the myriad other considerations present in making a conversion. It is, however, likely to be more significant in deciding whether to elect Subchapter S for a new business or newly incorporated business, because the basic highest marginal tax rate on corporate income will be 6% lower under Subchapter S than it will be under Subchapter C.

*Id.* Furthermore, rate inversion “is particularly significant to owners of certain personal service corporations” because

all taxable income of a ‘qualified personal service corporation’ is taxed at a rate of 34%. Since the effect of this provision is that such corporations cannot utilize the lower corporate tax brackets, the taxation of corporate income at lower personal tax rates will be especially attractive to these corporations.

*Id.* at 401 (footnotes omitted).

<sup>32</sup> LARO & PRATT, *supra* note 2, at 84.

distributions increases a shareholder's basis, which results in lower capital gains when the shareholder sells the stock.<sup>33</sup> This reduction of capital gains may result in more realized proceeds upon the sale of that stock.<sup>34</sup>

On the other hand, one notable disadvantage of S corporations involves disagreement over proper valuation strategies. The market approach poses a difficulty in valuing an operating company that has elected S corporation status because publicly-traded comparables are not S corporations.<sup>35</sup> Along the same lines, "[t]he income approach is also difficult to apply because that approach is structured to discount the cash flows of C corporations, not pass-through entities."<sup>36</sup>

However, the *Bernier* court notes that "[t]o distinguish between S and C corporations, however, does little in itself to clarify the issue of valuation."<sup>37</sup> Meaning, the differences in these types of entities does not in and of itself make it clear how or why these entities should be valued differently. Thus, each case must be considered based on its facts, and the advantage of electing S corporation over C corporation status depends on the manner in which each business owner operates.

### III. BUSINESS VALUATION

#### A. History

In the 1920s, when prohibition shut down breweries and distilleries, the government adopted Appeals and Review Memorandum No. 34

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<sup>33</sup> *Id.* It should also be noted that this treatment may also be accomplished through a limited liability company (LLC) because "for federal tax purposes, . . . LLCs and S corporations are treated as pass-through entities." JOHN E. GAGGINI ET AL., STATE TAX ISSUES ARISING FROM THE USE OF PASS-THROUGH ENTITIES TO STRUCTURE TRANSACTIONS, reprinted in 8 TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS, at 304 (Louis S. Freeman chair 2007).

<sup>34</sup> LARO & PRATT, *supra* note 2, at 84.

<sup>35</sup> Gregory A. Barber, *Valuation of Pass-Through Entities*, VALUATION STRATEGIES, Mar.–Apr. 2001, at 6. The market approach is based on the use of comparable companies. *See id.* Publicly-traded companies are not capable of existing as S corporations. Therefore, the use of publicly-traded companies as comparables for a privately-held S corporation creates difficulty in valuing the privately-held S corporation using the market approach.

<sup>36</sup> *Id.*

<sup>37</sup> *Bernier v. Bernier*, 873 N.E.2d 216, 225 (Mass. 2007).

(A.R.M. 34),<sup>38</sup> which established a method for valuing the intangible value lost when the breweries and distilleries were shut down.<sup>39</sup> A.R.M. 34 was later restated in Revenue Ruling 68-609,<sup>40</sup> which outlines the excess earnings method.<sup>41</sup> Revenue Ruling 68-609 superseded A.R.M. 34 in order to comply with changes in the law; that is, to make A.R.M. 34 consistent with the applicable current law.<sup>42</sup> The method outlined in Rev. Rul. 68-609 (and A.R.M. 34) would only be used today if other valuation methods were not applicable.<sup>43</sup> This Revenue Ruling acted as a springboard for modern business valuation theory. The premise behind A.R.M. 34—to provide a legally outlined method for valuing a privately-held business—remains a hot topic in various judicial contexts.

*B. Revenue Ruling 59-60*

Revenue Ruling 59-60<sup>44</sup> was promulgated in 1959 and outlines a set of factors to consider when valuing a privately-held business for gift and estate tax purposes.<sup>45</sup> Taxpayers may rely on revenues rulings as authority,<sup>46</sup> but courts typically give these pronouncements less weight than Treasury regulations.<sup>47</sup> However, experts should always rely on the eight factors outlined in Revenue Ruling 59-60 as a guideline.<sup>48</sup> The

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<sup>38</sup> A.R.M. 34, 2 C.B. 31 (1920) (establishing the excess earnings method).

<sup>39</sup> *Id.*; see also SHANNON PRATT, *THE LAWYER'S BUSINESS VALUATION HANDBOOK* 175 (2000). The practice of business valuation emerged from prohibition. See *id.* at 174–75. Modern business valuation techniques and theories evolved from this requirement of the government to compensate business owners for their lost business value. *Id.*

<sup>40</sup> 1968-2 C.B. 327.

<sup>41</sup> *Id.* The method outlined in Rev. Rul. 68-609 is to be used as a “method of last resort” because of the many arbitrary assumptions. See PRATT, *supra* note 39, at 174. Briefly, this method separates tangible and intangible assets. Rev. Rul. 68-609, 1968-2 C.B. 327. Earnings in excess of a reasonable rate of return on tangibles are capitalized. *Id.*

<sup>42</sup> Rev. Rul. 68-609, 1968-2 C.B. 327.

<sup>43</sup> *Id.*

<sup>44</sup> 1959-1 C.B. 237.

<sup>45</sup> *Id.*

<sup>46</sup> 26 C.F.R. § 1.6662-4(d)(3)(iii) (2008).

<sup>47</sup> *Davis v. United States*, 495 U.S. 472, 484 (1990).

<sup>48</sup> LARO & PRATT, *supra* note 2, at 342; see also DENNIS I. BELCHER, *Estate Planning for Family Business Owners*, in 3 *ESTATE PLANNING IN DEPTH* 1315, 1319 (1996); Martin J. Lieberman & David Anderson, *Will the Real Business Valuation Standards Please Stand* (continued)

factors noted in the ruling include (1) nature and history of the business, (2) “economic outlook in general” and specific industry, (3) “book value of the stock,” (4) “earning[s] capacity,” (5) “dividend-paying capacity,” (6) goodwill, (7) historical “[s]ales of the stock and the size of the block of stock to be valued,” and (8) market price of stocks in the same or similar kind of business.<sup>49</sup> The eight factors listed above allow the valuator to reach a “tentative fair market valu[e],” before various discounts, including minority or marketability.<sup>50</sup> Revenue Ruling 59-60 has been a cornerstone of valuation and “is [still] considered to be the finest and most comprehensive piece of scholarship on valuation.”<sup>51</sup>

Revenue Ruling 59-60 states that fair market value is “a question of fact [and] will depend upon the circumstances in each case.”<sup>52</sup> This Ruling defines “fair market value” according to the standard used for estate and gift tax valuation.<sup>53</sup> There, fair market value is defined 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

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*Up?*, CPA J., Jan. 2008, at 22, 22–23 (“[Revenue] Ruling 59-60’s continuing influence is also evident in the comprehensive business valuation standards that began to appear in the late 1980s. The most important of these was the Uniform Standards of Professional Appraisal Practice (USPAP), issued by the Appraisal Foundation in 1987, followed by standards from professional associations such as the American Society of Appraisers (ASA) in 1992, the Institute of Business Appraisers (IBA) in 1993, and the National Association of Certified Valuation Analysts (NACVA). . . . Also in 2006, the IRS issued general business valuation standards, applicable to all IRS employees and to those who provide valuation services or review valuations for the IRS. These comprehensive business valuation standards have much in common, both in content and terminology, including a common dependence on Revenue Ruling 59-60.”).

<sup>49</sup> Rev. Rul. 59-60, 1959-1 C.B. 237; *see also* Leo J. Zatta, *Off the Beaten Path: Applying Revenue Ruling 59-60*, N.J. LAW., Oct. 2002, at 64, 64–65 (discussing the eight factors).

<sup>50</sup> Harold S. Peckron, *How Much is That Doggie in the Window?—Tax Considerations in Valuing a Business*, 2 BARRY L. REV. 87, 99 (2001). This comment does not focus on the various discounts that are often considered in valuing a privately-held business. For a discussion on this topic, *see* SHANNON P. PRATT WITH ALINA V. NICULITA, VALUING A BUSINESS 381–482 (5th ed. 2008) (discussing various valuation discounts).

<sup>51</sup> LARO & PRATT, *supra* note 2, at 342.

<sup>52</sup> Rev. Rul. 59-60, 1959-1 C.B. 237.

<sup>53</sup> *Id.*

latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts.”<sup>54</sup> This valuation standard is also used in the divorce context.<sup>55</sup>

### C. Approaches and Methodologies

While business valuation is more of an art than an exact science, there are three basic approaches commonly used to establish the value of a privately-held business.<sup>56</sup> “[T]he income, market, and asset-based approaches” represent the three main approaches used by valuers.<sup>57</sup> There are various valuation methods within each approach; the selection among the various valuation methods depends on the business being valued. As noted in Revenue Ruling 59-60, “[n]o formula can be devised that will be generally applicable to the multitude of different valuation issues.”<sup>58</sup> However, relying on the three main approaches will most often lead to a sound valuation.

Theoretically, when all three approaches are applied appropriately they should produce approximately the same value.<sup>59</sup> However, certain approaches may not be appropriate depending on the type of business being valued; it is important to consider all material facts in establishing an opinion of value.<sup>60</sup>

The income approach is based on the premise that “[v]alue today always equals future cash flow discounted at the opportunity cost of

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<sup>54</sup> *Id.*

<sup>55</sup> See *infra* notes 84–86 and accompanying text.

<sup>56</sup> MORNINGSTAR, INC., STOCKS, BONDS, BILLS, AND INFLATION 2007 VALUATION EDITION YEARBOOK 9 (2007).

<sup>57</sup> *Id.*

<sup>58</sup> Rev. Rul. 59-60, 1959-1 C.B. 237.

<sup>59</sup> PRATT WITH NICULITA, *supra* note 50, at 475. It is also possible that experts may arrive at different opinions of value based on assumptions relied on in the valuation process. HAROLD S. NOVIKOFF, *Valuation Issues in Chapter 11 Cases*, in CHAPTER 11 BUSINESS REORGANIZATIONS 185, 202–03 (2007). For example, in applying the discounted cash flow method two different experts may arrive at different conclusions of value based on their selection of inputs. RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 77–83 (6th ed. 2000).

<sup>60</sup> LARO & PRATT, *supra* note 2, at 324, 326; see also PRATT WITH NICULITA, *supra* note 50, at 476–77 (noting the various steps to consider in the reconciliation process).

capital.”<sup>61</sup> The two main methodologies under the income approach include the discounted cash flow method<sup>62</sup> and the capitalization of earnings method.<sup>63</sup> Although the methodologies differ in application, the discounted cash flow method and the capitalization of earnings method both have two main components: the earning generated by a business and an appropriate discount/capitalization rate.<sup>64</sup>

The market approach relies on comparable transactions.<sup>65</sup> Generally, there are two methods a valuator looks at when considering this approach:

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<sup>61</sup> BREALEY & MYERS, *supra* note 59, at 77.

<sup>62</sup> The discounted cash flow method projects the historical earnings, among other things, of a business into the future and appropriately discounts them back to a present value. Edwin T. Hood et al., *Valuation of Closely Held Business Interests*, 65 UMKC L. REV. 399, 417–18 (1997). This method is often considered speculative in the context of litigation, as projections about costs and growth are forward looking. NOVIKOFF, *supra* note 59, at 202–03 (citing *Metlyn Realty Corp. v. Esmark, Inc.*, 763 F.2d 826, 835–36 (7th Cir. 1985)). However, this method is appropriate when valuing a business for purposes of a merger or acquisition. *Id.* at 203. Additionally, this method may be used when a company’s financial outlook is expected to experience “[p]redictable but uneven changes.” PRATT WITH NICULITA, *supra* note 50, at 245.

<sup>63</sup> The capitalization of earnings method relies on historical earnings and a capitalization rate. Hood et al., *supra* note 62, at 411–12. The historical earnings are analyzed and the expert establishes a single, sustainable amount of future economic income. *Id.* The capitalization rate is essentially the rate of return required of an investor in the corresponding business. *Id.* at 413. This rate is used with the single, sustainable economic income to arrive at a present value. *Id.* at 411. Hood et al. provide an example:

To illustrate the capitalization of earnings approach, assume that the projected earnings for a particular business is \$50,000 and a reasonable rate of return on the investment capital of the business would be 20%. If \$50,000 represents the earnings of the business for one year and such amount is equal to a 20% return on investment capital, then the value of the business would be worth five times earnings or \$250,000.

*Id.* This income-based method is often preferred because it takes many of the speculative factors out of the equation as the earnings relied upon are historical.

<sup>64</sup> PRATT WITH NICULITA, *supra* note 50, at 238 (“A discount rate converts all of the expected future returns on investment (however defined) to an indicated present value. In contrast . . . a capitalization rate converts only a single expected economic return number to an indicated present value.”).

<sup>65</sup> LARO & PRATT, *supra* note 2, at 210.

the publicly-traded guideline method<sup>66</sup> and the acquired-company guideline method (privately held).<sup>67</sup> The application of each method is similar, as multiples are selected from the comparable guideline companies and then applied to the appropriate financial variable of the company to be valued.<sup>68</sup> For example, the comparable companies may produce a sale price to revenues multiple of 1.0. In this case, the revenue base for the company to be valued would be multiplied by 1.0 to arrive at the sale price.

The asset-based approach is most appropriate when valuing a capital-intensive business, meaning the business relies on its assets to generate income.<sup>69</sup> This approach can also be used when valuing holding companies or companies that can predict future unprofitability.<sup>70</sup> The main method to determine a company's fair market value under the asset approach is the adjusted net asset value method.<sup>71</sup> Asset based approaches

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<sup>66</sup> As the name suggests, the publicly-traded guideline method relies on multiples of comparable companies that are actively, publicly-traded. *Id.* at 211. Specifically, the information from the guideline companies is based on minority interests. *Id.* Transactions involving actively, publicly-traded companies rely on minority interests. *Id.* Thus, in applying the publicly-traded guideline method, the level of value produced from market multiples results in a minority interest valuation.

For valuation purposes, it is important to establish whether the interest being valued is minority or control. A controlling interest represents 51% or more. *See* HOWARD A. LEWIS, IRS, *Internal Revenue Service Business Valuation Guidelines*, in BASIC ACCOUNTING FOR THE GENERAL PRACTITIONER 127, 139 (Alan A. Schachter chair 2002) (defining “[m]ajority interest” as “an ownership interest greater than 50% of the voting interest in a business enterprise”). A minority interest on the other hand is usually 50% or less. *Id.* Typically, a minority interest is worth less than its pro-rata share because of a lack of control. *See* PRATT WITH NICULITA, *supra* note 50, at 398.

<sup>67</sup> The acquired company guideline method relies on transactions of comparable companies that are privately held. LARO & PRATT, *supra* note 2, at 211. Transactions involving privately held guideline companies rely on controlling interests. *Id.* Thus, in applying the acquired company guideline method, the level of value produced from market multiples results in a controlling interest valuation.

<sup>68</sup> *Id.* at 211 (noting such financial variables as “earnings, sales, etc.”).

<sup>69</sup> *Id.* at 260.

<sup>70</sup> *Id.*; *see also* Estate of Dooley v. Comm’r, 64 T.C.M. (CCH) 824, 839 (1992) (holding company valued with an asset-based method).

<sup>71</sup> Michael W. Kalcheim, *Expert Testimony and Valuing Goodwill at Divorce*, 88 ILL. B.J. 652, 656 (2000). Specifically, the adjusted net asset value method converts a  
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are not speculative because the fair market value of a company's assets and liabilities are typically established as of a set valuation date.<sup>72</sup>

Nancy Fannon, a business valuation expert, has created a model specific to the valuation of S corporations.<sup>73</sup> Nancy Fannon's simplistic model aids with the understanding of an S corporation tax affect. Furthermore, her analysis focuses on how to generate an appropriate tax affect for S corporations that reflects the benefits of the (1) avoided dividend tax and (2) retained income.<sup>74</sup> Unlike the methods established by other experts in the field of valuation,<sup>75</sup> Ms. Fannon's model lacks the complexity of various inputs. In this case, her S corporation valuation methodology best suits the needs of the judicial system for clarity and reasoning in understanding expert witness testimony.

#### IV. JUDICIAL CONTEXTS FOR BUSINESS VALUATION

Business valuation pops up in many different areas of the law. When an owner of an interest in a closely-held business dies, "the interest must be valued for estate tax purposes."<sup>76</sup> Gifts of ownership interests in closely-held corporations must be valued for gift tax purposes.<sup>77</sup> In the context of divorce, when there is a closely-held business, a valuation is

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company's assets and liabilities to fair market value and then subtracts the liabilities from the assets. LARO & PRATT, *supra* note 2, at 260.

<sup>72</sup> See LARO & PRATT, *supra* note 2, at 260; Kalcheim, *supra* note 71, at 656.

<sup>73</sup> See Nancy Fannon, Fannon Valuation Group, S Corporation Valuation, It Ain't Over Yet . . . (in fact it just started), 2007 Update (Oct. 28, 2007), [http://www.fannonval.com/pdf/S\\_Corporations/S\\_Corporation\\_Valuation\\_July\\_2007.pdf](http://www.fannonval.com/pdf/S_Corporations/S_Corporation_Valuation_July_2007.pdf).

<sup>74</sup> *Id.* at 18–37, 58–63. Rather than applying a tax affect similar to C corporations, Nancy Fannon's model recognizes that a full C corporation tax may produce an undervaluation. *Id.* at 21. For a more in-depth analysis of Ms. Fannon's model, see *infra* notes 255–65 and accompanying text.

<sup>75</sup> For a discussion of some of these methods, see *id.* at 39–56; see also LARO & PRATT, *supra* note 2, at 79–136.

<sup>76</sup> Hood et al., *supra* note 62, at 401 (citing I.R.C. § 2031(a) (1986); Treas. Reg. § 20.2031-1(b) (1965)).

<sup>77</sup> *Id.* (citing I.R.C. § 2512(a) (1986); Treas. Reg. § 25.2512-1 (1992); Rev. Rul. 69-346, 1969-1 C.B. 227, limited by Rev. Rul. 73-61, 1973-1 C.B. 408).

typically performed to determine the marital property division.<sup>78</sup> When shareholder disputes arise valuation is often a remedy.<sup>79</sup> No matter the context, the issue of whether or not to tax-affect an S corporation remains.

#### V. STANDARDS OF VALUE

Two main standards often employed in the context of business valuation are fair market value and fair value. It is important to differentiate between fair market value and fair value because the resulting value of the company could differ significantly.<sup>80</sup> Fair market value is the most commonly “applied legal standard of value for the valuation of business interests and business assets.”<sup>81</sup>

Fair market value is the standard used for estate and gift tax, pursuant to Revenue Ruling 59-60.<sup>82</sup> States establish the standard of value for divorce purposes.<sup>83</sup> Among others, Ohio, Illinois, and Arkansas settled on fair market value as the standard of value for divorce. Ohio<sup>84</sup> and Illinois<sup>85</sup>

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<sup>78</sup> See, e.g., *Walter W.B. v. Elizabeth P.B.*, 462 A.2d 414, 415 (Del. 1983); *Moriarty v. Stone*, 668 N.E.2d 1338, 1342 (Mass. App. Ct. 1996); *Willis v. Willis*, 482 N.E.2d 1274, 1276–77 (Ohio Ct. App. 1984).

<sup>79</sup> Bayless Manning, *The Shareholder's Appraisal Remedy: An Essay for Frank Coker*, 72 YALE L.J. 223, 226 (1962).

<sup>80</sup> Robert D. Frawley, *Valuation Issues in Shareholder and Operating Agreements*, N.J. LAW., June 2006, at 25, 27 (noting that fair value establishes the pro rata portion of a company, whereas fair market value considers the percentage being valued and may apply discounts if appropriate).

<sup>81</sup> Peter C. Dawson, *The Economics of Valuing Covenants Not to Compete Under the Fair Market Value Standard*, 14 J. LEGAL ECON. 25, 29 (2007).

<sup>82</sup> See *supra* note 54 and accompanying text.

<sup>83</sup> See Terri A. Lastovka, *Appraising a Business*, BUS. L. TODAY, Jan.–Feb. 2006, at 43, 46. Lastovka notes that family law courts generally rely on fair market value because they assume the business will continue “as a going concern, meaning that it will continue to operate in the future as it has in the past.” *Id.* Under this rationale, fair market value is the most appropriate standard because it does not contemplate that the business should be liquidated, nor does the fair market value standard omit goodwill. *Id.* However, some states have relied on standards other than fair market value due to the circumstances of the case. See, e.g., *Heggen v. Heggen*, 452 N.W.2d 96 (N.D. 1990) (noting that “liquidation value, rather than fair market value, may be appropriate under certain circumstances,” such as foreclosure).

<sup>84</sup> See *Eisler v. Eisler*, 493 N.E.2d 975, 976 (Ohio Ct. App. 1985).

<sup>85</sup> See *In re Grunsten*, 709 N.E.2d 597, 601 (Ill. App. Ct. 1999).

established fair market value as the standard for divorce through case law; whereas Arkansas promulgated a state statute.<sup>86</sup>

Most states provided dissenting shareholders the right to have their holdings valued under a “fair value” standard, and some states use fair value for divorce purposes.<sup>87</sup> Fair value does not have a set definition like fair market value; each state, if it chooses, establishes its own definition.<sup>88</sup> This may add to the complexity of valuation because the expert must initially determine which standard applies; “different standards of value result in different . . . valu[ation] conclusions.”<sup>89</sup> The definition of fair value under the Revised Model Business Corporation Act (RMBCA) is similar to many state statutes.<sup>90</sup> “Fair value,” as defined by the RMBCA, is “the value of the corporation’s shares determined immediately before the effectuation of the corporate action to which the shareholder objects[.]”<sup>91</sup>

Fair value and fair market value can be, but are not always, synonymous.<sup>92</sup> Business valuations require different standards of value in various judicial contexts. In the analysis of the cases to follow note the standard of value and whether it has an impact on the analysis of the subject S corporation.

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<sup>86</sup> ARK. CODE ANN. § 9-12-315(a)(4) (West 2008).

<sup>87</sup> LARO & PRATT, *supra* note 2, at 13.

<sup>88</sup> *Id.* For example, Illinois defines “fair value” for a non-cash asset as:

(A) the amount at which that asset could be bought or sold in a current transaction between arms-length, willing parties;

(B) quoted market price for the asset in active markets should be used if available; and

(C) if quoted market prices are not available, a value determined using the best information available considering values of like assets and other valuation methods . . . .

215 ILL. COMP. STAT. ANN. 5/179E-15 (West Supp. 2008).

<sup>89</sup> Robert F. Reilly, *Ten Elements of the Bankruptcy Business Valuation Assignment*, 26 AM. BANKR. INST. J., Mar. 2007, at 48, 48.

<sup>90</sup> LARO & PRATT, *supra* note 2, at 13.

<sup>91</sup> REVISED MODEL BUS. CORP. ACT § 13.01(4)(i) (2007).

<sup>92</sup> LARO & PRATT, *supra* note 2, at 13.

## VI. EXPERTS

A. *Expert Testimony*

Expert testimony is frequently relied upon by the courts and the parties, both before and during litigation, to determine valuation.<sup>93</sup> However, if experts are admitted, courts “are not bound by the opinion of any expert witness, and [they] may accept or reject expert testimony in the exercise of [their] sound judgment.”<sup>94</sup> The *Heck* court notes that courts “may accept the opinion of an expert in its entirety,” rely on various “portions of an expert’s opinion,” or completely reject the analysis offered by an expert.<sup>95</sup>

Thus, it is important for experts to clearly explain the reasoning behind their calculations and analysis. When experts are unable to plainly detail how and why they reached their opinion of value to the lawyers and more importantly the judges, then bad case law can result.<sup>96</sup> This is particularly important to the valuation of S corporations and the need to tax affect. Experts must be able to detail and explain their methodology and reasoning. While tax affecting S corporations is a relatively a new concept,<sup>97</sup> various courts have dealt with the issue.<sup>98</sup> It is important for experts to be able to explain the implications of an appropriate tax affect on a pass through entity.

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<sup>93</sup> See, e.g., *Estate of Heck v. Comm’r*, 83 T.C.M. (CCH) 1181, 1185 (2002).

<sup>94</sup> *Id.* (citing *Helvering v. Nat’l Grocery Co.*, 304 U.S. 282, 295 (1938); *Estate of Newhouse v. Comm’r.*, 94 T.C. 193, 217 (1990)).

<sup>95</sup> *Id.* (citing *Parker v. Comm’r.*, 86 T.C. 547, 562 (1986); *Buffalo Tool & Die Mfg. Co. v. Comm’r.*, 74 T.C. 441, 452 (1980)).

<sup>96</sup> See, e.g., *Dallas v. Comm’r*, 92 T.C.M. (CCH) 313 (2006) (rejecting experts’ opinions for lack of a solid explanation). See *infra* Part VIII.F for a more in-depth discussion of the *Dallas* decision.

<sup>97</sup> See *Bernier v. Bernier*, 873 N.E.2d 216, 220 (Mass. 2007) (identifying the question of whether to “tax affect[]” an S corporation is “novel”).

<sup>98</sup> See *Dallas*, 92 T.C.M. (CCH) 313; *Estate of Adams v. Comm’r*, 83 T.C.M. (CCH) 1421 (2002); *Estate of Heck v. Comm’r*, 83 T.C.M. (CCH) 1181 (2002); *Wall v. Comm’r*, 81 T.C.M. (CCH) 1425 (2001); *Gross v. Comm’r*, 78 T.C.M. (CCH) 201 (1999), *aff’d*, 272 F.3d 333 (6th Cir. 2001); *Del. Open MRI Radiology Assocs., P.A. v. Kessler*, 898 A.2d 290 (Del. Ch. 2006); *Bernier*, 873 N.E.2d 216; *Vicario v. Vicario*, 901 A.2d 603 (R.I. 2006); see also discussion *infra* Parts VII–IX.

*B. Business Valuators as Expert Witnesses*

In order to offer conclusions and opinions of value, an appraiser must be qualified as an expert.<sup>99</sup> Federal Rule of Evidence (FRE) 702 specifically governs the testimony of experts.<sup>100</sup> FRE 702 provides:

If scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert by knowledge, skill, experience, training, or education, may testify thereto in the form of an opinion or otherwise, if (1) the testimony is based upon sufficient facts or data, (2) the testimony is the product of reliable principles and methods, and (3) the witness has applied the principles and methods reliably to the facts of the case.<sup>101</sup>

“[O]ther specialized knowledge” includes business valuation expertise.<sup>102</sup> While experts typically provide an opinion for the court, they may also—under the Federal Rules of Evidence—offer explanations of relevant principles and methods and let the “trier of fact . . . apply them to the facts.”<sup>103</sup> Consequently, it is important for the expert to explain herself clearly.

Furthermore, the Tax Court requires an expert to submit a written report, which serves as direct testimony.<sup>104</sup> Under Rule 143(f), the expert witness must include the following: “(1) [t]he qualifications of the expert witness[;] (2) [t]he witness’s opinion and the facts or data on which that opinion is based[; and] (3) [d]etailed reasons for the conclusion[.]”<sup>105</sup> The expert is allowed to testify at the discretion of the court in order to “clarify or emphasize matters in the report,” among other things.<sup>106</sup> Not only must

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<sup>99</sup> See LARO & PRATT, *supra* note 2, at 28.

<sup>100</sup> *Id.* (quoting FED R. EVID. 702).

<sup>101</sup> *Id.* (quoting FED R. EVID. 702).

<sup>102</sup> *Id.*

<sup>103</sup> *Id.*

<sup>104</sup> *Id.* at 30–31 (citing U.S. T.C. PRAC. & P. R. 143(f)(1)).

<sup>105</sup> *Id.* at 31 (citing U.S. T.C. PRAC. & P. R. 143(f)).

<sup>106</sup> *Id.* at 30–31 (citing U.S. T.C. PRAC. & P. R. 143(f)(1)).

experts comply with written report requirements, FRE 702 requires that expert testimony be reliable.<sup>107</sup>

Although there are no precise qualifications, the business valuation expert must (1) have some formal training, (2) possess credibility, (3) not be biased, and (4) be able to “assist and educate the court . . . .”<sup>108</sup> This last quality is especially important when the underlying theories or techniques are complicated, as is the case with S corporation valuations. Courts consider “knowledge, skill, experience, training, or education,” to determine whether the expert is qualified.<sup>109</sup> Again, it is particularly important for the valuation expert to educate the court regarding the appropriate tax affect for S corporations. Because S corporations are pass through entities the need for a tax affect is not evident; therefore, the expert must effectively lay out her rationale for the court.

#### VII. OPINIONS FROM VARIOUS JURISDICTIONS

The opinions that discuss the issue of tax affecting S corporations come from a variety of jurisdictions, including the Tax Court and state courts.<sup>110</sup> Four of the five cases discussed below which do not apply a tax affect were decided in the Tax Court.<sup>111</sup> The fifth case was decided in the

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<sup>107</sup> *Id.* at 29 (citing FED R. EVID. 702); *see also* Cynthia Lynne Pike, *The Impact of Revised MRE 702 and 703 in Response to Daubert*, 52 WAYNE L. REV. 285, 289 (2006) (“The Supreme Court enumerated four discretionary factors to aid a trial judge in determining whether the proffered expert evidence is sufficiently reliable to be admitted. The factors include whether the technique or theory underlying the evidence: (1) can be tested; (2) has been subjected to peer review and publication; (3) has been generally accepted in the scientific community; and (4) has a ‘known or potential rate of error.’”) (footnotes omitted).

<sup>108</sup> LARO & PRATT, *supra* note 2, at 33–34.

<sup>109</sup> *Wilke v. Adkins*, No. 268685, 2007 WL 1828788, at \*5 (Mich. Ct. App. June 26, 2007) (citing FED R. EVID. 702).

<sup>110</sup> *See* Estate of Adams v. Comm’r, 83 T.C.M. (CCH) 1421 (2002); Estate of Heck v. Comm’r, 83 T.C.M. (CCH) 1181 (2002); Wall v. Comm’r, 81 T.C.M. (CCH) 1425 (2001); Gross v. Comm’r, 78 T.C.M. (CCH) 201 (1999), *aff’d*, 272 F.3d 333 (6th Cir. 2001); Vicario v. Vicario, 901 A.2d 603 (R.I. 2006).

<sup>111</sup> *See* Adams, 83 T.C.M. (CCH) at 1425; Heck, 83 T.C.M. (CCH) at 1188 n.7; Wall, 81 T.C.M. (CCH) at 1432 n.19; Gross, 78 T.C.M. (CCH) at 209.

Supreme Court of Rhode Island.<sup>112</sup> All of these cases “suggest S corporation earnings should not be tax affected for valuation purposes.”<sup>113</sup>

Two decisions in the line of cases dealing with an S corporation tax affect are state court decisions.<sup>114</sup> These cases suggest S corporation earnings should be tax affected for valuation purposes to account for the benefits of avoided dividend taxes.<sup>115</sup>

Ultimately, each case was fact specific; however, the underlying analysis (or lack thereof) was relied upon by succeeding jurisdictions because of a lack of precedent.<sup>116</sup>

## VIII. COMPARISON – CASES THAT DO NOT APPLY A TAX AFFECT

### A. *Gross v. Commissioner*

The evolution of cases that deal with taxation of S corporations started out with a Pepsi-Cola bottler in Cincinnati, Ohio.<sup>117</sup> In *Gross*, the taxpayer made gifts of minority shares in G & J Pepsi-Cola Bottlers, Inc. (“G & J”), an S corporation.<sup>118</sup> The standard of value applied to this gift valuation was fair market value.<sup>119</sup>

Because “[v]aluation is an issue of fact,”<sup>120</sup> the taxpayer and the Commissioner both relied on experts to determine the fair market value of the transferred stock as of the date of the gift.<sup>121</sup> Although the experts relied on the same valuation methodology—the discounted cash flow

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<sup>112</sup> See *Vicario*, 901 A.2d at 609.

<sup>113</sup> LARO & PRATT, *supra* note 2, at 81.

<sup>114</sup> See *Del. Open MRI Radiology Assocs., P.A. v. Kessler*, 898 A.2d 290 (Del. Ch. 2006); *Bernier v. Bernier*, 873 N.E.2d 216 (Mass. 2007).

<sup>115</sup> *Kessler*, 898 A.2d at 230; *Bernier*, 873 N.E.2d at 229–31.

<sup>116</sup> Generally, it is not uncommon for courts to rely on cases from other jurisdictions. See, e.g., *Brown v. Brittain*, 773 P.2d 570, 572 (Colo. 1989) (en banc) (relying on a case from the Tenth Circuit); *Mullins v. Pine Manor Coll.*, 449 N.E.2d 331, 336 (Mass. 1983) (relying on cases from Illinois); *Pakmark Corp. v. Liberty Mut. Ins. Co.*, 943 S.W.2d 256, 260 (Mo. Ct. App. 1997) (relying on a case from Wisconsin).

<sup>117</sup> See *Gross v. Comm’r*, 78 T.C.M. (CCH) 201 (1999), *aff’d*, 272 F.3d 333 (6th Cir. 2001).

<sup>118</sup> *Id.* at 202–03.

<sup>119</sup> *Id.* at 203, 210.

<sup>120</sup> *Id.* at 203 (citing *Estate of Newhouse v. Comm’r*, 94 T.C. 193, 217 (1990)).

<sup>121</sup> *Id.* at 204.

method—they differed as to the application of a tax affect.<sup>122</sup> The taxpayer's expert applied a 40% tax rate, he said, in order to comply with the standards to which he was bound.<sup>123</sup> The Commissioner's expert also applied a tax affect, but established a rate of 0%.<sup>124</sup> The experts were at opposite ends of the spectrum in their analysis of the appropriate tax affect. Thus, their ultimate conclusions of value differed; the taxpayer's expert concluded a value of \$5,680 per share for G & J, whereas the Commissioner's expert established a value of \$10,910 per share.<sup>125</sup>

In establishing a 0% tax rate, the Commissioner's expert noted that the corporation was, and likely would remain, an S corporation.<sup>126</sup> He also assumed that the historical consistency of distributions, which approximated income, would likely continue.<sup>127</sup> The taxpayers also relied on the IRS's Examination Handbook and the IRS's Valuation Guide.<sup>128</sup> The guide notes that for S corporations "[y]ou need only to adjust the earnings from the business to reflect estimated corporate income taxes that would have been payable had the Subchapter S election not been made."<sup>129</sup> The handbook also provides a similar rationale; it states that "[i]f you are comparing a Subchapter S Corporation to the stock of similar firms that are publicly-traded, the net income of the former must be adjusted for income taxes using the corporate tax rates applicable for each year in question."<sup>130</sup> However, the *Gross* court rejected these IRS publications as "lack[ing] analytical support" and "the force of a regulation or ruling."<sup>131</sup>

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<sup>122</sup> *Id.* at 204–05, 207.

<sup>123</sup> *Id.* at 204. The expert noted that "various professional associations published standards governing the conduct of professional business appraisers." *Id.* The expert specifically referred to a "publication entitled the Uniform Standards of Professional Appraisal Practice (USPAP), which required business appraisers to be aware of, to understand, and correctly to employ recognized methods and techniques necessary to produce a credible result (the standards rule)." *Id.*

<sup>124</sup> *Id.* at 205.

<sup>125</sup> *Id.* at 204–05.

<sup>126</sup> *Id.* at 205.

<sup>127</sup> *Id.*

<sup>128</sup> *Id.* at 207.

<sup>129</sup> *Id.*

<sup>130</sup> *Id.*

<sup>131</sup> *Id.*

The *Gross* court ultimately concluded that a tax affect should be applied; however, the effective tax rate should be 0%.<sup>132</sup> The court agreed with the Commissioner's expert and applied a 0% tax affect to the gifts of minority shares in G & J based on the expert's assumptions that: (1) the S corporation status would not be lost, and (2) the company's earnings would be distributed to the shareholders.<sup>133</sup>

The court's rationale stemmed from the company's restrictive transfer agreement, which strictly prevented the termination of the company's S corporation election.<sup>134</sup> Additionally, the court noted that G & J typically distributed almost all the annual income.<sup>135</sup> The *Gross* court pointed out that the benefit of S corporation status—a reduction in tax payments—should not be ignored for valuation purposes.<sup>136</sup>

Although this analysis may seem logical, the court's ultimate holding “violates the willing buyer/willing seller standard not only as a matter of law, but also as a matter of the common sense it purports to possess.”<sup>137</sup> The Court strayed from the “hypothetical” willing buyer and willing seller standards and accepted the reasoning of the Commissioner's expert that G & J would continue as an S corporation.<sup>138</sup> Ultimately, this analysis overvalued the G & J stock because of the assumption of an “S-eligible buyer” versus a hypothetical willing buyer.<sup>139</sup>

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<sup>132</sup> *Id.* at 209.

<sup>133</sup> *Id.* at 205.

<sup>134</sup> *See id.* at 202, 208.

<sup>135</sup> *Id.* at 208.

<sup>136</sup> *Id.* at 209.

<sup>137</sup> Gerald J. Rapien & James J. Ryan, *Couples Dispute IRS Valuation of S Corporation Stock*, 2000 TAX NOTES TODAY 38-24, Feb. 9, 2000, at para. 19.

<sup>138</sup> *Id.* at para. 21.

<sup>139</sup> *Id.* at para. 22. “The courts have repeatedly held that the willing buyer/willing seller standard is violated by postulating a special individual or group of buyers or sellers for whom the property in question has greater value based upon their status or relationship to other relevant parties.” *Id.* One article notes that “[w]hile it is true that the majority's concern of examining the situation from the perspective of the willing seller is important, it is also true that too high a value placed on an interest by a willing seller will result in no willing buyers.” George B. Hawkins & Michael A. Paschall, *A Gross Result in the Gross Case: All Your Prior S Corporation Valuations Are Invalid*, Q.J. BUS. VALUATION COMMITTEE AM. SOC'Y APPRAISERS, Mar. 2002, at 1, 4-5.

The *Gross* holding was not a good start towards reaching a resolution on the issue of whether to tax affect S corporations. Because the *Gross* court did not definitively say either the tax affect was 0% or that a tax affect was inappropriate, many courts wrestled with interpreting the decision.<sup>140</sup> However, the ultimate result in either case is inappropriate, as S corporations should be tax affected. A 0% tax affect or no tax affect results in a failure to apply any taxes to an S corporation, which may lead to overvaluation. Subsequent courts relied on the *Gross* decision and inappropriately failed to apply a tax affect to S corporations.

Following the *Gross* decisions, many courts followed suit in not tax affecting the earnings of an S corporation. However, the reasoning and interpretation of the *Gross* decision varied.

#### B. *Wall v. Commissioner*

The facts in *Wall*, decided in 2001, were similar to the facts in the *Gross* case.<sup>141</sup> The taxpayer's business was valued for gift tax purposes, and the shares to be transferred represented minority shares.<sup>142</sup> Demco, Inc., the subject corporation, distributed and manufactured "office supplies, furniture, and accessories."<sup>143</sup> The shareholders of Demco, Inc. elected S corporation status.<sup>144</sup> Because the shares at issue in *Wall* were gifts, I.R.C.

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<sup>140</sup> Estate of Adams v. Comm'r, 83 T.C.M. (CCH) 1421, 1425 (2002) (citing *Gross* for the proposition that a zero corporate tax rate is appropriate when valuing an S corporation's stock); Wall v. Comm'r, 81 T.C.M. (CCH) 1425, 1432 n.19 (2001) (citing *Gross* for the proposition that tax affecting an S corporation leads to an undervaluation of the corporation's stock); Del. Open MRI Radiology Assocs., P.A. v. Kessler, 898 A.2d 290, 328 n.94 (Del. Ch. 2006) (citing *Gross* for the proposition that S corporations should not be tax affected); Bernier v. Bernier, 873 N.E.2d 216, 228 (Mass. 2007) (citing *Gross* for the proposition that, although S corporations can be tax affected, the corporate tax rate cannot be higher than 0%); Vicario v. Vicario, 901 A.2d 603, 609 (R.I. 2006) (citing *Gross* for the proposition that tax affecting S corporations is improper).

<sup>141</sup> *Wall*, 81 T.C.M. (CCH) 1425.

<sup>142</sup> *Id.* at 1426.

<sup>143</sup> *Id.*

<sup>144</sup> *Id.*

§ 2512(a) applied.<sup>145</sup> Under § 2512(a), fair market value is the applicable standard.<sup>146</sup>

The taxpayer's expert initially valued the company based on the market approach, using the publicly-traded guideline method.<sup>147</sup> The expert then revised her report to include an income-based approach, which established a value of \$192.20 per share.<sup>148</sup> She relied on a method that (1) projects cash flows of the company and (2) establishes a capitalization rate to apply to the projected cash flows.<sup>149</sup>

The Commissioner's expert also used both the publicly-traded guideline method and an income approach.<sup>150</sup> The court criticized both experts' valuation opinions, including their market and income approaches.<sup>151</sup>

In a footnote, the court stated that tax affecting Demco, Inc. is inappropriate because the company is an S corporation and applying a tax affect would undervalue the company.<sup>152</sup> The taxpayer's expert applied a tax affect to her income-based approach.<sup>153</sup> Her argument for tax affecting emphasized that "many potential buyers of S corporations are C corporations," and the purchasing C corporation would apply a tax affect in valuing the target company because the S corporation status would be lost upon acquisition.<sup>154</sup> The argument against tax affecting is the benefit of avoiding a second level of taxation, which may make an S corporation

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<sup>145</sup> See *id.* at 1429. Section 2512(a) states that, "[i]f the gift is made in property, the value thereof at the date of the gift shall be considered the amount of the gift." I.R.C. § 2512(a) (2006); see also *Wall*, 81 T.C.M. (CCH) at 1429.

<sup>146</sup> *Id.* Section 25.2512-1 of the Gift Tax regulations states that "[t]he value of the [gifted] property is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts." 26 C.F.R. § 25.2512-1 (2008); see also *Wall*, 81 T.C.M. (CCH) at 1429.

<sup>147</sup> *Wall*, 81 T.C.M. (CCH) at 1431.

<sup>148</sup> *Id.* at 1428, 1432.

<sup>149</sup> *Id.* at 1432.

<sup>150</sup> *Id.* at 1434–35. Based on the income approach, the Commissioner's expert established a value for Demco, Inc. of \$273.00 per share. *Id.* at 1435.

<sup>151</sup> *Id.* at 1436–39.

<sup>152</sup> *Id.* at 1432 n.19.

<sup>153</sup> *Id.*

<sup>154</sup> *Id.*

more valuable than a C corporation.<sup>155</sup> The judge opined that the application of a tax affect would negate the value of S corporation status, resulting in an undervaluation of the company.<sup>156</sup> Again, the *Wall* court rejected both experts' valuation opinions and gave little direction for or against applying a tax affect.

Ultimately, the *Wall* case reinforces the *Gross* decision to not tax affect an S corporation. The *Wall* court recognized both sides of the issue, but did not break from the precedent set by *Gross*.

The *Wall* court noted that the potential purchasers of an S corporation may be an S corporation or a C corporation. If an S corporation purchases the subject S corporation, then S corporation status would not be lost.<sup>157</sup> On the other hand, an S corporation would lose its S corporation status upon its purchase by a C corporation.<sup>158</sup> The valuation implications relate to taxes. Specifically, an S corporation to S corporation transaction would keep all the benefits of taxes passing through to the individual shareholders; whereas an S corporation to C corporation transaction would lose such benefits. These two courts acknowledged this dilemma, but did not provide an analysis for dealing with a mixed pool of buyers.

#### C. Estate of Adams v. Commissioner

In 2002, the Tax Court heard another case dealing with the issue of whether or not to tax affect S corporation earnings.<sup>159</sup> In *Adams*, the sole issue was the valuation of a controlling interest in an insurance company for estate tax purposes.<sup>160</sup> When the decedent died he owned 61.59% of Waddell Sluder Adams & Co. (WSA), an S corporation.<sup>161</sup>

The Commissioner's expert and the taxpayer's expert both relied on income-based approaches, but they differed as to the selected method.<sup>162</sup> The Commissioner's expert used the discounted cash flow method to arrive at a value of \$1,746,000, and the estate's expert relied on the capitalization

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<sup>155</sup> *Id.*

<sup>156</sup> *Id.*

<sup>157</sup> *See id.*

<sup>158</sup> *Id.*

<sup>159</sup> *See* Estate of Adams v. Comm'r, 83 T.C.M. (CCH) 1421 (2002).

<sup>160</sup> *Id.* at 1421–22.

<sup>161</sup> *Id.*

<sup>162</sup> *Id.* at 1424.

of earnings method to value the company at \$920,800.<sup>163</sup> The court disagreed with the capitalization rate used by the taxpayer's expert.<sup>164</sup> It is well established that "[t]he net cashflow and the capitalization rate used to compute the fair market value [of a company's] stock should have the same tax character; i.e., before corporate tax or after corporate tax."<sup>165</sup> Meaning, valuation requires the comparison of "apples to apples" or pre-tax earnings to a pre-tax rate and after-tax earnings to an after-tax rate.

In *Adams*, the taxpayer argued that its expert "properly converted the capitalization rate" to a pre-tax rate to match the earnings base, which was not tax affected.<sup>166</sup> In reliance on *Gross*, the *Adams* court disagreed with the argument that the taxpayer's expert used a pre-tax rate, "because it is appropriate to use a zero corporate tax rate to estimate net cashflow when the stock being valued is stock of an S corporation."<sup>167</sup> The court interpreted *Gross* to mean that the S corporation status of WSA necessitates a 0% tax rate.<sup>168</sup> The court rationalized that a 0% tax rate should be applied to WSA's earnings, which would then render the earnings base used by the taxpayer's expert an after-tax base.<sup>169</sup> As such, the conversion of the capitalization rate to pre-tax is not appropriate because now the expert's calculation is comparing "apples to oranges" since the earnings are pre-tax and the capitalization rate is after-tax.<sup>170</sup>

As mentioned above, the *Adams* Court interpreted the *Gross* decision to impute a 0% tax rate in valuing S corporations. This decision reeks of form over substance. A 0% tax rate produces the same result as applying no taxes at all: overvaluation of S corporations.

#### D. Estate of Heck v. Commissioner

*Heck* was also decided in 2002, and involved the valuation of a minority interest in a champagne producer for estate tax purposes.<sup>171</sup> Fair

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<sup>163</sup> *Id.* at 1423–24.

<sup>164</sup> *Id.* at 1424–25.

<sup>165</sup> *Id.* (citing *Gross v. Comm'r*, 78 T.C.M. (CCH) 201, 209 (1999), *aff'd*, 272 F.3d 333 (6th Cir. 2001)).

<sup>166</sup> *Id.* at 1425.

<sup>167</sup> *Id.* (citing *Gross*, 78 T.C.M. (CCH) at 209).

<sup>168</sup> *Id.*

<sup>169</sup> *Id.*

<sup>170</sup> *Id.*

<sup>171</sup> *Estate of Heck v. Comm'r*, 83 T.C.M. (CCH) 1181, 1181–82 (2002).

market value was the applicable standard of value in this case.<sup>172</sup> F. Korbel & Bros., Inc. (Korbel) elected S corporation status pursuant to I.R.C. § 1361(a)(1) in January of 1986.<sup>173</sup>

The Commissioner's expert utilized both the market approach and the income approach to arrive at a total value of \$30,300,000, or \$48,100 per share.<sup>174</sup> Specifically, the expert relied on a weighted average of the results from several methods, including the discounted cash flow method—an income-based method—and a market-based method.<sup>175</sup> The *Heck* court rejected the expert's use of the market approach due to a lack of comparable "guideline companies."<sup>176</sup>

The expert for the taxpayer relied exclusively on the discounted cash flow method; he rejected the market approach because he did not believe there were any comparable companies.<sup>177</sup> The taxpayer's expert arrived at a total value of \$18,707,000, or \$29,694 per share for the company.<sup>178</sup>

Both experts established a value for the minority shares in Korbel pursuant to the fair market value standard because "[f]air market value is the standard for determining the value of property for Federal estate tax purposes."<sup>179</sup>

The *Heck* court disassembled the valuations prepared by the experts and generated its own calculation.<sup>180</sup> In doing so, the court did not address the application of a tax affect to the income stream of Korbel, aside from a 1.5% tax affect for state taxes, because neither expert applied a tax affect.<sup>181</sup>

However, the implications of S corporation status were taken into account via discounts.<sup>182</sup> Specifically, the Commissioner's expert applied

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<sup>172</sup> *Id.* at 1184.

<sup>173</sup> *Id.* at 1182.

<sup>174</sup> *Id.* at 1183–84.

<sup>175</sup> *Id.* at 1183.

<sup>176</sup> *Id.* at 1187 (The guideline companies used by the Commissioner's expert "were not sufficiently similar to Korbel to permit the use of a market approach based upon those two companies alone.").

<sup>177</sup> *Id.* at 1184.

<sup>178</sup> *Id.*

<sup>179</sup> *Id.* (citing *United States v. Cartwright*, 411 U.S. 546, 550–51 (1973)).

<sup>180</sup> *Id.* at 1188–93.

<sup>181</sup> *Id.* at 1188 n.7.

<sup>182</sup> *Id.* at 1183–84.

a liquidity discount of 25%, including a 10% adjustment “for risks associated with Korbel’s status as an S corporation.”<sup>183</sup> He stated that the S corporation status subjects a company “to several restrictions impairing liquidity, including restrictions on the number and type of persons that can be shareholders.”<sup>184</sup> However, he did not quantify the advantages and disadvantages associated with S corporation status because he considered S corporation status to be an advantage in and of itself.<sup>185</sup>

The taxpayer’s expert arrived at a 35% total discount, which did not include consideration of the company’s S corporation status.<sup>186</sup> In dealing with S corporation status, the *Heck* court utilized a method different from that used by *Gross* and *Wall*. The court’s ultimate conclusion of value did not apply a tax affect, but instead relied on discounts to deal with the company’s S corporation status.<sup>187</sup>

The *Heck* court realized a difference in value between S corporations and C corporations, but the court failed to provide an appropriate analysis. The application of a marketability discount to deal with S corporation status does not accurately quantify the benefit of S corporation ownership. While discounts consider various factors and may be appropriate in certain circumstances, it is not appropriate to deal with a company’s S corporation status via a marketability discount.

#### *E. Vicario v. Vicario*

The Rhode Island Supreme Court addressed the issue of tax affecting S corporations in 2006 when it decided *Vicario*.<sup>188</sup> This divorce case involved the valuation of “a [50%] interest in Abacus Benefit Consultants, Inc. (Abacus), an actuarial consulting business.”<sup>189</sup>

The wife’s expert relied on the income approach, specifically the capitalization of earnings because projections were not provided in order for the expert to establish a value based on the discounted cash flow

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<sup>183</sup> *Id.* at 1191.

<sup>184</sup> *Id.* at 1192 n.14.

<sup>185</sup> *Id.*

<sup>186</sup> *Id.* at 1191.

<sup>187</sup> *Id.* at 1193.

<sup>188</sup> *Vicario v. Vicario*, 901 A.2d 603 (R.I. 2006).

<sup>189</sup> *Id.* at 606.

method.<sup>190</sup> The wife's expert arrived at a value of \$268,000 for Mr. Vicario's 50% interest in the company.<sup>191</sup>

The husband's expert used the same methodology as the wife's expert, except they differed as to the application of a tax affect.<sup>192</sup> The husband's expert applied a tax rate because it "allows one to arrive at a value for the cash flow of the business after it is taxed by the Internal Revenue Service."<sup>193</sup> The expert for the husband arrived at a value of \$100,000 for the husband's interest in Abacus.<sup>194</sup> On the other hand, the wife's expert did not believe a tax affect was appropriate because Abacus was an S corporation, which meant taxes are not applied at the entity level but "passe[d] through" to the individual shareholders.<sup>195</sup>

The *Vicario* court relied on the *Gross* decision and held that the application of a tax affect was incorrect.<sup>196</sup> Thus, we get yet another interpretation of *Gross*. Unlike the *Wall* court, which interpreted the holding of *Gross* to impute a 0% tax affect, the *Vicario* court interpreted the *Gross* decision to mean "that it is improper to tax-affect a Subchapter S corporation when valuing it."<sup>197</sup> As we already know, this is an incorrect conclusion. Although S corporation shareholders benefit from a single layer of taxation, the failure to apply any taxes to an S corporation overvalues it.

#### F. *Dallas v. Commissioner*

This case, which was decided in 2006, involved minority interest gifts of Dallas Group of America, Inc. (DGA), a manufacturer and distributor of ammonium chloride and synthetic magnesium silicate.<sup>198</sup> DGA was organized as an S corporation.<sup>199</sup>

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<sup>190</sup> *Id.* at 607.

<sup>191</sup> *Id.*

<sup>192</sup> *Id.* at 607–08.

<sup>193</sup> *Id.* at 607 n.4.

<sup>194</sup> *Id.* at 607.

<sup>195</sup> *Id.* at 607 n.4.

<sup>196</sup> *Id.* at 609 (citing *Gross v. Comm'r*, 272 F.3d 333 (6th Cir. 2001)).

<sup>197</sup> *Id.*

<sup>198</sup> *Dallas v. Comm'r*, 92 T.C.M. (CCH) 313, 314–15 (2006).

<sup>199</sup> *Id.* at 314.

The taxpayer had two experts, Empire and MPI, and the Commissioner presented one expert.<sup>200</sup> Empire used the income-based capitalization of earnings and MPI relied on the income-based discounted cash flow methodology and the market-based guideline company method.<sup>201</sup> Ultimately, the taxpayer's experts concluded that the value of DGA amounted to \$620 per share as of November 29, 1999, and \$650 per share as of November 29, 2000.<sup>202</sup> The Commissioner's expert applied the capitalization of earnings method and two market approaches, the (publicly-traded) guideline method and the (acquired company / privately held) guideline method.<sup>203</sup> The expert for the commissioner concluded that the value of DGA amounted to \$907 per share as of November 29, 1999, and \$906 per share as of November 29, 2000.<sup>204</sup>

The values differed mainly because of the treatment of taxes. The taxpayer's experts both tax affected the earnings of DGA. Specifically, Empire applied a 40% rate and MPI applied a 35% rate.<sup>205</sup> Empire rationalized that the company would lose its S corporation status should there be a sale, and MPI's justification for tax affecting stemmed from the fact that a taxpayer is responsible for paying taxes on profits, regardless of annual distributions.<sup>206</sup>

The taxpayer's MPI expert did not consistently explain his grounds for applying a tax affect to the earnings of DGA; therefore, the Court rejected his "analysis."<sup>207</sup> The taxpayer's Empire expert gave a wishy-washy rationales for applying a tax affect.<sup>208</sup> He noted (1) he "always tax-affected S corporation[s]"; (2) an informal conference poll indicated a high percentage of attendees applied a tax affect; (3) the American Society of Appraisers, a valuation organization, rejects reports that are submitted for certification purposes which do not tax affect S corporations; (4) "bankers,

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<sup>200</sup> *Id.* at 316.

<sup>201</sup> *Id.* at 317.

<sup>202</sup> *Id.* at 314.

<sup>203</sup> *Id.* at 317.

<sup>204</sup> *Id.* at 314.

<sup>205</sup> *Id.* at 317.

<sup>206</sup> *Id.*

<sup>207</sup> *Id.* at 318 (The expert "initially testified that MPI tax-affected DGA's earnings to apply C corporation tax rates and later testified that MPI reduced DGA's earnings to reflect individual income tax rates.").

<sup>208</sup> *Id.*

investment bankers, and business brokers” tax affect S corporations; and (5) his company applied a tax affect to S corporation valuations submitted to the Department of Labor.<sup>209</sup>

The *Dallas* court did not accept the rationales for tax affecting, stating that (1) there was no evidence the company would lose its S corporation status, (2) DGA had historically distributed enough each year for the taxpayers to pay their respective tax liabilities and it did not appear this practice would change, and (3) a hypothetical buyer would not tax affect earnings.<sup>210</sup>

The *Dallas* court distinguished this case from *Kessler*, which tax affected earnings, based on the differing standards of value.<sup>211</sup> Specifically, the *Dallas* court noted that fair market value (used by the *Dallas* court) does not equate to fair value (used by the *Kessler* court).<sup>212</sup>

The *Dallas* court “conclude[d] there [was] insufficient evidence to establish that a hypothetical buyer and seller would tax-affect DGA’s earnings and that tax-affecting DGA’s earnings [was] not appropriate.”<sup>213</sup> There is no real rationale for the court’s decision, other than its rejection of both of the taxpayer’s experts. This is a good example of the need for valuers who are capable of adequately explaining their opinion of value and the rationale behind it. When the valuation expert is unable to provide a solid explanation, even though they may be right, bad case law can result.

## IX. CASES THAT APPLY A TAX AFFECT

### A. Delaware Open MRI Radiology Assocs., P.A. v. Kessler

As noted above, *Dallas* specifically distinguished the holding of *Kessler*.<sup>214</sup> *Kessler* involved the valuation of a radiology practice (Delaware Radiology) for purposes of a dissenting shareholder action.<sup>215</sup> One of the main issues revolved around the fact that the company was an S

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<sup>209</sup> *Id.*

<sup>210</sup> *Id.* at 317–18.

<sup>211</sup> *Id.* at 318 (citing Del. Open MRI Radiology Assocs., P.A. v. Kessler, 898 A.2d 290, 328 (Del. Ch. 2006)). See discussion *infra* Part IX.A for a more detailed discussion of *Kessler*.

<sup>212</sup> *Dallas*, 92 T.C.M. (CCH) at 318.

<sup>213</sup> *Id.*

<sup>214</sup> *Id.*

<sup>215</sup> *Kessler*, 898 A.2d at 299.

corporation and there was no evidence the company would be anything other than an S corporation.<sup>216</sup>

Each side employed valuation experts, and both experts relied on the discounted cash flow methodology.<sup>217</sup> The expert for the majority shareholders applied a 40% tax rate to the company's earnings; whereas the minority shareholders' expert did not tax affect the earnings.<sup>218</sup> The majority's expert valued the total company at \$6,815,400, or \$17,038.67 per share, and the minority's expert valued Delaware Radiology at \$26,429,722, or \$66,074 per share.<sup>219</sup> The Court recognized that tax affecting S corporations for valuation purposes is a recurring issue and should be addressed.<sup>220</sup>

The *Kessler* court criticized the expert for the majority shareholders in applying a C corporation tax rate because there was no evidence the company would convert from an S corporation to a C corporation and "[t]he S corporation tax status is a highly valuable attribute to the shareholders of Delaware Radiology, given its profitability and the affluent status of its physician stockholders, who face top marginal tax rates."<sup>221</sup> In this case, the court reasoned that the expert for the majority shareholders deprived the S corporation's minority shareholders of the benefits of the company's S corporation status by applying a C corporation tax rate.<sup>222</sup>

On the other hand, the *Kessler* court disapproved of the minority shareholders' expert's analysis because it inflated the value of the company.<sup>223</sup> Specifically, the court noted that "[i]f 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>224</sup> The court asserted that the continuation of a company's S corporation status impacts the value to a potential purchaser; where S corporation status

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<sup>216</sup> *Id.* at 314.

<sup>217</sup> *Id.*

<sup>218</sup> *Id.* at 314, 326.

<sup>219</sup> *Id.* at 314.

<sup>220</sup> *See id.* at 326.

<sup>221</sup> *Id.*

<sup>222</sup> *Id.* at 327.

<sup>223</sup> *Id.*

<sup>224</sup> *Id.*

would not continue, the valuation would be overstated if a tax affect were not applied.<sup>225</sup>

Ultimately, the *Kessler* court held that the appropriate tax affect should be based on “individual rather than corporate tax rates.”<sup>226</sup> This court, unlike its predecessors, recognized that “[e]ven 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.”<sup>227</sup> The court stated that “[t]o 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>228</sup>

The *Kessler* court “proposed an alternate approach,” which “attempted to capture the tax benefit to the buyer of S corporation shares . . . of receiving cash dividends that are not subject to dividend taxes.”<sup>229</sup> A simple example clarifies the court’s analysis.<sup>230</sup>

	<b>C Corp.</b>	<b>S Corp.</b>	<b>S Corp. Valuation</b>
<b>Income Before Tax</b>	\$100	\$100	\$100
<b>Corporate Tax Rate</b>	40%	—	29.4%
<b>Available Earnings</b>	\$60	\$100	\$70.60
<b>Dividend or Personal Income Tax Rate</b>	15%	40%	15%
<b>Available After Dividends</b>	\$51	\$60	\$60

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<sup>225</sup> *Id.*

<sup>226</sup> *Id.* at 328.

<sup>227</sup> *Id.*

<sup>228</sup> *Id.* at 329.

<sup>229</sup> *Bernier v. Bernier*, 873 N.E.2d 216, 229 (Mass. 2007) (citing *Kessler*, 898 A.2d at 330).

<sup>230</sup> *See Kessler*, 898 A.2d at 330.

The court imputed a corporate tax rate to the “S corporation valuation” in order to arrive at an amount available after dividends equal to that of an S corporation whose shareholders receive all of the annual distributions and pay at the highest bracket (40%).<sup>231</sup> The *Kessler* court used the same dividend tax rate applicable to a C corporation shareholder and worked backward to figure out what the imputed tax rate would be. This calculation effectively retains the benefit a shareholder expects from owning an interest in an S corporation without overvaluation.<sup>232</sup> Overall, the value of the S corporation is 17.6% greater than a C corporation.

The *Kessler* court finally established a clear analysis for dealing with S corporations. Prior to this holding, courts overvalued S corporations by not applying a tax affect (or applying a 0% tax affect). The court recognized the benefit of a single layer of taxation in owning an S corporation, yet it was also aware that shareholders always bear the taxes and that ignoring taxes altogether effectively overvalues the company. Furthermore, this court identified the savings from avoided dividend taxes as the ultimate purveyor of value between S corporations and C corporations.<sup>233</sup>

#### B. *Bernier v. Bernier*

The Supreme Judicial Court of Massachusetts recently decided the question of whether it is appropriate to tax affect the earnings of an S corporation for purposes of a divorce proceeding.<sup>234</sup> In *Bernier*, the parties owned two supermarkets on Martha’s Vineyard.<sup>235</sup> The husband and wife both relied on expert testimony to present their valuation of the supermarkets, which were organized under two different S corporations.<sup>236</sup>

Similar to *Kessler*, the husband’s expert applied a C corporation tax rate to both S corporations based on the rationale that “a person contemplating the purchase of an S corporation would factor into his probable rate of return the tax consequences of the purchase,” and the wife’s expert did not rely on a tax affect because “an S corporation, unlike

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<sup>231</sup> *Id.* at 329–30.

<sup>232</sup> *Id.* at 330.

<sup>233</sup> *Id.*

<sup>234</sup> *See Bernier*, 873 N.E.2d 216.

<sup>235</sup> *Id.* at 221.

<sup>236</sup> *Id.* at 221–22.

a C corporation, does not pay taxes at the entity level, and because no sale of the business was contemplated.”<sup>237</sup> The husband’s expert arrived at a value of \$7,850,000 for the supermarkets, whereas the wife’s expert concluded the value of the supermarkets to be \$16,391,000.<sup>238</sup>

The trial court judge relied on *Gross* in ruling that it was proper to tax affect an S corporation.<sup>239</sup> On appeal, the wife argued that the supermarkets’ earnings should not have been tax affected.<sup>240</sup>

The husband’s expert, who tax affected the earnings was unable to clearly explain his use of a 35% rate.<sup>241</sup> On appeal, the Supreme Judicial Court distinguished the facts of its case from those of *Gross*. The *Gross* case involved gift tax valuations, while the *Bernier* case involved a divorce proceeding where the ultimate outcome was based on equitable distribution.<sup>242</sup> The *Bernier* court ruled that the trial judge was incorrect in basing her application of a tax affect on the *Gross* decision.<sup>243</sup> The appeals court criticized the trial judge for adopting a tax rate without supporting her decision with clarity.<sup>244</sup> However, the court analogized *Bernier* to *Kessler* because of the “fiduciary relationship” which existed in both cases: one between shareholders, the other between husband and wife.<sup>245</sup> The *Bernier* court adopted the approach used in *Kessler* for tax affecting.<sup>246</sup>

The *Bernier* court cited the *Kessler* court, which logically deduced that

den[ying] the reality that each shareholder owes taxes on his proportional interest in [the business] would result in the Kessler Group receiving a higher per share value from the court than it could ever have realized as a continuing

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<sup>237</sup> *Id.* at 223.

<sup>238</sup> *Id.* at 222.

<sup>239</sup> *Id.* at 223–24 (citing *Gross v. Comm’r*, 272 F.3d 633 (6th Cir. 2001)). The *Bernier* court noted that the Sixth Circuit “affirm[ed] [a] United States Tax Court judgment that it was proper to tax affect using [a] zero per cent corporate tax rate, in [the] context of valuing gift of S corporation stock.” *Id.*

<sup>240</sup> *Id.* at 220.

<sup>241</sup> *Id.* at 227 n.19.

<sup>242</sup> *Id.* at 227 n.20.

<sup>243</sup> *Id.* at 228.

<sup>244</sup> *Id.* at 228 n.21.

<sup>245</sup> *Id.* at 229.

<sup>246</sup> *Id.* at 231.

shareholder. . . . 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 . . . .<sup>247</sup>

The *Bernier* court agreed with the *Kessler* court and recognized that the tax advantage of an S corporation versus a C corporation stems from the dividends saved.<sup>248</sup> The *Kessler* case was a Delaware shareholder dispute decided under a fair value standard;<sup>249</sup> whereas the *Bernier* case was a Massachusetts divorce decided under a fair market value standard.<sup>250</sup> These differences in jurisdiction and factual circumstances did not deter the *Bernier* court from adopting the *Kessler* analysis.

Both courts noted that this analysis would likely be different had the shareholders consistently put the S corporation earnings back into the company versus distributing all of the annual earnings.<sup>251</sup>

## X. ANALYSIS

### A. *Who Gets It Right*

The *Kessler* and *Bernier* courts provide the most effective judicial analysis to date. While there is a “[c]onceptual [m]ismatch between S [c]orporations and C [c]orporations,”<sup>252</sup> it took the judicial system about six years to sort the real issue: that S corporations and C corporations differ in the “economic benefits attributable to the [respective] shareholders.”<sup>253</sup> It is appropriate to tax affect S corporations for valuation purposes. The rationale being that there is value in owning an interest in an S corporation, which avoids taxes at the entity level, versus a C corporation, which is double taxed.

### B. *The Judicial Model*

The *Kessler* and *Bernier* courts rely on a very basic model for valuing S corporations. The calculation the courts used to impute taxes at the

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<sup>247</sup> *Id.* at 229 (citing *Del. Open MRI Radiology Assocs., P.A. v. Kessler*, 898 A.2d 290, 328–29 (Del. Ch. 2006)).

<sup>248</sup> *Id.* at 225; *see also Kessler*, 898 A.2d at 330.

<sup>249</sup> *Kessler*, 898 A.2d at 299.

<sup>250</sup> *Bernier*, 873 N.E.2d at 220.

<sup>251</sup> *See Kessler*, 898 A.2d at 329 n.101; *Bernier*, 873 N.E.2d at 230 n.25.

<sup>252</sup> LARO & PRATT, *supra* note 2, at 119.

<sup>253</sup> *Id.* at 119–20.

corporate level takes into account the fact that S corporation shareholders do not pay dividend taxes while C corporation shareholders do pay dividend taxes. The avoidance of the dividend tax accounts for the value difference between S corporations and C corporations. These two cases brought an end to the line of cases which held that tax affecting S corporations was not appropriate. In doing so, the *Kessler* and *Bernier* courts endorsed a simplified, common sense explanation of the benefits of owning an S corporation without overvaluation.

*C. A Suggested Result*

As briefly mentioned above,<sup>254</sup> Nancy Fannon, a well-known valuation expert, has established a model for dealing with the benefits of owning an S corporation.<sup>255</sup> Nancy Fannon's simplified model for valuing S corporations is most similar to the methodology applied in *Bernier*. Boiled down to its basics, her S corporation valuation model calculates the benefit of the avoided dividend tax and the benefit of retained net income.<sup>256</sup> Her model also considers the benefits and risks of retaining net income for various holding periods.<sup>257</sup> She gives the following example between a publicly-traded corporation and an S corporation to demonstrate her method.<sup>258</sup>

	<b>C Corp.</b>	<b>S Corp.</b>
<b>Income before tax</b>	\$217	\$217
<b>Tax on income</b>	\$87	\$87
<b>Net income after tax (assume all distributed)</b>	\$130	\$130
<b>Investor dividend tax</b>	\$26	\$0
<b>Net to investor</b>	\$104	\$130

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<sup>254</sup> See *supra* notes 73–75 and accompanying text.

<sup>255</sup> See Fannon, *supra* note 73.

<sup>256</sup> *Id.* at 18.

<sup>257</sup> *Id.* at 16.

<sup>258</sup> *Id.* at 25–27.

She notes that investing in a Subchapter S corporation will put \$26 more in an investor's pocket.<sup>259</sup> This \$26 savings is the root of her analysis. She figures the rate of return on the dividend from a \$1,000 investment in a publicly-traded company (in this case the rate of return is 13%).<sup>260</sup> She then applies this rate of return to the tax avoided: the \$26 avoided dividend tax divided by 13% rate of return equals \$200, which is the *value* of the tax avoided.<sup>261</sup> In order to arrive at a value for the S corporation, Ms. Fannon adds the value of the dividend tax avoided (\$200) to the calculated value for the company as if it were publicly-traded (\$1,000) to achieve a total value for the S corporation (\$1,200).<sup>262</sup> Ultimately, her method establishes that the value of an S corporation is greater than that of a C corporation with similar pre-tax earnings.<sup>263</sup> Her "simplified model" emphasizes the tax savings of the avoided dividend tax.<sup>264</sup> This model is a better way to value S corporations than the judicial model utilized in *Kessler* and *Bernier* because those courts took the position that it was the income tax instead of the dividend tax that the S corporation shareholder is avoiding.<sup>265</sup>

## XI. CONCLUSION

In a period of eight years, the analysis for valuing an S corporation changed in the court system. It started in 1999 with the *Gross* decision, which applied either a 0% tax affect or no tax affect, depending on interpretation.<sup>266</sup>

Going forward, it is important to remember that business valuation is a question of fact to be determined by the circumstances of each individual

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<sup>259</sup> *Id.* at 27.

<sup>260</sup> *Id.* at 26 (\$130 dividend expected divided by \$1,000 investment equals 13% rate of return).

<sup>261</sup> *Id.* at 32.

<sup>262</sup> *Id.*

<sup>263</sup> *See id.* at 26, 32.

<sup>264</sup> *Id.* at 18.

<sup>265</sup> *Id.* at 34. Ms. Fannon's analysis illustrates that the model used by the courts overstates the value of the company, and their model "inherently predicts far more cash flow than is possible from the investment." *Id.* at 35.

<sup>266</sup> *See Gross v. Comm'r*, 78 T.C.M. (CCH) 201, 205, 210 (1999), *aff'd*, 272 F.3d 333 (6th Cir. 2001).

case.<sup>267</sup> However, when valuing an S corporation, the implicit savings of an avoided dividend tax should be considered. The method employed by the *Kessler* and *Bernier* courts is much more accurate than previous decisions; however, the methods created by experts are even better because they consider other variables. Thus, these experts can play a key role in establishing good case law if they can clearly lead attorneys and judges through the analysis. It appears this issue is capable of correcting itself through the court system. Although the question regarding an applicable tax affect for S corporations is still present, the evolution from 1999 to present is promising because current courts are now considering some form of an applicable tax rate. Thus, it is important for experts to clearly define the implications of omitting an appropriate tax affect, and they must also plainly detail the rationale behind tax affecting S corporations.

The S corporation valuation models created by the business valuation experts all rely on the “benefit of the avoided dividend tax.”<sup>268</sup> However, they differ in their underlying assumptions.<sup>269</sup> The method for valuing S corporations created by Nancy Fannon, the “Simplified Model,”<sup>270</sup> is easy to follow and appropriately takes into account the avoided dividend tax not the income tax. Thus, the use and understanding of this method by expert witnesses will be a step in the right direction for this issue. When expert witnesses rely on a sound methodology for the appropriate way to tax affect and ultimately value an S corporation, the issue should no longer plague the courts.

It is likely that the Tax Court can adopt this approach without reversing further decisions. The specific issue of tax affecting S corporations requires a sound methodology, which can now be clearly explained. Courts should not have a problem accepting this methodology because each case must be considered on its own facts, which negates the problem of reversing prior decisions.

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<sup>267</sup> *Sarrouf v. New England Patriots Football Club, Inc.*, 492 N.E.2d 1122, 1127–28 (Mass. 1986).

<sup>268</sup> Fannon, *supra* note 73, at 36.

<sup>269</sup> *See id.*

<sup>270</sup> *Id.* at 58.