

The S-Corporation, Fair Market Value, and Their Intersection with the Real World

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**James B. Lurie, CPA/ABV, CBA, CVA, BVAL, CIRA
Hughes Pittman & Gupton, L.L.P., Raleigh, NC**

Rarely, if ever, has a decision by the United States Tax Court set off a storm of comment like *Gross v. Commissioner*. That July 1999 decision implied a 67% difference in value determined by an income approach between S-corporations and C-corporations, with the incremental value arising solely from the tax status elected by the enterprise shareholders. When the case was appealed to the Sixth Circuit Court of Appeals, most valuation professionals fully expected that the Court would show the wisdom to reverse and remand what was believed to be faulty reasoning by the Tax Court. They were wrong.

Before and after the (split) appellate decision, numerous analyses have attempted to prove that the reasoning underlying the Tax Court's decision was generally faulty. Chris Mercer proved that there was no mathematical difference between S-corporations and C-corporations at the entity level. George Hawkins and Michael Paschall of Bannister Financial were highly critical of the decision. In the November and December 2002 issues of Shannon Pratt's *Business Valuation Update*, Michael Mattson, Donald Shannon, and David Upton analyzed reported transactions in the Pratt's Stats database and found that there was no significant difference between the multiples of revenue paid in transactions involving C-corporations and the multiples in transactions involving S-corporations.

On the other side of the question, Merle Erickson and Shiing-wu Wang of the University of Chicago found that there were significant differences in sales multiples between sales of S- and C-corporations. Notwithstanding that the conclusions of the study showed a statistically significant difference, that difference was far less than would have been expected based upon *Gross*.

The *Gross* decision was followed in relatively short order by two Tax Court decisions utilizing it as either an explicit or implicit precedent. *Adams v. Commissioner*, a North Carolina case, specifically cited *Gross* in the continuing application of after-tax discount factors to pre-tax cash flow. In *Adams*, however, the interest valued was not a small minority gift, but a controlling block held by an estate. There was no appeal of the case because other factors in the decision were sufficiently favorable to the Appellant to minimize the benefit of an appeal on that issue.

Given the level of research on the issue and the skills of the various experts expressing opinions regarding *Gross* and cases derived from it, it is unlikely that analysis leading to the divergent opinions was all wrong. My position is that, in fact, the analytical procedures are all right, but are incorrectly used in trying to apply a blanket rule to differing situations. Furthermore, it will be seen that, when considered under strict interpretations of the core rules governing both a) the creation and taxation of S-corporations, and b) valuation in federal tax matters, the *Adams* case decision would necessarily reverse, and, as reversed, provide reasonable guidance for non-tax related matters. The underlying rules which must be considered are: 1) Internal Revenue Code requirements providing the basis for creation and maintenance of an S-corporation, 2) the old standby, Revenue Ruling 59-60, and 3) specific and regularly-cited elements of case law. These must then be tied to the fact patterns of the specific cases in order to develop a logical and consistent way of valuing S-corporations.

The majority of the discussion surrounding the purported difference in value of S-corporations and C-corporations treats the two as different legal entities, as divorced from one another in form and substance as

corporations are from general partnerships. Nothing could be further from the truth. S-corporations are not entities in and of themselves; they are, instead, no different in legal form from C-corporations. As entities established under the laws of the respective states, S- and C-corporations are identical. S-status can only arise from the unanimous election by specific, qualified shareholders, the number and nature of whom are limited by a Federal statute which, itself, is subject to change over time.

The core factor here is the phrase “unanimous election.” The number of shareholders of an S-corporation is limited to 75. Each shareholder of an S-corporation today must be a(n):

Individual who is a citizen or a permanent (“green card”) resident of the United States; or

A qualified S-corporation, trust, or non-profit entity. Furthermore:

Each shareholder must specifically elect to have the tax attributes, obligations, and benefits passed through the corporate entity and recognized at the shareholder level; and

Each shareholder must effectively continuously ratify that election through refraining from taking any action which would disqualify the corporation from S-Corporation status. Such actions would include transfer of any interest to a holder who is not qualified to be a holder of shares of an S-corporation or disbursing ownership to the point where the number of qualified shareholders exceeds the statutory limit.

Finally, all S-corporations are not equal, because certain states do not permit the pass-through of corporate income to shareholders for state income tax purposes.

The S-Corporation, therefore, does not exist as a discrete and permanent entity, but can exist only after the creation of a corporation under State law and the subsequent election and continuing ratification by *specific* shareholders of a pass-through tax status. In both *Adams* and *Heck*, it is the concept of specific vs. hypothetical shareholder which failed to receive the attention of the respective Courts.

Every business valuation professional has cited the definition of Fair Market Value contained in Revenue Ruling 59-60:

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

The very concept of a hypothetical buyer and a hypothetical seller is contrary to the implication that the buyer of a specific S-corporation interest will consider the pass-through tax characteristics elected by the existing owners of the interest. First, the seller(s) consist of specific individuals, who elected S-corporation for their own specific, not hypothetical, reasons. Second the *a priori* assumption that the buyer or buyers would be qualified holders of stock in an S-corporation automatically excludes a potentially large group of parties, including corporations, which are potential buyers of businesses but whose ownership of an equity interest would void the S-corporation election.

There is a clear contradiction between imputing S-shareholder qualification to every potential purchaser of an interest in an existing S-corporation and the inclusiveness implicit in the concept of the hypothetical buyer. Nevertheless, in specific instances, it is not inappropriate to limit the universe of hypothetical buyers of an

interest to those parties qualified to hold interest in S-corporations, thereby eliminating the need to tax-effect earnings when using the income approach. The *Gross* case, which started the controversy, was one of those situations.

In *Gross*, the subject company was G&J Pepsi-Cola Bottlers, Inc. (“G&J”). The company was profitable, and it had a long history of distributions of virtually all of its profits to its shareholders. The G&J entity itself may have been a good acquisition candidate for another bottler which was looking for expansion. Such a purchaser, however, would not have been a likely candidate for the purchase of the interests which were the subject of the *Gross* case. Each of these interests constituted less than 1% of the equity. These micro-interests were too small to be of economic consequence as an investment with the sole goal of economic yield (without strategic implication) for a corporate acquirer, which would not have been a qualified S-corporation holder. More significantly, the holders of all of the equity interests in the subject corporation had entered into a valid shareholders’ agreement which precluded the transfer of interests in the corporation to any party who was not S-corporation qualified.

I believe that the *Gross* decision was correct in relation to its unique, fact-specific context. G&J was an S-corporation, but the driving factor was not the S-corporation qualification of the subject. The determinative factors in the Appellate decision appear to have been a) the small size of the subject interests, which would have severely limited the interest of non-S-qualified buyers, and, most importantly, b) the shareholders’ agreement, which was a valid restriction on the transfer of the shares. Like any other valid restrictive covenant impairing transferability of corporate shares, the agreement among the various G&J shareholders to take no action to impair the S-corporation status had to be factored into the valuation equation. If, because of that agreement, no one other than a qualified S-corporation holder could own the stock, the universe of potential equity holders was indeed restricted to those who would benefit from a cash flow free of corporate taxation. No others need apply. In connection with the underlying fact pattern, the decision made sense. □

The *Gross* driving factors were, however, case specific. Application of the *Gross* conclusion as a generalized rule, including cases which lack the specific *Gross* factors, is incorrect. This is seen when analyzing the *Adams* case.

Unlike *Gross*, which involved gifted interests which each constituted less than 1% of the issued and outstanding common stock, *Adams* involved a 61.59% controlling interest in Wadell, Sluder, Adams & Co. (“WSA”), a large regional managing general insurance agency which had an exclusive right to represent Maryland Casualty Company (“MCC”) in 17 counties in western North Carolina. The general agency generated 95% of the company revenues, while 5% was generated through sale of insurance to the public.

WSA was a well-established business. While Walter Adams began working for the agency in the mid-1940’s, he did not become President until 1972, and he had substantially withdrawn from the active management of the agency by the time of his death in 1995. Around 1982, Robert Gelder, an employee since 1976, became the sole liaison with MCC; 1987, he assumed general management of the agency. Mr. Gelder became President of the agency in 1994, and he had performed all management functions subsequent to Mr. Adams’ death. Mr. Gelder owned 36.33% of the issued and outstanding stock, the other 2.08% being held by Mr. Adams’ daughter Julia Adams Slipher. While Julia held the title of Vice President and Secretary and was active in the business, she could not have run it.

In the late 1980’s MCC had been acquired by Zurich International Group, a multi-line insurance conglomerate. Zurich’s original intent had been to replace its independent agencies, and the need for the services of the general agency, by implementing a service center concept. Mr. Gelder not only changed Zurich’s approach the WSA, but expanded the relationship between the companies.

The Memorandum of Findings of Fact and Opinion on *Adams* does not reveal the preparation date of the

appraisal for the estate. It is probable, however, that the appraisal report date was subsequent to the July 1999 *Gross* opinion. Prior to *Gross*, it would have been normal practice to simply tax-effect the corporate earnings, treating the corporation as a C-corporation; the after-tax distributable cash flow would have then been valued using discount and capitalization rates developed from after-tax information. Apparently responding to the *Gross* decision, the estate's appraiser, Foster Shriner, CPA/ABV, finessed the use of non-tax-effected earnings by utilizing a discount rate adjusted to a pre-tax level. It is, of course, a basic of business valuation that the discount rate and the cash flows being valued should have the same tax characteristic, either pre-tax or after-tax. The *Adams* court disagreed; citing *Gross*, it said:

“We disagree that Shriner’s estimates of WSA’s prospective net cashflows are before corporate tax because it is appropriate to use a zero corporate tax rate to estimate net cashflow when the stock being valued is the stock of an S-corporation... WSA is an S corporation, and its cashflows are subject to a zero corporate tax rate. Thus, Shriner’s estimates of WSA’s prospective net cashflows are after corporate tax (zero corporate tax rate) and not before corporate tax as the estate contends.

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

It is my belief that, in applying the *Gross* decision to the *Adams* facts, the *Adams* court erred in several respects:

The *Adams* Court ignored two basic factors in the *Gross* case. First, the gifted interests were too small to be of any economically-logical interest to a corporate buyer, keeping in mind that the sale of the interests to a C-corporation would be a disqualifying event. The fact that a sale of S-corporation stock to a non-S-qualified party would void the S-election does not affect value. A hypothetical seller of the interest would be interested only in obtaining the highest possible price for his asset, and that seller would have no interest in the subsequent tax status of either the corporation or its shareholders. What appears to have motivated the Sixth Circuit Court of Appeals in its affirmation of the Tax Court’s decision was the Shareholders’ Agreement executed at the approximate time of the S-corporation election:

“Also in 1982, the members of the Gross/Linnemann family group entered into an agreement restricting the transferability of their G&J stock. This restrictive agreement permitted certain transfers within the Gross/Linnemann family group, but provided that if other transfers were attempted, the G&J stock would be purchased by the family group at book value. ***More importantly, the agreement also restricted any transfers that would jeopardize G&J’s S corporation status.*** This agreement was still in effect as of July 31, 1992.”

A basic tenet of the required Fair Market Value Standard of Value is that the buyer and seller both be hypothetical parties. While courts have regularly ruled that the motivations of a sub-group of hypothetical buyers can be considered in applying the Fair Market Value standard, those cases implicitly assume that the goals of both parties will be met in the hypothetical transaction. The successful buyer will receive a strategically valuable asset with its price limited by the investment hurdle rate of the most aggressive, winning bidder; the seller receives the highest price available in a vibrant market.

By mandating the use of non-tax-effected earnings as the basis of the *Adams* cash flow, the Court made the assumption that the hypothetical buyer of the estate's interest would be a qualified holder of S-corporation stock. In doing so, the Court increased the Fair Market Value of the stock by 66.67% from the level which would have been determined using tax-effected earnings. In fact, no such assumption was warranted.

Unlike the G&J shareholders in *Gross*, the WSA shareholders had never entered into an agreement either restricting the sale of the shares or mandating that any purchaser of the shares be a qualified S-corporation shareholder. Based upon information in the opinion, the business was sufficiently profitable to pay out dividends of roughly \$270,000 in the year of the decedent's death, and that level of payout had increased at a compounded annual rate of 21.5% between 1991 and 1995. The pro-rata portion of that dividend capacity attributable to the decedent, and the ability to control the business, might have had appeal to a wide range of potential buyers, possibly including Zurich itself or any large regional brokerage. To simply assume that WSJ's controlling interest would be acquired by a qualified S-corporation shareholder simply because the deceased shareholder was so qualified and elected S-corporation status is a leap of faith with no logical basis. Furthermore, the systematic exclusion of corporate entities from the universe of hypothetical buyers with no economic, legal, or contractual basis for that exclusion violates the tenets of Fair Market Value.

In discussion I have had with other business appraisers, the argument has been raised that the bidding for an interest in an existing S-corporation will be dominated by S-corporation qualified shareholders because those shareholders will be able to realize greater returns through the continuing elimination of a layer of taxes. Logically, the greater yields would permit a higher bid price. Neither research nor logic supports such an argument.

Mattson, et al found no significant difference between the multiples used in pricing transactions involving the sale of existing S-corporations and existing C-corporations in a detailed review of hundreds of transactions from the Pratt's Stats database. Virtually all of those transactions involved either 100% or strongly controlling positions in the subject corporations. If the presumption --derived earlier and adopted by the Tax Court-- that S-corporations are worth 67% more than identical C-corporations, is true, why would a review of hundreds of transactions fail to find any significant difference between prices paid?

I believe that the answer is found in the economic concept of substitution. This concept is incorporated in Fair Market Value transactions involving buyers who are motivated primarily by economic factors rather than by the strategic and synergistic issues which dominate transactions which would be classified as falling within the Investment Value Standard of Value. The logic behind this belief is relatively straightforward.

Assume that a marketplace of enterprises for sale consists of a mixture of existing S-corporations and C-corporations or interests in them. A hypothetical buyer, with its goal limited to economic return and interest unrestricted by the specific type of enterprise, would have a broad selection of potential targets, and those targets would be interchangeable. The Fair Market Value buyer would be indifferent among an insurance agency, a bottling company, a winery, or a foundry, so long as those enterprises were equivalents in the relationship of risk, cash flow potential, and price.

The buyer who was not qualified to own S-corporation shares would not pay a premium to an S-corporation seller, because the S-election would be terminated upon the completion of the transaction. The corporate-level tax would reappear, and the premium would produce no value. Therefore, no transaction would take place at a price reflecting higher returns than would be available to the C-corporation shareholder.

The hypothetical buyer qualified to own S-corporation shares would have no incentive to pay a premium for S-corporation shares which were for sale. The reason is simple. The market, as defined, contains both S-corporation and C-corporation sellers. The hypothetical buyer, as defined, is interested only in financial returns, and he therefore has a large universe of potential targets. The S-qualified buyer will not pay the premium for 100% of an existing S-corporation's shares, even though the premium is undoubtedly justified by the incremental returns to that specific buyer. He will not do so because he can, after purchasing 100% of a comparable C-corporation's stock, elect S-corporation status at little or no cost, especially as measured against the size premium for S-corporations implied by *Gross* and *Adams*.

The Erickson and Wang study did show a small difference (approximately 12% to 17%) between sales of S- and C-corporations; however, the transactions in the study were, very large, drawn from the reporting of the acquisition of privately-held businesses by publicly-traded corporations. Since those transactions often have significant Investment Value characteristics, the differential may be more indicative of random variance in degree of motivation than tax characteristics. Furthermore, the authors focus on issues such as IRC Section 338(h)10 (joint elections to treat the transactions as asset sales rather than stock sales). Most significantly, however, for purposes of the income tax-effecting controversy, the differential range found in the study bears no relationship to the derived differential in value based upon the lack of a level of corporate taxation.

Mike Adikhari, a specialist in small business mergers and acquisitions, has used his software tool, *Business Value Express*, to test the difference in distributable cash flow to equity of both C- and S-corporations under the real-world condition of a leveraged acquisition with the acquisition loan including normal covenants. His conclusion is that there is a difference in the returns to equity arising from the two forms of taxation, but that the difference is not nearly as large as that which flows from the Tax Court's and Sixth Circuit's mandating the application of discount rates associated with after-tax cash flow to cash flow before taxation. Furthermore, as demonstrated above, there should, in a hypothetical context, be no difference in price, despite the difference in level of return, because of the rule of substitution.

No one can reasonably argue that there is no difference between being the holder of an S-corporation and being the holder of a C-corporation. The S-corporation holder will, at the end of the day, have more money in his pocket than will the holder of stock of an identical C-corporation. That is a result, however, reflected only during the period of holding the stock and, in the real world, in the difference in returns to shareholders when corporate assets are sold rather than corporate stock. When an appraiser is estimating the price which a hypothetical buyer would pay to a hypothetical seller for shares of corporate stock, there is neither empirical evidence or logical progression which can lead to the conclusion that the stock of an existing S-corporation should sell at a substantial premium to the stock of a similarly situated C-corporation.

The apparent move by the Tax Court to prescribe a generalized treatment of S-corporation interests puts the independent appraiser in a bind. While the prescription may indeed fit the case when the interest is small and when transfer is restricted, its application in the case of a controlling interest in a larger entity may be the equivalent of treating a viral infection with a band-aid, making no sense at all.

The appraiser must examine the logical marketplace of buyers for the appraised interest and must understand all of the factors which would affect a hypothetical sale of that interest. Case law evolves, and Federal case law may have no standing as precedent in state matters. An intellectually honest approach, measured against specific facts and circumstances is far more important and appropriate than passive compliance with a decision which may be based upon issues factually distinct from the case at hand. The appraiser should communicate the issues to the client so that he understands that the appraiser may be taking a stand that differs from an inapplicable, but existing Tax Court decision.

Most importantly, if the appraiser believes that the facts of *Gross* do not apply to his case (and that the *Adams*

decision was in error due to misapplication of *Gross*), the factual differences supporting ignoring *Gross* should be made crystal-clear within the body of the appraisal report. A detailed analysis must support an independent, reasoned conclusion. As appraisers, we can hope that continuing good, precise analyses will ultimately lead the courts away from generalized and erroneous application of good case law to distinctly different situations.

United States Tax Court, *Gross, et al v. Commissioner of Internal Revenue*, T.C.M. 1999-254, July 29, 1999, affirmed U.S. Court of Appeals for the Sixth Circuit, *Walter L. Gross, Jr. et al v. Commissioner of Internal Revenue*, November 19, 2001. Electronic citation: 2001 FED App. 0405P (6th Cir.).

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Erickson, Merle and Shiing-wu Wang, "The Effect of Organizational Form on Acquisition Price," Paper available by request from HYPERLINK "<mailto:merle.erickson@gsb.uchicago.edu>" merle.erickson@gsb.uchicago.edu.

United States Tax Court, *Estate of Adams v. Commissioner of Internal Revenue*, T.C.M. 2002-80, March 28, 2002. Interview with Foster Shriner, CPA/ABV, and the appraiser for the Estate.

In a separate and preceding case, *Estate of Heck v. Commissioner of Internal Revenue*, T.C.M. 2002-34, February 5, 2002, both experts applied an after-tax discount rate to pre-tax cash flows. For that reason, the analysis in this article is limited to the *Gross* and *Adams* cases, where the appraisers' approaches to the tax-effecting differed. It is pertinent to note that the Estate's expert was Dr. Mukesh Bajaj, who performed the IRS appraisal in *Gross*.

Revenue Ruling 59-60, Section 2.02, emphasis added.

In *Gross*, the shareholders' agreement had an expiration date approximately one year after the valuation date. The Tax Court treated this agreement as chilling any interest of a non-qualified purchaser, notwithstanding the agreement's pending expiration. A more pure approach would have applied an incremental discount for lack of marketability reflecting the temporary restriction in the universe of qualified buyers. We can only speculate that the Court treated the restriction as continuing due to the small size of the subject interest and the resulting limited appeal to a corporate acquirer.

The general agency serviced over 40 retail insurance agencies in its territory, and the contract between the insurer and the general agency was cancellable by either party on 180 days' notice.

United States Tax Court, *Adams v. Commissioner*, T.C.M. 2002-80, March 28, 2002, pp 14-15.

U.S. Court of Appeals for the Sixth Circuit, *Walter L. Gross, Jr. et al v. Commissioner of Internal Revenue*, November 19, 2001. Electronic citation: 2001 FED App. 0405P (6th Cir.). Available from HYPERLINK "<http://www.findlaw.com>" <http://www.findlaw.com>. Emphasis added.

Assuming state recognition of S-corporation pass-through, an effective blended state and federal income tax rate of 40%, and equivalence of income and cash flow, the Court assumed \$100 of distribution to an S-corporation shareholder where a C-corporation could distribute only \$60. $100/60 = 1.666667$.

There were significant risks to the dividend stream at WSA including a key-person risk associated with the dependence upon Gelder, the concentration of the business in MCC lines, and the terminable nature of the relationship with Zurich. These factors would not, however, restrict the type of party who would have a potential interest in the block of stock; they would, instead, affect the price that hypothetical party might pay.

This analysis could also include 100% interests in partnerships or partnership-electing LLC's, but would normally exclude minority interests in those entities because of either the contractual or statutory restrictions on the transfer of individual partnership or membership interests.

The conversion to S-corporation from C-corporation can have costs in specific situations. If the selling entity's tax books were on a cash basis rather than accrual, there can be instant recognition of tax attributes on current accounts, and there can be tax on built-in gains if the business sold within ten years of the S-conversion. These factors are not, however, general conditions distinguishing S- and C-corporations. Being case specific and outside the general distinction, they do not affect the general premise of equivalency in sale price.