

S-Corporation Valuation Debate – The Impact of *Cecil v. Commissioner*

In 1999, the federal tax case, *Gross v. Commissioner of Internal Revenue*, brought the issue of the impact of taxes on the value of a *subchapter S corporations* (S-corporations) to the forefront of consideration within the valuation community, with the Federal Tax Court’s rejection of “*tax affecting*” (i.e., “*allowing a deduction for taxes on corporate earnings*”)¹ for S-corporations. The case spawned much debate in the valuation profession, including the development of four (4) models to utilize in valuing interests in S-corporations (by Roger J. Grabowski, FASA; Z. Christopher Mercer, FASA, CRA, ABAR; Chris D. Treharne, ASA, MBA, BVAL; and, Daniel R. Van Vleet, ASA).² In the pending case *Cecil v. Commissioner of Internal Revenue*, which involves a bequest of shares in the Biltmore Company, the operator of the historic Biltmore estate in North Carolina, the Tax Court has once again taken up the issue of valuing S-corporations.³ This case provides another opportunity for the court to provide clarity to the valuation community regarding tax affecting S-corporations, and may serve to address the validity of the various models utilized in valuing interests in these entities.⁴ This *Health Capital Topics* article on the valuation of common stocks for S-corporations will briefly discuss the debate surrounding tax affecting S-corporations, as well as how the *Cecil* case may impact the resolution of this issue.

Although S-corporations and *subchapter C-corporations* (C-corporations) share many similar organizational characteristics, the rules regarding taxation differ between these types of entities. S-corporations, like C-corporations, have limited liability protection, which shields their members, officers, and shareholders from personal responsibility for business debts and liabilities.⁵ However, the value of each entity when using income-based approach methods may differ based on taxation rules for each entity type. A C-corporation’s earnings are subject to taxation at both the corporate level (corporate earnings), and at the shareholder level (e.g., on dividends and proceeds from stock sales); some refer to this practice as *double taxation*.⁶ In contrast, S-corporations enjoy the benefit of *single taxation* only at the shareholder level; consequently, these entities are often referred to as “*pass-through*” entities for tax purposes.⁷

When valuing a pass-through entity, such as a partnership or an S-corporation, using an income approach-based

method, valuation experts have asserted, and recent academic research has supported, that any variance in the tax benefit between C-corporations and pass-through entities is reduced or eliminated in the sale of the S-corporation.⁸ Accordingly, under these circumstances, the income stream of the subject entity should be tax affected using the corporate federal and state tax rates. However, in some tax court opinions, courts have ruled that under certain facts and circumstances S-corporation earnings should *not* be tax affected.

In the *Gross* case, the petitioners, shareholders of G & J Pepsi-Cola Bottlers, Inc. (G & J), gifted minority interest S-corporation shares to their children.⁹ One of the shareholders, Walter Gross, gifted 124.5 shares (0.63 percent of the outstanding shares of common stock) to each of his three children.¹⁰ On the same day, a separate shareholder, Patricia Linnemann, gifted 187.5 shares (0.95 percent) of common stock to each of her two children.¹¹ The gifts were valued at \$5,680 per share and reported to the IRS using this value.¹² The IRS noted a tax deficiency for each of the gifts, arguing that the *fair market value* (FMV) of each share was not \$5,680, but instead was \$10,910 per share.¹³

According to the Tax Court, the “*most significant differences between the parties’ expert witnesses*” regarded whether to adjust G & J’s earnings by tax affecting such earnings when determining the discounted cash flows in performing the FMV analysis.¹⁴ During the trial, the petitioners’ expert witnesses argued that it was necessary to tax affect the earnings of an S-corporation in order to reflect how S-corporations are “*committed to making distributions to shareholders to cover individual tax liabilities on allocated S-corporation earnings*.”¹⁵ The petitioners argued that this distribution is similar to C-corporations making tax payments to the IRS in that such remittances “*represent[] a known payment which reduces the availability of cash which could otherwise be used to maintain or expand existing operations*.”¹⁶ In contrast, the expert witness for the IRS refused to tax affect the earnings of G & J, noting that the company would remain an S-corporation indefinitely and that all earnings would be distributed to shareholders.¹⁷ The Tax Court agreed with the IRS’s position against tax affecting the earnings of G & J, opining that the “*principal benefit that shareholders expect from an S-corporation election*

is a reduction in the total tax burden imposed on the enterprise.”¹⁸ [Emphasis added]

Subsequent to the 1999 decision in the *Gross* case, four (4) models have been developed to value minority interests in S-corporations:¹⁹

- (1) The *S-Corporation Economic Adjustment Model* (SEAM) by Daniel R. Van Vleet, ASA;
- (2) The *Quantitative Marketability Discount Model* (QMDM) by Z. Christopher Mercer, FASA, CRA, ABAR;
- (3) The model set forth by Roger J. Grabowski, FASA; and,
- (4) The model set forth by Chris D. Treharne, ASA, MBA, BVAL.²⁰

While each model employs the standard of FMV,²¹ Tax Court Judge David Laro and Dr. Shannon Pratt, in their book entitled, *Business Valuation and Federal Taxes*, note that these models differ as to the following issues:

- (1) “*The starting point for the valuation;*
- (2) “*The extent to which current cash distributions affect value;*
- (3) “*The impact on value of retained cash flow (basis);*
- (4) “*The extent that shareholder benefits (i.e., personal taxes saved) impact the value determination;*
- (5) “*The amount, extent, and manner that discounts are taken against the value determined by the model*”; and,
- (6) “*The impact of today’s value of the asset sale amortization benefit resulting from future transactions.*”²²

Judge Laro and Pratt note that an appraiser’s selection of the appropriate model to value a minority interest in an S-corporation “*may depend on the extent to which the facts and circumstances fit with a particular model.*”²³

For example, Judge Laro and Dr. Pratt note that the valuation of controlling interests in S-corporations have distinct issues that must be addressed by the appraiser. These issues include:

- (1) “Some empirical studies of C and S corporation transactions in the marketplace do not support the notion that S corporations are worth more than C corporations; in fact, they point to the opposite conclusion. However, given the complexity of the corporate transaction structuring, not everyone agrees that this evidence is conclusive.” [Emphasis added];
- (2) “A 100 percent ownership interest in an S corporation does not necessarily come with a bundle of rights and obligations attached to it any more than does a 100 percent ownership interest in a C corporation. This is distinctly different than a minority interest in an S corporation or a C corporation.” [Emphasis added];

- (3) “The controlling shareholder can mimic the favorable tax characteristics of an S corporation (i.e., avoid the double-taxation disadvantage of C corporation dividends by paying additional salary).” [Emphasis added];
- (4) “Buyers will not pay for an election that they can make themselves for free, unless it has some value to them. Grabowski points out that in some instances, buyers will pay a premium for the possible benefits that come with an old-and-cold S corporation.” [Emphasis added]; and,
- (5) “S corporations logically make distributions of funds necessary to support taxes on corporate earnings. This is no different from a C corporation; in either case, the money is gone and no longer available for corporate investment and growth.” [Emphasis added]²⁴

However, Judge Laro and Dr. Pratt note that, in the context of valuing a controlling interest in an S-corporation:

“[T]he experts generally agree that there may be no difference in value between S corporations and C corporations. Logically, the experts’ consensus is that C corporation valuation methods may be used for valuing controlling ownership interests in S corporations.” [Emphasis added]²⁵

The pending *Cecil* case may address many of the issues relating to the valuation of interests in S-corporations that have developed since the *Gross* case. *Cecil* related to a dispute regarding the gifting of shares in the Biltmore Company.²⁶ The owners of the Biltmore Company valued the gift at \$20.88 million; however, the IRS disputed the figure, arguing that the FMV of the gift was \$95.29 million.²⁷ Notably, both experts in the case tax affected the earnings in the Biltmore Company when performing their valuation analysis, in contrast to the *Gross* case, in which the IRS’s expert did *not* tax affect the earnings of the S-corporation in question.²⁸ The Tax Court held a hearing in the *Cecil* case in February 2016, and the case is currently in deliberations.²⁹

Commentators on the case have noted that the case may provide insight on two issues: (1) whether the valuation of pass-through entities using the income approach should involve tax affecting; and, (2) the potential validity of utilizing the SEAM model under the facts and circumstances of the case.³⁰ Of note, both experts in the *Cecil* case utilized the SEAM model during their FMV analysis; the Tax Court’s opinion may address the validity of adjustments utilized in this model to reflect tax affecting issues under the facts and circumstances of the case.³¹ Valuation professionals would be well-served to monitor developments in the *Cecil* case in order to determine the potential effect of the outcome of the litigation on the valuation of S-corporations.

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2 “Business Valuation and Federal Taxes: Procedure, Law, and
Perspective” By David Laro and Shannon P. Pratt, Hoboken, NJ:
John Wiley and Sons, 2011, p. 99.

3 “S Corp Model Now in Tax Court” By Andy Dzamba, Business
Valuation Resources, June 30, 2016,
[https://www.bvresources.com/blogs/bvwire-news/2016/06/30/s-
corp-model-now-in-tax-court](https://www.bvresources.com/blogs/bvwire-news/2016/06/30/s-corp-model-now-in-tax-court) (Accessed 1/5/17).

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5 “What Is an S Corporation (S Corp)?” Incorporate.com,
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6 Fannon and Sellers, 2015, p. 10.

7 *Ibid.*

8 The findings of the Mattson, Shannon, and Upton study indicate
that the size of the transaction makes a difference in the deal
structure, and, at the very least, it indicates that the enjoyment of
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for wholly different reasons than the avoidance of the dividend
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(2003): 12. A study by Phillips found that stock sales of S-
corporations and C-corporations were priced similarly, and asset
sales of S-corporations and C-corporations were priced
similarly. John R. Phillips, “S-Corp or C-Corp? M&A Deal
Prices Look Alike,” Business Valuation Library Update,
BVUpdate (March 2004).

9 “Gross [, et al.] v. Commissioner of Internal Revenue” 78
T.C.M. (CCH) 201, (U.S. Tax Ct. 1999) p. 2.

10 *Ibid.*

11 *Ibid.*

12 *Ibid.*

13 *Ibid.* p. 3.

14 *Ibid.* p. 8.

15 *Ibid.* p. 10.

16 *Ibid.*

17 *Ibid.*

18 *Ibid.*

19 “Business Valuation and Federal Taxes: Procedure, Law, and
Perspective” By David Laro and Shannon P. Pratt, Hoboken, NJ:
John Wiley and Sons, 2011, p. 99.

20 “Pass Through Entity Tax Affecting for Business Valuations”
By Rudolf P. Armbruster, ASA, CVA, Cherry Bekaert, March
17, 2014, [http://www.cbh.com/guide/pass-through-entity-tax-
affecting-for-business-valuations/](http://www.cbh.com/guide/pass-through-entity-tax-affecting-for-business-valuations/) (Accessed 1/26/17).

21 “Business Valuation and Federal Taxes: Procedure, Law, and
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22 *Ibid.* p. 106.

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24 *Ibid.* p. 108-109.

25 *Ibid.* p. 110-111.

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27 *Ibid.*

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31 *Ibid.*



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