VALUATION OF NON-CONTROLLING INTERESTS IN BUSINESS ENTITIES ELECTING TO BE TREATED AS S CORPORATIONS FOR FEDERAL TAX PURPOSES

A JOB AID FOR IRS VALUATION ANALYSTS

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FOREWARD

This document is intended to serve as a Job Aid for IRS Valuation Analysts involved in the valuation of non-controlling interests in business entities that have elected to be treated as S Corporations for federal tax purposes (electing S Corporations).

An electing S Corporation is simply a domestic business entity that is treated as a corporation for Federal tax purposes and that has elected under § 1362(a) of the Internal Revenue Code to be governed by Subchapter S of the Code. See IRC §§ 1361 through 1379. In actual form, such an entity may be a state-chartered corporation or an unincorporated entity, such as a limited liability company. Other than the specific limitations imposed by Subchapter S on such things as the number and the type of owners (interest holders) and the number of classes of stock, such an entity shares all of the attributes of any similar domestic business entity formed under the laws of the applicable jurisdiction. Generally, electing S Corporations pay no entity level Federal taxes on their income. Instead, the income and deductions of the entity flow through to the interest holders who are responsible for their appropriate share of the entity's Federal income tax liability. Electing S Corporations may still be responsible for State and/or local income or franchise taxes.

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EXECUTIVE SUMMARY

This document has been prepared by representatives of the Engineering Program, Natural Resources and Construction Industry, Large Business and International Division (LB&I) and the Estate and Gift Tax Program, Small Business/Self-Employed Division (SB/SE), of the Internal Revenue Service (IRS). Its purpose is to serve as a Job Aid for LB&I Valuation Analysts engaged in issues requiring the valuation of non-controlling interests in business entities that have elected to be treated as S Corporations for federal tax purposes. It deals with several aspects of this valuation problem, including how electing S Corporations differ from other types of closely-held business entities. It also provides a review of the valuation parameters to be considered.

Electing S Corporations are domestic business entities that are organized under State law and have elected to be governed under the provisions of Subchapter S of the Internal Revenue Code for Federal tax purposes. Electing S Corporations are subject to the same valuation considerations that are applicable to any closely held business entity. Fundamental guidance in this regard is provided by Rev. Rul. 59-60, 1959-1 C.B. 237. However, given the organizational structure necessary to conform to Subchapter S, as opposed to that of otherwise similar closely-held business entities, potential differences in such things as the cost of capital and the marketability of non-controlling interests must be addressed.

Under IRC § 1362(a), a small business entity may elect to be an S Corporation. An S Corporation is not generally taxed on net income at the entity level; rather, it is treated as a conduit, similar to a partnership. See, however, sections 1374 and 1375 for entity level taxes that may apply in certain circumstances. All items of income, loss, deduction and credit flow through to the interest holders where such are taxed. IRC § 1371(a) provides that the rules of Subchapter C apply to business entities electing to be taxed per the provisions of Subchapter S unless their result is inconsistent with the purpose of treating an S Corporation as a pass-through entity.

A small business entity for these purposes:

- is a domestic entity
- has 100 or fewer interest holders who are:
    - Individuals
        - Individuals do not include nonresident aliens
    - estates
    - certain trusts under IRC § 1361(c)(2) or
    - certain pension plans and charitable organizations.

- has one class of stock
    - differences in voting rights alone are not considered to constitute another class of stock, and
    - straight debt as defined in § 1361(c)(5) does not constitute another class of stock.

The Valuation Analyst should pay specific attention to the risks attendant in a non-controlling interest in an electing S Corporation and how these risks are most properly recognized. Adjustments to the cost of capital and the minority and marketability discounts may or may not be appropriate based on the specific facts and circumstances.

With respect to the attribute of pass-through taxation, absent a compelling showing that unrelated parties dealing at arms-length would reduce the projected cash flows by a hypothetical entity level tax, no entity level tax should be applied in determining the cash flows of an electing S Corporation. In the same vein, the personal income taxes paid by the holder of an interest in an electing S Corporation are not relevant in determining the fair market value of that interest.

DISCUSSION AND ANALYSIS

INTRODUCTION

The proper approach to the valuation of a non-controlling interest in a business entity electing to be treated as an S Corporation came to the fore in the business valuation community as a result of a 1999 Tax Court opinion, *Gross v. Commissioner*[1]. Following *Gross*, concerns arose as to the appropriate treatment of Federal income taxes in valuing non-controlling interests in S Corporations. The specific question was whether hypothetical entity level taxes should be applied to the earnings stream (tax-affecting) and, if so, in what manner? Numerous articles were written and various theoretical models were proposed.

The LB&I Engineering Program formed a working group to identify the factors fundamental to the proper valuation of non-controlling interests in electing S corporations. We have approached this task from the perspective of our role both as valuators and as users of valuation studies prepared by others.

What follows is a background on electing S Corporations, a discussion of Rev. Rul.59-60, a discussion of the factors to be considered, and a summary.

THE IDENTIFICATION OF THE PROPERTY TO BE VALUED

In any valuation engagement, the threshold question is the identification of the property to be valued. Subsequent to the promulgation of the check the box regulations, many of the business entities choosing S Corporation status are not corporations at all. Frequently, their state law form will be that of a limited liability company.

One of the purposes of Subchapter S is to accommodate the needs of small businesses that wished to incorporate for business reasons, but did not wish, as a necessary consequence of incorporation, to be taxed as corporations for Federal income tax purposes. Thus, Subchapter S sought to minimize the effect of Federal income taxation on the owner's choice of the form of the business entity by permitting certain state law corporations to elect a partnership-like taxation regime.

The check the box regulations, effective January 1, 1997, provided additional flexibility in the choice of the business entity. See Treas. Reg. §§ 301.7701-1 through -3. These regulations allow certain business entities not otherwise

[1] Gross v. Commissioner, T.C. Memo. 1999-254, aff'd. 272 F. 3d 333 (6th Cir. 2001), cert. denied, 537 U.S. 827 (2002). See also references and commentary in Appendix B.

classified as corporations, to elect that classification and thereby become eligible to make an S election.

The check the box regulations begin by identifying entities that will always be treated as corporations. These include corporations denominated as such under state law, joint-stock companies, insurance companies, organizations that conduct certain banking activities, business entities wholly owned by a State, organizations taxable as corporations under a Code provision other than section 7701(a)(3), and certain named foreign entities. A business entity identified as a corporation that meets the requirements of a small business corporation under section 1361(b) may elect to be treated as an S Corporation. Treas. Reg. § 1.1361-1(c).

A business entity not identified as a corporation (an eligible entity) may choose its tax classification by filing an election[2] or opting for the default classification. An eligible entity with at least two members may be classified as either a partnership or an association taxable as a corporation, and an eligible entity with a single member may be classified as an association taxable as a corporation or may be disregarded as an entity separate from its owner. Thus, a state law partnership, or a limited liability company with more than one member, by making the check the box election, may choose to be classified as an association taxable as a corporation, rather than as a partnership. A business entity treated as a corporation as the result of a check the box election that meets the requirements of a small business corporation under section 1361(b) may then elect to be treated as an S Corporation. Treas. Reg. § 1.1361-1(c). Indeed, if an eligible entity makes an S Corporation election, the entity is also treated as having made an election under the check the box regulations to be classified as an association taxable as a corporation. Treas. Reg. § 301.7701-3(c)(1)(v)(C).

Valuation Analysts should familiarize themselves with the pertinent State and local laws, including tax laws, applicable to the specific business entity to be valued. The proper identification of the form and structure of the entity can have significant impact on the valuation conclusions reached. The suggestion by some commentators that a Valuation Analyst must apply, as a matter of conventional practice, a valuation paradigm based on taxable corporations (C Corporations) to entities that do not pay tax ignores a major factual component, that the entity being valued has chosen its form, including its pass-through tax status, for business reasons. If a valuation is to be persuasive, it must be based on the actual attributes of the interest being valued. Accordingly, pass-through entities should be, where at all possible, compared to other pass-through entities in the valuation process.

[2] Business entities identified as corporations may not elect to be treated otherwise.

VALUATION – BACKGROUND AND APPROACH

As a starting point for a general business valuation discussion, Rev. Rul. 59-60, 1959-1 C. B. 237, is widely accepted within the field of business valuation as the bedrock for the analysis of valuation problems involving closely held business entities. Section 3.01, Approach to Valuation, provides, in part:

> A determination of fair market value, being a question of fact will depend upon the circumstances in each case. No formula can be devised that will be generally applicable to the multitude of different valuation issues arising in estate and gift tax cases. . . . A sound valuation will be based upon all the relevant facts, but the elements of common sense, informed judgment and reasonableness must enter into the process of weighing those facts and determining their aggregate significance.

Section 2, Background and Definitions, describes fair market value as:

> the price at which the property would change hands between a willing buyer and willing seller when the former is not under any compulsion to buy and the latter in not under any compulsion to sell, both parties having reasonable knowledge of relevant facts. Courts have frequently stated that the hypothetical buyer and seller are assumed to be able, as well as willing…

Section 4, Factors to Consider, requires a careful analysis of:

(a) the nature of the business and the history of the enterprise from its inception;
(b) the economic outlook in general and the condition and outlook of the specific industry in particular;
(c) the book value of the stock and the financial condition of the business;
(d) the earnings capacity of the company;
(e) the dividend-paying capacity;
(f) whether or not the enterprise has goodwill or other intangible value;
(g) sales of stock and the size of the block of stock to be valued; and
(h) the market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter.

The conceptual foundation provided by Rev. Rul. 59-60 underscores the fact that the isolation of a single variable, such as the choice by a business entity of pass-through tax status, without simultaneously addressing all of the above factors, will likely lead to erroneous conclusions in a practical application.

Appendix A provides the complete text of Rev. Rul. 59-60. This Revenue Ruling should be referred to regularly in valuing interests in a closely held or non-publicly traded entity.

ADDITIONAL FACTORS FOR CONSIDERATION

Beyond the general factors cited in Rev. Rul. 59-60, there are other factors of specific importance to our analysis.

Public Market Data – C Corporations

Ibbotson Associates (Morningstar, Inc.) gathers rate-of-return data on investments in publicly traded taxable corporations. As such, the Ibbotson data reflects entity-level tax in the calculation of the reported rates-of-return. Some commentators have suggested that if Ibbotson rates-of-return are used in a present value calculation of the earnings stream (e.g. owner's discretionary income, net income or free cash flow) of an electing S Corporation, the S Corporation earnings stream should be reduced to reflect an imputed C Corporation tax liability. It is far from clear that the buyers and sellers of interests in electing S Corporations actually analyze their investments in this manner. A significant feature of the S Corporation election is to eliminate the payment of tax at the entity level. This is an important economic attribute that must be recognized in the valuation of an interest in an electing S Corporation.

Others have suggested that in the context of a pass-through entity the definition of the entity-level tax should include all of the tax associated with the entity's operations. First, this suggestion has the effect of redefining the valuation standard to be applied. The application of investor-level tax characteristics results in an investment value to an assumed candidate buyer rather than in a fair market value as defined in Section 2 of Rev. Rul. 59-60. Second, the hypothetical entity-level tax is now co-mingled with the investor-level tax. How does the valuator then account for the widely divergent individual tax rates, credits, and other items that will determine the effective tax rate on the entity's earnings? Many investors have ways to shield the taxes that would otherwise result at the investor level and are, therefore, indifferent to tax concerns.

Still others have suggested that the identity of the person who pays the tax is not relevant to the valuation problem. This suggestion overlooks the fact that the tax structures and rates differ between corporate payers and individual payers in

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ways that are too great to render them irrelevant to the determination of earnings measures such as cash flow and, ultimately, the determination of value.

Others have suggested that there is no difference between an electing S Corporation and a publicly traded C Corporation, at least where control interests are involved. This suggestion overlooks important valuation factors that are influenced by the public marketplace. For example, publicly traded corporations are subject to oversight regarding matters of reasonable compensation, tax planning, and timely disclosure of profits and losses. This level of oversight does not exist for closely held entities such as electing S Corporations and, therefore, leads to operational and reporting issues that must be specifically addressed by the Valuation Analyst.

Finally, Ibbotson rates-of-return data is after corporate level taxes but before investor level taxes. By bringing investor level taxes into the valuation problem at the entity level, a mismatch Is introduced between the characteristics of the S Corporation earnings stream and the rate-of-return being used to convert that earnings stream to value. Such a mismatch is a fundamental error in the conduct of the valuation process.

Shareholders' Agreements

In the case of an interest that is unable to control the policies of the entity, the impact of an election to be treated as an S Corporation is potentially more profound than in the case of a controlling interest. Perhaps the two most significant investor concerns are the distribution policy of the electing S Corporation and the differential tax rates that might exist between the corporate level and the investor level. If an S Corporation distributes just enough of its earnings to cover the interest holders' tax liabilities, there may be little potential valuation difference at the investor level between the S Corporation and a taxable entity, assuming similar tax rates at the entity and the investor levels. If the S Corporation distributes larger amounts of earnings to the investor, the S Corporation interest becomes potentially more valuable than an equal interest in a taxable entity, all other things being equal. If the S Corporation distributes less than the tax liability amount, an interest in the taxable entity could potentially be more valuable in the hands of the investor. These are the results, at least in theory, given no other variable changes and have been documented in a number of recent studies.

Given the importance of the amount and the timing of distributions to the holders of non-controlling interests in an electing S Corporation, a Shareholders' Agreement is generally put in place to document various operational understandings among interest holders including how and when distributions will be made. This Agreement gives the minority interest holders protection against

adverse tax consequences that might result from operations or management decision-making. It also provides recourse should the controlling interests change the distribution policy in a manner that would be injurious to the minority holders.

Appropriate Tax Rates

In order to address tax rates within a valuation assignment, certain assumptions must be made. In this regard, the effective average rate paid within an industry or a group of potential theoretical buyers may be anywhere from zero to the maximum statutory rate. It is important to analyze the pool of most-likely buyers to make a proper judgment as to a reasonable tax rate choice. Even if a non-qualifying interest holder is the logical choice as the buyer, the use of the maximum statutory rate may not be the right choice to gauge tax impacts.

The Universe of Hypothetical Buyers

Fair market value is determined based on a transfer between a hypothetical buyer and a hypothetical seller. Accordingly, the identity of the available hypothetical buyer for a given interest at the time and place of the transfer will determine many things about the nature of the transfer, including the resulting Federal tax status of the transferred interest. Therefore, it is essential to carefully study the buyer universe. Might the hypothetical buyer be a C Corporation, another S Corporation or an individual? Valuation theory tells us that, if a mixed universe of potential buyers exists, it is that buyer that does not suffer entity level taxation that will drive the ultimate transaction price, all other things being equal.

Implicit in a tax-affecting argument is the assumption that a nonqualified buyer is the sole hypothetical buyer, effectively eliminating from the pool other types of qualified buyers who can benefit from pass-through taxation. Even in the case of an electing S Corporation with a poor earnings and dividend history, the entity itself, as well as its other interest holders, should not be eliminated from the pool of potential buyers. Buyers can come in many forms – other interest holders, the entity itself through the reacquisition of entity interests, and other qualified individuals and entities. Except in the unusual case where the sole potential buyer is a nonqualified one, such a limitation on the buyer pool should be carefully scrutinized as a factual matter before being accepted as a possible scenario.

As noted above, the universe of hypothetical buyers includes the other holders of interests in the S Corporation. Typically, they will have entered into a Shareholders' Agreement specifically designed to protect the S Corporation's tax status by prohibiting transfers to nonqualified holders and providing rights of first

refusal. Regardless of whether or not the current interest holders actually enter the bidding, their mere presence in the pool of hypothetical buyers will tend to increase the bid that ultimately drives the transfer transaction.

The Hypothetical Seller

A necessary co-party to any sale is the seller. The definition of fair market value assumes that the seller is a hypothetical party and, like the hypothetical buyer, is fully informed and economically motivated. The seller is seeking the highest possible price, while the buyer is seeking the lowest possible price. It is the give and take in the market place between these hypothetical parties, through "dickering," that produces the fair market value.

Assuming that within the universe of hypothetical buyers, there exists an individual who would find the interest desirable and who could preserve the benefit of a single level of taxation, a rational seller would not ignore this buyer in favor of one who could not take advantage of the tax savings, and would therefore pay less. If an acceptable outside buyer did not emerge in the short term, it would very often be in the best interest of one or more of the existing interest holders to buy the seller's interest rather than to suffer a decrease in the value of their own holdings through the loss of S Corporation status. Only in very unusual circumstances (e.g. a creeping acquisition by a strategic buyer) would it be likely that a C Corporation or other non-qualified buyer could emerge as the highest bidder for a non-controlling interest in an S Corporation.

The Hypothetical Sale

Although the sale that forms the basis for a fair market value determination is a hypothetical one, that "hypothetical sale should not be constructed in a vacuum isolated from the actual facts that affect the value of the [property]…"[3] This tenet provides ample room for the valuator to be inclusive in terms of defining the potential pool of buyers to include those who can benefit from pass-through taxation. It allows the valuator to consider the specific entity structure as well as the potential of the entity itself or its owners to act as a buyer in, or influence the behavior of, the pool of hypothetical buyers.

> We need not identify exactly who the buyer would be or even what class of investors the buyer would belong to. The 'willing buyer' is supposed to be a hypothetical amalgam of potential buyers in the marketplace. Although we have, in prior opinions, identified types of hypothetical buyers, we did so only to determine which valuation approach, among several reasonable approaches, would result in

[3] _Estate of Andrews v. Commissioner_, 79 TC 938, 956 (1982)

> the highest bid, and therefore the one most acceptable to a willing seller… The question is not so much "who", but "how"[4].

Identifying the Most Important Factors

For any given valuation problem, focus on the specific facts and circumstances in the light of all of these factors and select those that are most relevant to the problem at hand. There are several specific factors that may deserve special attention in regard to a non-controlling interest in an electing S Corporation, as opposed to an interest in a similar closely-held entity that has not elected to be treated as an S Corporation. Among these factors are the cost of capital and the minority and marketability discounts.

Limitations may be imposed on an entity's ability to raise both debt and equity capital as a result of the requirements of Subchapter S relating to the number and type of interest holders, the necessity of a single class of stock, and the requirement of straight debt. On the other hand, these limitations may not differ materially from those experienced by similar closely-held entities that have not made an S election. The impact of these requirements should be evaluated as part of determining an appropriate rate of return to be used in the valuation.

Further, since only certain types of investors can qualify as S Corporation interest holders, the pool of hypothetical buyers might be smaller than would otherwise be the case. Moreover, the prospect of additional investor-level taxes may be a concern. On the other hand, in the context of a non-controlling interest, the limitation on the buyer pool may be no more onerous than that experienced by a similar closely-held entity that has not made an S election. Concern regarding investor-level taxes could be mitigated by a Shareholders' Agreement, as is typical in the case of electing S Corporations involving unrelated parties. The impact of these factors should be evaluated as part of determining appropriate discounts for marketability and lack of control.

[4] *Estate of Mueller v. Commissioner*, TC Memo 1992-284; 63 T.C.M. (CCH) 3027-16; 71 T.C.M. (RIA) 92-1415.

EVIDENCE-BASED VALUATION ANALYSIS

Examples of valuation from an evidence-based perspective can be found in both the analysis of the Tax Court and that of the academic community. The weight to be accorded these analyses will depend upon the validity of their reasoning and the thoroughness of the data considered. The Tax Court considers real world fact patterns and evaluates competing and often contradictory testimony put forth by litigants and their experts. Although the result is not a valuation conclusion of a text-book variety, it is the product of the best reasoning and market data the parties can bring to the table. Academics often approach valuation problems through the interpretation of a real world transactional data set that has been collected using a testable sampling methodology. The result reached is a function of the market-wide insight provided by the data set. We briefly examine each of these sources for what they might reveal about the valuation of an interest in an S Corporation.

A View from the Tax Court

In a series of opinions commencing in 1999, the Tax Court addressed tax-affecting in the context of valuing non-controlling interests in pass-through entities. "Tax-affecting" is the court's way of saying that the earnings stream of an entity is reduced to account for a hypothetical entity level income tax.[5] The first five cases involved corporations that had elected to be treated as S Corporations. The sixth involved a limited partnership, and the seventh involved a limited liability company that had elected to be treated as an S Corporation. In each case, the Court concluded on the record before it that in applying an income method to the earnings stream of the pass-through entity, the proper entity level tax rate was its actual tax rate, zero percent.

Appendix B provides a list of the relevant opinions. For the purposes of this Job Aid, the importance of the opinions lies not in their holdings, but in their reasoning.

[5] This should not be confused with the C Corporation built-in gains issue. That issue involves the treatment of the unrecognized income tax liability of a C Corporation attributable to its built-in capital gains.

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A View from Academia

An example of a data-based analysis is found in Merle M. Erickson and Shiing-wu Wang, Tax Benefits as a Source of Merger Premiums in Acquisitions of Private Corporations, The Accounting Review, Vol. 82, No. 2, pp. 359-387 (2007), addressing the effect of organizational form on the acquisition tax structure and price of controlling interests in S Corporations.[6] The analysis demonstrates that the tax structure used to acquire S Corporations differs from that used to acquire C Corporations. The differing structure permits the sellers to share some of the benefits of a single level of taxation with the buyer, through an election to step up the basis of the S Corporation's assets. This is economically feasible because the incremental tax costs to the sellers are generally less than the incremental tax benefits to the buyer, and permits the sellers to capture a premium. The authors conclude that controlling interests in S Corporations are more valuable on average than similar interests in equivalent C Corporations in a range of 10% to 20% of value.

Appendix C provides more detail on the study. For the purposes of this Job Aid, the importance of the study lies not in its conclusion, but in its methodology. It is an example of a theoretical model that has been validated by market based evidence, as opposed to a theoretical model untested in the real world of fully informed, economically motivated buyers and sellers. This distinction is addressed in the following section**.**

THEORY-BASED VALUATION ANALYSIS

In response to the *Gross* opinion, commentators proposed models for the valuation of non-controlling interests in electing S Corporations. These models are based on theoretical assumptions as to how potential buyers might act in making investment decisions and what factors they might consider in setting an offering price. Parameters considered include prevailing tax rates for C Corporations and individuals, assumed holding periods, the size and frequency of distributions, and the effect of outside basis build up on the gain or loss to be recognized on the disposition of the purchased interests.

Some of the models are quite sophisticated in terms of the factors considered; however, they remain just that, models based on theoretical assumptions. They focus almost exclusively on the economic concerns of the buyer while ignoring the concerns of the seller. They generally take a simplistic approach to the question of tax burden, assuming that all buyers pay income tax at the maximum statutory rate. Most significant, however, is the fact that the models have not

[6] See also David Denis and Atulya Sarin, Taxes and the Relative Valuation of S Corporations and C Corporations, Journal of Applied Finance, Fall/Winter 2002, pp.7-16.

been tested against market evidence to gauge their reasonableness or accuracy in a real-world context. Rev. Rul. 59-60 envisions the give and take of the real world marketplace as the ultimate arbitrator of value.

WEIGHTING OF FACTORS AND APPROACHES

A number of factors have been identified above that can affect the valuation of a non-controlling interest in a closely-held entity, in general, and in an electing S Corporation, in particular. Among these are: 1) the limit on the number of interest holders; 2) the limit on the type of interest holders; 3) the limit on the number of classes of stock; 4) the limit on what constitutes straight debt; 5) the absence of an entity-level Federal income tax; 6) the interests of the typical hypothetical buyer; and 7) the interests of the typical hypothetical seller. Depending upon the facts and circumstances, each of these factors may be of varying levels of importance. How do we then weigh these factors in conjunction with the available valuation approaches in coming to an ultimate valuation conclusion? Section 7 of Rev. Rul. 59-60, Average of Factors, provides as follows:

> Because valuations cannot be made on the basis of a prescribed formula, there is no means whereby the various applicable factors in a particular case can be assigned mathematical weights in deriving the fair market value. For this reason, no useful purpose is served by taking an average of several factors (for example, book value, capitalized earnings and capitalized dividends) and basing the valuation on the result. Such a process excludes active consideration of other pertinent factors, and the end result cannot be supported by a realistic application of the significant facts in the case except by mere chance.

Accordingly, all of the available information must be considered and synthesized using professional judgment based on expertise and experience to arrive at a defensible result. This is not an easy task and there is no short cut that can be applied as a substitute for a rigorous analysis conducted within an environment moderated by common sense.

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ASSESSMENT AND SYNTHESIS

Much has been said since the *Gross* opinion about the valuation of non-controlling interests in electing S Corporations. We now turn to the question of what does it all mean.

Setting a Framework for Evaluation

The examples provided below should be considered in conjunction with the commentary presented within the body of this Job Aid and in Rev. Rul. 59-60. The first example is presented to illustrate the role of the election to be treated as an S Corporation as one of the many pertinent variables to be considered. The second example is presented to illustrate the potential effects of an S Corporation election on the cost of capital and the discount for lack of marketability.

Example 1

The Tax Status of the Electing S Corporation

Although electing S Corporations have many benefits centered on simplicity of form and operation, in many cases the principal benefit is the avoidance of double taxation. An S Corporation with a trend toward strong and continued earnings with a high dividend paying capacity in a market with an adequate number of qualifying investors as hypothetical buyers is a strong candidate for retaining its S Corporation status. On the other hand, that same S Corporation operating in an industry heavily dominated by C Corporations may be subject to a creeping acquisition by a competitor C Corporation that would cause the loss of its S Corporation status.

The items that must be evaluated to ensure that the valuation approach selected is proper include:

- Are electing S Corporations common in the area of the entity's business or in its industry?
- How has the business changed and what will it look like in the future? What type of organizational structure, including tax structure, do present and projected future operations suggest?
- What is the economic outlook? Will the subject entity be paying significant entity level taxes if it loses its S Corporation status?
- What is the market like as concerns potential hypothetical buyers? What is the present percentage distribution of S Corporations and C Corporations in this industry? What is the trend of S Corporation

formations? As a percentage of the total, are they growing in number, declining, or remaining steady?
- A consideration of the goals of a hypothetical buyer in light of the definition of fair market value includes the concept of most productive use. If retaining an S Corporation election provides the most value, a buyer will tend to move in that direction to the extent permitted by law and prevailing circumstances. The buyer willing to pay the highest price for an interest will drive the transfer transaction.
- The interests of the seller must also be considered. Would an economically motivated holder of a non-controlling interest in an electing S Corporation willingly reduce the sale price of his/her interest by a significant tax adjustment if it were not absolutely necessary? If so, would the remaining interest holders allow this to happen or would they, instead, enter into the bidding to preserve the value of their own interests. (In this respect, consider the effect of any existing Shareholder's Agreement, or the possibility that the retiring interest holder could facilitate the implementation of such an Agreement as part of the sale transaction.)

Each of these factors can and often will have an influence on the value of a non-controlling interest in an electing S Corporation. Applying factors such as these to a company such as G&J Pepsi-Cola Bottlers, Inc. (the company of interest in the *Gross* opinion), we have an entity with a long-standing operating history, that is distributing basically all of its earnings, that is family-owned and that has a Shareholders' Agreement aimed at guaranteeing continued operation as an S Corporation. In addition, S Corporations and partnerships are a common form of ownership in the beverage industry. Based on these considerations, among others, the Tax Court determined that there was no reason to believe that G&J would lose its S Corporation status.

Example 2

Cost of Capital and Lack of Marketability

The Valuation Analyst has completed a consideration of the relevant facts and circumstances of an electing S Corporation and has concluded that there is little likelihood that the entity will lose its S Corporation status as a result of the transfer of a non-controlling interest in the entity. However, the entity's status as an electing S Corporation may limit the entity's ability to raise additional equity and/or debt capital.

Applying standard techniques for a valuation problem involving a closely-held entity, the cost of equity capital has been determined using a Modified CAPM approach and the discount for lack of marketability (DLOM) has been determined using a holding period analysis along with an assumed required rate of return. Applying the specific characteristics of the S Corporation, including the Shareholders' Agreement, and the experience of the Valuation Analyst, it is determined that the specific company premium in the modified CAPM and the DLOM should be increased incrementally to reflect the limitations on raising capital and the limited pool of buyers. All other input parameters remain as originally proposed.

On the other hand, depending upon the facts and circumstances of the case, it is also possible that no adjustments are required. As with any valuation assignment, professional judgment and common sense are required in arriving at the method and the parameters to be employed.

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Summary

The valuation of interests in electing S Corporations is guided by the principles of Rev. Rul. 59-60. Electing S Corporations, like the vast majority of the closely-held entities valued under Rev. Rul. 59-60, are not subject to entity level Federal income tax, a factor that tends to enhance value. However, there are also potential disadvantages inherent in an S Corporation's status that may not be present in other closely held entities and that may negatively affect value. Among the valuation parameters where this may be reflected are the cost of capital and the marketability discount and, in certain cases, the discount for lack of control. The Valuation Analyst should devote careful attention to these parameter choices to ensure that the factors chosen are appropriate given the facts and circumstances of the valuation problem at hand. In a given situation, it is quite possible that more risk has been introduced into the hypothetical transfer transaction. If such is the case, that additional risk should be recognized in an appropriate manner.

Factors for specific consideration by the Valuation Analyst can be conveniently summarized into a limited number of areas as illustrated below:

1. The size and composition of the pool of hypothetical buyers
2. The economic interests of the hypothetical seller
3. The actual revenues available to and the actual expenses to be paid by the entity that has elected to be taxed as an S Corporation
4. The availability at the entity level of equity and debt capital
5. The likely holding period of the transferred interest

With respect to the question of pass-through taxation, no entity level tax should be applied in the valuation analysis of a non-controlling interest in an electing S Corporation, absent a compelling demonstration that independent third parties dealing at arms-length would do so as part of a purchase price negotiation. In a similar manner, the personal income taxes of a potential interest buyer or interest seller are not relevant in determining the fair market value of an interest in an electing S Corporation. The application of investor level characteristics such as personal tax rates results in an investment value to an assumed candidate buyer rather than a fair market value based on the informed, competing interests of the hypothetical willing and financially able parties contemplated by the fair market value standard.

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APPENDICES

A – REVENUE RULING 59-60

B – A VIEW FROM THE U.S. TAX COURT

C – A VIEW FROM THE ACADEMIC COMMUNITY

APPENDIX A

TEXT OF REVENUE RULING 59-60, 1959-1 CB 237

In valuing the stock of closely held corporations, or the stock of corporations where market quotations are not available, all other available financial data, as well as all relevant factors affecting the fair market value must be considered for estate tax and gift tax purposes. No general formula may be given that is applicable to the many different valuation situations arising in the valuation of such stock. However, the general approach, methods, and factors which must be considered in valuing such securities are outlined.

Revenue Ruling 54-77, C.B. 1954-1, 187, superseded.

SECTION 1. PURPOSE.

The purpose of this Revenue Ruling is to outline and review in general the approach, methods and factors to be considered in valuing shares of the capital stock of closely held corporations for estate tax and gift tax purposes. The methods discussed herein will apply likewise to the valuation of corporate stocks on which market quotations are either unavailable or are of such scarcity that they do not reflect the fair market value.

SEC. 2. BACKGROUND AND DEFINITIONS.

.01 All valuations must be made in accordance with the applicable provisions of the Internal Revenue Code of 1954 and the Federal Estate Tax and Gift Tax Regulations. Sections 2031(a), 2032 and 2512(a) of the 1954 Code (sections 811 and 1005 of the 1939 Code) require that the property to be included in the gross estate, or made the subject of a gift, shall be taxed on the basis of the value of the property at the time of death of the decedent, the alternate date if so elected, or the date of gift.

.02 Section 20.2031-1(b) of the Estate Tax Regulations (section 81.10 of the Estate Tax Regulations 105) and section 25.2512-1 of the Gift Tax Regulations (section 86.19 of Gift Tax Regulations 108) define fair market value, in effect, as the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts. Court decisions frequently state in addition that the hypothetical buyer and seller are assumed to be able, as well as willing, to trade and to be well informed about the property and concerning the market for such property.

.03 Closely held corporations are those corporations the shares of which are owned by a relatively limited number of stockholders. Often the entire stock issue is held by one family. The result of this situation is that little, if any, trading in the shares takes place. There is, therefore, no established market for the stock and such sales as occur at irregular intervals seldom reflect all of the elements of a representative transaction as defined by the term "fair market value."

SEC. 3. APPROACH TO VALUATION.

.01 A determination of fair market value, being a question of fact, will depend upon the circumstances in each case. No formula can be devised that will be generally applicable to the multitude of different valuation issues arising in estate and gift tax cases. Often, an appraiser will find wide differences of opinion as to the fair market value of a particular stock. In resolving such differences, he should maintain a reasonable attitude in recognition of the fact that valuation is not an exact science. A sound valuation will be based upon all the relevant facts, but the elements of common sense, informed judgment and reasonableness must enter into the process of weighing those facts and determining their aggregate significance.

.02 The fair market value of specific shares of stock will vary as general economic conditions change from "normal" to "boom" or "depression," that is, according to the degree of optimism or pessimism with which the investing public regards the future at the required date of appraisal. Uncertainty as to the stability or continuity of the future income from a property decreases its value by increasing the risk of loss of earnings and value in the future. The value of shares of stock of a company with very uncertain future prospects is highly speculative. The appraiser must exercise his judgment as to the degree of risk attaching to the business of the corporation which issued the stock, but that judgment must be related to all of the other factors affecting value.

.03 Valuation of securities is, in essence, a prophesy as to the future and must be based on facts available at the required date of appraisal. As a generalization, the prices of stocks which are traded in volume in a free and active market by informed persons best reflect the consensus of the investing public as to what the future holds for the corporations and industries represented. When a stock is closely held, is traded infrequently, or is traded in an erratic market, some other measure of value must be used. In many instances, the next best measure may be found in the prices at which the stocks of companies engaged in the same or a similar line of business are selling in a free and open market.

SEC. 4. FACTORS TO CONSIDER.

.01 It is advisable to emphasize that in the valuation of the stock of closely held corporations or the stock of corporations where market quotations are either lacking or too scarce to be recognized, all available financial data, as well as all relevant factors affecting the fair market value, should be considered. The following factors, although not all-inclusive are fundamental and require careful analysis in each case:

(a) The nature of the business and the history of the enterprise from its inception.

(b) The economic outlook in general and the condition and outlook of the specific industry in particular.

(c) The book value of the stock and the financial condition of the business.

(d) The earning capacity of the company.

(e) The dividend-paying capacity.

(f) Whether or not the enterprise has goodwill or other intangible value.

(g) Sales of the stock and the size of the block of stock to be valued.

(h) The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter.

.02 The following is a brief discussion of each of the foregoing factors:

(a) The history of a corporate enterprise will show its past stability or instability, its growth or lack of growth, the diversity or lack of diversity of its operations, and other facts needed to form an opinion of the degree of risk involved in the business. For an enterprise which changed its form of organization but carried on the same of closely similar operations of its predecessor, the history of the former enterprise should be considered. The detail to be considered should increase with approach to the required date of appraisal, since recent events are of greatest help in predicting the future; but a study of gross and net income, and of dividends covering a long prior period, is highly desirable. The history to be studied should include, but need not be limited to, the nature of the business, its products or services, its operating and investment assets, capital structure, plant facilities, sales records and

management, all of which should be considered as of the date of the appraisal, with due regard for recent significant changes. Events of the past that are unlikely to recur in the future should be discounted, since value has a close relation to future expectancy.

(b) A sound appraisal of a closely held stock must consider current and prospective economic conditions as of the date of appraisal, both in the national economy and in the industry or industries with which the corporation is allied. It is important to know that the company is more or less successful than its competitors in the same industry, or that it is maintaining a stable position with respect to competitors. Equal or even greater significance may attach to the ability of the industry with which the company is allied to compete with other industries. Prospective competition which has not been a factor in prior years should be given careful attention. For example, high profits due to the novelty of its product and the lack of competition often lead to increasing competition. The public's appraisal of the future prospects of competitive industries or of competitors within an industry may be indicated by price trends in the markets for commodities and for securities. The loss of the manager of a so-called "one-man" business may have a depressing effect upon the value of the stock of such business, particularly if there is a lack of trained personnel capable of succeeding to the management of the enterprise. In valuing the stock of this type of business, therefore, the effect of the loss of the manager on the future expectancy of the business, and the absence of management-succession potentialities are pertinent factors to be taken into consideration. On the other hand, there may be factors which offset, in whole or in part, the loss of the manager's services. For instance, the nature of the business and of its assets may be such that they will not be impaired by the loss of the manager. Furthermore, the loss may be adequately covered by life insurance, or competent management might be employed on the basis of the consideration paid for the former manager's services. These, or other offsetting factors, if found to exist, should be carefully weighed against the loss of the manager's services in valuing the stock of the enterprise.

(c) Balance sheets should be obtained, preferably in the form of comparative annual statements for two or more years immediately preceding the date of appraisal, together with a balance sheet at the end of the month preceding that date, if corporate accounting will permit. Any balance sheet descriptions that are not self-explanatory, and balance sheet items comprehending diverse assets or liabilities, should be clarified in essential detail by supporting supplemental schedules. These statements usually will disclose to the appraiser (1) liquid position (ratio of current assets to current liabilities); (2) gross and net book value of principal classes of fixed assets; (3) working capital; (4) long-term indebtedness; (5) capital structure; and (6) net worth. Consideration also should be given to any assets not essential to the operation of the business, such as

investments in securities, real estate, etc. In general, such non-operating assets will command a lower rate of return than do the operating assets, although in exceptional cases the reverse may be true. In computing the book value per share of stock, assets of the investment type should be revalued on the basis of their market price and the book value adjusted accordingly. Comparison of the company's balance sheets over several years may reveal, among other facts, such developments as the acquisition of additional production facilities or subsidiary companies, improvement in financial position, and details as to recapitalizations and other changes in the capital structure of the corporation. If the corporation has more than one class of stock outstanding, the charter or certificate of incorporation should be examined to ascertain the explicit rights and privileges of the various stock issues including: (1) voting powers, (2) preference as to dividends, and (3) preference as to assets in the event of liquidation.

(d) Detailed profit-and-loss statements should be obtained and considered for a representative period immediately prior to the required date of appraisal, preferably five or more years. Such statements should show (1) gross income by principal items; (2) principal deductions from gross income including major prior items of operating expenses, interest and other expense on each item of long-term debt, depreciation and depletion if such deductions are made, officers' salaries, in total if they appear to be reasonable or in detail if they seem to be excessive, contributions (whether or not deductible for tax purposes) that the nature of its business and its community position require the corporation to make, and taxes by principal items, including income and excess profits taxes; (3) net income available for dividends; (4) rates and amounts of dividends paid on each class of stock; (5) remaining amount carried to surplus; and (6) adjustments to, and reconciliation with, surplus as stated on the balance sheet. With profit and loss statements of this character available, the appraiser should be able to separate recurrent from nonrecurring items of income and expense, to distinguish between operating income and investment income, and to ascertain whether or not any line of business in which the company is engaged is operated consistently at a loss and might be abandoned with benefit to the company. The percentage of earnings retained for business expansion should be noted when dividend-paying capacity in considered. Potential future income is a major factor in many valuations of closely-held stocks, and all information concerning past income which will be helpful in predicting the future should be secured. Prior earnings records usually are the most reliable guide as to the future expectancy, but resort to arbitrary five-or-ten-year averages without regard to current trends or future prospects will not produce a realistic valuation. If, for instance, a record of progressively increasing or decreasing net income is found, then greater weight may be accorded the most recent years' profits in estimating earning power. It will be helpful, in judging risk and the extent to which a business is a marginal operator, to consider deductions from income and net income in terms of percentage of sales. Major categories of cost and expense to be so analyzed

include the consumption of raw materials and supplies in the case of manufacturers, processors and fabricators; the cost of purchased merchandise in the case of merchants; utility services; insurance; taxes; depletion of depreciation; and interest.

(e) Primary consideration should be given to the dividend-paying capacity of the company rather than to dividends actually paid in the past. Recognition must be given to the necessity of retaining a reasonable portion of profits in a company to meet competition. Dividend-paying capacity is a factor that must be considered in an appraisal, but dividends actually paid in the past may not have any relation to dividend-paying capacity. Specifically, the dividends paid by a closely held family company may be measured by the income needs of the stockholders or by their desire to avoid taxes on dividend receipts, instead of by the ability of the company to pay dividends. Where an actual or effective controlling interest in a corporation is to be valued, the dividend factor is not a material element, since the payment of such dividends is discretionary with the controlling stockholders. The individual or group in control can substitute salaries and bonuses for dividends, thus reducing net income and understating the dividend-paying capacity of the company. It follows, therefore, that dividends are less reliable criteria of fair market value than other applicable factors.

(f) In the final analysis, goodwill is based upon earning capacity. The presence of goodwill and its value, therefore, rests upon the excess of net earnings over and above a fair return on the net tangible assets. While the element of goodwill may be based primarily on earnings, such factors as the prestige and renown of the business, the ownership of a trade or brand name, and a record of successful operation over a prolonged period in a particular locality, also may furnish support for the inclusion of intangible value. In some instances it may not be possible to make a separate appraisal of the tangible and intangible assets of the businesses. The enterprise has a value as an entity. Whatever intangible value there is, which is supportable by the facts, may be measured by the amount by which the appraised value of the tangible assets exceeds the net book value of such assets.

(g) Sales of stock of a closely held corporation should be carefully investigated to determine whether they represent transactions at arm's length. Forced or distress sales do not ordinarily reflect fair market value nor do isolated sales in small amounts necessarily control as the measure of value. This is especially true in the valuation of a controlling interest in a corporation. Since, in the case of closely held stocks, no prevailing market prices are available, there is no basis for making an adjustment for blockage. It follows, therefore, that such stocks should be valued upon a consideration of all the evidence affecting the fair market value. The size of the block of stock itself is a relevant factor to be considered. Although it is true that a minority interest in an unlisted corporation's

stock is more difficult to sell than a similar block of listed stock, it is equally true that control of a corporation, either actual or in effect, representing as it does an added element of value, may justify a higher value for a specific block of stock.

(h) Section 2031(b) of the Code states, in effect, that in valuing unlisted securities the value of stock or securities of corporations engaged in the same or a similar line of business which are listed on an exchange should be taken into consideration along with all other factors. An important consideration is that the corporations to be used for comparisons have capital stocks which are actively traded by the public. In accordance with section 2031(b) of the Code, stocks listed on an exchange are to be considered first. However, if sufficient comparable companies whose stocks are listed on an exchange cannot be found, other comparable companies which have stocks actively traded in on the over-the-counter market also may be used. The essential factor is that whether the stocks are sold on an exchange or over-the-counter there is evidence of an active, free public market for the stock as of the valuation date. In selecting corporations for comparative purposes, care should be taken to use only comparable companies. Although the only restrictive requirement as to comparable corporations specified in the statute is that their lines of business be the same or similar, yet it is obvious that consideration must be given to other relevant factors in order that the most valid comparison possible will be obtained. For illustration, a corporation having one or more issues of preferred stock, bonds or debentures in addition to its common stock should not be considered to be directly comparable to one having only common stock outstanding. In like manner, a company with a declining business and decreasing markets is not comparable to one with a record of current progress and market expansion.

SEC. 5. WEIGHT TO BE ACCORDED VARIOUS FACTORS.

The valuation of closely held corporate stock entails the consideration of all relevant factors as stated in section 4. Depending upon the circumstances in each case, certain factors may carry more weight than others because of the nature of the company's business. To illustrate:

(a) Earnings may be the most important criterion of value in some cases whereas asset value will receive primary consideration in others. In general, the appraiser will accord primary consideration to earnings when valuing stocks of companies which sell products or services to the public; conversely, in the investment or holding type of company, the appraiser may accord the greatest weight to the assets underlying the security to be valued.

(b) The value of the stock of a closely held investment or real estate holding company, whether or not family owned, is closely related to the value of the assets underlying the stock. For companies of this type the appraiser should

determine the fair market values of the assets of the company. Operating expenses of such a company and the cost of liquidating it, if any, merit consideration when appraising the relative values of the stock and the underlying assets. The market values of the underlying assets give due weight to potential earnings and dividends of the particular items of property underlying the stock, capitalized at rates deemed proper by the investing public at the date of appraisal. A current appraisal by the investing public should be superior to the retrospective opinion of an individual. For these reasons, adjusted net worth should be accorded greater weight in valuing the stock of a closely held investment or real estate holding company, whether or not family owned, than any of the other customary yardsticks of appraisal, such as earnings and dividend paying capacity.

SEC. 6. CAPITALIZATION RATES.

In the application of certain fundamental valuation factors, such as earnings and dividends, it is necessary to capitalize the average or current results at some appropriate rate. A determination of the proper capitalization rate presents one of the most difficult problems in valuation. That there is no ready or simple solution will become apparent by a cursory check of the rates of return and dividend yields in terms of the selling prices of corporate shares listed on the major exchanges of the country. Wide variations will be found even for companies in the same industry. Moreover, the ratio will fluctuate from year to year depending upon economic conditions. Thus, no standard tables of capitalization rates applicable to closely held corporations can be formulated. Among the more important factors to be taken into consideration in deciding upon a capitalization rate in a particular case are: (1) the nature of the business; (2) the risk involved; and (3) the stability or irregularity of earnings.

SEC. 7. AVERAGE OF FACTORS.

Because valuations cannot be made on the basis of a prescribed formula, there is no means whereby the various applicable factors in a particular case can be assigned mathematical weights in deriving the fair market value. For this reason, no useful purpose is served by taking an average of several factors (for example, book value, capitalized earnings and capitalized dividends) and basing the valuation on the result. Such a process excludes active consideration of other pertinent factors, and the end result cannot be supported by a realistic application of the significant facts in the case except by mere chance.

SEC. 8. RESTRICTIVE AGREEMENTS.

Frequently, in the valuation of closely held stock for estate and gift tax purposes, it will be found that the stock is subject to an agreement restricting its sale or transfer. Where shares of stock were acquired by a decedent subject to an option reserved by the issuing corporation to repurchase at a certain price, the option price is usually accepted as the fair market value for estate tax purposes. See Rev. Rul. 54-76, C.B. 1954-1, 194. However, in such case the option price is not determinative of fair market value for gift tax purposes. Where the option, or buy and sell agreement, is the result of voluntary action by the stockholders and is binding during the life as well as at the death of the stockholders, such agreement may or may not, depending upon the circumstances of each case, fix the value for estate tax purposes. However, such agreement is a factor to be considered, with other relevant factors, in determining fair market value. Where the stockholder is free to dispose of his shares during life and the option is to become effective only upon his death, the fair market value is not limited to the option price. It is always necessary to consider the relationship of the parties, the relative number of shares held by the decedent, and other material facts, to determine whether the agreement represents a bona fide business arrangement or is a device to pass the decedent's shares to the natural objects of his bounty for less than an adequate and full consideration in money or money's worth. In this connection see Rev. Rul. 157 C.B. 1953-2, 255, and Rev. Rul. 189, C.B. 1953-2, 294.

SEC. 9. EFFECT ON OTHER DOCUMENTS.

Revenue Ruling 54-77, C.B. 1954-1, 187, is hereby superseded.

NOTE: Rev. Rul. 65-192 states that Rev. Rul. 59-60 also applies for other tax purposes as well as determining FMV of business interests of any type

APPENDIX B

A View from the Tax Court

In a series of opinions commencing in 1999, the Tax Court addressed tax-affecting in the context of valuing non-controlling interests in pass-through entities. "Tax-affecting" is the court's way of saying that the earnings stream of a pass-through entity is reduced to account for a hypothetical entity level income tax. The first five cases involved corporations that had elected to be treated as S Corporations. The sixth involved a limited partnership, and the seventh involved a limited liability company that had elected to be treated as an S Corporation. In each case, the Court concluded on the record before it that in applying an income method to the earnings stream of the pass-through entity, the proper entity level tax rate was its actual tax rate, zero percent.

Each case was decided on its own facts, including the entity's pass-through tax status, and the fact that that status was not expected to change. The opinions merit careful consideration, as they address many of the arguments frequently encountered in this area.

Gross v. Commissioner, T.C. Memo 1999-254, aff'd. 272 F.3d 333 (6th Cir. 2001), cert. denied, 537 US 827 (2002) (corporation)
Wall v. Commissioner, T.C. Memo 2001-75 (corporation)
Estate of Heck v. Commissioner, T.C. Memo 2002-34 (corporation)
Estate of Adams v. Commissioner, T.C. Memo 2002-80 (corporation)
Dallas v. Commissioner, T.C. Memo 2006-212 (corporation)
Estate of Giustina v. Commissioner, T.C. Memo 2011-141, appeal docketed, No. 12-71747 (9th Cir. June 1, 2012) (limited partnership).
Estate of Gallagher v. Commissioner, T.C. Memo 2011-148, modified by T.C. Memo 2011-244 (limited liability company).

APPENDIX C

A VIEW FROM THE ACADEMIC COMMUNITY

The paper described below is an example of an evidence-based analysis utilizing a real-world data set. For the purposes of this Job Aid, the actual conclusion reached is of less importance than the methodology employed in reaching that conclusion. Accordingly, the Valuation Analyst is cautioned with regard to applying premium results derived from the analysis of controlling interests to the purchase and sale of non-controlling interests.

In Merle M. Erickson and Shiing-wu Wang, Tax Benefits as a Source of Merger Premiums in Acquisitions of Private Corporations, The Accounting Review, Vol. 82, No. 2, pp. 359-387 (2007), the authors investigate the effect of organizational form on the acquisition tax structure and price of controlling interests in electing S Corporations.

Erickson and Wang initially demonstrate that the acquisition tax structure used to acquire electing S Corporations differs from that used to acquire C Corporations. The analysis of optimal acquisition tax structure is conducted using theoretical constructs, and concludes that the structure that is most beneficial for the acquisition of a C Corporation is a stock purchase with no election under IRC § 338. If the target is a C Corporation the tax due immediately is larger than the present value of the tax benefits to be enjoyed by the acquirer downstream due to the time value of money. Thus, the buyer is better off to buy the stock of the entity and to make no election. On the other hand, the structure that is most beneficial for the acquisition of an electing S Corporation is a stock purchase with a joint election by buyer and seller under IRC § 338(h)(10). An election under § 338 to treat a stock purchase as an asset purchase generates a stepped up basis in the acquired assets in exchange for paying tax on the gain resulting from the step up at the time of the acquisition.

In the case of an electing S Corporation, there is no entity level tax; all tax on the deemed sale is born by the selling S Corporation interest holders. In making a joint election under § 338(h)(10), the buyer benefits from asset step-up while the sellers are often in no worse tax condition than they would have been under a straight stock sale. This is the case if their overall S Corporation stock basis closely mirrors the corporation's basis in its assets and that recapture amounts do not represent a major problem. In order to convince the sellers to join in the § 338(h)(10) election, the buyer will normally offer to share some of his tax benefit in the form of a higher purchase price. The amount of the premium can range from very little to the entirety of the tax benefit to be gained by the buyer.

Most reasonably it will be somewhere in the mid-range between these two extremes.

Having constructed this conceptual analysis, the authors tested it in the marketplace by analyzing 77 taxable purchases of electing S Corporations made during the period 1994 through 2000 in parallel with 77 similar C Corporation purchases made during the same period. All transferred entities were privately held corporations at the time of sale. In keeping with their hypothesis, the authors found that all electing S Corporation transactions used a stock purchase with a § 338(h)(10) election, whereas all C Corporation transactions used a stock purchase with no § 338 election.

In analyzing purchase price amounts from the two samples, based on multipliers for six income measures, the authors determined that the S Corporation transactions occurred at generally higher multiples than did those of the comparable C Corporation transactions. The amount of the apparent premium varied widely and was in many cases higher than the authors' logic would have predicted. Nevertheless, the overall result confirmed the original hypothesis that there is value residing in the pass-through tax status of an electing S Corporation. In analyzing their results, the authors explored other reasons for the premium but found none of the alternative explanations to be generally persuasive.

Based on the transactions analyzed, Erickson and Wang concluded that the average tax benefits available to a buyer of an electing S Corporation are in the range of 12% to 17% of the overall value of the deal. These benefits will likely result in negotiated purchase price premiums in the range of 10% to 20% of basic deal value, depending upon the specific facts and circumstances and the negotiating strengths of the parties. Under the right circumstances, the premium can range much higher than 20%, as illustrated by certain of valuation results observed by the authors. The range of the premiums is illustrative of the fact that few C Corporations pay tax at the full statutory tax rate, and that any tax related benefit that does result from the purchase of an electing S Corporation must logically be shared in some manner between buyer and seller. Accordingly, the premiums experienced in the marketplace are somewhat lower than the premiums that might be expected based on purely theoretical grounds.