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VALUATION ISSUES™

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S Corporations
To Tax Effect or Not To Tax Effect

by Gary L. Schroeder, ASA

Recent tax court cases (Gross, TCM 1999-254 and Wall, TCM 2001-75) have called into question whether or not to "tax effect" earnings of an S corporation when applying a capitalization of income or a discounted cash flow method to value interests in an S corporation. The basic question comes from the tax treatment of S corporations compared to C corporations. S corporations do not pay taxes at the corporate level but instead its shareholders pay personal level income taxes on their pro-rata share of the S corporation's earnings while C corporations pay taxes on its corporate-level income while its shareholders also pay personal-level income taxes on the dividends they receive from the C corporation. Therefore, there appears, on the surface, to be an advantage to the shareholders' of an S corporation in that there is no double taxation on dividends or distributions made to the S corporation shareholders as there would be to the C corporation shareholders. Due to this advantage some believe that this makes the case for not "tax effecting" the earnings of an S corporation when applying a capitalization of earnings or a discounted cash flow methodology. However, below the surface this "solution" is not as simple as it sounds.

I must first point out that the valuation of closely held businesses cannot be performed on a purely mechanical basis whereby the procedures and methods used in one situation are used in all other situations. Instead the valuation of a closely held business must in each case be based on the facts and circumstances of that particular situation. Therefore, even if it was found to be appropriate to "tax effect" in one particular situation based on the facts and circumstances of that case and on the procedures and methodology employed it does not follow that "tax effecting" would be appropriate in another situation. The old adage "it depends" is certainly appropriate when deciding whether to "tax effect" S corporation earnings or not.

> **"The old adage "it depends" is certainly appropriate when deciding whether to "tax effect" S corporation earnings or not."**

To assist in determining whether to "tax effect" or not to "tax effect" I have provided just a few of the questions that would need to be answered before deciding whether to "tax effect" or not to "tax effect." These questions are:

1. Is the method being performed on a minority or controlling interest basis?
2. Who is the most likely buyer of the interest being valued?
3. What is the historical and projected payout ratio of net income to the shareholders?
4. Is the resulting minority interest value greater than it would be on a controlling interest value if earnings were not tax effected?

If the answer to number 1 above is that the appraiser is performing the method on a controlling interest basis then number 2 must be answered. If number 2 is answered that the most likely buyer would be a C corporation then corporate taxes must be considered because the most likely buyer would have to pay corporate taxes or in other words could not keep the S corporation status. It doesn't matter whether or not there is any intention for the current management to change the status of the company or sell the company or if the appraiser is ultimately valuing a minority or controlling interest, if the methodology is based on valuing a controlling interest then the appraiser must tax effect if the most

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To Tax Effect or Not (Cont.)

likely buyer is a C corporation. We note that under this methodology the appraiser must make a projection of those revenues, expenses, profits, and capital expenditures that would be realized by a controlling interest buyer.

If the answer to number 1 above is that the method is being performed on a minority interest basis then not "tax effecting" may be appropriate. This may also be the case if the answer to number 2 above is that the most likely buyer would be an eligible S corporation shareholder who could keep the S status.

For question number 3 above, generally as the payout ratio increases the more likely that not "tax effecting" would be more appropriate and vice versa, as the payout ratio goes down then "tax effecting" becomes more appropriate. The reasoning is that as the payout ratio goes down the S corporation shareholders start to lose the tax benefits of the S corporation to the point of potentially being a detriment if the payout does not cover the taxes owed.

Number 4 above is basically a sanity check whereby if taxes are eliminated from the valuation analysis does the resulting value for a minority interest exceed the value of the interest on a pro rata basis of the control value of the company. Obviously this would be an absurd result but might be possible if taxes were merely eliminated from the valuation methodology.

In conclusion, it should be obvious that the answer to the question of whether to tax effect or not to tax effect when using a capitalization of income or a discounted cash flow analysis to value an interest in an S corporation is not simply a yes or no answer. Numerous factors, including many which I have not covered or mentioned due to space limitations, must be considered and as always in closely held business valuations it depends on the facts and circumstances of the particular situation.

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Tax Court
Estate of Helen Bolton Jameson
T.C. Memo
Judge Gale
5th Circuit Court Order

By John A. Thomson, ASA, MAI

The Jameson Tax Court decision was filed February 9, 1999. The case was appealed to the 5th Circuit Court and the case was vacated and remanded to the tax court on October 17, 2001.

Let us first discuss the tax court case. The case involved a 98 percent interest in a personal holding company known as Johnco (this was a "C" corporation). The date of value was September 22, 1991. Johnco owned 5,405 acres of timber property and certain other residential unimproved land in Harris County, Texas. The net asset value (NAV) was stipulated to $6,958,000. The key issue was the appropriate marketability discount, if any, on the large block of stock, and what, if any, consideration should be given for built-in capital gains tax. Note, as this was obviously a controlling interest, no minority discount (discount for lack of control) was involved.

> **"Expert testimony is not useful when the expert is merely an advocate for the position argued by one of the parties."**

The opinion goes on to say "expert testimony" sometimes aids the court in determining values, and sometimes it does not. Expert testimony is not useful when the expert is merely an advocate for the position argued by one of the parties. The taxpayer's first expert (Mr. Lax of Arthur Andersen) apparently miscalculated the net asset value. The taxpayer's second expert (Mr. Buck of RPR) calculated the "estimated capital gains tax at $1,698,000 or 24.4 percent of the net asset value of $6,958,000. This would appear to be a dollar for dollar discount for built-in capital gains. Mr. Buck then concluded an additional 10 percent discount because there was a minority interest (2 percent). This is what Judge Gale referred to as a nuisance discount, which he disallowed.

Mr. Buck concluded the value of Johnco stock at $4.2 million based on 81,641 shares. This represents $51.44 per share. The IRS took the position that the $86.80 per share filed with the estate return was the current value. Judge Gale in his Tax Court decision concluded $71.00 per share.

The respondent's (IRS) expert (Mr. Burns of IPC) determined that six percent should be the ceiling on any discount for lack of marketability mainly because of the non-timber assets.

Relative to built-in capital gains, Mr. Burns testified this could be avoided by using a number of tax strategies such as a 1031 exchange or electing "S" corporation status.

Judge Gale states on the above, "the tax strategies suggested by Mr. Burns, who is not an expert in taxation, can at best defer the recognition of built-in capital gains, but only by deferring income and ultimately cash-flow and suggests the work of an advocate rather than a disinterested expert witness."

Judge Gale believed some consideration for built-in capital gains was appropriate. However, left with a dollar for dollar approach by the taxpayer's expert and an "Advocated no consideration approach" by the IRS's expert, Judge Gale "crafted his own valuation."

Although Judge Gale cites the Davis case, he did not calculate his discount for built-in capital gains as it was done in Davis. Instead, he projected income for nine years and calculated the built-in capital gains tax based on income generated from timber harvesting over nine years which he then discounted

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Estate of Helen Bolton Jameson (Cont.)

back to present value. He used a net asset value approach for the value of the Company while using a future projected cash flow (income approach) to calculate built-in capital gains. This appears to be the main reason given by the U.S. Court of Appeals for the Fifth Circuit for vacating his decision and remanding it for further proceedings. We don't believe that you can value the Company as a holding company (NAV) and then calculate a discount for built-in capital gains using the Income approach.

The Appeals Court stated "although the tax court was not required to credit the valuation testimony of either party, its calculations must be tied to the record and to sound and consistent economic principle. Unfortunately, the court deviated from several necessary criteria of fair market value analysis and thus clearly erred in assessing Johnco's stock value." "The tax court's internally inconsistent assumptions that a hypothetical purchaser of Johnco stock would engage in long-range timber production even though the timber property's annual rate of return is substantially lower than the investor's required return, fatally flawed its decision to discount the future flow of capital gains taxes." "Because the tax court clearly erred in its approach to the discount of capital gains taxes on the timber property, this issue must be remanded for further considerations."

Judge Gale's calculations of built-in capital gains amounted to a 12.5 percent discount from NAV ($872,920/ $6,958,000).

We note had Judge Gale, who cited the Davis case, calculated the built-in gains in the same manner as Davis, he would have concluded approximately the same answer and his decision would most likely not have been overturned.

The discount for built-in capital gains in the Davis case was 13 percent (of Net Asset Value) which was included as part of the overall marketability discount (41 percent). However, in the Davis case a minority interest was being appraised (26 percent) whereas in the subject case a very large controlling interest (98 percent) was being appraised.

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Auditor Independence

By Alan M. Gochman, CPA

The question of auditor independence, especially regarding the effect when the same firm provides consulting services (including valuations) has been around for many years. However, the recent collapse of Enron Corp. has brought the debate to the forefront.

For years, accounting firms, especially the Big Five, have evolved into multi-disciplinary businesses beyond their traditional tax and auditing work. Allegations abound that audit fees are often set unprofitably low to establish client relationships and to sell other services. The quest for higher paying fee based work involving other aspects of their client's business is where the accountant's professional independence comes into question.

"Overall, the report suggests that the provision of non-audit services impairs independence and reduces the quality of earnings."

A study done by Richard M. Frankel, MIT, Sloan School of Business, Marilyn F. Johnson, Michigan State University, Eli Broad Graduate School of Management and Karen K. Nelson, Stanford University, Graduate School of Business analyzed the effects of accounting firms' consulting business on the objectivity of their auditors. The study was done to determine whether public accountants really are performing their role as independent gatekeepers, or has it become a game of winks and nods between corporate management and the auditors because the auditors don't want to lose these very lucrative consulting contracts according to Nelson. The study was based on data from the proxies of over 4,000 firms filed between February 5 and June 15 of 2001. Of the proxies reviewed, it was found that over half of the firms paid more for consulting services than audit services, and that over 95 percent of firms purchase at least some non-audit services from their auditor. The study found that corporations with the least independent auditors - those who paid the most in consulting fees - are more likely to just meet or beat analysts' forecasts and to report larger absolute discretionary accruals. Overall, the report suggests that the provision of non-audit services impairs independence and reduces the quality of earnings.

In 2001, the SEC, concerned with the public's perception, issued a modernized set of rules for auditor independence. The SEC indicated that the prior independence standards were outdated and ineffective in maintaining independence in fact and appearance.

In regards to valuation and appraisal services, the rules state that:

"We are adopting a rule that, with some exceptions, provides that an accountant is not independent if the accountant provides appraisal or valuation services or any service involving a fairness opinion. Appraisal and valuation services include any process of valuing assets, both tangible and intangible or liabilities."

In our next issue we will discuss the auditor independence statement which for appraisal or valuation services became effective on July 5, 2002.

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KTS CALENDAR

RECENT AND UPCOMING SEMINARS AND SPEAKING ENGAGEMENTS

5/14/02	Presentation—Open Presentation, Collinsville, IL.—"What's Going on in the World of Valuation."
06/17/02	Presentation—Ballard Spahr Andrews & Ingersoll, LLP, Philadelphia, PA.
07/19/02	Presentation—Southern Illinois CPA Society, Waterloo, IL.—"Business Valuation."
08/28/02	Presentation—ASA Annual International Conference, San Diego, CA., "Tax Court - The Path, The Trial and The Opinion."
9/25/02	Presentation—The CPA Club of New Castle County, Wilmington, DE.—"Business Valuation Issues."
10/31/02	Booth—The Bergen County's Estate Planner's Day Conference, Bergen County, PA.

KTS RECENT ENGAGEMENTS

* Valuation of steel fabrication company's reporting units and individual assets for goodwill impairment testing under FASB 142.
* Valuation of minority interest common stock of Mexican manufacturing company for estate tax purposes.
* Valuation of Canadian manufacturing company for estate tax purposes.
* Numerous critiques of appraisal reports for estate and gift purposes for the Internal Revenue Service.
* Allocation of purchase price for former Las Vegas utility plant.
* Valuation of manufacturing company in Brazil.

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"People are always ready to recognize a man's ability...after he gets there."
-Bob Edwards