

# S CORPORATION ASSOCIATION

February 9, 2004

Lewis J. Fernandez  
Deputy Associate Chief Counsel  
Internal Revenue Service  
1111 Constitution Avenue, NW  
Room 5300  
Washington, D.C. 20224

Dear Mr. Fernandez:

We very much appreciate the opportunity to meet with you and your colleagues last summer to discuss the IRS application of *Gross v. Commissioner* to S corporation transfer tax valuation matters.

As we discussed, S Corporation owners around the country are alarmed at the IRS application of *Gross* to cases with very different facts. Should the IRS continue to broadly apply *Gross* to mean that tax affecting, an earlier accepted practice, is generally disallowed for S corporations, and that S corporation owners should pay more in estate and gift taxes than owners of other types of businesses all things being equal, the existence of these small and family-owned businesses is threatened.

It goes without saying that efforts by the Service to seek to raise the estate and gift taxes levied on the owners of private business is especially disturbing at a time when the Administration has indicated its strong desire to eliminate the estate tax entirely.

Since we met, and in response to your offer to submit our views on this matter more formally to the Service, members of the S Corporation Association ("S-CORP") and other groups with whom we work have discussed this matter at length. In an effort to give you the most thorough response, we have been in contact with our members, trade associations with S corporation membership, and a number of our technical advisors and valuation experts. These discussions spawned the enclosed paper, which we at S-CORP strongly endorse.

The paper represents the views of its authors, two credentialed business appraisers on the topic of valuing ownership interests in S corporations: Chris Treharne of Gibraltar Business Appraisals in Longmont, Colorado and Nancy Fannon of Baker Newman & Noyes in Portland, Maine, as well as S-CORP and our members. It is based on sound valuation theory, sound economic theory, and market evidence. In particular, the paper addresses the following:

- The appraisers' perspectives on Tax Court and Appeals Court opinions that involved the valuation of S corporations.
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- The level of distributions paid to shareholders will affect the value of S corporation minority ownership interests. Depending on the facts, minority interests may be worth less, the same, or more than otherwise similar C corporation interests. The authors offer a model to quantify these differences.
- Market evidence suggests stock transactions of S corporations are no more valuable than C corporations at the controlling-shareholder, entity level.
- Under the fair market value standard of value, the seller's tax basis is not transferable and therefore, has no value to a knowledgeable buyer. As a result, it should not be considered in a fair market value appraisal analysis.

Although the authors typically use the phrase "S corporation" throughout their paper, they believe their analysis and conclusions often are consistent with other pass-through-tax entities.

We appreciate your offer and that of your colleagues to consider our concerns and the evidence we offer here to support them, and would welcome the opportunity to follow up with you on this very serious matter affecting America's Subchapter S businesses.

Respectfully yours,

Stephanie E. Silverman  
President and Executive Directors

cc: Greg Jenner, Deputy Assistant Secretary for Tax Policy, Department of the Treasury  
Tom McMahon, Chairman, S Corporation Association

1101 Connecticut Avenue, NW Suite 550, Washington, DC 20036  
Phone | 202-466-8700 Fax | 202-466-9666  
[www.s-corp.org](http://www.s-corp.org)

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# **VALUATION OF PASS-THROUGH-TAX ENTITIES: MINORITY AND CONTROLLING INTERESTS**

Submitted by

Chris D. Treharne, ASA, MCBA, BVAL  
President, Gibraltar Business Appraisals, Inc.  
1430 Nelson Road, Suite 223  
Longmont, CO 80501  
Voice: 303.449.8550  
Fax: 303.449.8090  
ctreharne@4avalue.com

Nancy J. Fannon, CPA-ABV, MCBA, BVAL  
Principal, Valuation Division of Baker Newman & Noyes  
100 Middle Street  
Portland, ME 04101  
Voice: 207-791-7111  
Fax: 207-774-1793  
nfannon@bnn CPA.com

The attached paper discusses issues related to the appraisal of ownership interests in S corporations, and it has the following sections:

1. Introduction
2. A review of recent Tax Court case history
3. Valuation theory
4. Valuing minority interests in S corporations
5. Valuing controlling interests in S corporations
6. The impact of the seller's tax basis on S corporation valuations
7. Summary

Information from the following sources was used in our paper:

- "Valuation of Pass-Through Entities: What is all the Fuss About??", presented at the AICPA National Business Valuation Conference November 16, 2003, in Phoenix, Arizona, by Nancy Fannon, CPA-ABV, MCBA, Chris D. Treharne, ASA, MCBA, and James R. Hitchner, CPA-ABV, ASA.
- Chris D. Treharne, "Comparing Three Payout Assumptions' Impact On Values of S Versus C Corps," *Shannon Pratt's Business Valuation Update*, September 2002.
- Other sources, as identified by footnotes throughout the paper.

## INTRODUCTION

Perhaps there has been no more controversial business valuation issue than the appraisal of pass-through-tax entities (e.g., S corporations, limited liability companies, partnerships). The uncertainty that surrounds the issue and the magnitude of the dollars involved can, in many cases, be extremely large. For the valuation practitioner who has studied this issue and clearly understands the economic realities of value and the uncertainties of the IRS audit process, giving meaningful guidance to taxpayers who are looking for certainty has been extremely difficult.

We believe it is important that the reader of this paper understand the following precepts:

- This paper is based on our understanding of economic, financial and valuation theory;
- It is critical to understand that there may be a difference between valuing an entire company, versus valuing a minority interest in it;
- Each entity and each ownership interest in an entity may have unique characteristics that must be examined and considered. As a result, no valuation model can be applied blindly without consideration of the specific attributes of the subject ownership interest; and
- In some cases, ownership interests in S corporations will be worth less than an otherwise similar C corporation interests; in some cases, they will be worth the same; and in some cases, they will be worth more than otherwise similar C corporation interests.

Although we typically use the phrase “S corporation” throughout this paper, our analysis and conclusions often are consistent with pass-through-tax entities. Exceptions, however, may exist.

The reader is responsible for his/her own use and due diligence in the application of the material presented in this paper. The authors make no warranty as to its fitness for any use and accept no liability for its application.

With that the preceding as background, we turn to our review of relevant case history.

## RECENT TAX COURT CASE HISTORY

We begin with a review of case law, not because it is necessarily relevant to the economic theory that is the heart of this paper, but rather, because it has driven the contemporaneous discussion of tax affecting S corporation earnings. There has been much information and much misinformation written and discussed – both at the valuation practitioner level and at the IRS-examiner level – that has created significant confusion regarding the valuation of pass-through-tax entities.

We are aware of four Tax Court and one Appeals Court opinion that suggest S corporation earnings should not be tax affected for valuation purposes.

- *Walter L. Gross, Jr. et ux, et al. v. Commissioner*, T.C. Memo. 1999-254, No. 4460-97 (July 29, 1999), affd. 272 F. 3d 333 (6th Cir. 2001)
- *Estate of John E. Wall v. Commissioner*, T.C. Memo. 2001-75
- *Estate of William G. Adams, Jr. v. Commissioner*, T.C. Memo. 2002-80
- *Estate of Richie C. Heck v. Commissioner*, T.C. Memo. 2002-34

As you review the opinions, please note that each is a “T.C. Memo.” It is our understanding that such opinions are case-fact specific and do not necessarily reflect the opinion of the Tax Court as a whole on a particular topic.

In the cases that followed *Gross*, we are unaware of any presented evidence that distinguished their facts from *Gross*. Thus, the issue of “valuing S corporations” was treated the same in all cases, regardless of whether control or minority interests were being valued, and regardless of the financial reality of the distribution stream and rights of the subject ownership interest. The lack of differentiation between *Gross*, *Heck*, *Wall* and *Adams*, allowed misinformation to perpetuate, such that now the *Gross* citation has become synonymous with the proposition that there is no differentiation between S corporation ownership interests and how those interests should be valued.

However, the facts of each case were dramatically different, as were the economic rights of the shareholders in each case. A tiny minority owner in the *Gross* case bears no relationship to a holder of an entire company – and yet, the *Gross* standard is being applied to such divergent ownership interests.

Thus, we begin with a review of these cases, as we believe that valuation practitioners and IRS examiners, alike, need to understand the framework under which taxpayers are currently being assessed.

As the reader reviews our paper, please realize that we are not attorneys and are not providing legal opinion or advice. Instead, our perspectives are solely that of credentialed business appraisers.

**Walter L. Gross, Jr. et ux, et al. v. Commissioner, T.C. Memo. 1999-254, No. 4460-97 (July 29, 1999)**

The following italicized summary has been excerpted from *FCG Estate & Gift Valuation E-Flash*, Volume 1-15/1999, Edited by John Gilbert, CPA/ABV, CVA (used with permission). Portions not related to the topic of tax affecting S corporation income may have been deleted.

*In a gift tax case, the Tax Court agreed with the IRS that "S" corporation earnings should not be reduced by imputed taxes for determining discounted cash flow in the calculation of fair market value. The court also sided with the IRS valuation expert in determining a 25% lack of marketability discount and 15.5% cost of equity capital. The IRS expert also survived a Daubert challenge on his valuation methodology. The taxpayers claimed a gift value of \$5,680 per share while the IRS argued a \$10,910 per share value at trial. The Tax Court accepted the IRS value, resulting in a \$2,332,691 gift tax deficiency.*

*The taxpayers were one of two family groups who each owned half of the outstanding shares of G&J Pepsi-Cola Bottlers, Inc., a Subchapter S corporation. In 1992, the Taxpayers made gifts of minority interests. S corporation net income (and, therefore, pre-tax income) for G&J averaged \$22,616,377 for the five years prior to the gift, and dividends to shareholders averaged \$22,716,842 during that same period.*

*Taxpayer Expert 1 - This expert used three separate methods to value the corporation, the "market price comparison method, discounted future free cash - flow method and valuation by capitalization of earnings." In his conclusion of value, he gave equal weight to the last two methods but only one-third of that weight to the first method. He applied a 35% discount for lack of marketability and arrived at a fair market value of \$5,680 per share. The expert testified that he was required under the Uniform Standards of Professional Appraisal Practice (USPAP) to be aware of, understand, and follow recognized appraisal methods and techniques. He further testified that in order to comply with this rule, it was necessary to "tax affect" earnings of an S corporation. He imputed a 40% corporate tax rate in his calculations.*

*He arrived at the cost of equity capital by adding (1) a 2.1% risk free rate (which he had reduced by 4% for inflation), (2) a 7% equity risk premium, (3) a 1% specific company risk, and (4) a 4.8% small company risk premium, for a total (rounded) of 19%. At trial, he admitted that he used Ibbotson Associates data for the small company risk premium, but that G&J did not fall into the Ibbotson definition of a small company.*

*IRS Expert - The IRS expert relied principally on a discounted cash flow approach. He "considered the values of companies he thought comparable to G&J" in order to test the validity of his valuation conclusion. He applied a 25% discount for lack of marketability, resulting in a fair market value of \$10,910 per share.*

*This expert calculated a 15.5% cost of equity capital. He arrived at this using the capital asset pricing model (CAPM) using a 7.46% risk free rate of return, and a 7.4% equity risk premium increased for a beta coefficient of 1.09 calculated as follows:  $[7.46 + (7.4\% * 1.09)] = 15.5\%$ .*

He “determined that a zero-percent corporate tax rate was an appropriate assumption to make in determining the earnings of G&J available for distribution.” The expert “also ignored shareholder level taxes in arriving at his discount rate.” The court believed that it was significant that the expert applied a “pre-tax” discount rate to pretax earnings, although it is not apparent why the discount rate was considered “pre-tax.”

**Taxpayers’ Daubert Challenge** The taxpayers filed a Motion in Limine to have the IRS expert’s testimony excluded because (1) it was derived from the application of scientifically unreliable methodologies, (2) neither the expert’s underlying data nor his empirical analysis had been published or submitted for peer review, and (3) part of the data used by the expert was not available in 1992 (the date of the gift) and, therefore, a willing and knowledgeable buyer and seller could not have relied on the expert’s marketability analysis in arriving at fair market value.

The Tax Court agreed that *Daubert v. Merrell Dow Pharm, Inc.*, 509 U.S. 579, 589 (1993) and *Kumho Tire Co. v. Carmichael*, 526 U.S., 119 S. Ct 1167, 1171 (1999) were applicable and the court had a “gatekeeping role to perform.”

The court concluded that the difference in opinions of the two experts in the cash flow approach was exclusively a difference as to the value of certain variables, not a difference in methodology and that the taxpayers’ argument was “nonsensical.” Because the difference was just one of factual disagreements, the court felt it unnecessary to address the taxpayers’ second concern that the IRS expert’s “method” had not been subjected to peer review.

The court denied the motion.

**Arguments on Tax Affecting S Corporation Earnings** - The taxpayers introduced two IRS documents: *A Valuation Guide for Income Estate and Gift Taxes* (the guide) and *Examination Technique Handbook for Estate Tax Examiners* (the handbook). One excerpt from the guide noted “S corporations are treated similarly to partnerships for tax purposes. S Corporations lend themselves readily to valuation approaches comparable to those used in valuing closely held corporations. You need only to adjust the earnings from the business to reflect estimated corporate income taxes that would have been payable had the Subchapter S election not been made.”

The court read the excerpt as “neither requiring tax affecting nor laying the basis for a claim of detrimental reliance.” Further, the court noted that the taxpayers “have failed to prove that they relied on either the guide or the handbook in any way” and the IRS was not estopped “from disregarding a fictitious tax when valuing an S Corporation.”

The taxpayer expert presented a list of costs or trade-offs shareholders incur because of electing S corporation status. The first argument that G&J might not make actual distributions sufficient to cover the shareholders’ tax obligations was dismissed by the court as an unreasonable assumption. The second argument that the S corporation might lose its favorable tax status was similarly dismissed by the court. The final argument that S corporations have a disadvantage in raising capital was also dismissed as the court believed

*this argument was appropriately addressed in the cost of capital rather than in the tax affecting of earnings.*

*The taxpayer introduced a second expert as a rebuttal witness in the use of a discounted cash flow approach with out tax affecting earnings. The Tax Court was unconvinced by this expert and was quite critical of his testimony and conclusions.*

*The court concluded, “the principal benefit that shareholders expect from an S corporation election is a reduction in the total tax burden imposed on the enterprise. The owners expect to save money, and we see no reason why that savings ought to be ignored as a matter of course in valuing the S corporation.”*

In addition to Mr. Gilbert’s summary, we quoted and commented on the following portions of the opinion. For example, the court stated:

“The decision whether to tax affect G&J’s project earning under the discounted cash flow approach accounts for the most significant differences between the parties’ expert witnesses.

[The IRS expert] assumed that G&J would continue to distribute **all of its earnings** annually. He made no explicit adjustment for any shareholder level taxes, although, undoubtedly, he knew such taxes would be due. [The IRS expert] did not, however, ignore shareholder level taxes. He simply disregarded them both in projecting G&J’s available cash and in determining the appropriate discount rate. The present value of any future (deferred) cash-flow is a function of three variables: (1) the amount of the cash-flow, (2) the discount rate, and (3) the period of deferral.

The discount rate reflects the return, over time, to the investor on the amount invested (commonly expressed as a rate of interest). If, in determining the present value of any future payment, the discount rate is assumed to be an after-shareholder-tax rate of return, then the cash-flow should be reduced (‘tax affected’) to an after-shareholder-tax amount. If, on the other hand, a preshareholder-tax discount rate is applied, no adjustment for taxes should be made to the cash-flow.” [footnote omitted]

It is particularly noteworthy to recognize that G&J had a history of distributing virtually all of its earnings. This characteristic distinguishes *Gross* from other cases.

Additionally we recognized that the trial court correctly stated that the value of a business appropriately can be determined by applying a pretax discount rate to a pretax cash flow stream or by applying an after-tax discount rate to an after-tax cash flow stream.

“Since, in applying his discounted cash-flow approach, [the IRS expert] assumed a preshareholder-tax discount rate, he made no error in failing to tax affect the expected cash-flow. If [the taxpayer’s expert] criticism is based on his assumption that [the IRS expert] wrongly disregarded shareholder level taxes, then he is in error.” [insertions not in original]

As mentioned in Mr. Gilbert’s summary, to justify tax-affecting the company’s cash flow stream, one of the taxpayer’s experts cited two IRS documents as authoritative sources:

- 1.) *IRS Valuation Guide for Income, Estate and Gift Taxes: Valuation Training for Appeals Officer*, and
- 2.) *IRS Examination Technique Handbook*.

The *Valuation Guide* states:

“[S] corporations are treated similarly to partnerships for tax purposes. S corporations lend themselves readily to valuation approaches comparable to those used in valuing closely held corporations. You need only to adjust the earnings from the business to reflect estimated corporate income taxes that would have been payable had the Subchapter S election not been made.”

Moving on to the *Handbook*, it states:

“If you are comparing a Subchapter S corporation to the stock of similar firms that are publicly traded, the net income of the former must be adjusted for income taxes using the corporate tax rates applicable for each year in question, and certain other items, such as salaries. These adjustments will avoid distortions when applying industry ratios such as price to earnings.”

The trial court dismissed the expert’s reliance on the IRS publications, saying:

“Both statements lack analytical support, and we refuse to interpret them as establishing respondent’s advocacy of tax affecting as a necessary adjustment to be made in applying the discounted cash-flow analysis to establish the value of an S corporation.

Even if we were to interpret the excerpts as petitioners do, petitioners do not claim that the excerpts have the force of a regulation or ruling, nor have they shown the type of detrimental reliance that might work an equitable estoppel against respondent.”

***Walter L. Gross, Jr. and Barbara H. Gross v. CIR, US Court of Appeals for the Sixth Circuit, Nos. 97-04460; 97-04469, November 19, 2001***

The following italicized summary has been excerpted from *FCG Estate & Gift Valuation E-Flash*, Volume 3-21/2001, Edited by John Gilbert, CPA/ABV, CVA (used with permission). Portions not related to the topic of tax affecting S corporation income may have been deleted.

***SUMMARY:***

*A US Court of Appeals has affirmed Walter L. Gross Jr., et ux., et al. v. Commissioner, T.C. Memo. 1999-254, July 29, 1999 (E-Flash 1-15). The court agreed that it was not proper to tax affect S corporation earnings for valuation purposes.*

***DETAILS:***

*In a split opinion, the US Court of Appeals for the Sixth Circuit has affirmed Walter L. Gross Jr., et ux., et al. v. Commissioner, T.C. Memo. 1999-254. The tax court had agreed with the IRS that no tax should be imputed on S Corporation earnings under the discounted cash flow method. The tax court had also allowed the 25% discount for lack of marketability asserted by the IRS. The Taxpayers appealed the tax court decision on two grounds: (1) the admissibility of testimony by the IRS expert under Daubert v. Merrill Dow Pharmaceuticals, Inc., 509 U.S. 579, 597 (1993) and (2) the tax court valuation of the gifts.*

## **ADMISSIBILITY OF EVIDENCE**

### **Testimony Regarding Tax Affecting Earnings**

*The taxpayers challenged the IRS expert's contention that a 0% income tax rate should be applied to earnings under the discounted cash flow method. The taxpayers' experts applied a 40% hypothetical tax rate. The Sixth Circuit said, "We disagree with the tax court's characterization of the respective experts' approaches to tax affecting as a mere difference in variables. There was no spectrum of tax percentages from which the court could have selected. Rather, the choice was either a corporate tax rate of 40% or a rate of 0%, the latter meaning no tax affect at all. But while the tax court's analysis was rather cursory, we do not believe that further evaluation was necessary under the circumstances."*

### **VALUATION OF THE GIFTS**

*Taxpayers contended that even if the IRS expert's testimony were admissible, the tax court's ultimate valuation conclusion was incorrect.*

*The Sixth Circuit's lead opinion written by Judge Clay says, "Although a majority of the factors the tax court used in calculating the valuation amount were proper, I take issue with the court's use of a 0% tax affect and would therefore hold that to the extent the valuation was based upon the use of a 0% tax affect, the court's ultimate finding that the G&J stock was worth \$10,190 per share was clearly erroneous. However, Judge Daughtrey and Judge Cohn disagree with me on this point, so that our majority holding is that the tax court's use of the 0% tax affect was proper."*

### **Tax Affecting – Minority Opinion**

*Taxpayers' main argument in support of tax affecting S corporation earnings was that a hypothetical buyer in 1992 would be presumed to know that tax affecting earnings was the generally accepted practice of the business appraisal community. The IRS expert was "largely discredited" because he admitted he had no first hand knowledge of what willing buyers did in 1992. Both taxpayer experts testified that tax affecting S corporation earnings was the approach the appraisal community generally followed. One of the taxpayer experts admitted on cross examination that there was growing controversy in 1992 regarding tax affecting and that this was still being debated at the time of trial. He also admitted that if he had to value the stock of G&J Corporation as of the trial date, he would give further consideration to whether he would use the tax affecting method.*

*Taxpayers also attempted to justify tax affecting based on a number of impediments that exist for S corporations. The tax court found that tax affecting was not a substitute for these "difficult to quantify disadvantages" of S corporation status. The minority opinion disagreed with this conclusion.*

*The minority opinion said, "On appeal Taxpayers assert that tax affecting was an accepted practice because it had been 'specifically approved' by the tax court, citing Maris v. Commissioner, 41 T.C.M. (CCH) 127, 138 (1980) and Hall v. Commissioner, 34 T.C.M. (CCH) 648, 667 (1975). Although not specifically holding that tax affecting was an acceptable approach to valuation in every circumstance, in both of these cases the tax court did use after-tax earnings in valuing the stock of S corporations. But perhaps Taxpayers most persuasive argument is that the IRS itself has implicitly endorsed the policy of tax affecting in*

*valuating stock of S corporations. In support of this claim, Taxpayers point to two internal IRS documents which mention making adjustments for taxes of S corporations.” The documents referred to were the IRS Valuation Guide for Income, Estate and Gift Taxes: Valuation Training for Appeals Officers and the IRS Examination Technique Handbook. The minority opinion went on to say, “Although I do not agree with Taxpayers' contention that the IRS is somehow estopped from now disclaiming tax affecting as a recognized practice, I recognize that these documents reflect a certain acceptance of tax affecting as a valid method of valuation.”*

*The minority opinion concluded, “I must recognize that we are merely determining those factors that hypothetical parties to a sale of G&J stock would have considered as of the gift date. In this regard, I believe that past practices, which the IRS had not deemed to create a deficiency, are demonstrative of the idea that such hypothetical actors would have considered tax affecting G&J stock. This fact in conjunction with the testimony of the experts informs my conclusion that the court's decision to use a 0% tax affect in deriving the value of G&J stock was implausible.”*

#### ***Tax Affecting – Majority Opinion***

*The majority opinion said that a careful review of the Taxpayer expert's testimony revealed that even he was not certain whether tax affecting was generally accepted, acknowledged some disagreement on this point, and was equivocal on whether he would continue to tax affect.*

*This opinion says, “The lead opinion, however, finds that the Tax Court clearly erred in its decision to not tax affect G&J's stock because willing buyers and willing sellers would have tax affected the stock in 1992. While I do not necessarily disagree with framing the issue in this manner, I do disagree with the way in which the lead opinion analyzes the issue. The lead opinion accuses the Tax Court of focusing on ‘its theoretical belief that tax affecting was not appropriate.’ The lead opinion also states that ‘the tax court's judgment was less than sound’ and ‘flies in the face of the evidence on the record.’ I read the record differently. The Tax Court was faced with the opinions of competing valuation experts and accepted one over the other.”*

*The majority opinion also discussed the use of the IRS Valuation Guide for Income, Estate and Gift Taxes: Valuation Training for Appeals Officers and the IRS Examination Technique Handbook and past tax court cases, but found these arguments were not compelling. The opinion concluded, “Valuation is a fact specific task exercise; tax affecting is but one tool in accomplishing that task. The goal of valuation is to create a fictional sale at the time the gift was made, taking into account the facts and circumstances of the particular transaction. The Tax Court did that and determined that tax affecting was not appropriate in this case. I do not find its conclusions clearly erroneous.”*

#### ***Estate of John E. Wall v. Commissioner, T.C. Memo. 2001-75, March 27, 2001***

The following italicized summary has been excerpted from *FCG Estate & Gift Valuation E-Flash*, Volume 3-9/2001, Edited by John Gilbert, CPA/ABV, CVA (used with permission). Portions not related to the topic of tax affecting S corporation income may have been deleted.

**SUMMARY:**

*This case concerns a dispute over the value of non-voting shares gifted in 1992. After noting that this was a case that should have settled without resorting to Tax Court, Judge Beghe accepted the IRS valuation, including a 40% discount for lack of marketability and a 2% discount for non-voting stock. The court also noted that it was not correct to subtract imputed income taxes on S corporation earnings in determining fair market value.*

**DETAILS:**

*In 1992, John Wall (and his wife as a result of gift-splitting) gifted nonvoting common stock of Demco, Inc. to 20 trusts for the benefit of their children. In the original gift tax return, the taxpayer claimed a value of \$221.75 per share, while in the statutory notice, the IRS asserted a value of \$260.13 per share. Judge Beghe was critical that the parties could not settle the case with only a 17% difference between values. Citing *Buffalo Tool & Die Manufacturing Co. v. Commissioner*, 74 T.C. 441, 451-452 (1980), he noted that this was one of those valuation cases that should have been settled, and rather than split the difference in values, the court should adopt the position of one of the parties.*

**Taxpayer Expert**

*In her original valuation report, the taxpayer expert determined a value of \$211.20 per share, but the taxpayer raised the value by 5% to \$221.75 on the gift tax return. He testified that he raised the value after his accountants advised him that, based on their experience with the local IRS personnel, the marketability and nonvoting stock discounts “might better be a little more conservative.”*

*In her original report, the taxpayer expert relied on the guideline public companies method. Because of criticism by the IRS, before trial she prepared a second report that included the income approach. Averaging this income approach value and the original value resulted in the \$192.20 value used in the revised report. The appraisal included a 40% discount for lack of marketability and a 5% discount for non-voting stock.*

**IRS Expert**

*The IRS asserted a value of \$260.13 in its statutory deficiency notice, but this was increased to \$273.99 at appraisal. The IRS expert used a guideline public companies approach similar to the taxpayer expert, except that he considered a \$1,080,000 note from a related party as a non-operating asset and added it separately. He subtracted a 40% discount for lack of marketability and a 2% discount for non-voting stock. He also used the income approach.*

**Court Analysis of Experts' Reports**

*The Tax Court completely ignored the income approach calculation of both experts, citing the inability of the Company to make projections. Even though this approach was ignored, the Tax Court's analysis made several comments about imputing income taxes to the earnings of an S corporation, saying that the tax-effected cash flow used by both appraisers was incorrect. The court said, “Because this methodology attributes no value to Demco's S corporation status, we believe it is likely to result in an undervaluation of Demco's stock. See *Gross v. Commissioner*, T.C. Memo. 1999-254.”*

*As discussed earlier, no where was the court provided with the tools to attempt to compare the facts of the Gross case to the facts of Wall. Indeed, the economic circumstances of a minority shareholder in the Gross case was drastically different than a minority shareholder in the Wall case. However, neither the experts nor the court made mention of these critical distinctions. The court also criticized both experts' calculations under the guideline public companies approach. The judge believed that the taxpayer expert's approach significantly understated value while the IRS expert's approach overstated value. The taxpayer expert's calculation was criticized because it (1) did not adequately take the \$1,080,000 non-operating note into account, (2) used erroneous measures of the company's projected 1992 income, and (3) did not use all of the guideline company multiples, but instead "picked and chose among the lowest."*

*The IRS expert was criticized for (1) not applying a minority discount to the non-operating note, (2) only using three guideline companies, (3) using only four performance measures, and (4) using multiples that varied greatly from company to company without an adequate explanation for his choice of multiples.*

*The court concluded that the taxpayer had not established that the fair market value per share was less than \$260.13 and that, in fact, it was at least equal to that amount. The court accepted the IRS's original statutory deficiency notice.*

In addition to the preceding summary by Mr. Gilbert, we quoted the following from the court's opinion:

“[B]oth [the taxpayer expert] and respondent's expert ... determined the discount (or capitalization) rates used in their income-based appraisals by reference to the actual rates of return available on publicly traded investments.” [insertion not in original]

Additionally, we noted that the court took exception to both experts tax affecting the cash flow stream:

“As [the taxpayer expert] acknowledged in her testimony, appraisers disagree on whether it is appropriate to tax-effect the income of an S corporation. The argument in favor of tax-effecting stresses that many potential buyers of S corporations are C corporations. [insertion not in original]

Because a C corporation would be unable to maintain a target company's S corporation status following an acquisition, the C corporation would tax-effect the S corporation's income (at C corporation rates) in deciding how much it would pay for the S corporation. See Trugman, *Understanding Business Valuation: A Practical Guide to Valuing Small to Medium-Sized Businesses*, at 198-199 (1998).

In contrast, the argument against tax-effecting stresses that although an S corporation's stockholders are subject to tax on the corporation's income, they are generally not subject to a second level of tax when that income is distributed to them. This could make an S corporation at least somewhat more valuable than an equivalent C corporation.

However, tax-effecting an S corporation's income, and then determining the value of that income by reference to the rates of return on taxable investments, means that an appraisal will give no value to S corporation status."

"We note that [the IRS expert], like [the taxpayer expert], tax effected Demco's future cash-flows by subtracting hypothetical income tax from Demco's projected net income ([the IRS expert] used a 40- percent rate, while [the taxpayer expert] used a 34-percent rate). We believe this is likely to result in an under-valuation of Demco because Demco is an S corporation." [insertions not in original]

Finally, we noted that one omission from the court's list of five items upon which the two experts agreed is that both tax-affected the cash flow streams.

Ultimately, the court relied on neither expert's income methods. Instead, it considered the market approach as the best indicator of value. Even so, the court commented:

"We also note that both experts' income-based analyses probably understated Demco's value, because they determined Demco's future cash-flows on a hypothetical after tax basis, and then used market rates of return on taxable investments to determine the present value of those cash flows."

***Estate of William G. Adams, Jr. v. Commissioner, T.C. Memo. 2002-80***

The following italicized summary has been excerpted from *FCG Estate & Gift Valuation E-Flash*, Volume 4-6/2002, Edited by John Gilbert, CPA/ABV, CVA (used with permission). Portions not related to the topic of tax affecting S corporation income may have been deleted.

***SUMMARY:***

*The Tax Court calculated the fair market value of a 61.59% interest in a closely held insurance agency. The Tax Court did not allow adjustment of the capitalization rate to account for imputed income taxes on the S corporation's income.*

***DETAILS:***

*Decedent died in 1995 owing 61.59% of the common stock of Waddell Sluder Adams & Co. (WSA), an insurance agency organized as an S corporation. Experts for both the IRS and the taxpayer used the income approach to determine fair market value. The two experts agreed on a 20.53% capitalization rate before the tax adjustment discussed below.*

*The most important disagreement in the case was the treatment of imputed income taxes in S corporations. The taxpayer expert "grossed up" the 20.53% after tax discount rate to 31.88% to match the pre-tax S corporation cash flow stream to which it was applied. The Tax Court said, "We disagree that [the taxpayer expert's] estimates of WSA's prospective net cashflows are before corporate tax because it is appropriate to use a zero corporate tax rate to estimate net cashflow when the stock being valued is stock of an S corporation. WSA is an S corporation and its cashflows are subject to a zero corporate tax rate. Thus [the taxpayer expert's] estimates of WSA's prospective net cashflows are after corporate tax (zero corporate tax rate) and not before corporate tax as the estate contends." The Tax Court, therefore, did not allow imputed income taxes to be used in the calculation of fair market value.*

The *Adams* court cited *Gross* and its appeal and agreed that the capitalization rate and income stream should be on the same basis:

“The net cashflow and the capitalization rate used to compute the fair market value of the WSA stock should have the same tax character; i.e., before corporate tax or after corporate tax. See *Gross v. Commissioner, T.C. Memo. 1999-254* (both the discount rate and cashflow should be before shareholder tax or after shareholder tax), *affd. 272 F.3d 333 (6th Cir. 2001)*.”

Again, citing *Gross* as a precedent, the court criticized the taxpayer’s expert in *Adams*, saying:

“We disagree that [the taxpayer’s expert] estimates of WSA’s prospective net cashflows are before corporate tax because it is appropriate to use a zero corporate tax rate to estimate net cashflow when the stock being valued is stock of an S corporation. ... WSA is an S corporation, and its cashflows are subject to a zero corporate tax rate. Thus, [the taxpayer’s expert] estimates of WSA’s prospective net cashflows are after corporate tax (zero corporate tax rate) and not before corporate tax as the estate contends. We disagree that [the taxpayer’s expert] properly converted the capitalization rate because there was no need to do so. The parties agree that [the taxpayer’s expert] estimated capitalization rate (before he converted it to before corporate tax) is an after corporate tax rate. Thus, as in *Gross*, the tax character of [the taxpayer-expert’s] estimate of WSA’s prospective net cashflows matches that of the unconverted capitalization rate because both are after corporate tax. It follows that [the taxpayer’s expert] should not have converted the capitalization rate from after corporate tax to before corporate tax because the tax character of both his estimated net cashflows for WSA and unconverted capitalization rates is after corporate tax.” [insertions not in original]

Judging by the proximity of the following citations to the above quote, a reader of the court’s opinion could assume that the citations were intended to justify the court’s criticism of the taxpayer-expert’s choice to adjust his capitalization rate from an after-tax basis to a pretax basis. The cited authorities were:

- Black & Isom Associates, *Fundamentals, Techniques and Theory of Capitalization/Discount Rates*, ch. 5, at 23 (1995);
- Ibbotson Associates, *Stocks, Bonds, Bills and Inflation: Valuation Edition 1999 Yearbook*, and
- Pratt, *Cost of Capital, Estimation and Applications* 62 (1998). 151-152, 155.

The Black & Isom Associates reference states:

“It would obviously be an error to apply pre-tax capitalization or discount rates to after-tax earnings and after-tax capitalization or discount rates to pre-tax earnings. Therefore, the analyst may find it necessary to convert the rates.”<sup>1</sup>

We noted, however, that the method proposed in the reference requires the analyst also to adjust the growth rate component of the capitalization rate, which is erroneous.

Turning to Ibbotson’s 1999 *Valuation Edition* reference, the following was identified:

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1 Robert L. Green, *Business Valuations Fundamentals, Techniques and Theory* (Black & Isom Associates, 1995), Chapter 5, p. 24.

“All of the risk premium statistics included in this publication are derived from market returns by an investor. The investor receives dividends and realizes price appreciation after the corporation has paid its taxes. Therefore, it is implicit that the market return data represents returns after corporate taxes but before personal taxes.

When performing a discounted cash flow analysis, both the discount rate and the cash flows should be on the same tax basis.”<sup>2</sup>

We believe it is equally accurate to restate the quote by replacing the underlined words in “Therefore, it is implicit that the market return data represents returns after corporate taxes but before personal taxes” with “Therefore, it is implicit that the market return data represents returns after the tax liability associated with entity operations has been paid but before personal taxes.”

As is suggested by the court, Ibbotson agrees that “both the discount rate and the cash flows should be on the same tax basis.” The court believes its approach is consistent with Ibbotson: As quoted earlier, the Tax Court stated:

“WSA is an S corporation, and its cashflows are subject to a zero corporate tax rate. Thus, [the taxpayer’s expert] estimates of WSA’s prospective net cashflows are after corporate tax (zero corporate tax rate) and not before corporate tax as the estate contends.” [insertion not in original]

While we agree with the Court that S corporations have a “zero corporate tax rate,” we also recognize that there is a tax liability associated with entity operations. As suggested by our rewording following the first Ibbotson quote, the “tax liability associated with entity operations” is recognized in Ibbotson-derived rates of return.

In *Gross*, the taxpayer’s expert chose to make an adjustment to the cash flow stream to recognize what he perceived were the inherent differences between the market data upon which Ibbotson’s data is based and the subject company.

In contrast, the taxpayer’s expert in *Adams* chose to adjust the capitalization rate to recognize the perceived differences between Ibbotson data and the company’s cash flow stream. While not whole heartedly endorsing the practice, Ibbotson also suggests that the taxpayer-expert’s adjustment to a pretax capitalization rate was appropriate if cash flow was reported on a pretax basis.

As noted above, the court indicated the company had a “zero corporate tax rate” which suggests its before corporate tax cash flow and after corporate tax cash flow are the same. However, as has already been mentioned and as will be discussed later, one such measure of cash flow is consistent with Ibbotson’s market derived rates of return, while the other is not.

Continuing with the court’s reliance on recognized authorities, the Pratt citation says:

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2 *Stocks, Bonds, Bills and Inflation Valuation Edition, 1999 Yearbook* (Ibbotson Associates, 2000), p. 62.

“Whether costs of capital are estimated by the build-up model, the Capital Asset pricing Model (CAPM), or the discounted cash flow (DCF) method, in all cases they are returns realized *after* [emphasis in original] the payment of corporate-level income taxes. If the entity being valued is subject to entity-level income taxes, then it is inappropriate to apply the cost of capital estimated by those methods to pretax return flows.”<sup>3</sup>

While the opinion acknowledged the subject entity was “An S corporation,” no distinction between it and the facts of *Gross* was made. However, we noted that the subject interest in *Adams* had control, while the *Gross* interest did not.

***Estate of Richie C. Heck v. Commissioner, T.C. Memo. 2002-34***

The following italicized summary has been excerpted from *FCG Estate & Gift Valuation E-Flash*, Volume 4-2/2002, Edited by John Gilbert, CPA/ABV, CVA (used with permission). Portions not related to the topic of tax affecting S corporation income may have been deleted.

***SUMMARY:***

*This case concerns the value of a minority interest in an S corporation. The Tax Court did not allow the market approach due to the small number of guideline companies identified as comparable and a lack of direct comparability of these companies. Neither the taxpayer expert nor the IRS expert included imputed income taxes in their income approach calculation, although the IRS expert did include a 10% discount for “additional risks associated with S corporations.”*

***DETAILS:***

*Richie C. Heck died on February 15, 1995, owning 39.62% of the common shares of F. Korbel & Bros, Inc. (Korbel), a California S Corporation. Korbel produced champagne under an exclusive distribution agreement with Brown-Forman Corp. Brown-Forman also had a right of first refusal on any sale of Korbel stock outside of the immediate family.*

*The IRS expert calculated fair market value using both the market approach and the income approach. The market approach was weighted at only 30% in the final conclusion due to the “lack of perfect comparables.” The expert subtracted a 15% “liquidity discount” and a 10% discount for “additional risks associated with S corporations,” including “the potential loss of S corporation status and shareholder liability for income taxes on S corporation income, regardless of the level of distribution” to arrive at the operating value.*

In addition to Mr. Gilbert’s commentary, we noted that both experts did not tax-affect the company’s cash flow stream or discount rates in their valuation analysis. It is noteworthy, however, that the taxpayer’s expert in *Heck* was also the IRS expert in *Gross*. Additionally, the IRS expert in *Heck* was the IRS expert in *Adams*. As a result the issue of tax affecting did not come up, and the court had no reason to extensively address the issue as was done in *Gross* and *Adams*.

Furthermore, we noted that the estate was represented *pro se* by its executor.

Finally, here again, no distinction was made between the facts of *Heck* and *Gross*.

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3 Shannon P. Pratt, *Cost of Capital Estimation and Applications* (John Wiley & Sons, Inc., 1998), pp. 151-152.

Indeed, in all three of the cases following *Gross*, no testimony was presented that would have allowed the parties and the court to examine those issues that affect the financial value of the interest at hand, namely, the economic benefit that ultimately attaches to the particular interest being valued.

## VALUATION THEORY

We began our review of valuation theory with the presumption that the appropriate standard of value for the purposes of this paper is fair market value as defined in Rev. Rul. 59-60:

“[T]he 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.”

Thus, we considered both the buyer’s and seller’s perspectives. Additionally, the buyer and seller are hypothetical – rather than specific (e.g., family members) – investors.

Also, we presumed the reader is familiar with the complex mathematical formula and concept that calculates the present value of a future income stream, and have not presented it. However, if the reader wants to know more, a short discussion of the formula can be found in *Stocks, Bonds, Bills, and Inflation Valuation Edition 2003 Yearbook*.<sup>4</sup>

With the preceding as a foundation, we then assumed that the role of a business appraiser is to determine the present value of an investor’s future benefits. A well respected author and business valuation authority, Dr. Shannon Pratt, confirms our assumption, stating:

“[T]he cost of capital, derived from investors’ expectations and the market’s consensus of those expectations, is applied to *expected economic income, usually measured in terms of cash flows...*”<sup>5</sup> [emphasis in original]

Our “future benefits” can be defined as the economic income stream available to equity investors. A common measure of economic income is net cash flow available to equity investors (hereafter, “net cash flow”). The cash flow generated by company operations is available for distribution to equity holders, may be retained by the company, or it may be partially distributed to investors and partially retained by the company.

Mathematically, net cash flow is defined in Exhibit 1, lines 1 to 10. Additionally, lines 11 to 15 restate the components of net cash flow and – depending on the form of the entity, C or S corporation – also depict components (i.e., dividends and distributions) of the company’s “Retained cash flow.” Using a formula to restate the preceding sentence, we recognized that:

$$\text{Net cash flow} = \text{Cash paid to owners} + \text{Retained cash flow}$$

Dr. Pratt also indicates that net cash flow includes “dividends [i.e., cash distributed to investors] and stock price change [i.e., which may be driven, in part, by the investment of retained cash flow],” which define value.<sup>6</sup> [insertions not in original]

Before proceeding, it is critical for the reader to recognize that net cash flow may not be the same as net cash flow to the company (“retained cash flow”) if the company is distributing cash

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4 *Stocks, Bonds, Bills and Inflation Valuation Edition 2003 Yearbook* (Ibbotson Associates, 2003), p. 12.

5 *Cost of Capital: Estimation and Applications*, p. 5.

6 *Ibid.*, p. 97.

to investors. In other words, if the company pays dividends to C corporation investors or distributions to S corporation investors, net cash flow and retained cash flow will not be identical. As will be demonstrated later, within these two discrepant cash flows lies the potential for value differences between minority interests in C and S corporations.

Exhibit 1  
Net Cash Flow to Investor and Retained Cash Flow

1	Pretax income
2	Income taxes (C corp)
3	-----
4	Net income
5	Noncash expenses
6	Changes in working capital
7	Fixed asset acquisitions
8	Debt principal payments
9	-----
10	Net cash flow
11	C corp dividends paid
12	S corp tax distribution paid
13	S corp "excess distributions" paid
14	-----
15	Retained cash flow

Summarizing the preceding discussion, we conclude that:

Exhibit 2  
Value Equation

Value

$$\begin{aligned}
 &= \textit{present value of} [\textit{future benefits}] \\
 &= \textit{present value of} [\textit{future economic income stream}] \\
 &= \textit{present value of} [\textit{Net cash flow to equity investors}] \\
 &= \textit{present value of} [\textit{C corp dividends + Retained cash flow}] \textit{ for a C corporation} \\
 &= \textit{present value of} [\textit{(S corp tax distribution paid + S corp "excess distributions" paid) + Retained cash flow}] \textit{ for an S corporation}
 \end{aligned}$$

For accounting and financial professionals, it is equally as critical to recognize that net cash flow as defined in Exhibit 1 is not the same as net cash flow as defined in Statement of Financial Accounting Standards ("SFAS") 95. In fact, the latter is more representative of what we have chosen to call "Retained cash flow." Astute valuation analysts will differentiate between the two identical terms and not confuse their applications.

The reader should also recognize that business appraisers may use measures of income other than net cash flow. This is acceptable, as long as the measure of income is matched with an

appropriate and corresponding discount rate, capitalization rate, or market multiple. Common examples of alternative measures include:

- owner’s discretionary cash flow,
- earnings before interest, taxes, depreciation and amortization (“EBITDA”),
- earnings before interest and taxes (“EBIT”),
- earnings before taxes (“EBT”), and
- net income.

Additionally, there are measures other than those listed above. However, their omission is not material to our topic and does not affect our conclusions.

Having identified the income stream (see Exhibit 1), we now focus on the discount rate. For clarity in future discussions, Dr. Pratt notes:

“[T]he terms ‘discount rate,’ ‘cost of capital,’ and ‘required rate of return’ are often used interchangeably.”<sup>7</sup>

Further, note that a price-earnings ratio is the inverse of a capitalization rate and one component of the capitalization rate is the discount rate. Hence, we believe our comments are applicable to the market approach, as well as the income approach.

Typically, business appraisers will rely on either the build-up method or the capital asset pricing model (“CAPM”) to determine a discount rate. As with the present value formula definition, we presume the reader has a basic understanding of both methods. Detailed information on both methods can be found in Pratt’s *Cost of Capital, Estimation and Applications*.

Additionally, it is critical to recognize that appraisers typically rely on data derived from public stock transaction data obtained from the Center for Research in Security Prices (CRSP) at the University of Chicago, and published by Ibbotson Associates (“Ibbotson”), to derive discount rates. Ibbotson states:

“The equity cost of capital is equal to the expected rate of return for a firm’s equity; this return includes all dividends plus any capital gains or losses.”<sup>8</sup>

Note that Ibbotson’s definition of the equity cost of capital (or discount rate) is consistent with our earlier definitions of cash flow. For future reference, we particularly noted Ibbotson’s reference to two components of value, “dividends” and “capital gains or losses.”

Because Ibbotson solely analyzes publicly traded stocks (which are C corporations), it uses the terms “dividends.” Logically, we assert:

**Conclusion #1: Ibbotson’s rates of return reflect satisfaction of tax liabilities associated with entity operations.**

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7 Ibid., p. 7.

8 *Stocks, Bonds, Bills and Inflation Valuation Edition, 2002 Yearbook* (Ibbotson Associates, 2002), p. 37.

Furthermore, it is critical to recognize that C corporation dividends are an after-entity-tax component of net cash flow (as shown in Exhibit 1, line 11).

Additionally, Exhibit 1 clearly establishes that C corporation net cash flow and retained cash flow are diminished when the tax liability associated with entity operations is paid.

**Conclusion #2: The payment of C corporation tax liabilities associated with entity operations Exhibit 1, line 2) diminishes the discount rates reported by Ibbotson.**

In our review of *Adams*, the court quoted the following from Ibbotson:

“All of the risk premium statistics included in this publication are derived from market returns by an investor. The investor receives dividends and realizes price appreciation *after the corporation has paid its taxes*. Therefore, it is implicit that the market return data represents returns *after corporate taxes but before personal taxes*. [emphasis added]

When performing a discounted cash flow analysis, both the discount rate and the cash flows should be on the same tax basis.”<sup>9</sup>

It is our opinion that Ibbotson’s position (as quoted in the *Adams* case) is consistent with our Conclusions #1 and #2, above.

More importantly, even though S corporations – at the company (versus investor) level – have no income tax liability (i.e., the income tax liability associated with entity operations is passed on to the shareholders), *it is unreasonable to assume that Ibbotson’s rates of return can be used with a net cash flow stream that does not reflect the tax liability associated with entity operations*.

Within this statement lies much of the economic substance of this paper. Accordingly, the reader should not casually dismiss the necessary symmetry between the Ibbotson-derived rates of return and the subject ownership interest’s economic income.

Instead, the income stream and the discount rate – if it is derived from public stock data, as Ibbotson’s is – both must reflect the satisfaction of income taxes associated with entity operations. Who pays the taxes – the C corporation, as an entity, or the S corporation shareholder – is not relevant. Either way, the dollars are not available for reinvestment by the entity or its owner. As a result, the income stream must be normalized to reflect the satisfaction of corporate tax liabilities if the Ibbotson data is used.

Ibbotson also states that an inaccurate conclusion will result from the misapplication of rates of return to improper income streams:

“One important aspect of the income approach model is that the discount rate and the cash flows need to be estimated on the same basis. For instance, if pre-tax cash flows are projected in the model, they must be discounted to present using a pre-tax cost of capital (as opposed to an after-tax cost of capital). ... Failure to properly match the discount rate with the cash flows will produce an inaccurate value.”<sup>10</sup>

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9 Ibid., p. 87.

10 Ibid., p. 16.

Said in another way: Failure to recognize that Ibbotson derived rates of return include the satisfaction of the tax liability associated with entity operations “will produce an inaccurate value.”

**Conclusion #3: If Ibbotson discount rates are used in a present value calculation, the economic income stream must reflect equivalent C corporation tax liabilities. If not, the “[f]ailure to properly match the discount rate with the cash flows will produce an inaccurate value.”<sup>11</sup>**

Discount rates (as published by Ibbotson) and market multiples (e.g., the P/E ratio) are stated on an after-entity and shareholder-pretax basis (again, public equity securities are C corporations and their Ibbotson-derived discount rates reflect the satisfaction of tax liabilities associated with entity operations). It is logical to do so because the individual investor recognizes that his/her net proceeds derived from multiple investments will be identical (i.e., regardless of the investment choice, the investor’s marginal tax rate will be unchanged). Hence, there is no need to introduce an additional level of analysis (i.e., the calculation of personal tax liabilities associated with the investment’s returns) because the relative ranking of each investment’s net cash flow to the investor will be identical to its rank on the shareholder-pretax basis.

However, there are examples in the public securities marketplace when investors will consider the impact of personal taxes. More explicitly, investors will consider this extra analysis when doing so affects the ranking of potential investments.

In particular, investors will accept lower rates of return (i.e., discount rates) on double-tax-exempt municipal bonds because their personal net cash flow is not reduced by personal income taxes related to the investment (i.e., there are no personal income tax liabilities associated with double-tax-exempt municipal bonds). In contrast, proceeds from corporate bonds of quality equal to the municipal bonds are taxable at the personal level, and the marketplace therefore demands higher rates of return so that the investor’s net proceeds associated with the investments are identical. Said in another way, to yield the same net cash flow to the investor (i.e., after payment of personal taxes associated with proceeds from the investment), corporate bonds must have a higher interest rate (on an investor’s pre-personal tax basis) to yield the same return on a post-personal tax basis as the double-tax-exempt municipal bonds.

A comparative example is shown in Exhibit 3. Note that both bonds have the same face value (line 1), the same net cash flow to the investor (line 7), and the same after-tax yield (line 8). Yet, because the investor will incur a personal tax liability with the corporate bond (line 5), it must have a higher interest rate (i.e., discount rate, line 2) to yield the same net cash flow (line 7) after the satisfaction of personal tax liabilities associated with the investment. Only then will the knowledgeable investor be indifferent towards the two investments.

The existence of lower rates of return for double-tax-exempt municipal bonds relative to corporate bonds of similar risk is market evidence that investors focus on net cash flow after personal taxes (line 7) when valuing securities.

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11 Ibid.

**Conclusion #4: Investors make investment decisions based on net proceeds after the satisfaction of tax liabilities directly attributable to the investment, whether those tax liabilities are associated with the security or the individual investor.**

Exhibit 3  
Investor Cash Flow: Corporate v. Municipal Bonds

		Corporate Bond	Municipal Bond
1	Face value	1,000	1,000
2	Interest rate (discount rate)	10.0%	5.9%
3		-----	-----
4	Interest earned by investor	100	59
5	Income taxes (personal)                      41%	(41)	0
6		-----	-----
7	Net cash flow to investor	59	59
8	Yield to investor (after personal taxes)	5.9%	5.9%

## S CORPORATION MINORITY INTEREST APPRAISALS

Controlling ownership interests have the ability to elect directors, appoint management, determine management compensation, set policy, acquire or sell assets, award contracts, make acquisitions, liquidate or sell out, sell or acquire treasury shares, declare and pay dividends and amend organizational documents. Conversely, minority owners have none of these rights. As a result, majority interests are more highly valued by investors than minority ownership interests.

In this section of our paper, we will focus on valuing S corporation minority shareholder interests using the valuation theory from the previous section. In doing so, we will consider a number of different ownership scenarios and recognize the restricted rights of minority owners versus controlling owners.

### **Scenario A: Distribute Net Income Equal to Minority Owners Tax Liability**

In Exhibit 4, C and S corporation cash flows at the shareholder (not entity) level (lines 1-15) are compared. We particularly note that the C corporation is paying its 40% tax liability associated with entity operations on line 2. As a result, its net income (line 4) is smaller than the net income of the S corporation (also line 4).

(NOTE: For ease of presentation, the represented cash flows are allocated on a prorata shareholder basis and do not represent 100% of the entity's cash flow. This was done to emphasize that this portion of the discussion deals solely with a minority shareholder's interest. When valuing a minority interest holder's share, one would more likely look at the cash flow of the entire company, and then pro-rate it to the holder's interest. In either case, the result is the same.)

While the S corporation has no entity taxes, it does have a tax liability associated with entity operations. In Scenario A, the company will distribute enough of its income to its shareholders to satisfy their personal tax liability associated with the entity's operations (line 12). Having done so, we note that the net cash flow available to the S corporation for reinvestment in the company is identical to the C corporation (line 15). If no such distributions are made, the shareholders might try to break the S election (presuming there is no contractual prohibition of such an act).

Assuming that the personal and corporate tax liabilities are identical (which they are not in the real world), retained cash flow (again, line 15) is identical whether the entity is a C or S corporation. Relating this to our earlier discussion, the retained cash flow component of the value equation (Exhibit 2) is identical for both entities under the prescribed circumstances.

Having calculated the retained cash flow component of value, we next calculated the second component, investor's cash flow (lines 17-24). We noted that the C corporation shareholder receives no cash flow from the company. In contrast, the S corporation shareholder receives \$400 from the entity (line 19). Yet, we also recognize that the S corporation investor must pay that \$400 to the government (line 22) to satisfy the tax liability associated with the entity's operations.

More importantly, we note that the net cash flow to the investor is identical for the C and S corporations (line 24). Hence, the second component of the value equation (Exhibit 2) also is identical for both forms of entities.

Recalling that the retained and investor's cash flows (lines 15 and 24, respectively) were identical, one would conclude that the value for a minority shareholder in either entity is identical (presuming corporate and personal tax rates are identical). In other words, there is no economic advantage for the minority investor to own one form of entity over the other.

**Conclusion #5: If S corporation distributions equal the tax liability associated with entity operations and the C corporation pays no dividends, the C and S corporation minority investors' values will be identical (presuming that S and C corporation income tax rates are identical).**

Exhibit 4  
C Versus S Corporation Values: Scenario A

		Scenario A	
		C Corp	S Corp
<b>Retained Cash Flow:</b>			
1	Pretax income	1,000	1,000
2	Income taxes (C corp)	40% (400)	
3	-----	-----	-----
4	Net income	600	1,000
5	Noncash expenses	60	60
6	Changes in working capital	(15)	(15)
7	Fixed asset acquisitions	(65)	(65)
8	Debt principal payments	(25)	(25)
9	-----	-----	-----
10	Net cash flow	555	955
11	C corp dividends paid	0	
12	S corp tax distribution paid	40%	(400)
13	S corp "excess distributions" paid		0
14	-----	-----	-----
15	Retained cash flow	555	555
16			
<b>Investor Cash Flow:</b>			
18	C corp dividends paid	0	
19	S corp tax distribution paid		400
20	S corp "excess distributions" paid		0
21	Personal taxes on C corp dividends paid	21%	0
22	Personal taxes on S corp operations	40%	(400)
23	-----	-----	-----
24	Net cash flow to investor	0	0

**Scenario B: Distribute 100% of Net Income to Minority Owners**

However, if the S corporation's distributions are different than the tax liability associated with entity operations, the retained cash flow and investor cash flow change.

An extreme example would be to assume that the S corporation distributes 100% of its net income (this assumption approximates the facts of the *Gross* case). As shown in Exhibit 5, the C corporation pays a dividend (line 11) equal to its net income (line 4). Similarly, the S

corporation pays its tax distribution (line 12) plus an “excess distribution” (line 13, with “excess distributions” being defined as those distributions in excess of the tax liability associated with S corporation operations on line 12).

For illustrative purposes, we have shown the tax distribution and excess distribution on separate lines. A GAAP financial statement would not separately identify the two distributions.

For both entity forms, retained cash flow (Scenario B, line 15) again is identical (although different from Scenario A). However, the Scenario B net cash flow to the investor (line 24) is different for the C and S corporation minority investors.

As with Scenario A, we noted that the S corporation investor in Scenario B receives a distribution for the tax liability associated with entity operations (line 19), and that tax liability is paid by the investor (line 22).

**Exhibit 5**  
**C Versus S Corporation Values: Scenarios A and B**

		Scenario A: Tax Distribution		Scenario B: Distribute 100% of Net Income	
		C Corp	S Corp	C Corp	S Corp
<b>Retained Cash Flow:</b>					
1	Pretax income	1,000	1,000	1,000	1,000
2	Income taxes (C corp)	40%	(400)	(400)	
3	-----				
4	Net income	600	1,000	600	1,000
5	Noncash expenses	60	60	60	60
6	Changes in working capital	(15)	(15)	(15)	(15)
7	Fixed asset acquisitions	(65)	(65)	(65)	(65)
8	Debt principal payments	(25)	(25)	(25)	(25)
9	-----				
10	Net cash flow	555	955	555	955
11	C corp dividends paid	0		(600)	
12	S corp tax distribution paid		40%		(400)
13	S corp "excess distributions" paid		0		(600)
14	-----				
15	Retained cash flow	555	555	(45)	(45)
16					
<b>Investor Cash Flow:</b>					
18	C corp dividends paid	0		600	
19	S corp tax distribution paid		400		400
20	S corp "excess distributions" paid		0		600
21	Personal taxes on C corp dividends paid	21%	0	(126)	
22	Personal taxes on S corp operations	40%	(400)		(400)
23	-----				
24	Net cash flow to investor	0	0	474	600

Additionally, the C corporation investor receives a dividend (line 18) that is identical to the “excess distribution” received by the S corporation investor (line 20). However, the C corporation investor must pay personal income taxes at a 21% rate (line 21, assuming 15% federal and 6% state tax rates) on the dividend received. In contrast, the income tax liability

associated with the S corporation investors distribution was satisfied when the tax liability associated with entity operations was paid (line 22). Therein is an economic advantage for an S corporation minority owner.

However, as noted at the outset, the analyst must consider the rights associated with the individual interest being valued. For example, the analysis might recognize the additional risk associated with the controlling owner authorizing distributions greater than amounts necessary to satisfy the tax liability, the likelihood of such distributions continuing, and whether or not the use of such cash will have a detrimental effect on the company. In general, we recommend using a higher rate of return for “excess distributions” to recognize that the risk of continued receipt is greater than the risk associated with the entity’s income stream (from which the “excess distributions” are drawn).

Additionally, the rate of return applied to retained cash flow might consider the fact that cash has been drained from the company, thereby reducing its growth prospects.

**Conclusion #6: If S corporation distributions exceed the tax liability associated with entity operations, the S corporation minority investor’s value will be greater than the C corporation minority investor’s value (presuming that S and C corporation income tax rates are identical). The benefit will be equal to the present value of the tax liability associated with the C corporation minority investor’s dividend.**

#### **Scenario C: Distribute 0% of Net Income to Minority Owners**

Another extreme condition is to assume that the S corporation makes no distribution for the tax liability associated with entity operations (keep in mind that the companion C corporation tax liability has been satisfied through a direct payment by the company to the government). Exhibit 6 compares Scenarios A and B against Scenario C, with the latter presuming that the S corporation distributes none of its income.

Unlike Scenarios A and B, the retained cash flow (line 15, Exhibit 6) differs for the C and S corporations. Clearly, there may be a benefit for the latter if the S corporation’s additional retained cash balance is reinvested in the company at its cost of capital. As was mentioned in the introduction to this section of the paper, though, the minority shareholder has no control over the efficient reinvestment of, or rights to, the retained funds.

Relative to the C corporation in Scenario C, there is a \$400 benefit to the S corporation shareholder associated with the company not paying a distribution (perhaps, as inferred above, the present value of which may be diminished by the controlling shareholder’s inefficient investment of retained funds at less than the cost of capital). However, we also noted that the S corporation’s excess retained cash flow (again, line 15) – to which the minority shareholder has no access – is offset by a \$400 liability (line 22) associated with the shareholder’s obligation to pay the tax liability associated with S corporation operations.

**Conclusion #7: If S corporation distributions are less than the tax liability associated with entity operations, the S corporation minority investor’s value will be no greater than, and likely less than, the C corporation minority investor’s value.**

**Exhibit 6**  
**C Versus S Corporation Values: Scenarios A, B and C**

		Scenario A:		Scenario B:		Scenario C:	
		Tax Distribution		Distribute 100% of Net Income		Distribute 0% of Net Income	
		C Corp	S Corp	C Corp	S Corp	C Corp	S Corp
<b>Retained Cash Flow:</b>							
1	Pretax income		1,000	1,000	1,000	1,000	1,000
2	Income taxes (C corp)	40%	(400)	(400)		(400)	
3	-----		-----	-----	-----	-----	-----
4	Net income		600	1,000	600	1,000	600
5	Noncash expenses		60	60	60	60	60
6	Changes in working capital		(15)	(15)	(15)	(15)	(15)
7	Fixed asset acquisitions		(65)	(65)	(65)	(65)	(65)
8	Debt principal payments		(25)	(25)	(25)	(25)	(25)
9	-----		-----	-----	-----	-----	-----
10	Net cash flow		555	955	555	955	555
11	C corp dividends paid		0	(600)		0	
12	S corp tax distribution paid	40%		(400)		(400)	0
13	S corp "excess distributions" paid			0		(600)	0
14	-----		-----	-----	-----	-----	-----
15	Retained cash flow		555	555	(45)	(45)	555
16							
<b>Investor Cash Flow:</b>							
18	C corp dividends paid		0	600		0	
19	S corp tax distribution paid			400		400	0
20	S corp "excess distributions" paid			0		600	0
21	Personal taxes on C corp dividends paid	21%	0	(126)		0	
22	Personal taxes on S corp operations	40%		(400)		(400)	(400)
23	-----		-----	-----	-----	-----	-----
24	Net cash flow to investor		0	0	474	600	0

Some analysts will argue that we have overlooked the contribution of the retained cash (line 15) to the shareholder's tax basis and, therefore, the seller's value. For the present, we will not address this issue. However, it will be discussed in the last chapter of this paper.

Additionally, Scenario C presumes that the minority S corporation shareholder does not make or is prohibited from making a disqualifying action which would force the entity to pay the tax liability associated with entity operations (i.e., convert the entity to a C corporation).

**Valuation Model for Minority Ownership Interests**

Next, a model for valuing minority ownership interest will be presented.

To begin, we first established discount rate assumptions, as shown in Exhibit 7, so that we could determine the present value of the various cash flow streams subsequently shown in Exhibit 8. The reader should assume that Ibbotson data (i.e., publicly traded stock returns) were used to develop these rates. Hence, as established earlier and summarized in Conclusion #1, the discount rates reflect the satisfaction of C corporation tax liabilities associated with entity operations.

Also, we chose a larger discount rate for the present value calculation associated with the double taxation adjustment in Exhibit 8 (lines 34 to 43, the shaded portion of the model). More specifically, the subject minority shareholder cannot force the entity to pay distributions even if the company has generated adequate cash flow to pay distributions. The choice of a larger discount rate reflects the greater risk associated with the minority owner's inability to control distributions.

Finally, the reader should also recognize that our choices of discount rates, growth, and capitalization rates are for demonstration purposes. Such rates may or may not be relevant for a particular assignment.

Exhibit 7  
Discount and Capitalization Rate Assumptions

	Retained Cash Flow	Double Taxation Adj.
Discount rate	20%	21%
Growth rate	5%	5%
	-----	-----
Capitalization rate	15%	16%

In Exhibit 8, the value of an otherwise similar C corporation minority interest was determined. It is the benchmark against which S corporation minority interest cash flows and values will be measured.

Moving on to the S corporation examples in Exhibit 8, three scenarios are presented. Unlike Exhibit 6, note that the C corporation and personal tax rates (40% and 41%, respectively) are different.

- Scenario 8a shows the valuation strategy for an S corporation distributing only enough of its income to satisfy the minority owner's tax liability associated with entity operations.
- Scenario 8b represents the valuation of an S corporation minority ownership interest in an entity distributing 100% of its net income (as noted earlier, facts similar to the *Gross* case) to minority owners.
- Scenario 8c demonstrates the valuation strategy for an S corporation paying no distributions to the minority owner.

Exhibit 8 General Comments:

The unadjusted retained cash flow (line 15) differs for each of the four scenarios.

Net cash flow (line 10) for the three S corporation scenarios is greater than the same measure for the C corporation scenario. If net cash flow is the basis for valuing the C corporation minority interest, the knowledgeable investor will always prefer the S corporation investment opportunities. Using the information previously presented in this paper in combination with Exhibit 8, we will demonstrate the folly of this position.

Exhibit 8  
Retained Cash Flow Component of Value

	C CORPORATION				S CORPORATION												
	Tax Rates	2004	2005	2006	Present Value	Scenario 8a			Scenario 8b			Scenario 8c			Present Value		
		2004	2005	2006	Present Value	2004	2005	2006	Present Value	2004	2005	2006	Present Value	2004	2005	2006	Present Value
<b>Retained Cash Flow:</b>																	
1 Pretax income		1,000	1,200	1,800		1,000	1,200	1,800		1,000	1,200	1,800		1,000	1,200	1,800	
2 Income taxes (C corp)	40%	400	480	720													
3		-----	-----	-----		-----	-----	-----		-----	-----	-----		-----	-----	-----	
4 Net income		600	720	1,080		1,000	1,200	1,800		1,000	1,200	1,800		1,000	1,200	1,800	
5 Noncash expenses		60	72	108		60	72	108		60	72	108		60	72	108	
6 Changes in working capital		(15)	(18)	(27)		(15)	(18)	(27)		(15)	(18)	(27)		(15)	(18)	(27)	
7 Fixed asset acquisitions		(65)	(78)	(117)		(65)	(78)	(117)		(65)	(78)	(117)		(65)	(78)	(117)	
8 Debt principal payments		(25)	(30)	(45)		(25)	(30)	(45)		(25)	(30)	(45)		(25)	(30)	(45)	
9		-----	-----	-----		-----	-----	-----		-----	-----	-----		-----	-----	-----	
10 Net cash flow		555	666	999		955	1,146	1,719		955	1,146	1,719		955	1,146	1,719	
11 C corp dividends paid		0	0	0													
12 S corp tax distribution paid	41%					(410)	(492)	(738)		(410)	(492)	(738)		0	0	0	
13 S corp "excess distributions" paid						0	0	0		(590)	(708)	(1,062)		0	0	0	
14		-----	-----	-----		-----	-----	-----		-----	-----	-----		-----	-----	-----	
15 Retained cash flow		555	666	999		545	654	981		(45)	(54)	(81)		955	1,146	1,719	
16 C corp valuation adjustment		0	0	0		0	0	0		0	0	0		(400)	(480)	(720)	
17		-----	-----	-----		-----	-----	-----		-----	-----	-----		-----	-----	-----	
18 Retained cash flow (C corp basis)		555	666	999		545	654	981		(45)	(54)	(81)		555	666	999	
19 Terminal value				6,993				6,867				(567)				6,993	
20		-----	-----	-----		-----	-----	-----		-----	-----	-----		-----	-----	-----	
21 Total		555	666	7,992		545	654	7,848		(45)	(54)	(648)		555	666	7,992	
22 Present value (retained cash flow)		463	463	4,625	5,550	454	454	4,542	5,450	(38)	(38)	(375)	(450)	463	463	4,625	5,550

Exhibit 8 (cont.)  
Cash-to-Investor Component of Value

	C CORPORATION				S CORPORATION														
	Tax Rates	2004	2005	2006	Present Value	Scenario 8a				Scenario 8b				Scenario 8c					
						2004	2005	2006	Present Value	2004	2005	2006	Present Value	2004	2005	2006	Present Value		
23	<b>Net cash flow to investor</b>																		
24	S corp tax distribution paid					410	492	738		410	492	738		0	0	0			
25	S corp "excess distributions" paid					0	0	0		590	708	1,062		0	0	0			
26	Personal taxes on S corp operations	41%				(410)	(492)	(738)		(410)	(492)	(738)		(410)	(492)	(738)			
27						-----	-----	-----		-----	-----	-----		-----	-----	-----			
28	Net cash flow to investor		0	0	0	0	0	0		590	708	1,062		(410)	(492)	(738)			
29	Terminal value				0			0				7,434				(5,166)			
30						-----	-----	-----		-----	-----	-----		-----	-----	-----			
31	Total		0	0	0	0	0	0		590	708	8,496		(410)	(492)	(5,904)			
32	Present value		0	0	0	0	0	0	0	492	492	4,917	5,900	(342)	(342)	(3,417)	(4,100)		
33																			
34	<b>Double Taxation Adj.</b>																		
35	Total S corp distributions		0	0	0	410	492	738		1,000	1,200	1,800		0	0	0			
36	C corp entity-related taxes		0	0	0	(400)	(480)	(720)		(400)	(480)	(720)		(400)	(480)	(720)			
37						-----	-----	-----		-----	-----	-----		-----	-----	-----			
38	S corp "excess distributions" paid		0	0	0	10	12	18		600	720	1,080		0	0	0			
39	S Corp "excess dist" tax benefit	21%	0	0	0	2	3	4		126	151	227		0	0	0			
40	Terminal value				0			25				1,488				0			
41						-----	-----	-----		-----	-----	-----		-----	-----	-----			
42	Total		0	0	0	2	3	29		126	151	1,715		0	0	0			
43	Present value (double taxation adj.)		0	0	0	2	2	16	20	104	103	968	1,176	0	0	0	0		
44																			
45	<b>Tax-Rate Differential Adj.</b>																		
46	S corp entity-related taxes	41%				(410)	(492)	(738)		(410)	(492)	(738)		(410)	(492)	(738)			
47	C corp entity-related taxes	40%				(400)	(480)	(720)		(400)	(480)	(720)		(400)	(480)	(720)			
48						-----	-----	-----		-----	-----	-----		-----	-----	-----			
49	S corp benefit (liability)		0	0	0	(10)	(12)	(18)		(10)	(12)	(18)		(10)	(12)	(18)			
50	Terminal value				0			(126)				(126)				(126)			
51						-----	-----	-----		-----	-----	-----		-----	-----	-----			
52	Total		0	0	0	(10)	(12)	(144)		(10)	(12)	(144)		(10)	(12)	(144)			
53	Present value (tax-rate differential adj.)		0	0	0	(8)	(8)	(83)	(100)	(8)	(8)	(83)	(100)	(8)	(8)	(83)	(100)		
54						-----	-----	-----		-----	-----	-----		-----	-----	-----			
55	Present value (cash to investor)				0				(80)				6,976					(4,200)	
56						-----	-----	-----		-----	-----	-----		-----	-----	-----			
57	<b>PV of retained &amp; investor cash flows</b>				5,550				5,370				6,526					1,350	

Relative to the C corporation and other S corporations, larger S corporation distributions (lines 12 and 13, as well as 24, 25, and 35) favorably affect the value of the minority investment (line 57). Conversely, smaller S corporation distributions adversely affect the value of a minority investment. If only net cash flow (line 10) is used as a basis in the valuation analysis, the conclusion will be wrong.

The three S corporation scenarios' entries on line 53, the present value of the tax-rate differential adjustment, is and always will be identical if the taxable income, line 1, is identical.

#### C Corporation Scenario: No Dividends

Because the C corporation pays no dividends to its minority shareholders, its net cash flow (line 10) is the same as its retained cash flow (line 15).

On the second page of Exhibit 8, we particularly note that the present value of the cash to the investor is zero (line 55) because the investor receives no dividends. Additionally, because the entity is a C corporation, there are no double taxation (line 43) or tax-rate differential (line 53) adjustments. Hence, the value of the benchmark C corporation minority interest is the value of its retained cash flow (line 22, which is identical to line 57).

#### Scenario 8a: Distributions Equal Tax Liability Associated with Entity Operations

If C corporation and personal tax rates (lines 2 and 12, respectively) are identical, the present value components (lines 22, 32, 43, 55, and 57) of the C corporation and the Scenario 8a S corporation will be identical and the knowledgeable investor will be indifferent toward the two investments.

If tax rates are different (as shown on lines 2 and 12), the investor will choose the C corporation minority investment since it has a slight economic benefit (line 57) relative to the otherwise identical S corporation in Scenario 8a (see Conclusion #4, above).

#### Scenario 8b: Distributions Exceed the Tax Liability Associated with Entity Operations

The Scenario 8b conclusion indicates that this particular S corporation minority interest is worth more than an S corporation minority interest receiving no distributions and is worth more than a C corporation paying no dividends. Note that the premium for the value of the S corporation minority interest versus the C corporation will vary with the amount of the excess distribution and the likelihood of continued receipt; thus the distinction in discount rates for the "tax" distribution and the "excess" distribution. Note further that contrary to the *Gross* opinion, both premiums are much smaller than one would derive if the S corporation income was not tax affected (which it should be so that it is consistent with the Ibbotson-derived discount rate). We also recognized that neither Scenario 8b premium is as great as the across-the-board 67% premium asserted by the IRS.

In Scenario 8b, the entity distributes all of its income (lines 12 and 13). Of course, in the real world, a premium could result from excess distributions being anywhere between the tax rate and 100% of income available for distribution. However, because our example represents the extreme case of distributing total income, the result is negative retained cash flow (line 15). A negative retained cash flow infers that the entity will be unable to fully generate (or service) the operating, investment, and financing activities' entries on lines 1 to 8 and pay owner

distributions at the indicated level. Over the long term, distributions cannot exceed net cash flow. The entity will either go out of business or have to reduce owner distributions. Logically, a knowledgeable investor would not value such an opportunity without giving consideration to a liquidation value premise.

However, if the entity in Scenario 8b is in a mature industry with minimal growth prospects (i.e., has minimal demands for additional working capital, line 6), does not require investment in capital equipment (line 7) greater than its depreciation expense (line 5), and has no debt service requirements (line 8), net income (line 4) and net cash flow (line 10) will be similar. In such circumstances, the S corporation can afford to pay all of its income to its minority owners without jeopardizing the entity's future. We understand that the preceding unusual circumstances are similar to the facts of *Gross*. Logically and as shown on line 57, one would expect the value of the Scenario 8b minority interest to be greater than the C corporation or Scenario 8a minority interest values.

Scenario 8c: Distributions Do Not Satisfy the Tax Liability Associated With Entity Operations

Consistent with Conclusion #3 above, the present value for each of the four scenarios must be calculated on an equivalent C corporation cash flow basis if Ibbotson data is used to develop a discount rate (as we have done). Because the C corporation income taxes have been recognized in the C corporation scenario (line 2) and in Scenario 8a and Scenario 8b (line 12) cash flows, the retained cash flow on line 15 does not need to be further adjusted to reflect the satisfaction of tax liabilities associated with entity operations. However, the C corporation tax liability has not been recognized in Scenario 8c's retained cash flow (line 15). As a result, for the purposes of the valuation analysis, an adjustment for the C corporation tax liability must be made and is done so on line 16. If the C corporation tax liability is not recognized and Ibbotson-derived discount rates are used in the valuation analysis, the conclusion will be wrong.

Because S corporation distributions (line 35) do not exceed C corporation taxes (line 36), there is no double-taxation benefit (line 39) in Scenario 8c. In general, when S corporation distributions do not exceed C corporation taxes, the minority investor will derive no double-taxation benefit.

Our valuation conclusions are summarized on lines 57 of Exhibit 8 and in Exhibit 9.

Exhibit 9  
Valuation Conclusions Summary: S Corporation Minority Interests  
(minority marketable basis)

	S Corporation			
Net cash flow for 2004	555	955	955	955
Present value (retained cash flow)	5,550	5,450	(450)	5,550
Present value (cash to investor)	0	(80)	6,976	(4,200)
Value to investor	----- 5,550	----- 5,370	----- 6,526	----- 1,350

Some readers might be concerned that the bifurcation of the company’s net cash flow represents a deviation from Treharne’s original model.<sup>12</sup> Instead, it is a variation of the previous model. More specifically, in the earlier model, Treharne first determined an “Equivalent C corp value” by discounting the company’s net cash flow. In contrast, Exhibit 8 breaks the company’s net cash flow into two components: “retained cash flow” and “cash to investor” as previously discussed in the text associated with Exhibits 1 and 2. Doing so allowed us to demonstrate that either model produces the same conclusion. The later model has the advantage of tying the analysis to Ibbotson’s statement (as noted earlier):

“The equity cost of capital is equal to the expected rate of return for a firm’s equity; this return includes all dividends plus any capital gains or losses.”<sup>13</sup>

Valuation Model Summary

Consistent with the Value formula in Exhibit 2 and the market’s expectations for evaluating tax-exempt investment opportunities (see discussion related to Exhibit 3), we determined the S corporation minority investor’s value using the following strategy:

1. First, as indicated by Conclusions #1 and #3 (above), we determined retained cash flow by tax affecting the S corporation’s earnings at C corporation income tax rates (Exhibit 8, line 18). Doing so normalizes the economic income stream to the same basis as the Ibbotson derived discount rates (i.e., the tax liability associated with entity operations has been paid). Then, the present value of net cash flow using discount rates derived from the Ibbotson data was calculated.
2. Second, value attributed to cash flow to the investor (line 28) was adjusted for the tax benefits associated with the S corporation shareholder not having to pay a second level of taxes on “excess distributions” (i.e., S corporation distributions in excess of the equivalent C corporation’s tax liability, Exhibit 8, line 38). When determining the present value of the S corporation minority shareholder’s tax benefit, we increased the discount rate to reflect greater uncertainty associated with receiving S corporation distributions. More specifically, the risk and discount rate associated with the company’s net cash flow stream is likely going to be smaller than the risk and discount rate associated with distributions because distributions are subordinate to and dependent upon net cash flow. Furthermore, distributions are made at the discretion of the controlling owner. When the company’s history of distributions has been consistent, the additional premium will be minimal, if

12 Chris D. Treharne, “Comparing Three Payout Assumptions’ Impact On Values of S Versus C Corps,” *Shannon Pratt’s Business Valuation Update*, September 2002, p. 4.

13 *Stocks, Bonds, Bills and Inflation Valuation Edition, 2002 Yearbook* (Ibbotson Associates, 2002), p. 37.

existent at all. Conversely, the knowledgeable investor of the fair market value standard will assign a larger discount rate to an ownership interest that had an inconsistent history of distributions. In any case, the analyst determines that future expectations differ from the past, prior history may not be an appropriate characteristic upon which the discount rate adjustment should be based.

3. Third, the present value of the cash flow to the investor (line 28) was adjusted for the income tax differences between C corporations and individuals (the latter being responsible for the tax liability associated with an S corporation's operations).

**Recommendation:**

When valuing an S corporation minority interest, we recommend that the analyst consider using the valuation model presented in Exhibit 8.

## S CORPORATION CONTROLLING INTEREST APPRAISALS

As established earlier, relative to an otherwise similar C corporation interest, the value of S corporation minority interests will be greater if distributions in excess of personal tax liabilities associated with entity operations are paid. The benefit is directly attributable to the present value of the benefit associated with not having to pay personal income taxes on C corporation dividends (S corporation “excess distributions”). Avoiding the double taxation of dividends is a benefit to the S corporation minority shareholder.

However, within certain compensation limits established by the Internal Revenue Code, the C corporation controlling shareholder can mimic an S corporation and avoid the double taxation of dividends by paying himself/herself additional salary. More specifically, the controlling shareholder will have to pay personal income taxes on the additional salary, but the C corporation will not pay corporate income taxes (i.e., the company gets a tax deduction for the compensation paid).

Mattson, *et al*, reported data that confirms the preceding theory regarding the C corporation controlling shareholder’s ability to mimic the single taxation of an S corporation. In particular, the study concluded:

“Indeed, the data in this sample seem to support the presumed tendency for C corporations to report lower earnings. Exhibit 2 [not included in our report] shows that the median Pretax Margin for all observations in the full data set is 4.5%. When this is broken down between S and C corporations, we find that the median Pretax Margin for the 1,285 S corporations is a healthy 6.9%, but for the 1,202 C corporations it is only 2.3%.”<sup>14</sup>

The authors wanted to use market multiples to measure the difference in value between C and S corporation controlling interests. However, because C corporation shareholders are motivated to avoid double taxation by minimizing entity income, the authors relied on the Price/Sales market multiple, rather than the more common Price/Earnings multiple, believing the latter ratios were not comparable between entity forms. Based on their data set, they concluded:

“For eight of the size categories, S corporations had lower Price/Sales ratios, only one of these being statistically significant. For nine of the size categories, S corporations had higher Price/Sales ratios, but again only one of these is statistically significant.

“We interpret these results to show that, after parceling out (1) the effects of industry affiliation, (2) whether the transaction was an asset or stock sale, (3) any unusual effects stemming from asset size, and (4) the effects of market swings, there appears to be no difference in the Price/Sales ratios for S and C corporations.”<sup>15</sup>

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14 Michael J. Mattson, MBA, Donald S. Shannon, PhD, CPA, David E. Upton, PhD, CFA, “Empirical research concludes S corporations values same as C corporations,” *Shannon Pratt’s Business Valuation Update*, November 2002.

15 *Ibid.*, p. 5.

In an attempt to measure the differences in value between C and S corporations, Erickson conducted a study on the “IRC § 338(h)(10) election on the purchase price paid for 200 subsidiary stock sales from 1994 to 1998.”<sup>16</sup> The study concluded:

“Acquirers are willing to pay a premium acquisition price *to obtain the tax benefits derived from the election.*”<sup>17</sup> (emphasis added)

And:

“Simply stated, the tax structure of the subsidiary sale affects the purchase price. Further, in a subsidiary sale, the seller should often be able to extract a purchase price premium for the tax benefits associated with the deal and the buyer should be willing to pay such a premium.”<sup>18</sup>

A commentator observed the following about the Erickson/Wang study:

“Erickson and Wang theorize that acquirers are willing to pay a premium for an S corporation's stock because an S can enter into a Section 338(h)(10) transaction without incurring a significant tax penalty. The effect of the 338(h)(10) election is to give the acquirer a step up in tax basis in the underlying assets. This result is no different than if the acquirer purchased the assets directly.”<sup>19</sup>

Thus, the differential found in the Erickson/Wang study is not about whether the company holds an S election or not. In the real world or under the fair market value statutory construct, no buyer is going to pay for an item that can be acquired for free. The reason there is a difference in the data has to do with asset sales versus stock sales, or structuring a stock sale with the benefits of an asset sale. When there is a significant basis step-up to be gained by the acquirer in an asset acquisition, the question should not be whether the company is an S or a C corporation; rather, the question should be: “Am I valuing the stock or the assets, and what step-up in basis is available?”

Unfortunately, the issue of S versus C corporation value has become intertwined with the basis issue. In reality, the investor needs to determine the tax advantages via basis step-up that the buyer can gain by acquiring the assets (versus the stock) and how much will he be willing to pay for that step-up in basis, as demonstrated by the Erickson/Wang study. Notably, this is not a question that can be answered with an “across the board” formula; it is an individual determination, on a case by case basis.

In summary, if the transactions in the Erickson/Wang study were asset deals, a premium was found.

In the real world, a buyer is often willing to pay a premium over the stock price, if he gains a step up in the basis of the assets. He is not willing to pay a premium for the S election. Why? Because it makes no difference to a buyer, who can elect S corporation status...for free.

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16 Research by Merle Erickson, “To Elect or Not to Elect: That is the Tax Question, What you don't know about an Internal Revenue Tax Code may cost you millions”, *Capital Ideas*, Vol. 2, No. 4, Winter 2001, Chicago Graduate School of Business, p. 1.

17 Ibid.

18 Ibid., p. 4.

19 R. James Alerding, Yassir Karam, Travis Chamberlain, “S Corporation Premiums Revisited: The Erickson-Wang Myth” *Shannon Pratt's Business Valuation Update*, January 2003, p. 2.

With respect to any value differential *strictly on the basis of S corporations versus C corporations*, we considered the following market-data study, in addition to the Mattson, *et al*, study described above:

“To examine the question, the Financial Resources Management, Inc. (FRM) study used data from the data bank of Business Valuation Resources (BVR). The first step was to choose a Standard Industrial Classification (SIC) to identify the impact of the S versus C designation. Under the Tax Court’s theory, it should not make any difference which SIC is chosen because in *any* situation S corporations should be valued more than C corporations. In this case, SIC 5411-Grocery Stores was chosen.”

“These results show that in this industry, a C corporation is valued significantly higher than an S corporation based on sales. Likewise, an S corporation is not valued significantly higher than a C corporation based on EBT. In any case, S corporations cannot be shown to be valued more than a C corporation in the same industry.”

“Another analysis was done on the entire BVR data base by entity form. The first observation is that the mean of C corporation sales is somewhat higher than S corporation sales, but the medians are very similar. Thus, mean-based statistics may be somewhat skewed, but the median price-to-sales ratios should be illustrative. ... the mean and median price-to-sales ratio for C corporations is higher than for S corporations.”

“EBT-related information... generates similar results.”

“These results show there are no indications that pass-through entities are valued more than C corporations.”<sup>20</sup>

Perhaps one of the most compelling reasons why S corporations are not more valuable than C corporations is the fact that the cost of an S corporation election is nil. Furthermore, it is only logical to presume that if there was inherent value in S corporation status, there would be no C corporations (presuming that the requirements of an S election could be satisfied).

Additionally, at the corporate level, the entity must pay taxes, either as a direct corporate expense, or as an indirect distribution so that corporate tax liabilities can be satisfied through the shareholder. Either way, that money is gone and not available for reinvestment back into the company. The above market data suggests controlling owners are indifferent as to who pays the tax liability associated with entity operations.

**Conclusion #8: There is no market evidence or logic that indicates controlling interests in S corporations are worth more than controlling interest in C corporations.**

**Recommendation:**

We recommend tax affecting the S corporation’s economic income stream at C corporation rates and using Ibbotson’s market data to determine controlling shareholder or company value.

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20 Joseph D. Vinso, Ph.D., MCBA, FIBA, ASA, “Distributions and Entity Form: Do They Make Any Difference in Value?” *Valuation Strategies*, Sept/Oct. 2003, pp. 14-17.

## IMPACT OF BASIS ON S CORPORATION VALUE

Returning to the issue of retained cash flow, some analysts maintain that even in the confines of the income approach, part of the value differences between C and S corporations lie in the ability of the S corporation to increase its basis and thereby reduce the capital gains tax liability of the S corporation shareholder upon sale of his/her stock.

However, the statutory construct called “fair market value” requires that the perspective of both buyer and seller be considered. While basis, to the extent it is available at the time when a company might be sold, has value to an individual S corporation selling shareholder, the seller cannot transfer it to the buyer. Hence, the hypothetical, knowledgeable buyer of the statutory fair market value construct attaches no value to the seller’s basis and, logically, would pay nothing for it.

Further, this represents a mixing of two valuation theories that are polar opposites: the income approach, which is based on the present value of future benefits, and the asset approach. To obtain the benefit of the increased basis, one must make the assumption that the corporation is sold. The income approach, by definition, assumes a going concern. As the court stated in *Dunn v. Commissioner* (TC Memo 2000-12, January 12, 2000):

“The fundamental assumption in the income or cash flow approach is that the assets are retained by the corporation, i.e. not globally disposed of in liquidation or otherwise.....the starting point for the earnings-based approach is that the corporations assets are retained – are not sold...”

Thus, it is internally inconsistent to presume a going concern *and* a sale of underlying assets at the same time.

### **Recommendation:**

When valuing S corporations under the federal fair market value standard of value, we recommend giving no consideration to the seller’s tax basis, unless a sale is contemplated.

## SUMMARY

This paper presents reasoned theory for the valuation of S corporations and interests in them. It is based on sound valuation theory, sound economic theory, and market evidence.

To value an S corporation ownership interest, the analyst first should determine if the subject is a controlling or minority ownership interest.

If the interest is a minority interest, the valuation model presented in Exhibit 8 should be considered. In particular, the minority interest valuation model provides analysts with a procedure for valuing such interests that is based on economic reality and market evidence.

In contrast, if valuing a controlling interest, the studies that have been conducted on controlling interest transactions in the marketplace provide no evidence that S corporations should be treated any differently than C corporations. Logically, we recommend that C corporation valuation methods be used for controlling ownership interests in S corporations.

Finally, with respect to any potential advantage attributable to the selling shareholder's basis, we believe that neither valuation theory or the statutory fair market value construct allow for the recognition of any such value contribution because the hypothetical, knowledgeable buyer will recognize that he/she cannot benefit from a transfer of the seller's basis and, therefore, will not pay for it. Further, it defies logic to assume both a going concern and a sale of the entity's underlying assets in the same valuation assignment.

**AUTHORS'**

***CURRICULA VITAE***

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# GIBALTAR

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BUSINESS APPRAISALS, INC.

**Chris D. Treharne, ASA, MCBA, BVAL**

*President*

1430 Nelson Road, Suite 223

Longmont, CO 80501

Voice: 303.449.8550

Fax: 303.449.8090

ctreharne@4avalue.com

## Experience

- **Gibraltar Business Appraisals, Inc. *President***  
Professional valuations of business interests (common and preferred stocks, partnership interests, options, debt instruments, intangibles, etc.) for estate taxes, ESOPs, gift taxes, S-corporation elections, divorce, litigation support, and business transactions.
- **Quist Financial, Inc. *Vice President***  
Similar responsibilities and activities as Gibraltar Business Appraisals, Inc. (above).
- **RELA, Inc. *Chief Financial Officer***  
Managed finance, contracts and administrative activities of firm that develops, designs and manufactures products for Fortune 500 and other firms.
- **Ford/Higgins Ltd. *Chief Financial Officer and VP of Operations***  
As an executive manager for the start-up mini-computer manufacturer, was responsible for negotiating a merger, creating a recapitalization plan, preparing stock valuations and business plans for venture capital investments, maintaining creditor relations, and managing manufacturing and administration.
- **Johnson and Johnson Ultrasound *Production Manager***  
Test and production managers for manufacturer of diagnostic medical equipment.
- **Colgate-Palmolive Co.**  
Industrial engineer, shipping/receiving foreman and production manager for international manufacturer of consumer products.
- **Adolph Coors Co. *Design Engineer***  
Electrical and mechanical engineer for the world's largest single-site brewery.

## Professional Designations and Licenses

- MCBA: Master Certified Business Appraiser designated by The Institute of Business Appraisers, Inc. (10/06/00)
- ASA: Accredited Senior Appraiser #009275 designated by the American Society of Appraisers (3/16/95)
- BVAL: Business Valuator Accredited for Litigation designated by The Institute of Business Appraisers, Inc. (9/21/00)
- Real Estate Broker ER01157335: State of Colorado
- Professional Engineer PE-14480: State of Colorado

## Education

- Masters in Business Administration, Finance – University of Colorado at Boulder (1977)
- Bachelor of Science, Electrical Engineering – University of Iowa (1972)

## Affiliations

- American Society of Appraisers
  - The Institute of Business Appraisers
  - National Center for Employee Ownership
  - Financial Consulting Group
  - Front Range Business Valuation Caucus
-

## Appraisal Education

- 11/03 American Institute of Certified Public Accountants (AICPA) – National Business Valuation Conference – Phoenix
- 11/03 Shannon Pratt’s “Hot Issues of FLPs/LLCs: Reality, Recognition, & Valuation” webcast
- 10/03 Shannon Pratt’s “McCord Case: Challenges to IPO & Restricted Stock Studies Used to Estimate DLOMs” webcast
- 9/03 Front Range Business Valuation Caucus – Denver
- 9/03 Financial Consulting Group (FCG) Annual Member Conference – Memphis
- 5/03 Institute of Business Appraisers (IBA) National Conference – Orlando
- 5/03 Front Range Business Valuation Caucus, “Real Options” – Denver
- 4/03 FCG University – Atlanta
- 10/02 Decisioneering Crystal Ball class – Denver
- 9/02 Decisioneering Real Options class – Denver
- 9/02 Front Range Business Valuation Caucus, “Quantifying Marketability Discounts Model” – Denver
- 8/02 AICPA tax-affecting S Corp earnings webcast
- 8/02 Shannon Pratt’s “Tax-affecting S Corp earnings” audio conference
- 7/02 FCG University – Denver
- 5/02 AICPA Real Options webcast
- 5/02 IBA National Conference – Washington, DC
- 4/02 FCG University – Atlanta
- 4/02 AICPA FASB 141/142 Webcast
- 3/02 American Society of Appraisers (ASA) FASB 141/142 Conference
- 12/01 FCG mini conference – Las Vegas
- 5/01 IBA National Conference – Orlando
- 7/00 ASA Valuation 2000 – Las Vegas
- 5/00 Boulder Tech. Incubator Mergers & Acquisitions Seminar – Boulder
- 2/00 IBA National Conference – Phoenix
- 2/00 IBA 7001: “Litigation Support and Expert Witness Training for the Business Appraiser” – Phoenix
- 10/99 ASA Advanced Business Valuation Conference – New Orleans
- 7/99 IBA 1003: “10 Advanced Steps to Take Your Appraisals from Ordinary to Outstanding” – Denver
- 7/99 IBA 1004: “12 More Advanced Steps in Your Appraisal’s Journey from Ordinary to Outstanding” – Denver
- 1/99 Uniform Standards for Professional Appraisal Practice home study
- 6/98 ASA International Appraisal Conference – Maui, HI
- 3/98 BV Caucus – Denver
- 10/97 ASA Advanced Business Valuation Conference – San Francisco
- 6/97 ASA International Appraisal Conference – Houston
- 10/96 ASA Advanced Business Valuation Conference – Memphis
- 9/95 Denver Estate Planning Council
- 6/95 ASA Expert Witness Class – Denver
- 6/95 ASA International Appraisal Conference – Denver
- 6/95 BV Caucus – Denver
- 4/95 ASA BV205: ESOP Valuation Techniques – Sacramento
- 1/95 IBA Appraising Closely Held Businesses – Las Vegas
- 1/95 BV Caucus – Denver
- 11/94 ASA/CICBV “Business Valuation in a Changing Environment” – San Diego
- 2/94 BV Caucus – Denver
- 10/93 USPAP (presented by the ASA) – Denver
- Estate Planning for Farmers & Ranchers – Des Moines
- 11/93 ASA “Business Valuation Selected Advanced Topics” (BV 204) – Denver
- 3/93 ASA “Business Valuation Case Study” (BV 203) – Denver
- 10/92 ASA “Business Valuation Methodology” (BV 202) – Denver
- 2/92 ASA “Introduction to Business Valuation” (BV 201) – Denver

## Presentations

- 11/03 AICPA National Business Valuation Conference – “Pass-Through Entities... What’s All the Fuss About?” [co-presented with Nancy J. Fannon & James R. Hitchner] – Phoenix
  - 11/02 Southern New Mexico Estate Planning Council, “A Review of Current Business Valuation Issues,” – Las Cruces, NM
-

- 8/02 Boulder County Estate Planning Council, “Gross Revisited: Are S Corporations Worth More than C Corporations?” – Boulder
- 5/02 American College of Trust and Estate Council, Big Sky Regional Conference, “A Review of Current Business Valuation Issues” – Santa Fe, NM
- 5/02 IBA National Conference, “Contents of an Expert Witness Report,” – Orlando
- 10/01 Southern New Mexico Estate Planning Council, “A Review of Current Business Valuation Issues,” – Las Cruces, NM
- 9/01 Wyoming State Bar Association, “Valuation & Limited Partnerships,” – Cheyenne
- 3/01 American College of Trust and Estate Council, Big Sky Regional Conference, “Valuation Update, Including Fractional Interests and FLP Issues,” – Keystone, CO
- 5/00 Preeo, Silverman, Green & Egle Law Firm, “Current Topics in Business Valuation,” – Denver
- 8/99 Holme, Roberts, & Owen Law Firm, “Issues in Business Valuation,” – Denver
- 6/99 National Business Institute, “Valuing Closely Held Business Interests,” - Denver
- 5/99 American College of Trust and Estate Council, Big Sky Regional Conference, “Sample Appraisal Report,” “Recent Market Data,” – Jackson, WY
- 5/99 University of Iowa College of Law Spring Tax Institute, “Family Limited Partnerships: Pitfalls and Opportunities,” – Iowa City, IA
- 4/99 Boulder County Estate Planning Council – “Valuing Family Limited Partnerships: Pitfalls & Opportunities” – Boulder
- 11/98 Estate Planning Council of Southeast Denver, “Valuation Discounts,” – Denver
- 9/98 University of Colorado Business School – Entrepreneurial Finance –Boulder
- 3/98 Gasket Fabricators Association, “Valuation of Closely Held Common Stock,” Howley-in-the Hills, FL
- 5/95 BV Caucus – The IBA Market Data Base – Denver

### **Instructor**

- 9/03 IBA 8001A “Mastering Appraisal Skills for Valuing the Closely-held Business,” – Denver
- 5/03 IBA National Conference, “Contents of an Expert Witness Report,” – Washington, DC
  
- 1/00 Lorman Educational Services, “Colorado Family Limited Partnerships: Pitfalls and Opportunities,” – Denver
- 3/96 Continuing Legal Education in Colorado, Inc., “Business Valuation in Estate Planning,” – Denver

### **Authored**

- “Comparing Three Payout Assumptions’ Impact on Values of S versus C Corps,” *Shannon Pratt’s Business Valuation Update*, September 2002, pp 1, 3-5.
- “Family Limited Partnerships,” Newsletter for Denver Chapter of ASA, 2000.
- IBA course 1038: *Valuing Family Limited Partnerships*, co-authored with Linda Trugman
- Valuation of Pass-Through-Tax Entities: Minority and Controlling Interests, co-authored with Nancy J. Fannon (submitted to the Department of the Treasury by the S Corporation Association)

### **Reviewed**

Dr. Johnathan Mun, *Real Options Analysis Course: Business Cases and Software Applications*  
 Dr. Shannon Pratt, *The Lawyers Business Valuation Handbook*  
 ASA Center for Advanced Valuation Studies (CAVS): “Advanced Issues in Developing Discounts and Premiums” and “Real Option Theory” – Denver

### **Professional Achievements**

- IBA, Northwest Region Governor – 1999 to present
- St. Vrain Valley School District, Finance and Audit Committee Chairman – 2002 to present
- Longmont Area Economic Council, two-term past Chairman, current board member
- Front Range Business Valuation Caucus, past Chairman and current committee member



**BAKER NEWMAN & NOYES**  
LIMITED LIABILITY COMPANY

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**Nancy J. Fannon, CPA\*ABV, MCBA, BVAL**

*Principal*

100 Middle Street

Portland, ME 04101

Voice: 207-791-7111

Fax: 207-774-1793

[nfannon@bnn CPA.com](mailto:nfannon@bnn CPA.com)

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**Responsibilities:**

Nancy is a Principal in the Valuation Consulting Division of Baker Newman & Noyes, specializing in business valuation and litigation support work. Her clients have included manufacturers, retailers and distributors, restaurants, service providers, medical providers, contractors and individuals. She has also worked extensively on acquisition structures and terms, cash flow forecasting for business planning and financial needs, and various closely held business issues. She is frequently retained to provide expert witness services relating to the value of a business; an opinion on the amount of financial damages relating to the lost profits or the loss of a business or segment of a business; and other financial matters. She is often appointed by a court or mediator as a court-appointed expert, and has served as an arbitrator in valuation cases.

Nancy regularly works with owners and attorneys on valuation aspects of Shareholder Agreements, consulting on issues ranging from front-end design to alternative buyout scenarios to negotiation and shareholder dispute resolution.

Nancy is a frequent speaker both locally and nationally on the topic of business valuation and damages. She is a regular contributing author for several national valuation journals, has participated in writing valuation textbooks, and has been a technical reviewer on several others.

**Education:**

University of Massachusetts-Amherst, Bachelor of Science, Business Administration – Accounting, 1980  
Numerous professional educational programs on Business Valuation and Litigation Support  
Numerous advanced tax-related courses

**Professional Designations:**

Certified Public Accountant, American Institute of Certified Public Accountants  
Master Certified Business Appraiser, Institute of Business Appraisers  
Certified Public Accountant\*Accredited in Business Valuation, AICPA  
Business Valuator Accredited in Litigation, Institute of Business Appraiser

**Activities:**

American Institute of Certified Public Accountants Business Valuation Committee Past Member  
AICPA 2001 Business Valuation Conference Chairperson and 2003 Committee Member  
AICPA Accredited in Business Valuation Review Course Committee past Chair and Instructor  
AICPA Advanced Business Valuation Studies Committee Past Member  
AICPA liaison re. FASB Purchase Price Method/Business Combination Task Force  
Editorial Board, “CPA Expert”  
Editorial Advisory Board, “National Litigation Consultants Review”  
Institute of Business Appraisers Member  
American Institute of Certified Public Accountants member  
Maine Society of Certified Public Accountants member  
Camp Calumet Internal Audit Committee

**Awards:**

1997 Tribute to Women in Industry (“TWIN”) Award Recipient  
1999 AICPA Business Valuation “Volunteer of the Year” Award Recipient

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**Nancy J. Fannon**  
Recent Publications Authored

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*When and How to Use a Business Valuation Expert*, Maine Lawyer's Review, Dec. 17, 1997

*Made in the USA: Appraisals in the Manufacturing Industry*, materials for Institute of Business Appraisers' Annual Conference, January 1998

*Difficult Valuation Issues for Divorce*, materials for the Maine State Bar program "The Use and Abuse of Expert Witnesses", 1998

*Buying and Selling Private Companies, Divisions and Subsidiaries in Maine*, The Cambridge Institute, June 1998

*Valuing My Business Fairly*, Intellectual Property and Venture Capital in Maine, June 1998

*Family Limited Partnerships and Family LLCs: An Effective Estate Planning Tool*, Maine Lawyer's Review, 1998 (w/D.Nucci)

*Determining the Value of a Business for Transfer Tax Purposes*, Maine Lawyer's Review, 1999

*Valuing Manufacturing Companies*, Business Valuation Update, May 1999

*Valuation, Private Capital Formation for the Emerging Business*, October 1999

*Valuation in the Context of Divorce: Schizophrenic Valuation at it's Best*, materials for the American Institute of Certified Public Accountants Annual Business Valuation Conference, December 1999

*Recasting the Financial Statements*, The 2000 Business Reference Guide, January 2000

*Business Valuation in the Context of Capital Formation for the Emerging Business*, Maine Lawyer's Review, January 2000 (with Deb Patry)

*Lost Profits Damages: A Natural Extension of Business Appraisal Skills*, Business Valuation Update, March 2000

*Valuing Small to Mid-Sized Manufacturing Companies*, FairShare, the Matrimonial Law Monthly, April 2000

*Tackling Valuation Issues in the Context of Divorce*, CPA Consultant, January-April 2000

*Served as technical reviewer of textbook by Shannon Pratt*, The Use and Application of the Market Data Approach, Summer 2000 publication date

*Preparing Your Practice for Litigation Support*, materials for the AICPA Annual Business Valuation Conference, Nov. 2000

*Lost Profits Damages: A Natural Extension of Business Valuation Skills*, CPA Expert, Spring 2001

*Determining Value of Your Business Can Be Complex*, Portland Press Herald, July 13, 2001

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*Buy-Sell Agreements: write 'em right!*, Judges & Lawyers Business Valuation Update, December 2001

*Practice Tips*, National Litigation Consultant's Review, January 2002

*Using Financial Statements and Tax Returns in Discovery*, materials for the AAML/AICPA National Conference on Divorce, May 2002

*"I Solemnly Swear"*, National Litigation Consultant's Review, 2002

*Served as technical reviewer of textbook by Shannon Pratt*, Body of Knowledge, Fall 2002 publication date

*It is Not All Fair Market Value, All the Time!...and Other Tips for Setting Out on a Successful Engagement*, co-authored with Deb Patry, CCH Business Valuation Alert, April 2003

Served as co-author of textbook, Financial Valuation: Applications and Models, April 2003 publication date

*Advising Business Owners: Tax Saving Strategies & Planning Considerations*, Lorman Education Services, August 2003

*Litigation Support & the Business Appraiser*, CPA Associates Annual Conference, August 2003

*The Direct Market Data Method: Common Errors in Application and a Closer Look at the Transaction Databases*, co-authored with Heidi Walker, CCH Business Valuation Alert, October 2003

*Valuation of Pass-Through Entities: What's all the Fuss??*, with Chris Treharne and Jim Hitchner, November 2003

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**Nancy J. Fannon**  
**Speeches and Seminars**

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*"Valuing My Business Fairly: Intellectual Property and Venture Capital in Maine"*, The Cambridge Institute, June 1998

*"Accredited in Business Valuation Review Course"*, American Institute of Certified Public Accountants, September 1998

*"Appraisals in the Manufacturing Industry"*, Institute of Business Appraisers' Annual National Conference, February 1998

*"Buying and Selling Private Companies, Divisions and Subsidiaries in Maine"*, Finance Authority of Maine, June 1998

*"Difficult Valuation Issues in Divorce"*, Maine Bar Association, February 1999

*Valuation of Flooring Distributorships*, NRF Distributor Network, 1999

---

*“Accredited in Business Valuation Review Course”*, American Institute of Certified Public Accountants, September/October 1999

*“Ethics and Profits in Business Valuation - Obtainable or Mutually Exclusive?”*, AICPA Annual Business Valuation Conference, December 1999

*“Divorce Valuation: Schizophrenic Valuation at Its Best”*, AICPA Annual Business Valuation Conference, December 1999

*“Lost Profit Damages Are a Natural Extension of Business Appraisal Skills”*, American Business Appraisers’ Annual Conference, May 2000

*Valuation in the Context of Divorce*, CPA Associates Annual Conference, August 2000

*“Buying and Selling a Business the Street Smart Way”*, Street Smart Seminars, June 2000

*“Preparing Your Practice for Litigation Support”*, AICPA Annual Business Valuation Conference, November 2000

*“Litigation Support Roundtable”*, discussion leader, AICPA Annual Business Valuation Conference, November 2000

*“Business Valuation in the Context of Divorce”*, Maine Bar Association, February 2001

*Valuation Game Show Panel*, Institute of Business Appraisers Annual Conference, May 2001

Panel presentation on *“Difficult Valuation Issues Panel”*, Financial Consulting Group Annual Conference, September 2001

*Valuation of Family Limited Partnerships*, Maine State Bar Association, Estate Section, 2001

*“Business Valuation”*, Maine State Bar Annual Conference, October 2001

*“Effectively Using the Expert Witness,”* Roundtable of Judges & Lawyers, 2002

*Taxation of Pass-through Entities*, Financial Consulting Group, September 2002

*Litigation Support and the Business Appraiser*, CPA Associates Annual Conference, August 2003

*Advising Business Owners: Tax Saving Strategies & Planning Considerations*, Lorman Education Services, August 2003

*Valuation of Pass-Through Entities: What’s all the Fuss??*, with Chris Treharne and Jim Hitchner, AICPA National Business Valuation Conference, November 2003

*“Valuation in the Context of Estate & Gift”*, various dates and locations

*“Business Valuation Primer”*, various dates and locations

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