Sub S Valuation: To Tax Effect, or Not to Tax Effect, Is Not Really the Question

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I. Introduction

The valuation of Subchapter S corporations is an important tax related issue for small corporations. For the 2008 tax year, Service data indicates that approximately 4 million Subchapter S corporations, with almost 7 million shareholders and total receipts of over $6.1 trillion, filed tax returns. This represents approximately 69% of the nearly 5.85 million tax returns filed by all corporations. Every year, some Subchapter S shareholders die, some get divorced, and some have disputes with other shareholders. After any of these events, valuation of S corporation shares is necessary to determine estate and gift taxes, divorce settlements, and equitable division of corporate ownership interests, as well as for a variety of other purposes.

The valuation of S corporations by courts is generally accomplished through the use of expert testimony. Because of the restrictions upon S corporations, they are never publicly traded, and therefore, there are no readily available

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3 See generally Jay E. Fishman et al., PPC’s Guide to Business Valuations (19th ed. 2009) (a reference for valuation experts, which has separate chapters on valuations for estate and gift taxes, for divorces, and for shareholder dissent and oppression actions); Tax, Family Law Matters Are Still the Top Revenue Generators, BFWire (Aug. 3, 2011), www.bvresources.com/BFWire/August2011Issue107-1.html (identifying gift and estate tax work as the most significant sources of revenue for business valuation firms, followed by matrimonial and family matters; other types of work listed included valuations in connection with business transactions, fair value studies connected with financial reporting, shareholder disputes, employee compensation issues, and ESOP).
market prices for their shares. As a result, experts in business valuation use a variety of approaches to value private corporations using the facts applicable to the case at hand, certain standard valuation approaches, and their own professional judgment.

What modifications, if any, need to be made to the methods of valuing public companies, where dividends are subject to tax at individual rates, when valuing S corporations, which are not publicly traded and where the dividends would be exempt from tax? For many years, most valuation experts believed that the S corporation status did not deserve a premium in valuation. To avoid overvaluing S corporation earnings, experts routinely “tax effected” those earnings, meaning they assumed the company was subject to the same taxes as regular corporations.

That practice of tax effecting was challenged in 1999, in Gross v. Commissioner. In Gross, the Tax Court agreed with the testimony of an expert testifying for the Service regarding the valuation of an estate as of 1992. Here, the expert testified that tax effecting at normal corporate rates was inappropriate. However, the result of not tax effecting the S corporation’s earnings at the prevailing tax rates meant they would be valued at 67% higher than they would be valued with tax-affecting. Since this decision, the proper way

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5 See George B. Hawkins, Valuation Issues for the Family Business in Estate 861, 873 (2004) (“At the heart of this issue is the nature of the rate of return data used by business appraisers to develop capitalization rates, such as from Ibbotson Associates and Standard & Poor’s. Rate of return data cannot be based on those returns demanded by investors for investing in private companies since the information is not observable or measurable. Therefore, by necessity, appraisers rely on studies based on rates of return (in terms of dividends and capital appreciation) realized over time by investors for investing in the stocks of publicly traded companies. Those publicly traded companies are regular C corporations, whose stated earnings are after the payment of C corporation taxes.”).

6 See Fishman et al., supra note 3.


8 The terms “tax effect” and “tax effect” both appear in the literature on this subject. For the sake of consistency, we have used “tax effect” in this article. In direct quotes, we have followed the language of the authors of the quoted material.

9 See Chris Trehan et al., Valuation of Pass-Through Entities, American Society of Appraisers 23rd Annual Advanced Business Valuation Conference 14 (Oct. 8, 2004) (citing evidence that during the 1990s, 83% of experts routinely tax eaffected Subchapter S earnings, 6% did not, and 11% varied their approach based on circumstances and further remarking that the Service training for its agents through at least 1997 recommended tax affecting); Nancy J. Fannon, Fannon’s Guide to the Valuation of Subchapter S Corporations 1–3 (2008) (“[W]hen determining the value of an S Corporation, it became established practice among valuation analysts to deduct income taxes from the corporate earnings stream.”); see also I.R.S. Valuation Training for Appeals Officers Coursebook, Training 6126-002 (Rev. 05-97), TPDS 87221R.

10 78 T.C.M. (CCH) 201, 1999 T.C.M. (RIA) ¶ 99,254, aff’d, 272 F.3d 333 (6th Cir. 2001).

11 Id. at 203, 1999 T.C.M. (RIA) ¶ 99,254 at 1663 (“Dr. Bajaj determined that a zero-percent corporate tax rate was an appropriate assumption to make in determining the earnings of G&J available for distribution.”).
to value S corporation earnings has been unsettled. As discussed below, in some cases courts have endorsed no premium—or extra value beyond that of a similar C corporation—for S corporations, in some cases a premium around 18%, and in others, such as the Gross decision, a premium as high as 67%.\textsuperscript{12} The appraisal profession considers this a controversial area, with some experts believing no S corporation premium is appropriate, and others endorsing the use of one of a number of different models to measure an S corporation premium.\textsuperscript{13} The disagreement over tax effecting continues, as evidenced by two 2011 decisions—one from the U.S. Tax Court\textsuperscript{14} wherein tax effecting was rejected, and one from the Supreme Judicial Court of Massachusetts\textsuperscript{15} wherein a different approach to the impact of S corporation status was taken.

In Part II we discuss the valuation process in general, and argue that the proper way to address the differential tax status of Subchapter S corporations must include the consideration of currently enacted tax laws. The appropriate valuation method can be complex and has changed over time with changes in federal tax laws. In Part III, we review the courts’ treatment of the issue. Since 1958, there have been three different periods that we believe have called for different valuation treatments. While tax effecting Subchapter S earnings at the corporate rate was a reasonable valuation approach until the early 1980s, it was no longer appropriate at the time of Gross because of changes in the tax laws that are discussed in Part III.B. Similarly, while the decision of the Tax Court in Gross to simply not apply any corporate taxes in valuing the Gross estate produced a reasonable result at the time, subsequent changes in tax laws related to the rate of taxation of dividends from C corporations means that simply not tax effecting is now inappropriate. Finally, Part IV presents our recommendations and our basic conclusion that valuation experts, attor-


\textsuperscript{13}See David Laro & Shannon Pratt, Business Valuation and Federal Taxes: Procedure, Law, and Perspective 79 (2005) (“Valuation of Subchapter S corporations has been one of the most controversial issues the appraisal profession has faced over the last several years.”); see also id. at 99 (“A multitude of theories and viewpoints ensued, with little consensus.”). Models they cite include those proposed by Roger J. Grabowski, Z. Christopher Mercer, Chris D. Treharne, and Daniel R. Van Vleet.


\textsuperscript{15}Adams v. Adams, 945 N.E.2d 844, 867–68 (Mass. 2011). Here, the special master in a divorce case had chosen to tax effect earnings using capital gains rates, and the Massachusetts Supreme Court required the master, upon remand, to provide a clearer explanation of why this might be appropriate. It is not necessarily error that the special master tax effected at a rate different from the rates advanced by both experts. See Fechter v. Fechter, 534 N.E.2d 1, 5 (Mass. App. Ct. 1989) (allowing judge to reject expert opinion altogether and arrive at a valuation on other evidence).
II. The Valuation of Private Companies

A. Legal Standards Governing Valuation in Various Contexts

The law recognizes different standards of value in such different situations as estate and gift tax, shareholder disputes, and divorce.

The valuation of estates and gifts for tax purposes is a well-developed area of valuation. The applicable standard is generally “fair market value.” Revenue Ruling 1959-60 defines fair market value as “the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts.” Fair market values may reflect a premium for control of the company, or a discount for having only a minority interest.

A similar fair market value standard may also be employed in business litigation, where a defendant’s breach of contract or tortious conduct has caused the destruction of a plaintiff’s business or interfered with a plaintiff’s ownership of a business. For example, in *Indu Craft, Inc. v. Bank of Baroda*, the United States Court of Appeals for the Second Circuit reinstated a jury award based on a $4.25 million valuation of a corporation whose business was destroyed by a bank’s failure to honor its letter-of-credit obligations. The court explained:

[W]hen the breach of contract results in the complete destruction of a business enterprise and the business is susceptible to valuation methods, such an approach provides the best method of calculating damages . . . . The methodology of determining a business’s earnings and applying an earnings multiplier to fix the value of a business that was completely terminated is one we have approved.

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16 Valuation guidance to practitioners, such as Fishman and NACVA, devote extensive coverage to the valuation of estates and gifts and cite applicable Service Revenue Rulings, such as Revenue Ruling 1959-60.


19 47 F.3d 490, 492 (2d Cir. 1995).

20 Id. at 496; see also Slattery v. United States, 583 F.3d 800, 819 (Fed. Cir. 2009) (affirming award of $276 million based on market value of bank, including control premium, prior to breaches of contract by FDIC leading to bank’s seizure); 24/7 Records, Inc. v. Sony Music Entm’t, Inc., 566 F. Supp. 2d 305, 317 (S.D.N.Y. 2008) (“The fair market value of the business before its destruction is the most common method of measuring destruction of business damages. . . . Fair market value is usually determined by capitalization of expected future profits.”) (citations omitted).
In contrast, in cases involving the rights of dissident shareholders, the standard is often one of “fair value.”\(^{21}\) In such cases, generally no discount is taken for a lack of control. Ibbotson Associates defined this term as follows:

Fair value is the amount that will compensate an owner involuntarily deprived of property. Commonly there is a willing buyer but not a willing seller, and the buyer may have more knowledge than the seller. Fair value is a legal term left to judicial interpretation. Many consider fair value to be fair market value without discounts.\(^{22}\)

Under the Uniform Business Corporation Act: “‘Fair value,’ with respect to a dissenter’s shares, means the value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable.”\(^{23}\)

This legal definition of fair value differs from that used in the accounting literature. The Financial Accounting Standards Board has defined fair value as “the price that would be received for an asset or paid to transfer a liability in a transaction between market participants at the measurement date.”\(^{24}\) This definition is similar to fair market value as defined above. However, in most cases fair market value, including discounts for lack of control or marketability, will not be well suited as remedies for dissenting shareholders precisely because “a marketability discount cannot be used unfairly by controlling or oppressing shareholders to benefit themselves to the detriment of the minority or oppressed shareholders.”\(^{25}\)

A third concept of value is the investment value—also known as “strategic value”—of an item in the hands of a particular party, based on that investor’s own requirements and expectations.\(^{26}\) In divorce cases, the goal is to have an equitable distribution of marital assets, and a sale of the property is not necessarily assumed. While courts in divorce cases do consider fair market

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\(^{21}\) See, e.g., Delaware Open MRI Radiology Ass’n, P.A. v. Kessler, 898 A.2d 290 (Del. Ch. 2006) (noting that fair value is the valuation standard applied by courts).


\(^{26}\) See NACVA, supra note 23, at 1-21.
value as in tax cases, considerations of fair market value must be weighed in light of the overarching goals of divorce proceedings—for example, equitable distribution. Thus, it is typically appropriate to assume the assets continue in their current use, rather than a sale to some hypothetical buyer, but the appropriateness of this assumption depends on the factual circumstances of the particular case. For example, in *Wechsler v. Wechsler*, the court held that in valuing a holding company owned by the husband, the principal asset of which was securities with embedded tax liabilities, the lower court should have taken into account that the husband would be forced to liquidate securities more quickly and at greater tax expense than he had done historically in order to comply with his equitable distribution obligations.

Under the law, the computation of value is seen as a matter of judgment—in the words of Chief Justice Roberts, “not a matter of mathematics” but “an applied science, even a craft.” As such, courts may, and usually do, consider expert testimony, although expert testimony is not required in every case. Revenue Ruling 1959-60 provides:

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

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28 Bernier, 873 N.E.2d at 220–21 (“where valuation of assets occurs in the context of divorce, and where one of the parties will maintain, and the other be entirely divested of, ownership of a marital asset after divorce, the judge must take particular care to treat the parties not as arm’s-length hypothetical buyers and sellers in a theoretical open market, but as fiduciaries entitled to equitable distribution of their marital assets”).


30 Id. at 125–27.

31 CSX Transp., Inc. v. Georgia State Bd. of Equalization, 552 U.S. 9, 10 (2007).

32 See, e.g., Polak v. Commissioner, 366 F.3d 608, 613 (8th Cir. 2004) (“the fact intensive valuation issue required the Tax Court to weigh the credibility of experts”); Gross v. Commissioner, 272 F.3d 333, 352 (6th Cir. 2001) (“complex factual inquiries such as valuation require the trial judge to evaluate a number of facts: whether an expert appraiser’s experience and testimony entitle his opinion to more or less weight; whether an alleged comparable sale fairly approximates the subject property’s market value; and the overall cogency of each expert’s analysis”) (quoting Ebben v. Commissioner, 783 F.2d 906, 909 (9th Cir. 1986)); Gaskill v. Robbins, 282 S.W.3d 306, 311 (Ky. 2009) (“[W]hen a business is established during a marriage and is thus marital property, the trial court is required to fix a value and divide it between the spouses. To do this, a trial court must hear factual evidence, which generally will include expert testimony.”). But see Portland Natural Gas Transmission Sys. v. 19.2 Acres of Land, 318 F.3d 279, 284 (1st Cir. 2003) (“The judge was entitled to reject the experts’ valuation and to use her independent judgment to determine value.”); Southern Cellular Telecom, Inc. v. Banks, 431 S.E.2d 115, 118 (Ga. Ct. App. 1993) (finding that minority shareholder competent to testify as to value of ownership share).
history of the enterprise from its inception. (b) The economic outlook in
general and the condition and outlook of the specific industry in particular.
(c) The book value of the stock and the financial condition of the business.
(d) The earning capacity of the company. (e) The dividend-paying capacity.
(f) Whether or not the enterprise has goodwill or other intangible value.
(g) Sales of the stock and the size of the block of stock to be valued. (h) The
market price of stocks of corporations engaged in the same or a similar line
of business having their stocks actively traded in a free and open market,
either on an exchange or over-the-counter.33

In general, although employing a variety of terminologies, the courts rec-
ognize three different approaches to valuing private companies. The “income
approach”—also known in some situations as the “discounted cash flow”34 or,
less frequently, the “investment”35 approach—relies on valuing future cash
flows or earnings from the company, and is related to the concepts of “earn-
ing capacity” and “dividend-paying capacity” cited above. This assumes the
company’s highest value will be achieved through continued operations. The
“asset approach” is related to the concept of “book value” cited above but is
not equivalent to it. It relies on valuing separately the individual assets and
liabilities of the company. This assumes the highest value is achieved through
breaking up the company. The “market approach,” related to the last item cited
above, relies on comparing the company to values of comparable companies
whose stock values are known.36 Because it is often hard to identify sales of
comparable companies within a reasonable time period of the valuation date
of a subject company, and because the asset approach is not generally useful
for valuing service companies or companies with significant goodwill, the
most commonly used approach is to value income or cash flow.37

34Cane Tennessee, Inc. v. United States, 71 Fed. Cl. 432, 438 (2005) (“[T]he capitalization
of income approach [is] . . . sometimes referred to as ‘discounted cash flow’ or the ‘present
worth of future income.’”) (quoting Foster v. United States, 2 Cl. Ct. 426, 447 (1983)).
35In re Spielfogel, 211 B.R. 133, 139 (Bankr. E.D.N.Y. 1997) (“[A]n income or capitalized
earnings approach [is] . . . also known as an investment approach.”).
36In theory, if all of the assets and liabilities of the company were liquid, and had measur-
able value separable from the company, the asset and market approaches would give the same
value.
closely held corporations “neither book value, nor sales of stock when they occur, may prove to
be reliable indicators of real worth”).
The law recognizes that the valuations coming from each method are heavily fact dependent. Typically, the trier of fact has great discretion on how much to rely upon expert testimony. Moreover, because valuation is a factual, rather than a legal, question, the standard of review on appeal is highly deferential. If a judge is the trier of fact—as he or she will be in most if not all tax and divorce cases, as well as some contract and tort cases—then an appellate court will generally only reverse the lower court’s decision in the case of “clear error.” Under that standard, if the lower court’s “account of the evidence is plausible in light of the record viewed in its entirety, the court of appeals may not reverse it even though convinced that had it been sitting as the trier of fact, it would have weighed the evidence differently.” In cases where a jury decides matters of valuation, the level of deference on appeal will be even greater.

It is also well established in both law and financial theory that value is affected by taxation. In financial theory, the appropriate discount rate for any investment depends upon how the returns are taxed. The reason for this is straightforward—investors are interested in personal, after-tax cash flows. Hence, if income from two securities is taxed differently, the one with the lower tax will have a lower discount rate. For example, in the U.S., municipal bond yields are typically lower than yields on comparable quality corporate

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38Rev. Rul. 1959-60, 1959-1 C.B. 237, 238. Valuing closely held stock incorporates a number of alternative methods of valuation, and the appellate courts have afforded the tax court broad discretion in determining what method of valuation most fairly represents the fair market value of the stock in light of the facts presented at trial. See Palmer v. Commissioner, 523 F.2d 1308 (8th Cir. 1975); see also Ebben v. Commissioner, 783 F.2d 906, 909 (9th Cir. 1986) ("[C]omplex factual inquiries such as valuation require the trial judge to evaluate a number of facts: whether an expert appraiser’s experience and testimony entitle his opinion to more or less weight; whether an alleged comparable sale fairly approximates the subject property’s market value; and the overall cogency of each expert’s analysis.").

39Okerlund v. United States, 365 F.3d 1044, 1049–50 (Fed. Cir. 2004) (quoting Lukens v. Commissioner, 945 F.2d 92, 96 (5th Cir. 1991)) ("The tax court’s determination of the fair market value of the timeshare units is a finding of fact reviewable under the clearly erroneous standard."); Morris v. Commissioner, 761 F.2d 1195, 1200 (6th Cir. 1985) ("[D]etermination of the fair market value of certain property . . . is a factual one and should not be reversed on appeal unless clearly erroneous.").


41See, e.g., Shane v. Shane, 891 F.2d 976, 978, 981 (1st Cir. 1989) (reasoning that when evaluating jury’s decision concerning valuation of closely held corporation, appellate court is “compelled . . . even in a close case, to uphold the verdict unless the facts and inferences, when viewed in a light most favorable to the party for whom the jury held, point so strongly and overwhelmingly in favor of the [appellant] that a reasonable jury could not have arrived at this conclusion”) (quoting Chedd-Angier Prod. Co. v. Omni Publ’n Int’l Ltd., 756 F.2d 930, 934 (1st Cir. 1985)).

This implies that a different discount rate should be used to value Subchapter S earnings than regular corporate earnings. Subchapter S earnings are taxed only once, when earned by the business, at the individual’s tax rates. In contrast, regular corporate earnings are subject to corporate income tax, and then, when dividends are paid, the dividends are taxed at the individual level. If regular corporate earnings are not distributed as dividends, the shareholder will presumably eventually recognize a capital gain, which will also result in taxation. Presumably, the Ibbotson measures of the premiums investors demand for investing in stocks take cognizance of the fact that the tax paid on dividends and capital gains are on income after corporate tax but before individual level tax.44

Courts’ recognition of the principle that taxation affects valuation follows from the above financial realities. For example, the leading case of Eisenberg v. Commissioner45 addresses the issue of whether a court should consider the future taxation of unrealized capital gains in light of the Taxpayer Relief Act of 1986 (TRA), which repealed existing rules that permitted buyers of corporations with built-in capital gains to avoid taxation on those gains.46 The court reasoned that, because taxation of the capital gains was inevitable under the TRA, any buyer would consider those taxes and reduce the amount it was willing to pay for the corporation.47 Thus, the reduction of the value of the corporation to account for taxes follows directly from the definition of market value—that is, the price a willing buyer would pay for the corporation in an arm’s length transaction. That reasoning has been widely accepted, and as one court recently explained, “after the Estate of Eisenberg, disputes between the taxpayers and the Commissioner focused upon the magnitude of the discount allowable, not the legal right of the taxpayers to claim them.”48


44 A widely used method of computing the appropriate discount rate to use for valuing companies under the income method of valuation is the “Ibbotson Build-Up Method,” which uses data from annual editions of Ibbotson Associates’ Stocks, Bonds, Bills, and Inflation publication to “build up” the discount rate by adding together a risk-free rate, an expected “equity risk premium,” and various other “premiums” or “discounts” related to the size of the company, its industry, or special factors. See NACVA, supra note 23, at 5-13.

45 155 F.3d 50 (2d Cir. 1998).


48 Jelke v. Commissioner, 507 F.3d 1317, 1326 (11th Cir. 2007).
B. The Special Problem of Valuing S Corporations

S corporations were created pursuant to the passage of the Technical Amendments Act of 1958. The election to be treated as an S corporation allows eligible companies to enjoy certain benefits of corporate status under state law—such as limited liability of shareholders—while, in general, not being subject to federal corporate income tax. Instead, corporate income is taxed at the individual level when earned by the corporation. The S shareholder’s basis in stock is increased to the extent of the previously taxed income. Dividends received, or capital gains on stock sales, are not taxed to the extent of previously taxed and undistributed income. C corporation income is taxed twice—at the corporate level, via the corporate income tax, and at the shareholder level, when dividends are paid or capital gains on stock sales are realized. The avoidance of the “double taxation” of corporate income is the primary benefit of S status.

While there is no fee to elect S corporation status, there are various restrictions on S corporations that make this treatment unsuitable for companies that need to access public capital markets. First, the number of shareholders is limited. Originally, the limit was 10 persons. In 1976 it increased to 25, in 1982 to 35, in 1996 to 75, and in 2004 to 100. Second, the type of the shareholders is limited; shareholders cannot include corporations, partnerships, or nonresident aliens. Third, the company can only have one class of stock. Fourth, all shareholders must consent to the election, which, for a public company, is a practical problem. Fifth, if the C corporation had previously been an S corporation, it may not reelect S status without consent.

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50 This Article does not specifically discuss the valuation of limited liability companies (LLCs), but they have pass-through tax status similar to that of S corporations. State-registered LLCs can choose to be taxed like partnerships for federal tax purposes. The rules governing LLCs are somewhat more permissive than those governing S corporations. There is no limit on the number of shareholders or on the types of eligible shareholders. LLCs may also make disproportionate allocations of profits and losses. See I.R.C. § 731(b).
52 Landau, supra note 49.
53 Id.
55 I.R.C. § 1361(b)(1)(D).
56 See I.R.C. § 1362(a) (“(1) In general. Except as provided in subsection (g), a small business corporation may elect, in accordance with the provisions of this section, to be an S corporation. (2) All shareholders must consent to election. An election under this subsection shall be valid only if all persons who are shareholders in such corporation on the day on which such election is made consent to such election.”).
until the fifth following year.\textsuperscript{57} Sixth, a corporation may have liability for tax on "built-in gains" on assets that have appreciated in value before the S corporation election under section 1374(c).\textsuperscript{58} Finally, an S corporation with prior Subchapter C earnings and profits and with net passive investment income totaling more than 25\% of gross receipts is subject to tax on "excess passive investment income" under section 1375(a).\textsuperscript{59}

In contrast, S corporations can become C corporations quite easily. The S corporation election can be formally revoked with the consent of shareholders holding more than 50\% of the stock.\textsuperscript{60} S corporations’ elections will also automatically terminate if they intentionally or unintentionally violate the restrictions on S status and are no longer a qualifying "small business corporation."\textsuperscript{61} When S status terminates, section 1377(b)(1) provides for a transition period during which the distribution of previously taxed but undistributed earnings is treated as a reduction of basis of the stock, not as dividend income.\textsuperscript{62}

The rules on eligibility have implications for valuation. A C corporation that suffers tax disadvantages, when compared to an otherwise similar S corporation, might be unable to avoid these disadvantages by changing status, since it might not be able to meet the S corporation eligibility requirements.\textsuperscript{63} In contrast, if there is a disadvantage to S status, the S corporation can always eliminate the disadvantage by converting. Thus, the eligibility rules imply that the value of S corporations should be either equal to C corporations—when tax advantages are not sizeable—or greater. The possibility that S status could be inadvertently lost could reduce the valuation premium.

There are extensive discussions in the finance and appraisal literature on the valuation of "pass-through" entities such as S corporations, partnerships, and LLC’s.\textsuperscript{64} The appraisal literature typically discusses the same methods of estimating the fair market value of private companies used by the courts—the

\textsuperscript{57} See I.R.C. § 1362(g) ("If a small business corporation has made an election under subsection (a) and if such election has been terminated under subsection (d), such corporation (and any successor corporation) shall not be eligible to make an election under subsection (a) for any taxable year before its 5th taxable year which begins after the 1st taxable year for which such termination is effective, unless the Secretary consents to such election.").

\textsuperscript{58} I.R.C. § 1374 ("(a) General rule. If for any taxable year beginning in the recognition period an S corporation has a net recognized built-in gain there is hereby imposed a tax (computed under subsection (b)) on the income of such corporation for such taxable year."); see also I.R.C. § 1374(d) (definitions).

\textsuperscript{59} I.R.C. § 1375(a).

\textsuperscript{60} I.R.C. § 1362(d)(1).

\textsuperscript{61} I.R.C. § 1362(d)(2).

\textsuperscript{62} I.R.C. § 1371(e) ("(1) In general. Any distribution of money by a corporation with respect to its stock during a post-termination transition period shall be applied against and reduce the adjusted basis of the stock, to the extent that the amount of the distribution does not exceed the accumulated adjustments account (within the meaning of section 1368(e))."); see also I.R.C. § 1368(e).

\textsuperscript{63} See supra notes 51–57.

\textsuperscript{64} See infra note 73.
The focus of this article is upon the income approach, which we believe to be the most commonly used approach for valuing private companies. The asset approach, because it only looks at present assets and liabilities, does not give weight to future earnings power. The market approach, while theoretically valid, is difficult to apply because it requires data about sales of comparable private companies near the valuation date.

Appraisal texts generally agree on the necessary steps an expert must take in computing firm value under the income approach. One necessary step is to project future benefits. Thus, an analyst using free cash flows as the basis of valuation will project future cash flows. Next, the analyst must determine and apply an appropriate discount rate to use. Finally, the analyst may apply discounts for such factors as a lack of control or a lack of marketability, or a premium for control. The selection of the appropriate discount rate is critical and requires judgment. The appropriate discount rate is the rate that an investor would require in order to invest in a comparable investment. It depends on interest rates in the economy, the risk involved with the subject company, and the taxability of the returns. The greater the discount rate, the lower the valuation.

Valuation experts often “build up” a risk-adjusted discount rate using a method and data suggested by Ibbotson Associates. In this method, the analyst “builds up” the discount rate by starting with a risk-free rate, typically a medium-term U.S. Treasury bond rate, and then adding factors to reflect risk—a premium for investing in stocks of large public companies, another premium for investing in smaller companies, a premium or discount reflecting the relative risk of particular industries, and factors specific to the company itself. The premiums for risk for investing in stocks of large public companies, investing in smaller public companies, and the differential risks of different industries are all measured by Ibbotson Associates based upon the long-term excess of the returns that investors in public companies—through a combination of dividends and capital gains—have earned over Treasury bond rates. Public company data are used because private company return data are not available.

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65 NACVA, supra note 23, at 6-1, 6-2.
66 See, e.g., NACVA, supra note 23; see also Fishman et. al., supra note 3.
67 See NACVA, supra note 23, at 6-5 to 6-9, ch. 7.
69 See NACVA, supra note 23, at 5-1 to 5-2 (regarding relations of discount rates to interest rates in the economy and risks involved with the company); see also id. at 5-40 to 5-41 (indicating that “it would obviously be an error to apply pre-tax capitalization or discount rates to after-tax earnings”).
70 See, e.g., Ibbotson Assoc., Inc., supra note 22 (publishing annual yearbooks with tables and data).
71 Id.; see also NACVA, supra note 23, at 5-7 to 5-13.
72 See Ibbotson Assoc., Inc., supra note 22.
Valuation experts face a significant problem in trying to use the income approach to value pass-through entities. The returns measured by Ibbotson are those earned by individuals on dividends and capital gains from C corporations after the corporation has paid corporate income taxes on its earnings but before paying individual level taxes. Owners of S corporations would be liable for personal tax on the earnings of their corporations but would receive subsequent tax-free distributions of these earnings through capital gains or dividends.

Thus, discount rates derived from Ibbotson data may incorrectly measure those actually demanded by S shareholders, leading to incorrect valuations. Whether, and how, to deal with this issue is at the heart of the S corporation valuation problem.

C. A Model for Valuation of S Corporations
In this Part, we discuss a model for valuing S corporations that underlies our analysis of past judicial decisions along with taking into consideration appropriate future policy. Its results are similar in some ways to those of other models in the practitioner literature. However, our approach is more general because it takes financial market equilibrium into account.

As discussed above, fair market value relies upon the presence of a willing buyer and a willing seller. In a free capital market, presumably potential investors would be indifferent between investing in S and C corporations, as long as the after-tax dollar returns are the same. Our analysis identifies situations in which the returns could be the same, the returns for investing in S

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73Market returns would reflect the actions of all market participants. Some market participants, such as pension funds, are exempt from taxes. To the extent that all market participants hold all assets, the tax rates reflected in discount rates depend upon the tax rates of all market participants. However, sometimes only a subset of investors will find it optimal to hold a particular security. As such, low-tax bracket investors have historically held high dividend yield stocks. The after-tax return of such stocks for high-tax bracket investors would be lower than those on low-dividend yield stocks because they can realize returns from the latter in the form of lower taxed capital gains. See John R. Graham & Alok Kumar, Do Dividend Clienteles Exist? Evidence on Dividend Preferences of Retail Investors, 61 J. Fin. 1305, 1315 (2006). This is referred to in the finance literature as a clientele effect. In such cases, the pricing of each asset class would, within limits, depend only on the tax rates and risk preferences of the investors holding those assets. See Philip H. Dybvig & Stephen A. Ross, Tax Clienteles and Asset Pricing, 41 J. Fin. 751, 751 (1986).


corporations would be higher, and the returns for C corporations are higher. In a free market, an S corporation premium would only be justified if the returns were systematically higher.

Assume there are two identical corporations, a C corporation (C) and an S corporation (S) with minimal outstanding debt. Assume they each earn X dollars before payment of corporate income taxes. Let d equal the percentage of income paid out as dividends, and (1-d) equal the percentage of income retained by the company.

There are several types of taxes, which could be at the state or federal level, or both. 76

\[ t_c = \text{the corporate tax rate.} \]
\[ t_p = \text{the personal tax rate on ordinary income.} \]
\[ t_{cg} = \text{the effective personal tax rate on capital gains.} \]
\[ t_d = \text{the personal tax rate on dividends.} \]
\[ t_{eq} = \text{the average personal tax on returns to equity, weighted by d, so } t_{eq} = dt_d + (1-d)t_{cg}. \] Where the tax rates on dividends and capital gains are different, the value of \( t_{eq} \) will vary considerably depending upon dividend policy.

An investor in C would receive returns partly from dividends and partly from allowing earnings to build up in the company, and then eventually selling the stock to capture this built up value. Tax would first be taken at the corporate level, at \( t_c \), and then at the individual level. Dividends are subject to tax at \( t_d \) and capital gains are subject to tax at \( t_{cg} \). The dollar return to the shareholder, \( R_C \), can be found as follows:

\[
R_C = dX(1-t_c)(1-t_d) + (1-d)X(1-t_c)(1-t_{cg})
\]

This simplifies to:

\[
R_C = X(1-t_{eq})(1-t_c)
\]

An investor in S would similarly receive returns equal to the earnings of the company, reduced by personal level taxes. Since the same tax treatment applies whether the money is distributed or held in the company, the return, \( R_S \), can be expressed as:

\[
R_S = X(1-t_p)
\]

For an investor to be indifferent between investing in S and C, the two returns must be equal. This means that:

\[
X(1-t_{eq})(1-t_c) = X(1-t_p)
\]

76 We assume throughout that there is no state tax at the corporate level on S corporation income.
Or, equivalently, the indifference condition can be written as:

\[(1 - t_{eq}) = (1 - t_p) / (1 - t_c)\]  

(5)

This model has six important simplifying assumptions, all of which would tend to favor the S corporations. First, we did not consider the impact of any debt financing. As discussed by Jalbert,77 C corporations would benefit more from leverage than S corporations under most tax regimes. Second, we did not include any impacts on valuation of the restrictions imposed in order to keep S status. Third, we assumed that S shareholders are indifferent between receiving current dividends and later capital gains, adjusting for the time value of money. Since S shareholders are subject to personal tax bills, they may in fact prefer current distributions, at least to the extent of the tax liability. Fourth, we assume that C corporations do not re-characterize payments to owner–employees as salary rather than dividends to avoid double taxation by lowering corporate level income.78 Finally, we assumed that there were no state or local corporation-level taxes on S corporation income.

The model has the following important implications:

1. The left side of equation (5) is the after-tax return to the C shareholder from dividends and capital gains. Its value will depend on both the tax rates applicable to those two types of returns and the dividend policy.

2. There are plausible combinations of dividend policy and tax rates that will allow equation (5) to be satisfied. If a C corporation can counteract the S corporation advantage by choosing an appropriate dividend policy, then the marginal investor should be indifferent between investing in S and C corporations. In this case, there should be no appreciable valuation advantage to the S status.79

For example, assume taxes on personal income and dividends were both 65%, corporate tax rates were 48%, and capital gains taxes were 7%

\[\text{Jalbert, supra note 74.}\]

\[\text{Compensation in the form of salaries and bonuses is generally deductible from corporate income, while shareholder dividends are not. While the Service may challenge the deductibility of unreasonable compensation to shareholders, small corporations whose owners work in the business and whose profits are not too extreme may have some flexibility to lower reported income in this manner. Owners of S corporations, subject to only a single level of tax, have no such incentive. Indeed, since salaries and bonuses—but not profits—are subject to FICA and Medicare taxes, there is an incentive to reduce compensation expense and increase profits. See James Reto, A Simplified Method to Value an S Corp Minority Interest, 10 Shannon Pratt’s Bus. Valuation Update, July 2004, at 10 (indicating this practice is common). However, there are limits to the usefulness of this strategy since, under the tax law, excessive compensation paid to an owner–shareholder may be treated by the Service as dividend income. See U.S. Master Tax Guide (CCH) ¶ 715 (2012).}\]

\[\text{Merton H. Miller & Myron S. Scholes, Dividends and Taxes, 6 J. Fin. Econ. 333 (1978) (arguing that through the judicious use of life insurance policies, it was possible to avoid taxes on equity income from C corporations altogether).}\]
a relatively low 25%. Then the right hand side = 0.35/0.52, or about 0.67. This implies the average tax on equity returns must = 1-0.67, or about 33%. The company could achieve this average tax burden by distributing 20% of its earnings as dividends, and reinvesting 80%. If it distributed even less in dividends, the tax burden would be lower than the S corporation’s.

3. There are also combinations of tax rates that give the S corporation an advantage that no dividend policy can overcome. If corporate tax rates are higher than ordinary personal income tax rates, the S corporation form will always allow its shareholders to enjoy a lower tax burden, even if capital gains and dividend taxes were zero. As a second example, if corporate tax rates, while lower than personal rates, are not sufficiently lower, and taxes on dividends and capital gains are not low enough, then (1- tP)/(1- tC) will be higher than both (1-tcg) and (1- tD). In this case, no dividend policy will allow the equation to be satisfied.

4. If shareholders insist on a minimum level of dividends and tax rates on capital gains are lower than those on dividends, then some companies will not be able to use all the advantages of the C form and will have to choose the S form due to the “clientele effect” of shareholders who want cash dividends. If there is a marginal investor, he or she should be able to exploit the mispricing. If there are no marginal investors, then S corporations will be favored.

5. There are combinations of tax rates that give C corporations a clear advantage. Relatively high personal taxes, and low corporate, dividend, and capital gains rates, would disadvantage S shareholders. In this situation, one would expect profitable S corporations to convert to C status. Since S corporations can convert readily, one would not expect to see a lower valuation for S corporations.81

When tax rates give a clear advantage to the S corporation, one would expect to see two effects. First, the number of C corporations should decline relative to S corporations.82 However, because of the restrictions on the numbers and types of shareholders of S corporations, and because of the existence of taxes upon built-in gains, the number of C corporations would be unlikely to go to zero. Second, the value placed on the pretax earnings of S corpora-

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80 See infra note 98.
81 However, the number of S corporations would probably not go to zero. Shareholders of unprofitable corporations might prefer the S form because the tax losses would be currently deductible in their individual tax returns. Organizations whose incomes fluctuate widely might hesitate to end the election, since there is a waiting period for resuming it.
tions should be higher than that placed on C corporations’ earnings. It would be appropriate to multiply the S earnings by \( \frac{(1-t_p)}{(1-t)(1-t_{eq})} \). It should be kept in mind that the relevant tax rates to use in the computation of this adjustment factor are not the maximum rates, but rather the tax rates of the marginal investor—the investor who is indifferent between investing in a C corporation or in an S corporation. Furthermore, the capital gains tax rate implicit in \( t_{eq} \) is the present value of the tax rate that will be paid when the capital gains are realized.

III. The Evolution of Judicial Approaches to Valuation of S Corpsorations

It can be posited that the treatment of S corporation valuation by the courts should be viewed separately and divided into three distinct time periods, each corresponding to changes in key tax rates. This is because the appropriate valuation method has changed over time.

Two tables have been provided to give empirical context to this discussion. Table 1 summarizes the maximum rates of federal tax in effect for corporate income, ordinary personal income, capital gains, and dividends from 1960 to the present. It also includes a column listing the factor by which S corporation earnings would need to be multiplied, according to the formula presented in Part II.C, and assuming maximum rates are the applicable rates, to reflect a premium associated with favorable tax treatment in valuation. Table 2 summarizes the relative number of business entities filing C corporation, S corporation, and partnership returns with the Service in various years.

A. The Period from 1958 Through 1981

From 1958, when Congress first created S corporations, through 1981, maximum personal tax rates fell from 91% to 70% and were always at least 22 percentage points higher than the corporate rates during the same period—48% to 52%. The result was that there was no clear advantage to the S election as long as a C corporation retained enough earnings. While S corporations escaped double tax, the combination of corporate tax and capital gains tax was actually lower than the personal tax, so corporations that did not need to distribute all their earnings as dividends could have an advantage. The last column of Table 1 shows that the minimum premium factor in this period is less than one, meaning S corporation shareholders could be disadvantaged. Not surprisingly, the C corporation was the dominant form chosen for structuring a business. S corporations were only about 16%, 18%, and 20% of all corporations in 1970, 1975, and 1980, respectively.

83 See infra Table 1.
84 See infra Table 1.
85 See infra Table 1. We have not shown the maximum premium factors, which occur if the corporation pays out all its earnings as dividends. Note that we are concerned with comparing the S tax burden with that of optimally run C corporation.
86 See infra Table 2.
For example, in 1978, ordinary income and dividends were taxed at maximum rates of 70%, corporate income was taxed at 48%, and capital gains at 36.5%. Assume that a hypothetical corporation had $1,000 in pretax earnings. If it were an S corporation, a shareholder in the top tax bracket would pay tax of $700 and would enjoy a remaining value of $300, either as an increase in retained earnings of his or her company or as dividends. If it were a C corporation, the company would pay $480 of tax and would have $520 left to distribute. If it paid dividends of around $90 and retained $430, the individual level tax on the dividends and the eventual capital gains would leave the shareholder with a remaining value of the same $300 available to the S shareholder.

In this period, it made sense to assume that earnings of an S corporation would not command a valuation premium for several reasons. As noted above, there was no tax advantage over a C corporation with an appropriate dividend policy. In addition, it was logical to assume that a likely buyer would be a C corporation. From the data in Table 2, as of 1980 S corporations were only about 20% of all corporations. Service data also indicate that S corporations tend to be smaller. Since the S corporation election would terminate upon the sale of shares to a C corporation, no C corporation would pay a premium for a benefit it could not enjoy. Finally, the restrictions on S shareholdings at this time were quite significant. As noted above, at this time the number of shareholders was still limited to 25.

While S corporations would not command premiums, neither should they suffer a penalty upon sale, since any S corporation could convert to a C corporation at minimal cost. Therefore, it was sensible to value S earnings as if the company was an equivalent C corporation. The easiest way to perform such a valuation was to assume the S corporation was subject to corporate income tax, tax effect its earnings, and then use a discount rate drawn from empirical studies of C corporations.

The practice of tax effecting became well established in this period. In the 1975 Tax Court case of *Estate of Hall v. Commissioner*, both experts assumed that corporate taxes should be applied when valuing an S corporation. In 1980, in *Maris v. Commissioner*, both experts and the Tax Court imputed tax on an S corporation using a 46% rate. In 1982, a law review article by Harry Haynsworth recommended adjusting the income of partnerships, proprietorships, and S corporations to assume they were subject to corporate taxes.
B. The Period from 1982 Through 2002

In 1982, Congress reduced individual tax rates substantially, from 70% to 50%, and brought them closer to corporate tax rates.\footnote{See infra Table 1.} As a result, there was now an advantage to the S corporation election that could not be overcome by a well-chosen C corporation dividend policy. As shown in Table 1 in the Appendix, in 1982 and 1984, a shareholder of an S corporation would retain 1.16 times the amount of pretax earnings that would be kept if his or her company had not made the S election. After the 1982 change to the tax rates, by 1986 the proportion of all corporations that filed S returns increased from 20% to 24%.\footnote{See infra Table 2.} It is not clear if the 1.16 premium factor was large enough to convince valuation experts that there was in fact a need to consider S corporations more valuable than C corporations. In 1986, 76% of all corporations were C corporations, which could not enjoy any benefits if they bought an S corporation, since, as discussed above, S corporation status requires that no shareholders be corporations.\footnote{See supra note 54 and accompanying text.} The factor was computed considering only federal taxes, and state taxes might reduce the size of the premium. If experts determined the premium was \textit{de minimis} and that S corporation pretax income should be valued consistently with C income, then continuing to tax effect was defensible.

One could speculate that valuation experts would have been tempted to continue to tax effect after 1986 for two additional reasons. First, keeping a consistent approach would probably enhance the expert’s credibility in judicial proceedings. Second, a large part of the valuation practice involved preparing gift and estate valuations. Continuing to tax effect meant that clients would pay lower taxes. As long as the courts and Service were not challenging the practice, an expert who systematically valued private companies higher than the rest of the profession might have greater difficulty obtaining clients.

In 1986, Congress made significant changes to rates,\footnote{Congress reduced the corporate income tax rates by 14% in 1986. See Tax Reform Act of 1986, Pub. L. No. 99-514, § 601, 100 Stat. 2085, 2249.} and by 1988, individual rates were reduced from 50% to 28%. Capital gains were treated the same as ordinary income, instead of being favored as they had been previously, and were also taxed at a maximum rate of 28%.\footnote{See supra note 54 and accompanying text.} Corporate income rates were reduced from 48% in 1986 to 34% in 1988, but in 1988, they were higher than individual rates for the first time. As a result, the S corporate structure now appeared to have a significant tax advantage. Table 1 shows that the premium factor rose from 1.16 in 1984 to 1.52 in 1988, and it stayed at close to that level for several years. This meant an S shareholder would keep 52% more money after tax than if his corporation had not made the election.
One would expect that such a major advantage would affect corporate decisions, and it did. As Table 2 indicates, the number of S corporations more than doubled from 1986 to 1992, increasing from 0.83 million to 1.73 million. In the same period, the number of C corporations fell from 2.60 million to 2.08 million, a 20% decline. While tax law changes in 1993 made the top tax rates for individuals only about 4% higher than for corporations, thereby reducing the S advantage, the number of S corporations grew from 1994 to 2000 and the number of C corporations continued to fall. By 2002, 60% of corporate tax returns were being filed by S corporations. If one looks at businesses more broadly, including proprietorships, partnerships, LLC’s, and S and C corporations, all but the C corporations are “pass-through entities” where business-level income “passes through” to the individual owners’ tax returns without a business-level federal income tax. The proportion of businesses that were C corporations fell from 16.6% in 1980 to 8.0% in 2002. As a result, it was no longer obvious that the most likely buyer of an S corporation would be a C corporation.

It is also likely that C and S corporations were becoming more distinct. The remaining C corporations must have been systematically different from S corporations. One example of the difference is that C corporations were dependent on raising capital through public equity markets. The data clearly indicate that the average taxable corporation was larger and more profitable. An examination of Service data on returns filed between 1987 and 1992 indicate that, over this period, the average total reported receipts per return for taxable corporations was between 3.9 to 4.7 times greater than the receipts shown for S corporation returns, and the average reported net income was between 5.7 to 8.8 times higher.

As a result of these dramatic shifts in tax rates, receipts, and reported income, it would not be surprising to expect a change in valuation practice. In 1988, Aaron Schackleford looked at examples of the impact of the Tax Reform Act of 1986 on the relative value of earnings from S and C corporations and found the S corporation could have some significant advantages.

There is also a body of finance literature dealing with the impact of taxation on valuation. For example, if shareholders fell into different tax categories, a “clientele effect” might affect value. If, as speculated above, C and S

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96 Petska, supra note 87, at 12; see also David A. Guenther, Taxes and Organizational Form: A Comparison of Corporations and Master Limited Partnerships, 67 Acct. Rev. 17 (1992) (providing another example of how tax considerations affect the choice of organizational form).


99 Clientele effect refers to where the investors in one kind of security differ in character—that is, risk aversion, tax bracket, or liquidity preference—from those in another kind of security.
corporations started to become more distinct during this period, it is likely that individuals choosing to invest in S corporations would have tended to be different from those investing in C corporations. As long as there are some investors who are indifferent between investing in C corporations and in S corporations, a clientele effect will not imply differential pricing. That is, the same pricing equation can be used to price S corporations and C corporations—with or without tax effecting as discussed above. However, when the individuals investing in the two types of corporations are entirely different, then a clientele effect in pricing would occur as well. In such a case, valuing S corporations using a discount factor derived from the market prices of C corporations might be inappropriate. In such cases, additional adjustments need to be made for different risk preferences of S corporation investors, as well as their dividend preferences and their tax brackets.\(^{100}\)

Then in 1991, the case of *In re Radiology Associates*\(^{101}\) found itself before the Delaware Court of Chancery. This case required the court to determine the fair value of dissenting shareholders’ interests.\(^{102}\) The court explicitly chose to discount S corporation cash flows without making any deductions or additions for taxes.\(^{103}\) While rejecting the specific adjustment to value proposed by the plaintiff’s expert—Anne Danyluk, a manager of valuation services at Coopers and Lybrand\(^{104}\)—the court stated “I believe that her ultimate goal of treating Radiology according to its nontaxable nature is meritorious.”\(^{105}\) The Court also noted that the opposing expert—Charles Stryker of the Benchmark subsidiary of KPMG Peat Marwick\(^{106}\)—had not deducted taxes in his earnings analysis:

Finally, and most importantly, under an earnings valuation analysis, what is important to an investor is what the investor ultimately can keep in his pocket. . . . Thus, I believe that ignoring taxes altogether is the only way that the discounted cash flow analysis can reflect accurately the value of Radiology's cash flows to its investors.\(^{107}\)

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\(^{102}\) *Id.* at 485.

\(^{103}\) *Id.* at 494–95.

\(^{104}\) *Id.* at 494.

\(^{105}\) *See id.*

\(^{106}\) *Id.* at 495.

\(^{107}\) *Id.*
There was no specific discussion of the merits of adjusting S corporation earnings in *In re Radiology Associates*. Likewise, a New York court similarly made no deduction for taxes in the 1997 case *In the Matter of the Dissolution of Bambu Sales, Inc.*, a case involving minority shareholders. The court was required to find the fair value of a minority interest as of April 1995. The court decided that neither the net asset approach nor the market approach to valuation was appropriate, so it relied on the “investment method,” which is referred to herein as the income approach.

Both experts agree that the investment value method capitalizes the adjusted income stream of the business entity as well as an average assumed rate of return on the owner’s investment to establish the valuation. The income stream is determined by adjusting the historical earning of the company, certain nonrecurring or unusual expenses, interest expenses and the add-back of the owner’s compensation and benefits.

It is noteworthy that the court mentions no adjustment for taxes. In the court’s computation of value, contained in a table, the court discounted pre-tax earnings. Thus, the effect was the same as in *In re Radiology Associates*—corporate level taxes were ignored. Despite this fact, there remained considerable momentum for the practice of tax effecting throughout most of the 1990s. The Delaware Court of Chancery, in *In re Radiology Associates*, is just one example of the rejection of the argument that adjusting the value of S corporations upward was a widely accepted valuation practice. One of the experts in *Gross* testified that, as of 1992, tax effecting was the dominant practice. One factor may be that the Service did not object to tax effecting in gift tax cases, and it would be a rare private expert who would systematically advise clients to pay more tax than the Service requested. As cited in *Gross*, the Service had accepted gift tax returns for the subject company in 1988 that imputed corporate taxes. A 1997 Service training material for agents advocated tax effecting S earnings.

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109 *Id.* at 614.
110 *Id.* at 615.
111 *Id.* at 616.
112 *Id.* at 617.
114 *Id.* at 494 (“Plaintiff’s only authority for adjusting a valuation analysis in order to account for S-Corp. status is one article: Shackelford, Valuation of ‘S’ Corporations, 7 Bus. Valuation Rev. 159 (1988). Whatever ‘generally considered acceptable in the financial community’ means, plaintiff clearly has not met this standard by relying on one article by a relatively unknown author.”).
116 See *id.* at 348.
In *Gross*, the issue was the valuation of stock in an S corporation that had habitually distributed substantially all of its income in annual dividends. The taxpayer’s expert—David O. McCoy—tax effected the company’s stock, using an estimated combined state and federal tax rate of 40%. The Service’s expert—Dr. Mukesh Bajaj—challenged the concept of tax effecting earnings. He argued that the shareholders did benefit from the elimination of double taxation, and thus tax-affecting was not necessary or appropriate. He did not explicitly consider any shareholder level taxes. The result was a valuation premium of 67% compared to a C corporation. The Tax Court sided with the Service, and the Sixth Circuit, in a split decision, affirmed the lower court’s decision, finding that the Tax Court’s acceptance of valuation without tax effecting was “not clearly erroneous.”

Do the verdicts in *Gross*, *Bambu*, and *In re Radiology Associates* comport with the analysis presented earlier in this article? The answer is yes, but only because of the particular fact pattern during the 1982–2002 time period within which the valuations for those cases took place. The model offered above in Part II.C indicates that it would be appropriate, in valuing the S income, to multiply it by \((1-t_p)/(1-t_f)(1-t_{eq})\). The facts in the three referenced cases were that the parties involved were wealthy, so it was sensible to assume the maximum tax brackets were applicable. Due to the companies’ dividend policies of distributing substantially all income each year, there were minimal retained earnings subject to capital gains rates, so the tax on equity income using our formula would be essentially just the tax on dividends. In 1992, the year of the valuation in *Gross*, the tax rate on dividends and the tax rate on personal income were the same. Federal tax rates, for individuals in the top brackets, were 40%. That means that the offered formula would yield a value of \((1-0.4)/(1-0.4)(1-0.4)\), or 1.67. This is the same valuation premium as was arrived at by the Tax Court by simply not tax effecting. The

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118 See *Gross*, 272 F.3d at 335.
119 See *id.* at 337.
120 *Id.* at 352.
121 *Id.* at 340–43.
122 *Id.*
123 *Id.* at 351, aff’g *Gross* v. Commissioner, 78 T.C.M. (CCH) 201, 1999 T.C.M. (RIA) ¶ 99,254.
124 See infra Table 1.
125 See infra Table 1.
math for the Delaware and New York cases would be similar.126

As a general matter, not tax effecting is no substitute for the more thorough analysis implied by the model presented above in Part II.C. While in the general case, the tax rate on C corporation income, the individual ordinary rate, and the rate of tax on C corporation dividends would all differ, the three rates were approximately the same at the time of Gross, Bambu, and In re Radiology Associates. In the general case, the individual level tax on C corporation income ($t_e$), would reflect a blend of the tax on dividends and the ordinary income rate. However, in the aforementioned cases, all the income was paid out as dividends, making the capital gains rate irrelevant.

In several subsequent Tax Court cases, the Court refrained from tax effecting S earnings. In Wall v. Commissioner, the Tax Court criticized both experts’ practice of tax effecting.127 In Estate of Adams v. Commissioner, one expert adjusted the discount rates from Ibbotson Associates to a higher, pretax level, while the other expert did not.128 The court chose the approach of not adjusting the discount rates to reflect taxes.129 In Estate of Heck v. Commissioner, neither of the parties’ respective experts tax effected the S corporation’s earn-

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126 The valuation date in Bambu was in 1995. Per Table 1, applicable 1994 federal tax rates were 40% on individual income, 35% for corporate income tax, and 28% for capital gains. If such a Subsection S company were assumed to distribute all earnings as dividends each year, the federal tax burden on the shareholders would be 35%, meaning they retained 65% of pretax income. The total tax related to a comparable C corporation would be 35% at the corporate level, and 26%—equal to 40% of 100% minus 35%—at the individual level, or a total tax burden of 61%, leaving the shareholders with 39% of pretax income. The ratio of the net funds left for S shareholders to funds left for C corporation shareholders in this situation is 1.53 to 1, which is the same ratio as the ratio of nontax effected income to income tax effected by 35%—100 to 65, or 1.53. The valuation date in In re Delaware Associates was in 1987. The applicable corporate rate was 40%. Internal Revenue Service, SIO Tax Stats—Historical Table 24 (Mar. 31, 2011), available at http://www.irs.gov/taxstats/article/0,,id=175911,00.html. The top individual rate was 38.5%. Internal Revenue Service, SIO Tax Stats—Historical Table 23 (Sept. 29, 2011), available at http://www.irs.gov/taxstats/article/0,,id=175910,00.html. Using similar computations as above, 61.5% of pretax S corporation income would flow through to shareholders after tax, as opposed to 36.9% of C corporation pretax income. The ratio of the net funds left to S shareholders to that left to C corporation shareholders is 61.5 to 36.9, or 1.67. This is exactly the same as the ratio of S earnings before a 40% tax effect and after a 40% tax effect.

127 81 T.C.M. (CCH) 1425, 2001 T.C.M. ¶ 2001-75. The court disliked the income approaches used by both experts, in part because both tax effected the earnings. “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.” Id. at 1439 n.25, 81 T.C.M. (CCH) 1425, 2001 T.C.M. ¶ 2001-75, at 592 n.25.


129 See id. at 1425, 2002 T.C.M. (RIA) ¶ 2002-80, at 456–57.
ings, and the court did not object.130

The valuation community initially disagreed with the Tax Court’s decisions that rejected tax effecting. George B. Hawkins and Michael Paschall, in their article *A Gross Result in the Gross Case: All Your Prior S Corporation Valuations are Invalid* referred to the decision as a “bombshell.”131 Shannon Pratt, commenting on the Tax Court cases, said:

> It is my opinion that these cases, if allowed to stand unchallenged and cited as precedent, represent bad case law and a misinterpretation of fair market value. Taxes on S corporation earnings have to be paid. Denying tax-affecting of the earnings limits the pool of potential buyers to nontaxable entities. I believe we will see some modification of these results in appeals of these cases or in future cases.132

Pamela Packard, Vice Chairman of BDO Seidman’s tax services, wrote in 2002 that:

> S shareholders are free to continue tax-affecting the valuations of their shares with the hope of achieving a different result in another circuit. (There was a strong dissent in *Gross.*) They may also be able to distinguish the facts of their situation from those in *Gross*, in which the longstanding practice had been to distribute virtually all corporate earnings on a current basis. This made the amount of future cashflow more highly predictable than would normally be the case.133

Lester Barenbaum and Lisa Cruikshank argued that it was not necessary to tax effect S corporations, since C corporations routinely avoid double taxation by using bonus to distribute profits.134

Over the period between 2000 and 2003, a number of academic articles were published that took a more thoughtful approach to the question of whether, and how, taxes should be reflected in the valuation of S corporations.

130 83 T.C.M. (CCH) 1181, 1188 n.7, 1189, 2002 T.C.M (RIA) ¶ 2002-34, at 182 n.7, 187 (“We modify Dr. Bajaj’s approach only to take into account small amounts of other income, which he takes into account in his rebuttal testimony. Dr. Bajaj’s projected profit margin, based upon an unweighted arithmetic average of operating margins from 1990-1994, and including ‘other income’ (interest and ‘Heck Cellars’ revenue), is 12.3%. We find that to be the proper assumed operating margin for purposes of determining Korbel’s value on the valuation date under the DCF method.”).
In 2000, Tyler J. Bowles and W. Chris Lewis published a formula, based on then-existing tax rates, to compare the worth of C and S corporations under various individual, corporate, and capital gains tax rates. In 2002, John E. Finnerty also concluded that in a minority interest situation, S corporations should command a premium, and in 2005, Michael Hawkins expressed a similar opinion. In 2002, David J. Denis and Atulya Sarin published an article comparing the relative worth of S and C corporations on theoretical grounds. Under then-current law, they could justify a premium as high as 54%. They also used data from 1984 and 1985 on publicly traded master limited partnerships to test whether pass-through entities did indeed have higher values, as they predicted. They found premiums ranging from 12% to 24% for the pass-through entities. Terrence Jalbert, in a 2002 article in the American Business Review, developed a theoretical model to compare the values of companies subject to double taxation with similar entities with pass-through tax status. The differences in values depended on relative individual, corporate, and capital gains taxes, as well as how much debt the companies had in their capital structure. If debt existed as a source of financing, the advantage of the pass-through status would be lower. Jalbert tested his hypotheses on a sample of master limited partnerships in the 1980s and found that the value per dollar of net income of the pass-through entities was higher than that of entities subject to double taxation.

There were also a variety of articles by valuation practitioners that agreed that, under certain circumstances, there could be an S corporation premium. In 2000, Carla G. Glass and Susan L. Mueller gave a presentation to a meeting of the American Society of Appraisers, in which they concluded that, under certain tax rates and dividend polices, S corporations would have an advantage. In 2001, Mark S. Luttrell and Jeff W. Freeman argued that tax effecting S corporation income in the traditional fashion would undervalue S corporations in divorce cases. Luttrell and Freeman note that the standard of value in a divorce case is often not based upon some hypothetical sale, but

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135 Bowles & Lewis, supra note 74, at 175–79.
136 Finnerty, supra note 74.
138 Denis & Sarin, supra note 74, at 9.
139 Id. at 10.
140 Jalbert, supra note 74, at 49.
141 Id.
142 Id. at 50.
143 Id. at 54.
145 Mark S. Luttrell & Jeff W. Freeman, Taxes and the Undervaluation of ‘S’ Corporations, 15 AM. J. FAM. L. 301, 301–06 (2001); see also id. at 301 (noting the authors have both the CPA and ABV credentials).
upon the investment value in the hands of the current owner.146 Similarly, Russell T. Glazer discussed some different scenarios of dividend practices and tax rates, and he concluded that the cash flows to S and C shareholders differed in a clear and measurable way and that it was important to thoroughly analyze the specific facts involved in the valuation at hand.147 Tax effecting at the corporate rate may not be supportable for companies that distribute all their earnings.148

During this period, empirical studies on differences in the value of S and C corporations did not arrive at a consensus. While the Dennis–Sarin and Jalbert studies found a premium in the valuation of master limited partnerships in the 1980s, a two-part article by Michael J. Mattson, Donald S. Shannon, and David E. Upton found no significant difference in general in the ratio of value to corporate sales in their sample of 2,487 transactions listed in the Pratt’s Stats database between 1991 and 2002.149 A study by M.M. Erickson and S. Wang published in 2007—dealing with pairs of acquisitions of S and C corporations from 1996 through 1999—compared sales prices of 77 matched pairs of corporations and found typical acquisition S corporation premiums of 12% to 17% of deal value.150 A study by James DiGabriele, using a very small sample, found no significant valuation differences.151


The Jobs and Growth Tax Relief Reconciliation Act of 2003152 “temporarily” made qualified dividends from domestic companies taxable at capital gains rates, rather than at ordinary income rates.153 This change, as enacted by the Tax Increase Prevention and Reconciliation Act of 2005,154 was effective for dividends paid in the period January 1, 2003, through December 31, 2010.155 The maximum tax on capital gains was lowered to 15%. When the provision expired, dividends were once again to be taxable at ordinary rates. Late in

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146 Id. at 304.
148 See id.
149 Michael J. Mattson et al., Empirical Research Concludes S Corporation Values Same as C Corporations Part 1, 8 Shannon Pratt’s Bus. Valuation Update, Nov. 12, 2002, at 5; see also Michael J. Mattson et al., Empirical Research Concludes S Corporation Values Same as C Corporations Part 2, 8 Shannon Pratt’s Bus. Valuation Update, Dec. 11, 2002, at 2 (noting also that some premium was found in the largest organizations in the sample).
153 Section 302 set the lower tax rates, and section 303 is the “sunset provision.”

Per the model set forth in Part II.C, this change in dividend tax rates should reduce the tax advantage of S corporations. In 2004, the individual tax rate, the corporate tax rate, and the capital gains tax rates were, respectively, 35%, 35%, and 15%.\footnote{See infra Table 1.} Using the Part II.C model, the value of the S corporation can be found by multiplying the C value by \( (1-t_p)/(1-t_c)(1-t_{eq}) \). Since the capital gains rates and dividend rates are the same, regardless of dividend policy, \( t_{eq} = 15\% \). This equals a multiplier of 1.176, meaning the S status has a 17.6% premium. This computation ignores the expiration rate of the capital gains treatment of dividends.\footnote{If the subject company was evaluated near the scheduled expiration date of December 31, 2012, and it distributed all its earnings, a premium of 53.8% would be appropriate.} While it may well be that most market participants expected Congress to extend the temporary provision, it should be noted that the financial accounting rules for dealing with future tax liabilities require them to be measured at the enacted rates scheduled to be in effect in those years.\footnote{Accounting For Income Taxes, Statement of Fin. Accounting Standards No. 109 (Fin. Accounting Standards Bd. 1992), at ¶ 18, available at http://www.fasb.org/pdf/aop_FAS109.pdf.}

Note that 17.6% is not the premium that would be computed by simply not tax-effecting by the corporate rate, which would produce a premium equal to 53.8%.\footnote{A hypothetical S corporation with pretax income of $100 would be assumed to retain it all. An otherwise identical C corporation would only retain $65 after 35% corporate taxes. The ratio of $100 to $65 is 1.538, meaning a premium of 53.8% exists.} A number of articles in the valuation literature acknowledge that computing an S corporation premium involves considering dividend policy as well as individual, corporate, capital gains, and dividend tax rates, and that simply tax effecting or not tax effecting would not yield a correct answer.\footnote{See Grabowski, supra note 74; Nancy Fannon, Please . . . Not Another S Corporation Debate, 12 Bus. Valuation Update 1 (2006); see also Franklin M. Fisher et al., The Sale of the Washington Redskins: Discounted Cash Flow Valuation of S-Corporations, Treatment of Personal Taxes, and Implications for Litigation, 10 STAN. J.L. BUS. & FIN. 18, 21 (2005) (arguing that a discounted cash flow analysis of an S corporation should adjust cash flows “to reflect its owners’ personal tax burdens”).} Valuation texts presenting a variety of models include James Hitchner’s \textit{Financial Valuation: Application and Models},\footnote{James R. Hitchner, \textit{Financial Valuation: Application and Models} 569–632 (2d ed. 2006). Chapter 11 presents four different models, plus another in an addendum.} Nancy Fannon’s \textit{Guide to the Valuation of Subchapter S Corporations},\footnote{See supra note 9.} PPC’s \textit{Guide to Business Valuations},\footnote{Fishman et al., supra note 3.} and a text published by the National Association of Certified
Valuation Analysts.\(^{165}\)

A cursory review of judicial opinions since 2003 would leave a reader confused as to the appropriate method of treating S income. The courts have varied in their appreciation of the impact of the change in tax laws on dividends upon the decision to tax effect or not. A range of decisions, discussed below, have included some where S corporation income was tax effected at corporate rates, some where it was not tax effected at all, and two where a premium similar to that given in the Part II.C model was computed. However, a closer review of the cases indicates the courts have generally, but not always, come to reasonable decisions on the facts presented to them.

In some cases in and shortly after 2003, the valuation date used was before dividends were given special treatment, so it was reasonable that the argument continued to be over tax effecting or not. Just one example is the 2006 case *Dallas v. Commissioner*, which dealt with gifts of stock in 1999 and 2000. In this case, the Tax Court decided that tax effecting was not appropriate.\(^{166}\) In the Rhode Island divorce case of *Vicario v. Vicario*, the valuation of the spouse’s business used data from 2002 even though the divorce proceedings were initiated in 2001.\(^{167}\) The Family Court, faced with experts who disagreed on whether tax effecting was proper, chose not to tax effect, and the Supreme Court of Rhode Island did not reverse.\(^{168}\) As discussed above, when corporate, individual, and dividend rates were similar, the results from simply not tax effecting approximated those given by the Part II.C model.

In other cases, the courts’ decisions do not correspond with the Part II.C model. The lower court decision in *Bernier v. Bernier*, which dealt with a valuation as of 2000 in a divorce case, decided to tax effect.\(^{169}\) This decision was later reversed.\(^{170}\) In 2003, the Delaware Chancery Court, in *Lane v. Cancer Treatment Centers of America*, addressed the issue of valuing Subchapter S stock in March of 1991.\(^{171}\) Both experts in the case tax effected the earnings at assumed corporate rates, and the court adopted a 38% rate.\(^{172}\) A third example of a case where earnings were tax effected is *Washington v. Washington*

\(^{165}\) NACVA, *supra* note 23 (noting that four different models are presented in Chapter 6, referencing the discussion in Hitchner).

\(^{166}\) 92 T.C.M. (CCH) 313, 318, 2006 T.C.M. (RIA) ¶ 2006-212, at 1447.

\(^{167}\) 901 A.2d 603 (R.i. 2006).

\(^{168}\) *Id.* at 608 (“Our standard in reviewing Family Court decisions is deferential.”). The court went on to state that “[t]his Court will not disturb a trial justice’s findings of fact in a divorce action unless he or she has ‘misconceived the relevant evidence or was otherwise clearly wrong.’” *Id.* (quoting Horton v. Horton, 891 A.2d 885, 888 (R.i. 2006)).

\(^{169}\) 873 N.E.2d 216, 220–21 (Mass. 2007).

\(^{170}\) *Id.* at 222 n.5 (valuation date); *id.* at 223 (lower court’s decision to tax effect). The reversal was largely because the lower court had misread *Gross* as supporting tax effecting, when in fact *Gross* had tax effected at zero percent, thus not tax effecting. See *id.* at 786–87 (“We conclude there is no support in *Gross* for the judge’s adoption of Horvitz’s figure, and moreover, the judge failed to offer a cogent explanation of her choice.”).


\(^{172}\) *Lane*, 2004 WL 1752847, at *1.
In this divorce case, the Court of Appeals of Virginia, without specifically commenting upon the fact that the valuation of a marital estate had been tax effected, affirmed a lower court determination of value. In these three cases the courts’ determinations would be significantly lower than our model would advise. Then came the Florida divorce case, Erp v. Erp, which involved a valuation date of December 31, 2003, by which time the change in tax rates for dividends had been enacted. The trial court chose to simply reject the husband’s expert’s advice to tax effect earnings. The appellate court did not comment on this treatment, and let this part of the decision stand. By the Part II.C model, this would overvalue the marital estate. Then, in 2011, the latest in a long string of cases to denounce tax effecting was decided. In Estate of Gallagher v. Commissioner, with a valuation date in 2004, the U.S. Tax Court rejected the tax effected adjustments of the taxpayer’s expert and stated that “we will not impose an unjustified fictitious corporate tax rate burden on [the company’s] future earnings.” By our model, this seriously overvalues the estate.

The first court to recognize the need to go beyond the choice of tax effecting or not tax effecting Subchapter S earnings was the Court of Chancery of Delaware, in Delaware Open MRI Radiology Associates v. Kessler. The issue was valuation in a dispute between shareholders as of a merger date in 2004. The court noted the standard applicable in such cases—“I am not trying to quantify the value at which Delaware Radiology would sell to a C corporation; I am trying to quantify the value of Delaware Radiology as a going concern with an S corporation structure and award the Kessler Group their pro rata share of that value.” The court rejected both tax effecting at corporate rates and not tax effecting at all. The court considered the differences in income that could be received by a shareholder in an S and a C corporation, after considering corporate taxes at 40%, dividend taxes at 15%, and individual taxes at 40% for a corporation that distributed all its earnings. Under these assumptions, out of $100 in pretax earnings, an S shareholder would retain a total of $60, and $51 would be retained by a C shareholder. The court then found that, if the S corporation income were tax effected at 29.7%, rather than the full 40% rate, the S and C shareholders would retain the same after-tax sums. The valuation was made on this basis.

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175 976 So.2d 1234 (Fl. Dist. Ct. App. 2008).
176 See id. at 1235–37.
177 See id. at 1240–41.
179 998 A.2d 290, 330 (Del. Ch. 2006).
180 Id. at 327.
181 This corresponds to a 17.6% premium value for the S shareholder, which accords with the Part II.C model.
Delaware Open MRI has met with considerable approval. In 2007, the Supreme Judicial Court of Massachusetts, in reversing the lower court decision in Bernier v. Bernier, cited it approvingly. It has also been well received in the practitioner literature. For example, Nancy Fannon in 2006 said, “We also have a great new case, Delaware Open MRI Radiology . . . in which the Delaware Chancery Court really ‘gets’ the crux of the issue.” This approach was confirmed again in the 2011 divorce case Adams v. Adams. In Adams the Massachusetts Supreme Judicial Court reversed the lower court’s decision, holding that it erred when it tax effected the husband’s partnership at a combined capital gains tax rate without sufficient reasons for doing so.

It should be noted that in the Delaware Open MRI case the court did not make any provision for future legislated changes in tax rates. The example used by the court implicitly assumed that tax rates stayed the same indefinitely, thus assuming Congress would change the enacted law. If the court assumed the temporary tax rate on dividends would return to 40% in 2012, as the law now provides, the premium to S status would have been higher, and the computation would have been more complex.

Empirical evidence on the valuation differences remains unclear. James DiGabriele found evidence of a modest premium in sales of businesses during the 2000–2006 period, the size of which was moderated by the organizations’ sales volume, the type of buyer, and the form of the acquisition transaction. John Phillips performed statistical analysis on over 2,300 corporate transactions listed in the Pratt’s Stats database, with mixed results. In his overall regressions, “the coefficient for S [corporation] stock, b5, is slightly positive, 0.045, but not statistically significant at a meaningful level.” As a result, both C and S corporation forms have no significant generalized impact on either asset or stock prices. However, if the analysis were confined to the last five years, S corporations would have had a premium of 19.8%, at a marginal significance level.

Further changes in tax law will affect the relative values of the two types of corporation. For example, a provision of the 2010 Small Business Jobs act, as modified by the 2010 Tax Relief Act, allows the holders of C corporation

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184 Fannon, supra note 161, at 1; see also Bret A. Tack, At Last, a Valid Way to Value S Corps, 145 Trust & Estates 61 (2006).
185 945 N.E.2d 844 (Mass. 2011).
186 See id. at 873.
188 See id.
190 John Phillips, S-Corp or C-Corp? M&A Deal Prices Look Alike, 10 Bus. Valuation Update 3 (March 2004).
191 Id.
192 Id.
stock in qualified small business corporations acquired between September 27, 2010, and December 31, 2012, to exclude from income gains from sale, if the stock is held at least five years.¹⁹³ Such a provision could effectively reduce capital gains rates to zero, if applicable to a company, and might reduce or eliminate the S corporation advantage.

IV. Recommendations and Conclusions

Precedents in the area of tax effecting must be used cautiously. As demonstrated above, the impact on valuation of taxes is very dependent upon the laws in place at the time the determination is made. The decisions of the Tax Court in 1975 in Hall and then later in 1980 in Maris, which both accepted tax effected valuations, were reasonable under the laws and economic conditions of their time. Since C corporations could use dividend policy to counteract the purported tax benefits of S corporations, no valuation advantage should have accrued to the S form, and tax effecting was a reasonable way to ensure that no such advantage was computed. Conversely, the valuation in Gross in 2001, which did not tax effect, may have properly reflected the relative premium of S corporation status at a time when tax rates favored that form strongly.

Currently, there seem to be three different approaches towards how to reflect the special tax status of S corporations in valuation. One involves using actual tax rates and other factors to compute a specific tax impact, which may differ from the current corporate tax rate. The model we used in this Article falls into this category. As discussed above, the valuation literature and finance literature includes a number of models, using similar factors, for determining what premium—if any—is applicable, based on current tax rates and other considerations. The Delaware Chancery Court and the Massachusetts Supreme Judicial Court, in the Delaware Open MRI and Bernier decisions, also follow this approach. A second approach, which was very common before the Tax Court’s decision in Gross, but which we argue has not been theoretically justified since the tax changes of the 1980s, is to tax effect Subchapter S corporate income using the statutory corporate tax rate. The valuation in the 2005 Virginia case of Washington v. Washington followed this approach. The third approach, which has been followed by the Tax Court in four cases, beginning with Gross in 1999 and continuing with Gallagher in 2011, is to not tax effect. The Service has firmly adopted this position. Indeed, at a 2011 symposium sponsored by the American Society of Appraisers and the Service, Miles Friedman, an Associate Area Counsel in the Service’s Office of Chief Counsel, responded to a question about tax effecting—“I can answer

this in a second. The cases say no. The Service says no. Any questions?\textsuperscript{194} This stance, notably, has remained the same despite the various changes in tax laws between 1998 and 2011.

Under the current laws, we believe neither ignoring taxes nor tax effecting Subchapter S corporations at full corporate rates is likely to be appropriate. Courts, valuation practitioners, and attorneys need to understand that the relative valuation of C corporations and pass-through entities depends upon a complex interplay of several factors. Tax rates and dividend policy have been the major focus of the above analysis, but valuation may also depend upon the degree of debt held by the company, the existence and nature of a likely buyer, the probability that S status will be forfeited, and the appropriate legal standard of valuation.

In the end, as Judge Cohn noted in his partial dissent in \textit{Gross}, “[v]aluation is a fact specific task exercise; tax affecting is but one tool in accomplishing that task.”\textsuperscript{195}

\textsuperscript{195} See Gross v. Commissioner, 272 F.3d 333, 356 (6th Cir. 2001).
## Table 1—Historic Tax rates and S Corporation Premium Factor for Various Years

<table>
<thead>
<tr>
<th>Year</th>
<th>Individual</th>
<th>Corporate</th>
<th>Capital Gains</th>
<th>Dividends</th>
<th>Minimum S Corp. Premium Factor*</th>
</tr>
</thead>
<tbody>
<tr>
<td>1960</td>
<td>91%</td>
<td>52%</td>
<td>25%</td>
<td>91%</td>
<td>0.25</td>
</tr>
<tr>
<td>1965</td>
<td>70%</td>
<td>48%</td>
<td>25%</td>
<td>70%</td>
<td>0.77</td>
</tr>
<tr>
<td>1970</td>
<td>72%</td>
<td>49%</td>
<td>32%</td>
<td>72%</td>
<td>0.82</td>
</tr>
<tr>
<td>1975</td>
<td>70%</td>
<td>48%</td>
<td>34%</td>
<td>70%</td>
<td>0.88</td>
</tr>
<tr>
<td>1980</td>
<td>70%</td>
<td>48%</td>
<td>37%</td>
<td>70%</td>
<td>0.91</td>
</tr>
</tbody>
</table>

**Tax rates did not unambiguously favor S corporations**

<table>
<thead>
<tr>
<th>Year</th>
<th>Individual</th>
<th>Corporate</th>
<th>Capital Gains</th>
<th>Dividends</th>
<th>Minimum S Corp. Premium Factor*</th>
</tr>
</thead>
<tbody>
<tr>
<td>1982</td>
<td>50%</td>
<td>46%</td>
<td>24%</td>
<td>50%</td>
<td>1.16</td>
</tr>
<tr>
<td>1986</td>
<td>50%</td>
<td>46%</td>
<td>20%</td>
<td>50%</td>
<td>1.16</td>
</tr>
<tr>
<td>1988</td>
<td>28%</td>
<td>34%</td>
<td>28%</td>
<td>28%</td>
<td>1.52</td>
</tr>
<tr>
<td>1990</td>
<td>28%</td>
<td>34%</td>
<td>28%</td>
<td>28%</td>
<td>1.52</td>
</tr>
<tr>
<td>1992</td>
<td>31%</td>
<td>34%</td>
<td>28%</td>
<td>31%</td>
<td>1.47</td>
</tr>
<tr>
<td>1994</td>
<td>40%</td>
<td>35%</td>
<td>28%</td>
<td>40%</td>
<td>1.29</td>
</tr>
<tr>
<td>1996</td>
<td>40%</td>
<td>35%</td>
<td>28%</td>
<td>40%</td>
<td>1.29</td>
</tr>
<tr>
<td>1998</td>
<td>40%</td>
<td>35%</td>
<td>20%</td>
<td>40%</td>
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<tr>
<td>2000</td>
<td>40%</td>
<td>35%</td>
<td>20%</td>
<td>40%</td>
<td>1.16</td>
</tr>
<tr>
<td>2002</td>
<td>39%</td>
<td>35%</td>
<td>15%</td>
<td>39%</td>
<td>1.11</td>
</tr>
<tr>
<td>2004</td>
<td>35%</td>
<td>35%</td>
<td>15%</td>
<td>15%</td>
<td>1.18</td>
</tr>
</tbody>
</table>

*This table assumes that the C corporation distributes no dividends at all, meaning all gains are taxed to the C shareholder at the capital gains rate. The value of C corporation income would be multiplied by the factor shown, based on the discussion in the text, to derive the value of the same income if earned by an S corporation. Factors greater than one indicate greater value to the S corporation.

### Table 2—Numbers of Corporate and Partnership Tax Filings, by Year

<table>
<thead>
<tr>
<th>Year</th>
<th>All Corporate Filings</th>
<th>S Filings</th>
<th>Non-S Corporations</th>
<th>Partnerships</th>
</tr>
</thead>
<tbody>
<tr>
<td>1960</td>
<td>1.14</td>
<td>0.09</td>
<td>1.05</td>
<td>0.94</td>
</tr>
<tr>
<td>1965</td>
<td>1.42</td>
<td>0.17</td>
<td>1.25</td>
<td>0.91</td>
</tr>
<tr>
<td>1970</td>
<td>1.67</td>
<td>0.26</td>
<td>1.41</td>
<td>0.94</td>
</tr>
<tr>
<td>1975</td>
<td>2.02</td>
<td>0.36</td>
<td>1.67</td>
<td>1.07</td>
</tr>
<tr>
<td>1980</td>
<td>2.71</td>
<td>0.55</td>
<td>2.17</td>
<td>1.38</td>
</tr>
<tr>
<td>1982</td>
<td>2.93</td>
<td>0.56</td>
<td>2.36</td>
<td>1.51</td>
</tr>
<tr>
<td>1984</td>
<td>3.17</td>
<td>0.70</td>
<td>2.47</td>
<td>1.64</td>
</tr>
<tr>
<td>1986</td>
<td>3.43</td>
<td>0.83</td>
<td>2.60</td>
<td>1.70</td>
</tr>
<tr>
<td>1988</td>
<td>3.56</td>
<td>1.26</td>
<td>2.31</td>
<td>1.65</td>
</tr>
<tr>
<td>1990</td>
<td>3.72</td>
<td>1.58</td>
<td>2.14</td>
<td>1.55</td>
</tr>
<tr>
<td>1992</td>
<td>3.87</td>
<td>1.79</td>
<td>2.08</td>
<td>1.48</td>
</tr>
<tr>
<td>1994</td>
<td>4.34</td>
<td>2.02</td>
<td>2.32</td>
<td>1.49</td>
</tr>
<tr>
<td>1996</td>
<td>4.63</td>
<td>2.30</td>
<td>2.33</td>
<td>1.65</td>
</tr>
<tr>
<td>1998</td>
<td>4.85</td>
<td>2.59</td>
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<td>1.86</td>
</tr>
<tr>
<td>2000</td>
<td>5.05</td>
<td>2.86</td>
<td>2.19</td>
<td>2.06</td>
</tr>
<tr>
<td>2002</td>
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</tr>
<tr>
<td>2004</td>
<td>5.56</td>
<td>3.52</td>
<td>2.04</td>
<td>2.55</td>
</tr>
</tbody>
</table>
