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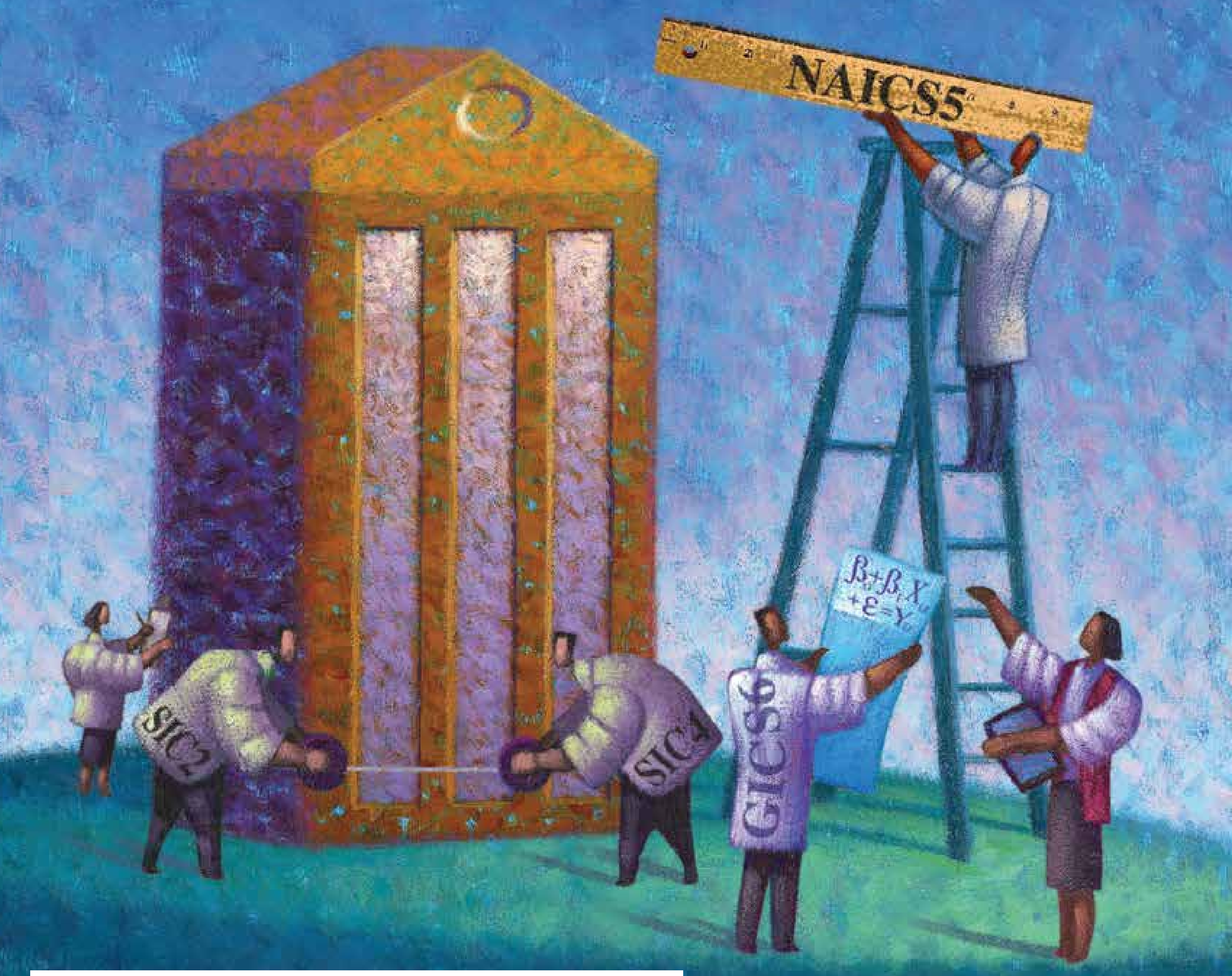

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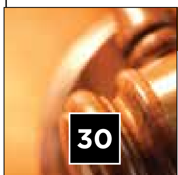
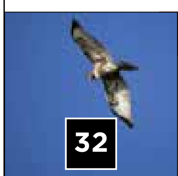


LITIGATION CONSULTING

COURT CORNER

By Robert James Cimasi, MHA, ASA, FRICS, MCBA, CVA, CM&AA; and Todd A. Zigrang, MBA, MHA, FACHE, ASA

Summaries and analysis of the most important cases that involve valuation and expert testimony issues, in both federal and state courts. In this issue, *The Value Examiner* assesses *Cecil v. Commissioner of Internal Revenue.*



PRACTICE MANAGEMENT

TIPS FOR PRACTITIONERS: WAYS TO IMPROVE YOUR PARTNER COMPENSATION PLAN

By Stephan D. Kirkland, CPA, CMC, CFC, CFF

One key difference between successful and unsuccessful financial service firms is the way partner compensation amounts are determined. This article gives a brief overview of what should—or should not be—considered when developing partner compensation plans.

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PRACTICING SOLO

By Rod P. Burkert, CPA, ABV, CVA

The series featuring sole practitioners enters its sixth year. In this first issue of 2017, we feature Margaret McDonnell, CPA, ABV, CFF, CVA, from North Fayston, Vermont.

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ALL SUBMISSIONS

The Value Examiner is devoted to current, articulate, concise, and practical articles in business valuation, litigation consulting, fraud deterrence, matrimonial litigation support, mergers and acquisitions, exit planning, and building enterprise value. Articles submitted for publication should range from 500 to 3,000 words. Case studies and best practices are always welcome.

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David W. Grauer, Esq., Jones Day, nationally-known healthcare attorney

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LITIGATION CONSULTING

Court Corner

S-CORPORATION VALUATION DEBATE – THE IMPACT OF *CECIL V. COMMISSIONER*

By Robert James Cimasi, MHA, ASA, FRICS, MCBA, CVA, CM&AA; and Todd A. Zigrang, MBA, MHA, FACHE, ASA

In 1999, the federal tax case, *Gross v. Commissioner of Internal Revenue*, brought the issue of the impact of taxes on the value of subchapter S corporations (S corporations) to the forefront of consideration within the valuation community. In that case, the court rejected "tax affecting" (i.e., "allowing a deduction for taxes on corporate earnings")[1] for S corporations. The decision spawned much debate in the valuation profession, including the development of four models to utilize in valuing interests in S corporations.[2] The court has again taken up the issue of valuing S corporations in the pending case, *Cecil v. Commissioner of Internal Revenue*, which involves a bequest of shares in the Biltmore Company, the operator of the historic Biltmore estate in North Carolina.[3]

This article on the valuation of common stocks for S corporations will briefly discuss the debate surrounding tax affecting S corporations, as well as how the *Cecil* case may impact the resolution of this issue.

In the *Gross* case, the petitioners, shareholders of G & J Pepsi-Cola Bottlers, Inc. (G & J), gifted minority interest S corporation shares to their children.[4] One of the shareholders, Walter Gross, gifted 124.5 shares (0.63 percent of the outstanding shares of common stock) to each of his three children. [5] On the same day, a separate shareholder, Patricia Linnemann, gifted 187.5 shares (0.95 percent) of common stock to each of her two children.[6] The gifts were valued at $5,680 per share and reported to the IRS using this value.[7] The IRS noted a tax deficiency for each of the gifts, arguing that the fair market value (FMV) of each share was not $5,680, but instead, $10,910 per share.[8]

According to the Tax Court, the "most significant differences between the parties' expert witnesses" regarded whether to adjust G & J's earnings by tax affecting such earnings when determining the discounted cash flows in performing the FMV analysis.[9] During the trial, the petitioners' expert witnesses argued it was necessary to tax affect the earnings of an S corporation in order to reflect how S corporations are "committed to making distributions to shareholders to cover individual tax liabilities on allocated S corporation earnings."[10] The petitioners argued that this distribution is similar to C corporations making tax payments to the IRS, in that such remittances "represent[] a known payment which reduces the availability of cash which could otherwise be used to maintain or expand existing operations."[11] In contrast, the expert witness for the IRS refused to tax affect the earnings of G & J, noting the company would remain an S corporation indefinitely and all earnings would be distributed to shareholders.[12] The Tax Court agreed with the IRS's position against tax affecting the earnings of G & J, opining that the *"principal benefit that shareholders expect from an S corporation election is a reduction in the total tax burden imposed on the enterprise."*[13] [Emphasis added]

Subsequent to the 1999 decision in the *Gross* case, four models have been developed to value minority interests in S corporations:[14]

(1) The S Corporation Economic Adjustment Model (SEAM) by Daniel R. Van Vleet, ASA;

(2) The Quantitative Marketability Discount Model (QMDM) by Z. Christopher Mercer, FASA, CRA, ABAR;

(3) The model set forth by Roger J. Grabowski, FASA; and,

(4) The model set forth by Chris D. Treharne, ASA, MBA, BVAL.[15]

1 "Taxes and Value: The Ongoing Research and Analysis Relating to the S Corporation Valuation Puzzle" By Nancy J. Fannon and Keith F. Sellers, Portland, OR: Business Valuation Resources, 2015, p. 12.

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

3 "S Corp Model Now in Tax Court" By Andy Dzamba, Business Valuation Resources, June 30, 2016, https://www.bvresources.com/blogs/bvwire-

While each model employs the standard of FMV,[16] Tax Court Judge David Laro and Dr. Shannon Pratt, in their book entitled, *Business Valuation and Federal Taxes*, note that these models differ as to the following issues:

a) The starting point for the valuation

b) The extent to which current cash distributions affect value

c) The impact on value of retained cash flow (basis)

d) The extent that shareholder benefits (i.e., personal taxes saved) impact the value determination

e) The amount, extent, and manner that discounts are taken against the value determined by the model

f) The impact of today's value of the asset sale amortization benefit resulting from future transactions.[17]

Judge Laro and Pratt note that an appraiser's selection of the appropriate model to value a minority interest in an S corporation "may depend on the extent to which the facts and circumstances fit with a particular model."[18]

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

1. *Some empirical studies of C and S corporation transactions in the marketplace do not support the notion that S corporations are worth more than C corporations; in fact, they point to the opposite conclusion. However, given the complexity of the corporate transaction structuring, not everyone agrees that this evidence is conclusive.* [Emphasis added] *A 100 percent ownership interest in an S corporation does not necessarily come with a bundle of rights and obligations attached to it any more than does a 100 percent ownership interest in a C corporation. This is distinctly different than a minority interest in an S corporation or a C corporation."* [Emphasis added] *The controlling shareholder can mimic the favorable tax characteristics of an S corporation (i.e., avoid the double-taxation disadvantage of C corporation dividends by paying additional salary).* [Emphasis added] *Buyers will not pay for an election that they can make themselves for free, unless it has some value to them. Grabowski points out that in some instances, buyers will pay a premium for the possible benefits that come with an old-and-cold S corporation."* [Emphasis added];

2. *S corporations logically make distributions of funds necessary to support taxes on corporate earnings. This is no different from a C corporation; in either case, the money is gone and no longer available for corporate investment and growth."* [19] [Emphasis added]

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

[T]he experts generally agree that there may be no difference in value between S corporations and C corporations. Logically, the experts' consensus is that C corporation valuation methods may be used for valuing controlling ownership interests in S corporations.[20] [Emphasis added]

The pending *Cecil* case may address many of the issues relating to the valuation of interests in S corporations that have developed since the *Gross* case. *Cecil* related to a dispute regarding the gifting of shares in the Biltmore Company.[21] The owners of the Biltmore Company valued the gift at $20.88 million; however, the IRS disputed the figure, arguing that the FMV of the gift was $95.29 million.[22] Notably, both experts in the case tax affected the earnings in the Biltmore Company when performing their valuation analysis, in contrast to the *Gross* case, in which the IRS's expert did not tax affect the earnings of the S corporation in question.[23] The Tax Court held a hearing in the *Cecil* case in February 2016, and the case is currently in deliberations.[24]

Commentators on the case have noted that the case may provide insight on two issues: 1) whether the valuation of

Court Corner *continued on page 35*

news/2016/06/30/s-corp-model-now-in-tax-court (Accessed 1/5/17).
4 "*Gross, et al. v. Commissioner of Internal Revenue*" 78 T.C.M. (CCH) 201, (U.S. Tax Ct. 1999), p. 2.
5 *Ibid.*
6 *Ibid.*
7 *Ibid.*
8 *Ibid*, p. 3.
9 *Ibid*, p. 8.
10 *Ibid*, p. 10.
11 *Ibid.*
12 *Ibid.*
13 *Ibid.*
14 "Business Valuation and Federal Taxes: Procedure, Law, and Perspective" By David Laro and Shannon P. Pratt, Hoboken, NJ: John Wiley and Sons, 2011, p. 99.
15 "Pass Through Entity Tax Affecting for Business Valuations" By Rudolf P. Armbruster, ASA, CVA, Cherry Bekaert, March 17, 2014, http://www.cbh.com/guide/pass-through-entity-tax-affecting-for-business-valuations/ (Accessed 1/26/17).
16 "Business Valuation and Federal Taxes: Procedure, Law, and Perspective" By David Laro and Shannon P. Pratt, Hoboken, NJ: John Wiley and Sons, 2011, p. 99.
17 *Ibid*, p. 106.
18 *Ibid.*
19 *Ibid*, p. 108–109.
20 *Ibid*, p. 110–111.
21 Dzamba, June 30, 2016.
22 *Ibid.*
23 Frazier, Ross, August 29, 2016.
24 *Ibid*, p. 5.