


A man in a dark suit and tie stands in an office, looking towards a woman whose back is to the camera. She is wearing a white shirt. They are in front of a large window with blinds, through which a cityscape is visible. The scene is lit with a cool, blue-toned light.

ROBERT J. GROSSMAN

DISSECTING THE

IRS JOB AID ON **S CORPORATION** **TAX-AFFECTING**



Rather than providing useful new guidance on how to tax affect S corporation income, the Job Aid offers little more than a compendium of information that is already available.

Once again, the business valuation community has been made privy to internal Job Aids intended primarily for use by Internal Revenue Service valuation analysts.

These two new documents were prepared by representatives of the Large Business and International Division NRC Industry, Engineering Program, and the Small Business/Self-Employed Division, Estate and Gift Tax Program. The first document, "Valuation of Non-Controlling Interests in Business Entities Electing to be Treated as S Corporations for Federal Tax Purposes,"¹ (hereafter, the Job Aid) is the subject of this article. The second document, offering guidance on reasonable compensation issues,² will be addressed by the author in a future article in this journal.

Background

The October 29, 2014 release of these documents is not the first time that internal agency documents have been made available to practitioners and taxpayers outside the IRS in recent years. The first occurrence was in the summer of 2010, when a document titled "Discounts for Lack of Marketability: Job Aid for IRS Valuation Professionals"³ was first inadvertently "leaked" to the business valuation community. On September 1, 2010, it was officially posted to the IRS website.⁴ The two recently-released IRS documents are also available on the Service's website.⁵

The release of this series of Job Aids has been hailed by many as a

new era of communication and understanding between the IRS, taxpayers, and practitioners. However, in the opinion of the present author and others, releasing these additional documents in such a formal manner seems to be an attempt to influence practitioner behaviors in specific practice areas without statutory support. The front cover of each Job Aid specifically notes: "not Official IRS Position" and "prepared for reference purposes only." Further, the cover qualifier of each Job Aid adds that "it may not be used or cited as authority for setting any legal position." If one were to approach the impact of the document from the point of view of a tax professional, he or she might argue that the content of the documents is nothing more than a compendium of information already available in the history of the two issues that they respectively address. As nothing is precedential in these releases, the content must be viewed with a cautious eye and an understanding that while the Service may be instructing its internal team to follow the path of the information contained therein, that information is in no way intended to be a legal requirement, or even free of taxpayer challenge as to technical propriety.

Perplexing Issue. The new Job Aid addresses one of the most perplexing theoretical issues facing business valuation practitioners today. Essentially, the question is simply whether it is appropriate to tax-affect economic benefit streams derived from an S corporation when valuing a non-

controlling equity interest in that corporation. In fact, the Executive Summary notes:

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

Lack of New Information. As was the case with the earlier DLOM Job Aid, the new Job Aid contains little fresh information. Predictably, the Service's position in the release is based primarily on a series of five key Tax Court decisions, dating back to 1999. In that year, the Tax Court first decided *Gross*,⁶ a case that forever changed the landscape for valuing equity ownership positions in electing S corporations by disallowing the tax-affecting of an economic benefit stream. The Tax Court followed up *Gross* with four cases that will be discussed briefly below. Suffice to say that, in general, each of those cases served to attack traditional valuation protocol of reducing expected future economic benefit streams for the economic effect of entity-level income taxes in the valuation of a non-controlling S corporation equity ownership interest. As time has passed, several additional cases have piggy-

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backed on the general thinking of the court in the earlier decisions.

Overview of *Gross* and its Progeny

So that the origin of this issue can be fully understood, it is necessary to provide an overview of each of these valuation decisions. Summaries are presented below in the order in which the cases were decided by the Tax Court.

Gross. This consolidated case involved a deficiency of gift tax for the year 1992 with the common question posed as to the value of certain shares of corporate stock transferred by gift. The shares transferred represented gifts of small, minority interests of G & J Pepsi-Cola Bottlers, Inc., an Ohio corporation that elected in 1982 to be taxed as an S corporation under the Internal Revenue Code.

The expert for the taxpayers argued for reduction of the earnings stream

of the S corporation by an assumed corporate tax rate of 40%. The expert then capitalized that earnings stream by a rate commensurate with equivalent Subchapter C corporations. He thus felt that he had matched after-tax earnings with an after-tax capitalization rate. The expert for the government applied a similar thought process, with one critical distinction. He assumed that the corporate tax rate was 0% since he foresaw no reason to expect that the corporation's S corporation status would not continue. Further, the expert dismissed the taxation of the corporate earnings at the shareholder level as irrelevant. It is important to understand that the government's expert also used an after-tax discount rate, arguing that the entity-level earnings had previously been tax-affected by a rate of 0%. Thus, he, too, argued that he was properly matching after tax earnings with an after-tax risk rate.

The court agreed with the government's expert and disallowed the tax-affecting of the earnings stream, thereby substantially increasing the value of the gifted shares. Note that there were several important (and distinguishing) facts present in the case that influenced the court's decision, including the fact that the company distributed far more cash flow (approximately 100%) than that necessary to fund the individual shareholders' annual tax liabilities on the pass-through income. Thus, under the S corporation tax regime, these excess amounts were found to essentially represent tax-free dividends. Additionally, an agreement restricting the transfer of the G & J shares by and among the members of the Gross family group existed at the date of the gifts, with express provisions restricting transfers that could compromise the company's S corporation status. Consequently, continued maintenance of the company's S status was deemed by the court to be assured, thus preserving the associated tax benefits. These distinguishing facts were critical in properly assessing the issue in this case and are repeated throughout the cases that followed and the narrative in the new Job Aid.

Wall. In this case,⁷ a dispute arose over the value of nonvoting capital stock transferred in January 1992 to a number of trusts, with the taxpayers' children named as beneficiaries. The taxpayers and the Internal Revenue Service each presented expert reports with both experts using market-based and income-based approaches to value the shares.

Interestingly, both experts tax-affected the future cash flow projections. The taxpayers' expert used a hypothetical income tax rate of 34%, while the expert for the Service applied a rate of 40%. The case contains comments on the testimony of the taxpayers' expert regarding general disagreement within the business valuation community on the matter of tax-affecting. The opinion notes that those advocating tax-affecting argue that the most likely buyers for an S corporation may not meet the Internal Revenue Code qualification requirements to maintain S corporation status and the S corporation benefit, if

any, would be lost. The opposing and contrasting argument addressed in the case is that the use of fully-tax-affected cash flow streams discounted by an after-tax rate of return attributes no value whatsoever to the associated tax benefits of S corporation status.

Ultimately, the opinion of the Tax Court dismissed the tax-affecting by both parties' experts, citing the *Gross* decision.

Heck. At issue in *Heck*⁸ was the valuation of 630 shares (a 39.6% non-controlling, nonmarketable S corporation stock interest) in F. Korbel and Bros., Inc. (Korbel) at the date of death of a decedent.

Both parties provided expert opinions to the Tax Court regarding the valuation of the shares in question. They both used an income approach, while only the IRS's expert used a market approach. The court rejected the market approach and agreed that the income approach, as well as the discounted cash flow method available thereunder, was most appropriate. However, in making this statement, the court found fault with both experts' calculations. To overcome the perceived calculation problems, the court's opinion noted that "it was deconstructing each expert's DCF analysis, and assembling our own."

Neither expert in this case tax-affected the earnings of Korbel. The calculation prepared by the taxpayers[esq.] expert was based on the pre-tax earnings of Korbel that were discounted by an after-tax weighted average cost of capital. Thus, the expert did not tax-affect the cash flow stream. The expert for the Service used a similar discounted cash flow method and an after-tax weighted average cost of capital. Numerous differences within the details of applying the methodologies were challenged and modified in the decision, with the court adopting certain positions of each experts[esq.] calculation.

With respect to after-tax weighted average cost of capital, the court (as the *Wall* court had done earlier) cited the *Gross* decision. The estate's expert added 10% to his 25% discount for lack of marketability (for a total discount of 35%) to account for a right of first refusal to which the shares were

subject, and disadvantages of the decedent's shares representing a minority interest, which he referred to as "agency problems." Alternatively, the government's expert determined that a 15% discount for "liquidity" was appropriate, as well as a 10% S corporation discount. The S corporation discount was intended to compensate for risk associated with the uncertainty that the S corporation would distribute sufficient cash flows to meet the shareholders' tax liabilities arising from the pass-through of the corporate income, and whether Korbel's S corporation status could be maintained throughout a hypothetical sale. He also included a 25% discount for lack of marketability.

The court decision notes that the expert for the Service seems to view the S corporation status as a benefit but "fail[s] to quantify the relevant advantages and disadvantages." In the end, the court adopted the estate's expert's findings and approach and applied a 35% discount for lack of marketability to the entire business operating value, plus all nonoperating assets. In effect, all operating and nonoperating assets of the company were discounted by this amount.

Adams. *Adams*⁹ is an estate tax case wherein valuation of an S corporation ownership interest was, again, at the center of the dispute. In this case, the expert for the estate used the income approach and the capitalization of cash flows method allowable thereunder. Instead of electing to tax-affect the S corporation earnings in this case, the expert developed an after-tax discount rate using the build-up model (BUM) and then converted the derivative capitalization rate to a pre-tax capitalization rate.

The expert's assumption in converting the capitalization rate to pre-tax was that the S corporation earnings



of the subject company were also pre-tax and, by making the conversion, he was properly matching the capitalization rate with the before-tax prospective earnings streams. The court disapproved of the treatment adopted by the estate's valuator and, although the court acknowledged the estate's expert as being "more thorough," it deemed the methodology employed by the expert to be in error. Citing *Gross* once more, the court reasoned that the S corporation earnings stream had been tax-affected at the corporate level and, in fact, the rate at which the earnings stream had been tax-affected is zero. Thus, use of a pre-tax capitalization rate, under this analysis and opinion, results in a mismatch of a pre-tax rate against after-tax earnings.

A significant fact distinguishing *Adams* from the earlier cases is that

¹ Job Aid for IRS Valuation Analysts, "Valuation of Non-Controlling Interests in Business Entities Electing to be Treated as S Corporations for Federal Tax Purposes," 10/29/2014.

² Job Aid for IRS Valuation Professionals, "Reasonable Compensation," 10/29/2014.

³ Job Aid for IRS Valuation Professionals, "Discount for Lack of Marketability," 9/25/2009.

⁴ Available at <http://www.irs.gov/pub/irs-utl/dlom.pdf>.

⁵ See <http://www.irs.gov/Businesses/Valuation-of-Assets>.

⁶ TCM 1999-254, *aff'd* 272 F.3d 333, 88 AFTR2d 2001-6858 (CA-6, 2001).

⁷ TCM 2001-75.

⁸ TCM 2002-34.

⁹ TCM 2002-80.

¹⁰ TCM 2006-212.

¹¹ TCM 2011-148.

¹² 114 AFTR2d 2014-6848 (CA-9, 2014).



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the equity ownership interest under valuation was a 61.6% controlling, nonmarketable interest. It is the only case in this series of decisions that includes this distinguishing feature.

Dallas. This decision¹⁰ was rendered after an extended four-year break in the issuance of new Tax Court cases addressing the S corporation tax-affecting issue. *Dallas* is a gift tax case in which many of the key facts, as well as the court's final finding, parallel those set forth in the *Gross* decision.

Among a number of complex issues associated with the determination of value of the subject equity ownership interests, the issue of tax-affecting represented a major hurdle for the taxpayer. The taxpayer provided expert reports from two appraisers, both of whom tax-affected the earnings of the subject company in determining value. The first expert used an income tax rate of 40%, while the second used a rate of 35%. The fundamental precept argued in the case was that the corporation would lose its S corporation status after a hypothetical sale of the company's stock. In addition, the experts argued that the facts in *Dallas* were distinguishable from *Gross* in that cash distributions in the attendant case

were specifically tied to income taxes due from shareholders as a result of the pass-through income, whereas, in *Gross*, almost all of the earnings were distributed annually.

The court rejected both arguments. First, it ruled that there was no evidence presented to suggest that the company would have expected to lose its status as an S corporation at any point. Second, the opinion noted that the company had a long history of distributing sufficient cash to meet all attendant tax obligations, and there was no evidence presented that would suggest that the practice would end.

Finding the taxpayer's experts "unpersuasive," and noting that "there was insufficient evidence that the hypothetical parties would tax-affect the S corp earnings," the court ruled that tax-affecting the company's earnings was not appropriate.

Common Thread. Several more-recent federal court cases, including *Gallagher*,¹¹ and *Giustina*,¹² have resulted in a disallowance of tax-affecting, but the foundational blocks for the current position of the Internal Revenue Service can be easily identified in the five early cases discussed above. A critical common thread in all of the cases (except *Adams*)

is that the equity ownership interests under valuation are noncontrolling. This is an exceedingly important distinction, in that the hypothetical buyer for a noncontrolling interest in an S corporation is likely to be vastly different than the hypothetical buyer for a controlling interest. This basic precept appears to serve as the basis for the new Job Aid developed by the Service. Little mention is made of controlling interests in it and since "non-controlling" is part of the new Job Aid's title, it seems fair to assume that the information contained therein may not be relevant or applicable to the valuation of controlling interests in S corporations.

Analysis by Section

The Job Aid is partitioned into four primary sections:

- Executive Summary.
- Discussion and Analysis.
- Assessment and Synthesis.
- Appendices.

It is interesting that the document numbers only 32 pages, while literally thousands of pages have been dedicated to this topic over the last 15-plus years. The Job Aid[esq]'s first section, the Executive Summary, addresses the fundamental tax law framework contained in Subchapter S of the Code, which dictates the qualification requirements for obtaining S corporation status. The presentation is basic and without explanation, simply listing the most common statutory requirements.

It is noteworthy that from this brief overview of the statutory rules, the Job Aid leaps to a broad and, generally cloudy conclusion that:

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

Discussion and Analysis Section The second section of the Job Aid sets out a brief introduction, followed by six separate subsections addressing the following items:

- Identification of Property to be Valued.

- Valuation—Background and Approach.
- Additional Factors for Consideration.
- Evidence-Based Valuation Analysis.
- Theory-Based Valuation Analysis.
- Weighting of Factors and Approaches.

After reintroducing readers to the *Gross* decision, the Introduction simply provides the process by which the Job Aid was developed and sets up the balance of the document. The first substantive topic of this section, *The Identification of the Property to be Valued*, sets out the obvious, and accurate, statement, “In any valuation engagement, the threshold question is the identification of the property to be valued.”

The primary content of the balance of that section topic addresses tax items related to classification of entities as S corporations for federal income tax purposes and the “check-the-box” regulations, including a very minimal discussion of Treasury Regulations 301.7701-1 through 301.7701-3, governing entity classification selection. While the issue of entity classification can be quite complex (and presents tax practitioners with significant challenges), the Job Aid, itself, does not provide ample guidance to gain this understanding. The document does, however, point out that, “Valuation Analysts should familiarize themselves with the pertinent State and local laws, including tax laws, applicable to the specific business entity to be valued.” Again, this statement, while logical and conveying common sense, does not really provide any additional technical guidance to practitioners or taxpayers.

The section concludes with another broad statement that:

The suggestion by some commentators that a Valuation Analyst must apply, as a matter of conventional practice, a valuation paradigm based on taxable corporations (C corporations) to entities that do not pay tax ignores a major factual component, that the entity being valued has chosen its form, including its pass-through tax status, for business reasons.

Importantly, the Job Aid further notes, “If a valuation is to be persuasive, it must be based on the actual attributes of the interest being valued.

Accordingly, pass-through entities should be, where at all possible, compared to other pass-through entities in the valuation process.”

While the statement is accurate, there are a number of difficulties in applying the concept in the real world of business valuation. There is rarely sufficient economic, financial, and other information within current available resources to facilitate a direct one-on-one comparison with any aspect of the valuation process. That being said, it becomes incumbent on the valuator under professional standards to attempt to research and identify credible sources of information that allow for meaningful application to the subject company under valuation. Oftentimes, as is well known, this information is imperfect and requires both mechanical and judgmental modification and adjustment to reflect the subject company’s attributes. Collecting collaborative data on S corporations, costs of capital specific to those entities, and specific pricing mandates and valuation multiples is likely to be difficult, at best, and possibly a fruitless effort, given currently available resources. Though some studies have started to be published, little credible and widely-accepted evidence exists at this time. This limitation drives the need to look at after-tax data more commonly available to the business valuation community.

Background Section. The next subsection, titled, *Valuation—Background and Approach* provides some general discussion on Rev. Rul. 59-60.¹³

Additional Factors Section. The *Additional Factors for Consideration* subsection discusses the availability of public market data published by Ibbotson Associates (Morningstar, Inc.),¹⁴ and the fact that the information gathered by Ibbotson “reflects entity-level tax in the calculation of reported rates-of-return.” The discussion goes on to point out, “some commentators have suggested that if the Ibbotson rates-of-return are to be used in a present value calculation of the earnings stream...of an electing S Corporation, the S Corporation earnings stream should be reduced to reflect an imputed C Corporation tax liability.”

The Job Aid offers no commentary or resolution to this observation. It simply notes that:

It is far from clear that the buyers and sellers of interests in electing S Corporations actually analyze their investments in this manner. A significant feature of the S Corporation election is to eliminate the payment of tax at the entity level. This is an important economic attribute that must be recognized in the valuation of an interest in an electing S Corporation.

An economic reality of any electing S corporation is the expectation that the company will, ultimately, distribute sufficient cash flow necessary to provide investing shareholders with the means to pay the required federal and state income taxes on the corporation’s income. If such were not the case, the investors would require a significantly higher rate of return to allow for the satisfaction of those corporate liabilities passed-through to the shareholder group. Moreover, the provision of these monies to shareholders to fund the shareholder-level tax liabilities arising from the reporting of corporation income at the shareholder level acknowledges the lack of availability for the funds for other uses within the corporate operating entity. Thus, the economic effect is to force the S corporation to distribute cash to pay taxes on its income.

A second common theory set out in this section notes that some have suggested “in the context of a pass-through entity the definition of entity-level tax should include all of the tax associated with the entity’s operations.” The Job Aid concludes that this suggestion redefines the valuation standard and moves it from fair market value to investment value while combining entity-level and investor-level

¹³ 1959-1 CB 237.

¹⁴ The Morningstar data originally reported by Ibbotson & Associates was discontinued and is now available through Duff & Phelps.

¹⁵ Guenther and Sansing, “The Effect of Tax-Exempt Investors and Risk on Stock Ownership and the Dividend Tax Penalty,” (Kellogg School of Management at Northwestern University, October 2007).

¹⁶ Dhaliwal, Krull, Li, and Moser, “Dividend Taxes and Implied Cost of Equity Capital,” 43 J. of Accounting Research 675 (December 2005).

taxes. The discussion sets out a number of difficulties that might arise in valuator selection of an appropriate individual income tax rate.

Thirdly, this subsection of the Job Aid notes that while some have suggested that the identity of the person who pays the tax is not relevant to the valuation problem, this proposition overlooks the fact that tax structures and rates differ between corporate and individual taxpayers in ways too great to render them irrelevant.

There is nothing new in the above three points, issues with which valuers have struggled mightily since the opinion in *Gross* was first rendered. It is noteworthy, however, that while the Job Aid does a competent job of identifying many of the difficult problems, it offers its employees no guidance on how best to deal with those issues in the context of an examination of value. This failure to include any meaningful new guidance or theoretical approaches to dealing with these complexities renders the Job Aid somewhat less than useful in aiding either the Service's employees or the business valuation community.

The Job Aid does minimally speak of "control interests" in this section, setting out the opinion by some that where these interests are involved, there is no difference between electing S Corporations and publicly-traded C Corporations. It notes that this position overlooks "important valuation factors that are influenced by the public marketplace" and lists some of these factors. The commentary seems to have missed the point, as few valuers complying with professional standards would use publicly-traded guideline information (under an income or market approach) without making appropriate adjustments in consideration of factors such as those listed in the Job Aid. The argument against the assertion that controlling interest valuations of S corporations versus C corporations are similar is in the definition of fair market value and the fact that many potential buyers in the hypothetical universe of buyers would not qualify as S corporation shareholders under the Internal Revenue Code.

Another matter addressed in this section of the Job Aid points out an



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additional issue regarding the Ibbotson data. Since that data is after entity-level tax, but before shareholder (investor)-level tax, consideration of shareholder-level taxes in the valuation of S corporation ownership interests represents a "mismatch" and a fundamental error in the valuation of these interests.

In fact, though not yet argued before the Tax Court, studies have shown that the effect of shareholder taxes on C Corporation dividends and gains does have a market impact on rates of return set out in the Ibbotson data. Example of such studies include work by David A. Guenther and Richard Sansing,¹⁵ as well as by Dan Dhaliwal, Linda Krull, Oliver Zhen Li, and William Moser.¹⁶ An excellent discussion of these studies and the application of the research to cost of capital in determining the value of equity ownership interest in S corporations can be found in the book, *Taxes and Value*, authored by Nancy J. Fannon and Keith F. Sellers.¹⁷ This treatise was published after the release of the Job Aid, and the studies noted above are not referenced in the Service's document.

The *Additional Factors for Consideration* subsection goes on to address the importance of shareholder agreements in valuing noncontrolling equity ownership interests in electing S

corporations, noting that, "perhaps the two most significant investor concerns are the distribution policy...and the differential tax rates that might exist between the corporate level and the shareholder level." While this information is well-known to informed practitioners within the business valuation community, it is good to know that the Service is in agreement with current thinking within that community with regard to distribution policies. In addition to other provisions within any shareholder agreement, obviously, distributions, or lack of distributions, can have an impact on the valuation of these equity interests.

With respect to appropriate tax rates, this section addresses varying circumstances that might call for an applied rate different from the maximum statutory, and marginal rate. Again, the issue has been framed for some time in the business valuation community but specific guidance for a means to calculate the "correct" tax rate does not exist, and the Job Aid provides no further clarification on this issue.

Hypothetical Buyers and Sellers.

Perhaps the most interesting element in the *Additional Factors for Consideration* subsection is the commentary on "The Universe of Hypothetical Buyers" and "The Hypothetical Seller."



The authors within the IRS are standing behind case law.

Both concepts are, of course, integral to understanding the fair market value standard of value and both require care and study by valuation analysts. With respect to the former, the Job Aid notes that it is essential to carefully study the buyer universe as “the identity of the available hypothetical buyer for a given interest...will determine many things about the nature of the transfer, including the Federal tax status of the transferred interest.” Interestingly, the commentary notes that “Valuation theory tells us that, if a mixed universe of potential buyers exists, it is the buyer that does not suffer entity level taxation that will drive the ultimate transaction price, all other things being equal.”

Therein lies the rub—“*all other things being equal.*” Most transaction practitioners would note that while the buyer would obviously prefer tax-free status at the entity level, there are many influences on acquisition entity structure in any business purchase. To suggest that the buyer that does not suffer entity level taxation will drive the ultimate transaction price is to significantly simplify the consideration of the hypothetical buyer.

The discussion in this section goes on to address the need to include, within the hypothetical pool, buyers able to qualify as pass-through entities. Again,

this conceptual statement seems exceedingly clear, but there is a lack of guidance on how best to ensure that the pool includes all hypothetical buyers. The Job Aid adds no clarity to that determination process. The importance of specific provisions within a shareholder’s agreement that restrict transferability of shares are discussed in this subsection, as well. These restrictions limit buyers to those that allow for protection of the S Corporation’s tax status by prohibiting transfers to nonqualified holders and providing rights of first refusal. Most often, these provisions affect noncontrolling equity interests. Both the distribution discussion and the commentary regarding transfer restrictions follow the case law first set out in *Gross* and followed in other cases. Though it is now formalized in the Job Aid, the information presented is well-known and simply reflects current common practice in the business valuation arena.

This section also includes a brief discussion of “The Hypothetical Seller.” The salient point made here is that the hypothetical seller is an integral element of the definition of fair market value – a point no one disputes. The document states that given a potential hypothetical buyer who is able to benefit from S corporation status and, therefore, pay a higher price,

the hypothetical seller would not choose a buyer subject to entity-level tax and an inability to pay the higher price. Once again, the Job Aid oversimplifies the issue. It is impossible to argue against such thinking in a vacuum, but it is more likely that any number of differences in buyers and transactions could influence value and not just tax status, though that item could, and does, impact value, as well.

Finally, a short discussion in this section centers on “The Hypothetical Sale,” reiterating the concepts noted above, and ending with a quote from the Tax Court opinion in *Mueller*:¹⁸

Although we have, in prior opinions, identified types of hypothetical buyers, we did so only to determine which valuation approach, among several reasonable approaches, would result in the highest bid, and therefore the one most acceptable to a willing seller... The question is not so much ‘who’, but ‘how’.

The point of inserting this quotation seems to be the instruction to Internal Revenue Service personnel that focus should turn to hypothetical parties and transactions that will result in the highest bid, thus first satisfying the primary motivations of the hypothetical seller. Again, the problem is noted without any solutions being offered. In addition, there is some question in the minds of many in the business valuation community as to whether the hypothetical sale should be accomplished via the outcome with highest probability, all things considered, or, alternatively, at the highest bid.

The subsection titled “Identifying the Most Important Factors,” is fairly self-explanatory. Essentially just a catch-all with little explanation, it identifies factors that specifically affect the

¹⁷ Fannon and Sellers, *Taxes and Value: The Ongoing Research and Analysis Relating to the S Corporation Valuation Puzzle* (Business Valuation Resources, 2015), page 53.

¹⁸ TCM 1992-284.

¹⁹ Erickson, and Wang, “Tax Benefits as a Source of Merger Premiums in Acquisitions of Private Corporations,” 82 Accounting Review 359 (2007).

²⁰ Denis and Sarin, “Taxes and the Relative Valuation of S Corporations and C Corporations,” 12 J. of Applied Finance 7 (Fall/Winter 2002).

valuation of noncontrolling interests in an electing S Corporation and “may” deserve special attention. The list includes cost of capital, marketability discounts, the entity’s ability to raise both debt and capital, a potentially smaller pool of hypothetical investors (due to S corporation shareholder qualification rules), and the effect of investor-level taxes. There is no question that each of these items can, and do, impact value conclusions.

The balance of the Discussion and Analysis Section of the Job Aid addresses *Evidence-Based Valuation Analysis*, *Theory-Based Valuation Analysis*, and *Weighting of Factors and Approaches*. The *Evidence-Based Valuation Analysis* section is bifurcated into “A View from the Tax Court” and “A View from Academia,” noting that “the weight to be accorded to these analyses will depend upon the validity of their reasoning and the thoroughness of the data considered.” The court section simply follows the line of cases previously discussed in this article. The entire listing of relevant opinions is set out in Appendix B to the Job Aid.

It is clear throughout the entire Job Aid that the authors within the Internal Revenue Service are standing behind the case law as the primary guiding element of their challenges to tax-affecting S corporation earnings. Much of what is written within the Job Aid, and which has been addressed within this article, is simply a reiteration of the relevant court decisions. However, valuers would be wise to take these case outcomes with a grain of salt—understanding, as always, that valuation is a question of fact. While the cases are insightful, there is much discussion and commentary on the rationale behind a number of those decisions.

View from Academia. In the “View from Academia” section, the Job Aid cites just one primary analysis data-based study as academic evidence that deserves consideration in the course of valuing noncontrolling interests in S corporations. The study, authored by Merle E. Erickson and Shiing-wu Wang¹⁹ concludes that controlling interests in S corporations are more valuable than similar interests in equiv-

alent C corporations in a range of 10% to 20% of value. The Job Aid discusses this study at length in Appendix C and notes that the importance of the study is not in the conclusion but, rather, in the methodology of the analysis. An earlier analysis and study of this issue is also referenced in a footnote²⁰ but is not discussed.

The *Theory-Based Valuation Analysis* section of the Job Aid addresses, in a very general sense, the theoretical models presented to the business valuation community since the *Gross* decision. While not named, it is assumed that the models referenced include those advanced by Treharne, Van Vleet, Fannon, Grabowski, etc. The work put forth by these efforts has moved the profession forward in a major way on this issue but are essentially dismissed within the Job Aid due to the fact that the models “have not been tested against market evidence to gauge their reasonableness or accuracy in a real world context.”

The mechanical nature of the models is not based in theoretical concepts necessarily requiring market confirmation, as noted in the Job Aid. The models all seem to generally function to quantify the economic benefits accorded an investor in an S corporation established by fixed statutory law. If one is arguing that there is an economic benefit accorded a federal income tax structure, one should only need to go to guiding tax law, as enacted by Congress, to understand the mechanics of quantifying those effects.

In the *Weighting of Factors and Approaches* section, the Job Aid sets out a number of specific considerations and the process by which the relative importance of each is addressed within any specific valuation. It reverts to Section 7 of Rev. Rul. 59-60, which basically notes that “there is no means whereby the various applicable factors in a particular case can be assigned mathematical weights in deriving fair market value.” This section of the Job Aid leaves readers with a feeling of dissatisfaction, simply suggesting that all of the available information must be considered and synthesized using professional judgment based on expertise

and experience to arrive at a defensible result. The document further notes what is a very well known fact, “This is not an easy task...”

Assessment and Synthesis. This section of the Job Aid provides two examples, reinforcing the information discussed earlier throughout the document, as well as a general summary, again deferring to Rev. Rul. 59-60. The summary also lists some additional specific factors that should always be considered in conjunction with meeting professional valuation standards.

Appendices. The final section consists of the three appendices noted earlier:

- Rev. Rul. 59-60.
- A View from the U.S. Tax Court.
- A View from the Academic Community.

Concluding Thoughts

More than a decade and half has passed since the Tax Court’s decision in *Gross* first brought the tax-affecting issue to the forefront in the profession. It is unfortunate that it has taken this long to gain some insight into the Service’s thinking on this matter. More unfortunate, however, especially if it was intended to serve as guidance, is that the information contained in the Job Aid offers little more than that which could be easily gleaned from a careful reading of the case law. It is clear that practitioners choosing to tax-affect earnings of S corporations in the valuation of noncontrolling equity interests have an uphill struggle before them, should the tax-affecting be challenged by the IRS. As illustrated in the Job Aid, the Service appears poised to stand on the foundation provided by the relevant cases.

Practitioners and taxpayers cannot dismiss out of hand the information set out in the Job Aid. At the same time, it is critical that readers of that document clearly understand that the information set forth therein is not legal statute or any specific guidance that is required of valuers, or which might be relevant to the identification and quantification of the benefits associated with holding a non-controlling interest in an electing S corporation. ■