



# Shannon Pratt's BUSINESS VALUATION<sup>®</sup>

UPDATE

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Timely news, analysis and resources for defensible valuations

Vol. 10, No. 3, March 2004

## Editor's Column:

### Trapped-in capital gains taxes should be deducted when valuing for divorce

I think it is exceedingly unfair in a marital dissolution property distribution to award an appreciated asset to one spouse without any deduction for the trapped-in capital gains tax while awarding the other spouse property that is free and clear of potential capital gains taxes.

#### Majority deny discount unless sale imminent

Although some states routinely deduct trapped-in capital gains taxes on appreciated property, the majority of states deny the capital gains deduction unless there is evidence of intent to sell. (For example, see *Owens v. Owens*, p. 7 and *Blevins v. Blevins*, p. 9.) Yet the philosophy articulated in most states is not to require or restrict the activities of either spouse post-divorce.

The implication of denying the capital gains tax deduction is that the operating spouse will continue to operate the business and will be precluded from selling it (or, if he or she decides to sell at some time in the future will realize proceeds less than those on which the property division was based).

#### Intent of party violates principles of equitable distribution

It seems to me that the *intent* at the valuation date with respect to disposition of the property is irrelevant. The spouse with the distributed property should be free to do with it as he or she

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## Guest Article:

### S corp or C corp? M&A deal prices look alike

By John R. Phillips, CPA/ABV, CFA\*

*In the June 2002 of the BVU we printed an article by Chris Mercer titled, "S corporation versus C corporation values." Since then, the topic made the front page again in five monthly issues in 2002 and 2003. We are revisiting the topic this month with an article presenting results of regression analyses using the Pratt's Stats<sup>™</sup> database (available at BVMarketdata.com). The author recommends that anyone valuing an S corp minority interest should perform a market analysis based on control transactions. —AN.*



John R. Phillips

Most valuation analysts are aware that S corp valuations have been controversial long before *Gross v. Commissioner*.<sup>1,2</sup> However, few may be aware of the sea change in the discussion of S corp valuations that emerged after *Gross*. In *Gross*, the court valued an S corp minority interest differently from a C corp by eliminating the C corp tax from the income approach. The appeals court held that this technique was not error. As the court noted, the income approach was the only method provided by either party.

Before *Gross*, discussion of S corp valuation was limited to purely theoretical income models that attributed hy-

*Continued to next page...*

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<sup>1</sup> Pratt, Shannon, "Editor Attempts to Make Sense of S Versus C Corporation Debate," *Shannon Pratt's Business Valuation Update*<sup>®</sup>, (March 2003), vol. 9, no. 3, p. 1-4.

<sup>2</sup> *Gross v. Commissioner*, 2001 U.S. App. LEXIS 24803 (6th Cir., Nov. 19, 2001).

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## S corp or C corp? M&A deal prices look alike

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pothetical price effects to differences between the taxation of C and S corps. However, no one had published any comparison of real C and S corp prices to establish that they were, in fact, different. Further, no study tested whether any income model could predict real C and S corp prices better than any other. Because S corp income models lacked empirical validation, they remained speculative, subjective, and inherently unreliable.

What sea change occurred after *Gross*? Since *Gross*, empirical tests have been published, and the tests both support and challenge the proposed S corp income models. In doing so, the profession has moved toward providing S corp income models with a valid empirical footing. Leading the new tests was a study by Erickson and Wang ("EW"), who published a test of their theory that, in the merger and acquisition ("M&A") market, a taxable S corp stock transaction should be priced at a premium to an otherwise identical taxable C corp transaction.<sup>3</sup> They found higher price multiples for S corp stock than for C corp stock. This finding appeared to agree with the theory in *Gross*, and EW attracted immediate opposition.

As EW took pains to point out, they limited their comparison strictly to taxable stock transactions involving stand-alone corporations with no significant net operating losses ("NOLs").<sup>4</sup> In other words, they excluded all nontaxable stock transactions and taxable stock transactions in which the buyer of a C corp could step up the asset basis and still avoid paying tax on the gain.

<sup>3</sup> Erickson, Merle, "Tax Benefits in Acquisitions of Privately Held Corporations," *Capital Ideas*, Winter 2002.

<sup>4</sup> Erickson, Merle and Shiing-wu Wang, "Response to the 'Erickson-Wang Myth,'" *Shannon Pratt's Business Valuation Update*<sup>®</sup>, (February 2003).

<sup>5</sup> Mattson, Michael J., Donald S. Shannon, and David E. Upton, "Empirical Research Concludes S Corporation Values Same As C Corporations," *Shannon Pratt's Business Valuation Update*<sup>®</sup>, (November 2002), vol. 8, no. 10, (December 2002), vol. 8, no. 11.

Criticism of EW was warranted only to the extent that they projected their results beyond this limited transaction set. Their results cannot be extended to asset transactions, nontaxable stock transactions, or taxable stock transactions for C corp subsidiaries or stand-alone C corps with significant NOLs. As a result, EW did not determine whether a C or an S corp would fetch a higher price if provided a complete set of possible deal structures.

Next, Mattson, Shannon, and Upton ("MSU") tested C and S corp M&A transactions. They examined 2,487 S and C corp asset and stock acquisitions from the *Pratt's Stats*<sup>™</sup> dataset, which they divided into 17 size-based tranches.<sup>5</sup> In 16 of the 17 tranches, they found higher average price-to-sales ratios among C corps than among S corps. In other words, MSU confirmed that EW's findings do not apply generally to a broad transaction set. Although limited to M&A transactions, MSU's findings suggest that the theory in *Gross* may not match real world experience.

These studies leave several important questions unanswered. First, the studies point to opposite conclusions. How can these conclusions be reconciled, if at all? Second, other statistical tests are possible. Would a different test produce more conclusive results? Last, both studies dealt with M&A transactions, presumably control transactions, whereas *Gross* dealt with minority interests. What relevance do these studies have for post-*Gross* minority interest valuations? Many income models have been proposed for S corp valuations. Does the data support one model better than another? This article describes our attempt to address these questions.

### Analysis of transactions

We analyzed transactions from the *Pratt's Stats*<sup>™</sup> database using regression analysis. We obtained 2,305 trans-

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## S corp or C corp? M&A deal prices look alike

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actions with SIC codes between 2000 and 5999 from the more than 4,000 transactions in the *Pratt's Stats™* database. These codes include manufacturers, wholesalers, distributors, and retailers, but exclude agricultural, mining, construction, financial, real estate, and service companies. We also excluded other pass-through entities ("OPTES"), including LLCs, LLPs, partnerships, and sole proprietorships. We screened out cases in which the balance sheet date followed the sale date. We reduced the dataset to 1,464 transactions that contained sufficient data for our test: (1) deal price, (2) sales, (3) EBITDA, (4) total assets, (5) the S or C corp status of the seller, and (6) asset or stock transaction.

The relative proportions of stock and asset sales among the C and S corp transactions are particularly interesting because they provide direct evidence of the relative frequency of each type of transaction. Some S corp income models assume that an S corp stock transaction is more valuable than a C corp stock transaction. Yet before EW and MSU, no test demonstrated the validity of this assumption.

Table 1 shows the number of transactions within each category: S corp; C corp; asset acquisition; and stock acquisition. S corp transactions compose 42.9% of the transactions, which is below 48%, the actual proportion of S corps among all corporate tax returns in 1993.<sup>6</sup> C corp acquisitions are split almost equally between asset and stock acquisitions. On the other hand, asset

acquisitions make up about three-quarters of S corp transactions. These proportions agree with MSU's findings.

The relative proportions of S corp asset and stock transactions raise an interesting question. If S corp stock transactions have exceptional tax advantages, why are there not more of them? A likely explanation is that S corp sellers are uniquely indifferent to either an asset or a stock sale. Why? Unlike C corp sellers, S corp sellers avoid double taxation in either transaction. In contrast, buyers prefer an asset transaction, both for the step-up in tax basis and to avoid unwanted assets and liabilities. Under this scenario, S corp asset sales will dominate.

To simplify our comparisons, we did not include the 498 OPTES transactions, but among the OPTES transactions, 92% were asset sales and only 8% were sales of ownership interests. Had we included this group, they would have exhibited the highest average discounts, or lowest average prices, relative to C corp stock prices among the transaction types, because of the overwhelming proportion of assets sales.

Next, in Table 2, we examined the statistics for the transactions in each of the four possible combinations of S corp, C corp, asset, and stock acquisition. The average prices for C and S corp stock acquisitions are not significantly different. On the other hand, the average prices for C and S corp asset acquisitions are different, both from stock acquisitions and from one another. As-

set acquisitions are skewed toward small transactions, with S corp asset acquisitions being the smallest. Sales, assets, and earnings before interest, taxes, depreciation, and amortization ("EBITDA") follow the same pattern.

These size differences may reflect underlying fragmentation of the market, which is not adequately understood. For example, fragmentation could be caused by preferred habitats for each type of transaction, but these preferred habitats have not been described.

Next, we tested the regression model in Table 3. The model is intended to remove differences in value caused by differences in fundamentals, thereby isolating value differences associated with each transaction type. The log-log form is necessary to linearize the nonlinear present value formula, which is a ratio of benefits over discount rate. Value differences between transaction categories are captured in the last three binary variables, which mark C corp asset, S corp asset, and S corp stock transactions. The default, in which all three dummy variables equal zero, consists of C corp stock transactions. From this analysis, we can make several observations.

First, the adjusted R-squared is about 37%. This level is not unusual for a cross-section sample of M&A prices drawn over the past decade. We tried to improve the fit by adding a time-series variable—the P/E ratio for the S&P 500 Index—but the variable had no sig-

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**TABLE 1: NUMBER AND PERCENTAGE OF TRANSACTIONS BY TYPE**

	C corps			S corps			Total		OPTES		
	#	% C	% Total	#	% S	% Total	#	% Total	#	% OPTES	% Total
<b>Assets</b>	671	51.0%	45.8%	732	74.0%	31.8%	1,403	60.9%	458	92.0%	16.3%
<b>Stock</b>	645	49.0%	28.0%	257	26.0%	11.1%	902	39.1%	40	8.0%	1.4%
<b>Total</b>	1,316	100.0%	57.1%	989	100.0%	42.9%	2,305	100.0%	498	100.0%	17.8%

<sup>6</sup> Hoffman, Jr., William H., William A. Raabe, James E. Smith, and David M. Maloney, Ed., *Corporations, Partnerships, Estates, and Trusts* (West Federal Taxation: 2004), p.12-3.

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nificance. In general, M&A market prices are not nearly as homogeneous as exchange market prices, because M&A prices are neither standardized nor contemporaneous.

For our purposes, the R-squared is not as important as the statistical significance of the explanatory variables. The coefficients for the fundamental explanatory variables— $\ln(\text{Assets}/\text{Sales})$  and  $\ln(\text{EBITDA}/\text{Assets})$ —are statistically significant, with t-Statistics of 28 and 14. As a result, we can be fairly confident that any apparent premium or discount found between S and C corp stock or asset transactions is not caused by differences in fundamentals be-

tween groups.

After the fundamental variables, the coefficients for both C and S corp asset transactions,  $b_3$  and  $b_4$ , are negative 0.230 and negative 0.203, respectively, both significant at the 99% level. This result indicates that, on average, all asset transactions are priced at an approximate 20% discount relative to C corp stock. Last, the coefficient for S corp stock,  $b_5$ , is slightly positive, 0.045, but not statistically significant at a meaningful level. As a result, both C and S corp forms have no significant generalized impact on either asset or stock prices.

However, two important statistical

flaws qualify these results. First, the residuals appear to be heteroskedastic, that is, they violate the regression assumption of constant variance. As a result, tests of statistical significance are overstated. Second, the coefficients are not stationary; the estimated values of the coefficients change over time. If the regression is restricted to the most recent five years, then all coefficients, except for C and S corp asset sales, fall outside the confidence intervals determined from the preceding five-year period. Intriguingly, S corp stock now has a premium of 19.8%, but with only marginal statistical significance.

### Conclusions

**1. Asset and stock prices are generally different, but C and S corp prices are not.**

Under the null hypothesis, the coefficients for C corp assets, S corp assets, and S corp stock,  $b_3$ ,  $b_4$ , and  $b_5$ , respectively, are equal to zero. Based on our observations, after taking margin and turnover into account, both C and S corp asset transactions are priced alike, and both C and S corp stock transactions are priced alike, but asset transactions are priced at an approximate 20% discount to stock transactions. The difference between C and S corps prices is not statistically significant in either asset or stock transaction.

This result opens a hole in the market approach for controlling interests. Asset and stock transactions have different prices, but no criteria predict the likelihood that a particular corporation will sell in an asset or a stock transaction. As a result, valuations must reflect some simple average of the two transaction values. Some will still argue, in the absence of aggregate empirical evidence, that their corporation should be priced solely as an asset or as a stock transaction.

**2. Taxes are not the primary determinant of M&A prices.**

Some income models assume that

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**TABLE 2: DESCRIPTIVE STATISTICS (\$ IN MILLIONS)**

		Asset Transactions		Stock Transactions	
		C corp	S corp	C corp	S corp
Deal Price	Low	\$ 0.0	\$ 0.0	\$ 0.0	\$ 0.1
	Mean	19.0	10.0	29.0	22.0
	High	368.5	302.0	749.0	336.1
Sales	Low	0.1	0.0	0.2	0.2
	Mean	27.9	17.4	41.6	40.5
	High	617.9	572.2	929.9	658.3
Assets	Low	0.0	0.0	0.0	0.0
	Mean	14.8	5.4	20.4	13.5
	High	322.3	165.0	200.4	375.7
EBITDA	Low	0.0	0.0	0.0	0.0
	Mean	2.4	1.3	3.4	2.8
	High	56.4	37.5	45.0	35.2
Deal Price / Sales	Mean	1.05	0.75	1.29	1.05
	Std. Dev.	4.11	0.88	2.48	1.06
Assets / Sales	Mean	58.3%	41.6%	61.8%	43.9%
	Std. Dev.	95.0%	50.8%	63.9%	29.5%
EBITDA / Assets	Mean	40.5%	85.6%	21.1%	29.8%
	Std. Dev.	77.5%	440.5%	17.1%	25.9%
EBITDA / Sales	Mean	11.7%	14.7%	11.1%	12.4%
	Std. Dev.	10.6%	11.5%	9.1%	11.8%
Sample Size	N	388	446	414	216

## S corp or C corp? M&A deal prices look alike

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taxes are a primary determinant of S corp prices; however, the empirical hierarchy of stock prices over asset prices cannot be explained by tax attributes alone. Table 4 describes the price impact of various advantages and disadvantages on buyers and sellers. In a competitive market, when sellers benefit, they bid prices down, and when buyers benefit, they bid prices up, and vice versa. Asset prices appear to be lower for two reasons, neither tax-related: (1) carve-outs of unwanted assets and liabilities decrease deal prices relative to the pre-acquisition size of targets; and (2) asset transactions impose more administrative costs on buyers.

### 3. Our results are consistent with both MSU and EW.

Our results comport with both MSU and EW. Consistent with MSU, the weighted average S corp transaction price is less than that for C corps. More precisely, the weighted average discount for S corps is negative 13.9%, (74% x -20.3% + 26% x 4.5%), whereas, that for C corps is negative 11.0%, (48% x -23.0%). S corp prices are not always higher than C corp prices. In general, they do not differ.

**TABLE 3: REGRESSION ANALYSIS**

<i>Regression Statistics</i>						
<b>Multiple R</b>	0.611					
<b>R Square</b>	0.374					
<b>Adjusted R Square</b>	0.372					
<b>Standard Error</b>	0.723					
<b>Observations</b>	1,464					
<i>ANOVA</i>						
	<i>df</i>	<i>SS</i>	<i>MS</i>	<i>F</i>	<i>Significance F</i>	
<b>Regression</b>	5	454.887	90.977	174.019	0.000	
<b>Residual</b>	1,458	762.243	0.523			
<b>Total</b>	1,463	1,217.131				
<i>Standard</i>						
	<i>Coefficients</i>	<i>Error</i>	<i>t Stat</i>	<i>P-value</i>	<i>Lower 95%</i>	<i>Upper 95%</i>
<b>Intercept</b>	0.786	-3.872	13.196	0.000	0.669	0.902
<b>ln(Assets / Sales)</b>	0.736	0.026	28.051	0.000	0.685	0.788
<b>ln(EBITDA / Assets)</b>	0.286	-1.412	14.410	0.000	0.247	0.325
<b>C corp Asset</b>	-0.230	0.051	-4.464	0.000	-0.331	-0.129
<b>S corp Asset</b>	-0.203	0.052	-3.917	0.000	-0.305	-0.101
<b>S corp Stock</b>	0.045	0.061	0.740	0.459	-0.075	0.165

Consistent with EW, when limited to stock transactions, S corp prices do reflect a small premium to C corp prices. However, our results fail to prove EW's hypothesis that taxable S corp stock transactions are priced at a premium to taxable C corp stock transactions. First, the S corp premium for stock transactions is not statistically significant in a

meaningful way. Second, we cannot exclude price differences caused by the inclusion of nontaxable stock transactions. Nontaxable stock deals have lower prices than taxable stock deals. On average, buyers pay three to four percent more for deals that are taxable to the seller.<sup>7</sup> As a result, C corp stock deals could have a lower average price

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**TABLE 4: TAX ADVANTAGES AND DISADVANTAGES OF CORPORATE FORM FOR MERGER OR ACQUISITION**

<b>Form</b>	<b>Seller</b>		<b>Buyer</b>	
	<b>Advantage / Disadvantage</b>	<b>Price Affect</b>	<b>Advantage / Disadvantage</b>	<b>Price Affect</b>
<b>STOCK S corp</b>	Adv: Avoids corporate-level tax	-	Adv: Obtains step-up in asset basis	+
	Adv: Earnings add to basis	-	Adv: §338(h)(10) election always available	+
	Adv: Nontaxable stock-for-stock deal possible	-	Adv: Noncash stock-for-stock deal possible	+
<b>STOCK C corp</b>	Adv: Avoids corporate-level tax	-	Adv: §338 election may be feasible	+
	Adv: Nontaxable stock-for-stock deal possible	-	Adv: Noncash stock-for-stock deal possible	+
			Dis: Prevents basis step-up, if §338 election not feasible	-
<b>ASSETS S corp</b>	Adv: Avoids corporate-level tax	-	Adv: Obtains step-up in asset basis	+
	Dis: Remaining assets and liabilities	+/-	Adv: Avoids unwanted assets and liabilities	+/-
	Dis: More costly to administer	+	Dis: More costly to administer	-
<b>ASSETS C corp</b>	Dis: Incurs corporate tax on gain	+	Adv: Obtains step-up in asset basis	+
	Dis: Remaining assets and liabilities	+/-	Adv: Avoids unwanted assets and liabilities	+/-
	Dis: More costly to administer	+	Dis: More costly to administer	-

<sup>7</sup> Weston, J. Fred, Juan A. Sui, and Brian A. Johnson, *Takeovers, Restructuring and Corporate Governance*, 3rd Edition, Prentice Hall, 2001, pp. 100-1, 214-15.

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than S corp stock deals, only because they include more nontaxable transactions. Unfortunately, we cannot identify whether transactions in the database are taxable or nontaxable.

### 4. Not generally, but under the right conditions, S corps may be found to sell at a premium to C corps.

We found that more recent transactions provide stronger support for an S corp premium than earlier transactions. In addition, we found S corps more concentrated in some industries than C corps. An entity's form is not a fundamental valuation variable but instead is a proxy for a complex package of legal and tax options. The idea that some packages may be more valuable than others under some circumstances, but not under others, appeals to common sense. We are left with the problem of identifying these combinations of circumstances. For this reason, S corp income models should be tempered with a market analysis of real transactions to demonstrate that such conditions exist.

Although the trend in the choice of corporate form increasingly favors S corps, only a few changes in tax law after 1993 increase the number of eligible shareholders. No clear event stands out on which to peg a structural break in pricing. This result should not be surprising, because the corporate form is not a fixed, fundamental valuation variable but instead is a proxy for a changing package of tax benefits. This changing package suggests that S corps need to be valued in reference to market prices within a few years of the valuation date.

### Implications for minority interests

Whatever the corporate form, the controlling interest price sets the ceiling on the price of an S corp minority interest. Why? First, if a corporate acquisition were imminent, the buyer of an S corp minority interest would not pay more than the control price per share. He or she would receive only the control price in

the subsequent acquisition. Further, in the same S corp, one minority shareholder would pay another more than the control price per share, particularly if the buyer acquired control. Presumably, a new controlling shareholder could sell only for the control price. More strongly, the sale of an S corp controlling interest would never be optimal if an additional premium could be obtained merely by selling stock in minority blocks.

Why is this important? The *Gross* valuation relied solely on an income approach without referring to market prices. Unfortunately, the income approach used alone provides no guarantee that any transaction ever occurred anywhere near the indicated price. For example, the simplest S corp income model produces an indicated S corp value more than 50% greater than the C corp value simply by adding back the 35% C corp income tax to S corp cash flow, leaving the discount rate unchanged. No transaction data support this premium.

Seemingly reasonable assumptions can produce ludicrous results when an income approach is used alone, untethered to any market data. Given this weakness, market data are required to calibrate income models and confirm the validity of the results. Our findings show that control transactions provide the market data needed to control the income approach; they place S corp minority income models in a reasonable upper bound and prevent extreme income valuations.

In sum, when valuing an S corp minority interest, I recommend a market analysis based on control transactions. Only a market analysis can establish the most likely S corp control price empirically, establish the conditions for C and S corp relative value, and place reasonable limits on the minority interest valuation. Like most newly hatched youngsters, the income approach should not be allowed to play alone and unattended. More than ever, it needs adult supervision. **BVU**

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wishes without a tax penalty relative to the other spouse. It really isn't a question of *whether* the operating spouse will dispose of it but *when* and *how*. If it is sold, capital gains tax will be owed. If it is transferred to his or her heirs at death, the heirs will not have to pay capital gains tax *per se*, but will owe estate tax on the transfer.

### Tax Court recognizes trapped-in capital gains tax

Family law courts frequently follow valuation practices of the U.S. Tax Court. Since 1998 the Tax Court has recognized trapped-in capital gains. In the *Eisenberg* appeal,<sup>1</sup> the Second Circuit commented favorably on the earlier *Davis* decision,<sup>2</sup> and allowed recognition of trapped-in capital gains.

In the *Welch* case,<sup>3</sup> in which the estate had an election to opt out of capital gains tax which they ultimately exercised, the Sixth Circuit said the intent was irrelevant. In *Estate of Dunn*, the Fifth Circuit said that capital gains tax would be deducted "*as a matter of law*"<sup>4</sup> (emphasis added).

### Capital gains tax is a liability

Uncertainty as to the future course of action of the operating spouse should not make any difference. The capital gains tax is built in and is a liability against the property. Whether the realization of that liability is imminent should be irrelevant.

Best wishes,



<sup>1</sup> *Eisenberg v. Commissioner*, 155 F.3d 50, 1998 U.S. App. LEXIS 20109 (2nd Cir. Aug. 18, 1998).

<sup>2</sup> *Estate of Davis v. Commissioner*, 110 T.C. 530, 110 T.C. No. 35, 1998 U.S. Tax Ct. LEXIS 35 (Tax Ct. June 30, 1998).

<sup>3</sup> *Estate of Welch v. Commissioner*, 2000 U.S. App. LEXIS 3315 (6th Cir. Mar. 1, 2000).

<sup>4</sup> *Estate of Dunn v. Commissioner*, 301 F.3d 339, 2002 U.S. App. LEXIS 15453 (5th Cir. Aug. 1, 2002).