Best Practices

Reviewing the Service's Job Aid on the Valuation of Noncontrolling Ownership Interests in S Corporations

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Valuation analysts often search for ways in which to perform valuation analyses that provide conclusions of value that are reasonable and supportable. However, a supportable conclusion may not be immediately recognized as such. Valuation conclusions will be accepted as valid if the trier of fact is in agreement with the supporting methods, assumptions, and other inputs into the valuation and if this "evidence" points the reader or trier of fact to the same conclusions. Understanding where the Internal Revenue Service auditors are coming from is helpful to all valuation analysts whose work will come under their review. The Service's Job Aid is a framework relied upon by the Service in its review of tax valuations. This discussion provides information that valuation analysts may consider while preparing their valuation analyses.

Introduction

On October 29, 2014, the Internal Revenue Service (the "Service") issued a document called a Job Aid on the subject of valuing noncontrolling interests in corporations electing to be taxed for federal income tax purposes under Subchapter S of the Internal Revenue Code.

These entities are commonly called "S corps" while other taxable corporations are known as "C corps." This discussion reviews the subject S corp Job Aid.

From this review, readers may develop some perspective on two major issues.

First, this discussion will help readers understand the Service's position on how to value noncontrolling S corp interests. This understanding will help the valuation analyst and other taxpayer advisers understand how to format their valuations in a manner that will most likely increase the Service's acceptance of the taxpayer's position when a return is audited.

Second, our review covers the deficiencies of the Service's analysis in its S corp Job Aid and points out missing or poorly documented positions in the Job Aid. This review will help taxpayers and their advisers to rebut unreasonable positions taken by the Service in valuing noncontrolling ownership interests in S corps on audit.

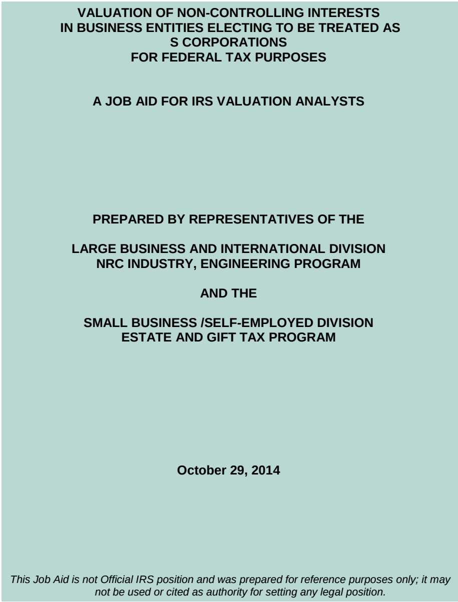
What Is a Service Job Aid?

A Service Job Aid is a reference work developed by Service personnel that discusses and provides guidance on a particular topic. Job Aids are typically authored by a selected task force of personnel with special knowledge or concern regarding the topic under discussion.

Job Aids are meant to be an internal communication conduit within the Service, somewhat like a reference library to aid less experienced examiners encountering an issue for the first time.

The Service has issued Job Aids on a wide variety of topics, ranging from setting forth talking points on new Service initiatives for taxpayers to how to calculate certain penalties.

In addition, the Service also previously issued at least one Job Aid on closely held business



VALUATION OF NON-CONTROLLING INTERESTS
IN BUSINESS ENTITIES ELECTING TO BE TREATED AS
S CORPORATIONS
FOR FEDERAL TAX PURPOSES

A JOB AID FOR IRS VALUATION ANALYSTS

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

October 29, 2014

This Job Aid is not Official IRS position and was prepared for reference purposes only; it may not be used or cited as authority for setting any legal position.

valuations. That Job Aid concerned the discount for lack of marketability and was dated September 25, 2009 (and became public in 2010).

Because Job Aids are internal Service documents, they are often made public via a Freedom of Information Act (FOIA) request. This is what happened in the case of the discount for lack of marketability Job Aid and the subject Job Aid on valuing S corps.

After release under the FOIA, the Service subsequently decided to make Job Aids concerning closely held business valuations (and the related topic of employee shareholder compensation) available on its website.[1]

How official are Job Aids? As noted on the title page of the subject Job Aid: "This Job Aid is not official IRS position and was prepared for reference purposes only; it may not be used or cited as authority for setting any legal position."

Therefore, a Job Aid is not the forum in which the Service publishes its official legal positions.

However, while the *Internal Revenue Manual* does not specifically require examiners to use the Job Aids, these aids are readily accessible for examiners online through the Service intranet.

The U.S. Treasury Department, the department of the U.S. government under which the Service operates, has criticized the Service for not using or documenting the use of Job Aids.

The Treasury Inspector General has indicated that Job Aids should be followed as they provide "a reliable and consistent method for directing and guiding examiners."[2] Thus, Job Aids seem to carry at least a significant amount of informal weight.

A Short History of the Disputes over Valuing S Corp Interests

The valuation of S corp stock and ownership interests in other so-called "pass through entities" (PTEs) has been an area of dispute between the Service, taxpayers, and the valuation profession. Prior to the 2000s, most valuation analysts made no material distinction between valuing S corp shares and valuing C corp shares.[3]

Corporate cash flow was present valued after consideration of the income tax obligations associated with the corporation's income.

This valuation procedure changed with the publication of the *Gross* decision in 1999.[4] The taxpayer lost that case when the Tax Court decided that the subject S corp noncontrolling ownership interest should be valued using pretax cash flow. Subsequent judicial decisions in the Tax Court and other venues were decided in a similar fashion.

These other judicial decisions include the following:

1. *Wall v. Commissioner*[5]
2. *Heck v. commissioner*[6]
3. *Adams v. Commissioner*[7]
4. *Dallas v. Commissioner*[8]
5. *Gallagher v. Commissioner*[9]
6. *Giustina v. Commissioner*[10]

How the S Corp Job Aid Is Structured

The S corp Job Aid consists of 32 pages. The first 20 pages are text, plus there are three appendixes totaling 12 pages. The text consists of three major sections: Executive Summary, Discussion and Analysis, and Assessment and Synthesis.

Appendix A is a reprint of Revenue Ruling 59-60, an outline addressing the issues of valuing closely held business interests in general (with no references to valuing S corp ownership interests).

Appendix B consists of judicial decision citations, as discussed above, in which S corp ownership interests and other PTE interests were the subject of valuation disputes in the Tax Court.

Appendix C incorporates a discussion of one academic study as "evidence-based analysis" even though the study addresses the sale of *controlling* interests in S corps versus in C corps.

A close reading of the subject Job Aid suggests that it is a product of at least two groups within the Service. The Large Business and International Division (LB&I) and the Small Business/Self-Employed Division (SB/SE) are identified as providing representatives to the development of the subject Job Aid.

Within each division, representatives appear to include both attorneys and valuation engineering staff. However, the S corp Job Aid is directly addressed only to LB&I valuation analysts.[11]

Therefore, there may be some compromises embodied in the Job Aid in terms of coverage and detail with regard to explaining the Service's position on valuation. For example, it is noteworthy that the subject Job Aid explicitly avoids the discussion of the valuation of controlling ownership interests in S corps, even though the only academic literature cited concerns controlling ownership interests in S corps.

What Is in the Job Aid?

For a Job Aid that allegedly addresses the valuation of corporate interests, the S corp Job Aid has little substantive detail on methods or calculations that will conclude a fair market value for a noncontrolling ownership interest in an S corp.

The valuation issues in the subject Job Aid that appear important to the Service are stated as broad-based factors that can be summarized as follows:

1. Any income valuation approach should be set up in a manner that does not apply an entity-level income tax to cash flow.[12]

   Therefore, the following methods should be performed using pretax cash flow:

   a. Capitalization of cash flow methods
   b. Discounted future cash flow methods

2. By logical extension, this would also seem to apply to the market valuation approach, as this valuation approach relies on similar cash flow metrics, such as pricing multiples applied to earnings. The Job Aid avoids discussion of this issue, however.
3. No mention is made of the asset-based business valuation approach. Therefore, the reader is not otherwise enlightened as to the Service's opinion on the application of tax-effects to this valuation approach.
4. The Service makes an exception to this policy if the valuation analyst can make "a compelling showing" that arm's-length parties would apply an entity-level tax adjustment to cash flow (or, presumably, some other valuation metric).
5. The Service does state that the application of personal income taxes are "not relevant" in valuing an S corp noncontrolling ownership interest. The stated reason for this position appears to be twofold:

   a. The Service considers the application of a specific personal tax rate to result in a value that is based on an investment value standard of value, rather than a fair market value standard of value.
   b. The source data from Ibbotson (now Duff & Phelps) on rates of return from publicly traded stocks do not consider investor-level taxes.

6. The Service states that the risks attendant to a noncontrolling ownership interest in an S corp should be recognized in the following areas, although the Job Aid provides no analysis as to how these factors should be applied in a quantitative fashion:

   a. As stated in Revenue Ruling 59-60, the determination of value is subject to the specific facts of each case.
   b. Differences in state laws regarding taxation or other applicable factors that are levied on S corps versus C corps should be considered.
   c. Any restrictions or enhancements arising from shareholder agreements or similar corporate or PTE organizational document terms should be considered.
   d. PTEs should be compared to other PTEs, where at all possible.[13]
   e. Adjustments to the costs of capital may be appropriate for S corp valuations, depending on the specific facts of the case.

      i. This can affect the company's ability to raise equity capital.
      ii. This can also affect the company's ability to raise debt capital.

   f. Adjustments to the discount for lack of control may be appropriate for S corp valuations, depending on the specific facts of the case.

      Since the Service indicates that a primary factor is the corporation's distribution paying capacity (and not the current policy regarding distributions), the Service' starting point appears to be a controlling-ownership-interest-based assumption. Thus, for a noncontrolling ownership interest, an explicit adjustment for lack of control is necessary.

   g. Adjustments to the discount for lack of marketability may be appropriate for S corp valuations, depending on the specific facts of the case.

"The S corp Job Aid . . . is helpful in that it points out the areas of valuation analysis that the Service will not accept initially in taxpayer returns that deal with noncontrolling ownership interests in S corps."

   h. The previous factors are influenced by the universe of potential willing buyers and sellers that are eligible to hold S corp ownership interests.

7. Any adjustments should be based on "market based" or "data-based" evidence. Academic studies that pass the peer-reviewed standard set forth in *Daubert* are to be given consideration.
   a. The Erickson-Wang study is favorably mentioned, even though it relates to the sale of controlling ownership interests in S corps versus C corps.[14]
   b. The Denis-Sarin study is also mentioned in a footnote.[15]

8. Any theoretical valuation adjustment models that are not based on this type of evidence are not given any weight by the Service. This Service position is because such models are not "data-based" as noted above.

   This Service position would include a number of models published in peer-reviewed professional journals or adopted in other courts, such as the following:[16]
   a. The Delaware Court of Chancery model[17]
   b. The S corp economic adjustment model (SEAM)
   c. The Treharne model
   d. The Fannon model
   e. The Grabowski model
   f. The Mercer model

What the S Corp Job Aid Leaves Out

The S corp Job Aid leaves out a number of peer-reviewed studies that appeared before the Service issued the subject Job Aid. Therefore, the Service can be accused of cherry-picking the studies it relies on to develop the subject Job Aid. There are at least seven studies of this type.[18]

Furthermore, the subject Job Aid leaves out other articles and publications that have appeared that seem to validate the notion that any premium that may attach to an S corp ownership interest relative to a C corp ownership interest is not as large as the difference seen in capitalizing pretax cash flow versus after-tax cash flow as originally debated in the *Gross* decision.[19]

Summary and Conclusion

The S corp Job Aid published by the Service in late 2014 and made public in March 2015 is helpful in that it points out the areas of valuation analysis that the Service will not accept initially in taxpayer returns that deal with noncontrolling ownership interests in S corps.

The conclusion in the subject Job Aid that only methods utilizing pretax cash flow are acceptable is particularly troubling. This position clashes with the fact that generally accepted valuation models exist that:

1. are based on the after-tax market returns of C corp stock properly matched with after-corporate income tax metrics and
2. make a separate valuation adjustment for any S corp economic advantage.

Nevertheless, valuation analysts may want to modify their models to incorporate pretax cash flow in their analysis in order to avoid the Service's initial objections on audit.

The subject Job Aid is not helpful in that it ignores or minimizes a number of studies and valuation models that are logical and based on market metrics. These flaws and omissions in the Job Aid can serve as a basis for valuation analysts to rebut the Service's position on valuing noncontrolling S corp ownership interests.

The subject Job Aid is also summary in nature and does not provide the reader with any details on quantitative methods that the Service may agree are acceptable.

Notes:

1. These Job Aid documents can be found at www.irs.gov/Businesses/Valuation-of-Assets.
2. www.treasury.gov/tigta/auditreports/2006reports/200630106fr.html.
3. As an example, the reader is invited to review the treatment of S corporation ownership interest valuation issues in each of the editions of *Valuing a Business*, a standard business valuation reference, between 1989 (the second edition) and 2008 (the fifth edition).

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