



EXCERPT FROM:

Taxes and Value

The Ongoing Research and Analysis
Relating to the S Corporation Valuation Puzzle

Nancy J. Fannon
Keith F. Sellers

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S Corporation Valuation Puzzle

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and
Keith F. Sellers



What It's Worth

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While this guide endeavors to present the reader with a comprehensive review of the academic literature relating to the effect of taxes on the cost of capital, and suggests how such research might apply to private-company valuations, it does not constitute U.S. federal tax advice and is not intended or written to be used, and cannot be used, for the purpose of avoiding penalties under the Internal Revenue Code. Each reader should endeavor to understand and interpret the research and apply it in the appraisal of pass-through entities as they determine it best fits the particular situation.

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Introduction

The publication of this guide has been seven years in the making, and it could not have happened without the help and guidance of many individuals and researchers along the way. However, the publication of the guide does not mean that this work is done. To the contrary, the reason it has taken this long is the continually evolving nature of research.

We expect and welcome the continuance of this work in an effort to move the valuation profession forward on this controversial issue. In this guide, we set forth the findings of decades of academic research on the impact of taxes on firm value. Relying on this research, we demonstrate that historical market returns impound the effects of shareholder taxes, and these returns can be adjusted to estimate a cost of capital appropriate for pass-through entity valuation. We hope and expect that others will consider this work and build upon it, as well as suggest areas for improvement and furtherance of the analysis. However, the discussion presented herein should move the valuation profession ahead of the hypotheses and largely unfounded presumptions that have heretofore framed the tax-affecting discussion, by providing substantive data and information to inform their calculations.

This work adds to the critical and ongoing controversy in the valuation profession relating to the relative value of pass-through entities in contrast to publicly traded C corporations that are subject to double taxation (and from which the return used to value private companies using the income approach is derived).

It is intuitive to many analysts and investors that a company that is perceived to have a lower tax burden would have greater value (such as the perception of the relative tax burden of an S corporation and its investors compared to the perception of the tax burden borne by a public C corporation and its investors). However, it is the evidence and research that should guide our analysis—not our perception. The now infamous *Gross*¹ case (discussed in Appendix E) stated: “If ... the discount rate is assumed to be an after-shareholder-tax rate of return, *then the cash-flow should be reduced ('tax affected') to an after-shareholder-tax amount.*” (emphasis added).

As of the writing of this guide, *no court has been presented evidence* that demonstrates that the discount rate *is* affected by shareholder taxes. It is that evidence which this book seeks to address, by presenting the evidence of the effect of taxes on value. We then suggest how analysts might consider this evidence in their valuation of closely held businesses.

1 *Gross v. Commissioner*, T.C. Memo 1999-254, aff'd, 272 F.3d 333 F.3d (6th Cir. 2001)

We begin our analysis in Chapter 1 with an overview of the concept of matching the cost of capital with the income stream. The terminology analysts use to talk about the cost of capital has caused a great deal of confusion about how taxes affect it and the appropriate income stream to apply it to. Chapter 1 seeks to address this issue. Chapters 2 and 3 present an explanation of the concept of implicit taxes and an explanation of how taxes affect value. These chapters are precursors for Chapters 4 and 5, which present a literature review of research related to the impact of taxes on value and the implications of it for private-company valuation. Chapter 6 presents a summary of prior methods used by valuation analysts. We then review the literature related to the magnitude of tax effects on value in Chapter 7 and conclude in Chapter 8 with suggestions for how the research might impact the manner in which analysts value pass-through entities.

Readers looking to this guide for a “quick fix” to the issue of how to value a pass-through entity will be disappointed: There are no easy answers, and the research is both dense and has further to go; our suggestions for areas of further research can be found in Appendix A. However, as outlined in this Guide, the breadth and depth of information currently available allows us to make informed inferences and arrive at reasonable valuation conclusions—just as we do in nearly every aspect of private-company valuation.

Our analysis presumes that the reader has a basic understanding of the evolution of this issue in the business valuation profession and in the courts. It also assumes that the reader has a firm understanding of how the cost of capital that most private-company analysts use is developed. These topics are important precedents to understanding the research and analysis presented herein. For readers seeking more information on these subjects, please refer to Appendix B (“The Evolution of Pass-Through Entity Valuation”), Appendix C (“Understanding the Basics of the Cost of Capital”), and Appendix E (“Abstracts of Cases Addressing Pass-Through Entity Valuation”). Additionally, studies of transactions of C versus S corporations have provided insight into the existence and magnitude of pricing differentials. A summary of these studies, as well as our own study, can be found in Appendix D.

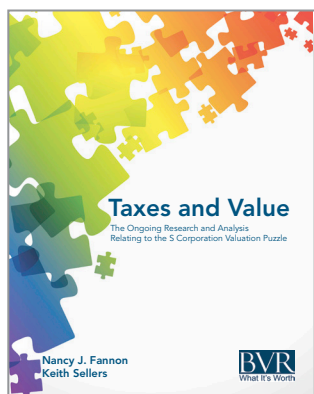
For the reader desiring a more in-depth understanding of the academic literature, Appendix F provides our complete bibliography of resources and Appendix G provides links to some of the most relevant research papers.

We hope that the research and analysis in this guide will assist the profession in moving its long-struggling quest to solve the pass-through entity valuation puzzle forward.

Nancy Fannon and Keith F. Sellers
2015

New! Taxes and Value: The Ongoing Research and Analysis Relating to the S Corporation Valuation Puzzle

Seven years in the making, *Taxes and Value: The Ongoing Research and Analysis Relating to the S Corporation Valuation Puzzle* guide provides a substantive contribution to the controversial issue of how to value pass-through entities. Authors Nancy Fannon and Keith Sellers present the findings of decades of academic research on the impact of taxes on firm value and demonstrate that historical market returns impound the effects of shareholder taxes. This guide brings the academic research together in one place and assists the profession in moving forward on its long-struggling quest to solve the pass-through entity valuation puzzle.



Authored by:
Nancy Fannon
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Here's what the technical review panel has to say:

"Great job marshalling the arguments and presenting them in a logical way."
(Aswath Damodaran, Professor of Finance, Stern School of Business, New York University)

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(Michael Gregory, Consultant, Michael Gregory Consulting)

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