



Gross v. Commissioner of Internal Revenue S Corp Earnings - To Tax-Affect or Not?

For many years, valuation professionals thought the rules on tax-affecting earnings of S corporations were straightforward. The standard was set. Tax-affecting was the appropriate course of action so that the pre-tax earnings of S corporations could be fairly assessed relative to the post-tax earnings of C corporations, which are the basis for well-established rates of return.

The case of *Gross v. Commissioner of Internal Revenue* and its subsequent appeal changed all that. The court ruled against tax-affecting S corp earnings, which raised significant questions about how to value S corporations in general.

A Gross Result?

The Gross case centered on a gift tax valuation of stock in a large bottling company owned by two families. For many years, the company's profits increased steadily, and shareholder distributions equaled almost 100 percent of income. When the company elected S status in 1982, a restrictive stock agreement permitted intra-family transfers but prohibited transfers outside the family. The agreement also restricted transfers that would jeopardize the S status. In 1992, five gifts were made.

The taxpayer estimated a value of \$5,680 per share. The IRS estimated a value of \$10,910 per share. The difference was due to the fact that the families' expert tax-affected (i.e., reduced) the company's earnings by an assumed 40 percent corporate rate, as if the company were a C corporation. The

IRS expert did not.

Who Said What?

The taxpayer's experts argued that tax-affecting was standard practice and that the IRS even recommended the method in its manuals. Further, they said that tax-affecting would compensate a hypothetical buyer from the risk that the bottler would lose its S corporation status.

The IRS countered that there was no indication that the company would lose its S status, and that a tax-affected valuation, therefore, was not appropriate. The courts agreed with the IRS, stating that there was no compelling evidence that tax-affecting was the standard in 1992. The court also commented that even though IRS manuals recommended tax-affecting, they included a disclaimer and were used for training only.

What's Next?

Many valuation experts believe that the courts were wrong on this one. Experts cite the fact that S corps have a smaller market because of the limited number of investors allowed. Moreover, analysis of private company transactions doesn't indicate a significant difference in the actual sales price between S corps and C corps. Experts also argue that it was improper for the IRS to introduce a new standard for determining the value of S corporation stock at trial in the Gross case and apply it retroactively.

The most popular argument against the court centers on the idea that it was improper for the IRS to introduce a new standard for determining the value of S corporation stock at trial and applying it retroactively.

Of course the courts' decisions were based only on the specific facts of the Gross case, and experts continue to discuss its implications. There's likely to be much more discussion to come as the valuation community decides how to proceed with this issue. In the meantime, attorneys and valuation experts must carefully evaluate circumstances in which tax-affecting is valid.

For more information about the Gross case or tax-affecting in general, please contact our office. We would be happy to

discuss how these rulings might affect your specific situation.

What is “Tax-Affecting?”

Business valuers are taught to match the discount rate to the financial statistic it is being applied to. Ibbotson Associates, a leading provider of stock market yield information from which valuation professionals derive discount rates, uses data from C corporations in determining those rates. Because C corporations pay corporate income tax, and S corporations do not, valuation experts often “tax-affect” the future earnings of the S corps by reducing them with a hypothetical corporate income tax before applying the discount rate.