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# Valuing S Corporation ESOP Companies

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On January 1, 1998, corporations with employee stock ownership plans (ESOPs) became eligible to elect S corporation status, and existing S corporations became eligible to form ESOPs, without nullifying the S corporation election. For 100% ESOP-owned companies, this change in the tax laws effectively eliminates federal income taxation. For companies that are less than 100% ESOP-owned, that portion of the income attributable to the ESOP's ownership is not taxable. For example, if an ESOP owns 35% of a company, then 35% of the company's income would not be taxable. The remaining 65% of the company's income would be taxable to the other shareholders at the shareholder level.

The elimination of taxes (completely for 100% ESOP-owned companies and partially for less than 100% ESOP-owned companies) presents some interesting valuation questions. Within the appraisal community, there long have been heated discussions regarding the appropriate methodologies to employ in valuing S corporations relative to C corporations due to their unique tax status. Thus, to a certain degree, the question of appropriate methodologies to employ in valuing S corporation ESOPs is not a new one. However, the ESOP's ability to completely eliminate taxes in some instances introduces a new factor to be considered.

In 2001 and 2002, three U.S. Tax Court cases addressed the valuation of S corporations (*Walter L. Gross, Jr. and Barbara H. Gross, Petitioners v. Commissioner of Internal Revenue, Respondent*, T.C. Memo 1999-254;4460-87,4469-97; *Estate of Richie C. Heck, Petitioner v. Commissioner of Internal Revenues, Respondent*, T.C. Memo 2002-34; 11619-99; and *Estate of William G. Adams, Jr. v. Commissioner of Internal Revenue, Respondent*, T.C. Memo 2002-80;14698-99).<sup>1</sup> These cases (not specifically about ESOP S corporations) support the premise that S corporations are more valuable than identical C corporations, a premise the authors take issue with. The court cases reignited the debate that occurred in 1998 when ESOP S corporations became legal. This debate continues to the present. In these cases, the court essentially agreed with the premise that the tax benefits of an S corporation relative to a C corporation create greater value. Opponents of this view point out that this added value is only theoretical; a buyer of the S corporation would have to retain its S status to retain that benefit.

The debate concerning valuation in ESOP S corporations is more specifically focused on the income approach (valuing companies based on a discounted value of future earnings) and the valuation of minority

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<sup>1</sup> The latest U.S. Tax Court Case is *Robert Dallas v. Commissioner*, T.C.M. 2006-212 (2006). The tax court found for the IRS in this gift tax case. The appraisers for the taxpayer tax-affected for C corporation taxes, reasoning that the firm would most likely be sold to a C corporation. The court said it could find no evidence that the company's S corporation status was likely to be lost. It is worth noting that the court stated in *Dallas* that how ESOP S corporation stock is valued was not germane because "There is no evidence that the Department of Labor's definition of value is similar to the definition of fair market value in this case." S corporation tax affecting has also been an issue in the Delaware Court of Chancery, *Del. Open MRI Radiology Associates, P.A. v. Kessler*, 898 A.2d 290 (Del. Ch. 2006), and in at least one divorce case (the Massachusetts Supreme Judicial Court in *Judith E. Bernier v. Stephen A. Bernier*, No. SJC-09836 (Mass. Sept. 14, 2007).

interests (how much less buyers should pay for a less-than-control interest), particularly minority interests of companies that are making distributions significantly above those necessary to meet shareholders' tax liabilities.

The income approach issue, as we will discuss below, revolves around whether the tax shield provided by the ESOP creates additional future income compared to what would occur if the company were a C corporation. If so, how much should this additional income be counted in assessing value?

The minority interest issue is somewhat more complicated. A minority interest is generally worth less than its pro rata portion of the 100% equity value of the company. This is because such an interest lacks control and lacks marketability. However, if such an interest receives significant interim returns in the form of dividends, then the receipt of such income returns tends to mitigate the minority interest's lack of control and lack of marketability. Investors receiving a sufficient income return on an investment are more indifferent to their lack of control and are less concerned about the investment's lack of marketability. The investor is not dependent on selling the investment in order to realize a return. The capital gains portion of the value is less than if the company reinvested the dividends, but the income portion is greater. Such a minority interest will have lower discounts for lack of control and lack of marketability, and thus, its fair market value may be much closer to its pro rata portion of the company's 100% equity value than a similar minority interest not receiving dividends or receiving dividends sufficient only to meet the owner's tax obligations. The fair market value of such a minority interest will never equal its pro rata portion of the 100% value, because the interest does not have the ability to declare dividends. Therefore, it is at risk that dividends may be reduced or completely curtailed.

The decisions rendered in the tax court cases cited above involve facts and circumstances unique to the specific companies. A discussion of the court cases is not germane to this chapter, and in the opinion of the authors the court cases are not applicable to S corporation ESOP valuation in general.

## Impact of S Corporation Election on ESOP Company Cash Flows

### Less Than 100% ESOP

In this case, the cash savings to the company are limited because cash payments are generally made to all shareholders so that the non-ESOP shareholders have cash available to pay taxes on the S corporation income attributable to the non-ESOP shareholders at the shareholder level. The distributions made to meet these personal tax obligations go, in the case of the non-ESOP shareholders, directly to the shareholder, and, in the case of the ESOP, to the ESOP trust. In either case, the cash is no longer available to the company to reinvest into productive assets. To the extent that these distributions can be used by the ESOP to pay principal and interest (in the case of a leveraged ESOP) or to pay ESOP benefit distributions, then there is a cash savings to the extent that distributions result in lower company contributions to the ESOP.

### 100% ESOP

In an S corporation that is 100% owned by an ESOP, there are no corporate federal income (and often state) taxes paid. Therefore, the company realizes, on an annual basis, a cash savings equal to the dollar amount of the taxes the company would have to pay were it a C corporation.

## Appraisal Methodologies

The Internal Revenue Service (IRS) and the U.S. Department of Labor (DOL) generally govern appraisals for ESOP purposes. In this chapter, we will not discuss appraisal methodologies as they apply to ESOPs in general, but rather how they apply to ESOP S corporations specifically.

### Value Enhancement Associated with S Corporation Election

There is no question that the absence of taxes represents true cash savings to a company. It follows, then, that the cash savings should translate into some form of enhanced value.

From the most global perspective, value is enhanced via the increase in cash flows available to the company. The source of these cash flows is the cash that would otherwise have gone to pay corporate federal income taxes. As discussed above, the magnitude of the savings depends on the percentage of the company owned by the ESOP. This value enhancement is realized in one of two ways: either through reinvestment of cash flows or through the payment of regular dividends. The reinvestment of the added cash flows into productive assets earning a return in excess of the company's cost of capital enhances value over time as those assets become productive and generate additional cash flows and higher levels of growth than would otherwise be the case. When the cash flows are paid out in the form of dividends, the owner of the ESOP common stock earns a portion of its total return in the form of dividends. In this case, the value is captured either in a capitalization of dividends approach or in the increased marketability (or conversely lower marketability discount) of the security due to its higher income return. The capital gains portion of the value is less than if the company reinvested the added cash flows, but the income portion is higher.

If the company merely retains the added cash flows in the form of cash and marketable securities, which do not earn a return in excess of the company's cost of capital, the S corporation election may not be value enhancing. *The mere avoidance of taxes does not enhance value. The cash savings associated with the S corporation status must be put to productive use.*

### Initial Transactions and Updates

*Standard of Value.* A significant governing factor in considering the most appropriate appraisal methodologies is the standard of value for ESOP appraisals. IRS regulations, proposed regulations by the DOL, and general case law dictate that the appropriate standard of value is fair market value. Fair market value is defined as follows:

Fair market value is considered to represent a value at which a willing seller and willing buyer, both being informed of the relevant facts about the business, could reasonably conduct a transaction, neither person acting under compulsion to do so.

*Appropriate Methodologies Within the Context of Fair Market Value.* The appropriate standard of value and the definition of fair market value require an appraisal incorporating the concept of "any willing buyer" and "any willing seller." For the ESOP company to retain its S election (and the associated tax savings), it must be purchased by an S corporation. The presumption of an S corporation buyer violates the fair market value standard because another S corporation is a specific buyer. It follows, then, that for annual update and transaction purposes, the S corporation is appropriately valued as if it were a C corporation. Given that valuing the S corporation ESOP company as a C corporation is appropriate, it is not appropriate to do the following:

1. Apply after-tax multiples to pretax numbers.
2. Add the present value of the tax savings associated with the S corporation election.
3. Apply after-tax discount rates to pretax cash flows.

*It is extremely important to recognize, however, that this does not mean that there will not be added value associated with the S corporation status.* The value of the S corporation election is realized over time as the cash flows are reinvested and the company's earnings are higher and/or growing faster than if the company were a C corporation. Intuitively this makes sense. "Any willing buyer" would naturally pay for value enhancements resulting from the reinvestment of cash flows into income-producing assets that were already in place earning a return. Those value enhancements or assets are transferable to "any willing buyer." It also follows, then, that there is no immediate "value pick-up" associated with S corporation status.

As a result, in an initial transaction, the ESOP should generally not pay for value enhancements that are not already in place. Nor should an ESOP pay for benefits that it brings to the table (such as the S election). As discussed above, when the added cash flows are paid out in the form of dividends, the enhanced value is captured in the increased liquidity (and thus the application of a lower discount for lack of marketability) associated with closely held paying securities.

To the extent large cash balances are developed over time, value may even be enhanced from an acquisition standpoint for those ESOP S corporations that simply hold their added cash flows. It is not likely that this value transfers to a minority shareholder, and to the extent it does transfer, it certainly is less than dollar-for-dollar.

Some argue that there is a significant amount of economic value associated with the S corporation election for ESOP companies, and that this economic value is equal to the present value of (or a multiple of) the future tax savings as a result of the S corporation election. Again, however, one must recognize that to retain this economic value, another S corporation must purchase the company and maintain the ESOP to keep the tax savings. Because there are far fewer S corporations than C corporations, the likelihood of an available S corporation buyer is much less. Therefore, within the context of fair market value, the presumption of an S corporation buyer requires the assumption of severely reduced liquidity resulting from a reduced number of "willing buyers." This reduced liquidity and resulting higher discount for lack of marketability would offset the added value implied by the present value of the tax savings to a large (if not total) extent. In addition, many other taxes (such as the LIFO recapture tax, and the built-in capital gains tax, which will be discussed later) may in fact be due from an S corporation upon sale of the company and/or upon conversion to an S corporation. These taxes would offset any value attributable to the tax savings calculated in this way.

Taking this concept one step further, one merely needs to consider the theory from a market perspective. Valuing the tax savings implicitly as described above presumes that a buyer of the S corporation would apply a multiple to pretax income. Assuming a 40% tax rate, a multiple of 5, and \$100 pretax income, this implies a significantly higher price for the S corporation, as shown in table 4-1.

Table 4-1. Applying a Multiple to Pretax Income

		S Corporation	C Corporation
Pretax income	\$100	\$100	
Corporate taxes	<u>\$ 0</u>	<u>\$ 40</u>	
Net income	\$100	\$ 60	
Times 5.0 multiple	<u>x 5</u>	<u>x 5</u>	
Value	\$500	\$300	

The question is, would any “willing buyer” (or any buyer) pay 67% more (\$500 versus \$300) for an S corporation relative to a C corporation? We believe the answer to this question is no. To a C corporation buyer, the S status of the selling company would be of no value. If the buyer were an individual, it would be more economical for that buyer to buy a C corporation and convert it to an S corporation. The cost of doing so would be much less than the 67% greater price for the S corporation. Such an individual may be willing to pay a premium for an S corporation but no more than the cost of converting a C corporation to an S corporation. If the buyer were an existing S corporation, it would not pay for tax benefits it already had.

## Sale of Company and/or ESOP Termination

We stated above that in an initial transaction, the ESOP should not pay for value enhancements that are not already in place, nor should it pay for benefits that it brings to the table such as the tax-free status in a S election. However, when the ESOP is selling its position, it may be appropriate for the ESOP trustee to consider the favorable S corporation tax treatment.

When an ESOP is selling its position or being terminated, the standard of value is still fair market value. However, the financial advisor to the ESOP trustee is often asked to determine whether the transaction is fair to the ESOP from a financial point of view. This is generally interpreted to mean that the transaction must be fair to the ESOP in both absolute terms (not less than fair market value) and relative terms when compared to many financial factors that are not necessarily part of fair market value. For example, is the consideration being received by the ESOP the same as other transaction participants? If the ESOP is leveraged with debt outstanding, we look to see whether or not the ESOP’s return on investment would be higher if it did not sell and simply held its investment until the debt was paid down. When the ESOP is considering a sale of its interest, then the trustee must determine that the sale is in the best interests of the ESOP participants. Therefore, a careful analysis of financial factors in addition to fair market value may include an analysis of the enhanced cash flow enjoyed by an S corporation ESOP. This is referred to by some as the ESOP’s “economic value.” It is typically defined as the present value of the ESOP’s pro rata portion of expected corporate income tax savings under an S election discounted at an equity-required rate of return. Many assume that fair market value will be below economic value.

The question is then whether the ESOP can sell at fair market value and thus below economic value. Arguably, an ESOP trustee would have difficulty accepting a fair market value buyout price if the economic value was considerably higher and no compelling reasons for a sale existed. This is most likely with a 100% ESOP-owned S corporation. In other words, an ESOP owning 100% of an S corporation may have a hold position, due to cash flows that are 100% free of corporate income taxes, that is more valuable than the price that a financial buyer or even a strategic buyer may be willing to pay. Absent compelling factors such as poor or deteriorating industry conditions or a repurchase obligation outstripping the liquidity abilities of the company, there may be no reason for the ESOP to forego its enhanced expected future cash flows if its return on investment is higher under a hold position than if it sells its ownership position. In terms of financial fairness, this seems entirely appropriate. It would be unfair to the ESOP to sell if it resulted in a return on investment below the return available to participants if the company continued on a stand-alone basis.

However, the discrepancy between fair market value and economic value as described above may be greatly overstated. First, the calculation of economic value must include all tax impacts. There are costs to converting to an S corporation as well as tax savings. These include LIFO recapture taxes and costs relating to the write-off of deferred tax assets and liabilities. Based on the experience of some of our ESOP clients who have converted from C to S corporate status, the break-even period may be two to three years. In addition, S corporations may be taxed on excessive passive income (over 25% of revenues) carried over from prior C corporation status. Finally, S corporations are subject to a built-in gains tax on disposition of appreciated

property carried over from the prior C corporation. This can be significant, particularly in the case where the value of the company experiences rapid growth from the time of conversion from C to S status. Also, some consideration must be given to possible changes in tax laws that eliminate the tax advantages of S corporations.

These costs may (most likely in the first years after the conversion), when factored in with the tax savings, reduce “economic value” and the relative difference to fair market value. Assuming over time the productive deployment of enhanced cash flows, the value of the S corporation will increase. As stated above, a third party should be willing to pay for this value because it is reflective of productive assets, not a tax status, and because it is transferable to a third party. Thus, over time, fair market value and economic value should converge, and “economic value” should be reflected in the price offered by a prospective buyer.

In conclusion, we urge caution in analyzing the concept of “economic value” as it pertains to S corporation ESOPs. While there may be some intuitive appeal to the concept, economic value is difficult to determine because it is affected by many variables:

- The level of distributions
- Subsequent investment returns
- Expected tax rates in the future
- Expected holding period of investment
- Expected sale price of investments at the end of the hold period

At a minimum, it must be considered within the context of the factors discussed above that offset economic value, such as the built-in capital gains tax.

In any transaction, from a fairness perspective, the question of whether or not the shareholder is being adequately compensated for his or her investment, given the terms of the transaction, is addressed. The 100% ESOP S corporation situation is no different. From this viewpoint, the analysis becomes a hold-versus-sell decision. As such, factors to be considered include a comparison of fair market value as a going concern compared to the proposed transaction price, the expected return if the ESOP holds its investment, the expected return if the ESOP sells its investment, and the risk factors that would tend to offset economic value.

## Conclusion

No increase in value is appropriate in the appraisal of S corporation ESOPs only as a result of a change in tax status. It is not appropriate to add the present value of the tax benefits. The appropriate standard of value and the definition of fair market value require an appraisal incorporating the concept of “any willing buyer” and “any willing seller.” For the ESOP company to retain its S election (and the associated tax savings), it must be purchased by an S corporation or individuals eligible to elect S corporate status. The presumption of an S corporation buyer violates the fair market value standard because another S corporation is a specific buyer. It follows, then, that for annual update and transaction purposes, the S corporation is appropriately valued as if it were a C corporation. The ESOP generally should not pay for the S corporation status at an initial transaction or for update purposes. However, consideration of the enhanced cash flows resulting from the S corporation status that have not yet been invested into productive assets may be appropriate as a part of the consideration of overall fairness when the ESOP is selling its ownership position or being terminated.