Viewpoint on Value

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S corporation conversions

Should you strike while the iron's hot?

Subchapter S election can potentially provide shareholders with more flexibility in business decisions, income and capital gains tax considerations, and distribution alternatives. And if you're contemplating electing S status, it may be prudent to plan now to minimize future taxes — especially since the recent enactment of new tax laws in which individual income tax rates have changed. But there are several valuation issues and implications worth considering before you take a precipitous leap toward Subchapter S status.

Potential tax savings

C corporations pay taxes twice. First, they're charged corporate-level income taxes. Shareholders then pay tax personally on C corporation distributions. But S corporations are flow-through entities for tax purposes. This means that income, gains and losses flow through to the owners' personal tax returns. S corporations are *not* taxed at the corporate level.

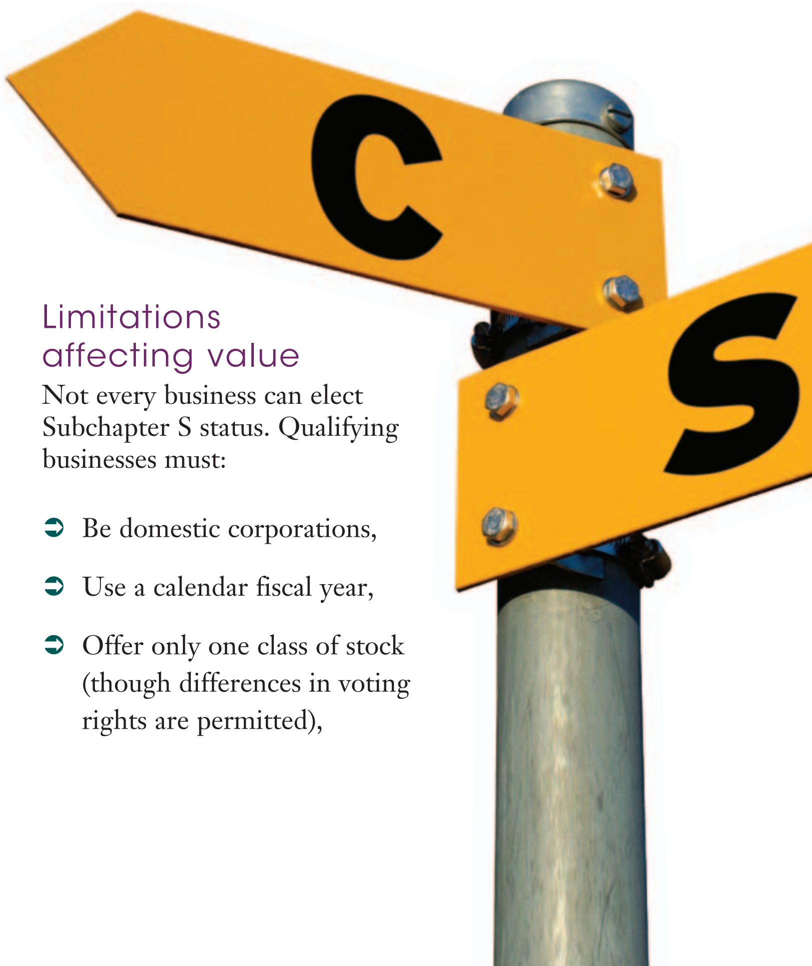
Double taxation of C corporations becomes a major issue when the owners decide to sell assets or transfer equity. Management can elect Subchapter S status when contemplating a sale to minimize corporate-level capital gains tax. But the Internal Revenue Code imposes a 10-year waiting period before gains on sales of assets or equity held by a newly converted S corporation can be treated as pass-through gains to shareholders. And while the Small Business Jobs Act of 2010 reduced this "recognition period" to five years (if the fifth year in the recognition period preceded the 2011 tax year), the reduction is *not* currently applicable to S corporations started in 2012 or 2013.

Recognition period gains

If a business sells assets or stock within the recognition period, only the appreciation in value from the date of the S corporation election will be exempt from corporate-level tax. So it's important to establish the company's fair market value at the conversion date and to allocate it to the company's assets. This enables taxpayers to quantify which portion of the gain should be taxed as C corporation gains and which portion should be taxed as flow-through gains to shareholders.

If a business is contemplating a Subchapter S election, there's no time like the present to start the clock on the 10-year recognition period. Asset and stock values are at all-time lows for many companies.

Suppose a business elects S status while asset and stock values are low, and it sells assets or stock before the recognition period expires. Then the portion of the gain taxed at C corporation rates will be minimized and the portion of the gain taxed as flow-through gains to shareholders will be maximized.



Limitations affecting value

Not every business can elect Subchapter S status. Qualifying businesses must:

- Be domestic corporations,
- Use a calendar fiscal year,
- Offer only one class of stock (though differences in voting rights are permitted),

Section 338(h)(10): Make everybody happy

Buyers and sellers sometimes butt heads when structuring deals. Buyers of S corporations prefer asset sales because they get a step-up in basis, which allows them to start depreciation and amortization anew. Also, they let buyers cherry-pick assets and liabilities.

Sellers, however, prefer stock sales, because sellers pay less tax. S corporation shareholders recognize the same gain or loss, regardless of whether assets or equity is sold. But part of the gain on an S corporation asset sale may be taxed at ordinary income rates, which are higher. Most gains on S corporation stock sales are usually taxed at capital gains rates, which are lower.

But an S corporation stock sale may be treated as an asset sale for federal tax purposes if 1) the buyer and seller jointly consent to elect Section 338(h)(10), and 2) the sale involves at least 80% of the company's equity. Now everybody's happy — sellers pay less tax and buyers receive stepped-up basis in the company's assets.

- Have no more than 100 shareholders — including individuals, certain trusts and estates but excluding partnerships, corporations, foreign individuals and entities, and ineligible corporations, and
- Distribute and liquidate assets to shareholders on a pro rata basis.

These eligibility requirements limit the pool of potential buyers of S corporation interests, but, if they're not adhered to, the company's Subchapter S status will be lost. A limited pool of potential buyers reduces an interest's marketability. Therefore, an S corporation may result in a higher discount for lack of marketability than an otherwise identical C corporation would.

S status and control

Although S corporations are required to make pro rata distributions to shareholders, they aren't required to distribute income to shareholders. So minority shareholders, who lack control over paying distributions, may find themselves required to pay personal-level taxes on S corporation income, regardless of whether the company actually distributed any cash to cover those respective shareholder tax liabilities.

If a business is contemplating a Subchapter S election, there's no time like the present to start the clock on the 10-year recognition period.

The annual tax burden can be substantial for highly profitable S corporations — and even more substantial for high-income taxpayers in light of recent tax rate increases. When an appraiser calculates discounts for lack of control for S corporations, historic and expected distributions and earnings are relevant considerations.

Projected earnings

One contentious issue valuators face when valuing S corporation interest is whether to tax affect earnings. In other words, should they subtract corporate-level taxes — as if the S corporation were a C corporation — before applying the income or market approaches?

The IRS began challenging the practice of tax affecting in 1999 and has had some success with the issue since then. Many valuators contend that tax affecting is still appropriate. What's clear, however, is that valuators can't mechanically tax affect S corporation earnings without considering the facts of each case and relevant case law.

The right choice

In deciding whether to convert to an S corporation and when, companies must consider several pros and cons. However, time is of the essence. As the economy heats up, corporate profits and asset values are likely to recover, and mergers and acquisitions will probably return to favor. Valuation professionals, working with tax advisors, can help determine the right choice for your circumstances. ●

Both sides of the story

Taking a balanced approach to damages calculations

Courts are leery of do-it-yourself calculations and hired guns. In cases involving damages, credentialed, independent financial experts bring reasonableness and credibility to the table by considering both sides of the story.

Data and context

Historic trends and statistical analysis can be useful tools in damages calculations — if put in a real-world context. If they aren't, the court might deem the analysis too speculative. For example, when predicting lost profits using historic revenue and expense trends, a valuator typically factors in economic data such as the guideline companies' performance, market surveys and the company's prelitigation financial projections.

Unlike traditional appraisal assignments, damages calculation analyses may benefit from hindsight. This means valuators can use *ex post* data, not merely information known or knowable when the injury occurred.

The defendant's actions might not necessarily be the sole reason the plaintiff's profits have declined. For instance, defendants aren't responsible for losses caused by external events, such as weak economic conditions, new technological advances or new competitors. A balanced analysis also factors in increased cost savings — such as reduced overhead costs, working capital requirements and capital investments — that may result from the defendant's alleged wrongdoing. In essence, it's necessary to consider all factors (both pro and con) that may have caused profits to decline.

Mitigating factors

Courts expect plaintiffs to take reasonable steps to mitigate damages once they have discovered a defendant's wrongdoing. An independent expert considers what the plaintiff did — or could have done — to offset the defendant's tortious acts. For example, the plaintiff might have selected an alternative supplier, reduced excessive capacity or, in the event of eminent domain, made an effort to find a suitable alternative location. Generally, the defendant bears the burden of proving that the plaintiff failed to reasonably mitigate damages.

A balanced analysis factors in increased cost savings — such as reduced overhead costs, working capital requirements and capital investments — that may result from the defendant's alleged wrongdoing.

It's important to keep in mind that damages are seldom permanent. Most plaintiffs can eventually recover from a defendant's wrongdoing.

The big picture

Sometimes lost profits aren't as relevant as lost business value in determining damages. To illustrate, egg producer Rose Acre Farms claimed in 1992 that the USDA's salmonella regulations resulted in a "regulatory taking" that violated the Fifth Amendment. The Court of Federal Claims awarded $5.4 million to Rose Acre Farms.

In 2009, the U.S. Court of Appeals for the Federal Circuit reversed that award, ruling that lost profits must reflect real-world costs and mitigations, including the value of Rose Acre Farms as a going concern and the government's need to protect the public through food-safety regulation. The appellate court estimated that government regulations caused the company's eggs to lose only 10% of their value — nowhere near the 219% profit loss the plaintiff claimed. The court held that a 10% loss "did not even approach the level of severe economic harm" that would persuade it to rule in favor of Rose Acre Farms.

Sanity checks

After an appraiser has estimated damages, his or her final step is to ask: "Does this number make sense?" To answer, the appraiser needs to reconcile his or her conclusion with alternative damages calculations.

The ceiling for damages is the entire business's value. But it's rare for a defendant's action to completely bankrupt a plaintiff. Another benchmark is the number that reflects how much the defendant actually profited from its wrongdoing. Alternatively, an appraiser might compare the plaintiff's damaged operations to its performance in an undamaged location or undamaged product market.

Reason wins

The last thing any plaintiff wants to admit is that the alleged "wrongdoer" might have done something that saved the plaintiff money — or that external factors, or the plaintiff itself, could be partially to blame for its financial losses. But an expert who takes a balanced approach — using empirical data and reasonableness rather than speculation and unfounded estimates — is most likely to convince the court that the damages calculation is objective and fair. ●

Help your valuator help you

How to ask the right questions

You undoubtedly understand how to run your business or practice, but do you know how to place a value on it? How do valuation experts determine what's relevant when appraising an asset and ensure all bases are covered? Asking the right questions and obtaining clarification up front can help you get the most from your valuator's expertise — and avoid costly mistakes.

What are your credentials?

It's critical that you assess your valuation professional's qualifications to determine whether he or she is credentialed and independent. Does your valuator belong to one or more business valuation professional organizations and possess business valuation credentials? What percentage of your valuator's time is spent valuing businesses and how many years of experience does he or she possess?

You may also want to know whether your valuator has had experience valuing companies in the same industry as the subject company. And be sure to ask how many valuation reports he or she has prepared.

How do you define *value*?

Most appraisals call for "fair market value," which is the price at which property would change hands in a hypothetical transaction involving informed buyers and sellers not under duress to buy or sell. But some assignments call for a different standard of value. A company that's considering acquiring a competitor might be more interested in "strategic value," which is the value to a *particular* investor.

Is your valuator able to clearly define and explain the appropriate standard of value? Keep in mind that, in court, a judge may disregard an expert opinion that measures an inappropriate standard of value.

Two levels of value — *controlling* and *minority* — typically apply to private business interests. Ask whether your valuator has considered the levels of value when selecting valuation methodology and applying valuation discounts.

Do you understand the appraisal's purpose?

Valuations are valid as of a specific date and for a specific purpose. Never reuse a valuation prepared for, say, gift tax purposes, later — unless your valuator specifically approves it. An appraisal purpose dictates which valuation techniques are used. For example, a divorce case might require the valuator to separately value professional and entity goodwill for equitable distribution of the marital estate.

In addition, your valuator needs to be familiar with these eight factors when valuing a business under Revenue Ruling 59-60:

1. Nature and history of the business,
2. Economic and industry outlook,
3. Book value and financial condition,
4. Earnings capacity,
5. Dividend-paying capacity,
6. Goodwill and intangible value,
7. Previous sales and size of the block, and
8. Comparable transactions.

Experienced valuators should have no trouble listing these characteristics and explaining them in detail.

What format will it take?

Check to make sure your valuator has defined the valuation parameters as well as other services that might be required. For instance, an oral presentation may suffice in some situations, such as preliminary settlement talks or merger consulting. But most assignments call for greater formality and a full written report. The appropriate format is a function of your preferences, the valuation purpose and the users of the valuation.

Your valuator should summarize the project's details in an engagement letter. One of the main purposes of the engagement letter is to achieve an understanding between you and your valuator. Therefore, it should discuss your valuator's duties, scope and responsibilities, as well as the proposed appraisal costs, retainers and late fees, if applicable. If the assignment's scope or the definition of value changes, ask your valuator to draw up a revised engagement letter or an addendum to the original contract.

Is everyone on the same page?

Nothing's more frustrating than sitting down for a consultation with a valuation professional and finding that you don't fully understand the process. Ask the right questions to ensure your business valuator will help you obtain a winning result. ●

Assessing the worth of a noncompete

Noncompete agreements are used to smooth management transactions after a merger or acquisition closes. After all, business buyers don't want valuable assets — such as trade secrets, key employees and business relationships — to walk out the door with the seller.

But how much are noncompetes *really* worth? Purchase price allocations have important tax and accounting implications when one is buying and selling business interests. In an M&A context, noncompetes are contractual agreements that restrict sellers from competing in the same industry for a given time period within a specific geographic area. For tax purposes, the value allocated to noncompetes must be reasonable and agreed to by both sides.

Noncompete appraisal is often a sticking point for buyers and sellers in business combinations. Buyers typically amortize noncompetes over 15 years, regardless of terms or payment conditions. The higher the value assigned to noncompetes, the more amortization the buyer can deduct in future periods.

Sellers normally recognize ordinary income for amounts allocated to noncompetes. Ordinary income tax rates are generally higher than capital gains tax rates, so sellers typically prefer lower values assigned to noncompetes.

A valuator typically begins by using the 11-factor test set forth in *Thompson v. Commissioner* to assess economic reality, looking at such factors as the grantor's (seller's) business expertise, intent to compete and economic resources as well as the potential damage to the grantee (buyer).

Next the valuator appraises the business with, and without, the noncompete agreement. Noncompete value equals the difference between these two values, net of the expected tax savings from amortizing the agreement and adjusted for the probability that the seller would actually compete with the buyer.

As a final step, an appraiser typically estimates the percentage of noncompete value to total selling price. Then, as a sanity check, he or she compares the subject company's ratio to the ratio observed in comparable transactions.

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John M. Leask II (Mac), CPA/ABV, CVA, values 25 to 50 businesses annually. Often, Mac's valuations, oral or written, are compiled in conjunction with the purchase or sale of a business, to assist shareholders prepare buy/sell agreements, or to set values when shareholders purchase the interest of a retiring shareholder. Here are examples:

- **Due Diligence & Assist with Purchase of a Business.** Mac has assisted purchasers of businesses by determining or reviewing the offer. He helps negotiate the price, perform due diligence prior to closing and/or helps structure and secure financing. Services have included, but are not limited to, verifying liabilities and assets, reviewing sales and expense records, and identifying critical issues relating to future success, and helping management plan future operations.
- **Family Limited Liability Partnerships, Companies & Closely Held Businesses.** Mac regularly values various sized business interests for estate and gift tax purposes. He provides assistance to estate and trust experts during audits of reports prepared by other valuators.

Mac also helps business owners and their CPAs and/or lawyers in the following ways:

- Planning — prior to buying or selling the business
- Prepare valuation reports in conjunction with filing estate and gift tax returns
- Plan buy/sell agreements and suggest financing arrangements
- Expert witness in divorce & shareholder disputes
- Support charitable contributions
- Document value prior to sale of charitable entities
- Assist during IRS audits involving other valuators' reports
- Succession planning
- Prepare valuation reports in conjunction with pre-nuptial agreements
- Understanding firm operations & improving firm profitability

More information about the firm's valuation services (including case studies) may be found at www.LeaskBV.com.

To schedule an individual consultation or to discuss any other points of interest, Mac may be reached at ***203 - 255 - 3805.***
The fax is ***203 - 380 - 1289****, and e-mail is* ***Mac@LeaskBV.Com****.*

If you have a business valuation problem, Mac is always available to discuss your options — at no charge.