Valuation & Litigation Briefing

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How much is a minority interest in an S corporation worth?

IRS job aid compiles guidance on valuing pass-through entities

Generally, S corporations pay no entity-level federal taxes on their income. Instead, an S corporation's income and deductions flow through to the interest holders, who are responsible for their appropriate share of the entity's federal income tax liability. The IRS job aid on valuing S corporations compiles guidance that explains how these pass-through tax attributes may affect how much investors will pay for noncontrolling interests in these entities.

The job aid is intended to help IRS valuation professionals, but it also can provide S corporation owners and advisors with valuable insights into this hot topic.

IRS cuts to the chase

"Absent a compelling showing that unrelated parties dealing at arms-length would reduce the projected cash flows by a hypothetical entity level tax, no entity level tax should be applied in determining the cash flows of an electing S Corporation," says *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.* The job aid goes on to say, "In the same vein, the personal income taxes paid by the holder of an interest in an electing S Corporation are not relevant in determining the fair market value of that interest."

The job aid also advises IRS professionals to consider the risks associated with owning a noncontrolling interest in an S corporation — and whether those risks might warrant adjustments to the cost of capital and valuation discounts.

Gross changes history

Before the late 1990s, most business valuation professionals believed that the values of otherwise identical

S and C corporations were equivalent. Even though S corporations technically pay no corporate-level income tax, valuation experts customarily tax-affected earnings — that is, they subtracted corporate-level taxes as if the S corporation were a C corporation before applying the income or market approaches to value the interest.

All that changed in 1999, when the Tax Court ruled in *Gross v. Commissioner* that, because of their tax advantages, S corporations were worth more than otherwise identical C corporations. Several other cases followed suit. In fact, in certain cases, the court began to mandate the application of after-tax discount rates to pretax S corporation earnings.

It's at this point, of course, that a debate broke out. Matching pretax earnings with after-tax discount rates generates higher values for S corporations, which are based solely on the owners' choice of entity type. Proponents of tax-affecting S corporation earnings argue that a superficial Subchapter S election provides no economic advantage, and entity choice has no impact on a company's operating cash flows. Further, they state that an S election doesn't make a company a more attractive acquisition candidate, all else being equal.

Others contend that the correct treatment depends on whether the valuator is appraising a controlling interest or a noncontrolling (or minority) interest. The general consensus is that controlling interests in otherwise identical S and C corporations are worth virtually the same amount.

Risks may warrant adjustments

Today, when valuing noncontrolling interests in S corporations, one thing is certain: Valuation professionals can no longer automatically tax-affect S corporation earnings. Instead, the decision requires careful consideration of relevant facts, including historic and expected distributions as well as shareholder rights and restrictions.

For example, S corporations may be limited in their ability to raise both debt and equity capital as a result of restrictions that apply to S corporations but not C corporations. Examples include limits on the number and type of interest holders, the necessity of a single class of stock, and the requirement of straight debt.

Similarly, these restrictions may limit the hypothetical pool of investors for noncontrolling interests in S corporations. In turn, these risks may require an adjustment to the subject company's cost of capital — or they may warrant a discount for lack of control or marketability.

Guidance calls for a custom approach

Ultimately, experts must decide on a case-by-case basis whether a noncontrolling interest is worth the same as, or more or less than, a similar interest in a C corporation. Contact a credentialed valuation professional for more information on how these complex concepts apply to a specific business interest. ■

Estate of Giustina

Tax Court slashes value of FLP interest

On remand from the U.S. Court of Appeals for the Ninth Circuit, the U.S. Tax Court dramatically reduced the value of a 41% FLP interest for estate tax purposes. The value was reduced from approximately $27.5 million to just under $14 million on a minority, nonmarketable basis.

Tax Court ruling

The FLP in *Estate of Giustina* primarily owned timberland with an agreed-upon value of approximately $150 million, including a 40% "absorption" discount to reflect delays inherent in selling the land. So, the decedent's 41% interest in the underlying assets was worth about $61.5 million (41% × $150 million) under the asset (or cost) approach.

The partnership agreement generally prevented limited partners from transferring their interests

without the general partners' approval. The agreement also required a two-thirds vote of the limited partners in order to liquidate the partnership, sell its assets and distribute the proceeds.

Originally, the Tax Court estimated that there was a 25% chance the FLP would sell its assets and a 75% chance the FLP would continue its operations. So, it assigned a 25% weight to the value derived using

Valuation discounts in jeopardy for family businesses

In August 2016, the IRS proposed regulations to curb valuation discounts that are currently available to family limited partnerships (FLPs) and other family-controlled entities. As proposed, the regulations would make it difficult or even impossible for these entities to use certain lapsing rights and liquidation restrictions to reduce the value of transferred interests for gift and estate tax purposes.

What's proposed?

The proposed regulations amend Internal Revenue Code Section 2704, including the creation of a new category of "disregarded restrictions." This change would substantially reduce (or even eliminate) discounts for lack of control and marketability when valuing interests transferred among family members.

Generally, these are restrictions that the family has the ability to remove and that:

1. Limit an interest holder's ability to liquidate his or her interest,
2. Limit liquidation proceeds to less than a "minimum value" (defined as the holder's pro rata share of the entity's net value),
3. Defer payment of proceeds for more than six months, or
4. Permit payment in any manner other than cash or property (with certain exceptions).

The proposal includes numerous additional restrictions and provisions, and there's some ambiguity regarding precisely how the proposed changes, if approved, would affect the value of an interest in a family-controlled entity.

How does this affect family businesses?

Although the proposed regulations could be modified before they're finalized — or rejected altogether — they demonstrate the negative attention that these entities could receive from IRS agents in the future. So, use caution and diligence when incorporating FLPs and other family-controlled businesses into your estate plans. If they're eventually approved, the final regulations will take effect 30 days after they're published in the Federal Register.

the asset approach ($61.5 million). No discount for lack of marketability (DLOM) was applied, because a 40% absorption discount was taken at the asset level.

Then the court assigned a 75% weight to the income approach. The estate's expert estimated that the timberland would generate only about $6.3 million in normalized annual net cash flows. The court generally accepted the estimates of projected cash flows and the components of the capitalization rate provided by the estate's expert.

However, the court rejected the expert's application of a 25% income tax rate, and it reduced the company-specific risk premium component of the capitalization rate from 3.5% to 1.75%, reasoning that a hypothetical buyer could reduce risk by diversifying its assets. The court valued the interest at about $51.7 million on a minority, marketable basis under the income approach.

After applying a 25% DLOM to only the value under the income approach and weighting the two

methods, the Tax Court valued the 41% interest at about $27.5 million.

Ninth Circuit ruling

On appeal, the Ninth Circuit disagreed that a hypothetical buyer could dissolve the FLP, because the general and limited partners favored continuing its operations. It directed the Tax Court to recalculate the decedent's interest using only the income approach. The appellate court also criticized the Tax Court's failure to adequately explain its basis for halving the company-specific risk premium.

On remand, the Tax Court decided that its reasons for reducing the company-specific risk premium were invalid, because it was unlikely that a hypothetical buyer would have the ability to "diversify the partnership-specific risk." Relying solely on the income approach, and increasing the company-specific risk premium back to 3.5%, the court lowered its value to approximately $14 million.

The disparity between the asset and income approaches is striking here. It implies an effective discount of about 77% [1 – ($14 million ÷ $61.5 million)], excluding the 40% absorption discount taken at the asset level.

Alive and well … for now

The *Giustina* case confirms that FLPs can generate significant valuation discounts for gift and estate tax purposes. However, if recently proposed IRS regulations are finalized in their current form, these discounts may be reduced or even eliminated in similar cases. (See "Valuation discounts in jeopardy for family businesses" on page 4.) ■

Making a federal case out of trade secrets

The Defend Trade Secrets Act (DTSA) was signed into law in May 2016. It creates federal subject matter jurisdiction over civil actions for trade secret misappropriation that previously had been under only state jurisdiction. Here are key advantages and provisions of the DTSA.

Take advantage of new federal jurisdiction

The DTSA is patterned after the Uniform Trade Secrets Act, which is similar to trade secret laws in most states. But the DTSA allows litigants to seek consistent relief nationwide, avoiding inconsistent state laws.

It also enables litigants to bring all types of intellectual property claims in federal court. Under prior law, federal courts generally couldn't hear trade secret cases unless federal jurisdiction was based on diversity of citizenship.

The DTSA expands trade secret relief beyond what's currently available in many states. It doesn't generally preempt state law. Rather, the DTSA allows trade secret owners to pursue federal civil remedies *in addition to* applicable state-law remedies.

Understand the remedies

The DTSA authorizes compensatory damages for an owner's actual losses caused by trade secret misappropriation, as well as damages based on the defendant's unjust enrichment. Or, when determining actual losses isn't feasible, the law allows courts

to award reasonable royalties. These damages are similar to those for other types of intellectual property, such as patents. Valuation experts have routinely assessed the damages calculations for such cases.

Federal courts may also grant injunctive relief to prevent actual or threatened misappropriation. Owners are entitled to exemplary (punitive) damages, up to two times compensatory damages, plus attorneys' fees for trade secrets that are "willfully and maliciously misappropriated."

Additionally, the DTSA permits owners to seek ex parte seizures of trade secret materials if they're able to show "extraordinary circumstances." For example, ex parte seizures may be granted to prevent imminent disclosure or flight to another country.

Disclose whistleblower immunity

The DTSA gives whistleblowers immunity from trade secret misappropriation claims if they disclose trade secrets to an attorney or government official for the sole purpose of reporting a legal violation. The whistleblower provision preempts inconsistent state laws.

Employers are also required to include notices regarding the whistleblower immunity provisions in "any contract or agreement with an employee [including contractors and consultants] that governs the use of a trade secret or other confidential information." Failure to provide immunity notices could result in loss of the right to seek exemplary damages or attorneys' fees against an individual.

Work together

To preserve the rights of trade secret owners, help clients provide immunity notices in their employment and contractor agreements and other relevant documents. And consult a valuation expert for assistance calculating damages in trade secret cases under the new law. ■

ACFE report: Awareness can help fight fraud

Every other year since 1996, the Association of Certified Fraud Examiners (ACFE) has published a comprehensive study of occupational fraud. The ACFE's *Report to the Nations on Occupational Fraud and Abuse: 2016 Global Fraud Study* provides valuable guidance to help businesses, attorneys and forensic experts prevent and detect fraud.

Costs and duration

The ACFE estimates that the typical organization loses 5% of its revenues to fraud each year. In the 2016 report, the average loss per case was $2.7 million, and the median loss was $150,000. (The median loss is significantly lower than the average loss, which factors in outliers in the data set with much higher losses.)

About 23% of the cases studied involved losses of $1 million or more. The median duration for all cases studied was 18 months.

The study found a correlation between duration and the costs of fraud: The longer a scam lasts, the more financial damage it generally causes. The ACFE reports that fraud schemes lasting more than five years caused a median loss of $850,000. The median loss for schemes continuing for six months or less was only $45,000.

Categories

Fraud can be classified into three basic categories:

1. Asset misappropriation. This form of occupational fraud occurred in 83.5% of cases studied in the latest ACFE report, although it resulted in the lowest median loss ($125,000).

2. Financial statement fraud. These scams are the least common. Misstatement occurred in only 9.6% of cases but caused the greatest damage. The median loss from financial statement fraud was a whopping $975,000.

3. Corruption. This category includes bribery and conflicts of interest. It occurred in 35.4% of cases and produced a median loss of $200,000.

In the 2016 report, the average loss per case was $2.7 million, and the median loss was $150,000.

Fraud risks vary depending on an organization's size. Corruption is more common in larger organizations. Conversely, asset misappropriation schemes involving check tampering, skimming, payroll and cash larceny are far more common in smaller organizations.

Detection methods

In the 2016 ACFE study, 39.1% of the frauds were detected from tips by employees, customers, vendors and other outside parties. Other common detection methods include:

- Internal audit (16.5% of the cases),
- Management review (13.4% of cases), and
- Accident (5.6% of cases).

Hotlines can be an effective way to solicit fraud tips. The ACFE reports that the percentage of fraud cases detected via tips increased from 28.2% for organizations without hotlines to 47.3% for

organizations with established reporting hotlines. The most common form of hotline was the telephone hotline (39.5%), followed by email (34.1%) and Web-based forms (23.5%).

Notably, active detection methods — such as monitoring, IT controls, account reconciliation and internal audit — are associated with lower median losses and fraud durations. Passive detection methods — such as notification by police or accidental discovery — were associated with higher losses and durations.

Fraud controls

Though effective, hotlines tend to be underused. Only 60% of organizations used hotlines in the 2016 study. Other antifraud controls are far more common, including external audits of financial statements, codes of conduct, internal audits, management certification of financial statements and management reviews.

These more visible antifraud controls serve a critical role in a strong internal control system: Regardless of their effectiveness in *detecting* fraud, they can be highly effective in *deterring* fraud.

Additional findings

Over the last 20 years, the ACFE's biennial fraud report has raised awareness about the costs and duration of fraud, common schemes, and methods to detect and prevent fraud. We've highlighted just a few findings from the ACFE's 92-page study. For more information, access the full report on the ACFE website or contact a certified forensic accounting expert. ■

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