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CHALLENGES TO VALUING AN S CORPORATION IN THE GROSS ENVIRONMENT: THE CONTINUUM MODEL AS A SOLUTION

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This article is the first in a two-part series describing a proposed solution to the problem of valuing the minority interests held in an S Corporation. Part I is the actual development of our Continuum Model to help solve this complex valuation issue. Part II (which will appear in the next issue of Valuation Viewpoint*) discusses how to deal with differences in the taxes due at the time of sale between a C and an S Corporation when valuing a minority interest.*

The conclusion in *Gross v Commissioner*[i] resulted in an S Corporation minority value which was 60%+ greater than the value of an otherwise identical C Corporation. The *Gross* case and its companion cases, *Heck*[ii] and *Adams*[iii], have created quite a stir in the valuation community. Much has been written, but little has been resolved.

In this article, we will look at the very complex and highly disputed matter of developing an appropriate methodology to value an S Corporation minority interest, while acknowledging that S Corporations receive benefits, which C Corporations do not enjoy, and that these benefits *may* result in a market value premium. Determining the extent, if any, of the potential premium is the disputed issue with a secondary emphasis on the capital gains issue, at the time of sale.

What the *Gross* decision says is that we need to value the S Corporation benefits that the seller has to sell and that the buyer may purchase. The willing buyer-willing seller concept is well established

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MARKET TRENDS AND INDICATORS

Indicator	Trend	Value
Office Buildings	→	0%
Retail Centers	↑	2%
Industrial Buildings	→	0%
Apartments	→	0%
New Housing Starts	↑	5.5%
Productivity	↓	1.9%
Composite PE	→	29
Consumer Confidence Index	↑	90.3
Number of IPOs (Qtr 1)	↓	4

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MARKET TRENDS AND INDICATORS

ECONOMIC INDICATOR

	1997	1998	1999	2000	2001	2002	1st Qtr 2003
New Housing Starts	238,000	332,000	349,600	303,200	330,300	350,200	59,800

P/E RATIOS IN SELECT INDUSTRIES

Industry (Year end)	1985	1990	1995	2000	2001	2002	1st Qtr 2003
Automotive	6	N/M	12	9	34	16	13
Banking	9	14	12	19	18	13	13
Retailing—General*	16	23	22	33	28	24	25
Food & Drug Retailing*	14	22	18	24	24	18	18
Fuel-Oil & Gas*	11	15	40	16	18	26	16
Health Care Equipment & Services*	18	22	22	45	58	22	21
Manufacturing—Capital Goods*	20	16	16	20	42	20	25
Service Industries—Commercial*	22	21	18	32	26	21	21
Telecommunications	11	15	21	26	25	24	16
Transportation	18.3	28	21	18	33	NM	NM
Utilities*	11	15	17	17	16	22	24
Pharmaceuticals & Biotechnology*	—	—	—	—	—	24	25
Composite	15	17	19	26	32	29	29

*Reporting categories changed in 3rd Qtr 2002 to more accurately identify and report industry activity. NM=not measurable

ECONOMIC INDICATORS

Indicator (5 yr. avg.)	1985	1990	1995	2000	2001	2002	1st Qtr 2003
Inflation	5.0%	4.0%	3.1%	3.4%	2.8%	1.6%	1.7%
Productivity	1.7%	0.6%	1.5%	2.9%	1.1%	4.7%	1.9%
GDP	4.0%	1.8%	2.7%	3.8%	.3%	2.4%	1.9%
Consumer Confidence	84.9	104.2	99.2	128.6	97.3	64	90.3
Initial Public Offerings	169	144	512	339	91	70	4
IPO in Volume ($ Billion)	5.7	9.9	26.6	55.46	37.1	24	1.0

RATES OF RETURN AND RISK HIERARCHY

Investment	Current
30 Year Treasury	4.9%
Aaa Bond	5.9%
Bbb Bond	7.2%
Commercial Mortgage	6–7%
Institutional Real Estate	5.5–7%
Non-Institutional Real Estate	6.5–8%

Investment	Current
Speculative Real Estate	10–12%
S & P Equity (Ibbotson)	12.9%
Land Development	10–15%
Equipment Finance Rates	10–13%
NYSE/OTC Equity (Ibbotson)	17.9%
NYSE Smallest Cap. Equity (Ibbotson)	20.9%

Sources: National Real Estate Index (2003), Appraisal Institute; F.W. Dodge Division, Business Week, Value Line, U.S. Chamber of Commerce, Standard & Poors, Investment Dealers Digest, U.S. Government Census.

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SHENEHON ONLINE

TAKING IT TO THE NEXT LEVEL

BY SCOT A. TORKELSON

The computer is now an integral part of your work day, you have high speed Internet access, e-mail, a cell phone, a digital camera and a palm computer. You're ready to take it to the next level:

Wi-Fi–'Wireless Fidelity'—a DSL connection and a $30 receiver on your notebook will provide you with wireless Internet and e-mail access to any computing device within 200 feet. Not a great distance, but these Wi-Fi broadcasters are springing up everywhere. Even easier, just attach the receiver card for your notebook or purchase a Wi-Fi enabled palm computer and you have web access in every airport, McDonald's, Starbucks, and the Mall of America.

Virtual Teleconferencing—Finally, a product that works in the realm of teleconferencing. For a reasonable $5,000, the Tandberg 1000 (www.tandberg.net) provides crisp, full motion teleconferencing capability. It is also completely portable: take it with you anywhere you go and eliminate the need to travel into the office, from home or the cabin, for that single meeting while on vacation. It is truly amazing.

Pdf documents—Increasingly, clients are not interested in the published report. All they want is an e-mailed copy. But there are problems with sending Word documents - primarily the ease with which such documents can be altered. Get the software from Adobe Acrobat (www.acrobat.com) and convert your Word documents into Pdf files, an unalterable format utilizing the free and universally available Acrobat Reader®. There are also scanners and copy machines that can copy your documents directly to Pdf files. Never fax again.

New Software—Annoyed with pop-ups when you browse the web? Switch your web browser from Microsoft (which has provided the pop-ups with access to their browser) to the new Linux version of Mozilla (www.mozilla.org). Not only does this little browser prevent pop-ups entirely, but it also allows for greater security by managing your security profiles and passwords, page by page. This system also boasts a much stronger encryption capability, another source of increased security while browsing the web. And it's Free.

Spam—Are you tired of spam? Get 'I Hate Spam' (find.pcworld.com/31556), a $20 Outlook e-mail add-on that is one of the most effective spam blockers on the market. A simple toolbar lets you add filters for any junk the program might miss. In tests, this little program eliminated 94% of the spam headed your way. VV

MEDIATING A TAX APPEAL

RECONCILING VALUATION DIFFERENCES WITH THE ASSESSOR

BY DARRELL V. KOEHLINGER AND DEREK R. PEDERSON

In the cyclical world of the commercial real estate market, property tax assessments often receive little to no attention in years in which property values are increasing. In these years, as the market values are on the rise, the property tax assessments often lag the growth in the market. The flip side of this phenomenon is that when property values are stagnant or declining, the assessments may overstate a property's current market value. In general, commercial real estate firms are busier, with assessment issues, in bad economic times than they are in good economic times. In the Year 2003, with both public and private entities under financial constraints, property taxes and, by implication, the assessed real estate market values are receiving closer scrutiny.

Our firm has looked at a variety of real estate assessment issues over the years. Most of our work is based in the State of Minnesota, but occasionally we are engaged for tax appeals in the Upper Midwest and beyond. The Minnesota assessment system, in and of itself, is relatively simple and fairly straightforward. Each year, on the 2nd of January, county and city assessors are required to issue an opinion of estimated market value for each residential and commercial property. The assessor's estimated market value is used as the basis for property taxation. The assessment is supposed to be at 100% of fair market value. Minnesota's real estate tax currently includes additional levies from the city, county, school district, and other special taxing districts. The typical real estate tax, on a commercial property, runs between 4% and 5% of the assessor's estimated market value. Taxes paid on commercial properties are traditionally amongst the highest in the nation. Because the assessor's yearly opinion determines the taxes which the owner will pay, it is essential that this opinion be an accurate reflection of what the market supports. This article describes some of the problems inherent in the assessment process. We also suggest some ways to mitigate or minimize the problems for the assessor, the taxpayer and other professionals involved.

"*Because the assessor's yearly opinion determines the taxes which the owner will pay, it is essential that this opinion be an accurate reflection of what the market supports.*"

Problems Inherent in the Assessment Process

The assessor is trying to do a difficult, if not impossible, task. In theory, he/she must re-appraise every property in the jurisdiction each year. Commercial real estate valuation is an involved process. Any number of factors may prevent a fair analysis of a particular property.

1. Lack of Time

A thorough appraisal of any single commercial property can take days, or even weeks. Due to the sheer number of properties that must be re-appraised by the assessor, individual properties cannot be appraised on an annual basis. As a result, assessors end up relying on general market data from the "bigger picture" when assigning the fair market value from which the property tax is generated. A good example of this is the assessment of a typical downtown office building. The assessor's tax value is based solely on how a particular building compares to similar office buildings in the immediate area. A full appraisal of that same property, however, includes attention to the

specific details of the building, its operating costs, leases, vacancy rates, the appraised value of comparable office buildings, economic conditions, etc.

2. Premise of Value

Properties must be assessed on a fee simple basis rather than on a leased fee basis. Every valuation assumption must be "market-derived", not based on the leases in place. The reason for this is relatively straightforward in that it does not allow a completely vacant building to be assessed differently from an identical building which is fully leased. Theoretically, owners who have done a good job leasing their properties are not penalized on behalf of those who have neglected to find, or who were unsuccessful in finding, tenants. When appraising for real estate tax purposes, this subtle requirement can lead to questions with unclear answers. For example, how does one appraise, at market level, a multi-tenant office building which could be used by either one large tenant or by 20 smaller tenants? When do you use the actual expenses rather than using the broader market level expenses? These are difficult questions and are best answered on a case by case basis.

> *"Any number of factors may prevent a fair analysis of a particular property."*

3. Unique Properties

Special use properties present a challenge because the assessor's jurisdiction is limited by geography, rather than property type. Unique properties frequently require the application of a special valuation methodology in order to accurately reflect their market values. For example, if an assessor is charged with assessing a property such as a malting plant or a semiconductor facility, he or she is likely to have limited experience with this unusual type of property. A lack of understanding of the proper methodology can lead to value estimates that do not accurately reflect the market.

> *"Special use properties present a challenge because the assessor's jurisdiction is limited by geography, rather than property type."*

Even when the assessor does have a firm grasp on the methodology, value estimates can be flawed from a lack of understanding of the individual variables which go into the appropriate model. In the valuation of land used for gravel mining, for example, market value is influenced by factors such as the value of developable land, gravel lease rates (based on the quality of the gravel), reclamation costs, and special assessments to develop the property. A lack of knowledge in any one of these areas can lead to inaccurate value estimates. Again, time constraints play a key role; it is unreasonable to assume that each assessor could learn the intricacies involved in the valuation of every special use property type that is contained within his/her jurisdiction.

This does not mean that city or county assessors cannot become experienced in the valuation of special use properties. A prime example is found in the City of Bloomington, whose assessors are especially well versed in the valuation of hotel properties. This is due, in part, to the many hotel properties located in their jurisdiction.

4. Interest Being Appraised

Assessors may have to distinguish between business, real estate, and personal property interests in the assessment process. This distinction can sometimes be a difficult one because of the various interpretations of what is considered real estate and what is not. This issue frequently arises in the valuation of special use properties, particularly if the property owner has various trade fixtures.

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and directs us to determine what is the S Corporation benefit, and then to value this benefit over and above the appraised value of a minority stock interest as a C Corporation. The continuum model identifies and values the benefits directly.

In valuing the S Corporation premium, we believe that sound economic theory supports the use of industry dividends rather than historical dividends because: the past may not be indicative of the future; over the long-term, companies do not have the ability to pay out greater dividends than the industry if they want to remain competitive and maintain current profit margins; and paying out dividends greater than the industry, over the long-term, will cause a decrease in retained earnings and an impairment of the subject's debt to equity ratio in comparison to the industry average.

It should also be emphasized that our method is appropriate only when valuing a minority interest. This is because the economic benefits are being measured by comparing the S Corporation minority interest shareholders with C Corporation minority interest shareholders.

> "*It should also be emphasized that our method is appropriate only when valuing a minority interest.*"

We believe that any premium associated with a capital gains tax on retained earnings is generally not supported by applicable law or sound economic theory; however, when such a premium is applicable, it is highly case specific. Because the continuum model applies only to a willing buyer of a minority interest, any future sale of the 100% interest would occur only as a possible future event, if at all. Therefore, the capital gains tax benefit associated with S Corporations would be small, as well as very difficult to calculate with any precision as a willing buyer would not know the time frame, pricing or terms of such future sale.

Introduction—Methodology Proposal

We would propose that the best place to start is to value a minority interest in an S Corporation as an otherwise identical C Corporation. The reason for such a starting point is that there is an historic precedent for this proposed method—that of the valuation of minority interests, which emerged over the past ten years. Disputes between taxpayers and the IRS resulted in a methodology which values the company as a 100% controlling interest by means of various approaches to value which all parties understand and can agree to, and then ascertaining what the appropriate minority and/or marketability discounts would be to reflect the partial interest being appraised. We are proposing the same generalized concept for the valuation of S Corporations.

> "*However, income retained by the C Corporation is subject to no second tax.*"

The recommended steps to determine the fair market value of an S Corporation are as follows:

1. Establish value of otherwise identical C Corporation (per share)
2. +/- Adjustment for S Corporation premium/discount
3. = Value of S Corporation (per share)

Considerations for Determining an S Corporation Premium

The calculation of an S Corporation premium is a product of comparing what shareholders of an S Corporation are entitled to receive relative to what shareholders of an otherwise identical C Corporation are entitled to receive.

S Corporations can make discretionary dividend distributions (beyond those necessary to pay shareholder level taxes) tax-free at the corporate level. In contrast, C Corporation discretionary dividends are made after corporate level taxes, and are then taxed a second time at the shareholder level. *However, income retained by the C Corporation is subject to no second tax.* This is an important distinction because the rhetoric related to the issue of C vs. S Corporation values revolves around C Corporations being taxed twice and S Corporations being taxed once. But that is not entirely true. The earnings of both a C Corporation and an S Corporation are subject to one level of tax that the Tax Code says has to be paid when it is earned (with C Corporations taxed at the corporate level and S Corporations taxed at the shareholder level). However, any dividends paid out and distributed to the shareholders by C Corporations are taxed a second time (at the shareholder's personal tax rate). Earnings retained by the C Corporation are subject to no further tax. They are taxed only once—the same as S Corporations.

Thus, in most businesses, the variable level of taxation discussed above creates a continuum of S Corporation benefits and a resulting continuum of S Corporation value premiums. Only in the instance where there is a 100% dividend distribution by the C Corporation is there a true 'double taxation,' as only in this instance are there no retained earnings. Distributions of 100% of earnings occur only rarely in the real world of small businesses; but it happened to be precisely the case in *Gross vs. Commissioner*, which set the S Corporation premium dispute in motion.

When we examine what happens to the relative shareholder economic benefits between a C Corporation and S Corporation, as distributions increase from 0% to 100%, the rising discount/premium is readily apparent (see Tables 1 and 2).

C Corporation

The C Corporation has a variable shareholder benefit depending on the level of distribution. As stated, only cash distributed to shareholders is subject to a second level of tax. We see, in viewing Table 1, that all operating income of a C Corporation is subject to a 41% estimated corporate tax ($100 less $41), for a net after corporate tax income of $59.00. Then, depending on distributions, there may be a differential from an otherwise identical S Corporation with the exact same level of retained earnings relative to distributions. *Note that the same level of earnings is retained whether the Corporation is C or S. Because we are valuing an S Corporation relative to an otherwise identical C Corporation, retained earnings must be kept equivalent so that, on an operational basis, the two entities remain identical.*

S Corporation

The S Corporation operating income is subject only to the personal tax rate (estimated at 46% in this article). Thus, irrespective of the dividend distribution vs. earnings retained by the S Corporation, the net shareholder's benefit would always be the same. In this instance: $100 of operating income paying $46 personal tax, nets $54 total

“*Only in the instance where there is a 100% dividend distribution by the C Corporation is there a true 'double taxation,' as only in this instance are there no retained earnings.*

shareholder benefit irrespective of what is paid as dividend or retained by the S Corporation. *Remember, the shareholder benefit to the S Corporation shareholder is always constant because shareholders are subject to only one level of tax irrespective of the level of distribution. Any discretionary distribution after taxes is paid tax-free.*

> *The C Corporation has a variable shareholder benefit depending on the level of distribution.*

As an example, if a 40% shareholder distribution is made by the C Corporation, the distribution is $23.60 (40% of the $59 net income). The net after tax distribution retained by the shareholder is $12.74 ($23.60 less personal income tax of $10.86). The earnings retained by the C Corporation total $35.40 (60% of $59 after tax net income), and are subject to no further tax. The total C Corporation shareholder benefit is $48.14 (composed of the net $12.74 shareholder distribution and $35.40 retained earnings). Therefore, where there is a 40% C Corporation distribution, one finds a +12.16% S Corporation premium ($54/$48.14 minus 1) relative to the C Corporation market value.

If a 60% distribution were made, the distribution is $35.40 with a 46% personal tax of $16.28, and a net after tax distribution retained by the shareholder of $19.12. The earnings retained by the C Corporation total $23.60 (40% of $59 after tax net income). The total C Corporation shareholder benefit is $42.72 (composed of the net $19.12 shareholder distribution and $23.60 retained earnings), compared to the otherwise identical S Corporation total shareholder benefit of $54 (always $54). Therefore, where there is a 60% C Corporation distribution one finds a 26.42% S Corporation premium ($54/$42.72 minus 1) relative to the C Corporation market value.

As shown in Tables 1 and 2, assuming various levels of C Corporation distributions from 0% to 100%, it is possible to develop a continuum of discount/premiums from -8.5% to 69.29% (the maximum benefit derived from an S Corporation election with 100% distribution).

Market Comparison

The continuum model has also been paired with market evidence. Merle Erickson and Shing Wu Wang studied 77 samples of acquisitions of S Corporations versus C Corporations and determined that S Corporations were more valuable[iv]. The overall S Corporation premium, in this study, was found to be in the range of 12% to 17%.

A review of the Dow Jones Industrial Average over the past five/ten years shows that discretionary distributions of C Corporations averaged from 40% to 50% of net income overall. The proposed continuum model predicts that the overall public market would find an S Corporation premium ranging from 12.2% (the 40% distribution) to 18.9% (the 50% distribution)—Table 3. The continuum model therefore appears to tie to the market evidence shown in the Erickson and Wang study. We would note however that this study is examining S Corporations at the entity level, whereas our analysis is at the shareholder level.

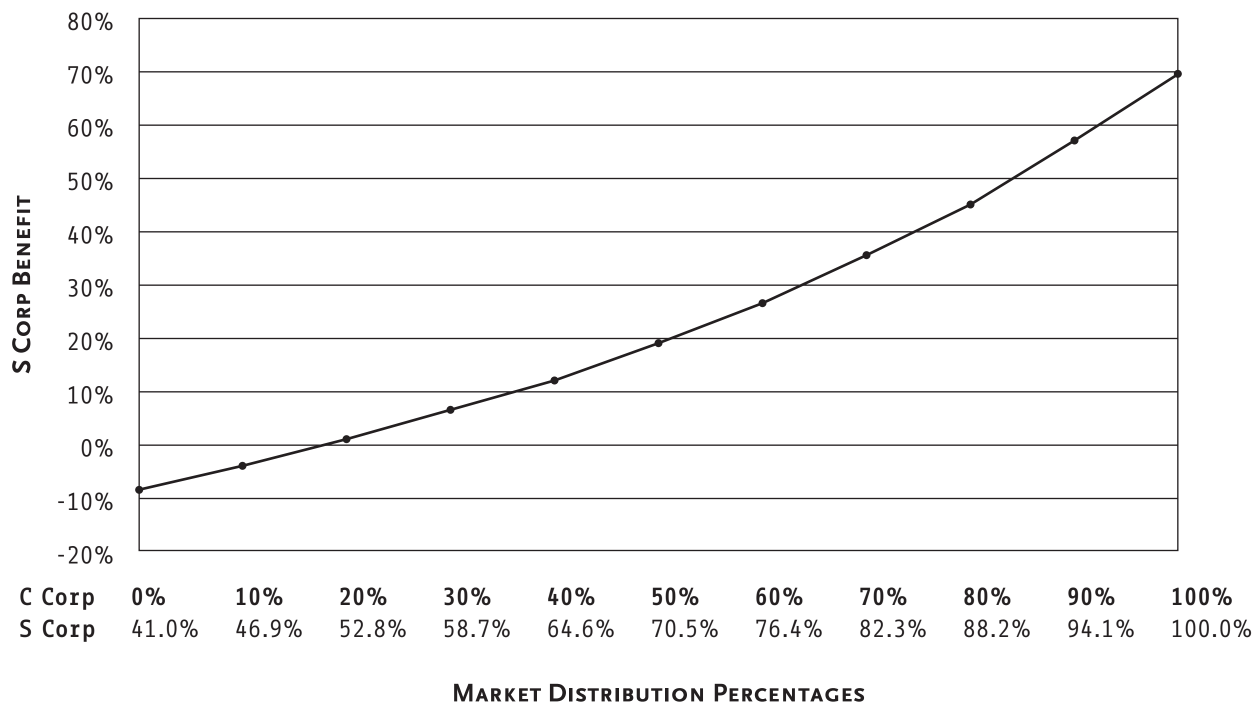
Considerations and Application to *Gross*

The continuum model is also consistent with the conclusions of the *Gross* decision, which today forms the background of any S Corporation valuation, especially in the area of Estate and Gift Tax. The case of *Gross vs. Commissioner* involved Pepsi-Cola Bottler 'G&J,' which was distributing 100% of its earnings. The Tax Court concluded that Dr. Mukesh Bajaj (the IRS appraiser) and the taxpayer's appraiser used the same discounted cash flow

TABLE 1—C CORP VS S CORP SHAREHOLDER BENEFIT

C Corp Shareholder Benefit						
Pre Tax Income	100.00	100.00	100.00	100.00	100.00	100.00
Tax	(41.00)	(41.00)	(41.00)	(41.00)	(41.00)	(41.00)
Net Income	59.00	59.00	59.00	59.00	59.00	59.00
C Corp Dividend % of Net Income	100.00%	80.00%	60.00%	40.00%	20.00%	0.00%
Dividend	59.00	47.20	35.40	23.60	11.80	0.00
Tax	(27.14)	(21.71)	(16.28)	(10.86)	(5.43)	0.00
Retained by Shareholder	31.86	25.49	19.12	12.74	6.37	0.00
Retained by Corporation	0.00	11.80	23.60	35.40	47.20	59.00
Total C Corp Shareholder Benefit	31.86	37.29	42.72	48.14	53.57	59.00
S Corp Shareholder Benefit						
Pre Tax Income	100.00	100.00	100.00	100.00	100.00	100.00
S Corp Dividend % of Pre Tax Income	100.00%	88.20%	76.40%	64.60%	52.80%	41.00%
Dividend	100.00	88.20	76.40	64.60	52.80	41.00
Retained by Corporation	0.00	11.80	23.60	35.40	47.20	59.00
Shareholder Tax	(46.00)	(46.00)	(46.00)	(46.00)	(46.00)	(46.00)
Total S Corp Shareholder Benefit	54.00	54.00	54.00	54.00	54.00	54.00
S Corp Premium/Discount	69.49%	44.82%	26.42%	12.16%	0.80%	-8.50%

TABLE 2—CALCULATION OF S CORP BENEFIT



method and that Dr. Bajaj's decision not to tax affect the company's earnings was not a difference of methodology but was, at least with respect to the discounted cash flow approach, exclusively the result of differences between the experts as to the values of certain variables. In this case, the question is whether to tax-affect the earnings of the S Corporation or not. The result was a greater than 60% premium to value for the S Corporation relative to an otherwise identical C Corporation. In this instance, the dispute was between 'tax-affecting' or 'not tax-affecting' the earnings. Despite the fact that these polar extremes formed the basis of the dispute, the Court, even in the case of the *Gross* decision, could see the need for a continuum type of analysis, which would tie the two polar positions together.

The Sixth Circuit Court stated, *"We disagree with the Tax Court's characterization of the respective experts' approaches to tax affecting as a mere difference in variables. There was no spectrum of tax percentages from which the court could have selected. Rather, the choice was either a Corporate tax rate of 40% or a rate of 0%, the latter meaning no tax affect at all.* But while the Tax Court's analysis was rather cursory, we do not believe that further evaluation was necessary under the circumstances." [v] (emphasis added)

In the case of G&J, which was distributing 100% of its earnings and achieving the maximum benefits as an S Corporation, the Tax Court was persuaded that there should be no tax affect.

A review of subsequent statements by Dr. Bajaj appears to support a continuum model, while yet arguing for the highest premium with regard to G&J, i.e., that 100% distributions were made to shareholders.

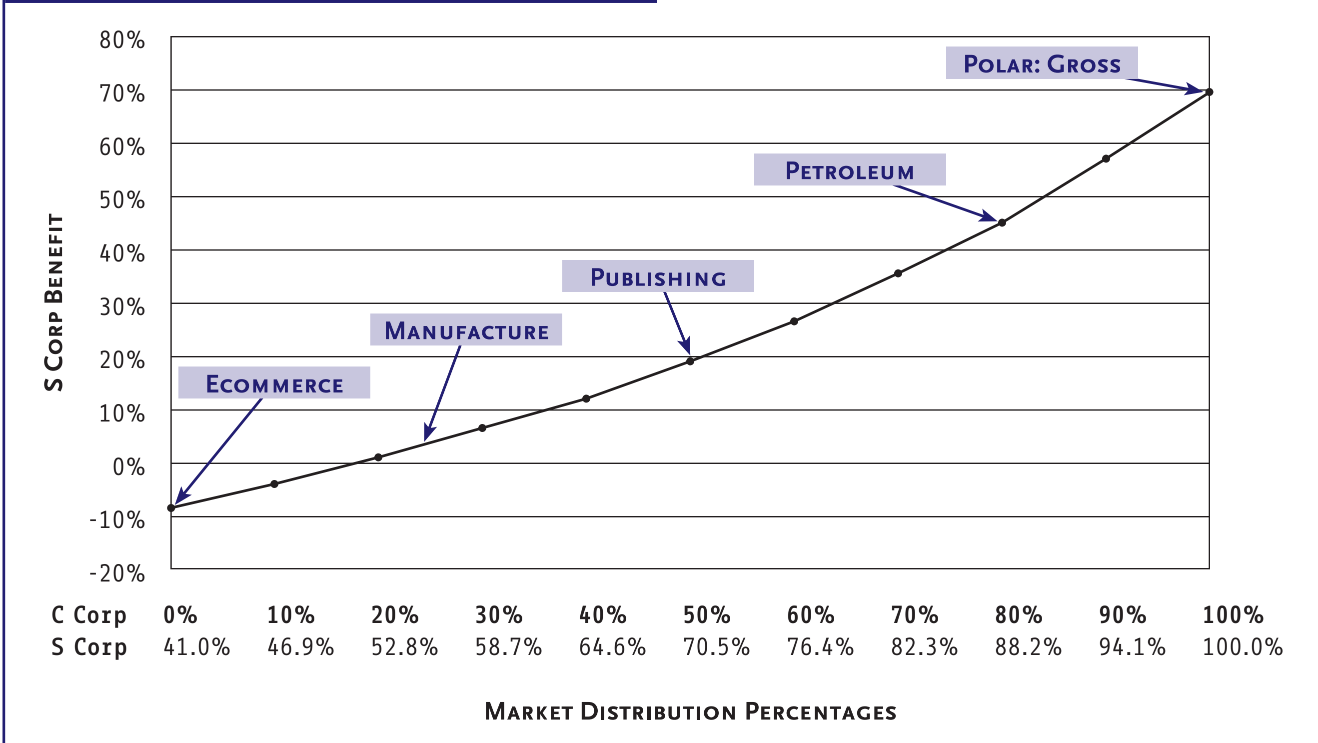
> "'Why won't people become S Corporation and increase market cap by 60%?' The answer is, well if they could, they should, and if you have the ability to fire managers when not doing so, you should. There are some Corporations that are better off as C Corporations partly because they reduce the tax bite of being a C Corporation by tax planning that you [the questioner] referred to and partly because there are offsetting advantages, and if organizations choose their organizational form appropriately, you will not see this large value gap." [vi]

> "In general, since 1982, when the marginal personal tax rate dropped from 70% to 50%, S Corporations have a tax advantage than C Corporations. *This tax advantage is **a function of payout rate**;* it is a function of corporate versus personal marginal tax rates. *If we consider the **polar case** where there is **100% payout**,* and we assume that both of the companies always have positive pretax income, then S Corporations will always have a tax advantage." [vii] (emphasis added)

TABLE 3—S CORP PREMIUM BENEFIT

		Low		High
Operating Profit		$100.00		$100.00
Taxes	41.0%	($41.00)	41.0%	($41.00)
Net Income		$59.00		$59.00
Discretionary Dividend Distribution	40.0%	23.60	50.0%	$29.50
Taxes	46.0%	($10.86)	46.0%	($13.57)
Net Retained by Shareholder		$12.74		$15.93
Net Retained by Corporation		$35.40		$29.50
Total C Corp Shareholder Benefit Shareholder + Corporation		$48.14		$45.43
Total S Corp Shareholder Benefit Shareholder + Corporation		$54.00		$54.00
S Corp Premium		**12.2%**		**18.9%**
Market Study High Estimate		**12.0%**		**17.0%**

TABLE 4A—CALCULATION OF S CORP BENEFIT



"The fact is, in general, corporations that are organized as C Corporations ***reduce*** *some of the potential value differential…because, given their investment and distribution policies, they expect* ***not to make*** *large distributions…which tend to favor C Corporations….*" viii (emphasis added)

Use of Market Evidence for Distributions Rather than Historic Distributions

In applying the continuum model more broadly, we believe that market evidence (industry data) should be used to determine the level of earnings which must be retained and also the amount which can be distributed.

The importance of market evidence for dividend paying capacity is supported by Revenue Ruling 59–60:

"Primary consideration should be given to the dividend-paying capacity of the company rather than to dividends actually paid in the past. Recognition must be given to the necessity of retaining a reasonable portion of profits in a company to meet competition. Dividend-paying capacity is a factor that must be considered in an appraisal, but dividends actually paid in the past may not have any relation to dividend-paying capacity. Specifically, the dividends paid by a closely

TABLE 4B

Type of Distribution Industry	C Corp Market Percentage	S Corp Equiv. Distribution Percentage	S Corp Benefit
E Commerce	0%	41.0%	-8.5%
Restaurant	10%	46.9%	-4.1%
Manufacturing	20%	52.8%	0.8%
Cosmetics/Household	30%	58.7%	6.2%
Railroad	40%	64.6%	12.2%
Publishing/Chemical	50%	70.5%	18.9%
Coal/Tobacco	60%	76.4%	26.4%
Natural Gas	70%	82.3%	35.0%
Petroleum	80%	88.2%	44.8%
Canadian Energy (Hydro)	90%	94.1%	56.2%
Gross	100%	100%	69.5%

held family company may be measured by the income needs of the stockholders or by their desire to avoid taxes on dividend receipts, instead of by the ability of the company to pay dividends…"

By comparing the S Corporation being appraised with its otherwise identical C Corporation counterpart in the public markets (relative to the market levels of retained vs. distributed income), one can assess the S Corporation benefit for the company within its industry and hence the appropriate S Corporation premium. For example, companies in the petroleum industry pay out a very high level of distributions (84%), having low retention needs. Therefore, the benefit of an S Corporation election would be relatively high. In contrast, the relative benefits for a restaurant which distributes low levels of dividends (10%) and must retain a significant portion of its earnings would show that there is, in this instance, a small discount associated with the S Corporation election. Table 4 illustrates the S Corporation benefit using various industry data. An even more detailed determination can be made by identifying the dividend paying capacity of guideline public companies relative to the subject company being appraised.

"The proposed continuum model predicts that the overall public market would find an S Corporation premium ranging from 12.2% (the 40% distribution) to 18.9% (the 50% distribution)"

In 1992, the industry average for dividend distributions, as a percentage of net income, for bottlers was 100%. Using industry averages, the continuum model finds a maximum S Corporation premium of 69.5% relative to the C Corporation value. The facts of the *Gross* Case also support the maximum benefit of the S Corporation election.

In conclusion, we are of the opinion that industry average dividends should be used to reflect the dividend paying capacity of the company being appraised into the future, due to the fact that over the long-term perspective, companies will tend to follow industry averages. Nonetheless, each appraiser must additionally consider the unique set of facts and circumstances when deciding dividend-paying capacity. VV

Endnotes

[i] *Gross v. Commissioner,* T.C. Memo 1999-254 (July 29, 1999)
[ii] *Heck v. Commissioner,* T.C. Memo 2002-34 (February 5, 2002)
[iii] *Adams v. Commissioner,* T.C. Memo 2002-80 (March 28, 2002)
[iv] Merle Erickson and Shing Wu Wang, *The Effect of Organizational Form on Acquisition Prices,* Journal of Economic Literature, May 7, 2002, pp. 1-44
[v] *Gross v. Commissioner,* T.C. Memo 1999-254 (July 29, 1999)
[vi] Shannon P. Pratt and Business Valuation Resources, *Tax-Affecting S Corporation Earnings,* Audio Confernence Transcript, August 13, 2002, p. 6
[vii] Ibid., p. 3.
[viii] Ibid., p. 31.

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The claim can be made that these are not part of the real property.

Suggestions For Reconciling Differences

Both the appraisal process and the assessment process are somewhat subjective. We recognize that working with the assessor to reach an understanding is sometimes better than fighting for a specific value. The following is a general list of suggestions which have worked well for us and our clients over the years.

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Both the appraisal process and the assessment process are somewhat subjective.

Provide More Information

Assessors usually operate without the owner's proprietary information. Typically, property owners are reluctant to share proprietary operating data with assessors when times are good. Assessors often comment that they only see operating data when times are more difficult.

As stated earlier, market levels of income and expenses, rather than contract terms and actual expenses must be used to arrive at fee simple value estimates. Notwithstanding this, and assuming sound management, the actual performance of an income producing property is typically more indicative of the property's submarket. Without the owner's proprietary information, however, assessors have a diminished ability to account for differences within market sectors. Property owners, appraisers and attorneys who give the assessor as much information as they themselves would require will likely see a reasonable valuation. No one, including assessors, likes to be blindsided by previously withheld information in the assessment process.

Understand the Assessor's Point of View in Reaching a Settlement

In tax appeal proceedings, assessed value adjustments can be sought for any tax year in which a Real Estate Tax Petition has been filed. Real Estate Tax Petitions must be filed on or before April 30th of the year in which the tax becomes payable. Considering that taxes are payable in the year following any given assessment date, the January 2, 2003 assessed values, for example, can be petitioned on or before April 30, 2004.

When an appraiser finds that the market value of a property is below the assessed value in any year in which a tax petition has been filed, the ultimate goal of the property owner, or attorney who is using this information, is to have the assessed value of the property adjusted to the market value of the property as reported in the appraisal. Although assessors will occasionally agree to adjust assessed values to the concluded market value estimates, during fiscally restrictive times assessors are hesitant to reduce assessments in past years. Thus, court proceedings may be necessary to realize assessed value adjustments for years in which corresponding tax revenues have already been collected. If the potential cost of court proceedings exceeds the potential tax savings that can be realized through these proceedings, property owners and attorneys may wish to consider other alternatives. One such alternative is to resolve assessment issues for years to come on a multi-year basis rather than for a specific year in which taxes have already been paid.

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Although assessors will occasionally agree to adjust assessed values to the concluded market value estimates, during fiscally restrictive times assessors are hesitant to reduce assessments in past years.

Reach as Many Areas of Agreement as Possible

Although assessors and appraisers may ultimately disagree on the market value conclusion in some instances, both parties normally agree on some or most of the assumptions and variables that were used to arrive at the value conclusion. If it can be established that both parties are in agreement on most issues, it becomes easier to pinpoint areas in which differences exist that can be resolved. For example, a review of the assumptions and variables used by an appraiser and an assessor may reveal a significant difference in market rent conclusions. If both sides share all of the information that they used to arrive at their respective conclusions for market rent, it is possible that the additional information will result in one or both sides determining that a change in the market rent conclusion is warranted. If other issues did not exist, this could result in a fair settlement.

> *If it can be established that both parties are in agreement on most issues, it becomes easier to pinpoint areas in which differences exist that can be resolved.*

When reaching areas of agreement it is important not to dwell on details that are not important. For example, it is pointless to argue about issues such as minute differences in a property's gross building or net rentable area.

Make the Dealings With the Assessor a Shared Learning Exercise

While due diligence must always be conducted on the appraiser's side to ensure that sound methodology is used to value a property, assessors do not usually have the luxury of adequate time to spend on the valuation of individual properties. As a result, it may be necessary for the appraisers to educate the assessors on the appropriate methodology for the valuation of special use property types that are not frequently valued in their jurisdiction.

> *Be prepared to stand behind your value conclusion and, if necessary, bring the issue to tax court.*

Occasionally, differences in value can also stem from a difference in sale or lease comparables, either in terms of the comparables used or the depth of knowledge on the details of individual sales or lease agreements. Both the appraiser and the assessor should consider any new information and its impact, if any, on the value conclusion.

Conclusions

In order to reach a settlement with the assessor in a timely and cost-effective manner, we advise the following steps:

- Prepare a well thought out, documented appraisal stating your value position.
- Understand the assessor's workload and his/her commitment to having the property valued at its fair market value.
- Be willing to work together when teaching and sharing information: it helps to understand his/her point of view.
- Be prepared to stand behind your value conclusion and, if necessary, bring the issue to tax court. VV

MARKET TRANSACTION: REAL ESTATE

Property:	US Bancorp Building 800 Nicollet Mall Minneapolis, Minnesota
Buyer:	Wells Operating Partnership, LP
Seller:	MN-Nicollet Mall, LLC
Source:	Buyer
Sale Date:	April 2003
Sale Price:	$174,000,000
Unit Price:	$187.16 per square foot net rentable area
Net Rentable Area:	929,694 square feet
Gross Building Area:	1,209,452 square feet
Zoning:	B4-2, Downtown Business District
Utilities:	All Available
Topography and Soil:	Level, assumed stable
Visibility and Access:	Good
Age:	2000
Land Size:	52,474 square feet
Remarks:	Property was over 99% leased at the time of the sale, with US Bancorp occupying over 77% of the rentable space. Other large tenants include Xcel Energy and Robert Half.

SCOPE OF SERVICES

Shenehon Company is a Real Estate and Business Valuation firm, serving both the private and public sectors throughout the United States. Our unique combination of real estate and business valuation expertise allows us to provide a wide range of services and to offer innovative solutions to difficult valuation issues. Obtaining accurate and reliable industry information and expertise should play a key role in any decision-making process, and Shenehon Company is dedicated to equipping its clients with the tools necessary to make informed and knowledgeable decisions regarding their capital investments.

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- Feasibility analyses
- General and limited partnership interests
- Gift tax evaluations
- Going public or private
- Highest and best use studies
- Industrial properties
- Insurance indemnification
- Intangible asset valuation
- Internal management decisions
- Investment counseling
- Land development cost studies
- Lease and rental analyses
- Lost profit analyses
- Marriage dissolution
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- Special assessment appeals
- Special purpose real estate
- Tax abatement proceedings
- Tax increment financing
- Utility and communication easements

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