Indé Global
Business Appraisers

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Valuation updates | Valuation of S – Corps

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This thought leadership paper provides insights on valuation of S corporations

What is an S Corp ?

S corporation can be defined as a form of corporation that meets the IRS requirements to be taxed under Subchapter S of the Internal Revenue Code. Under this structure, the corporation's profits are not taxed at the corporate level, but rather at the level of the shareholders.

The following requirements must be met for a corporation to qualify as an S corporation:

- Must be a domestic corporation
- Must not have more than 100 shareholders
- Must include only eligible shareholders
- Must have only one class of stock

The purpose of S corporations include:

- The prevention of double taxation of earnings received by a "small business corporation"
- The avoidance of complex adjustments made necessary by instances of such double taxation

What's the challenge in valuing an S Corp ?

It is implied by the definition, that S corporations have tax benefits over C corporations. The issue of whether an S corporation's earnings should be "tax affected" or not continues to be a controversial issue. In the past, valuators applied a corporate income tax rate of 40%, thus undervaluing the S corporation. However in the 1991 case of Gross vs. Commissioner, the tax court permitted no tax affecting at all. This approach would push up the value of the S corporation. To overcome these issues of underestimating or overestimating the value of S corporations, courts are now heading to a middle ground: a.k.a Kessler method of valuation.

Kessler method of valuation

The Kessler approach of valuing an S corporation is one of the popular methods of valuation. This approach is rooted in the 2006 case of Delaware Open MRI Radiology Associates, vs. Kessler. In this case, the Delaware Chancery Court adopted a hybrid approach. This approach was designed to capture the economic advantages enjoyed by an S corporation shareholder who receives dividends free of corporate taxes. Under this approach, a corporation tax rate applicable to S corporations is imputed so as to arrive at an after tax amount available to shareholders of the S corporation as dividend assuming a highest tax bracket of 40%. The tax rate so arrived is 29.4%. Thus a clear analysis was established for dealing with valuation of S corporations.

Particulars	C Corp	S Corp	S Corp Valuation
Income before tax			
Corporate tax rate			
Available earnings	500	500	500
Dividend or	40%	0	29.41%
Personal income tax	300	500	352.94
rate	15%	40%	15%
Available after taxes	255	300	300

This approach is based on the assumption that an S corporation is not likely to lose its S status. If there is a likelihood to the contrary, the application of a different approach is warranted.

About us

Indé Global Advisory Private Limited, an affiliate of KNAV PA, was established in 1999. All member firms of KNAV in India and North America have become member firms of Allinial Global effective January 28, 2016. Indé Global has grown into an International Tax and Business Advisory Firm specializing in valuations. Our team comprises of over 350 professional executives with office in India, USA, Canada, Netherlands, Switzerland, France and UK. Our bouquet of services encompasses business valuation, intellectual property valuation and valuations for financial reporting purposes.

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