

# Valuation Topic: Income Taxes in Pass-Through Entities

## Executive Summary

A common issue in the valuation of closely held businesses is the taxation of pass-through income derived from S corporations, limited liability companies and limited partnerships. Generally speaking, pass-through entities are not subject to tax at the entity level, but rather the income is passed through or allocated to the owners of the entity based on their ownership percentages, and includable on the owners' personal income tax returns.

We believe that the best way of valuing pass-through entities, with respect to the tax issue, is to first value the entity on a C corporation equivalent basis. Subsequently, it is appropriate to calculate the economic difference between holding stock in a pass-through entity relative to an otherwise equivalent C corporation. Typically a benefit is derived by the lack of dividend tax on distributions from pass-through entities. We apply a calculation that considers (1) the differences in C corporation income tax rates and personal income tax rates, (2) the C corporation dividend tax rate avoided in the pass-through entity context, and (3) the distribution policy of the entity.

Depending on the facts of the case, an adjustment (often referred to as the "S corporation premium") could be significant or may not be warranted at all.

## Further Discussion

A consistent hot button in the valuation of closely held businesses is the issue of income taxes when valuing pass-through entities. This typically includes operating companies organized as S corporations, limited liability companies or limited partnerships. Unlike publicly traded or privately held C corporations, pass-through entities are generally not subject to taxes at the entity level. Rather, the income is passed through or allocated to the owners of the entity based on their ownership percentages, and includable on the owners' personal income tax returns.

This presents an interesting valuation question as on its face, a pass-through entity may appear more profitable simply because there are no taxes paid by the entity. Let us imagine two otherwise identical companies, the first a C corporation and the second an S corporation, both with pre-tax profit of \$100. The former incurs taxes of say \$40, and reports net income of \$60, while the latter incurs no taxes and records net income of \$100. The owners of the S corporation, however, would be required to pay tax on their share of the \$100. We do not believe that this pass-through tax should be ignored in the entity valuation.

An additional important factor is the taxation of dividend income. Dividend taxes are not levied on distributions from pass-through entities, but are levied on C corporation dividends. The lack of a second layer of tax is a positive investment attribute of pass-through entities. This presumes, of course, that pass-through entities make distributions at least sufficient to cover owners' pass-through tax liabilities. If a pass-through entity does not make distributions in excess of the pass-through tax liability then there is not a benefit to the lack of a dividend tax on pass-through distributions. However, once distributions exceed the tax liability then the lack of a dividend tax is a significant benefit to the pass-through owners.

We firmly believe that the pass-through tax liability generated by an entity must be considered directly in the valuation analysis, even though the tax is not paid directly by the entity. This tax is an economic event that must be taken into account, and the large majority of the valuation community is in agreement on this point. We also believe that the potential benefit associated with the lack of dividend tax is a positive attribute that may call for a valuation adjustment.

We believe that the best approach for valuing a pass-through entity is to first treat the entity as if it were a tax-paying C corporation. Subsequently, a separate calculation is warranted to determine

the economic differences, if any, between a tax-paying C corporation and a pass-through entity. This calculation is driven in large part by the:

- (1) Differences in C corporation income tax rates and personal income tax rates,
- (2) C corporation dividend tax rate avoided in the pass-through entity context, and
- (3) Distribution policy of the entity.

Generally speaking, we find through analysis of these factors that entities distributing all or virtually all of their earnings (e.g., service firms, asset management companies, etc.) generate meaningful economic benefits to owners by being structured as pass-through entities rather than C corporations. On the other hand, pass-through entities that only make distributions to cover pass-through tax liabilities are not generating such benefits; a valuation adjustment would not be warranted in this case relative to a C corporation equivalent value.

We also consider the potential economic benefit of pass-through entity ownership relating to earned, but undistributed, income. For an S corporation, earned and undistributed earnings result in an upward adjustment to an S corporation shareholder's tax basis in the stock and, therefore, may shield a portion of the capital gains taxes to be paid upon the ultimate sale of the asset in question. While seemingly a positive factor, we believe this benefit carries with it only speculative and/or nominal present value. For example, a specific shareholders' current tax basis would have no bearing on the valuation of his or her stock (in the eyes of a third party purchaser) since the buyer of that stock does not enjoy the economic benefits of the seller's higher basis. Rather, the valuation impact (if any) to the buyer associated with this basis adjustment feature is principally based upon (i) the prospective earnings retention policy of the firm, (ii) the holding period for the investment and (iii) the exit value of the investment – all unknowns at the date of purchase.

In summary, it is our opinion that the pass-through tax should not be ignored, rather a pass-through entity should initially be valued as a tax-paying entity, and upward adjustments to value may be necessary based on factors specific to the company. Please feel free to contact us with any questions that you might have on this topic, including facts unique to a current situation.

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