

# Another Look at Valuing Pass-Through Entities: C vs. S Corp Income Tax Law



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For many years, the valuation community has devoted extensive energy, effort, and time to the valuation of pass-through entities. This started with four Tax Court decisions and one 6th Circuit Appeals Court decision between 1999 and 2002. These cases generally concluded that S corporation earnings are after entity level taxes, i.e., zero taxes. Subsequent to these decisions, the valuation community has debated these issues in depth. In response to these cases, a number of models were developed to assist in the analysis (i.e., Treharne, Van Vleet, Mercer, Grabowski and Fannon). These models and the valuation community's on-going discussions have been effective in helping us deal with this issue.

## BACKGROUND

While some valuers have an extensive income tax background, many don't. My purpose in writing this article is to be sure that we don't lose sight of the income tax law provisions that would be considered by the pool of hypothetical buyers in a fair market value analysis. It is important that the concepts discussed here are not overlooked in the S corporation valuation process. Thus, the issues discussed herein are intended to supplement the discussion and analysis of this important issue that has taken place to date.

The 1999 to 2002 cases referenced above are:

- *Gross v. Commissioner* (T.C. Memo, 1999-254, affd. 272 F 3d 333 6th Cir. 2001)
- *Estate of John E. Wall v. Commissioner*, T.C. Memo. 2001-75
- *Estate of William G. Adams, Jr. v. Commissioner*, T.C. Memo. 2002-80
- *Estate of Richie C. Heck v. Commissioner*, T.C. Z Memo. 2002-34

## HOW BIG IS THIS ISSUE?

I have found that many valuation professionals do not fully understand the implications of these cases. Table 1 (p.10) demonstrates the impact of treating S corporation income as after-tax as compared to pre-tax. *In that example, not tax affecting the income in an S corp valuation increases the resulting value by 67 percent.* This is a big issue.

To demonstrate the appropriate concepts, two examples will be used. They are summarized below:

The "Potential Big" below refers to the built in gains tax that may apply for up to ten years after a C corporation has elected S status. This is different from the potential trapped in gains tax that *Continued on next page*

### EXAMPLE 1

Assumptions: 3 identical entities, except:

- **Always S Corp** has been an S corporation since inception;
- **New S Corp** just elected S status effective January 1, 2011; and
- **C Corp** is and has always been a C corporation.

The balance sheet of each of the corporations is shown below:

Assets:	FMV	TAX BASIS	POTENTIAL BIG
Cash	100,000	100,000	-0-
Goodwill	<u>200,000</u>	<u>0 (internally developed)</u>	200,000
Total Assets	300,000	100,000	
<b>Liabilities:</b>			
None			
<b>Stockholders' Equity:</b>			
Capital Stock	300,000	100,000	

### EXAMPLE 2

Assumptions: 3 identical entities, except:

- **Always S Corp** has been an S corporation since inception;
- **New S Corp** just elected S status effective January 1, 2011; and
- **C Corp** is and has always been a C corporation.

*(Please note that these are the three same entities as in Example 1).*

The balance sheet of each of the corporations is shown below:

Assets:	FMV	TAX BASIS	POTENTIAL BIG
Cash	100,000	100,000	-0-
Goodwill	<u>200,000</u>	<u>200,000</u>	-0-
Total Assets	300,000	300,000	
<b>Liabilities:</b>			
None			
<b>Stockholders' Equity:</b>			
Capital Stock	300,000	300,000	

is frequently discussed in valuation circles.

In general, under Internal Revenue Code Section 1374, the built-in gains tax may apply to an S corporation if:

- It was a C corporation prior to making its S election,
- It has a net recognized built-in gain within the recognition period (generally 10 years after electing S, but with some exceptions), and
- It has taxable income for the year in question.

### NEW S CORP AND C CORP

These would logically be viewed identically by a potential purchaser. If the purchaser is a qualified S corporation shareholder (generally individuals, estates and certain trusts), then the purchaser could purchase C Corp and immediately elect S, putting C Corp into the identical position as New S Corp.

If the purchaser is not a qualified S corporation shareholder (partnerships, LLCs, corporations, most trusts, etc.) then the S election for New S Corp will be terminated when the stock is purchased. Thus, New S Corp will be put into the identical position as C Corp.

In either event, the New S Corp should not sell at any premium to C Corp. Therefore, based only upon this analysis, there should be no difference in values between the two.

### ALWAYS S CORP VS. C CORP

Beginning with the facts in Example 1, clearly it is likely that the stock of Always S Corp is worth more than that of C Corp. A purchaser of Always S stock could liquidate Always S in order to obtain a stepped-up basis. Unlike C Corp, Always S can be liquidated without any tax at the corporate level. Table 2 (page 11) shows how this works. In that table, the assumption is that a purchaser has paid \$300,000 for the stock in each case. This purchase is followed by an immediate liquidation. For the C Corp alternative, net income taxes of \$64,000 would be paid on the liquidation. Under the Always S Corp

alternative, no income taxes are paid on the liquidation.

Would the pool of hypothetical buyers require a discount if purchasing C Corp stock? Certainly. Would that discount be \$64,000 (or 21 percent of the purchase price)? Not necessarily. As many tax cases have held, beginning with the *Estate of Davis*, a purchaser of the stock will not necessarily incur these trapped-in taxes immediately. A time value of money analysis has been applied frequently in tax cases. For example, the purchaser will not necessarily demand a full \$64,000 discount. However, clearly some discount would be required by the pool of hypothetical buyers.

In determining the discount that might be required in purchasing C Corp, prospective buyers would likely consider the following factors:

- The buyer could elect S status for C Corp, wait ten years until the built-in gains tax no longer applies, and avoid the corporate level taxes. Of course, S status is only available to corporations where all shareholders are either individuals, estates, or certain trusts.
- Even during the ten-year period, the buyer has tax disadvantages. In the present example, the buyer would not be able to amortize the goodwill over 15 years under Section 197 of the Internal Revenue Code. This is because C Corp has no basis in the goodwill.
- If the buyer purchases Always S and liquidates (at no tax cost), the goodwill would have a tax basis equal to fair market value of \$200,000. That basis could then be amortized over 15 years, resulting in an annual deduction of about \$13,000.
- If the buyer is not an eligible S corporation shareholder (individual, estate or certain trusts), then there would be no reason for a discount in value between C Corp and Always S Corp. Thus, if the buyer is another corporation (C or S), an LLC, a partnership, etc., the buyer cannot take advantage of S status. For example, assume that a corporate buyer purchases 100 percent of the stock of



Always S Corp. Immediately upon that purchase, Always S Corp loses its S status and becomes a C corporation. For this purchaser, there is no benefit resulting from the S status enjoyed by Always S Corp.

- Even a buyer who is an ineligible S shareholder would likely demand a discount to purchase C Corp's stock. While the S election gives no benefit to the purchaser, a properly advised buyer will understand that C Corp is worth less than Always S Corp in a stock purchase. Therefore, the buyer would still likely demand a discount to purchase stock.

Of course, as discussed earlier the New S Corp would be treated identically to the C Corp in the above discussion. Thus, the New S Corp stock would require whatever discount the C Corp requires.

It's also important to keep in mind that the results are similar if there is depreciable property inside the corporation instead of goodwill as is the case in this example. If instead of goodwill, the corporations each owed equipment worth \$200,000, but depreciated to 0, the same type of analysis results. The differences in tax treatment as compared to our example are:

- The liquidation of the corporations would result in some or all of the corporate-level gain on the deemed sale of the equipment to be taxed as ordinary income from depreciation

*Continued on next page*

**TABLE 1**

**S Corporation Income: After-Tax vs. Pre-Tax**

	Net Income Treated as Pre-Tax	Net Income Treated as After-Tax
Net Income	100	100
Less Taxes @ 40%	-40	0
After-tax net income	60	100
After-tax capitalization rate	20%	20%
Value	300	500
Difference		200
Difference as a % of pre-tax value		67%

recapture. The goodwill is resulting in capital gains in our example.

- This difference in character could turn a tax-free liquidation of the Always S Corp into a taxable transaction. The \$200,000 corporate level gain would be taxed as ordinary income if it resulted totally from depreciation recapture. The capital loss on liquidation would therefore not offset this ordinary income.
- The \$200,000 of equipment would likely be depreciated over 5 or 7 years (depending upon the character of the equipment) instead of 15 years for goodwill.

**EXAMPLE 2**

For simplicity, we are assuming that this is also the balance sheet on January 1, 2011, the first day that New S Corp's S election was effective.

The key difference versus Example 1 is that the goodwill is purchased and has a tax basis equal to its fair market value. This eliminates most of the drawbacks (and the resulting discount) for both C Corp and New S Corp. That is:

- There is no trapped-in gain (see *Estate of Davis* and similar case law) for C Corp.
- There is no potential built in gains tax for ten years after New S Corp elected S.
- As a result, there is no logical reason for C Corp and New S Corp to have valuation discounts applied which would not be applicable to Always S

Corp.

If the IRS were to contend in this case that either Always S Corp or New S Corp should be valued higher than C Corp, I would present the following arguments:

- Regarding C Corp, any potential purchaser could have the full advantage of S status by simply buying the C Corp stock and electing S. The traditional drawback to this of the ten-year built in gains tax period is eliminated because there is no net unrecognized built in gain on the first day the S election is made.
- New S Corp would be in the same position as C Corp. That is, any potential purchaser could have the full advantage of S status by simply buying the New S Corp stock. What is left of the 10 year built in gains tax period is meaningless. There was no net unrecognized built in gain when New S Corp elected S.
- Of course, if the potential purchaser is an ineligible S shareholder (a corporation, partnership, LLC, most trusts, etc.), then the S election would have no value anyway because it will be terminated upon acquisition of the shares by the ineligible shareholder.

**CAUTION: BEWARE OF PASSIVE INVESTMENT INCOME ISSUES**

The above discussion has not considered any possible problems with passive investment income. While it is beyond the scope of this article to dis-

cuss this in depth, the valuator needs to be aware of the potential implications on the business value from this issue.


First, this issue is not a problem for Always S Corp (assuming it never acquired any other corporations). The general rule is that a tax on excess passive investment income can apply to an S corporation which has:

- Accumulated earnings and profits from C corporation years,
- Net passive investment income totaling more than 25 percent of gross receipts, and
- Taxable income.

“Passive Investment Income” means gross receipts derived from royalties, rents, dividends, interest (with some exceptions), and annuities. In addition, a corporation's S election is terminated if it has accumulated earnings and profits as of the end of three consecutive years, and the corporation's passive investment income exceeds 25 percent of its gross receipts in each of those three years.

The valuator does not want to overlook the possibilities of these passive investment rules applying to a company being valued. However, these rules typically create no current problem for operating companies because passive investment income would not be close to 25 percent of gross receipts.

**CONCLUSION**

The income tax ramifications discussed herein should be another element in the analysis of the appropriate valuation approaches to use when valuing pass-through entities. It is important that each subject company be analyzed in this light. 

(Table 2 on next page)

**expert TIP**

**Don't lose sight of the income tax law provisions that would be considered by the pool of hypothetical buyers in a fair market value analysis.**

**TABLE 2**
**Taxes on Liquidation: C vs. Always S Corps**

	<u>C Corp</u>	<u>Always S Corp</u>	<u>New S Corp</u>
<b><u>At the Corporate Level:</u></b>			
Fair Market Value of Goodwill + cash	300,000	300,000	300,000
Less Basis	(100,000)	(100,000)	(100,000)
Capital Gain on Liquidation	200,000	200,000	200,000
Corporate tax (40% federal and state-assumed)	80,000	----	80,000
Net proceeds distributed to shareholder on liquidation	220,000	300,000	220,000
<b><u>At the Shareholder Level:</u></b>			
Net proceeds on liquidation from above (after corp tax)	220,000	300,000	220,000
Less basis in stock (300,000 cost-assumed) <i>Note 1</i>	(300,000)	(500,000)	(300,000)
Capital gain (loss) on liquidation	(80,000)	(200,000)	(80,000)
Net capital gain (loss) taxed to shareholder <i>Note 2</i>	(80,000)	----	(80,000)
Shareholder capital gains tax (20% federal and state-assumed) <i>Note 3</i>	(16,000)	----	(16,000)
<b><u>Combined:</u></b>			
Total taxes paid (corporate and shareholder)	64,000	----	64,000

**Note 1:** The shareholder basis in Always S Corp stock is increased by the corporate capital gains passed through to the shareholder. Of course, that is not the case for C Corp shareholder's basis.

**Note 2:** For Always S Corp, the capital gain passed through from the corporate liquidation is offset by the higher shareholder basis resulting from the passed-through income.

**Note 3:** The shareholder net capital loss on liquidation is assumed to save tax on other shareholder capital gains. Of course, if the shareholder has no other capital gains, this loss can only be deducted to \$3,000 per year.

