



Clearing the Complexity From S Corp Valuations: A New, Simplified Model

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DATA & PUBLICATION UPDATE

Clearing the Complexity From S Corp Valuations: A New, Simplified Model

Fundamentals of S Corporation Logic, Nancy J. Fannon, ASA, CPA/ABV, MCBA, CPAExpert (Spring 2007).

“Unfortunately, while there has been a deluge of information regarding the valuation of S corporations”—and at least five U.S. Tax Court cases that have rejected any “tax affecting” for pass-through entities—“the basic logic of why an S corporation would be worth more than a publicly traded C corporation has gotten lost in the fray.” So begins Fannon’s clear-sighted analysis of S corporation valuation, in which she observes:

Taxes affect investments. The bottom-line for any investment is how much cash will end up in the pockets of investors. Those putting their money in public C corporations will bear federal income taxes at the corporate level, while investors in S corporation will pay pass-through taxes. “Where these taxes are borne makes no difference.” They must be paid, and as a result, there is less cash in the [investors’ pockets].” The critical difference: An investor in a publicly traded C Corp pays a dividend tax on any distributions, while an S Corp investor pays no such double tax.

Running the numbers. Fannon compares a hypothetical \$1,000 investment in both entities. Upon receipt of a \$100 dividend from a publicly traded C corporation, and assuming a federal/state tax rate of \$20, an investor will net \$80. “Knowing this, the investor determined a 10% rate of return was appropriate.” ($\$1,000 \times 10\% = \100 ; or, conversely, $\$100 \div 10\%$ rate of return = \$1,000.)

In the case of an equal S Corp investment—as assuming 100% of available income is distributed—the investor will receive \$167 as distributable income; after payment of pass-through income taxes (assuming a 40% rate), that same investor will net \$100. To find the applicable rate of return, proxies from public C corporations are used—in this case, the 10% from the publicly traded stock example. Thus, the value for the S corporation is calculated as $\$100 \div 10\% = \$1,000$.

Avoidance of dividend tax. However, the S Corp investor keeps the \$20 that the public C Corp investor has to pay in dividend taxes, and is willing to pay more to avoid this double tax. “Therein lies the benefit,” Fannon says, accounted for by the same equation: $\$20 \div 10\%$ rate of return = \$200 in additional value of the S Corp investment. Adding this to the investment value brings the total value to \$1,200.

“The ‘C corporation equivalent dividend’ is the metric we should be calculating when using a rate of return from the public markets,” Fannon concludes. The given example results in a 20% premium for the S corporation value.

Running these same numbers through the Tax Court’s model, however, results in an overstatement of the premium, because the model assumes the S Corp investor avoids *all* corporate taxes, including those paid at the pass-through level. As any tax-paying S Corp investor knows, “nothing could be further from the truth.”

What if an S Corp retains a portion of earnings? In those cases, it would be appropriate to determine a terminal period when the investor would sell the investment and realize the benefit in the stepped-up basis (savings in capital gains tax), present-valued back to the date of valuation.