The Economic Impact of Taxes on S Corporation Values

By C. Donald Wiggins, D.B.A., ASA
S. Mark Hand, CPA
Laura L. Coogan

Business Valuation Review
Vol. 19, No. 2
pgs. 88-94
June 2000

Introduction

One of the most highly debated topics in business valuation is the treatment of income taxes in valuing S corporations. There are two extreme positions on this point. The first is to include no income taxes at all in S appraisals. The second is to fully tax the income stream of S corporations and, in effect, to treat them as C corporations. This article discusses the treatment of income taxes in the valuation of S corporations and recommends a treatment different from both of these approaches. It describes a methodology that takes into account the tax advantage of S corporations and demonstrates an economically appropriate and supportable tax effect.

The Tax Advantage of S Corporations

The market values post-corporate tax, pre-personal tax cash flow**.** The cash flow that is valued in publicly held companies is dividends expected to actually be paid. In privately held companies, the cash flow that is valued is the free cash flow that is available to be paid to equityholders for their unrestricted use, whether it is actually paid or not. This available cash flow is what Revenue Ruling 59-60 calls “dividend paying capacity.”

Taxable income in an S corporation (S corp) is not taxed at the corporate level and is passed through to owners *pro rata* to be taxed at the individual level. If a company is an S corp, it has an advantage in most situations over a C corporation (C corp) in that it has more post-corporate tax, pre-personal tax cash available to pay equityholders. More personal tax will be paid because there is more post-corporate tax cash flow available. However in most cases, there will be less total tax paid because there is single taxation for S corps and no double taxation as with C’s. The simple example in Table 1 illustrates this point comparing the total tax effect on a stream of revenue for an S corp and a C corp.

As can be seen in the table, the total tax burden on the revenue stream is greater for the C corp than for the S corp, all else equal.[1] Thus, two companies that are otherwise identical would have different values if one is a C and one is an S.

But how much different? The answer depends on the amount of income taxes the appraiser deducts from the cash flows of the business being appraised and that investors consider to be economically appropriate. Historically, appraisers have usually taken one of two approaches. The first is to fully tax the cash flow stream as if the company being appraised is a C corp, especially if the most likely buyer is a C. The reasoning is that a C corp is purchasing the cash flow stream and will certainly have to pay taxes at the corporate level. Thus, C corps will deduct income taxes from the cash flow stream reflecting its own tax status.

This is absolutely correct if the most likely buying entity is taxable. However, the buying corporation (and the appraiser appraising the S corp as a stand-in for the buying market) must also take into account differences other than taxes between itself and the S corp it is purchasing. For example, the buying company may have more marketing resources and a better distribution system meaning that revenues will grow faster than if the S corp remains in its current mode of operation. Because of its size, the buying company may also have economies of scale in purchasing goods, services, raw materials, and other items resulting in more profit and cash flow per dollar of revenue. The buying company may have better access to the capital markets and a resulting lower cost of capital that the S corp. There may be other differences, but these are representative.

The net result is that rarely is the tax difference the only difference between an S and a C. If the appraiser decides that a larger C corp is the most likely buyer, all differences must be taken into account, and in most situations, the tax burden is one of those differences.

The second common approach to appraising S corps is to include no taxes in the projected cash flow stream of the company. The logic is that the market values post-corporate tax cash flows, and since S corps pay no corporate taxes, no taxes should be deducted in the valuation process. [2]

If the subject company is being appraised as an S corp, neither of these approaches is totally correct. In most situations, the S corp has an economic tax burden that it must bear if it is to sustain itself and grow. As a result, the appraiser should take a tax burden into account in the appraisal process. [3] This economic tax burden is the tax on the amount of pre-tax income necessary to support projected asset growth after taking into account net changes in other financing sources, specifically debt and common stock. Free cash flow to equityholders should be the cash that could be distributed to them after taking into account both income statement and balance sheet effects. This includes cash flow generated from operations and all other effects included in the income statement such as interest and an appropriate level of taxes. In addition, projected cash flow should include cash flows from asset increases and decreases, debt increases and decreases, and new stock issue and repurchase. Any remaining financing shortfall will be covered by reinvesting internally generated cash flow as retained earnings.

It is at this point that the tax economics of S corps and C corps diverge. The economic tax burden of a C corp is the total tax that it pays. It is a separate, tax paying entity and it pays taxes independently of its ownership, whether corporate or individual. The economic impact of the tax burden of the S corp is the tax it pays on enough pre-tax income to net the amount necessary after tax to reinvest through retaining earnings to support growth. Free cash flow should be cash flow that investors receive and can use unrestrictedly for any purpose they choose. If part of the cash flow must be used to pay what are effectively corporate taxes to support growth, rational investors will not consider tax they pay on the reinvested portion to be true free cash flow. Accordingly, this portion of taxes should be deducted from the cash flow used to value the company.

Table 2 extends the above example by showing the balance sheet of the hypothetical company over a two year period. The company currently has total assets of $250 financed by $125 each in total debt and total equity. In projected Year 1, total assets are expected to grow to $320. If the company wishes to maintain the same capital structure, this implies total debt of $160 and total equity of $160 as shown. Assuming the company does not plan to issue additional common stock, and additional $35 of retained earnings will be necessary to support asset growth.

The calculation of the tax burden for the example company is shown in Table 3. Reinvesting $35 in the company in the form of retained earnings will, of course, require that more than $35 of pre-tax income be earned to net the required amount after tax.

Assuming that equityholders have an average personal tax rate of 30%, the amount of pre-tax income can be calculated by dividing the required reinvestment by (1-personal tax rate of equityholders).[4] In this case, it would be:

$$\$35/(1-0.30) = \$50$$

The tax burden on $50 would be:

$$\$50 \times 0.30 = \$15$$

The tax burden assigned to the company to develop its economic income statement and to determine its cash flows for valuation purposes would be $15, regardless of how much income it earns. The restated economic income statement is shown in Table 4.

Maximum Implies Internal Growth

There is also an implied maximum growth level in any one year that can be funded internally without equityholders having to pay taxes out of their own personal funds. This maximum is the total net income of the S corp reduced for the total taxes that equityholders will have to pay on the income. In the above example, this maximum would be:

$$\$70 \times (1-0.30) = \$49$$

At this level of growth, the company would be able to pass $21 through to owners to pay personal taxes on the $70 of total corporate net income. Any growth in assets net of debt increases and issue of common stock greater that $49 (i.e., funded internally) would require equityholders to pay at least part of the tax burden from the S corp’s earnings out of their own pockets. The S corp would not have sufficient cash to pass through to its equityholders to cover their personal taxes from the S corp’s earnings.

The Effect on Value

The resulting effects on value of the three methods of treating taxes are shown in Table 5. Free cash flow to equityholders is calculated for the projected year using (1) a full C corp tax burden, (2) no corporate taxes, and (3) the economic tax burden described above. The resulting free cash flows to equityholders are $7, $35, and $20, respectively. Using a 20% capitalization rate, the resulting values for the equity ownership in the three cases are $35, $175, and $100.[5]

If the extreme conditions of either a full tax burden or no taxes are used to value the tax advantage of the S corp, the difference is $175 less $35, or $140. However, this large difference is overstated because the tax advantage of the S is recognized, but no provision is made for the personal taxes that owners will have to pay to fund internal growth as shown above. The true value of the tax advantage of the S corp over the C corp in this example is $100 less $35, or $65, and this result has an intuitive appeal.

S corps were specifically created to have a tax advantage. Depending on the situation, a specific s corp may be valued as if it is going to be an S or a C in the future. If the company is being valued as an S corp and all other factors are the same, this advantage should result in greater value.

However, owners generally recognize (and often complain) that they do not receive and are not free to use all of the income from S corps on which they are taxed. This condition has a negative impact on value. The methodology described above addresses and appropriately accounts for both of these effects in the valuation process.

The Effect on Value

There has long been a debate in the appraisal profession over the treatment of taxes in S corporations and C corporations, primarily centering around whether to include a full income tax burden on the company being appraised or to include no taxes at all. The real answer is that neither of these choices is usually correct and the appropriate tax burden lies somewhere between the extremes.

The true economic tax burden of the S corporation is the tax that must be paid by owners personally that will net sufficient internally generated cash flow to support growth not financed by other means. Using this tax burden in projecting cash flows yields a more economically sound and rational value that realistically reflects the true economic tax advantage of the S corporation.

Endnotes

1. There are some differences in tax provisions, such as the deductibility of certain items, but they are not relevant to the point of this article.
2. This same logic and the methodology described below for S corps would apply to any non-taxable entity, such as proprietorships, partnerships, and limited liability companies.
3. There would be no economic taxes on S corps in only a very limited number of circumstances. For example, the company may have negligible assets, such as a service company that sells its services for cash and leases its space and equipment. Another example would be a company that is not growing and has no debt. In these cases, the company has no need either to reinvest internally generated cash to fund additional assets or to pay off existing debt. Both of these conditions exist, but are relatively unusual.
4. There is also a question as to what personal tax rate is applicable. The answer is dependent on the definition of value being used in the appraisal. If the definition is fair market value, the appraiser should estimate the average tax rate of the most likely buyer in the market. If the appraisal is being conducted to determine the investment value to a specific individual or group of equityholders, the tax rate that should be used is the average rate of the specific individual or individuals. There is also an argument for using marginal tax rates instead of average rates, but in most cases, marginal and average rates should be effectively equal.
5. Discounted cash flow can be used in situations in which future cash flows are expected to be variable or to grow at a constant growth rate. For simplicity, the illustration here assumes constant future growth, but the tax effect would be conceptually the same no matter what the cash flow pattern is expected to be. The authors would like to thank Douglas Grider for his editorial comments on this article.

C. Donald Wiggins, D.B.A., ASA, is President of Business Valuation Inc., Jacksonville, FL and Professor of Accounting and finance at the University o f North Florida (currently on leave). He is President of the Central Florida Chapter of A.S.A. and received his B.B.A. and M.B.A. from Georgia Southern University and D.B.A. from Louisiana Tech University.

S. Mark Hand, CPA, is a Principal of Business Valuation, Inc. of Jacksonville, FL. Prior to joining BVI, he was a tax partner with KPMG Peat Marwick. He received his B.B.A. in accounting and masters degree in taxation from Georgia State University.

Laura L. Coogan is a senior analyst at Business Valuation, Inc., Jacksonville, FL and an M.B.A. candidate at the University of North Florida. She holds a B.S. from the United States Merchant Marine Academy, a B.A. from the New College of the University of South Florida, and is a member of Beta Gamma Sigma.

Table 1
S vs. C Tax Example
Projected- Year 1

C Corporation		S Corporation	
Revenue	$180.00	Revenue	$180.00
Expenses:		Expenses:	
Cash Expenses	$100.00	Cash Expenses	$100.00
Depreciation	10.00	Depreciation	10.00
Taxable Income	$70.00	Taxable Income	$70.00
Taxes (40%)	28.00	Taxes (0%)	0.00
Net Income	$42.00	Net Income	$70.00
Personal Taxes of Equityholders:			
Dividends	$7.00*	Income	$70.00
Personal Taxes on Income		Personal Taxes (30%)	21.00
to Shareholders (30%)	2.10		
Total Taxes Paid:			
Corporate	$28.00	Corporate	$0.00
Personal	2.10	Personal	21.00
Total	$30.10	Total	$21.00
Corporate Tax Rate	40%	Corporate Tax Rate	0%
Individual Tax Rate	30%	Individual Tax Rate	30%

*$7.00 is the actual dividend payment the c corp stockholders receive. See Table 5 below.

Table 2
Current and Projected Balance Sheets

	Current Year	Projected Growth	Projected Year 1
Cash	$20.00	$10.00	$30.00
Accounts Receivable	75.00	20.00	95.00
Inventory	75.00	15.00	90.00
Total Current Assets	$170.00		$215.00
Fixed Assets:			
Property & Equipment	$100.00	$35.00	$135.00
Less: Accumulated Depreciation	(20.00)	(10.00)	(30.00)
Net Fixed Assets	$80.00		$105.00
Total Assets	$250.00	$70.00	$320.00
Current Debt	$50.00	$15.00	$65.00
Long Term Debt	75.00	20.00	95.00
Total Debt	$125.00		$160.00
Common Stock	$100.00	$0.00	$100.00
Retained Earnings	25.00	35.00	60.00
Total Equity	125.00		160.00
Total Debt & Equity	$250.00	$70.00	$320.00

Table 3
Economic Tax Calculation

Net Income Necessary to Fund Increased Retained Earnings	$50.00
Taxes on Income	15.00
Net Income Added to Retained Earnings	$35.00

Table 4
S Corporation Income Restated
with Economic Taxes

Revenue	$180.00
Expenses:	
Cash Expenses	$100.00
Depreciation	10.00
Taxable Income	$70.00
Economic Taxes	15.00
Net Income	$55.00

Table 5
Value Comparisons for Different Tax Burdens

	(1) C Corp with Full Taxes	(2) S Corp with No Taxes	(3) S Corp with Economic Taxes
Net Income	$42.00	$70.00	$55.00
+Depreciation	10.00	10.00	10.00
Total	$52.00	$80.00	$65.00
Change in Current Assets	(45.00)	(45.00)	(45.00)
Change in Current Debt	15.00	15.00	15.00
Operating Cash Flow	$22.00	$50.00	$35.00
Change in Fixed Assets	(35.00)	(35.00)	(35.00)
Change in Long Term Debt	20.00	20.00	$20.00
Cash Flow to Equity	$7.00	$35.00	$20.00
Value with 20% Capitalization Rate	$35.00	$175.00	$100.00

Don Wiggins, D.B.A, ASA, CVA, CPA/ABV
http://businessvaluationinc.com
http://www.heritagecapitalgroup.com
904/354-9600
dwiggins@heritagecapitalgroup.com

Don Wiggins is president of both Business Valuation, Inc., a firm specializing in business valuations, and Heritage Capital Group, Inc., a boutique investment banking firm focusing on middle market companies. Headquartered in Jacksonville, Florida, Wiggins has over 30 years of experience advising clients on a wide range of mergers and acquisitions and finance transactions, including M&A, sales and divestitures, capital placement, value enhancement, exist planning and related business owner transitions. He has advised international and domestic companies and successfully led transactions in numerous sectors, including business services, healthcare, distribution and logistics and manufacturing.

Since 1989, Business Valuation, Inc. has performed thousands of valuations for professional service, as well as wholesale, retail and consumer product companies in a variety of industries including healthcare, transportation, logistics and distribution, manufacturing, technology and business services.

With more than 30 years of experience, Heritage Capital Group, Inc. has earned a reputation for negotiating highly successful outcomes in both sell-side and buy-side transactions, mergers and acquisitions, value enhancement prior to exit or transition, capital placement, debt management and numerous other business deals. Heritage's customers include hundreds of business owners of mid-sized companies in the southeastern United States and, as a founding-member of M&A International, lead numerous, successful international transactions. The Heritage team's extensive transactional and operational experience provides a vital perspective on the most effective means of maximizing value as measured in the market by either potential investors, partners or buyers. With a broad reach throughout the marketplace, Heritage Capital Group maintains a keen focus on the unique needs of owners of middle market companies.

Member FINRA/SIPC

"The world's leading M&A Alliance."