Income Taxes and Value Considerations

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Typically, income taxes result in a reduction in the net earnings and cash flow resulting from business operations. Further, income taxes typically reduce the net proceeds realized from the sale of a business or a business interest. Currently, an entity can be legally structured in a variety of ways, with the various structures resulting in different income tax treatment. The recognition and understanding by a valuation analyst of the variety of legal operating structures available to companies, and related income tax implications, will enable the analyst to develop more complete valuation analyses and conclusions. Such considerations are relevant when providing valuation services in a marital dissolution context.

Introduction

Some observers have argued that income taxes don't matter with regard to investment decisions. For example, Warren Buffet has said that he has never seen an investment the merits of which depended on income taxes. Apparently, Warren Buffet hasn't seen any of the situations that valuation analysts ("analysts") regularly encounter in which income taxes do matter.

Analysts often encounter many types of situations in which the decision about how to treat income taxes is of material consequence, including in a marital dissolution context.

In many situations, analysts are asked to render an opinion regarding the value of the ownership of (1) a business entity, (2) a fractional ownership interest in a business entity, or (3) a business interest such as an intangible asset. In many of these situations, the analyst is applying the fair market value standard of value, and the analyst is focused on the income tax consequences facing the hypothetical buyer and seller of that subject ownership interest.

That is, the analyst is focused on the entity level after-tax cash flow that is attributable to that subject ownership interest. With regard to the measurement of after-tax cash flow, income taxes obviously matter.

In most business and security analyses, the income tax consequences at the owner's personal tax level are not analyzed. Tax consequences at the owner's personal tax level are usually not considered by the analyst because personal income tax attributes can be very different from one individual investor to the next.[1] However, in some situations, personal income tax consequences may be factored into the financial analysis.

In a marital dissolution context, regardless of the standard of value relevant in a particular jurisdiction, income tax consequences typically come into play when an analyst estimates earnings and cash flow relied upon to estimate the value of family-owned business interests included in a marital estate.

Examples

The observable price paid for certain types of assets is generally recognized to be the fair market value of those assets. For example, the observable price of a share of common stock that is actively traded in an efficient market is recognized as the fair market value of that share of stock. Generally, (1) the seller's tax basis in that share and (2) the broker fees paid to execute that transaction are not considered when estimating the fair market value of that share. Depending on how a transaction is structured, these transaction costs will differ relative to the various actual or potential transaction participants.

This same perspective is usually adopted when estimating the fair market value of many types of

assets. For example, when estimating the fair market value of a real estate or personal property (such as a machine or a piece of artwork), the appraiser does not consider (1) the seller's personal tax basis in the property or (2) the brokerage fees that might be involved in executing a sale transaction involving the asset.

The legal form of the business may affect its value, and diligent analysts will consider the relevant facts and circumstances regarding the ownership interest that is the subject of the analysis. For example, when analyzing a C corporation, a description of the characteristics of the hypothetical willing buyer and seller is less critical than when analyzing a tax pass-through entity. Almost any person or entity can be the owner of a C corporation.

In contrast, to maintain the tax pass-through entity status, the hypothetical willing buyer and seller of a pass-through entity will usually have to have certain characteristics. For example, the hypothetical buyer of an S corporation, in order to maintain the S corporation status, must be an eligible S corporation shareholder or else the S corporation status for the corporation (and for all of its other shareholders) may be lost.

Partnership agreements usually contain stringent restrictions regarding who is an eligible partner. Similarly, the organization documents of a limited liability company usually do not permit just anybody to become a member. The hypothetical buyer and seller referred to in the typical definition of fair market value, while not specifically identified, are presumed to be knowledgeable of all relevant information about the subject ownership interest.

A business that is organized as a tax pass-through entity may confer certain tax-related economic benefits to its owners. The taxable income earned by a pass-through entity is taxed only once—on the owner's personal income tax return.

A C corporation, in contrast, pays federal income tax on its taxable income first. The remaining taxable income (net of the company's income tax expense) will be taxable to the C corporation owner—but not until the after-tax income is distributed to the shareholder in the form of dividends. In this way, shareholders of a C corporation are subject to a so-called double taxation that does not affect owners of tax pass-through entities.

Assigning a value premium (or incremental adjustment) to a tax pass-through entity (compared to the value of an otherwise identical C corporation) may be a mistake for a variety of reasons, especially if there is a high risk that the tax pass-through entity status might be revoked. Additionally, an entity may have a history of failing to make sufficient distributions to cover the income taxes accrued on earnings allocated to pass-through owners. Such a circumstance, if expected to continue, would eliminate the need for a value premium.

Data on required rates of return are almost always based on the after-corporate tax return on an investment in a C corporation. That is because those after-tax returns are the data that are publicly available and most easily accessible.[2] Accordingly, valuation methods relying on earnings and cash flow developed on an after-tax basis should contemplate the impact of any perceived income tax rate differences.

Definition of the Valuation Assignment

To arrive at a meaningful valuation of a business or business ownership interest, an important early step is to clearly define the valuation assignment. Defining the valuation assignment is the logical beginning of the valuation process, providing focus for all the valuation considerations and efforts to be undertaken.

The definition of the valuation assignment typically will include a written identification of the assignment's objective and purpose. A clear definition of the valuation assignment will help explain the proper treatment of the income tax attributes that affect the value of the subject business or subject business ownership interest.

A typical objective of a valuation assignment in a marital dissolution matter may be to express an opinion of the fair market value of the ownership interest on a going-concern basis as of a specific valuation date.

A common standard of value that may be applied is fair market value. Fair market value is based on the price that the hypothetical buyer and seller would reach and does not concern itself with the proceeds that the seller will enjoy after paying the income taxes that would be due (and other transaction costs such as broker fees) if the proposed hypothetical purchase/sale transaction took place.

Often, a valuation assignment in a marital dissolution will be based on the premise that the business will continue to operate as a going concern at its highest and best use. The highest and best use is the reasonably probable and legal use of the ownership interest that is physically possible, appropriately supported, and financially feasible.

Based on the business valuation income approach, the fair market value of the investment is often measured as the present value of the future economic benefits that an investor would expect to receive. When applying the income approach,

the income tax attributes associated with owning the investment may be an important part of the analysis.

The definition of the assignment should spell out the intended use of the analysis and the intended users. The results of the assignment may not be relevant for any other purpose.

Purpose of the Analysis

The purpose of the analysis is the use to which the valuation result is expected to be put. Different statutory, regulatory, and judicial precedent standards govern valuations of businesses and business interests under various jurisdictions for different purposes.

The valuation analyses may fail to reach a meaningful result if the analyst failed to match the valuation methods to the purpose for which the analysis was being performed. The conclusion of a valuation analysis prepared for one purpose may not be the appropriate value conclusion for another purpose. The value conclusion of a particular analysis may be inappropriate, and an unfortunate business decision could be the result if the reader attempts to use the valuation conclusion for some purpose other than the intended one.

Most business valuation purposes can be grouped into one of the following categories:

1. Transaction pricing and structuring
2. Financing securitization and collateralization
3. Gift, estate, income, or property taxation planning and compliance
4. Owner/operator information and strategic planning
5. Bankruptcy and reorganization analyses
6. Forensic analysis and dispute resolution, including marital dissolutions
7. Financial accounting compliance and reporting
8. Regulatory compliance

Valuations performed for federal estate tax compliance purposes typically do not include the insurance proceeds that would be triggered by the death of the business owner even if the death of the owner is imminent and predictable. Depending on the structure of the policies and their ownership, life insurance proceeds may not be taxable. However, the cash value of a life insurance policy may be taxable if redeemed before the death benefits are paid. This consideration may not be appropriate if the purpose of the business valuation is different than estate tax compliance.

Fiduciaries such as trustees have a duty to make decisions that are in the best interests of the beneficiary of their efforts. A fiduciary viewpoint may also affect an analyst's decision about how to treat certain risk factors facing a business. For example, it may not be reasonable for an analyst to assign a valuation adjustment (i.e., a discount) that results in a lower value due to an avoidable built-in gains tax by assuming the sale of an asset of the marital estate if a party who can avoid incurring the built-in gains tax has a fiduciary duty to maximize the value of the marital estate.

When analyzing either an offer price or the structure of a transaction—depending on the circumstances—a fiduciary may decide to not enter into a transaction even when the terms of the transaction are fair from a financial point of view.

When property that is being analyzed is going to be transferred incident to a divorce, Internal Revenue Code Section 1041 allows the parties in a divorce to defer recognition of any gain on the value of the property until the property is sold. In other words, the transfer of ownership of assets in a divorce is generally not considered to be a taxable transaction. The Internal Revenue Code does not totally exempt the gain from taxation. Rather, it allows the marital dissolution parties to defer the income tax recognition.

Failure to consider the income taxes that will be paid, and to adjust the value of the property to reflect the embedded income taxes, may result in an overvaluation of low tax basis property. For example, if 100 shares of corporation X have an observable price of $100,000, but were acquired for $20,000, and if the party to the divorce who will retain the shares plans to sell them within the next few months in a taxable transaction, the value of the shares to that party is obviously not the same as receiving $100,000 in cash. Instead, the value of the shares is $100,000 less the estimated built-in gain tax liability that will be incurred with the stock sale.

In either tort or breach of contract litigation matters, the measurement of economic damages generally is recognized to be the amount necessary to put the plaintiff in the economic position the plaintiff occupied before suffering the consequences of the defendant's alleged misbehavior. If the economic damages have been measured based on an after-tax lost profits analysis, and the damages award is a taxable event for the plaintiff, then it may be appropriate to adjust upward the award of the economic damages so that, after paying the income taxes on the award, the plaintiff occupies the same position the plaintiff would have occupied before the alleged misbehavior took place.

The analysis of fair market value is based on the assumptions that hypothetical buyers and sellers

would use in pricing the subject ownership interest. The definition of the ownership interest involves a decision of which financial items should be aggregated (or bundled). The definition of the ownership interest should describe the entire bundle of legal rights that are being analyzed. The bundle of rights may include properties and attributes that are so closely related that, effectively, they are parts of a single ownership interest with tax attributes, an overall profit margin, expected remaining life, amortization period, and highest and best use.

In these examples of different valuation assignment purposes, the subject business income tax attributes can affect the value indications.

Legal Form of the Subject Entity

Depending on the legal form of the subject entity, different income tax laws govern the recognition of income and losses at the entity and owner level.

C corporations are subject to the Internal Revenue Code of 1986, as amended, subchapter C. C corporations are subject to federal income tax on the income recognized by the entity, regardless of whether that income is distributed to the shareholders. When the after-tax income of a C corporation is distributed to the shareholders, then there is a second level of income tax due (on the dividend income) at the shareholder level.

Most companies with shares that are publicly traded are C corporations. The financial performance of companies with shares that are publicly traded should be reported (in accordance with generally accepted accounting principles) so that investors can confidently make their investment decisions.

By comparing the financial performance of companies with shares that are publicly traded with the pricing of their publicly traded securities, analysts estimate required rates of return on investment. Those comparative relationships are used by analysts to estimate the value of securities that are not publicly traded.

Partnerships are subject to Internal Revenue Code subchapter K. S corporations are subject to subchapter S of chapter 1 of the Internal Revenue Code. Usually, partnerships, S corporations, limited liability companies (LLCs), and sole proprietorships do not pay income taxes at the entity level. These entities are commonly referred to as “pass-through entities.” This is because the taxable income (and loss) is passed through to the owners of those entities who pay the taxes only at the owners’ level (and not at the entity level).

Most of the companies with shares that are publicly traded are C corporations. These types of entities have important attributes other than income tax attributes. C corporations can have an unlimited number of and types of owners. The liabilities associated with operating C corporations do not pass through to the owners of the business. C corporations can issue many different types of equity and debt securities to attract investors.

Prior to 1958, there were only three types of entities available. C corporations protected owners from liabilities but subjected the owners to the two layers of income tax. Partnerships had multiple owners and one layer of income tax, but partnerships did not limit the business liability. Sole proprietorships had one owner and one layer of income tax, but they did not limit the business liability.

To aid in the creation of small business, Congress enacted Subchapter S of the Code in 1958. S corporations offer limited liability and one layer of income tax. Availability of S corporation status is limited to domestic enterprises and owners. There must be 100 or fewer owners who are individuals or certain types of entities (trusts, employee stock ownership plans, qualifying S corporations) owning one class of common stock (although voting and nonvoting shares may be issued). Today, more S corporation income tax returns are filed than C corporation income tax returns.

The law providing for REITs was enacted by the U.S. Congress in 1960. A REIT is a company that owns income-producing real estate. To avoid incurring liability or U.S. federal income tax, REITs generally must pay out an amount equal to at least 90 percent of their taxable income in the form of dividends to shareholders. REITs can be publicly traded.

A master limited partnership (MLP) is a limited partnership that qualifies under Section 7704. It combines the income tax benefits of being a limited partnership with the liquidity of publicly traded securities. MLPs began appearing in the early 1980s. An MLP must receive at least 90 percent of its income from qualifying sources such as energy exploration, mining, extraction, refining of oil and gas, and the transportation of alternative fuels like biodiesel.

By 1996, nearly every state had enacted an LLC statute. LLCs are very similar to partnerships. However, the liability of operating the subject business does not pass through to the business owners. There are no restrictions on the number of owners. LLCs can have partnerships or S corporations as a member, but S corporations cannot have an LLC or a partnership as a shareholder.

The organization documents of an LLC can be drafted to specifically favor certain membership interests with regard to economic returns and income tax treatment. An LLC agreement can assign income streams and tax consequences differently among its members.

Tax pass-through entities such as REITs and MLPs, as a result of their favorable income tax status, may have a competitive advantage when bidding to acquire a business (that would qualify for pass-through entity status) over entities that are not structured as tax pass-through entities.

If a C corporation yields after-tax investor returns that are different from the returns yielded by pass-through entities, how can an analyst justify applying unadjusted valuation pricing multiples derived from C corporations to tax pass-through entities?

Let's look at how the structure of a transaction involving a C corporation can affect the value of that transaction and, hence, the business value of a C corporation.

Transaction Structure

Generally there are four ways to structure a transaction involving the sale of an entity.

1. The buyer may pay cash to the seller for the equity of the subject entity.
2. The buyer may pay cash to the seller for the assets of the subject entity.
3. The entity buyer may exchange its equity for the subject equity owned by the seller.
4. The entity buyer may exchange its equity for the assets of the subject entity.

Simple Illustration for a 100 Percent Ownership Interest in a C Corporation

This illustration discusses the effect of income taxes on transaction value. The example may not necessarily be indicative of actual income tax liabilities that would arise in the sale of the entity or the relationship of those tax liabilities (that is, some tax expenses are deductible and can offset other tax liabilities) in any particular transaction.

Cash for Stock

When a C corporation's equity is exchanged for cash, if the purchase price is greater than the price the seller paid for the equity, the seller recognizes a gain on the sale of the shares on his or her personal income tax return. This is referred to as a gain on the "outside" basis. A taxable gain on the outside basis is recognized at the personal tax level and is not recognized at the corporate level.

To illustrate, the owner paid $100,000 to buy all of the shares of Candy, a C corporation, five years ago. That owner sells his or her shares of Candy today for $500,000. The seller has a capital gain on his or her personal tax return of $400,000 for the sale of the shares and pays a 20 percent capital gains tax of $80,000. The seller nets $420,000 on the sale.

For income tax purposes, the buyer of the shares (under normal circumstances) will continue to operate Candy with the same inside tax basis of the assets as before the transaction.

Cash for Assets

If the seller of Candy agreed to exchange the assets (instead of the shares) of Candy for cash, generally more income taxes will be due and the seller will enjoy a lower amount of after-tax proceeds from the sale.

The sale of the assets of the corporation for a price greater than the inside tax basis of those assets will generate a gain to the corporation on the sale of its assets. After paying the tax on the gain on the inside basis of the assets at the ordinary corporate income tax rate, Candy's owner could then liquidate the company and distribute the proceeds. Those proceeds would be subject to the capital gains tax on the owner's outside basis.

Suppose the inside tax basis of Candy's assets is $400,000. When the buyer pays $500,000 for those assets, then Candy recognizes a gain of $100,000 and pays the 35 percent ordinary income tax of $35,000. The seller liquidates Candy in order to generate proceeds of $465,000. And, after subtracting the $100,000 outside tax basis, the seller pays a 20 percent capital gains tax of $73,000 ($365,000 times 20 percent) on his or her personal tax return. The seller nets $392,000 ($500,000 minus the $35,000 tax on the inside tax basis minus the $73,000 tax on the outside basis) after selling the assets of Candy.

Stock for Stock

If Candy's owner accepts equity from the buyer in exchange for Candy's equity, generally there are no immediate tax consequences to Candy's owner. The outside basis of the new equity is equal to the outside basis of the Candy equity regardless of the observable value of that new equity and no gain is recognized by Candy's owner until the new equity is sold.

Stock for Assets

If Candy's owner accepts equity from the buyer (that has a value of $500,000) in exchange for Candy's assets (that have an inside tax basis of $400,000), the corporation recognizes a gain of $100,000 and pays the 35 percent ordinary income tax of $35,000. The new equity is held inside of the Candy corporation. The seller's outside tax basis of $100,000 is unchanged until the new shares are sold.

In each of these transactions, the buyer has paid a cash-equivalent price of $500,000. However, the business value of Candy to its owner is not always $500,000.

Obviously, the seller of Candy will almost always prefer to receive cash for stock in order to avoid incurring a tax on the gain on the inside basis of the assets of Candy.

Conversely, the buyer of Candy will almost always prefer to pay cash for the assets so that a higher carryover basis in the assets can be established. The higher basis means that there will be more depreciation and amortization deductions available to reduce taxable income in the future.

The Tax Amortization Benefit

In a transaction such as the acquisition of the stock of Candy, whether the buyer pays with cash or equity, the buyer merely carries forward the tax bases in the existing tangible assets and the existing intangible assets—and continues to depreciate and amortize them. To the buyer, this is considered a nontaxable transaction.

The ability to recognize for income tax purposes the fair market value of all of the assets acquired (instead of only those that had been recognized in the hands of the seller), is one important reason why buyers prefer to buy assets and may be willing to pay a higher price to acquire assets instead of stock.

The present value of the projected income tax savings related to the property depreciation deductions increases the income approach value indication of real estate and personal property.

Similarly, with intangible assets, including intangible assets that were not recognized on the balance sheet of the target corporation, the tax amortization benefit increases the income approach value indication of intangible assets. The tax amortization benefit represents the present value of the income tax deductions associated with the tax amortization of acquired intangible assets.[3]

Tax Protection Agreements

In certain circumstances, tax protection agreements can be negotiated between the buyer and the seller in a stock transaction in order to prevent any future transactions from occurring that might be deemed a sale of assets that have a low inside tax basis.

For example, tax protection agreements are commonly made between long-time owners of real estate in a transaction in which the real estate is acquired by a REIT. In this situation, the buyer (the REIT) agrees to pay with equity to acquire the seller's equity and to not trigger the built-in tax on either the outside basis or the inside basis of the seller's investment for some period of time. If the REIT does breach the agreement and triggers the seller's personal income tax liability, then the typical remedy is for the REIT to pay economic damages equal to the amount of seller's personal income taxes that are due on the gain that was protected by the agreement.

In a bankruptcy proceeding, there is generally an effort made to retain and protect the seller's income tax attributes. Those income tax attributes are generally relatively costless to the acquirer of property from a bankruptcy estate and so the parties to a bankruptcy transaction may be willing to enter into a tax protection agreement that benefits the seller.

Even if the tax protection agreement states that the benefit of the tax protection is not transferable, that statement doesn't mean that the benefit of deferring the income tax does not have a value.

For partnerships, a Section 754 election may be made by the partnership which reconciles a buyer's inside tax basis with the outside tax basis. However, the Section 754 election is not necessarily a right of the buyer of partnership units. In other words, it means that the buyer of an ownership interest in a partnership might not be able to eliminate the timing difference between the gain on (1) the sale of the units (the outside tax basis) and (2) the inside tax basis in the underlying assets of the partnership. Not being able to make the Section 754 election may reduce the value of a partnership unit.

Some acquired entities have suffered losses historically in taxable income. In a C corporation ownership structure, a net operating loss (NOL) can be applied in future years to offset taxable income. This is called an NOL carryforward, and it may be considered a deferred asset of the C corporation.

The use of an NOL is restricted and can easily be forfeited inadvertently. For example, NOLs usually expire when a change-in-control transaction is deemed to have taken place. In some circumstances, when share redemptions take place in complex capital structure situations, a valuable NOL can be forfeited if the transaction is not structured carefully to protect the use of the NOL carryforward.

A deferred tax liability (or asset) and income tax attributes (such as an NOL or tax credit carryforwards) that are eligible to be transferred should be included in the businesses value when the analyst assumes that the hypothetical buyer and seller would include them.[4] In many circumstances, those income tax attributes are valuable even though they cannot be transferred.

The fair market value of an entity depends on whether the hypothetical buyer and seller would

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base their analysis on a transaction structured as a taxable transaction versus a nontaxable transaction. For purposes of estimating the fair market value of the assets of the entity, the income tax bases of the entity's assets and liabilities should be consistent with the assumption about the taxability of the transaction structure upon which the hypothetical buyer and seller would base their analysis.

An S Corporation Value Advantage

Internal Revenue Code Section 338(h)(10) (the "338 election") provides a particular federal income tax advantage in transactions involving the sale of the S corporation equity. The 338 election allows the buyer that acquires the S corporation equity to treat the transaction as if it was a purchase of S corporation assets (but only if all of the seller shareholders agree). The 338 election allows the buyer to enjoy the more attractive depreciation deductions related to the step-up in the income tax basis of the purchased assets.

Under the 338 election, the seller of the S corporation's equity pays the personal income tax on the outside tax basis. However, the seller does not have to pay the tax on the gain over the inside tax basis of the assets of the S corporation.

Therefore, in certain situations, the purchase price for an S corporation can be greater than the purchase price for an otherwise identical C corporation.

Value to the Holder

For the purpose of many business valuation assignments, the value to the holder of the ownership interest is the appropriate standard of value to be adopted. The value to the holder, or to the current owner, may be relevant in certain assignments where economic damages have been suffered. The value from the perspective of the holder does not necessarily contemplate a sale transaction. The holder may have a different overall effective income tax rate than the hypothetical willing buyer and seller due to the holder's other sources of income, expenses, and deductions.

Investment value is a different standard of value than the value to the holder standard of value. One difference is that investment value takes into consideration a particular defined set of individual investment criteria or unique attributes—such as a favorable income tax attribute that a potential buyer or group of buyers may have.

Conclusion

Income taxes do matter in certain investment decision making. In a marital dissolution setting, analysts often consider different valuation methods that require the consideration of the impact of income taxes.

For many purposes, the income tax consequences associated with an ownership interest exert a meaningful impact on the value of the interest, and should be part of the business valuation analysis. The entity level income taxes and the personal income taxes due from the holder of the interest should be part of many valuation analyses.

An important reason to analyze income tax consequences of ownership interests is that income tax rates can change. When a new federal administration considers a new tax regime, typically it is because that new administration anticipates that the new tax regime will exert a positive effect on business decisions.

By carefully analyzing the income tax attributes upon which the value of businesses and business ownership interests depend, the analyst can offer a more complete client service.

Notes:

1. As explained elsewhere in *Insights*, this discussion is not intended to provide legal, accounting, or taxation advice. Appropriate professional advisers should be consulted. This discussion is intended to be general in nature and not intended to address the specific facts and circumstances of any particular client situation.
2. Publicly traded real estate investment trusts (REITs) are tax pass-through entities. An analyst valuing a privately owned REIT may be able to match its income tax characteristics with publicly traded REITs and apply a guideline publicly traded company business valuation method.
3. For a discussion of the tax amortization benefit and how to quantify it, see *Guide to Intangible Asset Valuation* by Robert F. Reilly and Robert P. Schweihs (New York: American Institute of Certified Public Accountants, 2014), 354.
4. Financial Accounting Standards Board Accounting Standards Codification 350-35-21.

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