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Pass-Through Entity vs. C Corporation

BUSINESS ADVISORS, BUSINESS VALUATION

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There has been much recent debate about whether the difference between the amount of taxes paid by a C corporation, as compared to those paid by a pass-through entity ("PTE", e.g., an S corporation, partnership or a limited liability company), would result in different values for each entity, with all else being equal. Since the value of a company is driven by the present value of its expected future cash flows, it stands to reason that if a C corporation pays more in taxes than does an S corporation, it is possible that the C corporation would be worth less.

To understand how this may apply to your company (C corporation or PTE), it is important to first understand the differences in how each entity type is taxed. (This is meant to be an illustrative example; for tax consequences specific to your organization, please consult your tax advisor).

A C corporation generally pays taxes on its earnings while its shareholders pay taxes on any dividends and are also subject to capital gains taxes when they sell their C corp shares.

PTE owners, on the other hand, generally only pay personal income taxes on earnings of the PTE regardless of distributions received.

The simple example below illustrates these differences at the federal tax level (state and local taxes are not considered here).

Assumptions:

Federal corporate tax rate – 21%

Federal dividend and capital gains tax rates – 20%

Individual (pass-through) tax rate – 35%

Earnings before taxes – $100

Earnings distributed to owners – 50%

	C Corporation	PTE
Earnings Before Taxes	$ 100.0	$ 100.0
Corporate Income Tax	21.0	-
Net Income Availbale to Shareholders	79.0	100.0
Earnings Retained in Company	39.5	50.0

Dividends	39.5	50.0
Dividend Tax/Personal Income Tax	7.9	35.0
Net Distribution Cash Flow to Shareholders	**$ 31.6**	**$ 15.0**

If the hypothetical entity were then sold immediately after the first year of activity, the C corporation would be subject to capital gains taxes on the earnings retained by the entity, while the PTE owners would not, as indicated below:

	C Corporation	PTE
Capital Gain	$39.5	$50.0
Less Capital Gains Tax/No Tax	7.9	-
Net Cash Flow	**$ 31.6**	**$ 50.0**

In this example, the owner of a PTE receives $65 while the owner of the C corporation receives only $63.2, indicating the value of the PTE is higher.

But it should be noted that this an overly simplified example and does not take into account specific factors like the time value of money, nor does it cover every potential difference between a C corporation and PTE.

Given the significant complexities of valuing C corporations and PTEs, it is important to consult with advisors to make sure all appropriate factors are considered. Schneider Downs has significant experience preparing business valuations for both PTEs and C corporations for a wide range of purposes. Please contact Steve Thimons (412-697-5281; sthimons@sdcpa.com) or Joel Rosenthal (412-697-5387; jrosenthal@sdcpa.com) if you need any business valuation services.

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