

## VALUATION

# Partnerships and S Corporations: Not All Flow-through Entities are Created Equal

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Valuation of flow-through entities presents issues unique to this form—for example, the issue of tax-affecting the entity earnings stream. A closer look at flow-through entities suggests that other significant valuation issues arise too, depending on the type of flow-through entity that is the subject of the valuation. This article will explore some of the differences between partnerships (including limited liability companies treated as partnerships) and S corporations, and highlight what valuation professionals should consider in determining the value of partnerships and the owner/member's interests in them. Those considerations include:

- The impact of self-employment taxes as well as income taxes
- The availability and applicability of a Section 754 election
- After-tax cash flow at the entity level vs. the interest level
- Special allocations of income and distributions

Partnerships are tax-driven and tax-affecting entities. Like S corporations, partnerships are flow-through entities, which mean no double taxation. There is no tax at the entity level; owners are taxed as individuals on the income generated (or benefit from the losses incurred). The owners may incur a tax liability even if no money or property is distributed. Partnerships provide flexibility in structuring the economics of their operations among and between owners. This flexibility may be apparent in the special allocation of income, deduction, gain, or loss, as well as the timing and/or amount of distributions between partner/members.

## IMPACT OF TAX TREATMENT

The differences between S corporations and partnerships for federal tax purposes create sig-

nificant variances in the determination of value of interests in them. Following is a summary of these differences; followed by consideration of their impact from a valuation perspective.

### Entity-level Differences

Under current law, S corporations are limited to 100 shareholders. Partnerships, on the other hand, have no limits on the number of partners/owners. More important is the limit on the type of shareholders an S corporation may have. Generally, shareholders of S corporations are limited to domestic individuals; non-qualified shareholders will cause the S corporation election to terminate, resulting in taxation as a C corporation (with potential for double taxation). There is no limitation on the type of owner of a partnership interest. A partnership may be owned by individuals, both foreign and domestic corporations, trusts, and other partnerships.

A significant difference lies in the allocation of income and distributions. S corporations are limited to one class of stock, common; although there can be differences in voting rights (e.g., S corporations may have voting and non-voting common stock); all shares must have the same rights to distributions or liquidation proceeds. Similarly, S corporation income and loss may only be allocated pro-rata based on the number of shares owned ("per share, per day" rule). In other words, allocations of income and distributions must be made "straight up" based on ownership.

Partnerships have much greater flexibility. There may be different classes of interest, which provide for differing rights to income and distributions. An overriding theme of the partnership allocation regulations, however, is that distributions follow the economic arrangement separate and distinct from the tax consequences. As such, partners are allowed to structure their arrangement more freely than S corporation sharehold-

ers. This may result in differences in timing and/or amounts of distributions to which each partner is entitled.

### Owner-level Differences

Both the S corporation shareholder and the partner are generally taxed on income as it is earned, rather than when distributed, and increase their tax basis in their interest for their share of the earnings. This creates a tax burden at the owner level and none at the entity level. The increase in basis also decreases the gain on disposition. Further, distributions of cash are generally tax-free to the extent of owners' basis in their interests. Deductibility of losses is limited to the owners' basis in their interests. For S corporation shareholders, their basis is determined based on the equity of their contributions. Partners, however, also get basis for their share of the entity's debt, both recourse and nonrecourse. This allows partners to deduct more losses and receive more distributions on a tax-free basis than S corporation shareholders.

S corporation shareholders may be employees of their entity, whereas partners are treated as self-employed. S corporation shareholders receive a W-2 reporting the amount of compensation paid to them; their distributive share of S corporation income is not subject to self-employment tax. Partners may structure their compensation as either guaranteed payments (ordinary income subject to self-employment tax) or a distributive share of partnership income and commensurate distribution (character of income is based income generated at the partnership level). In addition, a partner's distributive share of income may be subject to self-employment tax based on the character of income and the partner's role in management of the entity. For example, a limited partner's distributive share of income is generally not

subject to self-employment tax; only his or her guaranteed payments are considered self-employment income. A general partner, however, is subject to self-employment tax on his or her distributive share of ordinary income as well as the guaranteed payments received.

Section 754 elections, and their resultant adjustments to basis of entity assets, are peculiar to partnerships. A Section 754 election allows the entity to adjust the basis of partnership assets on a sale or exchange of a partnership interest, on the death of a partner, and on certain distributions of cash or property. S corporation rules have no counterpart. The effect of a Section 754 election is a potential increase or decrease in depreciation expense and gain or loss on sale of affected assets, as well as non-pro-rata allocations of the deduction, gain or loss.

**Example 1**

Adam is a 30 percent partner in ABC Partnership. The tax basis of his partnership interest is \$100,000. Adam sells his partnership interest to Don for \$500,000. If ABC has a valid Section 754 election in effect, ABC steps up the basis of its assets by \$400,000. This adjustment to basis belongs solely to Don. To the extent the adjustment is allocated to depreciable assets, Don will realize the benefit of greater depreciation expense as compared to his partners.

If Adam were a shareholder of an S corporation under the same facts, no adjustment would be made to the basis of corporate assets. In essence, Don steps into the shoes of Adam for all purposes. The same result would occur if ABC Partnership did not have a Section 754 election in effect. Don would realize the benefit of the difference between his purchase price and his relative share of the entity's tax basis in its assets only upon liquidation or disposition of his interest.

Section 704(c), or the "built in gain/loss" rules, also creates issues with respect to a selling partner who has contributed appreciated or depreciated property to the partnership. Consider the following example:

**Example 2**

Xavier contributes property with a tax basis of \$100,000 and a fair market value of \$400,000 to XYZ, LLC, for a 40 percent interest. Upon sale of that property, the first

**Example 4**

	Partner	S Corp Shareholder
Distribution of sale proceeds (\$500,000 * 40%)	\$200,000	\$200,000
Taxable income	\$340,000	\$160,000
Effective tax rate	35%	35%
Tax	\$119,000	\$56,000
After-tax cash flow	\$81,000	\$114,000

\$300,000 of tax gain, the pre-contribution gain, is generally specially allocated to Xavier, the contributing partner.

Unlike an S corporation, where all tax items are allocated pro-rata based on ownership of stock, partnerships are required to allocate pre-contribution tax gain and loss inherent in the property to the contributing partner. This has the effect of increasing the amount of taxable income allocated to the contributing partner.

**Example 3**

Same as Example 2 but the property is sold by XYZ, LLC, for \$500,000. XYZ has taxable gain of \$400,000. The gain is allocated \$340,000 to Xavier (\$300,000 pre-contribution gain plus 40 percent of the remaining \$100,000) and \$60,000 to Yasmine and Zeke (60 percent of the appreciation that occurred while they had an interest in the property).

The taxable income allocation rules may differ from the cash allocation rules, as dictated by the operating agreement. The net after-tax consequences can be different for an S corporation shareholder. Consider Example 4, in which the contributing partner is entitled to only 40 percent of each distribution.

Partnership rules provide that a purchasing partner generally steps into the shoes of the selling partner with respect to any pre-contribution gain. As such, the buyer of that partnership interest inherits the economics of the original contributing partner. The effects of this may be mitigated by making a Section 754 election.

**VALUATION ISSUES**

The entity- and owner-level differences present issues unique to the partnership entity that the valuation analyst needs to carefully consider.

**Tax-affecting Earnings**

The issue of whether to tax-affect the earnings of an S corporation has been well discussed; despite Tax Court and the IRS rulings, valuation analysts believe S corporation earnings must be tax-affected when using the income approach. Numerous models have been developed to address this issue (e.g., Grabowski, Treharne, Van Vleet, Mercer, and Fannon models). Each model addresses the issue in a similar manner:

- Value the entity as if a C corporation.
- Adjust for the differences in corporate and individual tax rates.
- Adjust for the avoided dividend tax.
- Adjust for the build up of basis.

All the reasons for tax-affecting S corporation earnings still apply when valuing partnerships using the income method:

- Taxes are levied on entity earnings, albeit at a different level (owner/member level vs. entity level)
- Discount rates derived from public markets are based on entities subject to double taxation
- Status as a flow-through entity avoids the tax on dividend distributions, not the tax on entity earnings.

The focus is on net, after-tax cash flow available to the investor/owner/member. Further, the approach incorporated into the various S corporation models is applicable to partnerships as the basic premises are the same: tax at the owner/member level, avoidance of the tax on distributions, and build up of basis for earnings taxed but not distributed. As such, partnership earnings should be tax-affected when using the income approach, and use of any of the various S corporation models would be appropriate.

Table 1: Summary of Differences Between S Corporations and Partnerships

	S corporation	Partnership
Maximum number of owners	100	Unlimited
Types of owners	Domestic individuals and certain trusts	No restriction on type of owner
Allocation of income & distributions	Based on ownership of stock only	Allows for special allocations of income and distributions among owners
Classes of ownership	Common stock only, voting and non-voting	May have multiple classes of interest with different rights
Self-employment tax	Allocable income is not subject to SE tax	Allocable income may be subject to SE tax
Adjustment to basis of assets	Not applicable	Elective on certain events
Inclusion of entity liabilities in owner basis	Not included in basis	Included in basis

Certain differences, however, need to be incorporated into the analysis. If the approach uses or incorporates personal tax rates or otherwise adjusts for the differences in corporate and individual tax rates, the valuation analyst needs to consider the potential self-employment tax at the partner/member level. As previously mentioned, partners who are individuals are not employees of their partnerships, but are treated as self-employed individuals. S corporation employee/shareholders are presumed to receive reasonable compensation which is subject to all applicable payroll taxes, including Medicare and Social Security. The employer incurs one-half of these taxes while the other half is borne by the employee through withholding. Accordingly, the partner bears certain costs at the owner level that S corporations bear at the entity level. This may increase the applicable owner/member tax rate by another 15.3 percent, the maximum tax rate on self-employment tax. The effect depends on the nature of the interest being valued (general partner or managing member vs. limited partner or investor member) and the nature of the earnings attributable to the interest (distributive share of earnings vs. guaranteed payments for services). In addition, the treatment of these payroll tax costs should be consistent with the flow-through model used by the valuation analyst.

While both S corporations and partnerships are flow-through entities, S corporations may still be subject to income taxes at the entity level. S corporations that were previously C corporations are subject to tax at the entity level on the amount of realized gain in existence at the time of the conversion to S corporation status. The entity pays a tax at the highest corporate tax rate in effect on any gain realized during the 10-year term from conversion to S corporation status. If the subject entity was formerly a C corporation and the valuation date falls within the 10-year timeframe, the amount of tax to be incurred at the entity level

in an assumed sale of assets (e.g. asset approach) should be considered. In contrast, partnerships are never subject to entity-level income taxes.

**Restrictions on Owners**

With respect to S corporations, there is little, if any, value of the S corporation election to a C corporation purchaser, as well as any other “restricted” purchaser (e.g. foreign individual, partnership, tax-exempt trust). The benefit of a single level of tax disappears once the S corporation election is broken. This is not an issue with partnerships, as there are no tax restrictions on the ownership of partnerships; and status as a flow-through entity is not elective, it is inherent in its legal form. This has an impact on any premium the valuation analyst may ascribe to the flow-through status of the entity. A hypothetical purchaser may be a “restricted” purchaser and, as such, terminate the S corporation election. This often results in ascribing little or no benefit to the status as a flow-through entity. The benefit is always present, however, with respect to a partnership, regardless of owner, and should result in the valuation analyst ascribing a higher premium or value in a single tax model.

The restrictions on owners may also affect the discount for lack of marketability. The factors a valuation analyst should consider in determining an appropriate discount, as reflected in *Mandelbaum v. Commissioner*, T.C. Memo 1195-255 (June 12, 1995), include restrictions on transferability of stock. It is common for an S corporation’s articles of incorporation to include restrictions on the types of transferees, among other restrictions, to preserve its flow-through status. This type of restriction would not apply to a partnership. Accordingly, all other things being equal, an interest in an S corporation subject to restrictions on the type of transferee would be subject to a greater discount for lack of marketability than an interest in a partnership where no such restriction applies.

**Allocation of Income and Preferred Distributions**

There are no special allocations of income or distributions/cash flow at an S corporation. All S corporation shareholders are common shareholders with identical rights to income and distributions. Partners, on the other hand, may hold significantly different rights in the same partnership. This flexibility in allocations and distributions is the primary reason why the partnership form is more favorable than S corporation form. Couple this flexibility with the liability limitations of state law limited liability companies, and you can see why LLCs (partnerships for federal income tax purposes) are the “vehicle of choice.” So it may not be appropriate to ascribe a pro-rata portion of enterprise or equity value of a partnership to a particular partnership interest, as is done with S corporations and C corporations with only one class of stock. Partnership interests subject to these special allocations may be more appropriately treated like preferred stock interests. Many of the characteristics of preferred stock are present in partnership interests with preferred distributions and special allocations:

- Distribution rate
- Liquidation preference
- Cumulative vs. non-cumulative distributions
- Participating vs. non-participating rights in any future earnings

The valuation analyst needs a thorough understanding of the partnership allocation provisions of the operating agreement to properly determine whether to ascribe entity-level value to a particular interest or, rather, focus on interest-level cash flow; in the context of partnership interests, it may involve both.

**Deficit Restoration Obligations**

For partnership allocations to be respected, they must have substantial economic effect. One of

the requirements of economic effect is that partners must agree to a deficit restoration obligation (DRO). A DRO provides that partners will contribute cash or property to the partnership upon liquidation equal to their negative capital account. This allows the partner to receive allocations of losses greater than equity contributions. In lieu of a DRO, the partner must agree to a qualified income offset provision (QIO). This essentially limits the partner's share of allocable losses to his equity contribution. Like pre-contribution gain, a purchaser of a partnership interest inherits the selling partner's book capital account and DRO. This should be considered when determining the discount for lack of marketability—interests subject to a DRO are inherently riskier (and less marketable) than interests subject to a QIO or S corporation interests, as these interests generally carry no obligation to make additional capital contributions.

#### Unrealized Capital Gains

Gains and losses from the disposition of contributed assets are generally first allocated to the contributing partner to the extent of pre-contribution gain or loss (see Example 4). While affecting the amount of taxable income and, more importantly, the actual amount of tax paid, it does not otherwise affect the amount of cash flow the partner receives from the sale. Accordingly, gross cash flow may be identical as between a partner and an S corporation shareholder, but after-tax cash flow may be significantly different. The valuation analyst needs to identify all contributed assets with pre-contribution gain or loss and consider the allocation of those gains and losses when applying the asset approach, as each partner's share of after-tax cash flow may be significantly different even if holding an identical percentage interest in the entity. This difference may be reflected as a special allocation of the entity's after-tax cash flow or by ascribing a discount (contributing partner) or premium (non-contributing partner) to account for the additional tax to be paid by the contributing partners. As S corporations do not have a like counterpart, all gains and losses, as well as cash, are allocated pro-rata.

It is well settled that a discount for unrealized capital gains is appropriate in the context of a C corporation; the quantification of that discount is a matter of debate. The discount is applicable because of the double taxation—tax at the corporate level on the gain and again at the shareholder level when the proceeds are distributed. The question then arises, "Should a discount for unrealized capital gains be applied towards S corporation and partnership interests?" The courts have addressed the issue with respect to partnership interests in at least three cases:

- *Estate of Jones v. Commissioner*, 116 T.C. No. 121 (March 6, 2001)
- *Estate of Dailey v. Commissioner*, 82 T.C.M. 710 (October 3, 2001)
- *Estate of Temple*, 2006-1 USTC 60,523 (March 10, 2006)

In those cases, the primary issue was whether the discount is applicable when a Section 754 election may be made. The primary factor identified by the courts appears to be whether it is reasonable to believe that the purchaser and the partnership (i.e., the general partner or managing member) will negotiate for the election. In many instances, the existing partnership agreement specifically provides that a Section 754 election will not be made. In that situation, it may not be reasonable to believe that the election will be negotiated.

The other issue is whether the election carries any adverse tax consequences to existing partners or is otherwise burdensome to the partnership. An important reason for not making the election in the past was the possibility of a step-down in the basis of the assets, where the value of partnership assets decline below their tax basis. This reasoning was eliminated, for the most part, when the American Jobs Creation Act of 2004 made step-downs mandatory, even if a Section 754 election is not in effect when the amount of the step-down is greater than \$250,000. Partnerships still carry the burden, however, of calculating the amount of the adjustment, the allocation of the adjustment amongst the assets, and the calculation and allocation of any depreciation or gain/loss adjustment caused as a result of the adjustment.

While partnerships have Section 754 elections available to eliminate or mitigate the tax cost with respect to built-in gains, S corporations and their shareholders have no like provision. To the extent an S corporation has unrealized capital gains, those gains will be allocated pro-rata among the shareholders and subject to tax at their level. Assuming the court's primary reasoning for disallowing the discount for partnership built-in gain is the availability of a Section 754 election, it would stand to reason that the discount would be applicable to S corporations, as they may not avail themselves of a Section 754 election or similar provision. There is no definitive case law; valuation analysts need to consider all facts and circumstances before determining whether a discount is appropriate.

#### GREATER FLEXIBILITY FOR PARTNERSHIPS

Both partnerships and S corporations are pass-through entities, yet the greater flexibility

provided partnerships over S corporations dictate that these entities are not created equal in determining the value of interests in them. The ability to specially allocate income, as well as the statutory and regulatory allocation rules, all have an impact on determining a partnership interest's share of after-tax cash flow. Like S corporations, partnership earnings should be tax-affected; the individual tax rate that is considered with respect to partnership income, however, should include the potential for self-employment tax.

Finally, the non-availability of a Section 754 election to S corporations suggests that a discount for unrealized capital gains is applicable to S corporations but may not be to partnerships.

Partnership tax law continues to evolve. As practitioners become more creative, lawmakers and Treasury close the loopholes. This will continue to have an impact on valuation professionals, as they need to understand the economics of partnerships in order to determine the value of interests therein.

Shannon Pratt's summary with respect to the valuation of closely held preferred stock in *Valuing a Business* (Fifth Edition, McGraw Hill, 2008, pg. 583) is just as applicable to partnership interests:

The combination of rights and privileges found in closely preferred stock are limited only by the imaginations of the issuer, the financial adviser, and the legal counsel. It is the flexibility of the myriad characteristics of closely held preferred stock that makes the estimation of value so difficult. **VE**



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