Business Valuation Acquisition Premiums and Tax-Affecting Earnings of Pass-through Entities

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ABSTRACT

This study examines whether there is an acquisition premium paid for closely-held pass-through entities when compared to closely-held C corporations by examining over 10,000 transactions from the Pratt’s Stats private transaction database from 2001-2010. We add to the literature by expanding the DiGabriele (2008) study to include LLC/Partnerships and by examining the transaction date (before and after the recession of 2008-2011). We ran moderated multiple regressions using the transaction price as the dependent variable with results indicating that there is no significant price premium for S corporations over C corporations or for LLC/Partnerships over C corporations. The results did indicate that there is a statistically significant price premium for C corporations over LLC/Partnerships. We also separated the S corporation and C corporation dataset pre-recession and post-recession conducting moderated multiple regressions for each time period resulting in no significant transaction price premium for closely-held S corporations over closely-held C corporations for either time period. We also analyzed the average sales prices by for S and C corporations for these two time periods which provided additional evidence that there was no significant valuation premium for S corporations over C corporations in the 2008-2010 time periods.
INTRODUCTION

There has been controversy in the Tax Court regarding whether to tax-affect the earnings of pass-through entities since Gross v. Commissioner (1999). The courts have generally applied a zero percent tax rate to pass-through entity earnings resulting in a large valuation premium. This study examines whether there is an acquisition premium paid for closely held pass-through entities when compared to closely-held C corporations. We add to the literature by examining over 10,000 transactions from the Pratt’s Stats private transaction database from 2001-2010, expanding the DiGabriele (2008) study to include LLC/Partnerships, and by transaction date (before and after the recession of 2008-2011).

We ran moderated multiple regressions using the transaction price as the dependent variable. Contrary to DiGabriele’s findings, our results indicate that there is no significant price premium for S corporations over C corporations. We also ran regression analysis comparing transaction prices for C corporations and LLC/Partnerships. The results indicated that there is a statistically significant price premium for C corporations over LLC/Partnerships. Contrary to recent Tax Court cases, this study provides empirical evidence that pass-through entities should be tax-a effected to place them on an equivalent basis with closely-held C corporations.

CONCEPTUAL FRAMEWORK

The comparative tax structures of business entities are important in understanding valuation differences between S corporations, partnerships, and C corporations. Both S corporations and partnerships are pass-through entities that generally do not pay tax at the entity
level. Instead, tax is paid at the owner level on the individual tax returns of the pass-through entity owners. The tax attributes of the three entity types are summarized in Table 1.

**TABLE 1**

<table>
<thead>
<tr>
<th></th>
<th>Partnership/LLC</th>
<th>S Corporation</th>
<th>C Corporation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Maximum Entity Tax Rate</strong></td>
<td>0%</td>
<td>0%</td>
<td>35%</td>
</tr>
<tr>
<td><strong>Maximum Owner Level Tax Rate</strong></td>
<td>35%</td>
<td>35%</td>
<td>15% Dividends</td>
</tr>
<tr>
<td><strong>Increase in Owner Basis from Undistributed Earnings</strong></td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
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</tbody>
</table>

Business valuation professionals using income based methods will often tax-affect the income (or cash flows) of pass-through entities to place the pass-through entity on an equivalent basis with a comparable C corporation. Since the 1999 Tax Court case *Gross v. Commissioner* (Gross)\(^1\) the Tax Court has consistently rejected the concept of tax affecting the earnings of S corporations. Applying a zero percent tax rate in valuing pass-through entities under income based valuation methods results in S corporation being valued much higher than comparable C corporations. *Gross v. Commissioner* has led to multiple court cases citing *Gross* as precedent. If there is a price premium for pass-through entities over comparable C corporations, we believe it should be much lower if it exists at all. The tax structure of pass-through entities allows the entity and owners the key advantage of avoiding the tax on dividends. Although this would indicate that there may be a price premium for pass-through entities due to their single level tax structure, this premium may be minimal because many closely held C corporations will bonus out remaining C corporation income to the shareholders unless they run up against the issue of unreasonable compensation.

Partly in response to the Tax Court cases, various noncontrolling interest models for S corporations have been developed and have gained recognition in the valuation community.

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\(^1\) Gross v. Commissioner, TCM, 1999-254 (July 29, 1999).
including Grabowski (2004), Mercer (2004), Treharne (2004), and Van Vleet (2004). Numerous empirical studies of controlling interests have been conducted with mixed results when comparing the valuation of pass-through entities to C corporations. We add to the existing literature by providing an empirical study for controlling interests examining private transactions of both S corporations and LLC/Partnerships as compared to C corporations and by examining the data on a pre-recession and post-recession basis, concluding that there is no significant price premium for pass-through entities over comparable C corporations.

LITERATURE REVIEW

Court Cases

Since the 1999 Tax Court case Gross v. Commissioner (Gross)\(^2\) the Tax Court has consistently rejected the concept of tax affecting the earnings of S corporations. Prior to the Gross decision in 1999, it was common practice among valuation practitioners to tax-affect the benefit stream of S corporations to put the S corporation on a comparable basis with C corporations. In Gross v. Commissioner\(^3\) the valuation expert for the taxpayer tax-affect ed the S corporation benefit stream using a 40% assumed tax. The court agreed with the IRS and did not tax-affect earnings stating that the taxpayer’s expert “introduced a fictitious tax burden”.

In Wall v. Commissioner\(^4\) both the valuation expert for the taxpayer and the valuation expert for the IRS tax-affect ed the earnings of the S corporation. The court threw out both experts calculations under the income approach because it believed the valuations were understated from tax-affecting the cash flows of the company and then applying after-tax market rates of return to determine the present value of the cash flows. The court apparently believed

\(^4\) Wall v. Commissioner, TCM, 2001-75 (March 27, 2001).
that tax-affecting the earnings and then using discount rates based on C corporation rates of return on investments would place the S corporation on an equivalent basis with a C corporation but give no value to S corporation status. In Adams v. Commissioner\(^5\), the valuation analyst for the taxpayer correctly matched a pre-tax discount rate with pre-tax earnings. The court disagreed and stated that an after-tax discount rate should have been used under the assumption that the S corporation’s entity level tax rate was 0%. Tax-affecting S corporation earnings was also rejected in Dallas v. Commissioner\(^6\). In the 2011 case of Gallagher v. Commissioner\(^7\), citing Dallas, the court applied a tax rate of 0% in determining the fair market value of the subject company S corporation.

In Delaware Open MRI Radiology\(^8\), the court determined that the interest of a dissenting shareholder should be tax-aFFECTed. The court stated that ignoring personal taxes would “overestimate the value of an S corporation and would lead to a value that no rational investor would be willing to pay to acquire control.” The court developed a model that recognizes that tax is paid at the owner level, thus tax-affecting the earnings. The court’s model is similar to the Van Vleet model which is discussed in a separate section of this paper. In Bernier v. Bernier\(^9\), the Massachusetts Supreme Court believed that the trial court misapplied the Gross case and remanded the Bernier case back to determine a value for the S corporation using the methodology applied in the Delaware Open MRI Radiology case.

**Noncontrolling Interest Models**

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\(^6\) Dallas v. Commissioner, TCM, 2006-212 (September 28, 2006).
\(^7\) Gallagher v. Commissioner, TCM, 2011-148 (June 28, 2011).
Four models for the valuation of noncontrolling interests in S corporations have been developed by Daniel Van Vleet, Chris D. Treharne, Z. Christopher Mercer, and Roger J. Grabowski and have gained recognition in the valuation community.

Mercer (2004) concludes that there is no difference in value between “otherwise identical” C corporations and S corporations because operating cash flows are identical. Mercer also concludes that S corporations may be worth either more or less than C corporations because of differences based on the risk of whether or not the cash flows will be received by the shareholders. Mercer uses a discounted cash flows approach to determine value at the enterprise level and then applies the Quantitative Marketability Discount Model (QMDM) to calculate the minority interest discount and thus the value at the shareholder level. His valuation model does not deal with tax differences or basis differences.

The Treharne Model\(^\text{10}\) recognizes that capitalization and discount rates under the build-up approach are based on rates of return for publicly traded C corporations which reflect the two-level tax structure of C corporations. Thus, there is an inherent mismatch using a capitalization or discount rate for publicly traded companies with the earnings stream of pass-through entities that only pay tax at the owner level (Laro and Pratt, 2005, pp. 106-115). The Treharne model separates cash flow into cash flow retained by the company and cash flow distributed to the investor. This model first calculates the present value of the tax-affected retained cash flow of the entity. In calculating the present value of the tax benefits, the discount rate may be adjusted upward to reflect the greater risk of whether a minority shareholder will receive S corporation distributions because distributions are made at the discretion of the controlling shareholder. An

entity with a consistent record of shareholder distributions may result in a minimal or zero increase in the discount rate. The model then adjusts for the present value of avoiding the dividend tax on excess distributions (excess of distributions necessary to cover personal income taxes), adjusts for differences in the C corporation tax rate and the tax rate on S corporation shareholders, then applies a marketability discount if necessary.

The Grabowski Model (2004) maintains pass-through entities may have a higher value than “otherwise identical” C corporations. The Grabowski Model starts with the value of 100% of an equivalent C corporation assuming 100% of the free cash flow is distributed to the shareholders. He then makes the adjustments for the single level of taxation, the increase in basis from retained S corporation earnings, and that owners of the pass-through entity may realize more proceeds upon sale if the buyer gets asset acquisition treatment and receives a step-up in basis. If the sale of the S corporation is of a controlling interest, then the valuation analyst should examine the pool of potential buyers and whether they will likely continue the S corporation status. If the sale is of a minority interest, then this model assumes that the S corporation status will continue.

The Van Vleet model (2004) calculates an S corporation multiple referred to as the SEAM approach (S corporation Economic Adjustment Model). This approach is essentially the same as the method applied by the Delaware Chancery Court in the Delaware Open MRI Radiology case. The Van Vleet Model applies an S corporation premium multiple, the S corporation Economic Adjustment Model (SEAM), to the equivalent C corporation valuation for the additional economic benefits enjoyed by the owners due to the tax advantaged status. The same logic applies to valuing partnerships when using the income approach in business valuation.
Empirical Studies – Controlling Interests

The Jalbert study (2002) examined the market value/net operating income multiple for double-tax entities (DTFs) compared to pass-through entities (PTFs) considering the effects of both entity level and personal level taxes. Jalbert sampled 94 PTFs, which were master limited partnerships (MLPs), and matched them against C corporations. Many of the MLPs were from the oil and gas industry. T-tests revealed significant differences at the .05 level indicating that the market value/net operating income is higher for PTFs than DTFs. This difference in value was found to be mitigated among firms that have higher levels of debt.

In the Finnerty study (2002), the researcher concluded that pass-through entities have the same value in a tax-free acquisition as an otherwise identical C corporation. Finnerty also concluded that pass-through entities are more valuable than C corporations in a taxable acquisition because of the step-up tax elections. Finnerty stated that tax factors make a minority interest in a pass-through entity to be more valuable than a minority interest in a C corporation and that the S corporation premium is related to the single level tax structure and the firm’s dividend policy.

Similarly to Jalbert, the Denis and Sarin study (2002) examined MLPs heavily concentrated in the oil and gas industry. The researchers observed a valuation premium in favor of the MLPs ranging from 12% to 24%. Denis and Sarin concluded that the net tax advantage of the S corporation varies directly with the company’s marginal corporate tax rate, the payout ratio and the capital gains tax rate of the particular investor. The benefit varied inversely with the investor’s personal tax rate.

Mattson, Shannon and Upton (2002), reviewed 1,200 S and C corporations from the Pratt’s Stats database. The researchers made no distinction between asset sales and stock sales.
The researchers used the price to revenue multiple as the dependent variable. Mattson, Shannon, found that there was no significant difference between the multiples of revenue paid in transactions involving C-corporations and the multiples in transactions involving S-corporations.

Phillips (2004) examined 1,464 S corporation and C corporation transactions from the Pratt’s Stats database excluding partnerships, LLCs and LLPs. The researcher ran a multiple regression with deal price as the dependent variable and the independent variables sales, EBITDA, total assets, S corporation or C corporation status of the seller, and whether the transaction was an asset or a stock transaction. Phillips concluded that there was no valuation difference between S corporations and C corporations for asset transactions or stock transactions.

The Erikson and Wang study (2003) compared 77 matched pairs of C and S corporation taxable stock acquisitions examining six purchase price multiples. The researchers found that S corporations had higher multiples than C corporations averaging 12 to 17 percent of deal price.

The transactions in the Erikson and Wang study were very large transactions of privately held entities acquired by publicly traded C corporations. All of the target S corporations included the IRC Section 338(h)(10) election to treat a stock acquisition as an asset acquisition. Alerding, Karam, and Chamberlain (2003) criticized the Erikson and Wang study claiming that there is no incentive for a buyer to pay a premium price for the S corporation stock. Erikson and Wang (2007) responded to the criticisms stating that the buyer is willing to pay a premium to acquire the step-up in basis the Sec. 338(h)(10) election. We believe that because all transactions involved C corporation buyers, the C corporation buyer may be willing to pay a premium for the step-up in basis, but the premium in price for the S corporation will no longer be related to the single level tax structure of the S corporation because S corporation status will be terminated.
DiGabriele (2008) sampled 4,239 S corporation and C corporation transactions from the Pratt’s Stats database. He employed a moderated multiple regression analysis with purchase price as the dependent variable. The independent variables were net sales, buyer type, company type, and transaction type (asset sale or stock sale). DiGabriele also introduced two-way interaction terms into the model based on the possibility that the change in the dependent variable (purchase price), as one of the independent variables changes, depends on the value of another independent variable (Jaccard and Turrisi, 2003). DiGabriele concluded that the moderated multiple regression analysis shows that, all else being held equal, there is a price premium for S corporations over C corporations. He states that the premium depends positively on net sales, is higher for asset sales over stock sales, and is higher when the firm is acquired by a private buyer rather than a public buyer. DiGabriele caveats that calculating an S corporation premium should be based on the facts and circumstances in each case.

**METHODOLOGY, ANALYSIS, AND RESULTS**

In this study, we first replicated DiGabriele’s (2008) study (Analysis 1) with a larger dataset. We then extended his study by examining a potential acquisition premium of LLC/Partnership over C corporations (Analysis 2). We used data from Pratt’s Stats private transaction database over a ten year period (January 2001 – December 2010). After the two main analyses, we conducted an additional analysis to examine whether there is a difference in acquisition premiums before and after the start of the recession in the end of 2007.

In the regression analyses, we employed the log of transaction price as the dependent variable and the log of net sales, company type (LLC/Partnerships, C corporations, and S corporations), buyer type (public and private), and transaction type (asset and stock sale) as
independent variables. Because of the positively skewed data for sales price and net sales, we first conducted logarithmic transformations and then removed outliers that were 2.5 standard deviations from the mean (DiGabriele 2008).

Analysis 1 S Corporations

Descriptive Analysis

The first analysis is a replication of the DiGabriele (2008) study that examined whether there is an acquisition premium for S corporations over C corporations. However, DiGabriele (2008) used data from January 2000 to November 2006. This study extended this data by applying a larger dataset from more recent years (January 2001 through 2010). We utilized a two-step analysis that was used in previous studies to examine whether a moderating effect is present (Aguinis 2004, Aiken and West 1991, DiGabriele 2008, Jaccard and Turrisi 2003). We first employed a linear regression analysis that only included the main independent variables (no interactions). As in DiGabriele (2008), we coded the independent variables as follows: lnNetSales (mean centered), BuyerType (0 – private; 1 - public), CompanyType (0 – C-corporations; 1 - S-corporations), and TransactionType (0 – asset-based; 1 – stock-based). The initial dataset contained 8,308 transactions. One transaction was removed because it did not include information about the CompanyType and 267 transactions were removed because they were outliers (2.5 SD from the mean) in regards to lnNetSales and/or lnSalesPrice, resulting in a final dataset of 8,040 items. The dataset consisted of 6,174 private buyers versus 1,866 public buyers; 3,014 C corporations versus 5,026 S corporations; and 6,271 asset-based sales versus 1,769 stock-based sales. The means and standard deviations of all variables are presented in Table 2.
Regression Analysis

First, we conducted a simple multiple regression analysis using lnSalesPrice as the dependent variable and lnNetSales (mean centered), BuyerType, CompanyType, and TransactionType as the dependent variables. The regression model was statistically significant (F = 7.655; p < 0.01):

\[ Y (\text{lnSalesPrice}) = 13.088 + 0.724 (\text{lnNetSales}) + 1.556 (\text{BuyerType}) - 0.174 (\text{CompanyType}) + 0.561 (\text{TransactionType}) \]

The results reveal that there is no valuation premium of S corporations over C corporations. On the contrary, C corporations are significantly higher valued than S corporations (negative coefficient for CompanyType that is significant at p < 0.05 level), a finding that is consistent with prior research (DiGabriele 2008). However, in the second step, we included several moderating variables (interaction variables) that may influence the acquisition premium
(see DiGabriele 2008 for a more detailed discussion). This moderated multiple regression analysis examines whether the valuation premium exists for certain types of transactions (e.g., stock versus asset-based transactions). DiGabriele (2008) found that the premium for S corporations over C corporations was higher when the buyer was private (versus public), when it was an asset sale (versus stock sale), and when the selling company had high net sales. Therefore, consistent with prior research, we added the interaction variables CompanyType x BuyerType, CompanyType x TransactionType, CompanyType x lnNetSales, and BuyerType x lnNetSales to the regression model.

The $r^2$ increased from 0.819 in the simple multiple regression (step 1) to 0.830 in the moderated multiple regression (step 2). Therefore, the independent variables in the moderated multiple regression explained 83% of the change in the dependent variable (lnSalesPrice). The results for the second step regression ($F = 4,899; p < 0.01$) were as follows:

$$ Y (\text{lnSalesPrice}) = 13.036 + 1.013 (\text{lnNetSales}) + 2.109 (\text{BuyerType}) + 0.033 (\text{CompanyType}) + 0.560 (\text{TransactionType}) - 0.575 (\text{CompanyType x BuyerType}) - 0.202 (\text{CompanyType x TransactionType}) + 0.074 (\text{CompanyType x lnNetSales}) - 0.280 (\text{BuyerType x lnNetSales}) $$

Inconsistent with prior research, we did not find a premium of S corporations over C corporations (CompanyType coefficient slightly positive, but not statistically significant at $p < 0.05$). We conducted additional analyses to examine why we did not find an acquisition premium for S corporations.
In conducting additional analysis, we separated the dataset based on transaction date as “prior to the start of the recession” (January 2001 – December 2007) versus “after the start of the recession” (January 2008 – December 2010). DiGabriele’s (2008) study was conducted before the recession started and we examined whether C and S corporations were affected differently by the recession. We used December 2007 as the cut-off date because the National Bureau of Economic Research (2010) states that the most recent recession started at that time. We first conducted individual moderated multiple regressions for each time period (Table 4). The results showed that CompanyType was slightly positive (suggesting a premium for S corporations) for the 2001-2007 time period, but not statistically significant ($p=0.175$). For the 2008-2010 time period, the coefficient for CompanyType slightly decreased and the statistical significance became even more statistically insignificant ($p=0.354$).
Then, we analyzed the average sales prices for these two time periods. While the C corporations in this dataset only decreased 13.2% in value on average ($22,187,502 to $19,263,666) as a result of the recession, S corporations decreased 51.6% in sales value ($4,372,399 to $2,116,209). This difference in sales value decrease between S and C corporations provides a valid explanation why there was no significant valuation premium of S corporations over C corporations in recent years.

Analysis 2 LLC/Partnerships

Descriptive Analysis

The second analysis extends DiGabriele’s (2008) study by including LLCs and partnerships in the analysis. This analysis examines whether there is an acquisition premium for LLC/Partnerships over C corporations. Based on the findings of prior research, one would expect that a premium for LLC/Partnerships would exist because LLC/Partnerships are taxed in a similar manner as S corporations. We followed the same procedures as in analysis 1. The initial dataset contained 4,499 transactions. 45 transactions were removed because they did not identify

<table>
<thead>
<tr>
<th>Regression 2001 - 200711</th>
<th>Regression 2008 - 201012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Y (lnSalesPrice) = 13.197 + 0.806 (lnNetSales) + 2.206 (BuyerType) + 0.048 (CompanyType) + 0.545 (TransactionType) – 0.567 (CompanyType x BuyerType) – 0.212 (CompanyType x TransactionType) + 0.082 (CompanyType x lnNetSales) – 0.280 (BuyerType x lnNetSales)</td>
<td>Y (lnSalesPrice) = 12.631 + 0.800 (lnNetSales) + 2.432 (BuyerType) + 0.043 (CompanyType) + 0.597 (TransactionType) – 0.720 (CompanyType x BuyerType) – 0.170 (CompanyType x TransactionType) + 0.065 (CompanyType x lnNetSales) – 0.279 (BuyerType x lnNetSales)</td>
</tr>
</tbody>
</table>

11 All coefficients are statistically significant (p<0.05) except CompanyType (p=0.175)
12 All coefficients are statistically significant (p<0.05) except CompanyType (p=0.354) and CompanyType x Transaction Type (p=0.224).
CompanyType and 66 were eliminated because they were outliers in regards to lnNetSales and lnSalesPrice, resulting in a final dataset of 4,388 transactions. This dataset included 2,558 private buyers versus 1,830 public buyers; 3,189 C corporations versus 1,199 LLC/Partnerships; and 2,804 asset-based versus 1,584 stock-based sales. The mean and standard deviations are presented in Table 5.

**TABLE 5**

<table>
<thead>
<tr>
<th>Descriptive Statistics</th>
<th>Mean</th>
<th>Std. Deviation</th>
<th>N</th>
</tr>
</thead>
<tbody>
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<td>lnSalesPrice</td>
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<td>2.61074</td>
<td>4388</td>
</tr>
<tr>
<td>lnNetSales</td>
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<td>2.19012</td>
<td>4388</td>
</tr>
<tr>
<td>BuyerType</td>
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<td>CompanyType</td>
<td>.27</td>
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<tr>
<td>TransactionType</td>
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<td>.480</td>
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<tr>
<td>CompanyType x BuyerType</td>
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<td>4388</td>
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<tr>
<td>CompanyType x</td>
<td>.0490</td>
<td>.21589</td>
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<tr>
<td>TransactionType</td>
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<td>4388</td>
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<tr>
<td>CompanyType x lnNetSales</td>
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<td>1.13737</td>
<td>4388</td>
</tr>
<tr>
<td>BuyerType x lnNetSales</td>
<td>.7229</td>
<td>1.55007</td>
<td>4388</td>
</tr>
</tbody>
</table>

**Regression Analysis**

We employed the same two step regression analysis that we used to compare S and C corporations. The coefficients\(^{13}\) for the simple multiple regression were as follows:

\[
Y (\text{lnSalesPrice}) = 12.716 + 0.003 (\text{lnNetSales}) + 3.670 (\text{BuyerType}) - 0.383 (\text{CompanyType}) + 0.868 (\text{TransactionType})
\]

The regression model was statistically significant (F=2.159; p<0.05) and the \(r^2\) was 0.663.

The negative coefficient of CompanyType (-0.383) suggests that there is a premium of C

\(^{13}\) All coefficients are statistically significant (p<0.05) except lnNetSales (p=0.812)
corporations over LLC/Partnerships. However, as in the first analysis, we added several interactions (CompanyType*BuyerType, CompanyType*TransactionType, CompanyType*lnNetSales, and BuyerType*lnNetSales) to further examine whether an acquisition premium exists. The coefficients of the moderated multiple regression were as follows:

\[
Y \text{ (lnSalesPrice)} = 12.774 + 0.009 \text{ (lnNetSales)} + 3.605 \text{ (BuyerType)} - 0.494 \text{ (CompanyType)} + 0.869 \text{ (TransactionType)} + 0.280 \text{ (CompanyType x BuyerType)} + 0.135 \text{ (CompanyType x TransactionType)} + 0.044 \text{ (CompanyType x lnNetSales)} - 0.024 \text{ (BuyerType x lnNetSales)}
\]

<table>
<thead>
<tr>
<th>Model</th>
<th>B</th>
<th>Std. Error</th>
<th>Sig.</th>
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</thead>
<tbody>
<tr>
<td>1 (Constant)</td>
<td>12.774</td>
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<td>.000</td>
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<tr>
<td>lnNetSales</td>
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<td>.024</td>
<td>.720</td>
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<tr>
<td>BuyerType</td>
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<td>.000</td>
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<tr>
<td>CompanyType</td>
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<td>.064</td>
<td>.000</td>
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<tr>
<td>TransactionType</td>
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<tr>
<td>CompanyType x BuyerType</td>
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<tr>
<td>CompanyType x lnNetSales</td>
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<td>.416</td>
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<tr>
<td>TransactionType x lnNetSales</td>
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<td>.084</td>
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<tr>
<td>BuyerType x lnNetSales</td>
<td>-.024</td>
<td>.030</td>
<td>.429</td>
</tr>
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</table>

a. Dependent Variable: lnSalesPrice

The regression model is statistically significant (F=1.084; p<0.05) and has an \( r^2 \) of 0.664. Contrary to the expectations, the results show that there is a premium for C corporations over LLC/Partnership (coefficient of CompanyType is negative and statistically significant at p<0.05 level).
Conclusions and Recommendations for Further Research

This study examines whether there is an acquisition premium paid for closely held pass-through entities when compared to closely-held C corporations. Examining over 10,000 transactions from the Pratt’s Stats private transaction database from 2001-2010 we add to the literature by expanding the DiGabriele (2008) study to include LLC/Partnerships, and by examining the transaction date (before and after the recession of 2008-2011).

We ran moderated multiple regressions using the transaction price as the dependent variable. Contrary to DiGabriele’s findings, our results indicate that there is no significant price premium for S corporations over C corporations. We then separated the S corporation and C corporation dataset pre-recession and post-recession conducting moderated multiple regressions for each time period. Again, the results indicated that there is no significant transaction price premium for S corporations over closely-held C corporations. We also analyzed the average sales prices by entity type for these two time periods. While the C corporations in this dataset only decreased 13.2% in value on average as a result of the recession, S corporations decreased 51.6%. This difference in the transaction price decrease between S and C corporations provides further evidence that there was no significant valuation premium of S corporations over C corporations in the 2008-2010 time periods. We also ran regression analysis comparing transaction prices for C corporations and LLC/Partnerships. The results indicated that there is a statistically significant price premium for C corporations over LLC/Partnerships.

It has been common practice among business valuation practitioners to tax-affect the earnings of closely-held pass-through entities to place them on an equivalent basis with closely-held C corporations. Recent Tax Court cases have largely rejected tax-affecting, resulting in a valuation premium for closely-held pass-through entities over closely held C corporations. The
results of this study run contrary to such Tax Court cases. We believe the reasons for the lack of any significant difference between closely held pass-through entities and closely-held C corporations is because cash flow to the owners is similar when the entity level tax and owner level tax are both considered, and that these factors are taken into account by buyers and sellers in negotiating a transaction price for the entity. The tax structure of C corporations can result in a second level tax on dividends. However, unless the entity is running up unreasonable compensation issues, many closely-held C corporations bonus out any remaining income to the shareholders as compensation, mitigating the second level dividend tax.

We believe the Pratt’s Stats database provides a rich data mining environment conducive to further research. Using the Pratt’s Stats database, one may perform a similar study using key multiples such as; price/EBIT, price/cash flow and price/revenue as dependent variables broken out individually or by industry. Another research opportunity may exist by examining transaction prices pre and post recession broken out by industry or entity type. A third research opportunity may be found by obtaining additional data from Compustat to compare prices pre and post-recession by industry for closely held companies compared to selected publicly traded companies.
References


