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VALUATION IMPLICATIONS OF DIVIDEND INCOME

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10.2014

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The after-tax earnings resulting from ownership interests in Pass-Through Entities (PTEs) and C corporations are impacted by Federal income tax laws. Such laws legislate tax rates, income brackets and other matters – all of which have historically been subject to extreme volatility since the inception of the Internal Revenue Code. Such volatility has substantial business valuation and tax planning implications.

DIVIDEND INCOME HISTORY AND ITS EFFECT ON VALUATIONS

Let's consider the impact of just one law change – the taxation of C corporation dividends received by owners of C corporations. During the period 1913 through 1935 and from 1940 through 1953, dividend income was tax exempt. During these years, individual income tax rates in the maximum income bracket were much greater than maximum bracket C corporation tax rates. For example, during 1938, the federal income tax rate in the maximum individual income bracket was 79%, the federal income tax rate in the maximum C corporation income bracket was 19% - a difference of 60%! This created a very obvious tax incentive for profitable companies to be formed as C corporations.

During 1936 through 1939, and commencing in 1954, dividend income became fully taxable for federal income tax reporting purposes. The inclusion of dividend income as part of taxable income effectively created two levels of taxation on C corporation earnings – one level of tax at the entity level, and the second level of tax at the owner level. This created a very obvious tax disincentive for companies to be formed as C Corporation.

TAX LESSONS LEARNED FROM THIS ANALYSIS

1. *Operating a business in the form of a PTE may provide a tax savings benefit in some years but not in others.*
2. *Operating a business in the form of a C corporation may provide a tax savings benefit in some years but not in others.*
3. *After-tax cash flows to the investor are substantially impacted by entity form.*
4. *After-tax cash flows to the investor change when income tax rates change.*
5. *If entity form and tax laws both impact after-tax cash flows to the investor, then both factors must be considered when valuing PTEs.*

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This article was published by Fischer Barr & Wissinger LLC (FBW), now part of Marks Paneth LLP.