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DO YOU KNOW?

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A free periodical to promote education and alert you to important areas of interest in the financial valuation, fraud, and litigation services profession.

Do You Know...

... a new federal court case allowed tax affecting an S corp to value the company?

"The court finds GBP's subchapter S status is a neutral consideration with respect to the valuation of its stock."[1]

James F. Kress and Julie Ann Kress, Plaintiffs, v. United States of America, Defendant,
Case No. 16-C-795, United States District Court Eastern District of Wisconsin,
March 25, 2019.

This is a very interesting case in the valuation of minority shares in a gift tax context for the years ending December 31, 2007, 2008, and 2009. The following issues were addressed:

- Tax affecting the S corp
- The use of an S-corp premium
- The income approach vs. the market approach
- Discounts for lack of marketability
- Minority discounts
- The treatment of non-operating assets
- Who has the burden of proof
- The effects of the economic recession
- Family transfer restrictions
- Chapter 14 and § 2703(b)(1)-(3)

The taxpayers' experts were John Emory, ASA, with Emory & Co., and Nancy Czaplinski, CPA/ABV/CGMA, CFA, ASA, with Duff & Phelps LLC. The IRS's expert was Francis X. Burns, ASA, ABAR, with Global Economics Group. Emory had valued the company since 1999 and valued the stock for the gifts that are part of this dispute. Czaplinski was retained to add an income approach value. Burns is a frequent expert and testifier for the IRS. The various per share values are shown in Exhibit 1 below.

Exhibit 1
TAXPAYERS' EXPERTS **IRS'S EXPERT**

Year	Emory	Czaplinski	Burns	IRS	Court Decision
2007	$28.00	$30.87	$38.04	$45.97	$29.20
2008	$25.90	$25.92	$27.81	$47.63	$27.01
2009	$21.60	$25.06	$40.05	$50.85	$22.50

The court found for the taxpayer and gave Emory's valuation and values the most weight:

"The Government asserts that Emory cherry-picked comparable companies to find the lowest multiples and that Emory's approach was results oriented, but the record shows that Emory derived base values through the exercise of interviewing GBP management, reviewing his prior year reports, and analyzing the guideline companies and the multiples they yielded. He further examined attributes that were specific to GBP, analyzed GBP's debt and management philosophy, and reviewed business metrics including price, book value, earnings, dividends, EBITDA, assets, and sales on a "holistic" basis to determine a value that best fit the guideline companies. His analysis recognizes the variability and non-quantifiable judgments by which various factors are taken into consideration and impact the price of a share of minority stock. Emory did not create his valuations with the benefit of hindsight, for the purpose of litigation, or for Plaintiffs' benefit in transferring their stock to their children and grandchildren. He provided credible and thorough valuations supporting the value of the stock Plaintiffs reported on their tax returns."[2]

"The court therefore finds that the Government failed to prove by a preponderance of the evidence that Burns' determination of the fair market value of GBP's common minority stock is correct. In contrast, Emory provided reliable valuations of the GBP minority-owned shares of stock. Rather than accept Emory's discount for lack of marketability assessments, however, the court holds that a 27% discount for lack of marketability for tax years 2007 and 2008 and a 25% discount for lack of marketability for tax year 2009 are more fitting. Although the Kress Family Restriction was only given minimal consideration in Emory's analysis, any consideration of the Restrictions was improper. The three percent downward adjustment in discounts for lack of marketability, which does not take the Restriction into account, is therefore appropriate."[3]

The court also addressed tax affecting and the S-corp premium:

"Finally, the court notes Plaintiffs' argument that Burns applied a separate subchapter S premium to his valuation. Both Emory and Burns applied C-corporation level taxes to GBP's earnings to effectively compare GBP to the other C-corporations. Burns then assessed a premium to account for the tax advantages associated with subchapter S status, such as the elimination of a level of taxes, and noted GBP did not pay C-corporation taxes in any of the valuation years and did not expect to pay those taxes in the future. Emory and Czaplinski did not consider GBP's subchapter S status to be a benefit that would add value to a minority shareholder's stock because a minority shareholder cannot change GBP's corporation status. The court finds GBP's subchapter S status is a neutral consideration with respect to the valuation of its stock. Notwithstanding the tax advantages associated with subchapter S status, there are also noted disadvantages, including the limited ability to reinvest in the company and the limited access to credit markets. It is therefore unclear if a minority shareholder enjoys those benefits."[4]

The bottom line is that all three appraisers, including the IRS's expert, tax affected the S corp to determine the value. While this is not a tax court decision, this is still a big deal.

[1] *Kress v. USA, Findings of Fact and Conclusions of Law,* p. 20.
[2] Ibid., p. 25
[3] Ibid., p. 30.
[4] Ibid., p.19.

A longer, more detailed analysis of this case appears in Issue 78 of
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(https://www.valuationproducts.com/fvle-past)