

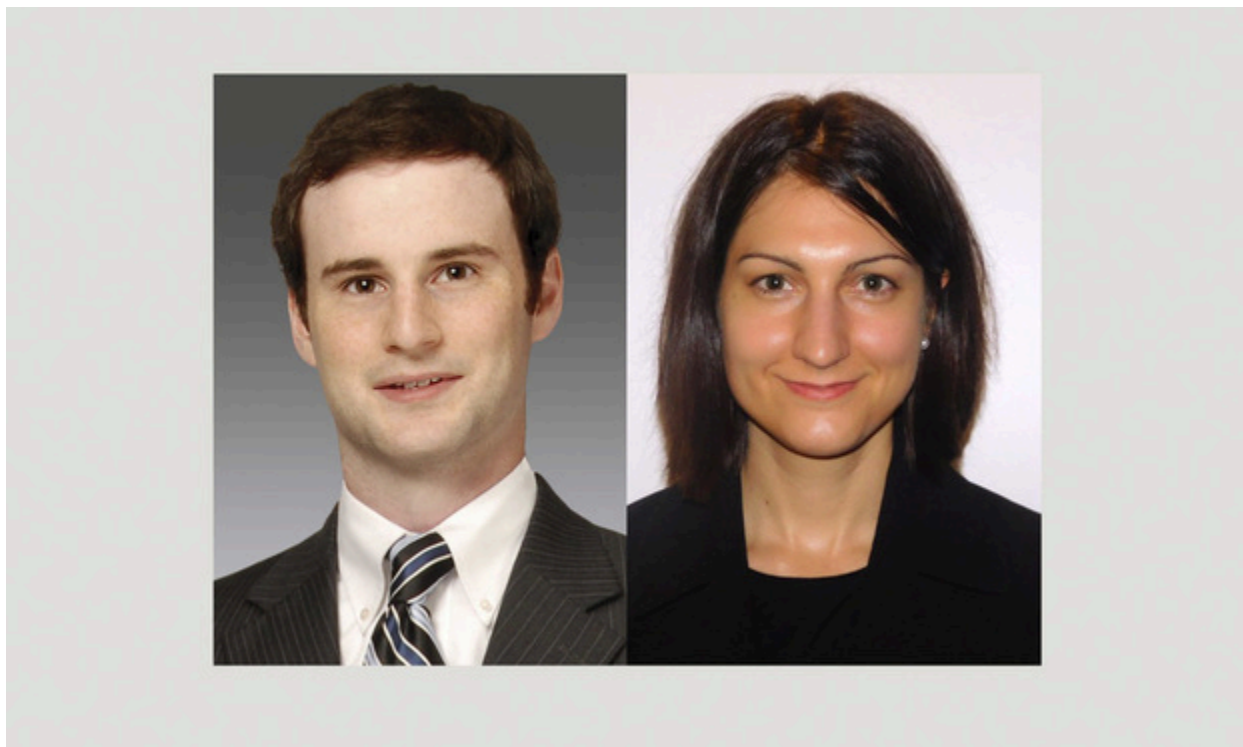
# Legal Intelligencer

<https://www.law.com/thelegalintelligencer/2019/08/20/valuation-discussion-and-tax-implications-of-kress-v-united-states/>

## Valuation Discussion and Tax Implications of 'Kress v. United States'

This case has become significant because the government's expert used a valuation methodology that differs from the IRS' and the government's traditional stance on the tax treatment of S-Corporations for valuation purposes. It should be noted that this was a district court decision; not a tax court decision.

By **Taylor B. Rosanova and Gloria Vasconcellos** | August 20, 2019 at 12:26 PM



Taylor Rosanova, left, and Gloria Vasconcellos, right, of Marcum LLP.

In the past few months there has been much discussion in the valuation community about the March court case, *Kress v. United States of America*, Case No. 16-C-795, U.S. District Court, E.D. Wisconsin (March 25, 2019). This case has become significant because the government's expert used

a valuation methodology that differs from the IRS' and the government's traditional stance on the tax treatment of S-Corporations for valuation purposes. It should be noted that this was a district court decision; not a tax court decision.

In the *Kress* case, both the Kress' experts and the government's expert "tax-affected" when valuing the subject S-Corporation. S-Corporations are generally not subject to entity-level taxation like C-Corporations. Instead, S-Corporation shareholders are taxed on entity earnings at their personal tax rate rather than at the corporate or dividend tax rate. By "tax-affecting" the S-Corporation's earnings, the valuation professional attempts to account for the S-Corporation shareholder's tax burden in determining the value of the business, even though no entity level tax exists.

In this case, the Kresses sought a refund for the overpayment of gift taxes and interest related to stock gifts to their children and grandchildren in the tax years 2007, 2008 and 2009. The Kresses gifted minority-interest stock in their family-owned S-Corporation, Green Bay Packaging, a specialized packaging and labeling company. The Kresses initially paid gift taxes of approximately \$2.4 million, but the IRS disagreed and assessed an additional gift tax liability of \$2.2 million. The Kresses paid the additional taxes and initiated the lawsuit for a refund in 2016. During the lawsuit, both sides presented experts to value Green Bay Packaging, and all experts "tax-affected" the S-Corporation earnings.

Agreement by the parties to "tax-affect" doesn't appear significant until we revisit the history of how courts have traditionally addressed the issue. Nearly 20 years ago, the case *Gross v. Commissioner*, TCM, 1999-254 (July 29, 1999), set the precedent in the tax courts for not tax-affecting S-Corporations. Here, the transaction subject was a gift of a minority interest in a family owned Pepsi-Cola bottler. The valuation expert for the taxpayer assumed a 40% tax rate in the appraisal, whereas the valuation expert for the IRS did not tax effect the company's cash flow streams. Ultimately, the court agreed with the valuation expert for the IRS.

Since the *Gross* case, the tax court reaffirmed its position repeatedly in cases such as *Wall v. Commissioner*, TCM, 2001-75 (March 27, 2001), *Estate of Heck v. Commissioner*, TCM, 2002-34 (Feb. 5, 2002), *Estate of Adams v. Commissioner*, TCM, 2002-80 (March 28, 2002), and *Dallas v. Commissioner*, TCM, 2006-212 (Sept. 28, 2006).

Beyond the tax courts, courts have allowed the tax affecting of S-Corporations since the mid-2000s. Most notably, in *Delaware Open MRI Radiology Associates*, 898 A.2d 290 (Del Chancery 2006), the Delaware Court of Chancery estimated the S-Corporation's corporate tax rate based on a double taxation structure, as if it were a C Corporation. The court then tax affected the earnings at the implied corporate equivalent rate, taking into account corporate rates, dividend rates, and personal income tax rates.

In the 2012 *Bernier v. Bernier* case, 82 Mass. App. Ct. 81 (June 29, 2012). the Massachusetts Supreme Court adopted the tax-affecting method developed in the *Delaware MRI* case. In this divorce case, the husband's expert tax-affected the two S-Corporations, while the wife's expert did not tax affect. Ultimately, the Massachusetts Supreme Court found that not tax affecting an S-Corporation would artificially inflate the company's value.

The IRS's position on the tax-affecting question is laid out in the Job Aid for IRS Valuation Analysts which states, "With respect to the attribute of pass-through taxation ... no entity level tax should be applied in determining the cash flows of an electing S Corporation. In the same vein, the personal income taxes paid by the holder of an interest in an electing S Corporation are not relevant in determining the fair market value of that interest." See Job Aid for IRS Valuation Analysts Page 5.

“Valuation of Noncontrolling Interests in Business Entities Electing to be Treated as S-Corporations for Federal Tax Purposes.”

For the better part of the last two decades, a subset of the valuation community has valued S-Corporations as if they were C-Corporations and then applied a premium to the value to account for the S-Corporation’s tax advantages. In fact, since *Gross v. Commissioner*, five notable models to quantify the S-Corporation premiums have been developed from valuation professionals including, Roger J. Grabowski, Z. Christopher Mercer, Chris D. Treharne, Daniel R. Van Vleet, and our colleague, Nancy Fannon.

The models from these professionals vary in how they attempt to capture the S-Corporation premium; however, each model tends to produce a similar result. All of these premiums are far lower than the premium implied by the tax courts’ and the IRS’ historical position that S-Corporations should not be tax affected at the entity level.

To illustrate the tax implications of the various corporate structures, if an otherwise identical C-Corporation and an S-Corporation each have \$1,000 in income before taxes and there is a 25% blended corporate tax rate, the C-Corporation would be viewed as having \$750 available for dividends while the S-Corporation would have \$1,000 available. Without tax-affecting the earnings, the Tax Courts would view the S-Corporation having a value that is 33% greater than the C-Corporation.

Many in the valuation community, including the five aforementioned professionals, take the position that personal income taxes do matter for valuation purposes. Building on the example above, the owner in the C-Corporation, which has \$750 available for dividends, would end up with \$600 in his pocket after taxes, assuming a 20% blended dividend tax rate. Conversely, the owner in the S-Corporation would receive the full \$1,000 distributed, but would have to pay ordinary income tax on his distributions. Assuming a blended personal income tax of 35%, the S-Corporation owner end up with \$650 in income after taxes. This amount is 8% more than the C-Corporation owner. This scenario would lead one to ask why an individual would pay 33% more for 8% more in net income after all taxes.

As more cases go through the courts, including *Cecil v. Commissioner of Internal Revenue*, which is still pending, it will be interesting to see how courts address this issue going forward in light of the *Kress v. United States*.

**Taylor B. Rosanova** is an advisory services manager and **Gloria Vasconcellos** is an advisory services accountant in the Philadelphia office of Marcum LLP, a national accounting and advisory services firm with offices in major business markets throughout the United States, as well as Grand Cayman, China, and Ireland ([www.marcumllp.com](http://www.marcumllp.com)).