Kress v. United States signifies approval of S corp tax affecting

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In a gift tax case teeming with valuation issues, one notable aspect was that, in valuing the minority shares of an S corporation, both parties' experts applied a C corporation tax rate to the company's earnings and the court, without ado, accepted the practice. To what extent this court's position reflects a wider agreement among judges adjudicating tax cases and government tax specialists that tax affecting is the appropriate method for valuing nontaxable entities remains to be seen.

Taxpayer prevails: The flash point was a very successful, family-owned packaging company that was organized as an S corp. As part of their estate planning, the taxpayers gifted minority shares in the company to junior family members. The IRS claimed that, for three tax years, the taxpayers paid insufficient gift taxes. The plaintiffs chose to amend their tax returns, pay, and then sue in federal district court for a refund.

At trial, both parties presented testimony from highly qualified valuation experts. The taxpayer retained two experts: a primary expert, who used the market approach, and a secondary expert, who valued the company based on a combination of market and income approaches The government's expert also used a combination but gave a different weight to each result: 60% to the market approach and 40% to the income approach. He said the market approach was most "effective at capturing the financial conditions at the time in the marketplace and industry."

The parties' experts tax affected. The government's expert also applied an S corp premium to account for perceived tax advantages to the company flowing from the S corp status. The taxpayer's experts said the S corp status here did not add value to the gifted stock because the minority shareholders could not change the status of the corporation. The court declared itself “neutral” on the issue. If there were benefits to S corp status, it was unclear that the minority shareholders would enjoy them, the court found.

The court credited the taxpayer’s primary expert, commending his profound understanding of the company (he had worked with the company since 1999) and his detailed examination of its unique aspects. He analyzed the company on a “‘holistic’ basis to determine a value that best fit the guideline companies,” the court noted. It only made a minor downward adjustment to the expert’s marketability discount.

What’s the impact? In deciding how far this opinion goes toward ending the tax-affecting controversy, valuators should note that this is not a U.S. Tax Court memo or a precedent-making decision from a U.S. Court of Appeals. Further, the court here does not get into a larger discussion on tax affecting (e.g., models) and does not address prior landmark decisions, including *Gross v. Commissioner.* At the same time, the court’s ruling and the government’s position signal a recognition that there are tax consequences to the owners of S corps and other pass-through entities that need to be accounted for in a valuation. It’s not clear whether the government will appeal the ruling.

Stay tuned: We will report on other aspects of the case at a later date. A digest of *Kress v. United States,* 2019 U.S. Dist. LEXIS 49850; 2019 WL 1352944 (March 26, 2019), and the court’s opinion will be available soon at *BVLaw.*

> *Extra:* Short on tax-affecting detail, the opinion leaves valuators yearning for further information. For example, what S corp model did the IRS’s expert use? Our quick research revealed the parties’ exhibits list, which lists the financial and valuation information the parties’ experts considered. Click here for the list.

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