Will *Kress v. U.S.* Change Your Life? Or Will It Change Your Valuation Practice?

Case Review

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Scott A. Womack, Senior Vice President, is active in family law litigation (traditional litigated divorce and collaborative divorce) and corporate valuation and leads Mercer Capital's Auto Dealer Industry team.

Scott assists estate planning attorneys in federal and state valuation matters, family law attorneys in divorce matters (including business valuation, forensic accounting, division of marital estate, etc.), and small business owners involving the potential sale of their businesses. Scott has testified in several jurisdictions involving family law matters. In addition, he has testified in Tax Court.

As the leader of Mercer Capital's Auto Dealership Industry team, Scott provides valuation services to dealerships throughout the U.S. related to corporate planning and reorganization, transactions, employee stock ownership plans, and tax issues as well as valuations of intangible assets, and assets subject to specific contractual restrictions. Scott and his team also consult with auto dealer clients in the process of selling or buying.

Scott's overall valuation concentration includes gift, estate, and income tax planning and reporting (valuation of businesses and business interests); financial Reporting under FASB ASC 350 (goodwill impairment testing- formerly FAS 142), FASB 718 (valuation of stock-based compensation including stock options, restricted stock, stock appreciation rights, etc.- formerly FAS 123R); and holding company valuations (real estate/marketable securities) and fractional interests in real estate.

Scott is a featured speaker for auto dealer industry groups, family law associations, attorneys, accountants, business appraisers, and business professionals on various valuation and financial advisory topics.

What We'll Cover Today

- S Corporation Premium
- *Kress v. U.S.*
- Key Takeaways
- Other Opinions of *Kress*

S Corporation Premium

S Corporations

- Allow tax liability for corporate earnings to be passed-through to shareholders at their personal rate
- Shareholders pay taxes on proportionate share of earnings regardless of whether the company distributes
- Most S Corps distribute enough to cover tax liability of shareholders
- Example: If an S Corp earns $100, then a 30% shareholder is taxed on $30 at their personal tax rate, regardless of whether the company distributes
- Avoids double taxation of C Corps
- Retained earnings increase tax basis

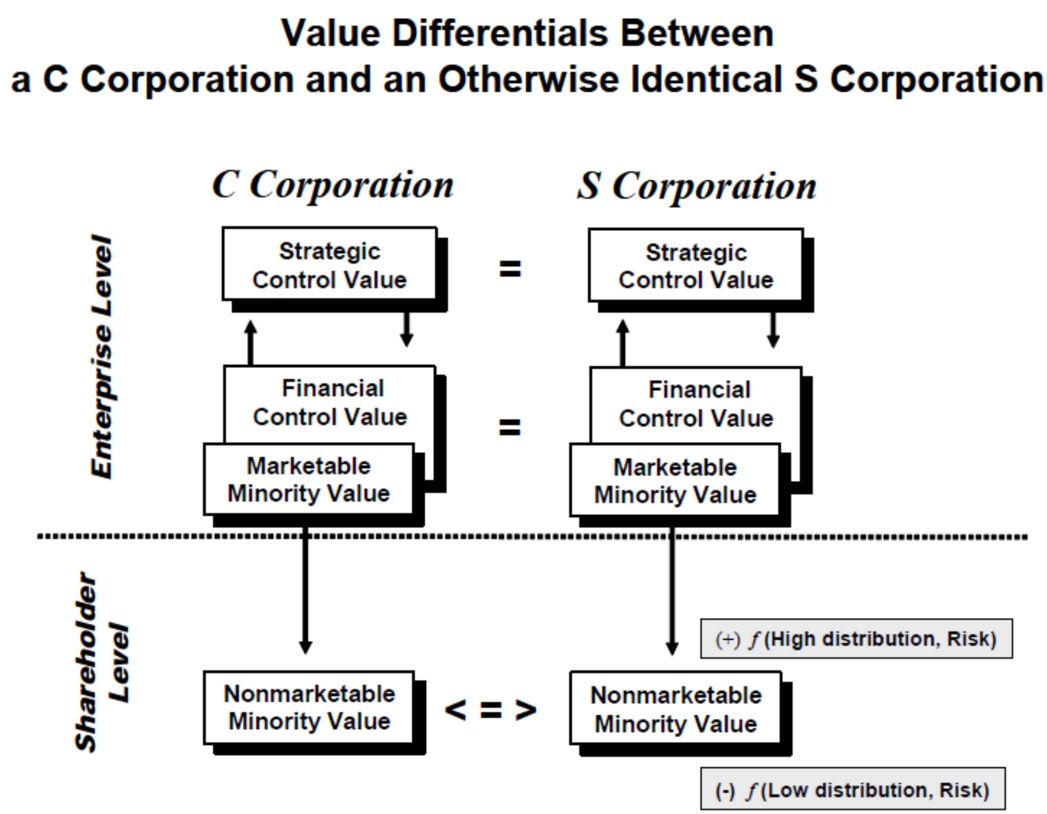
S Corporations

Are S Corps more valuable than C Corps?

- Some argue that the tax benefit that the elimination of the second layer of taxes means that S Corps are worth more than C Corps
- This inaccurately implies that the benefit accrues to the Enterprise rather than the Shareholder
- **Legal** obligation transfers from corporation to shareholder while the **Economic** obligation remains with corporation
- Actual benefit of S Corp election is elimination of second layer of personal taxes that shareholder would otherwise normally pay on distributions
- No market evidence of a premium

Enterprise Level v. Shareholder Level

- Enterprise still has economic obligation to cover tax liability
- Potential S Corp "Benefit" arises at shareholder level rather than enterprise level
- Magnitude of benefit related to dividend income tax rate avoided
- Effects marketability discount through dividend yield



MCM Approach

C Corp equivalency

- Value S Corp as if a C Corp
- Tax-Affect S Corp earnings

QMDM

- Minority interest in S Corp valued taking into account S Corp benefits & risks

Capitalization Rate

Capitalization rates derived using public company data

No publicly traded S Corps

Must tax-affect S Corp earnings to evaluate on C Corp equivalent basis

Market Approach

Guideline multiples developed using public C Corps

Must tax-affect S Corp earnings to reconcile to C Corp multiples

The QMDM

Shareholder level indication

Incorporates risk factors unique to S Corps

Any payout ratio

Specific holding period range

Illustration: Legacy

	0% Economic Payout		50% Economic Payout		100% Economic Payout	
	(Pay Out for Taxes)		*(Pay Out More Than Taxes)*		*(Fully Distribute)*	
	C Corp	S Corp	C Corp	S Corp	C Corp	S Corp
Pre-Tax Corporate Income	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000
Corporate Taxes	35.0%	0.0%	35.0%	0.0%	35.0%	0.0%
Corporate Net Income	$650	$1,000	$650	$1,000	$650	$1,000
Pre-Tax Corporate Income		$1,000		$1,000		$1,000
Shareholder Tax Rate		39.6%		39.6%		39.6%
Pass-Through Tax Liability		$396		$396		$396
Portion of C Corp Net Income Retained	92.9%	92.9%	50.0%	50.0%	0.0%	0.0%
Retained Earnings	$604	$604	$325	$325	$0	$0
Distribution	46	396	325	675	650	1,000
Shareholder Tax Liability		(396)		(396)		(396)
After-Tax Distribution		$0		$279		$604
Divided By: (1-Personal Dividend Tax Rate)		23.8%		23.8%		23.8%
C Corp Equivalent Distribution		$0		$366		$793
Marketable Minority Value	6,500	6,500	6,500	6,500	6,500	6,500
C Corp Equivalent Dividend Yield	0.7%	0.0%	5.0%	5.6%	10.0%	12.2%
Indicated DLOM	23.0%	27.0%	19.0%	16.0%	15.0%	5.0%
Implied S Corp Premium		**-5.2%**		**3.7%**		**11.8%**

TCJA Implications

Lower corporate rate

Lower personal rate

Larger spread between corporate and personal rates

QBI to level playing field

Resulting lower S Corp benefit

Illustration: TCJA

No QBI Deduction

	0% Economic Payout		50% Economic Payout		100% Economic Payout	
	(Pay Out for Taxes)		*(Pay Out More Than Taxes)*		*(Fully Distribute)*	
	C Corp	S Corp	C Corp	S Corp	C Corp	S Corp
Pre-Tax Corporate Income	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000
Corporate Taxes	21.0%	0.0%	21.0%	0.0%	21.0%	0.0%
Corporate Net Income	$790	$1,000	$790	$1,000	$790	$1,000
S Corp QBI Deduction		0.0%		0.0%		0.0%
QBI Deduction		$0		$0		$0
Shareholder Tax Rate		37.0%		37.0%		37.0%
Pass-Through Tax Liability		$370		$370		$370
Portion of C Corp Net Income Retained	79.7%	79.7%	50.0%	50.0%	0.0%	0.0%
Retained Earnings	$630	$630	$395	$395	$0	$0
Distribution	160	370	395	605	790	1,000
Shareholder Tax Liability		(370)		(370)		(370)
After-Tax Distribution		$0		$235		$630
Divided By: (1-Personal Dividend Tax Rate)		23.8%		23.8%		23.8%
C Corp Equivalent Distribution		$0		$308		$827
Marketable Minority Value	7,900	7,900	7,900	7,900	7,900	7,900
C Corp Equivalent Dividend Yield	2.0%	0.0%	5.0%	3.9%	10.0%	10.5%
Indicated DLOM	22.0%	33.0%	19.0%	25.0%	15.0%	13.0%
Implied S Corp Premium		**-14.1%**		**-7.4%**		**2.4%**

Illustration: TCJA

QBI Deduction

	0% Economic Payout (Pay Out for Taxes)		50% Economic Payout (Pay Out More Than Taxes)		100% Economic Payout (Fully Distribute)	
	C Corp	S Corp	C Corp	S Corp	C Corp	S Corp
Pre-Tax Corporate Income	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000
Corporate Taxes	21.0%	0.0%	21.0%	0.0%	21.0%	0.0%
Corporate Net Income	$790	$1,000	$790	$1,000	$790	$1,000
S Corp QBI Deduction		20.0%		20.0%		20.0%
QBI Deduction		$200		$200		$200
Shareholder Tax Rate		37.0%		37.0%		37.0%
Pass-Through Tax Liability		$296		$296		$296
Portion of C Corp Net Income Retained	89.1%	89.1%	50.0%	50.0%	0.0%	0.0%
Retained Earnings	$704	$704	$395	$395	$0	$0
Distribution	86	296	395	605	790	1,000
Shareholder Tax Liability		(296)		(296)		(296)
After-Tax Distribution		$0		$309		$704
Divided By: (1-Personal Dividend Tax Rate)		23.8%		23.8%		23.8%
C Corp Equivalent Distribution		$0		$406		$924
Marketable Minority Value	7,900	7,900	7,900	7,900	7,900	7,900
C Corp Equivalent Dividend Yield	1.1%	0.0%	5.0%	5.1%	10.0%	11.7%
Indicated DLOM	23.0%	29.0%	19.0%	19.0%	15.0%	8.0%
Implied S Corp Premium		**-7.8%**		**0.0%**		**8.2%**

Prior Case Law

Gross v. Commissioner

Heck v. Commissioner

Adams v. Commissioner

S Corp Premium

Centers around fact that S Corps eliminate second layer of taxes

More enterprise cash flow

Do not tax-affect S Corp earnings

SEAM Model

Tax Court Implied Premiums

Tax Court Logic	C Corp	S Corp
Pre-Tax Income	$1,000	$1,000
Pre-Tax Multiple	6.0x	6.0x
Equity Value	$6,000	$6,000
Tax Rate	25.0%	
After-Tax Multiple	8.0x	8.0x
Net Income	$750	$1,000
Equity Value	$6,000	$8,000
Implied Premium		**33.3%**

Equivalency of Tax Court Logic	C Corp	S Corp
Pre-Tax Income	$1,000	$1,000
Gross-Up S Corp		33.3%
Adjusted Pre-Tax Earnings	$1,000	$1,333
Corporate / Personal Taxes	25.0%	25.0%
Net Income	$750	$1,000
After-Tax Multiple	8.0x	8.0x
Equity Value	$6,000	$8,000
Implied Premium		**33.3%**

SEAM Model

Daniel R. Van Vleet

Model to estimate "S Corp Premium"

Assumptions:

- S Corps will be organized as such into perpetuity
- Assumes no changes in S Corp tax law
- Continued profitability
- Investors indifferent between dividends and capital gains
- C Corp investors recognize capital gains annually
- Buyers are willing to pay for S Corp benefit
- Only "correct" when 100% payout
- Infinite holding period

SEAM Model: Legacy

	C Corp	S Corp
Pre-Tax Income	$100,000	$100,000
Corporate Taxes	35.0%	0.0%
Corporate Net Income	$65,000	$100,000
Payout Ratio	50.0%	50.0%
Distribution	$32,500	$50,000
Personal Income Taxes	0.0%	35.0%
Personal Dividend Taxes	15.0%	0.0%
Taxes Due	4,875	35,000
After-Tax Distribution	$27,625	$15,000
Corporate Net Income	$65,000	$100,000
Distribution	32,500	50,000
Retained Earnings	32,500	50,000
Increase in Tax Basis	0	(50,000)
Taxable Capital Gain	32,500	0
Gross Capital Appreciation	$32,500	$50,000
Capital Gains Tax	15.0%	0.0%
After-Tax Capital Appreciation	$27,625	$50,000
After-Tax Distribution	$27,625	$15,000
After-Tax Capital Appreciation	27,625	50,000
Total Benefits to Shareholder	$55,250	$65,000
S Corporation Premium		**17.6%**

SEAM Model: TCJA

	C Corp	S Corp
Pre-Tax Income	$100,000	$100,000
Corporate Taxes	21.0%	0.0%
Corporate Net Income	$79,000	$100,000
Payout Ratio	50.0%	50.0%
Distribution	$39,500	$50,000
Personal Income Taxes	0.0%	37.0%
Personal Dividend Taxes	23.8%	0.0%
Taxes Due	9,401	37,000
After-Tax Distribution	$30,099	$13,000
Corporate Net Income	$79,000	$100,000
Distribution	39,500	50,000
Retained Earnings	39,500	50,000
S Corp Increase in Tax Basis	0	(50,000)
Taxable Capital Gain	39,500	0
Gross Capital Appreciation	$39,500	$50,000
Capital Gains Tax	23.8%	0.0%
After-Tax Capital Appreciation	$30,099	$50,000
After-Tax Distribution	$30,099	$13,000
After-Tax Capital Appreciation	30,099	50,000
Total Benefits to Shareholder	$60,198	$63,000
S Corporation Premium		**4.7%**

Kress v. U.S.

Company Profile

Kress v. U.S.

Green Bay Packaging Inc. ("GBP") – Privately owned, diversified paper and packaging manufacturer. Founded in 1933, this Green Bay WI based company has over 3,400 employees and 32 manufacturing locations, operating in 15 states that serve corrugated container, folder carton, and coated label markets.

Case Overview

Family-owned S Corporation

90% owned by Kress family

Paid annual distributions ranging from $15.6 million to $74.5 million per year between 1990 and 2009

Net sales increased during the period 2002 to 2008

Case Overview

James & Julie Kress gifted minority shares to children at year-end 2006, 2007, and 2008 ($21.60 per share)

Challenged by IRS ($50.85 per share)

Plaintiffs paid gift tax deficiencies & later filed lawsuit in federal district court

Trial held August 3-4, 2017

Appraisal Experts

Kress v. U.S.

1. John Emory – Original appraisals
2. IRS
3. Francis X. Burns – Hired by IRS
4. Nancy Czaplinski – Hired by plaintiffs

Appraisal Experts

Kress v. U.S.

	December 31, 2008	IRS	Burns	Emory	Czaplinski	Court
1	Guideline Public Companies		2 - 60%	6 - 100%	4 - 14%	Emory
2	Income Approach		40%	**0%**	86%	Emory OK
3	S-Corp Premium		Yes	No	No	No
4	Tax-Affect Earnings as-if C Corp		Yes	Yes	Pre-Tax Multiples	Emory
5	Non-Operating Assets		"Almost full value"	In Book Value	Discounted in Treatment	Emory
6	Interviewed Management		Depo of CFO	Yes	Not Clear	
7	**Specific Consideration of 2008 Recession**		No	Yes	Yes	Yes
8	Negative Impact Stock Restrictions		No	Small	No	Small
9	Marketable Minority Per Share		$45.10	$30.00	$31.33	$30.00
10	Marketability Discounts		11.2%	28.0%	20.0%	25.0%
11	Conclusion per Share	$50.85	$40.05	$21.60	$25.06	$22.50

S Corporation Treatment

Kress v. U.S.

	Emory	Czaplinski	IRS	Burns
S Corporation Premium	No	No	na	Yes
Tax-Affect Earnings	Yes	na	na	Yes
Conclusion per Share *Non-Marketable Minority*	$21.60	$25.06	$50.85	$40.05

Decision

Kress v. U.S.

Accepted tax-affected treatment of earnings of Burns & Emory

- Nancy's treatment was satisfactory

Did not accept S Corporation premium in Burns report

Accepted Emory report with the only exception of a 3% smaller marketability discount

- Court concluded $22.50 per share
- Emory report had concluded $21.60 per share

Decision

Kress v. U.S.

“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.”

Key Takeaways

Key Takeaways

Kress v. U.S.

Court accepting tax-affected S Corporation income

- S Corp = C Corp at Enterprise Value Level
- Goes against IRS claim that S Corps worth more because they do not pay corporate level taxes

Court did not accept S Corporation premium

- S Corp = C Corp at Enterprise Value Level

Case will be cited for appropriateness of tax-affecting S Corporation earnings & for elimination of S Corporation premiums

Key Takeaways

Courts criticism of number of guideline companies considered:

- Burns – 2
- Czaplinski – 4
- Emory - 6

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Key Takeaways

Non-Operating Assets

- Burns – treated at “almost full value”
- Emory – considered in book value approach, but no weight given to book value approach
- Czaplinski – provided some discounting of the non-operating assets in the marketable, minority valuation

Key Takeaways

Management Interviews

- Burns – did not visit or interview management
- Emory – visited with management
- Czaplinski – unclear whether interviewed management

Key Takeaways

Consideration of Recession

- Burns – mechanical approach to all three years; did not account for changes in the market due to the recession
- Emory/Czaplinski – methodologies considered the recession and it’s impact on GBP’s value

Key Takeaways

Impact on Family Transfer Restrictions on Value

- Burns/Czaplinski – didn’t consider in DLOM
- Emory – considered in “small amount” in overall DLOM determination
- Court – unclear, but only lowered Emory’s DLOM by 3%

Key Takeaways

Impact on Family Transfer Restrictions on Value

- Burns/Czaplinski – didn’t consider in DLOM
- Emory – considered in “small amount” in overall DLOM determination
- Court – unclear, but only lowered Emory’s DLOM by 3%

Key Takeaways

Marketable Minority Value Per Share

- Emory - $30.00 per share
- Czaplinski - $31.33 per share
- Burns - $45.10 per share, or 50% higher

Key Takeaways

Discount for Lack of Marketability (DLOMs)

- Emory – 28% DLOM
- Czaplinski – 20% DLOM
- Burns/IRS – 12% DLOM
- Court – 25% DLOM

Other Opinions of *Kress*

Paul Hood – Leimberg Information Services, Inc.

Court impressed with Taxpayer's return appraiser saying he employed a "holistic" valuation analysis

Court put heavy emphasis on timing of valuations; Taxpayer's return appraiser had no benefit of hindsight or in preparation for litigation

Reasonableness of comparing DLOMs

- Emory to prior DLOMs on GBP
- Burns compared to DLOM in other case

BVR

Valuation more than just mathematics;

Burns relied on 2 guideline companies in market approach;

One of those companies (Rock-Tenn’s) multiple effected by acquisition

Burns failed to consider Recession

Stout

Appraiser who had developed familiarity with business over extended period of time

Two Important Factors

1. Adequate due diligence from Appraiser
2. Availability/participation of Company management in due diligence process

Questions/Comments?

About Mercer Capital

Mercer Capital is a national business valuation and financial advisory firm.

We offer a broad range of services, including corporate valuation, financial institution valuation, family business advisory services, financial reporting valuation, gift and estate tax valuation, M&A advisory, fairness opinions, ESOP and ERISA valuation services, and litigation and expert testimony consulting.

We have provided thousands of valuation opinions for corporations of all sizes in a wide variety of industries. Our valuation opinions are well-reasoned and thoroughly documented, providing critical support for any potential engagement.

Our work has been reviewed and accepted by the major agencies of the federal government charged with regulating business transactions, as well as the largest accounting and law firms in the nation in connection with engagements involving their clients.

For over 35 years, Mercer Capital has been bringing uncommon professionalism, intellectual rigor, technical expertise, and superior client service to a broad range of public and private companies and financial institutions located throughout the world. Feel confident in our experience and expertise.

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