

**Valuation of S Corporation Shares;
Applicability of Section 2703(b) to
Family Transfer Restriction, *Kress v. U.S.*
(E.D. Wis, March 26, 2019)**

March 30, 2019

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Kress v. U.S., 123 AFTR 2d 2019-1224 (E.D. Wis. March 26, 2019) is a very interesting case with respect to various valuation issues. It is a gift tax refund case, with the sole issue being the value of minority interests in S corporation stock. The S corporation (Green Bay Packaging, Inc., referred to in the opinion as “GBP”) owned an operating business and non-operating assets.

- a. **Gift Tax Returns; Deficiency Assessment; Payment of Tax; Refund Action.** The gift tax returns (presumably making the split gift election) valued the gifted shares at \$28.00 in 2007, \$25.90 in 2008, and \$21.60 in 2009, and paid total gift tax for both spouses of \$2,438,482. The IRS assessed gift tax based on “the price used for actual share transactions between GBP and its employees which was \$45.97 on December 31, 2006; \$47.63 on December 31, 2007, and \$50.85 on December 31, 2008.” (About 90% of the stock was owned by family members, and about 10% was owned by employees and directors. The purchase price for shares sold to or purchased from employees and directors was 120% of the book value of the shares. There was no established price for shares transferred to members of the Kress family.) The taxpayers paid the gift tax deficiencies and accrued interest of \$2,218,465.80 and sued for a refund.
- b. **Burden of Proof Shifted to Government.** The burden of proof was shifted to the government because the taxpayer produced credible evidence (though it is not clear that finding made a difference because the court found that the government failed to prove by a preponderance of the evidence that the government appraisal was correct).
- c. **Appraiser’s Prior Position Used to Criticize the Appraiser.** The government appraiser was Francis Burns; in criticizing Burns’ appraisal, the court noted that Francis Burns allowed greater lack of marketability discounts in the *Holman* case (601 F.3d 763, 774 (8th Cir. 2010)) even though there was greater liquidity in that case than in the corporation being valued in *Kress* (GBP).
- d. **Tax-Affecting.** Both the taxpayer and government experts tax-affected the earnings of the S corporation to apply a C corporation level tax to effectively compare the S corporation being valued to other C corporations that were used as comparables.

For example, the government’s appraiser (Burns) used a market approach (deriving multiples of enterprise value to earnings *before* interest, *tax*, depreciation, and amortization (EBITDA) and price to earnings of selected comparable companies and applying “the multiples to relevant GBP financial data”) and also used an income approach by completing a capitalized cash flow analysis in which “[h]e applied an **effective tax rate to GBP as if it were a C-corporation** and then applied an adjustment to reflect the value of GBP as an S-corporation.”

Burns also applied an S corporation premium because of advantages associated with being an S corporation, but the court found the subchapter S status to be a neutral consideration because there were also disadvantages of S corporation status (“including the limited ability to reinvest in the company and the limited access to credit markets”), and it was “unclear if a minority shareholder enjoys those benefits.”

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- e. **Application of Section 2703(b) to Family Transfer Restriction.** A Family Transfer Restriction provided that family members could only transfer shares to other family members. The court addressed whether the transfer restriction satisfied the §2703(b) safe harbor.
- (1) **Bona Fide Business Arrangement, §2703(b)(1).** It satisfied the bona fide business arrangement test of 2703(b)(1) because it assured family control, minimized risks of a dissident shareholder, ensured confidentiality, and assured that sales were to qualified S shareholders. *Holman* had held that maintaining family control did not meet the bona fide business arrangement if there was not an operating business, but there was an operating business in *Kress*.
 - (2) **Device Test; “Natural Objects of Bounty” Regulation Rejected, §2703(b)(2).** The court held that the 2703(b)(2) “not a device” test was satisfied because this restriction was for inter vivos transfers, not just testamentary transfers, and the statute only applies to a device to transfer at less than fair market value to a DECEDENT’s family. The court rejected the “natural objects of the bounty” regulation as not satisfying the *Chevron* test [467 U.S. 837 (1984)] because the statute was unambiguous.
 - (3) **Comparability Test, §2703(b)(3).** The “comparable to arrangements in arms’ length transactions” test of 2703(b)(3) was not satisfied. “Though Plaintiffs contend restrictions like the Kress Family Restriction are common in the commercial world, they have not produced any evidence that unrelated parties at arms’ length would agree to such an arrangement.”
 - (4) **Section 2703 Had Little Impact.** Even though §2703 prevented the court from considering the Family Transfer Restriction, the taxpayer’s appraisers said that the restriction had little impact on the lack of marketability discount, and the court reduced the LOM discount by only 3% as a result on not taking into account the Family Transfer Restriction.
- f. **Judicial Notice of 2008 Economic Recession.** One of the years in question was 2009, and the court took judicial notice of the economic downturn at the end of 2008 and criticized the Burns appraisal because it did not “adequately account for the 2008 recession.” Also, the court concluded that Burns “relied on an outlier as a comparable company.”
- g. **Treatment of Non-Operating Assets.** The Burns appraisal added the value of non-operating assets “at almost their full value, with a slight discount ... for minority shareholders.” The Emory appraisal (the taxpayer’s appraisal that the court found most credible of the appraisals presented as evidence) “considered the non-operating assets to the extent that those assets contributed to GBP’s overall earnings. He did not add their overall value back into the value of the minority shares, reasoning that a minority shareholder cannot realize the valuations.”

The court said the government appraiser’s approach of adding the value of the non-operating assets at almost their full value was improper: “But a minority shareholder has no control over the use or dissipation of the assets and cannot realize the value of the assets until GBP is sold. Because there is no expectation of liquidation, Burns’ treatment of the non-operating assets overstated the value of the stock for each year in question.”

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- h. **Lack of Marketability Discount.** The court applied lack of marketability discounts of 25% for 2007-2008 and 27% for 2009 (which numbers included a 3% downward adjustment because the Family Transfer Restriction was not being taken into account). There were two taxpayer opinions, and the court found one of them (by Emory) to be the “most sound.” Emory had applied LOM discounts of 30% in 2007-2008 and 28% in 2009. Burns had used LOM discounts ranging from 10.8% to 11.2%.
- i. **Overall Credibility of Emory Appraisal.** Perhaps key to the court’s conclusion is the court’s high opinion of the credibility of the Emory appraisal. The court’s discussion of the reasons for its opinion of the Emory appraisal is instructive.

Emory has prepared valuation reports for GBP since 1999 and prepared the valuation of the stock that was submitted with Plaintiffs’ tax returns....

... In applying the market approach, Emory reviewed his prior GBP valuation reports, GBP’s audited consolidated financial statement for the previous five years, and GBP’s financial estimates for the upcoming year. He also met with GBP management to discuss the company’s state of affairs, its financial statements, and any unique circumstances GBP faced or expected to experience.

...

After reviewing the reports and testimony of these witnesses, the court finds the valuation methodology of Emory is the most sound. Emory is a certified appraiser who spent ample time with the company and management and truly understands GBP’s business. As a result of this understanding, he used more accurate projections to value the business and more adequately accounted for the effects of the economic recession.... [T]he 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.

The degree to which the court found Emory’s appraisal credible is truly reflected in its summary of his appraisal:

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.

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June 19, 2019

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