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Kress Case Signals Court's Assent to Tax-Affecting

A recent gift tax case, decided in a U.S. Federal District Court in Wisconsin in March, might have sweeping impact on the valuation of S corporations nationwide.

The case, *Kress v. United States*, involved Green Bay Packaging (GBP), a family-owned paper and packaging manufacturer founded by George Kress in 1933. The company has enjoyed steady and substantial growth over its history, and its balance sheet is strong.

GBP has more than 3,400 employees in 32 manufacturing locations in 15 states. Nearly 90 percent of its shares are owned by Kress family members, with the remaining shares owned by employees and directors.

Among many valuation issues addressed in the court case, the legitimacy of tax-affecting S corps has piqued the interest of valuation professionals the most.

Cost of Capital

The ongoing debate about tax-affecting centers on how to derive the cost of capital for S corps. To do so, valuation analysts rely on a variety of inputs, many of which are based on C corp data. But because C corps are subject to double taxation, valuation analysts often "tax-affect" S corps to create a C corp equivalent and then add a premium for S corp status when estimating fair market value.

While this sounds completely logical to most valuation analysts, until now, the IRS has not acknowledged that S corps should be tax-affected. Before the recent *Kress* decision, the landmark tax court case on tax-affecting, *Gross v. Commissioner*, resulted in a ruling that tax-affecting earnings should not be standard practice.

Kress might have changed that—or at least opened the door for further discussion.

Gift Taxes in Question

The *Kress* case centers on James and Julie Ann Kress's gift of minority shares of GBP to their children and grandchildren in 2006, 2007, and 2008. Their gift tax returns based the fair market value on annual valuation reports that were prepared for the company in the ordinary course of business. They each paid $1.2 million in taxes on the shares, for a total tax of $2.4 million.

In 2010, the IRS challenged the gift tax valuations and four years later told the Kresses that their tax payments were deficient, claiming they owed almost double the original amount.

In late 2014, the Kresses paid up—rendering to the IRS a total of $2.2 million more in deficiencies and interest.

Wasting no time, the Kresses then also filed amended gift tax returns—along with a lawsuit asking the court for a refund of the $2.2 million in additional taxes and interest. A trial took place in August 2017.

Valuations Challenged

In the trial, both the Kresses and the IRS presented testimony from highly qualified valuation experts. The Kresses' first expert, John Emory, had prepared valuations for the company for many years. It was Emory's valuation opinions on which the Kresses had relied for their gift tax calculations. Among other criticisms, the IRS objected to his sole use of the market approach.

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How to Structure Buy-Sell Valuation Provisions

A buy-sell agreement is among business owners' most important documents. Often incorporated into an operating agreement, a buy-sell agreement dictates the terms of transfer for a departing owner's interest in the company.

Among the legally binding provisions in a buy-sell agreement is a description of triggering events such as resignation, termination, retirement, death, disability, divorce, and personal bankruptcy. The agreement may also restrict who can buy a departing owner's interest.

Frequently, the agreement also identifies the funding mechanism for the transfer. Typical funding mechanisms include life insurance, company cash, or a loan from the selling owner.

Establishing Value

While there are many interesting issues to contemplate when drafting a buy-sell agreement, the valuation clause is among the most consequential. The goal of the valuation clause should be to satisfy both parties—the selling owner and the remaining shareholders. This clause defines how the departing owner's interest will be valued. It may also identify payment terms.

Fixed price: This approach is straightforward, but as the business matures the fixed price will become almost immediately outdated and will otherwise need to be updated regularly.

Formula: Like a fixed price, using a formula is problematic because as the business matures and capital markets change, the formula must be updated regularly. If not, once again, one side wins and the other loses.

Shotgun: Using this approach, one party offers to buy or sell, and the other party has to sell or buy under those terms. Though it sounds efficient, this approach doesn't account for differences in negotiating positions. For example, a 10 percent owner may not have the resources of a 90 percent owner. As a result, this approach is likely to result in an unsatisfactory number for one side.

Process: This approach is the most likely to result in an equitable outcome because it accommodates the dynamic nature of businesses and capital markets. It defines the standard, premise, and level of the valuation, which leads to an outcome based on current business conditions.

Best practices under this approach suggest that a valuation be done at the time the agreement is signed, with regular valuation updates scheduled, typically every year or every other year. Updates are less time consuming and less expensive because the parties are already familiar with the process and people involved.

To ensure consistency, the professional or firm performing the valuation should be named in the buy-sell document.

Following the "process" approach establishes a current baseline value and allows the owners to negotiate inputs to the process rather than argue about outputs from the process.

Start Talking Now

Buy-sell agreements are legal documents drafted by attorneys. Valuation professionals can help attorneys draft thorough buy-sell agreements by providing complementary expertise that yields the most equitable results and satisfies both parties.

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The Kresses' second expert, Nancy Czaplinski, also provided testimony, along with a new valuation report, which used both the market (weighted at 14 percent) and income (weighted at 86 percent) approach.

The IRS provided its own unnamed appraiser as well, who produced the valuation numbers used to calculate the tax deficiencies.

The IRS also retained Francis Burns, whose conclusion of value—using both the market (weighted at 60 percent) and income (weighted at 40 percent) approaches—was higher than both Emory's and Czaplinski's but lower than the unnamed IRS appraiser.

(Note that given the lower valuation by Burns—the IRS's expert—the Kresses knew at the outset of the trial that they were due a substantial refund even as they went into court.)

Both Emory and Burns tax-affected GBP's S corp earnings. Czaplinski avoided the tax-affecting question by using pre-tax multiples in her calculation. (It's unclear whether the IRS's initial appraiser tax-affected the earnings in his or her calculation.)

What the Court Found

The court found merit in many aspects of all of the appraisals, although it didn't agree with all of the conclusions of any of the four valuation analysts.

While the court slightly reduced Emory's discount for lack of marketability (DLOM) from 28 percent to 25 percent, it generally appreciated his initial valuation work, noting his understanding of the company and his overall analysis. In its discussion, the court didn't seem to mind his sole reliance on the market approach, noting that he "incorporated concepts of the income approach into his overall analysis."

The court also seemed to appreciate Burns' work, though it seemed slightly concerned that he used only two guideline companies in his appraisals. As for Czaplinski, the court didn't seem bothered by her lack of tax-affecting because it felt she had dealt with the issue appropriately and didn't find fault in her applying an S corp premium to reflect the tax advantages related to S corp status.

The court considered Emory's value of $21.60 per share, the IRS's value of $50.85 per share, Burns value of $40.05 per share, and Czaplinski's value of $25.06 per share. In the end, the court concluded the fair market value was $22.50 per share, only 4.2 percent higher than Emory's original value.

What It Means

This case is rife with valuation issues, from which equity adjustment model should be used to the treatment of non-operating assets, but tax-affecting rises to the top. By accepting tax-affected values without fuss, the court hinted at recognition that tax-affecting of pass-through entities is appropriate in valuation, acknowledging that there are tax consequences for pass-through entities that should be accounted for in valuations.

(It's worth noting that other Kress family members had likely been gifting stock for years using Emory's tax-affected valuations without IRS objection. Seamlessly accepting most of Emory's conclusions underscores this court's recognition that tax-affecting has merit.)

There is no doubt that this case leaves a cleft in the IRS's long-standing position on tax-affecting. While it is not a precedent-making decision—and the court didn't address tax-affecting in a larger sense in its ruling—*Kress* will be referenced by accountants, attorneys, and valuation analysts for years to come. This is especially true in the many ongoing cases where the IRS is arguing against tax-affecting and for a premium in the valuation of S corps relative to similar C corps.

Here, the taxpayer clearly won.

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Don't Want to Sell Yet?

Nearly 10,000 baby boomers turn age 65 every day. Many are in great health and look forward to a vibrant future. Some will continue to work, energetically leading their companies into the coming years.

Others would like to retire but hesitate to sell their companies when the economy is good and business is thriving.

What are the options for owners who want to retire while continuing to own the business? Here are some possibilities:

Consider a Leveraged Recap

This refinancing option involves partnering with a private equity firm to invest in the company, replacing the company's equity with a debt package secured by the future cash flows of the business.

The cash that the recap generates can be used to redeem owner shares, allowing him or her to unlock the illiquid value in the business while maintaining significant ownership.

Find a Future Buyer

Another option is to hire a highly qualified manager who will want to buy the company in a few years.

Finding the right person can be challenging, but the arrangement can be rewarding for both parties.

The owner gets to lighten his or her load, while the new manager gets to know the ins and outs of the business and has the responsibility of running it daily.

Eventually, ownership is transferred via a structured buyout.

Hire a Temporary Executive

Some owners like the idea of keeping the company for a few more years until the time is right to sell or the next generation is ready to take over.

This involves hiring a temporary executive to "babysit" the business, with active oversight from the owner.