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Valuation Issues and the* Kress *Case: How the Plaintiffs-Taxpayers Won a Judgment of Over $2.1 Million

Valuation of a minority share of stock in a private company can be as much of an art as it is a science.[1] Blindly following the numbers wherever they may lead—without accounting for variables such as changing economic conditions, company-specific circumstances, or other relevant information a reasonably informed hypothetical willing buyer and hypothetical willing seller in an arms-length transaction would consider[2]—will result in a skewed valuation. The math is important. But determining fair market value requires the valuation professional to exercise considerable judgment. The case of *Kress v. United States*, decided by the Eastern District of Wisconsin in March 2019, exemplifies this point.[3]

In *Kress*, two Wisconsin taxpayers gifted minority shares of Green Bay Packaging, Inc. ("GBP") stock and paid gift taxes on those gifts for tax years 2007, 2008, and 2009. They subsequently sued the Government for a gift tax refund totaling approximately $2.2 million. I was one of the attorneys who represented the Plaintiffs-taxpayers in the case.

Although the primary issue in the case was what was the fair market value of a minority share of GBP stock for the years in question, the outcome of the case was governed by the following five sub-issues: **(i)** how to account for GBP's S Corporation status; **(ii)** the appropriate discount for lack of marketability; **(iii)** the appropriate treatment of three so-called "non-operating" assets of GBP – an operating subsidiary; the value of key man life insurance policies; and corporate aircraft; **(iv)** the affect of the Great Recession that began in third quarter 2008; and **(v)** how to

[1] *See Estate of Ford v. Comm'r*, 1993 WL 501917, T.C. Memo 1993-580, at *4 (U.S. Tax Ct. 1993) ("The determination of the value of closely held stock is a matter of judgment, rather than of mathematics."), *aff'd*, 53 F.3d 924 (8th Cir. 1995).
[2] 26 C.F.R. § 25.2512-1.
[3] 382 F.Supp.3d 820 (March 25, 2019).

account for a family transfer restriction, which mandated that descendants of the original founder of GBP may gift GBP shares only to other family members.

These issues largely were litigated as a "battle of the experts." The Plaintiffs-taxpayers had two experts - John Emery, Sr. of Emory & Co., who had performed a yearly valuation of GBP stock since 1999; and Nancy Czaplinski of Duff & Phelps, whom the Plaintiffs retained in part to value the GBP stock using a separate income approach, to address the IRS's criticism that Mr. Emory used only a market approach. The Defendant United States' expert was Francis Burns of Global Economics Group in Chicago.

At the conclusion of a bench trial, the court granted the Plaintiffs-taxpayers almost the entirety of the gift tax refund they sought. This article explores how the respective valuation experts addressed the issues presented and how the court resolved them.

Issue 1: How to Account for S Corporation Status (& Whether to Apply a Separate S Corp Premium). There is no consensus in the case law or in the valuation community as to how to account for the S Corporation status of the subject company. Some cases and valuation professionals apply an S Corp marketability premium.[4] Other cases and valuation professionals apply an S Corp discount, to account for an S Corp minority shareholder's lack of control, or for an S Corp shareholder's additional risks, such as potential loss of S Corp status and the shareholder's income tax liability.[5]

[4] *E.g.*, *Estate of Jones v. Comm'r*, 118 T.C. Memo 143 (2019).
[5] *See Heck v. Comm'r*, 2002 WL 180879, 83 T.C.M. (CCH) 1181 (2002).

There also are divergent opinions regarding whether to "tax affect" to account for S Corporation status. A leading opinion issued over 20 years ago from the federal tax court concluded there should be no tax affecting.[6] However, a case decided several years later by the high court in Massachusetts permitted tax affecting, but observed there is doubt within the valuation community about the validity of doing so.[7]

The experts in *Kress* took different approaches to account for GBP's S Corporation status. Mr. Emory tax affected, but did not add a separate S Corp premium, due to a minority shareholder's lack of control. Mr. Emory accounted for the tax benefit associated with GBP's S Corporation status by adjusting downward his discount for lack of marketability.

Meanwhile, Mr. Burns tax affected, but then added back a separate S Corp premium. Mr. Burns believed tax affecting caused the business to be undervalued. He added the separate S Corp premium to account for the tax savings GBP realized due to its S Corporation status, which he asserted would be valuable to a hypothetical willing buyer of the corporation's stock.

To derive his premium, Mr. Burns modified the Van Vleet model. The Van Vleet model assumes an S Corporation distributes 100% of its net income. The model also assumes the S Corporation will maintain is S Corp status in perpetuity, which yields a 17.6% premium. Mr. Burns modified the Van Vleet model by assuming GBP's S Corporation status would last 12.5 years in the future, which yielded a premium between 6.8% and 7.8% for the tax years in question.

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[6] *Gross v. Comm'r.*, 1999 WL 549563, T.C. Memo 1999-254 (1999).

[7] *Bernier v. Bernier*, 873 N.E.2d 216 (Mass. 2007). Notably, since *Kress*, two cases have split on the question of whether to tax affect. *Raley v. Brinkman*, 2020 WL 4360053 (Tenn. Ct. App. July 30, 2020) (tax affecting); *but see R.D. Clark & Son, Inc. v. Clark*, 222 A.3d 515 (Conn. Ct. App. 2019) (no tax affecting).

The Plaintiffs contended Mr. Emory's approach was sound, while Mr. Burns' approach was not. They argued Mr. Emory's tax affecting allowed him to view GBP on par with his comparable company C Corps within his market approach, and his downward adjustment to his discount for lack of marketability was an appropriate way to account for GBP's tax savings as an S Corp.

In contrast, the Plaintiffs contended Mr. Burns' approach was hampered by methodological shortcomings. For starters, the Plaintiffs questioned whether it was appropriate for Mr. Burns to apply an S Corp premium at all. Although Mr. Burns testified he believed application of an S Corp premium is not controversial in the valuation community, the Plaintiffs introduced evidence and cited to case law to show S Corp premiums and treatment of S Corp status are controversial:

> [T]he valuation of an S corporation is an inexact science. . . . Compounding the difficulty in the case of an S corporation is the question whether, and how, to account for tax consequences. The matter has bedeviled the professional appraisers' community for some time. . . . While the [IRS] appears to have endorsed the practice of tax effecting an S corporation . . . both case law and professional scholarship have cast serious doubts on the validity of the practice.[8]

In addition, Mr. Burns' method for deriving his S Corp premium was suspect. The Van Vleet model assumes the subject S Corp will distribute 100% of its net income, but Mr. Burns admitted he did not know whether GBP did so. This was a significant methodological problem because of what Van Vleet says about his model:

> It cannot be overemphasized that the SEAM equation inherently assumes that the subject S corporation is expected to distribute 100 percent of its net income. If this is not the case, the SEAM may systematically overstate the value of S corporation equity.[9]

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[8] *Bernier*, 873 N.E.2d at 225-26.

[9] Van Vleet, *The S Corporation Economic Adjustment Model Revisited*, Income Tax Valuation Insights (Winter 2004).

So how did the court resolve the respective experts' competing views regarding how to account for GBP S Corporation status? The court rejected Mr. Burns' approach of applying a separate S Corp premium and determined GBP's S Corporation status had a neutral effect on the value of a minority share:

> Notwithstanding the tax advantages 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.[10]

<u>Issue 2: The Appropriate Discount for Lack of Marketability</u>. There was a large variance in the discount for lack of marketability ("DLM") the three experts applied. The following chart depicts this variance:

Year	**Emory DLM**	**Czaplinski DLM**	**Burns DLM**
2007	30%	20%	10.8%
2008	30%	20%	11.0%
2009	28%[11]	20%	11.2%

To underscore the effect of that variance, the Plaintiffs showed the court the fair market value determined by each expert both before and after application of their respective DLMs:

Year	**Emory (Before DLM)**	**Czaplinski (Before DLM)**	**Burns (Before DLM)**
2007	$40.00	$38.58	$43.05 [$3 > Emory]
2008	$37.00	$32.40	$31.25 [$6 < Emory]
2009	$30.00	$31.33	$45.10 [$15 > Emory]

Year	**Emory (After DLM)**	**Czaplinski (After DLM)**	**Burns (After DLM)**
2007	$28.00	$30.87	$38.04 [$10 > Emory]
2008	$25.90	$25.92	$27.81 [$2 > Emory]
2009	$21.60	$25.06	$40.05 [$18 > Emory]

[10] *Kress*, 382 F.Supp.3d at 836.
[11] Mr. Emory decreased his DLM for 2009 because of the company's stability, lack of debt, and apparent ability to survive the economic downturn.

The experts considered different information and applied different methods to derive their respective DLMs. In selecting his DLMs, Mr. Burns considered less information than Mr. Emory and Ms. Czaplinski, who considered a host of factors in selecting their respective DLMs. Mr. Burns considered a single restricted stock study and considered the cost of IPO, even though there was no evidence GBP would go public in the foreseeable future. For his part, Mr. Emory considered several restricted stock studies, his own IPO studies, and many company-specific factors. With respect to the latter, his familiarity with GBP helped. Mr. Emory had performed a valuation of GBP minority stock for eight consecutive years preceding the first tax year in question. In addition, before undertaking such a valuation, Mr. Emory had interviewed management each year to discuss its performance the preceding year and its plans for the coming year.

The court generally accepted Mr. Emory's DLMs, except adjusted them downward slightly to account for the family transfer restriction. The court's adjustment of Mr. Emory's DLMs based on the family transfer restriction will be discussed in greater detail below in association with Issue 5.

<u>Issue 3: The Appropriate Treatment of GBP's So-Called "Non-Operating" Assets</u>.

GBP had three significant so-called (by the IRS) "non-operating" assets:

(a) An operating subsidiary called Hanging Valley that holds assets but also contributes to income. Hanging Valley had assets valued between $65 million and $77 million and produced income of between $3.8 and $7.6 million for the tax years in question. Because GBP relied on Hanging Valley's income in its business operations, the Plaintiffs-taxpayers contended Hanging Valley actually was an operating asset.

(b) Key man life insurance policies with a net cash value of approximately $100 million.

(c) Two corporate aircraft with a business use value of approximately $11 million.

Again, the experts took differing approaches to the "non-operating" assets. Mr. Emory considered those assets to the extent they contributed to GBP's overall earnings. Ms. Czaplinski used a pre-tax multiple in her market approach to capture the value of the non-operating assets; under her income approach, she accounted for Hanging Valley's income or book value, the cash value of the life insurance, and 50% of the operating value of the aircraft. Finally, Mr. Burns valued the non-operating assets independently from GBP's operating financials, then added almost the full value of those assets back to GBP's market value of equity. By valuing the non-operating assets as he did, Mr. Burns was able to add back approximately $9.00 to $10.00 per share to his determined value of a minority share of GBP stock for each year.

The Plaintiffs contended Mr. Burns' manner of valuing the non-operating assets was not methodologically sound. For instance, a minority shareholder has no control over how the company manages those assets and does not realize the asset value for them unless and until they are sold. In addition, the literature Mr. Burns relied on as support for his valuing the non-operating assets at nearly their full value does not apply to valuing a minority share of stock. Rather, the literature discusses adding back the full value of non-operating assets when an ***entire business*** is being valued.

Ultimately, the court concluded Mr. Burns did not properly value the non-operating assets.[12]

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[12] *Kress*, 382 F.Supp.3d at 834-35.

Issue 4: The Effect of the Recession that Began in 3rd Quarter 2008. The fourth major sub-issue in the *Kress* case was whether the Great Recession that began in 2008 should be considered when determining the value of GBP stock for tax year 2009.

To discuss this issue, it is instructive to again revisit the values determined by each of the experts in the case:

Year	Emory	Czaplinski	Burns
2007	$28.00	$30.87	$38.04
2008	$25.90	$25.92	$27.81
2009	$21.60	$25.06	$40.05

As can be seen, the Burns value for 2009 is an outlier, increasing substantially over the prior year, while the Emory and the Czaplinski values decreased.

The explanation for this outlier is perhaps self-evident: Mr. Emory and Ms. Czaplinski both accounted for the recession in determining their respective values for 2009, while Mr. Burns did not specifically do so. Mr. Emory considered the recession and its effect on the price of equities in determining the value of GBP stock. Meanwhile, Ms. Czaplinski applied a company-specific risk factor within her income approach for 2009. In contrast, Mr. Burns adhered to a straight mathematical approach and "followed the numbers where they led him." Such an approach is inconsistent with law stating that valuation is as much as an art as a science and requires considerable judgment by the valuation professional.[13]

Mr. Burns' mathematical approach was further influenced by the comparable companies he chose for his market approach for tax year 2009. In his market approach, Mr. Burns used only two comparable companies to derive his market multiples, and one of those companies—Rock-

[13] *Kress*, 382 F.Supp.3d at 834; *see also Estate of Ford*, 1993 WL 501917, at *4.

Tenn—had an aberrant financial performance in 2008 because it acquired another company that year. Rock-Tenn's stock price increased 35% in 2008, while the stock prices of other comparable companies decreased approximately 34%.

The court concluded Mr. Burns' "attempt to maintain consistency throughout each tax year by applying multiples derived from Rock-Tenn's financial performance, despite the fact that Rock-Tenn was not an appropriate comparable for each year, led [Mr.] Burns to adhere to an approach that did not adequately account for the effect of the economic recession."[14]

Issue 5: The Kress Family Transfer Restriction. The final sub-issue was how to account for the Kress family transfer restriction. Pursuant to GBP's Bylaws, shares owned by Kress family members may be sold or gifted only to other members of the Kress family.

The Government challenged this restriction as not satisfying 26 U.S.C. § 2703(b). Section 2703(b) requires a transfer restriction to satisfy the following three requirements:

(1) The transfer restriction is a bona fide business arrangement;

(2) The transfer restriction is not a device to transfer property (upon death) at less than full and adequate consideration;

(3) The transfer restriction is comparable to similar arrangements entered into by persons in an arms' length transaction.

The court concluded two out of these three criteria were satisfied. It held the family transfer restriction is a bona fide business arrangement because: (a) it ensures the Kress family retains control of GBP; (b) it minimizes risk of disruption by a dissident shareholder; (c) it ensures confidentiality of GBP's affairs; and (d) it ensures all sales of GBP's minority stock are to qualified

[14] *Kress*, 382 F.Supp.3d at 834.

subchapter S shareholders. Next, the court held that the second criterion applies only to gifts upon death, not *inter vivos* gifts.

However, the court concluded the Plaintiffs did not satisfy the third criterion of Section 2703(b), *i.e.*, the Plaintiffs did not admit sufficient evidence that the family restriction was similar to other arrangements in arms' length transactions.

Based on its evaluation of the Kress family transfer restriction and how it applies to the Section 2703(b) criteria, the court concluded that, even though Mr. Emory said the family transfer restriction did not matter very much to the DLM he applied, any consideration of the family transfer restriction was not appropriate because not all three criteria in Section 2703(b) were satisfied.[15] The court, therefore, reduced Mr. Emory's DLMs by 3 percentage points in each of the three years to 27%, 27%, and 25%.[16]

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The Verdict. Based on its reduction of Mr. Emory's DLMs, the value of a minority share of GBP stock in the tax years in question as determined by the court were slightly higher than Mr. Emory's per share value:

Year	**Emory**	**Court**
2007	$28.00	$29.20
2008	$25.90	$27.01
2009	$21.60	$22.50

The value of a share of GBP stock for the tax years at issue as determined by the court resulted in a judgment in favor of the Plaintiffs-taxpayers for approximately $2.1 million, plus approximately $450,000 in interest.

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[15] *Id.*
[16] *Id.*

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