Kress v. United States of America—All Experts Consider Private Company's S Corporation Income Tax Status

Thomas M. Eichenblatt

This discussion considers the recent decision issued by the United States District Court of the Eastern Division of Wisconsin in Kress v. United States of America*. Specifically, this discussion describes (1) the main topics of the case and (2) the District Court's conclusion that the company's S corporation income tax status was merely a neutral factor in the valuation of a noncontrolling interest in the company common stock.*

Introduction

On June 24, 2016, James F. Kress and Julie Ann Kress (the "plaintiffs") sued the U.S. government, demanding a refund of the gift taxes and interest paid related to the plaintiff's series of gifts to their children and grandchildren of the noncontrolling stock (the "subject interests") of Green Bay Packaging, Inc. ("GBP"), an S corporation. The case, styled as *Kress v. U.S.*, was heard in the District Court of the Eastern Division of Wisconsin (the "District Court").[1]

The plaintiffs claimed that the subject interests were erroneously assessed by the Internal Revenue Service (the "Service") for the 2007, 2008, and 2009 tax years (the "disputed tax years"). The plaintiffs requested that the court decide the fair market value of the subject interests as of December 31, 2006; December 31, 2007; and December 31, 2008 (the "valuation dates"). A trial was held on August 3 and 4, 2017 (the "trial dates").

The judicial decision in *Kress v. U.S.* caught the attention of the valuation profession. That is because all valuation analysts in the case—both the taxpayer experts and the government expert—included quantitative and qualitative adjustments for the S corporation status of GBP when they estimated the fair market value of the subject interests.

The District Court decision, as well as the government's position in the case, recognize that there are income tax implications for S corporation entities—as compared to C corporation entities—that may be considered in a private company business valuation.

Background of the Case

GBP is a family-owned S corporation headquartered in Green Bay, Wisconsin. Founded in 1933, GBP is a vertically integrated manufacturer of corrugated packaging, folding cartons, coated labels, and related products. As of the trial dates, GBP employed approximately 3,400 people in 14 states.

As of the valuation dates, approximately 90 percent of the GBP shares of common stock were owned by the Kress family, and the remaining 10 percent were owned by the GBP employees and directors. Between 1990 and 2009, GBP paid annual dividends ranging from $15.6 million to $74.5 million to its shareholders.

According to the GBP bylaws, the purchase price for shares sold by GBP to its employees and directors is 120 percent of the book value of each share. For shares that are transferred to and from members of the Kress family, there is no legally binding buysell agreement stipulated price. However, certain restrictions set forth in the GBP bylaws do limit the ability of a GBP shareholder to sell both family shares and nonfamily shares of GBP stock.

The right-of-first-refusal restriction contained in the GBP bylaws requires that an employee or director shareholder give GBP written notice of his or her intent to sell and offer to sell that share to GBP before selling that share to others (i.e., a right of first refusal).

The GBP bylaws also contain a family transfer restriction (the "family transfer restriction clause") that limits how the members of the Kress family may transfer their shares. The family transfer restriction clause states as follows:

> Transfer of shares of the Corporation by shareholders who are members of the Kress Family . . . is hereby restricted to transfers by gift, bequest or private sale to a member or members of the Kress family, provided, however, that the children of George and Marguerite Kress may transfer shares of the Corporation by gift to such child's spouse or trust therefor and further provided that in the event of any such transfer as above provided to issue and descendants or spouse of a child or trust therefor of George and Marguerite Kress, that all of the restrictions set forth herein shall continue to be applicable to the shares of common stock then held by such issue and descendants or spouse or trust therefor as transferee.

The family transfer restriction clause requires that the Kress family only gift, bequest, or sell their shares to other members of the Kress family.

The plaintiffs maintained that the family transfer restriction clause ensured that the Kress family retained control of GBP, minimized the risk of disruption to the GBP affairs by a dissident shareholder, ensured confidentiality of the GBP affairs, and ensured that all sales of GBP minority stock are to qualified S corporation shareholders.

As part of their respective estate planning procedures, most senior Kress family members would annually gift equal amounts of GBP stock to the younger members of their families, such as the plaintiffs. From 1997 to the trial dates, no junior member of the Kress family had gifted GBP shares to a more senior member of the Kress family, and there were no transfers of GBP shares between senior members of the Kress family.

The plaintiffs gifted noncontrolling blocks of GBP common stock to their children and grandchildren during the disputed tax years. The plaintiffs gifted common stock shares at the following share prices:

- Tax year 2007 – $28.00 per share
- Tax year 2008 – $25.90 per share
- Tax year 2009 – $21.60 per share

The plaintiffs each paid $1,219,241 in gift tax with respect to the gifted shares, for a combined amount of $2,438,482.

On November 10, 2010, the Service challenged the amounts reported by the plaintiffs on their gift tax returns. On August 19, 2014, the Service sent the plaintiffs a statutory notice of deficiency for each of the disputed tax years.

The Service found that the fair market value of the subject interests equaled the price used for actual share transactions between GBP and its employees, at the following share prices:

- Tax year 2007 – $45.97 per share
- Tax year 2008 – $47.63 per share
- Tax year 2009 – $50.85 per share

Exhibit 1 compares the original share prices and the share prices determined by the Service.

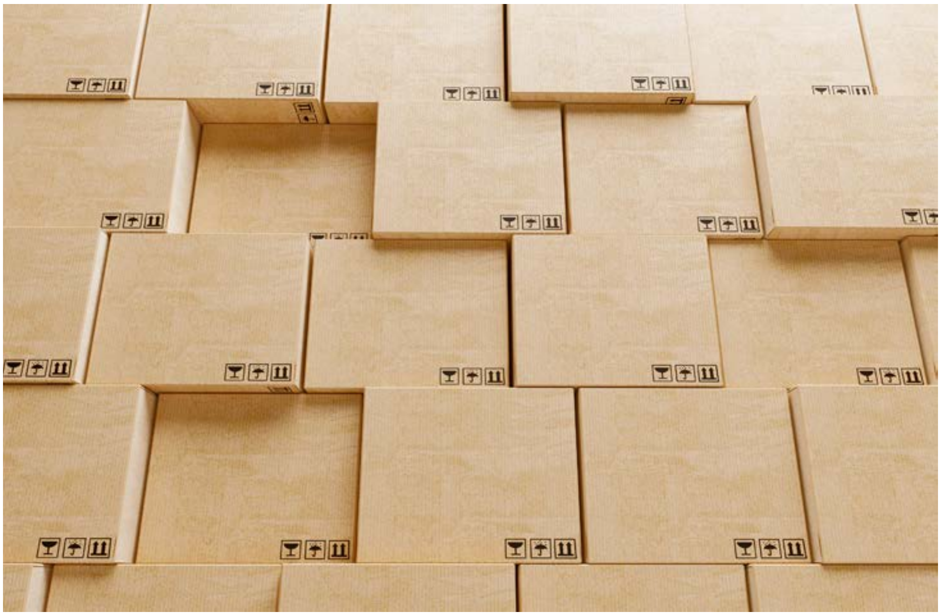
Exhibit 1
Fair Market Value of a Noncontrolling Share of GBP

Tax Year	Taxpayer Value ($)	Service Value ($)	Percentage Value Difference (%)
2007	28.00	45.97	64.18
2008	25.90	47.63	83.90
2009	21.60	50.85	135.42

As presented in Exhibit 1, the Service claimed that the actual fair market value of the subject interests were between 64.18 percent and 135.42 percent higher than the fair market value reported by the plaintiffs.

The plaintiffs paid the gift tax deficiencies and accrued interest in December of 2014, based on the Service audit findings, and then the plaintiffs filed amended gift tax returns for the disputed tax years seeking a refund for the additional federal taxes and interest they paid.

After six months without receiving a response from the Service, the plaintiffs initiated the *Kress v. U.S.* action on June 24, 2016.



The GBP group life insurance policies on key employees and shareholders had substantial cash surrender values. The cash surrender value of the GBP group life insurance policies, less the associated corporate liabilities of deferred compensation and nonqualified pension obligations during the disputed tax years, were as follows:

- Tax year 2007 – $86.0 million
- Tax year 2008 – $104.2 million
- Tax year 2009 – $111.4 million

GBP identified the cash surrender value of the life insurance as a nonoperating asset.

GBP owned two private aircraft during the disputed tax years. On average, the planes were used half of the time for GBP business and half of the time for the Kress family personal travel. The GBP cash flow projections categorized a portion of the aircraft as nonoperating income and expenses.

Description of Green Bay Packaging, Inc.

The following information summarizes the GBP financial position during the disputed tax years.

GBP Balance Sheet Information

GBP had a strong balance sheet during the disputed tax years, with little debt compared to its recorded book value of equity. GBP had three nonoperating assets during the disputed tax years:

1. Hanging Valley Investments, LLC ("HVI")
2. Group life insurance policies
3. Two private airplanes

HVI is a wholly owned subsidiary of GBP that was created in 2005 to manage the GBP long-term investments. During the disputed tax years, HVI had investments in mezzanine financing obligations, private equity funds, real estate investment funds, gas, oil, and other commodities. HVI contributed capital to GBP through appreciation of—and sale proceeds from—these investments. GBP used these capital contributions for core operations and for paying dividends.

During the disputed tax years, HVI had the following asset values:

- Tax year 2007 – $65.0 million
- Tax year 2008 – $71.5 million
- Tax year 2009 – $77.3 million

GBP identified HVI as a nonoperating asset and its cash flow as nonoperating income.

GBP Income Statement Information

From 2002 to 2008, the GBP net sales increased. The GBP net income increased overall from 2005 to 2008. In 2007, net income decreased by over $28 million, but increased in 2008 by $33 million. The decrease in net income was due to extraordinary costs incurred for maintaining a mill in Arkansas.

GBP management never considered terminating its S corporation status during the disputed tax years. During a management presentation in May of 2007, GBP management reported that they expected to save approximately $238.4 million in income taxes between 1988 and 2006 due to their S corporation tax status.

Valuation Analyst Opinions of the Fair Market Value of the Subject Interests

The plaintiffs engaged John Emory ("Emory") and Nancy Czaplinski ("Czaplinski") as testifying valuation analysts to opine on the fair market value of the subject interests as of the valuation dates. The government engaged Francis Burns ("Burns") as a testifying valuation analyst.

Each of the analyst opinions is discussed below.

Valuation Analysis by John Emory

Emory had been repeatedly engaged to prepare valuations for GBP since 1999. This history of prior valuation assignments included the valuations for the subject interests that were relied on by the plaintiffs in their original gift tax return filings.

Emory relied on the market approach for each of the valuation dates when estimating the fair market value of the subject interests. Emory did not rely on the income approach in his analyses.

Instead, he testified that the market approach was the better methodology to apply. That is because there were a sufficient number of comparable guideline publicly traded companies for each of the valuation dates.

Emory reviewed his prior GBP valuation reports, audited GBP financial statements, and projected GBP financial statements during each of his analyses. He also met with GBP management to discuss the current and future performance of GBP.

Emory selected five to six guideline publicly traded companies for each of the valuation dates. He then derived pricing multiples using a ratio of market value of invested capital to earnings before interest, taxes, depreciation, and amortization ("EBITDA"). By relying on pretax earnings metrics, Emory accounted for the GBP S corporation status.

Emory considered the nonoperating assets (previously discussed) to the extent that those assets contributed to the GBP earnings. He did not add their overall value back into the value of the subject interests, based on the premise that a noncontrolling shareholder in GBP could not realize the value of those assets.

Emory also accounted for the 2008 recession by excluding a guideline company for that year's analysis that was an outlier due in part to an acquisition.

Emory concluded his analysis by applying a discount for lack of marketability ("DLOM") to reflect the illiquidity of the subject interests.

Emory considered the following items in his selection of his DLOM:

- Restricted stock studies
- Pre-initial-public-offering studies
- The financial position of GBP as of the valuation dates
- The historical payment of dividends
- GBP's management expertise
- The possibility of any future initial public offering
- GBP's status as an S corporation

Emory did not quantify the effect of these factors on the selection of his DLOMs.

Emory stated that he also considered the family transfer restriction clause in his selection of DLOMs but noted that it did not have a significant effect on his final DLOM selections.

Emory applied a 30 percent DLOM for tax years 2007 and 2008, and a 28 percent DLOM for tax year 2009. His DLOMs were the highest of those used by the three experts in the case, but lower than the DLOMs applied in his previous work for GBP.

The Service took fault with Emory's lack of income approach analysis. In order to account for this, the plaintiffs engaged Czaplinski to prepare a valuation report for the subject interests as of the valuation dates using a combination of the market approach and the income approach.

Valuation Analysis by Nancy Czaplinski

Czaplinski estimated the following fair market values for the subject interests as of each of the valuation dates:

- Tax year 2007 – $30.87 per share
- Tax year 2008 – $25.92 per share
- Tax year 2009 – $25.06 per share

In contrast to Emory, Czaplinski applied both the market approach and the income approach in her analysis of the subject interests.

In the Czaplinski market approach analysis, she selected price-to-pretax income as the pricing multiple, and she used pretax income to capture:

1. the noncontrolling nature of the stock at issue,
2. the value of the nonoperating assets, and
3. the GBP S corporation status.

Czaplinski selected the lowest pricing multiple of the selected guideline publicly traded companies for each of the valuation dates due to the lower revenue and lower asset base of GBP compared to the selected comparable guideline publicly traded companies.

In the Czaplinski income approach analysis, she applied the capitalized economic income method and the discount dividend method. She accounted for the value of the nonoperating assets (previously discussed) by adding those values to the income approach method value indications.

In order to account for the GBP S corporation status in the capitalized economic income method, Czaplinski adjusted the discount rate in the base cost to reflect an equivalent after-corporate-tax and after-personal-tax return. Under the discount dividend method, she applied a tax rate based on three- and five-year averages and on the prior year effective date.

Czaplinski applied a company-specific equity risk factor to the income approach calculations in order to account for the 2008 recession in her December 31, 2008, analysis.

Czaplinski weighted the market approach 14 percent and the income approach 86 percent when concluding her aggregate value for the subject interests as of each of the valuation dates. She then applied a DLOM of 20 percent for each of the valuation dates.

When selecting her DLOM adjustment, Czaplinski considered company and industry characteristics, including the family transfer restriction clause and the GBP S corporation status. She stated that neither the family transfer restriction clause or the S corporation status affected the DLOM selection.

Valuation Analysis by Francis Burns

The government retained Burns to estimate the fair market value of the subject interests as of the valuation dates. Burns concluded the following fair market values for the subject interests as of each of the valuation dates:

- Tax year 2007 – $38.40 per share
- Tax year 2008 – $27.81 per share
- Tax year 2009 – $40.05 per share

Burns estimated the fair market value by using both the market approach and the income approach.

In the Burns market approach analysis, he analyzed enterprise-value-to-EBITDA pricing multiples and price-to-earnings pricing multiples for comparable guideline publicly traded companies. After selecting and applying the multiples to the GBP financial data, Burns applied an S corporation tax premium to account for GBP's tax advantages as an S corporation.

He also added back the nonoperating assets to reach an indicated value of GBP common stock. Burns did not identify an adjustment in his analysis that accounted for the 2008 recession. That is because he considered GBP to be in good financial condition as compared to its creditors. He testified that he simply, "followed the numbers where they led him."

In the Burns income approach analysis, he applied a capitalized cash flow analysis instead of a discounted cash flow analysis because GBP did not prepare long-term financial projections. Burns determined a normalized level of income from operations. He then applied an effective C corporation income 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.

His analysis also included a normalized level of capital expenditures, and he capitalized the earnings based on a perpetuity growth rate of 4.9 percent for each year.

He then added back the S corporation premium to account for the tax advantages associated with S corporation status. Burns also added back the value of the nonoperating assets previously discussed.

The Court's Opinion on the Valuation Reports

The District Court reviewed all the valuation reports and expert testimony in order to conclude the final value of the noncontrolling ownership interest.

The District Court found the valuation methods of Emory to be the most sound of the three experts. The Court found that Emory more adequately:

1. used projections that were more accurate due to his deep knowledge of GBP and
2. considered the effects of the recession of 2008.

The District Court concluded that Emory did not create his valuations with the benefit of hindsight or for the purposes of the litigation. The District Court found that Emory provided credible and thorough valuations that supported the fair market value of the subject interests that the plaintiffs reported on their original gift tax returns.

However, the District Court found that it was inappropriate of Emory to consider the family transfer restriction clause in his selection of DLOMs.

The District Court concluded that Burns overstated the value of the subject interests. The District Court took issue with the fact that Burns did not consider the effects of the 2008 recession and included an outlier comparable company in his market approach for the 2008 tax year. The court took issue with the fact that Burns only relied on two comparable companies for his market analysis, one of which was the outlier comparable company previously discussed.

The District Court also took issue with how Burns valued the nonoperating assets of GBP. In his analysis, Burns separated out the nonoperating assets and valued them separately, then added their value to the overall value of the operating company.

The court stated that a valuation analyst should only add back the value of the nonoperating assets when valuing a controlling ownership interest in a company, not when valuing a noncontrolling ownership interest. This is because a noncontrolling ownership interest has no control over how the nonoperating assets are used and cannot realize the value of the assets until the company is sold.

The District Court also concluded that the Burns selection of DLOMs were unreasonably low. The court took issue with the fact that Burns applied lower discounts to GBP than he applied to a limited partnership that held marketable securities in a prior case, which the court considered to be a much more liquid investment compared to the subject interests.

Finally, the District Court took issue with the S corporation premium that Burns included in his analysis. Burns assessed a premium to account for the tax advantages associated with S corporation status, including single-level taxation. Both Emory and Czaplinski did not consider the GBP S corporation status to be a benefit that would add value to the subject interests because, in their opinions, a noncontrolling interest cannot change GBP's S corporation status.

The District Court found the GBP S corporation status to be a neutral consideration with respect to the valuation of its noncontrolling stock. The District Court recognized that there are also noted disadvantages of being an S corporation, such as the limited ability to reinvest in the company and the limited access to credit markets.

The District Court found it was unclear whether a noncontrolling interest holder enjoys those benefits.

The District Court rejected both the Service's value determined in the November 2010 audit, as well as the value estimated by the Service's expert, Burns. The District Court found that while it agreed with most of the Emory analysis, it disagreed with the DLOMs Emory applied. Therefore the court adjusted the DLOMs applied in the Emory analysis to be 27 percent in 2007 and 2008, and 25 percent for 2009. This was a 3 percent decrease in the DLOMs used by Emory. Exhibit 2 presents the values determined by each of the parties, as well as the final values selected by the Court.

Exhibit 2
Fair Market Value of a Noncontrolling Share of GBP Summary of Opinions

Year	Emory	Czaplinski	Service	Burns	Court
2007	$28.00	$30.87	$38.04	$45.97	$29.20
2008	$25.90	$25.92	$27.81	$47.63	$27.01
2009	$21.60	$25.06	$40.05	$50.85	$22.50

Summary and Conclusion

The District Court concluded that Emory's original analysis provided the best fair market value indications for the subject interests as of the valuation dates. The District Court took issue with the Burns market approach due to his lack of consideration of the 2008 recession, his inclusion of the value of the nonoperating assets, and his low DLOM selections.

During this case, the District Court focused on how the analysts considered the effects of the 2008 recession, the consideration of the family transfer restriction clause, and the consideration of the GBP S corporation status. The District Court accepted Emory's analysis, which relied on pretax pricing multiples and DLOMs that considered the GBP S corporation status.

Additionally, the government relied on an expert witness who also incorporated qualitative and quantitative adjustments for the GBP S corporation status. The District Court did not find aspects of the Burns analysis to be as persuasive as the Emory analysis.

The subject interests in this case were a noncontrolling equity interest in GBP. The noncontrolling equity holder cannot change the company's S corporation income tax status. Accordingly, the District Court concluded that the GBP S corporation income tax status was merely a "neutral" factor in the gift tax valuation of the GBP noncontrolling common stock.

Note:

1. Kress v. United States, --- F.Supp.3d --- 2019 WL 1352944 (E.D. Wis. 2019).

Thomas Eichenblatt is an associate in our Atlanta practice office. He can be reached at (404) 475-2320 or at tmeichenblatt@willamette.com.