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Letter to the Editor:
Response to a Reader's Comments Concerning the *Kress* Case

Editor's note: The Kress *case has received a great deal of attention on a number of valuation fronts, most notably that both the taxpayer and the government tax affected the earnings of the subject S corp. This letter is a response to comments made by an IRS analyst that are in the accompanying sidebar. Please note that the author of this letter is only providing a summary, and this is not intended to be a detailed valuation method.*

I'm responding to IRS analyst Fuhrman's comments that appeared in the June 26, 2019, *BVWire* regarding the *Kress* case[1] and his reference to the *Gallagher v. Commissioner* ruling. He and the Tax Court are right: "[T]he principal benefit enjoyed by S corporation shareholders is the reduction in their total tax burden, a benefit that should be considered when valuing an S corporation" (quoting *Gallagher v. Commissioner*).

The traditional cash flow valuation model is C corporation-centric. Unfortunately, using this model to value S corporation ownership interests doesn't properly reflect the "total tax burden."

With the preceding as a foundation, I will identify the impact of three significant tax issues that differentiate C corporation cash flows and values from S corporation cash flows and values:

- The income tax liability associated with entity income;
- Personal dividend taxes; and
- Personal capital gain taxes.

Numerous market-based studies support consideration of the elements identified in the preceding paragraph.

Beginning with the income tax liability, the traditional C corporation cash-flow model identifies the income tax liability associated with entity income as an expense item. Logically, recording the expense appropriately reduces net income, cash flow, and the value of the subject C corporation ownership interest.

In contrast, there is no federal income tax expense on an S corporation operating statement, which increases net income relative to an otherwise comparable C corporation. Sometimes analysts incorrectly assume the absence of the S corporation income tax expense increases cash flow and value available to the subject S corporation ownership interest. However, knowledgeable investors (with the word "knowledgeable" deliberately being taken from the federal definition of fair market value) will recognize that the income tax liability associated with S corporation income should be recognized as a capital account adjustment (which I call the "tax distribution") on the lower portion of the cash flow model. This additional entry is not part of the

1 A digest of *Kress v. United States*, 2019 U.S. Dist. LEXIS 49850; 2019 WL 1352944 (March 26, 2019), and the court's opinion are available at *BVLaw* (bvresources.com/products/bvlaw).

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traditional C corporation cash flow model, so it might be overlooked by an analyst.

Some analysts have chosen to not modify the traditional cash-flow model and incorrectly recognize the tax liability associated with S corporation income as a fictitious expense on the income statement portion of the cash-flow model. The Tax Court has vigorously rejected this "fictitious corporate tax" (quote from *Gross v. Commissioner* and *Gallagher*). Nonetheless, the adverse impact on value attributed to the income tax liability associated with S corporation income should otherwise be recognized by modifying the cash-flow model. Otherwise, the value of the S corporation interest will be overstated.

To justify modifying the traditional C corporation cash-flow model, analysts will recognize that the conduit for paying (i.e., the C corporation entity or the S corporation owner) the tax liability to the government is irrelevant: Satisfaction of the income tax liability associated with entity income reduces cash flow and the value of the subject ownership interest. To recognize the absence of value created by the tax distribution, the traditional C corporation cash-flow model must be modified and the distribution must be subtracted to reflect the cash flow available to the subject ownership interest.

The second element of the "total tax burden" that should be considered is the potential for dividend taxes.

When dividends are paid to a C corporation owner, the owner incurs a personal dividend tax. In contrast, an S corporation owner will benefit from the avoidance of personal dividend taxes associated with capital account distributions in excess of the income tax distribution (which I call "excess distributions"). This burden for a C corporation owner is actually a benefit for the S corporation owner and should be considered.

The third element of the "total tax burden" that should be considered is the capital gain tax liability associated with eventual sale of the two entities' ownership interests.

The capital gain tax associated with the sale of a C corporation security is based on the original purchase price of the security. In contrast, the taxable basis of an S corporation security may increase if excess distributions are not paid to owners and are instead retained by the entity. If the S corporation's taxable basis increases over the life of ownership, the owner's personal capital gain tax liability will decrease relative to an otherwise similar C corporation ownership interest. As with the avoided divided tax burden discussed above, the avoided capital gain tax burden should be considered when valuing an S corporation ownership interest.

To summarize, I agree with Fuhrman and the Tax Court. Yet I believe the court has failed to recognize the "total tax burden" should consider not just C corporation income taxes, but also personal income taxes, personal dividend taxes, and personal capital gain taxes. Again,

Reader Comment on *Kress* Case Coverage

Responding to the attention the *Kress* case has received (at BVR and elsewhere), Harry Fuhrman, financial analyst with the Internal Revenue Service, gave us the following comments. (Note that this represents his opinion and not that of the IRS.)

"In the excitement surrounding the *Kress* case (tried in the Eastern District of Wisconsin, not in tax court), let us not forget the many other tax court cases which address the issue of whether or not to tax affect a pass-through entities' earnings:

- *"Gross v. Commissioner;*
- *"Wall v. Commissioner;*
- *"Rubin v. Commissioner;*
- *"Heck v. Commissioner;*
- *"Dallas v. Commissioner;* and
- *"Gallagher v. Commissioner.*

"The last decision included the following statement: '[T]he principal benefit enjoyed by S corporation shareholders is the reduction in their total tax burden, a benefit that should be considered when valuing an S corporation,' which addresses the pass-through taxation directly, whereas the court in the *Kress* decision, on the other hand, did not even directly address the tax-affecting issue.

"If the government and taxpayer's appraisers hadn't tax affected earnings, I suspect the decision would not be receiving the level of attention you (and other valuation organizations and individuals) have been devoting to it."

Source: *BVWire* Issue No. 201-4, June 26, 2019. Digests and the full court opinion of most of the cases mentioned are available at *BVLaw* (bvresources.com/products/bvlaw).

numerous market-based studies support my position.

When the "total tax burden" is properly considered, an S corporation ownership interest might have greater value than a C corporation interest, but it will not be associated with ignoring the income tax liability associated with the S corporation's income. The S corporation value benefit is more likely to be a function of avoided dividend and capital gain taxes.

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