

T&E Alert

Robert Dallas v. Commissioner U.S. Tax Court T.C. Memo 2006-212 filed September 28, 2006

The tax-affecting of S corporation income has, again, tripped some distinguished business appraisers in tax court. Tax-affecting refers to reducing S corporation income by C corporation taxes when discounting or capitalizing such income and thus determining value. Ever since Gross [T.C. Memo 1999-254, aff'd 272 F.3d 333 Sixth Circ. 2001;] Heck [T.C. Memo 2002-34 filed 2/5/02] and Adams [T.C. Memo 2002-80 filed 3/28/02] the tax court is clearly on record as prohibiting tax-affecting S corporation income. At the time, the Court was contradicting the accepted wisdom of most business appraisers. By now, we appraisers have had the time to develop acceptable techniques to value S corporations based on - generally non-tax affected - income approaches. After all, S corporations do not pay a federal entity income tax, and that alone has value unless the S corporation status is likely to change.

In Dallas, a profitable manufacturer and distributor of chemicals was paying its owners high salaries, and it had elected S-corporation status. The issue was the value of the stock for gift tax purposes. Two appraisal firms hired by the petitioner did tax-affect for C corporate tax, reasoning that the firm would most likely be sold to a C corporation. The firm hired by the Service did not tax-affect, and, accordingly, was found more credible by the Court. All appraisers did normalize salaries, and applied lack of control and marketability discounts. The Court pointed out that it could find no evidence that the S corporation status was likely to be lost, and found for the Service. Comparisons with an ESOP or a fair value environment, which one firm brought up, are invalid because such valuations refer to different standards than the fair market value standard used for tax matters.

The decision is available at
<http://www.ustaxcourt.gov/InOpHistoric/Dallas.TCM.WPD.pdf> or at
<http://www.NYNJCT-BV.com/Dallas.TCM.WPD.pdf>

Do not hesitate to call or e-mail to discuss this or any other valuation issue.

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October 2, 2006