Mack Business Appraisals, LLC

Dallas v. Commissioner, TC Memo 2006-212, September 28, 2006

The Facts: Mr. Dallas sold non-voting shares of Dallas Group of America, Inc. ("Dallas Group") stock to his two sons in 1999 and 2000 for cash and notes receivable. Each party agreed to be bound by an independent valuation for the sales price of the stock. The notes for the 1999 sale from Mr. Dallas to his sons were self-cancelling on the death of Mr. Dallas.

The Arguments:

The Court argued that intra-family transfers are presumed to be gifts unless evidence can overcome this presumption. The IRS argued that the sales were bargain sales and, therefore, gifts. The Court concluded that the stock sales were not arm's length transactions due to the following:

1. Both the 1999 and 2000 sales contained share adjustment clauses showing the transactions were specifically for estate tax purposes.
2. The sons were not represented by their own counsel and did not negotiate the agreement terms.

The Findings:

The taxpayer's appraiser in the original transaction had issued a restricted letter report. An additional appraiser was engaged by the taxpayer for trial testimony. The court was critical of the second appraiser's report because it literally copied portions of the first appraiser's report. Furthermore, the Court found that the second appraiser was not even familiar with his firm's report at trial.

The first appraiser tax-affected S corporation earnings using a 40% tax rate and the second appraiser used a 35% tax rate. The testimony of the taxpayers appraisers was that they both tax-affected the earnings under the assumption that Dallas Group would lose its S Corporation status after or as a result of the hypothetical sale of its stock.

The Court stated there was no evidence that the Dallas Group expected to lose its S Corporation status. Furthermore, the Court noted that the Dallas Group had a history of distributing sufficient cash for the shareholders to pay their taxes on their share of S Corporation earnings and there was no evidence that this practice would change.

The first taxpayer appraiser testified that:

1. He has tax-affected S corporation earnings for 20 years.
2. An informal poll at a recent conference showed 90% to 95% of responding appraisers' tax-affect corporation income.

3. The ASA rejects any application for certification if the report is submitted for review without tax-affecting S corporation earnings.
4. The appraisers experience is all bankers, investment bankers and business brokers tax-affect S corporation earnings in their calculations.
5. The appraisers firm tax-affects S corporation earnings for ESOP plans submitted to the Department of Labor.

The Court gave little weight to his testimony. The IRS appraiser stated his own reports for ASA certification had been accepted without tax-affecting. The testimony regarding ESOP plan valuation for the Department of Labor was unconvincing as there was no evidence that their definition of value was the same as fair market value for tax purposes. The Court said, "We conclude there is insufficient evidence to establish that a hypothetical buyer and seller would tax-affect the Dallas Group's earnings and that tax-affecting the Dallas Group's earnings is not appropriate."

The Court rejected any additional discount for the non-voting stock status of the minority interests transferred but determined there should be a 20% discount for lack of marketability.

The taxpayer asked to reform the 1999 notes, claiming the self-cancelling clauses were a mistake in the original draft. The Court rejected this argument and accepted the IRS appraiser's valuation.

<u>Parting Thoughts:</u>

Another case in which the tax affecting of S-corporation earnings comes into play. This has been a huge area of controversy with most experienced appraisers feeling that S-corporation earnings should be tax affected…but many differ as to the exact way to tax affect the earnings. The debate will continue…