

# KTS, INC.

## VALUATION ISSUES™

KLARIS, THOMSON & SCHROEDER, INC.

2020-1

### *Featured Article* **Kress vs United States, March 25, 2019**

*Prepared by:*  
*Mr. John A. Thomson, ASA, MAI*



Kress District  
Court Decision  
Case No. 16-C-795  
March 25, 2019

*P r e l u d e :*  
Klaris, Thomson  
& Schroeder, Inc. (“KTS”) reviewed the opinion with an eye toward the opinion’s discussion of tax affecting in a business valuation of an “S” corporation.

Some appraisers are now citing the Kress decision as support for tax affecting. This is contrary to the long standing IRS position of not affecting based on the 1999 Gross decision which was affirmed by the Court of Appeals in 2001.

An “S” corporation pays no Federal corporate tax (0). Therefore using a corporate tax to affect a valuation of an “S” corporation merely lowers the valuation conclusion for a fictional tax.

So did the court decision provide

guidance on tax affecting? Because both the taxpayer’s expert and the IRS expert did tax affect there was NO affirmative support or discussion of why to tax affect or not tax affect. The opinion did strike down the IRS expert of adding back a premium to account for the “S” corporation tax benefits.

#### **BACKGROUND**

Plaintiffs are shareholders in Green Bay Packing (GBP), a family-owned subchapter S-corporation with its corporate headquarters in Green Bay, Wisconsin. Founded in 1933 by George Kress, GBP is a vertically integrated manufacturer of corrugated packaging, folding cartons, coated labels, and related products. At the time this case was filed, GBP employed approximately 3,400 people in 14 states. Although GBP has the size and wherewithal to be a publicly-traded company, it has remained the closely held family company its

founder envisioned. Approximately 90% of the company’s shares of common stock are owned by the Kress family, and the remaining 10% are owned by GBP’s employees and directors. Between 1990 and 2009, GBP paid annual dividends, ranging from \$15.6 million to \$74.5 million, to its shareholders each year.

The purchase price for shares sold by GBP to its employees and directors is 120% of the book value of each share. While there is an established price for the sale and purchase of GBP shares by employees and directors, there is no price established for shares that are transferred to members of the Kress family.

#### **GREEN BAY PACKAGING**

GBP is an established company with a strong balance sheet and has little debt compared to its equity as

*(continued on page 2)*

of the valuation dates. From 2002 to 2008, GBP's net sales increased. GBP's net income increased overall from 2005 to 2008. In 2007, its net income decreased by more than \$28 million but rebounded in 2008 by more than \$33 million. The drop in GBP's net income was caused primarily by the extraordinary costs incurred for maintaining GBP's Arkansas Mill. Recognizing the value of the S-corporation structure, GBP did not seriously consider terminating its S-corporation election as of the valuation dates. In a May 2007 presentation, GBP management reported to their shareholders that they expected to save a total of \$238.4 million in taxes between 1988 and 2006 by virtue of classifying as an S-corporation.

GBP has three non-operating assets: Hanging Valley Investments LLC, Hanging Valley, group life insurance policies, and two GBP private airplanes. Hanging Valley Investments LLC is a wholly-owned subsidiary of GBP that was created in 2005 to manage GBP's long-term investments. During the relevant time period Hanging Valley had investments in mezzanine financing obligations, private equity funds, real estate investment funds, gas, oil, and other commodities. Hanging Valley contributes to GBP through appreciation of its investments which GBP uses for operations and to pay dividends. During the years in question, Hanging Valley's assets were \$65,002,000.00 on December 31, 2006; \$71,451,000.00 on December 31, 2007; and \$77,312,000.00 on December 31, 2008.

### VALUATION OF THE STOCK

A tax is imposed for "each calendar year on the transfer of property by gift during such calendar year by any individual resident." 26 U.S.C. § 2501(a)(1). The transfer of property by gift is subject to a gift tax if the value of the gift is greater than \$10,000.00. §§ 2501(a)(1), 2503(b). The amount of the gift is considered to be the value of the gift on the date it was given. § 2512(a). The sole issue in this case is the fair market value of the GBP stock Plaintiffs gifted to their children and grandchildren in the tax years 2007, 2008, and 2009.

### EXPERT OPINIONS

Plaintiff's experts and the Government's expert prepared reports and provided testimony regarding the valuation of the minority-shares of GBP stock on January 1, 2007; January 1, 2008; and January 1, 2009. The expert's reports use different valuation methods that resulted in three proposed valuations. Those valuations, as well as the IRS' determination, are summarized below:

Year	Taxpayer 1 expert	Taxpayer 2 expert	IRS expert	IRS original	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

The IRS expert used market and income approaches.

Under the market approach the IRS expert identified 19-20 companies that were in the same business as GBP but relied on only two. He utilized two market multiples; enterprise value-to-EBITDA and price-to-earnings. He applied an S-corporation tax premium to account for GBP S tax advantage as an S-corporation. He also added back the non-operating assets to reach an indicated value of GBP common stock. He did not adjust his methodology to take into account the 2008 recession because GBP was in good financial condition as compared with its creditors. He testified that he simply followed the numbers where they led him.

Under the income approach the IRS expert completed a capitalized cash flow analysis rather than a discount cash flow analysis, because GBP did not prepare any long-term forecasts and he would be required to speculate under that method.

The IRS expert applied an effective tax rate to GBP as if it were a C-corporation. He then added back an S-corporation premium to account for the tax advantage associated with S-corporation status and the non-operating assets which he valued separately.

Once the IRS expert calculated the preliminary minority share value, he then applied a marketability discount of 10.8% for 2007, 11.0% for 2008 and 11.2% for 2009.

After carefully reviewing and considering the evidence, the court finds that the IRS expert's valuation conclusions overstate the

value of a minority-held share of GBP stock. As an initial matter, his valuation under the market approach in his 2009 analysis is inflated because he did not adequately account for the 2008 recession and relied on an outlier as a comparable company.

The IRS expert's approach was to simply follow the numbers where they led him. But the determination of value of closely held stock is a matter of judgment rather than mathematics. Mathematical calculation may give an appearance of precision even when the mechanical formulae on which the rest depends on assigning arbitrary weights to factors that in truth are matters of prudential judgment.

The IRS expert's marketability discounts were significantly below those of the other experts. The court finds the IRS expert's

discounts for lack of marketability are too low.

Lastly, the IRS expert applied a separate subchapter S premium to his valuation. The court disagreed with the premium.

As both the IRS expert and the taxpayer's expert tax affected GBP's pretax earnings, there was no discussion as to whether this was correct, as there was no dispute between the opposing experts. Therefore this case does not endorse or deny tax affecting as the correct methodology for the valuation of an S-corporation. The court did not agree with the add back of an S-corporation premium utilized by the IRS expert. In this aspect there was a dispute between experts, so the court does endorse not adding any premium for S status tax benefits when tax affecting the S-corporation's pretax earnings. □

*Klaris, Thomson & Schroeder, Inc. ("KTS") has made one location change. We are pleased to announce that with the continued growth and expansion of our firm, our Los Angeles area office has relocated back to its original office address in Long Beach. The new address, as of July of 2019 for our Long Beach office is:*

### **PLEASE NOTE OUR NEW ADDRESS**

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We understand the potential impact COVID-19 will have on the appraisal profession. In order to support our profession, we have looked to articles in the Appraisal Institute and the ASA Foundation to help and support KTS Consultants in our appraisal assignments. The following articles taken from both the Appraisal Institute and ASA Covid-19 Resource Central, Important Covid-19 updates, webpage have information that may help appraisers in the U.S.:

## Coronavirus (COVID-19)

As the Appraisal Institute continues to monitor guidance from the Centers for Disease Control and Prevention<sup>1</sup> and the World Health Organization,<sup>2</sup> AI is taking seriously the health, safety and well-being of its professionals, customers and staff during the coronavirus pandemic.

In this fluid environment, the Appraisal Institute encourages its professionals to remain aware of developments and resources offered by health professionals and public health organizations and to respond accordingly.

Additionally, here is some guidance cultivated by AI Professional Practice staff:

- Appraisers should take care not to put themselves in harm's way while completing their assignments. Appraisers are advised to consult with their medical practitioners if they have concerns about exposure to the virus, and they should decline assignments if they feel their own

health would be put at risk. Here is the Centers for Disease Control and Prevention's current risk assessment.<sup>3</sup>

- An important part of any appraisal assignment is analysis of market conditions. The coronavirus threat may be impacting market conditions. However, in most markets it is not yet clear to what extent, if any, market conditions are affected. Related, complicating factors include fluctuations in the stock market and changes in mortgage interest rates.
- Market analysis includes observing market reactions. This analysis becomes more complicated when market participants themselves are facing uncertainty.
- Appraisal reports should include a discussion of market conditions, and so mention the Coronavirus outbreak and its

possible impact. However, it is not appropriate to include a disclaimer or extraordinary assumption that suggests the appraiser is not taking responsibility for analysis of market conditions.

- The Appraisal Institute has published Guide Note 10, Appraising in the Aftermath of a Disaster,<sup>4</sup> and Guide Note 12, Analyzing Market Trends.<sup>5</sup> These two Guide Notes, which can be found on the Appraisal Institute's web site, provide helpful guiding principles. □

<sup>1</sup><https://www.cdc.gov/coronavirus/2019-ncov/index.html>

<sup>2</sup><https://www.who.int/health-topics/coronavirus>

<sup>3</sup><https://www.cdc.gov/coronavirus/2019-ncov/summary.html#risk-assessment>

<sup>4</sup><https://www.appraisalinstitute.org/assets/1/7/guide-note-10.pdf>

<sup>5</sup><https://www.appraisalinstitute.org/assets/1/7/guide-note-12.pdf>

*Thank you from KTS to all*





## Expert Witness Depositions in the Time of COVID-19

*<https://www.appraisers.org>, Important Covid-19 updates.*

Today, expert witnesses may find themselves at a deposition, seated alone at their own desk, with a webcam and microphone, taking their oath remotely. Or have their deposition forgone entirely. Traditional methods and strategies may need some adjustment.

Surging numbers of coronavirus-related lawsuits the spectrum — as many from insurance and real estate law as med-legal — are fueling a demand for expert witnesses from all specialties, but traditional depositions are being replaced by remote telephonic and videoconferencing, or forgone.

Foregone depositions may give some experts a sense of relief, especially when facing combative and aggressive attorneys, but depositions can be as advantageous to experts as opposing counsel. Preparing to be deposed, experts normally return to their original reports, sometimes written long before, and on fresh review discover inaccuracies, less-than-stellar analyses or omissions that they can attempt to cure during the deposition, or in supplemental reports. Errors and omissions discovered at trial are far more difficult to correct.

Without being deposed, even for those with total confidence in their reports, expert witnesses miss the opportunity to discover the opposing counsel's skill level, subject matter knowledge and overall comfort level deposing them. Depositions can be used by experts to take all the weaknesses of the opposing attorney and develop plausible explanations, add new facts or revise theories and opinions to cover any potential weaknesses discovered at deposition. As well, when depositions are foregone, experts lose the opportunity to learn the opposing counsel's strategy — the theories, that may be used at trial to attack their reports, or themselves.

Rather than dispose of the deposition, many trial attorneys are pushing for remote telephonic and videoconferencing depositions. While some other attorneys are pushing back and cancelling depositions, courts in a number of states have weighed in favor of them to keep cases moving forward.

Some trial attorneys argue that it is high time the legal system moves into the 21st century and adopt remote videoconference depositions as a standard, even remote videoconference court hearings.

While the U.S. Justice Department has asked Congress to expand opportunities to use videoconferencing for some proceedings due to coronavirus, like arraignments, more sweeping proposals to use video technologies in the courts have been met with skepticism. The Justice Department's fall back position has been to request that the requirements of the Speedy Trial Act be eased and that the statute of limitations and deadlines for civil and criminal procedures be paused — ideas that have met with even greater skepticism in the Congress.

That said, courts in many jurisdictions are adopting rules for remote video depositions in civil cases to avoid delays. Both Texas and Florida have moved to temporarily relax requirements that the court reporter and deposition witness be in the same physical location, including civil and criminal matters. Some courts have issued rules that depositions may not be cancelled or delayed because a remote videoconference format has been selected.

Many experts have experienced telephonic or videoconference depositions, but historically they have

been accompanied by attorneys, clerks, opposing expert witnesses and of course court reporters or notaries. Now, experts may be deposed alone at their own desk.

Even though videoconferencing systems do not allow for the natural interaction of face-to-face meetings, they can offer advantages to those being deposed. Experts may receive off-video, real-time cues from their attorney or others through side chats at a traditional deposition, and any fidgeting or other non-verbal clues may not be caught on camera, but questioning attorneys have their own advantages, being able to mute microphones and consult with co-counsels, clients and experts to hone their questions.

Of course, using videoconferencing systems for depositions requires some knowledge and caution. Hosts of the popular Zoom system can accidentally save private chats to the cloud, allowing all participants to see the chats later on. Zoom is also facing a class action lawsuit for sharing user data with Facebook, dubious claims of end-to-end encryption and issues with uninvited guests turning up. And Zoom is not the only videoconferencing system with glitches; users beware.

When this pandemic abates, the likelihood is that remote telephonic and videoconferencing depositions will continue to be more common than in the past as courts push to keep cases on track, clients remain eager to reduce litigation expenses and attorneys become more comfortable with remote technologies.

Being deposed alone with a webcam and a microphone may become the norm. [www.lexvisio.com](http://www.lexvisio.com) □



## ASA USPAP Guidance for Real Property Appraisers – Coronavirus/COVID-19 Issues

*Note: All USPAP references are from 2020-21 Uniform Standards of Appraisal Practice (USPAP)*

The ASA recognizes that the Coronavirus is having an impact on the U.S. and world economies and on real property markets. At this point in time, the effect may not be quantifiable as there probably isn't enough data to clearly determined, through available market evidence.

### **I. Warning/Disclosure.**

Appraisers should consider adding to their reports some warning language. Similar to the situation in the aftermath of 9/11 and during the 2008 Financial Panic, the effects of the virus' impact on economic activity is unknown. The language does not need to be labeled or needs to appear in a particular report section but should be prominent.

Appraisers should consider adding warning language in their reports advising the reader of the uncertainty around the validity of assignment results – these include not only value opinions but opinions of highest and best use, functional utility, adjustments, and depreciation – going forward. The language is not a disclaimer or an assumption, but a clear statement that there is uncertainty in the appraisal's assignment results due to the uncertainty in the market.

Appraisers recognize that the effective date (date of value) of an appraisal provides protection for appraisers and clients against unanticipated, catastrophic future events but as value is the present value of future benefits, and there is great uncertainty associated with the future, client, intended users, and other interested parties

should be advised of this uncertainty. This is surely a catastrophic event whose effects are unknown and may well have an effect on property values, their cash flows, occupancy and desirability.

**Durability of Value Opinion:** The effective date (date of value) of an appraisal is recognized by appraisers, clients and intended users as providing a cut off for market conditions and the validity of the value opinion. It provides protection for the appraiser and any and all parties that may rely on the appraisal's results as to future events. The uncertainties around the effects of the COVID-19 pandemic have created very dynamic and changeable market conditions that vary between markets. Market uncertainty may well have an effect on property values and property use, utility, occupancy, marketability, income-producing capacity and marketing times going forward. *The client may consider having the property re-appraised once market conditions have stabilized and the current levels of uncertainty have abate.*

### **II. Market Analysis.**

A warning statement such as discussed in the preceding section does not absolve the appraiser of making every effort to gain an understanding of current and forecasted market conditions.

*FAQ 220, "Sudden Market Changes Related to Catastrophic Events," (P. 279. 2020-21 USPAP) provides guidance.*

*STANDARD 1 - Development requirements:*

- Standards Rule 1-2 (e) which “requires an appraiser to identify economic characteristics relevant to the subject property;” and,
- Standards Rule 1-3 (a)(iii) “specifically requires analysis of supply and demand.” See below for additional consideration regard market analysis.

*STANDARD 2 - Reporting Requirements:*

- For Appraisal Reports, Standards Rule 2-2-(a)(iv) requires an Appraisal Report to *contain information, documents, and/or exhibits sufficient to identify the real estate involved in the appraisal, including the physical, legal, and economic property characteristics relevant to the assignment. Market conditions (including changes related to catastrophic events) are economic property characteristics and, as such, should be identified in the development of an appraisal and disclosed in the appraiser report.*

*Market Analysis under Current Conditions*

- There may be limited comparable sales <sup>4</sup>or rental data to confirm trends. Under current conditions, care should be taken with using comparable data prior to the economic change and any adjustments applied to the data.
  - ❑ Under current conditions, care should be taken with using comparable data prior to the economic change and any adjustments applied to the data.
    - ❖ Broker Interviews: are brokers noticing that buyers/sellers, landlords/tenants backing out of, revising, or note entering into transactions?
    - ❖ Lenders: Lender attitudes and activities
    - ❖ Financial Market: what are possible effects of changes in liquidity, cost of

money, etc.

- ❖ Owners/Managers: is the crisis affecting operations.
- ❖ Property Sectors: How are different market sectors being affected specifically.
- ❖ Market rationality/Irrationality, Short Term/Long Term: Market participants don’t often act rationally in the short term; appraisers and the appraisal process presume rationality.
- Highest and Best Use Considerations
 

The comment under Standards Rule 1-3 (Market Analysis and Highest and Best Use) further notes: “An appraiser must avoid making an unsupported assumption or premise about **market area trends** (*emphasis added*), effective age and remaining life.” This would apply to adjustments made in the approaches, particularly the sales comparison approach and forecasts made in the income capitalization approach.

**III. Inspections.**

- USPAP does not require an inspection. What USPAP requires that the subject’s property’s relevant characteristics – which may differ based on the assignment, intended use, and property type - are identified (along with their sources) in order to provide credible assignment results ((SR 1 (d) (v), comment.) The Comment goes on to say that an “appraiser may use any combination of a property inspection, documents, such as a legal description, address, map reference, copy of a survey or map, property sketch, photographs, or other information to identify the relevant characteristics of the subject property.”
- A subject property Inspection may be required by the client. It may also be within

the discretion of the appraiser. All reasonable and prudent judgment should be exercised in conducting inspections where there is a threat to individuals' health and where the health of the public would be endangered.

- *Scope of Work Rule* requirements should be carefully observed, particularly in the determination of *Scope of Work Acceptability* (p. 14). Relevant guidance includes: An appraiser must not allow assignment conditions to limit the scope of work to such a degree that the assignments are not credible in the context of the intended use (p. 14). Also, the guidance further suggests that “if relevant information is not available because of assignment conditions that limit research opportunities (such as conditions that place limitations on inspection or information gather.... use an extraordinary assumption about such information, if credible assignment results can still be developed.” (p. 14). Additional guidance is found in *AO-2, Inspection of the Subject Property. The sections, Minimum Level of Inspection (P69, lines 45-72)* and *Disclosure Requirements (p. 70, lines 87 – 95)* provide specific guidance.
- See below for guidance on the use of extraordinary assumptions with respect to the appraiser's personal inspection of the subject property.

#### IV. Extraordinary Assumptions or Hypothetical Conditions.

The disaster disclaimer is not a hypothetical condition or extraordinary assumption. Using a hypothetical condition in the current situation, does not meet USPAP development or reporting requirements for the use of a hypothetical condition. Using a hypothetical condition would be misleading, unless specifically needed for analysis purposes, i.e., appraise the property as if the pandemic did not exist.

Likewise, using an extraordinary assumption, which assumes an uncertainty to be certain, might be utilized if needed for an assignment-specific purpose, but also would not be appropriate under the present circumstances.

For example, making an assumption that market conditions are or will be “normal,” requires defining what “normal” is.

Appraisers may utilize an extraordinary assumption with respect to the lack of a complete inspection. However, it is critical that any assumption elements be specifically clear and unambiguous. Use of subjective terms such as “normal,” “typical,” or average, should generally be avoided.

Making an assumption that the interior of a property is “average” would require defining what constitutes “average.” Similarly, making an assumption that a market is “normal” would require defining what normalcy is. Making the extraordinary assumption that the specific property is described based on the information relied upon – interviews, owner/broker photos, MLS or assessing data – is clearer and more defensible. Under USPAP, while extraordinary assumptions need not be specifically labeled as such, they should be, for clarity. Further, the extraordinary assumption needs to contain the language that “if the information relied upon is untrue, the assignment results could be affected.”

The effects of the pandemic are not uncertain, they are unknowable at the current time. That's why the use of the warning statement is appropriate. The statement doesn't assume; it points out that the effects can't be known. In this case, the appraiser is certain about uncertainty.

The decision to employ an extraordinary assumption is a decision made by the appraiser within the context of a specific assignment.



## V. Reporting.

Standard 2 provides guidance on “clearly and accurately” setting forth the appraisal in a manner that is “not misleading,” providing “sufficient information” so that intended users are able to understand the report properly, and, “clearly and accurately disclos[ing] all assumptions, extraordinary assumptions, hypothetical conditions, and limited conditions used in the appraisal.” Given current uncertainty, the requirements of Standard 2 takes on an enhanced importance.

- **Scope of Work Rule – Disclosure Obligations.** In the comment, USPAP notes that “proper disclosure is required because clients and other intended users rely on assignment results. Sufficient information includes disclosure of research and analyses performed and might also include disclosure of research and analyses not performed.” This disclosure is crucial in terms of having readers understand the nature and depth of market analysis. Reporting disclosure guidance is also provided in Standard 2-2 (a) (x) which requires that the appraisal “provide sufficient information to indicate that the appraiser complied with the requirements of Standard 1....”

## VI. Report Dates.

The effective date or date of value fixes the context of relevant market conditions affecting the subject property, i.e., the date to which an “appraiser’s analyses, opinions, and conclusions apply.” The report date represents the date the report was transmitted and also creates a perspective in terms of market conditions.

## VII. Exposure Time Opinions.

Standards Rules 1-2(c) states: “When reasonable exposure time is a component of the definition for the value opinion being

developed, the appraiser must also develop an opinion of reasonable exposure time linked to that value opinion.” Exposure time is a retrospective opinion based on historical data. (See also AO-35)

USPAP does not require an opinion of marketing time but many clients do. Marketing time is a “forecast that is made looking forward from the effective date.” (AO-7, ll 16-17) As such, it is future-oriented, based on perceptions of market participants as of the effective appraisal date. Under current conditions, appraisers should use due care so as not to not render marketing time opinions based on unsupported assumptions.

It might be useful to say that, in defining and supporting the opinion of exposure time, that the exposure time is retrospective and may be based on data prior to the pandemic’s effects. With marketing time, additional in-depth research might be required to understand current market conditions and how they affect marketing time, or, it may be appropriate to state that there is insufficient data with which to provide a supportable opinion. In either case, the opinion needs to be supported by market evidence and not constitute a best guess or assumption.

### Appraisal Foundation Link.

The Appraisal Foundation has provided a useful link, *Coronavirus and Appraisers: Your Questions Answered (Appraisal Foundation)*, on their website. The link aggregates information from a number of sources and provides access to relevant information about the virus and appraisal-related resources. □

# KLARIS, THOMSON & SCHROEDER, INC.

## SPOTLIGHT

Prepared by: Anita Thomson Graham



Klaris, Thomson & Schroeder, Inc. (“KTS”) is proud to announce Ms. Elisa M. Ferreira, as the newest member of our LA team. A part-time KTS employee, Elisa is based in our LA office and supports our Senior Valuation Consultants in LA, Philadelphia, and Washington D.C. Ms. Ferreira has recently received her Bachelor of Science of Business Administration, Option in Finance (2019) from CSULB. Despite Covid-19, Elisa will be graduating from CSULB with her Master of Science in Finance (June 2020).



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*“The ultimate measure of a man is not where he stands in moments of comfort and convenience, but where he stands at times of challenge and controversy.”*

Martin Luther King, Jr.

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