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

SUMMARY:
The Tax Court rejected tax-affecting S Corporation earnings, concluding a stock transaction was a bargain sale and thus a gift.

DETAILS:
Mr. Dallas sold non-voting shares of Dallas Group of America, Inc. (DGA) stock to his two sons in 1999 and 2000 in exchange for cash and notes receivable. All of the parties agreed to be bound by a third party appraisal to determine the sales price. The notes from the sons to Mr. Dallas for the 1999 sale were self-cancelling upon the death of Mr. Dallas. The IRS argued that the sales were bargain sales and, therefore, gifts.

The Court noted that intrafamily transfers are presumed to be gifts unless the presumption can be overcome by the evidence. Both the 1999 and 2000 sales contained share adjustment clauses that clearly showed the transactions were for estate planning purposes. The sons were not represented by their own counsel in the transactions and did not negotiate the terms of the agreements. The Court concluded the stock sales were not arm's-length transactions.

The taxpayer's appraiser in the original transaction issued a restricted "letter" report. The taxpayer engaged an additional appraiser for trial testimony. The Court was critical of the second appraiser's report for including verbatim portions of the first appraiser's report and for being unfamiliar with his own firm's report at trial.

The first taxpayer appraiser tax-affected S corporation earnings using a 40% tax rate and the second taxpayer appraiser used a 35% tax rate. According to the Court, the testimony of the taxpayer appraisers was that they tax-affected under the assumption that DGA would lose its S corporation status after or as a result of the hypothetical sale of its stock. The Court said there was no evidence that DGA expected to lose its S corporation status. The Court also noted that DGA 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 always tax-affected S corporation earnings for the past 20 years.
2. An informal poll at a recent conference showed 90% to 95% of responding appraisers tax-affect corporation income.
3. The American Society of Appraisers (ASA) rejects any application for certification if the candidate submits reports for review that do not tax-affect S corporation earnings.
4. His experience is that all bankers, investment bankers, and business brokers tax-affect S corporation earnings in their calculations.
5. His firm tax-affects S corporation earnings for ESOP plans submitted to the Department of Labor.

The Court gave little weight to this testimony. The IRS appraiser said his reports for ASA certification had been accepted without tax-affecting. The testimony about the ESOP plan valuation for the Department of Labor was also unconvincing because 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 DGA’s earnings and that tax-affecting DGA’s earnings is not appropriate.”

There was also a discussion in the case about the discounts for lack of control and marketability. The Court rejected any additional discount for the non-voting status of the minority stock transfers. The Court determined a 20% discount for lack of marketability.

The taxpayer asked to reform the 1999 notes, claiming the self-cancelling clauses were a drafting mistake. The Court rejected this argument and accepted the IRS appraiser’s valuation. There is no discussion of the method used by the IRS appraiser to arrive at the fair market value of the notes.

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