Tax Court Rejects Tax Affecting S Corporation Earnings

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Of particular interest to tax attorneys, the long battle between taxpayers and the IRS about whether S Corporation earnings should be tax-affected continues. The IRS won the latest round in Dallas v. Commissioner, TC Memo 2006-212, September 26, 2006.

At issue is whether earnings considered for valuing an S corporation should be before or after taxes. The income of a C corporation is subject to income tax at the business level and stockholders are taxed on dividends paid to them. There are no Federal taxes on earnings at the S corporation level as the income passes through to the stockholders and the income is taxed at personal rates. The obvious point of the argument is that the IRS wishes to place a much higher value on S corporation earnings.

In this case one of the petitioner's two experts reduced the corporation's earnings by 40% "on the assumption that, after a sale, the corporation will lose its S corporation status." The court rejected this position because there was "no evidence in the record that (the S corporation) expects to cease to qualify as an S corporation." The company "has a history of distributing enough earnings for shareholders to pay their individual income tax liabilities… There is no evidence that (the corporation) intends to change its practice…"

The other petitioner expert reduced income by 35% "because a shareholder is liable for income tax on S corporation profits even if those profits are not distributed to the shareholder." The expert supported the adjustment with the following arguments:

- He has tax affected S corporation earnings for the last 20 years
- An informal poll of attendees at a recent conference indicated that 90% to 95% of appraisers tax-affect S corporation earnings
- The American Society of Appraisers (ASA) rejects applications of candidates for certification if the candidate does not tax-affect S corporation earnings
- He tax affects S corporation earnings in valuing S corporation ESOP plans that he submits to the Department of Labor

The court gave "little weight" to the expert's opinion and rejected his calculation. In the opinion the court refuted claims regarding the ASA and the "informal poll at an unidentified conference held on a date not stated in the record." The court also stated that the DOL has a different definition of value than fair market value. In conclusion the court stated "there is insufficient evidence to establish that a hypothetical buyer and seller would tax-affect the earnings and that tax-affecting would be inappropriate."

The impact of this case is still being felt and it will be looked at for a long time, as it indicates the direction of the court on this issue.

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