KEEPING UP WITH THE JONESES: A FRESH PERSPECTIVE ON TAX-AFFECTING

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OVERVIEW

Two opinions were issued in 2019 that changed the landscape of valuing pass-through entities (PTE) for transfer tax purposes.[1] These two cases, *Estate of Jones v. Commissioner* and *Kress v. United States*, broke with the twenty-year-old convention that tax-affecting the earnings of a PTE (such as an S corporation, partnership, or limited liability company) for an assumed corporate tax rate is disallowed in fair market value (FMV) determinations.[2] In contravention of this practice, both *Jones* and *Kress* hold that it is appropriate to tax-affect the earnings of a PTE for federal gift tax purposes if the facts of the case and the accompanying valuation can support its application.[3] A third opinion, *Estate of Cecil v. Commissioner*, is currently in the tax court's pipeline and is expected to fully address and further clarify the permissibility of tax-affecting the initial valuation of PTEs.[4]

Prior to these cases, in the 1999 seminal case *Gross v. Commissioner*, the tax court agreed with the Internal Revenue Service's valuation experts and held that an S corporation's earnings should not be tax-affected for an assumed corporate rate in the context of valuing non-controlling interests.[5] Disallowing this tax-affecting practice effectively increased a PTE's estimated FMV for transfer tax purposes with a corresponding increase in transfer tax liability.[6] This prevailing view, solidified under *Gross*, continued for nearly two decades until the *Jones* and *Kress* rulings were released in 2019.[7]

Though *Jones* and *Kress* are groundbreaking opinions on the issue of tax-affecting, it is ironic that the Tax Cuts and Jobs Act of 2017 (TCJA) was enacted years after the gifts in question were made, but prior to the judges' respective rulings.[8] The transfers in both *Jones* and *Kress* were made during the sub-prime mortgage crisis circa 2008, but the opinions were issued in

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1. Est. of Jones v. Comm'r, 118 T.C.M. (CCH) 143 (2019); Kress v. United States, 382 F. Supp. 3d 820 (E.D. Wis. 2019).
2. *See Jones*, 118 T.C.M (CCH) at *17; *Kress*, 382 F. Supp. 3d at 841–42.
3. *See Jones*, 118 T.C.M (CCH) at *17; *Kress*, 382 F. Supp. 3d at 841–42.
4. *See* Opening Brief for Respondent at 40, Est. of Cecil v. Comm'r, No. 14639-14 (U.S. Tax Ct. May 26, 2016); Est. of Cecil v. Comm'r, 14640-14 (U.S. Tax Ct. filed June 23, 2014).
5. Gross v. Comm'r, 78 T.C.M. (CCH) 201, at *9 (1999), aff'd 272 F.3d 333 (6th Cir. 2001), cert. denied, 537 U.S.US 827 (2002); *see also* Est. of Gallagher v. Comm'r, 101 T.C.M. (CCH) 1702, at 12 (2011) (declining to tax effect earnings in discounted cashflow method), supplemented by 102 T.C.M. (CCH) 388 (2011); Est. of Giustina v. Comm'r, 111 T.C.M. (CCH) 1551, at *6 (2016) (upheld pretax (non-tax-affected) cashflow for valuation), supplementing Est. of Giustina v. Comm'r, 101 T.C.M (CCH) 1676 (2011), rev'd and remanded (on other grounds), 586 F. App'x 417 (9th Cir. 2014).
6. *See Gross*, 78 T.C.M. (CCH), at *9.
7. *See Jones*, 118 T.C.M (CCH), at *13; *Kress*, 382 F. Supp. 3d at 841–42.
8. Tax Cuts and Jobs Act, Pub. L. No. 115-97, 131 Stat. 2054, (2017). Any reference herein to "TCJA" refer to the Tax Cuts of Jobs Act of 2017.

2019.[9] By permanently lowering the top federal corporate income tax rate from 35% to a flat 21%, the TCJA limited the tax-affecting benefits that had long eluded planners.[10] That said, tax-affecting can still be a valuable tool for minimizing transfer tax liability.[11]

This article examines *Estate of Jones v. Commissioner*, provides a brief historical context of the opinions that consider tax-affecting in prior Tax Court and Federal Circuit Court opinions, reviews current trends in determining FMV for transfer tax purposes, and offers several key observations, specifically in light of the current economic climate with COVID-19.[12] As this article will discuss, valuation professionals may want to "keep up with the Joneses" by carefully reviewing whether it makes sense to provide similar supporting evidence, as provided in *Jones*, when appraising a closely-held business with similar characteristics for transfer tax purposes.[13]

I. INTRODUCTION

No two closely-held family businesses are exactly alike.[14] Their characteristics differ in formation, ownership structure, control, industry, investments, objectives, transferability, and family dynamics, just to name a few.[15] As owners transfer these interests by sale, *inter vivos* gift, or bequest, they can be difficult to value for estate and gift tax purposes.[16] Estate planning professionals, appraisers, and other tax professionals grapple with properly identifying the FMV of the transferred interests that will withstand scrutiny from the Internal Revenue Service (IRS) and other taxing authorities.[17] An unsubstantiated valuation will most likely result in unintended tax consequences for the transferor during their lifetime, or at death.[18]

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9. *See Jones*, 118 T.C.M (CCH), at *5; *Kress*, 382 F. Supp. 3d at 841–42.

10. I.R.C. § 11(b), as amended by § 13001(a) of TCJA. Any references herein to the "Code," "I.R.C." or "section" refer to the Internal Revenue Code, Title 26, United States Code, and the Treasury Regulations promulgated thereunder. All I.R.C. citations in this article refer to the current statute unless otherwise stated.

11. *See Valuation*, Mass. Continuing Legal Ed., Inc., 4 Mass. Divorce Law Practice Manual Ch. 15, § 15.15.4.5(l) (2019).

12. *See* Opening Brief for Respondent at 40, Est. of Cecil v Comm'r, No. 14. 639-14 (U.S. Tax Ct. May 26, 2016); *infra* Sections IV–VII.

13. *See Jones*, 118 T.C.M. (CCH) at *10, *14.

14. *See* César Camisón-Zornoza, et. al., Effects of Ownership Structure and Corporate and Family Governance on Dynamic Capabilities in Family Firms,16 INT'L ENTREPRENEURSHIP & MGMT. J. 1393, 1394–95 (2020).

15. *See id.*

16. *See infra* Section II.B.

17. *See infra* Section II.B.

18. *See infra* Section II.B.

Fair market value for transfer tax purposes is defined as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."[19] When determining the FMV of unlisted stocks for which no recent sales or bids have been made, several factors should be considered, including the company's net worth, its earning power, and dividend paying-capacity, its goodwill, the economic outlook in the industry, its management and its position in the industry, the degree of control of the business represented in the block of stock to be valued, and the value of stock in similar, publicly traded companies.[20] When determining the FMV of an interest in a partnership, the value of the partnership's assets may be considered, along with the same factors considered in determining the fair market value of the stock.[21]

The FMV of a hard-to-value asset is the keystone of any sophisticated wealth transfer technique.[22] The valuation methodology implemented in an appraisal has a significant effect on the value of the interests for transfer tax purposes.[23] Furthermore, it can be painstakingly difficult to value interests in business entities with characteristics of both an *operating* entity and an *investment* entity, as opposed to an entity with a single focus.[24] This may require an analysis of the appropriateness of using an income-based approach, an asset-based approach, or a weighing of the two approaches, which has a significant result on the dollar impact of the valuation.[25]

Once the proper valuation approach is determined, appraisers will typically apply valuation discounts.[26] Discounting, one of the most powerful tools in the estate planner's toolbox generally refers to the theory that the value of closely-held interests is usually lower than the value of publicly traded interests.[27] The elements of this argument include the owner's inability to quickly liquidate the interest, many times without significant cost (lack of marketability), and the inability to control the management or direction of the entity (lack of control).[28]

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19. Treas. Reg. § 20.2031-1(b); 25.2512-1; *see also* United States v. Cartwright, 411 U.S. 546, 551 (1973) (purposes of a gift).

20. Treas. Reg. § 25.2512-2(f)(2); *see also* Est. of Adell v. Comm'r, 108 T.C.M. (CCH) 107, at *42 (2014) (fair market value determinations).

21. Treas. Reg. § 25.2512-3(a).

22. *Id.*

23. *See* Justin P. Randome & Vinu Satchit, *Valuation Discounts for Estate and Gift Taxes*, J. ACCT. (July 1, 2009), https://www.journalofaccountancy.com/issues/2009/jul/20091463.html [https://perma.cc/ML2R-NSYD].

24. *Id.*

25. *Id.*

26. *Id.*

27. *Id.*

28. *Id.*

In some cases, like in *Jones* and *Kress*, valuation professionals will determine whether any further adjustments need to be made to account for the differential in taxation between the PTE and the C corp form.[29] Simply stated, tax-affecting means reducing the earnings of a pass-through business for an assumed corporate tax rate.[30] Generally, the PTE is an S-corporation, but tax-affecting applies to partnerships as well.[31] To highlight the benefits of tax-affecting, the focus will shift to the income-based method, specifically.[32] The income-based (or discounted cash flow) method discounts to present value the anticipated future income of the company whose stock is being valued.[33] More often than not, comparables for valuations in these cases are C corporations that measure returns on an after-tax basis.[34] C corporations earnings are taxed at the entity level and are taxable as dividends to the shareholder when distributed.[35] PTE's are not subject to this double layer of taxation as there is not an entity level tax, and the individual owners are responsible for paying tax on their proportionate share of the entity's earnings at ordinary tax rates, whether that income is distributed or not.[36] As one can see, tax-affecting can in many cases further depress the FMV of a PTE for transfer tax purposes.[37]

As no two closely-held family businesses are exactly alike, estate planners and valuation professionals must stay current and look to guidance from the IRS regarding the best practices for organizing, operating, and valuing closely-held businesses.[38] *Jones* in particular has provided a wealth of information to planners and appraisers in valuing a family-owned business with both operating and investment divisions, and sheds light on the proper factors to consider and raise in an appraisal.[39] *Jones* is the first case in over twenty years that holds that it is appropriate to tax-affect the valuation of an S corporation for federal gift tax purposes if the facts of the case and the accompanying valuation can support its application.[40] *Jones* also addresses the fundamental issue related to the valuation methodology of interests in business entities that have both significant operations and assets (or investments) of substantial value, such as lumber operations and timberland

29. *See* Est. of Jones v. Comm'r, 118 T.C.M. (CCH) 143, at *34 (2019); Kress v. United States, 382 F. Supp. 3d 820, 824 (E.D. Wis. 2019).

30. *See Jones*, 118 T.C.M. (CCH) at *34; *Kress*, 382 F. Supp. 3d at 824.

31. *See Jones*, 118 T.C.M. (CCH) at *34; *Kress*, 382 F. Supp. 3d at 824.

32. *See Jones*, 118 T.C.M. (CCH) at *34; *Kress*, 382 F. Supp. 3d at 824.

33. *See Jones*, 118 T.C.M. (CCH) at *34; *Kress*, 382 F. Supp. 3d at 824.

34. *See Jones*, 118 T.C.M. (CCH) at *34; *Kress*, 382 F. Supp. 3d at 824.

35. *See Jones*, 118 T.C.M. (CCH) at *34; *Kress*, 382 F. Supp. 3d at 824.

36. *See Jones*, 118 T.C.M. (CCH) at *34; *Kress*, 382 F. Supp. 3d at 824.

37. *Kress*, 382 F. Supp. 3d at 824.

38. *See id.*

39. *See Jones*, 118 T.C.M. (CCH) at *34.

40. *Id.*

ownership.[41] The decision in *Jones* is a resounding taxpayer victory and provides invaluable insight to attorneys and valuation professionals on best practices when selecting a valuation method and implementing a tax-affecting strategy.[42]

II. ESTATE OF *JONES V. COMMISSIONER*

A. Background

Aaron Jones was the owner and operator of a timberland and lumber operation in Eugene, Oregon, which he founded in 1954.[43] He ultimately structured his operation so that Seneca Sawmill Company (SSC), an S corporation, manufactured lumber while Seneca Jones Timber Company, L.P. (SJTC), a limited partnership, acquired, owned, and maintained the timberlands.[44] He formed the latter in 1992 after environmental regulations put his access to federal timberlands at risk.[45] SSC owned a 10% interest in SJTC and served as its general partner in exchange for its contribution of timberland.[46] Judge Cary Pugh, who authored the opinion for the tax court, reviewed the lumber and timberland operations of SSC and SJTC in great detail, illustrating the purposes and functions of each entity.[47]

According to the facts presented to the tax court, it appeared the business operations of SSC and SJTC were quite interrelated.[48] For example, SSC purchased 32% of its logs directly from SJTC and 24% indirectly from SJTC.[49] SJTC practiced sustained yield harvesting and sold, through trading arrangements, approximately 90% of its logs to SSC.[50] Because it was unlikely that SSC would be able to obtain financing on its own, "SJTC and SSC were joint parties to third-party credit agreements."[51] SSC and SJTC also transferred money to and from each other in the form of loans and receivables.[52] The companies operated out of the same headquarters and

41. *Id.*
42. *Id.* at 7–10.
43. *Id.*
44. *Id.*
45. *Id.* at 10–13.
46. *Id.* at 5
47. *Id.* at 4–8.
48. *See id.*
49. *Id.* at 2.
50. *See id.* at 3.
51. *Id.* at 4.
52. *See id.*

SJTC's management team was identical to SSC's team.[53] Both management teams were paid by SSC.[54]

Moreover, as one might imagine with traditional family-owned businesses, there were significant restrictions on the transferability of SSC shares and SJTC limited partner units.[55] Both were subject to buy-sell agreements that imposed several restrictions, including: (1) any transfer causing the company to lose its status as an S corporation/partnership would be null and void, (2) each respective company had a right of first refusal if the shareholder/partner intended to transfer the shares/limited partner units to a non-family member and (3) the other shareholders/partners had the option to purchase the shares/limited partner units, if the respective company did not exercise its right of first refusal at "fair market value."[56] Fair market value was determined using expected cash distributions, "lack of marketability, lack of control, and lack of voting rights."[57]

B. Estate Planning Transactions and IRS Valuation Challenge

Starting in 1996, Mr. Jones began succession planning with his attorneys to ensure that the family business would live on for future generations of the Jones family lineage.[58] Mr. Jones intended that his three daughters, Rebecca, Kathleen and Jody, would be equal stakeholders in the business.[59] In 2009, during the economic downturn, Mr. Jones made taxable gifts of stock (voting and non-voting) in SSC and interests in SJTC to his three daughters, individually, to generation-skipping trusts for their benefit and to generation-skipping trusts for their respective families' benefit.[60] Mr. Jones reported on his gift tax return that the value of those gifts was $20,895,000.[61] Mr. Jones signed net-net gift agreements with his daughters whereby they assumed liability for any gift and estate tax liability associated with the transfers.[62] The appraisal that accompanied the return, initially prepared by Columbia Financial Advisors, stated that the value of the SSC voting stock was $325 per share, the value of the SSC non-voting stock was $315 per share, and the value of each limited partnership unit in SJTC was

53. *Id.* at 2–3.
54. *Id.* at 3.
55. *See id.* at 5.
56. *Id.* at 6.
57. *See id.*
58. *Id.* at 7.
59. *See id.*
60. *See id.*
61. *See id.*
62. *Id.* at 7 (initially the IRS contested the net-net gift arrangement between Mr. Jones and the transferees in the Notice of Deficiency, but later conceded at trial that the arrangement was permissible).

$350.[63] At the time of the gifts, the United States was in the midst of a severe economic recession, which critically impacted the housing market, forcing SSC to reduce production and SJTC to cut back on timber harvests to diminish the sale of logs at down prices.[64] This in turn, affected the valuation of both companies.[65]

Shortly thereafter, the IRS issued a Notice of Deficiency to Mr. Jones, valuing the gifts at nearly $120 million and claiming a gift tax deficiency of $44,986,416.[66] The IRS asserted that the value of the SSC voting stock was $1,395 per share, the value of the SSC nonvoting stock was $1,325 per share, and the value of each limited partnership unit in SJTC was $2,511.[67]

Mr. Jones responded in the tax court in 2013 but passed away in 2014, at which time he was replaced in the proceeding by his estate ("the Estate") and his representatives, including his daughter Rebecca, and SSC's legal affairs officer.[68] The Estate also engaged a new appraiser, Richard Reilly, to conduct the ensuing litigation's valuation.[69] Mr. Reilly's valuation (the "Reilly Valuation") utilized the discounted cash flow (DCF) method (an income-based approach) and determined values of $390 per voting share of SSC, $380 per non-voting share of SSC, and $380 per limited partner unit of SJTC.[70] Additionally, the Reilly Valuation tax-affected the earnings of both entities at a 38% tax rate.[71]

The IRS hired an appraiser who, conversely, used the net asset value (NAV) approach (an asset-based approach) to value the limited partner units of SJTC at $2,530 per unit.[72] The IRS did not provide a valuation of the SSC shares to the court and appeared to accept the valuation method implemented in the Reilly Valuation.[73] The IRS also argued that tax-affecting of the two companies should be prohibited and advocated a rate of 0%.[74]

With respect to the marketability discount, only a 5% difference separated the Reilly Valuation (35%) and the IRS's valuation (30%).[75] Note

63. *See id.* at 8.
64. *Id.* at 5.
65. *Id.* at 13–14.
66. *Id.* at 1.
67. *Id.* at 7.
68. *Id.* at 1.
69. *See id.* at 9.
70. *Id.*
71. *Id.* at 12. The Reilly Valuation provided a value of $21 million for the SJTC LP interests on a non-controlling, non-marketable basis, and each block of SJTC LP units transferred to each daughter was valued at $3,901,715.
72. *Id.* at 9. The IRS valued the SJTC LP units at $140,398,000 on a non-controlling, non-marketable basis, and each block of SJTC LP units transferred to each daughter was valued at $25,973,611.
73. *See id.* at 15.
74. *Id.* at 12–13.
75. *See id.* at 16.

that the tax court did not discuss this at length and accepted the Reilly Valuation discount due to the IRS's lack of argument.[76]

C. Key Issues Presented to the Tax Court

This article will focus on three primary issues included in Judge Cary Pugh's tax court decision.[77] First, whether the limited partner units of SJTC should be valued using an income-based approach, as the Estate asserted, or an asset-based approach proposed by the IRS.[78] Second, which receives only cursory attention herein, whether a 35% discount for lack of marketability was appropriate, as opposed to the 30% asserted by the IRS.[79] Third, whether it was proper for Reilly to "tax-affect" both entities' earnings when preparing the Estate's valuation of the Jones family business enterprises.[80]

1. The Tax Court Determined that the Estate's Income-Based Valuation Approach Is Proper

There are three types of valuation methods used to calculate the FMV of an interest in a closely-held entity.[81] The market method compares the closely-held company with its unknown stock value to similar companies with known stock values.[82] The income-based (or discounted cash flow) method discounts to present value to the company's anticipated future income whose stock is being valued.[83] The net asset value (or balance sheet) method generally relies on the value of the company's assets, net of its liabilities.[84]

"The market method or income method is most often used when closely held companies carry on an active trade or business."[85] On the other hand, "the net asset value is most often used when a closely held company holds primarily real estate or investment assets and does not carry on an active trade or business."[86] Finally, "the income approach uses either the direct

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76. *Id.* at 17.

77. *Id.* at 10. The Tax Court reviewed the following issues: (1) the reliability of the Reilly 2009 revised projections, (2) the propriety of tax-affecting, (3) the proper treatment of intercompany loans from SSC to SJTC, (4) the proper treatment of SSC's 10% general partner interest in SJTC, and (5) the appropriate discount for lack of marketability. This article will not address all of these issues.

78. *Id.* at 12.

79. *Id.* at 17.

80. *Id.* at 14.

81. Exelon Corp. v. Comm'r, 147 T.C. 230, 244 (2016), aff'd, 906 F.3d 513 (7th Cir. 2018); Est. of Noble v. Comm'r, T.C. Memo 2005-2, 2005 WL 23303, at *7. (T.C. Jan 6, 2005).

82. *Noble*, 2005 WL 23303, at *7.

83. *Id.*

84. *Id.*

85. Justin P. Ransome & Vinu Satchit, *Valuation Discounts for Estate and Gift Taxes*, J. ACCT. (July 1, 2009), [https://perma.cc/XX5F-XXTR].

86. *Id.*

capitalization method or the DCF method to convert the anticipated economic benefits that the holder of the interest would stand to realize into a single present-valued amount."[87] By contrast, and as mentioned above, "the assetbased approach values the interest by reference to the company's assets net of its liabilities."[88]

Generally, when valuing an operating company that sells products or services, the company's income tends to receive the most weight, while in valuing a holding or investment company, asset value will receive the most weight.[89] As one might expect, this distinction has a significant effect on the valuation of a company from a dollar standpoint.[90] Not all companies are easily characterized as simply an operating, holding, or investment company.[91] In such cases, the court will not restrict its consideration to only one approach of valuation.[92]

The Reilly Valuation utilized the income-based approach on the grounds that SJTC was an operating company that sold products—logs.[93] As such, it "should be valued as a going concern with primary consideration to its earnings."[94] Mr. Reilly also contended that it was unlikely that SJTC would ever sell the timberland based on its relationship with SSC.[95] On the other hand, the IRS argued that the asset-based approach was proper because SJTC was, in essence, a natural resource holding company holding timber solely as an investment for its partners.[96] The IRS asserted that the FMV of SJTC's timberland was $424 million.[97] Though Mr. Reilly agreed that the IRS's FMV assessment was accurate, he used an income approach and calculated the weighted enterprise value of SJTC to be $107 million.[98] Clearly, the valuation method used significantly affects the dollar outcome.[99]

It should also be noted that the Reilly Valuation used revised projections based on the post-2008 economic outlook and the concern that SJTC may have been poised to violate its loan covenants with SSC.[100] As of the valuation date, the lumber was primarily used to build homes, and lumber sales were almost completely dependent on housing creation, which were at

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87. Est. of Jones v. Comm'r, 118 T.C.M. (CCH) 143, *29 (T.C. 2019) (*citing Noble*, T.C.M. (RIA) 2005-002, 7 (T.C. 2005)).

88. *Jones*, 118 T.C.M. (CCH) at *29.

89. *Id.*

90. *See id.* at *30.

91. *Id.* at *31.

92. *Id*. (*citing* Est. of Andrews v. Comm'r, 79 T.C. 938, 945 (1982)).

93. *Id.* at *26, *30.

94. *Id.* at *30.

95. *Id.*

96. *Id.*

97. *Id.* at *43.

98. *Id.* at *44.

99. *See id.* at *43–*44.

100. *Id.* at *35–*36.

a standstill when the gifts were made in 2009.[101] The IRS argued that the revised projections were "worst-case scenario" and were overly pessimistic even though the United States was in the midst of severe economic turmoil due to the subprime mortgage crisis.[102]

The tax court agreed with the Estate and held that the income-based approach was the proper method to value SJTC.[103] In its lengthy decision, the tax court found that SJTC had both aspects of an operating company and an investment or holding company, and did not fit neatly into either category.[104] Judge Pugh found that it was unlikely SJTC would sell its timberland, and that SJTC and SSC constituted a single business enterprise, which supported the conclusion that the income approach should be given more weight in valuing the company.[105] Several facts supported this conclusion.[106] For example, blocks of SJTC units could not force a sale of the timberlands under the partnership agreement because SSC had exclusive authority to direct SJTC to make such a sale.[107] SSC would never exercise that authority according to Judge Pugh.[108] "SSC's continued operation as a sawmill company depended on SJTC's continued ownership of timberlands. . . ."[109] The rights held by SSC would be considered by any hypothetical buyer of the interests.[110] Further, SSC's operation as a sawmill depended on SJTC's ownership of timberlands, and there was no likelihood that the SSC would direct SJTC to sell those lands.[111] In addition, they had almost identical ownership and shared administrative staff out of the same headquarters.[112] The two companies were so closely aligned and interdependent that their relationship must be factored into the analysis, according to Judge Pugh, so the tax court concluded that Mr. Reilly's income-based approach was appropriate.[113]

In addressing the use of Mr. Reilly's revised projections, the tax court found that even though the revised projections may not be reliable for an extended period, they were relevant and current as of the valuation date, and such use was appropriate based on the circumstances.[114]

101. *Id.* at *5.
102. *See id.* at *36.
103. *Id.* at *51.
104. *Id.* at *32.
105. *Id.* at *34, *48.
106. *Id.* at *34, *48.
107. *Id.* at *34, *48.
108. *Id.* at *34, *48.
109. *Id.* at *34, *48.
110. *Id.* at *34, *48.
111. *Id.* at *34, *48.
112. *Id.* at *34, *48.
113. *Id.* at *35.
114. *Id.* at *36.

2. The Tax Court Applied the Estate's 35% Lack of Marketability Discount

As mentioned earlier, values of interests in closely-held businesses can be discounted for lack of marketability when they are subject to restrictions and lack of control when they represent minority ownership interests.[115] Discounts for a lack of marketability are usually based on comparisons of the restricted stock of public companies or with share price differences pre and post-IPO.[116] Discounts for lack of control in a privately-owned entity are generally based on comparisons of share prices to net asset value per share of publicly traded closed-end investment funds, or, for real estate assets, real estate limited partnerships or investment trusts.[117]

The Reilly Valuation and the IRS valuation were only 5% apart on marketability discounts.[118] With respect to methodology, Mr. Reilly applied a 35% discount for lack of marketability to the weighted business enterprise value.[119] He based this on empirical studies of the discounts on transfers of restricted shares of publicly traded companies and on private transfers before IPOs.[120] The IRS applied a 30% discount for lack of marketability by analyzing the discounts applied in private sales of restricted stock.[121] The IRS argued "that Mr. Reilly's 35% discount for lack of marketability was excessive and that he did not explain sufficiently how he arrived at the discount."[122]

The tax court disagreed and did not dwell on the issue.[123] In siding with the Taxpayer, Judge Pugh opined that Mr. Reilly's Valuation did explain how he arrived at the discount and illustrated the same in the appendix of the report.[124] According to Judge Pugh, Mr. Reilly arrived at a 35% discount on the basis of various empirical studies, and on SJTC's unique characteristics, such as its buy-sell agreement, its lack of historical transfers, a potentially indefinite holding period, its reported loss in the twelve months before the valuation date, and the unpredictability of partner distributions.[125] The tax court also noted that it believed the expert for the IRS was "guessing" at his

115. *Id.* at *29.
116. *Id.* at *49.
117. *Id.*
118. *Id.* at *49.
119. *Id.*
120. *Id.*
121. *Id.*
122. *Id.*
123. *Id.* at *51.
124. *Id.*
125. *Id.* at *50.

discount during trial.[126] As such, the Tax Court concluded that the proper discount for lack of marketability was Mr. Reilly's 35%.[127]

3. The Tax Court Upheld the Estate's Tax-Affecting the Earnings of SJTC

The most remarkable aspect of *Jones* is that the tax court upheld the use of tax-affecting.[128] As stated earlier, for pass-through entities, tax-affecting means reducing the earnings of the business for an assumed corporate tax rate.[129] The rationale for this approach is that a willing buyer may have to restructure the business after a purchase, for example, if the new ownership structure no longer qualifies as an S corporation.[130] Most buyers are quite concerned with after-tax earnings and tax-affecting may provide a better understanding of the return on the investment after tax.[131] Additionally, comparables for valuations in these cases are most likely based on C corporations.[132] By contrast, the argument against tax-affecting stresses that although an S corporation's stockholders are subject to tax on the corporation's income; they are generally not subject to a second level of tax when that income is distributed to them.[133] Although electing S Corporation status has many benefits centered on simplicity of form and operation, in many cases the principal benefit is this benefit of the avoidance of double taxation.[134] This could make an S corporation at least somewhat more valuable than an equivalent C corporation.[135]

The Estate's Reilly Valuation employed tax-affecting to adjust the earnings of both SJTC and SSC. Reilly applied a 38% combined federal and state tax rate to account for the tax benefits inured to the shareholders as a result of the pass-through status of both companies (treating SJTC as a C corporation, though at an individual, not corporate tax rate).[136] In effect, the

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126. *Id.*

127. *Id.* at *51.

128. *Id.*

129. Daniel Tinkleman, *Tax Effecting and the Valuation of Pass-Through Entities*, THE CPA J. (Oct. 18, 2018), https://www.cpajournal.com/2018/10/24/tax-effecting-and-the-valuation-of-pass-through-entities/ [https://perma.cc/Y5KL-RYXE].

130. *See id.*

131. *See* Est. of Jones v. Comm'r, 118 T.C.M. (CCH) 143, *29 (T.C. 2019) (citing *Noble*, T.C.M. (RIA) 2005-002, 7 (T.C. 2005).

132. *Id.*

133. *Id.*

134. *Id.*

135. It should be noted that this should not be confused with the C corporation built-in gains issue. That issue involves the treatment of the unrecognized income tax liability of a C corporation attributable to its built-in capital gains. For more information on tax-affecting earnings, please review the S Corporation Economic Adjustment Model (SEAM). *See also* Est. of Richmond v. Comm'r, T.C. Memo 2014-26 (Feb. 11, 2014).

136. *Jones*, 118 T.C.M. (CCH) at *29.

calculus was intended to account for the differences between the taxation of pass-through entities and C corporations as mentioned above.[137] Reilly then adjusted both the earnings he used to calculate the net cashflow and the cost of debt capital he used to determine the appropriate discount rate.[138] Mr. Reilly also, and quite aptly, computed the benefit of the dividend tax avoided by estimating the implied benefit for SJTC's limited partners in prior years.[139]

The IRS argued that tax-affecting should be disallowed given that there was no evidence that either SJTC or SSC would ever lose their pass-through status and cited several tax court cases rejecting tax-affecting, namely *Gross v. Commissioner*, *Estate of Gallagher v. Commissioner*, and *Estate of Guistina v. Commissioner*.[140] The rate the IRS proposed was 0%.[141] Fatally, the IRS relied solely on precedent, and neglected to present facts or empirical evidence to support the proposition that tax-affecting was inappropriate in this case.[142]

In finding for the taxpayer, the tax court found that the propriety of tax-affecting is a fact-based issue and as such should be determined based upon the record, not on precedent.[143] Judge Pugh distinguished *Gross*, *Estate of Gallagher*, and *Estate of Giustina*, stating that while the facts presented in those cases did not support tax-affecting, they did not stand as a blanket prohibition against tax-affecting a pass-through entity's earnings.[144] The court found the Reilly Valuation more accurately took into account the tax consequences of SJTC's flow-through status than the analysis utilized in prior cases because his adjustments included "a reduction in the total tax burden by imputing the burden of the current tax that an owner might owe on the entity's earnings and the benefit of a future dividend tax avoided that an owner might enjoy."[145] The IRS proposed a rate of 0% without evidentiary justification and the tax court responded that "we do not have a fight between valuation experts but a fight between lawyers."[146] The court found that though Mr. Reilly's tax-affecting was not exact, it was "more complete and more convincing than [the IRS's] zero tax rate."[147]

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137. *Id.*
138. *Id.*
139. *Id.*
140. *See* Gross v. Comm'r, 272 F.3d 333 (6th Cir. 2001); Est. of Gallagher v. Comm'r, T.C.M. (CCH) 2001-148, 2011 WL 2559847, supplemented by T.C.M. 2011-244, and Est. of Giustina v. Comm'r, T.C.M. (CCH) 2011-141, *reversed and remanded* (on other grounds), 586 F. App'x 417 (9th Cir. 2014).
141. *Jones*, 118 T.C.M. (CCH) at *12.
142. *Id.* at *17.
143. *Id.* at *13.
144. *Id.* at *13.
145. *Id.*
146. *Id.*
147. *Id.* at *14.

D. Resounding Taxpayer Victory

Overall, the decision was a resounding victory for the Jones Estate and beneficiaries.[148] The tax court adopted the Reilly Valuation and found the value of the gifts at the valuation date were as reported in the Reilly Valuation, $390 per voting share of SSC, $380 per non-voting share of SSC and $380 per unit of SJTC, saving the taxpayer millions of dollars in potential transfer tax liability.[149] Though the court's decisions regarding the proper valuation method and the discount to be applied were beneficial for the taxpayer, the decision to apply tax-affecting to the earnings of the S corporation was a remarkable achievement for the taxpayer and has not been easily accomplished in the past.[150]

III. OTHER RECENT TAXPAYER VICTORIES

A. Kress v. United States

In addition to the Tax Court's decision in *Jones*, in early 2019 the Eastern District of Wisconsin upheld the application of tax-affecting the earnings of an S corporation in *Kress v. United States*.[151] In this case, James and Julie Kress transferred minority interest shares in their family-owned company, Green Bay Packaging, Inc., an S corporation, to their children and grandchildren.[152] Green Bay manufactured corrugated packaging, folding cartons, coated labels, and related products.[153]

> At the time this case was filed, GBP employed approximately 3,400 people in fourteen 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% were owned by GBP's employees and directors.[154]

Like in *Jones*, the gifts in question occurred during the subprime mortgage crisis of 2007 through 2009, and the court took judicial notice of the recession in the opinion.[155] The Kresses filed gift tax returns for the gifts

148. *Id.* at *13–*14.
149. *Id.*
150. *Id.*
151. *See generally* Kress v. United States, 382 F. Supp. 3d 820 (E.D. Wis. 2019) (upholding the application of tax-affecting the earnings of an S corporation).
152. *Id.* at 826.
153. *Id.*
154. *Id.* at 825–26.
155. *Id.* at 830.

and the IRS sued for a deficiency of approximately $1.8 million.[156] The Kresses paid the deficiencies, then subsequently filed claims for refunds in the federal district court of Milwaukee.[157] The issue at stake was the value of the minority share interests, and specifically for purposes of this article, how to account for the subchapter S election in the valuation of an operating business such as Green Bay Packaging.[158]

Both the taxpayers' and IRS's experts tax-affected the earnings as if Green Bay Packaging was a C corporation, but the IRS added a premium for the benefits of S corporation status.[159] Similar to *Jones*, Chief Judge William C. Griesbach relied substantially on the findings of the taxpayers' experts to value gifts of minority interests in a Subchapter S corporation operating company.[160] In the opinion, the court noted that the taxpayers' valuation expert had a great deal of familiarity with Green Bay and had worked with the company for over a decade, that his appraisal expressed a significant amount of quantitative and qualitative data, and that the appraisal he prepared was not in hindsight or in anticipation of litigation (which was distinguished from the IRS's expert).[161]

Ultimately, the court sided with the taxpayers, concluding that S corporation status was a neutral factor and not a valuation premium as the IRS expert contended.[162] The court also noted these transfers occurred during a time of economic crisis—the subprime mortgage recession.[163] Although *Kress* is not a U.S. Tax Court opinion, it may be influential to other courts considering tax-affecting and can provide additional insight for valuation professionals.[164] This is notable in light of the fact that the court in *Kress* was highly impressed with the taxpayers' expert and complimented him and his findings throughout the opinion.[165]

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156. *Id.* at 826–27.
157. *Id.*
158. *Id.* at 828–29.
159. *Id.* at 833.
160. *Id.* at 836–38.
161. *Id.* at 835, 838–39.
162. *Id.* at 836.
163. *Id.*
164. *Id.*
165. *See generally id.* (court compliments Emory, the taxpayer's expert, various times throughout the opinion).

B. Cecil v. Commissioner

Cecil v. Commissioner is also of particular importance to the applicability of tax-affecting.[166] In February 2016, the tax court tried this case and it is anticipated the resulting opinion should address tax—affecting S corporation shares as a primary issue.[167] Both the taxpayer's and the IRS's experts tax-affected the earnings of Biltmore Company, and the historic estate in North Carolina of George Washington Vanderbilt II, while using the discounted cash flow method to value the company for transfer tax purposes.[168] As of the date of this article, however, it is still waiting decision.[169]

IV. IRS'S RELIANCE ON PREVIOUS TAX-AFFECTING CASES

A. Gross v. Commissioner *and Subsequent Cases*

Prior to 2002, it appeared customary to adjust the earnings from the PTE to reflect estimated corporate income taxes that would have been payable had the pass-through form, specifically S status, not been elected.[170] These adjustments were meant to avoid distortions when applying industry ratios such as price to earnings.[171] However, *Gross* was a death knell to this generally accepted school of thought.[172] In finding that tax-affecting of an S corporation's earnings was not supported by the facts, and going so far as to call the assumed corporate tax rate of 40% "fictitious," the Sixth Circuit Court of Appeals' opinion in *Gross* marked a defining moment.[173] The ruling obstructed taxpayers' ability to reap the potential benefits of tax-affecting a PTE for nearly twenty years.[174]

In *Gross* and the cases following after its issuance, a 0% corporate tax rate was applied and tax-affecting was categorically rejected on grounds that

166. *See* James W. Brockardt, *Tax Affecting: After the Kress and Jones Cases, Will Cecil be "Strike Three?"*, BCG VALUATIONS (Feb. 20, 2020), https://bcgvaluations.com/tax-affecting-after-the-kress-and-jones-cases-will-cecil-be-strike-three/ [https://perma.cc/HMR9-6DRY].

167. *Id.*

168. *See S-Corporation Valuation Debate – The Impact of* Cecil v. Commissioner, HEALTH CAP. TOPICS (Jan. 2017), https://www.healthcapital.com/hcc/newsletter/1_17/PDF/CORP(a).pdf [https://perma.cc/6377-BWBE].

169. *Id.*

170. *See Valuation Training for Appeals Officers Course Book*, BUS. VALUATION RES., https://sub.bvresources ttps://sub.bvresources.com/FreeDownloads/irs.training.pdf [https://perma.cc/NJ88-Y3XR] (last visited Jan. 31, 2021) (providing general guidance on accounting for the differentials in taxation of the earnings of S corporations and partnership against C corporations).

171. *Id.*

172. Gross v. Comm'r, 78 T.C.M. (CCH) 201 (1999).

173. *Id.* at *337.

174. *Id.*

PTEs are not subject to double taxation.[175] Time and time again, the courts consistently sided with the IRS's valuation expert.[176] In each case, the court concluded that in applying an income method to the earnings stream of the pass-through entity, the proper entity level tax rate was its actual tax rate of 0%.[177] Each case was decided on its own specific facts including the entity's pass-through tax status and the argument that the tax status was expected to remain static.[178] Estate planners and valuation professionals should be familiar with these opinions, and the facts merit careful consideration because they expand upon each party's respective arguments with respect to the suitability of tax-affecting.

In *Gross*, the owners of G&J Bottling, a Pepsi bottling company structured as an S corp, transferred interests in the company to their descendants.[179] The taxpayers estimated a value of $5,680 per G&J share and tax-affected the earnings by an assumed 40% rate.[180] The IRS estimated a value of almost double that, and did not tax-affect.[181] The specific question raised in *Gross* was whether hypothetical entity level taxes should be applied to the earnings stream (tax-affecting) of a pass-through entity, and, if so, in what manner?[182]

In finding for the IRS, the Sixth Circuit Court held the tax-affecting presented by the taxpayers' expert was not appropriate based on the facts presented.[183] Going further, the court seemed to view tax-affecting as "fictitious" and noted that a benefit of S corporation status is a reduction in the tax burden.[184] The court also rejected the use of internal IRS guidance to support tax-affecting, such as the *IRS Valuation Guide for Income, Estate and Gift Taxes: Valuation Training for Appeals Officers and the IRS Examination Technique Handbook*, because the guides were intended for "IRS Use Only," and because the guides contained certain disclaimer language.[185] Though the court indicated that valuation was a fact-specific task exercise, the IRS has used *Gross* for the past twenty years to support the

175. *Id.* at *341.
176. *See The Hope for S Corp Valuation Clarity*, STOUT (Aug. 29, 2016), https://www.stout.com/en/insights/commentary/cecil-v-commissioner-the-hope-for-s-corp-valuation-clarity [https://perma.cc/X6L3-BMZY].
177. *Id.*
178. *Id.*
179. Gross v. Comm'r, 272 F.3d 333, 335 (6th Cir. 2001) (the judgment of the court and the opinion delivered by Judge Clay constitutes the opinion of the court with the exception of Part II.B.1. Regarding this specific part, the opinion of the court is limited to the separate concurring opinion delivered by Judge Cohn and concurred by Judge Daughtrey).
180. *Id.* at 336.
181. *Id.*
182. *See id.* at 345.
183. *See id.* at 351, 353 (Cohn, J. concurring in part).
184. *See id.* at 352–53.
185. *Id.* at 352–53.

argument that the tax court effectively "banned" tax-affecting in valuing pass-through entities, and have been quite successful in doing so.

For example, the following Tax Court Memoranda were all decided in favor of the IRS on the issue of tax-affecting. Though not published in a government reporter, these cases bolstered support for the repudiation of tax-affecting.[186] The tax court in *Wall v. Commissioner* rejected the use of tax-affecting, reasoning that tax-affecting would result in an undervaluation of the S corporation stock.[187]

In another Memorandum decision, *Estate of Heck v. Commissioner*, the tax court again rejected tax-affecting, finding the effect of S corporation status was "subsumed" within the lack of marketability and minority interest discounts.[188]

In *Estate of Adams v. Commissioner*, the tax court continued this trend by rejecting the tax-affecting argument put forth by the estate.[189] The court specifically noted that the pool of willing buyers for the PTE in this situation would have been able to continue operations as an S corporation (as opposed to a required conversion upon a sale or other disposition).[190] If the pool of willing buyers had been C corporations, which might have supported a tax-affecting stance, that argument should have been flushed out further by the taxpayer, according to the court.[191]

Likewise, *Dallas v. Commissioner* tracked the holding in *Gross*.[192] Here, the tax court rejected the taxpayer's argument because the taxpayer's expert failed to provide sufficient evidence to establish that a hypothetical buyer and seller would tax-affect the company's earnings.[193]

In *Estate of Gallagher v. Commissioner*, the court found no reason to impose an unjustified, fictitious corporate tax rate burden on future earnings, and therefore rejected the taxpayer's use of tax-affecting.[194]

In *Estate of Giustina v. Commissioner*, supplementing *Estate of Giustina v. Commissioner*, the tax court determined the value of a 41.128% limited partner interest in Giustina Land & Timber Company, an operating business limited partnership engaged in timberland operations as a going business.[195] Here, the court did not allow for tax-affecting the pretax earnings

186. Wall v. Comm'r, 81 T.C.M. (CCH) 1425 (2001).
187. *Id.* at *12, n.13.
188. Est. of Heck v. Comm'r, 83 T.C.M. (CCH) 1181, at *15–16 (2002).
189. Est. of Adams v. Comm'r, 83 T.C.M. (CCH) 1421, at *3 (2002).
190. *Id.*
191. *Id.* at *5.
192. Dallas v. Comm'r, 92 T.C.M. (CCH) 313, at *8 (2006).
193. *Id.*
194. Est. of Gallagher v. Comm'r, 101 T.C.M. (CCH) 1702, at *12 (2011), supplemented by, 102 T.C.M. (CCH) 388 (2011).
195. Est. of Giustina v. Comm'r, 111 T.C.M. (CCH) 1551, at *6 (2016), supplementing, 101 T.C.M. (CCH) 1676 (2011), *rev'd on other grounds*, 586 F. App'x 417 (9th Cir. 2014).

of the pass-through entity because it determined that the discount rate was derived from pretax level rates of return.[196] It should be noted the estate apparently admitted in its brief that tax-affecting was unsettled as a matter of law and the court made mention of it in the opinion.[197]

Though tax-affecting has been controversial in the past, the IRS's reliance on *Gross* as a ban on tax-affecting is becoming outmoded as valuation experts have become more diligent in relying on case specific facts and empirical evidence in contrast to the Tax Court Memoranda discussed above. *Jones* and *Kress* lend the presumption that courts are now willing to delve into the factual underpinnings, circumstances, and evidence presented by the experts to determine whether tax-affecting is appropriate. Counsel for the taxpayers in those cases were able to present the courts with "good facts" as a foundation to support tax-affecting, which ultimately resulted in taxpayer victories.[198]

V. THE FUTURE OF TAX-AFFECTING

A. The Tax Cuts and Jobs Act of 2017

1. Reduction of Federal Corporate Tax Rate

The ability to fully tax-affect the earnings of a PTE for a C corp equivalent using the higher pre-TCJA corporate level tax rate has a remarkable improvement in tax savings on transfers of the company interests.[199] The TCJA's modifications to the Tax Code, however, dull the blade of tax-affecting post *Jones* and *Kress* for transfers made after its enactment.[200] To summarize the relevant provisions, the TCJA lowers the top corporate income tax rate from 35% to a flat 21%, and the qualified dividend tax rate remains at its 2017 level of 20%.[201] The top individual ordinary income tax rate, which applies to a PTE owner's earnings, marginally dropped from 39.6% to 37% and new I.R.C. section 199A provides a deduction of up to 20% of qualified domestic business income for PTEs.[202]

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196. *Id.*

197. *Id.*

198. *See* Est. of Jones v. Comm'r, 118 T.C.M. (CCH) 143 (2019); Kress v. United States, 382 F. Supp. 3d 820, 824 (E.D. Wis. 2019).

199. Kelly M. Perez, *The TCJA Curtails the Benefits of Tax-Affecting, But Opportunity Remains*, TR. & ESTS. Aug. 2020, at 2.

200. *Id.*

201. *Id.*; I.R.C. § 11(b), *amended by* Tax Cuts and Jobs Act, Pub. L. No. 115-97, § 13001(a) (2017); I.R.C. § 1(a)(11).

202. Perez, *supra* note 199, at 2; I.R.C. § 1(a)(11), *amended by* Tax Cuts and Jobs Act, Pub. L. No. 115-97, § 11001 (2017).

The 21% corporate tax rate is permanent, under TCJA while the latter two provisions sunset after Dec. 31, 2025.[203]

Consider the following hypothetical example for a single individual using pre- and post-TCJA federal tax rates for a company with $1 million in pre-tax income, using the highest individual rate, and assuming the owner is not subject to additional state tax and does not qualify for a deduction under section 199A.[204] Using 2017 tax rates, a C corp shareholder's total tax liability is 50.47% of the total earnings, while an S corp shareholder's total tax liability is 43.40%.[205] When applying 2018 rates, the spread between a C corp shareholder's total tax liability and an S corp shareholder's tax liability is so narrow that it can be characterized as a rounding error.[206]

Under the TCJA, it appears that tax-affecting the earnings of a large PTE for an assumed corporate tax rate no longer has the profound effect on the FMV of an entity for transfer tax purposes that it once had, as in *Jones*.[207] Additionally, the ability of a PTE to offer a greater return on earnings compared to a C corp is further weakened once the TCJA's individual tax benefits, including section 199A, expire.[208] One could argue that valuing PTEs may now be less complicated, as previous methods using C corp comparables is outmoded.[209] Ultimately, appraisers must determine whether it is still prudent to award a premium or to consider a PTE more favorable than a C corp when determining the FMV of an entity for transfer tax purposes.[210]

2. COVID-19 and the Economic Downturn

The current pandemic environment, though fraught with uncertainty and market decline in many sectors of the economy, may be an ideal time to transfer interests in a closely-held family business to the next generation in a tax-efficient manner.[211] A fundamental element in the valuation of a company is the expectation of future performance with a focus on projected cash flows.[212] Though at the time of this article the stock market is performing relatively well, there remains a huge discrepancy with economic reality as many business sectors are financially suffering, and many individuals are still

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203. Perez, *supra* note 199, at 2; Tax Cuts and Jobs Act, Pub. L. No. 115-97, § 11001, 11011.
204. Perez, *supra* note 199, at 2.
205. *Id.*
206. *Id.*
207. *Id.*
208. *Id.*
209. *Id.* at 3.
210. *Id.*
211. *See id.* at 1.
212. *See id.* at 2.

unemployed and relying on stimulus or other government-based funds or programs for survival.[213]

The use of economic projections, larger marketability discounts due to volatility, and tax-affecting, the FMV of a closely-held, family-owned business can be further depressed for transfer tax purposes.[214] This is supported by the opinions in both *Jones* and *Kress*, in which the gifts were made during and around the 2008 recession, where both judges acknowledged the contributions the economic crisis had on the valuation of the respective company interests.[215]

Though tax-affecting may not move the needle as it once did, it's still a formidable tool.[216] The long-awaited tax court opinion in *Cecil* could provide additional support for the validity of tax-affecting as a trusted and established economic theory.[217] Under the TCJA, the benefits of tax-affecting have been tempered, but given the unpredictable nature of changes to our tax laws, tax-affecting could become more of a force should the corporate tax increase.[218]

On March 31, 2021, President Joe Biden unveiled the Administration's proposed "American Jobs Plan," a $2 trillion jobs plan focused on infrastructure and climate.[219] It is intended that the plan will be financed in part by a slight raise to the corporate tax rate from the current 21% to 28%, or somewhere in between.[220] The plan could also make other changes to TCJA that may affect a tax-affecting analysis.[221] While a discussion of the American Jobs Plan's viability in Congress is beyond the scope of this article, an increase in the corporate tax rate bodes well for the continued use of tax affecting. If tax-affecting becomes a widely accepted practice now, it may be less likely that the courts will revert to the dark and draconian days of *Gross* and the cases that followed in its footsteps.[222]

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213. Patti Domm, *How the Pandemic Drove Massive Stock Market Gains, and What Happens Next*, CNBC (Dec. 31, 2020, 11:47 AM), https://www.cnbc.com/2020/12/30/how-the-pandemic-drove-massive-stock-market-gains-and-what-happens-next.html [https://perma.cc/H4UA-VY83].

214. Perez, *supra* note 199, at 3.

215. *Id.*

216. *Id.* at 4.

217. *See* William A.V. Cecil, Sr. v. Comm'r, Docket Nos. 14639-14, 14640-14.

218. *See generally* Garrett Watson, *No 'Stealth Tax Hike' in 2021, but Individual and Business Tax Increases Loom*, TAX FOUND. (Nov. 18, 2020), https://taxfoundation.org/no-stealth-tax-increases-in-2021-republican-biden-taxes/ [https://perma.cc/Y6MR-46TZ] (demonstrating the unpredictable nature of taxes).

219. John Wagner & Reis Thebault, *Biden Pitches $2 Trillion Infrastructure Plan as a Chance to 'Rebuild the Backbone of America*,' WASH. POST (Mar. 31, 2021), https://www.washingtonpost.com/politics/2021/03/31/joe-biden-live-updates/ [https://perma.cc/9BHY-T55S].

220. Andrew Duehren, *Smaller Corporate Tax Increase Floated at White House Infrastructure Meeting*, WALL STREET J. (Apr. 19, 2021), https://www.wsj.com/articles/biden-infrastructure-meeting-focuses-on-taxes-scope-of-plan-11618857994 [https://perma.cc/B9TA-7T92].

221. *Id.*

222. *See* Brockardt, *supra* note 166.

VI. OBSERVATIONS ON TAX-AFFECTING

Jones is groundbreaking in that it is the first published opinion by the United States Tax Court in almost twenty years holding that it is appropriate to tax-affect the earnings of a pass-through entity when using the DCF method to value an entity for transfer tax purposes.[223] The opinion in *Jones* provides estate planners and valuation professionals with several key takeaways.[224] First, *Jones* is a perfect example of an estate planning transaction with "good facts."[225] The Jones' Seneca entities were distinct yet interrelated.[226] The gifts by Mr. Jones were part of a well thought out business succession plan and took place during a time of economic turmoil that severely affected the value of the interests as the family business enterprise was dependent on the housing market to be profitable.[227] Finally, the valuation report as prepared by Mr. Reilly for trial was carefully engineered, detailed and quantitatively and qualitatively accurate.[228] It is clear from the lengthy opinion that Judge Pugh was impressed with the appraisal, the specific facts of the case and the business operations of the Seneca entities.[229]

In determining the appropriate valuation method, Judge Pugh considered both the income and the asset approach to value, concluding that the income approach was appropriate due the interrelationship of the two entities being valued and the likelihood (or the lack thereof) of the assets being sold.[230] *Jones* appears to stand for the proposition that it is appropriate to consider the applications of both income-based and asset-based approach to valuate an interest in an entity that has characteristics of both an operating entity and an investment holding entity, such as the Seneca entities.[231] It could be problematic if a valuation fails to consider both approaches or considers the approaches yet fails to provide sufficient explanation of this consideration in their report.

In her determination that the income approach was the sole appropriate approach, Judge Pugh concluded there was no likelihood the assets would be sold by the general partner.[232] This scenario equates to the premise that the entity will never sell the assets.[233] While this premise might be appropriate in *Jones*, given that timberland is an asset with a long-time horizon, such a

223. *See* Est. of Jones v. Comm'r, 118 T.C.M. (CCH) 143, at *12 (2019).
224. *See id.*
225. *See id.*
226. *See id.*
227. *See id.* at *5.
228. *See id.* at *13–*14.
229. *See id.*
230. *See id.* at *10.
231. *See id.*
232. *See id.* at *16.
233. *See id.*

proposition should be reviewed and thoroughly substantiated by estate planning and valuation professionals.

It should also be noted that in reaching this conclusion, Judge Pugh cited the Ninth Circuit Court of Appeals opinion in *Giustina* remanding the case back to the tax court with instructions to weigh the valuation of a limited partnership interest in a timber entity as follows: 100% to the income approach and 0% to the asset approach.[234] If the estate had lost in *Jones*, it would have appealed to the Ninth Circuit and would possibly have received a favorable outcome.[235]

With respect to tax-affecting, Mr. Reilly's detailed support for both the benefits of and detriments of pass-through status provided the court with enough fuel to deviate from cases like *Gross*, and agree with the use of tax-affecting the earnings of an S corporation when using the DCF method for valuation.[236]

Judge Pugh's opinion distinguished *Jones* from previous cases such as *Gross* and *Gallagher* indicating the opinions of taxpayer experts in those cases were rejected not because they proposed tax-affecting, but because those cases failed to consider any S corporation benefits.[237] Therefore, if an appraiser is going to utilize tax-affecting, it is highly advisable that they consider the benefits (and in some situations disadvantages) associated with pass-through status.

Prior to the TCJA, tax-affecting had a significant impact on value conclusions.[238] With the current corporate tax rate at 21%, many valuation professionals believe the impact of tax-affecting has been significantly diminished since the spread between individual income tax rates and C corporation rates has narrowed substantially.[239] This view may change with an increase in the corporate tax rate to 28% as proposed by President Joe Biden under the proposed American Jobs Plan.[240] Because the gifts in *Jones* were made prior to the TCJA, the valuation method used and the implementation of tax-affecting created a staggering difference in value between the $424 million of SJTC LP that the IRS asserted, against the $107 million of value that Mr. Reilly asserted at trial.[241]

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234. *See* Est. of Giustina v. Comm'r, 101 T.C.M. (CCH) 1676 (T.C. 2011), *rev'd and remanded*, 586 F. App'x 417 (9th Cir. 2014).

235. *See id.*

236. *See Jones*, 118 T.C.M (CCH), at *12.

237. *See id.* at *13.

238. *See* Cindi Barela Graham et al., *Effects of Tax Changes on Business Valuations*, 2018 TEX. C.L.E ADVANCED FAM. L. 67-IV (2018).

239. *See* Charles J. Russo & James A. DiGabriele, *Impact of the Tax Cuts and Jobs Act on the Valuation of S Corporations*, 10:2 J. FORENSIC & INVESTIGATIVE ACCT. 153, 165 (2018).

240. *See* Wagner & Thebault, *supra* note 219.

241. *See Jones*, 118 T.C.M. (CCH), at *14.

Tax and valuation professionals should persist with tax-affecting for several reasons.[242] First, smaller businesses that qualify for the 20% deduction in qualified business income under Section 199A benefit from a more significant spread in the total tax liability when comparing a PTE and its C corporation equivalent.[243] Second, the impact of tax-affecting will be greater in states that assess a state-level corporate tax, especially in situations in which the corporate tax and individual income tax gap is substantial.[244] Third, because it has been allowed in cases such as *Jones* and *Kress*, and its benefits have been diminished by the TCJA, the IRS may be less motivated to challenge its use going forward.[245] Though the IRS has not released guidance as to whether it has acquiesced to the practice of tax-affecting, IRS valuation experts might not want to waste time and energy in argument.[246] This could be significantly beneficial should there be an increase in the corporate tax rate under the Biden Administration.

VII. CONCLUSION

A final thought is that an experienced appraiser is a vital component of any estate planning transaction involving the transfer of hard to value assets.[247] In both the *Jones* and *Kress* opinions, the respective judges were impressed with the thoroughness and diligence the appraisers displayed in their valuations.[248] For example, Judge Pugh noted that Mr. Reilly had performed nearly 100 business valuations of sawmills and timber product companies specifically.[249] As suggested in these cases, determining the value of an interest in a closely-held entity is ripe for contest, and the opinions of valuation experts vary.[250] Additionally, when estate planning attorneys review draft appraisals they should not limit their review to the reasonableness of valuation discounts, such as lack of marketability and control.[251] They should ensure that all positions are supported by evidence and fully developed.[252] Careful consideration of the issues discussed herein,

242. *See supra* notes 239–41.

243. *See Final Federal Tax Reform Bill Has State Tax Implications*, N.Y.C. BAR, Dec. 21, 2017, 2018 WL 2902395.

244. *See* Russo & DiGabriele, *supra* note 239, at 155.

245. *See Jones*, 118 T.C.M. (CCH), at *14; Kress v. United States, 382 F. Supp. 3d. 820, 841 (E.D. Wis. 2019).

246. *See* BOGDANSKI, FEDERAL TAX VALUATION ¶ 6.03 at 24 (Thomson Reuters, 2020).

247. *See Jones*, 118 T.C.M. (CCH), at *14; *Kress*, 382 F. Supp. 3d. at 841.

248. *See Jones*, 118 T.C.M. (CCH), at *14; *Kress*, 382 F. Supp. 3d. at 841.

249. *See Jones*, 118 T.C.M. (CCH), at *9.

250. *See* Gallagher v. Comm'r, 101 T.C.M. (CCH) 1702, at *5; Gross v. Comm'r, 272 F.3d 333, 351 (6th Cir. 2001); *Jones*, 118 T.C.M. (CCH), at *14; *Kress*, 382 F. Supp. 3d. at 841.

251. *See* Dunning et al., *Family Limited Partnerships: Strategies and Planning Techniques for 2011-2012*, 2012 TEX. CLE ADVANCED EST. PLAN. STRATEGIES 1, 3 (2012).

252. *Id.*

such as the company's operations, tax status, potential future transactions, etc., by an estate planning attorney and a valuation professional at the onset of a valuation engagement will lead to a well-supported conclusion, as well to minimize examination risk.[253]

253. *See supra* Sections II.A, IV.A.