
Estate of Aaron U. Jones v. Commissioner, T.C. Memo. 2019-101

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Tax Court Might Be Listening to Tax-Affecting Analysis; Operating Timber Business Valued Under Income Method Rather Than Based on Net Asset Value

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Synopsis

In May 2009, Aaron Jones made gifts to his three daughters, and to trusts for their benefit, of voting and nonvoting interests in an S corporation and limited partnership that together operated a lumber and timber business that he had originally founded in 1954. He reported the gifts on his gift tax return with a total value of about \$21 million, but the IRS notice of deficiency asserted a value of about \$120 million and a gift tax deficiency of about \$45 million. The Tax Court agreed with the taxpayer's appraiser that the value was about \$24 million, and the resulting gift tax owed will apparently be less than \$2 million.

The most significant issue from a monetary standpoint is that the timber is valued under the income method rather than the net asset value method in this situation where there is an ongoing business operation and the facts are clear that the timber will not be liquidated and the transferee would have no ability to force the liquidation. Another interesting issue is that the Tax Court concluded that "tax-affecting" the earnings of the S corporation and limited partnership was appropriate in determining the valuations of the entities under the income method. The Tax Court has been reluctant to accept tax-affecting following its decision twenty years ago in *Gross v. Commissioner*. That may be changing. *Estate of Aaron U. Jones v. Commissioner*, T.C. Memo. 2019-101 (August 19, 2019, Judge Pugh).

Basic Facts

1. **Background.** The core business involved in the 2009 gifts was Seneca Sawmill Co. (SSC) of Eugene, Oregon. Mr. Jones founded SSC in 1954 as a lumber manufacturing business; in 1986 it elected to be an S corporation. The Tax Court opinion describes the significant growth of the business since 1954 and includes considerable detail about the operation and business environment of the lumber business. At the time of the gifts in 2009, SJTC (introduced and described in the next paragraph) held approximately 1.45 billion board feet of timber over 165,000 acres in western Oregon.

Originally relying on timber from federal lands, SSC began purchasing its own land in 1989 when environmental regulations had reduced the access to federal lands. In 1992 Mr. Jones formed Seneca Jones Timber Co. (SJTC), an Oregon limited partnership, to hold timberlands intended to be SSC's inventory and to obtain debt financing secured by the timberlands. SSC was the 10 percent general partner of SJTC and contributed to SJTC the timberland it had recently acquired. SSC and SJTC share a management team and share their headquarters in Eugene, which was built in 1996.

SSC's shareholders could not sell, give away, or otherwise transfer their SSC stock, except in compliance with a Buy-Sell Agreement. Any sale of SSC stock that caused SSC to cease to be an S corporation would be null and void under the Buy-Sell Agreement, unless SSC and the holders of a majority of its outstanding shares consented. If an SSC shareholder intended to sell, give away, or otherwise transfer SSC stock to a person other than a family member, the shareholder had to notify SSC, which had a right of first refusal to purchase those shares. If SSC declined to purchase the shares, the other shareholders were given the option to purchase them. If either SSC or other shareholders exercised their option to purchase shares, the purchase price was the fair market value of the shares,

which was to be mutually agreed upon or, if the parties could not agree, determined by an appraisal. Under the Buy-Sell Agreement, the reasonably anticipated cash distributions allocable to the shares had to be considered and discounts for lack of marketability, lack of control, and lack of voting rights had to be applied in determining the fair market value.

Under SJTC's partnership agreement, no transfer of SJTC partnership units was valid if it would terminate the partnership for federal or state tax purposes. The consent of all partners was required for the substitution of a transferee of SJTC partnership units as a limited partner. A transferee who was not substituted as a limited partner would be merely an assignee. Limited partners were also subject to a Buy-Sell Agreement, which mirrored SSC's Buy-Sell Agreement: Any transfers that would terminate SJTC's partnership status for tax purposes were void; SJTC and then the other limited partners were granted a right of first refusal before a limited partner could transfer units; and a determination of fair market value had to take into account lack of marketability, lack of control, lack of voting rights of an assignee, and the reasonably anticipated cash distributions allocable to the units.

2. **The 2009 Gifts.** On May 28, 2009, pursuant to succession planning that began in 1996, Mr. Jones formed seven family trusts, made gifts to those trusts of SSC voting and nonvoting stock, and made gifts to his three daughters of SJTC limited partner interests.

The following tables show the ownership of SSC and SJTC before and after the gifts:

Ownership of SSC Before and After the 2009 Gifts

Shareholder	Voting Shares		Nonvoting Shares	
	Before	After	Before	After
Aaron Jones	4,900	3,600	39,468	8,700
Voting Trust		1,300		
Family Trust	600	600		
Rebecca Jones*	1,500	1,500	544	10,800
Kathleen Jones Hall*	1,500	1,500	544	10,800
Jody Jones*	1,500	1,500	544	10,800

* Aaron Jones's daughter. Numbers for the nonvoting shares include trusts for her and her family. After the gifts, Aaron and his daughters (or trusts for them and their families) each owned 12,300 total shares (voting and nonvoting).

Ownership of SJTC Before and After the 2009 Gifts

Partner	General Partner Units		Limited Partner Units	
	Before	After	Before	After
SSC	5,550.092	5,550.092		
Aaron Jones			43,290.717	12,487.707
Rebecca Jones			2,220.037	12,487.707
Kathleen Jones Hall			2,220.037	12,487.707
Jody Jones			2,220.037	12,487.707

3. **Gift Tax Valuation Dispute.** Mr. Jones timely filed a 2009 gift tax return, reporting values based on accompanying appraisals that had determined values of \$325 per share of SSC voting stock, \$315 per share of SSC nonvoting stock, and \$350 per SJTC limited partner unit, resulting in total gifts of about \$20,895,000.

The IRS's notice of deficiency asserted that the corresponding values should have been \$1,395 per share of SSC voting stock, \$1,325 per share of SSC nonvoting stock, and \$2,511 per SJTC limited partner unit, resulting in total gifts of about \$119,987,000 and a gift tax deficiency (including other much smaller items which were not disputed in the Tax Court) of \$44,986,416.

Mr. Jones filed a petition in the Tax Court in November 2013. He died on September 14, 2014, and was replaced in the Tax Court proceeding by his estate and his personal representatives. The estate engaged another appraiser, Robert Reilly of Willamette Management Associates, whose appraisal, employing a discounted cashflow (DCF) method, determined values of \$390 per share of SSC voting stock, \$380 per share of SSC nonvoting stock, and also \$380 per SJTC limited partner unit, somewhat higher than the values reported on Mr. Jones's gift tax return but far smaller than the values asserted by the IRS.

An appraiser engaged by the IRS, using a net asset value (NAV) approach, determined the value of an SJTC limited partner unit to be \$2,530, slightly higher than the notice of deficiency. (The court explained that "Respondent did not submit a valuation of SSC and largely accepted the valuation methods and inputs Mr. Reilly used in his valuation of SSC.")

The following table summarizes those per-share and per-unit values:

	Gift Tax Return	Notice of Deficiency	Estate's Expert	IRS's Expert	The Court
SSC voting	\$325	\$1,395	\$390		\$390
SSC nonvoting	\$315	\$1,325	\$380		\$380
SJTC limited	\$350	\$2,511	\$380	\$2,530	\$380

Opinion

A four-day trial was held in Portland, Oregon, in November 2017, and Judge Pugh's opinion in *Estate of Jones v. Commissioner*, T.C. Memo. 2019-101, was issued August 19, 2019, accepting all the values determined by Mr. Reilly.

In the view of the court:

The primary dispute between the parties is whether SJTC should be valued using an income approach or an asset-based approach. The parties have several other points of dispute: (1) the reliability of the 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.

1. **Income or Asset-Based Approach for SJTC.** Whether an income or asset-based approach is used for valuing the timberland in SJTC makes an enormous dollar difference in this case. The court noted that the parties did not dispute that SJTC is a going concern, but also noted that "SJTC has aspects of both an operating company ("SJTC ... plants trees and harvests and sells the logs") and an investment or holding company ("SJTC's timberlands are its primary asset, and they will retain and increase in value, even if SJTC is not profitable on a year-to-year basis")." The court stated:

[T]he less likely SJTC is to sell its timberlands, the less weight we should assign to an asset-based approach. See *Estate of Giustina v. Commissioner*, 586 F. App'x 417, 418 (9th Cir. 2014) (holding that no weight should be given to an asset-based valuation because the assumption of an asset sale was a hypothetical scenario contrary to the evidence in the record), rev'g and remanding T.C. Memo. 2011-141.

The court concluded that:

SJTC and SSC were so closely aligned and interdependent that, in valuing SJTC, it is appropriate to take into account its relationship with SSC and vice versa ...

We, therefore, conclude that an income-based approach, like Mr. Reilly's DCF method, is more appropriate for SJTC than [the IRS's expert's] NAV method valuation. See Estate of Giustina v. Commissioner, 586 F. App'x at 418.

- 2. Reliability of 2009 Revised Projections.** Mr. Reilly's valuation relied on revised projections that SJTC's management made less than two months after SJTC's annual report, out of concern that SJTC might violate its loan covenants. The revised projections were made in April 2009, and the gifts were made in May 2009. The IRS and its expert thought the revised projections "may have represented the worst-case scenario and were overly pessimistic."

The court acknowledged the ground for such alleged pessimism in its description of the background and history of the business, where it noted:

As of the valuation date SSC's dimension and stud lumber were used primarily to build houses and, therefore, its lumber sales were almost completely dependent on housing starts.

...

As of the valuation date the United States was experiencing severe economic turmoil amidst the subprime mortgage crisis, especially in the housing market. Housing starts, which measure new residential construction projects during a given period, declined in the United States from 2.3 million units in early 2006 to 490,000 units in early 2009. The crisis required SSC to reduce production. It also reduced the hours that its employees worked so that it could avoid layoffs.

Regarding the IRS's objection to the 2009 revised projections, the court turned the objection around and concluded:

The only ground for challenging the reliability of the revised projections is that the volatile economic conditions meant that they were not reliable for long. This is precisely why management wanted the revised projections. As they were the most current as of the valuation date, Mr. Reilly's use was appropriate.

- 3. Tax-Affecting.** Mr. Reilly "tax-affected" the earnings of SJTC and SSC by using a proxy for the combined federal and state income tax rates they would bear if they were C corporations, albeit taxed at individual, not corporate rates, in order to adjust for the differences between passthrough entities and C corporations (like the public companies used for comparison in the valuation process). The IRS objected to tax-affecting, arguing that there was no evidence that SJTC or SSC would lose its passthrough status and insisting that the Tax Court had rejected tax-affecting in cases such as *Gross v. Commissioner*, T.C. Memo. 1999-254, *aff'd*, 272 F.3d 333 (6th Cir. 2001), *Estate of Gallagher v. Commissioner*, T.C. Memo. 2011-148, and *Estate of Giustina v. Commissioner*, T.C. Memo. 2011-141.

But the court explained that prior cases such as *Gross*, *Gallagher*, and *Giustina* did not prohibit tax-affecting the earnings of a flowthrough entity per se. Instead, Judge Pugh viewed the issue as fact-based, and noted that the court in those cases had simply concluded that tax-affecting was not appropriate for various reasons on the facts of those cases. In *Jones*, on the contrary, Judge Pugh concluded that Mr. Reilly's detailed tax-affecting analysis was appropriate:

We find on the record before us that Mr. Reilly has more accurately taken into account the tax consequences of SJTC's flowthrough status for purposes of estimating what a willing buyer and willing seller might conclude regarding its value. His adjustments include 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. ... Mr. Reilly's tax-affecting may not be exact, but it is more complete and more convincing than respondent's zero tax rate.

As stated, *Jones* involves tax-affecting for both an S corporation (SSC) and a partnership (SJTC). The court's *discussion* of tax-affecting is addressed to the partnership, SJTC, which comes first in its opinion, probably so that the court could address first what it regarded as the "primary dispute" over the use of an income approach to value SJTC. But it should not be overlooked – and, it is hoped, won't be overlooked by the IRS and the judges in future valuation cases – that in the discussion specifically targeting SSC the court stated, without qualification:

Mr. Reilly used the same methodology to tax-affect his valuation of SSC except that he used a different rate for the dividend tax avoided because his analysis of the implied benefit for SSC's shareholders in prior years yielded a different rate. We accept Mr. Reilly's method of tax-affecting the valuation of SSC for the same reasons we accepted it for the valuation of SJTC.

4. **Intercompany Loans.** The IRS had argued that the intercompany debt (owed by SJTC to SSC) should be treated as a nonoperating investment asset and added to the value of SSC. Again emphasizing the interrelationship of the two companies, the court concluded:

By eliminating SSC's receivable and SJTC's payable and treating their intercompany interest income and expense as operating income and expense, Mr. Reilly captured their relationship as interdependent parts of a single business enterprise. Because SJTC's intercompany interest income and expense were accounted for in the DCF method valuation, the intercompany debt need not be added in at the end as a nonoperating asset. See Estate of Heck v. Commissioner, T.C. Memo. 2002-34.

5. **SSC's General Partner Interest in SJTC.** The IRS had argued that SSC's 10 percent general partner interest in SJTC should be valued as a *nonoperating* asset and a *controlling* interest by valuing it at simply 10 percent of the value of SJTC, rather than on the basis of expected distributions as in Mr. Reilly's DCF valuation. Consistently with its view of SSC and SJTC as a single business enterprise, the court rejected that argument.
6. **Discount for Lack of Marketability.** The court noted that only 5 percent separated Mr. Reilly (35 percent) and the IRS's expert (30 percent) on the subject of lack-of-marketability discounts. The court adds that "Respondent contends 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." There is no further elaboration of how the IRS found 35 percent to be excessive or how it defended its own expert's conclusion of 30 percent. If that is a true portrayal of the IRS's role on this issue, then the IRS must simply have been tired by this point.

To the allegation that Mr. Reilly had not sufficiently explained how he arrived at a 35 percent discount, the court replied “We disagree” and provided a whole paragraph summarizing what Mr. Reilly had done (quoted in section 5 of the Observations below). It then pointed out:

[The IRS’s expert] did not consider the restrictions on transferability in the SJTC Buy-Sell Agreement, and he conceded at trial that it would likely increase the discount by “something like 1%, 2%”. Because [the IRS’s expert] was guessing at changes to his discount during the trial to account for considerations that he left out, we conclude that the proper discount for lack of marketability was 35%.

7. **Conclusion.** The court concluded simply that “we therefore adopt the valuations in Mr. Reilly’s report.” A taxpayer victory, a decade after the gifts.

Analysis

1. **Income or Asset-Based Approach.** The differences between an income approach and asset-based approach can be huge, particularly in a case involving standing timber that obviously is not harvested every year. In *Jones*, Mr. Reilly agreed with a valuation submitted by the IRS that SJTC’s timberland had an estimated market value of \$424 million. Yet, using an income approach and comparisons to guideline operating companies, Mr. Reilly calculated the weighted enterprise value of SJTC to be \$107 million – barely one-fourth the asset value.

This is not the first time the Tax Court has chosen between an income and asset-based approach to the valuation of a Eugene, Oregon, timber business. *Estate of Giustina v. Commissioner*, T.C. Memo. 2011-141, also presented that issue, and the counsel for the estate, the counsel for the IRS, and the estate’s expert were all the same as in the *Jones* case. Rejecting Mr. Reilly’s view in *Giustina*, the Tax Court (Judge Morrison) gave a 25 percent weight to a \$151 million value determined by an asset approach, compared to a value of \$52 million determined by a cashflow method and given a 75 percent weight. As Judge Pugh’s reference to *Giustina* (quoted above) acknowledges, that decision was reversed by the Court of Appeals for the Ninth Circuit’s “holding that no weight should be given to an asset-based valuation because the assumption of an asset sale was a hypothetical scenario contrary to the evidence in the record.” In fact, quoting from a previous opinion, the Ninth Circuit stated in *Giustina*:

As in *Estate of Simplot v. Commissioner*, 249 F.3d 1191, 1195 (9th Cir. 2001), the Tax Court engaged in “imaginary scenarios as to who a purchaser might be, how long the purchaser would be willing to wait without any return on his investment, and what combinations the purchaser might be able to effect” with the existing partners.

If the Tax Court in *Jones* had accepted an asset-based valuation, the estate could have appealed that decision to the Ninth Circuit. It is certainly plausible that the taxpayer’s victory in *Jones*, at least on the issue of the asset-based approach, is attributable in part to the rebuke the Ninth Circuit had given the Tax Court in *Giustina*.

2. **The 2009 Revised Projections.** Neither is this the first time a court has been influenced in a gift tax valuation case by the gravity of the 2008 economic downturn. For example, judicial notice of that recession was a factor in *Kress v. United States* (discussed below), which was also a taxpayer victory that involved tax-affecting and the credibility and thoroughness of the taxpayer's valuation expert.
3. **Tax-Affecting.** "Tax-affecting" refers to the step in the valuation of a closely-held business that seeks to adjust for certain differences between passthrough entities and C corporations. Typically, the passthrough entity in mind is an S corporation, but tax-affecting can be applied in the partnership context too. Significantly, *Jones* involved tax-affecting for both an S corporation (SSC) and a partnership (SJTC).

- a. **Core Justifications.** While many discussions of tax-affecting are quite technical, the core justifications for tax-affecting are generally (1) that a hypothetical willing buyer in the willing-buyer-willing-seller construct of fair market value is looking for a return on the investment and necessarily will enjoy and therefore evaluate that return only on an *after-tax* basis and (2) that comparable data to use in the valuation process typically comes from public sources and therefore largely comes from C corporations, for which earnings are, again, necessarily determined on an *after-tax* basis. Corollaries to those justifications are that passthrough status (3) confers a benefit of a single level of tax compared to a C corporation, but also (4) limits the universe of potential buyers and investors, who might not be able to buy or invest without forfeiting or jeopardizing (or at least complicating) the S corporation status or other passthrough status. Thus, tax-affecting sometimes includes adjustments to accommodate those corollaries, or sometimes is followed by the application of, for example, an "S corporation premium" as the next step following the tax-affecting. That approach is incorporated in a well-known model used by many appraisers in valuing S corporation stock, referred to sometimes as the S Corporation Economic Adjustment Model and sometimes as the S Corporation Equity Adjustment Model, or, in either case, "SEAM."

- b. **Prior Internal IRS Guidance.** Some 20 years ago, the IRS's internal valuation guide for income, estate, and gift taxes explained tax-affecting (without calling it that) this way:

[S] corporations are treated similarly to partnerships for tax purposes. S Corporations lend themselves readily to valuation approaches comparable to those used in valuing closely held corporations. You need only to adjust the earnings from the business to reflect estimated corporate income taxes that would have been payable had the Subchapter S election not been made.

The IRS's internal examination technique handbook for estate tax examiners added:

If you are comparing a Subchapter S Corporation to the stock of similar firms that are publicly traded, the net income of the former must be adjusted for income taxes using the corporate tax rates applicable for each year in question, and certain other items, such as salaries. These adjustments will avoid distortions when applying industry ratios such as price to earnings.

c. **Gross v. Commissioner.** While tax-affecting was not a new concept 20 years ago, it may have been overtly and directly raised and considered in a gift tax case for the first time in *Gross v. Commissioner*, T.C. Memo. 1999-254. In *Gross* the taxpayer's appraiser tax-affected the value of stock of an S corporation, by using an assumed undiscounted corporate income tax rate of 40 percent. Judge Halpern viewed that as "a fictitious tax burden, equal to an assumed corporate tax rate of 40 percent." He tied the idea of tax-affecting for an S corporation to the "*probability*" that the corporation would lose its S status and concluded that "[w]e do not ... think it is reasonable to tax affect an S corporation's projected earnings with an undiscounted corporate tax rate without facts or circumstances sufficient to establish the likelihood that the election would be lost." He acknowledged that the taxpayer's appraiser had discussed the disadvantage of S corporations in raising capital, due to the restrictions of ownership necessary to qualify for the S election, but concluded:

This concern is more appropriately addressed in determining an appropriate cost of capital. In any event, it is not a justification for tax affecting an S corporation's projected earnings under a discounted cash-flow approach. [The taxpayer's appraiser] has failed to put forward any cognizable argument justifying the merits of tax affecting [the corporation's] projected earnings under a discounted cash-flow approach.

He also pointed out, although not in such words, that tax-affecting was counter-intuitive, noting (emphasis added) that "[w]e believe that the principal *benefit* that shareholders *expect* from an S corporation election is a *reduction* in the total tax burden imposed on the enterprise."

Regarding the IRS internal guide and handbook quoted above, Judge Halpern stated:

Both statements lack analytical support, and we refuse to interpret them as establishing respondent's advocacy of tax-affecting as a necessary adjustment to be made in applying the discounted cash-flow analysis to establish the value of an S corporation.

In a confusing set of opinions, in which the lead opinion was not "the holding of the court," the Court of Appeals for the Sixth Circuit affirmed. The judge who wrote the lead opinion stated:

I must recognize that we are merely determining those factors that hypothetical parties to a sale of [the corporation's] stock would have considered as of the gift date. In this regard, I believe that past practices, which the IRS had not deemed to create a deficiency, are demonstrative of the idea that such hypothetical actors would have considered tax affecting [the corporation's] stock. This fact in conjunction with the testimony of the experts informs my conclusion that the court's decision to use a 0% tax affect in deriving the value of [the corporation's] stock was implausible.

A judge who wrote an opinion "concurring in part, dissenting in part," but joined by another judge, viewed the issue essentially as an issue of fact, stating:

Valuing closely held stock incorporates a number of alternative methods of valuation, and the appellate courts have afforded the tax court broad discretion in determining what method of valuation most fairly represents the fair market value of the stock in light of the facts presented at trial. See *Palmer v. Comm'r of Internal Rev.*, 523 F.2d

1308 (8th Cir. 1975). Moreover, “complex factual inquiries such as valuation require the trial judge to evaluate a number of facts: whether an expert appraiser’s experience and testimony entitle his opinion to more or less weight; whether an alleged comparable sale fairly approximates the subject property’s market value; and the overall cogency of each expert’s analysis.” *Ebben v. Comm’r of Internal Rev.*, 783 F.2d 906, 909 (9th Cir. 1986).

...

Valuation is a fact specific task exercise; tax affecting is but one tool in accomplishing that task. The goal of valuation is to create a fictional sale at the time the gift was made, taking into account the facts and circumstances of the particular transaction. The Tax Court did that and determined that tax affecting was not appropriate in this case. I do not find its conclusions clearly erroneous.

d. **IRS Response to Gross.** The IRS jumped on the decision in *Gross*, viewed it as a Tax Court ban on tax-affecting, rewrote its internal guidance, and took very strong stands against tax-affecting in subsequent cases.

e. **Gallagher v. Commissioner.** The Tax Court largely went along with the IRS. For example, in *Gallagher v. Commissioner*, T.C. Memo. 2011-148, Judge Halpern, again, wrote (emphasis added):

As we stated in *Gross v. Commissioner*, ... the principal *benefit* enjoyed by S corporation shareholders is the *reduction* in their total tax burden, a *benefit* that should be considered when valuing an S corporation. [The estate’s expert] has advanced no reason for ignoring such a benefit, and we will not impose an unjustified *fictional* corporate tax rate burden on [the corporation’s] future earnings.

f. **Kress v. United States.** Then, this year, *Kress v. United States*, 123 AFTR 2d 2019-1224 (E.D. Wis. March 26, 2019), addressed tax-affecting in determining the gift tax value of stock in a family owned and operated S corporation, Green Bay Packaging, Inc. (referred to in the court’s opinion as “GBP”). GBP is a vertically integrated manufacturer of corrugated packaging, folding cartons, coated labels, and related products, founded in 1933 and headquartered in Green Bay, Wisconsin. Gifts of stock to younger family members in 2007, 2008, and 2009 resulted in gift tax deficiencies assessed by the IRS. The donors paid those gift tax deficiencies and then filed claims for refund and ultimately sued for refunds in the federal district court in Milwaukee. Both the taxpayers’ expert (John Emory of Emory and Co. in Milwaukee, who had been preparing valuation reports for GBP since 1999) and the Government’s expert (Francis Burns of Global Economics Group in Chicago) had tax-affected GBP’s earnings to apply a C corporation level tax to compare the S corporation being valued to C corporations that were used as comparables. For example, the court noted that “[u]nder the income approach, Burns ... applied an effective tax rate to GBP as if it were a C-corporation and then applied an adjustment to reflect the value of GBP as an S-corporation.” Overall, the court found that “Emory provided reliable valuations of the GBP minority-owned shares of stock” and accepted most of Mr. Emory’s conclusions, including his conclusions regarding tax-affecting.

g. **Jones, Looking to Experts.** Now, in *Jones*, back in the Tax Court with attorneys from the IRS rather than the Justice Department, Judge Pugh appeared to agree that tax-affecting had inappropriately become more an issue with examiners and lawyers than a factual inquiry informed by experts and that the experts needed to be listened to. She said:

While respondent objects vociferously in his brief to petitioner's tax-affecting, his experts are notably silent. The only mention comes in [the IRS's expert's] rebuttal report, in which he argues that Mr. Reilly's tax-affecting was improper, not because SJTC pays no entity level tax, but because SJTC is a natural resources holding company and therefore its "rate of return is closer to the property rates of return". They do not offer any defense of respondent's proposed zero tax rate. Thus, we do not have a fight between valuation experts but a fight between lawyers.

h. **Cecil v. Commissioner.** Over three and a half years ago, the Tax Court tried a case, still awaiting decision, that includes tax-affecting for valuing S corporation stock as one of its issues. *Estate of William A. V. Cecil, Sr. v. Commissioner*, Docket No. 14639-14, and *Estate of Mary R. Cecil v. Commissioner*, Docket No. 14640-14 (trial held February 2016). The only entries on the Tax Court's dockets since the filing of briefs in July 2016 have been papers in January 2018 to change the captions of the cases to reflect both William and Mary Cecil's deaths and Petitioner's Notices of Supplemental Authority this year on April 12 (probably *Kress*, discussed above) and August 20 (undoubtedly *Jones*), with IRS answers three days later in each case. In *Cecil*, both the taxpayer AND the IRS's expert used tax-affecting in their analysis. The Tax Court may have a hard time rejecting tax-affecting as a matter of law when both experts agree in its application. (Tax-affecting is not the only issue in the case.)

Observations

1. **No Mention of Section 2703.** Although there were relevant restrictions on transfer in the SSC and SJTC Buy-Sell Agreements, the IRS evidently did not raise the issue of section 2703. The *Jones* petition was filed in late 2013 and the IRS's answer in early 2014, before the IRS successfully invoked section 2703, at least for purposes of summary judgment, in *Estate of Cahill v. Commissioner*, T.C. Memo. 2018-84 (June 18, 2018).
2. **The Importance of the Appraiser.** The outcome in *Jones* is additional confirmation of the importance of thorough and credible appraisals in Tax Court litigation. Willamette Management Associates had its beginning in Portland, Oregon, and Judge Pugh said of Robert Reilly (whom she called "Richard Reilly") that he "has performed approximately 100 business valuations of sawmills and timber product companies." In rather stark contrast, she said of the IRS's valuation expert only that he "has performed several privately held business valuations." As seen in the foregoing discussion, she found Mr. Reilly's work to be thorough and credible and adopted his judgment, for example, regarding his reliance on the rather atypical "revised projections" and his analysis of tax-affecting that brought her to conclude that "Mr. Reilly's tax-affecting may not be exact, but it is more complete and more convincing than respondent's zero tax rate."

But Mr. Reilly, the appraiser whose opinion and work impressed Judge Pugh, apparently had not been engaged before the gift tax return was filed, but was engaged, like counsel was engaged, for the litigation. Nothing gets attention like a \$45 million notice of deficiency! It may even have given Mr. Reilly greater credibility that his valuation report actually came in a bit *higher* than the values on the gift tax return. But the Jones family may have been lucky that the new appraiser's higher value was not any more higher, as it could have been awkward to disavow it.

3. **Good Facts.** There were some "good" facts in *Jones* that should not be overlooked in evaluating its precedential application.
 - There was of course a legitimate 55-year-old family-owned operating business.
 - There is no indication that Mr. Jones' actions were taken for him under a power of attorney or any other agency arrangement.
 - Mr. Jones' gifts resulted in making his daughters and himself equal owners of the economic interests in both SSC and SJTC. There was no division like 99-1 to attract scrutiny.
 - These were not "deathbed" gifts. Mr. Jones survived the gifts by more than five years. When a deathbed scenario is encountered, it is not possible to go back. But the point remains that often the best estate planning is the earliest estate planning. The counterpoint is that decisions irrevocably made can later become a source of regret and friction, and the desirability of flexibility should not be overlooked.
 - Mr. Jones actually paid some gift tax with his return. The opinion tells us that in 1996 the Jones family built a new headquarters and began succession planning. The succession process was evidently deliberate and not hasty (and, as noted, not a "deathbed" scurry). Mr. Jones may have been advised to choose 2009 when business was down and a willing buyer would have paid less for the business, and there is nothing wrong with that. In 2010 the gift tax rate was scheduled to drop from 45 percent to 35 percent (with the exemption remaining \$1 million), but there was uncertainty, especially after the 2008 election, about what the law in 2010 would be. Overall, Mr. Jones seems to have been very well served by his advisors.
4. **Detailed Appraisal Approach Regarding Tax-Affecting.** Valuation experts are critical of the refusal to allow any adjustment to reflect that an S corporation's income is subject to shareholder-level taxes and most appraisers do tax-affect the earnings of S corporations despite the Tax Court's reluctance to accept tax-affecting. If the appraiser tax-affects earnings to be consistent with data available for the capitalization rate used in the capitalization of earnings method or the discount rate used in the discounted cash flow method, the appraisal should address in detail the reasons for doing so. Otherwise, the court will ask why the appraiser adjusted for entity-level taxes when the entity pays no taxes. In addition, the report should take into consideration and balance any benefits that are associated with flow-through status.

The estate's appraisal in *Jones* provides an excellent example of such a detailed approach that considered both the burden on net cashflow by the anticipated individual income taxes on the business income as well as the benefits of passthrough treatment. Mr. Reilly tax-affected the earnings of the partnership to reflect a 38 percent combined federal and state income tax that the owners would bear to calculate the net cashflow from the partnership as well as the cost of debt capital that was used to determine an appropriate post-tax discount rate. He also took into consideration the benefit of avoiding a dividend tax, including "by estimating the implied benefit for SJTC's partners in prior years and considering an empirical study analyzing S corporation acquisitions" and applying a 22 percent premium to the business enterprise value (that was determined both by a weighted discounted cashflow method and by a guideline publicly traded companies method) to reflect the benefit of avoiding the dividend tax.

The court does not give a detailed description of the analysis used in tax-affecting the S corporation earnings, but said that Mr. Reilly used the same methodology except that "he used a different rate for the dividend tax avoided because his analysis of the implied benefit for SSC's shareholders in prior years yielded a different rate."

5. **Detailed Appraisal Approach Regarding Lack of Marketability Discount.** The *Jones* opinion also provides an excellent example of a detailed analysis of how an appraiser might arrive at an appropriate marketability discount:

Mr. Reilly attached an appendix to his report in which he explained the reasoning behind the discount for lack of marketability. In doing so, he explained in detail the common empirical models—studies on the sales of restricted stock and on private, pre-IPO sales of stock—and the two theoretical models—the option pricing model and the DCF model—summarizing the methodology and results of individual studies. He then discussed the effect that restrictions on transferability have on a discount, as well as the other factors listed in Mandelbaum v. Commissioner, T.C. Memo. 1995-255, aff'd, 91 F.3d 124 (3d Cir. 1996). Mr. Reilly arrived at a 35% discount on the basis of the studies he previously discussed 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 12 months before to [*sic*] the valuation date, and the unpredictability of partner distributions.