

Courts finally warm to “tax affecting”

JOHN A. BOGDANSKI

In valuing the stock of an S corporation, appraisers often take steps to reflect the differences in tax treatment between S corporations and comparable public companies. One way to make the distinction is to reduce the projected income of the S corporation by a hypothetical corporate-level tax. This technique, known as “tax affecting” the income, is common practice among many valuation experts, but it has been slow to catch on with courts in federal tax cases. For two decades, taxpayers seeking lower stock values for estate and gift tax purposes have tried and failed to have the courts accept this methodology.¹

However, two breakthrough cases in 2019 have now established that the door is open for “tax affecting” income – at least if it is coupled with a countervailing adjustment to reflect the tax advantages of the S corporation’s status as a pass-through entity. Surprisingly, in one of the cases, the Tax Court also allowed “tax affecting” of the income of a partnership.

The issues

S corporation stock. Imagine that the assignment at hand is to value the stock of a minority block of stock in an S corporation, Sco. Sco has annual earnings of \$2 million, none

of which is taxable to Sco because of the corporation’s S status. Assume that (as is sometimes the case) the best way to value the Sco stock is through capitalizing the projected annual earnings of Sco.²

The stock of a highly comparable, publicly traded corporation, Compco – assume it is the only comparable company worthy of consideration³ – is trading at 10 times its annual after-tax earnings of \$100 million. Can one conclude, then, that the stock of Sco should also be valued at 10 times earnings, or \$20 million, minus applicable discounts for lack of marketability? To answer that question, the tax consequences of Sco’s operations, at both the corporate and shareholder levels, must be considered.

Taking the corporate level first: Assume that Compco, as a C corporation, pays federal, state, and local income taxes of 30% of pre-

tax earnings. To have after-tax earnings of \$100 million, therefore, Compco’s pre-tax earnings had to be about \$142.9 million. Viewed in terms of pre-tax earnings, the Compco stock is valued with a multiplier of 7, rather than 10. If the pre-tax multiplier is applied to Sco’s earnings, the value of the Sco stock is only \$14 million before lack-of-marketability discounts, not \$20 million.

So which would a hypothetical willing buyer pay for the stock? Some, like the IRS, might say \$20 million minus the lack-of-marketability discount. If investors are willing to pay 10 times after-tax earnings for Compco stock, the argument goes, they would pay 10 times the *untaxed* earnings of Sco, because there is, in fact, no tax bite taken out of Sco’s income. Investors care about firm income that is available to make distributions to owners, and Sco has more of that, per dollar of raw earnings, because of its pass-through tax status as an S corporation.

However, the tax-free nature of an S corporation is not guaranteed in perpetuity. S corporation status is a fragile affair. To qualify, a corporation must be a “small business corporation,” which means, among other restric-

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tions, that it can never have more than 100 unrelated shareholders, can never issue preferred stock, can never have nonresident alien shareholders, and can never have another for-profit corporation or a partnership as a shareholder.⁴ If Sco does any of these things, it turns into a C corporation immediately, bringing on the corporate-level tax. At that point, the annual earnings of \$2 million would be reduced to \$1.4 million after tax.

Here is where a counterargument to the IRS's position comes in. If the after-tax multiplier from a public company is being applied to Sco's earnings, something should be done in the appraisal process to reflect the fact that Sco's earnings, though untaxed at the corporate level now, could be taxed at the corporate level in the future. But what would that step entail? There are at least a few theoretical options.

One option is to increase the discount for lack of marketability. If the appraiser is capitalizing untaxed earnings, the assumption is that Sco will remain an S corporation forever. For that to be assured, the universe of hypothetical willing buyers would have to be limited to parties who are eligible to be S corporation shareholders. Moreover, those buyers must be willing to accept stock with no dividend or liquidation preference, and invest in a company that can never go public. Those limits on the universe of prospective purchasers could be reflected along with other value-depressing factors, such as lack of registration and lack of public awareness, in the lack-of-marketability discount. The Tax Court has gone this route in one federal tax valuation case⁵ and endorsed the concept in another.⁶

More popular among many (but not all) appraisers, however, is to "tax affect" the subject S corporation's earnings – in Sco's case, to reduce its \$2 million annual earnings by a hypothetical corporate tax. That adjustment would bring those earnings down to \$1.4 million, which when capitalized with a multiplier of 10 results in a value of \$14 million before the lack-of-marketability adjustment. Courts in federal tax cases have not previously accepted this approach,⁷ and it is easy to see why not. It assumes that the S corporation is turning into a C corporation, and thus becoming taxable, immediately. For Sco, which may be rolling merrily along as an S corporation and showing no sign of actually losing its pass-through tax status, that seems too steep an adjustment.

Another possibility is to apply the pre-tax multiplier derived from Compco stock prices – 7 instead of 10 – to Sco's earnings. As has been seen, that, too, would result in a steep reduction in the value of the Sco stock. But it also assumes an immediate downgrade to a C corporation, which may not be in the offing for Sco. This methodology has failed to be accepted in the only reported S corporation case decided by a court.⁸

The tax climate at the shareholder level also enters into the analysis. One advantage that Compco shareholders enjoy is that they are not taxed on Compco's earnings until they receive distributions. Thus, they can never find themselves in a tax-related cash-flow bind if Compco is doing well but holding onto its profits. Contrast that with the shareholders of Sco, who must pay income tax on their pro rata shares of Sco's taxable profits each year, even if they do not

receive a distribution. The shareholder-level tax on Compco profits is deferred until the shareholders receive dividends or sell their stock.⁹

In many S corporations, the cash-flow concern is alleviated by having the corporation contractually agree to make distributions to shareholders each year, at least in an amount sufficient to cover the shareholder-level taxes on the corporate income. But honoring such a promise restricts the corporation's ability to retain earnings and expand – a similar disadvantage to the one from which a C corporation such as Compco suffers on account of the corporate tax.

How should the shareholder-level disadvantage be reflected in the process of valuing Sco stock? On a crude level, it could be seen as bolstering the argument for subtracting corporate tax from the Sco earnings, but the phenomenon just described is more about the timing of shareholder-level taxes than it is about a corporate-level tax. A more sophisticated way of acknowledging this drawback of pass-through status is through a discount for lack of control. In the Sco scenario, a discount for minority status may not seem warranted, in that the after-tax multiplier of 10 already reflects the minority status of Compco's public shareholders. But one could, at least in theory, apply such a discount to reflect the disadvantages of status as a noncontrolling shareholder of an S corporation, who is vulnerable to the cash-flow problem. At least one court case has accepted this approach.¹⁰

To adjust values for shareholder-level tax consequences has a nice ring to it. What willing buyer doesn't consider the tax consequences of owning an investment?

But any practice of reducing market prices for the tax consequences of ownership veers toward violating basic principles of valuation. Discounts for the tax consequences of owning an asset are not the norm. For example, if one is valuing outright ownership of a parcel of real estate based on prices paid for comparable property, one does not discount the comparable prices for the fact that any rent from the property will be taxable to the owner. The taxable nature of rental income is already built into the market price of the comparable property.

In contrast, when S corporation stock is being valued based on public company data, the comparable assets in the open market (namely, the public companies' shares) do not share the tax characteristics of the S corporation stock at hand. Thus, some sort of adjustment for the shareholder-level disadvantage seems appropriate – be it a lack-of-control discount or something else.

On the other side of the ledger, however, any downward adjustment for S corporation shareholder tax burdens should be mitigated by the potential benefits of S

status. Pass-through income increases the shareholder's basis in S corporation stock,¹¹ reducing future capital gains – a benefit not enjoyed by C corporation shareholders. Moreover, unlike C corporation dividends, distributions by S corporations generally are not taxed to the shareholders, except in certain cases in which the S corporation used to be a profitable C corporation.¹² Also in the mix, at least for now,¹³ is potential deduction of 20 percent of pass-through “qualified business income” under Section 199A. In the right circumstances, an S corporation shareholder is entitled to this deduction, whereas it is never available to C corporations or their shareholders with respect to corporate profit. All these advantages should be reflected in a tax-sensitive valuation analysis, along with the disadvantages of being an S corporation shareholder.

Partnership interests. Valuation of partnership interests, if based on public company data, presents the same questions, but it is not clear that the answers should be the same. Like an S corporation, a partnership¹⁴ is a pass-through entity

that pays no income tax at the company level. But unlike an S corporation, there is no danger that a partnership will be involuntarily thrust into the double-tax world of C corporations. There are no eligibility requirements for partnerships. They can have an unlimited number of partners, complex capital structures, foreign investors, entities as partners, and the like, without fear of incurring an entity-level tax. The only serious eligibility restriction for pass-through status in a partnership is that the firm cannot (with few exceptions) go public.¹⁵

Although entity-level tax exposure is largely absent in a partnership, the owner-level disadvantage that S corporation shareholders suffer is present in the partnership setting. Partners pay income tax on their distributive shares of the partnership's taxable profits each year, even if they do not receive a distribution.¹⁶ They receive a basis increase for pass-through income that may offset future capital gains,¹⁷ and section 199A may be available, but in the short term, tax liability without cash is a possibility. In contrast, the shareholder-level tax on a C corpora-

¹ Cf. *Apruzzese*, TC Memo. 2019-141 (whistleblower award case; IRS collected estate and gift taxes after tip led to discovery that taxpayer had engaged in “tax affecting” in valuing business interests).

² Depending on the nature of Sco's activities, it might better be valued based on the net values of its assets. Even if income controls the valuation, discounting projected cash flow may be superior to capitalizing a single earnings figure. Alternatively, Sco's stock might best be valued by comparing figures relating to its assets with those of comparable companies whose values are readily available – i.e., public companies.

³ In a typical case, more than one comparable public company will appear.

⁴ See Section 1361(b)(1)(B).

⁵ *Estate of True*, TC Memo. 2001-167, aff'd on other grounds, 390 F3d 1210 (10th Cir. 2004).

⁶ *Estate of Luton*, TC Memo. 1994-539.

⁷ See *Estate of Gallagher*, TC Memo. 2011-

148; *Wall*, TC Memo. 2001-75; *Gross*, TC Memo. 1999-254, aff'd, 272 F3d 333 (6th Cir. 2001) (2-1 decision), cert. denied, 537 US 827 (2002). See also *Giselman*, TC Memo. 1988-391 (valuing stock of former S corporation, now C corporation, by capitalizing average after-tax earnings from prior years; for S corporation years, tax expense was set at zero).

⁸ *Estate of Adams*, TC Memo. 2002-80.

⁹ If Compco does not pay dividends and an individual shareholder dies, the shareholder-level tax on a sale of the stock by heirs is reduced or eliminated by the increase in basis that the stock receives under Section 1014. However, the accumulated earnings and profits of Compco remain for future taxation, if and when dividends are eventually paid to a successor shareholder.

¹⁰ *Estate of Heck*, TC Memo. 2002-34 (discount for “agency problems”).

¹¹ See Section 1367.

¹² See Section 1368.

¹³ Section 199A is scheduled to expire at the end of 2025. See Section 199A(i).

¹⁴ Including any entity taxed as a partnership, such as a limited liability with more than one owner that has not elected to be taxed as a corporation under the “check-the-box” entity classification regulations of Treas. Regs. 301.7701-1–301.7701-3.

¹⁵ See Section 7704.

¹⁶ See Section 702.

¹⁷ See Section 705.

¹⁸ See Section 731.

¹⁹ A major exception is a distribution that triggers the “hot asset” rules of Section 751(b).

²⁰ *Estate of Giustina*, TC Memo. 2011-141.

²¹ *Estate of Giustina*, 114 AFTR2d 2014-6848 (9th Cir. 2014) (per curiam, not officially reported).

²² TC Memo. 2019-101.

²³ Identified by the court as Richard Reilly, but evidently Robert F. Reilly of Willamette Management Associates.

tion's profits is deferred until the shareholders receive dividends or sell their stock. Like an S corporation, a partnership may agree to make annual distributions to partners each year to cover the partner-level taxes on pass-through income, and the distributions themselves generally will not be taxed.¹⁸ But living up to such a promise restricts the partnership's ability to use accumulated earnings for expansion.

On the other hand, there are some S corporation disadvantages about which partnerships need not worry. Once appreciated assets are situated in a corporation, even an S corporation, they cannot be removed without triggering a tax on the appreciation. This disadvantage is generally not present in a partnership, for which distributions are generally not taxable events on any level.¹⁹ And unlike partners, S corporation shareholders cannot make a Section 754 election to increase assets' bases inside the company when shares are sold or a shareholder dies. Thus, one would expect a discount for S corporation status to be greater than any discount for partnership status.

But is any adjustment for tax differences ever available in an income-based valuation of a partnership interest, given the lack of entity-level tax vulnerability? Until recently, this question had not been extensively litigated. The courts had been called upon to decide the issue primarily with respect to S corporation stock. In the one case in which "tax affecting" had been proposed in valuing a partnership interest, the Tax Court rejected it,²⁰ and the Ninth Circuit affirmed.²¹

Estate of Jones

"Tax affecting" of income finally influenced a valuation outcome in the Tax Court in *Estate of Aaron U. Jones*,²² a gift tax case decided in 2019. At issue were the fair market values of limited partners' interests in a partnership, SJTC, and of minority blocks of stock in an S corporation, SSC, that was the sole general partner in SJTC. The Tax Court accepted the valuations of both interests performed by the taxpayer's expert,²³ who "tax affected" the two companies' incomes. However, the expert also increased the values of the companies to reflect the advantages of their statuses as pass-through entities not subject to income tax, and the tax-free nature of their distributions to their owners (partners or S corporation shareholders, as the case may be).

The IRS, citing prior Tax Court decisions, argued that "tax affecting" was inappropriate. There was no evidence, the IRS said, that the partnership would ever become a C corporation, and to "tax affect" impermissibly favored the hypothetical willing buyer over the hypothetical willing seller. Thus, the government contended, a zero tax rate had to be taken as a given in the valuation analysis.

Rejecting this argument, the court found the estate's expert's approach superior in that he included in his analysis both "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." The burden reflected by "tax affecting," in other words, was offset in part by the benefits of pass-through status, reflected by the addition of a premium. The court anchored its opinion on the fact that a willing buyer and seller of the limited

partner's interests or the stock would take into account the tax consequences of the companies' business forms in determining the sale prices for the interests.

The details of the victorious approach were not laid out in the court's opinion, but the basic steps that the expert took were described. Taking the limited partners' interests first, he employed both a discounted cash flow approach and a guideline company, or "market," approach. In the discounted cash flow approach, he imposed a hypothetical 38% tax. This, the court said, represented the combined federal and state tax burdens that owners of partnership interests would bear.

In addition to reducing earnings, the expert also adjusted the

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cost of debt capital he used to determine the appropriate discount rate for the present-valuing of projected earnings. Similarly, in his market valuation, which used multiples of various financial attributes derived from comparison companies, he “tax affected” earnings, although, as the court described it, “the metrics he used to compare the companies to SJTC were pretax.”

In the opposite direction, the expert applied a 22% premium to the partnership’s enterprise value to reflect the benefit that the partners, like all owners of pass-through entities, enjoyed by being exempt from the tax that C corporation shareholders must pay on dividends. The expert calculated this percentage by estimating the implied benefit for the partners in prior years and considering an empirical study, unnamed in the court’s opinion, analyzing S corporation acquisitions. The net result of “tax affecting” and the premium was a discount from the value that would have resulted from treating the partnership as a non-taxpaying entity and ignoring partner-level consequences.

The expert used the same approach in valuing the stock of the S corporation. The only difference, according to the court, was the amount of the benefit of pass-through tax status. Instead of the 22% premium he applied to the partnership interests, he used a different percentage, not disclosed in the opinion, because his numerical analysis of the implied benefit to the shareholders in prior years resulted in a different rate. The court again accepted his work outright.²⁴ As this article went to press, the government had not filed an appeal to the Ninth Circuit.

Kress

“Tax affecting” was accepted – without any offsetting premium for pass-through status – in *Kress*, a Wisconsin district court decision earlier last year.²⁵ Valuing S corporation stock that was the subject of taxable gifts, experts on both sides reduced the corporation’s earnings for a hypothetical corporate tax. The government’s expert,²⁶ however, partially offset the “tax affecting” with a premium for the advantages of S corporation status – the very technique that the taxpayer’s expert employed with success in *Estate of Jones*. The taxpayers’ experts²⁷ in *Kress* objected to the premium, arguing that a minority shareholder, with no control over the corporation’s tax status, could not derive a benefit from it.

The court sided with the taxpayers. “The court finds [the corporation’s] subchapter S status is a neutral consideration with respect to the valuation of its stock,” the judge said.

Notwithstanding the tax advantages associated with subchapter S status, there are also noted disadvantages, including the limited ability to reinvest in the company and the limited access to credit markets. It is therefore unclear if a minority shareholder enjoys those benefits.

The court, which had held that the burden of proof shifted to the government, adopted, almost in its entirety, the valuation provided by one of the taxpayers’ experts. The only change made was to decrease the lack-of-marketability discount slightly, because the expert had considered stock transfer restrictions that should have been disregarded under Section 2703.²⁸

The government appealed to the Seventh Circuit, but soon voluntarily dismissed its appeal. Trial

court records show that sizable judgments against the government for tax refunds have been satisfied.

Analysis

The two 2019 decisions constitute the most significant development in federal tax valuation in quite some time. For several years, development of principles of valuation for federal tax purposes has taken a back seat to other issues of interest to the IRS and the courts. With valuation back at center stage, a number of observations about the new cases can be made, and several remaining questions regarding valuation of interests in pass-through entities can be identified.

Consistency with past decisions. *Estate of Jones* and *Kress* are watershed decisions in that they allow a hypothetical tax to be subtracted from income of pass-through entities in valuing interests in such entities. No previous court opinion had expressly sanctioned such a technique.

But older decisions by the Tax Court had never categorically ruled out the practice, either. *Gross*,²⁹ the 1999 Tax Court decision that kicked off the debate, refused to allow an S corporation’s earnings to be reduced by a hypothetical corporate tax, because such a reduction did not reflect the disadvantages of S corporation status. As asserted by the taxpayer, those disadvantages were “the possibility that, if an S corporation distributes less than all of its income, the actual distributions might be insufficient to cover the shareholders’ tax obligations[;]... the risk that an S corporation might lose its favorable S corporation status[;]” and the fact that “S corporations have a great disadvantage in raising capital due to the restrictions of

ownership necessary to qualify for the S corporation election.” Imposition of a hypothetical corporate tax did not adequately correlate with any of these drawbacks to convince the court to use that measure to quantify them, and without any other alternative on the record, Judge Halperin accepted the IRS’s position that no adjustment should be made. The Sixth Circuit affirmed,³⁰ and the Supreme Court declined review.³¹

But *Gross* hinted that the disadvantages could be quantified by other means. In *Estate of Jones*, other means were in fact employed. Though the prevailing expert began by “tax affecting,” he did so using individual rates, and he counteracted them with a premium.

The court had again rejected imposition of a hypothetical corporate tax on S corporation earnings in *Wall*,³² decided soon after *Gross*. In an explanatory footnote, the court noted that the primary rationale for “tax affecting” was that “a C corporation would be unable to maintain a target company’s S corporation status following an acquisition.” To subtract a full 34% corporate tax went too far for the court, in that when coupled with a discount rate derived from taxable investments, “this methodology attributes no value to [the company’s] S corporation status....” However, the court did not rule out using some

other mechanism to take into account the disadvantages of pass-through status in a future case.

Estate of Gallagher,³³ decided in 2011, also rejected an expert’s discounted cash flow analysis that subtracted an income tax of 39% from an S corporation’s earnings, and assumed a 40% tax rate in setting the discount rate for present-valuing. Not only did the appraiser fail to articulate the reasons for these assumptions, but he also neglected to explain how the 39% and 40% figures were reached. Most importantly, however, the expert failed to take into account the advantages of pass-through status. “[T]he principal benefit enjoyed by S corporation shareholders is the reduction in their total tax burden,” the court declared, “a benefit that should be considered when valuing an S corporation. [The expert] has advanced no reason for ignoring such a benefit, and we will not impose an unjustified fictitious corporate tax rate burden on [the S corporation’s] future earnings.” In *Estate of Jones*, an expert has now presented a satisfactory means for quantifying that benefit, opening the door for a fictitious tax burden to be applied, along with an offsetting adjustment.

S corporation premium. *Estate of Jones* and *Kress* clearly conflict on the precise mechanics of “tax affecting.” The former decision

calls not only for “tax affecting” of earnings, but also for a consideration of the offsetting advantages of pass-through status. The latter accepts “tax affecting” without an offset. Which court has the better of the argument?

The Tax Court position seems more reasonable. As courts and valuation experts have now thoroughly explored, pass-through status is a mixed bag from the investor’s perspective. As the Tax Court has noted for decades, if being an S corporation were all thorns and no rose petals, shareholders would not choose it. Assuming the pluses and minuses can be reliably quantified, they should both be considered. To treat S corporations as if they were liable for a corporate tax denies the current reality: They aren’t.

“Tax affecting” partnership income. Perhaps the most eye-opening aspect of *Estate of Jones* was the inclusion of a partnership in the analysis. Unlike *Kress*, in which only S corporation stock was being valued, *Estate of Jones* extended “tax affecting” to partnership interests.

The estate and the court in *Estate of Jones* applied the same “tax affecting” technique to both the S corporation and the limited partnership at issue. The only apparent difference was the size of the percentage premium applied to each on account of the

²⁴ For commentary, see McClure, “Timberland Transfer Pricing and Valuation,” 132 J. Tax’n 19 (Feb. 2020); “Gift Tax Valuation of Transfer of Interests in Closely-Held Timber Entities,” 47 ETPL 47 (Jan. 2020); Curry, “Estate Planners Gain Precedent on Pass-through Valuation Maneuver,” 165 Tax Notes 846 (2019); “Tax Court Holds Valuation of Limited Partner Units and Shares of Stock in Closely Held Businesses Proper,” 46 Corp. Tax’n 55 (Nov./Dec. 2019); Robak, “Tax Court Takes First Step Towards Tax-Affecting,” 158 Tr. & Est. 17 (Nov. 2019); “Keeping *Gross* Alive, Nimble Tax Court Accepts PTE Tax Affect-

ing,” 25 Bus. Val. Update 24 (Oct. 2019); Yauch, “Tax Court Hands IRS a Loss in \$45 Million Gift Tax Dispute,” 164 Tax Notes 1470 (2019).

²⁵ *Kress*, 382 F. Supp. 3d 820 (ED Wis., 2019).

²⁶ Francis X. Burns of Global Economics Group LLC.

²⁷ John D. Emory, Sr. of Emory & Co. LLC and Nancy M. Czaplinski of Duff & Phelps LLC.

²⁸ For commentary, see Basile & DiGaudio, “*Kress* and What It Means for S Corporation Stock Valuation,” 132 J. Tax’n 15 (Feb. 2020); Dougherty & Povlich, “The Latest Develop-

ment in Business Valuation: Burdens of Proof, Tax Affecting S Corporations, and Chapter 14 in *Kress*,” 44 Tax Mgmt. Est., Gifts & Tr. J. 179 (2019); Treharne, “Response to a Reader’s Comments Concerning the *Kress* Case,” 25 Bus. Val. Update 8 (Aug. 2019); Van Vleet, “*Kress* and S Corp Valuations: Be a Little Cautious,” 25 Bus. Val. Update 1 (June 2019).

²⁹ TC Memo. 1999-254.

³⁰ 272 F3d 333 (6th Cir. 2001) (2-1 decision).

³¹ 537 US 827 (2002).

³² TC Memo. 2001-75.

³³ TC Memo. 2011-148.

advantages of pass-through status. The two percentages were different, but it is not clear from the opinion which was larger.

This aspect of *Estate of Jones* may prove to be controversial. As noted earlier, although partnerships and S corporations share many characteristics, S corporations are less taxpayer-friendly in several respects. For example, if a corporation's S status terminates, it becomes immediately subject to the double tax regime applicable to C corporations, whereas partnerships can never become C corporations involuntarily. The eligibility requirements for S corporations, which limit their capital-raising abilities, do not apply to partnerships, so long as they are not publicly traded. Although they are pass-through entities, S corporations are nonetheless corporations, from which appreciated property cannot be transferred without triggering recognition of gain. Moreover, partnerships have opportunities to "step up" the bases of their assets under Section 754 when a partnership interest is sold or when a partner dies. In sum, the "tax effect" that decreases value would seem to be greater for S corporations than for partnerships.

Estate of Jones did not expressly acknowledge these differences. Although the prevailing expert treated the S corporation and the limited partnership differently, he did so only in quantifying the advantages of pass-through status, not the disadvantages. Perhaps sensing some of the theoretical problems that his approach presented, the court declared that the expert's "tax-affecting may not be exact, but it is more complete and more convincing than [the IRS's] zero tax rate." Elsewhere, the court struck a similar chord, noting that the taxpayer's

expert's calculations were "more accurate than [the IRS's] blunt zero-rate approach."

An earlier attempt to "tax affect" partnership income had been unsuccessful in *Estate of Giustina*,³⁴ a 2011 case with many parallels to *Estate of Jones*. (The lawyers were the same, the estate's expert was the same, and both companies were in the lumber business in the Pacific Northwest.) In *Estate of Giustina*, the Tax Court rejected "tax affecting" income because of a perceived mismatch between the projected income stream and the discount rate.

The 25-percent reduction [for partner-level taxes] is inappropriate, because the rate at which [the expert] discounted the cashflows to present value was a pretax rate of return, not a posttax rate of return. An appraiser should not reduce cashflows by income tax while simultaneously using a pretax rate of return to discount the cashflows to present value.³⁵

The Ninth Circuit affirmed *Estate of Giustina*,³⁶ but it did so in a way that did not rule out "tax affecting" categorically. "The Estate itself admits in its brief that 'tax-affecting is... an unsettled matter of law,'" the appeals court said. "We therefore cannot say that the Tax Court clearly erred in adopting a pretax rather than a posttax methodology."

The *Jones* court characterized the earlier case as rejecting the way the expert went about "tax affecting," rather than the propriety of "tax affecting" itself. But in fairness to the IRS, it does appear that the technique that the expert used in *Estate of Jones* was similar to the one rejected in *Estate of Giustina*. As the *Jones* court described it, in his guideline-public-companies approach in the later case, the estate's expert "used the tax-affected

earnings as well, although the metrics he used to compare the companies to SJTC were pretax."

In any event, valuation of partnership interests may now involve far more complex calculations than were once thought necessary or appropriate. Over the past three decades, many estate plans have featured discount-generating family limited partnerships. One wonders whether the appraisals on which such plans have relied took into account all the machinations of "tax affecting" – and if not, whether the estate planners left money on the table.

Level of hypothetical tax. One question raised by the *Estate of Jones* and *Kress* is whether the hypothetical tax applied in "tax affecting" is a C corporation income tax or an individual income tax. In *Kress*, an expert on each side applied a C corporation tax to the S corporation's income. In contrast, in *Estate of Jones*, the court described the estate's appraiser as doing something at least slightly different. The court said: "[H]e used 38% as a proxy for the combined Federal and State tax burdens that owners of SJTC would bear (treating SJTC in effect as a taxable C corporation, albeit at an individual, not corporate, tax rate)...." It is not clear from this passage exactly what was going on. If owner-level burdens are being reflected in "tax affecting," and if the owners are individuals, one would expect to see individual tax rates being used, rather than somehow treating the corporation as a C corporation.³⁷

³⁴ TC Memo. 2011-141.

³⁵ Citing *Gross*, supra.

³⁶ 114 AFTR2d 2014-6848 (9th Cir. 2014) (not officially reported), on remand on another issue, TC Memo. 2016-114.

³⁷ This may be especially significant now that the C corporation tax rate has been slashed to 21 percent. Section 11(b). Note that a C corporation, although it may be a partner, may not be a shareholder of an S corporation. Section 1361(b)(1)(B).

Shrinking stakes. As important as the “tax affecting” issue may be in valuing pass-through entity interests, the stakes of the game were likely lowered by the Tax Cuts and Jobs Act of 2017. That law reduced both individual and corporate tax rates; thus, “tax affecting” should not decrease projected income as steeply as it had before. Moreover, at least for the moment, the possibility of a qualified business income deduction under Section 199A would seem to lessen the drawbacks of pass-through status. The difference between a “tax-affecting” discount and a pass-through premium may be smaller than it was in the years at issue in *Estate of Jones* and *Kress*.

A two-edged sword. Despite the jubilation among some in the appraisal community over the acceptance of “tax affecting,” *Estate of Jones* and *Kress* may turn out to be money-makers for the IRS. The lifetime exemptions from estate and gift taxes, currently at astronomical levels, lead the vast majority of the population – even the merely rich, as opposed to the über-rich – to root for higher values, not lower. Higher values mean a greater step-up in income tax basis for property received from a decedent under Section 1014. For those not subject to wealth transfer taxes – 99% or more of the population – this is the new valuation dynamic. Thus, in an important sense, *Estate of Jones* and *Kress* are victories only for the wealthiest 1% (or less) of taxpayers.

Precedential value. Will future courts regard *Estate of Jones* or *Kress* as precedent? Certainly, most judges outside Wisconsin would have no compunctions about disregarding *Kress*, as it is only the view of one district court. But *Estate of Jones* comes from the Tax Court, which

has national jurisdiction and is the forum in which most civil tax litigation takes place. Can the courts be expected to follow *Estate of Jones*?

Caution is in order before drawing that conclusion. For one thing, judges have always stressed that the fair market value of an asset is a highly fact-dependent question – particularly so with respect to closely held businesses, which tend to be unique.³⁸ Moreover, value is a matter of opinion on which appraisers typically disagree. For that reason, as was on full display in *Estate of Jones*, courts sometimes make their findings based on which expert witness turned in a more convincing performance in court. Success might depend, therefore, on the skill of the witness as much as on the merit of the approach she takes.

To make matters even murkier, *Estate of Jones* is a memorandum opinion of the Tax Court. The weight to be given to such opinions has never been entirely clear.³⁹ It seems that they should be regarded as persuasive authority, but only to the extent that their facts parallel those of a given subsequent case.

That said, only a naïve soul would think that a future Tax Court judge might dismiss *Estate of Jones* entirely. In valuation cases, triers of fact are free to

accept the opinion of one or appraiser or another, to combine features of various appraisers' reports, to select any value within the range offered by the expert witnesses, and to reject all the witnesses' opinions. Given the wide latitude that the judges enjoy, the fact that the *Jones* court endorsed a particular methodology gives “tax affecting” a sheen of approval, likely to be given significant weight in future cases.

One weakness of the IRS's case in *Estate of Jones*, and a potential ground of distinction in the future, was the government's failure to produce an expert witness to present direct evidence on all of the open valuation issues. The IRS presented expert witnesses, but one of them⁴⁰ valued only the limited partnership interests, and the other⁴¹ served only to rebut the estate's expert in connection with his income-based approach. Apparently, neither of them testified in support of the government's position that “tax affecting” was never appropriate.

The only mention of “tax affecting” in the two experts' testimonies was in the rebuttal report. And there, according to the court, the IRS's expert argued that “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

³⁸ In *Estate of Giustina*, for example, the Ninth Circuit's standard of review on the “tax affecting” question was for “clear error.”

³⁹ See Levine, Peyser & Weintraub, Tax Court Litigation, Tax Mgmt. Portf. (BNA) No. 630-4th paragraph VIII(C) (2011) (court, although not bound by them, “does not regard those opinions lightly”); Zeidner, “Tax Court Judge Cohen Highlights Memo Opinions,” 58 Tax Notes 400 (1993) (sitting Tax Court judge quoted as advising practitioners not to discount weight of memorandum decisions); Shores, “Closing the Open Transaction Loophole: Mandatory Installment Reporting,” 10 Va. Tax Rev. 311, 344 (1990) (memorandum decisions “represent a decision by the Tax Court in exactly the same way as do reported decisions,

and may be cited as precedent with the same effect”); Murdock, “What Has the Tax Court of the United States Been Doing?” 31 ABAJ 297, 299 (1945) (by chief judge of Tax Court; “[i]f counsel finds in a Memorandum Opinion some precedent of value, he [or she] may cite it effectively in his [or her] brief, even though the opinion does not appear in the bound volumes of the reports of the court”). See also Banoff (letter), “The True Value of Tax Court Memorandum Opinions,” 58 Tax Notes 1551 (1993); Gamble (letter), “What's the Value of a Tax Court Memorandum Opinion?” 58 Tax Notes 1129 (1993).

⁴⁰ John E. Ashbrook of Stout.

⁴¹ Philip M. Schwab of Stout.

is closer to the property rates of return.” The failure to present an expert who endorsed the government’s main argument was damning. “[W]e do not have a fight between valuation experts,” the judge drily remarked, “but a fight between lawyers.” Not every expert blesses “tax affecting,” however, and in a future dispute, the IRS may find an appraiser who can make the case against the practice.

Even if *Estate of Jones* is considered binding on the Tax Court, it leaves much to the imagination. Many of the details of the prevailing appraiser’s work are omitted from the court’s opinion. Particularly sketchy was the court’s description of the premium that was applied to the interests in the limited partnership and S corporation at issue. Somehow the expert quantified the implied ben-

efits of pass-through status to the partners and S corporation shareholders, and in this regard, a study of S corporation acquisitions was helpful. The calculations produced a different premium for the S corporation from the 22% premium applied to the partnership. Beyond that, observers are left to speculate.

Conclusion

It took two decades, but appraisers have gotten courts to accept “tax affecting” the earnings of S corporations, and even partnerships, in valuing minority ownership interests in such entities for federal tax purposes. Taxpayers subject to wealth transfer taxes no doubt welcome this development, but those not subject to those taxes may not share the enthusiasm.

In light of the recent cases, any appraisal of interests in a pass-through entity for such purposes should give due consideration to the effects of both entity-level and owner-level tax attributes on value. The Tax Court opinion in *Estate of Jones* lays out, at least in general terms, the steps that won the day in that case. The details are less clear, however, and so thoughtful, well researched work of a competent valuation expert continues to be an essential ingredient for success against a valuation challenge by the IRS.

Meanwhile, estate planners should stay vigilant to observe how the IRS reacts to its losses in these cases. If and when the government next attacks a “tax affecting” appraisal in court, it will be interesting to see what another judge has to say. ■