Recent Court Cases Continue the "Tax Affecting" Controversy

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It remains one of life's great mysteries as to why a consensus cannot be reached on the issue of tax affecting anticipated future earnings streams associated with the use of the discounted cash flow methodology under the income approach in business valuation when valuing a "pass through" business entity. More than two decades after the United States Tax Court's *Gross*[1] decision, both practitioners and the courts continue to struggle with this issue.

In *Gross*, the Tax Court ruled that it was inappropriate to decrease the expected future cash flows of an S corporation for the income taxes that would ultimately be payable on the entity's income and "from" those cash flow streams. Among the key arguments offered by the Internal Revenue Service's expert, and accepted by the Court, was that the company in question, by virtue of its income tax status (i.e., having a valid S election in place at the date of valuation with no indication that this status would change in the future) had no legal responsibility to pay taxes on that income. In the appeal of the *Gross* decision, the Sixth Circuit Court of Appeals came to the conclusion that reducing the expected future cash flows of the subject company for income taxes (hereafter, "tax affecting") was not appropriate in this case. The Appellate decision was decided by two judges voting *against* tax affecting while a third voted *for* tax affecting.

The outcome in this case caused widespread discussion and commentary, as well as a good deal of consternation within the business valuation profession. An issue that had seemed so clear to many within the profession (based on historical guidance offered by the Internal Revenue Service, endorsement of such tax affecting practices in prior Tax Court decisions, and Internal Revenue Service acceptance of prior valuations involving the subject company's shares) suddenly became the most challenging matter to address in valuations aiming to produce a determination of fair market value.

The *Gross* decision was followed up by a number of other cases that provided victories for the Internal Revenue Service and served, in the intervening years, to cause significant angst for business valuation professionals and taxpayers.[2] While the Internal Revenue Service continually noted during this period that the decision in *Gross* was "fact-specific," each of the referenced cases went to the Service's position with eerie similarity to the ultimate finding in *Gross*.

In addition to the case law developments addressing this issue, in October 2014 the Treasury Department released a white paper described as a Job Aid for Internal Use titled, "Valuation of Non-Controlling Interests in Business Entities Electing to Be Treated as S Corporations for Federal Tax Purposes." This document was intended to help Internal Revenue Service valuation analysts evaluate appraisals of minority interests in S corporations for federal tax purposes. According to the Job Aid, a valuator "tax affecting" expected company's earnings must provide valid reasons that a hypothetical investor would discount the earnings for entity-level taxes.

The Job Aid further pointed out that, while avoiding entity-level taxes is an important benefit to consider when valuing an S corporation, valuators also must consider the negative aspects of owning a minority interest in an S corporation. Such considerations include how much the company distributes to shareholders and whether there is a difference between income tax rates imposed at the corporate level and those imposed at the investor level.

The Job Aid lists the following five factors to consider when deciding how to handle entity-level taxes:

1. Size and composition of the pool of hypothetical buyers
2. Economic interests of the hypothetical seller
3. Actual revenues and expenses of the entity that has elected to be taxed as an S corp
4. Availability at the entity level of equity and debt capital
5. Probable holding period of the transferred interest

The thrust of the Job Aid is to reemphasize that the determination of value is facts-and-circumstances specific, and that each case is different based upon those facts and circumstances in the subject case. This rule applies to all aspect of business valuation, including tax affecting.

While the facts involved in the *Gross* decision certainly favored

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the positions argued by the Internal Revenue Service, the findings in the case, and others, essentially served to increase the value of the subject business by the tax rate applied by the valuators for the estate. Such an approach to valuation is, of course, to accord a substantial increase in the conclusion of value, attributable solely to maintaining a valid S election.

The fallacy of a total dismissal of the tax affect in valuation is to make the assumption, as the courts did in *Gross*, that the Company in no way funds the income tax liability on its own earnings as would be associated with the expected future income, and the attendant cash flows. Certainly, as is well known, it is the expectation of all shareholders in any S corporation, that cash distributions are sufficient to meet the income tax responsibility due for the S corporation-level income that is reported on their individual income tax returns.

Lacking clarity, courts at all levels—and professionals practicing before them—continue to be challenged in matters concerning tax affecting. Recent cases demonstrate that the controversy continues and, in many ways, we have not come to the consensus necessary to eliminate technical challenges to the use of tax affecting in valuing S-corporation interests.

In a recent case in the state of Connecticut, *R.D. Clark and Sons, Inc.*,[3] an appellate court was tasked with reviewing a lower court decision concerning a legal dispute among shareholders, and the valuation of an ownership interest therein that would ultimately serve as the basis for the buyout of a departing shareholder.

In *Clark*, three brothers each owned one-third of a specialty freight trucking company that was structured as an S corporation. After a fallout among the brothers in 2011, one brother asserted shareholder oppression and fraudulent conduct, including a failure to make tax distributions for three consecutive years (which had been an historical occurrence prior to the dispute) by the remaining two brothers, and the matter moved forward to litigation. In response to the departing shareholder's request to liquidate the company, the remaining two brothers, through the company, selected the option under Connecticut law, to buy out the departing brother's shareholder interest.

The proper determination of "fair value" became an obstacle to resolution, and the matter ultimately went to trial. In the trial, which took place at the end of 2015 through early 2016, both parties offered expert testimony. Interestingly, both sides offered expert evidence valuing the company under an income approach, which incorporated tax affecting into their conclusions of value. As one might expect, the experts varied on the rate used for tax affecting, with the departing shareholder's expert using a 12.6 percent rate, while the company's expert used a 25.0 percent rate.

The Trial Court seemed to lean more in the direction of the company's expert, agreeing with his findings. Even so, the Trial Court ultimately chose to undertake the preparation of its own valuation of the subject shareholder interest. That valuation completely dismissed the income tax implications, choosing to forgo any tax affecting.

The issue of tax affecting was one of several challenges the company brought to the Appellate Court. The company's primary argument related to this issue was that a failure to tax affect the company's projected earnings "artificially inflated" the company's value.

In its opinion, the Appellate Court ruled that the company "could not prevail on its claim that the trial court erred by not tax affecting its earnings in analyzing its valuation"; nor did the lower court "abuse its discretion in declining to tax affect [the departing shareholder's] future cash flow, as the court, in the absence of binding authority, carefully considered cases from other jurisdictions, which provided considerable support for its approach, the court was tasked with determining fair value, as opposed to fair market value."

The Appellate Court noted the fact that tax affecting has been "the subject of considerable debate, and [that] there is no Connecticut law that mandates a specific approach to tax affecting." The decision further states that some courts "have chosen to reject the adjustment to S corporations' cash flows based on taxes." In supporting this statement, the Appellate Court cited *Gross*. In fairness, it must be noted that the Appellate Court also cited *Delaware MRI*[4] and *Bernier*[5] as other landmark cases where the courts approved of tax affecting.

The Appellate Court noted that its decision to uphold the findings of the lower court was "based on the facts of this case," and "the present case seems particularly ill-suited to tax affecting earnings," given the company's policy of covering shareholder's tax liabilities. It is interesting that the opinion states that the company's "practice of extending loans to shareholders to cover their tax liabilities and then retiring those liabilities through the payment of bonuses" was the reason that the company was "particularly ill-suited" for tax affecting earnings.

In the author's experience, these actions are often part of a classic intentional "squeeze-out" transaction undertaken by controlling equity owners in an enterprise to force a non-controlling equity owner to sell. The fact that the remaining shareholders had the company make loans to them, ver-

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sus a simple tax distribution, clearly demonstrates their intent to avoid distributing funds to the departing shareholder to pay his tax on his portion of the company's taxable income, thereby forcing him to come out-of-pocket to make the tax payments.

If the courts at both levels had viewed this "loan/bonus" strategy correctly, they would have determined that "the company" was in fact paying the tax liabilities associated with its income, at least for two of the three shareholders. At a minimum, if this practice was expected to continue, there should have been a decrease in expected cash flows for the "bonus" payments, as they constituted a true economic cash outflow. Had they done so, the value would have been reduced accordingly, replacing a portion of the value increment attributable to the disallowance of the tax affecting.

Finally, taking a fact from *Gross*, the Appellate Court noted that it was "totally foreseeable that such a practice would continue after [the] Company purchased the [dissenting shareholder's] shares." Certainly, if bonus payments equal to the tax liabilities were slated to continue, it is difficult to surmise why the Court would not include these payments in cash flows used to determine value.

Not particularly helpfully, the Appellate Court further noted that "the issue of tax affecting continues to be an open debate among experts in the field." Note that the author concurs with that statement in the opinion.

The courts have rarely incorporated the position of the shareholder in their analysis and opinions. Without question, there is a "separation" between the company and the shareholder. However, it is also important to consider the economic proposition between the company and that shareholder.

The shareholder can obviously be viewed as an investor. In exchange for his or her capital investment, he or she is provided an equity interest in the enterprise, which entitles him or her to an economic return fashioned on the risk and expected cash flows of the business. If it is expected that that investor/shareholder will provide further funding to pay income taxes on "non-cash" income allocated to him or her from the company, there will obviously be a requirement to obtain a greater economic return on the equity investment.

The hypothetical buyer envisioned in the definitions of fair market value and fair value makes his or her investment decision based on expected future returns matching risks for that investment. If he or she determines that the required rate of return is 20 percent given the economic, operational, and financial risk associated with that investment, forcing that hypothetical buyer to incur additional cash outflows to pay the income tax on pass through income from the 20 percent return is not reasonable. To draw the hypothetical buyer to an investment that requires out-of-pocket cash outflows for taxes on corporate income would require an additional investment return equal to that out-of-pocket cost.

Further, the question remains as to whether third-party economic information exists anywhere in the marketplace that can competently substantiate the "increased" value accorded one corporation over another simply due to its tax status as an S corporation.

It is questionable whether the *Clark* decision will have any lasting effect on the matter of tax affecting. While the Appellate Court's opinion makes reference to several of the early Tax Court and Appellate cases on this matter (principally, *Gross* and the early follow-on cases noted above), no mention is made in the opinion of more recent findings in which the applicable courts approved the use of tax affecting in the determination of value. The findings in these two cases are at least as important as the Connecticut Superior Court's findings in *Clark*, if not more so.

The first of these relevant recent cases was decided by the United States District Court-Eastern District of Wisconsin in March of 2019. In *Kress*,[6] the Court accepted valuations from both parties' experts. However, it deferred primarily to the evidence and testimony presented by the taxpayers' experts in valuing minority interests in a privately held S-corporation operating company. The expert's findings included a comparison of the value of the company as if it were first, a regular C corporation (where taxes would have been paid at the corporate level). As such, this initial determination would have included "tax affecting" the earnings streams under the income approach.

The second element of the expert's findings included an assessment of the quantitative and qualitative factors attributable to the company as a result of its S-corporation status to determine if there should be a further adjustment to the value determined under the fully "tax affected" calculation as if the company were a regular corporation (i.e., the S-corporation premium). Most often, this methodology is referenced by the business valuation community as the "C to S Method." Variations on this method have been utilized within the business valuation community for many years in one form or another and such methods have generally been viewed as being a reasonable means to addressing this complicated matter.

It should be noted that, while the opinion is short on details, the expert for the IRS also chose to apply tax affecting in determining value using the capitalization

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method under the income approach. Though the Court did not accept this expert's findings, it can only be viewed positively that experts on both sides chose to use similar methods in consideration of the income tax impact.

It is notable that the expert for the government included an S-corporation "premium" in his valuation to reflect the value accorded the shareholders for the perceived tax advantages associated with the company's S-corporation status. The taxpayers' experts accorded no value to this S-corporation status and did not include an S-corporation premium. It is important to understand that the need for an S-corporation premium is a fact-sensitive issue and one that requires careful consideration and analysis.

The opinion of the Court in *Kress* finds for the taxpayers. This decision is good news for both taxpayers and the business valuation profession, especially with respect to the total disallowance of income tax affecting advocated in earlier decisions and by the Internal Revenue Service in its Job Aid, as referenced earlier. Members of the profession have long taken issue with the findings in *Gross* and the follow-on cases noted earlier.

While this court decision finds movement in the thinking of the courts generally, its full impact will not be known for some time. The case is likely to have an important impact on valuations, as it provides welcome weight for business valuators to the use of tax affecting in preparing valuations for minority shareholder interests in S corporations in the future. Further, it is important to note that the *Kress* decision is not precedent setting and cannot be used as such when arguing for a different taxpayer.

The other recent case, *Estate of Jones*,[7] was decided in the United States Tax Court in August of 2019. Like *Kress*, *Jones* is a gift tax case. The gifts in question were equity ownership interests in two companies involved in the timber industry—one was an equity interest in an operating company (an S corporation), and the other was an investment holding company (a partnership). Very often such investment holding companies are valued on a net asset value methodology under the cost/asset approach. However, in the instant case, the expert deferred to an income approach because there was an active business operation that was expected to continue and there was no expectation that the timber resources were going to be liquidated.

In an interesting read beyond the scope of this article, the Court found for the taxpayers in deciding that the valuations must be considered in relation to each other, and that the operating characteristics of the combined companies trumped the investment-holding activities. It was determined that the income-based approach submitted by the taxpayer's expert was the most appropriate approach.

The taxpayers' expert "tax affected" the expected earnings in his determination of value by using a proxy rate for the combined federal and state income tax rates that would be borne if the enterprise was a regular C corporation. While the Internal Revenue Service argued that tax affecting was inappropriate, based on *Gross* and the earlier cases, the Court decided that the element of tax affecting in determining value was appropriate in this case. It further noted that the earlier cases cited by the Service were not relevant, as tax affecting is a "facts-based" determination and the facts may have differed in those cases.

The last sentence in the paragraph above seems to provide an out for taxpayers and valuators in any challenge by the Internal Revenue Service totally disallowing tax affecting. Of course, that is not to say that the tax affecting decision should be taken lightly. Those that decide to tax affect expected cash flows under the income approach should do so with careful assessment and analysis. This process should include an in-depth analysis of all available court decisions, the Job Aid cited earlier, and, most importantly, the facts of those cases that led to the decisions. Comparing those facts to the facts in the instant case will serve to allow credible and supportable decision-making in the course of addressing the tax affecting issue.

In summary, while the *Clark* case, decided in Connecticut at the end of 2019, is more than a little disconcerting, the earlier 2019 decisions, *Kress* and *Jones*, seem to support positions long advanced by members of the business valuation community. Hopefully, decisions such as these will lead to a set of "best practices" that can be utilized by taxpayers, business valuation professionals, and users—including the courts—to address these issues in the future in a consistent and reasonable manner.

After more than 20 years, perhaps there is light at the end of the tunnel. ꩜

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1 *Gross v. Commissioner*, T.C. Memo. 1999-254, July 29, 1999, *affd.* 272 F. 3d 333, (6th Cir 2001).

2 *Estate of John E. Wall v. Commissioner*, T.C. Memo. 2001-75, March 27, 2001.
Estate of William G. Adams, Jr. v. Commissioner, T.C. Memo. 2002-80.
Estate of Richie C. Heck v. Commissioner, T.C. Memo, 2002-34. *Robert Dallas v. Commissioner*, T.C. Memo. 2006-212, September 28, 2006.
Estate of Gallagher v. Commissioner, T.C. Memo. 2011-148, 2011 WL 2559847, June 28, 2011.

3 *R.D. Clark & Sons, Inc. v. Clark*, 194 Conn. App. 690 (Dec. 10, 2019).

4 *Delaware Open MRI Radiology Assocs. v. Kessler*, 898 A.2d 290 (Del. Ct. Ch. 2006).

5 *Bernier v. Bernier*, 449 Mass. 774, 782-83 n.15, 873 N.E.2nd 216 (2007).

6 *Kress v. United States*, 2019 U.S. Dist. LEXIS 49850; 2019 WL 1352944 (March 26, 2019).

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