TAX DEVELOPMENT CONSIDERATIONS IN VALUATION PROCESS

Many business owners choose to operate using pass through entities (PTE). A PTE such as an S corporation or a partnership allows for a single layer of income tax, as opposed to a C corporation. C corporations have two layers of tax - one at the entity level on earnings and one for distributions that are taxed as dividends at the shareholder level. With an S corporation, earnings pass through the company untaxed to the business and are taxed on the owner's personal return.

S corporations remain a popular choice for operating businesses as all owners of the business enjoy protection for their personal assets from claims that arise from the business. A popular alternative to the S corporation is the limited liability company (LLC), which also offers protection for the owner's personal assets and involves less corporate formality than an S corporation. An LLC does not have an independent tax status; however, the owners of the LLC can make an election and choose the tax status of the business for income tax purposes. Many owners that formed their business as an LLC choose to be taxed as an S corporation. This is done by filing an election with the IRS. Partnerships are less popular due to the requirement that in most partnerships at least one partner must have personal liability for business debts.

When valuing interests in a PTE, taxpayers and the IRS have disagreed on whether a discount should be applied in valuing the entity because of the untaxed nature of the entity's earnings. The standard used in valuing an asset is what a willing buyer would pay a willing seller, as long as the buyer and seller have full knowledge of all the relevant facts and neither party is under a compulsion to act.

There are essentially three methods used in the valuation process. They are the income approach, the asset approach and the replacement cost approach. Operating businesses that produce strong income streams each year and do not possess significant assets such as a natural resource tend to be valued based on the income approach. Taxpayers have argued for years that a willing buyer when examining the income stream of an S corporation or LLC that has elected S corporation taxation will take into consideration that the dollars forming a part of the income stream have yet to be income taxed given the flow thru nature of the S corporation. They assert that when analyzing that income stream, a willing buyer will undoubtedly reduce that income stream for the income tax that the business owner will owe each year on that income on his or her personal income tax return. This concept is called tax-affecting the income stream or tax-affecting for short. Unfortunately, since 1999, based on the United States Tax Court decision in *Gross v. Commissioner,* T.C. Memo. 1999-254, taxpayers have been denied the ability to tax-affect interests in PTEs for gift an estate tax purposes.

All of that changed in 2019. In *Estate of Aaron U. Jones v. Commissioner,* T.C. Memo. 2019-101 (August 19, 2019, Judge Pugh), the Tax Court adopted the taxpayer's expert's opinion on valuation, which tax affected the value of two PTEs. One business operated a lumber mill and one owned 165,000 acres of timberland in Oregon. The taxpayer in *Jones* had gifted interests in each entity to his daughters, and to trusts for his daughters. As for the PTE that owned the timberland, the Court concluded the income approach should be used and not the asset approach as the business interests of both entities were closely aligned. After holding the income approach should be used, the Court analyzed both experts' valuation reports using the income approach. The taxpayer's expert reduced the earning stream by applying individual income rates to arrive at the individual tax an owner would owe on that income and then added a premium for the tax advantage of not having to pay a dividend on amounts distributed from the PTE. The net result was that the $45 million dollar assessment made by the IRS was reduced to $2 million.

The Court in *Jones* determined it was not constrained by the Court's prior holding in *Gross*. The Court felt that *Gross* was a fact-based decision and it was free to adopt the report it felt was most accurate.

The Court stated:

> We find on the record before us that [the Taxpayer's Expert] has more accurately taken into account the tax consequences of [the PTEs] flow through 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. … [The Taxpayer's Expert's] tax-affecting may not be exact, but it is more complete and more convincing than respondent's zero tax rate.

Interestingly, the gifts in *Jones* occurred in 2009 shortly after the subprime mortgage crisis had engulfed the United States. As the income projections for a timber business were closely tied to housing start projections, that was an ideal time to gift.

Likewise, taxpayers presently exposed to significant federal or state estate and gift taxes may want to take advantage of planning techniques to reduce exposure to these taxes. Although present federal estate tax exemption levels have created a sense of security that those exemptions are sufficient to protect against exposure to federal estate tax, the current exemption levels expire at the end of 2026 and possible could be reduced sooner, depending on the outcome of the upcoming 2020 elections. For more information or questions that you may have, please contact PLDO Partner and estate, trust and tax attorney Gene M. Carlino in Rhode Island at 401-824-5100 or in our Florida office at 561-362-2030 or email gcarlino@pldolaw.com.

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