Barber Analytics

Valuation Issues in Gift and Estate Tax- March 2020

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Kress and Jones Courts Decide Valuation Issues in Taxpayer's Favor Based Upon the Better Argument

Two recent valuation cases, *Kress v. US* and the *Estate of Jones*, were decided based upon the best argument and evidence presented at trial. In refusing to weight unsupported positions or superficial analysis presented by the IRS experts, the Courts showed a refreshing ability to understand and decide between competing views of valuation issues. The most compelling issues decided were the selection of valuation method for real estate-oriented companies, acceptable techniques for the valuation of pass-through entities, and the valuation of non-operating assets in an operating company.

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Income or Asset Valuation Method for Real Estate-Oriented Companies
There are several types of companies that make significant investments in real property, such as timberland, vineyards, fruit tree farms, row crop ranches, apartments, and office buildings, for example. Depending on the type of real property held, the income generated from the asset itself absent any material input or activity from the owner, can vary widely. Agricultural real property tends to require significant inputs from the owner, while apartments and office buildings, for example, require much less supporting activity and are simply leased. Agricultural properties are usually not leased but actively farmed by the owners to generate income. The question for the valuation expert is how do minority investors value these types of companies – based upon their income producing capacity or the value of the underlying real property?

The IRS will often take the position that they are valued based upon the value of the underlying real estate, net of any debt and other liabilities, an approach called the net asset value method. The IRS took this position in *Jones* and it yielded a much higher value than an earnings-based approach ($2,530 versus $380 per LP unit). Minority investors, however, are sophisticated and understand that they don't control the assets and rely upon the skill and efficiencies of company management to generate returns. In short, minority investors pay for income, not net asset value. And commonly, net asset value isn't even reported by these types of companies in order to make an analysis of the share value relative to the net asset value even possible.

The *Jones* Court looked at the method question by first trying to determine if the subject company was an operating or holding company. The company in *Jones* held timberland in Oregon and actively replanted, harvested and generally managed the resource to produce a long-term supply of logs for its sawmills (held in a separate entity). The Court ultimately decided the

company had characteristics of both a holding company (which presumably would be valued using the net asset value method) and an operating company (which would be valued using an earnings-based approach).

But the Court's analysis didn't stop there and went on to apply another lens that was used in *Giustina v. Commissioner* by the US Court of Appeals – the *likelihood* the company was going to sell its timberland. If the timberland was going to be sold, the net asset value method should be weighted, if not, it shouldn't be. This last perspective apparently trumped the operating versus holding company analysis because the *Jones* Court decided, consistent with *Giustina*, to provide zero weight the net asset value method as there were no plans to sell the timberland. Although the *Giustina* and *Jones* cases both involve timberland, the principles applied can be used to select the appropriate valuation method for other agricultural companies holding material real property including wineries, row crop and fruit tree farmers.

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Valuation of Pass-Through Entities

Clients of Barber Analytics may know that I've written a few articles on the valuation of pass-through entities, the first almost 20 years ago in 2001. In that article, I described for the first time a method for adjusting the value of a C-Corporation for pass-through tax status. That model is the same one I use today, adjusted for current personal and entity level tax rates. Subsequently, several other practitioners developed similar models. Those models tend to find a value premium for pass-through entities of 0% to 30% relative to the same entity valued as a C-Corporation.

In the cases that have been decided in Tax Court though, the experts have historically presented a choice between two incorrect approaches – one where the pass-through entity is taxed at the C-Corporation rate with no further consideration or adjustment for the benefits of pass-through tax

status (0% premium, commonly called “tax-affecting”), and one where the entity pays no tax, again with no further analysis or value adjustments (historically a 65% to 70% premium). The Tax Court in *Jones,* however, rejected that simplified view and has finally landed on solid ground.

The *Jones* Court had to decide between a “middle-of-the-road” approach argued by the estate’s expert, and an argument against taxing the entity at all argued, notably, not by the IRS’s expert, but by their attorney. The Court reviewed the prior cases and approaches taken and noted that the “…question in those cases, as here, was not whether to take into account the tax benefits inuring to a flowthrough entity but how.” The Court ultimately selected the “more complete and convincing” approach argued by the estate which resulted in a pass-through premium of about 22%.

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It should be noted the *Jones* case addressed valuations dated in 2009. Today, with C-Corporation tax rates much reduced, and the lower personal tax rate on qualified dividends still in place, the *overall* tax burden of a C-Corporation and a pass-through entity are similar. If logic prevailed, this would likely end the “tax-affecting” dispute. But given that dispute is between two incomplete and incorrect approaches, I suspect it will go on.

Valuation of Non-Operating Assets in An Operating Company

Non-operating assets are assets not required to operate a business but owned by the company. They can be airplanes, condominiums, inter-company receivables or excess cash, for example. Although often not material in publicly traded companies, in private companies, these assets can be significant. So how these assets are viewed and valued by a minority investor can become important to the valuation conclusion. It has been common practice and teaching in the business valuation industry to add back 100% of the value of any non-operating assets to the operating value of a company.

“My family wants a genuine back-to-nature camping experience, but with Wi-Fi, air conditioning, and satellite TV.”

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The valuation industry and the courts, however, are coming to the realization that minority investors only consider the value of non-operating assets in that they contribute to earnings *or* in that they are going to be (sold and) distributed to them. Put another way, minority investors are primarily earnings, not asset focused. This same principle was reflected in the *Jones* decision discussed above when selecting the correct valuation method.

The *Kress* Court took a similar view and critiqued the IRS's expert when he added the full value of the non-operating assets back to the operating value stating that the "method of adding back the full value of non-operating assets is more properly employed when an entire business, rather than a minority stock interest, is being valued." And reflecting the thoughts of *Jones* again the *Kress* Court said "…a minority shareholder has no control over the use or dissipation of the assets and cannot realize the value of the assets until…" the company is sold. The Court accepted the taxpayer's approach of considering the non-operating assets "…to the extent those assets contributed to [the company's] overall earnings."

BA Perspective

The *Jones* and the *Kress* Courts did an excellent job of understanding the key valuation issues and deciding in favor of the best evidence and argument, and not simply looking for a compromise position or "middle ground." Hopefully we will see more decisions like this, and it will discourage the IRS (and taxpayers) from taking unsupported valuation positions.

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