HBK Valuation, Litigation & Forensics

Court Victories for Taxpayers: Support for Tax Affecting and Valuation Discounts

Presented by:

Todd Bryarly, ASA, CBA, CFA, MBA

Robert Zahner, CPA/ABV, ASA, CVA

Zachary Politsky, CVA

June 30, 2021

ABOUT HBK VALUATION GROUP

- HBKVG is a subsidiary of HBK CPAs & Consultants – a top 50 accounting firm with offices in Northeast OH, Columbus, Eastern and Western PA, NJ, and both the East and West coast of FL
- HBKVG has 4 regional offices in Youngstown, OH, Pittsburgh, PA, Cherry Hill, NJ, and West Palm Beach, FL
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  - Gift and estate
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  - Mergers & acquisitions
  - Shareholder buy-ins and buy-outs
  - ESOPs

CASE UPDATE: COURT VICTORIES FOR TAXPAYERS

- TAX AFFECTING
- VALUATION DISCOUNTS

Tax Affecting Passthrough Earnings

- One of the most hotly-contested topics in IRS challenges
- What is a passthrough entity?
  - S Corporation
  - Partnership
  - LLC
  - Do not pay corporate level taxes – items of income/loss passed through to owners who are taxed individually
- What is tax affecting?
  - Applying an income tax rate to passthrough earnings in the valuation process
- Why does it matter?
  - Significant difference in after-tax cash flow
  - Materially impacts value

Impact of Tax Affecting – Simple Example

	C Corporation	Passthrough	Premium
Pre-Tax Income	$100	$100	
Corporate Tax Rate	29%	0%	
Available Cash Flow After Entity Taxes	**$71**	**$100**	**41%**
Investor Level Tax Rate	23%	38%	
Available Cash Flow After Personal Taxes	**$55**	**$62**	**13%**

Unreasonable Premium

More realistic

Why We Tax Affect:

- Matching of cash flow to capitalization rate
  - Cap rate built up using after-tax C corporation returns
- Not doing so implies hypothetical buyers ignore investor-level taxes
  - Irrational
  - Tax-exempt municipal bond yields – investors accept lower rates of return
- Implies that a C corporation could immediately and materially increase its value by converting to an S corporation
  - No evidence of this in the marketplace

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IRS Position on Tax Affecting

- In general – DO NOT TAX AFFECT
- IRS Job Aid for valuation of S corporations (October 2014)
  - "Absent a compelling argument showing that unrelated parties dealing at arms-length would reduce the projected cash flows by a hypothetical entity level tax, no entity level tax should be applied in determining the cash flows of an electing S corporation. In the same vein, the personal income taxes paid by the holder of an interest in an electing S corporation are not relevant in determining the fair market value of that interest."
  - "The suggestion by some commentators that a valuation analyst must apply, as a matter of conventional practice, a valuation paradigm based on taxable corporations (C corporations) to entities that do not pay tax ignores a major factual component, that the entity being valued has chosen its form, including its pass-through tax status, for business reasons."
  - "The application of investor-level tax characteristics results in an investment value to an assumed candidate buyer rather than in a fair market value."

Court Cases Favorable to IRS

- Gross v. Commissioner (1999)
  - Sixth Circuit U.S. Court of Appeals
- Wall v. Commissioner (2001)
- Estate of Heck v. Commissioner (2002)
- Estate of Adams v. Commissioner (2002)
- Dallas v. Commissioner (2002)
- Estate of Gallagher v. Commissioner (2011)

COURT VICTORIES FOR TAXPAYERS

TAX AFFECTING:

- KRESS V. U.S.
- AARON U. JONES V. COMMISSIONER

VALUATION DISCOUNTS:

- PIERSON M. GRIEVE V. COMMISSIONER

Poll Question #1

Do you need CPE or CLE credit?

- ❑Yes, I require CPE credits.
- ❑Yes, I require CLE credits.
- ❑I need both CPE and CLE credits.
- ❑No, I don't require any credits.

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Kress v. U.S. – Fact Pattern

- Case No. 16-C-795
- Decision: March 25, 2019
- District Court – Eastern District of Wisconsin
  - A step below the Appellate Court in the Gross case, but still significant
- Plaintiffs gifted minority shares of Green Bay Packaging, Inc. (GBP) to children and grandchildren in 2006, 2007, and 2008
- In 2010, IRS challenged the amounts reported on the gift tax return
- Deficiency and accrued interest of over $2.2 million
- Kresses filed suit

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Green Bay Packaging, Inc.

- S Corporation
- Manufacturer of corrugated packaging, folding cartons, coated labels, and related products
- 3,400 employees in 14 states
- 90% of company shares owned by the Kress family
- Strong balance sheet – little debt compared to equity
- Between 1990 and 2009, paid annual dividends, ranging from $15.6 million to $74.5 million
- Court noted: “Although GBP has the size and wherewithal to be a publicly-traded company, it has remained the closely-held family company its founder envisioned.”

Valuation Experts

- Two for Kress:
  - John Emory – prepared the valuation for the initial gifts
  - Nancy Czaplinksi – provide valuation opinions to bolster Plaintiff's position at trial
- IRS:
  - Francis Burns

IRS Appraiser – Francis Burns: Overview of Methods and Approaches

- Income Approach
  - Applied C corporation tax rates to GBP (**tax-affecting**)
    - **In direct contradiction to IRS job aid**
    - Not uncommon for valuators, but uncommon for IRS practitioners
  - Applied an adjustment for GBP's status as an S Corporation
    - Court did not provide details, but likely one of several methods commonly employed in the industry
- Market Approach
  - Guideline public company method
  - Multiples of EBITDA (earnings before interest, taxes, depreciation, and amortization) and price to earnings
  - Also applied S corporation premium here, as well (Court silent as to magnitude)

Plaintiff Appraiser #1 – John Emory: Overview of Methods and Approaches

- Market Approach only
  - Guideline public company method
  - Multiples of EBITDA (to account for GBP's subchapter S status), Earnings, Dividends, Sales, Assets, and Book Value
- Did not apply any S corporation premium

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Plaintiff Appraiser #2 – Nancy Czaplinski: Overview of Methods and Approaches

- Income Approach
  - Czaplinski was engaged, in part, in response to IRS criticism that Emory did not employ an income approach
  - Adjusted selected discount rate to reflect an equivalent after-tax (both corporate and personal) return
  - Basically tax-affecting through the capitalization rate rather than through cash flow
- Market Approach only
  - Guideline public company method
  - Used a pre-tax income multiple, another way to effectively tax-affect an S corporation
- Did not apply any S corporation premium

Kress v. U.S. – DECISION

- Found the valuation methodology employed by **Emory** as the most sound
- Stated that Emory derived multiples via the ratio of market value of invested capital to EBITDA to account for GBP’s status as an S corporation

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Important Decision Discussions Noted by the Court

- Directly addressed the S corporation issue – noting that both Burns (IRS) and Emory (Plaintiff) applied C corporation taxes to GBP's earnings to effectively compare the Company to other C corporations. **The Court embraced those applications**.
- Noted that, "**GBP's Subchapter S status is a neutral consideration with respect to the valuation of its stock**. 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."
  - Therefore, the Court disagreed with Burns' application of an S corporation premium
- Found it important enough to note in its decision that GBP's management reported to shareholders that they expected to save **$238.4 million** in taxes between 1988 and 2006 by virtue being an S corporation. However, this did not sway the Court from its opinion that the Subchapter S status was a neutral consideration.

Poll Question #2

Have you ever been involved in an IRS audit where the service is challenging tax-affecting or discounts?

- ❑ Yes – Both
- ❑ Yes – Tax affecting
- ❑ Yes – Discounts
- ❑ No

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Jones v. Commissioner – Fact Pattern

- Docket No. 27952-13; T.C. Memo. 2019-101
- Decision: August 19, 2019
- United States Tax Court
- Plaintiff gifted limited partner interests in Seneca Jones Timber Co. (SJTC) and minority class A voting and Class B voting stock in Seneca Sawmill Co. (SSC) in May of 2009
- In 2013, the IRS challenged the amounts reported on the gift tax return
- IRS stated a deficiency and accrued interest of nearly $45 million
- Mr. Jones filed a petition in the Tax Court in November 2013

Seneca Sawmill Co. (SSC)

- Limited partnership
- Established in 1954 in Oregon as a lumber manufacturer
- SSC considered itself as one of the best lumber manufacturers in the world with two mills – its dimension and stud mills
- Owned more than 25 patents
- Products were primarily used to build houses
- Prior to forming Seneca Jones Timber Co. (SJTC), SSC acquired most of its lumber from federal timberlands but sought new suppliers as regulations increased
- As of the valuation date SSC's largest supplier was SJTC, although it purchased from other suppliers

Seneca Jones Timber Co. (SJTC)

- Limited partnership
- SJTC was formed in 1992 with timberlands purchased by Mr. Jones
- Practiced sustained yield harvesting, which means SJTC limited its harvest to the growth of its tree farm
- SJTC utilized highly advanced computer technology to optimize production
- SJTC's management team was identical to that of SSC and the companies operated in tandem

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Valuation Experts

- Jones:
  - Columbia Financial Advisors – prepared the valuation for the initial gifts by Mr. Jones
  - Richard Reilly of Willamette Management – hired by Estate after Mr. Jones passing in September 2014
- IRS:
  - Philip Schwab – SJTC valuation
  - John Ashbrook – SSC rebuttal expert

Plaintiff Appraiser – Richard Reilly: Overview of Methods and Approaches

- Valued both SSC and SJTC as going concern operating companies
  - Real property plays a significant role in SSC's income producing operations
  - SSC sells a product and therefore the company's earnings should primarily be considered
  - No expectation of selling its timberland
- Income Approach
  - Applied income approach – DCF method
    - Tax affected at a 38% combined federal and state (applied individual rates)
    - A hypothetical buyer would take into consideration taxes due by partners for income
    - 0% tax rate overstates value
    - Adjusted net cash flow and cost of debt capital
- Market Approach
  - Guideline Public Company Method
    - Six comps with 4 financial metrics (i.e., EBIT, EBITDA, revenue and a measure of adjusted tangible book value)
- Pass-Through Premium
  - Calculated dividend tax avoidance benefit
  - Empirical study analyzing S Corp acquisitions
  - Applied a 22% premium
- Conclusion
  - STJC was worth $21 million on a noncontrolling, nonmarketable basis.
  - SSC was worth $20 million on a noncontrolling, nonmarketable basis.

IRS SJTC Appraiser – Philip Schwab: Overview of Methods and Approaches

- SJTC – going concern holding company
  - Company is a natural resource holding company and, therefore, the value of its timberlands should be given primary consideration
- Asset Approach Net Asset Value (NAV) method
- Market Approach
  - Guideline Public Company Method
    - No specific details
- Tax-Affecting Criticisms
  - Tax-affecting was improper because SJTC is a natural resource holding company and therefore its rate of return is closer to the property rates of return
- Conclusion
  - Valued SJTC on a noncontrolling, nonmarketable basis was $140,398,000

IRS SSC Rebuttal Appraiser – John Ashbrook: Overview of Methods and Approaches

- SSC – rebuttal expert
- No valuation report submitted for SSC
- Challenges included:
  - Should not have tax-affected the DCF method
  - Improperly treated SJTC receivable as an operating asset
  - Improperly treated SSC's GP interest in SJTC as an operating asset

Jones v. U.S. – DECISION

- Found the valuation methodology employed by **Richard Reilly** as most sound for both SSC and SJTC

Key Decision Takeaways

- An income-based approach was a more appropriate valuation methodology because of the interdependence between SSC and SJTC as supported by their long-standing relationship
- In addition, an asset method was rejected for SJTC since there was no likelihood of a sale of SJTC's timberlands in the foreseeable future
- Mr. Reilly appropriately considered SSC's general partner interest in SJTC by including an estimated amount of income in his DCF considering historical distributions
- Although SSC and SJTC were separate legal entities, they operated as one entity. The intercompany accounts were used to move funds between the companies and were therefore considered operating in nature.
- It was noted that Mr. Reilly more accurately took into account what a willing buyer and willing seller would consider by not only tax affecting earnings but also considering the tax benefits of a pass-through entity

Poll Question #3

Do the previous cases make you feel more comfortable with taxpayer valuation reports that reflect tax affecting?

- ❑Yes – Tax affecting is clearly the correct answer regardless of the IRS' position
- ❑Somewhat – Although I am still concerned
- ❑No – I would rather not take an adverse position

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Valuation Discounts

- Discount for Lack of Control (“DLOC”)
  - Owners of controlling interests enjoy rights and powers not available to minority owners, including but not limited to:
    - Setting policies
    - Appointing management
    - Acquiring or liquidating assets
    - Making acquisitions
    - Declaring and paying dividend distributions
- Empirical Studies
  - Control Premium Data
    - Premiums paid to acquire controlling interests in publicly traded companies
  - Closed-End Fund Data
    - Measures price paid for a minority interest in a closed-end fund in relation to net asset value of the fund

Valuation Discounts

- Discount for Lack of Marketability (“DLOM”)
  - Lack of prompt salability
  - Lack of liquidity resulting from the inability to achieve a prompt sale
- Empirical Studies
  - Restricted Stock Studies
    - Securities of public companies which carry a restriction preventing them from being sold on the open market for a certain period of time
    - May be traded in private transactions, generally at a discount
    - Discounts lowered each time the SEC eased minimum holding period requirements
  - Specific Company factors:
    - Transfer restrictions
    - Prospect of distributions
    - Prospect of a sale or public offering
    - Ability to cause liquidation, sale, or merger
    - Put option

IRS Position on Valuation Discounts

- The IRS accepts valuation discounts
  - No hard and fast rule for magnitude
  - IRS will attack discounts on a case-by-case basis

Grieve v. Commissioner – Fact Pattern

- No. 8249-18; T.C. Memo. 2020-28
- Decision: March 2, 2020
- District Court – United States Tax Court
- Plaintiffs gifted minority interests in Rabbit 1, LLC (“Rabbit”) and Angus MacDonald, LLC (“Angus”) in 2013
- Each gift was comprised of non-voting units comprising 99.8% of total ownership interests in each of the LLCs
- IRS challenged the amounts reported on the gift tax return
- Gift tax deficiency of over $4.4 million
- Grieve filed suit

Rabbit 1, LLC and Angus MacDonald, LLC.

- Limited liability companies
- Investment holding companies
- Class A voting and Class B non-voting shares
- Voting shares owned by Pierson M. Grieve Management Corp. (“PMG”)
- Non-voting shares owned by Mr. Grieve’s revocable trust and Mr. Grieve individually
- Assets primarily comprised of cash, cash equivalents, and marketable securities
  - Rabbit NAV = $9.1 million
  - Angus NAV = $32.0 million

Valuation Experts

- Two for Grieve:
  - Value Consulting Group (“VCG”) – prepared the valuation for the initial gifts
  - Will Frazier of Stout – provided valuation opinions to bolster Plaintiff’s position at trial
- IRS:
  - Mark Mitchell

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IRS Appraiser – Mark Mitchell: Overview of Methods and Approaches

- Market Approach/Game Theory
  - Assumed the subject interests would seek to acquire controlling interests in the respective LLCs
    - Acquisition of controlling interest would eliminate valuation discounts
    - Owner of non-voting interest would pay premium for voting interest
      - Selected premium of 5% was unsupported
    - Uncommon for valuators and IRS practitioners, but not unheard of

Plaintiff Appraiser #1 – VCG: Overview of Methods and Approaches

- Market Approach only
  - Discounts for lack of control and lack of marketability applied to net asset value
  - DLOC supported by closed-end fund data
    - 13.4% for Rabbit
    - 12.7% for Angus
  - DLOM supported by restricted stock studies
    - 25% for both Rabbit and Angus
- Resulted in blended discount of approximately 35%

Plaintiff Appraiser #2 – Will Frazier: Overview of Methods and Approaches

- Market Approach
  - Discovered non-marketable interests in private equity and venture capital not addressed by VCG
    - Applied blended discount for lack of control and lack of marketability
  - Discounts for lack of control and lack of marketability applied to net asset value
    - DLOC supported by closed-end fund data
    - DLOM supported by restricted stock studies
  - Resulted in tiered discounts
- Income Approach
  - Non-marketable investment company evaluation (“NICE”) method
  - Based on expected holding period and incorporates discounts for lack of control and lack of marketability in the discount rate
  - Results in a minority, non-marketable value
- Equally weighting the income and market approaches resulted in a value proximate to VCG’s conclusion

Grieve v. Commissioner – DECISION

- Judge Kerrigan outright rejected Mitchell's (IRS) game theory valuation approach
  - "[w]e do not engage in imaginary scenarios as to who a purchaser might be."
  - Mitchell relied on an additional action which created further complexity and speculation
- Court accepted the initial values reported on the gift tax return

Important Decision Discussions Noted by the Court

- Reaffirmed the fair market value standard
  - Although the presented game theory events are possible, the IRS did not relay facts supporting that it was reasonably probable that the willing buyer and seller of the Class B units would also buy the Class A units and that the Class A units would be available for sale.
  - Although the underlying assets are highly liquid, a combined discount was still substantiated and upheld by the court using standard practices in the valuation industry.
- Did not directly address the application of tiered discounts. The court simply stated the IRS's opposition to the same.

Questions?

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- **November 3** - Valuation of Retirement Assets and Executive Compensation

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HBK Valuation, Litigation and Forensics

310 Grant Street, Suite 1550
Pittsburgh, PA 15219
412-431-4460

6603 Summit Drive
Canfield, OH 44406
330-758-0357

hbkvg.com

HBK Valuation, Litigation & Forensics

PROFESSIONAL PROFILE

TODD F. BRYARLY, ASA, CBA, CFA, MBA
Principal
HBK Valuation, Litigation & Forensics

Todd is a Principal in HBK Valuation, Litigation & Forensics.

Todd's seventeen-plus years of experience in financial and business valuation services has prepared him for his role as Principal and leader of the valuation division of HBK Valuation, Litigation & Forensics. Overseeing the Youngstown location and staff, Todd manages and performs business valuation analyses, specializing in financial reporting, for closely-held businesses in many diverse industries.

Todd earned his Bachelor of Science in Business Administration and Master of Business Administration from Youngstown State University. Todd has been awarded numerous valuation designations including Accredited Senior Appraiser from the American Society of Appraisers, Chartered Financial Analyst from the CFA Institute and Certified Business Appraiser from the Certified Financial Planner Board of Standards. Todd also serves as President of the Mahoning/Shenango Valley Estate Planning Council.

Email tbryarly@hbkvg.com
www.hbkcpa.com

6803 SUMMIT DRIVE - CANFIELD, OH 44406
PHONE: (330) 373-1620 - 1-800-733-8813
FAX: (330) 373-1840

HBK
Valuation, Litigation & Forensics

PROFESSIONAL PROFILE

ROBERT J. ZAHNER, CPA/ABV, ASA, CVA
Senior Manager
HBK Valuation, Litigation & Forensics

Bobby is a Senior Manager in HBK Valuation, Litigation & Forensics.

Bobby has leveraged his past experience and skills as a Certified Public Accountant for his role as Senior Manager in HBK Valuation, Litigation & Forensics in the Pittsburgh office. Bobby performs business valuations for clients in a variety of industries, as well as litigation support. His experience includes advising on valuation for estate and gift, financial reporting, shareholder transactions, disputes, divorces, and other matters. He has been qualified as an expert witness in the Court of Common Pleas in Pennsylvania.

Bobby earned his Bachelor of Science degree in Business Administration from Youngstown State University. He earned the Certified Public Accountant/Accredited in Business Valuation designation from the American Institute of Certified Public Accountants and the Certified Valuation Analyst designation from the National Association of Certified Valuators and Analysts. Bobby has also written articles on valuation and family law issues.

Email rzahner@hbkvlf.com
www.hbkcpa.com

310 GRANT STREET – SUITE 1550 - PITTSBURGH, PA 15219
PHONE: (412) 431-4480
FAX: (412) 431-4498

HBK Valuation, Litigation & Forensics

PROFESSIONAL PROFILE

ZACHARY F. POLITSKY, CVA
Senior Associate
HBK Valuation, Litigation & Forensics

Zack is a Senior Associate in HBK Valuation, Litigation & Forensics.

Focused on launching, analyzing, and facilitating business valuation engagements, Zack is experienced in financial modeling, valuation methodology, and producing deliverables that meet the needs of the client.

Zack earned his Bachelor of Science degree in Business Administration from Youngstown State University with a major in accounting. He has earned the Certified Valuation Analyst designation from the National Association of Certified Valuators and Analysts.

Email zpolitsky@hbkvg.com

www.hbkcpa.com

6603 SUMMIT DRIVE - CANFIELD, OH 44406
PHONE: (330) 373-1620
FAX: (330) 373-1640