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The Latest Development in Business Valuation: Burdens of Proof, Tax Affecting S Corporations, and Chapter 14 in *Kress*

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INTRODUCTION

On March 25, 2019, Chief Judge William C. Griesbach of the U.S. District Court for the Eastern District of Wisconsin issued an opinion that resolved a federal gift tax dispute case where business valuation was the sole issue.[1] There were three critical questions addressed in the opinion: (1) how the burden of proof can be shifted from the taxpayer to the government; (2) how to reflect the Subchapter S election in the valuation of an operating business structured in this manner; and (3) whether restrictions in an operating agreement of a family-owned business should be disregarded under §2703.[2] The Kress family chose to pay the gift tax deficiency and file suit for a refund, leading the case to be tried in district court. Judge Griesbach sided with the Kress family and its experts on nearly every issue. In addition to these three specific issues, the opinion is also noteworthy as the latest in a series of cases that address the proper approaches and techniques for valuing non-controlling interests in privately held operating businesses for federal gift and estate tax purposes.

The combination of the court's acceptance of tax affecting an S corporation's earnings, tax affecting by the Internal Revenue Service expert, and the court's determination that no S corporation premium applies amounts to a monumental development in the valuation of pass-through entities for federal estate and gift tax purposes.

THE GIFTS AND THE DISPUTE

This case involved a gift tax dispute between plaintiffs James and Julie Kress and the United States. The Kresses brought a tax refund action in federal district court to recover what they deemed to be an overpayment of gift taxes and interest. The gift taxes were assessed on gifts the Kresses made of stock in Green Bay Packaging, Inc. (GBP) to their children and grandchildren in tax years 2007, 2008, and 2009.[3] The trial took place in August 2017.

At the times the various gifts were made, GBP was an operating business that was originally founded in

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[1] *Kress v. United States*, 372 F.Supp. 3d 731 (E.D. Wis. 2019).

[2] All section references are to the Internal Revenue Code of 1986 (Code), as amended, or the Treasury regulations thereunder, unless otherwise specified.

[3] This case was before the district court instead of the Tax

1933. GBP is a vertically integrated manufacturer of folding cartons, corrugated packaging, coated labels, and related products. GBP was organized as a Subchapter S corporation under the Internal Revenue Code. Prior to the gifts, approximately 90% of GBP's common stock was owned by the Kress family, while 10% is owned by certain employees and directors of GBP. Like many closely held businesses, the governing documents of the business contained certain restrictions on transfers and price formulas for transfers to certain permissible parties. There were different provisions for family members and those who were employees or directors of GBP. The GBP shareholders' agreement specifically requires transactions between the company and its employees and directors, but not the Kress family members, to be at a price equal to 120% of book value. Employees and directors are subject to a right of first refusal; if they wish to sell their shares, they must first offer those shares to GBP. The shareholders' agreement only permits transfers by Kress family members to other Kress family members or trusts for their benefit (such restriction hereinafter the ''Bylaws Family Transfer Restriction'').

The Kresses gifted shares in GBP over three years. These transfers constituted transfers of minority positions in GBP. The Kresses filed gift tax returns based on the following fair market values for the gifted shares: $28 per share for tax year 2007; $25.90 per share for tax year 2008; and $21.60 per share for tax year 2009. All or a portion of the gifts were taxable. The Kresses each paid approximately $1.2 million in gift taxes with respect to the gifted shares, for a combined total in excess of $2.4 million.

The IRS issued a letter on November 30, 2010, challenging the values reported. Presumably after failing to reach a resolution or settlement, nearly four years later, on August 19, 2014, the IRS sent the Kresses separate Statutory Notices of Deficiency for the tax years at issue. At that time, the IRS took the position that the fair market value of the gifted shares equaled the prices used in actual share transactions between GBP and its employees, which were higher than the values reported by the Kresses: $45.97 on December 31, 2006; $47.63 on December 31, 2007; and $50.85 on December 31, 2008. The Kresses paid the gift tax deficiencies and accrued interest, totaling $2.2 million, in December 2014, and ultimately initiated a lawsuit against the government for a refund on June 24, 2016.

The opinion includes minimal discussion of GBP's financial picture, stating that the company had a strong balance sheet with little debt, significant non-operating assets, and increased overall net sales between 2002 and 2008. Non-operating assets included an investment portfolio, two aircraft, and group life insurance policies, the latter offset in part by associated liabilities.

Court because the taxpayers chose the district court as its forum to resolve the dispute by paying the tax liability and seeking a refund, which gives the district court jurisdiction pursuant to 28 U.S.C. §1346(a)(1).

With respect to GBP's Subchapter S election, the management team advised shareholders that tax savings approximated $238.4 million for tax years 1988 through 2006 as a result of the Subchapter S election. There was no contemplation on or about the valuation dates of terminating the Subchapter S election. An annualized and/or per share effect of these savings was not provided, nor were any details contained in the opinion as to how this number was computed.

In order to present evidence substantiating their respective positions taken, each side offered expert reports and testimony. The government put forward one expert, while the Kresses retained two—one who prepared the valuations for the gift tax reporting and another to help refute the government's arguments against the original valuations. The court's decision summarized the various positions taken by the experts and gave insight into the various valuation approaches and their respective shortcomings. Ultimately, the court found the methodologies employed by the Kresses to be more persuasive.

The Government's Expert Witness at Trial

At trial, the IRS abandoned its position that the stock ought to be valued based on the transaction price dictated by the shareholders' agreement, and instead asked the court to accept the conclusions of its expert, Francis X. Burns of Global Economics Group (Burns). Burns employed the guideline public company method within the market approach and the capitalization of cash flow method within the income approach.

Within the market approach, Burns applied multiples to EBITDA and earnings based on a comparison to four publicly traded companies, with emphasis on Rock-Tenn being the best guideline company. Given that most or all of the publicly traded companies used were structured as C corporations, this approach produces a publicly traded, C corporation equivalent value. Burns then applied an S corporation premium. Hereinafter, we refer to this two-step process as the ''C to S Method.'' It is not clear what method Burns used to quantify the S corporation premium. Separately, non-operating assets were added as a separate component of value.

Within the income approach, Burns turned to the capitalized cash flow method rather than a discounted cash flow method, stating that long-term forecasts were not available from GBP. After making several normalizing adjustments, Burns tax affected the earnings at a C corporation equivalent tax rate to derive a preliminary value, applied an S corporation premium, and added in the value of non-operating assets as a separate component of value.

Burns then weighted the market and income approach indications 60% and 40%, respectively, on the basis that the market approach better reflected economic and industry conditions on the valuation dates. After accounting for the number of shares outstanding, Burns determined a preliminary value for the GBP stock on a minority interest basis. Then, Burns

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applied a discount for lack of marketability (DLOM) of 10.8%, 11%, and 11.2%, respectively, for the 2006, 2007, and 2008 valuation dates. Burns relied on restricted stock studies, the costs of going public, and the overall academic research on the topic.

The court did not find Burns's analysis convincing for numerous reasons. First, the court said that Burns, for the 2008 transaction, did not properly account for the impact of the 2008 recession and wrongfully relied significantly on an outlier (Rock-Tenn) as a guideline company. The court found that Rock-Tenn, unlike the other guideline companies, saw its stock price increase in 2008 because of an acquisition. All of the other guideline companies' stock prices dropped by an average of 34% due largely to the effects of the 2008 recession. Burns claimed he was trying to be consistent in his approach from year to year and simply followed the numbers where they led him. The court saw things differently, stating that the determination of value ''of closely held stock is a matter of judgment, rather than mathematics. . . Mathematical calculations may give an appearance of precision even when the mechanical formulae on which they rest depends on assigning arbitrary weights to factors that in truth are matters of prudential judgment. . .''

Second, the court found that Burns did not value the non-operating assets correctly. With the exception of the investment portfolio, which was valued with a ''slight discount,'' Burns valued the non-operating assets at full value (i.e., without a minority interest discount). The court said that the valuation 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. Despite the government's position, the court went on to say that a minority shareholder has no control over the use or dissipation of the assets, cannot realize the value of the assets until GBP is sold, and, because there is no expectation of liquidation, Burns's treatment of the non-operating assets overstated the value of the stock for each year in question.

Third, the Court found Burns's lack of marketability discounts to be unreasonably low. The government and Burns argued that GBP was large enough and had the wherewithal to become a publicly traded company, meaning that only the cost associated with going public stood in the way. The implication was that this cost, therefore, was a proxy for the lack of marketability discount. The court rejected this line of reasoning completely, stating that ''GBP should not be penalized for its owners' decision to remain privately-held in order to protect its values in serving its employees, its family, and its community. . .Burns' analysis was also conducted with the benefit of hindsight and did not account for the reality of the difficulty of disposing of the stock of a relatively small company, in a capital intensive, mature, competitive business with no public interest. . .In short, Burns' reliance on the cost of an IPO resulted in the application of an incorrect discount for lack of marketability.'' This is a meaningful win for taxpayers of closely held operating businesses generally. At the examination level, taxpayers routinely face IRS challenges that include proposed discounts for lack of marketability approximating the levels sought by the government, argued by Burns, and rejected by the court in this case.

The Kresses' Experts at Trial

The Kress family used two valuation experts at trial: (1) John Emory of Emory & Co. LLC and formerly of Robert W. Baird and Company; and (2) Nancy Czaplinski of Duff & Phelps LLC. Emory performed stock valuations for GBP annually since 1999 and it was Emory's appraisal report that was used when the original gift tax return was filed. Emory only used the market approach, stating that this approach was most reliable given the existence of numerous guideline public companies. Emory reviewed financial statements, interviewed management, compared GBP to the guideline public companies with respect to various financial metrics, and derived multiples via the ratio of market value of invested capital to EBITDA and, while not described, by accounting for GBP's subchapter S status. It appears that Emory ultimately applied price-to-earnings, price-to-EBITDA, price-to-sales, and/or price-to-book multiples. Emory did not appear to separately account for non-operating assets except to the extent such assets were naturally included in book value and/or contributed to earnings.

After deriving an as-if publicly traded value, Emory applied DLOMs of 30% for 2006 and 2007, and 28% for 2009. The DLOMs were derived by reference to restricted stock studies and pre-IPO studies. Emory further testified that a number of factors were considered qualitatively, including dividends, S corporation status, management team, financial position, the possibility (or lack thereof) of a public offering in the foreseeable future, and the Bylaws Family Transfer Restriction. Emory noted that the Bylaws Family Transfer Restriction was not given much weight.

In response to the IRS's criticism that Emory did not use the income approach, the Kresses retained Czaplinski. Czaplinski prepared an appraisal using both market and income approaches, ultimately weighting the market and income approaches 14% and 86%, respectively. Czaplinski chose to apply the market approach by application of a price-to-pretax income multiple. The effect of non-operating assets was assumed to be embedded in the pre-tax income, and the Subchapter S corporation status was apparently contemplated in the selection of the multiple. Czaplinski selected the lowest observed multiple at each valuation date, reasoning that GBP had lower revenue and fewer assets than the comparable companies. Within the income approach, Czaplinski used two methods: (1) the capitalization of earnings method (CEM); and (2) the dividend discount model (DDM). Czaplinski used three sets of inputs within each method, resulting in six indications of value within the income approach. With respect to non-operating assets, Czaplinki separately accounted for the cash value of life insurance policies, and accounted for the family's personal use of the airplanes by adding back 50% of their operating costs. The

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other non-operating assets were only included to the extent they contributed to the earnings.

Within the CEM, in consideration of the Company's S corporation tax election, Czaplinski adjusted the discount rate in the base cost to reflect an equivalent after-corporate and after-personal tax return. In other words, it appears that Czaplinski tax affected the earnings stream and then applied a discount rate that was adjusted downward to an after-corporate and after-personal tax level. Within the DDM, Czaplinski used a tax rate based on three-year and five-year averages of, presumably, estimated shareholder tax rates. Czaplinksi then took an average of the seven valuation indicators from the market and income approach to determine the as-if publicly traded value of the stock. This value was divided by the shares outstanding to compute a freely traded value per share, to which 20% DLOMs were applied for all three years.

The Court's Analysis

The court found that the analysis and results of Emory (the Kresses' expert) were the most convincing. The court appears to have placed significant emphasis on the fact that Emory had, by far, the greatest familiarity with GBP, having valued the company's stock annually for a decade, and that his analysis was not prepared in hindsight or for litigation purposes. The court seemed to be impressed by Emory's consideration of a litany of quantitative and qualitative factors and the judgment and experience that he brought to bear. The court found that the government failed to prove by a preponderance of the evidence that Burns's determination of the fair market value of GBP's common minority stock was correct. In contrast, Emory provided reliable valuations of the GBP minority-owned shares of stock.

The court found that the Bylaws Family Transfer Restriction ought to be given no weight as a result of §2703, because it did not satisfy all three of the requirements of §2703(b)'s exception to the valuation disregard provision. The restriction failed the third prong of §2703(b) as the Kresses were not able to provide evidence that the "terms are comparable to similar arrangements entered into by persons in an arms' length transaction."[4] This is unfortunate, as it is common for shareholders' agreements entered into between unrelated parties to restrict the transfer of shares outright, or permit the transfer of shares if requisite consent is provided or subject to a right of first refusal. There are many non-tax reasons why owners of a closely held company would want to choose their partners.

Ultimately, the application of §2703 did not have a significant impact, as the court found Emory's overall analysis to be more persuasive. The court found that the government failed to prove by a preponderance of the evidence that Burns's determination of the fair market value of GBP's common stock was correct. The court, having the ability to make its own determination, made one adjustment to Emory's value. The court determined DLOMs of 27% and 25%, reasoning that downward adjustments of 3% were needed to exclude the approximate impact of the Bylaws Family Transfer Restriction on Emory's concluded DLOMs.

On the topic of the Subchapter S election, the court noted that both Emory and Burns applied C corporation level taxes to the earnings of GBP in order to compare GBP to the guideline publicly traded C corporations. Burns then posited that an S Corporation premium was applicable due to the elimination of a layer of tax. The Kresses' experts Emory and Czaplinski did not consider GBP's subchapter S status to be a benefit that would add value to a minority shareholder's stock because a minority shareholder cannot change GBP's corporate status. The court found that GBP's Subchapter S status was a neutral consideration, stating that while there are 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, and that it is unclear if a minority shareholder enjoys the benefits. As noted above, the combination of (1) the court's acceptance of tax affecting an S corporation's earnings, (2) tax affecting by the IRS expert, and (3) the court's determination that no S corporation premium applies amounts to a monumental development in the valuation of pass-through entities for federal estate and gift tax purposes.

This case is not a simple valuation case where the parties were arguing over the appropriate level of valuation discounts. In addition to addressing standard valuation issues, the case addressed three issues in detail that can surface in valuation cases involving closely held businesses: the impact of the shifting of the burden of proof; tax affecting pass-through entities; and the scope of the exceptions to §2703. The remainder of this article takes a deeper dive into each of these issues by not only drilling down on the analysis in *Kress*, but putting this case into context given existing jurisprudence.

SHIFTING (OR NOT) OF THE BURDEN OF PROOF UNDER §7491

One of the procedural issues the court addressed in *Kress* was the application of §7491 in determining whether the taxpayer or the government bore the burden of proof. Tucked away in Subtitle F of the Code, this provision was enacted in 1998 in an attempt to level the playing field between the taxpayer and the government.[5] In short, if certain criteria are met and the taxpayer invokes §7491, then the burden of proof on a factual issue shifts from the taxpayer to the government. While this provision appears to be a powerful tool on its face, in transfer tax cases it rarely has an impact as "it is uncommon for the burden to shift

[4] §2703(b)(3).

[5] IRS Restructuring and Reform Act of 1998, Pub. L. No. 105-206, §3001, 112 Stat. 685, 726-27 (1998).

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to the Commissioner. . .''[6] In *Kress*, §7491 was invoked and the court held that it applied, yet in its application to the factual issues in dispute the statute did not provide an advantage to the taxpayer. To better understand this statutory provision, an explanation of burden of proof issues and the requirements on the provision will be provided before reviewing the court's analysis of the issue.

The Historical Burden on the Taxpayer

Taxpayers and the IRS do not stand on even ground in controversies over liability, certainly the taxpayer has an uphill climb. If a taxpayer must ultimately seek judicial relief for an IRS determination, there are two substantial hurdles the taxpayer must overcome. The first hurdle is that the deficiency determined by the IRS is presumed to be correct.[7] This rule was not created by statute, but rather by case law dating back to the 19th century that has become engrained in the U.S. tax system.[8] The presumption, which was originally based on relying on the presumed correctness of a government official acting properly, now relies on the taxpayer being in the best position to provide evidence.[9] Though the presumption of correctness is not codified in the Code, the fact that the Code has explicit provisions that place the burden on the IRS for specific items has been interpreted as being necessary to provide an exception to the maxim that a notice of deficiency is presumed correct.[10] This presumption has the effect of allowing the IRS's deficiency to be established without the production of additional evidence. To the extent a taxpayer satisfies its burden of production by putting forward evidence to support facts that would rebut the presumption, then the first hurdle is cleared and the case may move forward.

Once past the first hurdle, the taxpayer will encounter the second hurdle—the burden of proof and persuasion to establish by a preponderance of the evidence that the taxpayer's position is correct. There is overlap between the two hurdles as evidence of the correctness of the taxpayer's position also serves the purpose of rebutting the presumption of the government's correctness. However, simply proving the government's assessment amount was incorrect is not enough to establish that the taxpayer's position is correct.[11] In considering the legislation that enacted §7491, Congress found that ''all other things being equal, facts asserted by individual and small business taxpayers who cooperate with the IRS and satisfy relevant recordkeeping and substantiation requirements should be accepted. The Committee believes that shifting the burden of proof to the Secretary in such circumstances will create a better balance between the IRS and such taxpayers, without encouraging tax avoidance.''[12] Since its enactment, this statutory burden-shifting rule has been incorporated into judicial proceedings challenging tax assessments and claiming refunds.[13] While the intent behind the provision is laudable, its application to date in transfer taxes cases shows that it has had little effect on these proceedings. The lack of an effect, however, is not attributable to the requirements of invoking the statute, but rather to the fact that shifting the burden of proof rarely changes the outcome of a case.

Operation of §7941

Shifting by Credible Evidence

The burden shifting rule of §7491 is comprised of a general rule and four exceptions to the rule. The general rule of §7491 seems simple enough: ''If, in any court proceeding, a taxpayer introduces credible evidence with respect to any factual issue relevant to ascertaining the liability of the taxpayer for any tax imposed by subtitle A or B, the Secretary shall have the burden of proof with respect to such issue.''[14] Put another way for transfer tax cases—in proving any question of fact (not law) in a case that involves a gift, estate, generation skipping tax liability, or gifts and bequests from a covered expatriate (Subtitle B), the burden will shift to the government if the taxpayer produces ''credible'' evidence. The burden to show that all conditions have been met is with the taxpayer.[15] The taxpayer must also ask the court that §7491 be applied, as the court may also determine that it has been waived.[16]

The only vague term in the general rule of §7491(a)(1) is what constitutes ''credible evidence.''

[6] *Estate of Adelina Cheng Van v. Commissioner*, T.C. Memo. 2011-22 (finding that it is uncommon for burden to shift but that it did in this case). I.R.M. §4.10.7.6.1.3 (2006) (noting the IRS has observed similar observation that few cases are decided based on which party bears the burden of proof).

[7] *Welch v. Helvering*, 290 U.S. 111, 115 (1933) (The IRS ''ruling has the support of a presumption of correctness, and the petitioner has the burden of proving it to be wrong'').

[8] *Arthur v. Unkart*, 96 U.S. 118, 122 (1878); *Arthur v. Rindskopf*, 105 U.S. 418 (1882).

[9] *Rockwell v. Commissioner*, 512 F.2d 882, 887 (2d Cir. 1975).

[10] *See* Staff of J. Comm. on Taxation, 105th Cong., Description of Senate Finance Committee Chairman's Mark Relating to Reform and Restructuring of the Internal Revenue Service (JCX-17-98) (J. Comm. Print 1998) (''Although this presumption is judicially based, rather than legislatively based, there is considerable evidence that the presumption has been repeatedly considered and approved by Congress. This is the case because the Internal Revenue Code contains a number of civil provisions that explicitly place the burden of proof on the [IRS] in specifically designated circumstances. The Congress would have enacted these provisions only if it recognized and approved of the general rule of presumptive correctness of the [Service's] determination.'').

[11] *United States v. Janis*, 428 U.S. 433, 440 (1976); *Lewis v. Reynolds*, 284 U.S. 281, 283 (1932).

[12] Staff of J. Comm. on Taxation, 105th Cong., General Explanation of Tax Legislation Enacted in 1998 (JCS-6-98), at 56 (J. Comm. Print 1998).

[13] Tax Ct. R. 142(a). *Cf.* Fed. R. Evid. 301. *See also* I.R.M. §4.10.7.6 (2006) (acknowledging application and impact of burden shifting rule).

[14] §7491(a)(1).

[15] Staff of J. Comm. on Taxation, n.10, above, at 57.

[16] *Estate of Blount v. Commissioner*, T.C. Memo. 2004-116, n.

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There is no Treasury regulation interpreting this provision. The legislative history explaining Congress's intent provides the following as to what Congress meant the phrase to say: ''Credible evidence is the quality of evidence which, after critical analysis, the court would find sufficient upon which to base a decision on the issue if no contrary evidence were submitted (without regard to the judicial presumption of IRS correctness). A taxpayer has not produced credible evidence for these purposes if the taxpayer merely makes implausible factual assertions, frivolous claims, or tax protestor-type arguments. The introduction of evidence will not meet this standard if the court is not convinced that it is worthy of belief.''[17] Various courts addressing the application of §7491 have adopted this definition in their analysis.[18]

Limitations Barring Burden Shifting

The general rule has four overarching limitations: (1) the taxpayer fulfilled its duty to substantiate any item reported; (2) the taxpayer maintained all records and cooperated with the requests from the IRS; (3) certain net worth thresholds were not exceeded; and (4) there is not another provision of the Code that overrides the application of the general rule. The first limitation, the duty to substantiate, requires that the taxpayer provide evidence as required by the Code or Treasury regulations to prove the fact being reported.[19] An example of a duty to substantiate in the transfer tax scenario would include certain items of tangible property that require an appraisal be included with an estate tax return.[20]

The second limitation, found under §7491(a)(2)(B), is that the taxpayer maintained all records required and cooperated with reasonable requests of the IRS. Like the requirement to substantiate, the duty to maintain records under the burden shifting rule of §7491 adds no additional burden on the taxpayer. Instead, the benefit of the potential shifting of burden will only go to those who comply with what the Code required of the taxpayer prior to the introduction of §7491. There is a general duty on all taxpayers to maintain records under §6001. Under the regulatory authority granted to the Treasury Department under §6001, both an estate and a gift tax regulation have been promulgated that require a taxpayer who made a gift or the fiduciary of an estate to maintain substantial records to verify what was reported on the return.[21] It should not be surprising that the benefit of burden shifting will not be available to a taxpayer that not only fails to produce evidence required, but does not produce evidence that should be in its possession and support its position. This is consistent with the well-established presumption that a negative inference may be drawn against a party that does not provide evidence that it possesses and, if true, would help its position.[22]

Whether a taxpayer ''cooperated'' has been one of the disputed issues in adjudicating the applicability of §7491. This provision was intended to level the playing field between the IRS and the taxpayer when the taxpayer is acting in good faith and cooperating with the IRS. The legislative history gives some guidance as to what the term ''cooperates'' does and does not mean. The limitation requires that the taxpayer provide ''reasonable assistance to the Secretary in obtaining access to and inspection of witnesses, information, or documents not within the control of the taxpayer. . .'' unless the taxpayer can establish there is an applicable privilege that would keep the information from being disclosed.[23] The refusal of a fiduciary to provide information and/or be interviewed by an agent assigned to the audit without establishing an applicable privilege would disqualify an estate from asserting §7491.[24]

To be clear, the duty to cooperate does not give the IRS carte blanche discovery. The ability to assert privileges can come up in many situations, but most relevant to transfer tax cases such as *Kress* is the determination of value of a closely held business. The IRS does have the authority and published procedures that permit fairly invasive actions to be taken to determine the value of business entities, including visits to the business site.[25] Fiduciaries of estates have a duty and donors of property have a legitimate interest in protecting information that is not relevant and/or proprietary from being disclosed to the IRS—if that information may become public—in order to protect the value of a business. While there are cases that stand for the proposition that failure to cooperate is a limitation that will bar the application of §7491, none of the cases that reaches such a conclusion ''involves a taxpayer's legitimate attempt to protect confidential or proprietary business information.''[26] Thus, if a taxpayer files a motion to quash with ''a good faith belief that some of the documents [the IRS] sought were irrelevant, sealed, or contained sensitive. . . business information. . .'' then that will not be considered a failure to cooperate even if the motion is denied pro-

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[17] Staff of J. Comm. on Taxation, n.10, above, at 58.

[18] *See e.g.*, *Griffin v. Commissioner*, 315 F.3d 1017, 1021 (8th Cir. 2003); *In re Wyly*, 552 B.R. 338, 383-84 (Bankr. N.D. Tex. 2016).

[19] Section 7491(a)(2)(A) only makes explicit reference to provisions in the Code, but the legislative history states that regulations are also to be included.

[20] Reg. §20.2031-6(b).

[21] Reg. §20.6001-1 (requiring executors to maintain ''complete and detailed records. . .''); Reg. §25.6001-1 (requiring the taxpayer to ''keep such permanent books of account or records as are necessary to establish the amount of his total gifts. . . All documents and vouchers used in preparing the gift tax return. . . shall be retained by the donor so as to be available for inspection whenever required.'').

[22] *Wichita Terminal Elevator Co. v. Commissioner*, 6 T.C. 1158, 1165 (1946).

[23] Staff of J. Comm. on Taxation, n.10, above, at 57.

[24] *Estate of Amlie v. Commissioner*, T.C. Memo. 2006-76.

[25] Reg. §301.7605-1; IRM §4.10.3.4. (2003).

[26] *Kohler v. Commissioner*, T.C. Memo. 2006-152.

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vided the taxpayer abides by the court's ruling.[27] Cooperation does not mean perfection is expected of the taxpayer. Provided that the taxpayer is generally cooperative and responsive to an auditor, it will not be precluded by the cooperation limitation if the auditor does not follow up on outstanding documents that were requested but not submitted.[28]

In addition to cooperating with the IRS in producing information that is requested, the taxpayer must participate in the administrative process. The legislative history of §7491 requires that the taxpayer exercise all administrative relief, which includes participating in the IRS appeals process. However, the requirement to cooperate does not require the taxpayer to extend the statute of limitations.[29] The requirement that appeal rights be exercised is consistent with the limited purpose of leveling the playing field for a taxpayer who has acted in good faith as opposed to making litigation more attractive.

The third limitation is not particularly relevant in transfer tax cases. Under §7491(a)(2)(C), the benefit of burden shifting is not available to partnerships, corporations, or trusts whose value exceed $7 million.[30] Given individuals and estates (including qualified revocable trusts under §645) do not fall under the net worth limitation, this limitation would not prohibit a taxpayer in litigation over a gift tax or estate tax issue.[31]

The fourth and final limitation is that provisions that specifically place the burden on the taxpayer will govern and §7491 cannot be applied to shift the burden.[32] In the transfer tax context, there are certain provisions that place the burden on the taxpayer. One example is with the inclusion of joint interest property where 100% of the value of the property must be reported unless the executor submits sufficient evidence that part or all of the property was contributed by the other joint owner(s).[33] As a result, in a case determining what portion of the joint property is included in the gross estate, §7491 cannot shift the burden away from the taxpayer as §2040 specifically requires the taxpayer to meet the burden.

Burden Shifting is Just a Tie Breaker

Even if the taxpayer meets the requirements to shift the burden to the IRS, none of the prohibiting limitations apply, and it is properly raised by the taxpayer—winning the burden of proof issue can often be a hollow victory. When the burden shifts to the IRS on a question of fact, the IRS must prove the issue by a preponderance of the evidence. This means that the shifting of the burden will only have an impact on the determination of the issue in the event of an evidentiary tie—to the extent that either the IRS or the taxpayer presented more persuasive evidence on an issue the burden of proof becomes irrelevant to the determination of the issue. An evidentiary tie can exist if both sides present equally credible evidence, which could include evidence that is not entirely comprehensive regarding the issue of fact.[34]

Courts have addressed the limited practical application of §7491 in transfer tax cases in two overarching ways. Some decisions have declined to rule on the applicability of §7491 because the issue was determined by the preponderance of the evidence one way or the other, so the tie breaker that the burden of proof provides was unnecessary.[35] Other decisions in transfer tax cases have ruled in favor of the taxpayer finding that §7491 was properly invoked, but ultimately it had no impact on the case.[36] As discussed in greater detail below, the decision in *Kress* falls into the latter category. Even in the event of an evidentiary tie, the "reallocation [under §7491] does not require the Tax Court to adopt the taxpayer's valuation, however erroneous, whenever the Court rejects the Commissioner's proposed value; the burden of disproving the taxpayer's valuation can be satisfied by evidence in the record that impeaches, undermines, or indicates error

[27] *Id.*

[28] *Estate of Litchfield v. Commissioner*, T.C. Memo. 2009-21.

[29] Staff of J. Comm. on Taxation, n.10, above, at 57.

[30] The dollar limitation itself is not set out in §7491, instead it is incorporated by cross reference to §7430(c)(4)(A)(ii), which then cross references 28 U.S.C. §2412(d)(1)(B). Reg. §301.7430-5(g)(3)(i)(A) incorporates in the dollar reference from Title 28.

[31] This limitation could however be an issue in the event of a GST taxable termination (as defined by §2603(a)(2)) or covered bequest or gift under §2801(e)(4) if the trust that would bear the liability for such tax exceeds the net worth threshold.

[32] §7491(a)(3).

[33] §2040(a); Reg. §20.2040-1(a)(2).

[34] *In re Wyly*, 552 B.R. at 536 ("If the record is deficient, it is the IRS' problem, not [the taxpayer's].").

[35] *See Estate of Bongard v. Commissioner*, 124 T.C. 95, 111 (2005) (finding that "the outcome of this case is determined on the preponderance of the evidence and is unaffected by section 7491."); *Huber v. Commissioner*, T.C. Memo. 2006-96 (determining the case based on the preponderance of the evidence); *Estate of Mitchell v. Commissioner*, T.C. Memo. 2011-94 (holding that burden did not shift because that resolving the case did not depend on which party had the burden of proof); *Estate of Giustina v. Commissioner*, T.C. Memo. 2011-141 (conclusions made based on a preponderance of the evidence rendered the allocation of the burden of proof immaterial); *Estate of Kelly v. Commissioner*, T.C. Memo. 2012-73 (decision based on the preponderance of the evidence so the burden of proof was immaterial to the case); *Estate of Bates v. Commissioner*, T.C. Memo. 2012-314. (decision based on the preponderance of the evidence so the burden of proof was immaterial to the case).

[36] *See In re Wyly*, 552 B.R at 381 (burden is placed on the government in gift tax cases); *Kohler v. Commissioner*, T.C. Memo. 2006-152 (holding burden shifted to government, but decision was reached based on the fact that taxpayer's valuation experts provided more credible and persuasive evidence); *Estate of Litchfield v. Commissioner*, T.C. Memo. 2009-21 (burden shifted to government, but decision was reached based on the fact that taxpayer's valuation experts relied on more accurate data and conclusions based on that data were appropriate); *Estate of Cheng Van v. Commissioner*, T.C. Memo. 2011-22 (burden shifted to IRS, but the IRS satisfied the burden of persuasion).

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in the taxpayer's valuation.''[37] Accordingly, even when the taxpayer believes it may properly invoke §7491, it should not lower the effort of the taxpayer to produce quality evidence on which the court may rule in its favor.

Application of §7491 in *Kress*

The *Kress* case is a clear example of how §7491, as applied, will have negligible effect on the resolution of transfer tax cases and is no substitute for creating a strong factual record. Outside of the various procedural issues the court ruled on in *Kress*, ''[t]he sole issue presented in this case is what the fair market value of'' the gifted stock was at each of the times a gift of such stock was made over several tax years.[38] In transfer tax cases, the determination of the fair market value of property is a question of fact for the court to decide.[39] As valuation is inherently a question of fact, it is an issue where the burden shifting rule of §7491 can apply. While the court in *Kress* was correct that the sole issue presented was the determination of fair market value, there were actually several underlying issues regarding the valuation. The *Kress* decision broke the analysis of this factual issue into two parts—(1) the valuation of the company in the absence of the application of Chapter 14 valuation rules[40] and (2) the impact on the valuation with the application of §2703. Ultimately, §7491 had no bearing on the determination of either part for different reasons.

Burden Shifted to Government

In determining whether §7491 applied, the court succinctly walked through the statutory requirements. It found that the taxpayer had submitted credible evidence as required by §7491(a). Further, it found that the application was not barred by any of the other limitations in §7491(a)(2) because the Kresses substantiated their position, maintained records, and was cooperative during the audit.[41] The court's decision was silent on the application of whether the limitation of §7491(a)(3) applied, but properly did not apply the limitation as the Code and Treasury regulations do not provide a specific burden as to the valuation of a closely held company.[42]

The decision quickly passed over the issue of what constitutes ''credible evidence,'' most likely because there was little dispute given taxpayer put forward two different valuation experts with extensive credentials and thorough reports. The court adopted the legislative record's definition of ''credible evidence'' that other courts have adopted, as discussed above.[43] An interesting and outstanding question for practitioners remains what does the definition in the legislative record mean when applied to valuation cases—in other words—what is the minimum the taxpayer must put forward?

The transfer tax provisions do not provide definitive guidance on what evidence is required or considered credible in terms of valuation for businesses where there are no available sale prices. For estate taxes, the Treasury regulations simply require that ''[c]omplete financial and other data upon which the valuation is based'' should be submitted for stock ownership and that a ''fair appraisal as of the applicable valuation date'' could be part of the determination of the value.[44] The Treasury regulations for gift taxes provide similar guidance.[45] The requirements for adequate disclosure for purposes of having a statute of limitations apply to gift taxes do provide guidance as to what requirements an appraiser and an appraisal must have in order to satisfy the disclosure requirements.[46] However, the adequate disclosure rules are not applicable for estate tax purposes—and are not even required for the statute of limitations to apply under the adequate disclosure rules—as other means of providing sufficient information to the IRS is allowed.[47] Further, courts have previously found that valuation evidence from those with little valuation experience or credentials were ''sufficiently credible and sufficiently qualified . . . to have their opinions considered by the Court'' in the context of whether the taxpayer acted in good faith for accuracy related penalties.[48] Even valuation evidence that is ''marginally credible'' based on the qualifications of those preparing the appraisal have been sufficient to shift the burden under §7491.[49]

While retaining a qualified appraiser may be best practice and not statutorily required to shift the burden—it makes a great deal of sense to do so for two reasons. The first reason is that even if the burden is shifted to the government, the burden shift only has an effect to the extent there is an evidentiary tie. As such, if there will be a ''battle of the valuation experts,'' the taxpayer will want to have someone with

[37] *Estate of Thompson v. Commisssioner*, 499 F.3d 129, 133 (2d Cir. 2007).

[38] *Kress*, at 739.

[39] *Leibowitz v. Commissioner*, T.C. Memo. 1997-243; *Estate of Dailey v. Commissioner*, T.C. Memo. 2001-263.

[40] The term Chapter 14 refers to refers to Chapter 14 of Subtitle B of the Code and is comprised of §2701-§2704, including their accompanying regulations.

[41] The decision was silent on the net worth limitation of §7491(a)(2)(C). However, the omission was almost certainly intentional given the restriction does not apply to individual taxpayers, and hence, to gift tax cases.

[42] The rules applicable to the valuation of stocks that do not have readily available prices do not specifically impose a burden on the taxpayer to demonstrate the value. Instead, the rules impose on the taxpayer a duty to substantiate the value of the company by providing the information on which the valuation is based. *See* Reg. §20.2031-2(f).

[43] *Kress*, at 738.

[44] *See* Reg. §20.2031-2(f); Reg. §20.2031-3(a).

[45] Reg. §25.2512-2(f); Reg. §25.2512-3(a).

[46] Reg. §301.6501(c)(3).

[47] *See* Reg. §301.6501(c)(2).

[48] *Estate of Thompson v. Commissioner*, 370 F. App'x. 141, 143 (2d Cir. 2010); *see also Estate of Berg v. Commissioner*, 976 F.2d 1163 (8th Cir. 1992).

[49] *Estate of Thompson v. Commissioner*, T.C. Memo. 2004-174.

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impeccable credentials and the ability to produce a high quality report. The second reason is that despite prior jurisprudence that has set a fairly low bar for what constitutes credible evidence for purposes of §7491, a recent Tax Court ruling required at least a ''certified appraiser,'' though preferably a ''qualified appraiser,'' in the context of an appraisal providing a good faith basis to defend against accuracy related penalties.[50] While the burden shifting rule of §7491 and the exception for accuracy related penalties under §6664 are distinct provisions under Subtitle F and do not have similar statutory text—neither has a requirement for a qualified appraiser, certified appraiser, or qualified appraisal for transfer taxes—the Tax Court has still made it a requirement in the context of §6664.

Issue Resolution Not Determined by the Tie Breaker

Ultimately, while the burden was shifted to the IRS in *Kress*, it was not particularly helpful for the taxpayer. As the court noted, ''the shifting of the burden is only significant in the event of an evidentiary tie.''[51] In weighing the evidence on the issue of the valuation of the shares in the absence of Chapter 14 considerations, the taxpayer prevailed because of the strength of the evidence provided. The only noticeable impact of §7491 on the decision was in the ordering of its analysis where the court held ''[b]ecause the Government has the burden of proof in this case, the court will first review the conclusions of its expert. . .''[52] The factual issue was ultimately determined as the taxpayers prevailed based on the preponderance of the evidence and the taxpayers won because ''[a]fter reviewing the reports and testimony of these [appraisers], the court finds the valuation methodology of [one of the taxpayer's appraisers] the most sound.''[53] This reinforces the importance of winning the ''battle of the valuation experts.''

Turning towards the impact of §7491 on the application of Chapter 14, despite the broad pronouncement that the taxpayer successfully shifted the burden to the IRS—that did not actually occur with this issue. In the *Kress* case, the Bylaws Family Transfer Restriction did not allow members of the family to transfer their shares within the family. This restriction was factored into the valuation by the taxpayer's experts by increasing the DLOM. The government's position was that this discount should be disallowed because §2703(a) requires that, for transfer tax purposes, the value be determined without regard to any restriction on the right to sell the property. While the restriction in the bylaws clearly are encompassed by §2703, this deemed valuation rule does not apply if three stated exceptions of §2703(b) are met. Whether each exception has been met is a question of fact.[54] As these exceptions are factual questions—the burden of proof would be on the taxpayer unless shifted to the government under §7491.

The first exception is that the restriction must be a ''bona fide business arrangement.''[55] The taxpayer asserted that the restriction in the bylaws existed to maintain family ownership and control over the business. Courts have recognized that this objective is a bona fide business purpose and would meet the requirements of the first exception.[56] The court in *Kress* noted that there is jurisprudence that this is not a legitimate business purpose if the company is solely a holding company for marketable securities,[57] but in this case the company in which shares were transferred was ''unmistakably an operating business.''[58] The government's response to the taxpayer's argument was that the restriction did not guarantee the objective of maintaining family ownership or control, as a family member shareholder could still create problems in the company and/or start a competing business. The court, however, found that a restriction did not need to be ''fail-proof'' to be a bona fide business arrangement.

The second exception is that the restriction ''is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth.''[59] For reasons discussed in greater detail later in this article, the holding of the case was that this exception did not apply because the court made the legal determination (as opposed to a factual one) that this exception will always be met in gift tax cases as it only applied to preventing abuses through testamentary transfers. However, the court did note in dicta that had the factual question been answered, the result would not have changed because the purpose was to maintain family control and not as a tax device.

The third and final exception is where the taxpayer lost the argument and illustrates the lack of impact and limited scope of §7491. For the third exception to be met, the restriction must be ''comparable to similar arrangements entered into by persons in an arms'

[50] *Estate of Richmond v. Commissioner*, T.C. Memo. 2014-26. For a detailed discussion of this case and its potential impact on transfer tax valuation issues, *see* Edward A. Renn, James I. Dougherty, and Marissa Dungey, *Gain from the Value of a Good Valuation*, 28 Probate & Property, no. 5, Sept./Oct. 2014 at 40.

[51] *Kress* at 738.

[52] *Id*. at 741.

[53] *Id*. at 747.

[54] *Holman v. Commissioner*, 601 F.3d 763, 769 (8th Cir. 2010) (finding that given the exception under §2703(b)(1), ''[t]he ultimate question of whether there was a bona fide business arrangement is a question of fact. . .''). *See also*, *Estate of True v. Commissioner*, 390 F.3d 1210, 1218-19 (10th Cir. 2004) (finding the factors in Reg. §20.2031-2(h), which the court held was codified in §2703, were questions of fact).

[55] §2703(b)(1).

[56] *Kress* at 748 (citing *Estate of Gloeckner v. Commissioner*, 152 F.3d 208, 214 (2d. Cir. 1998), *St. Louis Cty. Bank v. United States*, 674 F.2d 1207, 1210 (8th Cir. 1982), *Estate of Lauder v. Commissioner*, T.C. Memo. 1992-736).

[57] *Holman*, 601 F.3d 763.

[58] *Kress* at 748.

[59] §2703(b)(2).

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length transaction.''[60] The *Kress* decision held that this exception had not been met because the taxpayers ''have not produced any evidence that unrelated parties dealing at arms' length would agree to the arrangement.'' The decision does not explain what if any evidence the government introduced on this exception. As a result, the valuation of the shares in the company could not take into account the restriction in the bylaws. Leaving aside whether such restrictions are comparable to similar arrangements, for which there is a strong argument, the bigger question is—why must the estate produce such evidence if the burden shifted under §7491?

The answer to this question is: the burden didn't shift as to this exception despite the broad pronouncement to the contrary in the decision. The court contended that the Treasury regulations required that the taxpayer ''must submit specific evidence'' that the restriction is comparable to arrangements entered in arm's length transactions.[61] However, the regulations state no such burden that would invoke the limitation on the applicability of burden shifting under §7491 when either the Code or regulations ''provides for a specific burden of proof with respect to such issue.''[62] Instead, the burden would only be on the taxpayer because of the general rule that the taxpayer bears the burden of proof on any issue of fact. However, as previously explained, the court in *Kress* held that the burden shifted to the IRS.

The burden did not shift because the court's analysis of §7491 didn't differentiate between the factual issues at stake in the case. Section 7491(a)(1) requires the burden to shift when ''a taxpayer introduces credible evidence with respect to **any factual issue** relevant. . . [the IRS] shall have the burden of proof **with respect to such issue**.'' While the court held that the burden shifted to the government—that assumed that the ''sole issue presented in this case is what the fair market value'' was. However, the determination of value in fact involved more than one factual issue. For example, whether the exception of comparable business arrangements was met was its own factual issue. If the taxpayer presented no evidence on the issue, then the burden could not shift to the government.

The Reminder Provided by *Kress*

The court's ruling and application of §7491 serves as a useful reminder for controversies over transfer tax liabilities. The case does not create new law, but instead provides the practice points that could be taken from the compilation of transfer tax cases addressing the ability of the taxpayer to shift the burden of proof. The first point is that just as the burden on every question of fact is on the taxpayer, whether §7491 is applied or not applied is determined on a question by question basis. The taxpayer must present credible evidence and not be barred by one of the limitations for each question of fact on which it seeks to shift the burden. The second practice point is that there is no procedural mechanism that is a substitute for having the better evidence. Section 7491 only applies once the process has advanced to litigation and, even if it is applicable, only applies when there is an evidentiary tie. In valuation cases, having a highly credentialed and qualified valuation expert(s) involved in the estate planning to produce thoughtful and understandable reports is what really can give a taxpayer the edge.

A BREAKTHROUGH ON THE ISSUE OF TAX AFFECTING OF S CORPORATION EARNINGS

Prior to the Tax Court's 1999 opinion in *Gross*,[63] it was widely accepted that the earnings of a pass-through entity ought to be tax affected for valuation purposes. After all, while the entity does not pay tax, the earnings are taxed at the ownership level. The entity's earnings are passed through to the owners, who must include their pro-rata share of earnings as income on their personal income tax returns. Thus, most appraisers took the view that a pass-through entity (PTE) could be valued similarly to a C corporation (i.e., net of income tax). If we imagine a discounted cash flow (DCF) approach to valuing an operating business, if the entity earnings each year are $100, the first adjustment is to reduce the earnings by a tax rate of, say, 40%. Then, subject to other adjustments, these net amounts would be converted to present value. In addition, based on evidence submitted to the Tax Court in *Gross*, an internal IRS valuation guide for IRS appeals officers stated, ''. . .S Corporations lend themselves readily to valuation approaches comparable to those used in valuing closely held corporations. You need only to adjust the earnings from the business to reflect estimated corporate income taxes that would have been payable had the Subchapter S election not been made.''

The decision in *Gross* marked a turning point and, in hindsight, was the beginning of a 20-year debate that continues today. The Tax Court reasoned in *Gross* that an appraiser must not ignore the tax savings in valuing the equity of the PTE. That is, tax advisers have regularly recommended PTE structures to business owners as a means of reducing the overall income tax burden. The Tax Court, however, did not accept tax affecting the S corporation's earnings, stating that the taxpayer's expert, who explained the need for tax affecting by listing eight tradeoffs or risk factors of the S election, ''. . . has not convinced us that such an adjustment is appropriate as a matter of economic theory or that an adjustment equal to a hypothetical corporate tax is an appropriate substitute for certain difficult to quantify disadvantages that he sees attaching to an S corporation election.'' Rather, the Tax

[60] §2703(b)(3).

[61] *Kress* at 750 (citing Reg. §25.2703-1(b)(4)(i)).

[62] §7491(a)(3)

[63] *Gross v. Commissioner*, T.C. Memo. 1999-254, *aff'd*, 272 F. 3d 333 (6th Cir. 2001).

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Court found that the IRS expert's approach of applying a pre-shareholder tax discount rate (derived presumably from publicly traded C corporations through techniques such as the Capital Asset Pricing Model or Build-Up Method) to the actual net income of the entity, despite the net income being effectively pre-tax, was a valid approach due to the matching of the level of earnings to the discount rate.

The large majority of business valuation practitioners agreed that the Tax Court's decision on the tax affecting issue in *Gross* went too far. Based on the chart below, which assumes that the subject company distributes 100% of its earnings, the total tax burden in a given year associated with an S corporation is $40, or 40%,[64] compared to $52, or 52%, for a C corporation. Clearly the S election saves taxes in this example. However, if one takes the approach applied by the IRS expert in *Gross*, who assumed a zero percent entity level tax rate but used rates of return from publicly traded C corporations, the result is an implied total tax burden for an S corporation of $20, or 20%. Clearly, this is understated, resulting in a significant overvaluation of the S corporation. There is no mechanism by which the PTE owner could generate $80 in net after-tax cash flow if the pre-tax earnings of the PTE are $100. Excluding considerations for other differences between C corporations and PTEs, the chart below indicates that the Tax Court's methodology in *Gross* possibly overvalues the S corporation by 33.3% (($80-$60)/$60) given the tax rates used in this example (also implies a premium of 67% to an otherwise equivalent C corporation (($80-$48)/$48)). Moreover, for the S corporation shareholder to generate $80 in net after-tax cash flow, the pre-tax earnings of the PTE would have to be $133.33, 33.3% higher.

	C Corp	PTE	Gross PTE
EBT	100.00	100.00	100.00
Entity Taxes	(40.00)	-	-
Entity Net Income	60.00	100.00	100.00
Payout Ratio	100.0%	100.0%	100.0%
Pass-Through Tax Liability	-	(40.00)	
Dividend Taxes	(12.00)	-	(20.00)
Net Cash Flow to Owner	48.00	60.00	80.00

There are various reasons that support tax affecting the earnings of a PTE. Owner-level taxes matter in the valuation of financial assets. The clearest example of this phenomenon can be observed in the bond market on a daily basis. U.S. taxable investors in municipal bonds are not subject to federal income taxes on the interest income that they receive from the municipal bond, and are also generally exempt from state income tax if they purchase municipal bonds issued by a state government or agency in the state in which they reside. In comparison, U.S. taxable investors in corporate bonds are subject to federal and state income tax on interest income at ordinary income tax rates. Due to the differences in taxes owed at the investor level, municipal bonds are regularly priced at yields lower than otherwise equivalent corporate bonds. The table below compares A-rated corporate and municipal bonds with two, five, and ten years to maturity.

		Years to Maturity			
Index/Curve Type	**Date**	**2 Yrs**	**5 Yrs**	**10 Yrs**	**Source**
US General Obligation A Muni BVAL Yield Curve	3/31/19	1.678%	1.867%	2.215%	Bloomberg
USD US Composite A BVAL Yield Curve	3/31/19	2.657%	2.827%	3.308%	"
Implied Investor Tax Rate =>		36.85%	33.96%	33.04%	

If the pricing of financial assets were indifferent to owner-level taxes, we would expect little or no differential in yields between corporate and municipal bonds of equivalent risk.

Research supports the notion of tax-affecting because owner-level taxes matter. Dhaliwal, et al.[65] conducted research pertaining to the tax status of investors, finding a ". . .positive relation between the implied cost of equity capital and the tax-penalized portion of dividend yield. . ." Guenther and Sansing[66] conducted similar research. Their model "demonstrates that the dividend tax capitalization effect reflects the weighted average tax rate of all investors, where the weighting depends on investors' risk tolerances. This weighted average tax rate is not affected by the fraction of stock held by tax-exempt investors. . ." Simply stated, it is both the taxes payable by the investor on corporate dividends and the taxes payable

[64] The tax rates used in the table are meant to approximate tax rates that applied during the tax years in question in *Kress*. Corporate income tax rate: 40%; personal income tax rate: 40%; personal dividend tax rate on C corporation dividends: 20%.

[65] Dan Dhaliwal, Linda Krull, Oliver Zhen Li & William Moser, *Dividend Taxes and Implied Cost of Equity Capital*, 43 J. of Accounting Research, 651, 675-708 (2005).

[66] David A. Guenther & Richard Sansing, *The Effect of Tax-Exempt Investors and Risk on Stock Ownership and Expected Return*, 85 The Accounting Review, 753, 849-75 (2010).

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by the entity itself that matter in the pricing of financial assets.

Pratt explains the need for tax affecting in a slightly different way, stating, ''Whether the tax is actually paid by the corporation or the individual is absolutely irrelevant. . . Many analysts have confused the S corporation tax issue by focusing on the deductibility of corporate taxes. However, this is not the tax that an investor avoids, and is not the tax that is forgone when a corporation [makes a Subchapter S election]. . . Rates of return [on publicly traded stock] include an investor's expectation that when he or she receives his or her dividend. . .the investor will have to pay a dividend tax. . .''[67]

The taxpayer's expert in *Gross* was not able to successfully persuade the Tax Court to accept the economic reality of tax affecting. And despite the ability to take its own view, the Tax Court chose to side entirely with the IRS's expert in *Gross*, apparently feeling unequipped to dismiss both experts' opinions and either take its own view or find the middle ground. This left valuation professionals with a result that was simply detached from basic economic realities. Moreover, it may be that the Tax Court simply did not buy the taxpayer's expert's opinion because there was no attempt to acknowledge, no less quantify, the tax savings associated with the S election. While the result may have missed the mark, at least the IRS expert acknowledged and considered the tax savings.

The decision in *Gross* was appealed to the U.S. Court of Appeals for the Sixth Circuit. The decision of the Tax Court was affirmed, but notably the decision was not unanimous with respect to the issue of tax affecting.[68] In fact, the lead opinion, written by Circuit Judge Eric L. Clay, disagreed with the Tax Court's decision on tax affecting and held that the Tax Court's finding of fair market value was clearly erroneous. On appeal, the taxpayers argued that (1) tax affecting was a common practice that was essentially approved in prior Tax Court cases (*Maris*[69] and *Hall*[70]), (2) the IRS itself implicitly endorsed tax affecting in valuing pass-through entities, as evidenced by statements made within internal handbooks, and (3) the IRS had reviewed and accepted previously filed gift tax returns (1988) that relied on valuations that used tax affecting. Judge Clay generally agreed with the taxpayers, stating ''. . . I believe that. . .the tax court's judgment was less than sound in many respects, for it flies in the face of the evidence on the record. . . I believe that past practices, which the IRS had not deemed to create a deficiency, are demonstrative of the idea that such hypothetical actors would have considered tax affecting G&J stock. This fact in conjunction with the testimony of the experts informs my conclusion that the court's decision to use a 0% tax affect in deriving the value of G&J stock was implausible.'' Nonetheless, the two other Circuit Court judges did not find that the Tax Court cleared erred, and the Tax Court's decision was affirmed.

Within the business valuation field, numerous treatises, arguments, and models were developed in the years subsequent, all attempting to address what was readily apparent to valuation professionals—that while the PTE structure may be superior from a tax efficiency standpoint, the result in *Gross* did not make economic sense because tax efficient does not mean tax free. These new models were designed mostly to account for the elimination of the second layer of tax on the earnings of the PTE. Most practitioners advocated for the C to S Method, whereby a preliminary valuation is determined on a C corporation equivalent basis. A model is then used to quantify economic differences between the C corporation and S corporation/PTE structure. This typically would indicate a premium on account of the reduced overall tax burden of the S corporation or PTE. Such premium would be applied to convert the C corporation equivalent value into an S corporation or PTE value. Other practitioners explored adjustments to the discount rate or the cash flow to remove the effect of the second layer of tax without losing the impact of the pass-through tax liability.

Given the above, the decision of the Court of Chancery of Delaware in *Kessler*[71] was welcomed by valuation professionals, to a large extent vindicating most appraisers views on the *Gross* decision. As summarized below, the Court of Chancery of Delaware effectively concluded that tax affecting was appropriate, but used a lower rate than a C corporation rate to capture the benefit of the PTE structure (the ''Kessler Model''). The Court of Chancery of Delaware effectively bridged the gap between the taxpayer's expert's approach in *Gross* and the Tax Court's approach. The Court of Chancery of Delaware has since used the Kessler Model in subsequent cases, including in *Owen v. Cannon*.[72] The Massachusetts Supreme Court adopted the Kessler Model in *Bernier v. Bernier*.[73]

The Court of Chancery of Delaware pursued the concept of after-tax equivalence in the landmark *Kessler* decision. The court determined that tax affecting was necessary to account for pass-through taxes, but that the most logical and simplistic method to account for differences in the total tax burden was to apply a reduced entity level tax rate to the pre-tax earnings of the S Corporation for valuation purposes. In other words, what entity tax rate would force equivalence between the after-tax cash flows from the two structures. The following table illustrates the approach taken by the Court of Chancery of Delaware.

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[67] Valuing a Business: The Analysis and Appraisal of Closely Held Companies (Shannon P. Pratt with Alina V. Niculita, 2008).

[68] *Gross v. Commissioner*, 272 F.3d 333 (6th Cir. 2001).

[69] *Rudolph M. Maris v. Commissioner*, T.C. Memo 1980-444.

[70] *Estate of Oakley J. Hall v. Commissioner*, T.C. Memo 1975-141.

[71] *Del. Open MRI Radiology Assocs. v. Kessler*, 898 A.2d 290 (Del. Ch. 2006).

[72] *Owen v. Cannon*, No. 8860-CB, 2015 BL 192317 (Del. Ch. June 17, 2015).

[73] *Bernier v. Bernier*, 82 Mass. App. Ct. 81 (2012).

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	C Corp	PTE	Gross PTE	Kessler PTE
EBT	100.00	100.00	100.00	100.00
Entity Taxes	(40.00)	-	-	(25.00)
Entity Net Income	60.00	100.00	100.00	75.00
Payout Ratio	100.0%	100.0%	100.0%	100.0%
Pass-Through Tax Liability	-	(40.00)		
Dividend Taxes	(12.00)	-	(20.00)	(15.00)
Net Cash Flow to Owner	48.00	60.00	80.00	60.00

As shown above, the *Kessler* model accomplishes the dual objective of reflecting all taxes (entity and investor), but simultaneously reflecting the advantages of the PTE structure (net after-tax cash flow of $60 from the PTE compared to $48 from the C corporation). *Kessler* advocates applying C corporation multiples or capitalization rates to an earnings level of $75 rather than the $60 from a C corporation or the $100 that the court in *Gross* viewed as appropriate. This is not to say that the *Kessler* model is the only answer, but rather that the Kessler model struck a logical balance between the ''value as a corporation with full tax affecting'' and ''value without tax affecting'' approaches.

Meanwhile, in the roughly two decades since *Gross*, the Tax Court has yet to come to a conclusion similar to that of the Court of Chancery of Delaware or Massachusetts Supreme Court. Taxpayer's experts failed to convince the Tax Court that tax affecting was appropriate in six subsequent cases: *Wall*,[74] *Adams*,[75] *Heck*,[76] *Dallas*,[77] *Gallagher*[78] and *Guistina*.[79] Importantly, a common theme running throughout this series of cases is that the taxpayers' experts advocated for tax affecting the earnings of the PTE, but did not sufficiently consider the advantages of the PTE structure. This includes the principal advantage that the PTE avoids, the ''double taxation'' of earnings that occurs with a C corporation (earnings taxed inside the corporation and then taxed again when distributed to the owners). While easy to say with hindsight, we would like to think that had the advantages of the PTE structure been acknowledged or quantified, that tax affecting would have been allowed.

Thus, the decision in *Kress* is a major breakthrough. This decision was issued as we continue to wait for a decision by the Tax Court in the ongoing *Cecil* case.[80] It is believed that experts for both the IRS and the taxpayer tax affected the earnings of the PTE in this case as well, and also considered a premium for the PTE structure. While not a decision of the Tax Court, the opinion in *Kress* represents the first case in the federal court system since *Gross* to accept tax affecting of the earnings of a PTE and the C to S Method. The court's acceptance of the C to S Method not only led to a victory for the taxpayer in this case, but is a meaningful victory for most business valuation professionals, which have been advocating for the C to S Method, or close variations of it, for many years in its efforts to overcome results most professionals deemed incorrect in the series of cases referenced above. While the *Kress* decision may not have the same broad impact as a Tax Court decision, it may be persuasive to other courts considering the issue going forward. Though not precedential, other courts will likely look at the opinion put forth in the *Kress* case.

The *Kress* case should immediately be considered as support for tax-affecting the earnings of an operating business structured as a PTE for income tax purposes. This is not to say that there is no analysis to be performed to determine the relative values of the C corporation and PTE structures. Rather, it validates the approach of first determining value on a C corporation equivalent basis, which typically involves tax-affecting the earnings. A secondary analysis to assess whether adjustments to value for differences in the structures is then warranted.

Notably, with the passage of the Tax Cuts and Jobs Act of 2017,[81] the economic differences between C corporations and PTEs are being re-examined. Effective January 1, 2018, C corporations are subject to a much lower (and flat) 21% income tax rate on income above $335,000, in comparison to the prior marginal tax rate structure that contained a top rate of 35%. This implies, for a C corporation based in the United States with nominal foreign-sourced income, that the effective tax rate could have declined from 38% (including state and local taxes) to 25%. A decrease in the effective tax rate of 13% would mean an approximate increase in net income of 21.5%, all other factors held constant. The availability of deductions for interest, depreciation, and other items impacts this differential. In addition, the corporate tax rate cut is ''permanent'' (does not sunset like other provisions of the new tax law), although this does not preclude a future Congress from changing the rate through a new tax bill. Personal income tax rates are also set to increase to the pre-2018 levels on January 1, 2026, potentially reducing further any economic differences between C corporations and PTEs, or even making C corporations more appealing.

In fact, in at least one industry, alternative investment management, several public companies have announced conversion from publicly traded partnership structures to C corporations. A substantial group of firms in this industry completed public offerings over the last 15 years, with all U.S.-based managers[82] establishing publicly traded partnerships. With the pas-

[74] *Wall v. Commissioner*, T.C. Memo. 2001-75.

[75] *Estate of Adams v. Commissioner*, T.C. Memo. 2002-80.

[76] *Estate of Heck v. Commissioner*, T.C. Memo. 2002-34.

[77] *Dallas v. Commissioner*, T.C. Memo. 2006-212.

[78] *Estate of Gallagher v. Commissioner*, T.C. Memo. 2011-148.

[79] *Estate of Giustina v. Commissioner*, T.C. Memo. 2011-141.

[80] *Estate of Mary R. Cecil v. Commissioner*, No. 014640-14 (U.S. Tax Ct. filed June 23, 2014).

[81] Tax Cuts and Jobs Act, Pub. L. No. 115-97, 131 Stat. 2054 (2017).

[82] Examples include: Apollo Global Management, LLC, Ares Management Corporation; Fortress Investment Group LLC; KKR

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sage of the TCJA, as well as other factors, these firms have re-evaluated their organizational structures and many are converting (or have converted) to C corporations. For example, in February 2018, Ares Management Corporation (formerly Ares Management, L.P.) (Ares) announced[83] that it would convert to a C corporation on or about March 31, 2018. In an investor presentation, the firm stated, "The reduction in tax rates in 2018 results in corporate tax rates being meaningfully lower on average than individual tax rates, which enables Ares to pay taxes at a lower rate than investors may pay depending on their respective tax status. . . Ares plans to retain a portion of its earnings and reinvest for future earnings growth and other corporate purposes. . . This will enable Ares to reinvest and compound earnings generally at a lower tax rate than individual tax rates. . ." The actions of firms in the alternative investment management industry further support the concept that investors and firms are concerned about the overall effective tax rate on earnings, not just the tax rate at the corporate level.

With the *Kress* decision, valuation experts should now rightfully move to further refinement of the methods by which to appropriately reflect the differential in value, if any, between C corporations and PTEs. Not only does a PTE structure potentially generate ongoing tax savings on account of the net impact of tax rate differences and the elimination of the dividend tax, but investors in PTEs could see reduced capital gains taxes on exit due to the accumulation of outside basis in the stock on account of retained earnings. When a PTE retains earnings, the owners' cost basis in the equity is increased by their pro-rata share of the retained earnings. This does not create an immediate cash flow, but could reduce capital gains taxes payable from a subsequent liquidity event, thus increasing the after-tax rate of return on investment.

For example, assume a 25% owner of a PTE purchased an interest on January 1, 2018, and sells the interest on January 1, 2021, as shown below.

($USD)	2017	Purchase 1/1/18	2018	2019	2020	Sale 1/1/21
EBITDA	500.0		540.0	583.2	629.9	
D&A	(40.0)		(40.0)	(40.0)	(40.0)	
EBIT	460.0		500.0	543.2	589.9	
Interest Expense	(25.0)		(25.0)	(25.0)	(25.0)	
PTE Net Income	435.0		475.0	518.2	564.9	
Distributions (65% Payout Ratio)	(282.8)		(308.8)	(336.8)	(367.2)	
Retained Earnings	152.3		166.3	181.4	197.7	
Assumed Aggregate Value (6x LTM EBITDA)		3,000.0				3,779.1
Purchase/Sale Price - 25% Interest		750.0				944.8
Cost Basis (Outside Basis in Equity) - 25% Interest		750.0	791.6	836.9	886.3	

Sale Price	944.8
Less: Cost Basis	886.3
Capital Gain	58.5
Capital Gain Tax (20%)	11.7
Capital Gain w/o Basis Accumulation	194.8
Capital Gain Tax (20%)	39.0
Capital Gain Tax Savings from PTE Status	27.3

The PTE structure leads to a savings of $27.3 in capital gains taxes on exit in this example. Of course, there is risk that these savings will be generated, the timing of exit is uncertain, and, at a minimum, these savings ought to be discounted to present value.

Not only did the court in *Kress* accept tax affecting, the court went even further, stating that there was no material value associated with the Subchapter S election. The court placed significant weight and emphasis on the various disadvantages associated with the S election and the various risks that the S election

& Co. L.P., Oaktree Capital Group, LLC, Och-Ziff Capital Management Group LLC, The Blackstone Group L.P., and The Carlyle Group LP.

[83] Text of announcement available at: http://www.ares-ir.com/file/4438507/Index?KeyFile=1001232254.

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would persist. To qualify for S corporation status, the corporation must meet the following requirements:

1. Have no more than 100 shareholders;

2. Be a domestic corporation;

3. May not have shareholders that are partnerships, corporations, or non-resident aliens, and certain trusts are also not allowed;

4. Have only one class of stock — must allocate profits and losses among the owners based strictly on share ownership percentages.

Certain financial institutions, insurance companies, and domestic international sales corporations are simply barred from making an S corporation election. For all corporations, an S corporation election is not valid unless all shareholders of the corporation at the time of the election consent to the election.

A risk or potential disadvantage of an S corporation or other PTE structure is that the corporation does not make sufficient distributions to cover the pass-through income tax liability that arises from the earnings generated by the entity. Owners of a PTE are liable for tax on their pro-rata share of entity earnings, regardless of whether or not those earnings are distributed, in full or in part, to the owners. Unless a shareholders' agreement requires distributions sufficient to cover pass-through income tax liabilities, investors will undoubtedly view the potential of so-called ''phantom income'' as a meaningful risk factor.

The business valuation community will most likely review the risks of obtaining and/or sustaining S corporation status, as well as the disadvantages or risks unique to PTEs, more closely in the years ahead.

DEEMED SATISFACTION OF §2703(b)(2) FOR GIFTS

The final interesting issue addressed in the *Kress* decision can give practitioners an additional arrow in their respective quivers to challenge the application of §2703 in gift tax cases. As discussed above, the taxpayer ultimately lost the application of the Chapter 14 argument as it did not satisfy all of the required exceptions for the artificial valuation rule to apply. However, given the minimal impact it had on the valuation of the transferred property and the potential application in other cases—the Chapter 14 issue might very well be a pyrrhic victory for the IRS. This portion of the article drills down on the court's interpretation of §2703(b)(2), how this interpretation fits into exiting case law, and the potential use by estate planners going forward.

To truly understand the intended application of the four statutory provisions of Chapter 14, one must understand the abuses these provisions were enacted to prevent. For transfer tax purposes, taxes are imposed on the value of the property transferred.[84] Generally speaking, the value for transfer tax purposes is the ''fair market value'' at the time of death for estate tax purposes, the time the transfer is complete for gift tax purposes, and at the time of the generation-skipping transfer for GST purposes. The Treasury regulations interpreting both the estate and gift tax provisions define fair market value as ''the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts.''[85] This standard is intended to tax the true economic value of property that is transferred. However, this standard can lead to potential abuse if the fair market value is intentionally reduced by taxpayers by introducing various terms or restrictions on the property to have the impact of lowering the value under the willing buyer/willing seller standard while not reducing its value in the hands of the recipient.

Terms governing business interests that either restrict the ability of the owner to transfer property or fix the price at which the interest may be disposed have long been considered a potential area for abuse in artificially lowering the value for transfer tax purposes. Certainly such provisions are common in business dealings between unrelated parties with the terms being specific to the business and negotiated at arm's length. Nevertheless, such terms can be structured in a way to lower the value of a business while at the same time maintaining the economic benefit the recipient may receive. In the contact of transfer taxes, the potential for abuse with such terms is self-evident.

Pre-Chapter 14 Efforts

The IRS first confronted this perceived abuse in the late 1950's. In 1958, Treasury regulations were promulgated addressing specific estate tax valuation issues.[86] Reg. §20.2031-2(h) provided a valuation rule for business interests subject to a term setting the price—''The effect, if any, that is given to the option or contract price in determining the value of the securities for estate tax purposes depends upon the circumstances of the particular case. Little weight will be accorded a price contained in an option or contract under which the decedent is free to dispose of the underlying securities at any price he chooses during his lifetime.'' This rule, which was later codified in §2703, disregards legally enforceable rights for purposes of estate tax valuation. The regulation provides that this valuation disregard rule does not apply if certain exceptions are met, specifically: 1) the price is fixed or determinable under a formula contained in the agreement; 2) the decedent's estate must be obligated to sell; 3) the transfer restriction must apply

[84] §2031(a) (subject to special valuation rules such as an alternate valuation date under §2032); §2512(a); §2624(a).

[85] Reg. §20.2031-1(b); §25.2512-1.

[86] 26 C.F.R. §20.2031-2 (1958); 23 Fed. Reg. 4,529 (June, 24, 1958).

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during the lifetime of the decedent; and 4) the agreement must be "a bona fide business arrangement and not a device to pass the decedent's shares to the natural objects of his bounty for less than an adequate and full consideration in money or money's worth."[87]

By its own terms and its placement in the Treasury regulations — Reg. §20.2031-2(h) is an estate tax and not a gift tax provision. A few months after the set of estate tax regulations that included this provision were released, gift tax regulations were promulgated.[88] A gift tax provision substantially similar to Reg. §20.2031-2 was included in the gift tax regulations, but there was no equivalent to Reg. §20.2031-2(h) or mention of option/contract prices.[89] Since the 1958 promulgation, the gift tax regulation has been amended twice and still there is no mention of a price setting disregard rule found in the estate tax regulations.

Exceptions to Reg. §20.2031-2(h) are clearly directed towards potential transfer tax abuses at death. In one instance, Reg. §20.2031-2(h) gives "little weight" to a provision enforceable at death if the decedent was not similarly restricted during life. This rule makes good sense and is consistent with general estate tax "string provisions," such as §2036, that are intended to avoid a taxpayer from having de facto control and access during life and not being treated as the owner death when the property is valued. Further, it would make little sense for the estate tax regulation to require a restriction existing during life if such provision would then be disregarded for gift tax purposes. Another instance of the estate tax limitation clearly limiting itself is that it must "not [be] a device to pass the **decedent's** shares. . ."[90] The word decedent can only mean one thing—it cannot mean a living donor whose transfer would be subject to gift taxes, instead it is a taxpayer who is subject to estate taxes—one who is bereft of life. While this provision has generally appeared in estate tax cases and despite the apparently clear limiting terms of the estate tax regulation, it has nevertheless been cited to as authority in some gift taxes cases.[91]

The year following the issuance of the estate and gift tax valuation regulations, the IRS issued Revenue Ruling 59-60.[92] This ruling has been widely accepted by valuation practitioners as well as by the courts "as setting forth the appropriate criteria to consider in determining fair market value. . ." for transfer tax purposes.[93] Unlike Reg. §20.2031-2(h), this administrate pronouncement explicitly purports to apply to estate and gift tax cases. Rev. Rul. 59-60, in discussing restrictions and options in agreements, generally mimics the language of Reg. §20.2031-2(h) in that it refers primarily to decedents and transfers at death. It does make mention to the application in the gift tax context, but only to say the "option price is not determinative of fair market value for gift tax purposes."

The judicial interpretation of Reg. §20.2031-2(h) over the years in large part suggests that it was directed at transfers subject to estate tax and not gift taxes. This jurisprudence is based on the application of one of the exceptions set forth in the regulation, specifically "the agreement represents a bona fide business arrangement and not a device to pass the decedent's shares to the natural objects of his bounty for less than an adequate and full consideration." Although contained in the same sentence, the bona fide business arrangement prong and the testamentary device prong are separate and not conjunctive tests despite facts and issues that may overlap between the two.[94] Whether the restrictions or price formulas with property are a testamentary device is a question of fact. In making this determination, courts have set forward various factors to be considered in reaching the ultimate conclusion. Such factors include incidents that may only arise in the context of transfers at death and not inter vivos transfers, such as whether it was intended to "avoid estate taxes,"[95] the poor health of the taxpayer at the time the restrictions or price agreement was entered into,[96] and the alignment between the terms of the agreement and the taxpayer's testamentary documents.[97]

Enactment of §2703 and Regulations

In order to provide statutory rules preventing perceived abuses to the transfer tax regime, the Omnibus Budget Reconciliation Act of 1990 added Chapter 14 to the Internal Revenue Code.[98] While this legislation enacted §2701 through §2704, the focus of this portion of the article is on §2703. In summarizing what Congress had done in enacting this legislation, legislative history reflects that "Chapter 14 contains rules that supersede the willing buyer, willing seller standard. . ."[99] Each of the provisions of Chapter 14 was intended to prevent specific abuses. Section 2703 was

[87] Reg. §20.2031-2(h).

[88] 26 C.F.R. §25.2512-2 (1958); 23 Fed. Reg. 8,904 (Nov. 15, 1958).

[89] Reg. §25.2512-2.

[90] Reg. §20.2031-2(h) (emphasis added).

[91] *See e.g.*, *Mandelbaum v. Commissioner*, T.C. Memo. 1995-255.

[92] Rev. Rul. 59-60.

[93] *Estate of Newhouse v. Commissioner*, 94 T.C. 193, 217 (1990).

[94] *See Estate of Gloeckner*, 152 F.3d 208, 213 (2d Cir. 1998); *Estate of Lauder*, T.C. Memo. 1992-736.

[95] *St. Louis Cty. Bank v. United States*, 674 F.2d 1207, 1210 (8th Cir. 1982).

[96] *Id.*; *Estate of True v. Commissioner*, T.C. Memo. 2001-167, *aff'd*, 390 F.3d 1210 (10th Cir. 2004).

[97] *Estate of True*, T.C. Memo. 2001-167 (The Tax Court's decision set out other factors that are familiar to practitioners of whether there was donative intent or true arm's length dealings, such as inconsistent enforcement of the agreement, failure to seek professional valuation with the set price or formula, lack of negotiations, among other factors).

[98] Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, §11602(a), 104 Stat. 1388, 1388-491-1388-501.

[99] Staff of J. Comm. on Taxation, 104th Cong., Explanation of the Tax Technical Corrections Act of 1995 (JCS-6-95), (J. Comm.

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enacted to prevent efforts to reduce the value for transfer tax purposes through certain rights or restrictions.

Section 2703 operates by disregarding the impact of the fair market value of ''any option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property (without regard to such option, agreement, or right), or . . . any restriction on the right to sell or use such property.''[100] This casts a wide net and can apply to partnership agreements, shareholder agreements, buy-sell agreements, or any other mechanism that ingenuity can conjure.

While Chapter 14 supersedes the willing buyer/willing seller standard—§2703 did not supersede Reg. §20.2031-2(h).[101] Courts have held that any restrictions or options must not only satisfy §2703, but also the law in effect prior to its enactment which includes Reg. 20.2031-2(h).[102] The Eleventh Circuit has described the law in effect prior to §2703 as being ''codified and further limited. . .'' by the new statutory provision.[103] Further, Reg. §20.2031-2(h) was amended in 1992 to make reference to §2703 as providing ''for special rules involving options and agreements. . .''[104]

In passing §2703, Congress recognized that while transfer restrictions and set prices could be abusive—they could also be legitimate and innocuous provisions that exist for non-tax reasons. In the legislative history, Congress recognized ''that buy-sell agreements are common business planning arrangements and that buy-sell agreements generally are entered into for legitimate business reasons that are not related to transfer tax consequences.''[105] In order for the draconian disregard valuation rule to not apply to legitimate restrictions and price fixing terms, §2703 provides certain exceptions in which a restriction or price formula will be respected for transfer tax valuation purposes.

Accordingly, while §2703(a) casts the wide net, §2703(b) provides an exception to the rule. The disregard valuation rule will not apply to a transfer if: 1) ''[i]t is a bona fide business arrangement'' (§2703(b)(1)); 2) ''[i]t is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth'' (§2703(b)(2)); and 3) ''[i]ts terms are comparable to similar arrangements entered into by persons in an arms' length transaction'' (§2703(b)(3)). For the exception to apply, each of these three requirements must be met.

In 1992, Treasury regulations were issued to interpret the statutory provisions of Chapter 14.[106] With respect to §2703, the regulations largely reiterated the statutory provision, provided clarifications as well as examples, and provided a rule deeming that the three requirements needed to satisfy the exception of §2703(b) are met if the business being transferred did not have a majority of its interests held by the family. Generally, these provisions were neutral or taxpayer friendly.

However, there was one provision of the §2703 regulations pertinent to the *Kress* case that arguably exceeded the terms of statutory provision. In interpreting one of the three requirements for the §2703(b) exception to apply, namely that the restriction or determination of price was not a testamentary device to transfer property to members of the decedent's family, Reg. §25.2703-1(b)(1)(ii) provides ''[t]he right or restriction is not a device to transfer property to the natural objects of the transferor's bounty for less than full and adequate consideration in money or money's worth.'' This regulation expands the statutory requirement in two ways. First, §2703(b)(2) is limited to transfers to the ''family'' while the regulation expands to the broader class of ''the natural objects of the transferor's bounty.'' Unlike the other three statutory provisions of Chapter 14 that do provide definitions for the meaning of the term family—§2703 does not provide such a definition. However, the definition of ''member of the family'' or ''applicable family member'' provided in §2701, §2702, and §2704 are all more limited than ''the natural objects of the transferor's bounty.''[107] In finalizing this regulation, the Treasury Department was well aware that though the phrase ''natural objects of the bounty'' is a term of art, ''[t]his concept has long been part of the transfer tax system and cannot be reduced to a simple formula or specific classes of relationship. The class of persons who may be the objects of an individual's bounty is not necessarily limited to persons related by blood or marriage.''[108] The preamble to the proposed Chapter 14 Regulations explained this deviation from the plain statutory text as being consistent with the legislative intent in §2703 codifying Reg. §20.2031-2(h).[109]

The second issue where there appears to be a departure from the statutory text is whether it was intended to prevent only valuation manipulation for testamentary transfers or for both inter vivos and testamentary transfers. The statutory provisions provide that the restriction or price option cannot be a ''[d]evice to transfer such property to members of the **decedent's** family.'' The regulation provides it cannot be a device to ''transfer property to the natural objects of

Print 1995).

[100] §2703(a)

[101] *See* 136 Cong. Rec. 30,539 (1990) (explanatory material concerning Committee on Finance 1990 Reconciliation Submission pursuant to House Concurrent Resolution 310).

[102] *Estate of Amlie v. Commissioner*, T.C. Memo. 2006-76; *Estate of Blount v. Commissioner*, T.C. Memo. 2004-116.

[103] *Estate of Blount v. Commissioner*, 428 F.3d 1338, 1342 (11th Cir. 2005).

[104] 26 C.F.R. §20.2031-2 (1992); 57 Fed. Reg. 4254 (Feb. 4, 1992).

[105] *See* n.98, above.

[106] Special Valuation Rules, 26 C.F.R. §25.2701 - §25.2704-3 (1992); 57 Fed. Reg. 4255-4277 (Feb. 4, 1992).

[107] *See* §2701(e)(1); §2702(e) (incorporating the meaning given in §2704(c)(2)); §2703(e)(2); §2704(c)(2).

[108] 57 Fed. Reg. 4253 (Feb. 4, 1992).

[109] 56 Fed. Reg. 14321 (Apr. 9, 1991).

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the **transferor's** bounty.'' Thus the statutory provision refers only to a testamentary transfer while the regulation expands the scope to any inter vivos transfer as well. This expansion goes even farther than expanding the class of beneficiaries because if the justification in the preamble of the regulation is to be believed, in that §2703 is a codification of §20.2031-2(h), it was a codification of an estate tax regulation which applies to decedents (as discussed above). Despite the clear difference in the language used in the statute and the regulation—it has not always been one that has been noted or recognized. The IRS has taken the position that the regulation ''sets for the same requirements'' as §2703.[110] In one case, the Eleventh Circuit merged the differing words together in explaining that the purpose of this requirement is to ensure that §2703 does ''not permit a wealth transfer to the natural objects of the decedent's bounty.''[111]

Given the broad applicability of §2703, satisfying the three requirements for the exception of §2703(b) matters a great deal to the taxpayer. Effectively proving each of the three requirements is met is at the very heart of each defense against the IRS's use of §2703. If the requirement of §2703(b) means that a provision with an impact on valuation is only disallowed in cases of transfers at death—then the taxpayer will be deemed to have satisfied this requirement in any gift tax audit. If the requirement applies to all transfers—then the taxpayer in a gift tax audit would need to prove this requirement was met based on the facts and circumstances—which of course introduces additional costs and litigation risks in doing so.

A Plain Language Reading in Kress

The taxpayer in *Kress* prevailed on its §2703(b)(2) argument because the court held that as a matter of law, §2703(b)(2) only applied to transfers at death and therefore this requirement was automatically satisfied as this was a gift tax case. In arguing that the provision also applied to lifetime gifts, the government cited to the provision in the regulations and claimed that the regulation's interpretation of the statutory provision was appropriate because ''the term 'decedent' in §2703(b)(2) is ambiguous in light of the statute's placement within Subtitle B, Chapter 14 of the Internal Revenue Code, which includes other valuation rules targeting transfer avoidance schemes. Based on this ambiguity the IRS stated the court should defer to the agency's interpretation under the *Chevron* doctrine.''[112] In fairly short order, the court found that the term ''decedent'' unambiguously applied to those who were dead and therefore §2703(b)(2) only addresses transfers at death.

The decision in *Kress* is notable as it limits the exceptions the taxpayers must prove in gift tax cases. While a useful case citation to have, it is a district court opinion and does not carry with it binding precedential authority. Yet, it is persuasive authority, meaning that if the reasoning and conclusion are not be barred by contrary binding precedent it could be persuasive to another judicial body that would incorporate the rationale or holding into its decision. The decision in *Kress* checks both boxes. A firm understanding of the existing case law on the issue and the logic behind the decision can transform a simple citation that can be bandied about in an audit to an effective tool.

A review of the decisions interpreting §2703 reveals no contrary holding to the finding in the *Kress* decision and, to the extent that other courts have expounded on the scope of §2703(b), it favors the interpretation by the *Kress* court. Some of the cases addressing §2703 were limited to addressing and ultimately rejecting the government's position that the provision requires a partnership to be disregarded and that the underlying assets are subject to estate taxes.[113] While these holdings are generally helpful to taxpayers, they provide little guidance on the meaning of §2703(b)(2). Other cases do not address the issue of whether §2703(b)(2) is deemed to be satisfied in gift tax cases because they were cases to determine an estate tax liability. As a result, those courts were not called upon to determine whether the Treasury Department's interpretation of §2703(b)(2) in the regulations is valid in regards to a gift tax liability.[114] By process of elimination—this leaves only three cases which raised §2703 other than *Kress* in which there is relevant guidance: *Holman*, *Smith*, and *Pierre*.

The dissenting opinion in the Eight Circuit's *Holman* case provides the strongest and most direct support for the conclusion, and was cited for its rationale, in the *Kress* decision. As with many legal issues,

[110] PLR 200852029.

[111] *Blount*, 428 F.3d at 1342.

[112] *Kress* at 748.

[113] *Estate of Strangi v. Commissioner*, 115 T.C. 478, 489 (2000), *rev'd on other grounds*, 293 F.3d 279 (5th Cir. 2002) (Tax Court found no reason to address §2703(b) exception requirements as the government's argument to apply §2703(a) to disregard the existence of a partnership was rejected); *Church v. United States*, 85 A.F.T.R.2d 804 (W.D. Tex. 2000), *aff'd*, 268 F.3d 1063 (5th Cir. 2001) (The court rejected the IRS argument that the partnership should be disregarded, but did develop factual record sufficient to determine §2703(b)(2) was satisfied on the basis the partnership was not a device to transfer property to ''family'' for a depressed value). *See also Estate of Smith v. United States*, 103 Fed. Cl. 533 (2010) (court held §2703 did not apply as concern was over voting rights, which are covered by §2704).

[114] *Estate of True v. Commissioner*, 390 F.3d 1210 (10th Cir. 2004), *aff'g*, T.C. Memo. 2001-167 (Estate tax case in which the court held the government was not collaterally estopped from challenging valuation because testamentary intent would not have arisen in prior gift tax cases); *Estate of Gloeckner v. Commissioner*, 152 F.3d 208, 213 (2d Cir. 1997) (Estate tax case where §2703 was only cited as confirmation that the bona fide business purpose test and the testamentary device test under Reg. §20.2031-1(h) were distinct tests.); *Estate of Blount v. Commissioner*, T.C. Memo. 2004-116 *aff'd in part*, *rev'd in part*, 428 F.3d 1338 (11th Cir. 2005) (Estate tax case where §2703(b)(2) was satisfied by the taxpayer); *Estate of Amlie v. Commissioner*, T.C. Memo. 2006-76 (Estate tax case that cited and used the language of §2703(b)(2) but did not mention Reg. §20.2031-1(h)).

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when the best support for a position is a dissenting opinion, the position may be on thin ice. However, when there is such a dearth of analysis on this issue and the majority's opinion, as well as the Tax Court's opinion, is considered, this dissenting opinion is useful guidance that was not rejected by the majority. At trial, the Tax Court in *Holman* applied the terms of the Treasury regulation to hold that the inter vivos gift was subject to the scope of the §2703(b)(2) requirement. However, the Tax Court did not consider the taxpayer's argument that §2703(b)(2) was deemed to be satisfied as it was not an estate tax case because the taxpayer did not challenge the validity of Reg. §25.2703-1(b)(ii) and therefore the Tax Court ''assume[d] that they concede the validity of the regulation in applying the device test to transfers to 'the natural objects of the transferor's bounty' ''.[115] Therefore, the Tax Court's application of the regulation does not confirm that the regulation is a proper interpretation of the statute. Instead, quite the opposite is true, as the Tax Court explicitly stated in the opinion that it did not consider the merits of the issue. On appeal, the majority's opinion gave no further guidance or thought on the applicability to lifetime transfers. The majority's opinion held that the bona fide business arrangement requirement of §2703(b)(1) had not been satisfied, therefore ''we need not address the additional requirements of §2703.''[116]

Judge C. Arlen Beam's thoughtful dissent in *Holman* provides a persuasive case for the interpretation of §2703(b)(2) which would later appear in the *Kress* case. Unlike the majority, Judge Beam found that the requirement of §2703(b)(1) had been satisfied, so an analysis of §2703(b)(2) was not moot as it was in the majority's opinion. As the validity of §25.2703-1(b)(ii) is a legal question, the issue is to be reviewed *de novo* on appeal, thus freeing the analysis from deference to the Tax Court's holding. The dissent noted that though Treasury regulations are given substantial deference, the validity of all agency interpretations of federal statutes are reviewed under the *Chevron* standard.[117] Under this standard, the first question in reviewing the agency's interpretation is whether Congress directly addressed the issue. If Congress directly and unambiguously addressed the issue—then the agency and courts alike ''must give effect to the unambiguously expressed intent of Congress.''[118] If, however, the statute is either ambiguous or silent on an issue, then the court must determine if the agency's interpretation is a permissible construction.

Thus, the first question under a *Chevron* analysis about the validity of Reg. §25.2703-1(b)(ii)'s interpretation that §2703(b)(2) applies to inter vivos transfers is whether the term ''decedent's family,'' as used in the statute, is ambiguous. The taxpayer's argument was that the term ''decedent'' was unambiguous as it can only refer to a deceased person while the government argued it was ambiguous given §2703's placement in Chapter 14 which addresses all transfer taxes. The dissent found the government's argument unpersuasive for three reasons. First, the word ''decedent'' is unambiguous as it refers to someone who is deceased.[119] Second, the statutory provisions of Chapter 14 often do use the term ''transferor,'' but §2703(b)(2) did not, so this distinction should be given meaning. This is consistent with the well accepted construction principle that there is a consistent usage of terms, so that if there is a change in the term used then it is assumed there is also a change in meaning. This interpretation is also consistent with the construction principle that the language used a series of related statutes that should be considered together. Third, Congress did consider legislation to amend §2703(b)(2) to conform the statute's language to the Treasury regulation, but such legislation was never enacted. Given that Judge Beam found that the statute unambiguously applied for transfers at death, the Treasury regulation was invalid and he would have ruled that §2703(b)(2) was deemed satisfied.

The second case is the Smith decision, which ultimately found §2703(b)(2) is limited to testamentary transfers.[120] The decision was a federal magistrate's decision on various motions for summary judgment. The sole issue in the case was the value of a transfer of a family limited partnership for gift tax purposes. The decision noted the discrepancy between the statute and regulation, finding the terms of the regulation were an ''apparent recognition of the fact that §2703 applies to both testamentary and inter vivos transfers. . . Despite this discrepancy, it is obvious that one of Congress's primary concerns was the free passage of wealth to family members through a device that is **testamentary** in nature.''[121] The decision noted that there had been legislative attempts to conform the statute's terms to the regulation, but no such attempt had been successful. Ultimately, though the decision held that §2703(b)(2) was only about testamentary devices, it did not deem the provision satisfied and found there were issues of material fact that must be entered into evidence to determine if the intent of the taxpayer was to effect a testamentary transfer. Despite recognizing the statute is limited by its terms to testamentary transfers but allowing the issue to continue on, both the *Holman* dissent and *Kress* cited to this decision in support of their positions.

Finally, there is the *Pierre* decision by the Tax Court.[122] This case is an important transfer tax valuation case and is known for the proposition that a

[115] *Holman v. Commissioner*, 130 T.C. 170, n.9 (2008).

[116] *Holman v. Commissioner*, 601 F.3d 763, n.5 (2010). The court noted however that ''[o]ur election not to address these issues, however, should not be interpreted as implicit agreement with the dissent.''

[117] *Chevron, U.S.A., Inc. v. Natural Res. Def. Council Inc.*, 467 U.S. 837 (1984).

[118] *Id*. at 843.

[119] *Holman*, 601 F.3d at 781 (citing Black's Law Dictionary 465 (9th ed. 2009)).

[120] *Smith v. United States*, No. 02-264 ERIE, 2004 U.S. Dist. LEXIS 14839 (W.D. Pa. June 30, 2004).

[121] *Id*. at *17-*18 (emphasis added).

[122] *Pierre v. Commissioner*, 133 T.C. 24 (2009).

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single member entity that is disregarded for income tax purposes is not similarly disregarded for transfer tax purposes. As a result, transfer taxes are imposed on the value of the entity, which could include appropriate discounts, and not simply the full value of the underlying assets of the entity. This case was about the applicability of the ''check-the-box regulations'' under §7701 and how these regulations cannot be used to disregard valid state law provisions for purposes of the willing buyer/willing seller standard for transfer tax purposes.[123] Although §2703 was not at issue in this case, the Tax Court described the importance of the terms of this statute. Specifically, the Tax Court ''note[d] that Congress has enacted provisions of the Internal Revenue Code, see [§§] 2701, 2703, that disregard valid State law restrictions in valuing transfers. Where Congress has determined that the 'willing buyer, willing seller' and other valuation rules are inadequate, it expressly has provided exceptions to address valuation abuses. See Chapter 14 of the Internal Revenue Code, sections 2701 through 2704, which specifically are designed to override the standard 'willing buyer, willing seller' assumptions in certain transactions involving family members. . . the Commissioner cannot by regulation overrule the historical Federal gift tax valuation regime. . .''[124] Although the Tax Court prior to *Pierre* passed on the opportunity to determine the validity of Reg. §25.2703-1(b)(ii),[125] it held in *Pierre* that changes to the fair market value standard must come through statutory and not regulatory changes. The Tax Court's logic was not so limited as to only apply to the §7701 regulations and can be interpolated into the review of the §2703 regulation.

In future cases where the validity of Reg. §25.2703-1(b)(ii) is at issue, it is possible that those courts will deploy additional accepted principles of construction that have not yet been applied or fully explored to reach the outcome the court did in *Kress*. For example, the use of the term ''decedent,'' carries with it a negative connotation, meaning that all those not encompassed by that specific term (i.e. the living donor) must be excluded.[126] Further, a court adding the living to the category of transferors covered by §2703(b)(2) because of the IRS's position on legislative intent is ''not a construction of a statute, but, in effect, an enlargement of it by the court, so that what was omitted, presumably by inadvertence, may be included within its scope. To supply omissions transcends the judicial function.''[127] This is true even in tax cases where supplying additional terms to what the legislature crafted would make logical sense—in other words it is not a question of what is the right policy but who has the right to make policy.[128] As noted in *Kress*, *Holman*, and *Smith*—the legislature considered statutory language to change the terms of §2703(b)(2) but did not.[129] Finally, even if the term ''decedent'' was an error by the draftsperson, ''[a] drafting error that is not evident on the face of the statute is an error of the drafter, not of the house that voted for the draft; and citizens seeking to obey the law should not have to comb legislative history for covert drafting errors.''[130]

IMPLEMENTING THE LESSONS OF KRESS

The Court's decision in *Kress* gives planners and valuation experts much to think about. However, thoughts must ultimately be turned into practice to keep them from being merely academic. To distill the lengthy discussion into three practice tips—we would offer the following three lessons.

First, when it comes to valuation issues in transfer tax cases—there is no substitute for a high-quality appraisal from a valuation expert. Even with the benefit of burden shifting to the government under §7491, to prevail the taxpayer needs to put forward the best evidence for each question of fact including all of those related to valuation. The best evidence is put forth by having qualified appraisers retained to help win the ''battle of the valuation experts.''

Second, the holding to not tax affect PTEs in *Gross* is ripe for revisiting and reversal. The large majority of valuation professionals never accepted the departure from economic reality in Gross, state courts have rejected the approach, and now a federal court has done so as well. As we observe daily in the bond market and as anyone involved in the buying and selling of businesses can attest to—business entity and personal taxes are always considered. They should clearly be considered differently for C Corporations in comparison to PTEs—but all taxes must be considered. Tax affecting the earnings of a PTE is valid so long as the appraiser has sufficiently considered the economic and qualitative differences between C corporations and PTEs, as we saw in *Kessler*, *Bernier*, and now *Kress*.

Third, the regulatory interpretation of §2703(b)(2) to include donors should continue to be challenged. When planners are engaged in advising on lifetime gifts that have provisions that invoke §2703(a), nothing in this article suggests that the planning should not be done assuming the regulatory interpretation is valid. This is especially true given that the other two requirements of §2703(b) must still be met and there is overlap between the three. What this article does

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[123] Reg. §301.7701-1, §301.7701-2, §301.7701-3.

[124] *Pierre*, 133 T.C. at 36.

[125] *Estate of Strangi v. Commissioner*, 115 T.C. 478, 489 (2000).

[126] *See e.g.*, *United States v. Giordano*, 416 U.S. 505, 514 (1974).

[127] *Iselin v. United States*, 270 U.S. 245, 251 (1926).

[128] *See e.g.*, *Commissioner v. Asphalt Products Co.*, 482 U.S. 117, 120 (1987).

[129] Technical Correction Act of 1991, H.R. 1555, 102d Cong. §102(f)(12) (1991); Technical Correction Act of 1993, H.R. 17, 103d Cong. §101(f) (1993).

[130] Antonin Scalia & Bryan A. Garner, *Reading the Law: The Interpretation of Legal Texts*, 282-283 (1st ed. 2012).

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suggest is that in an examination or litigation where the applicability of §2703 to a lifetime transfer is being debated, the taxpayer should not only argue that the facts in the case satisfy §2703(b)(2), but also consider arguing that the requirement is deemed satisfied because §25.2703-1(b)(ii) is invalid.

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