

Thought Leadership Discussion

Estate of Aaron U. Jones v. Commissioner of Internal Revenue: Increasing Acceptance of Tax-Affecting

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The U.S. Tax Court has issued many judicial decisions throughout the past decades that involve the business valuation of a tax pass-through entity. However, there is ongoing debate with regard to how best to apply income tax in a valuation analysis of a tax pass-through entity. The recent Estate of Aaron U. Jones v. Commissioner of Internal Revenue decision was an important judicial decision that affirmed that the federal court system is increasingly willing to consider tax-affecting in a valuation analysis of a tax pass-through entity. This discussion summarizes the Jones case, the important valuation issues involved, and the ultimate impact that case may have moving forward.

INTRODUCTION

The Internal Revenue Service (the “Service”) has consistently opposed the concept of tax-affecting income for the valuation of tax pass-through entity (such as limited partnerships and S corporations) interests for transfer tax purposes under the Internal Revenue Code. This opposition has been observable in many judicial decisions since the *Gross* case¹ in 1999.

In the world of investment markets, however, investors have consistently recognized differences in the valuation of investment interests due to the different tax burdens levied on the cash flow of various types of investment returns.

The latest clash between these two world views was debated in front of—and decided by—Judge Pugh in the U.S. Tax Court case of *Estate of Aaron U. Jones, Donor, Deceased, Rebecca L. Jones and Dale A. Riddle, Personal Representatives v. Commissioner of Internal Revenue*² (the “Jones case”).

The result was a victory for the taxpayer in the *Jones* case and an affirmation by the Tax Court that the federal court system is increasingly willing to consider the investment market world view of tax-affecting income. This is especially true if the facts of the case merit such consideration and the investment and tax issues are properly and thoroughly laid out and analyzed in expert valuation testimony.

The *Jones* case verdict follows the *Kress v. U.S.*³ case decided earlier in 2019 in the U.S. District Court of the Eastern Division of Wisconsin, which also decided in favor of the taxpayer’s position on tax-affecting the income used to value the subject noncontrolling interest in a family-owned S corporation.

BACKGROUND OF THE CASE

Aaron Jones built his family’s forest products businesses from virtually nothing. Starting at age 33 in 1954, he rented an existing old sawmill at Seneca Street in West Eugene, Oregon, and began to



improve and expand the facilities to process logs into studs and other dimensional lumber products for residential and general construction uses. Later, Mr. Jones acquired and managed timberlands in order to assure a sustainable supply of logs for the sawmill operation.

The family business consisted of two companies, Seneca Sawmill Company (“SSC”) and Seneca Jones Timber Company, Limited Partnership (“SJTC”). The two companies were operated as a single integrated business.

Seneca Sawmill Company

As of May 28, 2009 (the date of the gifts subject to dispute), SSC was an Oregon-based forest products company that owned and operated two sawmills. Through the use of the sawmills, SSC was primarily engaged in producing dimension and stud lumber.

SSC maintained a technological advantage through its portfolio of more than 25 patents, many of which were developed by Mr. Jones.

The two SSC sawmills, as well as all manufacturing facilities and company headquarters, were located on the same site in the Eugene, Oregon, area. The SSC sawmills included a dimensional mill and a stud mill. The stud mill consisted of two lines (the “stud saw line” and the “hewsaw line”) that were housed in adjoining but separate buildings.

Those two mills were considered one mill for financial accounting purposes. Together, the mills produced over 250 million board feet of primarily Douglas fir dimension and stud lumber in 2008.

SSC was also the general partner of SJTC. As the sole general partner of SJTC, the SSC executive

management team exercised exclusive control over the management of SJTC.

Further, SSC was dependent on SJTC as (1) a primary supplier of logs used in the SSC sawmills and (2) the provider of short- and long-term debt financing, through the use of the SJTC timberland as collateral.

As of May 28, 2009, the SSC balance sheet prepared in accordance with generally accepted accounting principles (“GAAP”) reported total assets of around \$100 million. For the latest 12 months ended May 28, 2009, the SSC income statement reported

revenue of about \$66 million and a pretax loss of about \$10 million.

As of May 28, 2009, SSC was a subchapter S corporation, for federal income tax purposes. SSC was organized under the laws of the State of Oregon.

Seneca Jones Timber Company, Limited Partnership

Mr. Jones began to consider acquiring timberlands in the early to mid-1980s when environmental regulations put continued access to federal timberlands at risk. On August 25, 1992, Mr. Jones formed SJTC to invest in, acquire, hold, and manage timberlands and real property and to incur indebtedness, and he contributed the timberlands he purchased in 1989 and 1992 in exchange for an ownership interest.

Mr. Jones contributed the timberlands to SJTC rather than SSC because of tax and liability concerns. SJTC’s timberlands were intended to be SSC’s inventory.

As of May 28, 2009, SJTC was an Oregon-based limited partnership that owned, managed, and facilitated the harvest of timberlands primarily in Western Oregon. SJTC owned over 165,000 acres of timberland in Oregon and, at the end of 2008, had standing timber inventory on the timberlands of more than 1.4 billion board feet.

SJTC used its logs almost exclusively for (1) sales to the SJTC general partner (i.e., SSC) or (2) trades with third-party companies in exchange for logs to be used by SSC.

As mentioned earlier, the SSC executive management team exercised exclusive control over the management of SJTC. Further, SSC was dependent on SJTC as (1) a primary supplier of logs used in the SSC sawmills and (2) the provider of short- and long-term debt financing, through the use of the SJTC timberland as collateral.

SJTC operated its timber holdings on a sustainable-yield basis, with normal rotation ages of between 45 to 60 years. Any commercial thinning harvests on the SJTC land occurred between 25 and 45 years.

As the lands were harvested, they were replanted with specially selected “super-trees.” These newly planted trees were placed on a highly managed fertilization and vegetation control program, which provided them with a superior growth advantage over the natural seeding process. Through this process the SJTC assets were expected to provide a steady supply of timber inventory in perpetuity.

The SJTC management team was identical to that of SSC and was paid by SSC. SJTC had 21 employees as of May 28, 2009, composed primarily of administrative and forestry staff. SJTC relied on SSC for human resources, legal services, and its controller, and it paid a \$1.2 million annual fee for administrative services to SSC.

SJTC also used independent contractors for most of its activities on the tree farm, including planting seedlings, road construction, and harvesting trees.

The SJTC forestry staff oversaw between 150 and 200 contractors to ensure that they completed their tasks according to the SJTC standards and objectives.

As of May 28, 2009, the SJTC GAAP balance sheet reported total assets of roughly \$125 million. For the latest 12 months ended May 28, 2009, the SJTC income statement reported revenue of about \$30 million and a pretax loss of just under \$1 million.

As of May 28, 2009, SJTC was a limited partnership, organized under the laws of the State of Oregon.



The Gifts

In 1996, Mr. Jones began to create a succession plan to ensure that his family businesses remained operational in perpetuity. As part of this plan, he formed various family and generation-skipping trusts. He then gifted voting and nonvoting shares of SSC and limited partnership units of SJTC to his three daughters and these related entities.

The transfers all consisted of noncontrolling blocks of interests subject to restrictions on marketability that were part of the organizational documents of SSC and SJTC.

The effective date of these transfers (and, thus, the valuation date) was May 28, 2009.

The fair market values assigned to the shares and limited partnership interests on a per share/unit basis were \$325 for SSC voting shares, \$315 for SSC nonvoting shares, and \$375 for SJTC limited partnership units. The reported gifts totaled approximately \$21.7 million. These values were prepared by a firm of independent valuation analysts.⁴

Upon audit, the Service disputed the fair market values assigned to the gifts by the taxpayer.

The values determined by the Service for the shares and limited partnership interests on a per share/unit basis were \$1,395 for SSC voting shares, \$1,325 for SSC nonvoting shares, and \$2,511 for SJTC limited partnership units. The Service's values for the gifts totaled approximately \$119.9 million. These values were prepared by firms of independent valuation analysts.

Mr. Jones died in 2014 and his estate representatives continued to pursue a resolution of the tax dispute. When the parties could not arrive at a negotiated resolution, the case went to trial in Tax Court in 2017.

For trial purposes, the taxpayer's attorneys retained Willamette Management Associates ("Willamette") to review and prepare de novo fair market value opinions for the subject interest. The fair market values estimated for the shares and limited partnership interests by Willamette on a per share/unit basis were \$390 for SSC voting shares, \$380 for SSC nonvoting shares, and \$380 for SJTC partnership units. Thus, the taxpayer's reported gifts for trial purposes totaled approximately \$23.9 million.⁵

The Service also retained new valuation analysts for the trial. One of the new Service experts submitted a revised valuation for the SJTC interests, increasing the value to \$2,530 per unit.

The Service's new analysts did not prepare a new opinion of the value of the SSC shares, but only elected to prepare a rebuttal review of Willamette's SSC stock valuation report. As a result, the Service asserted a total value of approximately \$120.5 million for the subject gifts.

AREAS OF VALUATION DISPUTES AND EXPERT OPINIONS

The primary areas in dispute regarding the valuation issues in the *Jones* case can be divided into six issues. As stated by Judge Pugh:

The primary dispute between the parties is whether SJTC should be valued using an income approach or an asset-based approach. The parties have several other points of dispute: (1) the reliability of the 2009 revised projections, (2) the propriety of "tax-affecting", (3) the proper treatment of intercompany loans from SSC to SJTC, (4) the proper treatment of SSC's 10% general partner interest in SJTC, and (5) the appropriate discount for lack of marketability.

Both the Willamette expert opinions and the Service expert opinions for the value of the interests in the two companies are summarized below.

SJTC Valuation

The Willamette valuation variable inputs were as follows:

1. Intercompany loans offset as a clearing account
2. Income approach—discounted cash flow method
 - a. Assumed income tax rate: 38 percent
 - b. Discount rate: weighted average cost of capital ("WACC") of 13 percent
 - c. Projections: five-year projection period prepared by management as of April 29, 2009
 - d. Long-term growth rate: 3 percent
 - e. Discounted cash flow indicated enterprise value: \$75 million
 - f. Weight assigned to this method: 65 percent
3. Market approach—guideline publicly traded company method
 - a. Projections: five-year projection period prepared by management as of April 29, 2009
 - b. Number of guideline public companies: 6
 - c. Multiple selection: generally between the median and the low of the range
 - d. Metrics receiving the greatest weight: historical and projected (i) EBITDDA (earnings before interest, taxes, depreciation, depletion, and amortization) and (ii) EBIT (earnings before interest and taxes), both at 30 percent
 - e. Guideline publicly traded company method indicated enterprise value: \$107 million
 - f. Weight assigned to this method: 35 percent
4. Asset-based approach: not relied on
5. Third-party debt: \$60 million
6. Pass-through entity benefit: 23 percent (relatively high percentage of earnings distributed)
7. Discount for lack of marketability: 35 percent

The Service valuation expert valuation variable inputs were as follows:

1. Intercompany loan treated as part of third-party debt: increases debt by \$32.7 million
2. Income approach: not relied on
3. Market approach—guideline publicly traded company method

- a. Projections: average of projections prepared by management as of fiscal year-end 2008 and as of April 29, 2009
 - b. Number of guideline publicly traded companies: 7 (with special emphasis on 5 with large log sales)
 - c. Multiple selection: slightly below the median
 - d. Metrics receiving the greatest weight: historical and projected EBITDDA at 100 percent
 - e. Guideline publicly traded company method indicated enterprise value: \$97.4 million
 - f. Weight assigned to this method: 25 percent
4. Asset-based approach—adjusted net asset value method
 - a. Adjusted net asset value: \$332.7 million (timberlands increased from book value to appraised value based on a third-party real property appraisal)
 - b. Discount for lack of control: 30 percent (sources listed below)
 - i. Mergerstat
 - ii. Partnership Profiles
 - iii. Public company disclosures and analyst reports
 - c. Adjusted net asset method indicated enterprise value: \$232.9 million
 - d. Weight assigned to this method: 75 percent
 5. Third-party and related-party debt: \$84.4 million
 6. Pass-through entity tax benefit: no opinion offered; timberlands appraised using pretax income
 7. Discount for lack of marketability: 30 percent
 - e. Discounted cash flow indicated enterprise value: \$27 million
 - f. Weight assigned to this method: 65 percent
3. Market approach—guideline publicly traded company method
 - a. Number of guideline publicly traded companies: 6
 - b. Multiple selection: generally between the median and the low of the range
 - c. Metrics receiving the greatest weight: historical and projected (i) EBITDDA and (ii) EBIT, both at 30 percent
 - d. Guideline publicly traded company method indicated enterprise value: \$47 million
 - e. Weight assigned to this method: 35 percent
 4. Asset-based approach: not relied on
 5. Partnership income related to SJTC ownership interest: included in the SSC historical and projected cash flow
 6. Third-party debt: \$7.1 million
 7. Pass-through entity benefit: 10 percent (relatively low percentage of earnings distributed)
 8. Discount for lack of marketability: 35 percent
 9. Discount for lack of voting rights: 3 percent

The Service valuation expert valuation variable inputs were as follows:

1. The previous Service independent expert valued the Class A voting stock at \$1,395 per share and the Class B nonvoting stock at \$1,325 per share. These values represented the Service position during audit negotiations.
2. The Service did not submit an expert valuation report for the Tax Court litigation phase of this matter. Rather, the Service had its new expert submit a review/rebuttal report that “corrected” what they regarded as the Willamette valuation errors.
3. These adjustments included the following:
 - a. An upward adjustment to value for SSC’s 10 percent ownership interest in SJTC of \$28.8 million (based on the adjusted net asset value method less a 30 percent discount for lack of control)
 - b. An upward adjustment to value for the \$32.7 million intercompany receivable from SJTC

The SSC Valuation

The Willamette valuation variable inputs were as follows:

1. Intercompany loans offset as a clearing account
2. Income approach—discounted cash flow method
 - a. Assumed income tax rate: 38 percent
 - b. Discount rate: WACC of 16 percent
 - c. Projections: five-year projection period prepared by management as of April 29, 2009
 - d. Long-term growth rate: 3 percent

4. The resulting “corrections” increased the implied values to \$1,310 per Class A voting share and \$1,270 per Class B nonvoting share.
5. A 3 percent discount for lack of voting rights was applied by both valuation firms.

Income Valuation Approach versus Asset-Based Valuation Approach

Although there were a number of areas where the two experts differed in opinion, the issue with arguably the largest impact on value was the issue of applying an income valuation approach versus an asset-based valuation approach.

As noted above, the Service valuation expert used the adjusted net asset value method to value SJTC, relying on a real property appraisal of the timberland owned by the company and applying a discount for lack of control and discount for lack of marketability.

The Service valuation expert argued that an asset-based approach was more appropriate than an income approach for the following reasons:

1. SJTC was, in his opinion, a holding company and an income approach was less appropriate for valuing this type of entity.
2. The real property appraisal relied on in his application of the adjusted net asset value method utilized a form of income approach in estimating the value of the timberland.

Willamette offered the alternate position that an income approach was more appropriate than an asset-based approach to value the noncontrolling, nonmarketable ownership interests in SJTC.

Willamette offered the following reasons for its position:

1. SJTC was, in fact, an operating company that provided timber for processing in the SSC mills and the asset-based approach is often less applicable to the valuation of a noncontrolling, nonmarketable interest in an operating business enterprise than an income-based approach.
2. The asset-based approach assumes the sale of all company assets as of the valuation date. The subject interest was a noncontrolling ownership interest with no ability to initiate the sale of any of the subject company assets. Therefore, this valuation approach was not particularly relevant to a hypothetical buyer or a hypothetical seller of the subject interest.

3. SSC was the sole general partner of SJTC, and SSC executive management had exclusive control over the business and affairs of SJTC. SSC relied on SJTC as a primary supplier of the logs used in the SSC sawmills. Additionally, SSC relied on SJTC to secure short- and long-term debt financing for operations and major capital projects, by providing SJTC timberlands as collateral.

Therefore, it is very unlikely that SSC would cause the liquidation of the SJTC assets as long as SSC operated as a going-concern business.

Accordingly, it was an unreasonable assumption that a limited partner would be able to realize the underlying asset value of SJTC.

4. The discounted cash flow method would be particularly relevant to a hypothetical buyer of the subject interest because the projected cash flow of SJTC represented the most likely manner in which a noncontrolling ownership interest would realize a return on investment.

Willamette did not disagree that an asset-based valuation approach could be used to value SJTC with appropriate considerations and adjustments. Rather, the Willamette position was as follows:

1. The Service valuation expert did not apply the asset-based approach in a manner appropriate for the noncontrolling, nonmarketable ownership interest in SJTC.
2. An income valuation approach was more appropriate for the valuation of the noncontrolling, nonmarketable ownership interest in SJTC.

Is Tax-Affecting Appropriate?

One of the noteworthy issues in the *Jones* case was difference of opinion between the Service and Willamette regarding the appropriateness of tax-affecting the pass-through entity earnings.

The Willamette position was to treat the pass-through entities as C corporations from an income tax perspective, and then apply a premium to account for the value attributable to the subject entities’ pass-through income tax status versus an otherwise comparable C corporation.

The Service position was that a 0 percent tax rate was appropriate for the valuation of the subject entities due to their pass-through income tax status.

The Willamette reasons for tax-affecting the pass-through entities' earnings included the following:

1. The discount rate relied on in the application of the income approach was an after-tax discount rate.
2. The pool of hypothetical buyers of a subject pass-through entity are often C corporations that would place little to no premium on a subject company's pass-through income tax status.
3. The entities did pay income taxes at the shareholder level (and, therefore, the subject entities did incur a tax expense in the form of distributions for shareholder income tax liabilities).

It was the Willamette position that the value impact of the pass-through income tax structure was related to the following:

1. The excess distributions above income tax liabilities that are not subject to taxation at the capital gains tax rate
2. Any premium that an acquiring company may pay for the entities' pass-through income tax status.

In the *Jones* case, the issue of tax-affecting was not debated between the Service expert and Willamette, but rather between the Service and Willamette.

Judge Pugh noted that "While respondent objects vociferously in his brief to petitioner's tax affecting, his experts are notably silent. . . . They do not offer any defense of respondent's proposed zero tax rate. Thus, we do not have a fight between valuation experts but a fight between lawyers."

THE COURT'S OPINION ON THE VALUATION ISSUES

The Tax Court agreed with the Willamette valuation inputs and assumptions in all material respects.

Judge Pugh noted that both parties did not dispute that SJTC and SSC were going concerns and were, for the most part, operating companies. On that point, the Tax Court stated:



The likelihood that SJTC would sell its timberlands goes to the relative weight that we give an asset-based approach in valuing SJTC; the less likely SJTC is to sell its timberlands, the less weight we should assign to an asset-based approach. See *Estate of Giustina v. Commissioner*, 586 F. App'x 417, 418 (9th Cir. 2014) (holding that no weight should be given to an asset-based valuation because the assumption of an asset sale was a hypothetical scenario contrary to the evidence in the record), rev'g and remanding T.C. Memo. 2011-141, 2011 WL 2559847.

Because the Tax Court concluded that the interdependency of the companies should be considered in this case, and that the timberlands would not be sold for the foreseeable future (and could not be sold by the transferred noncontrolling interests), "We, therefore, conclude that an income-based approach, like Mr. Reilly's DCF method, is more appropriate for SJTC than Mr. Schwab's NAV method valuation. See *Estate of Giustina v. Commissioner*, 586 F. App'x at 418."

The reliability and usefulness of the most current projections as of the valuation date (updated projections as of April 29, 2009) was also upheld. These projections were prepared in the same manner as the projections presented in the 2008 annual report and reflected the most current conditions as of the valuation date. The updated projections were prepared in the regular course of business and updated due to the rapidly changing economic conditions at the time.

The Tax Court also agreed with the Willamette tax-affecting methodology which applied a premium for the tax advantages of the company's pass-through income tax status, stating, "We find on the record before us that Mr. Reilly has more accurately taken into account the tax consequences of SJTC's flow-through status for purposes of estimating what a willing buyer and willing seller might conclude regarding its value. His adjustments include a reduction in the total tax burden by imputing the burden of the current tax that an owner might owe on the entity's earnings and the benefit of a future dividend tax avoided that an owner might enjoy. . . . Mr. Reilly's tax-affecting may not be exact, but it is more complete and more convincing than respondent's zero tax rate."

The Tax Court confirmed that the proper treatment of the intercompany loans was to net them out, stating, "By eliminating SSC's receivable and SJTC's payable and treating their intercompany interest income and expense as operating income and expense, Mr. Reilly captured their relationship as interdependent parts of a single business enterprise."

The appropriate treatment of the SSC 10 percent ownership interest in SJTC using an income approach was affirmed by the Tax Court: "In this light we find Mr. Reilly's use of expected distributions to represent the value of the general partner interest to SSC to be reasonable. We, therefore, conclude that Mr. Reilly's treatment of SSC's 10% general partner interest in SJTC was appropriate."

The disagreement over the discount for lack of marketability was also resolved in the taxpayer's favor. The Tax Court concluded that the analysis was explained in sufficient detail and supported by calculations, references to empirical studies, and consideration of the impact of restrictions and other factors specific to the case, as discussed in *Mandelbaum*.⁶

SUMMARY AND CONCLUSION

The Tax Court took a significant step forward in validating a reasonably constructed and thorough analysis of tax-affecting cash flow under the income approach to value in the *Jones* case.

The Tax Court upheld the Willamette valuation of SJTC and SSC noncontrolling, nonmarketable private stock interests in all material respects.

Summarizing its findings, the Tax Court stated:

We summarize our conclusions as follows. First, we do not accept Mr. Schwab's (the Service expert) NAV method for valuing SJTC because there was no likelihood of a sale of SJTC's timberlands and, thus, an asset-based approach was not appropriate for valuing SJTC. Second, we find that Mr.

Reilly's use of the 2009 revised projections in his valuation of SJTC was proper. Third, we accept Mr. Reilly's tax-affecting in his valuations of SJTC and SSC as more accurate than respondent's blunt zero-rate approach. Fourth, we conclude that Mr. Reilly properly treated the intercompany loans from SSC to SJTC and SSC's 10% general partner interest in SJTC as operating assets. And finally, we find that Mr. Reilly's discount for lack of marketability was reasonable.

This type of decision signals that the federal courts will accept the best analysis, even if it goes against the judicial findings of other cases.

The Tax Court underlined this position by saying, "And as we admonished in *Buffalo Tool & Die Mfg. Co. v. Commissioner*, 74 T.C. at 452, 'in the final analysis, the Court may find the evidence of valuation by one of the parties sufficiently more convincing than that of the other party, so that the final result will produce a significant financial defeat for one or the other, rather than a middle-of-the-road compromise which we suspect each of the parties expects the Court to reach.'"

Notes:

1. *Gross v. Commissioner*, TCM 1999-254, aff'd, 272 F.3d 333 (6th Cir. 2001).
2. *Estate of Aaron U. Jones, Donor, Deceased, Rebecca L. Jones and Dale A. Riddle, Personal Representatives v. Commissioner of Internal Revenue*, T.C. Memo 2019-101 (Aug. 19, 2019).
3. *Kress v. United States*, --- F Supp.3d ---, 2019 WL 1352944 (E.D. Wis. Mar. 26, 2019).
4. The taxpayer reported lower values than those determined by its original appraiser for the SSC nonvoting shares and the SJTC units. Willamette Management Associates was not the appraiser that performed the valuation for the original gift tax return.
5. The taxpayer chose not to dispute the Service's higher value assigned to another, smaller closely held company stock gift.
6. *Mandelbaum v. Commissioner*, T.C. Memo. 1995-255, aff'd, 91 F.3d 124 (3d Cir. 1996).



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