Tax-Affecting and Lessons from the *Estate of Jones*

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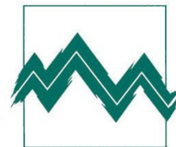

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Discussion Outline

- Introduction to tax pass-through entities
- The fundamental tax-affecting question
- Where tax-affecting affects business valuation
- The mathematics of tax-affecting
- Tax-affecting is a matching issue—not a tax rate issue
- The Internal Revenue Service position on tax-affecting
- Summary of judicial precedent
- Why analysts tax-affect (response to precedent)
- Facts and circumstances of the *Jones* case
- Numerous valuation issues of the *Jones* case

Discussion Outline (cont.)

- Taxpayer position regarding tax-affecting
- Taxpayer position regarding FMV and HABU
- Taxpayer position regarding the asset-based approach
- The Tax Court's decision
- Analyst best practices for tax litigation valuations
- Summary and conclusion; questions and discussion

Introduction to the Tax Pass-Through Entities

- Taxable entities
  - C corporation
  - Limited liability company—can elect to be taxed as a C corporation
- Tax pass-through entities (TPE)
  - S corporation
  - Partnership
    - Limited liability company
    - Limited partnership
  - Limited liability company
    - Can elect to be taxed as a partnership
    - Can elect to be taxed as an S corporation

Introduction to the Tax Pass-Through Entities (cont.)

- Tax pass-through entities are not tax-exempt entities
- This is a federal income tax regime
  - Many states do not recognize a TPE

Summary of Taxation Differences

- Where federal income tax (FIT) is paid
  - C corporations pay FIT on taxable income—at the corporation FIT rate
  - When a C corporation pays a dividend distribution, the shareholder pays FIT on the distribution—at the individual FIT rate
  - The TPE does not pay FIT on taxable income at the entity level
  - Owners pay FIT on 100% of the TPE income—at the individual FIT rate
  - Owners do not pay FIT on the profit distributions paid by the TPE

Summary of Taxation Differences (cont.)

- Sale of the entity
  - When a C corporation sells its stock, the company pays no FIT (there is an asset tax basis carryover)
    - Shareholders pay capital gain tax on difference between the stock price and their stock basis
  - When a C corporation sells its assets, the company pays FIT on the difference between asset sale price and asset basis
    - When the company distributes the net proceeds to shareholders, shareholders pay FIT on the distribution
  - When an S corporation sells its stock or its assets, the entity pays no FIT—and the gain is taxed to the shareholder

Summary of Taxation Differences (cont.)

- Basis adjustment for S corporation
  - If the S corporation does not distribute its income, the shareholder's basis in the stock increases by the amount of the undistributed income
  - This basis adjustment does not occur for partnerships
- This is a very summarized discussion of tax differences
  - There are other differences between C corporations and S corporations
  - There are other differences between S corporations and other TPEs

Summary Comments regarding DLOC/DLOM for S Corporations

- To be an S corporation, the entity must qualify as a “small business corporation.” These qualifications include:
  - No more than 100 unrelated shareholders
  - Only one class of common stock (some nonvoting exception)
  - No preferred stock
  - No nonresident alien shareholders
  - Cannot have a for-profit corporation or partnership as a shareholder
  - Can only have certain types of trusts as shareholders
  - Cannot be publicly traded

Summary Comments regarding DLOC/DLOM for S Corporations (cont.)

- The shareholders pay individual income tax on 100% of S corporation income—whether or not the S corporation makes any cash distributions to the shareholders
  - Shareholders could have to make tax payments to the IRS without receiving any cash from the corporation
- These issues arguably impact both the DLOM and the DLOC related to the value of S corporation stock

Simplified Example of C Corporation—S Corporation Differences

- Assumes a 0% profit distribution
- Tax rates are assumed
- The issue is double taxation, not relative tax rates

Simplified Example of C Corporation—S Corporation Differences (cont.)

		C Corp.	S Corp.
	Taxable income	$1,000,000	$1,000,000
-	Corporate income tax (assume 30%)	300,000	0
=	After-tax income	700,000	1,000,000
	Profit distributions (assume 0%)	0	0
-	Individual income tax (assume 25%)	0	250,000
=	Company income after all taxes	700,000	750,000
	Total taxes paid	300,000	250,000
	Total effective tax rate	30%	25%
	Cash paid to owner	0	0
	Cash paid by owner	0	250,000
	Owner net cash position	0	(250,000)

Simplified Example of C Corporation—S Corporation Differences (cont.)

- Assumes a 25% profit distribution
- Tax rates are assumed
- The issue is double taxation, not relative tax rates

Simplified Example of C Corporation—S Corporation Differences (cont.)

		C Corp.	S Corp.
	Taxable income	$1,000,000	$1,000,000
-	Corporate income tax (assume 30%)	300,000	0
=	After-tax income	700,000	1,000,000
	Profit distributions (assume 25%)	175,000	250,000
-	Individual income tax (assume 25%)	44,000	250,000
=	Company income after all taxes	656,000	750,000
	Total taxes paid	344,000	250,000
	Total effective tax rate	34%	25%
	Cash paid to owner	175,000	250,000
	Cash paid by owner	44,000	250,000
	Owner net cash position	131,000	0

Simplified Example of C Corporation—S Corporation Differences (cont.)

- Assumes a 50% profit distribution
- Tax rates are assumed
- The issue is double taxation, not relative tax rates

Simplified Example of C Corporation—S Corporation Differences (cont.)

		C Corp.	S Corp.
	Taxable income	$1,000,000	$1,000,000
-	Corporate income tax (assume 30%)	300,000	0
=	After-tax income	700,000	1,000,000
	Profit distributions (assume 50%)	350,000	500,000
-	Individual income tax (assume 25%)	88,000	250,000
=	Company income after all taxes	612,000	750,000
	Total taxes paid	388,000	250,000
	Total effective tax rate	39%	25%
	Cash paid to owner	350,000	500,000
	Cash paid by owner	88,000	250,000
	Owner net cash position	262,000	250,000

Simplified Example of C Corporation—S Corporation Differences (cont.)

- Assumes a 100% profit distribution
- Tax rates are assumed
- The issue in double taxation, not relative tax rates

Simplified Example of C Corporation—S Corporation Differences (cont.)

		C Corp.	S Corp.
	Taxable income	$1,000,000	$1,000,000
-	Corporate income tax (assume 30%)	300,000	0
=	After-tax income	700,000	1,000,000
	Profit distributions (assume 50%)	700,000	1,000,000
-	Individual income tax (assume 25%)	175,000	250,000
=	Company income after all taxes	525,000	750,000
	Total taxes paid	475,000	750,000
	Total effective tax rate	48%	25%
	Cash paid to owner	700,000	1,000,000
	Cash paid by owner	175,000	250,000
	Owner net cash position	525,000	750,000

Fundamental Tax-Affecting Issue

- Does the analyst value the TPE as if it was a C corporation?
- Does the analyst apply a hypothetical C corporation income tax rate to the TPE entity?
- This is the valuation procedure called “tax-affecting”
  - Apply a C corporation income tax rate in any income-based valuation analysis
  - Value the TPE as if it was a C corporation (or value the intangible asset as if it was issued by a C corporation)
- Some analysts apply an individual income tax rate to the TPE valuation
- There are two questions to the tax-affecting procedure:
  - Does the analyst apply an income tax rate to the TPE income?
  - Does the analyst apply a premium or adjustment (e.g., an S corp. premium) to recognize the economic benefit of avoiding double taxation?

Fundamental tax-Affecting Issue—Simple Illustration

- Simplified assumptions
  - Pretax income – $1,000,000
  - Effective corporate tax rate – 30%
  - After-tax direct capitalization rate – 7%
  - Pretax direct capitalization rate – 10% (= 7% ÷ (1-30%))
  - Direct capitalization valuation method
  - These examples do not incorporate S corp. premium
- Tax-affecting valuation

S corporation income	$1,000,000
- Assumed C corporation taxes	300,000
= C corporation equivalent income	700,000
÷ After-tax cap rate	7%
= Value of equity	$10,000,000

Fundamental tax-Affecting Issue—Simple Illustration (cont.)

- Valuation on a tax-neutral basis

S corporation income	$1,000,000
÷ Pretax cap rate	10%
= Value of equity	$10,000,000

- Valuation without tax-affecting (using after-tax cap rate)

S corporation income	$1,000,000
÷ After-tax cap rate	7%
= Value of equity	$14,300,000

Where Tax-Affecting Affects Business Valuation

- Tax-affecting affects all three generally accepted business valuation approaches
- Tax-affecting directly impacts the income approach
  - Discounted cash flow method
    - Discrete projection period income
    - Terminal period income
  - Direct capitalization method (impact is easiest to identify)
- Tax-affecting directly impacts the asset-based approach
  - Asset accumulation method
    - Income approach measurements for intangible assets
    - Market approach (RFR method) measurements for intangible assets
    - Cost approach (through economic obsolescence) measurements for intangible assets
  - Adjusted net asset value method
    - CEEM analysis for intangible value in the nature of goodwill

Where Tax-Affecting Affects Business Valuation (cont.)

- Tax-affecting indirectly impacts the market approach
  - Directly impacts application of direct equity pricing multiples (e.g., P/E multiple)
  - Tax neutral impact on application of invested capital pricing multiple (e.g., MVIC/EBITDA or MVIC/EBIT multiples)
  - This is a consideration in both guideline public company and guideline transaction methods

The Mathematics of Tax-Affecting

- Two analyst decisions:
  - Apply pretax or after-tax discount rate or capitalization rate?
  - Apply selected rate to pretax income (not tax-affected) or after-tax income (after application of hypothetical C corporation income tax rate)?
- If the analyst tax-affects, then additional decision is: Does the analyst apply some calculation for a TPE economic benefit (S corp. premium)?
- The mathematics of this issue are simple, using our simplified example assumptions:
  - S corporation income – $1,000,000
  - C corporation effective tax rate – 30%
  - After-tax capitalization rate – 7%
  - Pretax capitalization rate (7% ÷ (1-30%)) = 10%

The Mathematics of Tax-Affecting (cont.)

- Alternative mathematics:

1. Matching of Income Measure and Capitalization Rate

		Scenario A	Scenario B
	S corporation income	$1,000,000	$1,000,000
-	Hypothetical income taxes	0	300,000
=	Income to capitalize	1,000,000	700,000
÷	Direct capitalization rate	10%	7%
=	Equity value	$10,000,000	$10,000,000

The Mathematics of Tax-Affecting (cont.)

- Alternative mathematics:

II. Mismatching of Income Measure and Capitalization Rate

		Scenario A	Scenario B
	S corporation income	$1,000,000	$1,000,000
-	Hypothetical income taxes	0	300,000
=	Income to capitalize	1,000,000	700,000
÷	Direct capitalization rate	7%	10%
=	Equity value	$14,300,000	$7,000,000

Tax-Affecting Is a Matching Issue—Not a Tax Rate issue

- As illustrated in previous examples, value differences are caused by the matching—or mismatching—income measures and discount/capitalization rates.
- Value differences are not caused by the selection of the effective income tax rate, as long as the analyst matches the income measure and the discount/capitalization rate.

Tax-Affecting Is a Matching Issue—Not a Tax Rate issue (cont.)

- Simplified example of matching:
  - Pretax income - $1,000,000
  - Pretax direct capitalization rate – 10%

		0% Tax Rate	20% Tax Rate	40% Tax Rate
	Pretax income	$1,000,000	$1,000,000	$1,000,000
-	Income taxes	0	200,000	400,000
=	After-tax income	1,000,000	800,000	600,000
÷	After-tax cap rate (pretax = 10%)	10%	8%	6%
=	Value of equity	$10,000,000	$10,000,000	$10,000,000

- Value indications are tax-rate-neutral as long as analyst applies a consistent tax rate (1) to income and (2) to the discount/capitalization rate.

Is Matching Valuation Variables Important?

- Analysts are conscientious about matching other valuation variables:
  - Income approach examples
    - Depreciation expense and capex
    - Capex and growth estimates
    - Terminal income growth and terminal capitalization rate
  - Market approach examples
    - Apply pretax multiples to EBIT and EBITDA
    - Apply after-tax multiples to net income
  - Asset-based approach examples
    - Apply consistent income measures and discount/capitalization rates in MEEM, CEEM, and other intangible asset valuations
    - Apply consistent income measures and discount/capitalization rates in RFR intangible asset valuations
- Do you believe it is supportable to apply an after-tax discount capitalization rate to a pretax (not tax-affected) income measure for a TPE?

The Internal Revenue Service Position on Tax-Affecting

- I believe the IRS (don’t tax-affect) positions include:
  - There is a real economic benefit to TPE status
  - Tax-affecting (alone) understates the value of that benefit
  - TPEs never pay the hypothetical C corporation tax
  - TPE entities can earn their required after-tax rates of return through the TPE pre-tax income
  - No TPE owners would ever sell their ownership interest (even to a C corporation buyer) for a price that does not compensate them for the loss of the TPE economic benefit
- These positions appear to be an IRS national office policy
- These positions have generally been accepted by the federal courts in gift and estate tax litigation matters

Summary of Judicial Precedent

- The tax-affecting of TPE valuations has been consistently disallowed by the U.S. Tax Court:
  - *Gross v. Commissioner* (1999, affirmed 2001)
  - *Wall v. Commissioner* (2001)
  - *Heck v. Commissioner* (2002)
  - *Adams v. Commissioner* (2002)
  - *Dallas v. Commissioner* (2006)
  - *Gallagher v. Commissioner* (2011)
  - *Estate of Giustina v. Commissioner* (2011, appealed 2014, remand 2016)

Summary Comments regarding Judicial Precedent

- Basic tax-affecting adjustment; apply C corporation effective income tax rate; apply after-tax discount/capitalization rate
  - *Gallagher*
  - *Wall*
  - *Gross* (affirmed by 6th Circuit)
- Basic tax-affecting adjustment rejected; but the court allowed a DLOC (from public company pricing multiples) for the "agency problem" risk of an S corporation shareholder
  - *Estate of Heck*
- Apply pretax discount/capitalization rate to pretax income
  - *Estate of Adams*

Summary Comments regarding Judicial Precedent (cont.)

- Court claimed that pretax discount/capitalization rate was applied to after-tax income
  - *Estate of Giustina*
  - This is a partnership case

Summary of Judicial Precedent (cont.)

- The tax-affecting of TPE valuations has been accepted by certain courts other than the U.S. Tax Court, for example:
  - The Delaware Court of Chancery
    - *Delaware Open MRI Radiology Associates P.S. v. Kessler, et al.* (2006); this decision is particularly relevant for the judicial creation of an S corp. premium methodology
  - The U.S. District Court
    - *Kress v. United States* (2019); this is a federal gift tax case, but its precedent value is limited to the Eastern District of Wisconsin
  - Various state courts
    - Related to shareholder disputes, family law, etc.
    - These cases have no precedential value with regard to federal taxation matters
  - The tax-affecting of a TPE will likely be accepted by the U.S. Tax Court in *Estate of Cecil v. Commissioner*
    - This case has not yet been decided
    - Valuation analysts for both the taxpayer and for the IRS tax-affected and applied an S corp. premium

Reasons Why Analysts Tax-Affect

- Essentially all of the data that analysts use to construct discount rates and capitalization rates are after-tax data
- These data are derived directly from after-tax public company returns or indirectly from after-tax capital market returns
- Therefore, discount rates and capitalization rates are derived on an after-tax basis
- To apply after-tax discount/capitalization rates to TPE income, analysts have to either:
  - adjust (tax-affect) the TPE income or
  - adjust (gross-up) the discount/capitalization rate
- This is the matching principle issue
- This explanation may be the easiest for non-valuation analysts (e.g., judicial finders of fact) to understand

These Are Not Reasons Why Analysts Tax-Affect

- The following are not particularly supportable reasons (or explanations) why analysts tax-affect TPE income:
  - The typical buyer is a C corporation
  - The tax law benefits of TPE status may change over time
  - The seller will lose the TPE benefit when he/she sells the entity
  - The relationship between the corporation and the individual income tax rates may change over time
  - The subject entity may (or may elect to) lose its TPE status in the future

There Is a Benefit to TPE Status

- After tax-affecting TPE income (because of the matching principle), most analysts recognize that there is an economic benefit associated with the TPE status.
- There are a number of models (or mathematical procedures) that analysts may apply to measure this economic benefit associated with an entity's TPE status.
- Some of the more frequently applied TPE premium measurement models include the following:
  - The Van Vleet (SEAM) model
  - The Treharne model
  - The Mercer model
  - The Grabowski model
  - The Fannon model
  - The Sellers model
  - The Delaware Open MRI Radiology model

There Is a Benefit to TPE Status (cont.)

- All of these models quantify the value increment associated with:
  - The TPE/owners have a lower combined total tax rate than the combined total rate of C corporation/owners
  - TPE owners can receive distributions form the TPE that are not subject to individual income tax; TPE owners benefit when such distributions exceed the amount of cash needed to pay the individual income tax on the entity’s pass-through income

Facts and Circumstances of the *Jones* Case

- *Estate of Aaron U. Jones, et al. v. Commissioner* (2019) – U.S. Tax Court, TCM 2019-101 is a memorandum decision
- However, it is a fairly well documented memorandum decision (RIA version is 14 pages)
- On May 28, 2009, Aaron Jones made the following gifts:
  - 10,268 LP units of Seneca Jones Timber Company (SJTC)
  - 1,300 shares of Class A voting stock of Seneca Sawmill Co. (SSC)
  - 10,256 shares of Class B nonvoting stock of SSC
- Jones signed net-net gift agreements with his three daughters. The daughters were ultimately responsible for the gift tax related to the transfers.

Facts and Circumstances of the *Jones* Case (cont.)

- A Form 709 gift tax return was timely filed based on contemporaneously prepared appraisals of the SJTC units and SSC stock.
- SJTC was a partnership. SSC was the general partner of SJTC. SSC was an S corporation.
- SJTC owned land and grew trees (on a 50 or so year sustainable harvest cycle). SJTC sold logs to SSC.
- SJTC sold most of its logs to SSC. SSC bought most of its logs from SJTC
- SJTC had a restrictive partnership agreement with all partners. The general partner had absolute control over SJTC operations.
- SSC had a restrictive S corporation shareholder agreement with all shareholders.

Various Valuation Issues of the *Jones* Case

- Both the taxpayer and the IRS offered valuation reports regarding the SJTC LP units.
- Only the taxpayer submitted a valuation report regarding the SSC stock. The IRS offered a rebuttal report, critiquing the taxpayer's valuation report.
- Both parties stipulated to the value of the SJTC timberland, based on a third-party timberland real estate appraisal.

Various Valuation Issues of the *Jones* Case (cont.)

- Operating company versus holding company issue—how to value SJTC:
  - Taxpayer argued SJTC was an operating company. It should be valued based on the income approach and the market approach.
  - IRS argued SJTC was an investment or holding company. It should be valued based on the asset-based approach.
  - Valuation issue: Is FMV of LP units or stock based on HABU, if company HABU is liquidation of the company assets?
  - Legal issue: Could any of the transferred interests implement a sale of the company assets?
  - The court ultimately accepted the income approach valuation.

Various Valuation Issues of the *Jones* Case (cont.)

- The company HABU is based on the assumption that minority shareholders will come together to liquidate SJTC:
  - The IRS argued that the three Jones daughters would aggregate their voting shares, giving them control (but not 100% ownership) of SSC.
  - With control of SSC (i.e., the SJTC GP), the sisters would liquidate SJTC and obtain the stipulated $400+ million FMV of the SJTC timberland.
  - The taxpayer argued that FMV was the FMV of each gift individually.
  - The taxpayer argued that FMV meant unrelated willing buyer and willing seller—and not collusion of the Jones sisters.
  - The taxpayer argued that SSC and SJTC documents prohibited liquidation.
  - The taxpayer argued that the Aaron Jones will prohibited liquidation.

Various Valuation Issues of the *Jones* Case (cont.)

  - The taxpayer argued that a liquidation of SJTC would result in a liquidation of SSC.
  - The court accepted the taxpayer's position on FMV and HABU—and rejected the application of the asset-based approach to value SJTC.
- The supportable application of the asset-based approach:
  - IRS argued that the analyst should just substitute the timber appraisal value for the land value on SJTC balance sheet. No other adjustments.
  - The taxpayer argued that the timber value should be adjusted (for PV) based on the remaining term of the partnership agreement. Accrued selling and make-ready expenses should be a liability. And capital gain taxes should be a liability.
  - The court did not accept the asset-based approach, so the court did not have to rule on the correct application of this approach.

Various Valuation Issues of the *Jones* Case (cont.)

- April 2009 revised financial projections
  - The entities had to prepare these new financial projections for the company lender.
  - The IRS argued that the new financial projections were prepared at the nadir of the recession.
  - The taxpayer argued that these projections were appropriate for the valuation date.
  - The court accepted the April 2009 financial projections.
- Discount for lack of marketability
  - The IRS argued for a 30% DLOM
  - The taxpayer argued for a 35% DLOM, citing:
    - Contractual transferability restrictions
    - Paucity of buyers for an S corporation minority interest
    - Risk of an S corporation shareholder having to pay individual income taxes without receiving a cash distribution
  - The court accepted a 35% DLOM.

The Tax-Affecting Issue

- The IRS argued against tax-affecting as a matter of law.
  - The principal economic argument was: The entities will never pay these hypothetical C corporation income taxes.
  - The IRS ignored the matching principle issue and the TPE premium adjustment issue.
- The IRS experts did not tax-affect in the valuation of SJTC. The IRS experts applied the asset-based approach—and not the income approach.
- The IRS experts did not tax-affect in their rebuttal to SSC , with little or no explanation.
- The taxpayer applied a combined federal and Oregon C corporation income tax rate to the SJTC and the SSC income.

The Tax-Affecting Issue (cont.)

- Most of the cross-examination of the taxpayer expert related to legal arguments—and not economic arguments.
- Based on the taxpayer’s matching principle argument—and little or no rebuttal argument from the IRS experts, the court accepted the tax-affecting of SJTC and SSC.

TPE Premium Issues

- The IRS argued that no TPE premium was required because tax-affecting was not appropriate.
- The IRS argued that no TPE premium was appropriate because:
  - The seller would lose the TPE benefits in a sale to a C corporation
  - No C corporation would pay for a TPE benefit that it could not use
- The taxpayer quantified a separate TPE premium for SJTC and for SSC.

TPE Premium Issues (cont.)

- The taxpayer applied two methods to quantify the TPE premium:
  - First, the taxpayer quantified the PV of the income taxes not paid in the entity distributions in excess of the amount of distributions required to pay the individual income tax on entity income. This is the PV of the tax avoidance on the excess distributions.
  - Second, the taxpayer quantified the price premiums that C corporations pay for S corporations with regard to the acquirer's ability to make a Section 338(h)(10) election. This benefit was quantified in an empirical study of S corporation acquisitions described in "Tax Benefits as a Source of Merger Premiums in Acquisitions of Private Corporations" by Merle Erickson and Shiing-wu Wang published in *The Accounting Review*, March 2007. Erickson and Wu concluded the 338(h)(10) election (available to an S corporation target company) was equal to 12% to 17% of the deal purchase price.

TPE Premium Issues (cont.)

- The tax avoidance on excess distributions analysis quantified the value of the subject company TPE status to the current stockholders. These stockholders would not sell the TPE without being compensated for this forgone benefit.
- The Erickson and Wang empirical study quantifies the price premiums that real C corporation buyers pay to real S corporation sellers for the ability to obtain the 338(h)(10) step-up in tax basis benefit.
- These two methods quantify the value of the TPE status to both the willing buyer and the willing seller.
- These two methods quantify the value of the TPE status on both a theoretical basis and an empirical basis.

TPE Premium Issues (cont.)

- The taxpayer presented a simple methodology and an easily explained analysis. The taxpayer did not present any of the complicated TPE premium measurement models.
- The concluded TPE premium for SJTC was 23%. The concluded TPE premium for SSC was 10%.
- After considering relatively little rebuttal from the IRS experts, the court accepted the taxpayer's TPE premium.

Testifying Expert Best Practices

1. Do not rely on judicial precedent in the expert report. Do not rely on judicial precedent in the development of the valuation analysis.
2. Do not let the client's counsel turn your expert report into a legal brief. Do not allow your expert testimony to sound like legal argument.
3. Don't practice law without a license. Let the client's lawyer make the legal arguments. Don't answer legal questions.
4. The client's lawyer is not your lawyer. That lawyer has a duty to his/her client. That lawyer has no duty to you.
5. Don't' appear to be part of the legal team in the courtroom. Maintain your distance—and your independence.

Testifying Expert Best Practices (cont.)

6. It is extremely helpful to have a "second chair" analyst assist you during the litigation—particularly in the courtroom. Your second chair can work with legal counsel—while you maintain independence.

7. It takes a team to win a litigation matter. The team includes:

   Your second chair
   Client's legal counsel
   Compelling client
   Good facts and circumstances
   Engaged finder of fact
   You (testifying expert)
   Less than adequate opposing expert
   Less than adequate opposing counsel

   If your client prevails, you didn't win the case. The team won the case.

   In particular, good facts and a likeable taxpayer help to win a tax litigation matter.

Testifying Expert Best Practices (cont.)

8. Experts don't win cases based on their expert report or direct examination. Every expert scores points on offense. You win the case on defense—during cross-examination and redirect examination.

9. You need to prepare the client's counsel for redirect examination. Your second chair can assist counsel with redirect examination.

10. Know your expert report better than anyone in the room. Know your analysis better than anyone in the room. While you are testifying, you are the smartest person in the room—when it comes to your analysis and opinions.

11. Finders of fact believe: If it is not in your report, you didn't do it. Start every answer with: "As I said in my report . . ."

Testifying Expert Best Practices (cont.)

12. Finders of fact believe: If you can't explain it, you didn't do it. Your report, your work papers, your second chair analyst, etc., cannot explain the answer for you.
13. Know the subject company facts better than opposing counsel. (*Jones* examples: sale of logs from SJTC to SSC; SJTC purchase and sale of timber parcels.)
14. Engage the finder of fact. Let the finder of fact know what is important.
15. Push back against opposing counsel. Know when you are right. Declare when you are right. Declare when opposing counsel is wrong.
16. While you are testifying, you are the only person in the courtroom who is sworn to tell the truth.

Testifying Expert Best Practices (cont.)

17. Finders of fact make honest mistakes. Not reach opinions you disagree with—but make factual mistakes. (*Jones* example: DLOM percentage; use of individual income tax rate; taxpayer expert: Richard Reilly. *Giustina* example: Apply pretax discount rate to after-tax income.)

18. A lot of litigation activities happen months after your expert testimony. Closing arguments. Post-trial briefs. Response briefs. Proposed findings of fact and legal conclusions. Even appeals. You are not involved in this part of the process.

19. Months after the trial, finders of fact forget trial testimony and forget reading the expert reports. Finders of fact are informed (sometimes erroneously) about your analyses by post-trial briefs, response briefs, and proposed findings of fact and legal conclusions.

Testifying Expert Best Practices (cont.)

20. Keep it simple. Your analysis, your report, your trial testimony. The more complex the topic (e.g., quantifying a TPE value premium), the simpler the explanation.

Summary and Conclusion

- This gift tax case involved numerous complex valuation issues—tax-affecting was just one issue.
- The taxpayer’s tax-affecting analysis and argument was simple—and simple to understand.
- The IRS tax-affecting argument was legal—and not economic.
- The Tax Court accepted tax-affecting based on the facts and circumstances of this case.
- The Tax Court issued a memorandum decision, perhaps deliberately.
- In the next TPE gift or estate tax case, the IRS will likely argue that the facts and circumstances are different.
- This case does suggest numerous analyst best practices regarding tax litigation valuations.
- Thank you for your attention. Any questions or discussion?