The Changing Tax Affecting Landscape in S Corporation Valuations: Time to Say "I Do" in Divorce Cases?

by
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I. Introduction

One of the most hotly debated topics in business valuation is the tax treatment of S corporations. Since 2001, federal courts have embarked on a journey that considers whether to tax affect S corporation earnings in business valuations of those entities. That circuitous path, mostly in the context of gift tax disputes, sometimes conflicts with the two seminal divorce opinions of *Bernier v. Bernier* that address this issue in the family law setting. Recent trends send mixed messages as to tax-affecting S corporation earnings in business valuations of those entities regarding reaching more accurate conclusions of value. Part II of this article reviews the background of S corporations and their primary purpose. Part III of this article discusses premises and standards of value and how those selections can impact tax considerations. Part IV of this article analyzes the progression of federal tax precedent to current date, including the recent Michael Jackson estate litigation, and the impact of the important *Delaware Open MRI Associates v. Kessler* Delaware Court of Chancery opinion. Part V of this article reviews the most notable divorce precedent addressing this issue and harmonizes that precedent with federal and Delaware tax precedent. Finally, Part VI of this article evaluates this background and precedent and concludes that divorce courts must tax-affect earnings when valuing businesses structured as S corporations in order to most accurately determine value.

II. S Corporation Background

To evaluate whether to tax affect S corporation earnings, an understanding of the genesis S corporations is essential. Prior to the establishment of S corporations by the U.S. Congress, businesses could elect either C corporation, partnership, or sole proprietorship status.[1] C corporations had tax impact at both the corporate income and shareholder dividend levels with limited liability.[2] Partnerships and sole proprietorships had tax impact at only the personal tax level but left individuals with unlimited liability.[3] Neither of these choices were optimal. In particular, small businesses were forced to choose between structures that had two levels of taxation with limited liability or one level of taxation with unlimited liability. This choice placed smaller entities at a competitive disadvantage relative to larger enterprises. As early as 1946, the U.S. Department of Treasury proposed a business structure that melded together one level of federal taxation and limited liability. That initial suggestion led to Congress in 1958 creating subchapter S of the Internal Revenue Code.[4] The election of S corporation status had the following limits. First, S corporations must be domestic corporations.[5] Second, the only allowable shareholders of S corporations are individuals and certain trusts and estates, and not partnerships, corporations, or nonresident alien shareholders.[6] Third, S corporations must have no more than 100 shareholders.[7] Fourth, S corporations must have only one class of stock.[8] Finally, S corporations cannot be ineligible corporations (e.g., certain financial institutions, insurance companies, and domestic international sales corporations).[9]

Essentially, S corporation status emerged as an attempt to benefit small businesses by creating a single level of taxes and

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1 Zach Oehlman, *Valuing S, Corporations in Family Law Engagements*, Willamette Valuation Associates Insights, Spring 2013, at 50.

2 *Id.*

3 *Id.*

4 *Id.*at 51.

5 *Id.*

6 *Id.*

7 *Id.*

8 *Id.*

9 *Id.*

limited liability that would eliminate the tax disadvantages that might dissuade small businesses from adopting the corporate form.[10] This goal is accomplished by establishing a pass-through system under which corporate income, losses, deductions, and credits are attributed to shareholders in a manner akin to the tax treatment of partnerships.[11] As a result, S corporations pay no state or federal income tax, instead passing their income through to shareholders who report their *pro rata* shares of income on individual tax returns.[12] This favorable tax treatment led to increasing popularity for S corporation election. From this new form of entity emerged a new controversy in business valuation: Should S corporations be valued the same as C corporations by tax affecting income streams using C corporation tax rates? Is that a fairer result in removing the valuation distinction based on entity structure? If not removed, does using C corporation tax rates created a price premium for S corporations? Further, should the answer differ in the case of tax disputes, shareholder controversies, and divorce cases? This background laid the foundation for the evolution of S corporation business valuation approaches and precedent.

III. Premises and Standards of Value

To further evaluate this question and the progression of S corporation valuation, an understanding of both premise of value and standard of value is critical. Premise of value assists in defining the standard of value falls into two categories: value in exchange and value to the holder.[13] Value in exchange is the value derived from an interest changing hands in a real or hypothetical transaction.[14] Value to the holder is the value of an interest being maintained in its present form by its present owner and is sometimes called "going concern" or "intrinsic" value.[15] Value to the holder does not have to be marketable to have value.[16]

10 Gross v. Comm'r, 272 F.3d 333, 335 (6th Cir. 2001).

11 *Id.*

12 *Id.*

13 Jay E. Fishman, Shannon P. Pratt & William J. Morrison, Standards of Value – Theory and Application 20-21 (2d ed. 2013).

14 *Id.* at 20.

15 *Id.* at 21.

16 *Id.*

Premises of value help define standards of value that are applied. With a value in exchange premise of value, the fair market value standard typically is applied.[17] With a value to the holder premise of value, a fair value or investment standard of value may apply.[18] Unfortunately, most states do not specify a standard of value. Only Arkansas and Louisiana provide statutory guidance as to the standard of value.[19] Case law provides guidance in twenty-four additional states.[20] The standard of value in the remaining twenty-four states and the District of Columbia must be inferred from valuation concepts that are used and applied.[21] From this review, it can be inferred thirty-five states and the District of Columbia use a fair market value standard, three states use a fair value standard, five states use an investment value standard, and seven states use a hybrid standard.[22] Yet none of these standards distinguish between the subject matter of cases such as tax controversies, shareholder disputes, and divorce actions. This scattered landscape foreshadows why S corporation valuations have proven to be so problematic to both valuation professionals and the courts and offers insight as to the uneven history beginning with federal, primarily Tax Court, analysis.

IV. Federal Tax Precedent and the Delaware Court of Chancery Detour

The odyssey of S corporation valuations begins with *Gross v. Commissioner.*[23] Taxpayers Walter L. Gross, Jr. and Patricia G. Linnemann, and their spouses by virtue of consent, gifted shares of stock of Pepsi-Cola Bottlers, Inc. ("G & J") to their children.[24] By written agreement dated November 1, 1982, G & J shareholders elected to be taxed as an S corporation.[25] On July 31, 1992, Gross gifted each of his three children 124.5 shares of G & J

17 *Id.* at 20-21.
18 *Id.* at 20.
19 *Id.* at 265.
20 *Id.*
21 *Id.*
22 *Id.* at 268-72.
23 *See generally* Gross v. Comm'r, 272 F.3d 333.
24 *Id.* at 335.
25 *Id.*

stock.[26] That same day, Linnemann gifted each of her two her children 187.5 shares of G & J stock.[27] After hearing conflicting expert testimony, the U.S. Tax Court determined that the G & J stock should not be tax affected (or, as it put it, the stock should be discounted using a tax affect of 0%).[28] The lead opinion by Judge Clay concluded that the use of a 0% tax affect was clearly erroneous but, in an unusual procedural posture, the other two judges (Judge Daughtrey and Senior Judge Cohn) disagreed, so that the majority holding was that the Tax Court's use of the 0% tax affect was proper.[29] The Commissioner argued that tax affecting was not a generally accepted business practice at the time, but the Service's expert admitted on cross-examination that there was a growing controversy in 1992 as to the propriety of tax affecting.[30] The lead opinion noted that there were two internal IRS documents that endorsed the policy of tax affecting when valuing the stock of S corporations: The IRS Valuation Guide of Income, Estate, and Gift Taxes: Valuation Training for Appeals Officers *and* the IRS Examination Technique Handbook.[31] Further, the IRS had previously approved 1988 taxes paid by the taxpayers based on a tax affected discounted cash flow method under the income approach.[32] Judge Clay found the Service's internal directives and prior approval of tax affecting for the taxpayers made the Tax Court's decision to use a 0% tax affect implausible.[33] Judge Daughtrey and Senior Judge Cohn rejected this assertion and found the lead opinion's sole focus on perceived unfairness to the taxpayers to be improper under the willing buyer and willing seller fair market value concept.[34] They added that the entire valuation process is a fiction and that a court is not required to presume hypothetical, unlikely, or unreasonable facts in determining fair market value.[35] *Gross* sent

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26 *Id.* at 336.

27 *Id.*

28 *Id.* at 338; *see also* Gross v. Comm'r, 78 T.C.M. (CCH) 201, T.C.M. (RIA) 1999-254.

29 Gross v. Comm'r, 272 F.3d 333, 342.

30 *Id.* at 345.

31 *Id.* at 347.

32 *Id.* at 348.

33 *Id.* at 348-49.

34 *Id.* at 354.

35 *Id.* at 356.

shockwaves through the business valuation community and served as the standard for the next two decades as its vitality became increasingly called into question.

Less than one year later, the U.S. Tax Court in *Adams v. Commissioner*[36] followed the majority holding in *Gross* and concluded that a valuation expert's estimate of an S corporation's prospective net cashflows under the income approach to valuation was not pre-tax because it is appropriate to use a 0% corporate tax rate to estimate S corporation net cashflow. Interestingly, the Tax Court took issue with aspects of both valuation experts' reports and testimony and determined a business valuation ($1,161,705.00) much closer to that contended by the estate ($920,800.00) than by the Service ($1,746,000.00).[37] The focus on other factors and concessions benefitting the taxpayer made the outcome less precedentially impactful but demonstrated that the *Gross* methodology had a toehold on S corporation valuations.

Four years later, the Delaware Court of Chancery offered a detour from *Gross. Delaware Open MRI Associates v. Kessler*[38] involved the issue of whether shareholders of a radiology professional association received fair value in a freeze-out merger. Among the myriad issues was whether to tax affect the earnings of the radiology concern in determining fair value.[39] The chancery court considered the fact that the entity was an S corporation and found both experts' conclusions to be lacking.[40] The purchasers' expert, in treating the S corporation as a C corporation, understated the fair value of the merger price.[41] Conversely, the sellers' expert overstated the S corporation premium attributable to a potential sale.[42] The chancery court embraced the reasoning of prior decisions that an S corporation structure can produce a material increase in economic value for a shareholder and should be given proper weight in a valuation, and found this reasoning to be consonant with *Gross* and its prog-

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36 Adams v. Comm'r, 83 T.C.M. (CCH) 1421, T.C.M. (RIA) 2002-080.

37 *Id.*

38 898 A.2d 290, 299 (Del. Ch. 2006).

39 *Id.* at 326.

40 *Id.*

41 *Id.* at 327.

42 *Id.*

eny.[43] The chancery court undertook a detailed analysis in estimating an equivalent, hypothetical "pre-dividend" S corporation tax rate of 29.4% to the earnings of the radiology corporation in order to treat the S corporation shareholder as receiving the full benefit of untaxed dividends by equating its after-tax return to a C corporation shareholder.[44] *Kessler* effectively adopted a hybrid position of tax affecting S corporation earnings at a lower rate than the shareholders requested but well beyond a 0% tax affect contemplated by *Gross.* However, the reach of this decision at the time was dubious. Did traditional limitations of chancery court authorities apply? Did the precedent apply only to freeze-out merger situations? Did statutory fair value standards yield different outcomes from market-based fair value standards? The U.S. Tax Court's initial reaction was soon to follow.

Five months later, *Dallas v. Commissioner*[45] answered these questions. At issue was the value of 55% of non-voting stock of Dallas Group of America, Inc. ("Dallas") for gift tax purposes.[46] Dallas's expert witnesses reduced Dallas projected income by 40% and 35%, respectively based on tax affecting, assuming that Dallas's S corporation status could be lost after a sale.[47] The U.S. Tax Court found that assumption to be lacking in basis and damaged the experts' credibility.[48] The Tax Court considered and rejected evidence of tax affecting an employee stock ownership plan valuation because there was no evidence that the U.S. Department of Labor's definition of value was similar to the applicable definition of fair market value.[49] More significantly, the Tax Court rejected the *Kessler* rationale and noted that fair value in minority stock appraisal cases is not equivalent to fair market value.[50] Put another way, the Delaware chancery court did not decide the price that a hypothetical willing buyer would pay a hypothetical willing seller, both having reasonable knowledge of all relevant facts and neither being under compulsion to buy or

43 *Id.*

44 *Id.* at 330.

45 *See generally* Dallas v. Comm'r, 92 T.C.M. (CCH) 313, T.C.M. (RIA) 2006-212.

46 *See* T.C.M. (RIA) 2006-212 at *1.

47 *See id.* at *2.

48 *Id.* at *6.

49 *Id.* at *7.

50 *Id.*at *7.

sell.[51] The Tax Court concluded that there was insufficient evidence to conclude that a hypothetical buyer and seller would tax affect Dallas's earnings and that tax affecting was not appropriate.[52] From the Tax Court's perspective, an initial review of *Kessler* did not lead to immediate changes in the *Gross* approach to gift tax valuations.

Five years later, *Estate of Gallagher v. Commissioner*[53] revisited tax affecting. *Gallagher* involved the fair market value of 3,970 membership units in Paxton Media Group, LLC ("PMG"), a privately-held and family-owned newspaper publishing company, for gift tax purposes.[54] On December 26, 1996, PMG elected S corporation status and by agreement preserved that continued election upon its conversion to an LLC in 2001.[55] Among the many valuation issues was an assessment of the estate's valuation and the expert's tax affecting of PMG's earnings under the income approach discounted cash flow method.[56] The estate argued that *Gross* supported that adjustment in its commentary that a reduction in total tax burden should not be ignored in valuing an S corporation.[57] The Tax Court disagreed with the estate's analysis of *Gross,* noting that, as to S corporation tax affecting, the imposition of a 0% corporate tax rate properly reflected the tax savings and that the estate's experts tax adjustment should be disregarded.[58] The Tax Court found for the Service in part and the estate in part, and made an adjustment to the deficiency on other grounds.[59] *Kessler* a half decade later had no material impact on Tax Court S corporation income approach valuations, or so it seemed. That was about to change.

Also in 2011, the U.S. Tax Court considered *Estate of Giustina v. Commissioner* and rejected the estate's expert's reduction

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51 *See id.* at *7; *see also* Rev. Rul. 59-60 at *19-20.

52 T.C.M. (RIA) 2006-212 at *27.

53 *See generally* Estate of Gallagher v. Comm'r, 101 T.C.M. (CCH) 1702, T.C.M. (RIA) 2011-148.

54 *See* T.C.M. (RIA) 2011-148 at *1.

55 *Id.* at *2.

56 *Id.* at *9-20.

57 *Id.* at *17.

58 *Id.*

59 *See id.* at *20; *see also* Estate of Gallagher v. Comm'r, 102 T.C.M. (CCH) 388, T.C.M. (RIA) 2011-244 (supplemental opinion correcting an error in the discounted cash flow analysis).

of predicted cashflow by 25% to account for the income taxes that would be owed by the owner of the partnership interest on that owner's share of the partnership income.[60] The Tax Court opined that a business valuation expert should not reduce cashflows by income tax while simultaneously using a pre-tax rate of return to discount the cashflows to present value.[61] On remand, the Tax Court noted that the U.S. Court of Appeals for the Ninth Circuit held that the Tax Court's valuation was flawed because it should have valued the partnership as a going concern, and not considered the value of the partnership's assets, and not reduced the company specific risk premium.[62] On remand, the Tax Court adjusted normalized pre-tax income by a 25% reduction to determine normalized net income.[63] *Giustina* demonstrates federal appellate court limits to Tax Court tax-affecting autonomy and serves as a precursor to a monumental change in view toward S corporation tax affecting that was in the offing.

The year 2019 saw a seismic shift in the approach to tax affecting in the landmark case of *Kress v. United States.*[64] The plaintiffs were shareholders in Green Bay Packaging, Inc. ("GBP"), an S corporation that was a vertically integrated manufacturer of corrugated packaging, folding cartons, coated labels, and related products.[65] The Kress family owned approximated 90% of GBP common stock.[66] The Kress family could only gift, bequest, or sell their shares to other members of the Kress family.[67] The plaintiffs gifted minority shares of GBP stock to their children and grandchildren in 2006, 2007, and 2008 and valued the shares on gift tax returns at $28.00 for tax year 2007, $25.90 for tax year 2008, and $21.60 for tax years 2009 on gift tax returns.[68] The Service challenged the values, finding that the fair

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60 See Estate of Giustina v. Comm'r, 101 T.C.M. (CCH) 1676, *6, T.C.M. (RIA) 2011-141, *rev'd and remanded by* 586 Fed. Appx. 417 (9th Cir. 2014).

61 *Id.*

62 *See* Estate of Gisutina v. Comm'r, 111 T.C.M. (CCH) 1551, *1, T.C.M. (RIA) 2016-114.

63 T.C.M. (RIA) 2016-114 at *6.

64 *See generally* Kress v. United States, 382 F. Supp. 3d 820 (E.D. Wis. 2019).

65 *Id.* at 825.

66 *Id.* at 825-26.

67 *Id.* at 826.

68 *Id.*

market value of the stock was that used for actual share transactions between GBP and its employees: $45.97 on December 31, 2006, $47.63 on December 31, 2007, and $50.85 on December 31, 2008.[69] The plaintiffs paid gift tax deficiencies and accrued interest of $2,218,465.80 in December 2014 and initiated a lawsuit to recover those amounts on June 24, 2016.[70] The U.S. Court of Appeals for the Eastern District of Wisconsin considered competing expert testimony. The Service's expert, Francis Burns, weighted the market approach 60% and the income approach 40% to determine final fair market value.[71] The district court found that Burns's valuation overstated the value of a minority interest in GBP stock because his market approach analysis was inflated by not adequately accounting for the 2008 recession and relying on an outlier as a comparable company.[72] The district court found that Burns applied a too low discount for lack of marketability: 10.8% for 2007, 11.0% for 2008, and 11.2% for 2009.[73] More significant was the fact that Burns, like plaintiffs' experts, applied C corporation-level taxes to GBP's earnings to effectively compare GBP to C corporations.[74] Burns then assessed a premium to account for the tax advantages associated with subchapter S status, such as the elimination of a corporate level of taxes.[75] Burns calculated the fair market value of a share of GBP stock to be $38.40 for tax year 2007, $27.81 for tax year 2008, and $40.05 for tax year 2009.[76] The district court reiterated its conclusion that Burns overvalued a minority interest in GBP for tax years 2007, 2008, and 2009, and gave less weight to his conclusions.[77] The plaintiffs had two experts, John Emory and Nancy Czaplinski.[78] Emory employed the market approach and, although he did not explicitly complete an income approach assessment, applied income approach concepts in his overall analy-

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69 *Id.* at 826-27.

70 *Id.* at 827.

71 *Id.* at 833.

72 *Id.* at 833-34.

73 *Id.* at 835.

74 *Id.*

75 *Id.* at 835-36.

76 *Id.* at 832.

77 *Id.* at 836.

78 *Id.*

sis.[79] Emory's marketability discounts of 30.0% for 2007 and 2008 and 28.0% for 2009 were the highest of the three experts but lower than he had applied in the past.[80] Emory calculated the fair market value of a share of GBP stock to be $28.00 for tax year 2007, $25.90 for tax year 2008, and $21.60 for tax year 2009.[81] In response to Service criticism that Emory did not employ a separate income approach, the plaintiffs retained Czaplinski to prepare a report using a combination of the market approach and the income approach.[82] She weighted the market approach 14% and the income approach 86% and calculated the fair market value of a share of GBP stock to be $30.87 for tax year 2007, $25.92 for tax year 2008, and $25.92 for tax year 2009.[83] After reviewing the reports and testimony of all three witnesses, the district court found the valuation methodology of Emory to be the most sound.[84] However, the district court reduced Emory's discounts for lack of marketability to 27.0% for tax years 2007 and 2008 and 25.0% for tax year 2009, resulting in a GBP share value of $29.20 for tax year 2007, $27.01 for tax year 2008, and $22.50 for tax year 2009.[85] *Kress* is notable in that all three experts tax-affected GBP's earnings and the district court accepted that approach. While the district court's opinion might not carry the same gravitas as an opinion from the U.S. Tax Court, the facts illustrate flexibility in the Service's position and portended a similar re-evaluation by the Tax Court just five months later.

Estate of Jones v. Commissioner[86] directly tackled the tax-affecting issue left in limbo since *Gross* attempted to explicate the landscape. In 1954, the decedent established Seneca Sawmill Co. ("SSC"), a lumber manufacturing company incorporated in Oregon.[87] From its founding through the 1980s, SSC was largely

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79 *Id.*

80 *Id.* at 837.

81 *Id.* at 836.

82 *Id.* at 837.

83 *Id.*

84 *Id.* at 838.

85 *Id.* at 841.

86 *See generally* Estate of Jones v. Comm'r, 118 T.C.M. (CCH) 143, T.C.M. (RIA) 2019-101.

87 T.C.M. (RIA) 2019-101 at *1.

dependent on timber from federal lands.[88] In 1989 and 1992, the decedent purchased additional timberland from private owners.[89] On August 25, 1992, the decedent formed Seneca Jones Timber Co. ("SJTC"), an Oregon limited partnership, to invest in, acquire, hold, and manage timberlands, beginning with the timberlands he purchased in 1989 and 1992.[90] As of the valuation date, SSC's largest supplier of logs was SJTC.[91] SSC and SJTC operated in tandem in furtherance of SSC's sawmill business.[92] In 1996, the decedent began to create a succession plan that included forming family and generation-skipping trusts on May 28, 2009.[93] Gifts to the various trusts included Class A and Class B shares of SSC to the trusts and gifts of limited partnership units to each of his two daughters.[94] The estate submitted an expert report valuing the blocks of gifted SSC Class A and Class B shares and the Service submitted a report critiquing that valuation.[95] Both the estate and the Service submitted expert reports valuing the SJTC limited partnership units.[96] The estate valued the SSC Class A shares and Class B shares, and the SJTC units, at $325.00, $207.00, and $230.00, respectively, on the gift tax return but conceded the amounts to $390.00, $380.00, and $380.00, respectively.[97] The Service increased its value of an SJTC limited partnership unit from $2,511.00 to $2,530.00, placing that valuation in issue.[98] The estate's expert, Richard Reilly, valued SJTC and SSC as going concerns and relied on the discounted cash flow method under the income approach.[99] The Service's expert, Philip Schwab, valued SJTC as a going concern and relied on the asset approach.[100] The Service's rebuttal expert contested Reilly's use of certain projections, his treatment of SSC's general

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88 *Id.*
89 *See id.*
90 *Id.*
91 *Id.* at *2.
92 *Id.* at *4.
93 *Id.* at *7.
94 *See id.*
95 *Id.* at *8.
96 *Id.*
97 *Id.*
98 *Id.*
99 *Id.* at *9.
100 *Id.*

interest in SJTC, and the intercompany receivable it held in valuing SSC.[101] In a detailed analysis, the U.S. Tax Court concluded that an income approach like Reilly applied was the more appropriate approach to value SJTC.[102] Of most relevance, the Tax Court determined that Reilly's tax-affecting SJTC's earnings by a 38% proxy for combined federal and state C corporation tax burdens was appropriate.[103] Noting *Gross, Gallagher, and Giustina* each declined to tax affect earnings, the Tax Court noted the deficiencies in the experts' methods in those cases and elucidated that the question in those cases and this case was not whether to take into account the tax benefits inuring to a pass-through entity but rather how.[104] The rationale in *Gross* considered that an S corporation election is a reduction in total tax burden for the owners and the owners' tax savings should not be ignored in valuing S corporations.[105] The Tax Court also considered the different outcomes in *Kessler* and *Bernier v. Bernier,*[106] and noted the fact-sensitivity of the *Gross* decision based on the record before it.[107] The Tax Court concluded that Reilly had more accurately taken into account the tax consequences of SJTC's pass-through status and that his tax-affecting was more complete and convincing than the Service's 0% tax rate.[108] For the same reasons, the Tax Court accepted Reilly's tax-affecting in his valuation of SSC.[109] *Jones* stands as a hallmark deviation from *Gross*. A more accurate reading is that *Jones* explicates the reasoning in *Gross,* illuminates that different facts can produce different outcomes (especially when both side's experts tax affect cash flows), recognizes the relevance of non-tax opinions to tax controversies, and impresses the importance of cogent and effective expert advocacy. The *Jones* chapter remains open, as an appeal of the Tax Court decision remains pending.

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101 *See id.*

102 *Id.* at *12.

103 *Id*.

104 *See id.* at *12-14.

105 *Id.* at *13.

106 873 N.E.2d 216 (Mass. 2007), discussed in detail in Part VI, *infra.*

107 Estate of Jones v. Comm'r, 118 T.C.M. (CCH) 143, T.C.M. (RIA) 2019-101, *13

108 T.C.M. (RIA) 2019-101 at *14.

109 *See id.*

What does not remain pending is the longstanding saga of the Michael Jackson estate, with the recent U.S. Tax Court decision offering another turn in the tax affecting odyssey. In *Jackson v. Commissioner,*[110] the estate and Commissioner disputed the values of three intangible assets: (1) Jackson's image and likeness, (2) Jackson's interest in New Horizon Trust II, through which he held an interest in Sony/ATV Music Publishing, LLC, and (3) Jackson's interest in New Horizon Trust III, which contained Mijac Music, a music publishing catalog that owned copyrights to compositions Jackson wrote or co-wrote and compositions by other songwriters.[111] Jackson died on June 25, 2009.[112] On its 2009 Form 706, the estate valued Jackson's image and likeness at $2,105.00, New Horizon Trust II at $0.00, and New Horizon Trust III at $22,207,351.00.[113] The Commissioner audited the estate's tax return and in May 2013 issued a notice of deficiency in which it valued Jackson's image and likeness at $434,261,895.00, New Horizon Trust II at $469,005.086.00, and New Horizon Trust III at $58,478.593.00.[114] The adjusted valuation of these and other assets led the Commissioner to assert that the estate had underpaid estate tax by more than $500,000,000.00.[115]

The estate retained four experts for trial.[116] Mark Roesler, the founder and CEO of CMG Worldwide, Inc., and Jay Fishman, a managing director of Financial Research Associates, valued Jackson's image and likeness.[117] CMG Worldwide was an international licensing and rights-management company that specialized in representing living and deceased celebrities such as Marilyn Monroe, James Dean, Buddy Holly, Chuck Berry, Princess Diana, and Jackie Robinson.[118] Roesler projected ten years of revenues from the exploitation of Jackson's image and likeness under California law and from some associated trademarks.[119]

110 *See* Estate of Jackson v. Comm'r, T.C.M. 2021-48.
111 *Id.* at *2.
112 *Id.* at *12.
113 *Id.* at *18.
114 *Id.*
115 *Id.*
116 *Id.* at *19.
117 *Id.*
118 *Id.*
119 *Id.* at *19.

Fishman then used these projections under the income approach and discounted cash flow method to value Jackson's image and likeness at about $3,000,000.00.[120] Alan Wallis, the leader of the media and entertainment team in Ernst & Young's UK valuation practice applied the market and income approach and concluded that New Horizon's Trust II was worth $0.00 after consideration of debt.[121] Owen Dahl, the president and founder of Dahl consulting Group and a principal at Moss Adams, applied the income approach to value New Horizon Trust III at about $2,700,000.00.[122] Each of these experts tax affected the cashflows produced by the assets to reflect the tax implications to a hypothetical buyer.[123] Additionally, valuation expert Nancy Fannon testified for the estate as to the current state of academic research and empirical evidence that proved that the prospect of taxes would affect the price a prospective buyer would be willing to pay for assets.[124]

The Commissioner's sole expert was Weston Anson, the Chairman of CONSOR Intellectual Asset Management that had valued intangible assets of Dr. Seuss, Andy Warhol, Tupac Shakur, Audrey Hepburn, Marlon Brando, and Woody Allen.[125] Anson valued Jackson's image and likeness by considering five "opportunities" that he believed a hypothetical buyer could reasonably foresee at Jackson's death: themed attractions and products, branded merchandise, a Cirque du Soleil show, a film, and a Broadway musical, and reached a conclusion of value of $161,000,000.00.[126] He valued New Horizon Trust II applying the income and market approaches and reached a conclusion of value of $206,000,000.00.[127] Finally, Anson valued New Horizon Trust using only the income approach and reached a conclusion of value of $114,000,000.00.[128] Anson's credibility at trial was seriously damaged when he inaccurately contended that he had never previously worked for the Internal Revenue Service before

120 *Id.*
121 *See id.* at *60-65.
122 *Id.* at *20.
123 *Id.*
124 *Id.*
125 *Id.*
126 *See id.*
127 *Id.*
128 *Id.*

and that he and his firm had never advertised to promote business.[129] While Anson's testimony was not stricken, his credibility was undermined.[130]

The Tax Court noted that tax affecting was a consideration that impacted its valuation of all three disputed assets.[131] Each asset in dispute was held by a pass-through entity, which means that the Internal Revenue Code imposes no tax on the income that these assets produced.[132] All other things being equal, an income-producing asset would be worth more to a pass-through entity than to a C corporation.[133]

Each of the estate's experts in his respective discounted cash flow analyses concluded that the hypothetical buyer for each asset would be a C corporation and reduced cashflows by the income tax liability that would be paid by a hypothetical C corporation buyer, but each used a different tax rate.[134] The Tax Court noted that in the past it shied away from tax affecting because of difficult practical problems.[135] However, it noted that *Jones* allowed tax affecting in valuation.[136] Nevertheless, the Tax Court found, as it had consistently in the past apart from *Jones,* that by a preponderance of the evidence tax affecting was not appropriate in this case since the estate had failed to persuade that a C corporation would be the only or even likely buyer for these assets.[137] Further, the estate's experts used inconsistent tax rates and were met with opposing expert testimony that was persuasive in light of Tax Court precedent.[138] The Tax Court distinguished *Jones* since all the experts in that case tax affected cashflows but emphasized that it was not wholesale rejecting tax affecting in all instances.[139] What followed was an extensive analysis and critique of all the experts that led the Tax Court to conclude the following values: (1) Jackson's image and likeness

129 *See id.* at *21.
130 *See id.*
131 *See id.*
132 *Id.* at *26.
133 *Id.* at *27.
134 *Id.*
135 *Id.*
136 *Id.*
137 *Id.* at *28.
138 *Id.*
139 *Id.*

at $4,153,912.00, (2) New Horizons Trust II at $0.00, and (3) New Horizons Trust III at $107,313.561.00.[140]

Jackson seemingly reverts to the majority of Tax Court decisions that reject tax affecting, takes great pains to rebut certain assumptions when tax affecting is applied, and distinguishes *Jones.* Is *Jackson* a step back from *Kress* and *Jones* or simply a demonstration of the fact sensitivity of each case? More significantly, what do these decisions mean for tax affecting in divorce cases? To project the future, it is instructive to look to the past.

V. *Bernier v. Bernier*

The intersection of Tax Court and state divorce court views regarding tax affecting is best exemplified by two Massachusetts appellate court opinions in *Bernier v Bernier. Bernier I* involved the valuation of supermarkets: Bernier's Market, Inc. doing business as Cronig's State Road Market (and Bernier's Up Island Market (doing business as Cronig's Up Island Market).[141] The wife's expert, Mark Leicester, valued the supermarkets at $16,391,000.00.[142] The husband's expert, Joel Horvitz, valued the supermarkets at $7,850,000.00.[143] The experts were largely in agreement, and each applied the income approach to valuation.[144] One of the major points of disagreement was tax affecting. Horvitz tax affected as if the S corporation were a C corporation at a 35% "average corporate rate," reasoning that a potential buyer of an S corporation would factor into the probable rate of return the tax consequences of the purchase.[145] Leicester did not tax affect the supermarkets' income because an S corporation, unlike a C corporation, does not pay taxes at the entity level and no sale of the business was contemplated.[146] The trial court adopted Horvitz's method of tax affecting and $7,850,000.00 value, citing *Gross.*[147] The Supreme Judicial Court of Massachusetts recognized that C corporation earnings are

140 *Id*. at *85.
141 *See* Bernier v. Bernier, 873 N.E.2d 216, 222 (Mass. 2007).
142 *Id.*
143 *Id.*
144 *See id.*
145 *Id.* at 223.
146 *Id.*
147 *See id.* at 223-24.

taxed at both the corporate level and then at the individual level on shareholder dividends, while S corporations are taxed only at the individual level and avoid double taxation.[148] Noting that the valuation of an S corporation is an inexact science, the supreme court cited *Gross* and observed that both case law and professional scholarship cast serious doubt on the efficacy of tax affecting.[149] The supreme court further observed that the trial court incorrectly cited *Gross* as supporting tax affecting when the *Gross* court applied a zero percent tax affect rather than the 35% championed by Horvitz.[150] The trial court erred in applying the 35% tax adjustment, as it would produce an arbitrary result and a significant undervaluation of the supermarkets.[151] Turning next to an assessment of *Kessler* and the alternate approach applied in that case, the supreme court again recognized that application of a 35% tax adjustment understated the value of the supermarkets while failing to adequately account for the loss of S corporation benefits to the wife.[152] On remand, the supreme court instructed the trial court to reject the all-or-nothing approach and adopted the *Kessler* metric when tax affecting.[153]

Bernier I looked to federal and Delaware authorities, recognized marketplace realities as to tax considerations, and urged the trial court to evaluate the real tax implications of the supermarkets continuing to operate as S corporations post-divorce. In doing so, it followed the *Kessler* abstract framework but did not direct a specific tax adjustment on remand. Would this perspective make tax affecting easier for divorce courts? At least in Massachusetts, the answer would take five years to mature.

Bernier II[154]made clear that tax affecting in divorce cases, even with the apparent guidance of *Bernier I,* was complicated. On remand, the Appeals Court of Massachusetts explained that the *Kessler* approach attempted to capture the tax benefit to the buyer of S corporation shares of receiving cash dividends not

148 *See id.* at 225.
149 *See id.* at 225-26.
150 *See id.* at 227-28.
151 *Id.* at 228.
152 *Id.* at 229-30.
153 *Id.* at 231.
154 *See generally* Bernier v. Bernier, 970 N.E.2d 363 (Mass. App. Ct. 2012).

subject to dividend taxes at the entity level.[155] *Kessler* asked what the effective pre-dividend corporate tax rate would be for the S corporation shareholder even though the entity paid no corporate taxes.[156] This theoretical tax adjustment was designed to leave the shareholder of an S corporation with the same amount of money in his or her pocket as the shareholder of a C corporation.[157] On remand, the trial court had applied the same 29.4% tax affecting rate as in *Kessler* in valuing the supermarkets at $11,366,129.00.[158] The wife contended that the trial court's adoption of the *Kessler* court's percentage adjustment was error while the husband contended that, while the strict application of the *Kessler* metric yielded a zero percent tax adjustment, S corporation earnings must be tax affected to avoid an inequitable result in the valuation process.[159] The court of appeals rejected both the trial court's analysis and the husband's contentions, and opined that a zero percent tax affecting rate did not necessarily lead to an inequitable result.[160] Accordingly, applying the *Kessler* approach on remand, because the dividend tax rate in effect in 2000 was 40% a zero percent tax affecting rate was necessary to put an S corporation shareholder in the same position as a C corporation shareholder.[161]

Bernier II strictly follows the *Kessler* approach rather than mechanically applying the *Kessler* percentage, evaluates particular facts, circumstances, and tax rates, and results in no tax adjustment. That methodology, however, offers a ringing endorsement of tax affecting in divorce cases when applicable tax rates warrant. Both *Bernier* opinions attempt to harmonize existing federal and Delaware authorities with the realities of the distribution of marital property between spouses and the going concern, non-salable nature of businesses in that context.

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155 *Id.* at 371.

156 *Id.* at 368.

157 *Id.*

158 *Id.* at 370.

159 *See id.* at 370-71.

160 *Id.* at 371.

161 *See id.*

VI. Conclusion

As is evident, the U.S. Tax Court has struggled with tax affecting S corporations – mostly in the context of estate disputes. Even with that backdrop, the Tax Court has reasoned that there is a potential penalty to S corporation valuations if the double taxation impacting S corporations is not taken into consideration in business valuations. That impact is even more profound in divorce cases where there is potentially no sale, change of ownership, business interruption, business termination, or other structural alteration to a going concern. In, *Kessler,* the Delaware Court of Chancery confronted the realities of tax impact on businesses and their salability and applied a model for approximating tax consequences. That model, although imperfect, balances competing considerations and keeps irregular economic disincentives from becoming more pronounced. In turn, application of the *Kessler* approach allows businesses to be valued as if real-world transactions were occurring even though notional tax rates are employed. The Tax Court and divorce courts would do well to study, reflect upon, and apply the *Kessler* formula in some incarnation in order to equitably apportion the competing interests of private citizens and governmental authorities – particularly in the division of marital property.