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Valuing Stock: Does the Built-in Tax Hit Count?

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It has long been true that potential acquirers consider the built-in tax disadvantages of a corporation when setting a price to buy its stock. This trend has long existed, but was fundamentally altered by the fundamental tax changes enacted in 1986. The need to evaluate the built-in gain faced by a corporation was created by the 1986 tax law, which repealed the *General Utilities* doctrine.

Now, more than a decade later, practitioners

Continued on Page 3

ALSO IN THIS ISSUE:

RULES COALESCE

Continued from Page 2

Before and After

In both cases, pre- and post-transaction disposals of equity are largely ignored, except that such disposals (including the quasi-disposal associated with the making of an extraordinary distribution) will be taken into account where either the target (prior to the transaction) or the buyer (subsequent to the transaction) is a party to the disposition. In a pooling, pre- and post-transaction disposals of stock by "affiliates" to parties other than the target or the buyer, respectively, are also prohibited.

However, in a pooling transaction these disposals are only fatal if they occur during a brief "blackout" period that begins 30 days before the pooling is consummated and expires with the issuance of financial statements covering at least 30 days of post-pooling operations. ■

VALUING STOCK

Continued from Page 1

and businesspeople alike are used to considering how much a post-acquisition sale or restructuring of the company would be likely to cost. The tax cost of a sale or liquidation, or even a Section 338 election, simply have to be taken into account as a matter of pure economics.

To Discount or Not To Discount

Despite the patent need for these considerations, the IRS and the courts have continued to grapple with just how appropriate it is to consider these and other issues when valuing stock. In one recent case, *Estate of Charles K. McClatchy v. Commissioner*, No. 97-70128 (9th Cir., June 26, 1998), a divided Ninth Circuit Court of Appeals reversed the Tax Court to hold that a decedent's shares of stock in a family business should be valued by taking into account the securities law restrictions that applied to the stock during the life of the decedent. Okay, securities laws should be considered in determining value, but what about built-in tax liabilities?

In *Estate of Artemus D. Davis v. Commissioner*, 110 T.C. No. 35 (June 30, 1998), the Tax Court held that in valuing two minority blocks of common stock of a closely held corporation, the court could properly consider the corporation's built-in gain tax as of that valuation date. The corporation had built-in gain tax inherent in its assets by virtue of the repeal of the *General Utilities* doctrine in 1986.

Despite such case authority, the government continues to argue that potential built-in or capital gains taxes should not be considered in such circumstances. For example, in a case currently pending in the Second Circuit Court of Appeals, *Irene Eisenberg v. Commissioner,* 2d Cir. Dkt. No. 97-4331 (filed Feb. 18, 1998), the Justice Department is arguing that it is inappropriate to reduce the value of corporate stock that Irene Eisenberg gave to family members in 1991-1993 by the amount of potential capital gains taxes.

Big Bucks

Who is right in this dispute? The dispute clearly is not a little one, given the dollar volume and numbers of shares of stock that are transferred annually. The IRS long fought (and largely lost) the question whether minority discounts should be considered when gifts of closely held stock were made. In the context of family companies, perhaps an even better argument can be made that the potential capital gains or built-in gains taxes that could be levied on a sale or liquidation of the business must be considered.

However, the Service can sometimes appear to be disingenuous in these valuation disputes. In the case of *Estate of Artemus D. Davis v. Commissioner*, 110 T.C. No. 35 (June 30, 1998), for example, the taxpayer was arguing both for a blockage discount pursuant to SEC Rule 144, and also for a built-in gains tax discount to the shares. The Tax Court noted (seemingly with some mirth) that the IRS argued against *both* valuation discounts, but that the IRS' *own expert witness* supported the built-in gain tax discount! Whoops!

In *Artemus D. Davis*, Tax Court Judge Chiechi agreed with the estate (and the expert witnesses) that a hypothetical willing seller and willing buyer of the stock *would* have taken into account the tax in negotiating the price, even though a liquidation or sale of the company's assets was not planned or contemplated on the valuation date. After all, at some point down the road the tax would have applied.

Continued on Page 4

VALUING STOCK

Continued from Page 3

How Discount Applies

Unfortunately, even if one accepts the notion that the built-in tax liability should give rise to a discount, there can be questions how such a discount should apply. The Tax Court has not made it eminently clear precisely how the valuation discount should be applied. The court in *Estate of Artemus D. Davis* rejected the estate's contention that the full amount of the built-in capital gains tax should be subtracted from the net asset value of the corporation in arriving at the appropriate valuation figure. The Tax Court held that where no liquidation or asset sale is contemplated as of the valuation date, it was inappropriate for the *full* amount of the tax to be allowed as a discount.

Rather, Judge Chiechi held that the discount for *some portion* of the tax should be taken into account in valuing each block. The discount, the court held, should be part of the lack of marketability discount. Two of the experts involved in this case included \$8.8 million and \$10.6 million, respectively, of the built-in capital gains tax as part of this lack of marketability discount. Concluding that valuation was not an exact science, the Tax Court included \$9 million of the anticipated tax in the discount.

As far as the entire lack of marketability discount was concerned, the Tax Court leaned toward the higher side of the discount range presented by the experts. The court found that \$19 million was appropriate, before taking into account \$9 million for built-in capital gain tax. The court rejected the argument (made by the IRS expert) that each of the 25-share blocks would be able to influence management and could therefore represent a "swing block" of shares.

Not Over Yet...

The fact that the government continues to argue that *General Utilities* repeal should not be considered in such matters should be a continuing cause for concern to taxpayers. The brief filed in the pending Second Circuit appeal in *Irene Eisenberg v. Commissioner* again falls back on the notion that at the time the stock was given, there was no current plan or intention to sell the stock or liquidate the assets. According to the government, that makes any discount inappropriate.

Before the *Eisenberg* case reached the Second Circuit, the Tax Court had held that it was inappropriate for Eisenberg to reduce the value of the transferred shares by the potential corporate level capital gain taxes. The parties in that case had stipulated that there was no plan to liquidate or sell the corporate property as of the date the stock gifts were made. The Tax Court bought this argument, despite the fact that someday the tax piper will have to be paid. Hopefully, the Second Circuit will adhere to the notion of economic reality the Tax Court has adopted in *Estate of Artemus D. Davis v. Commissioner*.

Any predictions out there on how this important issue will ultimately be resolved? ■