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Inherent Tax at Corporate Level Reduces Value

By Robert W. Wood • Wood & Porter • San Francisco

Taxes and valuation are strange bedfellows. Although here at the M&A TAX REPORT we don't venture into estate and gift tax issues too frequently, these concepts are certainly relevant to private companies of all sizes. Moreover, the inherent liability presented by a significant difference between basis and market value (in what might be colloquially referred to as a "built-in gain" potential) can arise in virtually any sized company.

Of course, any time we start talking about built-in gains, we must be clear if we are talking about the concept in general, the Code Sec. 384 rules, or the Code Sec. 1374 built-in gain tax applicable to S corporations that were previously C corporations. In fact, these are just a few of the various areas in which this "built in gain" moniker is used.

Regardless of the context, this issue can have a major impact for federal estate tax purposes on the operation of buy-sell agreements, and can have other implications as well.

Latest Holding

The latest decision impacting this area—and it is an important one—is *F. Jelke III Est.*, CA-11, 2007-2 USTC ¶60,552 (2007). This was a case in which the Eleventh Circuit reversed the Tax Court in a case of first impression. It is also a case in which there was a strong dissent. But, before I get ahead of myself, let's start with the facts.

Frazier Jelke III died in 1999 owning (through a revocable trust) 3,000 shares of Commercial Chemical Company common stock, constituting 6.44 percent. The company (which had always been a C corporation) had been inactive since 1974, and had morphed into an investment company. Jelke's relatives owned the remaining shares in the company (also through trusts). Sale or transfer of the shares was not prohibited by the trust's terms.

The company managed its investments for long-term capital growth, which led to infrequent asset turnover and large unrealized

ALSO IN THIS ISSUE

capital gains. On Jelke's death, the company's board of directors had no plans to liquidate any appreciable portion of the assets. The increase in assets over the years came at a prodigious rate, averaging over 23 percent annually. On the date of Jelke's death, the company's net asset value (assets minus liabilities) was nearly $189 million.

Most of these assets were marketable securities. Not surprisingly, this made it relatively easy for the IRS and the estate to agree on the value of the company's underlying assets. But, what kind of discount for built-in capital gain would be appropriate?

On that point the IRS and the estate (predictably) disagreed. The estate contended that the value of the corporation would have to be reduced by the *full* amount of the built-in capital gain tax liability. In contrast, the IRS argued for a significantly smaller reduction, based on the present value of the built-in capital gain tax liability, discounted to reflect when the tax could actually be expected to be incurred.

In terms of actual dollars, the estate reported $4,588,155 as the discounted value of Jelke's interest in the company. The IRS countered, asserting a value of $9,111,111. These figures reflected reductions in value for capital gain tax liability, as well as discounts for lack of control and lack of marketability.

Battle of the Experts

A valuation dispute must have its experts, and this dispute was no different: Both the government and the estate had a valuation expert. The estate's valuation expert initially used a market approach to value the securities. Then, the appraiser reduced the total of the market prices for the securities by the liabilities shown on the company's books, and the tax liability that would have been incurred if all of the securities had been sold on the date of death.

This tallied to a $51,626,884 reduction attributable to capital gain tax. The taxpayer's expert made no adjustment to the tax liability for the possibility that sales of the company's securities would have occurred over time after the date of death. Again, there was no dispute over the company's historical buy and hold strategy.

The approach taken by the IRS valuation expert differed markedly. Although he started with the same market value for the securities, and he was willing to reduce the assets by liabilities, he started with a computation based on the company's actual average securities turnover. Using the turnover data from 1994-1998, he computed a 5.95-percent average annual turnover. Using this 5.95-percent turnover rate, the capital gain tax would be incurred (the expert contended) over a 16.8-year period.

The IRS expert then divided the $51,626,884 tax liability by 16 years, arriving at an annual average capital gain tax liability figure to be incurred each year over a 16-year period. That amount was $3,226,680. Using a 13.2-percent discount rate (based on the average annual rate of return for large-cap stocks in the period from 1926 through 1998), the IRS expert then computed the present value of the $3,226,680 annual tax liability discounted over six years using a 13.2-percent interest rate.

You get the idea—harsh but assertedly fair. Ultimately, this led the IRS expert to suggest a

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present value for the total capital gain tax liability of $21,082,226. Reducing the net asset value at Jelke's death ($188,635,883) by the $21,082,226 future tax liability, the IRS expert concluded the company was worth $167,553,607 as of Jelke's death. For Jelke's 6.44-percent interest in the company, that translated to a valuation for his shares on the date of death of $10,790,000.

Tax Court Battle

Should one assume the company will be liquidated, or must one look at the history? Even if the history suggests there will be no liquidation, can one apply a subjective intent to liquidate now? Must one prove that intent?

However one answers these questions, the Tax Court agreed with the IRS that it was simply inappropriate to assume that a liquidation would occur. While it was true that a tax would be incurred on liquidation, the legislation might not occur for quite a long time. There was nothing to support the assumption that it would. In fact, the Tax Court felt that the liability for the capital gain tax had to be calculated on the basis of the company's actually established history of securities turnover.

A hypothetical seller, said the Tax Court, would simply not accept a price that was reduced from a *possible* tax on all built-in capital gain. Such a hypothetical seller would know that the company *actually* sells or turns over only a very small percentage of its portfolio annually. Based on such reasoning, the Tax Court found that it would be inappropriate to assume a complete liquidation on the date of Mr. Jelke's death.

That ruling led naturally into the concept of discounting. Because the Tax Court found that tax liabilities would be incurred only when the securities were sold (at some point in the future), the tax liabilities would have to be discounted to account for the time value of money. Adopting the IRS expert's methodology and figures, the Tax Court allowed an 11.2-percent reduction in value for the built-in gain tax liability.

Before concluding the case, however, the Tax Court did allow a discount for 10 percent attributable to lack of control and a 15-percent discount for lack of marketability. Tallying up these figures and discounts, the Tax Court found Jelke's 3,000 shares of the company had a discounted value of $8,254,696 on the date of his death.

Eleventh Circuit Holding

The Eleventh Circuit had not previously faced this issue. However, the Eleventh Circuit was once a part of the Fifth Circuit, so the Eleventh Circuit often looks to Fifth Circuit authority in reaching decisions. That occurred here, and the Fifth Circuit law is much more favorable to the taxpayer than to the government on this point. In *Beatrice E.J. Dunn Est.*, CA-5, 2002-2 USTC ¶60,446, 301 F3d 339, the Fifth Circuit reversed the Tax Court to allow a reduction equal to 34 percent of the built-in capital gains tax on assets in a company, the shares of which were owned by a decedent.

This 34-percent figure compared to the Tax Court's reduction of only five percent. Ouch! Much like the Tax Court in *Jelke*, the Tax Court in *Beatrice E.J. Dunn* had based its holding on what it presumed a hypothetical willing buyer of the decedent's stock would seek to pay. That is, the Tax Court felt that a buyer could legitimately expect a significant reduction attributable to the built-in capital gains tax, only if the buyer *actually intended* to liquidate the corporation in the short term.

In contrast, the Fifth Circuit in *Beatrice E.J. Dunn* said it believed a hypothetical willing buyer of the decedent's shares would demand a reduction in price for the built-in gain tax liability at essentially 100 cents on the dollar. Market conditions would require that, said the Fifth Circuit, regardless of the subjective desires or intentions of the buyer regarding the disposition of the assets. That led the Fifth Circuit to allow a reduction for 34 percent (the then-prevailing federal tax rate) on the gain.

Follow the Leader?

The Eleventh Circuit in *Jelke* took notice of the Fifth Circuit approach, noting that it relied upon a snapshot of valuation. Indeed, it simply freezes the valuation as of the date of death, taking into account only facts known as of that date. The Eleventh Circuit found it both logical and appropriate to value the shares of the company on the date of death based on an assumption that a liquidation would occur without resort to present values or prophecies.

The Eleventh Circuit extolled the virtues of that approach. It eliminates the need for projections about what could or might happen. It provides certainty and finality to valuation.

Interestingly, the Eleventh Circuit also noted that the straight dollar-for-dollar approach it adopted would avoid the unnecessary expenditure of "judicial resources." That means there's some understandable self-interest here. Judges often have to wade through divergent expert witness testimony, which often involve both subjective conjecture and conflicting opinions.

Experts are often polarized, and each side in the dispute can be guilty of inflating or deflating figures. Some advisors, taxpayers and experts may take the cynical viewpoint that whatever they ask for they may get only half a loaf. A dollar-for-dollar approach, found the Eleventh Circuit, had the virtue of simplicity. Plus, its methodology was practical and straightforward.

That allowed the Eleventh Circuit to provide the $51 million discount for contingent capital gain taxes in valuing the company on the date of Jelke's death.

Other Circuit Law

It is worth noting that the circuits are not in perfect harmony on this issue. Other circuit courts have taken an approach that allows a reduction in the valuation of a company based on built-in capital gains taxes. In fact, for 51 years (1935-1986) the courts generally denied capital gains discounts.

One exception was *N. Obermer*, DC-HI, 65-1 USTC ¶12,280, 238 FSupp 29 (1965). Obermer stood for the theory that if the taxpayer could establish that the assets were required to be sold under a preexisting contract governing the assets, the taxpayer had thus proven that liquidation was imminent, not speculative.

The Second Circuit bell weather case is *I. Eisenberg*, CA-2, 98-2 USTC ¶60,322, 155 F3d 50, 57 (1998). Under it, the Second Circuit allows built-in capital gains discounts under the theory that any rational buyer of a business interest, with a built-in capital gains tax potential would take into account the consequences of the tax liability on the property. As a matter of economic reality, any reasonable buyer would consider the company's low basis in the investment property, and the potential tax, in determining a purchase price.

Note that liquidation of the corporation or sale of corporate assets need not be imminent, or even contemplated at the time of the transfer. Why? Because a willing buyer would demand a discount to take account of the fact that, sooner or later, the tax would have to be paid. In the same vein, the Second Circuit Court of Appeals in *A.D. Davis Est.*, 110 TC 530, Dec. 52,764 (1998), looked at marketability discounts. The court concluded that the existence of the corporate built in capital gains tax should be taken into account in determining the amount of the marketability discount.

The Sixth Circuit follows the rational of the Second Circuit. In *P. Welch Est.*, CA-6 (unpublished opinion), 208 F3d 213 (2000) [published in full-text format at 2000 U.S. App. LEXIS 3315], the Sixth Circuit reversed the Tax Court. The Tax Court had disallowed any discount. The Sixth Circuit now assesses what a hypothetical buyer would be likely to pay for an asset on the valuation date, considering all the facts and circumstances, including any built-in capital gains. However, under this amorphous standard, no dollar-for-dollar discount was implied and no dollar-for-dollar discount should be expected.

Who's on First?

Even in circuits that ostensibly have resolved these points, there can be confusion. For example, within the Fifth Circuit, there are inexplicably different interpretations of the rules, resulting in inconsistent outcomes. In *H.B. Jameson Est.*, CA-5, 2001-2 USTC ¶60,420, 267 F3d 366 (2001), the Fifth Circuit followed the Second Circuit and allowed a built-in capital gains discount. The theory was that any rational buyer of a business interest that came with built-in capital gains would have to take into account the consequences of the unavoidable, substantial built-in tax liability.

Clearly the modern trend is towards allowing built-in capital gains discounts. Yet the Fifth Circuit in *J.D. Smith,* CA-5, 2004-2 USTC ¶60,493, 391 F3d 621 (2004), refused to allow any built-in capital gains discount to a decedent's IRA. According to the Fifth Circuit, the face value of the IRA was what an arms-length buyer would pay. Therefore, that was the proper value.

More recently in *A. Temple*, DC-TX, 2006-1 USTC ¶50,523, 423 FSupp2d 605 (2006), a Texas District Court disallowed any discount for built-in capital gains. Here, though, we truly have apples and oranges, since *Temple* involved a partnership. The court found it likely that the hypothetical buyer and seller would negotiate with the understanding that the election to increase basis would be made. Thus the court suggested that the price itself would not reflect a discount for built-in gains.

Of course, as this case involved a partnership, Code Sec. 754 allows a general partner to elect to increase a buyer's basis in the partnership's assets to equal the basis in the acquired partnership interest. The buyer would thereby avoid future tax liability. In *Temple*, the court sensibly looked to the fact that no adverse tax consequences would arise for pre-existing partners. As there were also no significant administrative burdens from a Code Sec. 754 election, no discount for built-in gains was allowed.

Conclusion

Businesses and investors clearly take built in tax liabilities into account in the real world. Interestingly, the courts in tax cases are following suit. Amen!