Built-in Gain Tax and Valuation

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

Section ("Code Sec.") 1374 has been in the Internal Revenue Code for many decades, but was radically changed in 1986 with the repeal of the *General Utilities* doctrine. As a stopgap to prevent C corporations from electing S status and then selling their assets or liquidating, Code Sec. 1374 imposes a built-in gain tax. In effect, the tax is on the appreciation that occurred during the C years. It is measured and assessed on any sales that occur during the first 10 years of the corporation as an S corporation.

Yet even nine years into the S election, the C corporation appreciation needs to be determined as of the conversion nine years before. For that reason, appraisals of specific assets, or of the whole company, as of an S conversion can be important.

Whose Value?

Ringgold Telephone Co., TC Memo 2010-103, involves a C corporation that elected S status effective January 1, 2000. In turn, Ringgold owned a 25-percent partnership interest in Cellular Radio of Chattanooga. It had a right to sell that interest, but only subject to a right of first refusal in favor of other partners of Cellular Radio.

One of those partners was BellSouth Mobility, which also was a 25-percent partner in Cellular. Cellular's primary asset, in turn, was a 29.54-percent limited partnership interest in the Chattanooga MSA limited partnership. Tracing through the various entities, Ringgold held a 7.385-percent interest in Chattanooga *via* its ownership in Cellular Radio. BellSouth owned 62.695 percent in Chattanooga *via* its ownership in Cellular Radio and another entity.

Apparently Ringgold's General Manager was unaware of the built-in gain tax. Nevertheless, the facts suggest that in early 2000, Ringgold's CPA issued a written valuation of the company's Cellular Radio interest, pegging it at approximately $2.6 million. Yet in July of 2000, BellSouth offered to buy Ringgold's 25-percent interest in Cellular Radio for approximately $5 million, subject to working capital adjustments. The other partners in Cellular Radio did not exercise their rights of first refusal, and the sale was completed in late 2000 for $5,220,423. Readers will note that considerable run-up in value in a short few months!

On its first S corporation return (for 2000), Ringgold reported the amount of its built-in gain using the $2.6 million figure prepared by the CPA. In other words, Ringgold treated the difference between the $5.2 million sales price and the $2.6 million valuation as *not* subject to built-in gain tax. Therefore, it was subject only to the passthrough treatment to shareholders of Ringgold.

Predictably, the IRS assessed a deficiency based on the full sales price of $5,220,423 being subject to the built-in gain tax. The IRS also asserted a substantial understatement penalty.

Just the Facts

The Tax Court started with the notion that the sale of the Cellular Radio interest to BellSouth was an arm's-length sale. Of course, it was obvious that it occurred not too long after the

supposed valuation of the interest. Whether or not the Ringgold accountant was aware of the built-in gain issue (who could not be?), Ringgold's General Manager was apparently not aware of the existence of the built-in gain tax when the valuation report was prepared.

Yet it was prepared in early 2000, and a few months later in July of 2000, BellSouth made its offer to buy Ringgold's 25-percent interest in Cellular Radio. That relatively short period of time after the valuation date was not punctuated by any intervening events that would have affected the value between the valuation date and the date of sale. Thus, the Tax Court was inclined to view the sales price as *virtually* dispositive of value. But it was not dispositive, as we'll see.

Although Ringgold argued that the purchase price of the Cellular Radio interest had to be reduced by a control premium (since BellSouth did have control), the Tax Court rejected this notion. However, the court agreed with Ringgold's valuation expert that the sale price should be adjusted to reflect the likelihood that BellSouth viewed the Cellular Radio's interest as a strategic acquisition and was willing to pay a premium to avoid exercise of the rights of first refusal.

Accordingly, the Tax Court concluded that the BellSouth sale price was probative—but not conclusive—evidence of the value of the Cellular Radio interest on the valuation date. That was terribly important, allowing Ringgold to come out with at least a somewhat acceptable result.

Conclusion

After evaluating the findings of Ringgold's valuation expert and of the IRS' valuation expert, and after factoring in the BellSouth sales price, the Tax Court came up with its *own* figure: the fair market value of the Cellular Radio interest on the valuation date was $3,727,142. The Tax Court also determined that Ringgold was not liable for the substantial understatement penalty. Ringgold acted with reasonable cause and in good faith, relying on its CPA's advice in valuing the Cellular Radio interest, the court found.

Tax Court judges are well known for not liking to be valuation arbiters. Who can blame them? Faced with two diametrically opposed experts in a charitable contribution case, the Tax Court may take umbrage at both sides. The value question is factual. Even when you have wildly disparate figures, the Tax Court may think these disputes can (and probably should) be settled.

Code Sec. 1374 is a little different, but not that different. Whatever else you do, if your company converts from C to S, keep good evidence of valuation.