VALUING STOCK: BUILT-IN TAX, SECURITIES LAWS AND OTHER SUCH BLEMISHES

by Robert W. Wood

It has long been true that a corporation is not the primary vehicle of choice for holding real estate. Nonetheless, there are a variety of circumstances in which business owners find themselves holding appreciated assets, not infrequently including real estate, in a corporation. In this situation, gifting shares of this stock (or a transfer of shares on death) raises the appropriateness of valuation discounts for gift and estate tax purposes. The question whether the corporate tax would be payable upon a sale or liquidation of a corporation has been particularly important where the assets are highly appreciated, since the tax would be correspondingly greater. Since 1986, when the General Utilities repeal was enacted, it has not been clear precisely how such valuation discounts should be treated.

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 draconian 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 The need to evaluate the built-in gain faced by a corporation was created by the 1986 tax law, which repealed the General Utilities doctrine.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 and businesspeople alike are used to considering how much a post-acquisition sale or restructuring of the company would be likely to cost.

Beyond the purchase and sale context, the estate planning field has perhaps been most influenced by valuation disputes. Not only is there a need to value property (including stock) at death, but it is also necessary during life for gift tax purposes The general object of the latter situation is to shift value out of an older person's estate so that it is not ultimately subject to estate tax. It is also quite common to engage in charitable contribution planning where valuation is the lynchpin of the entire plan.

Valuation discounts have long been taken by tax planners for a variety of reasons. Discounts may be claimed by virtue of minority stock positions, by virtue of securities laws that restrict resale, because of contractual restrictions on the right to sell, for zoning and other legal restrictions, etc.

To Give or Not To Give

Despite the patent need for valuation considerations, the IRS and the courts continue to grapple with just how appropriate it is to consider certain valuation issues when valuing stock. In one recent case, Estate of Charles K. McClatchy v. Commissioner, 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. Securities laws should be considered in determining value, but what about built-in tax liabilities?

In Estate of Artemus D. Davis v. Commissioner, 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 tax that would be generated on a sale or liquidation as of that valuation date. Despite such case authority, the government continues to argue that potential capital gains taxes should not be considered in such circumstances. In a case recently decided by the Second Circuit Court of Appeals, Irene Eisenberg v. Commissioner, the Justice Department argued that it was 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.

The Eisenberg decision should be widely read by both estate planners and corporate tax practitioners—making the case a kind of curious melting pot for those on both sides of the aisle. The Eisenberg case arose out of Mrs. Eisenberg's transfer of shares in her corporation to her children. The sole asset of the corporation was a parcel of rental real estate located in Brooklyn. The question was whether the value of the stock (here, for gift tax purposes) should be reduced to reflect the inherent tax in the corporation's assets, even though it was acknowledged by the taxpayer that no realization event triggering the payment of the tax was imminent.

Interestingly, one of the stipulations in the case was the speculative nature of the timing of the taxable event. The corporation stipulated with the government that it did not have plans to liquidate, distribute or sell its building. However, being advised by tax planners, in making the calculation of the gift of shares, Mrs. Eisenberg reduced the value of the shares given by the tax the corporation would incur if it were liquidated, or if it distributed or sold its real estate.

The Tax Court held that this reduction in value could not be taken. The Tax Court hung its hat on the fact that there was no evidence that such a liquidation or sale was likely to occur. After all, the taxpayer had stipulated that there was no current plan to sell or liquidate. Indeed, a drafter of corporate minutes might take an implicit note of advice from this, since ostensibly it is never clear when just the right offer may come along and when a corporation may sell assets generating a corporate level gain!

Second Circuit Opens Doors

Since Mrs. Eisenberg was defeated in the Tax Court, she took her dispute to the Second Circuit Court of Appeals. The Second Circuit reviewed the history of such valuation discounts, noting that before the 1986 change in Subchapter C, the courts uniformly disallowed discounts attributable to inherent tax liabilities. The reasons the courts gave for these early disallowances were: (1) the tax was considered too speculative, and (2) the existence of former Section 337 (which allowed a corporate liquidation with no corporate level tax), the tax could easily be avoided.

Now, with the anti-General Utilities regime that has been the Service's mantra since 1986, the Second Circuit felt that the IRS could not have it both ways. Reliance on these cases, said the Second Circuit, was no longer appropriate. The critical point, said the court, was not that there was no indication that a liquidation was imminent, but that there was no evidence introduced by the IRS to dispute the fact that a willing buyer of stock would pay less because of the inherent tax liability inside this C corporation. The Second Circuit vacated the Tax Court's decision, holding that an adjustment for the potential tax should be taken into account, even though no liquidation of the corporation was planned.

Now that this concept has been recognized, one must assume that even more aggressive gift tax strategies will be developed. After all, the concept of gifting shares where there is no contemplated corporate liquidation, or where there is a contemplated sale or liquidation, occurs all the time. In Eisenberg, the Second Circuit validated the notion that the sometimes crushing corporate tax liabilities that would be paid on a sale or liquidation do reflect the value of the shares given. Whether or not there is an immediate (or even eventual) plan to make a sale or liquidation, should not prevent a valuation discount.

Both Eisenberg and Artemis Davis involved C corporations, but it is interesting to contemplate whether the same theory would apply to S corporations. A third case, Estate of Helen Bolton Jamison v. Commissioner, involved yet another valuation discount that was upheld by the Tax Court. On the valuation of a closely held corporation, here applicable for estate tax purposes, the Tax Court did not agree with the IRS' position that the capital gain tax that would have been payable by the corporation could be avoided upon liquidation. The Tax Court expressly stated that a hypothetical buyer would take into account some measure of the corporation's built-in capital gains. The court applied a discount, determining the net present value of the capital gain tax liability that would be incurred over time as the assets (in this case, timber to be cut and sold) were disposed of.

Valuation Methods

One nettlesome question remaining is exactly how one goes about valuing stock where there are tax liabilities involved. In Estate of Artemus D. Davis v. Commissioner, the taxpayer was successful in convincing the Tax Court that there should be a valuation discount to take the built-in gain tax into account. The Tax Court agreed with the estate (and with 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.

Even if one agrees that a corporate tax liability must give rise to a discount, there can be questions how such a discount can apply. Indeed, in Eisenberg, the Tax Court decision was vacated, the matter remanded for a determination of what discount was appropriate. And, in Estate of Artemus D. Davis, the Tax Court rejected the estate's contention that the full amount of the 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 was contemplated as of the valuation date, it was inappropriate for the full amount of the tax to be allowed at a discount. Waffling over what portion of the tax could be taken into account in valuing each block, the Tax Court concluded it should be part of the lack of marketability discount.

It should be apparent in cases such as Eisenberg and Estate of Artemus D. Davis that even though the IRS has been defeated in these valuation cases, taxpayers hardly have carte blanche to apply a full tax discount to transferred shares. Indeed, it would seem appropriate to acknowledge from time to time that transfers of stock may be made in a mileau where there is a mere possibility of sale, or there are in fact plans to sell or liquidate the company (or at least some of its assets). Assuming that there is truth to such recitations, they may bolster the discount, and even may have the IRS agreeing

that a discount is appropriate. After all, these cases we have been discussing only arise in the context of litigation—the IRS wants to see a plan (or at least a substantial possibility) that a sale or liquidation will occur before it will grant a discount without being forced to do so by a court.

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.

The Service sometimes seems disingenuous in these valuation disputes. In Estate of Artemus D. Davis v. Commissioner, 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 capital gain tax discount.

In Artemus D. Davis, the Tax Court held that the discount for some portion of the tax should be taken into account in valuing each block. 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 to the entire lack of marketability discount, 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 represent a "swing block" of shares.

Securities Laws, Too

McClatchy v. Commissioner, noted briefly above, is also an interesting case. The major issue in McClatchy was simply whether the admitted discounts (for securities restrictions under Rule 144), should be taken into account as of the moment of death, or before or after. The Ninth Circuit Court of Appeals recognized the fundamental rule that the value of the estate must be determined as of the time of death. Thus, assets are valued in the hands of the decedent, but prior to the transfer to the estate. The result in the McClatchy case was that the Rule 144 restrictions in question did not lapse at Mr. McClatchy's death. Instead, their continued application depended on the identity of the executors and the resulting non-affiliate status of the estate.

It has been suggested that the McClatchy holding prompts various planning ideas. For example, individuals may wish to consider actions that could preserve affiliate status. So, in a rare case where an individual can arrange to continue until death as a director of (or in an executive capacity with) a public company whose stock he or she owns, a Rule 144 discount could be generated for his or her estate. The reverse planning might be possible for a zero tax estate (let's assume that a full marital deduction applies). Here, the Rule 144 restrictions would limit a step-up in basis for income tax purposes, leaving a surviving spouse with potential capital gain exposure on a subsequent sale of

the stock. Avoiding the Rule 144 restrictions and their effect would therefore be preferable in this latter case.

Of course, valuation issues for lifetime gifts may need further thought. In the case of stock transferred by gift, Rule 144 restrictions may not apply. Plus, depending on the amount of stock given, lack of liquidity or blockage discounts may simply be inappropriate given the size of the stock transfer made.

Be Sensitive to Transfers

Perhaps the most fundamental problems for inter vivos transfers arise where a gift is determined to be incomplete (and thus ineffective). Normally, if this unthinkable circumstance occurs, it is discovered only several years later, and typically at least someone involved in the transaction is worried about their own liability. Take the facts described in IRS Technical Advice Memorandum 9751003. There, the IRS denied a gift tax annual exclusion for transfers of limited partnership interests. We all know that family limited partnerships (and family limited liability companies) are one of the truly hot issues facing estate planners (and lawyers and accountants in general) these days. The IRS has not exactly declared war on these family vehicles, but it has at least engaged in more than mere skirmishes around the fringes of the limited liability company and limited partnership bar.

In TAM 9751003, a gift tax annual exclusion for transfers of interests in a family limited partnership was denied, the rationale being that the gifts of partnership interests were simply not gifts of present interests. The reason the IRS so concluded was that there was no substantial economic benefit, the Service said, to the partnership interests. Why?

The partnership agreement in this case allowed the general partner to retain funds (rather than distribute them) for any reason whatsoever. Thus, the Service was able to read the partnership agreement to give this overwhelming discretion of the general partner to effectively deny any economic benefit to the limited partners. Although it would not seem common to draft a limited partnership agreement to give such wide latitude in the general partner, in this particular case the Service was able to conclude that these particular partnership interests transferred to family members were really future interests and therefore were not entitled to the gift tax annual exclusion.

Given the dollars involved in the case, a disaster happened. Particularly when one realizes that annual exclusion gifts are generally made to many different family members and generally made over the course of a number of years (depending, of course, upon the life expectancy of the transferors), this kind of tech advice is more than a little frightening. It should cause at least a few lawyers to go back to their limited partnership agreements (or LLC operating agreements) and to see whether they might contain offending language—giving so much discretion to the general partner that the Service might take the position that a complete gift has not yet occurred.

Not Over Yet

The fact that the government continues to argue that General Utilities repeal should not be considered in valuation matters should be cause for concern to taxpayers. Like most other valuation disputes discussed above, the IRS simply does not like valuation

discounts of most varieties. 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, because the parties 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; the Second Circuit did not. Now that the IRS has acquiesced in the case, the matter may be resolved.

Ultimately, the courts seem to be adopting a notion of economic reality in these discount cases. Let us hope this trend continues.

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