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## Valuing Stock: Taxing Issues Part II

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It was recently said that in the gift and estate planning fields, valuation is not an important consideration, it is *the only consideration*. Although this may be somewhat overstated, it is certainly true that valuation issues play a central role in any estate planning genre. For example, the entire field of family limited partnerships and family limited liability companies could not exist without valuation issues.

Disputes frequently arise between the IRS and taxpayers concerning just how much an interest in a corporation, partnership or LLC (with its minority discount and lack of marketability) may be worth. Similarly, the donation of conservation and historical

Continued on Page 2

**ALSO IN THIS ISSUE:**

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**VALUING STOCK** Continued from Page 1

facade easements could not make any economic (or tax) sense without considerable focus on valuation. Precisely how someone values any item of property, and precisely what factors should go into this valuation, make up much of the grist of the IRS appellate process and beyond.

In the August 1998 issue of *The M&A Tax Report*, we looked at valuing stock, and specifically at whether the built-in gain tax made famous by *General Utilities* repeal should be taken into account in valuing the stock. See Wood, "Valuing Stock: Does the Built-In Tax Hit Count?" Vol. 7, No. 1, *M&A Tax Report* (August 1998), p. 1. As a matter of pure economics, if there is a corporate level tax that will be incurred upon a sale of assets or liquidation, then the company is truly worth that much less. It can be argued that there needs to be some evidence that the company will in fact be liquidated (either in the foreseeable or even distant future). Indeed, the IRS has argued this very point in attempting not to have any discount applied for the tax liability that may eventually come home to roost.

## Planned vs. Remote Taxes

In the August 1998 article, I noted that there was a case currently pending in the Second Circuit Court of Appeals of significant import. That case, *Irene Eisenberg v. Commissioner*, 2d Cir. Dkt. No. 97-4331 (filed Feb. 18, 1998), has now been decided (82 A.F.T.R.2d ¶ 98-5173 No. 97-4331). In this case, the Justice Department was arguing that it was inappropriate to reduce the value of corporate stock

Continued on Page 3

## VALUING STOCK

Continued from Page 2

that Irene Eisenberg gave to family members in 1991 through 1993 by the amount of potential capital gains taxes. The *Eisenberg* decision has now been issued by the Second Circuit Court of Appeals, and 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 amount of 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. A drafter of corporate minutes might take an implicit note of advice from this stipulation, since it is ostensibly 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).

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.

Accordingly, the Second Circuit vacated the Tax Court's decision. The Second Circuit held in principle that an adjustment for the potential tax should be taken into account in valuing stock, even though no liquidation of the corporation is planned. The same conclusion held for the situation where there is no sale or distribution of assets by the corporation planned.

### Corporate Planners Unite

As we noted in the August issue, cases like *Eisenberg* may be of considerably more interest to estate planners than to corporate tax practitioners. However, that ought not to be the reaction to a case of such importance. Everyone advising corporations should take note that the courts are now validating what all of us have always known, namely, that a corporation with inherent built-in tax liability will command a far lower price than one which has no built-in tax liabilities. Duh!

Now that this concept has been recognized (and the Service has been defeated), one must assume that even more aggressive gift tax strategies will be developed. After all, the concept of gifting shares either where there is no contemplated sale or liquidation, or where there is not, occurs all the time. In *Eisenberg*, the Second Circuit has 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

Continued on Page 4

## VALUING STOCK

Continued from Page 3

a valuation discount.

### *How* to Value?

Perhaps the only remaining nettlesome question is exactly how one goes about valuing stock where there are tax liabilities involved. Recall that in *Estate of Artemus D. Davis v. Commissioner*, 110 T.C. No. 35 (June 30, 1998), 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.

However, 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 the *Eisenberg* case, the Tax Court decision was vacated, and the matter had to go back to the Tax Court for a determination of just 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 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 was contemplated as of the valuation date, it was inappropriate for the *full* amount of the tax to be allowed as a discount.

Instead, the Tax Court in *Estate of Artemus D. Davis* adopted a somewhat waffling approach that *some portion* of the tax could be taken into account in valuing each block. The discount, according to the Tax Court in *Estate of Artemus D. Davis*, should be part of the lack of marketability discount.

### Not the Last Word

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 milieu 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. What bothered the IRS and the Tax Court in *Eisenberg* was that it had been stipulated that there was no sale or liquidation even contemplated. It would not take much imagination to keep discussions of possibilities alive.

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. ■