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Valuation Reduction for Full Amount of Built-In Capital Gains Tax – Will Family Law Courts Follow Suit?

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Overview

In recent years, an important issue that has produced opinions by the U.S. Tax Court and several Federal Circuit Courts of Appeal involves the question of whether a full dollar-for-dollar discount should apply when valuing interests in a C corporation to reflect built-in capital gain tax. The IRS had maintained successfully (until 1998) that no discount should apply, but the courts have disagreed with that view. Initially, the courts focused on the level of the discount. But, in 2007, the United States Court of Appeals for the Eleventh Circuit,[1] reversed the Tax Court,[2] and held that in determining the estate tax value of holding company stock, the company's value is to be reduced by the *entire* built-in capital gain as of the date of death.[3]

In 2009, the U.S. Tax Court essentially allowed a full dollar-for-dollar discount in a case involving a C corporation with marketable securities.[4] So, it has come as no surprise that the Tax Court, in a recent opinion, again allowed a full dollar-for-dollar discount attributable to built-in capital gain when valuing an estate's 82 percent controlling interest in a closely-held C corporation holding real estate.[5]

A related question is whether the opinion could also begin to have some influence on family law courts handling divorce cases subject to equitable distribution procedures.

Illustration of the problem

The following example illustrates a typical scenario involving potential capital gains upon corporate liquidation:

> XYZ Corporation (a C corporation) owns a tract of real estate and no other assets or liabilities. The real estate is worth $2,000,000 and has a cost basis of $200,000. If XYZ Corp. were to liquidate, the distributions to shareholders would be taxed at two separate levels. The first tax would be at the corporate level and would be on the $1.8 million capital gain on the land ($2 million less the $200,000 cost basis). Assuming a hypothetical tax rate of 35 percent, the tax would be approximately $630,000. That would leave $1.37 million in cash to distribute to the shareholders. A second tax would then apply at the shareholder level on the amount of the distribution to each of them. This tax would be applied to the amount each shareholder receives in liquidation less each shareholder's basis in their stock. Assuming a $200,000 basis in the stock and a hypothetical individual income tax rate of 35 percent, the income tax liability at the shareholder level would be $409,500 ($1.37 million in distributed cash, less $200,000 basis, times a 35 percent tax rate). Thus, the total tax bill on liquidation is $1,039,500 and the net proceeds received would be $960,500.

So, after the entire liquidation process is completed, the shareholders will receive slightly less than one-half of the fair market value of the underlying assets of XYZ Corporation.[6]

A real world buyer

The discount for potential capital gains makes perfect sense from a real-world perspective, as illustrated by the following example:

> Sam is interested in buying a tract of real estate. Assume that Sam finds two identical tracts – tract "A" and tract "B." Sid owns tract A outright, and tract B is owned by a C corporation. Both tracts are worth $2 million and each have a cost basis of $200,000. If Sam buys tract A from Sid for $2 million and sells it five years later for $4 million, the capital gain triggered upon sale will be $2 million and the resulting tax (assuming a 35 percent effective capital gain tax rate) will be $700,000. So, the result is that Sam invested $2 million and five years later received $3.3 million. That's a five-year annual return of just over 10 percent.
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> However, if Sam were to buy 100 percent of the C corporate stock of the corporation that owns tract B, he would receive the corporation's stock with the land at the low $200,000 basis. Thus, upon sale of the land five years later for $4,000,000, the capital gain inside the corporation is $3.8 million). Based on a hypothetical capital gain tax rate of 35 percent, the capital gains tax liability inside the corporation is $1,330,000. This leaves $2,670,000 left to distribute from the corporation to Sam. Assuming Sam's basis in the corporate stock is $2,000,000 (the amount he originally paid for the stock), Sam has additional capital gain at the shareholder level of $670,000. Assuming a hypothetical capital gain tax rate of 35 percent, Sam must pay an additional $234,500 in capital gain tax at the shareholder level. So, the total tax bill to Sam is $1,564,500. So, Sam invested $2 million and five years later received $2,435,500. That's a five-year annual return of approximately 4 percent – much worse than if Sam had purchased the land outright from Sid. Clearly, Sam would demand a discount from the $2 million selling price of tract B to reflect the built-in capital gains tax.

There is no question as to whether a discount for built-in capital gain tax should apply (although the IRS maintained successfully until 1998 that no discount should apply). The only question is whether the discount should be considered as a dollar-for-dollar reduction when calculating the asset-based value of the corporation (i.e., 100 cents on the dollar) or whether the discount should be limited by the likelihood (or lack thereof) of corporate liquidation.

Facts of *Jelke III*[7]

The decedent died on Mar. 4, 1999, with a revocable trust that owned 3,000 shares of common stock (a 6.44% interest) in Commercial Chemical Company (CCC). The company had ceased active business operations in 1974. From that time on, CCC's only activity was to hold and manage investments for the benefit of its shareholders. The business was always was a C corporation. The decedent's relatives owned the remaining interests in the company through trusts, the terms of which did not prohibit the sale or transfer of CCC stock. CCC's portfolio was well managed with its primary investment objective being long-term capital growth. Consequently, the portfolio had low asset turnover and large unrealized capital gains. As of the date of the decedent's death, CCC's board of directors had no plans to liquidate most of CCC's portfolio, and they intended to continue to operate the business as a going concern.

CCC's net asset value increased from $59.5 million at the end of 1994 to $139 million at the end of 1998. On the date of the decedent's death, CCC's net asset value (assets less liabilities) was almost $189 million.

CCC's holdings were mostly in marketable securities. The IRS and the estate ultimately agreed on the value of CCC's underlying assets, and that a discount for the built-in capital gain tax was proper. However, they differed as to the amount of the reduction from the value for the potential capital gain tax liability that would arise upon sale of the marketable securities held by the corporation. The estate claimed that the value of the corporation should be reduced by the full amount of the built-in capital gain tax liability. Alternatively, IRS claimed CCC's value should be reduced by a lesser amount based on the present value of the built-in capital gain tax liability discounted to reflect when the tax was expected to be incurred.

The estate reported $4,588,155 as the discounted value of the decedent's interest, but IRS pegged it at $9,111,111. The discounted values reflected reductions for the capital gain tax liability and discounts for lack of control and lack of marketability.

The estate's valuation expert initially used the market approach to value CCC's securities. He then reduced the total of the market prices for CCC's securities by the liabilities shown on CCC's books and the tax liability that would have been incurred if all of CCC's securities had been sold as of the decedent's date of death. This resulted in a reduction for $51,626,884 in capital gain tax. No adjustments to the tax liability were made for the possibility that sales of CCC's securities would have occurred after the date of death.

The IRS expert started with the same market value of CCC's securities, and then reduced the assets by liabilities via a different approach. The IRS expert computed CCC's average securities turnover by reference to the most recent data (1994–1998). From that data, the expert computed a 5.95% average annual turnover derived from the parties' stipulated asset turnover rates for 1994–1998. Using a 5.95% turnover rate resulted in the capital gain tax's being incurred over a 16.8-year period (100% ÷ 5.95%). The expert then divided the $51,626,884 tax liability by 16 years to arrive at the average annual capital gain tax liability that would have been incurred each year over this 16-year period--$3,226,680. Next, he selected a 13.2% discount rate based on the average annual rate of return for large-cap stocks in the period from 1926 to 1998. He then computed the present value of the $3,226,680 annual tax liability discounted over 16 years using a 13.2% interest rate to arrive at a present value for the total capital gain tax liability of $21,082,226. By reducing the $188,635,833 net asset value at the date of the decedent's death by the $21,082,226 future tax liability, he arrived at a $167,553,607 value for CCC. That resulted in an undiscounted value (i.e., value before lack of control and lack of marketability discounts) for the decedent's 6.44% interest in CCC of about $10,790,000.

The Tax Court opinion[8]

The Tax Court agreed with IRS that an assumption of liquidation, given the history of the business, was not appropriate and that the tax liability for the capital gain should be calculated on the basis of CCC's established history of securities turnover. Thus, the Tax Court reasoned that a hypothetical seller would not accept a price that was reduced for possible tax on all built-in capital gain knowing that CCC historically sold or turned over only a small percentage of its portfolio annually. Thus, the court reasoned, it would not be appropriate to assume a complete liquidation on the date of death.

The Tax Court then held that because the tax liabilities would be incurred when the securities are sold, they must be indexed or discounted to account for the time value of money. It adopted IRS's expert methodology and figures. This resulted in an 11.2% reduction in value for built-in capital gain tax liability. In addition, the court allowed a 10 percent lack of control discount and a 15 percent discount for lack of marketability. Ultimately, the Tax Court held that the decedent's 3,000 shares of CCC had a discounted value of $8,254,696 on the date of his death.

The Eleventh Circuit's opinion[9]

On appeal, the Eleventh Circuit reversed based on *Estate of Dunn v. Commissioner*.[10] In *Dunn*, the United States Court of Appeals for the Fifth Circuit, in determining the asset-based value of a decedent's 62.96 percent interest in a corporation, allowed a reduction equal to 34 percent of the assets' built-in capital gains. The Tax Court had ruled that a reduction in the amount of only 5 percent of the built-in gains was appropriate, based on its conclusion that a hypothetical willing buyer of the decedent's block of stock would seek a substantial reduction for built-in capital gain *only if the buyer* *intended to liquidate the corporation in the short term.*[11] But, the Fifth Circuit was satisfied that the hypothetical willing buyer of the decedent's block of stock would demand a reduction in price for the built-in gains tax liability of the corporation's assets at essentially 100 cents on the dollar, regardless of his subjective desires or intentions regarding the use or disposition of the assets. Under the facts of the case, that resulted in a 34 percent reduction (the rate of federal tax on the gain).[12]

The Eleventh Circuit said that, under the Fifth Circuit's approach, the estate tax owed is calculated based upon a "snap shot of valuation" frozen on the date of decedent's death, taking into account only those facts known on that date. The Eleventh Circuit said it is more logical and appropriate to value the shares of CCC stock on the date of death based upon an assumption that liquidation has occurred, without resort to present values or prophesies. The court reasoned that such an approach eliminates the need for a "crystal ball" or a "coin flip" and provides the greatest degree of certainty and finality to valuation.

The Eleventh Circuit stressed that its approach eliminated the unnecessary expenditure of judicial resources utilized in sorting through a numerous and divergent expert witness testimony, based upon subjective conjecture, and divergent opinions. The court reasoned that its approach was simple and its methodology provided a practical and theoretically sound foundation as to how to address the discount issue. As a result, the court allowed a full, $51 million discount for contingent capital gains taxes in valuing CCC on the date of decedent's death.

Tax Court's 2009 opinion

In early 2009, the Tax Court, in a case involving a C corporation with marketable securities that had substantially appreciated in value, allowed a discount for built-in gain that was practically a dollar-for-dollar discount (even though the estate did not argue for it) because the court allowed consideration of expected post valuation date appreciation.[13] In the same case, the court also allowed a substantial built-in gain discount (52 percent) for a former C corporation that had elected S status about 2 years prior to the valuation date.[14] That meant that the Tax Court was willing to follow the valuation theory for determining the discount for built-in gain that was utililized in *Dunn*[15] and *Jelke III*.[16]

Tax Court's 2010 opinion

In an August 2010 opinion, the Tax Court ruled on the valuation of an estate's controlling 82 percent interest in a closely-held corporation that owned real estate (a girls' summer camp).[17] The decedent was the trustee of a revocable trust that held the controlling interest in the C corporation. Over time, the corporation's property had been improved with modern facilities. At death, the estate valued the corporation under the net asset value approach and then subtracted a dollar-for-dollar discount for tax liability attributable to built-in gain (computed at $1.13 million). IRS limited the discount on the basis of closed-end fund transactions that it analyzed and that there existed ways in which the estate could avoid the tax such as a like-kind exchange, or an S corporation election. But, the Tax Court did not view closed-end funds as comparable to the corporation at issue pointing out that closed-end funds usually invest in various economic sectors and asset classes, but the decedent's corporation held only a single asset - improved real estate. The Tax Court also noted that a prospective buyer couldn't really avoid the built-in gain tax, just defer it. So, a willing buyer would negotiate a price that would reflect the built-in gain tax. The Tax Court computed various appreciation rates, determined future built-in gain tax liability and then discounted the computations over 17 years (the depreciation rates for the useful life of the improvements on the corporation's real estate). The Tax Court came up with a value that was close to the estate's valuation - a dollar-for-dollar discount.

Implications for divorce cases

While the rulings in *Jelke III*, *Litchfield* and *Jensen* are important ones for estate tax valuation cases, they may not have a great amount of practical application given that very few estates are subject to federal estate tax, and of those that are taxable, only a few involve a determination of the impact of built-in capital gains tax on valuation. However, the impact of built-in gains tax in equitable distribution settings involving divorce may have much greater practical application.[18] In divorce settings, courts tend to be reluctant to deduct potential tax liability from the distribution of the underlying assets. For example, a Pennsylvania court, in a 1995 opinion, refused to deduct the potential tax liability associated with the distribution of defined benefit pension plans.[19] The court held that potential tax liability could be considered in valuing marital assets only where a taxable event has occurred or is certain to occur within a time frame such that the tax liability can be reasonably predicted. The North Carolina Court of Appeals has ruled likewise,[20] as have courts in New Jersey,[21] Deleware,[22] West Virginia[23] and South Dakota.[24] But, the Oregon Court of Appeals, has indicated that a reduction for taxes should be allowed in divorce cases subject to equitable distribution rules.[25]

Conclusion

Jelke III,[26] *Litchfield,*[27] and *Jensen*[28] are a welcome relief from the IRS's irrational view which is completely contrary to the way buyers in the real world operate. But, the United States Circuit Court of Appeal for the Second Circuit has allowed only a partial reduction for built-in capital gain in a case involving facts similar to *Jelke III*.[29] So, while the Fifth Circuit, the Eleventh Circuit and the Tax Court have allowed a full dollar-for-dollar discount, the Second Circuit has not so ruled. If the IRS continues to litigate this issue, the matter ultimately may have to be resolved by the Supreme Court. It also remains to be seen whether family law courts will adopt the rationale espoused in *Dunn,*[30] *Jelke III,*[31]*Litchfield* [32] and *Jensen*.[33]

> **Note:** On October 6, 2008, the U.S. Supreme Court declined to hear *Jelke III*.[34]
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> **Warning:** The C corporation involved in *Litchfield* held marketable securities that had substantially appreciated in value. Legislation has been proposed (and endorsed by the Administration) in the current session of the Congress that would eliminate discounts for entities owning marketable securities and cash.[35]

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[1] Estate of Jelke III v. Comr., 507 F.3d 1317(11th Cir. 2007).
[2] Estate of Jelke III v. Comr., T.C. Memo. 2005-131.
[3] A dissenting judge would have adopted the view of the Tax Court, which had agreed with IRS that the built-in capital gain tax liability should be discounted to reflect when the tax is reasonably expected to be incurred. The two approaches can result in a big difference in the amount of the reduction. The Eleventh Circuit's approach reduced the net asset value of the corporation by about $51 million while the Tax Court's approach reduced it only by about $21 million.
[4] Estate of Litchfield v. Comr., T.C. Memo. 2009-21.
[5] Estate of Jensen v. Comr., T.C. Memo. 2010-182.
[6] Before 1986, under the General Utilities doctrine, corporations were allowed to liquidate with the proceeds being taxed only at the shareholder level. The doctrine was based on the 1935 Supreme Court decision in General Utilities v. Helvering, 296 U.S. 200 (1935) . The 1986 effectively repealed the General Utilities doctrine, establishing the double-taxation scenario described in the example. The double tax scenario is consistent with the tax treatment of C corporation dividends, which are taxed at two levels – corporate and shareholder.
[7] 507 F.3d 1317 (11th Cir. 2007).
[8] T.C. Memo. 2005-131
[9] 507 F.3d 1317 (11th Cir. 2007).
[10] 301 F.3d 339 (5th Cir. 2002)
[11] Also, the holder of the decedent's shares, acting alone, could not force a liquidation because the applicable state (Texas) law required the approval of at least two-thirds of the outstanding shares.
[12] In an earlier opinion, the Fifth Circuit noted that a hypothetical buyer would have to take into account the consequences of unavoidable, substantial built-in tax liability on the property at issue, and remanded the case to the Tax Court for a determination of whether the evidence supported an economic case for the buyer to not engage in long-term timber production. But, the court did not hold (as it did later in *Dunn*) that a dollar-for-dollar discount should be utilized for built-in gain tax. Estate of Jameson v. Comr., 267 F.3d 366 (5th Cir. 2001).
[13] Estate of Litchfield v. Comr., T.C. Memo. 2009-21 (the discount was 91 percent for the built-in gain using a present value calculation).
[14] *Id*. At the time the case was filed, S corporations that were formerly C corporations incurred corporate-level capital gain tax on the sale of assets within 10 years of the S election based on the appreciation in asset value occurring up to the date of the S election. Under the American Recovery and Reinvestment Act (Act) of 2009, the 10 year period is reduced to seven years for built-in-gain *recognized* in 2009 or 2010. To get the reduced seven-year period, the seventh taxable year in the recognition period must precede either 2009 or

2010. Thus, C corporations with built-in-gain property that elected S treatment in 2000-2002 are eligible for the reduced recognition period. *Act, Sec. 1261, amending I.R.C. §1374(d)(7)*. So, while the discount for built-in gain (as a percentage of the total built-in gain tax) in the S corporation was less than the discount for built-in gain for the C corporation, the difference may be attributable to the fact that post-election appreciation in value is ignored in an S corporation. Unfortunately, the court's opinion does not provide sufficient information to determine if the court properly accounted for this feature of S corporation taxation.

[15] 301 F.3d 339 (5th Cir. 2002).

[16] 507 F.3d 1317 (11th Cir. 2007).

[17] Estate of Jensen v. Comr., T.C. Memo. 2010-182 (on another note, the parties had stipulated to a 5 percent lack-of-marketability discount).

[18] Many states utilize the principles of equitable distribution in divorce cases. Under such principles, the court may distribute any assets of either the husband or wife in a just and reasonable manner. Any factor necessary to do equity and justice between the parties shall be considered. Technically, the tax consequences to each spouse are to be considered. However, the amount (or even the allowance) of a discount for built-in capital gains tax is not well settled.

[19] Smith v. Smith, 439 Pa. Super. 283, 653 A.2d 1259 (1995).

[20] Weaver v. Weaver, 72 N.C. App. 409 (1985) (improper for court to consider tax consequences as a distributive factor except where a taxable event has already occurred or the distribution ordered by the court will create immediate tax consequence to either of the parties involved); Wilkins v. Wilkins, 111 N.C. App. 541, 432 S.E.2d 891 (1993)(same); Harvey v. Harvey, 112 N.C. App. 788 (1993), 437 S.E.2d 397 (1993)(tax consequences not relevant in partnership liquidation setting).

[21] Stern v. Stern, 331 A.2d 257 (N.J. 1975); Orgler v. Orgler, 237 N.J. Super. 342, 568 A.2d 67 (1989); Goldman v. Goldman, 275 N.J. Super. 452, 646 A.2d 504 (1994), *cert. den*., 139 N.J. 185, 652 A.2d 173 (1994).

[22] Book v. Book, No. CK88-4647, 1990 Del. Fam Ct. LEXIS 96 (1990).

[23] Hudson v. Hudson, 399 S.E.2d 913 (W. Va. 1990); Bettinger v. Bettinger, 396 S.E.2d 709 (W. Va. 1990).

[24] *See, e.g.,* Kelley v. Kirk, 391 N.W.2d 652 (1986).

[25] In re Marriage of Drews, 153 Ore. App. 126, 956 P.2d 246 (1998).

[26] 507 F.3d 1317 (11th Cir. 2007).

[27] T.C. Memo 2009-21.

[28] T.C. Memo 2010-182.

[29] *See, e.g.,* Eisenberg v. Comr., 155 F.3d 50 (2d Cir. 1998) (for valuation purposes, relevant considerations include what a hypothetical buyer would consider to affect fair market value of the property under consideration for purchase; court did not rule explicitly, however, that a dollar-for-dollar discount for built-in capital gain was the appropriate amount of the discount). The IRS has acquiesced, at least in part, to the *Eisenberg* decision. *Acq. 1999-4 I.R.B. 4. The* Sixth Circuit has ruled similarly in an unpublished opinion (which cannot be cited as precedent). Estate of Welch v. Comr., No. 98-2007, 2000 U.S. App. LEXIS 3315 (6th Cir. 2000) (reversing the Tax Court's disallowance of a discount for built-in capital gains tax on the basis that the taxpayer could not establish that the corporation was likely to be liquidated or its assets were likely to be sold; case remanded for determination of appropriate discount).

[30] 301 F.3d 339 (5th Cir. 2002)

[31] 507 F.3d 1317 (11th Cir. 2007).

[32] T.C. Memo 2009-21.

[33] T.C. Memo 2010-182.

[34] Estate of Jelke III v. Comr., 507 F.3d 1317 (11th Cir. 2007), *cert. den.,* 129 S. Ct. 168 (2008).

[35] H.R. 436, The Certain Estate Tax Relief Act of 2009.