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Court Demands Net Asset Value Be Reduced by 100% of Built-In Capital Gain Tax Liability

"There has been substantial controversy regarding the appropriate treatment of embedded capital gains in determining the fair market value of interests in C corporations since the repeal of the General Utilities doctrine by the Tax Reform Act of 1986 (TRA '86)." The preceding is the first sentence in an article titled "Embedded Capital Gains in C Corporation Holding Companies," written by Z. Christopher Mercer, ASA, CFA and published in *Valuation Strategies* November/December 1998; and, it is as true today as it was some ten years ago. Hopefully, the United States Court of Appeals for the Eleventh Circuit decision on *Jelke v. Commissioner* will put an end to this controversy.[1]

As Chris mentions in his article, prior to TRA '86 investors were not much concerned with built-in capital gains in C corporations as it was possible for the corporation to distribute appreciated property to its shareholders without incurring any taxable income at the corporate level. TRA '86 required recognition of corporate level gains and losses on liquidating sales and on distributions of corporate property. At that point it became important to consider the built-in capital gain tax liability at the corporate level as it affects the value of the corporation.

In the years since TRA '86, the Tax Court has been inconsistent in the treatment of built-in gains tax liabilities, from no acknowledgement of this liability to consideration of 100% of the liability. Mercer Capital's position has always been that rational buyers will not negotiate pricing that does not recognize the full built-in gain tax liability and rational sellers cannot expect to receive more favorable pricing than that available through liquidating the asset holding entity (because buyers are assumed to have alternative investments available not inside a C corporation wrapper).[2]

The position is supported in Exhibit 2 of the 1998 article mentioned above. In this exhibit five alternative purchase options available to a buyer of appreciating assets are analyzed. The analysis shows that there are two ways to produce the best (and same) return to the buyer, no matter what the assumed holding period. They are the purchase of the asset in the market at market prices or the purchase of the stock of the asset holding C corporation for the market value of the assets held by that corporation less the entire built-in gain tax liability. The *Jelke*

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reversal recognizes this economic reality by demanding a reduction in the value of the company that is equal to the built-in capital gain tax liability at the valuation date.

The United States Tax Court opinion in the original *Estate of Jelke* case was filed May 31, 2005.[3] A brief summary follows:

> Decedent owned a 6.44% interest in a closely held C corporation (incorporated in 1922) whose assets consisted mainly of marketable securities. The corporation's primary investment objective was long-term capital growth, resulting in low asset turnover and large unrealized capital gains. In the five years prior to the valuation date, the net asset value increased at a compound annual growth rate exceeding 23% and the turnover in the portfolio averaged about 6% annually. The built-in capital gain tax liability for the corporation was approximately $51.6 million on the date of death.

The Estate contended that the market value of the corporation's holdings should be reduced by the entire amount of the built-in capital gain tax liability that would be due if all of the securities were sold on the valuation date.

The Commissioner admitted that there should be a reduction, but the potential tax liability should be discounted for time value as it would be incurred in the future rather than immediately. The Commissioner used the portfolio turnover rate during the last five years to arrive at a 16.8 year period over which the capital gain tax would be incurred, resulting in corporate taxes of approximately $3.2 million per year. Using a 13.2% discount rate (the average rate for large cap stocks from 1926 to 1998) he determined that the present value of the built in gains tax liability was $21.0 million.

The Court agreed with the Commissioner and held that the built-in capital gain tax liability should be discounted to reflect when it is reasonably expected to be incurred and that future appreciation of the securities need not be considered. The court held that the net asset value should be reduced by $21.0 million for the built-in capital gain tax liability, before consideration of minority and marketability discounts. The Estate appealed the tax court's decision regarding the built in capital gain. The United States Court of Appeals for the Eleventh Circuit heard the appeal and filed its opinion on November 15, 2007. A brief summary follows:

The Eleventh Circuit in *Jelke* presents a review of the case law prior to and after TRA '86 relating to built-in gains. In reviewing *Estate of Dunn v. Commissioner*, the Eleventh Circuit Court notes that in *Dunn:*

> ...the Fifth Circuit Court held, as a matter of law, that as a threshold assumption, liquidation must always be assumed when calculating an asset under the net asset value approach. The Fifth Circuit labeled as a 'red herring' the fact that no liquidation was imminent or even likely.

In their decision the Eleventh Circuit Court wondered why a willing buyer of an interest in the company would not adjust his purchase price to reflect the entire built-in gains tax liability, when the buyer could acquire in the market an identical portfolio with no exposure to the underlying tax liability. In endorsing the Fifth Circuit Court's approach in *Dunn*, the Eleventh Circuit states:

> This type of "economic reality approach" mimics the marketplace and places a practical, transactional overlay upon the proverbial willing buyer-willing seller analysis. It allows the issue to conform to the reality of the depressing economic effect that the lurking taxes have on the market selling price. The hypothetical willing buyer is a rational, economic actor. Common sense tells us that he or she would not pay the same price for identical blocks of stock, one purchased outright in the marketplace with no tax consequences, and one acquired through the purchase of shares in a closely-held corporation, with significant, built-in tax consequences.

The Eleventh Circuit then instructed the Tax Court to recalculate the net asset value of the company on the date of Jelke's death using a dollar-for-dollar reduction to net asset value of the total $51.6 built-in capital gain tax liability.

The dissenting judge wrote:

> By adopting and extending the arbitrary assumption rule of least effort from *Estate of Dunn v. Commissioner*, 301 F.3d 339 (5th Cir. 2002), the majority gives in to the judicial equivalent of the doctrine of ignoble ease. To avoid the effort, labor, and toil that is required for a more accurate calculation of the estate tax due, the majority simply assumes a result that we all know is wrong. We can do better than that. The tax court did.

We at Mercer Capital applaud the decision of the Eleventh Circuit Court. One can only hope the dissenting judge will make the effort to understand that from an economically rational point of view, the majority decision is the correct one.

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1 *Estate of Jelke et al v. Commissioner* (05-15549, US Court of Appeals for the 11th Circuit, November 15, 2007)

2 The underlying assumption in the 1998 articles is that buyers have a choice of acquiring appreciating assets either inside C corporations, or outside, in the normal markets for the assets. Subsequent to this article, we have become aware of certain markets where there is no availability of naked assets and the only assets available are inside C corporations. In these kinds of markets there tends to be a negotiated "sharing" of the embedded capital gains liabilities between buyers and sellers.

3 *Estate of Jelke v. Commissioner* (T.C. Memo 2005-131, filed May 31, 2005)

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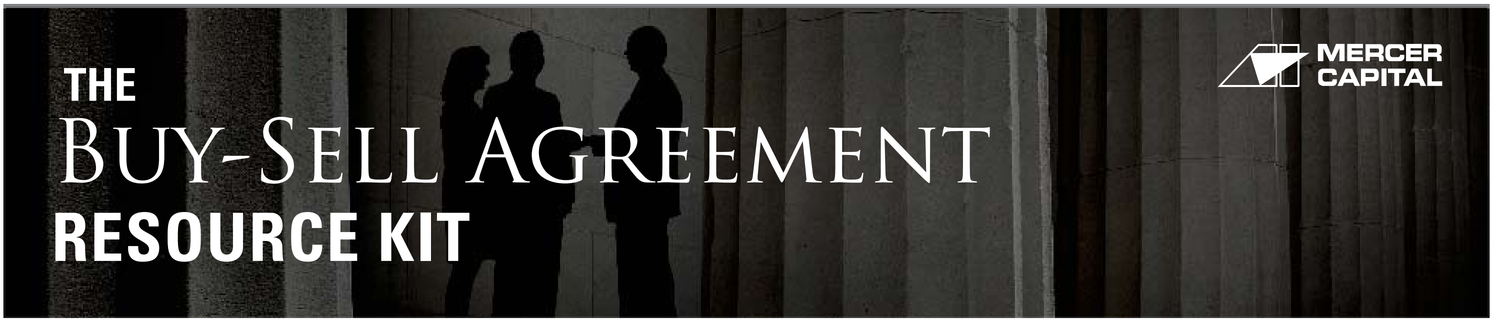

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