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Tax Court Clarifies Treatment in Built-In Gain

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How should potential income taxes on a corporation's built-in gain—that is, the excess of the fair market value of its assets over their tax basis—be taken into account in determining the fair market value of the stock of the corporation? This issue arises in many tax controversies, including valuation of property for estate and gift tax purposes, determination of gain required to be recognized by reason of distribution of stock of a subsidiary, and valuation of amounts received on a taxable exchange of securities.

Prior to enactment of the Tax Reform Act of 1986, courts often disregarded the corporate tax that might be imposed on a sale of assets of the corporation in determining the value of its stock, absent some evidence that an event that would trigger that tax was imminent.[1] This approach reflected Internal Revenue Code provisions that then provided several significant options for avoiding any tax at the corporate level on a sale of assets, particularly in the context of a corporate liquidation, even if the assets were sold to a third party for cash.

In 1986, however, the Code was amended to eliminate most of these opportunities for "nonrecognition" of gain by the corporation, even in the context of a complete liquidation.

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Within a few years of that change to the Code, it became generally accepted that the potential tax on the built-in gain of a corporation should be taken into account in determining the value of its stock, even if a liquidation or sale of assets was not imminent at the date of valuation, because a hypothetical willing buyer of the stock of the corporation, with reasonable knowledge of the relevant facts, would take some estimate of that tax into account in determining the amount the buyer was prepared to pay for the stock.[2]

However, it has been unclear whether the tax on the built-in gain should be taken into account as reducing the value of the stock on a dollar-for-dollar basis, to the full extent of the tax that would be imposed if the assets were sold at the time of valuation, an approach adopted by the Court of Appeals for the Fifth and Eleventh Circuits in *Estate of Dunn v. Commissioner* and *Estate of Jelke v. Commissioner*, or only to a lesser extent that takes into account, for example, the contingent nature of the liability and time-value-of money considerations.[3]

In a very recent memorandum decision, the Tax Court declined to follow the approach of *Dunn* and *Jelke*, but came close to the same result in upholding the discount for built-in gain sought by the petitioner.[4]

Jensen v. Commissioner

Marie Jensen created a revocable trust in 2003. The property of the trust included 82% of the stock of Wa-Klo, Inc. (Wa-Klo), a C corporation the principal asset of which was a parcel of land in New Hampshire and improvements used in operating a summer camp. The value of the stock of Wa-Klo on the date of Mrs. Jensen's death in 2005 was included in her estate for estate tax purposes.

A real estate appraiser calculated that the value of the land and improvements at the date of Mrs. Jensen's death was $3,300,000. Another appraisal firm then determined a net asset value for Wa-Klo as a whole, taking into account its other assets—mainly cash of approximately $935,000—and its liabilities, and determined discounts for (i) lack of marketability of the stock and (ii) a projected tax liability of $965,000 (calculated at a tax rate of 34%) by reason of a $2,800,000 built-in gain in the land and improvements.

The approach used to determine the value of the stock of Wa-Klo for estate tax purposes was the so-called "adjusted book value" method, under which the assets of a corporation are restated to fair market value and corporate liabilities are then subtracted to determine the corporation's net worth. An income-based methodology was not used, because the corporation did not generate substantial cash flows from its operation of the camp, summer camps of this nature were generally only modestly profitable at best, and operating performance in the last two years had declined.

In light of these circumstances, and taking into account as well the fact that the stock held by the trust represented a controlling interest (so that the trust would be in a position to direct whether or not the business of Wa-Klo would continue), the firm appraising the corporate stock determined that value would likely be maximized through a sale by the corporation of its assets. However, at the time of Mrs. Jensen's death, neither a sale of the stock of Wa-Klo nor a liquidation of its assets was imminent or planned.

The estate initially filed an estate tax return reporting a value of $2,600,000 for the estate's 82% interest in Wa-Klo, based on the appraisal of its shares described above, and then filed an amended return reporting a slightly lower value of $2,554,000.

Following an examination of the amended return, the IRS determined a much greater value for the estate's interest in Wa-Klo and a resulting estate tax deficiency of $333,000. The estate filed a petition for review of the deficiency in the Tax Court.

Before the Tax Court, the estate claimed that the value of the stock was even lower than had been reported in the estate tax return, on the theory that the tax that would be imposed on the corporation in connection with a sale of its assets should be computed at a tax rate of 40%, apparently reflecting estimated state as well as Federal taxes, rather than the 34% rate that had been used in the original appraisal. The estate argued, based on the Fifth and Eleventh Circuit decisions described above, that, taking into account the likelihood that the business of the corporation would not be continued, it was appropriate to deduct the entire amount of the estimated corporate tax liability in valuing the stock of Wa-Klo.

The government countered that the court to which *Jensen* was subject to appeal, the Court of Appeals for the Second Circuit, had opined in *Eisenberg v. Commissioner*[5] that a discount should be allowed by reason of built-in gain, but had remanded that case to the Tax Court for the computation of the appropriate discount. *Eisenberg* had been decided before *Dunn* and *Jelke*, and the Second Circuit had not since adopted the approach in those cases of allowing a discount equal to the full amount of the corporate tax that would be imposed upon a sale of assets.

The Tax Court agreed that it should not assume that the Second Circuit would adopt the full discount approach of the Fifth and Eleventh Circuits. However, the Tax Court also found fault with the discount calculation advocated by the government.

The government's expert offered information from studies of closed-end investment funds investing in various sectors of the economy (not limited to real estate), on the basis of which the expert sought to measure the extent to which the built-in gain of a fund was a factor in causing the value of its shares to be lower than the aggregate value of its assets.

The expert's analysis found built-in gains for closed-end funds ranging between 10.7% and 41.5% of net asset values, but no clear correlation between those gains and the differential between the value of shares in the fund and underlying asset values. On the basis of these findings, the expert concluded that built-in gains would be taken into account by buyers of shares of closely held corporations such as Wa-Klo only to the extent the built-in gain exceeded 41.5% of the asset values.

The court noted that closed-end funds tended to invest in diversified portfolios of stocks, real estate, or fixed income instruments associated with specific sectors not comparable to Wa-Klo's investment in a single parcel of property; and that the differential between asset values and share values of closed-end investment funds could be accounted for by a range of factors not relevant to Wa-Klo, such as the past performance of, and investor confidence in, a fund manager. Accordingly, the Tax Court found the analysis of the government's expert unconvincing.

The government also referred to various possible means by which the imposition of a corporate level tax might be avoided, such as through the election of S corporation status or a like-kind exchange within the meaning of section 1031.

The court noted, however, that such methods tended (for the most part) to defer, rather than to eliminate, the recognition of gain and had other limitations; accordingly the court was "not convinced" that any viable method existed for a hypothetical buyer to avoid the tax on the built-in gain. Thus, these possibilities did not justify a substantial reduction in the appropriate discount by reason of the built-in gain.

The court also faulted the analysis of the government's expert for failure to account for the likelihood that the assets of the corporation would appreciate (thereby increasing the built-in gain), or to take into account present value concepts.

The court concluded that a present value approach was applicable to determine the appropriate discount. Based on information provided by the petitioner's experts, the court thought it appropriate to calculate future values for the land and improvements based on a range of rates from 5.0% to 7.725% annually over a period of 17 years (apparently the average useful life of the real estate and related improvements), then calculated a tax based on a realization of those future values (and the same tax basis as at the valuation date) at the combined Federal and State tax rate of 40% agreed by the parties to be applicable, and then discounted the resulting tax liabilities back to the present at the same rates in the range of 5% to 7.725%.

This approach resulted in a computation of a discount for built-in gain within a range that was greater than the discount actually claimed by the estate before the Tax Court. Accordingly, the court ultimately accepted in full the estate's built-in gain discount for the stock of Wa-Klo.

Observations

The Tax Court here adopted an approach similar in result, but far from identical in concept, to the dollar-for-dollar discount approach of *Dunn* and *Jelke*. The Tax Court's approach has some serious conceptual and computational uncertainties.

For example, the opinion observes that neither party had provided information regarding a turnover rate for the assets of Wa-Klo; the court said that it was using 17 years as the relevant period on the theory that the average life of the asset s wa s about 17 years and that each asset would be retired once its useful life was exhausted. The merits of such an approach where the principal asset was land, and the land was apparently not being used for its most profitable use, seem questionable.

In short, it is unclear whether the Tax Court's approach in *Jensen* is any more likely to achieve an appropriate result in determining the appropriate discount for built-in gain in any particular circumstances than the approach taken by the Fifth Circuit and Eleventh Circuit in other cases, which assumed, in effect, that a buyer of stock of a corporation would value the stock on the assumption that the assets would be sold immediately and that the full tax that would be due on a sale would actually be incurred in the near term.

In any event, taxpayers should be pleased. At the same time, wariness is appropriate, as the potential for different projections of future growth in value and appropriate time horizons for a disposition, based on variations in facts and circumstances, may increase or sharply curtail the appropriate discount for built-in gain under the approach described in *Jensen*.

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1 See, e.g., *Ward v. Commissioner*, 87 T.C. 78 (1986).

2 See, e.g., *Eisenberg v. Commissioner*, 155 F.3d 50 (2d Cir. 1998). Even if a buyer intended to continue the activities of the corporation, a low tax basis for its assets would result over time in smaller depreciation and amortization deductions and, therefore, in larger corporate tax liabilities than would be the case if the assets' tax bases were equal to their fair market value at the time of the purchase of the stock.

3 *Estate of Dunn v. Commissioner*, 301 F.3d 339 (5th Cir. 2002), reversing and remanding RIA TC Memo ¶2000-12; and *Estate of Jelke v. Commissioner*, 507 F.3d 1317 (11th Cir. 2007), vacating and remanding RIA TC Memo ¶2005-131.

4 *Jensen v. Commissioner*, Dkt. no. 25681-08 (Aug. 10, 2010).

5 Note 3 *supra*.