CASE LAW UPDATE
Built-in Gains Tax in C Corporation Holding Companies

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In 1998, two landmark decisions were rendered regarding the treatment of built-in capital gains taxes in valuing interests C corporations.

Prior to the Tax Reform Act of 1986 (TRA '86), a C corporation could avoid a corporate level capital gains tax by effecting a transfer of corporate assets with built-in gains to shareholders who, in turn, would record the transfer at a stepped up basis. This procedure was based on the General Utilities doctrine, which originated in General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935).

However, with the passage of TRA '86, Congress repealed the General Utilities doctrine. Since that time, many professional business appraisers have been of the opinion that imbedded capital gains and associated potential tax liabilities should be considered in valuing interests in C corporations at least in cases where liquidation scenarios were considered relevant or major asset dispositions likely. The logic of their position was straightforward. If capital gains taxes would likely be paid in the future, a fair market value investor would account for them in some fashion. By extension, some appraisers factored the full effect of potential capital gains taxes into all of their asset based calculations whether liquidation was considered probable or not.

The IRS position has been to reject the premise that imbedded capital gains affect fair market value in all but very limited circumstances. Specifically, they have argued that unless a corporate liquidation is probable, there should be no adjustment in value for built-in taxes. All other liquidation scenarios and resultant capital gains are considered "speculative" and, as such, should not impact value today. Additionally, the Service has offered arguments that capital gains taxes at the corporate level can be avoided if a C corporation makes an S election and holds the assets for ten years. This possibility, the IRS has stated, adds to the speculative nature of the hypothetical corporate taxes.

Estate of Davis v. Commissioner

In Davis, Judge Carolyn P, Chiechl, of the U.S. Tax Court, reversed more than a decade of rulings that have generally favored the IRS position:

> *"Me ... find that... a willing buyer and… a willing seller of.. the blocks of stock at issue would have agreed on a price on the valuation date at which each block would have changed hands that was less than the price that they would have agreed upon if there had been no... built-in capital gains tax as of that date.*
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> *In the present case... we have found that in determining the fair market value on the valuation date... it is necessary to apply a discount or adjustment attributable to... built- in capital gains tax because that is what a hypothetical willing seller and a hypothetical willing buyer would have done under the facts and circumstances existing on that date."*

The basic facts in the Davis case were as follows:

- Artemus D. Davis, the decedent, made 2 gifts of 25 shares each in the common stock of a holding company called A.D.D. Investment and Cattle Company (ADDI&Q, representing separate 25.8% interests of the 97 shares outstanding as of November 1992.

- Among other assets, ADDI&C owned a block of stock of WinnDixie Stores, Inc., with market value as of the appraisal date of approximately $70 million. The cost basis in the stock was $338,000. Davis was a founder of WinnDixie, and ADDI&C was incorporated in 1947.

- The company's net asset value was approximately $80.1 million. The imbedded capital gain was $70.9 million (after giving effect to a loss carry forward of $1.6 million). The stipulated tax rate was 37.63%, resulting in a tax liability of $26.7 million.

- A gift tax return was timely file d. In it, decedent reported that the value of each of the two25 share blocks of ADDI&C was $7,444,250 on the valuation date. (Both petitioner and respondent later modified their market value claims to $6,904,886 and $13,518,500, respectively.)

- The IRS, in a notice of deficiency, stated that the value of each block on the valuation date was $12,046,975.

In this case the IRS, relying on several cases denying the capital gains tax discount both before and after the repeal of the General Utilities doctrine, sought to deny any reduction in value for the imbedded capital gains and resultant taxes. The Service claimed that as a matter of law, no discount or adjustment attributable to ADDI&C's built-in capital gains was allowable. Among the cases cited were Ward v. Commissioner, 87 TC.78, 104 (1986); Estate of Andrews v. Commissioner, 79 TC. 938, 942 (1982);, Estate of Piper v. Commissioner, 72 TC. 1062, 10861087 (1979); Estate of Crulkshank v. Commissioner, 9 TC. 162, 165 (1947); Estate of Luton v. Commissioner, TC Memo. 1994539, 68 T.C.M. (CCH) 1044, tO52 (1994); Estate of Bennett v. Commissioner, T.C. Memo. 199334, 65 TC.M. (CCH) 1816, 1825 (1993).

The Court rejected this position noting that all but two of the cases (Luton and Ford) involved valuation dates prior to the repeal of the General Utilities doctrine. Moreover, the Court noted that with the exception of Luton, none of the experts who testified in any of the aforementioned cases considered built-in capital gains tax as a factor in appraising any of the stock interests at issue in those cases. (In Luton, one of the taxpayer’s experts, but not respondent's expert, reduced the value of the subject interests for capital gains taxes that would have been paid on liquidation). The Court noted that in the remaining cases, the taxpayers (not their experts) argued for the full amount of the capital gains-related reductions.

In an interesting twist, the judge affirmed that the Court had denied in each of these cases the taxpayer's requests for a reduction in valu e equal to the full amount of such capital gains taxes where there was no evidence as of the respective valuation dates that a liquidation of the Corporation

In question was planned or contemplated. In Davis, the judge noted two important distinctions: first that all three of the experts in the case (including the IRS' expert) recognized that a diminution in value existed because of the built-in capital gains tax; second that there were two different approaches used by the experts to account for the effect of the tax on value.

In the first approach, one of the three experts deducted the full amount of the tax in determining the value of the blocks. In the second approach, the two remaining experts, one for the petitioner and the one for the IRS, gave effect to the tax by increasing the size of the discount for lack of marketability applied to the two blocks. Importantly, both of these experts recognized a reduction in value that was less than the full amount of the tax. The Court rejected the first approach, citing precedent. However, it embraced the second approach:

> *"We are... in agreement with petitioner's expert and respondent's expert that... it is not appropriate in valuing each of the two blocks... to apply a discount or adjustment equal to the full amount of... built-in capital gains tax. Nonetheless,... we find that on the valuation date there was even less of a ready market for each of the two blocks because of ADDI&C's built-in capital gains tax than there would have been without such a tax. We thus agree... that such a discount or adjustment should be part of the lack of marketability discount that the parties and a// of the experts concluded should be applied in that valuation process."*

A significant footnote to the decision points out that a hypothetical willing buyer and a hypothetical willing seller would certainly be aware of the ability to buy WinnDixie stock in the open market without ADDI&C's built-in capital gains taxes being applicable to the stock. That knowledge would have affected the price of ADDI&C's shares.

With regard to the IRS position that the built-in capital gains tax could be avoided if the Company elected S corporation status, the Court also rejected that argument. It agreed with two of the three arguments put forth by one of the petitioner's expert's: (i) it was improper to assume that the Company would have been able to make an S election because it would have impermissibly limited the hypothetical willing buyer of the two blocks to certain individuals and entities who were permitted to be S corporation shareholders; and (ii) the assumption that none of the Company's assets would be sold for ten years would have reduced the marketability of each block, and such a requirement would have made it unlikely that the Company's shareholders would have consented to an S election. The Court further stated:

"Based on the record before us, we reject respondent's unwarranted assumptions that ADDI&C's could have avoided all of ADDI&Cs built-in capital gains tax by having it elect S corporation status... "

The Davis court mentioned on numerous occasions that its decision was based on the record before it, and that somehow Davis was different than the earlier cases. However, the court failed to state what those differences were. 'Was it the fact that the built-in capital gains and resultant taxes were so large? Was it because most of the capital gain was attributable to the corporation's largest holding, or that the holding happened to be stock in a publicly traded company with a readily observable market value? Perhaps it was the fact that the IRS's own expert conceded the applicability of the discount for built-in capital gains. These and other questions will undoubtedly be addressed in future cases.

Eisenberg v. Commissioner

In August 1998 the U.S. Court of Appeals, Second Circuit reversed the U.S. Tax Court decision in Eisenberg v. Commissioner and allowed a discount from net asset value to reflect potential capital gains taxes for a C corporation that held a building in Brooklyn, New York as its main asset. The Appeals Court remanded the case to the Tax Court to determine the gift tax liability taking into consideration the potential built-in capital gains tax.

- Irene Eisenberg, the petitioner, made gifts of all 1,000 issued and outstanding shares of stock in Avenue N Realty Corp. in three separate transfers, in the years 1991, 1992, and 1993. The shares were divided among her son, granddaughter, and grandson.

- The corporation received income only from rents generated by the building. Both parties agreed that the net asset value method was appropriate for the valuation of the stock of the corporation for gift tax purposes. They also agreed on the fair market value of the property, and the valuation of shares as reported in the Federal gift tax returns.

- The petitioner filed Federal gift tax returns on a timely basis for the three years involved. The petitioner received a notice of deficiency from the IRS on July 18, 1995.

- The parties agreed that the corporation would have recognized capital gains of $530,500, $402,094, and $402,892 for the year's 199t, t992, and 1993, respectively, if the property had been sold.

- The parties disagreed on whether adjustments should be made to the net asset value to reflect costs that potentially would be incurred if its assets were liquidated.

- The petitioner contended that for gift tax purposes she is entitled to take into account the full amount of capital gains taxes to reduce the fair market value of the stock of the corporation.

As in the Davis case, the petitioner argued that a willing buyer of the stock would have discounted the fair market value because of the tax liability inherent in the property. The IRS argued that the petitioner was not entitled to discount the value since there was no liquidation, distribution, or sale of the stock at the transfer dates. The petitioner stated that any willing buyer of the corporate stock, having reasonable knowledge of the capital gains taxes, would reduce the price paid for the stock by the full amount of the tax, and that the amendments made by TRA '86 justified the allowance of a discount for potential taxes.

In overturning the decision of the Tax Court, the Court of Appeals noted that IRS reliance on cases that were decided prior to TRA '86 should no longer continue, as the law had effectively closed the option to avoid capital gains taxes at the corporate level. The Court also cited Estate of Davis v. Commissioner, emphasizing that its concern was not whether the donees would liquidate the property, "...but what a hypothetical buyer would take into account in computing the fair market value of the stock." As in Davis, the Court said that a full deduction of the tax liability might not be considered, but it clearly supported an adjustment:

> *"... We believe that an adjustment for potential capital gains tax liabilities should be taken into account in valuing the stock at issue in the closely held C corporation even though no liquidation or sale of the Corporation or its assets was planned at the time of the gift of the stock. "*

In conclusion, there are now two cases that clearly support the use of a valuation adjustment for stock in C corporation holding companies for imbedded capital gains liabilities when using the asset-based approach. The Court also has made clear its opinion that reliance on pfe1986 cases is not valid for this particular issue related to imbedded gains. Additional work needs to he done to support the size of the valuation adjustment. As we saw in these two cases, the Courts did not support an adjustment for the full amount of the tax thus far.