JELKE: SIMPLICITY IN VALUATION OF
CLOSELY HELD INVESTMENT COMPANIES

By

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The Eleventh Circuit's decision in *Jelke*[1] lays down a simple rule for valuation of corporate stock in closely-held investment companies. At issue is the extent to which built-in capital gain tax liability should be taken into account. In reaching its decision, the Court provides, in an easy to read, well written opinion, a short history of valuation of investment companies. The Eleventh Circuit assumes that such corporations will always be liquidated on the date of death, and the tax liability paid, thus requiring a reduction of value by 100% of the tax attributable to the built-in capital gain, and providing an easy to understand method of valuation, similar to that mandated by the Fifth Circuit in *Dunn*[2] But the dissent in the present case provides good reasons for caution against relying on the majority decision.

<u>Background Facts.</u> Mr. Jelke died in March of 1999 owning a 6.44% interest in Commercial Chemical Company ("CCC"). CCC's only business was making investments in marketable securities, which were worth $178 million. If the securities were liquidated, a $51 million tax liability would be created. CCC had a long history of producing dividends and appreciation yielding an average of 23% per year, and the company had no plans to liquidate.

<u>Positions of the Parties; Tax Court's Decision.</u> The estate took the position that the net asset value of CCC should be reduced dollar for dollar by the built-in capital gain tax liability, as though CCC were liquidated. The IRS's expert, in the trial at the Tax Court[3], computed an average turnover rate of the investments inside CCC of 5.95% per year, which meant that the sale of all of the holdings would take 16.8 years. Based on that long span of time, the Service gave no discount for built-in capital gain.

The Tax Court disagreed with both sides, saying that a $0 discount for built-in capital gain was not appropriate, and likewise neither was a dollar for dollar discount. Instead, the Tax Court reasoned that Jelke's 6.44% interest was too small to compel a liquidation. And because management had no plans to liquidate, and also because CCC's long history belied the idea of any impending liquidation, the Tax Court reasoned that the liability should be spread over the anticipated time to sell off the securities, and then discounted back to present value. Ultimately, the Tax Court concluded that a $21 million reduction for built-in capital gain was appropriate[4].

<u>History of the Issue.</u> The Eleventh Circuit pointed to the Supreme Court decision in *General Utilities*[5] in 1935 where the court said that a C corporation did not recognize

taxable income at the corporate level on the distribution of appreciated property to its shareholders. That created what became known as the "General Utilities doctrine" which stood for 51 years until Congress passed the Tax Reform Act of 1986. That statute, among other things, repealed the General Utilities doctrine and made asset distributions taxable.

From 1935 to 1986, the case law did not allow for discounts for built-in capital gain when a sale or liquidation was neither planned nor imminent. The courts deemed the imposition of tax too uncertain, remote or speculative. In only one case did the facts show that a sale was imminent[6] and there a discount was allowed.

Having said that it was possible for a corporation to avoid any income tax liability at the corporate level by simply distributing appreciated property to its shareholders, the Eleventh Circuit reasoned that the repeal of the General Utilities doctrine superseded the case law. "[N]o corporate tax would have been required to be paid and no discount who have been allowed."

With the repeal of the doctrine, courts began to recognize the possibility of discounts related to built-in capital gains. But for the next 12 years, the Service steadfastly denied the discount while agreeing that it was allowable in theory, unless the taxpayer could prove that liquidation was imminent[7].

But the *Davis*[8] case began to change all of that. While no liquidation or sale was planned, the Tax Court used an economic reality theory to say that a hypothetical buyer and seller would not have agreed on a stock price that did not take into account the corporation's built-in capital gain.

Even though the Tax Court did not give a built-in capital gain discount, the decision opened the door. And the Second and Sixth Circuits peeked in. In the *Eisenberg*[9] case, the Second Circuit said that the requirement of imminent sale or liquidation was unnecessary. That court remanded the case back to the Tax Court for a determination of the discount.

Then came the *Welch*[10]case in which the Sixth Circuit remanded a case back to the Tax Court where the lower court had found no discount for built-in capital gain.. The Sixth Circuit instructed the Tax Court to re-determine the fair market value of the stock, taking into account the built-in capital gain.

In both the *Eisenberg* case and the *Welch* case, there is language that suggests that a dollar for dollar discount might not be appropriate.

Then came the two Fifth Circuit decisions in *Jameson*[11] and *Dunn*.[12] In *Jameson*, the court said that using a method which took into account the length of time over which assets might be liquidated actually required an assumption that the buyer was a "strategic" buyer who would continue to operate the company. That position is contrary to the notion of the "hypothetical" buyer.

In *Dunn*, the Fifth Circuit went further, finding that even if the share interest would not be large enough to force liquidation, a sale must always be assumed to occur immediately. The *Dunn* decision said that claiming that no liquidation was planned is a red herring.

Turning to the amount of the discount, the Fifth Circuit said that the hypothetical buyer of an investment company would be predisposed to buy stock to gain control for the sole purpose of acquiring the underlying assets. And in acquiring assets from a C corporation, the built-in capital gain liability would be precipitated. As a result, 100% of that cost should be taken into account.

The Eleventh Circuit found Dunn persuasive. It concluded that a willing buyer would not pay full price for the CCC stock when that same buyer could go buy an identical portfolio for $51 million less, and without risk of exposure to built-in capital gains tax. The court went on to say that the size of the stock interest, and whether it could force a liquidation, is irrelevant, because the assumption always will be made that liquidation will occur.

The court called the IRS's approach "fluidly ethereal" requiring "hunt-and-pack forecasting." The court went on to say:

> "In reality, this method could cause the Commissioner to revive his 'too speculative a tax' contention made prior to Estate of Davis in 1998. This methodology requires us either to gaze into a crystal ball, flip a coin, or, at the very least, split the difference between the present value calculation projections of the taxpayers on the one hand, and the present value calculation projections of the Commissioner, on the other."

On the other hand, the court said its approach avoided the crystal ball and coin flip and provided certainty and finality to the "vague and shadowy" world of valuation. In addition, it would bypass the unnecessary expenditure of judicial resources being used to wade through a myriad of divergent expert witness testimony, and substitute for that a practical and theoretically sound approach to the issue.

The Dissent. Judge Carnes wrote the dissent, and minced no words in his rebuke of the majority opinion. The underlying thread of his opinion was that the court was shirking its duty and seeking an easy way out instead of dealing with reality.

The practical reality, according to Judge Carnes, was that CCC had no plans to liquidate. He said it would be economically foolish to liquidate a company that was producing an average annual return of more than 23%. And while the buyer would adjust his price downward to reflect the liability, the seller could not be expected to agree to a price that ignored completely the time value of money. Even though the IRS's approach was more complicated, Judge Carnes said it would produce a result closer to the actual value.

Judge Carnes finished off his criticism of the majority opinion by making light of the notion that their methodology would "provide certainty and bypass the unnecessary expenditure of judicial resources." He argued why not extend it to other areas, such as the computation of lost future earnings in a tort case? And then mocking the majority's references to coin flips and prophesying, Judge Carnes cited Justice Oliver Wendell Holmes in *Ithaca Trust Co. v. United States*[13] where he said:

> [T]he value of property at a given time depends upon the relative intensity of the social desire for it at that time, expressed in the money that it would bring in the market. Like all values, as the word is used by the law, it depends largely on more of less certain prophecies of the future, and the value is no less real at that time if the later the prophecy turns out false than when it comes out true.[14]

<u>Conclusion.</u> For practitioners in the 5th and 11th Circuits, the Jelke and Dunn decisions are very taxpayer friendly, and may be considered a windfall. The end result in the Second and Sixth Circuits, which hinted at a contrary result, is yet to be seen. And whether these cases would create enough "uncertainty" that Treasury would try writing regulations to dictate a different result[15] remains to be seen.

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[1] *Estate of Frazier Jelke, III, Deceased v. Commissioner*, 507 F.3d 1317, U.S. App. LEXIS 26477, 2007-2 U.S. Tax Cas. (CCH) P60,552; 100 A.F.T.R.2d (RIA) 6694; 21 Fla. L. Weekly Fed. C 188 (11th Cir. 2007)
[2] *Estate of Dunn v. Commissioner*, 301 F.3d 339 (5th Cir. 2002)
[3] *Este of Jelke v. Commissioner*, 89 T.C.M. (CCH) 1397 (2005)
[4] The parties also differed over the issues of discounts for lack of control and lack of marketability. The estate claimed 20% for lack of control and 35% for lack of marketability. The Tax court allowed 10% and 15%, respectively. The Eleventh Circuit did not disturb the Tax Court's finds on those issues, saying that
[5] *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935)
[6] *Obermer v. United States*, 238 F.Supp. 29 (D.Haw. 1964)
[7] See *Estate of Gray v Commissioner*, 73 T.C.M. (CCH) 1940 (1997)
[8] *Estate of Davis v. Commissioner*, 110 T.C. 520 (1998)
[9] *Estate of Eisenberg v. Commissioner*, 155 F.3d 50 (2d Cir. 1998)
[10] *Estate of Welch v. Commissioner*, (unpublished) 203 F.3d 213 (6th Cir. 2000)
[11] *Estate of Jameson*, 267 F.3d 366 (5th Cir. 2001)
[12] *Estate of Dunn v. Commissioner*, 301 F.3d 339 (5th Cir. 2002)
[13] *Ithaca Trust Co. v. United States*, 279 U.S. 151
[14] Id. at p. 292
[15] See the proposed regulations to Section 2053, which would negate taxpayer friendly decisions in four circuits in favor of a contrary approach in only one circuit.