Estate of Jensen v. Commissioner, T.C. Memo. 2010-182 (August 10, 2010)

"Built-In Gains Discount" Allowed in Valuing C Corporation Based on Present Value Analysis of Corporate Income Tax Liability on Eventual Sale of Assets, Taking Into Consideration Anticipated Future Appreciation in Corporate Assets

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Synopsis

The built-in gains tax discount was determined under a present value discounting approach. The case is appealable to the Second Circuit, and the court refused to speculate on whether the Second Circuit will use a "dollar for dollar" approach for determining the built-in gains tax discount that has been adopted by the Fifth and Eleventh Circuits. The court rejected the IRS appraiser's approach of analogizing to closed-end funds, which would have disallowed any built-in gains discount to the extent that the built-in gains tax was less than 41.5% of the corporation's net asset value. The court made its own present value analysis, assuming equal growth rates and discounts under two scenarios (5% in one and 7.5% in the other). Not surprisingly, the court's calculation was very similar to the dollar-for-dollar discount based on the amount of built-in gains tax at the date of death (because the assumed appreciation in the assets and the capital gains tax was offset by the assumed discount to present value when the factors were the same).

Basic Facts

1. Decedent died with a revocable trust that owned 82% of a C corporation, the primary asset of which consists of appreciated real estate and improvements used as a summer camp. If the assets had been sold on the date of death, there would have been a built-in long term capital gains tax to the corporation of approximately $1.1 million. (The liability was initially estimated at $965,000 but the estate on brief claimed a built-in gains tax of $1,133,283.) At the date of death, a sale or liquidation of the corporation or its assets was not imminent or planned.
2. The IRS on audit allowed a 5% lack of marketability discount and a discount of $250,042 for built-in capital gains tax. Eventually, the parties agreed to a 5% lack of marketability discount (there is no discussion in the case as to why the agreed lack of marketability discount was so low), and the only issue for the court was the amount of built-in gains tax discount.

Holding

The built-in gains tax discount is determined (by Judge Vasquez) based on a present value analysis, taking into consideration anticipated future appreciation in the corporate assets over an estimated 17-year holding period after the date of death. The court rejected the IRS appraiser's approach of analogizing to closed-end funds, which would have disallowed any built-in gains tax discount to the extent that the built-in gains tax was less than 41.5% of the corporation's net asset value. Instead, the court calculated a present value built-in gains tax discount of about $1.2 million under several different scenarios, and therefore allowed the full $1,133,283 built-in gains tax "dollar-for-dollar" discount requested by the estate.

Analysis

1. <u>Taxpayer's Expert</u>. The estate's expert calculated the built-in gains tax based on the difference between the fair market value of the real estate at the date of death less the estimated tax basis times a 34% tax rate plus a small tax increase for income over $100,000. The calculation was:

   [$3,300,000 (FMV) - $500,000 (basis)] x 34% + $13,000 (tax increase for income over $100,000) = $965,000.

The estate’s brief subsequently requested a discount of $1,133,285 for state and federal tax. [Observe: the additional $168,000 equals the amount of the $2.8 million gain times 6%, which is approximately the amount of the state income tax. The parties agreed that the combined state and federal income tax rate was 40%.]

The estate's appraiser calculated that a dollar-for-dollar discount was appropriate because “[t]he adjusted book value method is based on the inherent assumption that the assets will be liquidated, which automatically gives rise to a tax liability predicated upon the built-in capital gains that result from appreciation in the assets.” The appraiser also noted that the Estate of Dunn Fifth Circuit case allowed a dollar-for-dollar discount.

2. IRS Expert. The IRS expert used a novel approach of examining the amount by which built-in gains tax exposure to each of six closed-end funds depressed their values in relation to their net asset values. The built-in gains tax exposure did not exceed 41.5% of the net asset value for any of the six funds. The expert found no direct correlation between higher exposure to built-in gains tax to the discounts for net asset value for the funds. Therefore, the expert concluded that no built-in gains tax discount should be allowed to the extent that the built-in gains tax did not exceed 41.5% of the net asset value.

   The expert “opined that full consideration (i.e., a dollar-for-dollar discount) should be given” for the built-in gains tax that exceeded 41.5% of the net asset value.

   To support its conclusion of allowing a discount of about 50% of the built-in gains tax, the expert opined that there are methods to avoid paying the built-in gains tax by engaging in a § 1031 like kind exchange or converting to an S corporation (while acknowledging that there are limits and restrictions on those methods).

3. Burden of Proof. The court's conclusions were based on a preponderance of the evidence so the court did not address whether the burden of proof shifted to the IRS.

4. Dollar-for-Dollar Discount. The Fifth (Estate of Dunn) and Eleventh (Estate of Jelke) Circuits have allowed dollar-for-dollar discounts of the built-in gains tax (i.e., 100% of the built-in gains tax based on the amount of gain in the corporation's assets at the date of death.)

   This case is appealable to the Second Circuit, and a Second Circuit case, Estate of Eisenberg (1998), was one of the first cases to allow any built-in gains tax discount after the repeal of the General Utilities doctrine. Indeed, that was the case in which the IRS, by its acquiescence (1999-1 C.B. xix), acknowledged that a discount for built-in gains tax may be applied in appropriate circumstances. Eisenberg did not address whether the discount should be dollar-for-dollar, but the estate argued that the Second Circuit will do so when it next addresses the issue, in light of the Fifth and Eleventh Circuit opinions that were decided after Eisenberg. The court refused to speculate on what the Second Circuit will do, and did not address whether a dollar-for-dollar discount should be allowed based on date of death values. (Instead, as discussed below, the court applied a present value analysis based on its estimate of future circumstances, the result of which was basically a dollar-for-dollar discount.)

5. Rejection of Closed-End Funds Approach and Minimizing Discount Because of Alternate Methods to Avoid Payment of the Built-In Gains Tax. The closed-end funds reviewed by the IRS expert were not comparable to the real estate owned by the corporation. Closed-end funds invest only indirectly in real estate (such as with real

estate investment trusts) and hold various types of real estate. Also, discounts for closed-end funds are attributable to various factors (including manager or fund performance) and the built-in gains tax effect cannot be estimated.

After reviewing the limitations and restrictions on the possible avoidance (really deferral) methods, the court was "not convinced that a viable method for avoidance of the built-in LTCG exists for a hypothetical buyer" of the corporation's stock. The court concluded that the possible avoidance methods would not significantly reduce the discount for built-in gains tax.

In sum, "we do not give much weight to respondent's expert's valuations."

6. Present Value Approach to Determine Built-In Gains Discount. Footnote 13 observes that the Tax Court "has frequently applied a present-value approach based on all the facts and circumstances . . . to determine the taxpayer's discount for the built-in tax liability" (citing Estate of Litchfield, Estate of Jelke, Estate of Borgatello, Estate of Dunn, and Estate of Jameson.)

   The court calculated estimated future values of the land and related improvements under two assumed scenarios: using a 5% appreciation rate (the rate of appreciation assumed in the taxpayer's separate real estate appraisal) and using a 7.5% appreciation rate (based on pre-tax return of income data in the taxpayer's expert's report). It assumed assets would be sold in 17 years. (There was no evidence of what turnover rate was anticipated. The court looked to the "average useful or depreciable life" based on the depreciation figures used in the taxpayer's real estate report.)

   The amount of built-in gains tax based on those appreciated values in 17 years was determined by multiplying the assumed appreciated values by a 40% tax rate. The resulting tax amounts were discounted to present value using a discount rate equal to the assumed appreciation rate. There was no discussion by the court as to how the discount rate was chosen and why the discount rate should equal the assumed rate of appreciation.

   The court's calculation resulted in a built-in gains tax having a present value of $1.23 million and $1.26 million under its two scenarios. Each of these exceeded the estate's request for a 1.13 million discount, so the estate's requested discount was allowed. The end result was that the court allowed a dollar-for-dollar built-in gains tax discount in light of the way it calculated the present value of the built-in gains tax.

Observations

1. Present Value Approach. There are two general approaches for calculating the built-in gains discount. First, a dollar-for-dollar approach is allowed in the Fifth and Eleventh Circuits. (Estate of Dunn, 301 F.3d 339 (5th Cir. 2002); Estate of Jelke III, 507 F.3d 1317 (11th Cir. 2007), cert. denied (2008). (In Estate of Jelke, the court observed (in footnote 38) that in Simplot, 112 T.C. 130, 166 n.22 (1999) rev'd on other grounds, 249 F.3d 1191 (9th Cir. 2001), the IRS presented an expert witness who concluded that, when valuing a closely held corporation's interest in publicly traded stock, full recognition of built-in capital gains was appropriate.) Second, other courts have applied a present value analysis, considering when the corporation might sell appreciated assets and determining the present value of the additional corporate level capital gains costs. This case follows the trend of prior Tax Court cases of estimating the present value of the

eventual built-in gains tax. The cases have made that present value determination in different ways, but the clear trend in the Tax Court, so far, is to use a present value approach rather than just allowing a dollar-for-dollar discount. (In Estate of Litchfield, the court specifically observed in footnote 10 that the expert did not apply a dollar-for-dollar discount and that the court did not need to decide if that approach "would be appropriate in another case where that argument is made.")

2. Consideration of Future Appreciation. There is no consistency in the cases as to whether future appreciation should be considered in the present value analysis. On one hand, the corporation is being valued as of a particular valuation date, and arguably neither increased liabilities nor increased asset values should be taken into account. On the other hand, a purchaser buying a corporation with appreciating assets will have to incur a second level capital gains tax on future appreciation that a purchaser of directly owned assets will not have to bear. As a result, prospective purchasers presumably will pay less for the corporate interest that would be subject to the additional tax on future appreciation, and an adjustment should be made in some manner with respect to the built-in gains tax attributable to future appreciation.

a. Cases Rejecting Consideration of Subsequent Appreciation.

In Estate of Bailey (T.C. Memo. 2002-152), the IRS expert made various assumptions in its present value analysis of the built-in gains tax, including an assumed growth rate of 2%, a discount-to-present value rate of 8%, and an assumed 5-year holding period. The court did not specifically comment about considering future appreciation, but just concluded that the expert "offered no explanation or support for any of the many assumptions that he utilized" and found the report unpersuasive.

The Tax Court in Estate of Jelke (T.C. Memo. 2005-131, Judge Gerber) specifically rejected the taxpayer's expert's argument that if a present value approach is used, there should a consideration of "a long term projection... that the stock will appreciate" and that "[i]f the stock appreciates, the capital gains tax liability will appreciate commensurate [sic]." The court responded:

> "If we were to adopt the estate's reasoning and consider future appreciation to arrive a subsequent tax liability, we would be considering tax (that is not "built in") as of the valuation date. Such an approach would establish an artificial liability. The estate's approach, if used in valuing a market-valued security with a basis equal to its fair market value, would, in effect, predict its future appreciation value and the tax liability and then reduce its current fair market value by the present value of a future tax liability."

The taxpayer in Jelke pointed out that the IRS experts, in several other cases, have considered future appreciation in determining the present value of the built-in gains tax. In Estate of Borgatello, the IRS expert used assumed future appreciation in its determination of the built-in gains discount, and the court used a compromise between the positions of the IRS's and taxpayer's experts. In Estate of Bailey, the IRS expert similarly assumed future appreciation in its analysis, but the court rejected that expert's approach as being unpersuasive. The Tax Court in Jelke responded that it was not bound to follow the same approach used by experts in other cases, and that even in Borgatello, "the expert's approach does not represent the ratio decidendi of the case." [*Ratio decidendi? I'm impressed. Remember that term for cocktail party discussions.*] Of course, keep in mind that the Eleventh Circuit eventually reversed the Tax Court, holding that a dollar-for-dollar discount is appropriate. 507 F.3d 1317. The Eleventh Circuit took note of the taxpayer's concern about not taking into consideration future appreciation: "The estate attacks this approach on the basis that it is incomplete and inconsistent, as over this 16-year period, CCC's securities could appreciate in value, increasing tax payments and obviating the need to reduce built-in capital gains by present value principles. The same could be true if the assets were to depreciate in value over the projected period." Id. n.9.

b. Cases Supportive of Considering Subsequent Appreciation.

In Estate of Borgatello (T.C. Memo 2000-264, Judge Wells), the IRS expert's approach of determining the built-in gains tax discount was to use a present value approach, assuming that the corporation's assets would have a 2% growth rate, that the assets would be held for 10 years before being sold, and that the resulting built-in gains tax at the end of 10 years would be discounted to present value at 8.3% (the long term applicable federal rate + 2% for added risk). This approach resulted in a 20.5% built-in gains tax discount (discount to net asset value). The taxpayer's expert used a dollar-for-dollar discount, resulting in a 32.3% discount to net asset value. The court concluded that there was not much support for the government's contention that a buyer would wait 10 years before liquidating the assets and reached a middle ground of using a 24% discount to net asset value. (This represented about 74.3% of the dollar-for-dollar built-in gains tax based on the amount of gain at the date of death.) The court did not have any discussion whatsoever of whether it was appropriate to assume a future growth of the assets in applying the present value analysis, but took into account the IRS's expert's conclusion (based on considering future growth of the assets) in reaching an eventual compromise amount of the appropriate discount.

In Estate of Dailey (T.C. Memo. 2001-263, Judge Foley), one of the IRS's experts acknowledged that he would take into account holding-period asset appreciation in calculating appropriate valuation discounts to net asset value (as cited in footnote 12 of Estate of Litchfield).

Estate of Litchfield (T.C. Memo. 2009-21, Judge Swift) is the first case in which the court has specifically criticized the IRS's expert for not assuming a growth rate during the holding period in making the present value computation. That case involved the valuation of a decedent's stock in two corporations that had elected S corporation status about one year before the decedent died (so still had nine years to run on the 10-year period of built-in gains after conversion from C corporation to S corporation status). The taxpayer's expert calculated the built-in gains discount by projecting holding periods and estimated sale dates after discussions with the officers and boards of directors of the corporations (5 and 8 years for the two separate corporations, vs. 54 and 29 years used by the IRS's expert), estimated appreciation of the assets up to the anticipated sale dates, calculated the estimated capital gains taxes on those sales dates (taking into account appreciation before the date of death as well as anticipated appreciation after the date of death up to the sale date for anticipated sale dates that were within ten years of the S conversion), and discounted the tax amounts to present values. The court agreed with the estate's appraiser as to the built-in gains discount. The opinion does not describe the assumed appreciation rates or the discount rates used by the estate's appraiser. (The IRS's expert used an 11.0% discount-to-present value factor.)

In Estate of Litchfield, the court was more persuaded by the taxpayer's expert as to the turnover estimates, including conversations with management and discovery that there were many elderly shareholders concerned with paying estate taxes, and that management had addressed selling assets to be able to provide liquidity to the shareholders' estates. A key distinction between the approaches of the parties is that the taxpayer's expert considered an amount of assumed appreciation in the assets during the holding period and took into consideration the additional capital gains taxes attributable to that appreciation in some manner.

The court agreed that an adjustment should be considered with respect to the additional level of capital gains taxes on future appreciation.

> "[R]espondent's expert does not take into account appreciation during the holding period that also likely will occur and that will be subject to taxes at the corporate level — what one expert has described as the tax-inefficient entity drag. See Johnson & Barber, 'Tax-Inefficient Entity Discount,' 6 Valuation Strategies 20, 46 (Mar./Apr. 2003). On the facts presented to us, we believe that, as of the valuation date, a hypothetical buyer of LRC and LSC stock would attempt to estimate this extra corporate level tax burden on holding-period asset appreciation and would include the estimated cost or present value thereof in a built-in capital gains discount that would be negotiated between the hypothetical buyer and seller."

The built-in gains tax discounts allowed in Litchfield were not "dollar-for-dollar," (the estate did not request a "dollar-for-dollar" discount so the court did not have to address whether that is a proper approach to determine the discount), but the discounts were very substantial.

The Estate of Jensen opinion specifically criticized the IRS expert because the expert's report "did not account for the likelihood that the [the corporation's] assets would appreciate (and that concomitantly the built-in LTCG tax would increase) nor take into account time value of money concepts." The court cited Estate of Litchfield and Estate of Borgatello.

c. Summary Regarding Consideration of Future Appreciation. Courts have not yet resolved whether anticipated future appreciation of corporate assets should be considered in determining the present value of the built-in gains tax discount. However, the two most recent Tax Court cases to address the issue have criticized IRS experts for not taking into consideration anticipated future appreciation in making the present value analysis of the built-in gains tax. In Estate of Litchfield, the court specifically criticized the IRS's expert for not taking into account appreciation after the valuation date to the anticipated sale dates "that also likely will occur and that will be subject to taxes at the corporate level

— what one expert has described as the tax-inefficient entity drag." Similarly, Estate of Jensen criticized the IRS expert for not taking into account "the likelihood that [the corporation's] assets would appreciate (and that concomitantly the built-in LTCG tax would increase)." The rationale for this approach is that if the asset were not in the corporation, future appreciation would not be subject to the double tax, so the analysis assumes that a hypothetical buyer would take this extra corporate level tax burden into account in negotiating a sales price. Jeff Pennell, at the 2010 Heckerling Institute, said this issue is unsettled and that commentators disagree on the proper approach as to whether future anticipated appreciation should be considered. Estate of Jensen, coming on the heels of Estate of Litchfield last year, suggests a trend toward considering future anticipated appreciation.

3. Choice of Discount-to-Present Value Factor (Which May Result in Dollar-For-Dollar Discount).

In Estate of Litchfield, the court relied on the taxpayer's expert's present value analysis to determine the built-in gains tax discount. However, the opinion does not describe the assumed appreciation rates or the discount rates used by the estate's appraiser. (The IRS's expert used an 11.0% discount-to-present value factor.) The present value of the built-in gains tax was less than the date of death value, so the assumed appreciation rate must have been less than the assumed discount rate.

Several other cases have described some of the growth rates and/or discount rates used by appraisers in making the built-in gains tax present value computations. E.g., Estate of Jameson, 267 F.3d 366, 370 (10% annual growth to harvest rate of timber, 4% annual inflation rate in the value of harvest, and a 20% discount rate); Estate of Jelke (IRS expert used 13.2% discount rate "based on the average annual rate of return for large-cap stocks in the period for 1926-1998"); Estate of Bailey (IRS expert used 2% growth rate and 8% discount rate); Estate of Borgatello (2% growth rate and discount rate of 8.3%, based on long term AFR + 2% for added risk).

The recent Ludwick case had a discussion of growth and discount rates in the court's estimate of the discount for valuing 50% undivided interests in a residence. The court assumed a growth rate of 3% and a discount rate for the present value calculation of 10%.

In Estate of Jensen the court used a factor to discount the anticipated future built-in gains tax to the present value that was exactly equal to the assumed appreciation rate (i.e., 5% and 7.5% in the two scenarios considered by the court). Using the same number for the assumed rate of appreciation and the rate to discount the future capital gains taxes to present value results in an offset. In effect, the built-in gains tax is compounded by an assumed appreciation rate and then discounted back to present value by the same rate. If the appreciation rate and the discount-to-present value rate are the same, it makes no difference how long the assumed turnover period will be. Indeed, the court's calculation of the present value of the built-in gains tax over 17 years ($1.23 million and $1.26 million) was about the same as the estate's determination of the current "dollar-for-dollar" built-in gains tax ($1.13 million).

The math analysis is not quite that straightforward, because the value of the real estate is being compounded, but the income tax basis that is subtracted to determine the amount of the gain is static and does not compound. (That is why there is a slight difference in the court's calculation of the present value built-in gains tax for the 5% versus 7.5% assumed appreciation/discount rate scenarios, and why the court's calculation is slightly different than the dollar-for-dollar discount amount.)

The assumed holding period, assumed growth rate, and "discount-to-present value" factor obviously greatly impact the calculation of the built-in gains discount. Courts should focus on specific discussion by experts of the reasons supporting the specific values for these factors used in their analyses.

4. Practical Planning Guidance. In the Fifth and Eleventh Circuits, claim a dollar-for-dollar built-in capital gains discount. Outside of those circuits, there is no certainty. If the experts use a present value approach, the trend of the current cases suggests that future anticipated appreciation should be taken into consideration in determining the present value of the built-in gains tax. In determining the estimated holding period before assets are sold, consider historical data, recent data, and actual conversations with management about anticipated plans (which is what the taxpayer's expert did in Estate of Litchfield).

   Is it possible to admit testimony that buyers typically reduce the purchase price because of the built-in gains tax liability when purchasing interests in corporations without having a detailed analysis of the precise amount of the built-in gains tax discount? The difficulty is that the built-in gains tax factor is merely one factor considered in the negotiation process, and it is hard to say how much discount is allowed specifically for that factor. Furthermore, some judges have refused to allow that kind of general testimony.