Corporate-level Capital Gains Taxes and Fair Market Value

"Speculative Sale" Theory Irrelevant Under the Standard of Value

In Technical Advice Memorandum 9150001, the IRS concluded, based on prior tax court decisions, that the repeal of *General Utilities* by the Tax Reform Act of 1986 (General Utilities and Operating Company v. Helvering,, 296 U.S. 200 (1935) has no material effect on the transfer tax value of the stock of a C corporation holding appreciated assets where liquidation of the underlying assets was speculative. Taxpayers and the business valuation community strongly disagree with this position. **1**

While the IRS position that capital gains taxes on corporate-level built-in gains are not recognized for purposes of valuing common stock in a closely-held company is without economic justification, it is a notion that, even with the repeal of *General Utilities,* continues to receive support in the tax court, albeit on an inconsistent basis. The reason for this, in our view, is entirely understandable given the failure of experts providing testimony in earlier tax cases to give the Court cogent reasons for considering the capital gains tax as a legitimate discount.

According to the *General Utilities* doctrine, if an acquisition involved the purchase of corporate stock, the purchaser's basis in the acquired stock would be the purchase price. If the purchaser subsequently liquidated the corporation, his basis in the stock would be allocated to the assets. The liquidation would not generate any tax at the corporate level. Similarly, if the corporation sold its assets and then liquidated within a year, the purchaser of the assets would assume a basis equal to the purchase price.The corporation would recognize no gain at the corporate level but the shareholder, would recognize gain on liquidation.

The changes brought by the 1986 Act dictate that if the corporation liquidates, it must recognize gain or loss on its assets at the time of liquidation as if it sold the assets at fair market value. Furthermore, such a sale, whether it occurs within one year of the liquidation or not, is taxable to the corporation.

The arguments for recognizing the built-in corporate capital gains tax liability in valuing common stock of closely-held businesses are qualitative ones based on observations of the marketplace. The issue most frequently arises in the valuation of asset holding companies which do not generate significant cash flow and are, consequently, valued in relation to the underlying net assets. This includes companies holding undeveloped real estate or agricultural lands, marketable securities or mineral interests. However, regardless of the type of company or valuation method, the built-in corporate capital gains tax should be allowed

consideration whenever it can be justified that the consideration of this liability mirrors investment behavior taking place in the market.

In order to illustrate the current backdrop of tax court opinions on this subject a certain amount of judicial history and examination of court cases is required. It is stressed at the outset that this author is not an attorney and admits to being out of his element in citing court cases, preferring to stay within the confines of financial theory, market data, and investment analysis. However, if the definition of "fair market value" is to be believed and it is to remain the standard of value for tax purposes, it must be recognized that there is a point at which law, codes, rules and regulations overlap and intertwine with the realities of the marketplace. This "no man's land" can be successfully explored and understood only with the close cooperation of legal and valuation practitioners.

In our view, it is incumbent upon the valuation community to provide the Court with the proper framework enabling it to disregard fifty years of precedent without appearing capricious. We will attempt to prove our point by showing that the post-*General Utilities* tax environment will not permit the dismissal of the capital gains tax for purposes of calculating fair market value.

Prior to the repeal of *General Utilities* there was no rationale for necessitating the application of a capital gains tax in determining the net asset value of a C corporation as the wording of landmark cases on the subject such as *Cruikshank* illustrate. In *Cruikshank*, decided in 1947, the Court held that a discount for potential capital gains tax at the corporate level is unwarranted where there is no evidence that either:

1. a liquidation of the corporation was planned
2. liquidation could not have been accomplished without incurring a capital gains tax at corporate level

With the *General Utilities* Doctrine in place, the second condition for the inapplicability of the tax was almost always valid. For this reason, the tax was deemed not a reasonable expense of most liquidation scenarios. With the repeal of *General Utilities* in 1986, however, this second condition vanished. The IRS contends that this second exemption is still in place since all the corporation has to do is convert to a Sub S status and not liquidate for ten years. No serious discussion of this unreasonable position is warranted.

The first condition of *Cruikshank* case remains intact, of course. Many scholars have presumed that

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since this doctrine has existed for decades and is uneffected by the 1986 Tax Act, that it must still remain as a valid deterrent to the use of the capital gains tax as a discount from value in the liquidation of a C corporation. In fact, this first condition has never been adequately examined because, from its first pronouncement to 1986, it existed in the shadow of the more cogent *General Utilities* Doctrine. This second condition rendered critical examination of the first condition moot.

A recent case in the Tax Court dealing with this issue is *the Estate of William F. Luton*, T. C. Memo 1994-539. In this case the applicability of the capital gains tax was denied. The reasons for the denial, however, do not address the core argument for allowing the discount in today's tax environment. In fact, the case is off-point because the company subject to the liquidation analysis was an S corporation. Accordingly, no corporate level taxes were appropriate.

Although the S status of the two companies owned by the Luton estate made impermissible the use of a capital gains tax for valuation purposes, it is interesting that the judge also noted that, true to the classic formula of the *Cruikshank* case, in his opinion, the history of the property indicated no intent by the family to liquidate. Presumably, this fact would also, in his opinion, disqualify the use of the capital gains tax as a reduction in value.

In the 1993 case of the *Estate of Charles Russell Bennett*, involving 100% of the common stock of a closely-held corporation, the court denied liquidation expenses because a liquidation was only speculative. The court once again cites the old standard of *Cruikshank* without further comment.

In *Bennett* the Court further stated that: "Whether or not a purchaser of a controlling interest...could liquidate the corporation and sell its assets is immaterial as there must still be found a purchaser of the stock who would be willing to undertake such a procedure. Our goal of determining the price a willing seller could get from a willing buyer is not assisted by considering what a buyer might eventually realize from the sale of all of the corporation's assets".

This seems a rather confusing statement if we consider the fact that the standard of value used in *Bennett* is the Asset-Based Approach. Under this approach the only way value is attributed to the shares is through the underlying value of the corporation's assets. The amount at which a prospective purchaser of the stock might liquidate the assets for is, indeed, entirely germane. It is the essence of value in this instance. The Court's finding conflicts with the investment behavior exhibited in the marketplace.

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Fortunately, support for adherence to observable market pricing evidence is affirmed in other cases such as *Estate of Tompkins v. Commissioner*: "Before we can place a value on the stock we must first determine the fair market value, as of the valuation date, of the underlying assets."

It comes as no surprise that the expertise necessary for preparing a valuation using fair market value as the standard requires years of education and training. Tax court judges will be the first to admit that they are not valuation experts and that they have to make their decisions based upon a combination of the evidence presented and "sound judgement". Since the IRS' determination is presumed to be correct initially, it is the petitioner's burden to overcome this presumption of correctness. Where no cogent testimony is offered the judge is often in the unenviable position of making a decision on valuation issues which, although part legal in concept, are also based on specialized knowledge of investment behavior and financial theory.

Before we go further it is imperative to explore the concepts embodied in the term relevant to "fair market value". It is, after all, the standard upon which tax-related values are based. Fair market value is defined as: "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts". (Treasury Reg. Section 20.2031-1(b)).

Following is a brief discussion of the key components of fair market value:

1. Property

The valuation procedure is actually a determination of the monetary value at some specified date of the property rights encompassed in an ownership. The word "property" refers to the rights of the future benefits derivable from something owned to the exclusion of other persons. **2**

2. Specific Time to the Hypothetical Transaction

It is critical to the concept of "fair market value" that there be a specific transaction at one specific moment in time. As we will later discuss, this key concept seems to have been forgotten in the "speculative sale" disallowance of the corporate-level capital gains tax in calculating value.

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3. Hypothetical Willing Seller and Willing Buyer

The IRS Valuation Guide for Income, Estate and Gift Taxes, published in 1994, states: "The willing buyer and willing seller are hypothetical persons, not actual persons. (See *United States v. Simmons* and *Estate of Bright v. United States*). Accordingly, the identity, intentions and desires of any real person is entirely irrelevant *(emphasis added)*. The important thing to remember is that valuation must consider the motivations of both the hypothetical willing seller and hypothetical willing buyer. " As we will later explain, TAM 915001 flies directly in the face of the IRS' own valuation guidelines.

4. No Compulsion to Act

The hypothetical transaction must be presumed to be completed in an atmosphere in which neither side is in the position of being a forced buyer or seller. The hypothetical willing buyer and willing seller are presumed to be dedicated to achieving maximum economic advantage. (*Estate of Curry v. United States* [83-1USTC].) This advantage must be achieved in the context of market conditions, the constraints of the economy, and the financial and business experience of the corporation existing at the valuation date. Moreover, in valuing stock, the rights, restrictions, limitations of the various classes of stock must be considered. (*Estate of Anderson v. Commissioner*, T.C. Memo, 1988-511.) **3**

5. Both Parties Have Reasonable Knowledge of Relevant Facts

The operative word here is "relevant". Even though the transaction is a hypothetical one, it does not mean it is presumed to take place in a vacuum. To the contrary, the buyer is presumed to have considered all relevant facts associated with the purchase of the property (shares of a closely-held C corporation for our purposes). Is it reasonable to assume a built-in capital gains tax is not relevant?

Assume, for example, that two identical corporations have as their only assets two nearly identical parcels of undeveloped real estate with market values equalling $10 million apiece. The basis of Company A in its real estate asset is $1 million. The basis of Company B, which recently purchased its property, is $10 million. Company A, then, has capital gains tax liability of over $3 million. Company B has no built-in capital gains tax at the current valuation. Neither company has any liabilities. Can anyone possibly believe that they

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would pay the same for the stock of either company?

The Built-in gains tax liability issue arises most frequently when value is determined by the Asset-based Approach. In this approach the fair market value of the corporation's equity is expressed in relation to the underlying asset values. As we suggest, the equity value is also impacted by the corporation's liabilities, which includes any corporate-level capital gains taxes. This approach is used most often when corporations own investment assets such as undeveloped or low income-producing real estate, marketable securities or mineral interests. Frequently, asset-holding companies do not generate sufficient cash flow to warrant valuation by an income or cash flow oriented methodology. Application of a multiple or capitalization rate to cash flow of many asset holding companies would produce a value well below the level determined by the Asset-based Approach.

Operating companies, on the other hand, are normally only valued by the Asset-based Approach if income and cash flow are substandard or nonexistent. The purpose of an operating company's land, buildings and equipment is to generate income-- not to hold for appreciation. Thus, valuing an operating businesses in relation to its underlying assets is used only as a defensive measure.

It is also germane to interject at this point that it is not only the capital gains tax which explains all of the value differential in the stock versus assets purchase consideration. In companies with depreciable assets, purchase of the stock also means lower federal income tax deductions from depreciation, depletion and amortization from that which would be realized by the step-up in basis achieved by the purchase of assets.

There is no doubt, however, that the corporate tax attributes of an operating business influences its value. The higher a company's asset depreciation base, the less income taxes which will be paid and the higher the after tax cash flow. For this reason, buyers prefer to buy assets so that the depreciable base can be written up to its purchase price thereby creating greater after tax cash flow. If the buyer were faced with the prospect of having to buy stock in a situation in which the seller had a low depreciation basis, he would obviously pay less than under an asset sale scenario. By assuming the low depreciation basis of the seller, the company will incur more income taxes and, hence, less after tax cash flow is generated. The seller, of course, would prefer to sell stock, especially in situations in which he has a low depreciable basis, since, by definition, he will also have a larger capital gains tax liability than he would if his depreciation base was high.

There are several valuation issues which arise relative to the capital gains and income tax implications of a hypothetical sale of a controlling block of shares of a closely-held operating company valued by its income or cash flow. However, these issues need to be explored at length and are beyond the scope of the

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more narrowly-defined "speculative sale" theory issue which we are addressing.

Without question, the tax implications of the sale process places the seller and buyer in direct conflict and most definitely influences the final pricing of the transaction. Frequently, the pricing difference created by the tax implications of the proposed structure is an area of compromise in which both parties usually must accommodate the other party by accepting a pricing result which is that which would have been attained had capital gains taxes not been an issue. Many prospective transactions have been derailed by this issue, however. It can be seen, then, that fair market value, asset basis and corporate level federal taxes, whether they be income or capital gains, are inseparable.

In *Clark, Jr. V. U.S.* (36 AFTR2d 75-6417), the Court recognized the economic validity of the trapped-in capital gains tax liability. While the Court did not permit a separate calculation which explicitly delineated the tax as a discount, it did, in its application of a 40% discount from net asset value, concur with the validity of the underlying economic implications of the built-in capital gains tax: "A well-informed willing buyer in determining what he would pay for a share of stock in the corporation would consider that the underlying assets of the corporation included an active investment portfolio which upon liquidation would incur a substantial capital gains tax liability. However, this same investor would consider further several other factors affecting the value of the stock... While it is appropriate to consider capital gains tax liability as a factor an investor might consider, there is no absolute right as a matter of law for plaintiffs to separately deduct such hypothetical tax liability from the assets of the corporation."

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In the *Clarke* case the Court is trying to balance the weight of prior precedent against the irrefutable economic reality of the capital gains tax. It did not state that such a discount is explicitly permissible (i.e., a separate calculation) but it does state that an implicit discount for this factor be taken in the overall discounting from net asset value.

More recently, in more than one case of which the author is aware, the IRS has elected not to litigate the capital gains tax issue. In the *Estate of Stewart Kett,* TC Docket No. 1742-94, which related to the valuation of a 100 percent common stock ownership of two closely-held C corporations owning appreciated assets, the IRS eventually conceded a 40 percent discount from net asset value. Since 100 hundred percent interests were being valued, the only justification for a discount of this magnitude is the built-in capital gains tax . **4**

In the *Kett* case, the IRS sought to prevent the valuation experts testifying on the effect of the repeal of the General Utilities Doctrine, claiming that the experts were unqualified to address what, in their view, were purely legal issues. The judge properly denied their motion. As we alluded to before, the issue on the impact on value of the repeal of *General Utilities* spans both legal and valuation theory issues. Both sets of expertise are required to be used interdependently in properly resolving once and for all an issue which needlessly plagues taxpayers.

A layman's reading of court cases also suggests a constitutional ground for dismissing the "speculative sale" exclusion of the capital gains tax at the corporate level. The notion that there is no "real" capital gains tax attached to the corporation's underlying assets when the decedent, who controlled the assets through his stock ownership, expressed no intention to liquidate implies that the estate would be gaining an unfair advantage by being allowed to discount the asset's value while the beneficiaries will continue to own and enjoy the assets for many years to come. This further suggests that the value of the estate is not the monetary value of the property at the moment of the decedent's death but the value of the assets which the beneficiaries will enjoy in the future.

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In *Luton*, for example, the Court mentions that the ranches had been in the family for fifty years and, because of this history and their increasing market value, there was no reason to presume they might be sold in the foreseeable future. Clearly, the value and hence, the basis for the taxation, is ascribed (improperly as we suggest below) to the <u>ownership</u> of the ranches--that is, the value to the family of continuing to <u>hold</u> this valuable real estate.

We would assert that for estate tax purposes value should not be based on the intrinsic value of owning or holding a property, but strictly on its monetary value at its presumed sale. Perhaps in the future, a plaintiff's attorney might wish to consider language in the case of the *Estate of Daniel J. Harrison, Jr*. relating to this issue: "... in *United States v. Land* [62-1 USTC ? 12,078], 303 F.2d 170, 171-173 (5th Cir. 1962), cert. denied 371 U.S. 862 (1962), ... it was stated:

> The statute applicable here is Section 2033 of the Internal Revenue code ... This provides that "the gross estate shall include the value of all property... to the extent of the interest therein of the decedent at the time of his death." The Regulations reiterate the truism that the tax is "an excise tax on the transfer of property at death and is not a tax on the property transferred." Treas. Reg. 20-2033-1(a). It is of course imperative that the tax be imposed on the transfer of the property in order to avoid the constitutional prohibition against unapportioned direct taxes. ...it follows that the valuation of the estate should be made at the time of the transfer. The time of transfer is the time of death. Treas. Reg. 20-2031-1(b)."

It is dictated, therefore, that: (1) value is based solely on a hypothetical transaction at the moment of death and (2) fair market value is the standard of value. This being the case, value will be based upon replication of the investment behavior of a hypothetical willing seller (i.e., disregarding the proclivities of the decedent and his family) and a hypothetical willing buyer. As is aptly stated in *Clark,* the buyer would consider in his pricing the impact of any liability of the corporation-- be it contractual or contingent. There is no question, then, that any corporate capital gains tax would be factored in to the pricing of common stock.

The case of the *Estate of Samuel I. Newhouse* is a classic case of making determinations of value based on a hypothetical sale of stock in the light of an array of economic, market, legal and tax issues. In the final analysis, it was concluded that the most reasonable manner in which the subject shares could be sold was through an underwritten public offering. The petitioner's value, determined by the firm of Goldman Sachs, was based on the seller's net realizable value *after* a seven percent discount for selling expenses. The Court

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concurred with this methodology and adopted this value in its decision. No public offering was contemplated at the time. During his lifetime, Mr. Newhouse had many opportunities to take the company public but had no interest in doing so. There was no intention by the Board of Directors to sell the Company's shares to the public. Fifteen years after Mr. Newhouse' death the company is still closely held. The hypothetical sale scenario was indeed very speculative yet the discount for selling expenses was allowed in this case because it properly belonged within the equation of fair market value.

The *Newhouse* case has another very important lesson to impart with respect to the reality of capital gains taxes in determining fair market value. One of Goldman Sach's valuation approaches, referred to as the "arithmetic sum value" contemplated the independent sale of corporate properties and business units. This approach produced a much higher value than the public offering methodology described above. However, to avoid capital gains taxes, the hypothetical liquidation would have to be concluded in less than one year in order to take advantage of exemptions from the tax available in 1980. In Goldman Sach's opinion this would have had a seriously depressing effect on the market for such properties, rendering the approach unreasonable. Again, the Court concurred.

This hypothetical liquidation scenario provides a double lesson for us today. First, the overwhelming significance to sellers of capital gains taxes is accepted by the Court. Secondly, the Court permitted a reduced value of the estate by agreeing that capital gains taxes were to be considered in a hypothetical liquidation scenario. Just as Newhouse had not planned to go public, neither were there any plans for a liquidation.

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Conclusion

It is our opinion that the Court must uniformly let go of the ill-founded notion that the built-in corporate capital gains tax not be allowed as a reduction in the value of the equity of a closely-held company where liquidation is only speculative. The premise for this policy has been undermined with the repeal of *General Utilities*. Observations from the marketplace, which should be the primary source of value determination, clearly show that the application of outdated legal precedents and the IRS viewpoint espoused in TAM 9150001 are out of step with economic reality resulting in tax valuations which are unjustly burdensome. Failing to do so will result in the continuation of an ambiguous policy of determining value by a standard different from fair market value.

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3. Appraisal Principles and Procedures. Henry A. Babcock, FASA American Society of Appraisers, 1980.

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5. "Developing a "*General Utilities*" Repeal Discount". Estate Planning Review. Sidney Kess, J.D., L.L. M., C.P. A., editor. April 20, 1995.

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