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**JELKE AND THE LIQUIDATION SCENARIO
PARADOX**

*By: William H. Frazier, ASA**

Relying heavily on the Fifth Circuit's decision in *Dunn*,¹ the Eleventh Circuit's decision in *Jelke*² adds significant weight to the argument that the law of the land, when valuing a Corporation by the asset approach, now permits the deductibility in full of built-in capital gains taxes. The decision by the majority of the Eleventh Circuit is certainly the correct one. Nonetheless, the rather diffident wording of the opinion lead to a stinging dissent and opened the Court to the criticism that it took the easy way out.

The Court correctly pointed out that the *Dunn* decision already covered the built-in capital gains tax debate before it in *Jelke*. Perhaps, it should have just stopped there. Instead, its rationale in rendering its majority opinion revealed a lack of conviction as to the Court's findings on the persuasiveness of the petitioner's position relative to the Service.

One legal commentator summarized the opinion: "The Eleventh Circuit assumes that such [investment] 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*."³ This is an accurate summary of the opinion, but, as the appraiser for the petitioner in *Jelke* and *Dunn*, this is not an accurate portrayal of how I view the task of valuing a non-controlling interest in a C corporation based on its underlying assets,⁴ which was the type of subject entity involved in *Jelke*. The off-

***ABOUT THE AUTHOR**

William H. Frazier, ASA is a principal and founder of the firm of Howard Frazier Barker Elliott, Inc. and had thirty years of experience in business valuation and corporate finance. As an Accredited Senior Appraiser of the American Society of Appraisers (ASA) since 1987, he has participated as an appraiser in numerous U.S. Tax Court cases, including testimony in *Jelke*, *McCord*, *Dunn* and *Gladys Cook*. He currently manages the Dallas office of Howard Frazier Barker Elliott, Inc. Will is a member of the Business Valuation Committee of the ASA and currently served as its secretary. He is also a member of the Government Relations committee of the ASA. Will has recently been named as a member of the Internal Review Program Advisory Committee (IRPAC) of the IRS and works with issues relating to the Office of Professional Responsibility (OPR).

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point wording of the opinion, with its focus on the date of death, seems to open the door for the IRS to reassert its arguments in gift tax cases in the Eleventh Circuit. The same would not be true in the Fifth Circuit where the Court admitted to belaboring its point so that its meaning would be clear and unambiguous.

The subject entity in *Jelke* was Commercial Chemical Company ("CCC"). Once an operating business, the Company had existed for over twenty years as an investment company holding primarily a portfolio of mostly S&P 500-type common stocks valued at \$188.6 million. The assets were managed by a large and highly respected bank trust department. The Company itself was professionally managed, with none of the shareholders being active in decisions. In fact, most shares were held in trusts not scheduled to liquidate for at least 20 years.

A prerequisite for a complete understanding of this discussion is an understanding of the history of tax law for built-in gains—most importantly, the *General Utilities* doctrine and its repeal in 1986. 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 eliminated this approach, and now 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 that 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. But, 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.

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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.

Despite the change in the law, it took another twelve years before taxpayers could convince a court that the built-in capital gains tax was now a real liability that should be deducted in determining the net asset value of an investment company. In 1998, in the *Estate of Davis*, taxpayers were awarded a small monetary benefit when the Tax Court recognized the legitimacy of the built-in capital gains tax as a decrement to value when it, *sua sponte* the liability as one of the factors in the discount for lack of marketability the Court determined.

Following *Davis*⁵ was a flurry of built-in capital gains Tax Court cases: *Welch*,⁶ *Jameson*⁷ and *Dunn*.⁸ In addition, immediately after *Davis*, the issue was taken up for the first time by an appellate court, when the Second Circuit overturned the Tax Court's denial of the built-in capital gains tax liability in *Estate of Eisenburg*. Once remanded, the Commissioner acquiesced and no decision was rendered.

As mentioned previously, of greatest importance in *Jelke* was *Dunn*. The taxpayers essentially lost their argument before the Tax Court, receiving a mere 5% reduction in asset value for the liability. On appeal to the Fifth Circuit, however, for the first time in U.S. history, the taxpayers in *Dunn* were able to secure a dollar-for-dollar reduction in asset value for built-in capital gains tax liability. The Court stated:

It is inconceivable that, since the abolition of the *General Utilities* doctrine and the attendant repeal of relevant I.R.C. sections, such as §§ 333 and 337, any reasonably informed, fully taxable buyer (1) of an operational-control majority block of stock in a corporation (2) *for the purpose of acquiring its assets*, has not insisted that all (or essentially all) of the latent

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tax liability of assets held in corporate solution be reflected in the purchase price of such stock.

We are satisfied that the hypothetical willing buyer of the Decedent's block of Dunn Equipment stock would demand a reduction in price for the built-in gains tax liability of the Corporation's assets at essentially 100 cents on the dollar, regardless of his subjective desires or intentions regarding use or disposition of the assets. Here, that reduction would be 34%. This is true "in spades" when, for purposes of computing the *asset*-based value of the Corporation, we assume (as we must) that the willing buyer is purchasing the stock to get the assets, . . . whether in or out of corporate solution. We hold as a matter of law that the built-in gains tax liability of this particular business's assets must be considered as a dollar-for-dollar reduction when calculating the *asset*-based value of the Corporation, just as, conversely, built-in gains tax liability would have no place in the calculation of the Corporation's *earnings*-based value.

Getting back to the Eleventh Circuit's somewhat confusing wording, nowhere in *Dunn* or in our valuation opinion was it assumed that the corporation was liquidated (even hypothetically). Rather, as a way to measure the value the corporation's assets (and as required under the asset approach to value) we "mark-to-market" or "price" the corporation's assets. CCC's assets could basically be priced by looking in the *Wall Street Journal* to find their selling prices. This calculated value of assets is a hypothetical value from the standpoint of the shareholders, because the corporation is not liquidating **and none of these assets will be distributed**. This is the same exercise that mutual funds and closed end funds do every day in calculating net asset value. No one is suggesting they are liquidating.

So, just as the asset value is hypothetical, so is the capital gains tax. One can't say the capital gains tax is not "real" without saying the same about the asset value from which the tax liability is calculated. Both are hypothetical, but both are part and parcel of the valuation procedure used to determine the value to the shareholders of a C corporation based on its underlying assets.

The shareholders do not have access to the assets, because the company is not contemplating a liquidation. In determining net asset value available to shareholders, however, one must deduct all liabilities. That includes the liability associated with the hypothetical sale values. To do otherwise would overstate the amount of assets available to shareholders.

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The majority in *Jelke* rendered the correct decision but seemed to lack conviction at the end. The minority dissent was off target but was clearly not lacking in conviction. Its argument may have won converts by its sheer forcefulness.

The central flaw with the dissenting opinion was the same myopia afflicting the Tax Court decision. The Service's expert proffered the opinion that the capital gains tax liability, which amounted to \$51.6 million, was overstated for valuation purposes, because the tax would be realized only as the underlying shares were sold. Based on CCC's historical turnover rate of its portfolio, 5.95% per year, it would take 16 years to sell all of the stock held in the Company's portfolio at the valuation date and, thus, the tax would be realized in small increments (\$3.2 million) every year for the next 16 years.⁹ The present value of this stream of funds when discounted at the Company's cost of capital (13.2%) equated to about \$21 million. In the opinion of the Tax Court and the minority for the Eleventh Circuit, this figure represented a more reasonable portrayal of the true effect of the built-in capital gains tax on the value of a small minority interest in the shares of CCC.

Splitting the baby on difficult decisions is a time honored tradition of the Tax Court and, it seems, that is what occurred in *Jelke*. My own belief is that the Court felt that "giving" the Estate a dollar-for-dollar deduction for the built-in gains liability and a minority interest discount and a discount for lack of marketability was simply too much tax relief. From the standpoint of social policy and fairness, perhaps the Court's decision can be understood. But relative to fair market value, the decision was wrong and was correctly overturned.

The Tax Court also justified its position by citing the government's expert's testimony regarding the value of tax losses:

Mr. Shaked explained that the need to discount the built-in capital gain tax liability is analogous to the need to discount carryforward losses because they cannot be used until years after the valuation year. Mr. Shaked's approach is to calculate the built-in capital gain tax liability by determining when it would likely be incurred. We agree with Mr. Shaked's approach of discounting the built-in capital gain tax liability to reflect that it will be incurred after the valuation date.

It is one thing to agree with the assertion that the present value of net operating losses—when applied against future tax liabilities—is less than its stated amount, because these carryforwards do not appreciate in value; they stand still. Mathematically, because this fixed amount is consumed in future periods, the present value must be less than the stated

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amount. The CCC portfolio, however, was not expected to stand still. In the words of the respondent's expert, the portfolio was expected to appreciate "fantastically."

The Tax Court dismissed our opinion on this topic as follows:

If we were to adopt the estate's reasoning and consider future appreciation to arrive at 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 appreciated value and tax liability and then reduce its current fair market value by the present value of a future tax liability.

I was a bit puzzled by this observation, as it was the respondent's expert's opinion that was based on a future construct—not ours. We believed the real, GAAP-required liability on the Company's books was the correct liability. We only engaged in a consideration of the future consequences of the liability in order to rebut the IRS expert. In fact, the only artificial liability was the present value adjustment to the actual built-in capital tax liability concocted by the respondent's expert. This expert stipulated to the fact that the stock would appreciate at an annual rate of 13.2%, yet, refused to consider this fact in his present value calculation.

The Tax Court's second statement is simply untrue. First, if a stock's basis and its value were the same, there would be no built-in gain and the issue would be moot. But, more to the point, if we could presuppose a future sale date (which we obviously can not) the market price would adjust itself to account for this future "certainty." The market price is the present value of all expected future net cash flows. If it was known that: 1. the stock would appreciate at a specific rate; and 2. the stock would be sold at a specific date, then the stock price would automatically reflect this future scenario today. If the market price and the basis were equal, it would be only by coincidence. The two have nothing to do with each other. The mathematical problem the Court saw was invalid, as it obviously assumed that the future gains and tax analysis could be performed in isolation from the market price. This is simply impossible.

Back to the Eleventh Circuit dissent. Here, the judge presented a 15 page treatise extolling the virtues of the Tax Court's viewpoint. Unfortunately, the dissent labored under the mistaken premise that the \$51 million capital gains tax liability was carved in stone.

The dissenting opinion states:

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Any rational being would prefer to pay \$51 million in tax that is spread out over the next 16.8 years which is how long it would take the embedded tax liability to come fully due under the company's historical rate of liquidation, instead of the \$51 million immediately.

We would certainly agree with the judge on this point. He is right—of course, anyone would agree with this statement. Unfortunately, the \$51 million is not carved in stone and, in fact, varies in direct proportion to the value of CCC's stock portfolio. For the judge's statement to be true, the portfolio would have to move (up or down) not one iota in 16.8 years. To quote the philosopher Hegel:

Dialectics teaches that no individual thing, whether in the external world or in thought, remains static, but that it constantly changes, that every single thing, every single institution must have a beginning and therefore necessarily an end, a rising and a declining phase of development.¹⁰

In fact, all parties stipulated that the portfolio was expected to grow at 13.2%. Based on this, the total capital gains taxes which would be paid over the 16.8 years is not \$51 million but about \$200 million! (The \$200 million in future taxes incurred over the ensuing 16.8 years, when discounted to the valuation date at 13.2% was \$51 million.)

Both the Tax Court and the Eleventh Circuit described the net asset value of CCC at \$188 million. If one believes GAAP accounting is to be followed, this figure is incorrect. CCC's audited financial statements, performed in accordance with GAAP, record the \$51 million deferred tax liability and reveal shareholders' equity at \$137 million. Shareholders' equity in an asset holding company is synonymous with net asset value.

By ignoring the \$51 million GAAP-mandated tax liability, the respondent's expert, the Tax Court and the dissenting judge in the Eleventh Circuit have contradicted years of research, analysis and the deliberative process of the Financial Accounting Standards Board. In 1999, SFAS 115 required that investment assets "available for sale" be recorded at market value and the corresponding tax liability is recorded as a liability. Liabilities, however, also are required to be stated at fair value. Changes in market value either increase or decrease shareholders' equity (net asset value). The Tax Court and the dissenting opinion are suggesting that this GAAP methodology is grossly misleading.

If CCC were a public company and the chief financial officer followed the Tax Court's and the dissenting justice's advice, net asset value would be greatly overstated. In fact, he would be in violation of Sarbanes-Oxley and thereby subject to fines or even imprisonment.

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To book the CCC assets at market value is to state what these assets are worth if they are sold. If they are sold at such price, the capital gains tax liability is inescapable. If one objects to the hypothetical sale scenario then the assets should be stated at cost not market. And because there is no intention to liquidate, and as the Tax Court and Eleventh Circuit noted "to operate CCC as a going concern," value should not be determined through the asset approach. About the only approach left would be capitalizing the income of the investment company. The resulting value by the income approach would be far lower. This is why Revenue Ruling 59-60 requires the use of the asset approach in valuing investment companies.

The Tax Court and the Eleventh Circuit dissent argue that considering the \$51 million liability today rests on the uncertain assumption that the stock held in the portfolio will appreciate. And, of course, because no one has a crystal ball, relying on this assumption is tantamount to flipping a coin. Without question any expectation of the future is bound to change. But, at the valuation date, the best consensus of the future is the market itself. A stock's price is, in fact, the market's evaluation of the risk adjusted present value of all future cash flows. Far from the "vague and shadowy" alchemy suggested by the *majority* of the Eleventh Circuit, it is the market's valuation of the CCC portfolio that is important here—and it has already taken into account the risk of price volatility. To discount this amount again is to double count the risk of volatility.

To be sure, the concepts relating to the applicability of the capital gains tax liability in the *Jelke* case do require laborious mental exertion. It is somewhat paradoxical that value is determined based on the assumption the company's portfolio is liquidated when, in fact, the company has no such intentions. But, by assiduously wrestling with the issues, rather than merely flipping a coin, the correct methodology points us to one, clear answer: The entire amount of the GAAP required liability for capital gains taxes that is reflected on the Company's books must offset the value of the Company's assets in determining the fair market value of the Company.

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FOOTNOTES

¹ *Dunn v. C.I.R.*, 301 F.3d 339, 2002-2 U.S. Tax Cas. (CCH) ¶ 60446, 59 Fed. R. Evid. Serv. 529, 90 A.F.T.R.2d 2002-5527 (5th Cir. 2002).

² *Estate of Jelke v. C.I.R.*, 507 F.3d 1317, 2007-2 U.S. Tax Cas. (CCH) ¶ 60552, 100 A.F.T.R.2d 2007-6694 (11th Cir. 2007).

³ Jim Roberts, *Jelke: Simplicity In Valuation of Closely Held Investment Companies*. American Bar Association Real Property Trust and Estate Law eReport, February 2008.

⁴ In *Jelke* we valued a 6.44% minority interest in an investment holding company whereas, in *Dunn*, we valued a 62.96% non-controlling interest in a marginally profitable operating business. Value to the shareholders of *Dunn* was heavily influenced by its underlying assets.

⁵ *Davis v. C.I.R.*, 110 T.C. 530, Tax Ct. Rep. (CCH) 52764, Tax Ct. Rep. Dec. (RIA) 110.35, 1998 WL 345523 (1998).

⁶ *Estate of Pauline Welch v. C.I.R.*, 208 F.3d 213, 2000-1 U.S. Tax Cas. (CCH) ¶ 60372, 85 A.F.T.R.2d 2000-1200, 2000 WL 263309 (6th Cir. 2000).

⁷ *Estate of Jameson v. C.I.R.*, 267 F.3d 366, 2001-2 U.S. Tax Cas. (CCH) ¶ 60420, 88 A.F.T.R.2d 2001-5922 (5th Cir. 2001).

⁸ *Estate of Dunn v. C.I.R.*, T.C. Memo. 2000-12, T.C.M. (RIA) P 2000-012, 79 T.C.M. (CCH) 1337 (2000), rev'd, 301 F.3d 339, 2002-2 U.S. Tax Cas. (CCH) ¶ 60446, 59 Fed. R. Evid. Serv. 529, 90 A.F.T.R.2d 2002-5527 (5th Cir. 2002).

⁹ The Company's assets consisted of a portfolio of mostly S&P 500-type common stocks valued at \$188.6 million and were managed by a large and highly respected bank trust department. The Company itself was professionally managed, with none of the shareholders being active in decisions. The majority of the shares.

¹⁰ Judge Carnes, the dissenting justice in *Jelke* "opened the door" for this comment by equating estate tax law with Hegelian metaphysics. The paradox we deal with here does seem to fit within the constructs described by Hegel.

