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Built In Capital Gains Update: *Estate of Richmond*

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In *Estate of Richmond v. Commissioner (T.C. Memo. 2014-26)*, the tax court bucked a 15-year trend of a full or near-full dollar-for-dollar reduction for built-in capital gains (BIG) in a C corporation, instead calculating the BIG liability based on the present value of the cost of paying off that liability in the future. In bucking this trend, the *Richmond* court differed from multiple recent tax court decisions as well as decisions in four separate U.S. Court of Appeals districts since 1998. Despite this, the overall discount in *Richmond* (including the BIG adjustment along with discounts for lack of control and lack of marketability) is in line with the overall discounts seen in the other BIG cases. In this article, we will explain the issue of built-in capital gains (also called trapped-in capital gains), trace the history of the adjustment for BIG, and look at this adjustment in the context of the overall discount allowed by the courts.

Illustration of Potential Capital Gains

A simple illustration of a typical scenario involving potential capital gains is as follows. Suppose a C corporation owns one piece of real estate and no other assets or liabilities. The real estate has a fair market value of $1,000,000 and a basis of $100,000. Were the C corporation to liquidate, the distributions to shareholders would be taxed at two separate levels. The first tax would be at the corporate level and would be on the $900,000 capital gain on the land ($1,000,000 value less $100,000 basis). Assuming a hypothetical corporate tax rate of 40%, the tax would be approximately $360,000 ($900,000 capital gain times 40% tax rate), leaving $640,000 in cash to distribute to the shareholders.

But the IRS isn't finished yet. The second tax would be at the shareholder level and would be a tax on the capital gain to the shareholders. This tax would be applied to the amount each shareholder receives in liquidation less each shareholder's basis in his or her stock. Assuming a $100,000 basis in the stock and a hypothetical individual capital gains tax rate of 20%, the capital gains tax liability at the shareholder level would be $108,000 ($640,000 in distributed cash, less $100,000 basis, times 20% tax rate). This adds up to a total tax bill of $468,000 and net proceeds received of $532,000. Therefore, the net result to a C corporation's shareholders may be that, once the dust has cleared, they receive only a fraction of the fair market value of the underlying asset of the C corporation.

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Prior to 1986, corporations were allowed to liquidate with the proceeds being taxed only at the shareholder level. This was called the *General Utilities* doctrine and was based on a 1935 case. The 1986 Tax Reform Act effectively repealed the *General Utilities* doctrine, establishing the double-taxation scenario described above. The double-taxation scenario as it exists today is consistent with the Service's treatment of C corporation

dividends, which are also taxed at two levels (corporate and shareholder).

The Real World Buyer

The discount for potential capital gains makes sense from a real-world perspective as it is something that any rational buyer and seller would consider. Consider the following situation. Buyer Bob, a real estate speculator, is interested in buying a parcel of land to hold and eventually sell. There are two nearly identical parcels available to him in the market. One parcel has a fair market value of $1,000,000 and is owned outright by individual seller Sam. The other parcel is the $1,000,000 parcel (with a basis of $100,000) owned by C Corporation.

If Bob buys the parcel from individual Sam, Bob pays Sam $1,000,000 and now owns the land with a $1,000,000 basis (the amount he paid for the land). Five years later, when Bob goes to sell the land for its $2,000,000 fair market value, the capital gain on the parcel purchased from Sam is $1,000,000 ($2,000,000 sale price less $1,000,000 basis). Assuming a hypothetical 20% individual capital gains tax rate, Bob's capital gains liability under this scenario is $200,000. Because there is no corporate ownership of the land, there is only one level of taxation under this scenario. Under this scenario, Bob invested $1,000,000 in year 0 and received $1,800,000 in year 5 ($2,000,000 sale proceeds less $200,000 in taxes paid). Bob's five-year compound annual return is about 12.5%

On the other hand, if Bob buys 100% of C Corporation's stock for $1,000,000 (thereby owning the land in corporate form), Bob takes the C Corporation stock with the land at the low $100,000 basis. Now when Bob goes to sell the land for its $2,000,000 fair market value in five years, the capital gain inside the corporation is a whopping $1,900,000 ($2,000,000 fair market value less $100,000 basis). Based on a hypothetical 40% corporate tax rate, the capital gains liability inside the corporation is $760,000. This leaves $1,240,000 left to distribute from the corporation to Bob. Assuming Bob's basis in C Corporation's stock is $1,000,000 (the amount he originally paid for the stock), Bob has an additional capital gain at the shareholder level of $240,000. Assuming a hypothetical 20% individual capital gains tax rate, Bob must pay an additional $48,000 in capital gains tax at the shareholder level, bringing his total tax bill to $808,000. Under this scenario, Bob invested $1,000,000 in year 0 and received $1,192,000 in year 5 ($2,000,000 sale proceeds less $808,000 in total taxes paid). This equates to a five-year compound annual return of about 3.6%, a significantly worse scenario than if Bob had purchased the land outright from individual seller Sam.

So what is Bob to do when faced with the above dilemma? As we see it, Bob can either (1) pay individual Sam $1,000,000 for the land and realize his 12.5% five-year compound annual return, or (2) pay *less* than $1,000,000 for 100% of C Corporation so that Bob's actual return is equal to the 12.5% return he would achieve under scenario 1. For example, assume Bob pays only $620,000 for 100% of C Corporation. When Bob sells the land in five years for $2,000,000, his corporate level tax liability is still $760,000. His shareholder level capital gain liability is $124,000 (distributable cash of $1,240,000, less $620,000 basis, times the 20% individual capital gains rate). After all taxes have been paid, this scenario gives Bob net proceeds in year five of $1,116,000 ($2,000,000 less $884,000 in total taxes paid) on an original investment of $620,000. This translates to a five-year compound annual return of about 12.5%. When faced with this choice, a rational investor would not care between paying $1,000,000 under the first scenario and $620,000 under the second scenario because the returns are equal.

Summary of Built-In Gain (BIG) Cases Since 1998[1]

Case	Year	Court	Underlying Asset(s)	Interest Valued	Total Discount Allowed	% of BIG Discount Allowed
Davis	1998	Tax	stocks	minority	49.9%	33%
Eisenberg	1998	US App 2	real estate	minority	44.4%	100%
Welch	2000	US App 6	real estate	minority	67.0%	100%
Dunn	2002	US App 5	equipment	minority	44.3%	100%
Jelke	2007	US App 11	stocks	minority	44.4%	100%
Litchfield	2009	Tax	stocks / R/E	minority	46.2%	91%
Jensen	2010	Tax	real estate	control	33.5%	100%
Richmond	2014	Tax	stocks	minority	46.8%	43%

[1]US App is U.S. Court of Appeals (with the specific circuit noted numerically). This is the appellate court immediately above the U.S. Tax Court. The Total Discount Allowed includes adjustments for BIG, lack of control, and lack of marketability from the 100% control, marketable net asset value of the respective entity. The percent of BIG Discount Allowed reflects the percentage of the total BIG liability that the Court allowed as an adjustment. Cases discussed in more detail below.

The above illustration does not mean that the discount for potential capital gains is automatically 38% ($1,000,000 paid in scenario 1 versus $620,000 paid in scenario 2), however, it does illustrate the thought pattern and subsequent prices offered in a real-world

situation. No rational buyer would pay $1,000,000 for an 3.6% return when an equally risky 12.5% return was available. The above examples are shown on a very simplified basis for illustrative purposes only. They are not indicative of specific valuation scenarios and therefore are not to be relied upon as such.

Case Histories

Prior to 1998, the IRS enjoyed a long string of victories where no adjustment for BIG was made. The IRS argument was basically twofold. First, the IRS argued that the Internal Revenue Code *does* allow for the avoidance of capital gains at the corporate level. To qualify for this nonrecognition, a C corporation must convert to an S corporation and wait ten years before selling its assets. The second IRS argument against a capital gains discount focused on the uncertainty of liquidation of the appreciated corporate assets. Basically, the IRS successfully argued that no discount for potential capital gains is appropriate if the liquidation of the appreciated corporate assets is speculative. Until 1998, the courts agreed with the IRS, refusing to allow discounts for built in capital gains. In 1998, however, the landscape changed dramatically with the *Davis* and *Eisenberg* cases. Starting with *Davis* and *Eisenberg*, courts generally allowed for a full (or near-full) reduction for the BIG liability.

A summary of these cases since *Davis* and *Eisenberg* is as follows:

A brief description of each case is as follows:

Davis. This 1998 U.S. Tax Court case involved a non-controlling interest in an entity owning marketable securities with a BIG. The Tax Court ultimately settled on an overall valuation discount of about 49.9%, including a discount for potential capital gains. The Tax Court, however, does not provide an objective method for calculating the adjustment for BIG. In its rationale for applying a discount for potential capital gains, the Tax Court noted the capital gains discount amount (in dollars) ranged from roughly $8.8 million (Estate's expert) to $10.6 million (IRS's expert). The Court then noted that this was the "appropriate range" from which they could determine the discount for potential gains. Then, "[b]earing in mind that valuation is necessarily an approximation and a matter of judgment, rather than of mathematics," the Tax Court divined a $9 million value as a "part of the lack-of-marketability discount" due to potential capital gains.

Eisenberg. This case involved a non-controlling interest in an entity owning real estate with a BIG. In 1997, the Tax Court initially held that no discount or adjustment for BIG was allowed. The Tax Court's rationale for its decision was based on the historical line of cases that did not allow for an adjustment for BIG when the sale or liquidation is speculative. In 1998, the U.S. Court of Appeals (Second Circuit) reversed the Tax Court. Property analyzing the case from the perspective of a willing buyer and willing seller, the Appellate Court stated that, "[t]he issue is not what a hypothetical willing buyer plans to do with the property, but what considerations affect the fair market value of the property he considers buying…. We find that even though no liquidation of the corporation or the sale of its assets was planned or contemplated on the valuation date, a hypothetical willing seller and a hypothetical willing buyer would not have agreed on that date on a price for each of the blocks of stock in question that took no account of the corporation's built-in capital gains tax." The Appellate Court then remanded the decision back to the Tax Court to determine the proper discount. The Tax Court never determined the proper discount, however, as the IRS (in AOD 1999-001) acquiesced to the Second Circuit's ruling.

Welch. This case involved a non-controlling interest in two separate but similar entities, each of which owned real estate with a BIG. In 1998, the Tax Court did not allow an adjustment for BIG due to the fact that the sale or liquidation was speculative. In 2000, in an unpublished opinion, the U.S. Court of Appeals (Sixth Circuit) reversed the Tax Court, holding that a reduction for the BIG liability was available. The *Welch* court relied on the same reasoning as in Eisenberg.

Dunn. This case involved an interest in an operating company that owned and rented out heavy equipment used primarily in the petroleum refinery and petrochemical industries. Although the interest valued was in excess of 50%, supermajority provisions at the company did not give the owner of this interest the unilateral ability to liquidate the company. In 2000, the Tax Court allowed a downward adjustment to value equaling approximately 15% of the BIG liability (calculated as 5% of the total BIG). The Tax Court cited *Davis* but distinguished the facts in *Dunn.* As opposed to the holding company in *Davis,* the Tax Court noted that the company

in *Dunn* was an operating company and an owner of this company could choose to continue to operate it (as opposed to liquidate it and realize the BIG liability). As such, a less-than-100% adjustment for the BIG liability was allowed by the Tax Court.

In 2002, the U.S. Court of Appeals (Fifth Circuit) reversed the Tax Court and allowed a full, dollar-for-dollar reduction to value for the BIG liability. The Appellate Court criticized the Tax Court's reasoning as to the likelihood of the liquidation of the company. In *Dunn,* two valuation methodologies were used: (1) an income approach (which assumes that the company will continue to be operated) and (2) a cost approach (which assumes that the company will be liquidated). The Appellate Court held that a full reduction for the BIG liability is appropriate under the cost approach since that approach (viewed independently) assumes a 100% likelihood of the liquidation of the company. It then is incumbent on the appraiser to *weight* the preliminary indications of value between the two valuation approaches as to the likelihood of the continued operation of the company versus the liquidation of the company.

Jelke. This case involved an interest in a holding company owning marketable securities. In 2005, the Tax Court allowed a reduction of approximately 41% of the BIG liability. The Tax Court calculated this figure based on the forecasted present value of the capital gains liability incurred over a hypothetical liquidation period. In 2007, the U.S. Court of Appeals (Eleventh Circuit) reversed the Tax Court and allowed a 100%, dollar-for-dollar reduction to value for the BIG liability. The Appellate Court relied completely on the holding in *Dunn,* opining that the dollar-for-dollar reduction reflects the reality of the assumed immediate liquidation, provides a clear and objective measurement of the liability, and eliminates the risk of subjective over-engineering of alternative methods.

Litchfield. This 2009 Tax Court case involved a non-controlling interest in two entities, each of which had appreciated stocks and/or real estate. The Tax Court accepted the methodology of the estate's expert in this case. The estate's expert calculated the reduction for the BIG liability by projecting (1) holding periods and sale dates for the assets, (2) appreciation of the assets over the holding periods, and (3) the estimated capital gains taxes due upon sale of the appreciated assets on the projected sale dates. The estate's expert then discounted the calculated capital gains liability back to the valuation date and subtracted this figure from the net asset value for each company. The allowed discount under this method equated to 90.5% of the total BIG liability.

Jensen. This 2010 Tax Court case involved a controlling interest in an entity with appreciated real estate. The Tax Court did not find that any viable method for the avoidance of the BIG liability existed for a hypothetical buyer of the company's stock and therefore employed the same valuation methodology as used in *Litchfield.* In *Jensen,* however, the Tax Court used the same rate for both (1) the appreciation of the property's value and (2) the discount rate to compute the present value of the future BIG liability. Mathematically, this results in a 100%, dollar-for-dollar reduction for the BIG liability. Said another way, the Tax Court in *Jensen* reaches the same result as in *Dunn* and *Jelke,* but by a different route.

Before we get to *Richmond,* it is helpful to review the outcome in the prior cases. As seen in the earlier table, the *Davis* court allowed for a reduction for BIG liability that was equal to about 33% of the actual total BIG liability. Then, in all but one of the cases from *Eisenberg* through *Jensen,* the court allowed a deduction for 100% of the total BIG liability (the lone oddball, *Litchfield,* still allowed a deduction for a significant 90.5% of the total BIG liability). The total discounts (including

Summary of Holding in Richmond

Item	Discount	Total Company
Total Net Asset Value		$52,114,041
Times: Interest Valued		23.44%
Equals: NAV of 23.44% Interest		$12,215,531
Less: BIG Liability	15.0%	($1,832,330)
Subtotal		$10,383,201
Less: DLOC	7.75%	($804,698)
Subtotal		$9,578,503
Less: DLOM	32.1%	($3,074,699)
Final Value		$6,503,804
Total Discount		*-46.8%*

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discounts for BIG liability, lack of control, and lack of marketability) in these cases were also significant. The low total discount of 33.5% in *Jensen* was influenced primarily to the fact that a controlling interest was involved. The total discounts in the other cases (all of which involved non-controlling interests that did not have the ability to liquidate the entity) ranged from 44.3% to 67.0%.

Richmond

The decedent in *Richmond* owned a non-controlling 23.44% interest in an entity that consisted primarily of marketable securities. This entity had existed since 1928 with a stated philosophy of maximizing dividend income. The turnover of securities in the company was very low, averaging 1.4% annually in the past ten years. As a result, the company had a large number of long-term securities holdings that had a significant BIG. The NAV of the company was $52.1 million with a BIG of $45.6 million and BIG liability of $18.1 million. The decedent's pro-rata share of the NAV of the Company was therefore approximately $12.2 million, prior to any discounts or adjustment for BIG.

The estate's expert was a CPA with no valuation credentials and limited valuation experience. Using a capitalization of dividends method, the estate's expert determined a value of $3.1 million for the decedent's 23.44% ownership interest, or an approximate 75% discount from NAV. The valuation expert for the IRS applied a total 40% discount to NAV to determine a $7.3 million value. The 40% discount was comprised of a 6% discount for lack of control and a 34% discount for both lack of marketability as well as the BIG liability.

The Court ultimately applied an approximate 47% total discount to arrive at a final value for the decedent's interest of $6.5 million. This discount was comprised of a discount for lack of control of 7.75% and a discount for lack of marketability of 32.1%. The Court also made an adjustment for the BIG liability that was equal to 15% of the Company's NAV.

The reduction for BIG liability allowed in *Richmond* (calculated as 15% of NAV) equates to about 43.2% of the total BIG liability existing.

The *Richmond* Court first notes the contrasting positions of the parties:

The IRS argued for a 0% adjustment for the BIG liability. The Court dismissed this position by noting that an investor could easily replicate the Company's marketable securities portfolio with an identical portfolio that had no BIG or BIG liability. As such, an investor would not purchase an interest in the Company without some reduction in value for the BIG liability.

On the other end of the spectrum, the estate argued for a 100% adjustment for the BIG liability. In support of this position, the estate cited the holdings in *Dunn, Jelke,* and other similar cases.

Noting that other courts have not adopted the 100% adjustment approach as in *Dunn* and *Jelke,* the Court in *Richmond* also declined to approve the 100% adjustment approach. The *Richmond* Court offered the hypothetical of a holding company as in *Richmond* (with an $18.1 million BIG liability) versus a holding company with no BIG liability but an $18.1 million note payable that is due tomorrow. The Court believed that the investor would not treat these situations as identical due to the fact that the buyer of the holding company with the immediately-due liability is faced with the reality that, starting tomorrow, he earns dividends on a net asset value of only $34 million ($52 million NAV less the $18.1 million liability). By contrast, an investor in the *Richmond* situation can defer the payment of the $18.1 million BIG liability until the appreciated securities are sold. Until that time, an investor in *Richmond* receives the capital gains and dividends generated by the entire $52 million portfolio.

The *Richmond* Court stated:

> PHC is simply worth more than HHC, because a prospective BIG liability is not the same as a debt that really does immediately reduce the value of a company dollar for dollar. A 100% discount, on the other hand, illogically treats a potential liability that is susceptible of indefinite postponement as if it were the same as an accrued liability due immediately. We do not accept this approach. It stands to reason that a potential buyer would be willing to pay more for a company with a contingent liability of $18.1 million than he would pay for a company otherwise equivalent but that had an unconditional liability of $18.1 million payable now. Likewise, the sale of the company with the contingent future liability would demand

> a higher price than the seller of a company with the unconditional current liability. As a result, despite contrary holdings by some courts, we find that a 100% discount would be unreasonable, because it would not reflect the economic realities of PHC's situation.

The *Richmond* Court explained its acceptance of the adjustment for BIG liability as being based on the adjustment proposed by the business valuation expert for the IRS. Although the Court did not agree with this expert's analysis, the Court held that the 15% of NAV adjustment for the BIG liability was effectively a concession by the IRS and therefore was allowed in this case.

The *Richmond* Court proposed an adjustment for the BIG liability based on the present value of the cost of paying off that liability in the future. This is the same approach taken in *Jensen* (see discussion above). The Court first attempted to define a reasonable time frame over which the BIG liability would be realized. As noted earlier, the actual turnover rate at the Company would imply a 70-year period in which all of the existing BIG liability would be realized. At an assumed 7% discount rate, the present value of the existing BIG liability realized over a 70-year period would be about $3.7 million. The Court instead chose a 20 to 30 year turnover period as more indicative of a normal period. Using a range of discount rates (between 7% and 10.3%) and both 20 and 30 year periods, the range of potential adjustments for the BIG liability is between $5.6 and $9.6 million. The Court noted that the IRS expert's figure of $7.8 million fell within this range.

Summary

The issue of adjustments for the BIG liability in the C corporation context continues to be somewhat fluid. After a fairly long line of cases allowing a dollar-for-dollar deduction for such liabilities, the *Richmond* court followed the *Jensen* practice of calculating the BIG liability based on the present value of the cost of paying off that liability in the future. While this resulted in a much lower 43% of the total BIG liability allowed as a discount, the overall discount on the interest in Richmond still fell within the range observed in the prior BIG cases. ◆

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