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FAIR VALUE™

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DISCOUNTING FOR BUILT-IN CAPITAL GAINS IN LLCS, PARTNERSHIPS, AND S CORPORATIONS

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Introduction. In a related article in this issue of *Fair Value*, George Hawkins analyzes and discusses the recent *Dunn* case and its impact on the ability to take a discount for built-in (or unrealized) capital gains in a C corporation. *Dunn* is the latest in what is becoming a long line of cases since 1998 that allow for a valuation discount for built-in capital gains in a C corporation. As discussed by Hawkins, what is different about *Dunn* is that the Court of Appeals allows a dollar-for-dollar reduction in value due to the built-in capital gains evident in that case. Previous cases had been far less specific about the amount or calculation of the appropriate discount in the case of built-in gains.


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While it appears that we now have some clarification and solidification on the built-in gains issue for C corporations, this still leaves a major unanswered question: what to do about appreciated assets in pass-through tax entities such as partnerships, LLCs, and S corporations? As mentioned in Hawkins' article, C corporations are unique in that they subject their owners to two levels of taxes: one at the corporate level and one at the individual level. In contrast, owners of such tax-advantaged entities as partnerships, LLCs, and S corporations have no entity-level tax and are taxed only at the personal level. Despite this difference, the built-in gains issue can still exist with a tax-advantaged entity.

This raises a choice for the hypothetical willing buyer: (1) purchase an asset (such as marketable securities or real estate) outright and get a basis equal to the purchase price, or (2) purchase an interest in a Partnership, LLC, or S corporation, and take a potentially low inside basis on the appreciated assets of that entity. Under scenario (2), the sale of an appreciated asset can mean the pass-through of capital gains liability to the partners, members, or S corp shareholders of the entity. Although this can result in an increased basis, the benefits of which may be realized upon the later sale of the entity, it also may result in immediate tax liability on the capital gain. If scenario (2) is therefore relatively unattractive to scenario (1), wouldn't the hypothetical willing buyer demand some discount on the purchase of an interest in such an entity?

Recent Tax Court cases of *W.W. Jones II Est.*, 116 TC 121, Dec. 54,263 (2001) and *E.M. Dailey Est.*, 82 TCM 710, Dec. 54,506(M), TC Memo 2001-263, may help shed some light on this situation. Both *Jones* and *Dailey* involved gifts of partnership interests. In *Jones*, no discount for built-in gains was allowed on the two gifts made, however, the reasoning by the Tax Court on one of these gifts is highly flawed. In *Dailey*, a discount for built-in capital gains was recognized as valid by experts for both the taxpayer and the IRS. The discount for built-in capital gains was allowed, however, the court did not give any direction as to how the discount should be calculated.

Keeping up with the Joneses. We will first look at the *Jones* case. In *Jones*, the decedent had one son and four daughters. The decedent formed family partnership A with his son as each party contributed assets (primarily a cattle ranch) to the partnership. The son was the sole general partner and the decedent was a limited partner. The decedent then transferred an 83.03% limited partnership interest to his son.

The decedent also formed family partnership B with his four daughters as each person contributed assets (primarily another cattle ranch) to the partnership. Two of the daughters were general partners. The decedent and the other two daughters were limited partners. The decedent then transferred 16.915% limited partnership interests to each of his four daughters (or 67.66% total).

The tax court held that both partnerships were properly formed and there was no taxable gift by the decedent to his children upon the formation of the partnerships. The tax court also held that the interests transferred were actual limited partnership interests and not assignee interests.

There were significant built-in gains at both partnerships. At the time the decedent made his transfers, Partnership A had a net asset value of $11.6 million and a basis of about $500,000, or a built-in capital gain of about $11.1 million. Likewise, Partnership B had a net asset value of $7.7 million and a basis of $1.8 million, or a built-in capital gain of about $5.9 million.

The Discount Battle. The decedent's estate employed an independent business appraiser to determine the appropriate discounts for federal gift tax purposes. This appraiser applied discounts for lack of control, lack of marketability, and built-in gains. This appraiser took a 66% discount for the partnership A gift and a 58% discount for the partnership B gifts. Not surprisingly, the appraiser for the IRS opined that no discount was appropriate on either gift.

In first addressing Partnership A, the Tax Court allowed only an 8% discount for lack of marketability on the gift of the 83.03% interest. A key reason for the Tax Court's decision in this matter was the fact that the partnership agreement for Partnership A required a 75% limited partnership vote to remove the general partner or liquidate the partnership. Consequently, the buyer of an 83.03% interest could immediately remove the general partner, install himself as general partner, and liquidate the partnership. The Tax Court's analysis of Partnership B was different. Because the gifted interests in Partnership B were true minority interests, the Tax Court allowed a 40% discount for lack of control and 8% discount for lack of marketability on the gifts of the 16.915% interests.

The Section 754 Election. Both parties agreed that the tax on the built-in gains could be avoided by use of a section 754 election. The Court noted as follows:

> "The parties and the experts agree that tax on the built-in gains could be avoided by a section 754 election in effect at the time of sale of partnership assets. If such an election is in effect, and the property is sold, the basis of the partnership's assets (the inside basis) is raised to match the cost basis of the transferee in the transferred partnership interest (the outside basis) for the benefit of the transferee. See sec. 743(b). Otherwise, a hypothetical buyer who forces a liquidation could be subject to capital gains tax on the buyer's pro-rata share of the amount realized on the sale of the underlying assets of the partnership over the buyer's pro-rata share of the partnership's adjusted basis in the underlying assets. See sec. 1001. Because the [Partnership A] agreement does not give the limited partners the ability to effect a section 754 election, in this case the election would have to be made by the general partner."

The Built-in Gains Issue: Partnership A. The taxpayer's expert argued that a discount for built-in gains was appropriate for the Partnership A gift. Although the taxpayer's expert acknowledged that there was a 75% to 80% chance that the 754 election would be made and that the election would not create any adverse consequences or burdens on Partnership A, this expert nonetheless believed that a discount for built-in gains was appropriate due to the fact that the decedent's son (the sole general partner of Partnership A) stated that he might refuse to cooperate with an unrelated buyer of the 83.03% interest. The Tax Court rejected the opinion of the taxpayer's expert as an "attempt to bootstrap the facts to justify a discount that is not reasonable under the circumstances."

The expert for the IRS argued that no discount for built-in gains was warranted for Partnership A. The expert for the IRS argued that:

> "a hypothetical willing seller of the 83.03% interest would not accept a price based on a reduction for built-in capital gains. The owner of that interest has effective control, as discussed above, and would influence the general partner to make a section 754 election, eliminating any gains for the purchaser and getting the highest price for the seller. Such an election would have no material or adverse impact on the preexisting partners."

The Tax Court rejected the reliance on the *Davis* and *Eisenberg* cases by the taxpayer's expert. *Davis* and *Eisenberg* were earlier cases where the Tax Court allowed a discount for built-in capital gains due to appreciated assets held in a C corporation. In rejecting the taxpayer's reliance on *Davis* and *Eisenberg*, the Tax Court noted the following:

> "In the cases in which the discount was allowed [namely, *Davis* and *Eisenberg*], there was no readily available means by which the tax on built-in gains would be avoided. By contrast, disregarding the bootstrapping testimony by [the decedent's son] in this case, the only situation identified in the record where a section 754 election should not be made by a partnership is an example by [the taxpayer's expert] of a publicly syndicated partnership with 'lots of partners…and a lot of assets' where the administrative burden would be great if an election were made. We do not believe that this scenario has application to the facts regarding the partnerships in issue in this case. We are persuaded that, in this case, the buyer and seller of the partnership interest would negotiate with the understanding that an election would be made and the price agreed upon would not reflect a discount for built-in gains."

The Built-in Gains Issue: Partnership B. The Tax Court also did not allow a discount for built-in gains for the gifts of the limited partnership interests in Partnership B. The Tax Court relied primarily on the assumption that a 754 election would not cause a significant burden on Partnership B:

> "For the reasons set forth in the built-in capital gains analysis for [Partnership A], an additional discount for lack of marketability due to built-in gains in [Partnership B] is not justified. Although the owner of the percentage interests to be valued with respect to [Partnership B] would not exercise effective control, there is no reason why a section 754 election would not be made. [The taxpayer's expert] admits that, because [Partnership B] has relatively few assets, a section 754 election would not cause any detriment or hardship to the partnership or the other partners. Thus, we agree with the [expert for the IRS] that the hypothetical seller and buyer would negotiate with the understanding that an election would be made. [The] assumption [by the taxpayer's expert] that [the general partners of Partnership B] might refuse to cooperate with a third-party purchaser is disregarded as an attempt to bootstrap the facts to justify a discount that is reasonable under the circumstances. Therefore, a further discount for built-in capital gains is not appropriate in this case."

Where do we go from here? In trying to read between the lines to apply the rationale of this case in future situations, it appears the Tax Court placed weight on the following issues as concerns the ability to take a discount for built-in gains in a partnership scenario:

1. Influence that the transferred interest has over the ability to make the 754 election. This is a particularly important issue as relates to the Tax Court's decision to not allow a discount for built-in capital gains with the gift of the Partnership A interest. As noted earlier, the Partnership A interest transferred was an 83.03% limited partner interest that had the unilateral ability to direct key actions of that partnership (due to the 75% majority vote required to remove the general partner, sell the partnership assets, etc.). It is easier to see how a discount for built-in gains would be disallowed on such an interest as it represents a controlling interest

that presumably can make (or at least heavily influence) the 754 election. On the other hand, the interests being valued in Partnership B were minority 16.915% limited partner interests that did not have any ability to influence key actions of the partnership. It is far less clear in this situation that the buyer of a 16.915% interest would be able to force or heavily influence the 754 election and therefore far more reasonable that some discount for built-in gains should be considered.

2. Resulting detriment or hardship to the partnership or other partners following the 754 election. About the only real peg that the Tax Court hangs its hat on as concerns the Partnership B gifts was the assumption that a 754 election "would not cause any detriment or hardship to the partnership or the other partners." Although this is a factor that should be considered, this should not be a determinative factor in not allowing a discount for built-in gains, particularly when there are other compelling factors that argue for at least the consideration of a discount for built-in capital gains. There are several characteristics about the 754 election that suggest its careful use. Among these characteristics are the fact that the election can be made only once, the election can be very difficult to revoke, the election is not necessarily beneficial to the other partners in the partnership, and there are additional (and perhaps significant) administrative and accounting costs associated with the election. The Tax Court notes that "the only situation identified in the record where a section 754 election would not be made by a partnership is…a publicly syndicated partnership with 'lots of partners…and a lot of assets' where the administrative burden would be great if an election were made." Unfortunately for the rest of us, we are left to wonder just how many partners constitute "lots of partners," how many assets are "a lot of assets," and the exact location of the line where administrative burden crosses from moderate to great. Based on our conversations with a number of estate planning attorneys, the 754 election is rarely made in the real world due to the disadvantage of additional accounting and tax preparation fees that arise from the election. Due to this increase in compliance costs, a very significant step-up in basis is usually required to make the 754 election worthwhile.

3. Likelihood that the willing buyer and willing seller would negotiate a 754 election. In not allowing a discount for built-in capital gains with the Partnership B gifts, the Tax Court makes a fairly bold leap in assuming that "the hypothetical seller and buyer would negotiate with the understanding that an election would be made." This is an unconvincing argument. It is far more compelling in the Partnership A scenario (where a "controlling" 83.03% limited partnership interest is the issue) that the hypothetical willing buyer and willing seller would negotiate a 754 election. It is far less likely that a hypothetical willing buyer of a 16.915% limited partnership interest (an interest that has virtually no power over the entity) would be successful in negotiating a 754 election, no matter how light the administrative burden of such an election would be. Why would the other 83.085% owners go along with the desire of a 16.915% owner when the 83.085% owners may derive no benefit from the election and, more than likely, would incur greater administrative costs and hassles with the 754 election?

In *Jones*, then, we are left with a useful framework for analysis of the built-in capital gains issue, however, the logic and reasoning surrounding the failure to allow a discount for built-in capital gains on the Partnership B gifts are less than compelling.

The *Dailey* Case. In *Dailey*, a contemporary case with *Jones*, the Tax Court approves a discount for built-in gains in a partnership, however, the Court does not quantify the discount or give appraisers any guidelines to follow. In *Dailey* the decedent made two separate gifts of limited partnership interests in a family limited partnership that held highly-appreciated marketable securities (primarily Exxon stock).

Even the IRS Expert Recognizes Discounts for Built-in Gains. The taxpayer's expert in *Dailey*, "citing published data, opined that the aggregate discount is 40 percent for lack of marketability, control, and liquidity." The taxpayer's expert further "testified that he considered the significant amount of unrealized capital gains relating to the Exxon stock." The expert for the IRS argued for aggregate discounts of 13% and 16% on the two gifts. At trial, however, this IRS expert admitted that he had not reviewed the partnership agreement in this case. Furthermore, this expert did not analyze the partnership to determine the existence and magnitude of any unrealized capital gains, even though he stated at trial that unrealized capital gains are "an important source of discounts."

The Tax Court ultimately affirmed the 40% discount taken by the taxpayer, finding that the testimony of the expert for the IRS was

"contradictory, unsupported by the data, and inapplicable to the facts." The Tax Court, in a sense, was choosing between the lesser of two evils, stating that "neither expert was extraordinary." As a result, it is difficult to have much faith in the conviction of the Tax Court's decision.

Lessons from *Dailey*. The important thing to glean from the *Dailey* case is that the Tax Court gives credit to both experts' statements that unrealized capital gains are an important issue to consider and actually sides with the expert who considered the unrealized capital gains in determining his discount. The unfortunate aspects of the *Dailey* case are that neither expert was particularly compelling and the Tax Court did not quantify the particular discount for unrealized capital gains. In a sense, the *Dailey* case is similar to the 1998 *Davis* and *Eisenberg* cases. As noted earlier in this article, the *Davis* and *Eisenberg* courts stated that a discount for unrealized capital gains in a C corporation was appropriate, however, these courts did not give any guidance on how that discount was calculated. Only with *Dunn* (see George Hawkins' related article in this issue) do we finally have some definitive direction as to how the discount should be calculated.

Conclusion. In summary, the recent *Jones* and *Dailey* cases have at least addressed the issue of built-in capital gains in pass-through entities such as partnership, LLCs, and S corporations. Part of the *Jones* decision makes sense and part of it doesn't. Not allowing a discount for built-in capital gains on the gift of the "controlling" Partnership A interest seems reasonable given the significant control and influence that interest has over the partnership's ability to make a 754 election. Far less compelling is the *Jones* decision to not allow a discount for built-in capital gains on the true minority interests gifted in Partnership B.

The *Dailey* case offers hope that the courts are moving towards the recognition of the reality of the impact of built-in capital gains on value. On the C corporation side, the courts have taken four years from the ambiguity of the *Davis* and *Eisenberg* cases in 1998 to the specificity of the *Dunn* case in 2002. During this time, the courts have moved from the position that a discount for built-in capital gains is appropriate (but we are not going to tell you how to calculate it) to the position that a dollar-for-dollar reduction in value is the appropriate discount for the built-in capital gain. Will the same thing happen for discounts for built-in gains for tax-advantaged entities? Stay tuned… ♦

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