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Reprinted from the Winter/Spring 1999 Issue

VALUATION DISCOUNT FOR POTENTIAL CAPITAL GAINS: HOW MUCH IS ENOUGH?

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Introduction. One of the hottest topics in business valuation today is the recent line of court cases allowing discounts for potential (or "built-in") capital gains on stock in C Corporations holding appreciated assets. In two 1998 cases, *Davis* and *Eisenberg*, the courts ruled that some discount is appropriate on the shares of C corporations to allow for the potential capital gains on the underlying assets in the corporation. Although this may be a beginning to what we believe is a more realistic position on this issue, the *Davis* and *Eisenberg* cases by no means provide a specific and clear road map as to what the appropriate discount is or how it should be calculated. Blindly applying a full capital gains discount on top of full minority and marketability discounts could result in the severe undervaluation of a company and a completely indefensible position with the IRS. Many professionals, fueled by an excited but mistaken interpretation of these cases, have jumped to the conclusion that *Davis* and *Eisenberg* now mandate a full capital gains discount, some going so far as to publish this in their newsletters. In fact, as will be evidenced in this article, the analysis and calculation of the proper potential capital gains discount is not clear and extreme caution is warranted in this area. In addition to their impact on estate planning, these cases could also affect family law valuation issues where, at least in North Carolina, a discount for potential capital gains currently may *not* be considered for equitable distribution purposes.


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This article will first illustrate the concept of potential capital gains and why we believe that willing buyers and willing sellers do take such potential gains into account in real-world transactions. Next, we will discuss the evolution of the discount on potential gains, from the long-standing position of the courts and the IRS to the recent developments in the *Davis* and *Eisenberg* cases. Finally, we will address the practical applications and potential limitations of the *Davis* and *Eisenberg* cases.

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 distribution 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 income tax rate of 40%, the income tax liability at the shareholder level would be $216,000 ($640,000 in distributed cash, less $100,000 basis, times 40% tax rate). This adds up to a total tax bill of $576,000 and net proceeds received of $424,000. 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.

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. We believe 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 40% individual tax rate, Bob's capital gains liability under this scenario is $400,000. 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 $1,600,000 in year 5 ($2,000,000 sale proceeds less $400,000 in taxes paid). Bob's five-year compound annual return is about 9.9%

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 40% individual tax rate, Bob must pay an additional $96,000 in capital gains tax at the shareholder level, bringing his total tax bill to $856,000. Under this scenario, Bob invested $1,000,000 in year 0 and received $1,144,000 in year 5 ($2,000,000 sale proceeds less $856,000 in total taxes paid). This equates to a five-year compound annual return of about 2.7%, 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 9.9% 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 9.9% 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. Bob's shareholder level capital gain liability is $248,000 (distributable cash of $1,240,000, less $620,000 basis, times the 40% individual tax rate). After all taxes have been paid, this scenario gives Bob net proceeds in year five of $992,000 ($2,000,000 less $1,008,000 in total taxes paid) on an original investment of $620,000. This translates to a five-year compound annual return of about 9.9%. 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.

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 2.7% return when an equally risky 9.9% 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.

Historical Background. There exists a long line of court cases where the IRS successfully argued that a capital gains discount did not apply. The IRS has basically taken a twofold position. First, since the 1986 Tax Reform Act, the IRS has 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 focuses on the uncertainty of liquidation of the appreciated corporate assets. Basically, the IRS has 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 *Davis* and *Eisenberg* cases signaled a significant shift in the thinking of some courts.

***Davis* Case.** The *Davis* case was decided by the U.S. Tax Court and was filed on June 30, 1998. Mr. Davis, a founder of Winn-Dixie supermarkets, owned 100% of a personal holding company holding Winn-Dixie stock with a market value of $70 million and a cost basis of about $340,000. The total net asset value of holding company was over $80 million. Mr. Davis originally owned 100% of the holding company and made two minority interest gifts to his sons in November of 1992. Among other discounts, Mr. Davis took a discount for the full amount of the capital gains tax liability on the appreciated assets in the holding company.

Following Mr. Davis' death, the gifts were challenged by the IRS. The valuation experts for Mr. Davis' Estate argued that a discount for potential capital gains was appropriate due to the significant appreciation in the Winn-Dixie stock held in the personal holding company. Holding to its long-successful and well-supported position, the IRS disagreed, saying no discount for potential capital gains was appropriate. Interestingly enough, the valuation expert hired by the IRS felt that some discount for potential gains was indeed appropriate. Both the Estate and the IRS agreed that some level of minority and marketability discounts were appropriate. At the trial, the Estate argued for a total discount of 67% while the IRS argued for a total discount of 35%.

The Tax Court ultimately settled on an *overall* valuation discount of about 50%, including a discount for potential capital gains. However, in reading the opinion closely, the court does not provide much solid data that business valuators may use going forward. One of the Estate's experts as well as the expert for the IRS believed that a 15% discount for capital gains was appropriate. The dollar amount of each expert's capital gains discount differed, however, due to differences in earlier discounts taken for blockage, minority interest, and lack of marketability. 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.

Therefore, although the Tax Court specifically stated that part of the marketability discount is due to potential capital gains, it didn't exactly give the business valuator a hard and fast formula to follow. According to the record in the *Davis* case, the actual potential capital gains liability was $26.7 million, far above the $9 million discount actually allowed by the Tax Court. The fact that the Tax Court did not apply the full capital gains discount and derived its discount in a seeming arbitrary manner illustrates the danger of applying a full capital gains discount in addition to full minority and marketability discounts.

***Eisenberg* Case.** The *Eisenberg* case was decided by the U.S. Court of Appeals (Second Circuit) on August 18, 1998, revoking an earlier decision of the Tax Court. Mrs. Eisenberg owned 100% of a personal holding company whose sole asset was a commercial building in Brooklyn, NY. The building was rented and there were no plans to sell the property. Mrs. Eisenberg made minority

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interest gifts to family members over three years, reducing the value of the stock by the full amount of the capital gains tax she would have incurred upon the sale or distribution of the building.

The gifts were challenged by the IRS and the Tax Court upheld the long-standing IRS position that a discount for potential capital gains is not allowable. Upon appeal, the U.S. Court of Appeals reversed the Tax Court, holding that a discount for potential capital gains was appropriate. 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.

Summary. While estate planning professionals and their clients may be jumping for joy after this summer's rulings, we in the business valuation community are left scratching our heads. Although both the *Davis* and the *Eisenberg* case clearly establish a preference for discounts for potential capital gains, neither case provides much solid guidance as to how much of a discount is appropriate. The *Davis* court states that the potential capital gains discount is a "part of the lack of marketability discount" but it doesn't indicate how much of the discount. Furthermore, neither case indicates if the potential capital gains discount "adds to" the marketability discount that would be derived before consideration of the potential capital gains. Most studies show marketability discounts for minority interests in the 25% to 45% range, however, marketability discounts can fall outside of this range depending on the circumstances of the particular valuation.

Suppose that, prior to the *Davis* and *Eisenberg* cases, you performed the recommended *Mandelbaum* analysis and determined that the appropriate marketability discount on a minority interest in a particular company was 35%. Even though this particular company had a potential capital gains issue, you followed the long-standing IRS position and determined the marketability discount without considering such potential capital gains. Now comes *Davis* and *Eisenberg*. Does your marketability discount increase because you can now consider the potential capital gains? Or does your marketability discount remain the same, with the potential capital gains issue now becoming a "part" of the overall discount? The answer isn't clear.

Other limitations of the *Davis* and *Eisenberg* cases include their application only to C corporations. The impact on these cases on S corporations and other ownership entities is not clear. Also, these cases are very recent and have only been upheld in one circuit. It is conceivable that other circuits may not follow the *Eisenberg* court and would uphold the long-standing IRS position disallowing the potential capital gains discount. Finally, as mentioned earlier, equitable distribution law in such states as North Carolina currently does not allow any consideration of a discount for potential capital gains. Whether *Davis* and *Eisenberg* change this aspect of family law is yet to be seen.

We believe the prudent course of action with this issue is caution, analysis, and a "wait and see" approach as to what future courts do. Beware the business appraiser who takes a 25% minority discount, 35% marketability discount, and 15% potential capital gains discount, relying solely on *Davis* and *Eisenberg*. Although this combination of discounts may be appropriate in particular situations, a blind application of these discounts without adequate analysis and support is asking for trouble. ♦

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