

FAIR VALUE™

Reprinted from Volume XII, Number 2

Summer 2003

***DUNN* COURT ALLOWS DISCOUNTS FOR BUILT-IN GAINS- HOPE FOR ESTATE PLANNING (AND AVOIDING INEQUITABLE OUTCOMES IN EQUITABLE DISTRIBUTION)**

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Introduction. One of the many controversial 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. Interest in the topic accelerated in 1998 as a result of two U.S. Tax Court cases, *Davis* and *Eisenberg*, in which 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.

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Valuators saw a glimmer of hope that this represented a possible beginning to a new and more realistic position on this issue. However, the *Davis* and *Eisenberg* cases by no means provided a clear and specific road map as to what the appropriate discount is or how it should be calculated. Many business appraisers erroneously believed that these cases opened the door, with Tax Court approval, to take the full capital gains discount on top of minority and/or marketability discounts. A reading of what the Tax Court actually said in these cases suggests that this practice could be a dangerous one that could result in the severe undervaluation of a company and a completely indefensible position with the IRS. However, a subsequent U.S. Appeals Court opinion (*Dunn v. Commissioner*) takes a more specific position on the subject of capital gains discounts that gives business appraisers cause for hope.

***Dunn* Provides Hope in the Family Law Arena as Well.** This hope is not only of interest to estate planning attorneys, but should be to their colleagues in family law as well. The North Carolina Court of Appeals has not allowed divorcing couples to consider the tax implications of appreciated assets in a company in determining value in the context of equitable distribution. The U.S. Court of Appeals obviously has nothing to do with what position the Courts in North Carolina choose to take in family law matters. However, the strong position and logic expressed by the *Dunn* Court could provide strong ammunition for family law attorneys who want to challenge the validity of North Carolina’s illogical position, a position that flies in the face of what real world buyers and sellers of companies consider.

This article will first illustrate the concept of potential capital gains and why willing buyers and willing sellers do take such potential gains into account in real-world transactions. It will then discuss the *Dunn* case and the well enunciated position taken by the U.S. Court of Appeals. Next, this article will briefly discuss what the North Carolina courts have said about the issue in the equitable distribution context. The North Carolina “old world” logic is very similar to the one just trounced by the U.S. Court of Appeals in *Dunn*. We will also give examples of just why the current North Carolina logic can result in very inequitable outcomes in equitable distribution proceedings.

An Example of the Built-In Gains Dilemma.

In the Spring 1999 issue of *Fair Value* (“Valuation Discount for Potential Capital Gains: How Much is

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Enough?" Available at www.businessvalue.com), Michael Paschall gave an example of the built-in gains issue and the contrary positions of the IRS (and of the North Carolina Court of Appeals) and a real world buyer. He gave a simple illustration of a typical scenario involving potential capital gains 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 cost 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. 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

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(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 a 2.7% return when a higher rate of return of 9.9% was available with the same level of risk. 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 non-recognition, 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 (US Tax Court) signaled a significant shift in this thinking. Both cases, however, were vague about how tax implications could be considered in determining the value of a company's shares. Furthermore, the cases stopped far short of allowing the true, full impact to be taken into account.

A Bright Ray of Hope- *Dunn v. Commissioner*.¹ There is encouragement in the 2002 opinion of *Dunn v. Commissioner*, where the Fifth Circuit Court of Appeals reversed and remanded (in August 2002) the Tax Court's use of a 5% built-in

capital gains tax in the valuation of Dunn Equipment, an equipment leasing and services company located in Texas. The Fifth Circuit determined that the appropriate valuation methodology under the asset approach was to reduce the market value of the assets by the full (34% rate) built-in gain liability. The decedent's interest in the company was 62.96%, however, this was a non-controlling interest as Texas requires a two-thirds super majority vote to sell off substantially all of a company's assets.

In *Dunn*, the IRS argued that a minimal discount for built-in capital gains was warranted under the asset valuation approach given that there was no plan of liquidation in effect or under contemplation at the valuation date. The Fifth Circuit stated that the Tax Court made a significant mistake in the way it factored the likelihood of liquidation under the asset approach.

The Fifth Circuit held as a matter of law that the built-in gains tax liability of Dunn Equipment's assets must be considered as a **dollar-for-dollar** reduction when calculating the asset-based value of the corporation. The Fifth Circuit faulted the Tax Court's finding that the likelihood of a corporate liquidation that would trigger the recognition of a built-in gains liability was a valid consideration in whether or not the net asset value of the company should be tax-affected. In other words, the Tax Court was saying that if liquidation was likely, built-in gains taxes would soon be paid, and it was appropriate to tax-affect for them. If liquidation was not likely, then tax-affecting was inappropriate. The Tax Court in *Dunn* concluded that liquidation was unlikely, therefore tax-affecting was inappropriate. The Fifth Circuit was highly critical of the Tax Court's focus on the likelihood of liquidation in whether or not to tax-affect. The Fifth Circuit instead took the real world, market view, as follows:

“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

(emphasis added), 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.

¹ (CA-5), U.S. Court of Appeals for the Fifth Circuit, No. 00-60614, August 1, 2002, 2002 U.S. App. LEXIS 15453. Reversing and remanding the decision of the United States Tax Court, 79 TCM 1337, CCH Dec. 53,713(M), T.C. Memo. 2000-12

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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."

With respect to liquidation, the Appeals Court took aim at the longstanding position of the IRS and prior Tax Court rulings which hinged, in part, on the likelihood of liquidation as having an impact on whether or not the net asset value should be tax-affected for built-in capital gains liability. The historic position of the Service has been that unless a plan of liquidation is in effect, the taxpayer cannot deduct the built-in gains liability from net asset value. The Service's logic was that the taxpayer could control when, if ever, this liquidation might occur and built-in gains taxes might be recognized. Since this might actually occur many years in the future, the Service reasoned that the present value of this future tax liability is small or negligible. Therefore, it is unreasonable to deduct the built-in gains liability on a full dollar-for-dollar basis, if at all.

In *Dunn*, the Appeals Court stated that the likelihood of liquidation was completely irrelevant and that the Tax Court erred in taking this limited probability into account as a reason to tax-affect only to a very minor degree. The Appeals Court stated this clearly in the following excerpt from the opinion, which says under the standard of fair market value (the applicable standard for gift and estate taxes) buyers and sellers will consider the built-in gains liability without respect to the likelihood of liquidation and that the net asset value method, by its very nature, must consider such taxes:

"The Tax Court made a more significant mistake in the way it factored the 'likelihood of liquidation' into its methodology, a quintessential mixing of apples and oranges: considering the likelihood of a liquidation sale of assets when calculating the asset-based value of the Corporation. Under the factual totality of this case, the hypothetical assumption that the assets will be sold is a foregone conclusion—a given—for purposes of the asset-based test. The process of determining the value of the assets for this facet of the asset-based valuation methodology must start with the basic assumption that all assets will be sold, either by *Dunn Equipment* to the willing buyer or by the willing buyer of the Decedent's block of stock

after he acquires her stock. By definition, the asset-based value of a corporation is grounded in the fair market value of its assets (a figure found by the Tax Court and not contested by the estate), which in turn is determined by applying the venerable willing buyer-willing seller test. By its very definition, this contemplates the consummation of the purchase and sale of the property, i.e., the asset being valued. Otherwise the hypothetical willing parties would be called something other than 'buyer' and 'seller.'

"In other words, when one facet of the valuation process requires a sub-determination based on the value of the company's assets, that value must be tested in the same willing buyer/willing seller crucible as is the stock itself, which presupposes that the property being valued is in fact bought and sold. It is axiomatic that an asset-based valuation starts with the gross market (sales) value of the underlying assets themselves, and, as observed, the Tax Court's finding in that regard is unchallenged on appeal: When the starting point is the assumption of sale, the 'likelihood' is 100%!"

The Fifth Circuit Court hammered away at the Tax Court's approach, stating:

"Bottom Line: The likelihood of liquidation has no place in either of the two disparate approaches to valuing this particular operating company. We hasten to add, however, that the likelihood of liquidation does play a key role in appraising the Decedent's block of stock, and that role is in the determination of the relative weights to be given to those two approaches: The lesser the likelihood of liquidation (or sale of essentially all assets), the greater the weight (percentage) that must be assigned to the earnings (cash flow)-based approach and, perforce, the lesser the weight to be assigned to the asset-based approach."

"Belabored as our point might be, it illustrates the reason why, in conducting its asset-based approach to valuing *Dunn Equipment*, the Tax Court erred when it grounded its time-use-of-money reduction of the 34% gains tax factor to 5% on the assumption that the corporation's assets would not likely be sold in liquidation. As explained, the likelihood of liquidation is inapposite to the asset-based approach to valuation."

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“In our recent response to a similarly misguided application of the built-in gains tax factor by the Tax Court, we rejected its treatment as based on ‘internally inconsistent assumptions.’ In that case we reversed and remanded with instructions for the Tax Court to reconsider its valuation of the subject corporation’s timber property values by using a more straightforward capital gains tax reduction. Similarly, because valuing Dunn Equipment’s underlying corporate assets is not the equivalent of valuing the Company’s capital stock on the basis of its assets, but is merely one preliminary exercise in that process, the threshold assumption in conducting the asset-based valuation approach as to this company must be that the underlying assets would indeed be sold. And to whom? To a fully informed, non-compelled, willing buyer. That is always the starting point for a fair market value determination of assets qua assets. That determination becomes the basis for the company’s asset-based value, which must include consideration of the tax implications of those assets as owned by that company.”

“We must reject as legal error, then, the Tax Court’s treatment of built-in gains tax liability and hold that—under the court’s asset-based approach—determination of the value of Dunn Equipment must include a reduction equal to 34% of the taxable gain inherent in those assets as of the valuation date. Moreover, the factually determined, “real world” likelihood of liquidation is not a factor affecting built-in tax liability when conducting the asset-based approach to valuing Dunn Equipment stock. Rather, the probability of a liquidation’s occurring affects only (but significantly) the relative weights to be assigned to each of the two values once they have been determined under the asset-based and income-based approaches, respectively—which brings us to the second methodology issue presented in this appeal.”

North Carolina Courts Say No to Tax Considerations in Equitable Distribution. In the real world, buyers and sellers of shares do consider built-in gains tax issues when buying an asset holding company with appreciated assets, a position the *Dunn* Court clearly recognizes. However, this is not the view of the North Carolina Court of Appeals in equitable distribution settings, as outlined in a recent *Family*

Forum article by Doyle Early, Esq.² In **Weaver v. Weaver**, 72 N.C. App. 409 (1985), and **Wilkins v. Wilkins**, 111 N.C. App. 541 (1993), the Court of Appeals held it was improper to consider tax consequences as a distributive factor except where a taxable event has already occurred or the distribution ordered by the court will create an immediate tax consequence to either of the parties involved. Similarly, **Harvey v. Harvey**, 112 N.C. App. 788 (1993) relied on the earlier cited cases in not taking into account tax consequences in a partnership. In short, the North Carolina courts have taken the old U.S. Tax Court view that was trounced by the U.S. Court of Appeals in *Dunn*. Namely, unless the taxes are in the process of being incurred (such as through a liquidation) or are likely to be incurred, they are speculative and should not be considered.

This North Carolina logic fails to consider how real world buyers and sellers consider built-in gains tax consequences on the purchase or sale of an asset holding company’s shares. Therefore, the family law courts, while they proclaim to arrive at net value (or fair market value) of a company’s shares, selectively ignore market realities and instead live in the pretend world of equitable distribution.

Equitable Distribution Equals Inequitable Outcomes. Depending upon the tax circumstances of the assets involved, the current North Carolina view of ignoring the tax positions of assets in equitable distribution can lead to grossly unfair outcomes to divorcing parties. Let’s give a simple example of why.

John and Mary file for divorce and appear in court for their equitable distribution hearing. Mary is a real estate investor, having purchased and held a shopping center in a family business (unfortunately a C corporation) where she owns 100% of the shares. The real estate held by the Company has been appraised and is worth \$15 million as of the date of separation. Mary’s C corporation bought the shopping center 15 years ago for \$7 million. After taking into account depreciation taken for tax reasons over the years, the shopping center now has a cost basis for tax purposes of \$5 million. Meanwhile, John has a \$15 million portfolio of U.S. government bonds, which have a cost basis of the same amount. The judge in the case, properly versed in North Carolina case law, refuses to consider the tax conse-

² “Upon Reflection: Consideration of Built-In Taxes and Other Tax Consequences in Equitable Distribution,” Doyle A. Early, Esq., *Family Forum* (Volume 22, January 2002). *Family Forum* is published by the North Carolina Bar Association’s Family Law section. While Early’s view suggested that tax impacts should be considered, strong views have been stated in support of the view that the North Carolina position is right. For example, see “Another View: Taxes Which are Remote and Speculative Should Not be a Consideration in Equitable Distribution,” *Family Forum* (Volume 23, Number 1, November 2002).

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quences in dividing up the assets. Since both parties have assets worth \$15 million, the Judge calls it a draw, letting Mary keep her shopping center corporation and John his bond portfolio. Justice and equity have been served. Or have they...?

Six months later, Mary's family business sells the shopping center for the \$15 million market value. Her accountant indicates that the gain will be taxed at about 38.6% (34% Federal C corporation tax, and 6.9% North Carolina rate, with the NC taxes deductible for Federal purposes, or a net rate of 38.6%). Since the property sold for \$15 million and it had an adjusted cost basis of \$5 million, there is a taxable gain of \$10 million, all taxed at ordinary corporate income tax rates. At a 38.6% rate, this means Mary's company will have to write a check to the government for \$3,860,000 (38.6% of the \$10 million gain) straight out of the \$15 million in proceeds, leaving the Company she owns with \$11,140,000 in cash. By contrast, John can sell his \$15 million bond portfolio (which has a cost basis of \$15 million), and pay no taxes at all, allowing him to park a cool \$15 million in his money market account. Because North Carolina case law kept the judge from considering tax consequences, Mary came out \$3,860,000 the worse than John. Additionally, that only considers the tax incurred by her Company at the corporate level. Once Mary tries to take that money out of her C corporation as a dividend to park it in her personal money market account, she'll be taxed again personally on the FULL \$11.14 million in proceeds she receives at personal income tax rates, further distancing her outcome from that of John.

A Million Here, A Million There- Just Chump Change for the Rich. Maybe it is hard to feel sorry for Mary, who still walks away with millions no matter what the tax consequences. The typical divorcing couple does not have the luxury of arguing over millions. Nonetheless, the failure to consider tax consequences can still lead to major inequities when the court looks at the less wealthy divorcing couple's pool of assets and tries to figure who gets what: shares in a small business, a house, a retirement plan account, and so on. If tax impacts are not considered by the court, the odds of the unfair treatment of one spouse or the other are vastly increased. Not only does North Carolina case law allow these inequities to occur, it actually forces them to occur because of its refusal to allow the tax consequences to be considered.

But The Judge Levels the Playing Field. The skeptical North Carolina attorney will say that, yes, all of this true, but this is precisely why the judge is allowed to consider "distributional factors" in dividing up the marital pot one way or the other. But where does that

leave the parties? Since the case law implies that the judge is theoretically not supposed to consider tax consequences, he or she will want to avoid an opinion with error that can be appealed. Therefore, in attempting to be fair, the judge may come up with some other excuse as to how the assets are to be divided, with a result that is still very different and still has inequities than if the judge had just been allowed to directly consider, dollar for dollar, the actual tax implications. This assumes, of course, that the judge realizes what the tax consequences are, having been informed by the attorneys and their experts. But what if, in light of case law, the attorneys assume taxes are a losing cause and don't bring it up or the judge simply dismisses the issue because of the case law?

Conclusion. The Fifth Circuit's opinion in *Dunn* is very encouraging for several reasons. First, it recognizes the market reality of the impact of built-in gains that neither the Tax Court nor the IRS had been willing to fully accept in prior cases. The Fifth Circuit's opinion in *Dunn* moves away from the vague, non-committal view of *Davis* where the business appraiser is left scratching his or her head about the size, calculation of, and appropriateness of a discount for built-in gains. Instead, in *Dunn*, the Appeals Court leaves no ambiguity and is very harsh in its criticism of the Tax Court on this issue. *Dunn* provides one of the clearest indications to date that built-in gains are a real issue considered by real buyers in the real world. *Dunn* is just one specific case with a unique set of facts. Whether it can be confidently applied to other valuation matters is a legal issue. Finally, *Dunn* challenges the irrational view taken by the U.S. Tax Court which is completely contrary to the way buyers in the real world operate. The North Carolina Court of Appeals lives in the same dream world as the Tax Court, and North Carolina's position is vulnerable to much the same criticism so clearly enunciated in *Dunn*. It is time for North Carolina courts to revisit these outdated opinions and see if more rational thinking will prevail. ♦

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