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Estate of Jensen - Revisiting Built-In Capital Gain Discounts

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Estate of Jensen

The 2010 U.S. Tax Court case, *Estate of Jensen v. Commissioner of Internal Revenue,* focuses us again on the treatment of built-in long-term capital gains within C-Corporations. We thought we'd take this opportunity to review the Tax Court's opinion in the *Estate of Jensen*, and broaden the discussion to include our thoughts on the appropriate treatment of built-in capital gains in other legal entities, such as partnerships, limited liability companies, and S-corporations. We'll also discuss how the size of the interest being valued can also impact the treatment of built-in capital gains.

The *Jensen* case involved the valuation of an 82% interest in a C-Corporation, Wa-Klo, Inc. (Wa-Klo), that held a 94-acre waterfront parcel of real estate in New Hampshire. The property was improved with playing fields, a gymnasium, a horse stable, a dining hall, cottages and bunkhouses. Wa-Klo operated a summer camp for girls on the property. Unfortunately, operating a girl's summer camp did not generate substantial cash flow for Wa-Klo. Given that the 82% interest was controlling and could liquidate the assets, both appraisers in the case selected the adjusted book value method to value the company's equity. Both appraisers also agreed on the value of the underlying assets. The dividing issue however, became how much of the built-in capital gain tax liability to recognize in the valuation of the equity.

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The estate's expert stated that because the inherent assumption in the adjusted book value method is a liquidation of the entity, he recognized the full amount of the built-in capital gain for both federal and state tax, despite the fact that no liquidation or sale was planned or imminent.

The respondent's expert used a different approach. He examined closed-end mutual funds with built-in capital gain exposure to see how the market adjusted the prices of these funds. On the surface, this sounds like a great approach, because we can hope to see how investors and prices react to large built-in capital gains. Investor behavior is exactly what we are trying to emulate when valuing interests in a fair market value construct. Unfortunately, the respondent's expert found that the two funds (he used only six in total) with the largest exposure to built-in capital gains, sold at a premium to net asset value, the opposite of what one would expect. Given that he could find no evidence that large built-in capital gains were reflected in the stock prices of the mutual funds, he went through some rather convoluted calculations to determine a tax liability about 43% of the amount calculated by the estate.

In the opinion, the Court discussed the General Utilities doctrine, and how, once it was repealed and an investor's ability to avoid the built-in capital

gain was thwarted, the discount for built-in capital gain was allowed. This principle of "reasonable avoidance" of the built-in capital gain is a recurring theme in most of these cases and an important consideration when examining built-in capital gains in various legal entities for interests of different sizes. Further, the Court did not find that the respondent's expert presented any viable method to avoid the built-in capital gain in Wa-Klo.

While we agree with the Court's conclusion, we would have taken a different path.

The Court did not find the use of closed-end funds persuasive due to the fact that the discounts from net asset value are attributable to many factors including share liquidity, manager reputation, and fund performance. We agree with the Court. In the case of mutual funds there are many independent variables (manager, performance, liquidity, built-in capital gain) impacting a single dependant variable (discount to net asset value). In such cases, it is very difficult to extract the impact of a single independent variable with a high degree of confidence.

In the final analysis, The *Jens*en Court did its own calculation of the built-in capital gain. It avoided the complication of the lack of a planned liquidation at the time of death by forecasting the liquidation of the assets in 17 years. The Court allowed for appreciation of the assets and the underlying built-in capital gain. By doing so, the Court essentially allowed for recognition of the full tax liability regardless of the current liquidation/sale plan. While we agree with the Court's conclusion, we would have taken a different path.

First, since the 82% interest was controlling, and the highest value of the interest was derived from a liquidation of the underlying assets, we believe recognition of the full tax liability at the time of death is appropriate. The fact that the Wa-Klo had no plan to liquidate is irrelevant. What is relevant is that a hypothetical buyer would need to liquidate Wa-Klo's assets to realize the value indicated by the adjusted book value approach.

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Second, by calculating a present value of the future tax liability, the Court is recognizing a principle we have advocated for nearly a decade: Investing in real estate through a C-Corporation is tax inefficient. If an investor finds themselves in that circumstance, the inefficiency must be recognized in the valuation of the interest. The *Jensen* Court, perhaps unwittingly, supported the "tax-inefficient entity" discount, when it forecast the future tax liability. We think this method yields the appropriate result when valuing minority interests that can't force liquidation and none is planned.

Built-In Capital Gain Discounts in Partnerships and LLCs

The U.S. Tax Court in *Estate of Jones* and the U.S. District Court for the Eastern District of Texas in *Estate of Temple* have both made clear that a discount for built-in capital gains for both partnerships and LLCs is not appropriate. Their reasoning is that the hypothetical seller and buyer would ensure that the general partner would make a §754 election to increase the inside basis of the assets. The Tax Court stated that it was plausible there could be a very large partnership with multiple assets and many limited partners, where the general partner, because of the administrative burden, would not, or could not make §754 elections for new partners. But the situation in *Estate of Jones* did not qualify. We agree with the Court's decisions in these cases. These two decisions also highlight once again the importance of the principle of "reasonable avoidance" in the Courts' mind.

Built-In Capital Gain Discounts in S-Corporations

At first glance, one would think a pass-through entity like an S-corporation would be treated in the same manner as partnerships and LLCs. However, we believe there are differences which would allow a built-in capital gain discount in certain circumstances. The key again, is the concept of "reasonable avoidance." The ability of a buyer to avoid the built-in capital gain in the case of S-Corporations turns on the size of the interest and the level of control associated with it.

A buyer of 100% of the shares of an S-Corporation with a large built-in capital gain can avoid it by making a §338(h)(10) election, thus increasing the basis of the assets to the basis of the stock. This effectively eliminates the built-in capital gain issue. A §338(h)(10) election is generally available for acquisitions of 80% or more of the vote and value of a corporation. However, all shareholders of the target S-corporation must consent to the election, making the avoidance of built-in capital gain dependant on the facts and circumstances of the case.

A buyer of control, but less than 100% of the target S-corporation shares, however, has the option of liquidating the assets of the company. In this scenario, the buyer would recognize a capital gain on the sale of the underlying assets, and an off-setting capital loss on the effective liquidation of the stock, eliminating the built-in capital gain. It could occur though, that income is generated on the sale of the assets, which would be taxed at a higher rate.

A minority, non-controlling investor in an S-corporation with a built-in capital gain is in a unique situation which has similarities to both a C-corporation and a Partnership. To date, we have found no Tax Court cases that address the built-in capital gain issue within S-corporations. Similar to the C-corporation, the hypothetical buyer of a minority, S-corporation interest has no way to avoid the built-in capital gain. The minority investor also has no control of when the assets will be liquidated, or the company sold. However, the treatment of growth in asset value and the related future capital gains must be treated differently than a C-corporation. This is due to the fact that the S-corporation structure does not impose any penalty (double-taxation) that warrants consideration of capital gains tax on future asset appreciation. Put another way, an investor with the option of investing in an S-corporation that holds the asset, or the asset directly, are in the same place with regard to future capital gains. Therefore, it isn't appropriate to penalize the S-corporation value today. Valuation approaches could include using going-concern methods such as the income and market approaches, as well as an adjusted balance sheet method recognizing the built-in capital gain and its timing.

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