RECOGNIZING ASSET VALUE AND TAX BASIS DISPARITIES TO VALUE CLOSELY-HELD STOCK

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I. INTRODUCTION

Your client has worked many years successfully building the company from the ground up and, rather than selling the business, is interested in retaining the corporate stock in the family. The client is considering whether to give away the shares or pass them on upon death. While the client recognizes that the shares of stock can be conveyed by gift or will to family members, the focal point of inquiry revolves around the value of these shares for federal wealth transfer tax purposes. For estate tax

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purposes, if property is to be included in a decedent's gross estate, it will be taxed based upon its value as of the date of death.[1] If the property is the subject of a gift, it is taxed on its value as of the date of the gift.[2] The value of closely-held stock for estate and gift tax purposes is made that much more difficult because of the paucity or lack of market quotations. In recognition of this fact, the estate and gift tax regulations start by defining value to mean fair market value and then provide: "The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."[3]

The willing buyer and willing seller are hypothetical persons under the definitional formula. Under the willing buyer/willing seller rule, each party attempts to optimize his economic advantage. The seller wishes to maximize the sales price while the buyer seeks to minimize cost. Economic principles simultaneously support a seller of stock wishing to maximize the sales price and the stock buyer motivated to minimize the purchase price. However, because transfer taxes are measured by the value of the stock, a donor or decedent has an incentive to reduce the value of the stock to lessen the impact of taxes. The question remains: Is the value claimed for gift or estate taxes less than what the shares would ever realistically be sold for? Consequently, the transfer tax rules place the donor and decedent in the position of a being a hypothetical seller. Although hypothetical, the donor or decedent is thrust into the transactional setting of corporate acquisitions. The client is jettisoned from the wealth transfer taxation arena into the world of stock and asset deals.

Consider two corporations each owning a portfolio of publicly traded securities having the same aggregate fair market value. Where these two companies differ concerns the purchase price each had to pay to amass the respective portfolios. The higher investment cost for one of the corporations will produce a lower corporate income tax liability in comparison to the other corporation even though each corporation, should it decide to, sells the portfolio for the same price. In choosing which corporation to acquire, little doubt exists that a prospective purchaser of the stock of either of these corporations would be unwilling to pay the same

[1] I.R.C. § 2031(a) (2000).

[2] *Id*. § 2512(a).

[3] Treas. Reg. § 20.2031-1(b) (as amended in 1965); *see also* Treas. Reg. § 25.2512-1 (as amended in 1992).

price for each corporation knowing full well the potential for a greater income tax bite for the corporation with the lower investment cost in its assets.

Shares of closely-held corporations may be valued using the net asset value. Under this method, stock value begins by looking to the value of the underlying corporate assets. From this value, liabilities of the corporation are then subtracted out.[4] Current liabilities of the corporation are properly deducted in the valuation equation. The same thing cannot be said for potential future or prospective liabilities. Disputes have arisen concerning whether tax liabilities for built-in capital gains are properly included as liabilities in this valuation calculation.

For assets with built-in gains, the issue becomes whether the entire amount of the calculated income tax liability should be subtracted in determining net asset value. Proponents of the subtraction in value for the entire amount of the tax liability apply the reduction even though there is no tax due and owing on the applicable valuation date. No current tax liability is incurred because the corporation is neither liquidating nor selling its assets on the valuation date. However, a number of assumptions implicit in the net asset value method support valuation reduction by the entire built-in gain tax liability and counter the fact that the corporation has not actually incurred the income tax liability. Liquidation of the corporation is assumed when using asset based valuation. The hypothetical buyer of the stock is assumed to be purchasing the shares in order to obtain the underlying assets.

The proper application of the willing buyer/willing seller definition of fair market value requires taking into account the potential tax costs attributable to closely-held corporations having assets whose inside basis is less than the fair market value of those assets. Because it is important to ascertain the value of the stock, it becomes clear that the hypothetical buyer's outside basis, i.e., the basis in the shares of stock, will not directly correspond with the corporation's basis in its assets.

The hypothetical buyer and seller will be required to negotiate a price for the shares of stock to reflect the disparity between the inside and outside basis. This Article proposes a means for determining the valuation discount attributable to the adjusted basis and fair market value differential. The willing buyer/willing seller definition facilitates looking to the transactional world in which businesses, closely held or otherwise, are bought and sold.

[4] *See* Estate of Borgatello v. Comm'r, 80 T.C.M. (CCH) 260, 266 (2000).

By resorting to the transactional analysis, it becomes important to take into account the tax considerations buyers and sellers engage in when deciding whether the deal will be structured as an asset deal or stock deal.

As the courts now recognize, since the 1986 repeal of the *General Utilities* doctrine, buyers of stock do not obtain a fair market value basis in the assets owned by the acquired corporation. It then becomes important to quantify the loss in value caused by the inability to step up the basis of assets to their fair market value as of the valuation date. Taxpayers and the courts have struggled with the proper way to treat the built-in gain scenario for stock valuation purposes. With the advent of *Estate of Davis* and *Eisenberg*,[5] the courts have only fairly recently come around to accept the notion of the potential valuation adjustment. However, no precise guidance on calculating the adjustment has been established. One emerging approach is to treat the assets of the corporation as being sold in liquidation as of the valuation date.[6] Another method requires factoring in a forecast as to when the affected assets will eventually be sold.[7] Under this alternative approach, the amount of the valuation adjustment will be reduced the further in time the forecasted sale date moves away from the valuation date. This method of calculating the valuation discount may revive the "too speculative" arguments advanced under the pre-*Davis* decisions.[8]

This Article suggests that the question is best seen from the perspective of the lost tax benefits generated from the inside basis being less than the assets' fair market value. The lower basis figure will produce a smaller income tax deduction amount. A buyer will be paying more in taxes due to the inability to properly claim Accelerated Cost Recovery System (ACRS) or amortization deductions on the higher basis amount pegged to fair market value. With more cash being paid to the government there is a reduction in cash flow to the owner of the stock.[9]

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[5] *See infra* text accompanying notes 67–68, 73–79.

[6] *See* Estate of Dunn v. Comm'r, 301 F.3d 339, 350 (5th Cir. 2002).

[7] James A. Fellows & Michael A. Yuhas, *Estate and Gift Taxation: Valuation Discounts in Determining the Market Value of Real Estate Companies*, 29 REAL EST. L.J. 183, 201 n.26 (2001); James R. Hamill, *Built-In Corporate Tax Liability Reduces Taxable Estate*, 62 PRAC. TAX STRATEGIES 68, 72–73 (1999). *See also Estate of Borgatello*, 80 T.C.M. (CCH) at 264; Edward Kessel & Barbara A. Sloan, Valuing Closely Held Stock: Dealing with Built-In Capital Gains, Address at the American Bar Association Spring Meeting, Section of Taxation—Estate and Gift Tax Committee (May 15, 1998).

[8] *See* Fellows & Yuhas, *supra* note 7, at 201–02.

[9] Raby & Raby, *How Tax Attributes Affect Valuation of Equity Interests*, 77 TAX NOTES 1481, 1482 (1997).

II. THE DOUBLE-TAXATION MODEL FOR C CORPORATIONS

A fundamental concept of C corporation taxation is that earnings are taxed first at the corporation level and then again when distributed to its shareholders. With the enactment of the Tax Reform Act of 1986, Congress expanded the double taxation tenet, in part, through its repeal of the *General Utilities* doctrine.[10]

A. The Law Prior to the Tax Reform Act of 1986

In *General Utilities & Operating Co. v. Helvering*, the Supreme Court held that a corporation did not recognize taxable income on a distribution of appreciated property to its shareholders.[11] In so holding the Supreme Court rejected several theories of taxation advanced by the government.[12] The first theory rejected was that by declaring a dividend, a debt was created and then satisfied by the distribution of appreciated property.[13] Further rejected was the notion that the sale of the property immediately after the distribution should be attributed to the corporation.[14]

The legislative response to *General Utilities* was to enact I.R.C. § 311(a). It provided, in part, as follows, "[N]o gain or loss shall be recognized to a corporation on the distribution (not in complete liquidation) with respect to its stock of—(1) its stock (or rights to acquire its stock), or (2) property."[15]

The fair market value of the distributed property became the shareholders' adjusted basis in the property received.[16] In the tax world existing prior to *General Utilities* repeal, it was possible for a corporation to distribute its appreciated assets to its shareholders without corporate income tax liability. The recipient shareholders could, in turn, sell the assets to the

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[10] The doctrine is named after the famous case discussed *infra* at text accompanying note 11.

[11] 296 U.S. 200, 206 (1935).

[12] *See id*. at 204, 206.

[13] *Id*. at 205–06.

[14] This alternate theory of taxation was belatedly raised on appeal rather than at trial and the Court stated it should not have been considered on appeal. *Id*. It should be noted, however, that in *Comm'r v. Court Holding Co.*, attribution was found in circumstances where the corporation negotiates the sale and then belatedly, to avoid gain recognition, distributes the property to its shareholders prior to the sale. 324 U.S. 331, 334 (1945).

[15] I.R.C. § 311(a) (2000).

[16] *Id*. § 301(d).

new owner who would obtain an adjusted basis in the assets equal to their purchase price.[17]

The non-recognition treatment accorded non-liquidating distributions of appreciated property was extended to cover liquidating sales and distributions of property,[18] provided the 12 month liquidation rules of I.R.C. § 337 were satisfied. Under § 337:

> If, within the 12 month period beginning on the date on which a corporation adopts a plan of complete liquidation, all of the assets of the corporation are distributed in complete liquidation, . . . then no gain or loss shall be recognized to such corporation from the sale or exchange by it of property within such 12 month period.[19]

In the context of liquidations, the prior law rules thus permitted the corporation to sell its assets without corporate-level tax impact. Liquidating distributions to shareholders were treated as in full payment for their stock and the assets distributed received an adjusted basis equal to their fair market value.[20]

B. *Tax Reform Act of 1986 and Repeal of* General Utilities

The Tax Reform Act of 1986 made dramatic changes for corporations distributing assets. Through the repealing legislation, new rules were

[17] The recipient shareholders would have tax consequences measured by the difference between the fair market value of the distributed assets and the adjusted basis in their stock. *Id*. § 301(c)(3)(A). For non-liquidating distributions of property, the distribution is treated the same as if cash were distributed. Therefore, the shareholder will have dividends to the extent of current and accumulated earnings and profits. *Id*. § 301(c)(7). The portion of the distribution that exceeds current and accumulated earnings and profits is then tax-free and used to reduce the shareholder's adjusted basis in the stock. *Id*. § 301(c)(2). Any further amount which exceeds the adjusted basis in the stock is treated as a gain from the sale or exchange of the stock. *Id*. § 301(c)(3)(A).

[18] I.R.C. § 336 (1982), *amended by* I.R.C. § 336 (Supp. 1987). Section 336 provided that "no gain or loss shall be recognized to a corporation on the distribution of property in complete liquidation." *Id.*

[19] I.R.C. § 337(a) (1982), *amended by* I.R.C. § 337 (Supp. 1987).

[20] I.R.C. §§ 331, 334 (1982) (amended 1987). The recipient shareholders would have tax consequences measured by the difference between the fair market value of the distributed assets and the adjusted basis in their stock. By permitting shareholders to obtain a fair market value basis the distributed assets, shareholders could then sell the assets and avoid tax on the appreciated value at the time of distribution.

enacted to require the recognition of corporate-level gains on the distributions of appreciated property.[21] Moreover, the recognition of such corporate-level gains and losses is required on liquidating sales and distributions of property.[22] For shareholders, amounts distributed in complete liquidation are treated as in full payment in exchange for their stock.[23] Shareholders will then have gain or loss measured by the difference between the amount realized and the adjusted basis in the stock. Any property received in the liquidation has an adjusted basis equal to the fair market value on the date of distribution.[24]

C. Treating Stock Acquisitions as Asset Acquisitions – Section 338

Taxable acquisitions in the corporate world require the buyer and seller to determine whether stock or assets will be purchased. A buyer who purchases a business by acquiring the stock from its shareholders obtains an

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[21] I.R.C. § 311(b) (2000) provides as follows:

> Distributions of appreciated property—
>
> (1) In general.—If—
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>> (A) a corporation distributes property (other than an obligation of such corporation) to a shareholder in a distribution to which subpart A applies, and
>>
>> (B) the fair market value of such property exceeds its adjusted basis (in the hands of the distributing corporation),
>
> then gain shall be recognized to the distributing corporation as if such property were sold to the distributee at its fair market value.

[22] This was accomplished through the repeal of former § 337 and the enactment of new I.R.C. § 336 (2000) which now provides, in part, as follows:

> § 336. Gain or loss recognized on property distributed in complete liquidation
>
>> (a) General rule.—
>>
>> Except as otherwise provided in this section or section 337, gain or loss shall be recognized to a liquidating corporation on the distribution of property in complete liquidation as if such property were sold to the distributee at its fair market value.

New § 337 contains an exception to § 336 to permit a liquidating subsidiary to distribute to its parent corporation its assets in complete liquidation without incurring any tax consequences.

[23] *Id*. § 331(a).

[24] *Id*. § 334(a).

adjusted basis in the stock equal to the amount paid for the stock.[25] In turn, the selling stockholders recognize gain or loss on the sale.[26] In general, as the purchase was structured as a stock acquisition, the amount the buyer paid for the stock does not alter the adjusted basis of the retained target corporation's assets. Unless a § 338 election is made, the adjusted basis of corporate assets is the same as before the stock acquisition. Further, the target corporation remains in existence and does not experience any current tax consequences. To obtain a new adjusted basis in the assets, the buyer would have to buy the assets from the corporation. In a taxable asset acquisition, the selling corporation itself, rather than its shareholders, would be taxable on its sale of assets. A subsequent liquidation distribution to the target corporation shareholders is taxable to the recipient shareholders.[27] However, in contrast to the stock acquisition, the purchaser would obtain a new cost basis in the acquired assets.

D. Purchase Price Allocations for Asset Acquisitions

A buyer of the target's assets must allocate the purchase price among the assets acquired.[28] The purchase price allocation rules of § 1060 incorporate by reference the manner in which amounts are allocated under § 338(b)(5).[29] Under § 338(b)(5), the purchase price is allocated among the assets based on the classification of the assets and their fair market value.[30] Regulations establish seven classes of assets.

[25] Section 1012 provides that the adjusted basis of property acquired equals its cost. *Id.* § 1012.

[26] The sale of stock is a sale or other disposition of property under § 1001. *See also id*. § 61(a)(3). Section 1001 requires that the taxpayer compare the amount realized and the adjusted basis of the property sold or otherwise disposed of. *Id.* § 1001(a). The amount realized equals the amount of cash received plus the fair market value of any property received. *Id*. § 1001(b). The seller will have a gain realized if the amount realized on the sale of the stock exceeds its adjusted basis. *Id*. § 1001(a). A loss will result if the adjusted basis of the stock sold exceeds its amount realized. *Id*.

[27] For a more detailed discussion of the income tax consequences upon corporate liquidation, *see supra* text accompanying notes 18–24.

[28] *Id*. § 1060. It should be noted that the allocation rules apply to both the buyer's adjusted basis and seller's gain or loss. *See id*. § 1060(a)(1)–(2).

[29] *Id*. § 1060(a).

[30] Treas. Reg. § 1.338-6 (as amended in 2004).

Pursuant to Treas. Reg. § 1.338-6(b), cash and bank deposits are known as Class I assets.[31] Actively traded personal property together with certificates of deposit, U.S. government and other marketable securities are Class II assets.[32] Class III assets are marked to market assets.[33] Class IV assets include stock in trade, inventory and property held primarily for sale to customers in the ordinary course of business.[34] Class V assets are assets other than Class I to IV assets and Class VI and VII assets.[35] Class VI assets are section 197 intangibles other than goodwill and going concern value.[36] Goodwill and going concern value are Class VII assets.[37]

As Class V assets may qualify for ACRS deductions, it is important to know the § 168 recovery period applicable to the particular asset. Recovery periods are linked to the class life of the asset.[38] For personal property, the recovery periods range between three years and twenty years.[39] For real property, residential rental property has a recovery period of 27.5 years and nonresidential real property has a recovery period equal to 39 years.[40]

In 1982, § 338 was enacted, in part, to provide a greater equivalency between stock acquisitions and asset acquisitions.[41] Section 338 has its own benefits and burdens. If certain requirements are met,[42] a § 338 election

[31] *See id*. § 1.338-6(b)(1).

[32] *See id*. § 1.338-6(b)(2)(ii).

[33] *Id*. § 1.338-6(b)(2)(iii).

[34] *Id*. § 1.338-6(b)(2)(iv).

[35] *Id*. § 1.338-6(b)(2)(v).

[36] *Id*. § 1.338-6(b)(2)(vi).

[37] *See id*. § 1.338-6(b)(2)(vii).

[38] I.R.C. § 168(e) (2000).

[39] Under § 168(e), items of personal property may be classified as 3 year property, 5 year property, 7 year property, 10 year property, 15 year property, or 20 year property. *Id.*

[40] *Id*. § 168(c).

[41] *See id*. § 338.

[42] Section 338 requires a corporate purchaser to acquire at least 80% of the stock within a twelve month period. *Id*. § 338(d)(3); *see also id*. § 1504(a)(2). Further, the corporate purchaser in the qualified stock purchase needs to make a timely election to treat the stock purchase as an asset purchase. *Id*. § 338(a), (g).

A prospective buyer may be interested in acquiring the stock of a subsidiary corporation from its parent corporation. The corporate subsidiary stock acquisition is also covered by § 338. In addition to providing for the purchasing corporation's election under § 338(a) to obtain a cost basis (rather than retain the historic adjusted basis) in the target corporation's assets, through a § 338(h)(10) election, a selling corporate shareholder may receive non-recognition treatment on the sale of its subsidiary stock. The subsidiary is treated as if it sold all of its assets for fair market value to a new subsidiary and then distributed the sales proceeds to its parent corporation in a taxtreats the target corporation as having sold all of its assets in a single transaction for their aggregate fair market value to a hypothetical new target corporation. In turn, the new target takes an aggregate adjusted basis in the assets equal to the amount the buyer paid for the target corporation stock.[43] The ability under § 338 to obtain a cost basis in the underlying corporate assets is not without income tax cost to the purchaser. As a consequence of the § 338 election by the purchasing corporation, the target corporation recognizes gain or loss on the deemed sale of its assets to the new target corporation.[44] These tax consequences, though at the corporate level, are effectively borne by the new purchaser through the stock acquisition.[45] The *General Utilities* repeal consequently increases the purchase price for stock acquisitions in cases where a § 338 election is contemplated by the buyer as part of the acquisition.[46]

III. VALUATION DISCOUNTS FOR INCOME TAX LIABILITIES – CASE LAW DEVELOPMENT

A. The History – Before the Tax Reform Act of 1986

In valuing shares of closely-held stock, shareholders sought to reduce the value of such stock for the unrealized income tax liabilities at the corporate level. At first glance, it appears rather aggressive to seek a discount currently for a future corporate income tax liability. However, taxpayers achieved some success in situations in which it was established that future tax triggering events would actually occur. In *Obermer v. United States*, a discount was permitted because the taxpayer established that assets were required to be sold by the corporation to meet the terms of an agreement to pay corporate debt holders.[47] In another case, the taxpayer's claimed tax discount was allowed when the facts established that

free liquidation under § 332. A § 338(h)(10) election is made by both the purchasing corporation and the selling corporate shareholder.

[43] The buyer must be a purchasing corporation acquiring stock in another corporation. *Id*. § 338(a).

[44] The recognition of corporate-level tax consequences is in addition to the tax consequences experienced at the shareholder level.

[45] The cash needed to pay any corporate income tax liability will be disbursed from the newly acquired corporation.

[46] Prior to the repeal of *General Utilities*, the § 338 deemed sale of assets was tax free because it was treated as occurring in connection with tax free liquidations under former § 337.

[47] 238 F. Supp. 29, 35–36 (D. Haw. 1964).

certain corporate assets would be sold to satisfy divestiture requirements imposed by the Federal Communications Commission.[48]

The discount was claimed even under circumstances where the corporation neither contemplated a sale of assets nor planned to cause [undergo] a liquidation. Taxpayers were not greeted with the same success enjoyed by the taxpayers in the two cases mentioned previously. As noted as early as 1947, there is no impairment to value to justify a discount for "a hypothetical and supposititious liability for taxes on sales not made nor projected." [49] According to the Tax Court:

> A hypothetical willing buyer of the shares in an arm's-length sale could expect no reduction in price for sales expenses and taxes that he might incur in a subsequent sale of either the shares or the corporation's underlying assets. When liquidation is only speculative, such costs are not to be taken into account.[50]

When there is no reasonable prospect of liquidation, liquidation is a speculative event.[51] "When liquidation is only speculative, the valuation of assets should not take these costs into account because it is unlikely they will ever be incurred."[52]

Beyond disallowing the discount because of its speculative nature when sale or liquidation was neither planned nor imminent, a further rationale was offered by the court in *Estate of Piper v. Commissioner*.[53] The court stated: "We consider such a discount unwarranted under the net asset valuation technique employed herein, where there is no evidence that a liquidation of the investment companies was planned or that it could not

[48] *See* Estate of Gray v. Comm'r, 66 T.C.M. (CCH) 254, 254, 261 (1993).

[49] Estate of Cruikshank v. Comm'r, 9 T.C. 162, 165 (1947), *superseded by statute*, Tax Reform Act of 1986, Pub. L. No. 99-514, § 631, 100 Stat. 2085, *as recognized in* Eisenberg v. Comm'r, 155 F.3d 50 (2d Cir. 1998).

[50] Ward v. Comm'r, 87 T.C. 78, 104 (1986), *superseded by statute*, Tax Reform Act of 1986, Pub. L. No. 99-514, § 631, 100 Stat. 2085, *as recognized in* Eisenberg v. Comm'r, 155 F.3d 50 (2d Cir. 1998).

[51] Estate of Andrews v. Comm'r, 79 T.C. 938, 942 (1982).

[52] *Id*.

[53] 72 T.C. 1062, 1087 (1979), *superseded by statute*, Tax Reform Act of 1986, Pub. L. No. 99-514, § 631, 100 Stat. 2085, *as recognized in* Eisenberg v. Comm'r, 155 F.3d 50 (2d Cir. 1998).

have been accomplished without incurring a capital gains tax at the corporate level."[54]

Thus, until 1986 the stated rationale for not permitting a discount for inherent gains was that (a) the sale of assets, or the liquidation of the corporation, was uncertain, remote or speculative, or (b) they could not have been accomplished without imposition of income tax by the corporation.

Estate of Jephson v. Commissioner presented another valuation question for closely-held C corporation stock.[55] Upon her death, decedent owned stock in two wholly-owned investment corporations.[56] The assets of both companies consisted solely of cash and marketable securities.[57] In determining the value of decedent's stock holdings for estate tax purposes, decedent discounted the net asset value for lack of marketability.[58] The government challenged the appropriateness of the claimed discount for lack of marketability because any purchaser of decedent's 100 percent interest in the investment companies would acquire unconditional control over, and access to, their underlying cash and securities.[59] The Tax Court rejected the lack-of-marketability discount because "neither the decedent nor her estate nor a hypothetical seller would have sold the stock of either company for less than that which could have been realized through liquidation." [60] While the taxpayer's marketability discount was rejected, the court held the value of the stock of each investment company was its net asset value reduced by the cost of liquidation.[61]

B. From 1986 to Estate of Davis

The more things change the more they remain the same. This old saying holds true as to tax valuation discount cases subsequent to the *General Utilities* doctrine repeal. The Internal Revenue Service and the courts would soon face whether the logic underlying tax discount cases remained applicable following the repeal of *General Utilities* and the

[54] *Id*.
[55] 87 T.C. 297, 302 (1986).
[56] *Id*. at 298.
[57] *Id*. at 303.
[58] *Id*. at 302.
[59] *Id*.
[60] *Id*. at 303.
[61] *Id*.

attendant inability to avoid the corporate-level tax liability through tax planning and structuring.

The government tackled the issue head on in 1991 by issuing Technical Advice Memorandum (TAM) 91-50-001. Although subject to the 1986 legislation, no discount was permitted for the corporation even though a corporate level income tax would be incurred upon its liquidation.[62] In failing to alter its position, the government noted that the 1986 legislative amendments to sections 336 and 337 should have no impact on the decision "disallowing a discount for potential income tax liability."[63] TAM 91-50-001 signaled the historical adherence to the long established rule against the tax discount.

Taxpayers' arguments that the repeal of the *General Utilities* doctrine made it more difficult, if not effectively impossible, for corporations to avoid gains tax liability received an unwelcome reception in the courts. In *Estate of Gray v. Commissioner*, the decedent's personal holding company owned appreciated real property that was sold to trusts established by the decedent.[64] The trusts issued a promissory note in exchange for the real property.[65] In denying the taxpayer a stock discount for the tax liability attributable to the installment sale of the realty, the court concluded the estate failed to establish the likelihood that income tax would be paid by the corporation since the payment of the note by the trust was dependent on subsequent sale of the realty which had not yet occurred.[66]

The donor, in *Eisenberg v. Commissioner*, gave away shares of her closely-held corporation and sought to reduce the value of the gifted shares to account for the fact that its assets would produce a tax gain to the corporation if its assets were sold.[67] As the gains tax was speculative where taxpayer failed to show that neither the donee/beneficiaries were likely to, nor the hypothetical buyer would want to, liquidate the corporation or sell its underlying assets as of transfer date, no valuation adjustment was warranted notwithstanding *General Utilities'* repeal.[68]

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[62] I.R.S. Tech. Adv. Mem. 91-50-001 (Aug. 20, 1991).

[63] *Id.*

[64] *See* 73 T.C.M. (CCH) 1940, 1942–43 (1997).

[65] *Id*. at 1944.

[66] *Id.* at 1947. The selling corporation had foreclosure rights, and if it became necessary to exercise its right of foreclosure, it would not pay tax on gain from the sale unless it found another buyer. *Id*.

[67] 74 T.C.M. (CCH) 1046, 1047 (1997), *vacated*, 155 F.3d 50 (2d Cir. 1998).

[68] *Id*.

The decedent was a minority shareholder of two closely-held corporations in *Estate of Welch v. Commissioner*.[69] Two of the properties owned by the corporations were subject to condemnation and sold after the decedent's death.[70] In concluding that the estate was not entitled to discount the shares of stock for corporations' resultant income tax liability, the court found that the taxpayer failed to prove that liquidation of corporations' assets was likely to occur on valuation date.[71] Moreover, even if condemnation and subsequent sale of the properties was foreseeable on the valuation date, the estate did not show that the corporations would pay built-in gains tax upon the sale in view of the potential applicability of I.R.C. § 1033.[72]

In *Estate of Davis v. Commissioner*, donor owned shares in a closely-held holding company.[73] The holding company owned shares of Winn-Dixie Stores, Inc., a publicly traded corporation.[74] He gave two blocks of the closely-held corporation's common stock to his two sons.[75] At the time the stock was given to the sons, there were no plans to liquidate the holding company or sell any of its assets.[76] In determining the value of the gifted stock on the valuation date, the court permitted discounts for both the minority interests and the lack of marketability of the shares.[77] Significantly, the court concluded that approximately $9 million of the permitted lack of marketability discount was based on the gains inherent in the Winn-Dixie stock.[78] While no liquidation of the holding company's assets was planned on valuation date, experts for the taxpayer and the government were in agreement that a hypothetical buyer and seller would

[69] 75 T.C.M. (CCH) 2252, 2253 (1998), *rev'd*, 208 F.3d 213 (6th Cir. 2000).

[70] *Id*. at 2254.

[71] *Id*. at 2256.

[72] *Id*. Section 1033 permits the nonrecognition of gain from the involuntary conversion of property if replacement property is acquired by the taxpayer. I.R.C. § 1033 (2000).

[73] 110 T.C. 530, 531 (1998).

[74] *Id*.

[75] *Id*.

[76] *Id*. at 534.

[77] *Id*. at 553.

[78] *Id*. at 554.

account for the potential income tax liability in determining the fair market value of the stock in question.[79]

C. *Beyond* Estate of Davis

The Tax Court's reversal of direction in *Estate of Davis* played a pivotal role in the appellate court. In *Eisenberg v. Commissioner*, the corporation owned improved realty as its only asset.[80] The Second Circuit Court of Appeals concluded that, although no liquidation of the corporation or sale of corporate assets was planned at the time of gift, the Tax Court should have allowed the taxpayer a valuation adjustment for her closely-held stock to account for the corporation's potential income tax liability relating to its appreciated real estate holdings.[81] Relying upon and quoting *Estate of Davis*, the Second Circuit stated:

> "We are convinced on the record in this case, and we find, that, even though no liquidation of [the corporation] or 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. We are also persuaded on that record, and we find, that such a willing seller and such a willing buyer of each of the two blocks of [the corporation's] stock at issue would have agreed on a price on the valuation date at which each such block would have changed hands that was less than the price that they would have agreed upon if there had been no . . . built-in capital gains tax as of that date . . . . We have found nothing in the . . . cases on which respondent relies that requires us, as a matter of law, to alter our view . . . ."
>
> Further, we believe, contrary to the opinion of the Tax Court, since the General Utilities doctrine has been revoked

[79] *Id*. at 545. The government's contention that the discount did not apply because the corporation could have avoided such income tax liability by electing S corporation status and thereafter not selling any assets for 10 years was rejected. *Id*. at 546–47.

[80] 155 F.3d 50, 52 (2d Cir. 1998), *acq*., 1999-4 I.R.B. 4.

[81] *Id*. at 59.

> by statute, a tax liability upon liquidation or sale for built-in capital gains is not too speculative in this case.[82]

At the time of her death, the decedent in *Jameson v. Commissioner* owned 98% of the closely-held stock of her predeceased husband's timber company.[83] According to the government, the company had low earnings necessitating its valuation using the net asset value method.[84] The corporation had a valid tax election in place that permitted it to recognize the built-in capital gains on the timber as it was cut.[85] Therefore, the corporation would incur its tax liability over time rather than all at once.[86] Although the Tax Court agreed with the government expert regarding the propriety of its valuation methodology, the court nevertheless concluded the government erred when it failed to account for net present value of the unrealized income tax liability.[87]

In *Estate of Dunn v. Commissioner*, at the time of her death, Mrs. Dunn owned 62.96% of the stock of a family owned corporation engaged in the rental of heavy equipment.[88] Although the decedent owned the majority of shares at her death, she could not effect any liquidation of the corporation as applicable Texas corporate law required two-thirds of the voting shares.[89] This fact contributed, in part, to the conclusion that the likelihood of liquidation was low.[90] In order to determine the correct value of decedent's closely held stock, the Tax Court utilized both the earning value and asset value methods.[91] Thirty-five percent of the stock value was determined using the capitalization of net cash-flow to equity method with the remaining sixty five percent of value being calculated by reference to the

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[82] *Id*. at 58.

[83] *See* 77 T.C.M. (CCH) 1383, 1388 (1999), *vacated*, 267 F.3d 366 (5th Cir. 2001).

[84] *Id*. at 1391.

[85] *Id*. at 1392.

[86] *Id*. at 1396.

[87] *Id*. at 1401.

[88] 79 T.C.M. (CCH) 1337, 1337 (2000), *rev'd*, 301 F.3d 339 (5th Cir. 2002).

[89] *Id*. at 1340. Under Texas law, the power to compel a liquidation, a sale of all or substantially all the assets, or a merger or consolidation of the corporation requires the approval of at least two-thirds of the outstanding shares. TEX. BUS. CORP. ACT ANN. art. 6.03 (Vernon 2003). The court allowed a 7.5% discount for lack of super-majority control. *Estate of Dunn*, 79 T.C.M. (CCH) at 1345.

[90] *Id*. at 1340–41.

[91] *Id*. at 1339, 1345.

assets' fair market value.[92] Further, the court made valuation adjustments for the unrealized potential corporate income tax liability, lack of marketability, and lack of super-majority control.[93] The court allowed a discount for 5% of the potential tax costs rather than the entire tax liability claimed by the estate.[94] Although no liquidation or sale of assets was imminent, the court distinguished *Estate of Davis* based on the nature of the underlying corporate assets.[95] Rather than owning publicly traded securities that could be purchased on the open market as in *Estate of Davis*, the corporation in *Estate of Dunn* primarily owned equipment.[96]

The Sixth Circuit in *Estate of Welch* held in favor of the taxpayer and found that the Tax Court improperly determined that the estate was not entitled, as matter of law, to discount the value of the closely held corporate stock to reflect the built-in gains tax liability on the condemned corporate realty.[97] Noting the shift in controlling case law since *Estate of Davis*, the "hypothetical willing buyer and willing seller" analysis incorporated the availability of a built-in capital gains discount.[98] The ability of taxpayers to avail themselves of the nonrecognition treatment offered under § 1033 is a factor the hypothetical buyer would consider in determining stock's FMV rather than grounds for precluding the valuation discount.[99]

In *Estate of Borgatello v. Commissioner*, decedent owned 82.76% of the stock of a closely-held real estate company.[100] The C corporation owned two shopping centers together with other real estate and investment assets.[101] The government conceded a 19% discount for the appreciation on

[92] *Id*. at 1341.

[93] *Id*. at 1339. The taxpayer had valued the stock under a 50-50 weighting of asset and earnings values. *Id*. However, this allocation was rejected because it overestimated the likelihood of liquidation of the corporation. *Id*.

[94] *Id*. at 1345.

[95] *Id*. at 1344.

[96] *Id*. Stock purchased on the open market would entitle the purchaser to have an adjusted basis equal to the cost of the stock. I.R.C. § 1012 (2000). The cost basis rule would negate the inherent gain problem when stock, rather than underlying corporate assets, is purchased.

[97] No. 98-2007, 2000 U.S. App. LEXIS 3315, at *21–22 (6th Cir. Mar. 1, 2000).

[98] *See id*. at *20.

[99] *Id*. at *15. Although the record indicated the taxpayer failed to establish its entitlement to a full discount, the appellate court indicated that on remand the taxpayer would be permitted to present evidence of the appropriate discount where the lower court had not previously considered it as part of the valuation determination. *Id*. at *21.

[100] 80 T.C.M. (CCH) 260, 264 (2000).

[101] *Id*. at 261.

corporate assets while the taxpayer sought a discount in the range of 31% to reflect the potential income taxes attributable to the appreciation.[102] Against the government's argument that a prospective buyer would wait ten years before selling assets or liquidating the corporation, the taxpayer overlooked any asset holding period projection to determine the present value of the future tax liability.[103] On the record before it, the Tax Court found neither evidence of an immediate sale by the hypothetical buyer nor facts to support the hypothetical buyer waiting ten years prior to liquidation.[104] Nevertheless, the Tax Court utilized a 24% valuation discount for future corporate income taxes and, consistent with *Estate of Davis*, treated the discount as part of the aggregate 33% discount for lack of marketability.[105]

The Fifth Circuit weighed in on the proper valuation adjustment for potential income tax liabilities attributable to built-in gains on corporate assets in *Estate of Jameson v. Commissioner*.[106] In recognizing that the stock valuation would be affected by income taxes, the corporation would owe on potential timber sales, the Tax Court allowed a partial discount for the built-in gains tax liability based on the discounted present value of the future tax liability.[107] The Fifth Circuit found the court's approach to be in error as it presupposed the company would incur income tax liability based on continuing sales in the future rather than immediately pursuant to a liquidation of assets.[108] The Tax Court reached its conclusion notwithstanding facts suggesting an investor's required rate of return would be too low from the ongoing production of timber.[109] The court further erred by equating the hypothetical buyer with a strategic buyer who would continue ongoing operations, an error that prevented the taxpayer from qualifying for a full discount for income taxes on inherent gains.[110]

In *Estate of Dunn v. Commissioner*, the Fifth Circuit again expressed

[102] *Id*. at 268.

[103] *Id*. at 269.

[104] *Id*.

[105] *Id*.

[106] 267 F.3d 366 (5th Cir. 2001). The corporation owned highly appreciated assets. *Id*. at 367. The adjusted basis in the property was approximately $217,000, while it had a fair market value of $6 million. *Id*. at 368.

[107] *Id*. at 372.

[108] *Id*. at 371–72.

[109] *Id*.

[110] *Id*.

dissatisfaction with the Tax Court's valuation analysis regarding potential income tax liability on appreciated corporate assets.[111] The court of appeals held the Tax Court should have permitted the taxpayer to reduce the stock value by the entire amount of the inherent income tax liability[112] rather than the five percent of the potential tax obligation.[113] Because the equipment rental company was an ongoing enterprise, the Tax Court should have utilized an 85/15 allocation between earnings and asset valuation methodologies rather than its 35/65 weighting ratio that too heavily weighted asset valuation for a going concern.[114] The court of appeals also concluded that in determining the correct weighting between the bifurcated earnings and assets approaches, the lower court should have ignored liquidation only with respect to the relative weight to attach to each approach.[115]

In *Estate of Jelke v. Commissioner*, at the time of his death, Frazier Jelke was the beneficiary of a revocable trust that owned 3,000 shares (6.44% of the outstanding shares) of Commercial Chemical Co., a closely-held C corporation.[116] Although previously operated as a chemical manufacturing company, since 1974 the corporation held and managed investments for the benefit of its shareholders.[117] These marketable securities were acquired for long-term capital growth producing a low asset turnover rate for the corporation.[118] As a result, as of the date of Jelke's death, the corporation owned highly appreciated assets.[119] The corporation had no plans to liquidate as of decedent's death.[120]

While the decedent's estate included the 6.44% stock interest in the federal gross estate and the parties were in agreement as to the value of the assets owned by the corporation, the estate and the government disagreed as

[111] 301 F.3d 339, 342–43 (5th Cir. 2002).

[112] *Id*. The full amount of the income tax liability equals the amount of the gain in question multiplied by the taxpayer's marginal income tax rate.

[113] *Id*. at 354.

[114] *Id*. at 358–59. The court of appeals supported its conclusion by noting that the corporation had zero dividend paying capacity and that as an ongoing enterprise it would be acquired for future business operations rather than liquidation or asset sale. *Id*. at 357.

[115] *Id*. at 359.

[116] 89 T.C.M. (CCH) 1397, 1398 (2005).

[117] *Id*.

[118] *Id*. at 1399.

[119] *Id*.

[120] *Id*. at 1406.

to the value of the decedent's shares.[121] Although the parties agreed that it was appropriate to discount the stock for the gain inherent in the corporate assets, the parties differed regarding the proper amount of the valuation reduction.[122] The estate reduced the value by the full amount of the built-in tax liability.[123] In so doing, the estate relied on the Fifth Circuit's decision in *Estate of Dunn* as supporting the notion that under the net asset value approach the income tax liability and, in turn the valuation reduction, is calculated as if all assets were sold on the date of death.[124] In contrast, the government argued that the *Estate of Dunn* liquidation assumption was inapplicable and should be based on the portfolio of assets turnover rate.[125] Under this contention, the value should be reduced by a lesser amount based on net present value principles to more properly reflect the timing of when the tax liability would be recognized.[126]

In rejecting the argument that *Estate of Dunn* required the automatic assumption of asset liquidation when valuation is premised upon the asset-based approach, the Tax Court stated that because the case was not appealable to the Fifth Circuit,[127] *Estate of Dunn* was not binding authority.[128] Further, the Tax Court distinguished the *Dunn* case from *Jelke* by stating that the Court of Appeals had applied its holding to a majority stock interest and indicated some question whether the Fifth Circuit would automatically apply the liquidation assumption to value minority stock interests.[129]

[121] *Id*. at 1399.

[122] *Id*. at 1400.

[123] *Id*. at 1399.

[124] *Id*. at 1403.

[125] *Id*. at 1402. The portfolio of assets turnover rate is the percentage of assets in the portfolio that are sold in a given year. The government's expert looked to the asset turnover rate for the 5 year period prior to death and calculated an average turnover rate equal to 5.95%. *Id*. By dividing the average turnover rate into 100%, the expert determined that the built-in gain tax liability would be incurred over a 16.8 year period (100% ÷ 5.95% = 16.8). *Id*.

[126] *Id*. at 1403.

[127] Any appeal in *Jelke* would be to the 11th Circuit.

[128] Under *Golsen v. Commissioner,* the Tax Court is not bound to follow decisions of a court of appeals to which its decision is not appealable. 54 T.C. 742, 757 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971).

[129] The Tax Court cited footnote 25 in *Dunn v. Commissioner*, 301 F.3d 339, 353 n.25 (5th Cir. 2002). Footnote 25 provides as follows:

> "[I]f valuing a minority ownership interest, one would normally adopt the premise of 'business as usual. . . .'" "[T]he asset-based approach tends to be more appropriate

IV. ADJUSTED BASIS, DEDUCTIONS, TAXES AND TIME-VALUE OF MONEY

Individual taxpayer owns an asset with a fair market value of $100. C corporation owns a similar asset having the same fair market value and an adjusted basis of $40. The income tax consequences to a prospective purchaser of the asset may be dependent upon whether the asset is acquired from the individual seller or through a C corporation stock purchase from its shareholder. With the asset purchase from the individual owner, the buyer's adjusted basis in the newly acquired asset equals its cost of $100.[130] The $100 adjusted basis becomes the amount eligible for depreciation deductions[131] or amortization deductions.[132] In contrast and assuming the fair market value of the stock equals the fair market value of the underlying corporate owned assets, the buyer's adjusted basis in the stock is $100.[133] However, the adjusted basis of the corporate owned asset remains at $40. Structured as a stock acquisition, the $60 difference in the adjusted basis of the asset will have important tax ramifications that are not merely limited to the subsequent sale of the asset by the corporation. The $60 adjusted basis differential between an asset acquisition versus stock acquisition will increase the income tax liability of the corporation as a result of the inability to claim $60 of depreciation and amortization deductions.

Income tax deductions do not result in a dollar for dollar savings in income tax liability.[134] The tax savings attributable to an income tax deduction equals the amount of the deduction multiplied by the taxpayer's marginal rate of taxation.[135] Assuming marginal tax rates of 35% for

> when valuing a controlling ownership interest than a noncontrolling ownership interest." The Decedent's non-supermajority interest is a hybrid, somewhere between minority and full control, so neither approach trumps the other totally.

Id. (citations omitted).

130 I.R.C. § 1012 (2000) (providing that the adjusted basis of property equals its cost).

131 Property is depreciable pursuant to § 168 if it is used in the taxpayer's trade or business, *see id*. § 162, or held for the production or collection of income, *see id*. § 212.

132 For example, under § 197, certain acquired intangible assets are eligible for an amortization deduction. *See generally id.* § 197. Section 197 qualified assets may be amortized ratably over a 15 year period beginning with the month of acquisition. *Id.* § 197(a).

133 *Id*. § 1012.

134 Income tax credits, in contrast, produce a tax savings equal to the amount of the credit. A tax credit of $100 will reduce the taxpayer's tax liability by $100 irrespective of the taxpayer's marginal tax rate.

135 A taxpayer's marginal rate of taxation can be ascertained by determining the highest

individual and corporate taxpayers, a buyer acquiring the asset previously described through a stock purchase arrangement will owe $21 more in income taxes[136] in comparison to the direct asset purchase and its correlative higher asset basis. The calculation is made more complex by the fact that the added $60 of depreciation deductions are not all taken in the current year. Because the tax savings attributable to the increased deduction amount is taken ratably[137] over time, time-value of money concepts need to be included in the calculation to correctly determine the tax savings. The proper calculation requires a present value analysis[138] to reflect the tax savings obtained from the $60 increased deduction amount arising over a prescribed interval of time. Assuming the $100 adjusted basis asset is depreciated straight line over three years, there will be $33.33 in depreciation deductions each year for three years. The tax savings equals $11.66 annually for three years.[139] In contrast, with an adjusted basis of $40 there will be $13.33 in annual deductions triggering a yearly tax savings of $4.66 for three years.[140] Thus, there is a tax benefit of $7 annually ($11.66 - $4.66) for three years for a total tax savings of $21 over the three year period.

The closely-held stock subject to valuation is not worth its pro-rata share of the underlying asset value. What is needed is a method to assess the economic loss in value to the willing buyer who, by acquiring the stock, fails to obtain an adjusted basis in the underlying assets equal to their fair market value. The corporation will owe more in income taxes as a consequence of the lost amortization and depreciation deductions calculated on the lower adjusted basis figures instead of those very same deductions being computed and attributable to a stepped up adjusted basis linked to an asset acquisition. The difference between the buyer's adjusted basis of the hypothetically purchased stock and the underlying corporate assets represents an economic loss to prospective purchasers in the real world of business acquisitions. It is the present value of these lost tax benefits that must be taken into account to value the stock in question because the

income tax rate bracket that taxpayer falls into under the rate schedules set forth in § 1. The corporate tax rates are set forth in § 11.

136 $60 deduction amount x .35 marginal tax rate = $21.

137 In actuality, § 168 provides for certain accelerated methods of depreciation.

138 Present value principles recognize that $1 tax saved in the future is worth less than a $1 tax saved currently.

139 $33.33 depreciation deduction x .35 marginal rate = $11.66.

140 $13.33 x .35 marginal rate = $4.66.

corporation's post acquisition income tax liability will be greater. The resulting valuation adjustment is necessary and is not dependent on any liquidation, distribution or sale of corporate assets being contemplated.[141]

A. Time-Value of Money Considerations

A dollar today is economically worth more than the same dollar received at some future date. Conversely, the promise to pay a dollar in the future is not currently worth a dollar. Even if the promisor's credit were beyond reproach, no promisee would pay a dollar today to receive its equivalent at the future date. Recognized time-value of money principles are not limited to income streams generated by assets and can apply equally to the transfer of tax dollars to satisfy tax liabilities. A tax dollar received currently is worth more than a tax dollar to be received in the future. Similarly, a tax dollar to be paid in the future[142] is worth less than a tax dollar paid today. A sum to be paid in the future is commonly discounted back to its present value to reflect this concept.

Suppose a particular investment offers an annual tax savings of $10,000 for 3 years. Although the total savings equals $30,000, the value today is less than the aggregate savings of $30,000. The economic value of saving $30,000 in the current year is more valuable than receiving the same aggregate tax savings over a successive year period. A calculation is required in order to determine precisely how much more valuable. The result is quantified by ascertaining the present value of the savings of $10,000 annually for three years.

The following formula is used to determine the present value of cash payments to be made or received over a given period of time:

$$PV = \sum FV_i/(1 + k)^i$$

where:

PV = present value
FV = expected annual savings in each of the future periods

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[141] Of course, if a liquidation or sale of corporate assets were anticipated as of the valuation date, the adjusted basis and value difference would result in an income tax liability that would be readily calculable and certain rather than speculative.

[142] The tax liability may correspond to an income tax gain realized and recognized in the future. Formulas exist for the quantification of how much less a dollar to be received in the future is than a dollar received currently.

$\sum$ = the sum of
k = discount rate
i = number of years payment is to be made

Applying the present value formula with a 10% discount rate assumption along with the $10,000 annual amount for three years, the formula produces the following present value figure:

$$\begin{aligned} PV &= \$10{,}000/1.1 + \$10{,}000/1.1^2 + \$10{,}000/1.1^3 \\ &= \$9{,}090 + \$8{,}264 + \$7{,}513 \\ &= \$24{,}867 \end{aligned}$$

An annual tax savings of $10,000 for three years is the economic equivalent of saving $24,867 currently.

The above discounted cash flow approach to calculate the present value of income tax savings is made more complex if we recognize that there may be tax savings in years beyond year three. The concept of "terminal value" can be used to assist with valuation for years beyond the specific forecast period.[143] The formula is as follows:

$$PV = \sum FV_i/(1 + k)^i + \frac{FV_i \div (k - g)}{(1 + k)^i}$$

where:

PV = present value
FV = expected annual savings in each of the future periods
$\sum$ = the sum of
k = discount rate
i = number of years payment is to be made
g = growth rate

If tax savings beyond the original three year forecast period were thereafter to be $5,000 annually, the formula above would produce the following:

[143] *See* SHANNON P. PRATT ET AL., THE LAWYER'S BUSINESS VALUATION HANDBOOK 114 (2000); SHANNON P. PRATT ET AL., VALUING SMALL BUSINESSES & PROFESSIONAL PRACTICES 242 (McGraw-Hill 3d ed. 1998) (1993).

$$\begin{aligned} PV &= \$24{,}867 + \frac{\$5{,}000 \div .1}{(1 + .1)^5} \\ &= \$24{,}867 + \$31{,}046 \\ &= \$55{,}913 \end{aligned}$$

B. An Illustrative Example – Putting It All Together

Mystic Golf Ventures, Inc. (Mystic) has 100 shares of common stock outstanding, of which 80 are owned by Client. Mystic is a calendar year taxpayer and Client's shares are to be valued as of January 1, the relevant valuation date. The applicable corporate income tax rate equals 34%. Mystic owns and operates Mystic Highlands Golf Club and Range, a nine hole golf course and practice facility. Mystic sells 20% of its investment securities each year. Mystic owns the following assets worth $4.9 million, some of which are eligible for ACRS and amortization deductions:[144]

Asset	Adjusted Basis	Fair Market Value
Stocks	$200,000	$1,000,000
5 year class life	$ 50,000	$ 300,000
7 year class life	$ 10,000	$ 100,000
Goodwill – § 197 property	$ 0	$1,500,000
39 year property	$500,000	$2,000,000
Total	$760,000	$4,900,000

Table 1 may be used to determine the annual deduction amount for those assets owned by Mystic eligible for ACRS and amortization deductions:[145]

[144] Those assets eligible for § 168 ACRS deductions have been categorized by asset class life. Though not amortizable by Mystic, amounts paid for goodwill by a prospective purchaser are eligible for amortization deductions pursuant to § 197.

[145] Table 1, Rev. Proc. 87-57, 1987-2 C.B. 687; Table E, Instructions for Form 4562. For § 197 intangibles the annual percentage figure equals 1 divided by the 15 year amortization period (1 ÷ 15 = .0666). The amounts in Table 1 are percentages to be applied typically to the adjusted basis of the taxpayer's asset in question.

Table 1. Applicable ACRS Percentages Based on Recovery Period.

Year	5 year assets	7 year assets	39 year assets	§ 197 Asset
1	20	14.29	2.461	.0666
2	32	24.49	2.564	.0666
3	19.2	17.49	2.564	.0666
4	11.52	12.49	2.564	.0666
5	11.52	8.93	2.564	.0666

As the investment securities owned by Mystic do not qualify as depreciable property and are not entitled to ACRS deductions, Table 1 is inapplicable to these assets. For situations appealable to the Fifth Circuit, the complete liquidation analysis adopted in *Estate of Dunn v. Commissioner* requires that the gain inherent in Mystic's investment securities be treated as taxable on the valuation date.[146] By itself, this approach appears to provide the potential for a valuation discount windfall. Unless supported by a historically high asset turnover rate or where the corporation possesses a plan to liquidate, sell or distribute its property, collapsing the entire tax liability into the relevant valuation date appears unjustified as overstating the valuation discount.

On the other hand, *Estate of Jelke* with its rejection of the complete liquidation analysis in *Estate of Dunn* requires the $800,000 inherent gain to be recognized ratably over five years given Mystic's 20% asset turnover rate.[147] Mystic will incur its income tax liability attributable to the securities over five years instead of the overstated acceleration of tax liability into one year.

Utilizing the percentage figures from Table 1, Tables 2 and 3 below show the lost ACRS and amortization deductions resulting from the difference between the adjusted basis and fair market values of Mystic's underlying assets. The foregone annual tax savings is also determined by multiplying the deduction and amortization amounts by the assumed corporate income tax rate of 34%. Tables 2 and 3 differ regarding the treatment accorded the investment securities owned by Mystic. Table 2 applies the ratable sales approach from the *Estate of Jelke* case.[148] In contrast, Table 3 applies the complete liquidation approach adopted in

[146] *See generally* 301 F.3d 339 (5th Cir. 2002).

[147] *See generally* Estate of Jelke v. Comm'r, 89 T.C.M. (CCH) 1397 (2005).

[148] Ratability is a function of the asset turnover rate. Given the assumed 20% turnover rate, all of the gain on the prospective stock sales will be recognized at the end of the five year period.

Estate of Dunn with the result that the entire stock gain is recognized in year 1.

Table 2. Lost Deductions and Tax Savings – Forecast Method.

	Year 1	2	3	4	5
Mystic's Assets					
Stock	160,000	160,000	160,000	160,000	160,000
5 year property	50,000	80,000	48,000	28,800	28,800
7 year property	12,861	22,041	15,741	11,241	8,037
39 year property	36,915	38,460	38,460	38,460	38,460
Goodwill	99,999	99,999	99,999	99,999	99,999
Total	359,775	400,500	362,200	338,500	335,296
	x .34	x .34	x .34	x .34	x .34
Lost Annual Tax Savings	122,323.50	136,170	123,148	115,090	114,000.64

Table 3. Lost Deductions and Tax Savings – Complete Liquidation Method.

	Year 1	2	3	4	5
Mystic's Assets					
Stock	800,000	0	0	0	0
5 year property	50,000	80,000	48,000	28,800	28,800
7 year property	12,861	22,041	15,741	11,241	8,037
39 year property	36,915	38,460	38,460	38,460	38,460
Goodwill	99,999	99,999	99,999	99,999	99,999
Total	999,775	240,500	202,200	60,690	175,296
	x .34	x .34	x .34	x .34	x .34
Lost Annual Tax Savings	339,923.50	81,770	68,748	60,690	59,600.64

At this stage, Tables 2 and 3 show the lost annual tax savings attributable to the foregone tax deductions. However, the process is more complex than merely totaling the amounts over the five-year period. Tables 2 and 3, though informative, do not reflect time value of money principles. The attached appendices calculate the net present value (NPV) of the lost tax benefits attributable to a hypothetical stock acquisition instead of an asset acquisition. Consistent with Revenue Ruling 59-60, the net present value is calculated over a five year period.[149] The total discount, the amount subtracted from the underlying asset value, is comprised of two parts: (1) the discounted value attributable to calculating tax deductible amounts on the difference between a fair market value adjusted basis over a historic adjusted basis; and (2) the terminal benefit amount[150] computed at the end of the five year period.

Appendix 1 and 2 differ with regard to the valuation discount treatment accorded the corporate-owned investment securities. The discount valuation approach suggested in Appendix 1 is in accordance with *Estate of Jelke* and is based upon using the asset turnover concept to calculate the tax liability as it is to be incurred. This approach offers a more realistic calculation by not telescoping the entire tax liability into the valuation date as is the case with the complete liquidation approach. However, Appendix 2 recognizes that circumstances may exist that warrant a modified approach. Appendix 2 provides for the *Estate of Dunn* dollar for dollar reduction consistent with cases appealable to the Fifth Circuit as well as those situations where, as of the valuation date, there is a plan to liquidate, sell or distribute the property in connection with the stock transfers.

As already established, significant tax law differences exist for buyers

[149] Rev. Rul. 59-60, 1959-1 C.B. 237 provides that financial statements for a five year period should be utilized.

[150] *See* John R. Cooper & Richard Gore, *Recent Cases and Valuation Model Show "State of the Art" Built-In Gains Discount Calculation*, 4 VALUATION STRATEGIES 4, 13 (2001); PRATT ET AL., *supra* note 143. The concept of terminal value is utilized to provide a value of the corporation at the end of the five year forecast period. From the perspective that the corporation being valued is not contemplating liquidation or sale or distribution of corporate assets, use of the terminal value approach bridges the problem of the indefinite corporate existence and the reliability of too lengthy forecast periods. By using the terminal value component, an income capitalization approach is incorporated. The terminal value amount calculated in the appendices is comprised of the lost tax savings in the last period divided by the interest rate assumption and reduced to present value pursuant to the following formula:

$$\frac{FV_i \div (k - g)}{(1 + k)^i}$$

of stock and buyers of assets. For stock acquisitions, the retention of low historic asset basis results in the loss of the additional ACRS and amortization deductions. The lost deductions translate into a loss of tax savings. Unlike the historic situation concerning the sale of assets or corporate liquidation, the difference between a buyer's adjusted basis in acquired stock and the adjusted basis of corporate assets is real and directly affects the corporation's prospective tax liability. ACRS and amortization deductions are much less in one case over the other. Through the adjusted basis disparity, the increased income tax liability results in less cash in the corporate bank account and, as the trapped-in gain is a corporate liability, the value of the corporation is reduced. The greater annual tax liability underlying the equity interest being valued along with the attendant decrease in cash flow available to the purchaser of the stock are significant factors that would not escape notice by the hypothetical buyer under the willing buyer/willing seller rule.

Appendices 1 and 2 attempt to quantify the present value of the lost tax savings attributable to the adjusted basis disparity. By using the recovery and amortization periods applicable to the various asset classes owned by the corporation, it becomes unnecessary to rely upon estimates or forecasts of future tax liability on gain recognition. The approaches suggested in the appendices adhere to the certain time periods well established in the tax code and do not resort to the uncertainty of the timing of prospective events.

As reflected in the appendices, column 2 begins by incorporating the amount of the total lost tax benefits found in Tables 2 and 3. The annual lost tax savings figures in column 2 are attributable to the tax basis and fair market value disparity for Mystic's assets. For each five year time period, column 2 initially establishes that the five year aggregate lost tax savings is the same in each scenario.[151] However, as column 3 importantly provides, the numbers change once the different discount interest rates assumptions are added and present value principles are applied. The higher the interest rate used to discount the lost tax savings, the lower the total valuation discount. Column 4 incorporates the value of the terminal benefit calculated based on year 5. Column 5 is the sum of the present value and terminal benefit amounts indicated in columns 3 and 4. The total discount

[151] Although the column 2 totals are identical at the end of the five-year period, it must be remembered that the foregone tax deductions are incurred over time rather than all in the same year.

amount reflected in column 5 is the figure to be subtracted from Mystic's $4.9 million underlying asset value.

The total discount amount is dependent on the particular interest rate assumption used in the calculation. The interest rate used for discounting purposes may be referenced, in part, to the applicable federal rate.[152] Because of the suggested five-year discount period, the Federal midterm rate as of the valuation date is appropriate. The applicable federal rate may, in all likelihood, produce too low of a discount rate. Accordingly, the appropriate applicable federal rate may be adjusted to reflect the risk inherent in the business being valued.[153]

A buyer who could purchase assets and receive an adjusted basis equal to the purchase price would be unwilling to purchase stock in a corporation whose assets, though similar, possess a low basis, without a decrease in the purchase price. No seller would accept an offer that reduced the purchase price by the full amount of the unrealized gain on the corporate assets. In this manner, the failure to take into account the time-value of money overstates the amount of the valuation reduction. The approach suggested in this Article provides a more realistic perspective upon valuation and is in keeping with the willing buyer/willing seller rule. Of course, it is important to note that room for disagreement may be found between the parties in selection of the proper discount rate. As the interest rate is a key component of the discounted present value formula, too high an interest rate assumption will understate the amount subtracted from the underlying fair market value of the assets. The approach advocated also gives proper recognition to the fact that adjusted basis has an important role in the valuation process when assets are held in corporate form. Further, it appears to avoid notions of being too speculative since it is not based upon

[152] I.R.C. § 1274(d) (2000). The applicable federal rate is the rate of interest the Treasury would need to pay to borrow money. The actual applicable federal rate is based on the term of the loan and is set forth in the table below:

Term of Loan	Applicable Rate
Not over 3 years	Federal short-term rate
> 3 years but ≤ 9 years	Federal midterm rate
> 9 years	Federal long-term rate

Id. § 1274(d)(1)(A).

[153] Estate of Borgatello v. Comm'r, 80 T.C.M. (CCH) 260, 269 (2000) (In determining the discounted value of the future tax liability, the Tax Court used the appropriate applicable federal rate together with a risk adjustment).

the taxpayer's unilateral forecast or projected timetable of when tax gains will be realized and recognized on the sale of appreciated corporate assets.[154] Few would question the valuation difficulties attendant to a corporation owning low basis assets. For an informed buyer with reasonable knowledge of relevant facts, there is a probable valuation disparity for stock in a corporation whose assets have a low tax basis and a corporation owning assets whose tax basis and fair market value are equivalent. Reduced ACRS and amortization deductions triggered by the low basis of assets within the corporation increase the income tax liability and reduce the cash flow available to shareholders. The hypothetical buyer's pricing decision would not ignore the reduction in cash available for distribution. Beyond lower tax deductions, there is a further tax detriment associated with the low tax basis in the form of increased prospective tax liabilities incurred from corporate asset sales. In a post-*Davis* and *Eisenberg* world, the depressing effects corporate income taxes have on stock valuation are now recognized and a methodology to assist in the quantification of the reduction in value is also provided in this Article.

[154] Any forecast of prospective sales harkens back to the former speculative rationale that was used to preclude a discount for the corporate level tax. From the taxpayer's perspective, the valuation discount will be greater the sooner the forecasted sale of corporate assets. On the other hand, present value principles serve to minimize the valuation effect of income tax liabilities to be incurred for sales in the distant future.

Appendix 1. NPV of Lost Tax Benefits – Asset Turnover Model.

Column 1	Column 2	Column 3	Column 4	Column 5
Year 1	122,323.50			
Year 2	136,170			
Year 3	123,148			
Year 4	115,090			
Year 5	114,000.64			
		Present Value at 6%	Terminal Benefit at 6%	Total Discount
Total	**610,732.14**	$516,337.75	1,419,790	$1,936,127.75
Year 1	122,323.50			
Year 2	136,170			
Year 3	123,148			
Year 4	115,090			
Year 5	114,000.64			
		Present Value at 8%	Terminal Benefit at 8%	Total Discount
Total	**610,732.14**	$489,946.69	969,831	$1,459,777.69
Year 1	122,323.50			
Year 2	136,170			
Year 3	123,148			
Year 4	115,090			
Year 5	114,000.64			
		Present Value at 10%	Terminal Benefit at 10%	Total Discount
Total	**610,732.14**	$465,656.73	707,850	$1,173,506.73

Appendix 2. NPV of Lost Tax Benefits – Complete Liquidation Model.

Year 1	339,923.50			
Year 2	81,770			
Year 3	68,748			
Year 4	60,690			
Year 5	59,600.64			
		Present Value at 6%	Terminal Benefit at 6%	Total Discount
Total	**610,732.14**	$543,788.93	742,276	$1,286,064.93
Year 1	339,923.50			
Year 2	81,770			
Year 3	68,748			
Year 4	60,690			
Year 5	59,600.64			
		Present Value at 8%	Terminal Benefit at 8%	Total Discount
Total	**610,732.14**	$524,595.11	507,034	$1,031,629.11
Year 1	339,923.50			
Year 2	81,770			
Year 3	68,748			
Year 4	60,690			
Year 5	59,600.64			
		Present Value at 10%	Terminal Benefit at 10%	Total Discount
Total	**610,732.14**	$506,710.66	370,069	$876,779.66