

Valuation Treatment of Built-In Gains in a C Corporation

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A built-in capital gains adjustment, if appropriate, is a discount or adjustment in the value of an ownership interest in an entity, typically a C corporation, that has a built-in capital gains tax liability. Corporate income taxes that will be due on the appreciation in the value of assets owned by a business can affect the value of an ownership interest in that business. The valuation analyst can develop an appropriate adjustment to value to offset the impact of capital gains taxes paid on the appreciated assets at some future liquidation event. This discussion demonstrates that, under most circumstances, built-in capital gains taxes in a C corporation (even though payment of those taxes is not due until the asset is sold in the future) reduces the value of the C corporation. Illustrative examples are provided in this discussion. In addition, this discussion summarizes the factors that the analyst typically considers in determining the amount of any value adjustment related to the built-in capital gains in a C corporation.

HISTORY OF THE “BIG” TAX LIABILITY ISSUE

Prior to the Tax Reform Act of 1986, taxpayers were allowed an election to treat the acquisition of the equity of a C corporation as if it was an acquisition of the assets of the C corporation. The asset-acquisition tax treatment allowed the C corporation buyer to depreciate the acquisition date fair market value (i.e., the “stepped-up basis”) of the acquired assets.

In addition, the asset-acquisition tax treatment allowed the seller to recognize the gain on the sale of the C corporation assets at the amount of the purchase price for the transaction.

This federal income tax treatment was referred to as the *General Utilities*¹ doctrine, named after a landmark tax case. The so-called *General Utilities* doctrine allowed the selling shareholders to avoid the payment of double taxation on the “deemed” liquidation of the C corporation assets.

The *General Utilities* doctrine became obsolete as a result of the Tax Reform Act of 1986.

As a result of the discontinuation of the *General Utilities* doctrine, when all of the stock of a C corporation is acquired, normally² the income tax basis of the acquired assets is carried forward and no step-up in the basis of the acquired corporate assets is recognized by the stock buyer.

When an asset with unrecognized appreciation is held by a C corporation, then a built-in gains (BIG) tax obligation exists. The BIG tax is not paid by the C corporation until that asset is sold. A BIG tax obligation is common whether the subject C corporation³ is either an operating company or an investment or holding company.

When valuing C corporations after 1986, the issue of how to treat the BIG tax obligation is frequently encountered by the valuation analyst. The issue presents itself when the valuation analyst conducts an assignment for various purposes, including estate tax purposes.

In federal estate tax matters, the BIG tax issue has been the subject of litigation. Recently, federal courts have increasingly allowed a valuation adjustment to reflect the BIG tax obligation when

determining the business value of a C corporation. However, not all courts have allowed a valuation adjustment equal to 100 percent of the estimated current built-in gains tax liability.

JUDICIAL PRECEDENT

In 1998, the Tax Court recognized the valuation implications of the liability represented by the built-in capital gains tax associated with appreciated capital assets held in a C corporation. The *Estate of Davis*⁵ was the first judicial decision to recognize the BIG tax valuation impact following the repeal of the *General Utilities* doctrine.

In *Estate of Davis*, the gift tax value of two 25-share blocks of stock in a company with a total of 97 shares of common stock outstanding and organized as a C corporation was at issue.

The taxpayer's two valuation experts and the Internal Revenue Service ("Service") valuation expert (but not a Service employee) testified that a valuation adjustment was warranted—that is, a willing buyer and a willing seller would have taken the built-in tax liability into account in arriving at a purchase price for the stock.

The dispute in the *Estate of Davis* was over the appropriate amount of the valuation adjustment.

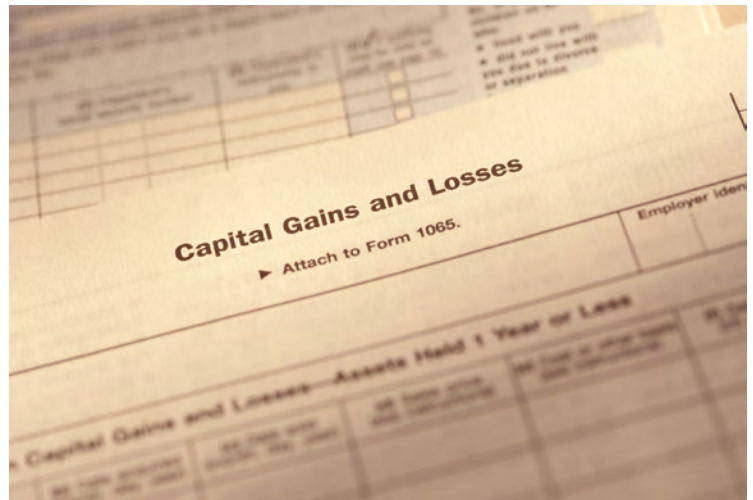
The Tax Court found that the full amount of built-in tax liability (\$26.7 million) should not be taken as a valuation discount when there was no evidence that the subject C corporation planned to liquidate or sell any of its appreciated assets.

The Tax Court concluded that it was appropriate to include a BIG tax valuation discount (of \$9 million) as a part of the discount for lack of marketability (or DLOM) to be applied in the gift tax valuation of the two blocks of stock.

Shortly after the *Davis* decision, in *Eisenberg v. Commissioner*,⁶ the Second Circuit reversed a memorandum decision of the Tax Court. The Appeals Court found that the Tax Court erred in not considering the BIG tax liability as a valuation adjustment, and the Second Circuit remanded the case back to the Tax Court to decide on the amount of the liability-related valuation adjustment.

The Service has acquiesced to the *Eisenberg* decision "to the extent that it holds that there is no legal prohibition against such a discount."⁷

In 1999, the Tax Court again allowed a valuation discount related to the BIG tax liability. In the *Estate of Jameson*,⁸ the decedent owned an interest in a closely held corporation that held timberland as its primary asset.



In its memorandum decision, the Tax Court stated the following:

We may allow the application of a built-in capital gains discount if we believe that a hypothetical buyer would have taken into account the tax consequences of built-in capital gains when arriving at the amount he would be willing to pay for decedent's Johnco stock. Because Johnco's timber assets are the principal source of the built-in capital gains and, as discussed infra, are subject to special tax rules that make certain the recognition of the built-in capital gains over time, we think it is clear that a hypothetical buyer would take into account some measure of Johnco's built-in capital gains in valuing decedent's Johnco stock.⁹

As the timber was cut and sold, recognition of the built-in gain was certain to occur. According to the Tax Court decision, a hypothetical willing buyer of the subject equity "would take into account Johnco's built-in capital gains, even if his plans were to hold the assets and cut the timber on a sustainable yield basis."

The Tax Court, however, limited the amount of the valuation discount to "an amount reflecting the rate at which they [the BIG taxes] will be recognized, measured as the net present value of the built-in capital gains tax liability that will be incurred over time as timber is cut."

The Fifth Circuit Court of Appeals reversed the Tax Court's *Estate of Jameson*¹⁰ decision. The Appeals Court noted that the Tax Court denied "a full discount for the accrued capital gains liability" based upon internally inconsistent long range timber production assumptions.¹¹

“ . . . the Appeals Court decided that, as a matter of law, the BIG tax liability should be considered as a dollar-for-dollar reduction when calculating the asset-based value.”

The Fifth Circuit Court remanded the case back to the Tax Court for a valuation analysis consistent with its opinion that the buyer would either lower the purchase price or sell the interest quickly and redeploy the proceeds elsewhere.

In 2002, the Fifth Circuit applied a dollar-for-dollar valuation discount related to a BIG tax liability. In the *Estate of Dunn*,¹² the Appeals Court decided that, as a matter of law, the BIG tax liability should be considered as a dollar-for-dollar reduction when calculating the asset-based value.¹³

The Appeals Court concluded that the asset-based valuation approach contemplates the consummation of the sale of the subject asset, thereby triggering the BIG tax. In the *Estate of Jelke*,¹⁴ the Eleventh Circuit has adopted the Fifth Circuit’s dollar-for-dollar valuation discount procedure.

In 2009, the Tax Court allowed a BIG-tax-related valuation discount based on the assumption that the assets would be sold over time. In the *Estate of Litchfield*,¹⁵ the Tax Court adopted the taxpayer’s methodology of:

1. projecting holding periods and estimated sales dates for the corporation’s assets,
2. projecting asset appreciation to the estimated sales dates, and
3. discounting the expected future BIG tax back to the valuation date.

In 2010, the Tax Court determined that the BIG tax valuation discount was to be applied in a case where the principal assets of the C corporation were real estate and real property improvements.

In the *Estate of Jensen*,¹⁶ the Tax Court made its own calculation of the size of the BIG tax discount by applying a present value methodology. The Tax Court assumed that the assets would be sold in the future and calculated the appreciated future value of the land and improvements.

The resulting estimated future tax payments were then discounted to a present value using a discount rate equal to the assumed appreciation rate. Ultimately, the Tax Court accepted the taxpayer’s BIG discount because the Tax Court’s analysis

resulted in a BIG tax liability slightly greater than the taxpayer’s.

In 2014, the Tax Court decided in *Estate of Richmond*¹⁷ that a BIG tax valuation discount was appropriate for an interest in a corporation that held publicly traded securities. The Tax Court held that the built-in gains discount should be calculated as the present value of paying the tax over a 20- to 30-year turnover period.

STOCK PURCHASE VERSUS DIRECT ASSET INVESTMENT

There can be economic disadvantages of acquiring the C corporation stock (with the built-in gain liability) relative to a direct investment in the underlying appreciated assets.

The following section presents an illustrative example of the BIG tax liability economic disadvantages in a stock purchase versus a direct asset investment.

An Illustrative Example of the Economic Disadvantage of BIG in a Stock Purchase versus a Direct Asset Investment¹⁸

ABC Company (“ABC”), a C corporation, owns one asset: a single marketable security. Based on the public trading price on the valuation date, that marketable security is worth \$52 million. There are no ABC liabilities other than the obligation to pay the BIG tax whenever the marketable security is sold.

For simplicity, let’s assume that:

1. the ABC tax basis in the underlying security is \$0 and
2. the BIG tax rate for a C corporation is 40 percent.

Suzy, the ABC current owner (and the hypothetical willing seller), expects the underlying security to increase in value over time.

As an alternative to buying ABC, Ben (a hypothetical willing buyer) could acquire the identical underlying marketable security at that same market price—that is, \$52 million.

If Ben paid \$52 million for a 100 percent ownership interest in the ABC stock and then liquidated the corporation, the marketable proceeds after paying the BIG tax would be \$31.2 million (i.e., \$52 million times (1 – 40 percent)).

Of course, Ben can buy the ABC stock and defer the payment of the \$20.8 million BIG tax liability indefinitely. If Ben acquires ABC, from that point forward, Ben will earn investment returns on the total asset value of ABC (i.e., \$52 million).

Suzy tells Ben that this scenario has the same effect as an interest-free loan from the government of \$20.8 million.

Suzy wants Ben to share with her the economic benefit of the deferral attribute of the C corporation that Ben will be enjoying. That is, Suzy expects Ben to pay some amount greater than \$31.2 million for the stock of ABC.

Let's assume that Ben negotiates an even split of the amount of the deferred BIG tax with Suzy by paying Suzy \$41.6 million (i.e., \$31.2 million plus the BIG tax split of \$10.4 million each). In that case, Ben can still defer the payment of the full \$20.8 million BIG tax liability indefinitely while earning a return on the full \$52 million marketable security value.

Ben pays Suzy \$41.6 million cash for the ABC stock. Ben holds on to the ABC stock for many years while enjoying:

1. investment returns on the \$52.0 million security value and
2. an interest-free loan on the \$20.8 million BIG tax liability.

Who Made the Better Deal?

Should Ben have acquired the value of the underlying marketable security by buying the ABC stock or by making a direct investment in the underlying security?

Let's examine that investment decision by analyzing Ben's investment and Suzy's investment.

For purposes of this analysis, let's assume that Suzy:

1. takes all of the cash received from Ben (i.e., this example will not adjust for the personal income taxes that Suzy would have to pay on the capital gains above her outside basis in the ABC stock) and
2. enters into an interest-bearing loan.

If the after-tax gain on investment is greater for Ben than for Suzy, then acquiring the ABC stock after splitting the amount of the built-in gain with Suzy (and enjoying the "interest-free loan" on the unpaid BIG tax) is a better investment than buying the security directly.

In order to analyze which is the better deal, let's assume that Suzy:

1. takes the \$41.6 million in cash that Ben paid,
2. borrows \$10.4 million from a lender,
3. buys \$52.0 million of that identical security, and
4. holds that security for the same period of time that Ben holds the ABC stock.

Let's assume that Suzy (1) can borrow at the same interest rate that the underlying security is expected to appreciate and (2) can accumulate and defer the principal and interest payments on the debt for the entire holding period.

Let's assume an expected holding period of 10 years and an annual rate of return on the underlying security of 10 percent. Also, let's assume:

1. an income tax rate of 40 percent for corporate income and for ordinary (personal) income and
2. a personal capital gains tax rate of 20 percent.

Finally, let's assume that the underlying security pays no dividends during the entire holding period.

These assumptions are listed in Exhibit 1.

Later, we'll relax these assumptions.

After buying the security for \$52 million and holding it for 10 years, let's assume that Suzy sells her interest for \$134.87 million. Let's assume that Suzy pays off the loan, recognizes a tax benefit for the interest expense on the loan, and pays all of the personal income taxes on the investment. Suzy's interest is a direct investment and, therefore, Suzy has no BIG tax to pay.

Ben also sells the security for \$134.87 million after 10 years. Ben pays \$53.95 million in BIG tax (\$20.8 million of which existed on the date of acquisition and was deferred: the "tax-free loan"). And, then Ben liquidates the ABC corporation.

Let's assume that Ben pays his personal income tax on the gain from the proceeds related to the liquidation of ABC.

Exhibit 2 presents a comparison of the after-tax proceeds from Ben's investment and from Suzy's investment.

In this situation, Suzy clearly made the better deal. Making the direct investment generated a better after-tax benefit than buying the ABC stock and enjoying the interest-free loan. The conclusion of this analysis is that Ben paid too much for the stock of ABC.

Exhibit 1 Table of the Illustrative Example Assumptions

Income Tax Basis in the Underlying Security	\$ 0
C Corporation Income Tax Rate on Built-In Capital Gains = Personal Ordinary Income Tax Rate	40%
Personal Capital Gains Tax Rate	20%
Expected Holding Period (years)	10
Expected Annual Rate of Return on Underlying Single Security (cost of equity)	10%
Future Value Factor for Equity [a]	2.59374
Expected Cost of Debt	10%
Future Value Factor for Debt [b]	2.59374

[a] \$1 held for expected holding period of 10 years at expected rate of increase of 10% (i.e., the cost of equity).

[b] \$1 held for expected holding period at the expected cost of debt the 10%. The interest is accumulated and unpaid.

Exhibit 2 Ben and Suzy Evenly Split the BIG Tax

	Ben	Suzy
Estimated Asset Value at the End of the Expected Holding Period [a]	\$134.87	\$134.87
Less: C Corporation Income Tax on the Built-In Gain (“inside”) [b]	<u>53.95</u>	<u>53.95</u>
Equals: Sale Proceeds Available to the Owner	80.92	134.87
Less: Total Investment Basis [c]	<u>41.60</u>	<u>52.00</u>
Equals: Taxable Gain on Investment (i.e., personal taxable gain)	39.32	82.87
Less: Personal Capital Gains Tax (“outside”) [d]	<u>7.86</u>	<u>16.57</u>
Equals: Pre-Debt After-Tax Sales Proceeds Available to the Owner [e]	73.06	118.30
Less: Original Amount of the Debt [f]		10.40
Less: Accrued and Unpaid Interest Expense during Expected Holding Period		16.57
Plus: Income Tax Benefit from Interest Expense at Personal Ordinary Income Tax Rate [g]		<u>6.63</u>
Equals: After-Tax (and after-debt expense) Proceeds	<u>\$73.06</u>	<u>\$97.95</u>

[a] \$52 million times 2.59374, the future value factor for equity (held for 10 years at 10 percent per year).

[b] For Ben, \$134.87 million minus \$0 basis times 40 percent, the BIG income tax rate on the “inside” basis.

[c] Purchase price for the underlying security.

[d] Gain on the investment times the BIG income tax rate on the “outside” basis.

[e] Sale proceeds to the owner less the personal capital gains tax.

[f] Original amount borrowed.

[g] Accrued and unpaid interest expense times 40 percent, the ordinary income tax rate.

How Much Should Ben Have Paid for the ABC Stock?

Ben decides that it would be fair to pay Suzy no more than the amount that would put them both in the same after-tax economic position.

Ben makes the same analysis based upon his decision to pay no more than \$31.2 million for the ABC stock.

The amount of \$31.2 million is the amount of proceeds that Ben would receive if he bought the ABC stock and immediately sold the security and liquidated the C corporation. In other words, Ben assigns a 100 percent, dollar-for-dollar price discount for the BIG tax liability.

There is no reason for Suzy to agree to a price less than that amount. This is because Suzy could sell the security and liquidate the C corporation herself.

As before, let's assume that Suzy takes the \$31.2 million in cash that Ben paid, borrows \$20.8 million from a lender under the same terms as previously described, buys \$52.0 million of that identical security, and holds that security for 10 years.

Exhibit 3 presents a comparison of the Ben and Suzy after-tax proceeds after liquidating their investments after ten years.

The conclusion of this analysis is as follows: the difference narrowed, but making the direct investment generated a better after-tax benefit than buying the ABC stock and enjoying the interest-free loan.

Even at a 100 percent BIG tax discount, buying the ABC stock and holding it is a bad deal for Ben.

Comparing these two scenarios, Ben earned a \$2.08 million greater after-tax return (\$73.06 million – \$70.98 million) by paying Suzy \$10.4 million more for the ABC stock in the first scenario.

Obviously, Ben would have generated a greater return by investing that \$10.4 million directly in the underlying security.

Typically, the willing buyer would not

pay a price greater than the amount after subtracting a 100 percent valuation discount for the BIG tax. And, typically, the willing seller would never accept a price lower than the amount after subtracting a 100 percent valuation discount for the BIG tax.

Let's Relax the Illustrative Example Assumptions

How would this basic analysis conclusion change if a different analysis assumption is applied?

If the underlying security pays dividends during the holding period, the owner of the C corporation will be subject to double taxation on those dividends, if those dividends are distributed, compared to the direct investment scenario.

Therefore, if the underlying security generates cash flow during the holding period, making the direct investment would generate a better after-tax benefit than buying the ABC stock after (1) applying a 100 percent BIG tax discount and (2) enjoying the interest-free loan.

Let's return to the Exhibit 1 analysis assumptions. Let's apply other reasonable assumptions or even a combination of reasonable assumptions.

The analysis conclusion that making the direct investment generated a better after-tax benefit than buying the ABC stock after applying a 100 percent BIG tax discount and enjoying the interest-free loan does not change whenever there is a BIG in the security held by ABC.

Exhibit 3 Ben Subtracts All of the BIG Tax

	Ben	Suzy
Estimated Asset Value at the End of the Expected Holding Period	\$134.87	\$134.87
Less: C Corporation Income Tax on the Built-In Gain ("inside")	53.95	
Equals: Sales Proceeds Available to the Owner	80.92	134.87
Less: Total Investment Basis	31.20	52.00
Equals: Taxable Gain on Investment (i.e., personal taxable income)	49.72	82.87
Less: Personal Income Tax ("outside")	9.94	16.57
Equals: Pre-Debt After-Tax Sales Proceeds Available to the Owner	70.98	118.30
Less: Original Amount of Debt		20.80
Less: Accrued and Unpaid Interest Expense during Expected Holding Period		33.15
Plus: Income Tax Benefit from Interest Expense at Personal Tax Rate		13.26
Equals: After-Tax (and after-debt expense) Proceeds	\$70.98	\$77.61

In other words, the analysis conclusion doesn't change whenever:

1. the holding period is greater than zero,
2. the cost of equity is greater than the cost of debt, or
3. the corporate tax rate is greater than the personal capital gains tax rate.

When those factors are set equal to each other, making the direct investment generates an economic benefit that is equal to buying the ABC stock after applying a 100 percent BIG tax discount and enjoying the interest-free loan.

If the underlying asset of ABC was something other than a single marketable security, the analysis would be slightly more complicated. This is because, during the holding period, (1) most other types of assets produce taxable income (similar to dividends) and (2) the original amount invested in most other types of assets is eligible for depreciation or amortization tax deductions.

The taxable income generated during the holding period is taxed twice inside of a C corporation (when compared to a direct investment).

When those other assets are liquidated inside the C corporation, the amount of the depreciation deductions may be subject to depreciation recapture.

A Noncontrolling Ownership Interest in ABC

As demonstrated in this illustrative example, buying a controlling ownership interest in a C corporation after applying a 100 percent BIG tax discount is not an attractive investment compared to a direct investment in the underlying assets. This statement is true regardless of the period of time that the assets are held prior to liquidation.

The controlling ownership interest holder in a C corporation is in a position to exercise the prerogatives of control. One of those prerogatives is the right to decide if and when to liquidate any or all of the assets of the C corporation.

Based on the foregoing, on any valuation date before the date the underlying security is liquidated, the fair market value of a noncontrolling interest in ABC is less than a pro rata percentage of the net asset value of ABC. That is, the value of the underlying security is less the application of a 100 percent BIG tax discount.

From the perspective of a hypothetical willing seller of a noncontrolling ownership interest in ABC, the "tax-free loan" argument is not justifiable.

The tax attributes of a noncontrolling ownership interest in ABC are not particularly attractive to a hypothetical willing buyer. Any cash flow from ABC during the holding period will be subject to double taxation compared to the direct investment alternative.

Upon the sale of the ABC equity (at a point other than after liquidation of the underlying assets), the "outside" basis is taxed at the same personal capital gains rate to which the direct investment is subject.

However, the amount of the 100 percent BIG tax liability will have increased during the holding period at a higher rate than the direct investment rate. Therefore, the noncontrolling ownership interest in ABC becomes less valuable (than the direct investment alternative) as time goes on.

Besides deciding the length of the holding period prior to liquidation of the assets, there are many other prerogatives of control that the owner of the noncontrolling ownership interest in ABC may not enjoy.

For instance, the owner (i.e., from the perspective of either the hypothetical willing seller or the hypothetical willing buyer) will not be in a position to unilaterally:

1. influence the investment philosophy of ABC,
2. decide with whom ABC will conduct business, or
3. challenge the compensation paid to the management of ABC.

During the holding period of the investment in a noncontrolling ownership interest in ABC, the owner (i.e., from the perspective of either the hypothetical willing seller or the hypothetical willing buyer) will not be able to redeploy the funds used to buy the noncontrolling ownership interest.

In contrast to an investment in a noncontrolling ownership interest in ABC, an investor who made a direct investment in the single marketable security owns and controls the investment. That investor can freely change the investment decision as a result of changing market conditions.

In addition, that investor can sell all or a portion of the security at any time. That investor can change the investment philosophy.

In sum, the investor who makes a direct investment in a single marketable security has full control over a readily marketable security.

FACTORS TO CONSIDER

There is not a definitive answer for how to treat BIG in an analysis. It depends on the analyst's judgment based on the specific facts and circumstances.

However, there are certain factors that should be considered, some of which are as follows:

- Carrying value of the BIG tax liability—The BIG tax liability carrying value is equal to the difference between the tax basis and the market value of the assets (the “unrealized gain”), multiplied by the marginal corporate tax rate. See Exhibit 4 below for an illustrative example.
- Historical turnover of the portfolio(s)—The historical turnover of the portfolio or assets may be a good indicator or proxy of the portfolio turnover expectations going forward. All else held equal, the higher the turnover, the faster the BIG tax would be realized. Exhibit 5 presents an illustrative turnover analysis.
- Third-party portfolio manager—A third-party portfolio manager may indicate an actively managed portfolio. All else held equal, an actively managed portfolio typically will realize the BIG tax sooner.
- Noncontrolling interest or a controlling interest—An owner of a noncontrolling interest typically could not control when the capital gains are realized.
- Expected appreciation in underlying assets—It may be necessary to project the expected appreciation in the underlying assets. All else held equal, appreciation in the underlying assets would increase the projected BIG tax liability over time.
- Holding period expectations—An analyst should discuss holding period expectations related to the underlying assets with the subject company management and/or the portfolio manager(s).
- The subject company industry—The nature of the industry can impact the realization of the BIG tax liability. For example, in the timber industry there are certain circumstances where a timber company must recognize built-in capital gains each time it cuts and sells timber.
- The type of entity—Typically, adjustments to value for a BIG tax liability pertain to C corporations or recently converted S corporations. Unlike corporate tax law, partnership tax law provides for adjustments to the tax bases of partnership assets if the partnership has made an Internal Revenue Code Section 754 election (754 election).
In general, a 754 election allows adjustments to be made to a partner's share of the

Exhibit 4 Carrying Value of Built-In Capital Gains Tax

	6/30/2012 Tax Basis	6/30/2012 Market Value	Unrealized Gains		Carrying Value Built-In Capital Gains Tax
<u>Portfolio 1</u>					40%
Managed By: Columbia	22,289,191	25,652,769	3,363,577	40%	1,345,431
<u>Portfolio 2</u>					
Managed by: JP Morgan	17,983,256	24,069,086	6,085,830	40%	2,434,332
<u>Portfolio 3</u>					
Managed by: Goldman Sachs	7,865,577	9,393,987	1,528,410	40%	611,364
<u>Portfolio 4</u>					
Managed by: UBS	<u>24,060,496</u>	<u>28,159,264</u>	<u>4,098,768</u>	40%	<u>1,639,507</u>
Total Investments	<u>72,198,521</u>	<u>87,275,106</u>	<u>15,076,585</u>		6,030,634

tax basis of the partnership assets, referred to as the “inside basis,” so that it is equal to the tax basis of his partnership interest, referred to as the “outside basis.”

If no 754 election has been made, no adjustments can be made to the inside bases of partnership assets unless mandatory adjustments are required under Sections 743(a) and 734(b).¹⁹

BIG tax in partnerships could be avoided by a 754 election at the time of sale of partnership assets. If such a 754 election is in effect and the property is sold, then the basis of the partnership’s assets (the inside basis) is raised to match the cost basis of the transferred.

For S corporations it is possible to minimize or eliminate the BIG tax when the stock of the S corporation is liquidated in the same tax year as the liquidation of the underlying asset. For these instances, the investor would not seek a discount from the net asset value for the BIG tax.

- The valuation approach/method—Typically, the BIG tax liability adjustment is made to the adjusted net asset value (ANAV) method indicated value as part of an asset-based valuation approach.

The ANAV valuation method subtracts the fair market value of the total liabilities from the fair market value of the total assets to arrive at a total equity value before consideration of the BIG tax. The total equity value derived from ANAV method is then reduced for the fair market value of the BIG tax liability, if any.

TREATMENT OF BIG TAX IN A VALUATION

The review of the recent judicial precedent indicates that federal courts have consistently allowed a valuation adjustment for the built-in capital gains tax contingent liability.

The issue for judicial determination does not appear to be whether a BIG tax valuation adjustment should be allowed. Rather, the issue for judicial determination is how much of a valuation adjustment should be allowed with regard to the built-in gains tax.

There are three generally accepted methods that are used to estimate the BIG tax liability:

1. Carrying value model
2. Present value with appreciation model

Exhibit 5 Equity Turnover Analysis

<u>Average Equity Security Balance</u>	2011 Average Market Value	2010 Average Market Value
Portfolio 1	35,132,581	39,138,375
Portfolio 2	21,678,406	16,453,317
Portfolio 3	9,017,743	7,583,275
Portfolio 4	26,544,255	22,056,997

<u>Proceeds</u>	2011	2010
Portfolio 1	35,009,382	39,551,402
Portfolio 2	7,995,656	5,327,655
Portfolio 3	2,169,213	1,929,368
Portfolio 4	9,038,109	5,303,426

<u>Portfolio Turnover Calculation [a]</u>	2011	2010	Average
Portfolio 1	99.6%	101.1%	100.4%
Portfolio 2	36.9%	32.4%	34.6%
Portfolio 3	24.1%	25.4%	24.7%
Portfolio 4	34.0%	24.0%	29.0%

[a] Portfolio turnover equals proceeds divided by average investment balance.

3. Present value without appreciation model

The BIG tax liability is a reduction to the net asset value (i.e., the total equity) of the subject company.

Carrying Value Model

The carrying value model is a simple calculation equal to the following formula: (market value of assets – the tax basis of assets) × the corporate capital gains tax rate. See Exhibit 4 for an illustrative example of the carrying value built-in gains tax model.

Present Value with Appreciation Model

The present value with appreciation model is based on the present value of the projected annual realized gains over an expected holding period. The expected holding period relies on a normalized portfolio turnover. The projected annual realized gains is based the unrealized built-in capital gains as of the valuation date increased by an expected growth rate.

The expected growth rate is based on the expected annual increase in the built-in capital gains as the assets appreciate over time. See Exhibit 6 for an illustrative example.

The present value with appreciation model results in the same indicated value as the carrying value model because the expected appreciation in the BIG offsets the present value discount rate. This is the case when the appreciation rate is equal to the present value discount rate. In instances where the appreciation rate is lower than the discount rate, the indicated value will be lower than the carrying value.

Present Value without Appreciation Model

The present value without appreciation model is based on the present value of the projected annual realized gains over an expected holding period. The expected holding period relies on a normalized portfolio turnover.

The projected annual realized gains are based on the unrealized built-in capital gains as of the valuation date without any increases by an expected growth rate.

Effectively, this model assumes that the assets are not expected to appreciate. And, therefore,

the built-in capital gains will not increase over the holding period (i.e., an expected growth rate of 0 percent). See Exhibit 7 for an illustrative example.

The present value without appreciation model results in a lower value (approximately 9 percent lower) than the other two models. This model should only be used if the underlying assets are not expected to appreciate over time.

Given that most investments and real estate are expected to appreciate over time, this model may result in a fundamentally flawed result that erroneously understates the fair market value of the corporate BIG tax liability.

SUMMARY AND CONCLUSION

The issue of how to treat the BIG tax obligation is frequently encountered by the valuation analyst. This issue presents itself when the valuation analyst conducts an assignment for various purposes, including estate tax purposes.

In federal estate tax matters, the BIG tax issue has been the subject of litigation. Recently, federal courts have increasingly allowed a valuation adjustment to reflect the BIG tax obligation when determining the business value of a C corporation. However, not all courts have allowed a valuation adjustment equal to 100 percent of the estimated current built-in gains tax liability.

There are many factors a valuation analyst may consider in an analysis of a BIG tax liability, including the following:

1. The carrying value
2. Historical turnover
3. Third-party manager
4. Controlling or noncontrolling
5. Expected appreciation
6. holding period
7. The subject industry
8. The type of entity
9. The valuation approach/method

The most appropriate model to use in estimating the BIG tax liability may be the present value with

“The most appropriate model to use in estimating the BIG tax liability may be the present value with appreciation. . . .”

Exhibit 6 Present Value of Built-In Capital Gains Tax Liability—With Asset Appreciation

	6/30/2012 Built-in Capital Gains	Normalized Portfolio Turnover [a]	Years to Realize Gains (Rounded)	Annual Realized Gains
Portfolio 1	3,363,577	100%	1	3,363,577
Portfolio 2	6,085,830	35%	3	2,028,610
Portfolio 3	1,528,410	25%	4	382,102
Portfolio 4	4,098,768	30%	3	1,366,256
Total Built-In Capital Gains	15,076,585			
Multiplied by Estimated Corporate Tax Rate				
	Year	Annual Realized Gains With Growth of 5.5% [b]	Present Value Factors @5.5% [b]	Present Values
Portfolio 1	1	3,548,574	0.9479	3,363,577
		3,548,574		3,363,577
Portfolio 2	1	2,140,183	0.9479	2,028,610
	2	2,257,894	0.8985	2,028,610
	3	2,382,078	0.8516	2,028,610
		6,780,155		6,085,830
Portfolio 3	1	403,118	0.9479	382,102
	2	425,290	0.8985	382,102
	3	448,681	0.8516	382,102
	4	473,358	0.8072	382,102
		1,750,446		1,528,410
Portfolio 4	1	1,441,400	0.9479	1,366,256
	2	1,520,677	0.8985	1,366,256
	3	1,604,314	0.8516	1,366,256
		4,566,392		4,098,768
Present Value of Total Built-In Capital Gains				15,076,585
Multiplied by Estimated Corporate Tax Rate				40%
Present Value of Built-In Capital Gains Tax Liability (growth in unrealized gains)				6,030,634

[a] Based on the equity turnover analysis summarized on Exhibit 5.

[b] Based on the geometric mean of the capital appreciation of large company stocks from 1926 to 2011.

Source: Ibbotson SBBI 2012.

Exhibit 7

Present Value of Built-In Capital Gains Tax Liability—Without Asset Appreciation

	6/30/2012 Built-In Capital Gains [a]	Normalized Portfolio Turnover [b]	Years to Realize Gains (Rounded)	Annual Realized Gains	Present Value of Gains @ 5.5% [c]
Portfolio 1	3,363,577	100%	1	3,363,577	3,188,225
Portfolio 2	6,085,830	35%	3	2,028,610	5,473,054
Portfolio 3	1,528,410	25%	4	382,102	1,339,326
Portfolio 4	4,098,768	30%	3	1,366,256	3,686,068
Total Built-In Capital Gains	15,076,585				13,686,674
Multiplied by Estimated Corporate Tax Rate					40%
Present Value of Built-In Capital Gains Tax Liability (no growth in unrealized gain)					5,474,670

[a] See Exhibit 4

[b] Based on the equity turnover analysis summarized on Exhibit 5

[c] Based on the geometric mean of the capital appreciation of large company stocks from 1926 to 2011. Source: Ibbotson SBBI 2012.

appreciation, which can be the same as the carrying value (as illustrated in this discussion). The failure to consider appreciation in a present value model could be a fundamental flaw.

Notes:

1. General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935).
2. Under certain circumstances, it makes economic sense for the buyer and seller to agree to a Section 338(h)(10) election, which allows for the basis of the acquired assets to be stepped up. For example, it makes sense if the C corporation has sufficient net operating losses to shield the tax on the gain of the sale of the assets (if those NOLs would not be available in the future to the buyer).
3. Other legal entities treat the BIG tax liability differently than C corporations. For example, when a noncontrolling (i.e., LP) interest in a partnership is acquired, the GP will often allow for a Section 754 election to be made. This allows the partnership to account for the acquisition of that interest at its purchase price, thus allowing that partner to avoid the double taxation up to the amount of the purchase price when assets are eventually sold.
4. Updated from Robert P. Schweihs, "Valuation Adjustment for Built-In Capital Gains in a C Corporation," Willamette Management Associates *Insights* (Summer 2012): 25–27.
5. Estate of Davis v. Comm'r, 110 T.C. 530 (1998).
6. Eisenberg v. Comm'r, 155 F.3d 50 (2d Cir. 1998).
7. AOD 1999 001.
8. Estate of Jameson v. Comm'r, 77 T.C.M. (CCH) 1383 (1999).
9. *Id.* at 1396.
10. Estate of Jameson v. Comm'r, 267 F.3d 366 (5th Cir. 2001).
11. Earning a 14 percent gross annual rate of return while requiring a 20 percent rate of return.
12. Estate of Dunn v. Comm'r, 301 F.3d 339 (5th Cir. 2002).
13. The court did not apply the same reduction when determining value under the income-based approach.
14. Estate of Jelke v. Comm'r, 507 F.3d 1317 (11th Cir. 2007).
15. Estate of Litchfield v. Comm'r, T.C. Memo. 2009-21 (January 29, 2009).
16. Estate of Jensen v. Comm'r, T.C. Memo 2010-182 (August 10, 2010).
17. Estate of Helen P. Richmond, Amanda Zerbey v. Commissioner, T.C. Memo 2014-26 (February 11, 2014).
18. Schweihs, "Valuation Adjustment for Built-in Capital Gains in a C Corporation": 27–31.
19. http://www.cpa2biz.com/Content/media/PRODUCER_CONTENT/Newsletters/Articles_2011/CPA/Jun/PartnershipBasis.jsp

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