

Valuation Adjustment for Built-in Capital Gains in a C Corporation

Robert P. Schweih

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. This discussion demonstrates that, under most circumstances, every dollar of built-in 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 by one dollar.

INTRODUCTION

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* doctrine, named after a landmark tax case. The *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, normally¹ 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 corporation² is either (1) an operating company or (2) 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 purposes such as: merger and acquisition pricing, transaction fairness analysis, shareholder disputes, estate and gift tax planning and compliance, shareholder buy/sell agreements, ESOP formation, and so forth.

In federal estate and gift tax matters, this 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.

This discussion (1) summarizes recent federal court decisions regarding the consideration of the BIG tax liability in the C corporation valuation and (2) dispels various myths that surround the valuation of a C corporation that owns/operates appreciated (i.e., BIG) assets.

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* was the first judicial decision to recognize the BIG tax valuation impact following the repeal of the *General Utilities* doctrine.³ In *Davis*, the gift tax value of two 25-share blocks of stock of the total of 97 shares of 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*, 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.⁴ The Service has acquiesced to the *Eisenberg* decision "to the extent that it holds that there is no legal prohibition against such a discount."⁵

In 1999, the Tax Court again allowed a valuation discount related to the BIG tax liability.⁶ In the *Estate of Jameson*, 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.⁷

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 reversed⁸ the Tax Court's *Estate of Jameson* 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.⁹ 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.¹⁰ In the *Estate of Dunn*, 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.¹¹

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*, the Eleventh Circuit has adopted the Fifth Circuit's dollar-for-dollar valuation discount procedure.¹²

In 2009, the Tax Court¹³ allowed a BIG-tax-related valuation discount based on the assumption that the assets would be sold over time. In the *Estate of Litchfield*, 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 case¹⁴ where the principal assets of the C corporation were real estate and real property improvements. In the *Estate of Jensen*, the Tax Court made its own calculation of the size of the BIG tax discount by applying a present value approach. 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.

This 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.

AN ILLUSTRATIVE EXAMPLE

Candy Company ("Candy"), 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 Candy liabilities other than the obligation to pay the BIG tax whenever the marketable security is sold.

For simplicity, let's assume that:

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

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

As an alternative to buying Candy, 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 Candy 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 Candy stock and defer the payment of the \$20.8 million BIG tax

liability indefinitely. If Ben acquires Candy, from that point forward, Ben will earn investment returns on the total asset value of Candy (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 Candy.

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 Candy stock. Ben holds on to the Candy 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 Candy 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 Candy 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 Candy 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 Candy 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. And, 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 Candy corporation.

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

Exhibit 2 presents a comparison of the after-tax proceeds from Ben's and 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 Candy stock and enjoying the interest-free loan. The conclusion of this analysis is that Ben paid too much for the stock of Candy.

HOW MUCH SHOULD BEN HAVE PAID FOR THE CANDY 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 Candy stock.

The amount of \$31.2 million is the proceeds Ben would receive if he bought the Candy 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.

Exhibit 1 Illustrative Example Assumptions

Candy 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]	53.95	
Equals: Sale proceeds available to the owner	80.92	134.87
Less: Total investment basis [c]	41.60	52.00
Equals: Taxable gain on investment (i.e., personal taxable gain)	39.32	82.87
Less: Personal capital gains tax (“outside”) [d]	7.86	16.57
Equals: Predebt 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]		6.63
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% per year).
 [b] For Ben, \$134.87 million minus \$0 basis times 40%, 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.

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 Candy stock and enjoying the interest-free loan. Even at a 100 percent BIG tax discount, buying the Candy 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 minus \$70.98) by paying Suzy \$10.4 million more for the Candy stock in the first scenario.

Obviously, Ben would have generated a greater return by

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: Predebt 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	<u>\$70.98</u>	<u>\$77.61</u>

investing that \$10.4 million directly in the underlying security.

The willing buyer would not pay a price greater than the amount after subtracting a 100 percent valuation discount for the BIG tax. And, 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 Candy 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 Candy 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 Candy.

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 Candy stock after applying a 100 percent BIG tax discount and enjoying the interest-free loan.

If the underlying asset of Candy 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 CANDY

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 these rights is 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 Candy is less than a pro rata percentage of the net asset value of Candy. 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 Candy, the "tax-free loan" argument is not justifiable.

The tax attributes of a noncontrolling ownership interest in Candy are not particularly attractive to a hypothetical willing buyer. Any cash flow from Candy during the holding period will be subject to double taxation compared to the direct investment alternative. Upon the sale of the Candy 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 Candy 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 Candy 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 Candy, (2) decide with whom Candy will conduct business, or (3) challenge the compensation paid to the management of Candy.

During the holding period of the investment in a noncontrolling ownership interest in Candy, 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 Candy, 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. 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.

SUMMARY AND CONCLUSION

This discussion (1) summarized recent Tax Court decisions regarding the BIG tax and (2) presented an illustrative example that addressed various myths that surround the valuation of a C corporation with appreciated underlying assets.

Based on the illustrative example, buying a controlling interest in a C corporation, even after recognizing 100 percent of the built-in gains tax liability, is not an attractive investment compared to making a direct investment in the C corporation's underlying assets. The ability to defer the built-in gains tax liability does not have the same economic effect as an "interest-free" loan from the government.

In addition, on any valuation date before the date that the underlying security is liquidated, the fair market value of a noncontrolling ownership interest in a C corporation is less than a pro rata percentage of the net asset value of the C corporation (i.e., the value of the underlying security less

the application of a 100 percent BIG tax discount). This is because a noncontrolling ownership interest holder in a C corporation, even after fully recognizing 100 percent of the built-in gains tax liability, suffers from both a lack of control and a lack of marketability.

Notes:

1. 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).
2. 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.
3. Estate of Davis v. Comm'r, 110 T.C. 530 (1998).
4. Eisenberg v. Comm'r, 155 F.3d 50 (2d Cir. 1998).
5. AOD 1999 001.
6. Estate of Jameson v. Comm'r, 77 T.C.M. (CCH) 1383 (1999).
7. 77 T.C.M. at 1396.
8. Estate of Jameson v. Comm'r, 267 F.3d 366 (5th Cir. 2001).
9. Earning a 14 percent gross annual rate of return while requiring a 20 percent rate of return.
10. Estate of Dunn v. Comm'r, 301 F.3d 339 (5th Cir. 2002).
11. The court did not apply the same reduction when determining value under the income-based approach.
12. Estate of Jelke v. Comm'r, 507 F.3d 1317 (11th Cir. 2007).
13. Estate of Litchfield v. Comm'r, T.C. Memo. 2009-21 (January 29, 2009).
14. Estate of Jensen v. Comm'r, T.C. Memo 2010-182 (August 10, 2010).

Robert P. Schweih is a managing director of the firm. Bob can be reached at (773) 399-4320 or at rpschweih@willamette.com.



“... the investor who makes a direct investment in a single marketable security has full control over a readily marketable security.”