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THE "BIG" TAX DISCOUNT IN ASSET-BASED BUSINESS/STOCK VALUATIONS FOR ESTATE PLANNING/ESTATE TAX PURPOSES

James G. Rabe

When the business interest included in the estate of a high net worth individual is an asset holding company, the asset-based valuation approach is particularly applicable. This statement is true whether the asset holding company is a corporation, limited liability company, or family limited partnership. And, this statement is true regardless of whether the assets included in the asset holding company include publicly traded debt or equity securities, the stock of a closely held operating business, real estate, or other investment assets. The asset-based approach involves the discrete appraisal of the individual assets included in the holding company "portfolio." When the portfolio includes appreciated assets, analysts typically consider the built-in capital gains (BIG) tax liability as an adjustment (or discount) to the individual asset values. This discussion summarizes the procedures that analysts commonly use to quantify the BIG tax valuation discount.

INTRODUCTION

When the stock of a closely held business is an asset in the deceased's estate, the valuation of the business/stock often causes controversy for estate tax purposes. In a typical estate planning or estate tax valuation, the closely held business may be a family-owned or other privately owned corporation. Or, the valuation subject may be the restricted stock of a public company or the stock of a very thinly traded public corporation.

Valuation analysts typically use three generally accepted approaches to a value closely held business/stock: the income approach, the market approach, and the asset-based approach. Analysts typically synthesize the quantitative value indications of two or more of these analytical approaches in reaching a final value conclusion.

The income approach values a closely held corporation as the present value of the future income expected to be earned by the owners of the business. The most common closely held business/stock valuation income approach methods are (1) the direct capitalization method and (2) the yield capitalization (or discounted cash flow) method.

The market approach values a closely held company by reference to market-derived pricing multiples extracted from actual sales of comparative companies or securities. The most common closely held business/stock market approach valuation methods are (1) the guideline merged and acquired company method and (2) the guideline publicly traded company method.

The asset-based approach values a closely held corporation by reference to (1) the current value of all its assets (both tangible and intangible) less (2) the current value of all of its liabilities (both contingent and recorded). The most common closely held business/stock asset-based approach valuation methods are (1) the net asset value method (where total corporate asset appreciation is estimated collectively) and (2) the asset accumulation method (where the company's individual tangible and intangible assets are separately identified and valued).

THE "BIG" TAX LIABILITY ISSUE

In the asset-based approach, the analyst estimates the value of the subject corporation's assets either in aggregate (the net asset value method) or individually (the asset accumulation method). In any event, this appraised value of the deceased's ownership interest (either aggregate or individual) is typically in excess of the income tax basis of the subject corporate assets. This is almost always the case with regard to the corporation's intangible assets. This is because these intangible assets typically have little or no income tax basis.

If the subject company's assets were sold in a fair market value transaction (i.e., the conceptual premise of the asset-based approach), the corporation would pay capital gains tax. The amount of the capital gains would be based on the appreciation of the company's assets—that is, the fair market value sales price of the assets less the income

tax basis of the assets. The capital gains tax liability would be based on (1) the amount of the capital gains (i.e., the asset appreciation over income tax basis) and (2) the corporate capital gains tax rate.

Since this capital gains tax liability is associated with the appraised value of the corporate assets, it is typically called the built-in gains (or BIG) tax liability.

The individual asset appraisals in the asset-based business valuation approach are typically performed based on the premise of value of "value in continued use, as part of a going concern." This premise of value assumes that the subject corporate assets are sold collectively as a going-concern business.

However, such a hypothetical sale would, in fact, trigger the BIG tax. This conceptual issue ultimately relates to a basic procedural question: how should the analyst account for the BIG tax liability in an asset-based business/stock valuation performed for estate planning/estate tax purposes?

This valuation issue has been addressed over the years in several federal gift and estate tax court cases. In 2002, the Fifth Circuit weighed in on this valuation issue (based on an appeal of a U.S. Tax Court estate tax case). This Fifth Circuit decision provides important professional guidance to analysts who value closely held or family-owned business interests for estate planning/estate tax purposes.

GUIDANCE FROM THE DUNN CASE

In the *Estate of Beatrice Ellen Jones Dunn*, No. 00-60614, 2002 U.S. App. Lexis 15453 (5th Cir. Aug. 1, 2002), *rev'g and rem'g* (with instructions) T.C. Memo 2000-12 (Jan. 12, 2000), the U.S. Court of Appeals for the Fifth Circuit accepted the taxpayer argument that stock valuations should be adjusted for the potential BIG tax on appreciated corporate assets.

Prior gift and estate tax cases held that a holding company valuation may be adjusted (i.e., discounted) for the potential BIG tax liability. However, the valuation discounts allowed by the courts in these previous holding company valuation cases typically did not reflect the full 34 percent corporate capital gain tax rate.

The *Estate of Dunn* provides practical guidance on two issues related to the BIG tax valuation discount.

First, the appellate court upheld the taxpayer position of a BIG tax valuation discount on appreciated assets based on the full 34 percent corporate capital gains rate tax.

Second, in addition to allowing a valuation adjustment for the full BIG tax liability, the *Estate of Dunn* is significant because of the type of business enterprise involved. The subject corporation in the *Estate of Dunn* was an operating company, not a property holding company. The previous judicial precedent related to the BIG tax valuation discount all involved property holding companies. Such companies

included real estate development companies or companies that owned only a portfolio of marketable securities.

The Facts of the Case

On the date of her death in 1991, Beatrice Ellen Jones Dunn (the decedent) owned a block of stock in Dunn Equipment, Inc. (the Company). Dunn Equipment, Inc., was incorporated in Texas in 1949. The Company was a family-owned business throughout its existence. The Company operated from four locations throughout Texas. In 1991, the Company had 134 employees, including three executives and eight salesmen.

Dunn Equipment, Inc., owned and rented out heavy equipment and provided related services, primarily in the petroleum refinery and petrochemical industries. The personal property rented from the Company by its customers consisted principally of large cranes, air compressors, backhoes, man lifts, and sanders and grinders.

The Company frequently furnished operators for the equipment that it rented to its customers, charging for both equipment and operators on an hourly basis. For example, the Company's revenue resulted in significant part from the renting of large cranes, both with and without operators.

Ms. Dunn died on June 8, 1991, at the age of 81. After Ms. Dunn's death, the estate timely filed the Form 706 federal estate tax return. The decedent's block of shares represented approximately 63 percent of the outstanding stock of the Company. Accordingly, the decedent's block of stock represented a controlling ownership interest in the subject closely held corporation.

However, at the trial level, the Tax Court found that, even though the decedent's 63 percent of stock ownership gave Ms. Dunn operational control of the Company, under Texas law she lacked the power to compel a liquidation, a sale of all or substantially all of its assets, or a merger or consolidation.

In order to initiate each of these control events under Texas law, a "super-majority" equal to or greater than 66.67 percent of the outstanding shares is required.

The Tax Court further concluded that, in addition to lacking a super-majority herself, Ms. Dunn would not have been likely to garner the votes of additional shareholders sufficient to constitute the super-majority required to instigate liquidation or sale of all assets. This was because the other Company shareholders were determined to continue the independent existence and operations of Dunn Equipment, Inc., indefinitely.

In November 1994, approximately three and one-half years after the decedent's death and two and one-half years after her estate tax return was filed, the Internal Revenue Service (Service) issued a notice of deficiency. The notice of deficiency assessed additional estate taxes of \$238,515.

The estate filed a complaint (*Dunn v. Commissioner*) in the U.S. Tax Court. In an amended answer filed in the Tax

Court, the Service increased the asserted estate tax deficiency to approximately \$1,100,000. This deficiency was predicated on the Service's contention that the decedent's 492,610 shares of Dunn Equipment, Inc., stock had been undervalued on the estate tax return.

The Internal Revenue Service Position

In the Tax Court proceeding, the Service valued the decedent's stock ownership using an asset-based valuation approach—specifically, the NAV method. The Service, however, did not apply a valuation discount related to the potential BIG tax liability on the Company's appreciated assets.

At the Tax Court trial, the Service argued that a BIG tax valuation discount was not an appropriate methodological procedure in an asset-based business/stock valuation analysis. In addition, the Service argued that there was no plan to liquidate the profitable company or to actually sell the appreciated corporate assets. Therefore, the Company would not actually have to pay the BIG tax liability in the foreseeable future.

However, the Service did not present an independent valuation expert at the Tax Court trial. Instead, the Service presented its position through legal argument and rebuttal testimony. The Fifth Circuit did not find this strategy convincing. In its decision, the Appeals Court states the following regarding the Service presentation of evidence:

Indeed, at trial, the Commissioner did not favor the Tax Court with testimony of an expert appraiser, even though the Commissioner had affirmatively proposed his own, geometrically higher value for the decedent's block of stock—values that started out higher than the ones reported on the estate tax return and that were then multiplied, by virtue of the Commissioner's amended answer, to almost four times the Estate's figures. Yet instead of supporting his own higher values (for which he had the burden of proof) by proffering professional expert valuation testimony during the trial, the Commissioner merely engaged in guerrilla warfare, presenting only an accounting expert to snipe at the methodology of the Estate's valuation expert. The use of such trial tactics might be legitimate when merely contesting values proposed by the party opposite, but they can never suffice as support for a higher value affirmatively asserted by the party employing such a trial strategy. This is particularly true when, as here, that party is the Commissioner, who has the burden of proving the expanded value asserted in his amended answer.

Using such tactics remains the prerogative of the Commissioner and his trial counsel, at least up to a point. But when his choice of tactics is

viewed in the framework of the substantive valuation methodology urged by the Commissioner in the Tax Court, his posture at trial is seen to be so extreme and so far removed from reality as to be totally lacking in probative value.

The Taxpayer Position

At the Tax Court trial, the taxpayer's valuation expert estimated the value of the decedent's stock ownership using two business valuation approaches.

First, the taxpayer's expert used the income approach and, specifically, the direct capitalization of income method. In this expert's application of the direct capitalization method, the income was measured as net income, and not as net cash flow.

Second, like the methodology proposed by the Service, the taxpayer's expert used the asset-based approach and, specifically, the NAV method. The taxpayer's expert made an adjustment (i.e., a reduction) to the NAV method value indication for the associated BIG tax liability.

This adjustment was based on the \$7.1 million BIG tax liability that would arise if the corporation actually sold its assets at their individual appraised fair market values.

The taxpayer's expert reached a final value conclusion for the subject stock by (1) weighting the income approach value indication by 50 percent and (2) weighting the asset-based approach value indication (adjusted for a \$7.1 million BIG tax liability discount) by 50 percent.

The Tax Court Decision

As reported in *Dunn v. Commissioner*, T.C. Memo 2000-12, the Tax Court concluded an overall value of the decedent's stock by assigning (1) a 65 percent weight to the NAV method value indication and (2) a 35 percent weight to the direct capitalization of income method value indication.

However, the Tax Court reduced the NAV method value indication by only 5 percent of the estimated \$7.1 million BIG tax liability.

The Tax Court reasoned that a hypothetical willing buyer would not necessarily liquidate the company. Rather, a hypothetical willing buyer may buy the subject stock with the intention of entering into a different but ongoing line of business.

Accordingly, the Tax Court concluded that the likelihood of a near-term corporate liquidation—an event that would actually trigger the payment of the corporation BIG tax liability—was low.

Finally, in its valuation of the decedent's stock, the Tax Court allowed (1) a 15 percent discount for lack of marketability and (2) a 7.5 percent discount for lack of supermajority control.

The estate did not appeal the amount of these two valuation discounts at the Court of Appeals proceeding. Accordingly, the Fifth Circuit did not have to opine on either of these two valuation adjustments.

The Fifth Circuit Decision

The Appeals Court started its review of the subject valuation issues by quoting the authoritative literature regarding business/stock valuation, as follows:

As a broad generality, appraising corporations or blocks of corporate stock involves consideration of three approaches: income, market, and assets-based. n19

n19 See Shannon P. Pratt, et al. *Valuing a Business: The Analysis and Appraisal of Closely Held Companies* (4th ed. 2000).

The Fifth Circuit Court ultimately assigned (1) an 85 percent weight to the income approach value indication and (2) a 15 percent weight to asset-based approach value indication.

Within the asset-based approach value indication, the Fifth Circuit rejected the Tax Court's 5 percent BIG tax valuation discount. Rather, it applied a BIG tax valuation discount based on the full 34 percent corporate capital gains tax rate.

Commenting on this valuation issue, the Court of Appeals decision states:

No one can dispute that if Dunn Equipment had sold all of its heavy equipment, industrial real estate, and townhouse on the valuation date, the Corporation would have incurred a 34% federal tax on the gain realized, regardless of whether that gain were labeled as capital gain or ordinary income. The question, then, is not the rate of the built-in tax liability of the assets or the dollar amount of the inherent gain, but the method to employ in accounting for that inherent tax liability when valuing the Corporation's assets (not to be confused with the ultimate task of valuing its stock).

The Court of Appeals reasoned that the asset-based business/stock valuation approach should not consider the likelihood of a corporate liquidation in determining the corporation's NAV. Rather, the Court of Appeals concluded that the estimation of the BIG tax liability is an integral component of a corporation's value as derived by an asset-based approach valuation.

Regarding this fundamental valuation issue, the Fifth Circuit decision states the following:

Bottom Line: The likelihood of liquidation has no place in either of the two disparate approaches to valuing this particular operating company.

The Court of Appeals reached this overall conclusion regarding the Tax Court decision in *Dunn v. Commissioner*:

We conclude that the Tax Court erred as a matter of law in the valuation methodology that it selected and applied to facts that are now largely uncontested by virtue of stipulations, concessions, and non-erroneous findings of that court. This legal error produced an incorrect valuation and thus an erroneous final Tax Court judgment as to the Estate's tax deficiency, requiring remand to that court.

The Court of Appeals specifically describes the perceived errors in the Tax Court decision as follows:

The Tax Court's fundamental error in this regard is reflected in its statement that—for purposes of an asset-based analysis of corporate value—a fully-informed willing buyer of corporate shares (as distinguished from the Corporation's assemblage of assets) constituting an operational-control majority would not seek a substantial price reduction for built-in tax liability, absent that buyer's intention to liquidate. This is simply wrong: It is inconceivable that, since the abolition of the General Utilities doctrine and the attendant repeal of relevant I.R.C. sections, such as §§ 333 and 337, any reasonably informed, fully taxable buyer (1) of an operational-control majority block of stock in a corporation (2) for the purpose of acquiring its assets, has not instituted that all (or essentially all) of the latent tax liability of assets held in corporate solution be reflected in the purchased price of such stock.

We are satisfied that the hypothetical willing buyer of the Decedent's block of Dunn Equipment stock would demand a reduction in price for the built-in gains tax liability of the Corporation's assets at essentially 100 cents on the dollar, regardless of his subjective desires or intentions regarding use or disposition of the assets. Here, that reduction would be 34%. This is true "in spades" when, for purposes of computing the asset-based value of the Corporation, we assume (as we must) that the willing buyer is purchasing the stock to get the assets, whether in or out of corporate solution. We hold as a matter of law that the built-in gains tax liability of this particular business's assets must be considered as a dollar-for-dollar reduction when calculating the asset-based value of the Corporation, just as, conversely, built-in gains tax liability would have no place in the calculation of the Corporation's earnings-based value. n24

n24 Pratt et al., *Valuing a Business*, (“Tax consequences of ownership and/or transfer of stock ... usually are quite different from those of ownership and/or transfer of direct investment in underlying assets. These tax implications often have a significant bearing on value.”).

The Appeals Court also presented a strong opinion of the conceptual position—and the trial tactics—of the Service in the *Dunn v. Commissioner* Tax Court case:

Consequently, the Commissioner’s insistence at trial that the value of the subject stock in *Dunn Equipment* be determined exclusively on the basis of the market value of its assets, undiminished by their inherent tax liability—coupled with his failure to adduce affirmative testimony of a valuation expert—was so incongruous as to call his motivation into question.

Regarding the Service’s position in the *Estate of Dunn* appellate case, the Fifth Circuit stated the following:

The Commissioner’s abrupt change of position on appeal is so inconsistent and unreconcilable with his pretrial and trial positions that all of his urgings to us are rendered highly suspect. We keep this duplicity in mind as we proceed to examine the Tax Court’s valuation methodology.

SUMMARY AND CONCLUSION

Valuation analysts typically use income and market approach methods (more commonly than asset-based approach methods) in business/stock valuations prepared for estate planning/estate tax purposes. However, the asset-based approach is a generally accepted approach for estate planning/estate tax valuations. And, the asset-based approach is applied often enough so that the BIG tax discount conceptual issue should be resolved.

The asset-based approach assumes that the subject company sells the business in an asset (versus a stock) transaction. The corporate assets sell at the total of their appraised fair market values. After the assumed sale, the subject corporation would generally have to pay capital gains tax on the excess of the assets’ sales price over the assets’ tax basis. Since the repeal of the General Utilities doctrine in 1986, corporations have few options available to mitigate this capital gains tax.

All business/stock valuations are based on hypothetical sales transactions. In the market approach, there is a hypothetical sale of the corporate stock (in either a public market or in a private transaction). The fact that the company does not actually sell its stock does not invalidate the use of

the market approach. Likewise, the fact that the company does not actually sell its assets does not invalidate the use of the asset-based approach. In a hypothetical sale of the corporate assets, a hypothetical BIG tax liability would be paid.

The *Estate of Dunn* concludes that a company’s NAV should be adjusted (discounted) for the amount of this hypothetical BIG tax liability. The Appeals Court reaches this conclusion regardless of whether or not the company plans to actually sell its corporate assets. And, the Fifth Circuit reaches this conclusion regardless of whether or not the company is an operating company or a property holding company.

In fact, the Fifth Circuit conclusion regarding this issue in the *Estate of Dunn* is unambiguous:

We must reject as legal error, then, the Tax Court’s treatment of built-in gains tax liability and hold that—under the court’s asset-based approach—determination of the value of *Dunn Equipment* must include a reduction equal to 34% of the taxable gain inherent in those assets as of the valuation date.

The *Estate of Dunn* provides important professional guidance to valuation analysts on two issues. First, when the asset-based approach—and specifically the NAV method—is used to estimate business/stock value, the *Estate of Dunn* supports the calculation of the BIG tax valuation discount at the full capital gains corporate tax rate. According to the *Dunn* decision, the estimated BIG tax liability should not be reduced by an estimate of the probability of a near-term corporate liquidation.

Second, *Dunn* indicates that the BIG tax adjustment should be considered in the asset-based valuation of any going concern business—and not just in the valuation of property holding companies. The estimation of the potential BIG tax liability on appreciated assets is an integral methodological step in any asset-based approach business valuation. The consideration of the capital gains tax on revalued assets is a function of the selected valuation approach (i.e., the use of an asset-based approach valuation method). The consideration of the capital gains tax is not a function of the type of subject business enterprise (i.e., operating company versus holding company).

The *Estate of Dunn* provides practical professional guidance to valuation practitioners. This is because the BIG tax valuation adjustment is a relevant issue with respect to closely held business/stock valuations performed for estate planning/estate tax purposes.

Jim Rabe is a managing director of the firm and director of our Portland, Oregon, office. Jim can be reached at (503) 243-7505 or jgrabe@willamette.com