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TAX COURT CASE UPDATE

FCG Valuation Case E-Flash

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Citation:

Estate of Marie J. Jensen, v. Commissioner, T.C. Memo. 2010-182, Filed August 10, 2010.

Overview:

The Tax Court considered the amount of discount allowable for built-in long-term capital gains tax when calculating the value of an estate's controlling, 82 percent interest in a closely-held C corporation owning real estate.

Reversing its positions in *Eisenberg*, *Estate of Dunn*, and *Estate of Jelke*, the Tax Court allowed Jensen's built-in, long-term capital gains tax to be deducted dollar-for-dollar. In addition, the taxpayer and IRS stipulated that the value of the 82-percent, controlling interest was subject to a 5 percent discount for lack of marketability from its pro rata share of tangible net asset value.

Controlling Owner's Estate and IRS Disagree on BIG Tax:

When Marie Jensen died on July 31, 2005, she was trustee of the Marie J. Jensen Revocable Trust. Included in the corpus of the trust was 164 shares (an 82 percent interest) of Wa-Klo, Inc., a closely-held C corporation. Wa-Klo's primary asset was 94 acres of waterfront property in New Hampshire. The property had been improved to operate a girls' camp. Improvements included state-of-the art facilities including bunkhouses, cottages, a dining hall, a horse stable, an indoor gymnasium, and playing fields.Upon Ms. Jensen's death, the estate's experts valued Wa-Klo using the net asset value method from which it subtracted a dollar-for-dollar built-in gains ("BIG") tax liability of $965,000 (which was revised upward to $1.13 million).

The IRS's expert used the net asset value method to value Wa-Klo as well but determined a BIG tax liability of $250,042. In particular, the IRS's expert analyzed transactions of closed-end funds to determine a discount for the BIG tax. Additionally, the IRS's expert asserted that there were ways that the BIG tax could be avoided (1031 exchange, conversion to S corporation, etc.). As a result, the IRS's expert determined a lower BIG liability than the estate's expert.

Use of Closed-end Funds for BIG Tax Rejected:

The Tax Court rejected the IRS's expert's reliance on closed-end funds. The Court noted the differences between an investment in a single parcel of real estate as in Wa-Klo and closed-end funds, which typically invest in various sectors and asset classes. Additionally, closed-end funds

investing in real estate typically invest indirectly (i.e., they buy shares in REITs or other entities that own real estate) and invest in multiple types of real estate.

The Tax Court further rejected the reliance on closed-end funds as it found that closed-end fund discounts were determined by many factors, not just exposure to BIG tax. The Court noted that "studies on the effects of unrealized capital gains on the discounts from a closed-end fund's net asset value are inconclusive."

Strategies to Avoid BIG Tax Rejected:

The Court dismissed the IRS's expert's contention that the BIG tax could be avoided. The Tax Court argued that the best an investor could hope for was deferment of the tax, which would shift payment of the tax from the seller to the buyer. As a result, the negotiated price would reflect the tax (i.e., the tax would still exist).

Tax Court's Calculation of BIG Tax:

Using appreciation rates provided in the taxpayer's real estate appraisal and based on data provided by the estate's experts, as well as calculating a 17-year useful depreciable life for the real estate and its improvements, the Tax Court calculated a range of reasonable future values for the property. The Court then determined future BIG tax liabilities, which it then discounted back over 17 years using the previously determined appreciation rates. Because the estate's upwardly adjusted calculation of BIG was reasonably close to the Tax Court's calculation, that value was accepted dollar-for-dollar by The Court while the IRS's expert's calculated value was rejected.