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Valuation and C Corp. Taxes on Embedded Gains

Part One of a Three-Part Article

By Thomas A. Hutson

The First Department Appellate Division's Oct. 21, 2008 decision in *Wechsler v. Wechsler*, 866 NYS2d 120 (1st Dept. 2008), demonstrated how, when financial experts present differing points of view when valuing a marital asset, a seemingly simple concept can nonetheless raise many questions.

The Puzzle

The principal issue addressed in the *Wechsler* decision is the extent to which the value of a holding company structured as a subchapter C corporation should be reduced to reflect the federal and state corporate level income taxes associated with the unrealized appreciation of marketable securities (or real estate or other assets in a different situation) owned by the corporation. The allowance, or provision, for deferred taxes is contingent, and is not realized until the underlying securities are sold.

Everyone agrees that under current tax law, a C corporation is subject to taxation on realized capital gains at the statutory rates in effect for the year in which such gains are realized. There are, however, significant differences of opinion regarding when and how a reduction (or discount) for the contingent taxes associated with these embedded (or built-in) gains should be quantified when valuing a business or an interest therein. This is currently a hot issue, not only for New York's matrimonial courts but also for federal estate and gift tax matters, and in shareholder oppression cases and buy-out proceedings under New York's Business Corporation Law (BCL).

Many factors affect the method of quantification that may be selected by a valuation expert or the court, including but not limited to: 1) the size of the ownership interest being appraised; 2) the method or methods of valuation used to appraise the business; 3) the weight given to each method utilized in arriving at a conclusion of value; 4) the premise of value (*i.e.*, going concern value or liquidation value); 5) the expected holding period for the marketable securities portfolio (or real estate or other assets having embedded gains); 6) the amount, if any, of the provision for deferred taxes already reflected in the corporation's financial statements; and 7) perhaps most importantly, the specific facts and circumstances of each case.

Repeal of the General Utilities Doctrine

Before turning to a discussion of the decision in Wechsler, let's look at some of the statutory, regulatory and case law history surrounding the issue. Long ago, based on the 1935 Supreme Court decision in *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935),

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a corporation's distribution of property, whether in complete liquidation or partial liquidation, produced neither gain nor loss to the distributing corporation. This non-recognition concept became known as the "General Utilities" doctrine and was subsequently codified in 1954 with the enactment of Section 311(a) for distributions not in complete liquidation, and Sections 336 and 337 for distributions in complete liquidation. There were some exceptions to the rule and, as time passed, statutory changes and judicial interpretations resulted in an increasing number of circumstances in which gains or losses were recognized.

The Tax Reform Act of 1986 (TRA86) fully repealed the General Utilities doctrine and dramatically changed the tax code, including new rules enacted under Section 311(b), which require the recognition of corporate-level gains on distributions of appreciated property. Before TRA86 became effective, the General Utilities doctrine permitted a C corporation to distribute certain appreciated assets to its shareholders without incurring corporate level income taxes on the gain. Under current tax law, tax avoidance opportunities for distributions of appreciated property are very limited. Corporations recognize a capital gain on nearly all distributions of appreciated property to shareholders. As a result of the repeal, such distributions are taxed twice, since the C corporation is deemed to have sold the property at fair market value and then to have distributed a taxable cash dividend to the shareholders. Accordingly, gains on post 1986 distributions of appreciated property by C corporations are generally subject to corporate-level income taxation.

Although pre-1986 tax cases were superceded by statute, the IRS maintained its position that case law did not allow a discount for built-in capital gains tax liability when a sale or liquidation was neither planned nor imminent, and it continued to be treated by courts as too uncertain, remote or speculative for well over a decade. During this period the IRS uniformly denied a discount for built-in capital gains tax liability (frequently referred to as BIG Tax), unless the taxpayer could prove payment was imminent. It wasn't until the Tax Court's 1998 decision in *Estate of Davis v. Commissioner of Internal Revenue*, 110 T.C. 530 (2nd Cir. 1998), and the Second Circuit Court of Appeals' 1998 decision in *Estate of Eisenberg v. Commissioner of Internal Revenue*, 155 F.3d 50 (2nd Cir. 1998), that the concept of a reduction for BIG Tax was embraced by the courts. These cases set a new precedent that, although no liquidation of the corporation or sale of corporate assets was imminent or contemplated at the valuation date, the requirement of an imminent sale was unnecessary; it was the opinion of the courts that a willing buyer would demand a discount to take account of the fact that, sooner or later, BIG Tax would have to be paid. The IRS ultimately acquiesced in the face of these and other decisions, accepted the concept, and now generally argues only about how the discount for BIG Tax should be quantified given the particular set of facts and circumstances presented in each case — but not the legal right of taxpayers to claim the discount.

Conclusion

In next month's issue, we'll look at non-matrimonial cases that have dealt with this issue, and discuss the *Wechsler* trial court's decision-making process.

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Valuation and C Corp. Taxes on Embedded Gains

Part Two of a Three-Part Article

By Thomas A. Hutson

In the first part of this article, we noted that the problem of how to value a holding company structured as a subchapter C corporation was recently tackled by the Appellate Division, First Department, in the context of a dissolution of marriage. But the question of whether and how such value should be reduced to reflect the federal and state corporate-level income taxes associated with the unrealized appreciation of marketable securities owned by a corporation is controversial. Before taking an in-depth look, in next month's issue, at the First Department's reasoning in the appeal of *Wechsler v. Wechsler*, 866 NYS2d 120 (1st Dept. 2008), we need to understand the *Wechsler* trial court's decision and discuss how other courts have handled the issue.

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Recent Non-Matrimonial Cases

Outside of the matrimonial arena, a Dec. 9, 2008 decision and May 22, 2008 decision in the Business Corporations Law (BCL) Section 1118 valuation case, *Murphy v. U.S. Dredging Corp.*, 2008 NY Slip Op 31535 (Sup. Ct., NY Cty. 5/19/08), also addressed the built-in capital gains tax (BIG Tax) issue for C corporation assets, and the many factors that may influence how it is applied and quantified. In addition, since *Murphy v. U.S. Dredging* is a Section 1118 case, the applicable standard of value — *i.e.*, fair value versus fair market value — was an important consideration in the decision rendered by the Nassau County Supreme Court. Factors addressed in the Court's May 22, 2008 decision included: 1) the nature of the assets owned by U.S. Dredging, which was a real estate holding company with substantial cash equivalent investments; 2) the premise of value (going concern or liquidation value); 3) the nature of valuation approaches used by the experts (an asset-based approach and an income-based approach); 4) the nature of valuation methods used by the experts (net asset value method and discounted future net cash flow method); 5) the shareholders' intent and the corporation's history, as these items bear on whether or not an election to become an S corporation (pass-through entity) may possibly be made, and on a decision to enter into an Internal Revenue Code Section 1031 tax-free exchange that deferred the recognition of the capital gain and BIG Tax associated with a sale of real estate, since the proceeds were reinvested in like-kind property; 6) the weighting that should be afforded the result returned by each method of valuation for purposes of arriving at an overall conclusion of value; 7) whether the entire date of valuation BIG Tax should be reflected in the calculations or a discounted present value of the BIG Tax, assuming a hypothetical sale some years in the future since the BIG Tax is not payable until the property is sold; and 8) the holding period assumed for the underlying corporately owned assets.

In *Murphy v. U.S. Dredging*, the court decided that a discounted value for the BIG Tax should be used and, in its Dec. 9, 2008 decision, applied a weighting of 45% to the net-asset-value method and 55% to the discounted-future-net-cash-flow method.

In the appeal of the Tax Court case, E*state of Dunn v. Commissioner of Internal Revenue*, 301 F3d

339 (5th Cir. 2002), the U.S. Court of Appeals for the Fifth Circuit concluded, in a case where many similar issues presented themselves, that a weighting of 85% to the earnings-based approach and 15% to the asset-based approach was appropriate, and that under the asset-based approach the market value of appreciated assets should be reduced by the full amount of the BIG Tax (rather than a discounted value), assuming a hypothetical sale took place on the date of valuation.

In a more recent Tax Court case, *Estate of Jelke v. Commissioner of Internal Revenue*, 507 F3d 1317 (11th Cir. 2007), the fact pattern was somewhat different, but the U.S. Court of Appeals for the Eleventh Circuit likewise decided that the full amount of the BIG Tax should be reflected in the calculations (rather than a discounted value), assuming a hypothetical sale took place on the date of valuation. It was not necessary to apply a weighting to different methodologies in the *Jelke* decision, since both experts used an asset-based approach to valuation.

The Supreme Court Decision In *Wechsler*

In *Wechsler*, the Supreme Court, New York County, equitably distributed the divorcing parties' marital properly. At the date of commencement, Wechsler & Co., Inc. (WCI) was a C corporation and was in essence a holding company that bought and sold marketable securities for its own account, which securities constituted virtually all of its assets. The valuation date selected in *Wechsler* was the date of commencement. Three experts testified in the case before the Supreme Court: a neutral expert, an expert chosen by the husband, and an expert chosen by the wife. All three agreed that Mr. Wechsler's 100% ownership interest in WCI should be valued using a net asset-based approach to valuation. Accordingly it was unnecessary for the Supreme Court to assign a weighting to an income-based approach to valuation, since none of the three experts used it. Supreme Court Justice Judith J. Gische adopted a baseline value of $70,848,107, meaning the value determined by the neutral expert before any reduction for embedded taxes, and that amount was not disputed on appeal. The primary issue decided by the First Department related to the differing approaches to quantifying a reduction for the contingent corporate level capital gains taxes taken by each expert.

With respect to quantifying a reduction for embedded taxes, the Supreme Court rejected the approach taken by the Fifth Circuit in *Estate of Dunn*, which includes the assumption that under asset-based methodologies a hypothetical sale of the corporation's assets has taken place on the date of valuation and that the value of the corporation's net assets (assets minus liabilities) should be further reduced by the full amount of capital gains taxes that would be generated by the sale of the securities. At an effective combined federal and state tax rate of 41.74%, the contingent liability for embedded taxes would have been calculated to be $29,572,000 using this method.

After rejecting the *Estate of Dunn* method, the Supreme Court accepted the approach of the wife's expert, which reduced the baseline value by only 11%, or $7,793,292. The 11% represented the wife's expert's quantification of the historical rate of annual taxes paid by WCI relative to its annual gross revenue. The neutral expert and the husband's expert both disagreed strongly, and testified that the procedure was, in essence, fundamentally flawed, since taxes should be calculated as a percentage of pretax net income rather than as a percentage of gross revenues, among other things.

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Matrimonial Actions and the Valuation of C Corp. Taxes on Embedded Gains

Part Three of a Three-Part Article

By Thomas A. Hutson

The first part of this article noted that the problem of how to value a holding company structured as a subchapter C corporation was recently tackled by the Appellate Division, First Department in the context of a dissolution of marriage. But the question of whether and how such value should be reduced to reflect the federal and state corporate-level income taxes associated with the unrealized appreciation of marketable securities owned by a corporation is controversial. Last month's continuation discussed the First Department's reasoning in the appeal of *Wechsler v. Wechsler*, 866 NYS2d 120 (1st Dept. 2008). Herein, we take an in-depth look at the decision itself.

First Department Appellate Decision

It is important to bear in mind that at the time of the Supreme Court's decision in *Wechsler*, which was issued Aug. 11, 2005, the Nov. 15, 2007 decision of the Eleventh Circuit Court of Appeals in *Estate of Jelke v. Commissioner of Internal Revenue,* 07 F3d 1317 (11th Cir. 2007), had not yet been rendered. In fact, the First Department noted that the Supreme Court's comprehensive, thoughtful and painstakingly written opinion relied in significant part on the decision of the Tax Court in *Estate of Jelke*, which was reversed by the Eleventh Circuit after the *Wechsler* appeal was argued, but before its opinion was issued. In *Jelke*, the Eleventh Circuit adopted the approach of the Fifth Circuit in *Dunn*, and concluded, based on the assumption of a sale of the corporations assets on the date of valuation (under an asset-based approach), that the value of the corporation's net assets should be reduced by the full amount of the embedded taxes that would be payable as a result of the sale.

After eloquently summarizing the Eleventh Circuit's divided decision in *Jelke*, including the dissenting opinion of Justice Edward Carnes, the First Department noted that the *Wechsler* appeal did not require them to decide, based on the merits and demerits of the majority and dissenting opinions in *Jelke*, which of the two approaches is preferable with respect to the issue of embedded taxes. This is because, at trial, the Supreme Court was not asked to decide between the Fifth Circuit and Eleventh Circuit decisions in *Dunn* and *Jelke* versus the approach argued by the Commissioner of Internal Revenue or in Justice Carnes' dissent. Rather, the Supreme Court was asked to choose between the approach of the Fifth Circuit in *Dunn* and an approach different from the one advanced by the Commissioner of Internal Revenue in *Jelke* — namely, the approach advanced by the wife's expert.

The Majority Decision

The First Department's decision, after thoroughly discussing the many reasons why they rejected the historical approach adopted by the wife's expert, concluded, given the factual circumstances of the case, only that as and between the competing methodologies advanced at trial the Supreme Court should have adopted the methodology adopted by the Fifth Circuit in *Dunn*. Accordingly they determined WCI was overvalued by $21,778,708 ($29,572,000 - $7,793,292). In arriving at its decision, the First Department also explained how others of the Supreme Court's rulings, including the size of the distributive award and the equitable distribution of other marital assets, require the husband to bear the lion's share of the risk of a decline in the value of the securities owned by WCI. This was of particular concern to them since the husband was left without any substantial cushion to protect himself in the event of a significant decline in the market value of these securities. A need for liquidity required to pay, among other things, the distributive award, could also trigger realiza-

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tion of BIG Tax if and when corporately owned securities are sold.

The First Department also reviewed the various arguments presented in Justice John W. Sweeney's dissent (summarized below), and explained that they were at a loss to understand why the dissenter expressly rejected not only the approach of the majority in *Jelke*, but also implicitly rejected the dissent of Justice Carnes in that case, and of the IRS, without explaining why.

The First Department further noted that it is simply wrong to attempt to distinguish the *Wechsler* case from *Dunn* and *Jelke* on the grounds that there is no indication that Mr. Wechsler's ownership of WCI will cease or that WCI will cease operations with the entry of the decree. In *Dunn*, the corporation was an operating company, not an investment holding company like WCI, and the Tax Court found that the likelihood of liquidation was slight. The First Department noted that the Fifth Circuit could not have been clearer in holding that a dollar-for-dollar reduction for the built-in tax was required because the likelihood of liquidation is inapposite to the asset-based approach to valuation and that the probability of a liquidation's occurring affects only the relative weights to be assigned to the different approaches and methodologies that are advanced by the experts (there are three generally recognized approaches to valuation, namely the income-based approach, the asset-based approach and the market-based approach). The First Department also points out that in *Jelke,* there is no indication at all that the investment holding company was about to cease operations or sell the securities it owned. The Eleventh Circuit held that when valuing an investment holding company using the net-asset value method, whether or not the company will actually liquidate its assets is irrelevant, and an assumption that a liquidation has occurred should be made for purposes of quantifying the amount of the BIG Tax liability so that it is unnecessary to prophesize the future and discount such prophecies to present value.

The *Jelke* and *Dunn* courts favored this approach in no small part because they viewed it as a simple and logical analysis that provides practical certainty to tax practitioners, appraisers, and financial planners — noting that it eliminates the need for complex and uncertain prognostications about the present value of future events, which require a crystal ball. Basing the BIG Tax calculation on a snapshot of a date of valuation balance sheet, marked to market, provides certainty and finality, which these courts preferred to what they perceived as an unnecessary expenditure of judicial resources to wade through myriad divergent expert witness testimony, based upon subjective conjecture. In *Dunn*, the Fifth Circuit noted that its methodology may be viewed by some valuation professionals as unsophisticated, dogmatic, overly simplistic, or just plain wrong, but the court made this observation: that on the end of the methodology spectrum opposite of oversimplification lies over-engineering.

Justice Sweeney's Dissent

All of the First Department's Appellate Judges concurred in the *Wechsler* decision, with the exception of Justice Sweeney, who agreed with the majority on all but one point. Justice Sweeney did not believe that a discount for BIG Taxes should be applied in arriving at a value for WCI. He noted that the valuation methodology discussed in the *Jelke* and *Dunn* decisions arose out of valuations performed for estate tax purposes, and he believed that such methodology might not always be appropriate for matrimonial valuation purposes. As similarly noted by Justice Ira B. Warshawsky in *Murphy v. U.S. Dredging*, Justice Sweeney believes that the nature of the case and the area of law are important considerations in determining the appropriate methodology to employ.

In addition to finding the absence of an expressed intent to sell the appreciated property or dissolve the corporate entity a fact worthy of consideration, Justice Sweeney disagreed with the majority's finding that the trial court erred in accepting the wife's expert's method of valuation, since he used historical taxes as a percentage of gross revenues and, in Justice Sweeney's opinion, no one demonstrated to the trial court that the wife's expert's approach was inherently improper or should not be applied in this case where the amount of capital gains that will actually be paid in the future is uncertain.

After complimenting the majority for their lengthy and eloquent argument for their position, Justice Sweeney stated that there was no reason to substitute the First Department's judgment for that of the trial court on issues of valuation. He further noted that the trial court viewed the witnesses, carefully examined the evidence and wrote a detailed and thoughtful decision. Justice Sweeney emphasized that Mrs. Wechsler was denied any maintenance because of the valuation the trial court placed on her equitable share of WCI and that, although it is still a very sizable award, the appellate decision reduces her award considerably from the amount she was entitled to under trial court's careful analysis of Domestic Relations Law Section 236 (b).

Justice Carnes' Dissent in *Jelke*

Justice Carnes dissent from the Eleventh Circuit Court of Appeals decision in *Jelke* focused on the virtues of hard work, as espoused by Teddy Roosevelt, in contrast to the doctrine of ignoble ease that the majority used to justify what he viewed as arbitrary assumptions made for the sake of certainty and finality. The bypassing of what the majority perceived as an un-

necessary expenditure of judicial resources did not seem a valuable goal to Justice Carnes, who argued that the expenditure of judicial resources is required to make more realistic calculations. He warned that the idea of taking the easier route, if allowed to reign, would result in no end to the shortcuts that can be taken by the judiciary.

Justice Carnes pointed out that the history of the judicial system reveals that prophesying is sometimes necessary, and he quoted Justice Oliver Wendell Holmes' decision in *Ithaca Trust Co. v. United States*, 279 U.S. 151, as follows: "The value of property at a given time depends upon the relative intensity of the social desire for it at that time, expressed in the money that it would bring in the market. Like all values, as the word is used by the law, it depends largely on more or less certain prophecies of the future, and the value is no less real at that time if later the prophecy turns out false than when it comes out true."

In summary, Justice Carnes expressed his belief in *Jelke* that the effort required to analyze each case's specific attributes, along with any necessary prophesying about the future and expenditure of judicial resources, is time and money well spent.

Conclusion

Interestingly, Paragraph 5(b) of Internal Revenue Service Revenue Ruling 59-60, which applies to valuations performed for estate and gift tax purposes, reads as follows:

> The value of the stock of a closely held investment or a real estate holding company, whether or not family owned, is closely related to the value of the assets underlying the stock. For companies of this type, the appraiser should determine the fair market values of the assets of the company. Operating expenses of such a company and the cost of liquidating it, if any, merit consideration when appraising the relative values of the stock and the underlying assets. The market values of the underlying assets give due weight to potential earnings and dividends of the particular items of property underlying the stock, capitalized at rates deemed proper by the investing public at the date of appraisal. A current appraisal by the investing public should be superior to the retrospective opinion of an individual. For these reasons, adjusted net worth should be accorded greater weight in valuing the stock of a closely held investment or real estate holding company, whether or not family owned, than any of the other customary yardsticks of appraisal, such as earnings and dividend paying capacity.

No one argues with the simple concept that, after the repeal of the General Utilities doctrine in 1986, a C corporation almost universally pays corporate level taxes on the disposition of appreciated assets. However, many complex subtleties make the quantification of an appropriate discount for BIG Taxes, given each particular set of facts and circumstances, a many faceted task that has already required a great deal of effort by numerous courts.

The Commissioner of Internal Revenue filed a petition for a writ of *certiorari* with the Supreme Court of the United States on July 21, 2008 with respect to the Eleventh Circuit's decision in *Jelke*. The Estate filed its brief in opposition on Aug. 20, 2008 and the IRS filed its reply on Sept. 3, 2008. Although the Supreme Court denied the IRS's petition on Oct. 6, 2008, for those who may be interested, the papers filed provide some interesting additional insight regarding the issues and the positions taken by the IRS versus those taken by taxpayers and courts' relative to a dollar-for-dollar discount for contingent embedded capital gains taxes existing at the date of valuation.

The cases discussed in this article are not the only cases addressing the quantification of a contingent liability for BIG Taxes, but they do squarely address the fundamental concepts raised in the *Wechsler* case. One thing is for certain: Whether it comes from the New York State Court of Appeals, the Tax Court, the United States Court of Appeals, or some other judicial body, additional guidance on the application of a C corporation discount for embedded capital gains taxes will almost certainly be forthcoming in the relatively near future.