12-18-1998

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**DISCOUNT FOR POTENTIAL CAPITAL GAINS TAX LIABILITY**

— by Neil E. Harl *

Although it has been well established for years that discounts could be claimed on corporate stock (and some other ownership interests) for minority interest and non-marketable,¹ the courts until this year have resisted efforts to obtain a deduction for potential capital gains tax liability.² However, two 1998 cases have been responsible for a break-through and have allowed discounts for potential income tax liability from liquidation in valuing corporate stock.³ Both Eisenberg v. Commissioner,⁴ and Estate of Davis v. Commissioner,⁵ involved stock valuation for federal gift tax purposes.

**Guidance from regulations**

The value of a gift in property, whether of corporate stock or otherwise, is determined under a long-standing formula.⁶ The value for federal gift tax purposes is—

"The price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts…. All relevant facts and elements of value as of the time of the gift shall be considered…."⁷

For stock not traded in a market, the value is generally determined by taking into consideration the firm's net worth, prospective earning power and dividend paying capacity as well as other relevant factors including the firm's good will, its position in the industry, its management, the degree of control of the business represented by the stock to be valued and the value of securities of corporations engaged in the same or similar lines of business that are traded on a stock exchange.⁸

There is no set formula for determining the value of closely-held corporation stock that is not traded on an exchange.⁹

**Judicial resistance in earlier cases**

The Tax Court, until 1998, had consistently held that projected capital gains taxes did not reduce the value of closely-held stock when liquidation was speculative and uncertain.¹⁰ In a case decided May 6, 1998, the Tax Court disallowed a discount for income tax on liquidation even though condemnation was foreseeable because there was no showing that the corporation would pay tax on the condemnation of properties.¹¹ The judicial resistance to a discount for the potential capital gains tax liability was based on two factors—(1) when the actual facts did not suggest that the shareholders intended to liquidate the corporation, the court refused to assume that the hypothetical buyer would do so;¹² (2) before 1986, the Internal Revenue Code

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⁹ Robert P. Achenbach, Jr.

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¹¹ Robert P. Achenbach, Jr.

¹² Robert P. Achenbach, Jr.
permitted the tax-free liquidation of a corporation under certain circumstances which made it possible to avoid all or most of the income taxes upon corporation liquidation. This rendered the tax liability on corporate liquidations so speculative as to be irrelevant.

**Reasons for the shift in position**

The Tax Court in *Estate of Davis v. Commissioner*, the first of the two 1998 cases to be decided, indicated that it was convinced that, even though no liquidation of the corporation or sale of its assets was contemplated on the valuation date, a hypothetical willing seller and a hypothetical willing buyer would not have agreed on that date to a price which did not involve the potential capital gains tax. The court opined that a willing buyer and a willing seller would have agreed to a price less than the price that would have been agreed upon had there been no built-in tax liability.

The Tax Court declined, however, to allow a discount equal to the full amount of the potential capital gains tax. The court allowed a $9 million discount for the total potential capital gains tax liability of $28 million. Thus, the court permitted a discount for about 32 percent of the total capital gains tax liability that would have been incurred on liquidation.

In *Eisenberg v. Commissioner*, the Second Circuit Court of Appeal acknowledged the reasons why the Tax Court had resisted a discount for potential capital gains tax liability and emphasized in its analysis the fact that the 1986 changes in corporate liquidation assured that capital gains tax would ultimately be triggered in the case at hand. The Second Circuit brushed off the government's assertion that the tax liability on corporate liquidations was so speculative as to be irrelevant.

The court concluded that an adjustment for potential capital gains tax "should be taken into account in valuing the stock at issue in the closely-held C corporation even though no liquidation or sale of the corporation or its assets was planned at the time of the gift of the stock." The Second Circuit remanded the matter to the Tax Court to ascertain how much discount should be allowed and the gift tax to be paid by the taxpayer.

**Conclusions**

Based on the two decisions, it is reasonably clear that a discount for the full amount of potential capital gains tax will not be allowed if a sale or liquidation is not contemplated or in prospect. As the probabilities of liquidation or sale rise, the percentage of the potential capital gains tax that should be allowed as a discount should rise, also. In this respect, the outcome depends upon the facts and circumstances of the situation.

The cases involved C corporations but a similar argument can be made for transfers of interests in other types of entities. It is important to note that, for S corporations, no gain is normally recognized at the corporate level unless the built-in gains tax applies although gain is recognized at the shareholder level as with C corporations. The Tax Court in *Estate of Davis v. Commissioner*, rejected the argument that a corporation could avoid tax on liquidation by converting to S corporation status and waiting 10 years before liquidating.

In all likelihood, more cases will be needed before the Internal Revenue Service accepts discounts based on potential capital gains tax liability. Also, additional cases (and, ultimately rulings) will provide more definitive guidance on the size of the discount under various circumstances.

**FOOTNOTES**

4. *Id.*
5. See n. 3 *supra*.
7. *Id.*
16. *Id.*
17. *Id.*
18. *Id.*
19. *Id.*
20. *Id.*
21. 155 F.3d 50 (2d Cir. 1998).
22. *Id.*
23. *Id.*
24. *Id.*
25. Ltr. Rul. 9218019, Jan. 23, 1992 (no recognition of gain or loss on distribution of cash in complete liquidation of S corporation; any gain or loss would be recognized by S corporation's shareholders but no built-in gains tax on real estate because held on December 31, 1986).