Discount for Potential Capital Gains Tax Liability in Valuing S Corporation Stock?

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The discounting of C corporation stock for potential built-in capital gains tax liability has become well-established in recent years although the courts, until 1998, had consistently held that potential income taxes (capital gains tax, recapture tax and tax on ordinary income) that would be incurred on corporate liquidation did not reduce the value of closely-held corporation stock when the fact of liquidation was speculative or uncertain.

A recent Tax Court case, *Estate of Litchfield v. Commissioner*, has allowed a discount for potential income tax liability on S corporation stock where the corporation had shifted from C corporation status to S with several years to run before the sale or other disposition of appreciated assets would not result in built-in gains tax.

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*by Neil E. Harl*

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**Dollar-for-dollar discounting**

Two Circuit Courts of Appeal, the Fifth and the Eleventh, have allowed dollar-for-dollar discounting of the potential tax liability, thus eliminating the issue of determining what proportion of the maximum potential tax liability should be allowed as a discount. The Fifth Circuit, in *Estate of Dunn v. Commissioner*, approved a 34 percent reduction in the value of assets for a 67.96 percent interest in a corporation for the tax liability on built-in gains in the event of a liquidation. The same Circuit reversed the Tax Court in *Jameson v. Commissioner* which had denied a full discount for accrued capital gains. The Eleventh Circuit, in *Estate of Jelke III* allowed a dollar-for-dollar discount for the tax on built-in gains and also allowed discounts for lack of control and lack of marketability. That case was appealed to the U.S. Supreme Court but certiorari was denied.

**Estate of Litchfield v. Commissioner**

In the 2009 Tax Court case of *Estate of Litchfield v. Commissioner*, the issue was the appropriate methodology for valuing the decedent’s interest in two closely-held corporations for federal estate tax purposes. One of the corporations (of which the decedent owned a 43.1 percent interest) consisted mainly of Iowa farmland that was leased under crop-share leases to tenants; the other corporation as to a 22.96 percent interest owned by the decedent, held principally marketable securities. Both corporations had converted from C corporation status to S corporation status in 2000. After the S election had been...
filed, the shareholders executed a shareholder agreement under which the shareholders were prohibited from making stock transfers that, in the opinion of the counsel for the corporations, would jeopardize the S corporation status. The decedent died on April 17, 2001 and the estate elected alternate valuation which fixed the valuation date as October 17, 2001.

For the corporation owning mostly farmland, the Tax Court allowed discounts based on net asset methodology of 14.8 percent for lack of control and 25 percent for lack of marketability. Discounts were approved for the corporation owning securities of 11.9 percent for lack of control and 20 percent for lack of marketability.

The estate had argued that, if a sale of assets occurred before January 1, 2010, the corporation would be subject to corporate capital gains taxes for assets owned before January 1, 2000, the effective date of the S corporation election. The tax imposed on such gains is the maximum corporate tax rate for the year in which the disposition occurs applied to the lesser of – (1) the recognized built-in gains (the net of built-in gains and built-in losses) or (2) the amount of taxable income as if the corporation were not an S corporation. As of the valuation date, the net asset value of the corporation owning mostly farmland totaled $33,174,196, with built-in capital gains of 86.7 percent of that amount or $28,762,306. The corporation owning principally securities had a net asset value of $52,824,413 of which 73.8 percent or $38,984,799 was built-in capital gains. The estate discounted the stock value by 17.4 percent in the corporation owning the securities. That was based, using data from the corporation’s records, on calculated projected holding periods and sale dates for the appreciated assets with an estimated appreciation of assets until the estimated sale dates with the capital gains taxes estimated, discounted to present value. The present value of the projected capital gains taxes was subtracted from the net asset values for the respective corporations.

For the corporation owning the farmland, the asset turnover rate resulted in a projected average asset holding period of five years. Using a capital gains tax rate of 38.8 percent (corporations are not eligible for the reduced rates on long-term capital gains available to individual taxpayers), the present value of the estimated capital gains taxes due for that corporation would be $5,616,085 or 17.4 percent of net asset value. For the securities-owning corporation, the 12.5 percent annual turnover rate resulted in a projected holding period of eight years and estimated capital gains taxes of $32,995,835. Using an assumed capital gains rate of 35.32 percent, the present value of the estimated capital gains taxes that would be due was $12,455,695 which resulted in a 23.6 percent discount from net asset value.

The Tax Court noted, in a footnote to its opinion, that not all S corporations are eligible for a discount for potential income tax on liquidation and cited to Dallas v. Commissioner where there was no adjustment for potential income tax for an S corporation. Ordinarily, S corporations do not incur income tax liability on liquidation but that is not the case with the built-in gains tax imposed on S corporations that have shifted from C corporation status. The Tax Court in Estate of Litchfield v. Commissioner agrees that a discount is available in that situation.

Endnotes


3 T.C. Memo. 2009-21.

4 See I.R.C. § 1374(d)(3).

5 301 F.3d 339 (5th Cir. 2002).

6 267 F.3d 366 (5th Cir. 2001) (timber property).

7 507 F.3d 1317 (11th Cir. 2007).


10 Id.

11 I.R.C. § 2032(a)(2).


13 Id.

14 I.R.C. § 1374(a).

15 I.R.C. § 1374(b)(1).


18 T.C. Memo. 2006-212.

19 I.R.C. § 1374.

**ADVERSE POSSESSION**

HOSTILE POSSESSION. The plaintiff and defendant owned adjoining properties. The defendant’s property was bisected by a road, with the disputed strip of land on the plaintiff’s side of the road. The plaintiff claimed to have harvested some of the trees on the disputed strip as part of harvesting operations of the trees on the plaintiff’s property and posted no trespassing signs on some of the trees. The trial court granted title to the disputed strip to the plaintiff based on the existence of the road as a natural boundary between the properties acknowledged by the users of the road. The appellate court reversed, holding that the plaintiff failed to show any open, continuous and hostile use of the disputed property. The occasional harvesting of trees and sign postings were insufficient activity to transfer title to the plaintiff by adverse possession. *Howe v. Boyle*, 2009 Wisc. App. LEXIS 55 (Wis. Ct. App. 2009).

**ANIMALS**

HORSES. The plaintiff participated in a trail ride with the defendant near the defendant’s home using the defendant’s horse. The plaintiff was injured when the horse bolted after attempting to cross a boggy area. The plaintiff filed a suit in negligence, claiming that the defendant failed to exercise ordinary care in selecting a horse and trail suitable for the plaintiff’s riding skill and failing to warn about the existence of bogs on the trail. The trial court granted summary judgment to the defendant under *Tex. Civ. Prac. & Rem. Code Ann. § 87.003* which provided immunity from suit for inherent risks in equine activities. The plaintiff appealed, holding that the plaintiff failed to show any open, continuous and hostile use of the disputed property. The court held that the occasional harvesting of trees and sign postings were insufficient activity to transfer title to the plaintiff by adverse possession. *Howe v. Boyle*, 2009 Wisc. App. LEXIS 55 (Wis. Ct. App. 2009).

**BANKRUPTCY**

FEDERAL TAX

DISCHARGE. The debtor originally filed for Chapter 13 and included secured, unsecured priority and unsecured non-priority claims. The case was converted to Chapter 11 and debtor’s confirmed plan provided for full payment of the secured claim and partial payment of the unsecured claims. During the plan, the IRS assessed additional taxes and penalties for the tax years giving rise to the claims filed in the bankruptcy case. The IRS filed a Notice of Lien and Levy to collect the additional taxes and penalties and the debtor sought a determination that the tax claims were discharged. The court held that the tax claims were nondischargeable because the claims were either assessed within 240 days of the bankruptcy filing or the tax returns were due within three years of the bankruptcy petition filing. Therefore, the additional taxes and penalties were nondischargeable and collectible outside the bankruptcy case. *In re Newman v. United States*, 2009-1 U.S. Tax Cas. (CCH) ¶ 50,237 (Bankr. M.D. Fla. 2008).

SALE OF CHAPTER 12 PROPERTY. The debtor had raised corn in 2005 and retained the corn for use as feed for the debtor’s cattle. Prior to and after the bankruptcy petition was filed in July 2006, the debtor sold the corn to the debtor’s corporation...