Estate of Jelke. v. Commissioner, T.C. Memo 2005-131, May 31, 2005

The Facts: Frazier Jelke III died on March 4, 1999. He owned, among other things, a 6.44% equity interest in Commercial Chemical Co. ("CCC") through a revocable trust. CCC was a "C" corporation holding company that owned a diversified portfolio managed by Wilmington Trust Bank that consisted of approximately 92% domestic equities and 8% international equities. CCC's primary investment objective was long-term capital growth, which resulted in low asset turnover and large unrealized capital gains. CCC had a net asset value of approximately $189 million at the date of death. Furthermore, if the assets were sold on the valuation date it would have resulted in a capital gain tax liability of $51.6 million. The Estate's Federal estate tax return indicated the value of the 6.44% equity interest in CCC to be $4,588,155—which was computed by reducing the net asset value of approximately $189 million by the $51.6 million built-in gain tax liability and then applying a 20% lack of control discount and a 35% lack of marketability discount. The IRS indicated the value of the 6.44% equity interest was $9,111,111 (through using a reduced built-in gain amount based upon anticipated asset turnover, a 5% discount for lack of control and a 10% discount for lack of marketability).

The Arguments:

The Estate supported its built-in capital gain position by stating that use of a net asset approach to valuation requires an assumption of liquidation on the valuation date. The IRS stated that an assumption of liquidation is not appropriate in this case and that the tax liability should be calculated on the basis of CCC's historical securities turnover.

The Estate relied on an analysis of closed-end mutual funds to arrive at a 25% discount for lack of control, whereas the IRS arrived at a 5% discount for lack of control based on an average discount for closed-end funds obtained from an article in the Journal of Economics. The Estate determined a 35% discount for lack of marketability based on restricted stock studies, whereas the IRS arrived at a 10% discount by applying the Mandelbaum factors analysis to a starting discount of 20% (*Mandelbaum v. Commissioner*, TCM 1995-255).

The Findings:

The Court determined that while a hypothetical buyer would take into account the built-in gains, a seller would not accept a price that was reduced for possible tax on all the built-in gain knowing that CCC sells or turns over only a small percentage of its portfolio annually. Furthermore, the interest valued was a minority interest that could not compel liquidation of the assets (which differs from a controlling interest valued in the Estate of Dunn), one of the Trusts holding CCC shares was designed so as not to terminate before 2019, and none of the CCC shareholders had sold or planned to sell their interests. Accordingly, the Court determined that the asset turnover rate reasonably estimated when the capital gain tax liability would be incurred (a 16-year period of recognition in this

case). Accordingly, they arrived at a discounted total capital gains tax liability of approximately $21 million (or approximately 40% of the total built-in gain tax liability).

Regarding the lack of control discount, the Court was critical of both the Estate's analysis and the IRS appraisers' analysis and arrived at their own lack of control discount of 10%. The Court also disagreed with both appraisers' analyses of the lack of marketability discount. The Court indicated that restricted stock studies provided only limited guidance and said that the companies in these studies were not sufficiently comparable to CCC. The Court disagreed with the IRS appraisers' analysis of the factors applied to the Mandelbaum analysis. However, the Court did say that they find the factors considered in Mandelbaum to be a helpful guide to determining the marketability discount and performed their own Mandelbaum analysis in arriving at a 15% discount for lack of marketability.

Thus, after application of a discounted capital gains tax liability of $21 million, a lack of control discount of 10%, and a 15% discount for lack of marketability, the Court determined that the 6.44% equity interest owned by the Estate had a value of approximately $8.25 million.

Parting Thoughts:

The IRS expert's starting point of 20% for their Mandelbaum analysis was not disclosed (which is interesting to me because most appraisers use a starting point of approximately 30-35% when using a Mandelbaum analysis for determining a lack of marketability discount). Furthermore, it appears that the Court also used this 20% starting point in their determination of the 15% lack of marketability discount. If the Estate's expert argued against the 20% starting point, it may have persuaded the Court to use a higher starting point in their lack of marketability discount computation.

The proper handling of built-in gains taxes is still a muddled mess as there is no clear consensus on handling of this issue across several cases out there such as Dunn, Eisenberg, Davis, Jameson, and Welch. It appears that the appraiser should consider the specific facts and circumstances surrounding each case in determining the magnitude of this adjustment.