John G. Mack, ASA, CBA
Mack Business Appraisals, LLC
26956 N. 90th Lane
Peoria, Arizona 85383
(623) 340-6770 (ph) (623) 476-5405 (fax)
john@mackbusinessappraisals.com
www.mackbusinessappraisals.com

Estate of Jelke. v. Commissioner, T.C. Memo 3512-03, November 15, 2007

The Facts: The original case (see my previous original case summary on the next page) was heard by the United States Court of Appeals for the Eleventh Circuit on November 15, 2007, to determine the proper valuation method and related fair market value of a 6.44% stock interest (or 3,000 shares) of a closely held investment holding company, owned by Mr. Frazier Jelke III at the time of his death. In the original case, the Tax Court adopted an expert witness appraiser's approach that allowed for only a partial $21 million dollar discount of built in capital gains tax liability, indexed to reflect present value at the time of Mr. Jelke's death, using projections based on when the assets would likely be sold and tax liability incurred. The estate argued under Estate of Dunn v. Comm'r, 301 F.3d 339 (5th Cir. 2002), that the estate was entitled to a dollar for dollar discount of the entire $51 million capital gains tax liability. The estate used methodology which assumed all assets of the holding company were sold as of Mr. Jelke's death, regardless of the parties' intent to liquidate of not, or restrictions on the holding company's liquidation in general.

The Findings: The Estate urged the application of methodology as used in the Estate of Dunn by posing the question of why would a hypothetical willing buyer not adjust his or her purchase price to reflect the entire $51 million of capital gain when the buyer could just as easily venture into the open marketplace and acquire an identical portfolio of blue chip domestic and international securities without any risk exposure to an underlying tax liability?

The Appeals Court determined the simple, logical analysis the estate put forward in regard to the tax discount valuation was the correct method for determining the value of the discount to be given. The Appeals court, by a majority ruling, vacated the judgment of the Tax Court and remanded the case with instructions that the Tax Court recalculate the net asset value of the holding company on the date of Mr. Jelke's death, and his 6.44% interest therein, using a dollar for dollar reduction of the entire $51 million built in capital gains tax liability, under the arbitrary assumption that the holding company was liquidated on the date of Mr. Jelke's death and all assets were sold.

Parting Thoughts:

This is a major victory for taxpayers and further ammunition to support full reduction for capital gains taxes (even in the case of valuing a minority interest such as this situation).

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.