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Estate of Marie J. Jensen, Petitioner v. Commissioner of Internal Revenue Service, Respondent, T.C. Memo 2010-182, Dated August 10, 2010.

The Facts:

Ms. Jensen was a resident of New York when she passed away on July 31, 2005. Prior to her death, in February 2003, Ms. Jensen had created the Marie J. Jenson Revocable Trust and had appointed herself trustee. Upon Ms. Jensen's death, the trust held 164 shares of common stock in Wa-Klo, which equated to a controlling 82% equity interest in Wa-Klo. Wa-Klo's principal asset as of Ms. Jensen's death was a 94-acre waterfront parcel of real estate which included athletic facilities, horse stables and a girl's summer camp. Wa-Klo was a C Corporation created in 1956 in the state of New Hampshire.

Upon the death of Ms. Jensen, the estate hired an appraiser to value Wa-Klo. The appraiser indicated that the asset approach was most appropriate and that the income approach did not apply because (1) the company's camp operations did not generate significant cash flows; (2) the asset value was the highest and best use; and (3) the estate's controlling interest could dictate a sale. Furthermore, the appraiser disregarded the market approach because the underlying real estate appraisal already incorporated sales comparables. The appraiser computed a net asset value of approximately $4.2 million. The appraiser then reduced the net asset value by $965,000 to account for the built-in long term capital gains tax liability (calculated on a dollar-for-dollar basis). The appraiser then computed the value of an 82% equity interest and applied a 5% marketability discount, ultimately valuing the 82% equity interest in Wa-Klo at $2.55 million.

The IRS agreed with the 5% marketability discount and the use of the net asset value approach, but calculated a $250,000 discount for the built-in long term capital gains tax liability. Thus, the IRS computed and assessed a $333,245 deficiency in the Estate Tax Return.

The Arguments:

The IRS claimed that 2nd Circuit precedent was controlling (the 1998 decision of Eisenberg v. Comm) – which first allowed a discount for embedded capital gains tax as a question of valuation dependent on the facts and circumstances of the case and taking into account the fair market value standard of willing buyer/willing seller. The IRS argued that only a portion of the built-in gain should be considered in the valuation of the company. The IRS' expert examined data from general closed-end funds, finding built-in capital gains exposure ranging from 10.7% to 41.5%. From these findings, the IRS appraiser was unable to find a direct correlation, at least up to 41.5% of net asset value, between higher exposure to built-in capital gains tax and discounts from net asset value (NAV). Thus, the IRS appraiser divided the company's improved real estate assets by its net asset value and concluded that 66% of NAV was subject to tax liability at the corporate and shareholder levels. However, since the data did not support any discount for the first 41.5% of long term capital gains tax exposure, he deemed that only the portion of gain in excess of 41.5% (66% less 41.5% = 24.5%) should be given a full dollar-for-dollar discount. This total was then utilized to calculate a 40% Federal and state tax amount, which resulted in an IRS discount of $415,000 (or approximately 10% of NAV). The IRS also argued that there are additional common ways of avoiding a built-in gain tax, such as a 1031 like-kind exchange or conversion from a C-Corp to an S-Corp.

The estate referred to Court of Appeals for the Fifth Circuit (Estate of Dunn) and Eleventh Circuit (Estate of Jelke) decisions which allowed dollar for dollar reductions in value for built-in gains tax.

The Findings:

The Tax Court reviewed the arguments of the IRS and the Estate. The Court agreed with the IRS that the broader factual inquiry of Eisenberg applied to this case, but declined to speculate how the 2nd Circuit "may hold in the future." However, the Court rejected the IRS closed-end comparison and analysis because they were not comparable to the assets owned by Wa-Klo. Wa-Klo owned real estate on which operated a summer camp that was not generating profits. Therefore the value of the assets was the value of the underlying real estate. The Court pointed out that closed-end funds have value based on multiple investments in many types of real estate. Furthermore, when valuing the funds, the market typically considers the skill of the management, supply and demand, investor confidence and the funds' prior history.

Consequently, the Court reviewed all the evidence and conducted its own present value calculations based on the fair market value of the improved property, multiplied by appreciation (using both 5% and 7.725%) and compounded interest rates (over a 17-year holding period – which was determined to be the remaining depreciable life of Wa-Klo's assets), plus a 40% effective tax rate to reach a long term capital gains tax liability of approximately $1,200,000. As this long term capital gains tax liability amount was higher than the estate's appraised dollar-for-dollar discount, the court concluded that the Estate qualified for the full dollar-for-dollar discount on the calculated built-in capital gain.

Parting Thoughts:

This decision is a good victory for the taxpayer in the arena of the built-in long term capital gains tax liability. It is important to note that this reduction in value was still allowed even though at date of death neither a sale nor liquidation of Wa-Klo or its assets was imminent or planned. However, the Court specifically declined to adopt a per se rule of 100% discount for long term capital gains tax liability. Thus, it is an area that is still ripe for appeal to the 2nd Circuit.