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Big News on Discounting for Potential Income Tax Liability

-by Neil E. Harl*

The decades-long battle over discounting of values of assets for potential income tax liability reached a major milestone in August with a Tax Court decision¹ accepting dollar-for-dollar discounting of assets based on potential income tax liability.²

Until the 2010 Tax Court case was decided, dollar-for-dollar discounting had been approved in two cases by the Fifth Circuit Court of Appeal³ and in one case by the Eleventh Circuit Court of Appeal.⁴ Approval of dollar-for-dollar discounting by the Tax Court extends the authority to Circuit Court areas that have heretofore not decided a case on the subject. The lack of clear authority undoubtedly discouraged use of such discounting in the First, Second, Third, Fourth, Seventh, Eighth, Ninth and Tenth Circuit Court of Appeals areas.

History of discounting for built-in capital gains

For several years, the position of the Internal Revenue Service⁵ and the Tax Court⁶ was that an estate could not discount the value of corporate stock for federal estate tax purposes to reflect the potential built-in capital gains on corporate liquidation. The "breakthrough" case came in 1998 in *Eisenberg v. Commissioner*⁷ where the Second Circuit Court of Appeals agreed that a discount should be available if the corporation was likely to liquidate or asset sale was likely. This placed a great deal of emphasis on the probabilities of liquidation (which is often very difficult to assess) and the chances that the appreciated assets would be sold (which is also difficult to determine). The Sixth Circuit Court of Appeals followed, in 2000, with *Estate of Welch v. Commissioner*⁸ where the appellate court held that there was no legal prohibition to a discount for built-in gains and the estate was entitled to present evidence of the tax expected on built-in gains in valuing corporate stock. Interestingly, the Internal Revenue Service in 1999 acquiesced in the *Eisenberg* decision.⁹

As for S corporations, the Tax Court in 2006 denied a discount, noting that there was insufficient evidence that the S corporation election might be lost.¹⁰ However, in 2009 the Tax Court allowed a discount after a shift from C corporation to S corporation status.¹¹

The difficulty in ascertaining the chances for corporate liquidation, and the reluctance to rely on a limited number of Court of Appeals decisions, fueled the arguments for dollar-for-dollar discounting without regard for the probabilities that the corporation would be

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liquidated or the assets sold. In 1999, the Tax Court rejected that argument in *Jameson v. Commissioner*¹² but the Tax Court decision was ordered vacated and remanded on appeal to the Fifth Circuit Court of Appeal in 2001.¹³ The appellate court stated that the Tax Court had “inappropriately” denied consideration of a full discount for the tax on the built-in gains involved in a case involving timber property.¹⁴ In 2002, the Fifth Circuit decided a second case, *Estate of Dunn v. Commissioner*.¹⁵ In that case, the value of assets was reduced by 34 percent for the tax on built-in gains for a 67.96 percent interest in the corporation. The third case, *Estate of Jelke III v. Commissioner*,¹⁶ involved a reversal of the Tax Court¹⁷ by the Eleventh Circuit Court of Appeal which approved a discount dollar-for-dollar for the tax on built-in gains in addition to discounts, also, for lack of control and non-marketability.

The Tax Court case in 2010

In a case involving the valuation of a summer camp owned by a corporation the shares of which had been placed in a revocable trust, the court allowed dollar-for-discounting for the potential tax on the built-in gains in addition to a discount for lack of marketability.¹⁸ This development is especially notable in that it provides authority nation-wide, including in Courts of Appeal areas where the issue had not been litigated to a court of record.

ENDNOTES

¹ Estate of Jensen v. Comm’r, T.C. Memo. 2010-182.

² See generally 8 Harl, *Agricultural Law* § 58.05[2][c][iii] (2010); Harl, *Agricultural Law Manual* § 7.02[5][d] (2010). See also 2 Harl, *Farm Income Tax Manual* Ch. 7 (2010 ed); Harl, “The Allowable Discount for Potential Income Tax Liability on Corporate Stock at Death,” 18 *Agric. L. Dig.* 177 (2007); Harl, “Discount for Potential Capital Gains Tax Liability in Valuing S Corporation Stock,” 20 *Agric. L. Dig.* 33 (2009). Compare Harl, “Federal Estate Tax Discounts for Potential Income Tax Liability for Retirement Accounts?” 17 *Agric. L. Dig.* 105 (2006)

³ Estate of Dunn v. Comm’r, 301 F.3d 339 (5th Cir. 2002) (value of assets reduced by 34 percent for built-in gains for 67.96 percent interest in corporation); Estate of Jameson v. Comm’r, T.C. Memo. 1999-43, *vac’d and remanded*, 267 F.3d 366 (5th Cir. 2001) (Tax Court “inappropriately” denied consideration of full discount of accrued capital gains; involved timber property).

⁴ Estate of Jelke III v. Comm’r, T.C. Memo. 2005-131, *rev’d*, 507 F.3d 1317 (11th Cir. 2007), *cert. denied*, 129 S. Ct. 168 (2008) (value of interest in closely-held corporation discounted dollar-for-dollar for built-in capital gains tax; discounts also for lack of control and non-marketability).

⁵ Ltr. Rul. 9150001, Aug. 20, 1991 (C corporation; valuation based on net asset value).

⁶ E.g., Eisenberg v. Comm’r, T.C. Memo. 1997-483, *rev’d*, 155 F.3d 50 (2d Cir. 1998), *acq.*, 1999-1 C.B. xix.

⁷ 155 F.3d 50 (2d Cir. 1998).

⁸ 208 F.3d 213 (6th Cir. 2000).

⁹ Eisenberg v. Comm’r, T.C. Memo. 1997-483, *rev’d*, 155 F.3d 50 (2d Cir. 1998), *acq.* 1999-1 C.B. xix.

¹⁰ Dallas v. Comm’r, T.C. Memo. 2006-212.

¹¹ Estate of Litchfield v. Comm’r, T.C. Memo. 2009-21. See Harl, “Discount for Potential Capital Gains Tax Liability in Valuing S Corporation Stock?” 20 *Agric. L. Dig.* 33 (2009).

¹² T.C. Memo. 1999-43.

¹³ 267 F.3d 366 (5th Cir. 2001).

¹⁴ *Id.*

¹⁵ 301 F.3d 339 (5th Cir. 2002).

¹⁶ 507 F.3d 1317 (11th Cir. 2007).

¹⁷ Estate of Jelke v. Comm’r, T.C. Memo. 2005-131.

¹⁸ Estate of Jensen v. Comm’r, T.C. Memo. 2010-182.

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr

ANIMALS

HORSES. The plaintiff was injured when a defendant’s car struck the plaintiff’s car after hitting a horse belonging to another defendant and cared for on another defendant’s property. The plaintiff sued for negligence in confining the horse under the Missouri Stock Law, Mo. Stat. § 270.010, which infers negligence for damages caused by unconfined horses. The defendant argued that the statute applied only to owners of livestock. The trial court had allowed a jury instruction which was based on mere possession as subjecting the defendant to liability for the accident. The appellate court reversed

and remanded the case, holding that the statute clearly refers only to owners of livestock. Although the court acknowledged that possession was a part of ownership, the defendant in this case did not have sufficient rights in the horse to constitute the defendant as an owner of the horse. The case was remanded for possible trial on the issue of other theories of negligence by the defendant. **Gromer v. Matchett, 2010 Mo. App. LEXIS 994 (Mo. Ct. App. 2010).**

The plaintiff was injured during a horse riding lesson at the defendant’s stables. The plaintiff’s horse tripped over some logs placed on the floor of an arena which were to be part of the lesson. When the horse tripped, the plaintiff was thrown onto a portable mounting block which was being used by the students to mount their