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Issue Contents

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The Allowable Discount for Potential Income Tax Liability on Corporate Stock at Death

-by Neil E. Harl*

Whatever doubt existed as to the amount of discount allowed on corporate stock at death for built-in capital gains tax liability was largely wiped out with a November, 2007, decision by the Eleventh Circuit Court of Appeals in *Estate of Jelke III v. Commissioner*.[1] That case followed earlier Fifth Court of Appeals decisions in 2001 and 2002 which pioneered the idea that the date of death value of corporate stock was properly discounted, dollar-for-dollar, by the amount of built-in capital gain tax liability.[2]

History of the controversy

Until 1998, the Tax Court had consistently held that potential income taxes (capital gains tax, recapture tax and tax on ordinary income) that would be incurred on liquidation did not reduce the value of closely-held corporation stock when the fact of liquidation was speculative and uncertain.[3]

Unwillingness to allow a discount for the potential income tax liability was based largely on two factors – (1) when the facts did not suggest that the shareholders intended to liquidate the corporation, the court refused to assume that a hypothetical buyer would do so;[4] and (2) before 1986, the Internal Revenue Code permitted the tax-free liquidation of corporations under some circumstances[5] which made it possible to avoid all or most of the potential income tax that would be levied on corporate liquidation (that came to an end with "General Utilities" repeal in the Tax Reform Act of 1986).[6] Other than for eligible closely-held corporations which were entitled to prior law treatment for liquidating sales and distributions occurring before January 1, 1989, if the liquidation was completed before that date, gain or loss is recognized to a liquidating corporation on the distribution of property in complete liquidation as if the properties were sold to the distributee at fair market value.[7]

These two factors, for years before 1986, were viewed by the courts as rendering the tax liability on corporate liquidations so speculative as to be irrelevant.[8]

The turning of the tide

The tide turned with a Second Circuit Court of Appeals case in 1998, *Eisenberg v. Commissioner*.[9] The court in that case acknowledged the reasons why the Tax Court had resisted a discount for potential income tax liability but downplayed the government's assertion that liquidation was not imminent in that case and also the argument that tax

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liability was too speculative to be allowed.[10] The Court of Appeals concluded that an adjustment for potential income tax liability

> ". . . should be taken into account in valuing the stock at issue in the closely-held C corporation even though no liquidation or sale of its assets was planned at the time of the gift of the stock."[11]

The Second Circuit did not, however, hold that the potential tax liability should reduce the stock value dollar for dollar and in dictum suggested that it would be incorrect to conclude that the full amount of tax liability should be deducted.[12] The allowance of the discount was related to the probability that he corporation would be liquidated.

Allowance of a dollar-for-dollar discount

In the most recent case to face the issue, *Estate of Jelke III v. Commissioner*,[13] the decedent's 6.44 percent interest in a closely-held investment company, owned through a revocable trust, was allowed to be discounted for the entire amount of the corporation's built-in capital gains tax liability. The corporation had a net asset value of $188 million and $51 million in potential income tax liability.[14] The Eleventh Circuit Court of Appeals took the position that the Tax Court[15] erred in adopting the Internal Service argument that the capital gains discount should be reduced to the present value of the tax liability based on when the tax liability would likely be incurred (computed on the corporation's average annual turnover over a 16-year period).[16] The appellate court also allowed a 10 percent discount for lack of control and a 15 percent discount for lack of marketability.[17]

The Eleventh Circuit case followed the earlier Fifth Circuit holdings in *Estate of Dunn v. Commissioner*,[18] and *Estate of Jameson v. Commissioner*,[19] which had allowed a dollar-for-dollar discount from the date of death value. The Tax Court in *Estate of Jelke III v. Commissioner*[20] had rejected both of the Fifth Circuit cases.

While the Internal Revenue Service may pursue similar cases in other circuits in hopes of eventually succeeding with its arguments, the cases decided to date in the Fifth and Eleventh Circuits are compelling authority for the taxpayer.

FOOTNOTES

[1] 2007-2 U.S. Tax Cas. (CCH) ¶ 60,552 (11th Cir. 2007). See generally 8 Harl, *Agricultural Law* § 58.05[2][c] (2007); Harl, *Agricultural Law Manual* § 7.02[5][d] (2007). See also Harl, "Discount for Potential Capital Gains Tax Liability," 9 *Agric.L. Dig*. 189 (1998). Compare Harl, "Federal Estate Tax Discounts for Potential Income Tax Liability for Retirement Accounts?" 17 *Agric. L. Dig*. 105 (2006).

[2] Estate of Dunn v. Comm'r, 301 F.3d 339 (5th Cir. 2002). See Jameson v. Comm'r, 267 F.3d 366 (5th Cir. 2001).

[3] E.g., Estate of Andrews v. Comm'r, 79 T.C. 988 (1982). See Estate of Welch v. Comm'r, T.C. Memo. 1997-167.

[4] Estate of Ford v. Comm'r, T.C. Memo. 1993-580, *aff'd*, 53 F.3d 924 (8th Cir. 1995).

[5] See I.R.C. § § 336, 337.

[6] Pub. L. No. 99-514, § 631(a), 100 Stat. 2817 (1986).

[7] Tax Reform Act of 1986, § 631(a), 100 Stat. 2817 (1986).

[8] Estate of Davis v. Comm'r, 110 T.C. 530 (1998).

[9] 155 F.3d 50 (2d Cir. 1998).

[10] *Id.*

[11] *Id.*

[12] *Id.* See also Estate of Welch, 208 F.3d 213 (6th Cir. 2000).

[13] 2007-2 U.S. Tax Cas. (CCH) ¶ 60,552 (11th Cir. 2007).

[14] *Id.*

[15] Estate of Jelke III v. Comm'r, T.C.Memo. 2005-131.

[16] Estate of Jelke III v. Comm'r, 2007-2 U.S. Tax Cas. (CCH) ¶ 60,552 (11th Cir. 2007).

[17] *Id.*

[18] 301 F.3d 339 (5th Cir. 2002).

[19] 267 F.3d 366 (5th Cir. 2001).

[20] T.C. Memo. 2005-131.

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr

BANKRUPTCY

CHAPTER 12

CONVERSION. The debtor filed for Chapter 12 and successfully defended a motion that the debtor was not eligible for Chapter 12. After all the real property was sold to pay off secured creditors, the debtor filed a motion to convert the case to Chapter 13. A creditor objected, arguing that there was no statutory authority for conversion of Chapter 12 cases to any other type of case except Chapter 7. The court reviewed cases and found that the majority of cases allowed the conversion of Chapter 12 cases to Chapter 11 or 13 where the debtor filed the Chapter 12 case in good faith and the conversion would not prejudice creditors. The court noted that the conversions were allowed because the alternative, forcing the debtor to dismiss the Chapter 12 case and refile under another chapter, could result in unnecessary inconvenience and possible prejudice to creditors from the recomputation of the preference period. Thus, the court sided with the majority and held that the debtor could convert the case to Chapter 13, with the issues of good faith filing and prejudice to creditors litigated as part of the process of confirmation of the plan. ***In re*** **Vantiger-Witte, 2007**