



Challenging Issues In Estate, Gift Tax Valuations

CAPITAL GAINS JUST ONE TOPIC THAT ATTORNEYS NEED TO CONSIDER

By JOHN M. DELGREGO

The valuation of a business or business interest for estate and gift tax purposes presents certain challenges due to unique facts and circumstances specific to each engagement, requiring consideration of and an understanding of recent topics, court opinions, and legislative changes. Over the years, there have been some lively debates within the business valuation community over a number of hot topics, three of which are: 1) tax-affecting earnings of pass-through entities; 2) calculating deductions for built-in capital gains taxes; and 3) consideration of subsequent events.

Tax-Affecting Earnings

At the forefront of the contentious topics is whether to tax affect pass-through entities. The debate over applying federal income taxes to pass-through entity income has been ongoing since the *Gross v. Commissioner* decision was released in 2001. The *Gross* case was followed by *Estate of John E. Wall v. Commissioner*, *Estate of William G. Adams, Jr. v. Commissioner*, *Estate of Richie C. Heck v. Commissioner* and *Robert Dallas v. Commissioner*. In each of these cases, the tax court rejected the premise of tax-affecting, pass-through entities.

This issue has remained a significant consideration as yet another decision, supporting past opinions, was handed down in June 2011, again disallowing the application of income taxes to pass-through entity income. In the 2011 decision, *Gallagher v.*

Commissioner, the estate's expert applied taxes to the income stream and added a premium to the overall value conclusion for the benefit of owning an interest in a Subchapter S corporation. The estate's expert provided no support or explanation for these adjustments, while the Internal Revenue Service's expert did not tax affect at all. Due to the lack of support provided by the estate's expert, the court confirmed its ruling in *Gross*.

Since *Gross*, it has been a general consensus within the valuation community to value the shares of the pass-through entity from the perspective of the *investor*; giving consideration to the cash flow available to a hypothetical purchaser of the interest and the benefits of pass-through entity ownership. Numerous financial models have been developed to quantify the pass-through entity benefits. These models have gained recognition within the valuation community and appear to recognize the benefit of the avoidance of the dividend tax and build up in basis.

Two non-tax court cases clearly support the notion of a pass-through entity benefit as well, *Delaware Open MRI Radiology Assocs. v. Kessler* (Del. Ct. Ch. 2006) and *Bernier v. Bernier* (Mass., 2007).

The estate's expert in *Gallagher*, in line with the current valuation trend, recognized a pass-through entity benefit. However, he failed to provide enough evidence or explanation to support his conclusion. As such, the court concluded that the estate "fails to convince us of the accuracy of [the

estate's expert's] adjustments and, therefore, we disregard them."

The tax-affecting debate is expected to continue, as all of the tax court cases mentioned were issued as

T.C. Memos. As such, the holdings are thus limited to the specific facts and circumstances of the case.



John M. DelGrego

Capital Gain Taxes

Assets on a company's financial statements are typically recorded at their original cost. However, certain assets, such as real estate, marketable securities, and the like, can appreciate over time. The difference between the asset's book value and its market value represents a "built-in" capital gain at the corporate level.

The treatment of built-in gain taxes has been a debated issue in estate and gift tax valuations. For some time, the IRS has argued that built-in gains should not be recognized if the liquidation of the appreciated corporate assets is speculative. Recent tax court cases have supported deductions for built-in capital gain taxes in situations where the subject company is organized as a C corporation. But this is not a clear-cut standard, as the courts have lacked consistency with respect to the proper calculation of the deduction, with some circuits approving discounts of 100 percent of the capital gains liability, dollar for dollar, while

John M. DelGrego is a Senior Manager of the Valuation and Litigation Assistance team at Meyers, Harrison & Pia LLC, a certified public accounting firm and business valuation firm based in New Haven, with additional offices in Greenwich, Glastonbury, and New York City.

others allowing only partial discounts.

In *Estate of Jensen v. Commissioner*, the appraiser for the estate urged the tax court to consider a dollar-for-dollar discount for built-in capital gains. The IRS appraiser argued that only a 10 percent to 13 percent discount was appropriate, which amounted to approximately half of the built-in tax liability. The tax court conducted its own calculations to reach a built-in capital gain liability that was actually slightly higher than the taxpayer's amount, which led the court to accept the estate's value without actually adopting a dollar-for-dollar discount.

The application of a dollar-for-dollar or discounted reduction for built-in capital gains tax liabilities remains subject to debate. However, consensus in the valuation community, which has been supported by recent tax court cases, appears to be that, if the built-in gains tax liability cannot be avoided, then it should be considered in the valuation.

Subsequent Events

Estate and gift tax valuations represent a value at a particular valuation date, such as the date of death, an alternate valuation date, or the date of a gift. Consequently, events subsequent to the relevant valuation date are typically not considered in determining value. The guiding source is Revenue Ruling 59-60, which tells us that information that is known or reasonably

knowable as of the valuation date is relevant and must be considered.

The American Institute of Certified Public Accountants (AICPA) *Statement on Standards for Valuation Services* states that the valuation analyst should only consider facts and circumstances existing at the valuation date, as well as transactions and events leading up to the valuation date. Subsequent events are defined as "conditions that were not known or knowable at the valuation date." The AICPA specifically states that, "The valuation would not be updated to reflect those (subsequent) events or conditions."

The concept of "known or reasonably knowable" has presented numerous controversies in estate and gift tax valuations. Assume, for example, that a business owner gifted shares of a privately held company to various family members, but subsequently sold the entire company six months later for a significant appreciation in comparison to its previously appraised value. Should the appraisal be updated and amended? The answer to that question depends on whether management actually intended to sell the business on the valuation date.

The tax courts have routinely opined that actual sales transactions occurring after the valuation date are strong evidence regarding value on the earlier date. In *Estate of Noble v. Commissioner*, for example, the

court found a transaction more than 13 months after the valuation date to be more indicative of value than a transaction two months prior to the valuation date.

The tax courts have generally held that it is acceptable to include even unknown, but knowable, facts and information that would have been uncovered by reasonable inquiries arising from good-faith negotiations between hypothetical willing buyers and willing sellers. Therefore, it is important, as part of an appraiser's due diligence, to interview management regarding significant matters that may affect the value of the company. Documented evidence, such as board minutes, business calendars, and meetings notes, should be reviewed to determine whether a subsequent event was considered at the valuation date.

Conclusion

The consideration and review of recent court decisions, legislation, and trends in the valuation professional is of utmost importance when performing an estate and gift tax valuation. Attorneys and appraisers must have the knowledge and resources to support their opinions and to lend credence to the appraiser's selection of specific discounts, tax rates, or other relevant factors. Without this consideration and support, the valuation opinion may be discredited or disallowed in part, resulting in significant potential negative repercussions. ■