



Tax Court Adopts Discount for Embedded Capital Gains but Declines Dollar-for-Dollar Rule

Estate of Jensen v. Commissioner, 2010 WL 3199784 (U.S. Tax Ct.)(Aug. 10, 2010)

A wealthy widow held the majority (82%) of a private C corporation, which owned and operated real estate and improvements. At her death, the estate's appraiser used the net asset approach to value the corporation at just over \$4.2 million, minus \$965,000 for built-in long-term capital gains tax (LTCG) liability, calculated on a dollar-for-dollar basis. After applying a 5% marketability discount, the appraiser valued the decedent's share at \$2.55 million.

The IRS agreed with the net asset value approach and the 5% marketability discount, but calculated a \$250,000 discount for LTCG liability and assessed a deficiency of just over \$333,000. (Interestingly, the IRS did not explain how it determined the LTCG liability in its deficiency notice.) The estate appealed to the Tax Court, claiming a 100% LTCG discount applied not only because the net asset method presumes a sale of assets, but also because the U.S. Court of Appeals for the Second Circuit (the appellate forum in this case) would most likely follow recent decisions in both the 5th and 11th circuits that have a dollar-for-dollar discount.

The IRS argued that 2nd Circuit's decision in *Estate of Eisenberg* was still controlling, and permitted a discount for embedded capital gains tax based on the facts and circumstances of the case, taking into account the fair market value standard of willing buyer/seller. Accordingly, its expert began with the \$4.2 million net asset value calculated by the estate's expert and then examined data from general closed-end funds. He found no direct correlation between a higher exposure to built-in capital gains tax liability beyond 41.5% of net asset value (NAV), and thus applied a dollar-for-dollar discount only to the portion of the unrealized capital gains beyond 41.5% of NAV in this case. This resulted in a LTCG liability of just over \$415,000, or approximately 10% of net asset value.

The Tax Court agreed that the broader factual inquiry of *Eisenberg* applied to this case, and it expressly declined to consider how the 2nd Circuit might interpret other federal circuit decisions. At the same time, the court rejected the IRS expert's analysis, because closed-end data were simply not comparable to the assets in this case. The expert also failed to account for the assets' appreciation, the time value of money, and how a hypothetical buyer could practically avoid LTCG liability. As a result, the court conducted its own present value calculations based on the fair market value of the improved property, multiplied by appreciation and compounded interest rates (over a 17-year holding period), plus a 40% effective tax rate to reach an LTCG tax liability of approximately \$1.2 million. This amount was higher than the estate's appraised dollar-for-dollar discount, which led the court to adopt the same, "because although not precise, it is within the range of values that may be derived from the evidence (and the estate did not argue for a greater amount)." Having specifically declined to adopt a *per se* rule of 100% discount for LTCG liability, the Tax Court has left the issue ripe for appeal to the 2nd Circuit.