

Valuation Discounts and Premiums Insights

**C CORPORATIONS WITH APPRECIATED ASSETS:
VALUATION DISCOUNT FOR BUILT-IN CAPITAL GAINS**

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INTRODUCTION

The valuation of a C corporation is a common valuation assignment. Experienced analysts routinely value 100 percent of the stock of a C corporation for such purposes as: merger and acquisition pricing; estate and gift tax planning and compliance; shareholder buy-sell agreements; ESOP formation and ERISA compliance; transaction fairness analysis; and shareholder disputes and other litigation matters.

The valuation of a C corporation with appreciated underlying assets is also a common valuation assignment. A C corporation will have appreciated underlying assets when the market value of its owned assets exceeds the income tax basis of its owned assets. This is a common phenomenon for C corporations whether the company is (1) an operating company or (2) an investment or holding company.

When the C corporation owns appreciated assets, a question arises as to how the analyst should consider the built-in capital gains tax liability. This is the tax liability that would be paid if (and only if) the C corporation liquidated (i.e., sold) its underlying assets at their current market values. The built-in capital gains tax is determined by (1) the amount of the gain on the sale of the assets multiplied by (2) the corporation's capital gains income tax rate.

Particularly with regard to the estate and gift tax arena, there is conflicting judicial precedent regarding the valuation effects (if any) of the built-in capital gains tax liability of a C corporation with appreciated assets. Some courts have allowed a valuation adjustment (i.e., a valuation discount) of 100 percent of the estimated built-in capital gains tax liability in arriving at a business value. Other courts have allowed some valuation discount—but less than 100 percent of the subject company's estimated built-in capital gains tax liability.

This discussion will summarize the various issues related to the valuation of a C corporation with appreciated underlying assets. This discussion will also present a practical framework for quantifying the appropriate valuation adjustment (if any)

related to the capital gains tax contingent liability related to such corporations.

REVIEW OF RECENT JUDICIAL PRECEDENT

A review of the relevant judicial precedent related to valuation discounts for the built-in capital gains tax liability begins with the Tax Reform Act of 1986 repeal of the *General Utilities* doctrine. This is because, prior to 1986, C corporations could avoid paying capital gains tax on appreciated assets by making a liquidation election.

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RELEVANT CASE LAW HISTORY

The first U.S. Tax Court decision on the subject since the 1986 repeal of the *General Utilities* doctrine was the *Estate of Davis v. Commissioner*, 110 T.C. 530 (1998). In *Davis*, the Tax Court allowed a valuation discount of a little less than half of the subject built-in capital gains tax liability. All federal taxation cases since *Davis* have allowed valuation discounts for some part of (if not all of) the built-in capital gain tax liability for a C corporation with appreciated assets.

“When the C corporation owns appreciated assets, a question arises as to how the analyst should consider the built-in capital gains tax liability.”

For example, the relatively recent decision in the *Estate of Simplot v. Commissioner*, 112 T.C. 13 (1999), *rev'd and rem'd on other grounds* in 249 F.3d 1191 (9th Cir. 2001), allowed a 100 percent valuation discount associ-

ated with the subject corporation's built-in capital gains tax contingent liability.

RECENT JUDICIAL PRECEDENT

The *Estate of Helen Bolton Jameson*, T.C. Memo 1999-43 (Feb. 9, 1999), is the most recent federal taxation precedent with regard to this valuation discount issue. In *Jameson*, the taxpayer died owning the shares of a personal holding company. The main asset of that company was timberland. The Service and

the taxpayer's estate disagreed on how the built-in capital gains taxes (which would be incurred on the sale of the timber or on the sale of the land) would affect the value of decedent's interest in the corporation.

At the trial level, the Tax Court allowed a valuation discount for the capital gains tax liability that the holding company would incur—but only the capital gains taxes from its ongoing timber sales. The Tax Court disallowed a valuation discount based on the immediate sale of the timberland. Instead, the Tax Court concluded that a willing buyer of the timberland would operate it on an ongoing business. The taxpayer appealed the Tax Court decision to the U.S. Court of Appeals.

In its review of the Tax Court decision in *Jameson*, the Fifth Circuit noted that the stock value for estate tax purposes depends on the timberland's fair market value on the taxpayer's date of death. Any sale of the subject company shares would cause a transfer of the timberland—which would trigger the built-in capital gains tax liability. The estate's valuation experts noted that the only sound economic strategy for a hypothetical willing buyer of the holding company would be an immediate liquidation of the timberland, thereby triggering the 34 percent capital gains tax.

According to the Appeals Court, the Tax Court should not have assumed that there was a strategic buyer for the timberland that could have continued to operate and produce timber. Instead, the Fifth Circuit stressed that a fair market value analysis depends on a hypothetical (instead of a specific) willing buyer. Therefore, according to the Fifth Circuit, the Tax Court erred in disallowing a 100 percent valuation discount for the built-in capital gains tax liability.

LESSON FROM JUDICIAL PRECEDENT

A review of the relevant judicial precedent indicates that, recently, federal courts are consistently allowing a valuation discount for the built-in capital gains tax contingent liability. The critical issue in most recent court cases is not: *if* a valuation discount should be allowed. The critical issue is: *how much* of a valuation discount for built-in capital gains tax should be allowed.

ACQUIRING THE STOCK OF A C CORPORATION WITH APPRECIATED ASSETS

Certainly, buyers are willing to make stock acquisitions of C corporations with appreciated assets. Of course, these buyers recognize that the target C corporations come with an associated built-in capital gains tax liability. Such acquisitions are consummated if the transaction purchase price is sufficiently discounted to reflect the economic impact of the built-in capital gains tax liability.

In fact, if the transaction purchase price (i.e., the C corporation value) is appropriately discounted for the effect of the capital gains tax on the target company appreciated assets,

the acquirer will realize the following economic benefits from the acquisition:

1. The acquirer (a) buys control of the target company appreciated underlying assets at a price discount and (b) earns investment returns based on the discounted purchase price; this has the same economic effect as an interest-free loan.
2. The "effective interest-free loan" is contingent—that is, it does not have to be "repaid" (the acquirer does not actually pay the corporate capital gains tax to the Internal Revenue Service) to the extent that the acquired appreciated assets decline in value (to their income tax basis) over time.

Therefore, some valuation analysts have argued (and some court decisions have held) that the value of a C corporation should be greater than the subject company's net asset value adjusted (i.e., discounted) for a full 100 percent of the built-in capital gains tax liability.

THE BUILT-IN CAPITAL GAINS TAX LIABILITY

To illustrate the valuation impact of the built-in capital gains tax liability, let's assume that Target Company (a C corporation) owns a single asset: a marketable security with (1) a fair market value of \$1,000 and (2) a \$ zero inside tax basis. Let's assume (1) the corporate income tax rate is 34 percent and (2) the individual income tax rate is 20 percent.

Let's assume that Buyer acquires 100 percent of the stock of Target Company for \$660. This \$660 transaction purchase price is Target Company's \$1,000 net asset value discounted by the \$340 built-in capital gains tax liability on its single appreciated assets. Target Company has no other liabilities.

Let's assume that Buyer can borrow \$340 and then purchase the subject single asset (that is, the same marketable security) directly for \$1,000. In each case, Buyer has invested \$1,000 to buy the underlying asset—of which \$660 is financed by equity and \$340 is financed by debt. Buyer will then earn investment returns associated with an asset worth \$1,000.

STOCK PURCHASE VERSUS DIRECT ASSET INVESTMENT

The economic differences (1) between acquiring 100 percent of the stock of a C corporation and (2) making a direct investment in the underlying asset (through the use of borrowing) are:

1. The direct investment in the underlying asset requires the payment of cash interest expense during the investment holding period, a factor in favor of the acquisition of the C corporation stock.

2. The debt associated with the direct investment in the underlying asset is (a) fixed and (b) not contingent on earning any particular rate of return on the underlying asset, a factor in favor of the acquisition of the C corporation.
3. The direct investment in the underlying asset has a greater tax basis (i.e., \$1,000) than the investment in the C corporation stock (i.e., \$660), a factor in favor of the direct investment in the underlying asset.
4. The acquisition of the C corporation stock means that all of the investment returns will be subject to double taxation (i.e., once at the corporate level and once at the distributee/shareholder level), a factor in favor of the direct investment in the underlying asset.

There is a potential economic disadvantage of acquiring the C corporation stock (with the built-in capital gain liability) relative to a direct investment in the underlying appreciated assets. This relative economic disadvantage depends on whether (1) the amount of the built-in capital gains tax liability of the C corporation is less than (2) the avoided cost of debt service from the direct investment in the underlying asset.

VALUATION ADJUSTMENT ILLUSTRATIVE EXAMPLE

In the following discussion, we will present the comparative after-tax results of these two investment alternatives: (1) the acquisition of C corporation stock versus (2) underlying appreciated assets. We will analyze these two investment alternatives over a 10-year investment holding period.

We will consistently use the valuation variable assumptions presented in Table I in our analyses.

Table I
Buyer Acquisition of Target Company
Valuation Adjustment
Illustrative Example Assumptions

Value of the underlying asset:	\$1,000
Inside tax basis of the underlying asset:	\$0
Transaction purchase price of the C corporation Target Company	\$660
Expected rate of return on investment:	10%
Borrowing interest rate:	10%
Corporate income tax rate:	34%
Individual income tax rate:	20%

In addition, we assume that the debt interest expense is capitalized. The capitalized interest expense will increase the income tax basis of the directly purchased underlying asset.

It is noteworthy that our illustrative example assumptions present the most favorable case for measuring the economic advantage of the acquisition of the C corporation stock (rela-

tive to the direct purchase of the underlying asset). For example, all of the analyses assume that (1) the inside tax basis of the C corporation assets is zero and (2) the avoided cost of borrowing (i.e., the debt interest rate) is equal to the expected rate of return on the asset investment.

BASE CASE SCENARIO ANALYSIS

Table II below presents the calculations of the expected after-tax returns (i.e., profit) of the two investment alternatives: (1) stock acquisition of C corporation and (2) direct purchase of the underlying asset.

Table II
Base Case Scenario
Comparison of After-Tax Gains

	Purchase of Target Company Stock \$	Purchase of Underlying Asset with Borrowing \$
Estimated year 10 value	2,594	2,594
Inside tax basis of assets	-	2,594
Sale proceeds less inside tax basis	2,594	-
Less: Corporate income taxes	(882)	-
Sale proceeds available to owner	1,712	2,594
Less: Investment basis	(660)	(1,000)
Equals: Taxable gain on investment/ personal income	1,052	1,594
Less: Personal income taxes	(210)	(319)
Pre-debt, after-tax cash inflow	1,501	2,275
Less: Outstanding asset purchase debt	-	(340)
Less: Capitalized interest expense	-	(542)
Add: Income tax benefit from interest expense	-	108
Terminal value	1,501	1,501
Less: Original equity invested	(660)	(660)
Net after-tax gain	<u>841</u>	<u>841</u>

The analysis summarized in Table II indicates that Buyer is economically indifferent between these two investment alternatives. That is, the after-tax returns of these two investment alternatives are identical.

Hereinafter, we will refer to Table II as the "base case" scenario analysis. This base case scenario is next adjusted for a normal spread between (1) the borrowing/interest rate and (2) the investment rate of return. This adjusted base case scenario is presented in Table III below.

ADJUSTED BASE CASE SCENARIO

In Table III, the "normal spread" is based on the historical excess of (1) public market equity rates of return compared to (2) the risk-free rate of return. Historically, large cap company

equity rates of return have averaged approximately 13 percent. The historical annual excess of (1) large cap company equity rates of return compared to (2) long-term risk-free (Treasury bond) income return has been approximately 8 percent.

From a lender's perspective, the acquisition debt used for the direct asset purchase is well secured by the value of the collateral (i.e., the appreciated underlying asset). The direct asset purchase debt is also secured by the existence of put options, as will be discussed later.

Table III
Adjusted Base Case Scenario
Comparison of After-Tax Gains

	Purchase of Target Company Stock \$	Purchase of Underlying Asset with Borrowing \$
Expected year 10 value	3,395	3,395
Inside tax basis of assets	-	3,395
Sale proceeds less inside tax basis	3,395	-
Less: Corporate income taxes	(1,154)	-
Sale proceeds available to owner	2,240	3,395
Less: Investment basis	(660)	(1,000)
Taxable gain in investment/ personal income	1,580	2,395
Less: Personal income taxes	(316)	(479)
Pre-debt, after-tax cash inflow	1,924	2,916
Less: Outstanding purchase debt	-	(340)
Less: Capitalized interest expense	-	(214)
Add: Income tax benefit from interest expense	-	43
Terminal value	1,924	2,405
Less: Original equity invested	(660)	(660)
Net after-tax gain	<u>1,264</u>	<u>1,745</u>

Considering the put options, the asset purchase debt is arguably risk-free to the lender. This assumption supports an 8 percent interest rate spread.

In the analysis presented in Table III, the direct asset investment alternative clearly generates a greater after-tax benefit than does the purchase of the C corporation (Target Company) stock.

The analysis summarized in Table III assumes both (1) positive expected rates of return as well as (2) positive actual rates of return throughout the 10-year investment horizon. Now, let's assume that the investment becomes worthless immediately following the purchase.

Under these assumed circumstances, the investment in the C corporation stock alternative generates an economic benefit (i.e., the net after-tax loss is less) compared to the direct investment in the underlying asset alternative. In this scenario, when Buyer acquires the C corporation stock, it loses \$660. When Buyer purchases the underlying asset, (1) it loses \$660

and (2) it has to repay the \$340 loan. However, in the direct purchase of underlying asset alternative, the buyer has a tax basis of \$1,000.

In the direct asset purchase alternative, Buyer can cover this contingency by purchasing a put option. The put option will have a strike price equal to the market value of the security in an amount equal to the value of the security times the corporate tax rate. The intrinsic value of the put option would exactly offset the amount by which (1) the return on the investment in the C corporation exceeds (2) the return of the direct investment under any combination of tax assumptions and basis assumptions.

Where Target Company has any positive tax basis in the purchased assets, we assume that the sale at a loss will generate an income tax benefit equal to (1) the income tax rate times (2) the amount of the loss. To the extent that there is no "inside" income tax benefit available from the loss, the put strategy should be correspondingly adjusted.

PUT OPTION STRATEGY

Whether or not the direct asset purchase alternative is more attractive than the purchase of Target Company stock depends on (1) the price of the put relative to (2) the financial advantage of the direct asset purchase.

The analyses presented in Tables II and III above calculate the year 10 after-tax benefit of the two investment alternatives. These analyses allow for the differences in income tax and in financing costs. The price of the put option should be measured in today's dollars for purposes of comparing the two investment alternatives with the put option.

We should, therefore, adjust the amount of the year 10 value to a present value. The discount rate for this calculation is adjusted to reflect the fact that the excess of the year 10 benefit of the direct asset investment alternative is after individual income taxes.

The rate of return assumption is, therefore, adjusted to reflect the fact that the year 10 benefit is after tax. This adjustment is based on individual income tax rates. The present value of the after-tax amount of excess return is the maximum amount the direct asset investor would pay for the put option.

The maximum price of the put option using "real world" assumptions amounts to approximately 53 percent of the value of the underlying asset. Based on "real world" assumptions, Buyer would pay no more than 53 percent of the asset value of the direct asset investment alternative for the put option.

SUBCHAPTER S ELECTION

The period for the financial analysis presented in Tables I through III is 10 years. The selection of the 10-year time period

Table IV
Stock Acquisition with S Election
Comparison of After-Tax Gains

	Alternatives		
	I Direct Asset Investment —with Borrowing \$	II Purchase of Target Company Stock —with S Election \$	III S Election Equivalent to the Stock Purchase —with Borrowing \$
Year 0 value = \$803			\$2,841
Year 0 value = \$1,000	3,395	3,395	
Sale proceeds less inside tax basis	-	-	-
Less: Corporate income tax rate	-	-	-
Sale proceeds available to owner	3,395	3,395	2,841
Less: Investment basis	<u>1,000</u>	<u>660</u>	<u>660</u>
Personal gain on investment/taxable income	2,395	2,735	2,181
Less: Personal income taxes	<u>479</u>	<u>547</u>	<u>436</u>
Pre-debt, after-tax cash inflow	2,916	2,848	2,405
Less: Outstanding purchase debt	340	-	-
Less: Capitalized interest expense	214	-	-
Add: Income tax benefit from capitalized interest expense	<u>43</u>	<u>-</u>	<u>-</u>
Terminal values	2,405	2,848	2,405
Less: Equity invested	<u>660</u>	<u>660</u>	<u>660</u>
Net after-tax gain	<u>1,745</u>	<u>2,188</u>	<u>1,745</u>

is based on the ability of Buyer to elect to be taxed under Subchapter S of the Internal Revenue Code. By making such an S election, the Buyer could avoid the built-in capital gains tax liability entirely by continuing to own the appreciated assets for a 10-year holding period.

Accordingly, let's expand the analytical model to allow for the avoidance of the capital gains tax entirely. This assumption regarding the deferral/avoidance of capital gains tax makes the acquisition of the C corporation stock more attractive than the direct purchase of the underlying assets.

However, the price that Buyer will pay for the C corporation stock is affected by the illiquidity of the S election. That price reflects the fact that the asset cannot be sold—and therefore lacks marketability—for the statutory 10-year holding period. A sale of the appreciated asset within the 10-year holding will generate a lower rate of return than a direct purchase of the underlying asset.

THE LACK OF MARKETABILITY ADJUSTMENT

The lack of marketability impact is measured by setting (1) the after-tax terminal value of the C corporation alternative equal

to (2) the after-tax (post-debt) terminal value of the direct asset purchase alternative. By solving for the beginning dollar amount of the stock required to be inside the C corporation, we can estimate the amount of stock necessary to provide an equivalent rate of return to the direct asset purchase alternative.

It would be a lesser amount because both (1) the cost of borrowing and (2) the built-in capital gains tax are avoided. The amount, however, has a bearing on whether or not Buyer is willing to "lock up" the asset ownership position—that is, to forgo marketability, for 10 years.

In the example presented in Table IV, the value—using "real world" assumptions—is \$803. Therefore, \$803 inside the C corporation that elects S corporation status will generate the same post-tax benefit as a \$1,000 direct asset purchase investment. However, the client asset purchase differs in one important respect from the stock acquisition: the degree of marketability of the investment.

The buyer of the C Corporation stock must not sell the underlying assets for a period of 10 years. This 10-year holding period will avoid triggering the built-in gain (BIG) tax on the sale of the underlying assets. And, this \$803 value implies a

lack of marketability discount of 19.7 percent—as compared to a \$1,000 asset purchase price. Most analysts would agree that the lack of marketability discount for a 10-year asset investment holding period (i.e., a period of no marketability) is at least 19.7 percent.

Another way to analyze this issue is to solve for the beginning amount of 10-year holding period stock that equals the direct asset investment alternative. If the \$1,000 freely traded value would be discounted by more than the capital gains tax, then the direct asset investment is clearly the economically advantageous alternative. In that alternative, there would be no borrowing and no put option.

SIMPLIFYING ASSUMPTIONS

For purposes of the analysis presented in Table IV, we made the following simplifying assumptions:

- Transaction costs are ignored.
- Dividends are assumed to be zero.
- The price of a 10-year put option is estimated using market volatility, current risk-free rates of return, an assumption of zero dividends, and a 10-year duration in the Black-Scholes option pricing model.

The Black-Scholes option pricing model may not be the best analytical procedure for estimating the price of a long-term option. Moreover, the price of a series of put options covering the interest component of the direct asset investment alternative is ignored.

If we assume the cost of these options was the same as the put on the principal (which is probably overstating the case), then the basic conclusion remains the same.

- The price of put options is not considered in the estimate of the discount for lack of marketability. This discount is used in measuring the rate of return on the direct asset investment in order to set it equal to the C corporation asset. This assumption does not change the basic conclusion.
- Income taxes are estimated as follows:
 1. The income tax benefit of the interest deduction is simply considered an addition to tax basis in year 10, and the individual capital gains tax rate is used. To the extent that a current interest expense deduction is available at ordinary income tax rates, it is an economic benefit to the direct asset investment alternative.
 2. The income tax basis in the put option is ignored in all calculations.

“Most analysts would agree that the lack of marketability discount for a 10-year asset investment holding period (i.e., a period of no marketability) is at least 19.7 percent.”

3. The proceeds from the exercise of the put option is assumed to offset the loss on the underlying asset. The income tax benefit of the loss is calculated at the assumed individual income tax rate.
4. Losses at the individual taxpayer level are assumed to generate an economic benefit equal to the income tax rate times the amount of the loss.
5. Losses inside the Target Company C corporation are assumed to generate income tax benefits equal to (a) the corporate income tax rate times (b) the amount of the loss.
6. State and local income taxes are ignored.

SUMMARY AND CONCLUSION

Each S corporation valuation depends on its unique set of facts and circumstances. However, there appears to be no financial advantage to (1) the stock acquisition of a C corporation with built-in capital gains relative to (2) the direct purchase of the underlying assets and a put option.

Accordingly, no willing buyer would pay a price premium for the acquisition of the C corporation stock over the tax-adjusted net asset value of the target company. No willing buyer would pay a price premium over the target company tax-adjusted net asset value, and no willing seller would accept less than the target company tax-adjusted net asset value.

The principal reason for this outcome is the fact that 100 percent of the gains inside the target corporation are subject to double taxation.

This double taxation offsets the

apparent financial benefits described in the introduction. No rational tax adviser will advise a client to structure his or her transactions in a way that will subject investment returns to double taxation if it can be avoided.

The apparent economic advantage of (1) buying the C corporation stock and (2) electing S corporation status is more than offset by the fact that the underlying assets become non-marketable for a 10-year holding period.

Any asset holding period of less than 10 years will cause the direct asset purchase alternative to generate a greater after-tax rate of return than the acquisition of C corporation stock alternative.

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