

Discounts on Embedded Capital Gains for Real Estate

BY CHARLES S. LUNDEN, CPA, BEDERSON & COMPANY LLP



In August 2010, concerning the matter of the *Estate of Jensen v. Commissioner of the Internal Revenue Service (IRS)*, the tax court issued guidance on a matter of great concern to valuation professionals performing estate tax valuations. At issue was the extent to

which it was appropriate for the real estate valuation to include a discount for embedded long-term capital gains on appreciated real property when measuring the fair market value of the estate's share of the holding company.

The Case

Marie Jensen's estate owned an 82-percent interest in Wa-Klo Inc., a real estate holding company that held title to a 94-acre waterfront parcel housing a New Hampshire summer camp. Camp Wa-Klo had a sports facility, including an indoor

gymnasium, ball fields, horse stable, cottages, dining hall and bunkhouses. The estate retained a valuation expert to value the privately held C corporation. The expert used a net asset value to begin the valuation process. The net asset value of the real property and other assets was \$4.7 million. The estate's expert deducted \$500,000 in long-term capital gains. The IRS expert argued that with tax planning, this gain could be avoided (deferred) and, as a result, no reduction in net asset value was appropriate. At the time of the litigation, a \$333,000 deficiency was assessed by the IRS.

Estate's Position

The valuation expert for the estate took a dollar-for-dollar discount for the anticipated future long-term capital gains tax on the sale of the real estate. He explained that the adjusted book value method was based upon the premise that assets will be liquidated, thus triggering the long-term capital gains tax resulting from appreciation of the underlying asset. He followed the tax court's reasoning in the *Estate of Dunn v. Commissioner* ruling. He did not rely on an income method to value the holding company, because its earnings results were below a 5-percent return on an asset benchmark common in the camp industry.

He did not rely on a discounted cash flow method, because the camp did not generate substantial cash flow from operations. He assumed a 34-percent tax rate on the sale of the real property.

IRS Position

The IRS valuation expert agreed with the measurement of the fair market value of the holding company, but felt the liability for future capital gains should be \$250,000, without explaining how he arrived at that conclusion. He used six closed-end real estate funds to measure the impact of appreciated property and exposure to capital gains tax in real estate investment trusts and the impact that appreciation had on market value. He was unable to find a correlation between the extent of appreciation and the discount in marketability beyond 41.5 percent of the appreciation. He also argued that this gain could be avoided by employing a 1031 like-kind exchange or by converting to an S corporation. The IRS expert argued that the *Eisenberg v. Commissioner of the IRS* case held that no discount for long-term capital gains should be allowed.

Tax Court Consideration

The tax court was not

moved by the IRS argument that the gain could be avoided. It pointed out that although some deferral methods may be available, the long-term capital gains tax could not be avoided. In addition, the hypothetical buyer of the 82-percent interest may or may not have an interest in a like exchange, and assuming that such a buyer would agree to reinvest the sale proceeds into a similar asset class was speculating. The court also observed that a hypothetical buyer may not qualify to be an S corporation. It did not believe there was an effective method to avoid the long-term capital gains tax. It took issue with the comparability of the closed-end funds the IRS expert used in his study. None of those closed-end funds held interests in summer camps.

The court commented that other factors, including fund management performance, supply and demand, investor confidence and liquidity, all affect discounts for lack of marketability noted in the disparity between trading price and net asset value. ❏

Charles S. Lunden, CPA, CFE, ABV, CFE, CMA, CLU, FLMI, is a partner at Bederson & Company LLP. He is a New Jersey Society of CPAs member. Contact him at clunden@bederson.com.


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